Office of Inspector General

February 2006
Report No. 06-008

Consideration of Safety and Soundness Examination Results and Other Relevant Information in the FDIC's Risk-Related Premium System

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Background and Purpose of Audit

To assess deposit insurance premiums on financial institutions, the FDIC uses the Risk-Related Premium System (RRPS). The FDIC places each institution into one of nine assessment risk classifications using a two-step process based first on capital ratios (the Capital Group assignment) and then on safety and soundness examination results and other pertinent information (the Supervisory Subgroup assignment).

This audit reviewed the FDIC's consideration of risk in determining the insurance premiums paid to the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF).

The audit objective was to determine whether the RRPS is adequately tied to the results of examinations by the primary federal regulators and to other information relevant to the institutions' financial condition.

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Results of Audit

We found that the RRPS-assigned Supervisory Subgroups are adequately tied to the results of examinations by the primary federal regulators and to other information relevant to the institutions' financial condition. The FDIC adequately reviewed the appropriateness of the Supervisory Subgroups assigned by the RRPS and maintained adequate support for its decisions.

Capital Group assignments, however, are based solely on an institution's financial reports unless an institution appeals its assessment. An institution with a poor safety and soundness capital component rating can be assigned by the RRPS to the best Capital Group if it meets the definition of well capitalized in its financial reports as of the cutoff date for the assessment period. We identified 28 institutions in one assessment period that paid lower insurance premiums because the institutions met the capital ratio requirements for a well capitalized institution as set forth in FDIC Rules and Regulations Part 327, even though examiners viewed capital as deficient with substantial probability of loss to the deposit insurance funds.

We also found that the FDIC has performed analyses related to various aspects of deposit insurance, but has not updated its analysis supporting the basis points used to calculate premiums and assigned to the assessment risk classifications in the RRPS matrix. The FDIC's analysis was limited to bank failures from 1988 to 1992 and did not include thrift failures due to significant changes in the supervision of the thrift industry. Since that time, the banking and supervisory environment has changed significantly, including the establishment of Prompt Corrective Action requirements. Consequently, the assessment rates for the deposit insurance funds may not be representative of trends based on more recent institution failures.

Recommendations and Management Response

The report recommends that the FDIC pursue regulatory and procedural revisions to permit Capital Group adjustments when capital is impaired. The FDIC partially concurred with the recommendation and is considering improvements to the assessment system that would reflect changes in an institution's capital levels and CAMELS composite ratings more frequently than semiannually. The FDIC's comments are responsive to the recommendation, and we consider it resolved.

However, a change to the assessment regulations may still be warranted that would provide the FDIC with the discretion to reclassify an institution's Capital Group for RRPS purposes when capital is considered impaired. Therefore, we are highlighting this matter for the Board's consideration as it implements changes to the assessment system pursuant to deposit insurance reform legislation.

The report also recommends that the FDIC update the analysis supporting the basis points in the assessment rate matrix, present the updated analysis to the FDIC Board with recommendations for assessment rates, and establish a schedule for periodically updating the assessment rate analysis. The FDIC concurred with the recommendations, which we consider resolved.

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Federal Deposit Insurance Corporation
801 17th St., NW Washington, DC 20434

Office of Audits
Office of Inspector General

DATE: February 17, 2006

MEMORANDUM TO: Arthur J. Murton, Director
Division of Insurance and Research

Christopher J. Spoth, Acting Director
Division of Supervision and Consumer Protection

FROM: Russell A. Rau [Electronically produced version; original signed by Russell A. Rau]
Assistant Inspector General for Audits

SUBJECT: *Consideration of Safety and Soundness Examination Results and Other Relevant Information in the FDIC's Risk-Related Premium System* (Report No. 06-008)

This report presents the results of our audit of the FDIC's consideration of risk in determining the deposit insurance premiums paid to the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). To assess semiannual premiums on financial institutions, the FDIC uses the Risk-Related Premium System (RRPS) and considers capital levels, safety and soundness examination results, and other pertinent information to assign insured institutions to one of three Capital Groups and to one of three Supervisory Subgroups for the purpose of determining an insurance assessment risk classification.[1] The audit objective was to determine whether the insurance assessment system is adequately tied to the results of examinations of financial institutions by the primary federal regulators and to other information relevant to the institutions' financial condition. Appendix I of this report discusses our objective, scope, and methodology in detail.

BACKGROUND

Section 302(a) of the FDIC Improvement Act of 1991 (FDICIA) required the FDIC's Board of Directors (Board) to establish a risk-based assessment system.[2] In September 1992, the Board amended its regulations on assessments to comply with FDICIA and to provide for a transition from a uniform rate to a risk-based insurance assessment system.[3] The FDIC envisioned a system that would provide a financial incentive to all FDIC-insured institutions to improve or maintain a safe and sound status and would not burden weaker institutions. Details on the Board's adoption of the multi-tiered risk-based system for assigning assessment risk classifications are in Appendix II. The Financial Institutions Reform, Recovery, and

[1] Appendix III describes how the Capital Groups and Supervisory Subgroups are determined.
[2] See the Glossary in Appendix V for FDICIA's definition of a risk-based assessment system.
[3] FDICIA, Section 302(f), authorized the FDIC to promulgate regulations governing the transition from the assessment system in effect at the date of the statute's enactment to the risk-based assessment system.

Enforcement Act of 1989 established specific designated reserve ratios for the BIF and SAIF. Under FDICIA, the Board may set higher ratios in certain circumstances.

Part 327 of the FDIC Rules and Regulations (12 Code of Federal Regulations, Part 327) established the risk-based assessment system and addresses the determination of the annual assessment risk classifications based on capital and supervisory risk factors and the process for an institution to request a review of its assessment risk classification. FDIC Circular 4700.1, *Risk-Related Premium System*, addresses Division of Supervision and Consumer Protection (DSC) regional office responsibilities for reviews of the Supervisory Subgroup assignments, Call Report amendments, and financial institution requests for a review of the assigned Capital Group or Supervisory Subgroup. The circular also designates the Division of Insurance and Research (DIR) as responsible for assigning an institution's Capital Group and establishes the coordination of the assessment process by DSC and DIR.

Table 1 shows the results of the classification of 9,031 financial institutions for the first semiannual assessment period in 2005.[4] For that period, a total of 617 institutions paid premiums (shown in the shaded sections of the table).

Table 1: Institutions Insured by the BIF and SAIF

	Supervisory Subgroup		
Capital Group	**A**	**B**	**C**
1. Well Capitalized			
Assessment Rate (bps)[a]	**0**	**3**	**17**
Number of Institutions	8,414	462	77
Percent of Institutions[b]	93%	5%	1%
Assets (in billions)	$9,619.8	$ 93.1	$28.1
2. Adequately Capitalized			
Assessment Rate (bps)[a]	**3**	**10**	**24**
Number of Institutions	61	3	8
Percent of Institutions[b]	1%	0%	0%
Assets (in billions)	$ 15.4	$ 0.6	$ 1.3
3. Undercapitalized			
Assessment Rate (bps)[a]	**10**	**24**	**27**
Number of Institutions	2	0	4
Percent of Institutions[b]	0%	0%	0%
Assets (in billions)	$ 0.3	$ 0.0	$ 1.4

Source: OIG analysis based on the January 1, 2005 assessment period documentation provided by DIR.
[a] The assessment rate is shown in basis points (bps), which are discussed in detail in Finding C and are shown in Table 4 on page 11 of this report.
[b] The percentage is based on the 9,031 institutions.

[4] For the first semiannual assessment period, the supervisory cutoff date is September 30th of the previous year. For the second semiannual assessment period, the supervisory cutoff date is March 31st of the current year.

RESULTS OF AUDIT

We found that the RRPS-assigned Supervisory Subgroups are adequately tied to the results of examinations by the primary federal regulators and other information relevant to the institutions' financial condition. However, the Capital Group assignments are based solely on an institution's financial reports[5] and do not always reflect the primary federal regulator's or DSC's analysis and concerns. As a result, in isolated cases, insurance premiums may not be entirely reflective of the risk or unique circumstances at an institution when the assessment risk classifications are determined.

Based on our review of available information for 50 financial institutions in various DSC regions and interviews with regional office case managers, we concluded that DSC had adequately reviewed the RRPS-assigned Supervisory Subgroups and made appropriate adjustments based on the results, maintaining adequate support for its decisions (Finding A).

Unless an institution appeals its assessment, the Capital Group assignments are based solely on an institution's financial reports and do not always reflect supervisory analysis and concerns. Therefore, an institution with a poor safety and soundness examination capital component rating can be assigned by the RRPS to Capital Group 1 (the well capitalized group) if the institution meets the definition of well capitalized in its financial reports as of the supervisory cutoff date for the assessment period. As a result, for the January 1, 2005 assessment period, 28 financial institutions, with assets totaling $15.5 billion, paid insurance premiums that are commensurate with a well capitalized institution, even though examiners viewed capital as deficient at these institutions with a substantial probability of loss to the BIF or SAIF (Finding B).

Additionally, we found that the FDIC has performed analyses related to various aspects of deposit insurance but has not updated its analysis supporting the basis points used to calculate premiums and assigned to the assessment risk classifications in the RRPS matrix. The analysis was limited to bank failures over a 5-year period, from 1988 to 1992, and did not include thrift failures due to significant changes in the supervision of the thrift industry. Since that time, the banking and supervisory environment has changed significantly, including the establishment of Prompt Corrective Action (PCA) requirements by FDICIA, which became effective in December 1992. Consequently, the assessment rates for the deposit insurance funds may not be representative of trends based on more recent institution failures (Finding C).

[5] For the purposes of this report, "financial reports" are the Reports of Condition and Income (Call Reports), Reports of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks, or Thrift Financial Reports.

FINDINGS AND RECOMMENDATIONS

FINDING A: SUPERVISORY SUBGROUPS SUPPORTED BY EXAMINATION RESULTS AND OTHER RELEVANT INFORMATION

We found that DSC adequately reviewed the appropriateness of the Supervisory Subgroups assigned by the RRPS for the 50 institutions included in our sample and made appropriate adjustments based on the results. Specifically, we found adequate support for the case managers' reviews and decisions for the Supervisory Subgroup assignments. We concluded that the Supervisory Subgroups were adequately tied to the results of examinations by the primary federal regulators and to other information relevant to the financial condition of the institutions.

The FDIC's RRPS Process and Related Responsibilities

DIR coordinates the insurance assessment process and maintains the financial documentation for the institutions recorded in RRPS. Division of Information Technology (DIT) analysts process data from internal and external sources into RRPS. Internal sources include DSC examination results. External sources include the institutions' financial reports as well as Reports of Examination (ROE) from the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board (FRB), and the Office of Thrift Supervision (OTS), which provide CAMELS component and composite ratings (see Appendix V).

The reconcilement process begins shortly after the supervisory cutoff date for determining the Supervisory Subgroup assignments. RRPS generates both a universe list and a reconcilement list for DSC regional reviewers (case managers or designated field personnel). The universe list consists of all active institutions. The reconcilement list consists of institutions for which FDIC Circular 4700.1 requires a review of the preliminary Supervisory Subgroup assignments during the reconcilement period, including situations in which the SCOR[6] composite rating indicates potential disagreement with the Supervisory Subgroup assignment and/or the current FDIC CAMELS composite rating disagrees with the preliminary Supervisory Subgroup determined by the primary federal regulator's composite rating. DSC is to analyze the institutions' condition as of the supervisory cutoff date, using information available during the reconcilement period, to determine the final Supervisory Subgroup assignments.

The RRPS assigns a preliminary Supervisory Subgroup based on the most recent CAMELS composite rating in the primary regulator's ROE as of the supervisory cutoff date. However, an institution's condition can change subsequent to the CAMELS rating assignment. Therefore, DSC reviewers may revise the Supervisory Subgroup assignments if warranted. DSC reviewers communicate with the primary federal regulator prior to any final decision to change an institution's Supervisory Subgroup assignment.[7] After DSC reviewers have validated the assignments, the DSC Regional Director approves the universe and reconcilement lists. DSC

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[6] SCOR is the Statistical CAMELS Off-Site Rating (SCOR) model. SCOR uses the balance-sheet and income-statement information that banks are required to report quarterly to their primary federal supervisor (Call Reports). The SCOR model attempts to predict CAMELS ratings by relating 12 financial ratios to each bank's future composite rating (similar models are developed for the component ratings).

[7] Appendix III describes the factors to be considered before changing a Supervisory Subgroup.

regional offices then notify DIR that the reconciliation process is completed and Supervisory Subgroup assignments are final.

The Capital Group assignments in RRPS are based on the capital ratios from the institutions' financial reports. An institution's Capital Group is automatically assigned by RRPS based on capital definitions in Part 327 of the FDIC Rules and Regulations.[8]

DSC's Review of Supervisory Subgroups

We judgmentally selected 25 FDIC-insured financial institutions from the Dallas Regional Office reconcilement lists for the January 1, 2004; July 1, 2004; and January 1, 2005 assessment periods. We interviewed four Dallas Regional Office case managers, who were assigned to 1 or more of the 25 institutions in our sample, concerning RRPS procedures, assignments of risk classifications, and general information about the RRPS. Additionally, we reviewed relevant ROEs to determine whether weaknesses had been noted that should have been considered in the insurance assessment ratings. We also reviewed problem bank memorandums, bank correspondence files maintained by DSC case managers, and bank rating change memorandums to determine whether the issues noted had been considered, or should have been considered, in the assessment rating.

Documentation we reviewed indicated that DSC had appropriately assessed the institutions' conditions and ratings. We found evidence that DSC reviewers communicated with primary federal regulators prior to a final decision on an institution's Supervisory Subgroup assignment. We also found adequate support for the case managers' reviews and decisions for the Supervisory Subgroup assignments.

Additionally, we analyzed another sample of 25 FDIC-insured financial institutions from the other 5 DSC regional offices to compare examination results and capital ratios with those in RRPS. We concluded that the Supervisory Subgroups were adequately tied to the results of examinations by the primary federal regulators and to other information relevant to the financial condition of the institutions.

[8] The definitions of Capital Group categories in Part 327, *Assessments*, of the FDIC Rules and Regulations differ from the definitions of capital categories in Part 325, *Capital Maintenance*. Part 327 defines Capital Group categories for insurance assessment purposes exclusively on the basis of capital ratios reported in an institution's financial reports except for insured branches of foreign institutions, which must meet certain other requirements. Part 325 defines an institution's capital category for certain purposes other than insurance assessment. Part 325 defines capital categories by ratios similar to those defined in Part 327; however, a number of significant differences exist. For example, under Part 325 an institution is not designated as "well capitalized" if the institution is subject to a written agreement, regardless of the capital ratio.

FINDING B: CONSIDERATION OF DSC ANALYSIS AND CONCERNS IN CAPITAL GROUP ASSIGNMENTS

Unless an institution appeals its assessment, the Capital Group assignments are based solely on institutions' financial reports and do not always reflect supervisory analysis and concerns. Therefore, an institution that has received a safety and soundness examination capital component rating of 4 or 5 can be assigned to Capital Group 1, the highest Capital Group rating, if the institution meets the capital ratio requirements for a well capitalized institution as set forth in FDIC Rules and Regulations Part 327. Consequently, an institution would pay a lower insurance premium based on the capital ratios from the institution's financial reports, even if the primary regulator's most recent examination as of the supervisory cutoff date showed that capital was deficient and poorly rated. This is particularly a concern where the institution also receives a poor composite rating.

Capital Considerations for Insurance Assessments

The purposes of capital are to absorb losses, promote public confidence, and provide protection to depositors and the insurance funds. Part 327 of the FDIC Rules and Regulations establishes the capital rules applicable to RRPS for insurance assessment purposes. Part 325 of the FDIC Rules and Regulations establishes the criteria and standards the FDIC uses in calculating minimum leverage capital requirements, determining capital adequacy, and determining whether an institution is subject to PCA provisions. Insured institutions are expected to maintain capital commensurate with the nature and extent of their risks.

FDIC Directive 4700.1 contains procedures for the FDIC's RRPS and states that DIR is responsible for assigning the institution's Capital Group which, along with the Supervisory Subgroup, is one of the two primary variables considered in determining an institution's insurance premium. In addition, the directive states that Part 327 defines Capital Group categories for insurance assessment purposes "exclusively on the basis of capital ratios reported in an institution's Call Report" and that "a number of significant differences exist" between the definition of capital categories for Capital Group purposes and the definition of capital categories for examination and supervisory purposes. Specifically, the directive does not allow for an adjustment to the RRPS Capital Group assignment based on examination results or other supervisory considerations.

In contrast to the RRPS capital rules set forth in Part 327, the PCA provisions of the Federal Deposit Insurance (FDI) Act permit the federal banking supervisor to treat an institution as if it were in the next lower capital category in certain cases. PCA requires federal regulators to assign financial institutions to one of five categories on the basis of their capital levels and mandates increasingly severe restrictions and supervisory actions as an institution's capital condition deteriorates. Section 325.103(b)(1)(iv) states that an institution is not designated as well capitalized if it is subject to a written agreement, order (such as a Cease and Desist order), capital directive, or prompt corrective action directive issued by the FDIC pursuant to sections 8 and 38 of the FDI Act, or any regulation thereunder, to meet and maintain a specific capital level for any capital measure, regardless of the capital ratios. In accordance with PCA, the federal banking supervisor may also treat an institution as if it were in the next lower capital category in certain cases when the institution is deemed to be in an unsafe or unsound condition or is engaging in unsafe or unsound practices.

Comparison of Objective and Subjective Factors

In adopting a multi-tiered matrix for assessing insurance premiums, the Board decided to apply a combination of objective and subjective factors, after concluding that neither one alone could be relied upon to present a complete picture of an institution's condition. Additionally, the Board recognized the value of objective measures. A desirable attribute of a risk-based premium system should be to give weak institutions an immediate financial reward for improving their condition by a quantitative, defined indicator. Thus, the Board decided that this financial reward would be provided by a system that bases premiums, in part, on the institutions' capital ratios from their financial reports. Weak institutions would have the incentive to reduce their deposit insurance premiums by meeting specific capital-ratio standards. Also, greater capital increases an institution's cushion against loss and increases the owners' stake in a sound operation. Therefore, the Board believed that capital ratios would play an important role in a risk-based premium system. (See Appendix II for a detailed discussion of the Board's decision.)

FDIC Rules and Regulations, Section 327.4, addresses the relationship of the Capital Group and Supervisory Subgroup assignments for assessment risk classifications. Section 327.4(a)(1) sets the acceptable capital ratios for each assigned Capital Group (1, 2, or 3) based on the institutions' financial reports. As a result, unlike the Supervisory Subgroup assignment discussed previously, there is no opportunity for DSC or DIR to consider an institution's other risk areas, such as its assets, management, or operations. Thus, except in the case of an assessment appeal, neither DSC nor DIR have the authority to reclassify the Capital Group for an institution.

Comparison of CAMELS Capital Component and Composite Ratings

From the universe of 9,031 insured financial institutions for the January 1, 2005 assessment period (see Table 1), 77 institutions were classified in the RRPS as Group 1C (1 represents the Capital Group, and C represents the Supervisory Subgroup). Of these 77 institutions, 28 institutions, with assets totaling $15.5 billion, had CAMELS capital component[9] and composite[10] ratings of 4 or 5, but their capital ratios met the well capitalized requirements, for RRPS purposes, for Capital Group 1. Institutions classified as Group 1C pay 17 basis points in insurance premiums on their assessable deposits compared to institutions rated lower that pay

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[9] A capital component rating of 4 indicates a deficient level of capital such that the viability of the institution may be threatened. A capital component rating of 5 indicates a critically deficient level of capital such that the institution's viability is threatened. Immediate assistance from shareholders or other external sources of financial support is required.

[10] Financial institutions with a composite rating of 4 generally exhibit unsafe and unsound practices or conditions. The weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. Institutions in this group pose a risk to the deposit insurance fund, and failure is a distinct possibility. Financial institutions with a composite rating of 5 exhibit extremely unsafe and unsound practices or conditions. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed in order for the financial institution to be viable. Institutions in this group pose a significant risk to the deposit insurance fund, and failure is highly probable.

either 24 or 27 basis points. Table 2 shows the capital component and CAMELS composite ratings of the 28 institutions.

Table 2: Institutions Classified as Group 1C with Capital Rated 4 or 5

Capital Component Rating	CAMELS Composite Rating	Number of Institutions	Total Assets (Thousands)
4	4	23	$2,073,691
4 or 5	5	5	$13,400,044
Total		**28**	**$15,473,735**

Source: OIG analysis of documentation provided by DIR for the January 1, 2005 assessment period.

Of these 28 institutions, 20 institutions, with assets totaling $14.7 billion, were subject to enforcement actions that addressed capital-related matters yet were considered well capitalized for insurance premium purposes. The Board's stated intent in tying the RRPS Capital Groups directly to an institution's capital ratios was to provide an incentive (a reduced insurance premium) for increasing capital. However, the institutions classified as Group 1C are not motivated in this manner because they are already considered well capitalized for RRPS purposes, and they pay the lowest insurance premiums for institutions in their Supervisory Subgroup.

We reviewed the ROE comments on capital for three of the institutions, included in Table 2, with capital rated 4 or 5. The ROEs were applicable to the January 1, 2005 assessment period. The ROE for one institution stated, "Capital is deficient in light of the institution's risk profile threatening its viability." For another institution, the ROE reported, "Capital [was] unsatisfactory in relation to the institution's risk profile. Critical deficiencies in management, asset quality and earnings are a constant drain on the capital account, and the current capital level cannot support the myriad of risk exposures that …[the] bank faces; risks such as credit, operational, legal, reputation, and liquidity." For a third institution, the ROE stated, "Capital is critically inadequate. The hazardous actions of former management have caused the distressed financial condition of the institution. Unsatisfactory asset quality has caused a substantial operating loss that has eroded capital." Additional details on these institutions are provided in Appendix IV.

The FDIC OIG conducted material loss reviews for five institutions that failed from 1998 through 2003. Table 3 on the next page shows these institutions' RRPS risk classification in the four semiannual assessment periods prior to failure and the estimated costs to the BIF and SAIF.

Table 3: Assessment Risk Classifications for Failed Institutions in the Four RRPS Periods Prior to Failure

Institution	Risk Classification (from earlier to later RRPS periods)				Date of Failure	Loss to Insurance Funds $(000s)
BestBank	2C	3B	1B	2B	7/23/98	$221,454
Pacific Thrift and Loan Company	2C	3C	3C	3C	11/22/99	$42,049
Superior Bank, FSB*	1B	2C	2C	3C	7/27/01	$338,694
Connecticut Bank of Commerce	1B	1B	1B	2C	6/26/02	$57,759
Southern Pacific Bank	2C	2C	3C	3C	2/7/03	$63,445

Sources: Division of Finance (DOF) and *FDIC Closings and Assistance Transactions* report. Loss to insurance funds is final loss or DOF estimate as of December 31, 2005.
* Although this institution was not supervised by the FDIC, the FDIC OIG was asked by the Senate Committee on Banking, Housing, and Urban Affairs to prepare an analysis of the institution's failure, applying the same objective as a material loss review.

For three of the failures (Pacific Thrift and Loan Company; Superior Bank, FSB; and Southern Pacific Bank), Capital Group ratings tended to lag behind Supervisory Subgroup ratings, even though there were long-standing supervisory concerns about capital adequacy at the institutions.[11] This reflects a disconnect between Capital Group assignments of 1 and 2, which indicated either a well or adequately capitalized institution, and safety and soundness examination ratings that indicated less than satisfactory capital levels. Further, in the remaining two institutions (BestBank and Connecticut Bank of Commerce), alleged fraud was a factor in the institutions' failures, so their financial reports may not have been reliable for assigning Capital Groups for assessment purposes. These cases illustrate that, in certain circumstances, supervisory judgment may be beneficial in assigning Capital Groups in RRPS.

Conclusion

Capital Group assignments do not reflect the results of examinations of financial institutions by the primary federal regulators and other information relevant to the institutions' financial condition. As a result, based on Part 327 requirements, it is possible for an institution to be placed in Capital Group 1, even though capital may be rated 4 or 5 for safety and soundness examination purposes. Some institutions with the worst capital ratings can be placed into the best Capital Group based solely on capital ratios from financial reports, without consideration of other pertinent factors, such as written enforcement agreements; asset quality problems; poor earnings performance; ineffective management practices relative to the institution's size, complexity, and risk profile; and possible errors or fraud in financial reporting. Although strictly applying capital ratios to Capital Group assignments works well for most institutions, the capital ratios for some institutions may be inadequate for determining assessment rates.

[11] In the 3 years prior to failure, these three institutions received composite and capital component ratings of 3 or worse from the FDIC.

RECOMMENDATION

We recommend the Director, DIR:

(1) Pursue revisions to Part 327 and related implementing procedures to permit Capital Group adjustments during the RRPS process when capital is considered impaired based on CAMELS ratings and related supervisory concerns.

CORPORATION COMMENTS AND OIG EVALUATION

Based on a January 18, 2006 meeting with DSC and DIR management, we made some revisions to the report in relation to events subsequent to an RRPS cutoff date. On January 30, 2006, the Directors, DSC and DIR, provided a written response to the draft report, which is presented in its entirety in Appendix VI of this report. DIR concurred in part with recommendation 1 and offered an alternative action. DIR stated that the Board's decision to use both subjective factors (CAMELS composite ratings) and objective factors (capital ratios) when it created the assessment risk categories was correct. DIR also stated that the current system already takes into account particular capital requirements that bank regulators may impose. DIR explained that an institution that meets the requirements to be considered well capitalized for assessment purposes but fails to meet special capital requirements imposed by its primary federal regulator, will, in most cases, receive a lower CAMELS composite rating than it otherwise would.

As an alternative action, DIR is considering improvements to the assessment system that would reflect changes in an institution's capital levels and CAMELS composite ratings more frequently than semiannually. DIR plans to present these improvements to the Board in conjunction with changes pursuant to deposit insurance reform legislation or consider similar changes by year-end 2006.

DIR's proposed alternative action could reduce the number of institutions with disparities between their capital categories and the supervisory assessment of capital adequacy. However, instances may still occur where an institution is considered well capitalized for RRPS when the supervisory assessment is that capital is deficient. To address these situations, a change in the assessment regulations may still be warranted that would provide the FDIC with the discretion to reclassify an institution's Capital Group for RRPS purposes in those instances in which capital is impaired. Therefore, we are highlighting this matter for the Board's consideration as it implements changes to the assessment system pursuant to deposit insurance reform legislation. The recommendation, which we consider resolved, will remain open for reporting purposes until we have determined that the agreed-to corrective action has been completed and is effective.

FINDING C: SUPPORTING ANALYSIS FOR MATRIX BASIS POINTS

Although DIR has performed analyses related to various aspects of deposit insurance, the division has not updated its analysis that specifically supports the basis points assigned to the risk classifications in the RRPS matrix. The analysis was limited to bank failures over a 5-year period, from 1988 to 1992 and did not include thrift failures because of significant changes in the supervision of the thrift industry as a result of the savings and loan crisis. Since that time, the banking and supervisory environment has changed significantly, including the establishment of PCA requirements by FDICIA. Consequently, the assessment rates for the BIF and SAIF may not be representative of trends based on more recent institution failures.

Statutes and Regulations Related to the Risk-based Assessment System

Section 302(a) of FDICIA required the Board to establish a risk-based assessment system. The risk-based assessment schedules adopted by the Board separately for BIF- and SAIF-insured deposits have been expressed in terms of basis points charged against adjusted total deposits.

The first rate schedule the Board established in accordance with FDICIA ranged from 23 to 31 basis points (see Appendix II). The current assessment rate schedule (Table 4) ranges from 0 to 27 basis points. This same rate schedule has been applied for insurance premiums since 1996 for the BIF and since 1997 for the SAIF.

Table 4: Rate Schedule for the January 1, 2005 Assessment Period

Capital Group	**Supervisory Subgroup**		
	A	**B**	**C**
1. Well Capitalized	0 bp	3 bp	17 bp
2. Adequately Capitalized	3 bp	10 bp	24 bp
3. Undercapitalized	10 bp	24 bp	27 bp

Source: DIR's November 15, 2004 memorandums to the Board addressing BIF and SAIF assessment rates for the first semiannual assessment period of 2005.

In setting assessment rates for each deposit insurance fund, the Board considers:

- the probability and likely amount of loss to the fund posed by individual insured institutions;
- the statutory requirement to maintain the fund at the designated reserve ratio of 1.25 percent; and
- other relevant statutory provisions, such as:
  - case resolution expenditures and income,
  - expected operating expenses,
  - revenue needs of the fund, and
  - effect of assessments on the earnings and capital of fund members.

Generally, the FDIC may alter the existing rate structure and change the base BIF and SAIF assessment rates only by rulemaking with notice and comment. However, the Board has determined that it has authority to increase or decrease the effective rate schedule uniformly up to a maximum of 5 basis points to maintain the target designated reserve ratio without notice and comment.

DIR's Supporting Analysis for Assessment Rates

The FDIC has issued various papers related to deposit insurance. One study focused on merging the insurance funds, eliminating the designated reserve ratio as a trigger for charging premiums, and indexing insurance coverage. Another paper discussed pricing risk, funding insurance losses, and coverage levels. Other papers prepared by DIR have discussed deposit insurance pricing options, such as estimating actuarially-fair premiums and evaluating the existing FDIC risk-related premiums, both in absolute terms and as a ranking of relative risk, and an alternative moving-average approach to the current assessment policy.

Additionally, DIR conducts and presents an analysis to the Board for BIF and SAIF assessment rates for each semiannual assessment period. DIR reviews each fund's reserve ratio to determine if the assessment rates should be adjusted and evaluates three significant factors related to the funds:

- impact of probable insurance losses (primarily failed institutions),
- amount of interest income for the semiannual period, and
- unrealized gains and losses on available-for-sale securities for the semiannual period.

However, DIR's supporting analysis for assessment rates has not considered the impact of significant changes in institution failures and in supervision and regulation after 1992.

We reviewed the Board cases for proposed assessments for BIF-insured institutions for the first semiannual period of 2003 through the second semiannual period of 2005 for changes in DIR's methodology or comments, analysis performed, and general statements supporting the assessment rates. The section of each Board case presenting proposed assessment rates contained the statement, "The current rate spreads also generally are consistent with the historical variation in bank failure rates across cells of the assessment rate matrix." In response to our inquiry about the basis for this statement, DIR provided a 1994 article from the *FDIC Banking Review,* which analyzed bank failure rates from January 1, 1988 through December 31, 1992.[12] However, in the November 2005 Board cases for the first semiannual period of 2006, DIR removed the reference to "the historical variation in bank failure rates." Notwithstanding, it would be prudent for DIR to update the analysis for the Board's consideration in determining the appropriateness of continuing with the same assessment rates.

[12] The article is entitled, *Risk Measurement, Actuarially-Fair Deposit Insurance Premiums and the FDIC's Risk-Related Premium System*. This analysis did not include insured thrifts.

Changes in Institution Failure Rates and Supervision

During the 5-year period covered by DIR's initial analysis – January 1, 1988 through December 31, 1992 – there were 1,838 bank and thrift failures. In contrast, the FDIC reported a total of 55 failures during the 10-year period from January 1, 1995 through December 31, 2004, which represents a significant decrease.

The implementation of FDICIA prompted significant differences in supervision and regulation that may have contributed to fewer bank failures. Since taking effect December 19, 1992, FDICIA, Section 111, has required the appropriate federal banking agency to conduct a full-scope, on-site examination of each insured depository institution, at least once during each 12- or 18-month period. FDICIA also empowered the regulators in monitoring and restraining risky activities of institutions. Specifically, FDICIA, Section 131, required each banking agency and the FDIC to take prompt corrective action to resolve the problems of insured depository institutions and established new capital categories and FDICIA, Section 132, required the federal banking agencies to set standards for safety and soundness applicable to all insured institutions and their holding companies. FDICIA, Section 141, has required the FDIC to pursue a least-cost resolution approach to bank failures. FDICIA, Section 302, also authorized the FDIC to establish a risk-based assessment system for insured institutions.

In a paper entitled, *Costs Associated With Bank Failures*, dated October 10, 2003, the Division of Resolutions and Receiverships (DRR) addressed how the FDIC handles financial institution failures and provided an overview of the costs associated with failing institutions, focusing on the 34 institutions that failed between 1997 and 2002. DRR's concluding observations made the following points—relevant to our finding—that the analysis supporting the assessment rates should be updated:

- The failure of a financial institution always results in losses to at least some stakeholders. This aspect of failures has not changed. What has changed, however, is a reversal of the distribution of these losses, by size, of the failed institution. In the past, smaller failures resulted in disproportionately larger losses to stakeholders. More recently, losses on larger failures increased substantially, while the average loss rate in small failures has fallen. The increased loss rate among larger institutions can be explained by the disproportionate number of subprime lenders in this group, some of which were involved in fraudulent transactions.

- The loss rates for smaller financial institution failures—those with total assets under $100 million—were considerably lower compared to financial institutions that failed during the 1980s and early 1990s. In addition, a greater proportion of financial institution failures resulted in no loss to the FDIC. Of the 34 failures in this study, 2 (6 percent) are actual no-cost failures to the FDIC. This compares to a no-cost failure rate of just 1.5 percent from 1986 to 1992.[13]

- The lower loss rate among smaller failures may be a trend that continues. The economic environment was more forgiving during the late 1990s compared to the 1980s and early

[13] Excluded from these no-cost failures were banks that failed due to the exercise of the FDIC's cross-guarantee authority.

1990s. While recent economic growth has been sluggish, the likelihood of a 1980s-style recession appears low for the foreseeable future. Further, the franchise value of financial institutions improved substantially during the 1990s, and the outlook continues to be robust for institutions with a core deposit franchise.

- The lower loss rates among the smaller failures also may be the result of PCA measures where the resolution process begins when a financial institution's equity reaches 2 percent, as opposed to 0 percent prior to 1991. Prompt corrective action measures are more effective in smaller institutions where there are not significant asset valuation issues (except in cases of major fraud), which cloud a bank's true capital position. Earlier closure results in lower losses. The FDIC is afforded more time to resolve the institutions, so more assets can be passed to the acquirer, and there is a greater opportunity to obtain a higher premium. Additionally, current asset sales practices impact failure costs. Specifically, the FDIC's practice of aggressively marketing and selling assets at market value at the time of failure has substantially reduced overhead and administrative costs, resulting in a more efficient resolution process.

Conclusion

DIR's supporting analysis for assessment ratios relies on data that is 13 years old and may no longer accurately reflect the probability and extent of insurance loss and other factors the Board considers in setting assessment rates. Institution failures decreased substantially after 1992, and the FDIC and the other banking regulators have made numerous improvements in their supervisory regimen in recent years, some in response to statutory and regulatory changes, particularly those brought about by FDICIA. Thus, institution failures that occurred after relevant sections of FDICIA took effect in December 1992 may be more representative for developing an analysis to support the range of basis points in the assessment rate matrix. Further, with the passage of deposit insurance reform by the Congress, DIR should reassess the deposit insurance rate structure contained in the current RRPS matrix. Finally, we offer no opinion on whether rates should be increased, decreased, or held constant.

RECOMMENDATIONS

We recommend the Director, DIR:

(2) Update the analysis supporting the basis point rate spreads applied to the assessment rate matrix for the deposit insurance funds.

(3) Present the updated analysis as part of the assessment rate cases to the Board with recommendations for assessment rates for financial institutions based on their assessment risk classification.

(4) Establish a schedule for periodically updating the assessment rate analysis and reassessing the basis point spreads and assessment rates, as needed.

CORPORATION COMMENTS AND OIG EVALUATION

DIR concurred in part with recommendations 2 and 3 and offered an alternative action to recommendation 4. The following summarizes management's written response to these recommendations, which is presented in its entirety in Appendix VI of this report. DIR stated that it has been examining a possible update to assessment rates but has not recommended that the Board change the rates due to legal and practical limitations on DIR's ability to construct a rate schedule that is always actuarially accurate. DIR stated that the benefits of changing assessment rates were outweighed by the costs and potential risks due to the following:

- The Deposit Insurance Funds Act of 1996 prevents the FDIC from charging an institution in the 1A risk category for deposit insurance so long as the institution's deposit insurance fund is at or above the designated reserve ratio and is expected to remain so. Since 1995, at least 90 percent of institutions have been in this category, and presently, 94 percent of institutions are in this category.
- The assessment schedule in place over the last 10 years has continued to fulfill the purposes intended by the Board. Riskier institutions pay more for their deposit insurance coverage, and the reserve ratios have remained at or above target levels.
- During the past 5 years, the FDIC has focused on a broader set of deposit insurance reform recommendations.
- The relatively few failures in the years since the current rate schedule has been in place have provided little new information to re-evaluate the spreads between rates in the assessment matrix.
- During approximately the past 10 years, only 6 to 10 percent of institutions have paid deposit insurance assessments at any time.

DIR will propose to the Board substantial revisions to the assessment system as part of deposit insurance reform implementation. DIR's goal will be to recommend assessment rates that better reflect differences in risk among FDIC-insured institutions and are most likely to keep the fund's reserve ratio within the range contemplated by legislation.

Regarding recommendation 4, DIR stated that it would be premature to establish a schedule for periodically updating the assessment rate analysis and reassessing the basis point spreads and assessment rates. DIR proposed that considerations of the frequency of rate updates await initial implementation of assessment system changes pursuant to reform legislation. DIR stated that much will depend on the outcome to the initial changes and the manner in which the Board wants to evaluate their effectiveness. Further, DIR indicated that the success of the new system in keeping within the statutory range for the reserve ratio will also play a role in determining the frequency of assessment rate updates.

These recommendations are resolved but will remain open for reporting purposes until we have determined that the agreed-to corrective actions have been completed and are effective.

OBJECTIVE, SCOPE, AND METHODOLOGY

The audit objective was to determine whether the RRPS is adequately tied to the results of examinations of institutions by the primary federal regulators and to other information relevant to the institutions' financial condition. We performed our field work at DSC and DIR headquarters and at selected DSC regional offices from March through October 2005 in accordance with generally accepted government auditing standards.

Management Controls

To accomplish the audit objective and gain an understanding of the applicable control environment, we did the following:

- Reviewed applicable laws and FDIC Rules and Regulations.
- Reviewed the FDIC's Circular 4700.1, Financial Institution Letters, and other documentation pertaining to the insurance assessment process.
- Evaluated applicable policies and procedures in DSC's *Risk Management Manual of Examination Policies* and *Case Manager Procedures Manual*.
- Interviewed DSC, DIR, DIT, and DOF officials in headquarters, regional, and field offices.
- Reviewed the FDIC's established performance goals and objectives related to insurance premiums.
- Reviewed previous Government Accountability Office reports, testimonies, and responses to the Congress related to deposit insurance system reform after the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.
- Reviewed and analyzed DSC reports in the Virtual Supervisory Information on the Net (ViSION) System and related information from RRPS.
- Selected a judgmental sample of FDIC-insured financial institutions from each of the FDIC regional offices to test information in RRPS.
- Selected a judgmental sample of banks to determine if weaknesses were noted that should have been factored into the insurance premium assessment rating. Reviewed ROEs, problem bank memorandums, bank correspondence files maintained by case managers, and bank rating change memorandums.
- Reviewed DOF's and DIR's documentation as to the history of the BIF and SAIF funds as of 2005.

- Analyzed samples of FDIC-insured financial institutions by risk classifications for selected field/regional offices to test risk assignment and premiums assessed based upon CAMELS and composite ratings and capital ratios.

- Reviewed various studies and analyses on bank failures since the 1980s.

- Reviewed the former FDIC Chairman's proposals to the Congress for deposit insurance reform related to proposals that would change assessments of insurance premiums.

- Obtained documentation of the progress of deposit insurance reform in the Congress.

Pertinent Laws and Regulations and Consideration of Potential Fraud and Illegal Acts

We gained an understanding of relevant laws and regulations and evaluated the FDIC's implementation of procedures applicable to deposit insurance assessments and RRPS. These included the following:

- Federal Deposit Insurance Act – Section 7;

- FDICIA, Section 302;

- FDIC Rules and Regulations, Part 325, *Capital Maintenance*, which also incorporates, Subpart A – *Minimum Capital Requirements* and Subpart B – *Prompt Corrective Action*; and

- FDIC Rules and Regulations, Part 327, *Assessments.*

We did not identify any instances of noncompliance with applicable laws and regulations, and throughout our audit, we were alert to the potential for fraud, waste, abuse, and mismanagement.

Computer-based Data

We used computer-based data from ViSION and, particularly, the RRPS and Supervisory Tracking and Reporting Modules to apply the RRPS criteria to supervisory examinations conducted by the various regulatory agencies from January 2004 through January 2005. We also used computer-based data as a supplemental source of information in conjunction with supporting documents and in generating a universe of examinations from which to select our sample. Although we did not perform assessments of computer-based data, no discrepancies between computer-based data and supporting documentation came to our attention during the audit. Additionally, the OIG performed an audit to determine whether the RRPS application provides the appropriate level of confidentiality, integrity, and availability through the use of effective management, operational, and technical controls. Final Audit Report No. 05-037, *Controls Over the Risk-Related Premium System*, dated September 23, 2005, presents the results of that audit.

APPENDIX I

Government Performance and Results Act

We found that the FDIC has established performance measures related to the RRPS. The FDIC's 2005 performance plan outlines goals and objectives relating to deposit insurance reform and maintaining a sound deposit insurance system as follows:

- identify and address risks to the insurance funds,
- maintain viable insurance funds, and
- improve and update information technology related to RRPS.

Our audit focused on matters for identifying and addressing risks to the insurance funds. We did not identify any proposals that might directly affect the RRPS; however, deposit insurance reform may provide the FDIC with greater flexibility for determining the basis points charged to institutions for deposit insurance coverage.

APPENDIX II

ADOPTION OF THE RISK ASSESSMENT MATRIX

The following is an excerpt from the October 1, 1992 *Federal Register*, describing the Board's rationale in adopting a multi-tiered matrix for determining assessment risk classifications.

> The Board believed that the ongoing supervisory monitoring process produced more and better information concerning an institution's risk exposure than can be obtained solely from financial reports. A risk measurement system that relies solely on data obtained from Reports of Income and Condition or Thrift Financial Reports would not adequately capture important risk factors, such as loan underwriting standards, management quality, or other operational elements that can substantially affect the FDIC's risk exposure. Accordingly, the Board believed that a risk-based insurance system in which supervisory factors played an important role would lead to less inequity in the pricing of risk than one based exclusively, or almost exclusively, on reported financial data.
>
> The Board also recognized the value of objective measures. An attribute of a risk-based premium system is to give weak institutions an incentive for improving their condition. The Board decided that this incentive would be provided by a system that bases premiums, in part, on the institutions' capital ratios as derived from data on their financial reports. By meeting specific capital-ratio standards, weak institutions would be able to reduce their deposit insurance premiums. Greater capital increases the cushion against loss, both for the institution and for the FDIC, and increases the owners' stake in a sound operation. Thus, the Board believed that capital ratios should play an important role in a risk-based premium system.
>
> On September 15, 1992, the Board adopted final rules on the risk-based assessment system and PCA. The Board decided to incorporate the PCA capital-ratio standards for "well capitalized" and "adequately capitalized" into the final rule for the assessment system. For purposes of assigning capital categories, risk-based ratios would be estimated by the FDIC using the method agreed upon by the Federal Financial Institutions Examination Council [FFIEC].

The Board initially established an eight basis-point spread between the highest and lowest premium rates, realizing that the spread did not adequately reflect the difference in risk to the insurance funds between the weakest and strongest institutions. However, the Board believed that a relatively modest rate spread was appropriate at the time the spread was established. Widening the spread beyond eight basis points to maintain adequate assessment revenue would have required that the highest premium rates be very high. The Board was concerned that imposing even greater rate increases for weaker institutions could, at the early stage in the development of a risk-based assessment system, cause a degree of disruption and hardship for such institutions. The initial risk-based assessment schedule adopted by the Board separately for BIF and SAIF member institutions, expressed in terms of basis points assessed against deposits, is in Table 5.

Table 5: Rate Schedule for the January 1, 1993 Assessment Period

Capital Group	**Supervisory Subgroup**		
	A	B	C
1. Well Capitalized	23 bp	26 bp	29 bp
2. Adequately Capitalized	26 bp	29 bp	30 bp
3. Undercapitalized	29 bp	30 bp	31 bp

Source: FDIC Rules and Regulations, Section 327.9(b)(3)(ii).

The Board subsequently approved the current rate schedule as shown earlier in Table 4. That rate structure has been in effect since January 1, 1996 for the BIF and since January 1, 1997 for the SAIF, omitting a premium for any institution in group 1A.

APPENDIX III

ASSESSMENT RISK CLASSIFICATION

The FDIC uses a risk-based insurance premium system that assesses higher rates on those institutions deemed to pose greater risks to the BIF or SAIF. To assess premiums on institutions, the FDIC places each institution into one of nine assessment risk classifications semiannually, using a two-step classification process involving the Capital Group and Supervisory Subgroup assignments. Capital Group assignments are based on the capital ratios from the institution's financial reports. Supervisory Subgroup assignments are based on the institution's most recent ROE and any other information relevant to the institution's financial condition and risk posed to the funds.

Step 1 – Capital Group Assignment

Capital Group assignments are made in accordance with Section 327.4(a)(1) of the FDIC Rules and Regulations, using the method agreed upon by the FFIEC for calculating capital ratios. Institutions are assigned to one of three Capital Groups on the basis of data in an institution's financial reports as of the preceding September 30 for the January 1 to June 30 semiannual period and the preceding March 31 for the July 1 to December 31 semiannual period. No changes to capital ratios are considered except for amendments to the financial reports during the reconcilement process or when an institution appeals its assessment.

FDICIA established FDI Act Section 38, *Prompt Corrective Action*, which requires federal regulators to place financial institutions into one of five categories on the basis of their capital levels. The five capital categories are well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The Board adopted the capital levels from these categories and applied "well capitalized" as Capital Group 1, "adequately capitalized" as Capital Group 2, and the remaining three categories as Capital Group 3 in the matrix for risk-based assessments (see Table 6).

Table 6: Capital Group Descriptions

Capital Group	Total Risk-Based Capital Ratio	Tier 1 Risk-Based Capital Ratio	Tier 1 Leverage Capital Ratio
1. Well Capitalized	= or > 10%	= or > 6%	= or > 5%
2. Adequately Capitalized	= or > 8%	= or > 4%	= or > 4%
3. Undercapitalized	Not qualified in Group 1 or 2	Not qualified in Group 1 or 2	Not qualified in Group 1 or 2

Source: FDIC Rules and Regulations, Section 327.4.

***Well Capitalized*—**The well capitalized risk category (or group 1) consists of institutions satisfying each of the capital ratio standards set forth for group 1 in Table 6.[14]

***Adequately Capitalized*—**The adequately capitalized risk category (or group 2) consists of institutions that do not satisfy the standards of "well capitalized" but satisfy each of the capital ratio standards set forth for group 2 in Table 6.[15]

***Undercapitalized*—**The undercapitalized risk category (or group 3) consists of institutions that do not qualify as either "well capitalized" or "adequately capitalized."

Step 2 – Supervisory Subgroup Assignment

Supervisory Subgroup assignments for insured institutions are made in accordance with Section 327.4(a)(2) of the FDIC Rules and Regulations, which states:

> Each institution will be assigned to one of three subgroups based on the Corporation's consideration of supervisory evaluations provided by the institution's primary federal regulator. The supervisory evaluations include the results of examination findings by the primary federal regulator, as well as other information the primary federal regulator determines to be relevant. In addition, the Corporation will take into consideration such other information (such as state examination findings, if appropriate) as it determines to be relevant to the institution's financial condition and the risk posed to the BIF or SAIF.

The three Supervisory Subgroups, described in Table 7, are generally based on safety and soundness composite ratings but include consideration of other pertinent factors. The RRPS assigns a preliminary Supervisory Subgroup based on the most recent ROE safety and soundness composite rating as of the supervisory cutoff date for the semiannual assessment period, regardless of when the corresponding ROEs are received by the FDIC. However, an institution's condition can change subsequent to the safety and soundness rating assignment. Thus, the FDIC reviews and revises, as needed, the assignments of BIF or SAIF institutions to a Supervisory

[14] New insured depository institutions coming into existence after the insurance assessment report date specified are included in this group for the first semiannual period for which the institutions are required to pay assessments. For purposes of assessment risk classification, an insured branch of a foreign bank is deemed to be "well capitalized" if the insured branch: (1) maintains the pledge of assets required and (2) maintains the eligible assets prescribed at 108 percent or more of the average book value of the insured branch's third-party liabilities for the quarter ending on the report date specified.

[15] For purposes of assessment risk classification, an insured branch of a foreign bank is deemed to be "adequately capitalized" if the insured branch: (1) maintains the pledge of assets required, (2) maintains the eligible assets prescribed at 106 percent or more of the average book value of the insured branch's third-party liabilities for the quarter ending on the report date specified, and (3) does not meet the definition of a "well capitalized," insured branch of a foreign bank.

Subgroup for each semiannual assessment period based on a variety of factors. These include an FDIC review of the:

- results of the last examination finalized and transmitted by the primary regulator to an institution prior to the supervisory cutoff date;
- other written findings that result in a composite rating change by the primary regulator;
- results of independent, joint, or concurrent FDIC examinations finalized prior to the supervisory cutoff date; time elapsed since the last examination; and
- results of off-site statistical analyses of reported financial statements or analyses of other pertinent information.

Table 7: Supervisory Subgroup Descriptions

Subgroup	Composite Rating	Description
A	1 or 2	Financially sound institutions with few minor weaknesses.
B	3	Weaknesses, if not corrected, could result in significant deterioration of institution and increased risk of loss to BIF/SAIF. May include formal or informal enforcement action.
C	4 or 5	Pose substantial probability of loss to BIF/SAIF. Formal enforcement action may be necessary.

Sources: FDIC Rules and Regulations, Section 327.4(a)(2), for subgroup and description and the FDIC Statement of Policy for composite rating and description.

CHRONOLOGY OF SIGNIFICANT EVENTS FOR INSTITUTIONS

Institution 1

DATE	EVENT
September 23, 2003	Cease and Desist Order required Tier 1 capital to equal or exceed 7.5 percent of a bank's total assets.
September 30, 2003 ROE	Call Report of September 30, 2003 needed amending for $4.1 million in unused loan commitments, brokered deposits, and provision to the ALLL. Bank was in undercapitalized category for PCA. Management reports overstated Tier 1 Leverage Capital at 7.18 percent because deferred tax assets were not properly deducted. Tier 1 was 4.41 percent after replenishing the ALLL. The ROE stated, "Capital is deficient in light of the institution's risk profile threatening its viability." Asset quality was unsatisfactory, and lending practices were deficient. Earnings were poor and continued to decline. The bank needed a $1 million capital injection. Bank management and the bank's board of directors failed to address deficiencies.
March 31, 2004 ROE	After adjustments for ALLL, legal settlement, and other assets were classified as a loss, Tier 1 capital was $(0.5) million. As of March 31, 2004, Tier 1 capital was 3.52 percent before examination adjustments. The high level and severity of assets subjected to adverse classification reflects a high exposure to loss within the portfolio. Bank earnings declined due to overhead and ALLL provisions. The bank's board of directors and management failed to address prior ROE deficiencies.
May 2004	State of Florida and Federal Reserve Bank approve acquisition of the bank.
September 30, 2004	Supervisory cutoff date for RRPS. DSC began review in October 2004.
April 27, 2005	DSC reported improved CAMELS ratings and stated, "significant improvement in bank's overall financial condition." Capital injections totaling $4.8 million provided by acquirer increased the Tier 1 leverage capital ratio to 17.35 percent as of September 30, 2004. Asset quality improved. Earnings were negative due to loan losses but were forecasted to be positive in 2005.

Institution 2

DATE	EVENT
October 16, 2002	FDIC and state banking department Cease and Desist Orders required Tier 1 capital to equal or exceed 8 percent of the bank's total assets as of December 31, 2002.
June 30, 2003 ROE	The ROE stated, "Capital is unsatisfactory in relation to the institution's risk profile. Critical deficiencies in management, asset quality and earnings are a constant drain on the capital account, and the current capital level cannot support the myriad of risk exposures that … bank faces; risks such as credit, operational, legal, reputation, and liquidity." Loan losses, legal and settlement fees, and ALLL provisions eliminated a $3 million capital injection made December 2002. Capital ratios calculated in the ROE consider the provision to ALLL, and assets and loans were classified as a loss. Ratios at ROE date were: Tier I Leverage Capital - 7.00, Tier 1 Risk-based Capital - 10.25, and Total Risk-based Capital - 11.53. Bank's financial condition due to the bank's board of directors' negligence and former president's dominance. The bank's president participated in criminal activities, conflicts of interest, and breach of fiduciary duty. The president's lending relations contributed to large loan losses. Asset quality threatened the bank's viability due to excessive adverse classification and past due loans. ALLL was inadequate by $500,000, and ALLL methodology was not in compliance with FDIC Rules and Regulations.
April 2004	FDIC and the state banking department issued additional formal enforcement actions to address weakness not covered in their 2002 Cease and Desist Orders.
September 30, 2004	Supervisory cutoff date for RRPS. DSC began review in October 2004.
December 2004	Corrected unsafe lending practices. Resolved asset quality problems and normalized legal expenses. Continued operating losses. Capital level is less than satisfactory even though owners contributed more than $6.2 million since last examination.

APPENDIX IV

Institution 3

DATE	EVENT
June 30, 2003 ROE	The ROE stated, "Capital is critically inadequate. The hazardous actions of former management have caused the distressed financial condition of the institution. Unsatisfactory asset quality has caused a substantial operating loss that has eroded capital." Underfunded ALLL and losses in other assets reduced Tier 1 Leverage Capital Ratio to 1.08 percent. Erosion in asset quality was abrupt and severe. ALLL with $8.7 million at June 30, 2003 was reduced to ($318,000). Inadequate board of directors oversight contributed to the bank's financial problems. Hazardous lending practices for the former president/chief executive officer contributed to the depleted capital. The holding company injected $3.5 million in July effective June 30, 2003 with two additional or $1 million each in August and October 2003. Capital ratios for June 30, 2003 revised: Tier 1 leverage was 1.08, Tier 1 capital was 1.78, and total capital was 3.12.
January 1, 2004	Cease and Desist Order required bank to have and maintain Tier 1 capital equal to exceeding 8.0 percent of the bank's total assets by December 31, 2004.
March 31, 2004 ROE	The ROE stated that continuous asset quality problems and operational losses necessitated continued financial assistance from the bank's parent holding company. Holding company injections totaled $9.064 million in 2003 and increased the December 31, 2003 Tier 1 capital ratio to 5.11 percent. The holding company injected $875,000 in 2004 that increased Tier 1 to 8.35 percent on June 30, 2004. The ROE stated, "Despite the increased Tier 1 capital Ratio, capital levels are deficient in relation to the bank's current risk profile. [The holding company's] "financial condition is weak … from the losses associated with the subject bank."
September 30, 2004	Supervisory cutoff date for RRPS. DSC began review in October 2004.

APPENDIX V

GLOSSARY

TERM	DEFINITION
CAMELS Component and Composite Ratings	Defined in an FDIC Statement of Policy, CAMELS (an acronym for capital, asset quality, management, earnings, liquidity, and sensitivity to market risk) represents the six individual component ratings assigned by a bank's safety and soundness examination and the overall rating based on an assessment of these components. A composite rating of 1 through 5 is given, with 1 having the least regulatory concern and 5 having the greatest concern. The composite ratings are described as follows: Rating 1: Financial institutions are sound in every respect. They exhibit the strongest performance and risk management practices. They give no cause for supervisory concern. Rating 2: Financial institutions are fundamentally sound. There are only moderate weaknesses. These financial institutions are in substantial compliance with laws and regulations. There are no material supervisory concerns, and the supervisory response is informal and limited. Rating 3: Financial institutions exhibit some degree of supervisory concern in one or more of the component areas. They exhibit a combination of weaknesses that may range from moderate to severe. Risk management practices may be less than satisfactory. Failure appears unlikely. Rating 4: Financial institutions generally exhibit unsafe and unsound practices or conditions. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved. Rating 5: Financial institutions exhibit extremely unsafe and unsound practices or conditions and exhibit a critically deficient performance. They are of the greatest supervisory concern. Immediate outside financial or other assistance is needed in order for the financial institution to be viable. Ongoing supervisory attention is necessary. Institutions pose a significant risk to the deposit insurance fund, and failure is highly probable.

APPENDIX V

TERM	DEFINITION
Capital Group Assignments	DIR's Pricing Section determines the institution's Capital Group assignment. Capital Group assignments are made in accordance with section 327.4(a)(1) of the FDIC Rules and Regulations, using the method agreed upon by the FFIEC for calculating capital ratios.
FDIC Circular 4700.1 October 14, 2005	Circular conveys DSC's RRPS procedures. It addresses regional office responsibilities for review of RRPS Supervisory Subgroup assignments, Call Report amendments, and financial institutions' request for review of subgroup assignments.
FFIEC	The FFIEC is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the Board of Governors of the Federal Reserve System, the FDIC, the National Credit Union Administration, the OCC, and the OTS and to make recommendations to promote uniformity in the supervision of financial institutions.
Risk-Based Assessment System	FDICIA defines a risk-based assessment system as a system for calculating an institution's semiannual assessment based on the probability that the institution would cause a loss to the deposit insurance funds, considering the risks posed by asset and liability concentration, and other factors set by the Board, the likely amount of such loss, and the revenue needs of the fund.
Risk Related Premium System (RRPS)	Menu-driven system in the FDIC's mainframe that involves the semiannual assignment of insured institutions to one of three Capital Groups and to one of three Supervisory Subgroups for insurance assessment purposes.
Supervisory Subgroup Assignments	Supervisory Subgroup assignments are made in accordance with section 327.4(a)(2) of the FDIC Rules and Regulations, which provides that each institution will be assigned to one of three subgroups based on the FDIC's consideration of supervisory evaluations provided by the institution's primary federal regulator as well as other information the primary federal regulator determines to be relevant. The FDIC considers other information relevant to an institution's financial condition and the risk posed to the BIF or SAIF.

APPENDIX V

TERM	DEFINITION
Tier 1 Leverage Capital Ratio	Tier 1 capital divided by total assets. A definition is provided in Part 325 of the FDIC Rules and Regulations.
Tier 1 (Core) Capital Ratio	Defined in Part 325 of the FDIC Rules and Regulations and is the sum of: • common stockholders' equity, • noncumulative perpetual preferred stock, and • minority interests in consolidated subsidiaries. Minus: • All intangible assets other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships eligible for inclusion in core capital pursuant to Section 325.5(f). • Noneligible credit-enhancing interest-only strips. • Deferred tax assets in excess of the limit set forth in Section 325.5(g). • Identified losses (to the extent that Tier 1 capital would have been reduced if the appropriate accounting entries to reflect the identified losses had been recorded on the institution's books). • Investments in financial subsidiaries subject to Part 362 (subpart E), FDIC Rules and Regulations. • The amount of the total adjusted carrying value of nonfinancial equity investments subject to deduction as set forth in Part 325, Appendix A.
Total Capital Ratio	FDIC Rules and Regulations Part 325 states that Total Capital (used in the risk-based calculation) is the sum of Tier 1 Capital and Tier 2 Capital, less investments in unconsolidated banking and finance subsidiaries and reciprocal holdings of capital instruments of other banks. The FDIC may also consider deducting investments in other subsidiaries, either on a case-by-case basis or, as with securities subsidiaries, based on the general characteristics or functional nature of the subsidiaries.

APPENDIX V

TERM	DEFINITION
Tier 2 (Supplementary) Capital	Tier 2 Capital is defined in Part 325 of the FDIC Rules and Regulations, Part 325, Appendix A., I.A.2, and generally consists of: • ALLL, up to a maximum of 1.25 percent of gross risk-weighted assets. • Cumulative perpetual preferred stock, long-term preferred stock (original maturity of at least 20 years) and any related surplus. • Perpetual preferred stock where the dividend is reset periodically based, in whole or in part, on the bank's current credit standing. • Hybrid capital instruments, including mandatory convertible debt. • Term subordinated debt and intermediate-term preferred stock (original average maturity of 5 years or more and not redeemable at the option of the holder prior to maturity, except with the prior approval of the FDIC). • Net unrealized holding gains on equity securities, up to 45 percent pretax.
Virtual Supervisory Information on the Net (ViSION)	ViSION is a bank-supervision tracking and reporting database that contains information on all insured depository institutions. Users rely on ViSION as a central repository for compiling, reviewing, analyzing, and managing financial, examination, and other data on financial institutions. The ViSION user community includes FDIC executives, regional managers, case managers, review examiners, field examiners, DIR analysts, and federal and state regulatory agencies.
Written Agreement	A written agreement is executed by authorized representatives and is entered into with the FDIC by an insured depository institution. The agreement is enforceable by an action under section 8(a) and/or section 8(b) of the FDI Act.

CORPORATION COMMENTS

FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Division of Insurance and Research and
Division of Supervision and Consumer Protection

DATE: January 30, 2006

MEMORANDUM TO: Stephen M. Beard
Deputy Assistant Inspector General for Audits

FROM: Christopher J. Spoth, Acting Director [Electronically produced version; original signed by Christopher J. Spoth]
Division of Supervision and Consumer Protection

Arthur J. Murton, Director [Electronically produced version; original signed by Arthur J. Murton]
Division of Insurance and Research

SUBJECT: Draft Report Entitled, *Consideration of Safety and Soundness Examination Results and Other Relevant Information in the FDIC's Risk-Related Premium System* (Assignment No. 2005-033)

This memorandum constitutes the joint response of the Division of Insurance and Research and the Division of Supervision and Consumer Protection to your Draft Report Entitled, *Consideration of Safety and Soundness Examination Results and Other Relevant Information in the FDIC's Risk-Related Premium System* (Assignment No. 2005-033). We are pleased that you found that we "appropriately assessed the institutions' conditions and ratings," that "Supervisory Subgroups were adequately tied to results of examinations," and that we communicated with other primary regulators regarding Supervisory Subgroup assignments. Our response follows the report's recommendations, which we reproduce.

OIG Recommendation

(1) We recommend that the Director, DIR, pursue revisions to Part 327 and related implementing procedures to permit Capital Group adjustments during the RRPS process when capital is impaired based on CAMELS ratings and related supervisory concerns.

DIR concurs in part and offers an alternative.

We continue to believe that the Board's decision to use both subjective factors (CAMELS composite ratings) and objective factors (capital ratios) when it created the assessment risk categories was correct. An institution always has an incentive to maintain its capital ratios at the level required to be considered well capitalized for assessment purposes and always has an incentive to improve its CAMELS composite rating to at least a 2.

We also believe that the current system already takes into account particular capital requirements that bank regulators may impose. Capital is the "C" component of the CAMELS rating and, therefore, is taken into account when the composite rating is computed. Thus, an institution that meets the requirements to be considered well capitalized for assessment purposes, but fails to meet special capital requirements imposed by its primary federal regulator, will, in most cases, receive a lower CAMELS composite rating than it otherwise would.

However, we do agree that the present assessment system may at times be slow to respond to subsequent events.[1] DIR is considering improvements to the assessment system that would:

- Evaluate an institution's capital levels quarterly, rather than semiannually, as at present, using the existing objective capital definitions; and

- Reflect changes in CAMELS composite ratings more frequently than semiannually, as at present.

DIR envisions that these improvements to the assessment system would be brought to the Board in conjunction with changes brought about by pending deposit insurance reform legislation. However, in the event that this legislation does not pass, DIR still intends to consider similar changes by year-end 2006.

[1] In at least one respect, the present system responds promptly enough. Call reports are validated offsite and checked during examinations. Banks are required to amend their reports where errors are identified. If the amendment adversely affects the institution's capital category for risk-assessment period to which the Call Report applied, then the RRPS system will automatically bill the institution retroactively at a higher rate (including interest) for the earlier period. If the amendment results in a better capital category, then the system will automatically credit the institution based on a lower premium rate (with interest).

OIG Recommendations

We recommend the Director, DIR:

(2) Update the analysis supporting the basis point rate spreads applied to the assessment rate matrix for the deposit insurance funds.

(3) Present the updated analysis as part of the assessment rate cases to the Board with recommendations for assessment rates for financial institutions based on their assessment risk classification.

(4) Establish a schedule for periodically updating the assessment rate analysis and reassessing the basis point spreads and assessment rates, as needed.

DIR concurs in part on (2) and (3) and offers an alternative to (4).

DIR has been examining a possible update to assessment rates for some time, but has not recommended that the Board change assessment rates for several reasons. There are both legal and practical limitations on our ability to construct a rate schedule that is always actuarially accurate.[2]

First, the Deposit Insurance Funds Act of 1996 prevents the FDIC from charging an institution in the 1A risk category for deposit insurance, so long as the institution's deposit insurance fund is at or above the designated reserve ratio (DRR), 1.25 percent, and is expected to remain so. Since 1995, at least 90 percent of institutions have been in this category; at present 94 percent of institutions are in this category. Collectively these institutions currently account for more than 98 percent of the assessment base. Of course, every institution poses some risk, so

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[2] Existing law provides that a:

> "[R]isk-based assessment system" means a system for calculating a depository institution's semiannual assessment based on—
>
> (i) the probability that the deposit insurance fund will incur a loss with respect to the institution, taking into consideration the risks attributable to—
>
> (I) different categories and concentrations of assets;
>
> (II) different categories and concentrations of liabilities, both insured and uninsured, contingent and noncontingent; and
>
> (III) any other factors the Corporation determines are relevant to assessing such probability;
>
> (ii) the likely amount of any such loss; and
>
> (iii) the revenue needs of the deposit insurance fund.

12 U.S.C. § 1817(b)(1)(C). The Board must set assessment rates only to the extent necessary to maintain the reserve ratio of each deposit insurance fund at the designated reserve ratio or to return the reserve ratio to the DRR if it has fallen below. 12 U.S.C. § 1817(b)(2)(A)(i). In doing so, the Board must:

> [C]onsider the deposit insurance fund's—
>
> (I) expected operating expenses,
>
> (II) case resolution expenditures and income,
>
> (III) the effect of assessments on members' earnings and capital, and
>
> (IV) any other factors that the Board of Directors may deem appropriate.

12 U.S.C. § 1817(b)(2)(A)(ii).

these institutions are not being charged—and cannot be charged, under existing law—actuarially accurate assessments.

In 1995, when the FDIC adopted a base assessment schedule for the Bank Insurance Fund of 4 to 31 basis points, it noted that an actuarially accurate premium spread would have been much wider than 27 basis points.[3] However, the spread chosen, the Board noted, would not threaten the solvency of the riskiest banks.

Second, the assessment schedule in place over the last ten years continues to fulfill the purposes intended by the Board. Riskier institutions pay more for their deposit insurance coverage and the reserve ratios have remained at or above target levels. The assessment schedule for both funds for approximately the past ten years has been the base schedule reduced by four basis points—so that the best-rated institutions pay a zero rate, consistent with the requirements of the Funds Act, and the rate spread remains 27 basis points. Riskier institutions pay more and have an incentive to improve their risk classification.[4]

Third, during the past five years, the FDIC has focused on a broader set of deposit insurance reform recommendations.

Fourth, the relatively few failures in the years since the current schedule has been in place have provided little new information to re-evaluate the spreads between rates in the assessment matrix.

Finally, during approximately the past ten years, only six to ten percent of institutions have paid deposit insurance assessments at any time

For these reasons, the benefits of changing assessment rates were, in DIR's opinion, outweighed by the costs and potential risks.

However, DIR does intend to propose to the Board substantial revisions to the assessment system as part of deposit insurance reform implementation (assuming reform legislation is

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[3] When it adopted this base assessment schedule, the Board noted that:

> FDIC research likewise suggests that a substantially larger spread would be necessary to establish an "actuarially fair" assessment rate system. Insurance premiums are actuarially fair when the discounted value of the premiums paid over the life of the insurance contract is expected to generate revenues that equal expected discounted costs to the insurer from claims made by the insured over the same period. A 1994 FDIC study used a "proportional hazards" model to estimate the expected lifetime of banks that were in existence as of January 1, 1993. The study estimated the actuarially fair assessment that each bank must pay annually so that the cost of each bank failure to the FDIC would equal the revenue collected through insurance assessments. The estimates indicated a rate spread for 1A versus 3C institutions on the order of magnitude of 100 basis points. See, Gary S. Fissel Risk Measurement, Actuarially Fair Deposit Insurance Assessments and the FDIC's Risk-Related Assessment System, FDIC Banking Review (1994), at 16-27, Table 5, Panel B.

60 Fed. Reg. 42680, 42688 (1995).

[4] Both funds have remained at or above 1.25 percent (with the exception of one quarter, during which the Bank Insurance Fund fell to 1.24 percent). As of September 30, 2005, the Bank Insurance Reserve ratio was 1.25 percent and the Savings Association Insurance Fund reserve ratio was 1.30 percent.

enacted, as appears likely). DIR's goal will be to recommend assessment rates that better reflect differences in risk among FDIC-insured institutions and are most likely to keep the fund's reserve ratio within the range contemplated by pending reform legislation. We will achieve this goal in 2006.

It would be premature at this time to establish a schedule for periodically updating the assessment rate analysis and reassessing the basis point spreads and assessment rates. Instead, DIR proposes that considerations of the frequency of rate updates await initial implementation of assessment system changes pursuant to reform legislation. Much will depend on the outcome to the initial changes and the manner in which the Board wants to evaluate their effectiveness. The success of the new system in keeping within the statutory range for the reserve ratio will also play a role in determining the frequency of assessment rate updates.

In the event that reform legislation does not pass, DIR intends to consider possible improvements in the assessment structure within the confines of current law by year-end 2006.

MANAGEMENT RESPONSE TO RECOMMENDATIONS

This table presents the management response on the recommendations in our report and the status of the recommendations as of the date of report issuance.

Rec. Number	Corrective Action: Taken or Planned/Status	Expected Completion Date	Monetary Benefits	Resolved:[a] Yes or No	Open or Closed[b]
1	DIR is considering improvements to the assessment system that would reflect changes in an institution's capital levels and CAMELS composite ratings more frequently than semiannually. Improvements will be presented to the Board in conjunction with changes resulting from deposit insurance reform legislation.	December 31, 2006	None	Yes	Open
2	DIR will propose to the Board substantial revisions to the assessment system as part of deposit insurance reform implementation. DIR will recommend assessment rates that better reflect differences in risk among FDIC-insured institutions and are most likely to keep the insurance fund's reserve ratio within the range contemplated by legislation.	December 31, 2006	None	Yes	Open
3	See 2 above.	December 31, 2006	None	Yes	Open
4	DIR proposed that implementation of assessment system changes, pursuant to reform legislation, be completed before considering the frequency of rate updates.	December 31, 2006	None	Yes	Open

[a] Resolved – (1) Management concurs with the recommendation, and the planned corrective action is consistent with the recommendation.
(2) Management does not concur with the recommendation, but planned alternative action is acceptable to the OIG.
(3) Management agrees to the OIG monetary benefits, or a different amount, or no ($0) amount. Monetary benefits are considered resolved as management provides an amount.

[b] Once the OIG determines that the agreed-upon corrective actions have been completed and are effective, the recommendation can be closed.