FDIC
Federal Deposit Insurance Corporation
801 17th Street NW, Washington, DC 20429-9990
Division of Insurance and Research

December 12, 2008

MEMORANDUM TO: The Board of Directors

FROM: Arthur J. Murton
Director
Division of Insurance and Research

SUBJECT: Assessment Rates for the First Quarter of 2009

RECOMMENDATION

Staff recommends that the FDIC's Board of Directors authorize publication of the attached final rule that would raise rates uniformly by 7 basis points for the first quarter 2009 assessment period only.

BACKGROUND: RESTORATION PLAN AND PROPOSED RULE

Recent failures of FDIC-insured institutions caused the reserve ratio of the Deposit Insurance Fund (DIF) to decline from 1.19 percent as of March 31, 2008, to 1.01 percent as of June 30 and 0.76 percent as of September 30. The FDIC expects a higher rate of institution failures in the next few years compared to recent years, leading to a further decline in the reserve ratio. Because the fund reserve ratio fell below 1.15 percent as of June 30 and was expected to remain below 1.15 percent, the Federal Deposit Insurance Reform Act of 2005 required the FDIC to establish and implement a Restoration Plan to restore the reserve ratio to no less than 1.15 percent within five years.

On October 7, 2008, the FDIC established a Restoration Plan for the DIF, published on October 16.[1] In the FDIC's view, restoring the reserve ratio to at least 1.15 percent within five years requires an increase in assessment rates. Since the current rates are already three basis points above the existing base rate schedule, a new rulemaking was required. Consequently, the Board adopted on October 7, 2008, a notice of proposed rulemaking with request for comments on revisions to the FDIC's assessment regulations.[2] The rulemaking proposed that, effective January 1, 2009, current assessment rates would increase uniformly by 7 basis points for the first quarter 2009 assessment period. Effective April 1, 2009, the rulemaking proposed to alter the way in which the FDIC's risk-based assessment system differentiates for risk and again change

[1] 73 FR 61598.

[2] 12 CFR part 327.

Concur: ________________
John V. Thomas
Acting General Counsel

deposit insurance assessment rates. Also effective on April 1, 2009, the proposal would make technical and other changes to the rules governing the risk-based assessment system. The proposed rule was published concurrently with the Restoration Plan on October 16, 2008,[3] with a comment period scheduled to end on November 17, 2008.

On November 7, 2008, the FDIC Board approved an extension of the comment period until December 17, 2008 on the parts of the proposed rulemaking that would become effective on April 1, 2009. The comment period for the proposed 7 basis point rate increase for the first quarter of 2009, with its separate proposed effective date of January 1, 2009, was not extended and expired on November 17, 2008.

If adopted by the Board, this final rule will implement a uniform increase to current rates for the first quarter 2009 assessment period only. The staff will recommend to the Board publication of another final rule early in 2009 to make changes, effective April 1, 2009, in how the assessment system differentiates for risk, set rates that would become effective beginning the second quarter of 2009, and make certain technical and other changes to the assessment rules.

ASSESSMENT RATE SCHEDULE FOR THE FIRST QUARTER OF 2009

Staff recommends that the Board adopt a final rule raising the current rates uniformly by 7 basis points for the quarterly assessment period beginning January 1, 2009. The higher assessments would be reflected in the fund balance as of March 31, 2009, and due June 30, 2009. Rates for the first quarter of 2009 are shown in Table 1 as follows:

Table 1
Proposed Assessment Rates for the First Quarter of 2009

	Risk Category				
	I*		**II**	**III**	**IV**
	Minimum	**Maximum**			
Annual Rates (in basis points)	12	14	17	35	50

* Rates for institutions that do not pay the minimum or maximum rate would vary between these rates.

[3] 73 FR 61560.

FACTORS CONSIDERED IN SETTING FIRST QUARTER 2009 ASSESSMENT RATES

Summary

Staff expects that the economic downturn and continuing troubles in the housing and construction sectors, financial markets, and commercial real estate will prolong the challenging operating environment that banks and thrifts face. Losses experienced by many large institutions in recent quarters are likely to spread to a growing number of small institutions. The percentage of the industry that is unprofitable is expected to remain high, primarily due to asset quality problems. These troubles lead the staff to project an increase in failures and higher losses to the insurance fund. The insurance fund balance and reserve ratio are likely to decline further before increased assessment revenue can begin to offset the effects of higher losses.

Since the October proposed rulemaking, the staff has updated its projections through the first quarter of 2009 of losses and other factors affecting the reserve ratio. The staff bases its updated near-term loss projections on analysis of specific troubled institutions, analysis of recent and expected loss rates given failure, as well as the stress analyses of the effects of housing price declines and an economic slowdown underlying the projections included in the October proposed rulemaking.

The staff also assumes that insured deposits would increase at an annual rate between 5 and 6 percent through March of next year. (Insured deposits include only those under the basic limit of $100,000 and $250,000 for retirement accounts.) For the four quarters ending September 30, 2008, insured deposits rose 7.1 percent. Over the 5-year period ending in September, insured deposits rose at an average annual rate of 5.9 percent.

Table 2 shows projected reserve ratios for the fourth quarter of 2008 and first quarter of 2009 for alternative insured deposit growth assumptions. At 5 or 6 percent insured deposit growth, the reserve ratio would fall from 0.76 percent in the third quarter of 2008 to 0.61 percent at the end of 2008. It would rise slightly to 0.63 percent (assuming 5 percent annualized insured deposit growth) or 0.62 percent (with 6 percent growth) in the first quarter of 2009 due to the increase in assessment rates adopted in the final rule. In the absence of the rate increase, the reserve ratio would end the first quarter at 0.60 percent (with 5 or 6 percent insured deposit growth).

Table 2
Projected Reserve Ratios
(September 30, 2008 reserve ratio = 0.76 percent)

	Annualized insured deposit growth*			
Quarter Ending	4%	5%	6%	7%
12/31/2008	0.61%	0.61%	0.61%	0.60%
3/31/2009 (without rate increase)	0.60%	0.60%	0.60%	0.59%
3/31/2009 (with 7 b.p. rate increase)	0.63%	0.63%	0.62%	0.62%

*Assumes assessable (domestic) and insured deposits increase at the same rate. Estimated insured deposits do not include those resulting from the temporary coverage limit increase to $250,000 under the Emergency Economic Stabilization Act of 2008, or those non-interest bearing transaction deposits covered by the Temporary Liquidity Guarantee Program.

The recommended rates for the first quarter of 2009 would raise almost as much assessment revenue as the rates that would become effective beginning April 1, 2009 under the October proposed rulemaking. Combining the updated near-term projections above with the longer-term projections included in the October proposed rulemaking and the proposed assessment rates effective April 1, the staff expects that the reserve ratio will reach 0.69 percent by the end of 2009. By the end of 2013 – the last year of the Restoration Plan -- the reserve ratio is projected to reach 1.21 percent, allowing for a margin for error in achieving the 1.15 percent threshold if the staff's assumptions do not hold.[4] However, the staff will update its longer-term projections for the insurance fund before adopting a final rule on assessment rates and risk-based pricing changes that would take effect in the second quarter of next year.

The FDIC recognizes that there is considerable uncertainty about its projections for losses and insured deposit growth, and that changes in assumptions about these and other factors could lead to different assessment revenue needs and rates. Under the terms of the Restoration Plan, the FDIC must update its projections for the insurance fund balance and reserve ratio at least semiannually while the plan is in effect and adjust rates as necessary. In the event that losses exceed the FDIC's best estimate or insured deposit growth is more rapid than expected, the Board will be able to adjust assessment rates.

Analysis

In setting assessment rates, the Board must consider the following factors required by statute:

[4] In the October proposed rulemaking, the staff's best estimate of the cost of failures over the six years from 2008 through 2013 was about $40 billion and its projected 2013 ending reserve ratio was 1.26 percent. Combining updated near-term loss estimates with the longer term forecasts from October, total failures costs for 2008-13 are now projected to exceed $42 billion, contributing to a lower projected reserve ratio for 2013.

(i) The estimated operating expenses of the Deposit Insurance Fund.
(ii) The estimated case resolution expenses and income of the Deposit Insurance Fund.
(iii) The projected effects of the payment of assessments on the capital and earnings of insured depository institutions.
(iv) The risk factors and other factors taken into account pursuant to section 7(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1817(b)(1)) under the risk-based assessment system, including the requirement under section 7(b)(1)(A) of the Federal Deposit Insurance Act (12 U.S.C. 1817(b)(1)(A)) to maintain a risk-based system.
(v) Other factors the Board of Directors has determined to be appropriate.[5]

The factors considered in setting assessment rates are discussed in more detail below.

Case Resolution Expenses (Insurance Fund Losses)

A higher rate of failures is likely to cause the insurance fund balance and reserve ratio to decline at least through the end of 2008 before increased assessment revenue can begin to offset the effects of increased losses. The economic downturn and continuing troubles in the housing and construction sectors, financial markets, and commercial real estate will prolong the challenging operating environment that banks and thrifts face going into 2009. Losses experienced by many large institutions in recent quarters are likely to spread to a growing number of small institutions. The percentage of the industry that is unprofitable is expected to remain high, primarily due to asset quality problems.

The staff's updated near-term projections relied heavily on supervisory analysis of specific troubled institutions. Recent and expected loss rates given failure and stress analyses of the effects of housing price declines and an economic slowdown in specific geographic areas on loan losses and bank capital also served as a basis for insurance fund loss projections.

The staff estimates that failures in all of 2008 will cost the insurance fund almost $19 billion. After taking into account a projected year-end 2008 contingent loss reserve for anticipated failures, insurance fund loss provisions for 2008 are currently projected to total $30.4

---

[5] Section 2104 of the Reform Act (amending section 7(b)(2) of the Federal Deposit Insurance Act, now 12 U.S.C. 1817(b)(2)(B)). The risk factors referred to in factor (iv) include:

(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.

Section 7(b)(1)(C) of the Federal Deposit Insurance Act (12 U.S.C. 1817(b)(1)(C)).

billion.[6] For the fourth quarter, loss provisions are estimated at $7.7 billion. The fund is also projected to incur another $1.1 billion in loss provisions during the first quarter of next year.

Before recommending to the Board a final rule on changes to risk-based pricing rules and assessment rates beginning the second quarter of 2009, the staff will update its long-term stress analyses and other factors and assumptions underlying its projections of losses in 2009 and over the five-year Restoration Plan horizon.

Operating Expenses and Investment Income

Operating expenses are projected to average close to $300 million per quarter in the fourth quarter of 2008 and first quarter of 2009.

The FDIC projects that its quarterly investment contributions (investment income and realized gains on the sale of securities, plus or minus unrealized gains or losses on available-for-sale securities) will average $309 million in the fourth quarter of this year and first quarter of next year. The FDIC is investing new funds in overnight investments and short-term Treasury bills to accommodate increased bank failure activity. The FDIC generally expects that these investments will earn lower rates than the longer-term securities that they are replacing, particularly given the consensus forecast of a near-term decline in Treasury rates, and will therefore result in less interest income to the fund.[7]

Assessment Revenue, Credit Use, and the Distribution of Assessments

The staff expects that assessment revenue in 2008 will total about $3.0 billion: $4.4 billion in gross assessments charged less $1.4 billion in credits used. Fourth quarter revenue is projected at about $1.0 billion. By the end of 2008, the projections indicate that only 4 percent of the original $4.7 billion in credits awarded will be remaining. Under the statutory provisions governing the Restoration Plan, the FDIC has the authority to restrict credit use while the plan is in effect, providing that institutions may still apply credits against their assessments equal to the lesser of their assessment or 3 basis points.[8] The FDIC decided not to restrict credit use in the Restoration Plan adopted in October. The FDIC concluded that the amount of credits remaining at the time that the proposed new rates go into effect will be very small and that their continued use would have very little effect on the assessment rates necessary to meet the requirements of the plan.[9]

[6] The $30.4 billion 2008 loss provision is derived by adding $18.9 billion for the cost of failures, $11.5 billion for the contingent loss reserve, and another $0.1 billion adjustment for failures in earlier years, then subtracting the $0.1 billion year-end 2007 contingent loss reserve.

[7] Projections of interest rates are based on consideration of December Blue Chip Financial Forecasts.

[8] Section 7(b)(3)(E)(iv) of the Federal Deposit Insurance Act (12 U.S.C. 1817(b)(3)(E)(iv)).

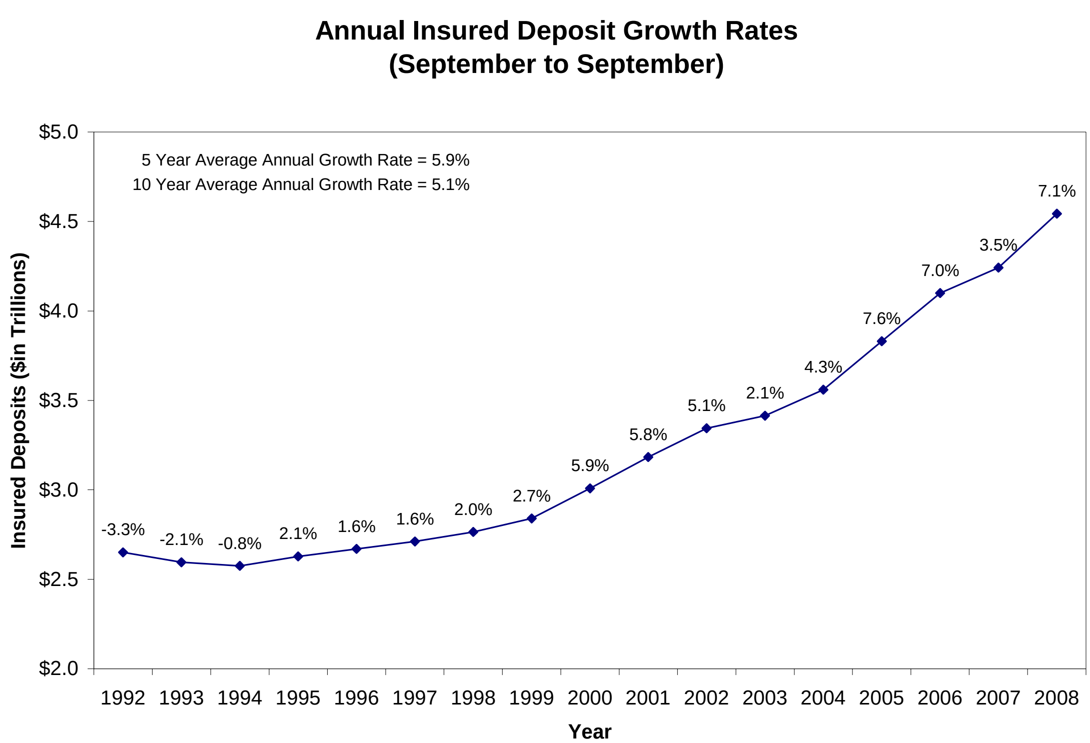
[9] For 2008, 2009 and 2010, credits may not offset more than 90 percent of an institution's assessment. Section 7(e)(3)(D)(ii) of the Federal Deposit Insurance Act (12 U.S.C. 1817(e)(3)(D)(ii)).

The staff projects that the 7 basis point uniform increase in rates for the first quarter of 2009 will result in first quarter assessment revenue of just over $2.3 billion, about $1.2 billion more than in the absence of a rate increase. The staff derived its assessment revenue projections by assigning each insured institution an assessment rate based on the current rate schedule for the fourth quarter and the recommended rate schedule for the first quarter of next year. It then adjusted each institution's assessments for any remaining credits. For the fourth quarter of 2008, the staff estimated an industry average rate of approximately 6.4 basis points, increasing to approximately 13.4 basis points in the first quarter of 2009.

<u>Estimated Insured Deposits</u>

The staff believes that it is reasonable to plan for annual insured deposit growth of between 5 and 6 percent through the first quarter of next year. Over the 12 months ending September 30, 2008, estimated insured deposits increased by 7.1 percent.[10] However, the most recent 5 and 10-year averages are about 6 percent and 5 percent, respectively. Chart 1 depicts insured deposit growth rates since 1992.

Chart 1



[10] Estimated insured deposits do not include those resulting from the temporary coverage limit increase to $250,000 under the Emergency Economic Stabilization Act of 2008, or those non-interest bearing transaction deposits covered by the Temporary Liquidity Guarantee Program.

Projections of insured deposits are subject to considerable uncertainty. Insured deposit growth over the near term could continue to rise at the more rapid pace observed in the third quarter (1.8 percent quarterly rate, or 7.2 percent annualized) due to a “flight to quality” attributable to financial and economic uncertainties. On the other hand, as the experience of the late 1980s and early 1990s demonstrated, lower overall growth in the banking industry and the economy could depress rates of growth of total domestic and insured deposits. As Table 2 shows, differences in annualized growth rates of insured deposits over the next couple of quarters will have little effect on the projected reserve ratio in the near term.

<u>Projected Fund Balances, Insured Deposits, and Reserve Ratios</u>

Assuming annualized insured deposit growth of 5 percent through March of next year, projections of the fund income, expenses, and losses, the fund balance, estimated insured deposits, and the reserve ratio are shown below in Table 3.

Table 3
Projected Fund Balance, Estimated Insured Deposits, and Reserve Ratio
Under the Recommended Rates
Assuming 5 Percent Annual Insured Deposit Growth
($ in billions)

	4th Qtr 2008	1st Qtr 2009
Beginning Fund Balance	34.6	28.0
Plus: Net Assessment Revenue	1.0	2.3
Plus: Investment Income	0.3	0.3
Less: Loss Provisions	7.7	1.1
Less: Operating Expenses	0.3	0.3
Ending Fund Balance	28.0	29.1
Estimated Insured Deposits	4,599.5	4,656.0
Ending Reserve Ratio	0.61%	0.63%

Note: Components of fund balance changes may not sum to totals due to rounding.

Effect on Capital and Earnings

The staff analyzed the effect of the recommended rates for the first quarter of 2009 on the capital and earnings of insured institutions. Given the assumptions in the analysis, for the industry as a whole, projected total assessments in the first quarter of 2009 would result in capital that would be 0.12 percent lower than if the FDIC did not charge assessments and 0.04 percent lower than if current assessment rates remained in effect. The recommended assessments would cause three institutions whose equity-to-assets ratio would have exceeded 4 percent in the absence of assessments to fall below that percentage and two institutions to fall below 2 percent. The recommended *increase* in assessments would cause one institution whose equity-to-assets ratio would have exceeded 4 percent under current assessments to fall below that threshold and no institutions to fall below 2 percent equity-to-assets.

For profitable institutions, assessments in the first quarter of 2009 would result in pre-tax income that would be 5.9 percent lower than if the FDIC did not charge assessments and 3.4 percent lower than if current assessment rates remained in effect. For unprofitable institutions, assessments would result in pre-tax losses that would be 4.4 percent higher than if the FDIC did not charge assessments and 2 percent higher than if current assessment rates remained in effect.

COMMENTS RECEIVED ON THE PROPOSAL

The FDIC received comments from three nationwide industry trade groups and a few banks that specifically addressed the 7 basis point increase in assessment rates for the first quarter of 2009. The FDIC also received many comments from banks and others concerning rates for all of 2009 and beyond. Several of them also discussed proposed changes to risk-based pricing methods beginning in the second quarter of 2009.

One of the nationwide industry trade groups criticized the magnitude of the first quarter increase and expressed concern about the pace at which the FDIC would restore the insurance fund. It argued that the proposed assessment rates are too high—especially in the early stages of the Restoration Plan—and questioned why the FDIC does not take advantage of the flexibility that Congress provided to extend the restoration period beyond five years under “extraordinary circumstances.” The trade group argued that the FDIC’s invocation of its systemic risk authority to provide additional guarantees on non-interest bearing transaction deposits and senior unsecured debt is evidence of “extraordinary circumstances.” The group believes that high premiums would restrain credit and run counter to other government efforts designed to stimulate lending. It urged the FDIC to implement a longer recapitalization period, such as six or seven years, and to rely on lower insured deposit growth assumptions to achieve a more moderate increase in rates. The comment letter recommended that the FDIC consider phasing in higher assessment rates and argued that it was counter-intuitive for the proposed minimum rate in the first quarter (12 basis points) to be higher than the proposed minimum rate in the second quarter (10 basis points initially and as low as 8 basis points after adjustments).

Another nationwide industry trade group commenting on the first quarter 2009 rate increase urged the FDIC to adopt a more modest increase in assessment rates and to use its "extraordinary circumstances" authority to extend the restoration period to at least seven years. The comment expressed the view that a smaller rate increase would keep additional funds in local communities for lending to small businesses and consumers during the current period of economic stress.

A third nationwide industry trade group estimated that the proposed 7 basis point assessment rate increase would reduce the banking industry's pre-tax income by 7 percent or more at a time when the industry needs to build its capital. It requested that the FDIC and other bank regulators take steps to reduce losses to the DIF from insured institution failures. To the extent that such efforts to reduce losses succeed, the FDIC should develop a revised plan incorporating lower assessment rates.

One bank specifically discussing the first quarter 2009 proposed assessment rates described the measure as "ill-timed," given current pressures on banks' capital and profitability, and urged the FDIC to implement a more modest increase. Another expressed concern that the increase would make it more difficult for safe and well-managed institutions to meet local credit needs.

As noted before, many comments received from banks and others pertained to the proposed increase in rates for all of 2009 and beyond (as well as proposed changes to risk-based pricing methods). Two comment letters supported the proposed changes to the assessment system, including the increase in premiums. Many commenters made similar points to those of the three industry trade groups. Several comments from banks and from state trade groups opposed any significant increase in assessment rates in the short term because many institutions are struggling to maintain adequate levels of capital and profitability. Several commenters urged the FDIC to withdraw the proposed rule and delay increasing assessment rates and overhauling the assessment system until the end of 2009. They argued that the delay would allow time for a thorough evaluation of the effectiveness of measures recently taken by the Federal government to restore stability to the banking system. One comment asserted that the proposed Restoration Plan penalizes safe and well-run community banks and urged the FDIC to require the largest banks to recapitalize the DIF. Finally, several comments urged the FDIC to invoke its "extraordinary circumstances" authority to extend the time period to rebuild the DIF from five to at least ten years. By lengthening the restoration period, the FDIC could keep assessments at a more moderate level, thereby reducing the burden on institutions during stressful periods.

The staff agrees with comments that significant increases in deposit insurance premium rates in times of economic and financial stress are not desirable. Indeed, the FDIC sought for several years legislative reforms that would allow it to charge every insured institution a risk-based premium regardless of the level of the reserve ratio, and to have the ability to let the fund rise under good economic conditions in order to have room to decline under adverse conditions without needing to sharply increase premium rates. The reforms sought by the FDIC became law in February 2006, and most of the implementing regulations became effective at the start of 2007. However, the one-time assessment credits granted to over 80 percent of the industry did not enable the fund to earn significant new revenue last year, resulting in only a 1 basis point increase in the reserve ratio during all of 2007. Thus, the insurance fund was unable to increase sufficiently to prevent the increase in failures this year from causing the reserve ratio to fall below the 1.15 percent lower bound established by Congress. While Congress gave the FDIC new flexibility to manage the fund, it prescribed limits on how much the reserve ratio could decline, requiring the FDIC to implement a Restoration Plan to increase the fund to at least 1.15 percent generally within five years. In the staff's view, higher premiums are necessary to meet this statutory requirement.

As the trade groups and many other commenters noted, the law does allow FDIC to take longer than five years for the reserve ratio to reach 1.15 percent FDIC due to "extraordinary circumstances." The staff recognizes the current severe strains on banks and financial system. The FDIC's Temporary Liquidity Guarantee Program (TLGP) is part of a coordinated effort by the government -- including the Treasury Department's Troubled Assets Relief Program (TARP) and the Federal Reserve's Commercial Paper Funding Facility – to stabilize the financial system and provide much needed liquidity. However, in the staff's view, it would be premature to conclude at this time that extraordinary circumstances should warrant extending the Restoration Plan horizon beyond five years. There is considerable uncertainty about future insurance fund losses and insured deposit growth. Under the Restoration Plan published in October, the staff will update its projections at least semiannually while the plan is in effect and adjust rates as necessary. As the staff updates its projections to account for changing conditions, it could also recommend to the Board that it consider whether it is appropriate to adjust the time frame for reaching the 1.15 percent target due to extraordinary circumstances.

While higher deposit insurance premiums next year will result in lower industry earnings than would otherwise be the case, the staff believes that the coordinated efforts by the Treasury, Federal Reserve, and FDIC to expand banking system liquidity will help enable banks to increase lending to communities and businesses.

Finally, if Congress did not enact the reforms in 2006 that FDIC had sought, the FDIC would have to increase the reserve ratio to 1.25 percent within one year or charge an average rate on assessable deposits of at least 23 basis points. Banks and thrifts, in fact, did pay a minimum of 23 basis points in the early 1990s to rebuild the insurance funds.[11] The first quarter 2009 rates adopted in the final rule are significantly lower – most banks will be charged an annual rate between 12 and 14 basis points.

<u>Administrative Procedures Act</u>

The final rule setting assessment rates for the first assessment period of 2009 will become effective on January 1, 2009. In this regard, the FDIC invokes the *good cause* exception to the requirements in the Administrative Procedure Act that, once finalized, a rulemaking must have a

[11] The insurance funds were the Bank Insurance Fund and Savings Association Insurance Fund. The funds were merged in 2006.

delayed effective date of thirty days from the publication date.[12] The FDIC has determined that good cause exists for waiving the customary 30-day delayed effective date.

[12] 5 U.S.C. § 553(d)(3).

Staff Contacts

Division of Insurance and Research:

Matthew Green
Chief, Fund Analysis and Pricing Section
(202) 898-3670

Legal Division:

Christopher Bellotto
Counsel
(202) 898-3801

Attachments