



November 3, 2003

**MEMORANDUM TO:** The Board of Directors

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

**SUBJECT:** SAIF Assessment Rates for the First  
Semiannual Assessment Period of 2004

**Recommendation**

The staff recommends that the Board maintain the existing Savings Association Insurance Fund (SAIF) assessment rate schedule of 0 to 27 basis points (bp)<sup>1</sup> per year. This rate schedule complies with the statutory requirements of the Federal Deposit Insurance Act for the Board to establish a risk-based assessment system and set assessments only to the extent necessary to maintain the SAIF at the DRR of 1.25 percent.

Concur:

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William F. Kroener, III  
General Counsel

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<sup>1</sup> Although the current effective rate schedule is 0 to 27 basis points, the base rate schedule, established in 1995, is still 4 to 31 basis points. The FDIC may alter the existing rate structure and may change the base SAIF rates by rulemaking with notice and comment. Without a notice-and-comment rulemaking, the Board has authority to increase or decrease the effective rate schedule uniformly up to a maximum of 5 bp, as deemed necessary to maintain the target DRR.

## **Summary**

Staff believes that the SAIF reserve ratio will remain above the DRR throughout the assessment period. Therefore, staff recommends maintaining the existing assessment rate schedule. Based on June 30, 2003, data and projected ranges for the relevant variables at June 30, 2004, this rate schedule would result in an average annual assessment rate of approximately 0.12 bp.

Staff has considered a range of plausible events that could produce significant movements in the SAIF reserve ratio. We have continued to refine the methodology introduced in the previous assessment rate case. Our methodology provides ranges for estimated insurance losses that are primarily based on estimated changes to the contingent liability for anticipated failures (contingent loss reserve); changes in both interest income and in the market value of available-for-sale (AFS) securities resulting from changes in interest rates; and growth of insured deposits.

## **ANALYSIS**

In setting assessment rates since the recapitalization of the SAIF, the Board has considered: (1) the probability and likely amount of loss to the fund posed by individual insured institutions; (2) the statutory requirement to maintain the fund at the DRR, currently 1.25 percent, and (3) all other relevant statutory provisions.<sup>2</sup>

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<sup>2</sup> The Board is required to review and weigh the following factors when establishing an assessment schedule: a) the probability and likely amount of loss to the fund posed by individual institutions; b) case resolution expenditures and income; c) expected operating expenses; d) the revenue needs of the fund; e) the effect of assessments on the earnings and capital of fund members; and f) any other factors that the Board may deem appropriate. These factors directly affect the reserve ratio prospectively and thus are considered as elements of the requirement to set rates to maintain the reserve ratio at the target DRR.

## **Projections for the SAIF Reserve Ratio over the Next Assessment Period**

Staff's best estimate for the SAIF reserve ratio as of June 30, 2004 is 1.37 percent. The lower and upper bounds of the likely range for the SAIF reserve ratio as of June 30, 2004 are 1.31 percent to 1.42 percent, respectively.

The following is an analysis of the anticipated effect of changes in the fund balance and the rate of insured deposit growth on the reserve ratio as of June 30, 2004.

### **1. Fund Balance**

Staff evaluates three significant inputs in estimating changes to the fund balance. First, staff estimates the impact of probable insurance losses, which are primarily losses from failed institutions. Second, staff estimates the amount of interest income that the fund will receive during the year. Third, staff projects the level of unrealized gains and losses on available-for-sale (AFS) securities that will be present at the end of the period.

#### **A. Insurance Losses**

Insurance losses primarily consist of two components: a contingent liability for anticipated failures (contingent loss reserve) and an allowance for losses on institutions that have already failed. The Financial Risk Committee (FRC) recommends the amount of the contingent loss reserve each quarter, and this recommendation represents the FRC's best estimate of SAIF losses from potential institution failures. It reflects the staff's view of those potential losses that are "probable and estimable," as required by generally accepted accounting principles. Actual results could differ from these estimates. As of June 30, 2003 the SAIF loss reserve stood at \$26 million. The SAIF loss reserve declined to \$2 million as of September 30, 2003.

Staff estimates a likely range of insurance losses based on projected changes in the contingent loss reserve. Several factors drive changes in the contingent loss reserve for the twelve months ending June 30, 2004. These factors include: (1) the shifting of problem institutions among different risk categories within the reserve, (2) the movement of institutions out of the reserve due to improved financial conditions, mergers, or failures, and (3) the addition of new problem institution assets to the reserve. To capture the effects of these changes, staff estimates the probabilities of institutions moving within categories, entering, or leaving the contingent loss reserve. These probabilities are based on the recent history of changes to the reserve. Other factors driving changes in the contingent loss reserve are changes in expected failure rates and changes in rates of loss given failure. For purposes of this nine-month estimation of the contingent loss reserve, staff assumes that failure and loss rates remain constant through the period.

Table 1 shows the range of potential loss provisions based on changes in the contingent loss reserve, adjustments for net losses/recoveries due to the resolution of closed institutions, adjustments for litigation losses, and adjustments for other contingencies.

**Table 1**  
**Potential Provisions and Adjustments for Loss Allowances**  
**For the Twelve Months Ending June 30, 2004**

	<b>Low Estimate</b>	<b>Best Estimate</b>	<b>High Estimate</b>
Provision Related to Future Failures (1)	\$75 million	(\$4 million)	(\$24 million)
Adjustment for Closed Institutions' Net Recoveries (2)	\$14 million	\$0	(\$14 million)
Adjustment for Litigation Losses (3)	\$3 million	\$0	(\$3 million)
<b>Potential Provision for Losses</b>	<b>\$92 million</b>	<b>(\$4 million)</b>	<b>(\$41 million)</b>

*Notes:*

- (1) Includes provisions required to account for the differences between the actual balance of the contingent loss reserve on June 30, 2003 (\$26 million) and the June 30, 2004, balance estimated by statistical analysis. Changes in the contingent loss reserve occur from reductions in reserves after failures, reductions in reserves from improvement in problem institutions' conditions, and additions of reserves due to problem institutions' deterioration.
- (2) Assumes a range of -5% to +5% of the estimated net recovery value of resolutions, \$288 million as of December 31, 2002.
- (3) Based on the standard deviation of changes in the contingent liability for litigation losses for the period 1998 to 2002.

Staff believes that the range provided by the statistical analysis adequately represents the most likely range of additional provisions needed to cover insurance losses from future failures. However, the bounds of this range do not represent "best case" and "worst case" scenarios, and larger or smaller provisions could occur.

Staff believes that subprime lending continues to be the most likely source of near-term losses to the insurance funds. Subprime lending has been a significant factor in 28 percent of failures since 1997. While the number of subprime lenders and dollar volume of subprime loans have declined from 2000 levels, the percentage of "problem" subprime lenders to total subprime lenders has increased during the same period.

Staff continues to monitor the potential effects of higher interest rates on the bank and thrift industries. Rising interest rates have the potential to adversely affect some insured institutions through net interest margin compression, a substantial decline in the mortgage origination volume, and unrealized and realized losses on their security holdings. Institutions

most sensitive to an upward movement in interest rates include mortgage lenders and other institutions with a high percentage of fixed-income assets in their portfolio. However, these institutions generally appear to have adequate capital to sustain a substantial decline in net interest margins that is comparable to 1993-95 experience.

Commercial real estate loan loss rates remain at historical lows. However, insured institutions with high exposure to commercial real estate loans may experience an increase in credit risk associated with persistent weak fundamentals in the commercial real estate and the rising debt service burden and lower property values that may result from rising interest rates. Newer banks and thrifts and those in certain geographic areas are more vulnerable to deterioration in the commercial real estate loans than other insured institutions; however, insured institutions in general appear to be well positioned to withstand a significant stress in their commercial real estate portfolio.

Based on these findings, combined with signs of improving overall economic conditions, staff believes that current industry trends do not foreshadow widespread deterioration in the bank and thrift industries.

## **B. Interest Income and Unrealized Gains and Losses on AFS Securities**

Staff relied upon expert forecasts as detailed in the *Blue Chip Financial Forecasts* to develop interest rate projections and analyze the potential effect of changes in interest rates on interest income and unrealized gains and losses on AFS securities. The forecasts defined as our “best estimate” were the consensus forecasts through the second quarter of 2004 as detailed in the September issue of the *Blue Chip Financial Forecasts*. Adopting the experts’ consensus forecasts also allows for forecasted yield curves that change in shape over time.

Along with forecasting yield curves based upon the experts' forecasts, staff also calculated bounds within which interest rates are likely to fall using the historical differences between the experts' forecasts and the actual interest rates. These bounds vary over the assessment period and change in shape over time, as opposed to being parallel shifts in rates. The bounds are consistent with the notion that the projections represent the most likely scenarios and that the actual rates may be above or below the projections. In general, the projections indicate stable or slightly rising rates for the period under consideration. The lower (upper) bound generally reflects rates that are as much as one percentage point lower (higher) than current rates, with the range increasing over time. Charts showing the projected rates, upper bound, and lower bound are included as an appendix to the BIF assessment rate case.

Table 2 shows projections for the low, best, and high estimates for interest income and unrealized gains and losses on AFS securities using the forecast rates and the bounds. Because of the significant percentage of AFS securities held in the insurance fund portfolio at this time, when interest rates change, the magnitude of the resulting change in market value of these securities dominates the effect of changes in interest income.

**Table 2**  
**Potential Changes in Interest Income and**  
**Unrealized Gains (Losses) on AFS Securities**  
**June 30, 2003 to June 30, 2004 (\$ in millions)**

	<b>Low Estimate (1)</b>	<b>Best Estimate (1)</b>	<b>High Estimate (1)</b>
Interest Income	590	584	577
Unrealized Gain (Loss) on AFS Securities (2)	(217)	(139)	(60)

*Notes:*

- (1) The Low Estimate is calculated using upper bound interest rates, the Best Estimate is calculated using the projected rates, and the High Estimate is calculated using the lower bound rates. Net estimated failure resolution outlays equal \$105 million for the Low Estimate and \$0 for both the Best Estimate and the High Estimate.
- (2) Includes actual unrealized gains on AFS securities for the period July 1, 2003 through August 31, 2003 and projected gains/losses for the remaining period through June 30, 2004.

Staff does not anticipate dramatic changes in interest rates. Nevertheless, as the remaining maturity of the existing AFS portfolio shortens, previously identified unrealized gains will dissipate. In addition, falling interest rates would be detrimental to interest income in the long term.

### C. Projected Fund Balance.

Table 3 summarizes the effects on the fund balance of the low, best, and high estimates assumed for insurance losses, interest income, and unrealized gains and losses on AFS securities. The projection also assumes that the current assessment rate schedule will remain in effect through June 30, 2004.

**Table 3**  
**Projected Fund Balance (1)**  
(\$ in millions)

	<b>Lower Bound</b>	<b>Best Estimate</b>	<b>Upper Bound</b>
Assessments (2)	13	13	13
Interest Income (3)	590	584	577
Total Revenue	603	597	590
Operating Expenses (4)	150	150	150
Provision for Losses	92	(4)	(41)
Total Expenses & Losses	242	146	109
Net Income	361	451	481
Unrealized Gain (Loss) on AFS Securities (3)	(217)	(139)	(60)
Comprehensive Income (Loss) (5)	144	312	421
Fund Balance – 06/30/03	12,083	12,083	12,083
Projected Fund Balance – 06/30/04	12,227	12,395	12,504

*Notes:*

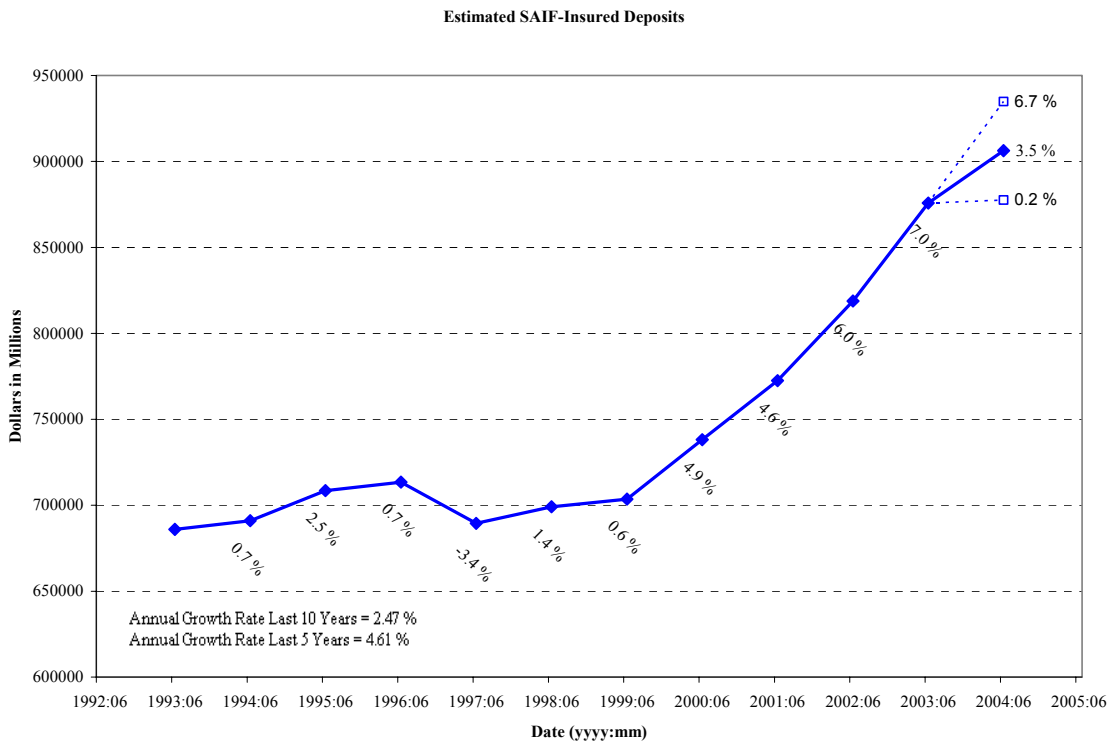
- (1) Projected income and expense figures are for the twelve months ending June 30, 2004.
- (2) Assumes that the current assessment rate schedule remains in effect through June 30, 2004.
- (3) See also Table 2 for an explanation regarding changes in interest revenue and unrealized gain (loss) on AFS securities under these projections.
- (4) Operating expenses for 2003 allocated to the SAIF are estimated based on the FDIC's 2003 budget.
- (5) Comprehensive Income is used instead of Net Income due to the magnitude of the change in market value of AFS securities that occurs with fluctuations in interest rates. See note (3) above.



## 2. Insured Deposits

Since June of 1994, the annual growth rate for SAIF-insured deposits has been as high as 7.0 percent and as low as an annual shrinkage of 3.4 percent (Figure 1). Insured deposits grew 0.7 percent, 2.5 percent, and 0.7 percent annually from June 1994 through June of 1996. After a contraction for the twelve months ending June of 1997 (minus 3.4 percent annual growth) and minimal growth between June of 1998 and June of 1999 (1.4 percent and 0.6 percent annually), insured deposits grew by 4.9 percent, 4.6 percent, 6.0 percent, and 7.0 percent for the twelve months ending June 2000, June 2001, June 2002, and June 2003, respectively. Staff projects that insured deposits will grow at a rate of 3.5 percent in the twelve months to June 30, 2004.

**Figure 1**



It takes approximately \$6.4 billion in insured deposit growth to create a 1 basis point decline in the SAIF reserve ratio, all other things held constant. Based upon the June 30, 2003,

fund balance, it would take about \$91.1 billion in insured deposit growth (10.4 percent) to reduce the reserve ratio to the DRR as of June 30, 2004, all else being equal. Our preliminary estimate indicates that deposit growth over the next year will be far lower than this figure.

Staff developed a statistical model that projects insured deposit growth based upon previous growth in insured deposits and previous and current growth in total deposits. After analyzing the results of this model, the best judgment of the staff is that SAIF-insured deposits are likely to experience a growth rate in the range of +0.2 percent to +6.7 percent between June 2003 and June 2004. This range represents the statistical margin of error in the model.<sup>3</sup> Staff believes the most likely scenario is that insured deposits will grow at the midpoint of this range (3.5 percent) which will bring the total for SAIF insured deposits to \$908 billion. The model estimates future growth rates in insured deposits through historical growth rates in insured and total deposits and, as such, does not explicitly incorporate economic shocks into the model. However, some events that could force insured deposits into the high range of our forecast are a depressed stock market with high volatility as well as monetary expansion. Some events that could force insured deposits into the low range of our forecast are an upturn in the stock market and in the U.S. economy as a whole.

### **3. SAIF Reserve Ratio**

Based on the projected SAIF balance and the growth of the insured deposit base, the best estimate of the SAIF reserve ratio at June 30, 2004, is 1.37 percent (Table 4, next page). The

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<sup>3</sup> The model is a regression model where the current growth rate in insured deposits is estimated as a linear function of the previous growth rate in insured deposits as well as the current and previous growth rates of total (insured and uninsured) deposits. The range (+0.2%, +6.7%) corresponds to a 95% confidence level. In other words, we can be sure with 95% confidence that the actual growth rate in insured deposits, over the year 2003, will lie within this range. The growth rate predicted by the model (thus, the most likely rate) is the midpoint of this range (3.5% annual growth).

best estimate assumes a baseline of a small reversal of loss provisions, stable or slightly rising interest rates, and an insured deposit growth rate of 3.5 percent.

The staff projects the lower bound and upper bound of the likely range to be 1.31 percent and 1.42 percent, respectively (Table 4, next page). The lower bound, which reflects a 7 bp decrease from the June 30, 2003, ratio, assumes a strong increase in the insured deposit base (6.7 percent growth) and a higher interest rate scenario, resulting in a downward adjustment to the fund balance due to a reduction in the aggregate amount of unrealized gains on AFS securities (Table 3). The lower bound also incorporates the high loss estimate for insurance losses from possible near-term failures as projected by staff. The estimate reflects the staff's view of a reasonably possible adverse scenario. It is not intended to represent a "worst case" scenario.

The upper bound produces a 4 bp increase in the reserve ratio at June 30, 2004. This estimate assumes slower growth (0.2 percent) in the SAIF-insured deposit base, the low loss estimate for the provision for losses, and lower interest rates, resulting in a smaller downward adjustment to the aggregate amount of unrealized gains on AFS securities.

**Table 4**  
**Projected SAIF Reserve Ratios**  
(\$ in millions)

	<b>June 30, 2003</b>		
Fund Balance	\$12,083		
Estimated Insured Deposits	\$875,857		
SAIF Ratio	1.38%		
	<b>Lower Bound (1)</b>	<b>Best Estimate (2)</b>	<b>Upper Bound (3)</b>
	<b>June 30, 2004</b>		
Projected Fund Balance	\$12,227	\$12,395	\$12,504
Estimated Insured Deposits	\$935,143	\$907,727	\$880,312
Estimated SAIF Ratio	1.31%	1.37%	1.42%

*Notes:*

- (1) The Lower Bound refers to the scenario of higher loss provisions (Low Estimate in Table 1), higher interest rates (Low Estimate in Table 2), and a higher insured deposit growth rate (+6.7 percent).
- (2) The Best Estimate refers to a baseline scenario of moderate loss provisions (Best Estimate in Table 1), stable or moderately rising interest rates (Best Estimate in Table 2), and the insured deposit growth rate projected by staff (+3.5 percent).
- (3) The Upper Bound refers to the scenario of lower loss provisions (High Estimate in Table 1), moderately declining interest rates (High Estimate in Table 2), and a lower insured deposit growth rate (+0.2 percent).

The entire range depicted in Table 4 is above the DRR. However, staff's best estimate indicates a decline in the reserve ratio. Reasons to believe that the reserve ratio will fall, or at least go no higher, include:

- Interest rates have remained at very low levels throughout 2003, but staff believes rates are unlikely to decline further during the upcoming nine months. The SAIF's unrealized gains on available-for-sale securities will be reduced even in a stable interest rate environment, because such unrealized gains dissipate as securities move closer to their maturity dates. In a rising rate environment, reductions in unrealized gains would accelerate.
- Substantial negative provisions for losses from failures seen in recent quarters are unlikely to continue (the SAIF's contingent loss reserve currently is only \$2 million).
- SAIF insured deposit growth, unlike that for the BIF, has remained relatively high. SAIF insured deposits grew 7.0 percent in the twelve months ending June 30, 2003.

As a result of these factors, staff believes that a stable or slightly declining SAIF reserve ratio is reasonable. However, given that the entire expected range for the SAIF reserve ratio is greater than the DRR of 1.25 percent, staff believes that it is reasonable to maintain the existing SAIF rate schedule.

### **Risk-Based Assessment System.**

Staff recommends retaining the current spread of 27 bp between the assessments paid by the best- and worst-rated institutions as well as the rate spreads between adjacent cells in the assessment rate matrix. The proposed assessment rate schedule appears in Table 5. The Board previously determined that the current rate spreads provide appropriate incentives for weaker

institutions to improve their condition and for all institutions to avoid excessive risk-taking, consistent with the goals of risk-based assessments and existing statutory provisions. The current rate spreads also generally are consistent with the historical variation in institution failure rates across cells of the assessment rate matrix.

**Table 5**  
**Proposed Assessment Rate Schedule**  
**First Semiannual Assessment Period of 2004**  
**SAIF-Insured Institutions**

<b>Capital Group</b>	<b>A</b>	<b>B</b>	<b>C</b>
<b>1. Well</b>	<b>0 bp</b>	<b>3 bp</b>	<b>17 bp</b>
<b>2. Adequate</b>	<b>3 bp</b>	<b>10 bp</b>	<b>24 bp</b>
<b>3. Under</b>	<b>10 bp</b>	<b>24 bp</b>	<b>27 bp</b>

In setting assessment rates to achieve and maintain the reserve ratio at the target DRR, the Board is required to consider the effects of assessments on members' earnings and capital. The estimated annual revenue from the existing rate schedule is \$13 million, which is the same as the annual amount that was projected six months ago. In recommending that the Board maintain this schedule, the staff has considered the impact on thrift earnings and capital of the current rate schedule and found no unwarranted adverse effects.

## The Assessment Base Distribution and Matrix Migration

Table 6 summarizes the current distribution of institutions across the assessment matrix.

**Table 6**  
**SAIF Assessment Base Distribution (1)**  
**Assessable Deposits as of June 30, 2003**  
**Supervisory Subgroup and Capital Groups in Effect July 1, 2003**

<b>Capital Group</b>		<b>A</b>		<b>B</b>		<b>C</b>	
<b>1. Well</b>	Number	1,099	91.4%	82	6.8%	13	1.1%
	Base (\$billion)	1,005	96.4%	35	3.4%	1	0.1%
<b>2. Adequate</b>	Number	4	0.3%	1	0.1%	3	0.2%
	Base (\$billion)	1	0.1%	0	0.0%	0	0.0%
<b>3. Under</b>	Number	0	0.0%	0	0.0%	0	0.0%
	Base (\$billion)	0	0.0%	0	0.0%	0	0.0%

Estimated annual assessment revenue                   \$13 million  
Assessment Base   \$1,042 billion  
Average annual assessment rate (bp)                   0.12 basis points

*Notes:*

(1) "Number" reflects the number of SAIF members (excludes BIF-Oakar institutions). "Base" reflects all SAIF-assessable deposits.

With 98.5 percent of the number of institutions and 99.9 percent of the assessment base in the three lowest assessment risk classifications of "1A," "1B," and "2A," as of July 1, 2003, the current distribution in the rate matrix reflects little fundamental difference from the previous semiannual assessment period. The current distribution reflects a slight increase in the percentage of institutions in the best-rated premium category. Since the previous assessment period, 22 institutions migrated into the "1A" risk classification (Table 7, next page), and 15 institutions migrated out of the "1A" risk classification. Only 103 institutions are currently classified outside of the best risk classification.

**Table 7**  
**SAIF Migration To and From Assessment Risk Classification "1A"**

Institutions entering "1A"	Number	Base (\$billion)
Due to capital group reclassification only	5	2.5
Due to supervisory subgroup reclassification only	17	10.7
Due to both	0	0.0
Total	22	13.2
Institutions leaving "1A"	Number	Base (\$billion)
Due to capital group reclassification only	2	0.7
Due to supervisory subgroup reclassification only	13	1.7
Due to both	0	0.0
Total	15	2.4

*Notes:* The table reflects SAIF-insured institutions that moved in and out of assessment risk classification "1A" from the first semiannual assessment period of 2003 to the second semiannual assessment period of 2003. The numbers only include institutions that were rated in both periods. The table does not reflect other assessment risk classification migrations that are not either to or from "1A."

Overall, the supervisory subgroup component of the risk classification was upgraded since the previous period for 22 institutions with an assessment base of \$11.4 billion and was downgraded for 15 institutions with an assessment base of \$1.8 billion.

### **Other Issues**

**FICO Assessment.** The Deposit Insurance Funds Act of 1996 (Funds Act) separates the Financing Corporation (FICO) assessment from the FDIC assessment, so that the amount assessed on individual institutions by the FICO is in addition to the amount paid according to the SAIF rate schedule. All institutions are assessed the same rate by FICO, as provided for in the Funds Act, and the FICO rate is updated quarterly. The FICO rate for the first quarterly payment in first semiannual assessment period of 2004 will be determined using September 30, 2003 Call Report and Thrift Financial Report data.

## **STAFF CONTACTS**

For information about deposit insurance assessments, please contact Christopher Newbury, Chief, Fund Analysis Section, Division of Insurance and Research, at (202) 898-3504, or Joe DiNuzzo, Counsel, Legal Division (202) 898-7349. For FICO assessment information, please contact Richard Jones, Chief, Deposit Insurance Pricing Section, Division of Insurance and Research, at (202) 898-6592.



Concur:

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John M. Brennan  
Deputy to the Chairman