May 3, 2006

MEMORANDUM TO: The Board of Directors

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

Fred S. Selby
Director
Division of Finance

SUBJECT: Proposed Amendments to Part 327 to Improve The Operational Processes Governing the FDIC's Deposit Insurance Assessment System

Recommendation

Provisions in the Federal Deposit Insurance Reform Act of 2005 and the Federal Deposit Insurance Reform Conforming Amendments Act of 2005 (collectively, the Reform Act) have removed longstanding restraints on the deposit insurance assessment system and granted the FDIC discretion to revamp and improve the manner in which assessments are determined and collected from insured depository institutions. The proposed amendments set forth by staff are intended to make the system react more quickly and more accurately to changes in institutions' risk profiles, and in so doing to eliminate several causes for complaint by insured depository institutions.

The present assessment system assigns an institution's risk classification for a future semiannual period as of a date before the beginning of the period and leaves that assignment in place for the entire period. The proposed revisions, by contrast, would provide for assessment collection after each quarter ends, which would allow for consideration of more current supervisory information. The computation of institutions' assessment bases would change in the following ways: institutions with $300 million or more in assets would be required to determine their assessment bases using average daily deposit balances and the float deduction used to determine the assessment base would be eliminated. In addition, the rules governing unpaid assessments of institutions that go out of business would be simplified; newly insured institutions would be assessed for the assessment period they become insured; prepayment and double payment options would be eliminated; institutions would have 90 days from each quarterly certified statement invoice to file requests for review and requests for revision; and the rules governing quarterly certified statement invoices would be adjusted for a quarterly assessment system and for a three-year record retention period rather than the present five-year period. These recommendations, if adopted by the Board, would become effective on January 1, 2007, except for the use of average daily assessment bases which may be delayed pending appropriate changes to the reports of condition. Staff recommends that

Concur: ________________________
Douglas H. Jones
Acting General Counsel

the Board of Directors authorize publication of the proposed regulations in the Federal Register for a 60-day comment period.

Background

Prior to passage of the Reform Act,[1] the FDIC was statutorily required to set assessments semiannually. The FDIC did so by setting assessment rates and assigning institutions to risk classes prior to each semiannual assessment period. The semiannual assessment was collected in two installments, one near the start of the semiannual period and the other three months into the period, so that, in practice, assessment collection was accomplished prospectively every quarter.

The Reform Act eliminated any requirement that the assessment system be semiannual. The FDIC has been vested with discretion to set assessment rates, classify institutions for risk-based assessment purposes and collect assessments within a system and on a schedule designed to track more accurately the degree of risk to the deposit insurance fund posed by depository institutions.

The risk-based system has been in operation for 13 years. Staff's experience with that system and with approaches and arguments made by institutions that have filed requests for review with the Division of Insurance and Research (DIR) and subsequent appeals to the Assessment Appeals Committee (AAC) have prompted some of the present proposals to revise the FDIC's deposit insurance assessment system. For example, many appeals to the AAC involved assertions by insured institutions that the FDIC's system did not take into account their improved condition quickly enough. The proposed changes to the assessment system will enable the FDIC to make changes to an institution's assessment rate closer in time to changes in the institution's risk profile. The revisions will enhance the assessment process for institutions and eliminate many of the bases for requests for review filed with DIR by insured institutions as well as appeals filed with the AAC.

The amendments to the FDIC's operational processes governing assessments affect Sections 327.1 through 327.8 of Part 327 of the FDIC's regulations.[2] These sections detail the process governing deposit insurance assessment and collection as well

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[1] Federal Deposit Insurance Reform Act of 2005, Pub. L. No. 109-171, 120 Stat. 9; Federal Deposit Insurance Conforming Amendments Act of 2005, Pub. L. No. 109-173, 119 Stat. 3601.

[2] The Reform Act requires the FDIC, within 270 days of enactment, to prescribe final regulations, after notice and opportunity for comment, providing for assessments under section 7(b) of the Federal Deposit Insurance Act. See Section 2109(a)(5) of the Reform Act. Section 2109 also requires the FDIC to prescribe, within 270 days, rules on the designated reserve ratio, changes to deposit insurance coverage, the one-time assessment credit, and dividends. An interim final rule on deposit insurance coverage was published on March 23, 2006. See 71 Fed. Reg. 14629. A notice of proposed rulemaking on the one-assessment credit and a notice of proposed rulemaking on dividends are both being considered by the Board of Directors at the same time as this notice on operational changes to Part 327. Additional rulemakings on the designated reserve ratio and risk-based assessments are expected to be proposed in the near future.

as calculation of the assessment base; risk differentiation and pricing of deposit insurance will be the subject of a separate rulemaking.

Collect Quarterly Assessments in Arrears

Under the present system assessments are collected from insured institutions on a semiannual basis in two installments. The first collection is made at the beginning of the semiannual period; the second collection is made in the middle of the semiannual period.[3] Staff recommends changing this approach to collect assessments in arrears, that is, after the period being insured. The assessment for each quarter would be due approximately at the end of the following quarter, on the specified payment date.[4] The charts below present a comparison of the current and proposed processes.

Current Process

Quarterly Installment	Date of Capital and Supervisory Evaluation	Assessment Base[5]	Invoice Date	Payment Date
First Semiannual Period: January 1 – June 30, 2007				
1	September 30, 2006	September 30, 2006	December 15, 2006	January 2, 2007[6]
2	September 30, 2006	December 31, 2006	March 15, 2007	March 30, 2007
Second Semiannual Period: July 1 – December 31, 2007				
1	March 31, 2007	March 31, 2007	June 15, 2007	June 30, 2007
2	March 31, 2007	June 30, 2007	September 15, 2007	September 30, 2007

[3] In December of 1994, the FDIC modified the procedure for collecting deposit insurance assessments, changing from semiannual to quarterly collection.

[4] Adjustments to prior period invoices will continue to be reflected in invoices for later periods.

[5] That is, the date of the report of condition on which the assessment base is determined.

[6] Under the existing process, December 30, 2006 is the alternate payment date.

Proposed Process

Quarter	Date of Capital Evaluation[7]	Assessment Base[8]	Invoice Date	Payment Date
1	March 31, 2007	March 31, 2007	June 15, 2007	June 30, 2007
2	June 30, 2007	June 30, 2007	September 15, 2007	September 30, 2007
3	September 30, 2007	September 30, 2007	December 15, 2007	December 30, 2007
4	December 31, 2007	December 31, 2007	March 15, 2008	March 30, 2008

Staff recommends that the new rule take effect January 1, 2007. The last deposit insurance collection under the present system (made on September 30, 2006, in the middle of the semiannual period before the new system becomes effective) would represent payment for insurance coverage through December 31, 2006. The first deposit insurance collection under the new system (made on June 30, 2007, at the end of the second quarter under the new system) would represent payment for insurance coverage from January 1 through March 31, 2007. No deposit insurance assessments would be based upon September 30 or December 31, 2006 reported assessment bases. However, institutions would continue to make the scheduled quarterly FICO payments on January 2 and March 30, 2007, using, respectively, these two reported assessment bases. Staff proposes no changes to the way FICO payments are charged or collected.[9]

Generally Accepted Accounting Principles (GAAP) will allow the FDIC to estimate and recognize income in advance of receipt, which will diminish any effect on the Deposit Insurance Fund reserve ratio in the transition between systems.

[7] Staff is proposing that supervisory rating changes would become effective as they occur. The Reform Act requires that the FDIC prescribe regulations providing for assessments. In connection with rulemaking on risk differentiation and assessment rates, staff intends to recommend that the Board propose that an institution's capital evaluation be determined based upon information in its report of condition as of the last day of each quarter.

[8] That is, the date of the report of condition on which the assessment base is determined.

[9] Pursuant to statute and a memorandum of understanding with the Financing Corporation (FICO), the FDIC collects FICO assessments from insured depository institutions based upon quarterly report dates. See 12 U.S.C. 1441(f)(2). FICO payments represent funds remitted to FICO to ensure sufficient funding to distribute interest payments for the outstanding FICO obligations. FICO collections will continue during the transition period and will not be affected by staff's proposals. (The method for determining assessment bases would change for institutions that report average daily assessment bases, but the date of the assessment base on which FICO payments are based would not change.)

Invoices would continue to be presented using FDIC*connect*, and institutions would continue to be required to designate and fund deposit accounts from which the FDIC would make direct debits. Invoices would, as at present, be made available no later than 15 days prior to the payment date on FDIC*connect*. However, the payment dates themselves, in relation to the coverage period, would shift in keeping with the proposal. Collections would be made at or near the end of the following quarter (*i.e.*, June 30, September 30, December 30, and March 30). In this way, the proposed assessment system would synchronize the insurance coverage period with the reporting dates and the institutions' risk classifications.

The FDIC would set assessment rates for each risk classification no later than 30 days before the date of the invoice for the quarter, which would give the Board the option of setting rates before the beginning of a quarter or after its completion. For example, the FDIC could set rates for the first quarter of the year in December of the prior year (or earlier if it so chose) or any time up to May 16 of the following year (30 days before the June 15 invoice date). However, the Board would not necessarily need to continually reconsider or update assessment rates. Once set, rates would remain in effect until changed by the Board. Institutions would have at least 45 days notice of the applicable rates before assessment payments are due.

Staff recommends that the Board invite comment on whether to adopt the proposed system of assessing in arrears or whether to keep the present assessment process of collecting premiums in advance.

<u>Ratings Changes Effective When the Change Occurs</u>

An insured institution at present retains its supervisory and capital group ratings throughout a semiannual period. Any change is reflected in the next semiannual period; in this way, an examination can remain the basis for an institution's assessment rating long after newer information has become available. Staff proposes that any changes to an institution's risk rating be reflected when the change occurs.[10] If an examination (or targeted examination) led to a change in an institution's CAMELS composite rating that would affect the institution's insurance risk classification, the institution's rating would change as of the date the examination or targeted examination began, if such a date existed.[11] Otherwise, it would change as of the date the institution was notified of its rating change by its primary federal regulator (or state authority), assuming in either case that the FDIC, after taking into account other information that could affect the rating, agreed with the classification implied by the examination, or it would change as of the

[10] As discussed in an earlier footnote, staff intends to recommend in another rulemaking that the Board propose that capital evaluations be determined based upon information in reports of condition as of the last day of the quarter. Staff also intends to recommend that, as at present, the FDIC continue to have the discretion to determine an institution's risk rating.

[11] Small institutions generally have an examination start date; very infrequently, however, a smaller bank's CAMELS rating can change without an exam, or there may be no exam start date. Large institutions, on the other hand - especially those with resident examiners - often have no exam start date.

date that the FDIC determines that the change in the supervisory rating occurred.[12] In this way, assessments for prior quarters might increase or decrease if an examination is started during a quarter but not completed until some time after the quarter ends, which could result in institutions being billed additional amounts for earlier quarters or refunded amounts already paid for earlier quarters. Interest as provided at section 327.7 would be charged on additional amounts billed and would be paid on any amounts refunded.

Suppose, for example, that an institution's primary federal regulator began an examination of an institution one month into a quarter. If the examination resulted in an upgrade to the institution's CAMELS composite rating that would affect the institution's risk classification, the institution would obtain the benefit of the improved risk rating for the last two months of the quarter, rather than waiting until the next period. In a similar situation, if the institution were downgraded, the effect would be an increased assessment for the last two months. Staff proposes that this new rule take effect January 1, 2007.

Minor Modifications to the Present Assessment Base

At present, an institution's assessment base is principally derived from total domestic deposits. The current definition of the assessment base is detailed in section 327.5 of the FDIC's regulations. Generally, the definition is deposit liabilities as defined by section 3(*l*) of the Federal Deposit Insurance Act (FDI Act) (12 U.S.C. § 1813(*l*)) with some adjustments. However, because the total deposits that institutions report in their reports of condition do not coincide with the section 3(*l*) definition, institutions report several adjustments elsewhere in their reports of condition; these adjustments are used to determine the assessment base.

For example, banks are specifically instructed to exclude Uninvested Trust Funds from deposit liabilities as reported on Schedule RC-E of their Reports of Income and Condition (Call Reports). However, these funds are considered deposits as defined by section 3(*l*) and are therefore included in the assessment base. Line item 3 on Schedule RC-O of the Call Report was included to facilitate the reporting of these funds. For this line item and for the many others, banks simply report the amount of each item that was excluded from the RC-E calculation. Other line items require the restoration of amounts that were netted for reporting purposes on Schedule RC-E. For example, when banks were instructed to file Call Reports in accordance with Generally Accepted Accounting Principles (GAAP), they were permitted to offset deposit liabilities against assets in certain circumstances. In order to comply with the statutory definition of deposits, lines 12a and 12b were added to Schedule RC-O to recapture those amounts.

Staff recommends retention of the current assessment base as applied in practice with minor modifications. The definition would be reworded in concert with a proposed simplification of the associated reporting requirements on insured institutions' reports of

[12] An examination that began before staff's proposed amendments were implemented (i.e., before January 1, 2007) would be deemed to have begun on the first day of the first assessment period subject to the amendments.

condition.[13] The assessment base definition would continue to be deposit liabilities as defined by section 3(*l*) of the FDI Act with enumerated allowable adjustments. These adjustments would include drafts drawn on other depository institutions, which meet the definition of deposits per section 3(*l*) of the FDI Act but are specifically excluded from the assessment base in section 7(a)(4) of the FDI Act (12 U.S.C. § 1817(a)(4)). Similarly, although depository institution investment contracts meet the definition of deposits as defined by section 3(*l*), they are presently excluded from the assessment base under section 327.5 and would continue to be excluded, as would pass through reserves. Certain reciprocal bank balances would also be excluded. Unposted debits and unposted credits would be excluded from the definition of the assessment base for institutions that report average daily balances because these debits and credits are captured in the next day's deposits (and thus reflected in the averages). For consistency and because they should not materially affect assessment bases, unposted debits and unposted credits would be excluded from the definition of the assessment base for institutions that report quarter end balances. Staff is, however, concerned that excluding unposted credits from the assessment base could lead to manipulation of assessment bases by institutions that report quarter end balances and recommends that the Board request comment on this issue.

The current definition of the assessment base as detailed in section 327.5 has been driven by reporting requirements that have evolved over time. These requirements have changed because of the evolving reporting needs of all of the federal regulators. As a result, the FDIC's regulatory definition of the assessment base has required periodic updates when reporting requirements in reports of condition are changed for other purposes.[14] By rewording the definition of the assessment base to deposit liabilities as defined by section 3(*l*) of the FDI Act with allowable exclusions, the FDIC will not be required to update its regulation periodically in response to outside factors.

Staff recommends that the new rule take effect on January 1, 2007.

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[13] At present, 26 items are required in the Reports of Condition and Income (Call Reports) to determine a bank's assessment base and 11 items are required in the Thrift Financial Report (TFRs) to determine a thrift's assessment base. Staff intends to recommend changes to the way the assessment base is reported that could reduce these items to as few as two. Essentially, instead of starting with deposits as reported in the report of condition and making adjustments, banks would start with a balance that approximates the statutory definition of deposits. Staff believes that this balance is typically found within most insured institutions' deposit systems. In this way, institutions would be required to track far fewer adjustments. In any case, this approach should impose no additional burden on insured institutions since the items required to be reported would remain essentially the same under the revised regulatory definition. The changes to reporting requirements should also allow institutions to report daily average deposits more easily, since they will not have to track and average adjustment items separately. As now, the Call Report and TFR instructions would continue to specify the items required to meet the requirements of section 3(*l*) for reporting purposes. Staff intends to propose that appropriate changes to reports of condition become effective March 31, 2007 and will coordinate with the Federal Financial Institutions Examination Council (FFIEC) on the necessary changes to the reports of condition.

[14] In fact, the regulatory definition has not kept pace with these reporting changes. In practice, however, the assessment base is calculated as if the regulatory definition had kept pace.

Staff recommends eliciting comment on whether this proposal should be adopted or whether the current regulatory language and regulation should remain in place.

Average Daily Deposit Balance for Institutions with $300 Million or More in Assets

Currently, an insured institution's assessment base is computed using quarter-end deposit balances. Most schedules of the Call Report and the TFR are based on quarter-end data, but there are drawbacks to using quarter-end balances for assessment determinations. Under the current system, deposits at quarter-end are used as a proxy for deposits for an entire quarter, but balances on a single day in a quarter may not accurately reflect an institution's typical deposit level. For example, if an institution receives an unusually large deposit at the end of a quarter and holds it only briefly, the institution's assessment base and deposit insurance assessment may increase disproportionately to the amount of deposits it typically holds. A misdirected wire transfer received at the end of a quarter can create a similar result. Using quarter-end balances creates incentives to temporarily reduce deposit levels at the end of a quarter for the sole purpose of avoiding assessments. Institutions of various sizes have raised these issues with the FDIC.

Instead of using quarter-end deposits, therefore, staff recommends using average daily balances over the quarter, which should give a more accurate depiction of an institution's deposits. This recommendation, when combined with the staff's previous recommendations, will provide a more realistic and timely depiction of actual events.

Institutions do not at present report average daily balances on Call Reports and TFRs. Reporting average assessment bases will therefore necessitate changes to Call Reports and TFRs requiring the approval of FFIEC and time to implement. Until these changes to the Call Report and TFR are made, staff recommends continuing to determine assessment bases using quarter end balances.

In addition, for one year after the necessary changes to the Call Report and TFR have been made, staff recommends giving each existing institution the option of using average balances to determine its assessment base. Thereafter, institutions with $300 million or more in assets would be required to report average daily balances. To avoid burdening smaller institutions, which might have to modify their accounting and reporting systems, existing institutions with less than $300 million in assets would continue to be offered the option of using average daily balances to determine their assessment bases.[15]

If its assessment base were growing, a smaller institution would pay smaller assessments if it reported daily averages rather than quarter-end balances, all else equal.

[15] In those instances where a parent bank or savings association files its Call Report or TFR on a consolidated basis by including a subsidiary bank(s) or savings association(s), all institutions included in the consolidated reporting must file in the same manner. For example, if the parent bank submits a consolidated Call Report and must report daily averages on the Call Report, then all subsidiary banks that have been consolidated must also report daily averages on their respective Call Reports. Each institution's daily averages must be determined separately.

Nevertheless, a smaller institution that elected to report quarter-end balances could continue to do so, so long as its assets, as reported in its Call Report or TFR did not equal or exceed $300 million in two consecutive reports. Otherwise, the institution would be required to begin reporting average daily balances for the quarter that begins six months after the end of the quarter in which the institution reported that its assets equaled or exceeded $300 million for the second consecutive time. An institution with less than $300 million in assets would be allowed to switch from reporting quarter-end balances to reporting average daily balances for an upcoming quarter.

Any institution, once having begun to report average daily balances, either voluntarily or because required to, would not be allowed to switch back to reporting quarter-end balances. Any institution that becomes insured after the necessary modifications to the Call Report and TFR have been made would be required to report average daily balances for assessment purposes.

Eliminate the Float Deduction

The largest overall adjustments to the current assessment base are deductions for float, deposits reported as such for assessment purposes that were created by deposits of cash items (checks) for which the institution has not itself received credit or payment. These deductions are currently a 16 ⅔ percent float deduction for demand deposits and a 1 percent float deduction for time and savings deposits. Two basic rationales exist for allowing institutions to deduct float. First, without a float deduction, institutions would be assessed for balances created by deposits of checks for which they had not actually been paid. Second, crediting an uncollected cash item (a check) to a deposit account can temporarily create double counting in the aggregate assessment base - once at the institution that credited the cash item to the deposit account, and again at the payee insured institution on which the cash item is drawn. Deducting float from deposits when calculating the assessment base reduces this double counting.

Before 1960, institutions computed actual float and deducted it from deposits when computing their assessment bases. This proved to be onerous at the time. In 1960, Congress by statute established the standardized float deductions in an effort to simplify and streamline the assessment-base calculation. Section 7(b) of the FDI Act defined the deposit insurance assessment base until passage of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which removed the statutory definition. Since then, the FDIC's regulations alone have defined the assessment base. The current definition, at section 327.5, generally tracks the former statutory definition.

The basis for the percentages chosen by Congress is not clear. Even if the percentages were a realistic approximation of average bank float when they were selected over 40 years ago, legal, technological and payment systems changes - such as Check 21

- that have accelerated check clearing should have reduced float, everything else equal, and made the existing standard float deductions obsolete, at least in theory.[16]

The FDIC does not collect information on actual float from institutions. However, commercial banks and FDIC-supervised savings banks that have $300 million or more in total assets or that have foreign offices report an item on the Call Report called "Cash items in process of collection." This item appears to include actual float, but includes other amounts as well.[17]

Cash items in the process of collection as a percent of domestic deposits for commercial banks with total assets greater than or equal to $300 million has been decreasing. Over the long term, the ratio of cash items to total domestic deposits has fallen significantly, as Table 1 illustrates:

Table 1—Ratio of Cash Items to Total Domestic Deposits[18]

Year-End	Cash Items as a Percent of Total Domestic Deposits
1985	7.35
1990	5.19
1995	4.97
2000	4.18
2005	2.93

Staff recommends that the Board propose eliminating the float deductions on the grounds that, based on available information, the standard float deductions appear to be obsolete and arbitrary, actual float appears to be small and decreasing as the result of legal, technological and payment systems changes, and requiring institutions to calculate actual float would appear to increase regulatory burden.

Eliminating the float deductions would favor some institutions over others. Institutions with larger percentages of time and savings deposits would see the least

[16] Congress enacted Check 21 on October 28, 2004. Check 21 allows banks to electronically transfer check images instead of physically transferring paper checks. The Federal Reserve Board, What You Should Know About Your Checks, http://www.federalreserve.gov/pubs/check21/shouldknow.htm (updated Feb. 16, 2005). As a result, the transmission and processing of electronic checks can be done faster than transferring paper checks through the clearing process. A recent Federal Reserve payment survey indicates that, for the first time, bank-to-bank electronic payments have exceeded payments by check. Treasury and Risk Management, Just Another Step Along the Way to a Checkless Economy, www.treasuryandrisk.com, September 2005. With Check 21, the volume of paper checks processed is expected to continue to decline with more payments processed electronically resulting in a smaller float.

[17] For example, this item includes, among other things: (1) redeemed United States savings bonds and food stamps; and (2) brokers' security drafts and commodity or bill-of-lading drafts payable immediately upon presentation in the U.S. The full Call Report instructions for "Cash items in process of collection" are included in Attachment A.

[18] Table 1 includes all Call Report filers with $300 million or more in assets.

increase in their assessment bases; conversely, those with large percentages of demand deposits would see the greatest increases in their assessment bases. However, eliminating the float deductions would only minimally affect the relative distribution of the aggregate assessment base among institutions of different asset sizes and between banks and thrifts (although it would have a greater effect on the assessment bases of some individual institutions).[19] While eliminating the float deductions would increase assessment bases and affect the distribution of the assessment burden among institutions, it should not, in itself, increase assessments. The assessment rates that staff will propose in the new pricing system will take into account the elimination of the float deduction.

Based upon available information, staff recommends eliminating the float deduction, with the new rule taking effect on January 1, 2007. However, in light of the alternatives discussed below, staff believes that comment would be particularly helpful in evaluating this proposal, especially on how much float remains, how accurate the present float deductions are, and how burdensome calculation of actual float would be. Thus, staff recommends seeking comment on the following two alternatives, as well as on the proposal to eliminate the float deduction.

Deduct Actual Float

One alternative to eliminating the float deduction would be to deduct actual float to determine the assessment base.[20] While legal, technological and payment systems changes that have accelerated check clearing appear to have reduced float, there is evidence that actual float has not been completely eliminated as indicated in Table 1 above.

Deducting actual float rather than the standard float deductions to arrive at the assessment base would favor some institutions over other institutions. Institutions with float percentages on demand deposits that exceed 16 ⅔ percent would have a larger assessment base deduction than they currently have. Institutions with float percentages on demand deposits less than 16 ⅔ percent would have a smaller assessment base deduction than they currently have.

The smallest banks (and all savings associations, which file TFRs) do not report cash items in process of collection separately. All other banks separately report cash

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[19] See Attachment B for further analysis of the effect of eliminating the float deductions.

[20] One possible basic definition of actual float would be limited to the actual amount of cash items in process of collection: (1) included in the assessment base; and (2) for which the institution has not been paid. As soon as an institution received payment or credit for a cash item, the item would no longer be eligible for the float deduction. A variation on this definition would limit float to cash items in process of collection: (1) included in the assessment base; (2) due from another insured depository institution, a clearinghouse, or the Federal Reserve System; and (3) for which the institution has not been paid. A third alternative would be similar to the second alternative except that the actual amount of cash items in the process of collection would have to be credited to customer deposit accounts. Other definitions are possible and any definition adopted would probably be complex. Comments are particularly sought on the definition that should be used if actual float were deducted in determining the assessment base.

items in process of collection, and among these banks the assessment bases of medium-sized banks would, as a whole, increase by the greatest percentage if institutions deducted actual float rather than 16 ⅔ percent. It appears unlikely that using actual float would result in a major change in the relative distribution of the aggregate assessment base among institutions of different sizes, at least among the medium to largest institutions. However, staff has no proxy for actual float at smaller banks or for Office of Thrift Supervision (OTS) supervised savings institutions of any sizes, and thus cannot estimate the distributional effects on these institutions as a group.[21]

Deducting actual float rather than the standard float deductions to arrive at the assessment base would require that institutions report actual float. Institutions that determine their assessment base using average daily balances would be required to report average daily float. This would necessitate a new information requirement for float data.[22] Before 1960, institutions computed actual float and deducted it from deposits when computing their assessment bases. Because this proved to be onerous at one time, Congress established the standardized float deductions by statute. Asking institutions to again report actual float could create significant regulatory burden. In addition, if actual float were deducted, institutions that report their assessment bases using average daily balances would be required to report their float deduction the same way.

Retain the Existing Float Deduction

Staff considered retaining the current float deduction. The current deduction has largely been in place for over 40 years and is well known. This option would impose no conversion costs and would neither increase nor decrease record keeping or reporting costs at present.[23] Current standardized float deductions, however, probably do not reflect real float for most institutions.

Modify the Terminating Transfer Rule.

At present, complex rules apply to terminating transfers to ensure that the assessment of a terminating institution is paid.[24] Determining and collecting assessments

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[21] See Attachment B for further analysis of the effect of deducting actual float.

[22] The Call Report item "Cash items in process of collection" could not be used to determine the actual float deduction for individual institutions. Because "Cash items in process of collection" contains items other than float, it may overstate actual float. For a few institutions, "Cash items in process of collection," exceeds the institutions' assessment bases. (These institutions' "Cash items" are not included in the approximation of actual float in the text.) Conversely, given the small size of the "Cash items in process of collection" reported by many institutions, this item may understate float at some institutions.

[23] For assessment base reporting, the FDIC would need to retain a breakout of demand deposits and time and savings deposits.

[24] Generally speaking, a *terminating transfer* occurs when an institution assumes another institution's liability for deposits—often through merger or consolidation—when the terminating institution essentially goes out of business. Neither the assumption of liability for deposits from the estate of a failed institution nor a transaction in which the FDIC contributes its own resources in order to induce a surviving institution to assume liabilities of a terminating institution is a terminating transfer.

after the end of each quarter and using average daily assessment bases make these complex rules obsolete and unnecessary. An acquiring institution (or institutions) would remain liable for the assessment owed by a terminating institution, but the assessment base of the disappearing institution would be zero for the remainder of the quarter after the terminating transfer.

The proposed terminating transfer provision would deal with a few remaining situations. When a terminating transfer occurs, if the terminating institution does not file a report of condition for the quarter in which the terminating transfer occurred or for the prior quarter, calculation of its quarterly certified statement invoices for those quarters would be based on its assessment base from its most recently filed report of condition. For the quarter before the terminating transfer occurred, the acquired institution's assessment premium would be determined using its rate, but for the quarter in which the terminating transfer occurs, the acquired institution's assessment premium would be pro rated according to the portion of the quarter in which it existed and assessed at the rate of the acquiring institution.

Under the proposal, once institutions begin reporting average daily deposits, the average assessment base of the acquiring institution will properly reflect the terminating transfer and will increase after the terminating transfer. For an acquiring institution that does not report average daily deposits, however, staff proposes that its assessment base as reported at the end of the quarter be reduced to reflect that the acquiring institution did not hold the acquired institution's assessment base for the full quarter. Thus, for example, suppose an institution that reports end-of-quarter balances acquires another institution by merger one month (one-third of the way) into a quarter. The acquiring institution's assessment base for that quarter would be decreased by one-third of the acquired institution's assessment base.

Staff recommends that these amendments go into effect January 1, 2007.

Assess Newly Insured Institutions for the Quarter They Become Insured

At present, a newly insured institution is not liable for assessments for the semiannual period in which it becomes insured, but is liable for assessments for the following semiannual period. The institution's assessment base as of the day before the following semiannual period begins is deemed to be its assessment base for the entire semiannual period. These special rules are needed because, at present, assessments are based upon assessment bases that an institution has reported in the past. A newly insured institution reports an assessment base at the end of the quarter in which it becomes insured but that assessment base is not used to calculate its assessment until the following semiannual period. Further, if an institution becomes insured in the second half of a semiannual period, it will have no reported assessment base on which to calculate the first installment of its premium for the next semiannual period.

Under staff's proposals, each quarterly assessment will be based upon the assessment base that an institution reports at the end of that quarter. Thus, a newly insured institution will have reported an assessment base for the quarter in which it becomes insured and the special assessment rules for newly insured institutions will no longer be needed. Staff recommends that the special assessment rules for newly insured institutions be eliminated and that the normal rules for determining assessment bases apply to newly insured institutions.

Staff recommends that this new rule go into effect January 1, 2007.

Allow 90 Days Each Quarter to File a Request for Review or Request for Revision

The current deadline for an institution to request a review of its assessment risk classification is 90 days from the invoice date for the first quarterly installment of a semiannual period. Under staff's proposal, each quarterly assessment will be separately computed in the future. Consequently, a conforming change is needed to the rules for requesting review, so that institutions would have 90 days from the date of each quarterly certified statement invoice to file a request for review. Institutions would also have 90 days from the date of any subsequent invoice that adjusted the assessment of an earlier assessment period to request a review.

A parallel amendment would be made so that requests for revision of an institution's quarterly assessment payment computation would be made within 90 days of the quarterly assessment invoice for which revision is requested (rather than the present 60 days).

Staff recommends that these amendments go into effect January 1, 2007.

Conforming Changes to Certified Statement Rules

The Reform Act eliminated the requirement that the deposit insurance assessment system be semiannual and provided a new three-year statute of limitations for assessments. Accordingly, staff proposes to revise the provisions of section 327.2 of the FDIC's regulations to clarify that the certified statement is the quarterly certified statement invoice and to provide for the retention of the quarterly certified statement invoice by insured institutions for three years, rather than five years under the prior law.

Staff recommends that the amended rule take effect January 1, 2007.

Eliminate the Prepayment and Double Payment Options

When the present assessment system was proposed more than 10 years ago, the original quarterly dates for payment of assessments were: March 30, June 30, September 30, and December 30. The FDIC recognized that the December 1995 collection date could present a one-time problem for institutions using cash-basis accounting, since these institutions would, in effect, be paying assessments for five quarters in 1995. The FDIC believed that few institutions would be adversely affected. Soon after the new system was adopted, however, the FDIC began to receive information that more institutions than had originally been identified would be adversely affected by the December collection date. As a result, the FDIC amended the regulation in 1995 to move the collection date to

January 2, but allowed institutions to elect to pay on December 30, thus establishing the prepayment date.

Staff recommends eliminating the prepayment option. With implementation of the revamped assessment system, a transition period will be created in which institutions will not be subject to deposit insurance assessment premiums after the September 30, 2006 payment date until June 30, 2007. Consequently, reestablishing the original December 30 payment date should have no adverse consequences for institutions that use cash-basis accounting. No institution would make more than four insurance payments in calendar year 2006; those using the December 30, 2005 payment date would make only three payments in 2006. All institutions would make four payments annually thereafter. This change will keep all assessment payments within each calendar year.[25]

In addition, insured institutions presently have the regulatory option of making double payments on any payment date except January 2. Under the proposed system, this option would also be eliminated. The double payment option has its origins in the 1995 amendment, when the payment date was modified from December 30, 1995 to January 2, 1996. The double payment option was adopted to provide cash basis institutions the opportunity to pay the full amount of their semiannual assessment premium on December 30 so as to have the complete benefit of this modification. The transition period from September 30, 2006 to June 30, 2007 and four payments annually beginning in 2007 should eliminate the need for the double payment option. Moreover, the FDIC will no longer be charging semiannual premiums.

Staff recommends that these amendments take effect January 1, 2007. Comment on the elimination of the prepayment and double payment options will be sought from insured institutions.

Conclusion

The proposed amendments set forth by staff represent improvements to the deposit insurance assessment process designed to make the system react more quickly and more accurately to changes in institutions' risk profiles, and in so doing to eliminate several causes of complaint by insured depository institutions.

The proposed amendments would provide for assessment collection after each quarter ends and take into account more current supervisory information. With one small exception, institutions' assessment bases would remain unchanged from the present system, but institutions with $300 million or more in assets would determine their assessment bases using average daily deposit balances, while smaller institutions would have the option to do so; and the float deduction used to determine the assessment base would be eliminated. In addition, the terminating transfer rules would be simplified; newly insured institutions would be assessed for the assessment period they become

[25] The allowance for payment on the following business day - should January 2 fall on a non-business day - will be eliminated as well.

insured; 90 days from each quarterly certified statement invoice would be allowed to file requests for review and requests for revision; the rules governing quarterly certified statements would be adjusted for a quarterly system; and prepayment and double payment options would be eliminated as unnecessary. These recommendations, if adopted by the Board, would become effective on January 1, 2007.

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Attachment A
Call Report Instructions for Cash Items in Process of Collection

Cash items in process of collection include:

(1) Checks or drafts in process of collection that are drawn on another depository institution (or on a Federal Reserve Bank) and that are payable immediately upon presentation in the United States. This includes:

  (a) Checks or drafts drawn on other institutions that have already been forwarded for collection but for which the reporting bank has not yet been given credit ("cash letters").

  (b) Checks or drafts on hand that will be presented for payment or forwarded for collection on the following business day.

  (c) Checks or drafts that have been deposited with the reporting bank's correspondent and for which the reporting bank has already been given credit, but for which the amount credited is not subject to immediate withdrawal ("ledger credit" items).

  However, if the reporting bank has been given immediate credit by its correspondent for checks or drafts presented for payment or forwarded for collection and if the funds on deposit are subject to immediate withdrawal, the amount of such checks or drafts is considered part of the reporting bank's balances due from depository institutions.

(2) Government checks drawn on the Treasurer of the United States or any other government agency that are payable immediately upon presentation and that are in process of collection.

(3) Such other items in process of collection that are payable immediately upon presentation and that are customarily cleared or collected as cash items by depository institutions in the United States, such as:

  (a) Redeemed United States savings bonds and food stamps.

  (b) Amounts associated with automated payment arrangements in connection with payroll deposits, federal recurring payments, and other items that are credited to a depositor's account prior to the payment date to ensure that the funds are available on the payment date.

  (c) Federal Reserve deferred account balances until credit has been received in accordance with the appropriate time schedules established by the Federal Reserve Banks. At that time, such balances are considered part of the reporting bank's balances due from depository institutions.

(d) Checks or drafts drawn on another depository institution that have been deposited in one office of the reporting bank and forwarded for collection to another office of the reporting bank.

(e) Brokers' security drafts and commodity or bill-of-lading drafts payable immediately upon presentation in the U.S. (See the Glossary entries for "broker's security draft" and "commodity or bill-of-lading draft" for the definitions of these terms.)

Exclude from cash items in process of collection:

(1) Cash items for which the reporting bank has already received credit, provided that the funds on deposit are subject to immediate withdrawal. The amount of such cash items is considered part of the reporting bank's balances due from depository institutions.

(2) Credit or debit card sales slips in process of collection (report as noncash items in Schedule RC-F, item 5, "Other" assets). However, when the reporting bank has been notified that it has been given credit, the amount of such sales slips is considered part of the reporting bank's balances due from depository institutions.

(3) Cash items not conforming to the definition of in process of collection, whether or not cleared through Federal Reserve Banks (report in Schedule RC-F, item 5, "Other" assets).

(4) Commodity or bill-of-lading drafts (including arrival drafts) not yet payable (because the merchandise against which the draft was drawn has not yet arrived), whether or not deposit credit has been given. (If deposit credit has been given, report as loans in the appropriate item of Schedule RC-C, part I; if the drafts were received on a collection basis, they should be excluded entirely from the bank's balance sheet, Schedule RC, until the funds have actually been collected.)

Attachment B – Additional Float Analysis

Eliminate the Float Deduction

If the standard float deductions were eliminated, holding all else equal, the aggregate assessment base would have increased by about 2.7 percent, as of December 31, 2005. Table 2 illustrates how individual assessment bases would have changed if the standard float deductions were eliminated as of that date. Institutions in Table 2 are ranked by percentage change in their assessment bases, from least change on the left to greatest change on the right. The table shows, for example, that the median (50th percentile) change would have been a 3 percent increase. Table 2 also demonstrates that the assessment bases of the vast majority of institutions would have increased between 1.3 and 6.1 percent, but the assessment bases of a few institutions would have increased by much larger percentages. (The largest change for a single institution would have been a 20 percent increase.)

Table 2—Percentage Increase in Assessment Bases at Various Percentiles If the Current Float Deduction Were Eliminated

Percentile	1	5	10	20	30	40	50	60	70	80	90	95	99
Percent change in assessment base	1.0%	1.3%	1.7%	2.2%	2.6%	2.9%	3.0%	3.5%	3.9%	4.4%	5.2%	6.1%	9.3%

The 100 institutions whose assessment bases would have increased by the greatest percentage include several bankers' banks and trust banks and other banks of many different sizes, but no thrifts or extremely large institutions. Small to medium-sized institutions (including many thrifts) predominate among the 100 institutions whose assessment bases would have increased by the smallest percentage; however, some large institutions are also represented.

Table 3 compares the percentage of the industry aggregate assessment base held by institutions grouped by asset size, with and without float deductions, as of December 31, 2005. Based on this analysis, eliminating the float deductions would only minimally affect the relative distribution of the aggregate assessment base among institutions of different asset sizes (although it would have a greater effect on the assessment bases of some individual institutions).

Table 3—Current Float/No Float Comparison by Institution Asset Size

	All Insured Institutions				
Percentage Share of Industry Assessment Base	Very Small < $100m	Small $100m - $300m	Medium $300m - $1b	Large $1b - $100b	Very Large > $100b
With Float Deduction	2.60%	6.51%	9.24%	37.20%	44.45%
Without Float Deduction	2.62%	6.56%	9.25%	37.18%	44.40%
Percent Change	0.97%	0.75%	0.08%	-0.06%	-0.13%

Table 4 compares the percentage of the industry aggregate assessment base held by charter type (commercial banks versus thrifts), with and without float deductions, as of December 31, 2005. With the current standard float deductions (16⅔ percent for demand deposits, 1 percent for time and savings deposits), institutions that hold a larger percentage of demand deposits—typically, commercial banks—hold a relatively smaller percentage of the aggregate assessment base. Nevertheless, given Table 4, eliminating the float deductions would only minimally affect the relative distribution of the aggregate assessment base between banks and thrifts (although, again, it would have a greater effect on the assessment bases of some individual institutions).

Table 4—Current Float/No Float Comparison by Charter Type

Percentage Share of Industry Assessment Base	Insured Commercial Banks	Insured Savings Institutions
With Float Deduction	82.50%	17.50%
Without Float Deduction	82.63%	17.37%
Percent Change	0.16%	-0.76%

<u>Deduct Actual Float</u>

Using data as of December 31, 2005, Table 5 illustrates how individual assessment bases would have changed if institutions deducted the cash items in process of collection Call Report item as a proxy for actual float. Institutions in Table 5 are ranked by percentage change in their assessment bases, from greatest decrease on the left to greatest increase on the right. The table shows, for example, that the median (50th percentile) change would have been a 1.6 percent increase. Table 5 also demonstrates that the assessment bases of the vast majority of banks would have changed between -1.3 and 4.2 percent. (However, the assessment bases of a few banks would have increased or decreased by much larger percentages.)

Table 5—Percentage Change in Assessment Bases at Various Percentiles If Cash Items (as a Proxy for Actual Float) Were Deducted

Percentile	1	5	10	20	30	40	50	60	70	80	90	95	99
Percent change in assessment base	-5.8%	-1.3%	-0.5%	0.2%	0.7%	1.2%	1.6%	2.0%	2.4%	2.8%	3.5%	4.2%	6.0%

Medium-sized banks predominate among those institutions whose assessment bases would have increased by the greatest percentage. Many large banks are included among the institutions whose assessment bases would have decreased by the greatest percentage.

Again using data from December 31, 2005, Table 6 compares the percentage of the aggregate assessment base held by medium-sized, large, and very large banks (collectively, banks with assets of at least $300 million) under the current standard float deduction and the actual float deduction, using the cash items in process of collection Call Report item as a proxy for actual float. Based on this analysis, it appears unlikely that using actual float would result in a major change in the relative distribution of the aggregate assessment base among institutions of different sizes, at least among the medium to largest institutions. However, the FDIC has no proxy for actual float at smaller banks or for OTS-supervised savings institutions of any size.

Table 6—Comparison of Current Float Deduction to Cash Items (as a Proxy for Actual Float) Deduction for Medium-Sized, Large, and Very Large Banks

		Banks*	
Percentage Share of Industry Assessment Base**	Medium $300m - $1b	Large $1b - $100b	Very Large > $100b
With Current Standard Float Deduction	9.78%	48.62%	41.60%
With Estimated Actual Float Deduction	9.97%	48.90%	41.13%
Percent Change	1.91%	0.58%	-1.12%

* Banks include commercial banks and FDIC-supervised savings banks.
** Percentages are of the aggregate base of medium, large, and very large commercial and savings banks only.