Federal Deposit Insurance Corporation
550 17th Street NW, Washington, DC 20429
Division of Insurance and Research

May 10, 2005

MEMORANDUM TO: The Board of Directors

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

SUBJECT: SAIF Assessment Rates for the Second Semiannual Assessment Period of 2005

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) [1] 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 Designated Reserve Ratio (DRR) of 1.25 percent.

Concur:

William F. Kroener, III
General Counsel

[1] 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 basis points, 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 December 31, 2004 data and projected ranges for the relevant variables at December 31, 2005, this rate schedule would result in an average annual assessment rate of approximately 0.05 basis points (bp).

Staff has considered a range of plausible events that could produce significant movements in the SAIF reserve ratio. 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 capitalization 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.[2]

[2] The Board reviews and weighs 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 December 31, 2005 is 1.31 percent. The lower and upper bounds of the likely range for the SAIF reserve ratio as of December 31, 2005 are 1.26 percent and 1.36 percent, respectively. The lower bound of the estimated range exceeds the statutory requirement of 1.25 percent.

The following is an analysis of the anticipated effect of changes in the fund balance and the rate of insured deposit growth on the projected reserve ratio as of December 31, 2005.

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 through December 31, 2005. Third, staff projects the level of unrealized gains and losses on available-for-sale (AFS) securities through December 31, 2005.

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. This recommendation represents the FRC's best estimate of "probable and estimable" SAIF losses from potential institution failures, as required by generally accepted accounting principles. Actual results could differ from these estimates. As of December 31,

2004 the SAIF loss reserve stood at $2 million. The SAIF loss reserve increased to $10 million as of March 31, 2005.

Staff has estimated a likely range of insurance losses based on projected changes in the contingent loss reserve for the period ending December 31, 2005. These projections are influenced by several factors, including: (1) the shifting of problem institutions among different risk categories within the reserve, (2) the reduction in problem institutions due to improved financial conditions, mergers, or failures, and (3) the addition of new problem institutions. To capture the effects of these changes, staff uses a migration approach, which estimates the probabilities of institutions entering into or leaving the contingent loss reserve as well as the probability of institutions moving between loss reserve risk categories. 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 in the event of failure. For purposes of estimating the contingent loss reserve, staff assumes that failure and loss rates remain constant through the period.

Based on consideration of the above factors, staff estimates that potential loss provisions for failures for the twelve months ending December 31, 2005 will range from -$1 million to $70 million, with a best estimate of $20 million.[3] Table 1 shows the range of potential loss provisions for failures as well as provisions for net losses/recoveries on resolution receivables, and litigation losses.

[3] Staff estimates that the balance of the contingent loss reserve as of December 31, 2005 will range from $0.5 million to $60 million, with a best estimate of $17 million.

Table 1
Potential Provisions and Adjustments for Loss Allowances
For the Twelve Months Ending December 31, 2005

	Low (High Provision) Estimate	Best Estimate	High (Low Provision) Estimate
Provision Related to Future Failures (1)	$70 million	$20 million	-$1 million
Provision for Closed Institutions' Net Recoveries (2)	-$4 million	-$22 million	-$39 million
Other Provisions (3)	$3 million	$0	-$3 million
Potential Provision for Losses*	**$69 million**	**-$2 million**	**-$43 million**

* Figures may not add to totals due to rounding.

Notes:

(1) Includes provisions required to bring the contingent loss reserve to estimated December 31, 2005 levels after accounting for a) actual losses sustained in the first quarter of 2005 ($0) and b) estimated losses sustained through December 31, 2005 ($5 million under the Best Estimate). Changes in the contingent loss reserve occur because of failures, mergers, improvement in problem institutions' conditions, deterioration of existing problem institutions, and new problem institutions.

(2) Estimates include a first quarter 2005 decrease of $21.5 million in estimated losses on receivables from prior failures. Low and high estimates assume a range around the best estimate of -5% to +5% of the estimated net recovery value of institution resolution receivables totaling $347 million as of December 31, 2004.

(3) Range is based on the standard deviation of changes in the year-end contingent liability for litigation losses for the period 1998 to 2004.

Staff believes that the range provided by the statistical migration 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.

SAIF-insured institutions in general appear to be well positioned to withstand considerable financial stress from unlikely economic shocks. Staff has considered economic stress events as they relate to specific risk concerns enumerated in the industry outlook contained in Tab 1. To determine the potential insurance fund implications of these concerns, staff has run several two-year stress event simulations based on data through year-end 2004 affecting institutions specializing in residential mortgages, subprime loans, commercial real estate mortgages, commercial and industrial loans, and consumer loans. The results of each simulation, which were derived from historical stress events, demonstrate that SAIF-insured institutions are

well positioned to withstand a significant degree of financial adversity. In most cases, stress simulations resulted in fewer failed bank assets over a two-year horizon than simulations based on year-earlier data, and in no case did the results raise any significant concerns.

Therefore, staff believes that widespread deterioration in thrift industry performance is unlikely in the next one-to-two years. However, if the stress conditions analyzed were to persist beyond a two-year horizon, it is possible that the effects on bank performance could be more severe. Furthermore, the historical experiences underlying the stress scenarios may be less applicable in the future. For example, greater "democratization" of credit, larger securitization volumes, and higher household debt levels in recent years could have altered the magnitude of stress on bank conditions from potential future problems in residential mortgage or commercial real estate sectors. Thus, conclusions drawn from stress scenario analyses should be treated with some degree of caution.

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 fourth quarter of 2005 as detailed in the March issue of the *Blue Chip Financial Forecasts*. Adopting the experts' consensus forecasts also allows for forecasted yield curves that change in shape over time.[4]

[4] Staff also developed alternative interest rate projections using actual forward rates available as of approximately the same time that the projections in the March *Blue Chip Financial Forecasts* were generated. Forward rates are yields on future securities of varying maturities derived from the term structure of interest rates. (The term structure of interest rates refers to the relationship between yields on comparable securities but different maturities.) Staff developed upper and lower bounds using historical differences between actual interest rates and corresponding forward rates. The projections using forward rates were similar to the *Blue Chip* experts' consensus forecasts and

Along with forecasting yield curves based upon the experts' forecasts, staff also calculated upper and lower bounds for interest rates 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 rising rates for the period under consideration. Charts showing the projected rates, upper bound, and lower bound are included as Appendix A to this case.

Table 2 shows projections for low, best, and high estimates for interest income and unrealized gains and losses on AFS securities using the forecast rates and upper and lower bounds.[5] 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 outweighs the effect of changes in interest income.

result in a projected range and best estimate for the reserve ratio as of December 31, 2005 that are very similar to the results using the *Blue Chip* projections.

[5] The projections incorporate actual investment results for the first quarter of 2005.

Table 2
Potential Interest Income and
Unrealized Gains (Losses) on AFS Securities
December 31, 2004 to December 31, 2005 ($ in millions)

	Low Estimate (1)	Best Estimate (1)	High Estimate (1)
Interest Income	596	589	581
Unrealized Gain (Loss) on AFS Securities (2)	-144	-97	-52
Net Fund Contribution from Investment Activities	**452**	**492**	**529**

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. Higher interest rates generally correspond to lower unrealized gains (higher unrealized losses) on AFS securities. On the other hand, because interest rates are generally higher in the Low Estimate than in the other two, overall interest revenue is also higher in that scenario. However, the Low Estimate also assumes more failures and higher resolution outlays, which results in a smaller balance invested during the period and partially offsets the effect of higher interest rates on investment income.

(2) Figures include actual investment income and unrealized gains/losses on AFS securities for the first quarter of 2005 and projected investment income and gains/losses for the remaining period through December 31, 2005.

Staff's best estimate reflects recent trends in market interest rates as well as expert forecasts. Since the Board last considered semiannual assessment rates, short-term Treasury yields have increased as the Federal Reserve raised the target for the federal funds rate by 100 basis points. Long-term Treasury yields also increased during the same period as the economy picked up steam. The rise in long-term yields fell short of that of short-term yields, leading to a further flattening of the yield curve. Experts continue to forecast a gradual increase in long-term Treasury yields, accompanied by a slightly sharper increase in short-term yields over the nine-month period ending in December 2005 as the economy continues to grow at a robust pace and inflationary concerns loom larger. Some depreciation in the value of AFS securities should be expected if interest rates rise at a pace similar to staff's best estimate. As the remaining maturity of the existing AFS portfolio shortens, previously identified unrealized gains will also dissipate. Over the longer term, higher yields on Treasury securities will boost overall interest earnings as securities reprice upward and as maturing securities are reinvested at higher rates.

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 December 31, 2005.

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

	Lower Bound	Best Estimate	Upper Bound
Assessments (2)	6	6	6
Interest Income (3)	596	589	581
Total Revenue	602	595	587
Operating Expenses (4)	123	123	123
Provision for Losses	69	-2	-43
Total Expenses & Losses	192	121	80
Net Income	410	473	507
Unrealized Gain (Loss) on AFS Securities (3)	-144	-97	-52
Comprehensive Income (Loss) (5)	266	376	455
Fund Balance – 12/31/04	12,720	12,720	12,720
Projected Fund Balance – 12/31/05	12,986	13,096	13,175

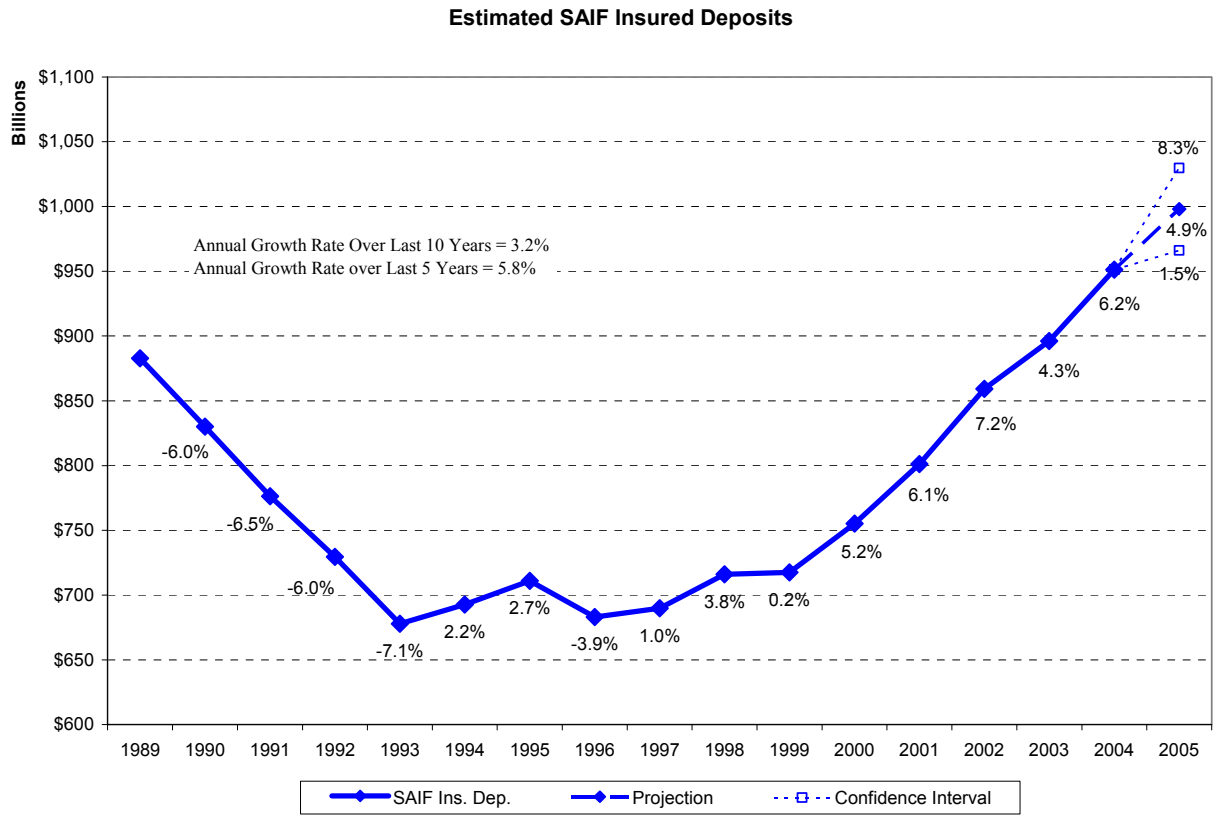
Notes:

(1) Projected income and expense figures are for the twelve months ending December 31, 2005. Figures may not sum exactly to totals due to rounding.
(2) Assumes that the current assessment rate schedule remains in effect through December 31, 2005.
(3) See notes to Table 2 for an explanation of changes in interest revenue and unrealized gains (losses) on AFS securities under these projections.
(4) Projected operating expenses are based on the Board approved 2005 annual budget for ongoing operations of the FDIC. Expenses are allocated across FDIC-managed funds based on the allocation of actual 2004 expenses for budgeted items.
(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

Figure 1 shows that SAIF-insured deposit growth rates since 1994, measured as of December of each year from the previous December, have been as high as 7.2 percent and as low as -7.1 percent. After positive growth rates of 2.2 percent and 2.7 percent in 1994 and 1995, respectively, SAIF-insured deposits declined 3.9 percent in 1996. Following modest growth in 1997, 1998 and 1999, SAIF-insured deposits increased at a significantly faster pace, with annual growth rates ranging between 4.3 percent and 7.2 percent through December of this year.

Figure 1



Staff's best estimate for insured deposit growth over the four quarters from December 2004 through December 2005 is 4.9 percent. The estimate takes into account the likely strength in deposit growth due to an expected rise in short-term interest rates relative to long-term interest rates, which may make bank deposits more attractive than alternative investment opportunities.

Based upon the December 31, 2004 fund balance, it takes approximately $7.2 billion in insured deposit growth to reduce the SAIF reserve ratio by 1 basis point. Therefore, if there is no change in the fund balance, an increase in insured deposits of $66.3 billion (7 percent growth) from the December 2004 level would reduce the reserve ratio to the DRR of 1.25 percent. The staff's best estimate indicates that deposit growth over the next four quarters will be significantly lower than this figure.

Based on projections using a statistical model, the best judgment of the staff is that SAIF-insured deposits are likely to experience a growth rate in the range of 1.5 percent to 8.3 percent between December 2004 and December 2005.[6] Staff believes the most likely scenario is that insured deposits will grow at the midpoint of this range (4.9 percent), which will bring the total for SAIF-insured deposits to $998 billion. Future conditions that could result in insured deposit growth at the high end of the range of our forecast may include a depressed stock market with high volatility. In contrast, a rising stock market and strong U.S. economic growth could result in insured deposit growth at the low end of the range of the forecast.

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 December 31, 2005 is 1.31 percent (Table 4). The best estimate assumes modest loss provisions for future failures, moderately rising Treasury yields, and insured deposit growth of 4.9 percent over the four quarters ending December 31, 2005.

[6] 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, the current and previous growth rates of total (insured and uninsured) domestic deposits, as well as the current yields on 3-month Treasury bills and 10-year Treasury notes. The range corresponds to a 95% confidence level. In other words, if the process generating insured deposit growth in the future is the same as in the past, we can be sure with 95% confidence that the actual growth rate in insured deposits over the four-quarter projection period, will lie within this range. The growth rate predicted by the model (thus, the most likely rate) is the midpoint of this range.

Staff projects the lower bound and upper bound of the likely range to be 1.26 percent and 1.36 percent, respectively (Table 4). The lower bound, which reflects an 8 bp decrease from the December 31, 2004 ratio, assumes a strong increase in the insured deposit base (8.3 percent growth) and higher interest rates that reduce the fund balance by raising unrealized losses on AFS securities (Table 3). The lower bound also incorporates the high insurance loss estimate as projected by staff. Although the estimate reflects staff's view of a reasonably possible adverse scenario, it is not intended to represent a "worst case" scenario.

The upper bound produces a 2 bp increase in the reserve ratio relative to December 31, 2004 levels. This estimate assumes an increase of 1.5 percent in the SAIF-insured deposit base, a small reverse provision for failure-related losses, and a more modest increase in interest rates, which results in smaller unrealized losses on AFS securities.

Table 4
Projected SAIF Reserve Ratios
($ in millions)

	December 31, 2004		
Fund Balance	$12,720		
Estimated Insured Deposits	$951,316		
SAIF Ratio	1.34%		
	Lower Bound (1) December 31, 2005	**Best Estimate (2) December 31, 2005**	**Upper Bound (3) December 31, 2005**
Projected Fund Balance	$12,986	$13,096	$13,175
Estimated Insured Deposits	$1,029,817	$997,933	$966,050
Estimated SAIF Ratio	1.26%	1.31%	1.36%

Notes:
(1) The Lower Bound refers to the scenario of higher loss provisions (Low Estimate in Table 1), the higher end of the range for interest rates (Low Estimate in Table 2), and insured deposit growth of 8.3 percent.
(2) The Best Estimate refers to a baseline scenario of moderate loss provisions (Best Estimate in Table 1), moderately rising interest rates (Best Estimate in Table 2), and insured deposit growth of 4.9 percent.
(3) The Upper Bound refers to the scenario of lower loss provisions (High Estimate in Table 1), the lower end of the range for interest rates (High Estimate in Table 2), and insured deposit growth of 1.5 percent.

Staff's best estimate of the reserve ratio for December 31, 2005 is 6 bp higher than the DRR but represents a decline of 3 bp from the ratio at December 31, 2004. Staff believes that

the following factors indicate that a decline in the reserve ratio between now and December 31, 2005 is likely:

- The most significant factor influencing the reserve ratio's projected decline is the projected strong growth in insured deposits. Staff believes that insured deposits are likely to experience a growth rate of 4.9 percent.
- Interest rates have begun to move higher. Unrealized gains on AFS securities will decline even in a stable interest rate environment because these gains disappear as securities move closer to their maturity dates. With rates moving higher, reductions in unrealized gains (or increases in unrealized losses) can be expected to accelerate.
- Although staff remains optimistic about industry prospects, reserves for anticipated losses are already at low levels, precluding substantial reversals to loss provisions going forward.

As a result of these considerations, staff believes that the SAIF reserve ratio is likely to decrease over the four quarters ending in December. Because 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
Second Semiannual Assessment Period of 2005
SAIF-Insured Institutions

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

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 $5.6 million. 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 December 31, 2004
Supervisory Subgroup and Capital Groups in Effect January 1, 2005

Capital Group		A		B		C	
1. Well	Number	1,058	93.1%	65	5.7%	9	0.8%
	Base ($billion)	$1,143	98.8%	$13	1.1%	$1	0.1%
2. Adequate	Number	2	0.2%	1	0.1%	0	0.0%
	Base ($billion)	$0	0.0%	$0	0.0%	$0	0.0%
3. Under	Number	0	0.0%	0	0.0%	1	0.1%
	Base ($billion)	$0	0.0%	$0	0.0%	$0	0.0%

Estimated annual assessment revenue	$5.6 million
Assessment Base	$1,157 billion
Average annual assessment rate (bp)	0.05 basis points

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

With 99.0 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 January 1, 2005, 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, 13 institutions migrated into the "1A" risk classification (Table 7), and 15 institutions migrated out of the "1A" risk classification. Only 78 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 ($billion)
Due to capital group reclassification only	1	0.1
Due to supervisory subgroup reclassification only	12	1.4
Due to both	0	0.0
Total	13	1.5
Institutions leaving "1A"	**Number**	**Base ($billion)**
Due to capital group reclassification only	1	2.8
Due to supervisory subgroup reclassification only	14	2.5
Due to both	0	0.0
Total	15	5.3

Notes: The table reflects SAIF-insured institutions that moved in and out of assessment risk classification "1A" from the second semiannual assessment period of 2004 to the first semiannual assessment period of 2005. 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 13 institutions with an assessment base of $1.4 billion and was downgraded for 16 institutions with an assessment base of $2.6 billion.

Other Issues

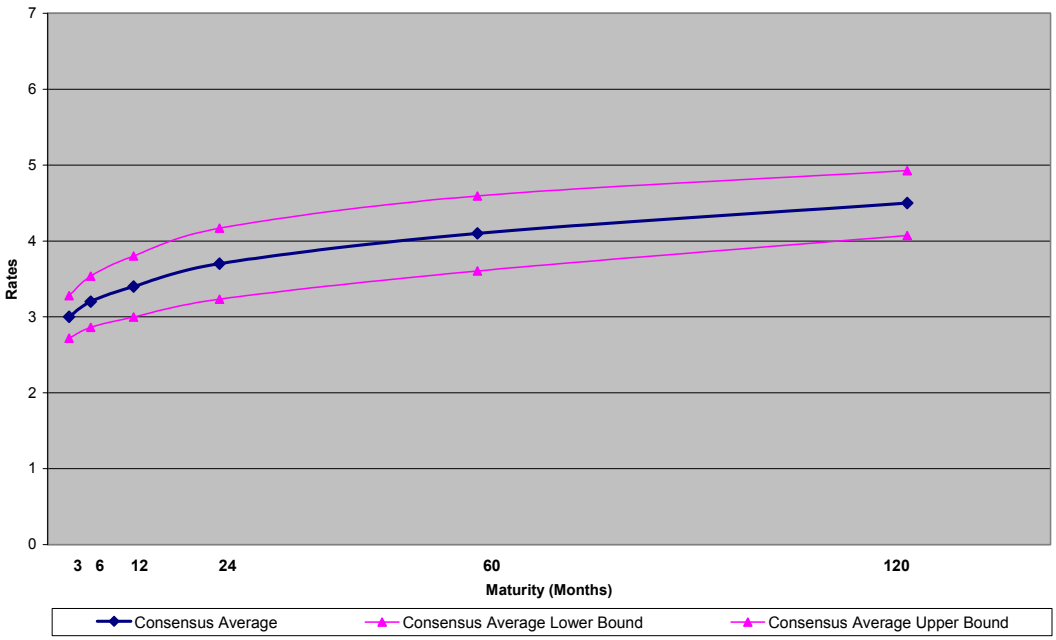
FICO Assessment. The Deposit Insurance Funds Act of 1996 (Funds Act) separates the Financing Corporation (FICO) assessment from the FDIC assessment, so that the amount assessed on individual institutions by the FICO is in addition to the amount paid according to the SAIF rate schedule. All institutions 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 the second semiannual assessment period of 2005 will be determined using March 31, 2005 Call Report and Thrift Financial Report data.

STAFF CONTACTS

For information about deposit insurance and FICO assessments, please contact Matthew Green, Chief, Fund Analysis and Pricing Section, Division of Insurance and Research, at (202) 898-3670, or Joe DiNuzzo, Counsel, Legal Division, at (202) 898-7349.

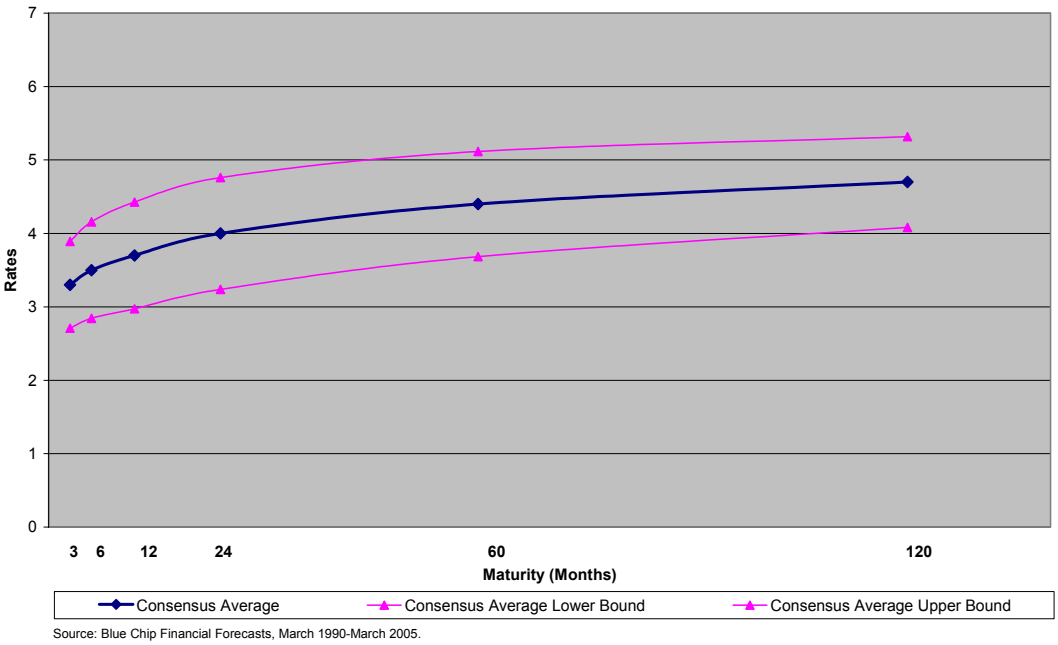
Appendix A – Interest Rate Assumptions

Figure 1: Estimated Yield Curve and Interval for Second Quarter 2005



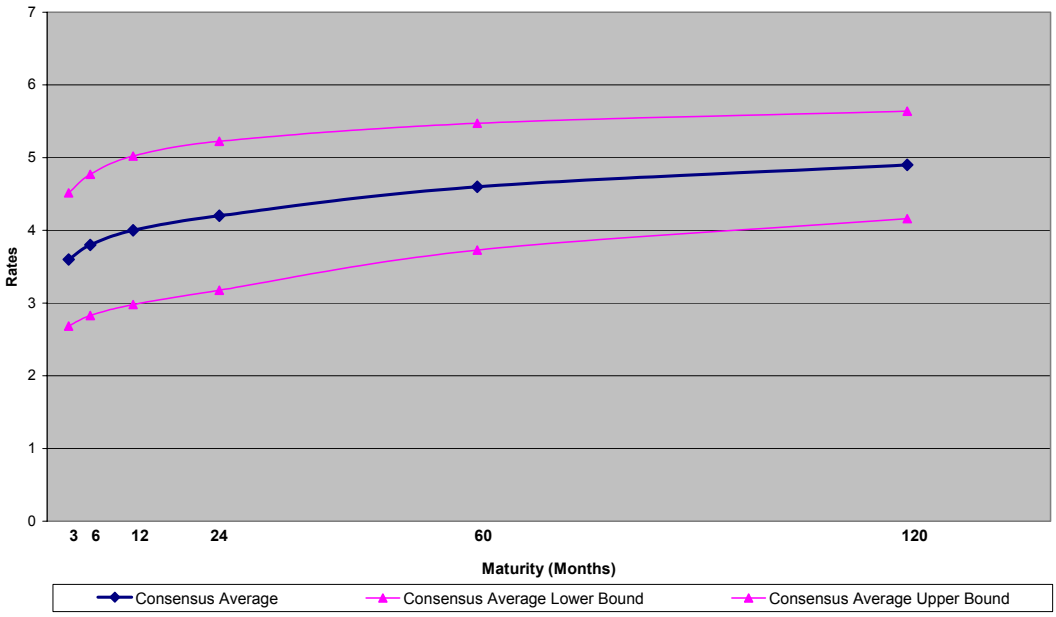
Source: Blue Chip Financial Forecasts, March 1990-March 2005.

Figure 2: Estimated Yield Curve and Interval for Third Quarter 2005



Source: Blue Chip Financial Forecasts, March 1990-March 2005.

Figure 3: Estimated Yield Curve and Interval for Fourth Quarter 2005



Source: Blue Chip Financial Forecasts, March 1990-March 2005.

Concur:

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Jodey C. Arrington
Chief of Staff