March 10, 2008

MEMORANDUM TO: The Board of Directors

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

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Director
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SUBJECT: Notice of Proposed Rulemaking (NPR) on Assessment Dividends

INTRODUCTION

The Federal Deposit Insurance Reform Act of 2005 (the Reform Act) requires that the FDIC's Board of Directors provide by regulation, after notice and opportunity for comment, the method for the calculation, declaration, and payment of assessment dividends. In October 2006, the FDIC's Board of Directors (the Board) issued a temporary final rule to implement the dividends requirements of the Reform Act. In September 2007, the FDIC issued an advanced notice of proposed rulemaking (ANPR) to explore alternative methods of allocating future dividends after the temporary rule expires on December 31, 2008.

RECOMMENDATION

Staff recommends that the Board authorize publication of the attached NPR on dividends, for a comment period of sixty days, to replace the temporary final rule. The proposed rule, if adopted, would take effect on January 1, 2009.

THE ANPR

The sole focus of the September 2007 ANPR was on dividend allocation. In devising a system for allocating dividends, the Reform Act requires that the FDIC take into account an institution's assessment base at the end of 1996 (as a proxy for assessments paid through the mid-1990s) compared to the total assessment base at the end of 1996;

Concur: ________________
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assessments paid since 1996; amounts paid for higher risk; and such other factors as the FDIC deems appropriate.

The ANPR sought comment on two general approaches to allocating dividends—the fund balance method and the payments method. The two allocation methods potentially differ most significantly in the way they balance two of the statutory factors that the Board must consider—the institutions' relative 1996 assessment bases and assessments paid after 1996—and, thus, in the way each method treats older versus newer institutions.[1] Both approaches would also take into account amounts paid attributable to higher risk through the definition of an "eligible" premium.

In summary, under the fund balance method, an institution's share of dividends would be based on a share of the fund balance assigned to it for this purpose. The share would initially be determined by the institution's portion of the 1996 assessment base. Thereafter, shares of dividends would be adjusted for increases or decreases in the size of the fund and premium payments. Under most likely scenarios—that is, absent large and continuing fund losses—the fund balance method would likely benefit older institutions for decades. Eligible premiums would not include payments made with one-time assessment credits.

Under the payments method, increases or decreases in the size of the fund would not directly affect an institution's share of dividends. The ANPR presented two illustrative variations of the payments method. Under *Variation 1*, the Board could, as under the fund balance method, initially divide the 2006 fund balance based on each institution's share of the December 1996 assessment base. Eligible premiums after 1996 would be added to that amount. Under *Variation 2*, only premiums paid over some prior period (such as the previous 15 years) would be considered. When the prior period covered any year before 2007, the years 1997 through 2006 would be skipped, since the great majority of institutions paid no deposit insurance premiums then. Because the weight accorded the 1996 ratio would effectively decline to zero over time, eligible premiums after 2006 would include eligible premiums offset with credits.

SUMMARY OF COMMENTS

We received five comment letters on the ANPR: two from banking trade associations (the ABA and ICBA); one from a trade association representing large financial services companies (the Financial Services Roundtable); one from a coalition of four insured

[1] The terms "older" and "newer" do not simply refer to age. An institution that had a large 1996 assessment base compared to its current assessment base is considered an older institution, and an institution that had no assessment base in 1996 or only a small assessment base compared to its present assessment base is considered a newer institution.

depository institutions; and one from a single depository institution that also was a member of the coalition.[2]

The ABA, ICBA and Financial Services Roundtable all stressed the importance of keeping the reserve ratio of the Deposit Insurance Fund below the 1.35 percent statutory level that would trigger dividends.

Neither the ABA nor ICBA took a position on either of the two proposed dividend allocation methods, the fund balance method or the payments method. The depository institution coalition recommended adopting a modified form of the ANPR's *Variation 2* of the payments method: instead of a 15-year look-back period that would exclude the years 1997 through 2006, it recommended a shortened look-back period of 5 years, without skipping the years from 1997 through 2006. Unlike the ANPR's *Variation 2*, it did not explicitly describe how, if at all, the 1996 assessment base would be considered in determining an institution's dividends. The Financial Services Roundtable recommended that, if the FDIC is not able to maintain the fund below 1.35 percent, it adopt the payments method, structured as simply as possible. Specifically, it supported a 3 to 5 year look-back period for premiums, with no weight given to the 1996 assessment base.

The ABA, ICBA and Financial Services Roundtable recommended that eligible premiums be defined as premiums charged up to the maximum rate for a Risk Category I institution. The coalition did not explicitly discuss this aspect of the ANPR. The Financial Services Roundtable and the coalition recommended that premiums offset with credits be excluded from eligible premiums.

Respondents generally were interested in simplicity and transparency. The ICBA cautioned that any method adopted should be simple, transparent, and not require constant FDIC intervention and decision-making.

THE PROPOSED RULE

The proposed rule is focused on the dividend allocation methodology but, unlike the ANPR, it also addresses and seeks comment on all aspects of the dividend regulation. Only minor changes (discussed below) are proposed to the non-allocation provisions of the temporary final rule.

Allocation of dividends

In the temporary final rule, the FDIC adopted a simple system for allocating any dividends that might be declared during the two-year duration of the regulation. Any dividends awarded before January 1, 2009, will be distributed simply in proportion to an institution's 1996 assessment base ratio, as determined pursuant to the one-time assessment credit rule. In the proposed rule, staff is proposing a variation of the

[2] The single institution's comments and recommendations were virtually identical to the coalition's and not included separately in the following summary.

payments method to replace the current dividend allocation method. Congress has given the Board considerable discretion in determining the proper balance of the statutory factors, and the proposed method represents a compromise between the interests of older and newer institutions.

The proposed rule would divide the total dividend in any year into two parts. One of the two parts would be allocated based on the ratio of each institution's (including any predecessors') 1996 assessment base to the total of all existing eligible institutions' 1996 assessment bases (an institution's "1996 assessment base share"). The other part of the total dividend would be allocated based on each institution's (including any predecessors') ratio of cumulative eligible premiums (defined below) over the previous five years to the total of cumulative eligible premiums paid by all existing institutions (or their predecessors) over the previous five years (an institution's "eligible premium share"). The part of any potential dividend that would be allocated based upon 1996 assessment base shares would decline steadily from 100 percent to zero over 15 years; the part of any potential dividend that would be allocated based upon eligible premium shares would increase steadily over the same 15-year period from zero to 100 percent. After the 15-year period, any dividend would be allocated solely based on eligible premium shares.

The 15-year period would run from the end of 2006 to the end of 2021 and would govern dividends based upon the reserve ratio at the end of the years 2008 through 2021.[3] Actual dividends, if any, would be allocated and paid the following year. Table A shows the change in the allocation of potential dividends over time.

Table A
Total DIF Dividend Distribution Table

Based Upon the DIF Reserve Ratio at Year-End	**Part of Total DIF Dividend Determined by:**	
	1996 Assessment Base Shares	**Eligible Premium Shares**
2006[3]	1 (100.0%)	0 (0%)
2007[3]	14/15 (93.3%)	1/15 (6.7%)
2008	13/15 (86.7%)	2/15 (13.3%)
2009	4/5 (80.0%)	1/5 (20.0%)
2010	11/15 (73.3%)	4/15 (26.7%)
2011	2/3 (66.7%)	1/3 (33.3%)
2012	3/5 (60.0%)	2/5 (40.0%)
2013	8/15 (53.3%)	7/15 (46.7%)
2014	7/15 (46.7%)	8/15 (53.3%)
2015	2/5 (40.0%)	3/5 (60.0%)
2016	1/3 (33.3%)	2/3 (66.7%)
2017	4/15 (26.7%)	11/15 (73.3%)
2018	1/5 (20.0%)	4/5 (80.0%)
2019	2/15 (13.3%)	13/15 (86.7%)
2020	1/15 (6.7%)	14/15 (93.3%)
2021	0 (0%)	1 (100.0%)
Thereafter	**0%**	**100.0%**

[3] Had dividends actually been awarded based upon the 2006 and 2007 reserve ratios, the dividends would have been allocated pursuant to the temporary final rule.

Thus, for example, if a dividend were awarded based upon the reserve ratio at the end of 2018, one-fifth of the total dividend would be allocated based upon 1996 assessment base shares and four-fifths of the total dividend would be allocated based upon eligible premium shares.[4]

The 15-year period over which the influence of 1996 assessment bases would decline represents a compromise between two legitimate, but opposing, arguments. On one hand, a 15-year period recognizes the significant contributions made by some institutions in the early 1990s to capitalize the deposit insurance fund and that the interest earned on this capital continues to help fund the FDIC. On the other hand, a 15-year period does not give these institutions an advantage that could last indefinitely in obtaining dividends, as would occur under the fund balance method absent very large insurance losses. It is also consistent with an argument noted in a comment letter that the $4.7 billion one-time assessment credit, which was awarded under the Reform Act and distributed according to the 1996 assessment base shares, was intended to compensate institutions that helped capitalize the insurance funds in the early1990s.

Cumulating eligible premiums over the 5-year period preceding the year of the dividend is consistent with the specific recommendations made by the Financial Services Roundtable and the coalition in their comment letters. A 5-year look-back period recognizes that the Reform Act enhances the FDIC's ability to control the growth of the fund over time through the level of assessment rates. Certain events, however, such as an unanticipated decline in estimated insured deposits or unexpectedly high investment income, could raise the fund over the 1.35 percent dividend threshold. Thus, assessments charged over some relatively short period preceding the unexpected events would have proven in retrospect to be too high, and the dividend would serve as a rebate of excess funds.[5]

Based upon the three trade associations' recommendations, we are proposing that eligible premiums be defined as premiums charged up to the maximum rate for a Risk Category I institution. Payments made using one-time assessment credits would be included as eligible premiums. Staff currently anticipates that the great bulk of assessment credits (over 95 percent) will have been used by the end of 2008.

The proposed dividend allocation method would affect institutions differently depending upon their 1996 assessment base and the amount of eligible premiums credited during the most recent five year period. Those with 1996 assessment bases would initially receive larger shares of any dividend, all else equal, than newer institutions without a 1996 assessment base. This advantage would decrease systematically each year for 15 years and totally disappear after 15 years when the most recent 5-year eligible premiums would solely determine the dividend allocation.

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[4] The dividend would actually be awarded and paid in 2019.

[5] One of the banking trade associations that commented on the ANPR cited essentially the same argument as a justification for adopting the payments method.

An institution that consistently paid the lowest rate applicable to Risk Category I would receive a smaller dividend than one that paid the highest rate applicable to Risk Category I, assuming identical future assessment bases and identical 1996 assessment base shares, since the institution paying the higher rate would have paid higher premiums and would have a larger eligible premium share. However, institutions paying premiums in excess of the highest Risk Category I rate would not receive the benefit of premiums above the Category I rate in the dividend calculation.

Proposed changes to other aspects of the temporary final rule

The proposed rule includes one minor change to the provisions in the temporary final rule on the annual determination of whether dividends are required and the declaration of dividends. As under the temporary final rule and as required by statute, the FDIC would determine annually whether the reserve ratio at the end of the prior year equals or exceeds 1.35 percent of estimated insured deposits or exceeds 1.50 percent, thereby triggering a dividend requirement. If a dividend is triggered, the FDIC would determine whether it should limit or suspend the payment of dividends based on the statutory factors. As proposed, any declaration with respect to dividends would be made on or before May 10th for the preceding calendar year. The May 10th date for the declaration of dividends differs from the May 15th date in the temporary final rule. This slightly revised timing still would provide enough time for the Board to consider final data for the end of the preceding year regarding the reserve ratio, as well as to perform an analysis of what amount is necessary to maintain the fund at the required level and whether circumstances warrant limiting or suspending the payment of dividends. In addition, the May 10th date would allow more time, operationally, for the notification and payment of dividends and handling of requests for review of dividend amounts.

As under the temporary final rule, an institution would be able to request review of its dividend amount and its 1996 assessment base share. In addition, under the proposed rule, an institution could request review of its eligible premium share. The proposed rule also states that the FDIC intends, beginning no later than 2010, to include with its quarterly assessment invoices to insured depository institutions the institution's 1996 assessment base share and its rolling five-year eligible premium share. Under the proposed rule, an institution could request review of its 1996 assessment base share and eligible premium share as reflected in each quarterly invoice. If an institution does not submit a timely request for review of its dividend-related information in a quarterly invoice, it would be barred from subsequently requesting review of that information.

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