



March 10, 2008

MEMORANDUM TO: The Board of Directors

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

SUBJECT: Assessment Rates for 2008

Recommendation and Summary

The staff recommends that the Board maintain the existing rate schedule of 5 to 43 basis points per year for the Deposit Insurance Fund (DIF).¹

The DIF stood at 1.22 percent of estimated insured deposits as of December 31, 2007, unchanged from September 30, 2007 and up from 1.21 percent as of December 31, 2006. The use of the one-time credits provided by the Federal Deposit Insurance Reform Act of 2005 (Reform Act) limited assessment revenue in 2007. Assessment revenue in 2008 will rise as credits are used up, helping to raise the reserve ratio toward the Board's target.

Insured deposit growth was 3.4 percent in 2007, substantially slower than in the previous two years. The staff believes that it is reasonable to plan for insured deposit growth in the 3 to 4 percent range. With insured deposit growth of 3 or 4 percent in 2008 and 2009, the fund could reach the 1.25 percent designated reserve ratio (DRR) at the end of 2008 or early in 2009 under the recommended rate schedule if the staff's other assumptions hold. Even at 5 percent or 6 percent growth this year and next year, the fund could reach the DRR in 2009.

The staff's recommendation therefore is consistent with the Board's objective to increase the reserve ratio to the DRR before the end of 2009. Moreover, with 99 percent of insured institutions well capitalized, the staff believes that it is preferable to leave current rates in place this year to further strengthen the fund in case more severe industry conditions and significantly higher insurance losses should materialize.

¹As provided for in the risk-based assessments rule adopted in November of 2006 implementing the Federal Deposit Insurance Reform Act of 2005, rates set by the Board remain in effect until the Board changes them. 12 CFR 327.10(c)(4)

Concur: _____
Sara A. Kelsey
General Counsel

After taking credits into account, the industry would on average pay an assessment rate this year that is less than, or in line with, average rates over the past six decades (excluding 1997-2006, during which the FDIC could not charge most institutions any premium). Approximately 60 percent of insured institutions will start 2008 with credits still available. The industry average assessment rate, net of credits, is estimated to be 3.8 basis points in 2008. This rate is significantly lower than rates charged from 1990 through 1996, but in line with the average rates for FDIC-insured banks from the 1950s through the early 1980s.²

Under the current rates, assessments would consume a relatively modest share of industry income. Assessments could reduce overall industry pre-tax income this year by 1.7 percent.³ By contrast, during the years 1990 through 1996, which included both strong and weak years for industry profits, assessments reduced annual pre-tax income by between 4.3 percent and 23.1 percent.

The staff's projections include higher insurance loss provisions in 2008 and 2009 compared to recent years. Nonetheless, in light of the current difficulties facing insured institutions and the economy, a reasonable possibility exists that even these higher projections may understate losses to the fund. If losses turn out to be much higher, or if insured deposits increase by more than 6 percent in 2008 and 2009, the reserve ratio is likely to fall short of the DRR at the end of 2009. The Board may make adjustments to rates at any time it chooses.

By statute, when setting assessment rates, the Board must consider several factors:

1. The estimated operating expenses of the DIF;
2. The estimated case resolution expenses and income of the DIF;
3. The projected effects of the payment of assessments on the capital and earnings of insured depository institutions; and
4. The risk factors and other factors taken into account in the statutory definition of the risk-based assessment system, including the requirement to maintain a risk-based system.⁴

² Excluding funds used for Financing Corporation (FICO) bond interest, the banking and thrift industry average rate during the 1990-1996 period ranged between 12 and 22 basis points. From the 1950s through the early 1980s, FDIC-insured banks generally paid a rate between 3 and 4 basis points per year after application of credits that were then in effect.

³ This assumes that 2008 income remains at 2007 levels. The Appendix explains the assumptions and analysis in more detail.

⁴ These factors are:

1. The probability that the DIF will incur a loss with respect to an institution, taking into consideration the risks attributable to—
 - a. Different categories and concentrations of assets;

The Board may also consider any other factors that it may determine to be appropriate.⁵ Staff's analysis of the statutory factors is set forth below.

Analysis

Table 1 shows projected reserve ratios under the recommended rate schedule through the year in which the reserve ratio first reaches or exceeds the DRR of 1.25 percent, assuming different average annual growth rates for insured deposits.

Table 1
Projected Reserve Ratios Assuming Different Growth Rates in Insured Deposits
Under the Recommended Rate Schedule

Period	Insured Deposit Growth Rate					
	3%	4%	5%	6%	7%	8%
2008	1.25%	1.24%	1.23%	1.22%	1.20%	1.19%
2009		1.30%	1.28%	1.25%	1.23%	1.21%
2010					1.26%	1.23%
2011						1.25%

Note: The year-end 2007 reserve ratio was 1.22 percent.

In developing these projections for the reserve ratio and its recommendation for assessment rates, the staff considered future changes to the fund balance from insurance losses (case resolution expenses), operating expenses, risk-based assessments, and comprehensive investment income, as well as the outlook for insured deposit growth. Staff also analyzed the effects of the recommended rates on banking industry earnings and capital.

1. Projected changes to the fund balance

Table 2 shows actual changes to the fund balance in 2007 and projected changes this year and next year, based on the recommended rate schedule. Future changes to the fund balance depend, in turn, on projections and assumptions for insurance losses, operating expenses, assessment revenue, and investment contributions. These components of fund balance changes are discussed below.

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- b. Different categories and concentrations of liabilities, both insured and uninsured, contingent and noncontingent; and
 - c. Any other factors the Board determines are relevant to assessing such probability;
2. The likely amount of any such loss; and
 3. The revenue needs of the DIF.

12 U.S.C. § 1817(b)(1)(C).

⁵ 12 U.S.C. § 1817(b)(2)(B).

Table 2
Projected Changes to the Fund Balance Under the Recommended Rate Schedule
(\$ in millions)

Period	Beginning Fund Balance	Net Assessment Revenue	Investment Income	Loss Provisions	Operating Expenses	Ending Fund Balance
2007	50,165	643	2,665	95	965	52,413
2008	52,413	2,746	2,174	1,063	1,031	55,239
2009	55,239	4,191	2,291	450	1,064	60,207

Note: Revenue and loss projections in this table, tables 2A and 2B, table 3, and table 5 assume that the assessment base (domestic deposits) and insured deposits both increase at an annual rate of 3 percent after 2007. Alternative growth assumptions would result in relatively small changes in projected fund balances.

a. Insurance losses (case resolution expenses) and operating expenses

Projected loss provisions

The staff's projections for the reserve ratio under the recommended rate schedule include a substantial increase in loss provisions compared to earlier years. The number of problem institutions rose to 76 at the end of 2007 from 50 at year-end 2006. Assets of problem institutions totaled \$22 billion at year-end 2007, an increase of almost \$14 billion from last year. Three insured institutions failed in 2007 – the first failures since June of 2004. Difficulties stemming from the decline in housing prices, mortgage sector problems, and a slowdown in the economy raise the likelihood of an increase in the number of insured institution failures. Insurance loss provisions are projected to be \$1.06 billion in 2008 and \$450 million in 2009.⁶ Total losses from failures projected to occur this year and next year are expected to be higher than the average over the past ten years, a period in which the fund suffered relatively low insurance losses.

⁶ Loss provisions in 2007 totaled \$95 million: \$9 million in estimated costs of 2007 failures in excess of the amount reserved at year-end 2006, plus a \$124 million contingent loss reserve established at year-end 2007 to cover 2008 failures, less \$38 million in other provision adjustments (primarily for failures prior to 2007). The provision of \$1.06 billion for 2008 is the sum of \$662 million of projected costs for 2008 failures in excess of the year-end 2007 reserve, plus the establishment of a year-end 2008 reserve of \$401 million. The costs of failures in 2009 and later years are assumed to equal the contingent loss reserve at the end of each prior year.

Staff relied on input from supervisors concerning troubled institutions, as well as two models as a guide to developing its projections of insurance losses. One model projects insurance losses by taking into account (1) the shifting of problem banks among different contingent loss reserve risk categories, (2) the reduction in problem banks due to improved financial condition, mergers, and failures, and (3) the addition of new problem banks. To capture the effects of these changes, the model calculates the probabilities of banks entering into or leaving the group of banks included in the contingent loss reserve as well as the probability of banks moving between loss reserve risk categories. These probabilities are based on the recent history of changes to the reserve. The second model, referred to as the Loss Distribution Model or LDM, employs many of the same techniques and methods used in credit risk and economic capital models used by large financial companies to measure and manage risk. The LDM provides estimates of failure-related losses that are most likely given current industry conditions, as well as failure-related losses that might result from changes in the condition of the economy and the industry.

Possibility of higher losses

While 99 percent of insured institutions meet the “well capitalized” criteria, the possibility remains that the fund could suffer insurance losses that are significantly higher than anticipated. The U.S. economy and the banking sector currently face a significant amount of uncertainty from ongoing housing sector problems, financial market turbulence and potentially weak prospects for consumer spending. These problems could lead to significantly higher loan losses and weaker earnings for insured institutions.

Higher insurance losses, in turn, could lengthen the time it takes for the reserve ratio to rise to the DRR. Table 2A shows projected reserve ratios under the current rate schedule assuming that loss provisions in 2008 and 2009 are twice, three times, or four times the staff’s best estimates, and that insured deposits increase by 3 percent or 4 percent each year. (After 2009, loss provisions revert to the staff’s best estimates.)

Under these assumptions, the fund could reach the 1.25 percent target either in 2009 or 2010. For example, if loss provisions are \$2.1 billion in 2008 and \$900 million in 2009 – double the amounts shown in Table 2 – the fund could still reach the 1.25 percent DRR in 2009. However, if loss provisions are \$3.2 billion in 2008 and \$1.4 billion in 2009 – triple the amounts shown in Table 2 – the fund could reach the DRR under 3 percent insured deposit growth but would not reach the target until 2010 under growth of 4 percent. In the event of losses that are four times the staff’s best estimates, the fund could reach 1.25 percent in 2010 with growth of 3 or 4 percent.

**Table 2A
Effect of Higher Loss Provisions on the Reserve Ratio
For Insured Deposit Growth Rates of 3 Percent and 4 Percent**

Year	Using best estimate:		If loss provisions are equal to a multiple of staff’s best estimates:					
			Two times		Three times		Four times	
	3%	4%	3%	4%	3%	4%	3%	4%
2008	1.25%	1.24%	1.23%	1.21%	1.20%	1.19%	1.18%	1.17%
2009		1.30%	1.29%	1.27%	1.25%	1.23%	1.22%	1.20%
2010						1.30%	1.29%	1.26%

In addition to higher losses, the possibility also exists that insured deposit growth over the near term may exceed staff's assumption of 3 to 4 percent.⁷ Like Table 2A, Table 2B below assumes that loss provisions are twice, three times, and four times the staff's best estimates – *but also assumes future annual insured deposit growth of 5 or 6 percent*. Under these assumptions, the delay in reaching the 1.25 percent target would range between one and three years after 2009. For example, the reserve ratio would reach 1.25 percent in 2010 if loss provisions are double the staff's best estimates. If losses are three times the best estimates, the reserve ratio could still reach 1.25 percent in 2010 under 5 percent growth, but would take until 2011 under 6 percent growth. At loss provisions of four times the best estimates, the reserve ratio would reach 1.25 percent in 2011 under 5 percent growth and in 2012 under 6 percent growth.

Table 2B
Effect of Higher Loss Provisions on the Reserve Ratio
For Insured Deposit Growth Rates of 5 Percent and 6 Percent

Year	Using best estimate:		If loss provisions are equal to a multiple of staff's best estimates:					
			Two times		Three times		Four times	
	5%	6%	5%	6%	5%	6%	5%	6%
2008	1.23%	1.22%	1.20%	1.19%	1.18%	1.17%	1.16%	1.15%
2009	1.28%	1.25%	1.24%	1.22%	1.21%	1.19%	1.18%	1.16%
2010			1.30%	1.26%	1.26%	1.23%	1.23%	1.20%
2011						1.27%	1.28%	1.24%
2012								1.28%

If losses turn out to be sufficiently high to prevent the fund from reaching the DRR in 2009 under the current rate schedule, the Board may re-consider rates and the timetable for achieving the DRR at any time it chooses. The Board may weigh several factors, including economic conditions affecting financial institutions, the desirability of avoiding sharp increases in assessments at a time of industry stress and the need to maintain the fund within the range authorized by the Reform Act.

Operating Expenses

For 2008 operating expenses are estimated at \$1.03 billion. Thereafter, the reserve ratio projections assume that annual operating expenses increase by 3.2 percent annually.

b. Investment contributions

As shown in Table 2 above, projections of fund balances assume that annual investment contributions amount to approximately \$2.2 billion in 2008 and \$2.3 billion in

⁷ Over the 15-year period from 1992 to 2007, the average annualized 8-quarter growth rate in insured deposits was about 3 percent. However, 8-quarter insured deposit growth rose above and fell below this average with about equal frequency, ranging from an annualized rate as low as -2.7 percent to a high of 7.3 percent.

2009.⁸ Investment contributions equal interest income plus (minus) unrealized gains (losses) on available-for-sale securities. The projected investment contributions remain in line with recent investment return experience.

Projections for 2008 are based on, among other factors, expert forecasts for interest rates next year, as detailed in the February edition of Blue Chip Financial Forecasts released at the end of January.⁹ The Federal Reserve cut the target federal funds rate sharply, from 5.25 percent at the end of August 2007 to 3.00 percent after the January 31, 2008 meeting. Futures markets suggest that the most likely outcome at the next Federal Open Market Committee meeting is an additional reduction of 75 basis points to the target federal funds rate. After a year of yield curve inversion, the federal funds rate has finally fallen below long-term interest rates. Interest rates at all points along the Treasury yield curve remain low, perhaps reflecting a “flight to quality” among investors due to the problems in other financial markets. Interest rates will likely remain low due to anticipated below-potential economic growth.

c. Risk-based assessments and assessment credits

Table 3 below shows projected gross assessment revenue, assessment credit use, and net assessment revenue for 2007-2009 under the recommended rate schedule.

Table 3
Assessment Revenue and Credit Use Under the Recommended Rate Schedule
(\$ in millions)

Period	Gross Revenue	Credits Used	Net Revenue	Effective Rate (bp)
2007	3,731	3,088	643	0.9
2008	4,178	1,433	2,746	3.8
2009	4,323	132	4,191	5.7

Note: Net revenue may not equal the difference between gross revenue and credits due to rounding.

Projected gross assessment revenue is derived by assigning each insured institution to a Risk Category, and assigning each institution in Risk Category I to the minimum rate, maximum rate, or a rate in between, using supervisory ratings, debt issuer

⁸ Projected investment contributions equal 4.15 percent of the start-of-year fund balance in 2008 and beyond. This is lower than the 5.3 percent investment contribution to the fund balance in 2007 for four primary reasons: 1) Treasury Inflation-Protected Securities (TIPS) held by the DIF experienced unusually high inflation compensation during the second quarter of 2007 that is not expected in 2008; 2) The FDIC is maintaining a large portion of its funds in overnight balances that are expected to have lower yields during the year; 3) Yields on any newly-purchased Treasury securities are expected to be generally lower than the yields on maturing securities; and 4) Unrealized gains on AFS securities occurred in 2007 due to declines in Treasury yields (especially shorter-maturity yields), but the February 2008 *Blue Chip Financial Forecasts* project Treasury yields to rise beginning in the second half of 2008, contributing to higher projected unrealized losses this year

⁹ Staff recently received the March Blue Chip Financial Forecasts. The latest interest rate forecasts would result in little change in revenue and virtually no change in the reserve ratio projections.

ratings, and financial data. Table 4 shows the distribution of institutions and assessment bases among the Risk Categories as of September 30, 2007. For purposes of assessment revenue projections, the staff used more recent preliminary information on the distribution of risk-based rates and generally held these rates constant going forward.

Table 4
Distribution of Institutions and the Assessment Base Among Risk Categories
as of September 30, 2007
(\$ in billions)

Risk Category & Rate (in bps)	Number of Institutions	Percentage of Total Institutions	Assessment Base	Percent of Total Assessment Base
I - Minimum (5)	2,709	32%	3,872	56%
I - Middle	4,510	53%	2,534	37%
(5.01 - 6.00)	3,088	36%	2,078	30%
(6.01 - 6.99)	1,422	17%	456	7%
I - Maximum (7)	859	10%	296	4%
II (10)	422	5%	163	2%
III (28)	64	1%	14	0%
IV (43)	7	0%	1	0%
Total	8,571	100%	6,880	100%

Note: Percentages may not sum to 100 percent due to rounding. Assignment of risk categories and rates is based on supervisory ratings, debt issuer ratings, and financial data as of September 30, 2007. Each institution's fourth quarter rate will be finalized in March.

Assessment revenue projections reflect the use of credits authorized under the Reform Act and distributed in accordance with the final rule adopted for assessment credits. For 2008, 2009 and 2010, credits may not offset more than 90 percent of an institution's assessment. Staff estimates that, under the recommended rate schedule, 18 percent of institutions in Risk Category I (17 percent of all institutions) will be able to offset all but the required minimum assessment with credits in 2008.¹⁰ Therefore, as indicated in Table 3, the effective rate applicable to the industry this year under the proposed schedule is projected to be 3.8 basis points. At the end of this year, staff projects that about 96 percent of the \$4.7 billion total credit authorized under the Reform Act will have been drawn down. Under the current rate schedule, the effective rate is projected to rise to 5.7 basis points in 2009 as credits have been largely used up.

Use of authority to adjust risk-based assessment rates of large institutions

As required under current regulations, the FDIC, after consulting with the applicable primary federal regulator, determines quarterly whether to adjust the assessment rates for large institutions. These adjustments are intended to ensure consistency, fairness, and consideration of all available information. The FDIC makes these determinations by evaluating risk information including current financial performance and condition information and trends, current market information,

¹⁰ In addition to a 90 percent cap on credit use, certain banks may be subject to restrictions on the use of credit depending on capital ratios and supervisory ratings.

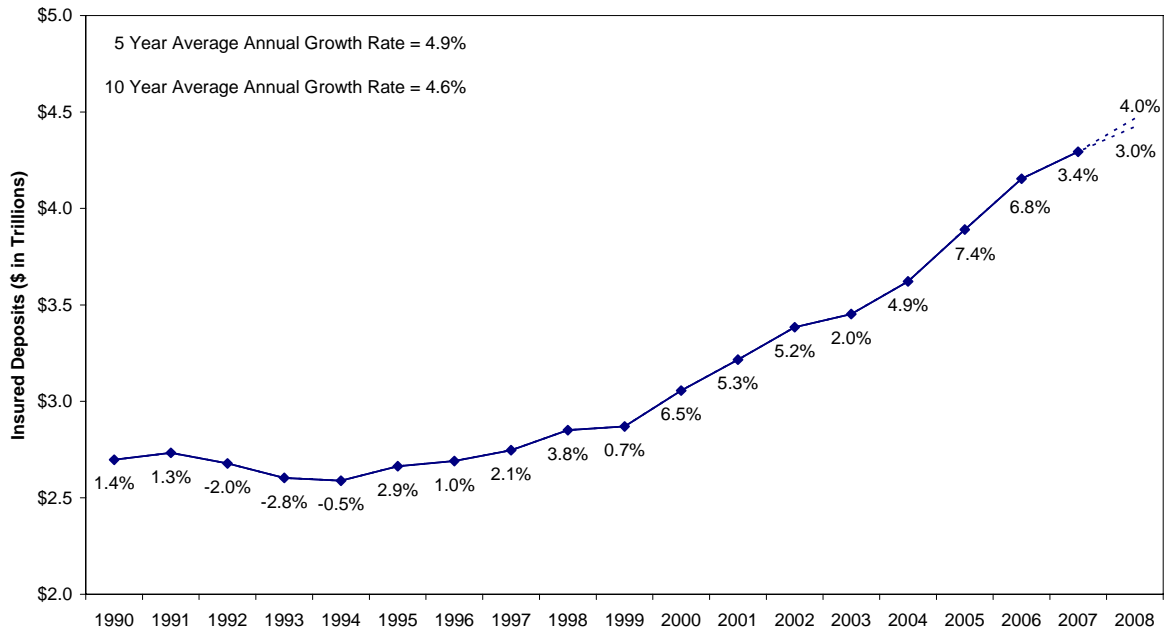
information pertaining to an institution's ability to withstand financial adversity, and information pertaining to severity of losses in the event of failure. Any adjustments to assessment rates are limited to 0.50 basis points (higher or lower). Upward adjustments do not take effect without notification to and consideration of responses from both the primary federal regulator and the institution. Downward adjustments do not take effect without notification to and consideration of responses from the primary federal regulator. No rates are adjusted below the minimum rate for Risk Category I institutions in effect for an assessment period or above the maximum rate for Risk Category I institutions in effect for the period.

Six institutions received rate adjustments related to third quarter assessments (two decreases and four increases in rates). One advance notification of intent to increase an institution's third quarter assessment rate was withdrawn due to a Risk Category downgrade. In addition, four institutions have received advance notification of potential increases in their assessment rate beginning with the fourth quarter 2007.

2. Projected insured deposits

Chart 1 shows levels of insured deposits and corresponding four-quarter growth rates since 1990, including forecasts through 2008. Over the 1990-2007 period, annual growth rates in insured deposits ranged between -2.8 percent and 7.4 percent. After three consecutive annual declines in insured deposits from 1992 to 1994, annual growth in insured deposits picked up in the mid-1990s and reached 6.5 percent in 2000. Growth slowed in the following few years, down to 2.0 percent in 2003, before climbing to 7.4 percent in 2005. After rising by 6.8 percent in 2006, insured deposit growth slowed to 3.4 percent in 2007. The high growth in insured deposits in 2005 and 2006 may have resulted partly from an increase in short-term interest rates from mid-2004 through the first half of 2006, triggered by a tightening in monetary policy by the Federal Reserve. Higher short-term interest rates relative to long-term rates makes short-term investment instruments, such as bank deposits, more attractive to investors. An easing of monetary policy in 2007 that has reduced short term rates, along with a slightly steeper yield curve, may have contributed to slower insured deposit growth in 2007.

Chart 1
Annual Insured Deposit Growth Rates
(December over December)



The results of a statistical model developed by the staff suggest that insured deposits may rise by 3 percent in 2008, but staff think it is reasonable to plan on insured deposit growth in the 3 to 4 percent range.

Table 1 shows that if insured deposits increase by 6 percent or less in 2008 and 2009, the fund could reach the 1.25 percent designated reserve ratio (DRR) no later than 2009 under the recommended rate schedule. At 7 percent growth this year and next year, the fund could reach the DRR by 2010; at 8 percent growth, the fund could reach the DRR by 2011.

3. Projected reserve ratios

Assuming insured deposit growth of 3 percent per year beginning in 2008, projections for 2008-2009 under the recommended rate schedule are as follows:

Table 5
Projected Fund Balances, Insured Deposits, and Reserve Ratios
(\$ in millions)

Period	Ending Fund Balance	Ending Insured Deposits	Ending Reserve Ratio
2007	52,413	4,293,201	1.22%
2008	55,239	4,421,997	1.25%
2009	60,207	4,554,657	1.32%

The table shows that the reserve ratio is expected to increase this year due to slower insured deposit growth and a rise in assessment revenue. With almost two thirds of the credits drawn down by the end of 2007, assessment revenue should accelerate this year and help the fund to meet the DRR.

4. Effect of the rate schedule on capital and earnings of insured institutions

The Appendix contains an analysis of the projected effects of the payment of assessments under the recommended rates, compared to the absence of assessments, on the capital and earnings of insured depository institutions. In sum, the rate schedule is not expected to materially impair the capital or earnings of insured institutions.

Rate Recommendation

Staff recommends that the Board maintain the existing assessment rate schedule. The current rate schedule is shown below in Table 6.

Table 6
Recommended Risk-Based Assessment Rate Schedule

	Risk Category				
	I*		II	III	IV
	Minimum	Maximum			
Annual Rates (in basis points)	5	7	10	28	43

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

The staff's recommendation is consistent with the Board's objective to increase the reserve ratio to the DRR before the end of 2009. Moreover, with 99 percent of insured institutions well capitalized, the staff believes that it is preferable to leave current rates in place to further strengthen the fund in case more severe industry conditions and significantly higher insurance losses should materialize.

After taking credits into account, the industry would on average pay an assessment rate this year that is less than, or in line with, average rates over the past six decades (excluding 1997-2006, during which the FDIC could not charge most institutions any premium). Approximately 60 percent of insured institutions will start 2008 with credits still available. The industry average assessment rate, net of credits, is estimated to be 3.8 basis points in 2008. This rate is significantly lower than rates charged from 1990 through 1996. During that period, the banking and thrift industry average assessment rate ranged between 12 and 22 basis points.¹¹ The 2008 estimated average rate is in line with the average rates for FDIC-insured banks from the 1950s through the early 1980s, which ranged between 3 and 4 basis points after the application of credits that were then in effect.

Under the current rates, assessments would consume a relatively modest share of industry income. Assuming 2008 income remains at 2007 levels, assessments could reduce overall industry pre-tax income this year by 1.7 percent. By contrast, during the years 1990 through 1996, which included both strong and weak years for industry profits, assessments reduced annual pre-tax income by between 4.3 percent and 23.1 percent.

The staff's projections include higher insurance loss provisions in 2008 and 2009 compared to recent years. Nonetheless, in light of the current difficulties facing insured institutions and the economy, a reasonable possibility exists that even these higher projections may understate losses to the fund. If losses turn out to be much higher, or if insured deposits increase by more than 6 percent in 2008 and 2009, the reserve ratio is

¹¹ The 1990 – 1996 rates were adjusted to exclude the costs of Financing Corporation (FICO) bond interest for comparison with rates at other times. Since 1996, the FICO assessment is separate from the FDIC assessment.

likely to fall short of the DRR at the end of 2009. The Board may make adjustments to rates and the timetable for achieving the DRR at any time it chooses, consistent with the assessment regulations. While prescribing a range for the target reserve ratio, the Reform Act gives the Board wide latitude in managing the fund within that range in order to account for economic and financial conditions affecting insured institutions and to avoid sharp swings in assessment rates.

FICO Assessments

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 DIF 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.

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

Analysis of the Projected Effects of the Payment of Assessments On the Capital and Earnings of Insured Depository Institutions

I. Introduction

This analysis estimates the effect in 2008 of deposit insurance assessments on the equity capital and profitability of all insured institutions, assuming that the Board approves the recommended assessment rate schedule of 5 to 43 basis points. The analysis assumes that each institution's pre-tax, pre-assessment income in 2008 is equivalent to the amount reported over the four quarters ending in December 2007, and that an institution's assessment rate and base remain unchanged from December 2007 forward.¹² In addition, the projected use of one-time credits authorized under the Reform Act is taken into consideration in determining the effective assessment for an institution.

II. Analysis

While deposit insurance assessment rates generally will result in reduced institution profitability and capitalization compared to the absence of assessments, the reduction will not necessarily equal the full amount of the assessment. Two factors can mitigate the effect of assessments on institutions' profits and capital. First, a portion of the assessment may be transferred to customers in the form of higher borrowing rates, increased service fees and lower deposit interest rates. Since information is not readily available on the extent to which institutions are able to share assessment costs with their customers, however, this analysis assumes that institutions bear the full after-tax cost of the assessment. Second, deposit insurance assessments are a tax-deductible operating expense; therefore, the assessment expense can lower taxable income. This analysis considers the effective after-tax cost of assessments in calculating the effect on capital.¹³

An institution's earnings retention and dividend policies also influence the extent to which assessments affect equity levels. If an institution maintains the same *dollar* amount of dividends when it pays a deposit insurance assessment as when it does not, equity (retained earnings) will be less by the full amount of the after-tax cost of the assessment. This analysis instead assumes that an institution will maintain its dividend *rate* (that is, dividends as a fraction of net income) unchanged from the weighted average rate reported over the four quarters ending December 31, 2007. In the event that the ratio of equity to assets falls below 4 percent, however, this assumption is modified such that an institution retains the amount necessary to achieve a 4 percent minimum and distributes any remaining funds according to the dividend payout rate.

¹² All income statement items used in this analysis were adjusted for the effect of mergers. Institutions for which four quarters of earnings data were unavailable, including insured branches of foreign banks, were excluded from this analysis.

¹³ The analysis does not incorporate any tax effects from an operating loss carry forward or carry back.

The analysis indicates that the overall effect on the capital of insured institutions is very small. The equity capital of insured institutions (excluding those mentioned in the note to Table A.1 below) as of December 31, 2007 was \$1.350 trillion. Based on the assumptions for 2008 earnings described above, December 31, 2008 equity capital is projected to equal \$1.403 trillion if the recommended assessment rates are adopted. In the absence of an assessment, total equity would be an estimated \$1.3 billion higher, or \$1.404 trillion. Specifically, the \$2.7 billion in net assessments charged in 2008 would lead to a reduction in retained earnings of \$1.3 billion and a reduction in dividends paid of \$551 million.¹⁴ The remaining \$859 million in additional assessment costs would be offset by the tax benefit of deducting assessment expenses.

Table A.1 shows the distribution of the effects of assessments on 2008 equity capital levels across the banking industry. On an industry weighted average basis, projected assessments in 2008 would result in capital that is 0.09 percent less than in the absence of assessments. Forty-four percent of institutions would have ending 2008 capital that is at most 0.1 percent lower than if no assessments were charged, and 65 percent of institutions would have capital that is at most 0.2 percent lower. The projections indicate that assessments would cause only two institutions to have an equity-to-assets ratio below 4 percent by the end of 2008 that would otherwise have met this threshold.

Table A.1
Percentage Reduction in Equity Capital due to Assessments
(\$ in billions)

Reduction in capital	Number of Institutions	Percent of Institutions	Total Assets	Percent of Assets
0.0 - 0.1%	3,711	44%	8,547	66%
0.1 - 0.2%	1,759	21%	2,773	21%
0.2 - 0.3%	1,379	16%	712	5%
0.3 - 0.4%	752	9%	458	4%
0.4 - 0.5%	349	4%	310	2%
0.5 - 1.0%	337	4%	157	1%
> 1.0%	105	1%	75	1%
Total	8,392	100%	13,033	100%

Note: Eleven insured branches of foreign banks and 141 institutions having less than 4 quarters of reported earnings were excluded from this analysis.

The effect of assessments on institution income is measured by deposit insurance assessments as a percent of income before assessments, taxes, and extraordinary items

¹⁴ Assessment revenue projections in this analysis differ slightly from those included in Tables 1 through 5 because the 2008 assessment base, like income, is assumed to remain flat here at 2007 levels.

(hereafter referred to as “income”). This income measure is used in order to eliminate the potentially transitory effects of extraordinary items and taxes on profitability. The analysis indicates that assessments under the recommended rate schedule amount to a modest share of income for most profitable institutions. Table A.2 shows that approximately 71 percent of profitable institutions are projected to owe assessments equal to between 0 and 4 percent of income in 2008. The median projected reduction in income for profitable institutions under the recommended rates is 2.3 percent, while the weighted average reduction for the same institutions is 1.4 percent. For the industry as a whole (including profitable and unprofitable institutions), assessments in 2008 would reduce income by 1.7 percent.

Table A.2
Assessments as a Percent of Income for Profitable Institutions
(\$ in billions)

Assessments as Pct. of Income	Profitable Institutions	Percent of Institutions	Profitable Institutions	Percent of Assets
0.0 - 0.5%	1,384	18%	3,535	28%
0.5 - 1.0%	758	10%	2,530	20%
1.0 - 2.0%	1,186	16%	1,863	15%
2.0 - 3.0%	1,186	16%	1,130	9%
3.0 - 4.0%	830	11%	375	3%
4.0 - 5.0%	518	7%	285	2%
5.0 -10.0%	1,003	13%	527	4%
> 10.0%	659	9%	2,206	18%
Total	7,524	100%	12,452	100%

Notes:

- (1) Income is defined as income before taxes, extraordinary items, and deposit insurance assessments. Assessments are adjusted for the use of one-time credits.
- (2) Unprofitable institutions are defined as those having negative merger-adjusted income (as defined above) over the 4 quarters ending December 31, 2007, and, by assumption, in 2008. There were 868 unprofitable institutions excluded from Table A.2.
- (3) Eleven insured branches of foreign banks and 141 institutions having less than 4 quarters of reported earnings were excluded from this analysis.
- (4) Figures may not sum to totals due to rounding.