September 5, 2007

MEMORANDUM TO: The Board of Directors

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

Bret D. Edwards
Director
Division of Finance

SUBJECT: Advance Notice of Proposed Rulemaking (ANPR) on Assessment Dividends

INTRODUCTION

The Federal Deposit Insurance Reform Act of 2005 (the Reform Act) requires that the FDIC prescribe 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 (Board) issued a temporary final rule to implement the dividends requirements of the Reform Act. At the time, the Board stated its intention to initiate a second, more comprehensive rulemaking on dividends beginning with an advance notice of proposed rulemaking (ANPR) to explore alternative methods for distributing future dividends after the temporary dividend rule expires on December 31, 2008.

The possibility of a dividend before the rule expires appears remote. In fact, because the Board has the ability to lower assessment rates below the base assessment rate schedule (2 to 4 basis points for institutions in Risk Category I), the Board can, if it chooses, reduce the probability of a dividend occurring thereafter.

RECOMMENDATION

Staff recommends that the Board authorize publication of the attached ANPR as the first step of that comprehensive rulemaking. The sole focus of the ANPR is the type of assessment dividend allocation method that the FDIC should adopt. Staff proposes that whether and how the FDIC should retain or revise the other aspects of the temporary final rule (such as the timetable for determining and paying dividends and institutions' requests for review) be addressed in a notice of proposed rulemaking to follow the ANPR.

Concur: ________________
Sara A. Kelsey
General Counsel

SUMMARY OF THE ANPR

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

Congress has given the Board considerable discretion in determining the proper balance of these statutory factors. The ANPR seeks 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. Both approaches would also take into account amounts paid attributable to higher risk through the definition of an "eligible" premium, as discussed below. Staff believes that obtaining the views of the industry and the public through an ANPR will aid the Board in its determination.

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. In its basic form, this method would not require additional Board decisions about the allocation between newer and older institutions.[1] Under most likely scenarios—that is, absent large and continuing fund losses—the fund balance method would likely benefit older institutions for decades.

Under the payments method, increases or decreases in the size of the fund would not directly affect an institution's share of dividends. In addition, the Board would make an explicit decision about the allocation of dividends between older and newer institutions. Two variations are included in the ANPR. The payments method could be structured to benefit older institutions for many years, or it could be structured to put newer institutions on an equal footing quickly.

Alternatives

The fund balance method

Under the fund balance method, every quarter, each institution's share of any dividend would be determined by assigning the institution a dollar portion of the fund balance (its fund allocation), solely for purposes of determining the institution's dividend share. An institution's portion of the 1996 assessment base would determine its initial fund allocation, which would

[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.

subsequently rise or fall based on whether the fund grew or shrank. Returns on investments and ineligible premiums (discussed directly below) would tend to increase allocations; fund losses, operating expenses and dividends paid out would tend to decrease allocations. Institutions would also increase their fund allocation by paying eligible premiums. An eligible premium would need to be defined. Possible definitions include: (1) all premiums paid in cash; (2) premiums paid in cash up to the lowest risk-based rate; or (3) something in between, such as the highest rate charged in Risk Category I. Each institution's fund allocation as a percentage of the total fund would determine its share of any dividend authorized by the Board.

When allocating dividends the Board is required by statute to take into account the portion of assessments paid by an insured depository institution that reflects higher levels of risk posed by that institution. In essence, this statute requires that the Board determine the degree to which dividend allocation should reinforce the risk incentives of the risk-based premium system. Under the fund balance method, the Board would do so through its definition of an eligible premium.

However, if the Board chose the basic form of this method, it would not make further explicit decisions about how to allocate dividends between older and newer institutions. That allocation would occur automatically and would depend primarily upon fund performance.

Under most likely scenarios—that is, absent large and continuing fund losses—the fund balance method would likely benefit older institutions for decades. However, newer institutions could more quickly reach rough parity for dividend purposes if the Board adopted a variant of this method in which something less than the December 31, 2006 fund balance were allocated among older institutions and the remainder of the fund balance were left unallocated.

In general, the fund balance method would rely on more data than the payments method described below and would be more complex, which could reduce transparency. However, the method would be operationally feasible.

The payments method

As described above, in its basic form under most probable scenarios, the fund balance method would most likely benefit older institutions for decades. Under the payments method, the Board would make an explicit decision about the allocation of dividends between older and newer institutions. The payments method could be structured to benefit older institutions for many years, or it could be structured to put newer institutions on an equal footing quickly.

Under the payments method, neither fund performance nor dividends paid would affect dividend shares directly. Rather, each institution's share of any dividend would depend on its portion of the 1996 assessment base, weighted in some fashion, and the eligible portion of the institution's premiums paid after 1996. Under some variations of this method, eligible premiums could include eligible premiums offset with credits.

How the payments method would affect the dividend shares of older and newer institutions would depend on the weight that the Board assigns the 1996 assessment base (initially and over time) compared to the weight it assigns eligible premiums paid each year after 1996. The ANPR provides two variations of the payments method to illustrate how it might be implemented and the range of its effect. Alternatively, however, the Board could, at the outset of the system, expressly reserve the right to change the relative weights assigned the 1996 assessment base and post-1996 eligible premiums in the future.

Under the first variation, 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 and add eligible cash premiums to that amount. Given low losses, this method of implementation would result in older institutions retaining relatively large dividend shares for many years, similar to the fund balance method.

The second variation would tend to put newer institutions on an equal footing with older institutions more quickly. Rather than eligible premiums including all such premiums paid from the beginning of the new assessment system (January 1, 2007), the method could consider only premiums paid over some prior period. For example, to determine dividend shares at the end of 2009, the FDIC could consider premiums paid over the previous 15 years. However, the years 1997 through 2006 would be skipped, since the great majority of institutions paid no deposit insurance premiums then. Therefore, the 15-year period in this example would include the years 1985 through 1996 as well 2007 through 2009. 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. An eligible premium paid in 1996 or any earlier year would be calculated as an institution's share of the 1996 assessment base times total deposit insurance fund assessment income in that year. Under this example, newer institutions would achieve parity with older institutions for dividend purposes in 15 years.

In general, under the payments method, the Board's decision on the relative weight accorded 1996 assessment bases would have a great influence on the pace at which newer institutions achieved parity with older institutions. Higher assessment rates (whether arising from fund losses or rapid insured deposit growth) would also tend to make accelerate the pace, but the effect would not be great.

Under the payments method, as under the fund balance method, the Board would define an eligible premium and, therefore, determine the extent to which dividend allocation should reinforce the risk incentives of the risk-based premium system.

The payments method would rely on fewer data elements than the fund balance method and would likely be less complex and easy to administer. The method would be operationally feasible.

Staff Contacts

Division of Insurance and Research:

Munsell St. Clair
Senior Policy Analyst
(202) 898-8967

Missy Craig
Senior Program Analyst
(202) 898-8724

Legal Division:

Joseph A. DiNuzzo
Counsel
(202) 898-7349

Attachment