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

November 4, 2005

MEMORANDUM TO: The Board of Directors

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

SUBJECT: BIF Assessment Rates for the First
Semiannual Assessment Period of 2006

SUMMARY AND RECOMMENDATION

The staff recommends that the Board maintain the existing Bank Insurance Fund (BIF) 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 BIF at the Designated Reserve Ratio (DRR) of 1.25 percent.

The reserve ratio for the BIF stood at 1.26 percent as of June 30, 2005 (unaudited), the latest date for which complete data are available. While data are incomplete, an early estimate indicates that the reserve ratio stood at 1.25 percent as of September 30, 2005.

[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 BIF 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.

Concur:

William F. Kroener, III
General Counsel

The staff's single point estimate for the reserve ratio as of June 30, 2006, is 1.22 percent (assuming no additional premium income is collected). Staff believes several factors will contribute to a decline in the reserve ratio between now and June 30, 2006. First, and most significant, is growth in insured deposits. Although the fund balance rose in each quarter between July 1, 2004, and June 30, 2005, insured deposits grew faster in all but one quarter. Insured deposits are projected to continue outpacing fund growth during the year ending June 30, 2006. Second, with interest rates projected to move higher, additional unrealized losses on available-for-sale securities are expected. Even in a stable interest rate environment, unrealized gains will disappear as securities move closer to their maturity dates. Finally, reserves for anticipated insurance losses are already at very low levels and preclude any material reversals to loss provisions going forward.

Nonetheless, there is significant uncertainty about factors affecting the reserve ratio, especially future insured deposit growth. For example, if BIF-insured deposits increase at the pace of the past 12 months, the reserve ratio will fall below 1.22 percent by next June. On the other hand, if insured deposits grow at the slower pace observed in the two prior 12-month periods, the reserve ratio likely would remain at or above the 1.25 percent target. Staff's projected lower and upper bounds for the June 2006 reserve ratio of 1.18 percent and 1.26 percent, respectively, primarily reflect the broad range of possible outcomes for insured deposits.

Given the uncertainty underlying the factors affecting future changes in the reserve ratio, the Board would be justified in either maintaining the current rate schedule or increasing rates. Staff recommends that the Board maintain the current rate schedule for three reasons:

First, the most recent reserve ratio based on complete data is above 1.25 percent. While the staff's point estimate for the reserve ratio at the June 30, 2006, is below the DRR, the

projected range for the reserve ratio includes plausible outcomes that meet or exceed 1.25 percent.

Second, if the reserve ratio is less than the DRR as of December 31, 2005, the FDIC would still have two full semiannual periods from when the Board next sets rates (in May of 2006) to return the reserve ratio to 1.25 percent, i.e., until June 30, 2007. Staff believes that, under reasonably likely circumstances, retaining the current rates would not significantly increase the rates that the Board would have to charge if the Board were required to raise rates six months from now.

Finally, deposit insurance reform legislation, if enacted, would merge the BIF and the SAIF. Based on the staff's projected ranges for the BIF and SAIF reserve ratios, the combined fund reserve ratio would be between 1.20 percent and 1.29 percent (with a point estimate of 1.24 percent) if there is no increase in BIF premium rates in January 2006. Depending on the provisions of the final legislation and the date of enactment, the BIF may not exist by the end of the January to June 2006 semiannual assessment period. The fund merger and other changes to the system expected under reform legislation argue against changing BIF premium rates at this juncture.

Based on June 30, 2005 data and projected ranges for the relevant variables at June 30, 2006, the recommended rate schedule would result in an average annual assessment rate of approximately 0.1 basis points (bp).

If the Board desires greater protection against the chance that the reserve ratio may fall below the DRR, an alternative approach would be to increase assessment rates. However, if the reserve ratio at the end of June 2006 exceeds the DRR, the FDIC would be required to refund the excess amount to certain insured depository institutions.

Staff has considered a range of plausible events that could produce significant movements in the BIF reserve ratio. Our methodology provides ranges for: (1) estimated insurance losses primarily based on changes to the contingent liability for anticipated failures (contingent loss reserve); (2) interest income and changes in the market value of available-for-sale (AFS) securities due to changes in interest rates, and (3) growth in insured deposits.

ANALYSIS

In setting assessment rates since the capitalization of the BIF, the Board must consider: (1) the probability of failure 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]

Projections for the BIF Reserve Ratio over the Next Assessment Period

Staff's point estimate for the BIF reserve ratio as of June 30, 2006, is 1.22 percent. The lower and upper bounds of the likely range for the BIF reserve ratio as of June 30, 2006, are 1.18 percent and 1.26 percent, respectively.

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 June 30, 2006.

[2] By statute, the Board must review and weigh 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.

1. Fund Balance

Staff evaluates three significant inputs to project the fund balance. First, staff estimates the effect 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 June 30, 2006. Third, staff projects unrealized gains and losses on available-for-sale (AFS) securities through June 30, 2006.

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 banks 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" BIF losses from potential bank failures, as required by generally accepted accounting principles. Actual results could differ from these estimates. As of June 30, 2005, the BIF loss reserve stood at $1.6 million, increasing to $4.3 million as of September 30, 2005.

Staff has estimated a likely range of insurance losses based on projected changes in the contingent loss reserve for the period ending June 30, 2006. These projections are influenced by several factors, including: (1) the shifting of problem banks among different risk categories within the reserve, (2) the reduction in problem banks due to improved financial conditions, mergers, or failures, and (3) the addition of new problem banks. To capture the effects of these changes, staff uses a migration approach, which estimates 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. 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 projecting changes to 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 June 30, 2006 will range from $2 million to $195 million, with a best estimate of $65 million.[3] Table 1 shows the range of potential loss provisions for failures as well as provisions for net losses/recoveries on resolution receivables, litigation losses, and other contingencies.

Table 1
Potential Provisions and Adjustments for Loss Allowances
For the Twelve Months Ending June 30, 2006

	Low (High Provision) Estimate	**Best Estimate**	**High (Low Provision) Estimate**
Provision Related to Future Failures (1)	$195 million	$65 million	$2 million
Provision for Closed Banks' Net Recoveries (2)	-$47 million	-$67 million	-$87 million
Other Provisions (3)	$17 million	$0	-$17 million
Potential Provision for Losses*	**$165 million**	**-$2 million**	**-$102 million**

* Figures may not add to totals due to rounding.

Notes:

(1) Includes provisions required to bring the contingent loss reserve to estimated June 30, 2006 levels after accounting for a) actual losses sustained in the third quarter of 2005 ($0), and b) estimated losses sustained through June 2006 ($4 million under the Best Estimate). Changes in the contingent loss reserve occur because of failures, mergers, improvement in existing problem institutions' conditions, deterioration of existing problem institutions, and the addition of new problem institutions to the problem institutions list.

(2) The best estimate includes a third quarter 2005 provision of -$67 million due primarily to lower 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 bank resolution receivables totaling $403 million as of June 30, 2005.

(3) Range is based on the standard deviation of changes in the year-end contingent liability for litigation losses and other contingent liabilities (e.g., representations, warranties, and asset securitization guaranties) for the period 1998 to 2004.

[3] Staff estimates that the balance of the contingent loss reserve as of June 30, 2006 will range from $4 million to $176 million, with a best estimate of $62 million.

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.[4]

Banks 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 June 30, 2005, 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 banks are well positioned to withstand a significant degree of financial adversity. In no case did the stress simulation results raise any significant concerns.

Therefore, staff believes that widespread deterioration in banking 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, an introduction of

[4] FDIC staff economists, working with academic researchers, have developed an alternative approach to measure risks posed to the insurance funds. This approach, 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 employed 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. Using the LDM, staff developed alternative BIF loss provisions related to future failures. The results are close to those of the statistical migration analysis shown in Table 1 and lead to a similar projected range (and best estimate) for the reserve ratio as of June 30, 2006.

new and higher risk mortgage products, larger securitization volumes, and higher household debt levels in recent years could increase the magnitude of stress on bank conditions from potential future problems in the consumer, residential mortgage, and commercial real estate sectors. Thus, conclusions drawn from stress scenario analyses should be treated with some degree of caution.

The Effects of Hurricane Katrina on the Deposit Insurance Funds

Staff believes it is too early to make a reasonable estimate of the effects of Hurricane Katrina on the deposit insurance fund balances. There remains substantial uncertainty about the ultimate effects of Katrina on the credit quality of Gulf Coast financial institution loan portfolios. The economic dislocations as well as the adverse effects on collateral values and the repayment capacity of borrowers resulting from the hurricane may stress the balance sheets of several financial institutions in the region. It will take some time to determine to what degree the expected influx of insurance payments and financial assistance from Government and private sources will reduce the stress on the affected banks and mitigate risks to the deposit insurance funds. Staff continues to evaluate a range of possible outcomes for economic damage, insurance proceeds, and Government assistance. At this point, staff deems that an adjustment either to the point estimate or the range of projected insurance loss provisions shown in Table 1 would be premature.

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 used as the "best estimate" were the consensus forecasts through the second quarter of 2006 as detailed in the September issue of the *Blue Chip Financial Forecasts*. Adopting the experts' consensus forecasts allows for forecasted yield curves that change in shape over time.[5]

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 "best estimate" rates and upper and lower bounds. 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.

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[5] Staff also developed alternative interest rate projections using actual forward rates available as of approximately the same time that the projections in the September *Blue Chip Financial Forecasts* were generated. Forward rates are expected yields on securities of varying maturities for specific future points in time that are derived from the term structure of interest rates. (The term structure of interest rates refers to the relationship between current yields on comparable securities with different maturities.) Staff developed upper and lower bounds using historical differences between actual interest rates and corresponding forward rates. The projections using forward rates incorporate only a small increase in short-term interest rates with virtually no change in long-term interest rates over the assessment period. However, projections using more current forward rates (early October 2005) indicate an increase in short-term rates that is largely comparable to the consensus forecast. In addition, Federal funds futures prices as of early October imply an increase in the short-term interest rates similar to that of the consensus forecast. Much uncertainty remains about how long-term interest rates will respond to an increase in the federal funds rate over the assessment period, with experts sharply divided over the probability of a steeper vs. a flatter yield curve. Given recent market information and uncertainty regarding the outlook for long-term interest rates, staff believes the *Blue Chip* consensus forecasts are reasonable. However, use of the forward rates would produce similar projections for the reserve ratio to those based on the *Blue Chip* forecasts.

Table 2
Potential Interest Income and
Unrealized Gains (Losses) on AFS Securities
July 1, 2005 to June 30, 2006 ($ in millions)

	Low Estimate (1)	Best Estimate (1)	High Estimate (1)
Interest Income (2)	1,617	1,604	1,588
Unrealized Gain (Loss) on AFS Securities (2)	-328	-205	-80
Net Fund Contribution from Investment Activities	**1,289**	**1,399**	**1,508**

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 scenario 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 third quarter of 2005 and projected investment income and gains/losses for the remaining period through June 30, 2006.

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 125 basis points. Long-term Treasury yields were virtually unchanged over the same period, largely due to continued foreign capital inflows to the U.S. and historically low and stable long-term inflationary expectations. These diverging trends in short-term and long-term interest rates led to a further flattening of the yield curve. Experts forecast a gradual and largely parallel increase in short-term and long-term Treasury yields over the nine-month period ending in June 2006 as the economy continues to grow at a robust pace and short-term inflationary concerns loom larger. Some reduction 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 the proceeds from 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 June 30, 2006.

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

	Lower Bound	Best Estimate	Upper Bound
Assessments (2)	43	43	43
Interest Income (3)	1,617	1,604	1,588
Total Revenue	1,660	1,647	1,631
Operating Expenses (4)	828	828	828
Provision for Losses	165	-2	-102
Total Expenses & Losses	993	826	726
Net Income	667	821	905
Unrealized Gain (Loss) on AFS Securities (3)	-328	-205	-80
Comprehensive Income (Loss) (5)	339	616	825
Fund Balance – 6/30/05	35,094	35,094	35,094
Projected Fund Balance – 6/30/06	35,433	35,710	35,919

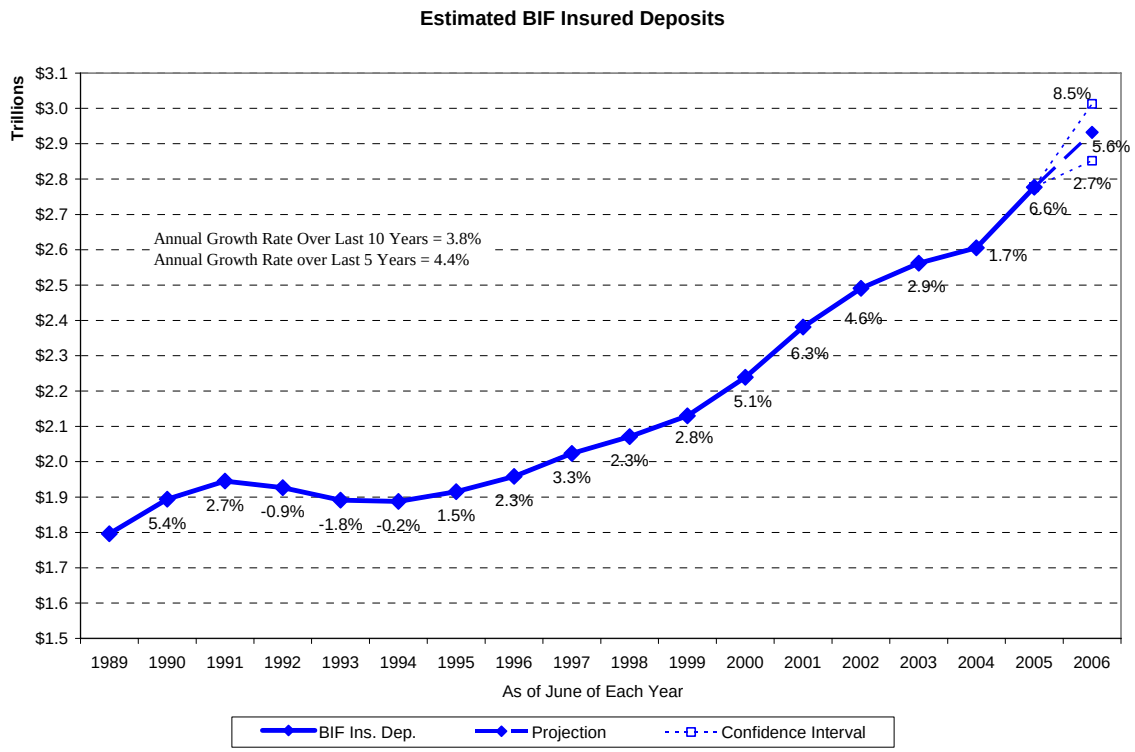
Notes:

(1) Projected income and expense figures are for the twelve months ending June 30, 2006. Figures may not sum exactly to totals due to rounding.
(2) Assumes that the current assessment rate schedule remains in effect through June 30, 2006.
(3) See notes to Table 2 for an explanation of changes in interest revenue and unrealized gains (losses) on AFS securities.
(4) Projected operating expenses are based on the Board approved 2005 budget for July through December, and the most current projected budget for January through June 2006.
(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 BIF-insured deposit growth rates since 1990, measured at June of each year compared to the previous June, have been as high as 6.6 percent and as low as -1.8 percent. After declining in 1992, 1993, and 1994, BIF-insured deposits grew at annual rates between 1.5 percent and 3.3 percent in 1995-99. The pace of growth picked up in the next three years: 5.1 percent in 2000, 6.3 percent in 2001 and 4.6 percent in 2002. Improved stock market conditions and historically low short-term interest rates helped reduce growth to 2.9 percent in 2003. Deposit growth further slowed to 1.7 percent in 2004, but accelerated significantly in 2005, growing by 6.6 percent. The high growth in insured deposits may result partly from an increase in short-term interest rates, following monetary policy actions by the Federal Reserve. An increase in short-term interest rates relative to long-term rates makes short-term investment instruments such as bank deposits more attractive to investors. Short-term interest rates have been rising steadily since the second half of 2004 while long-term rates remained largely unresponsive to a gradual increase in the Federal funds rate.

Figure 1



Staff's best estimate for insured deposit growth over the four quarters ending June 2006 is 5.6 percent. This estimate, based on an analysis of historical data, is 1.2 percentage points higher than the average growth rate in BIF-insured deposits over the past five years. The current earnings capacity of the fund is not sufficient to prevent the projected rate of insured deposit growth (even in the absence of significant insurance losses) from causing a gradual decline in the reserve ratio.

Based upon the June 30, 2005 fund balance, it takes approximately $22 billion in insured deposit growth (0.8 percent) to reduce the BIF reserve ratio by 1 basis point (bp). The staff's point estimate indicates that insured deposits will increase by $155 billion over the next four quarters.

Based on projections using a statistical model, the best judgment of the staff is that BIF-insured deposits are likely to experience a growth rate in the range of 2.7 percent to 8.5 percent between June 2005 and June 2006.[6] Staff's point estimate is based on growth at the midpoint of this range (5.6 percent), which will bring total BIF-insured deposits to $2.9 trillion**.** Insured deposits grew more rapidly over the most recent reported 12-month period (June 2004 to June 2005) than the long-term historical experience upon which staff based its model. If this recent rapid growth continues, insured deposits may grow at a rate closer to the upper end of our forecast range. Additionally, staff notes that in previous periods of Federal Reserve tightening, insured deposit growth has strengthened as short-term rates rise. Another factor that could result in higher insured deposit growth would be a lackluster stock market performance coupled with stock price volatility. In contrast, a rising stock market and strong U.S. economic growth could result in a lower growth rate for insured deposits.

3. BIF Reserve Ratio

Based on the projected BIF balance and the growth of the insured deposit base, the best estimate of the BIF reserve ratio as of June 30, 2006 is 1.22 percent (Table 4). The best estimate assumes modest loss provisions for future failures, moderately rising Treasury yields, and insured deposit growth of 5.6 percent over the four quarters ending June 30, 2006.

Staff projects the lower and upper bounds of the likely range to be 1.18 percent and 1.26 percent, respectively (Table 4). The lower bound, which reflects an 8 bp decrease from the actual June 30, 2005 ratio, assumes a strong increase in insured deposits (8.5 percent growth) and

[6] Specifically, the statistical model explains growth in insured deposits as dependent on current and last quarter growth in domestic deposits (both insured and uninsured) as well as on last quarter's growth in insured deposits. The range corresponds to a 95 percent confidence interval. That is, to the extent that insured deposits can be described by their past growth and by growth in domestic deposits, staff is 95 percent certain that actual growth of insured deposits for the year ending June 30, 2006 will lie in this range. The growth rate predicted by the model, i.e., the point estimate, is the midpoint of this range. Thus, it is considered the most likely growth rate for insured deposits.

higher interest rates that reduce the fund balance by raising unrealized losses on AFS securities (Table 3). The lower bound also incorporates higher insurance losses for future failures. Although the estimate reflects staff's view of a reasonably possible adverse scenario, it is not intended to represent a "worst case" scenario.

Table 4
Projected BIF Reserve Ratios
($ in millions)

	June 30, 2005		
Fund Balance	$35,094		
Estimated Insured Deposits	$2,777,086		
BIF Ratio	1.26%		
	Lower Bound (1) June 30, 2006	**Best Estimate (2) June 30, 2006**	**Upper Bound (3) June 30, 2006**
Projected Fund Balance	$35,433	$35,710	$35,919
Estimated Insured Deposits	$3,012,843	$2,932,247	$2,851,651
Estimated BIF Ratio	1.18%	1.22%	1.26%

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 8.5 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 5.6 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 2.7 percent.

The upper bound produces no change in the reserve ratio from June 30, 2005. This estimate assumes an increase of 2.7 percent in the BIF-insured deposit base, very low loss provisions for future failures, and a more modest increase in interest rates, which results in smaller unrealized losses on AFS securities.

Staff's point estimate of the reserve ratio for June 30, 2006 is 3 bp lower than the DRR and represents a 4 bp decline from the June 30, 2005 ratio. Staff believes several factors will contribute to a decline in the reserve ratio between now and June 30, 2006:

- The most significant factor influencing the reserve ratio's projected decline is the projected strong growth in insured deposits. Staff's point estimate is for insured deposits to rise 5.6 percent, higher than the past five-year average for BIF-insured deposits.

- Interest rates continue 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 continue.
- Although staff remains optimistic about industry prospects, reserves for anticipated losses are already at very low levels and preclude any material reversals to loss provisions going forward.

As a result of these considerations, staff believes that the BIF reserve ratio is likely to decrease over the four quarters ending in June 2006. Nonetheless, there is significant uncertainty about factors affecting the reserve ratio, especially future insured deposit growth. If BIF-insured deposits increase at the rate experienced during the past 12 months, the reserve ratio will fall below the staff's point estimate of 1.22 percent. On the other hand, if insured deposits increase at rates of either of the two previous 12-month periods (1.7 percent in June 2003 – June 2004 or 2.9 percent in June 2002 – June 2003), the reserve ratio will remain at or above the 1.25 percent target assuming the fund balance increases as projected. Therefore, staff believes that the 1.18-to-1.26 percent range for the June 2006 reserve ratio appropriately reflects these uncertainties.

Assessment Rates for the Next Semiannual Assessment Period

1. Statutory Requirements Regarding the Assessment Rate Schedule

The Federal Deposit Insurance Act (FDI Act) requires that the Board set semiannual assessment rates:

> [W]hen necessary, and only to the extent necessary -- (I) to maintain the reserve ratio of each deposit insurance fund at the designated reserve ratio; or (II) if the reserve ratio is

> less than the designated reserve ratio, to increase the reserve ratio to the designated reserve ratio . . . .[7]

Because the BIF reserve ratio was above 1.25 percent as of June 30, 2005, the Board can raise semiannual assessment rates for the first half of 2006 only pursuant to clause (I), to maintain the BIF at 1.25 percent. The statutory provisions that require the FDIC to return the ratio to 1.25 percent when the ratio falls below that target have not been activated.

If the reserve ratio falls below 1.25 percent, section 7 of the FDI Act requires that the FDIC restore it to the DRR no later than one year after "such rates are set."[8] The statute does not define when "rates are set" and legislative history provides no guidance on this issue. A reasonable interpretation of the assessment provisions of section 7 of the FDI Act is that "rates are set" on the date of the Board meeting at which the Board votes to approve rates for the ensuing semiannual period. Also, it is consistent with the intent of the statute that the FDIC be given one year to restore the reserve ratio to the DRR to conclude that the one-year period begins with the first semiannual period following the Board meeting at which the rates are set. Thus, for example, if the BIF reserve ratio falls below 1.25 percent as of December 31, 2005, the one-year period to re-establish the reserve ratio to 1.25 percent would begin when the rates set by the Board in May 2006 become effective (that is, July 1, 2006).

Under the section 7 assessment provisions, the FDIC must do one of two things if the December 31, 2005, BIF reserve ratio (which is the ratio used to set the July 1, 2006, rates) is below 1.25 percent. The FDIC must either: (1) set assessment rates to achieve the 1.25 percent target by June 30, 2007, which would allow two semiannual periods to re-establish the 1.25 percent ratio—the periods beginning July 1, 2006 and January 1, 2007—in addition to any

[7] 12 U.S.C. 1817(b)(2)(A).
[8] Id. at 1817(b)(3)(A)(i).

amounts collected during the first half of 2006, or (2) the FDIC must establish a recapitalization schedule of 15 years or less culminating in a reserve ratio equal to the DRR.[9]

2. Assessment Rate Recommendation

Table 5 summarizes the current distribution of institutions across the assessment matrix.

Table 5
BIF Assessment Base Distribution (1)
Assessable Deposits as of June 30, 2005
Supervisory Subgroup and Capital Groups in Effect July 1, 2005

Capital Group		**A**		**B**		**C**	
1. Well	Number	7,301	94.0%	352	4.5%	47	0.6%
	Base ($billion)	$4,570	98.0%	$72	1.5%	$13	0.3%
2. Adequate	Number	50	0.6%	5	0.1%	7	0.1%
	Base ($billion)	$8	0.2%	$1	0.0%	$0	0.0%
3. Under	Number	0	0.0%	0	0.0%	3	0.0%
	Base ($billion)	$0	0.0%	$0	0.0%	$0	0.0%

Assessment Base	$4,665 billion
Estimated assessment revenue 7/1/05 to 6/30/06	$ 43 million
Average assessment rate (bp) 7/1/05 to 6/30/06	0.09 basis points

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

Staff recommends maintaining the current assessment rate schedule rather than raising rates at this time for several reasons:

First, the BIF reserve ratio has not fallen below 1.25 percent as of June 30, the date of the most recent reserve ratio based on complete information. While data are incomplete, an early estimate indicates that the reserve ratio stood at 1.25 percent as of September 30, 2005. While staff's single point estimate for the reserve ratio is 1.22 percent as of June 30, 2006 (assuming no additional premium income is collected), staff's range of estimates includes the possibility that the fund will be as high as 1.26 percent. As previously discussed, uncertainties about factors

[9] Id. at 1817(b)(3)(A)(i) and (ii).

affecting the reserve ratio, especially future insured deposit growth, result in a fairly wide range of possible outcomes for the June 2006 ratio.

Second, under current law, if the BIF reserve ratio were to fall below 1.25 percent as of December 31, 2005, the FDIC would still have two full semiannual periods—until June 30, 2007—to return the reserve ratio to 1.25 percent. Staff considered the potential differences in premiums for the 12 months ending June 2007 depending on whether the Board maintains the current rate schedule through June 2006 or raises premiums effective January 2006. If the staff's point estimate for the June 2006 reserve ratio is realized, premium rates for the July 2006 to June 2007 period would need to be approximately 2 bp higher if the Board maintains the current rate schedule for the January to June 2006 period than if the Board increases rates beginning in January 2006, under reasonable assumptions. Alternatively, if insured deposits rise at the upper end of the projected range for the year ending June 2006 (8.5 percent), premium rates for the following 12 months (assuming the current schedule is maintained for January to June 2006) would need to be about 4 basis points higher than if the Board raised premiums sooner, under reasonable assumptions.[10] In staff's opinion, these potential differences in rates are not large enough to justify an increase in rates now.

Third, deposit insurance reform legislation, if enacted, would merge the BIF and the SAIF. Based on the staff's projected ranges for the BIF and SAIF reserve ratios, the combined fund reserve ratio would be between 1.20 percent and 1.29 percent, with a point estimate of 1.24 percent, without any increase in BIF premium rates for the January to June 2006 semiannual

[10] If insured deposits are projected to rise more slowly than the fund's investment returns (less expenses and losses) between June 2006 and June 2007, then the differences in premium rates would be smaller.

assessment period.[11] Depending on the provisions of the final legislation and the date of enactment, the BIF may not exist by the end of the January to June 2006 period.

The legislation would also permit the FDIC to manage the combined fund reserve ratio within a range that extends above and below 1.25 percent. While it would allow the FDIC to charge all institutions a risk-based premium, it would award initial assessment credits to institutions that paid high premiums to build up the insurance funds in the early-to-mid 1990s. Staff therefore believes that the changes to the system expected under reform legislation argue against changing BIF premium rates at this juncture.

If the Board desires greater protection against the chance that the reserve ratio may fall below the DRR, an alternative approach would be to increase assessment rates. However, if the reserve ratio at the end of June 2006 exceeds the DRR, the FDIC would be required to refund the excess amount to certain insured depository institutions.[12]

3. Spread between Assessment Rates

Staff's recommendation would also retain 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 current (and proposed) assessment rate schedule appears in Table 6.

[11] This assumes that the current SAIF escrow funds are included in the combined fund balance, as the proposed legislation would allow.

[12] Refunds must not exceed the excess assessments paid by institutions during that semiannual period. Also, refunds may not be made to institutions that exhibit financial, operational, or compliance weaknesses, or institutions that are not "well capitalized."

Table 6
Proposed Assessment Rate Schedule
First Semiannual Assessment Period of 2006
BIF-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

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.

BIF assessments for the second half of 2005 were about $27 million. Retaining the current assessment base schedule would generate approximately $16 million during the first semiannual period of 2006.

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. In recommending that the Board maintain the existing rate schedule, the staff has considered the effect on bank earnings and capital and found no unwarranted adverse effects.

4. Matrix Migration

With 99.2 percent of the number of institutions and 99.7 percent of the assessment base in the three lowest assessment risk classifications of "1A," "1B," and "2A," as of July 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, 146 institutions migrated into the "1A" risk classification (Table 7), and 115 institutions

migrated out of the "1A" risk classification. Only 464 institutions are classified outside of the best risk classification.

Table 7
BIF Migration To and From Assessment Risk Classification "1A"

Institutions entering "1A"	Number	Base ($billion)
Due to capital group reclassification only	38	8.5
Due to supervisory subgroup reclassification only	107	13.5
Due to both	1	0.3
Total	146	22.3
Institutions leaving "1A"	**Number**	**Base ($billion)**
Due to capital group reclassification only	38	6.6
Due to supervisory subgroup reclassification only	75	43.1
Due to both	2	0.4
Total	115	50.2

Notes: The table reflects BIF-insured institutions that moved in and out of assessment risk classification "1A" from the first semiannual assessment period of 2005 to the second 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."

More broadly, considering all institutions, the supervisory subgroup component of the risk classification was upgraded since the previous period for 121 institutions with an assessment base of $15.4 billion and was downgraded for 80 institutions with an assessment base of $43.8 billion.

Other Issues

Refunds for second semiannual period of 2005. Since BIF-insured institutions classified as "1A" currently pay no assessments to the BIF under the proposed rate schedule, they are ineligible to receive any refund for the second semiannual period of 2005.

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 BIF 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 first semiannual assessment period of 2006 will be determined using September 30, 2005 Call Report and Thrift Financial Report data.

STAFF CONTACTS

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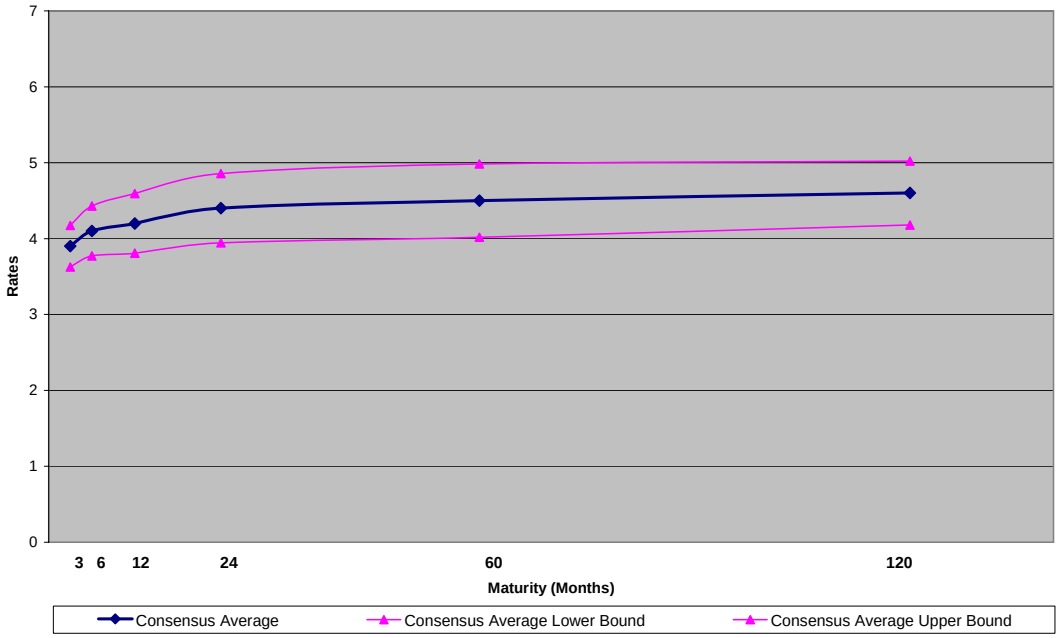
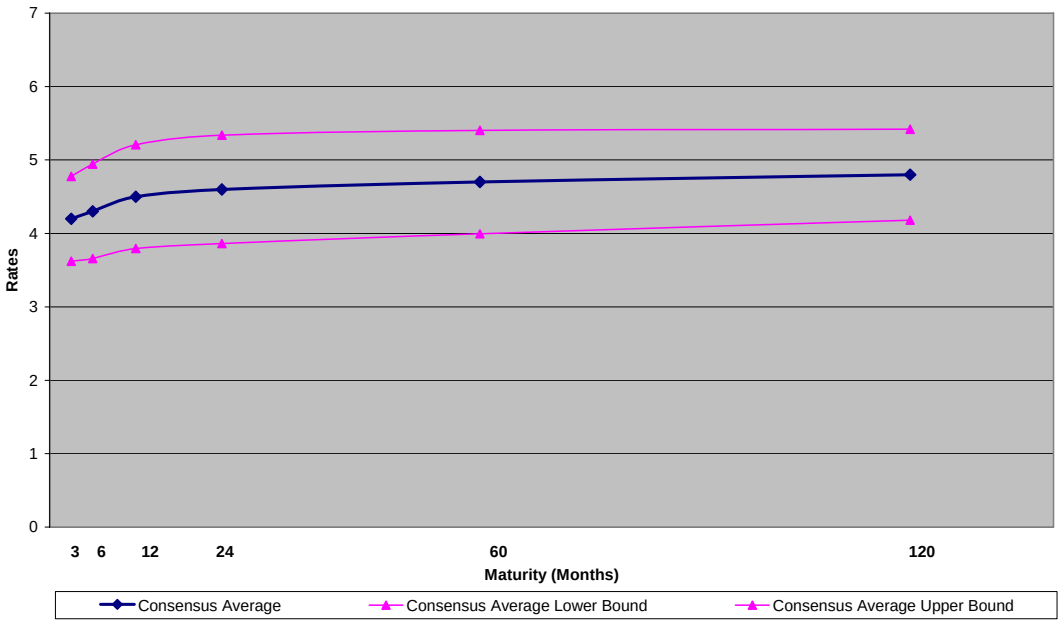
Appendix A – Interest Rate Assumptions

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



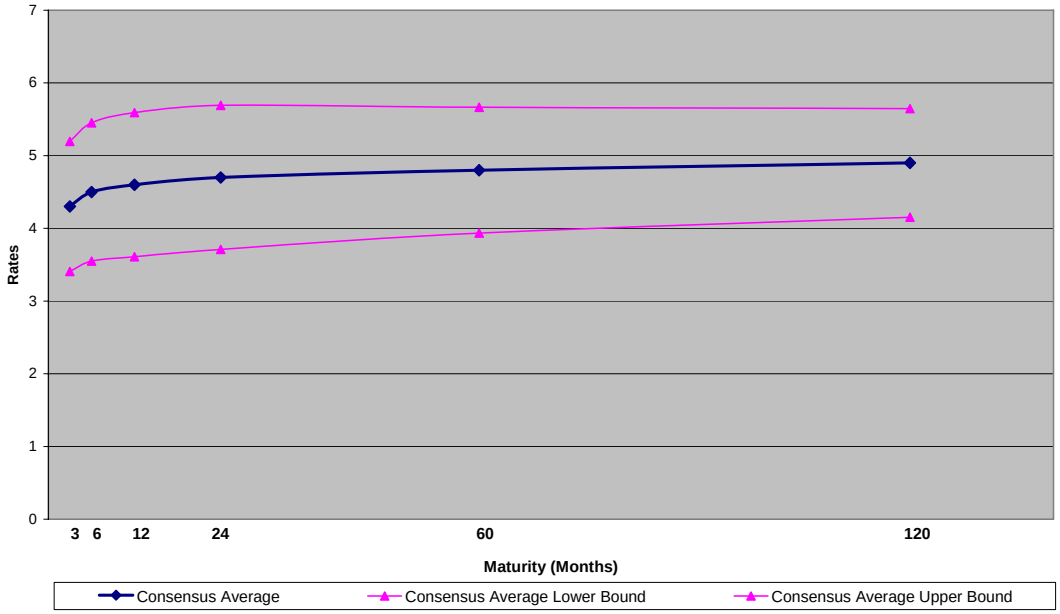
Source: Blue Chip Financial Forecasts, March 1990-September 2005.

Figure 2: Estimated Yield Curve and Interval for First Quarter 2006



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

Figure 3: Estimated Yield Curve and Interval for Second Quarter 2006



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

Concur:

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Jodey C. Arrington
Chief of Staff