Restoring Banking's Safety Net: Deposit Insurance's Steeper Cost

By Kory Killgo

Premiums will rise for banks in the Dallas-based Eleventh Federal Reserve District—but not by as much as they will for banks in the rest of the country.

Deposit insurance has been a fundamental part of the U.S. banking system since the newly chartered Federal Deposit Insurance Corp. (FDIC) opened on Jan. 1, 1934. Over the next 75 years, the FDIC has protected millions of depositors and helped thousands of institutions weather economic storms—without the loss of any insured deposits.

Banks pay premiums to insure their deposits. Institutions with more deposits or weaker conditions pay more—much like the cost of automobile insurance depends on the value of the car and the driving record of the person behind the wheel. Insured banks contribute each quarter to the Deposit Insurance Fund (DIF), which the FDIC uses to cover the expenses related to resolving failed banks.

For banks, the premiums are an ongoing expense, a recurring reduction in earnings and profitability. However, deposit insurance's protection is a key factor in institutions' ability to attract and retain deposits. A stable deposit base insulates banks from the kind of runs that marked the early years of the Great Depression, allowing the institutions to function more efficiently as financial intermediaries. In turn, greater efficiency in the financial system promotes a more efficient and robust economy.

A recession now in its 21st month has presented tremendous challenges to the deposit insurance system. Actual and expected bank failures have left the DIF below its mandated level; the fund's balance declined from $45.2 billion on June 30, 2008, to $10.4 billion on June 30, 2009.

The FDIC has responded by raising the premiums banks pay. Premiums will rise for banks in the Dallas-based Eleventh Federal Reserve District—but not by as much as they will for banks in the rest of the country.[1] This additional cost is an important consideration because every dollar spent on insurance is a dollar that can't be lent or otherwise invested.

Replenishing the DIF

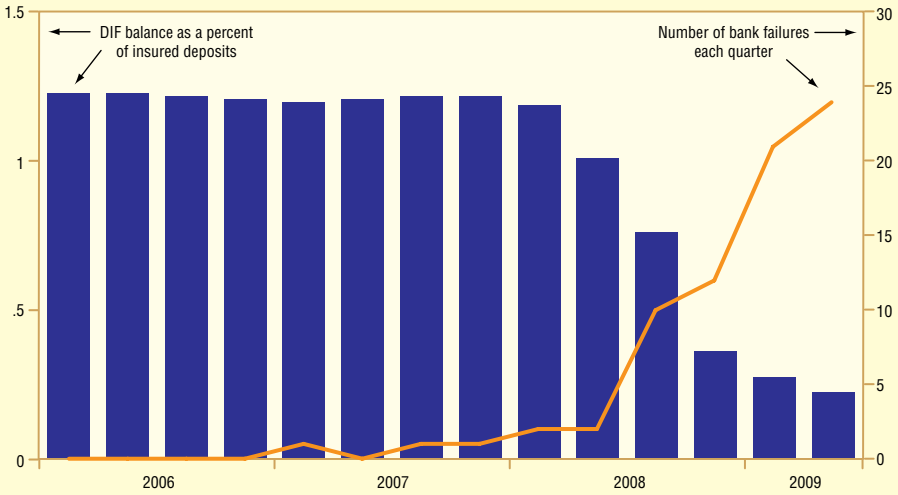
Twenty-five FDIC-insured institutions failed nationwide in 2008, and another 45 failures occurred in the first six months of 2009. This followed a decade with no more than 11 failures a year, including a 31-month period from mid-2004 to early 2007 with no failures.

The DIF reserve ratio—its balance as a percentage of estimated insured deposits—fell from 1.22 percent at the end of 2007 to 0.36 percent on Dec. 31, 2008, then slipped further to 0.22 percent on June 30, 2009 (*Chart 1*).[2]

When the reserve ratio fell below 1.15 percent in the second quarter of 2008, the law required the FDIC to return it to at least that level within five years. The current downturn's severity led the FDIC to grant an extension to seven years. Even with the added time, forecasts indicated that collecting premiums at rates then in effect wouldn't rebuild the DIF quickly enough to meet expected demands on the fund.

To ensure the DIF's stability and maintain public confidence, the FDIC implemented

Chart 1
Pressure Builds on the Deposit Insurance Fund



SOURCE: Federal Deposit Insurance Corp.

three changes to the way insurance premiums are calculated. These adjustments are expressed in basis points, a banking industry measure equal to one 100th of a percentage point.

First, it imposed an annualized premium increase of 7 basis points in the first quarter of 2009—7 cents for every $100 of assessable deposits.

Second, the FDIC adjusted the premium formulas to make the system more sensitive to insured institutions' financial conditions and the impact their failures could have on the DIF. The new approach considers more factors in calculating assessments and widens their range. Annualized premiums were 12 to 50 basis points in the first quarter of 2009. Starting in the second quarter, the premiums range from 7 to 77.5 basis points.

Third, the FDIC proposed a one-time premium of 20 basis points on applicable deposits at all institutions, regardless of condition, as of June 30, 2009. After further analysis and public comment, the FDIC modified its proposal, opting to calculate the one-time assessment as 5 basis points on adjusted assets.[3]

To bolster confidence in banks, Congress raised the insurance limit from $100,000 to $250,000 per depositor on individual accounts in October 2008. This year, Congress extended the extra coverage through the end of 2013. Higher assessments would likely have been needed with or without the new limits.

The Cost to Banks

The FDIC believes these changes are critical to restoring the DIF to appropriate levels. But how will they impact banks, particularly smaller banks, which tend to fund more of their business with deposits? And how will the changes affect Eleventh District banks?

Addressing these questions begins with a baseline that looks at the premium assessment method in place for 2008 (*see box*). Then we compare it to the adjusted method used in the first quarter of 2009 (step 1) and to the revised method used beginning in the second quarter (step 2). Finally, we look at the impact of the special assessment.

Data for comparing the different calculation methods are collected in the quarterly Report of Condition and Income filed by financial institutions as of Dec. 31, 2008. Other inputs are institutions' safety and soundness ratings and, where available, their long-term

Calculating the Assessment: A Primer

Risk categories determine the assessment rates banks pay for deposit insurance. The FDIC assigns all insured institutions to one of four risk categories based on two factors: regulatory capital and supervisory group.[1]

A bank's capital level determines whether it's well, adequately or undercapitalized.[2] The supervisory group reflects a bank's safety and soundness rating. The rating, assigned by bank examiners, ranges from 1 to 5, with a 1-rated institution the most sound.

In this table, supervisory group A includes most banks with safety and soundness ratings of 1 or 2. Most 3-rated banks are in group B, and most 4- or 5-rated banks are in group C.

	Supervisory group		
Capital level	**A**	**B**	**C**
Well capitalized	Category I	Category II	Category III
Adequately capitalized	Category II	Category II	Category III
Undercapitalized	Category III	Category III	Category IV

Under the baseline method in place on Dec. 31, 2008, assessment rates for banks in category I, the safest, are set in a range based on additional analysis of their safety and soundness rating, plus their long-term debt rating (for banks with more than $10 billion in assets that have such ratings) or condition ratios (for all other banks).[3]

Annualized assessment rates for the four risk categories calculated for Dec. 31 were:

Baseline method	**Risk category**			
	Category I	Category II	Category III	Category IV
Assessment rates (basis points)	5 to 7	10	28	43

With the March 31, 2009, assessment, the FDIC increased all categories by 7 basis points (step 1).

Step 1	**Risk category**			
	Category I	Category II	Category III	Category IV
Assessment rates (basis points)	12 to 14	17	35	50

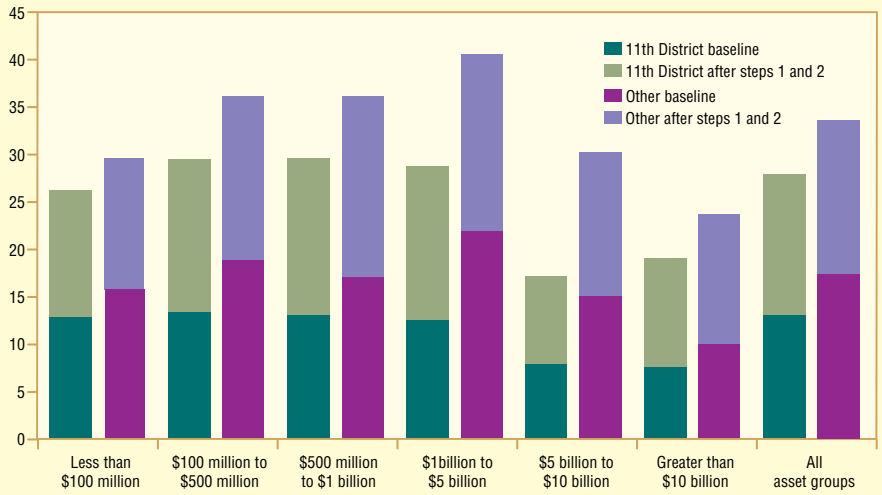
The FDIC made extensive adjustments beginning with the June 30, 2009, assessment. The new model analyzes the condition ratios of all banks regardless of size. It adds special rate adjustments for levels of secured liabilities and brokered deposits, which can increase a bank's assessment rate, and unsecured debt, which can lower the rate.

The resulting approach (step 2) is more sensitive to the factors that the FDIC's research has shown to be important predictors of a bank's financial condition. The overall range of possible assessment rates has also expanded significantly.

Step 2	**Risk category**			
	Category I	Category II	Category III	Category IV
Assessment rates (basis points)	7 to 24	17 to 43	27 to 58	40 to 77.5

NOTES:
[1] A thorough description of recent developments in the FDIC's premium assessment process is available at www.fdic.gov/deposit/insurance/assessments/index.html and in the Federal Register, vol. 74, no. 41, March 4, 2009, pp. 9,525–63.
[2] A detailed definition is available in the Federal Reserve's Commercial Bank Examination Manual, Section 4133.1, updated November 2006; the manual is available online at www.federalreserve.gov/boarddocs/supmanual/supervision_cbem.htm.
[3] Ratios represent tier 1 leverage, loans past due 30–89 days, nonperforming assets, loans charged off, pretax net income and (under step 2) brokered deposits.

Chart 2
FDIC Premiums Lower for Eleventh District Banks



SOURCES: Federal Deposit Insurance Corp.; Federal Reserve's National Examination Database; SNL Financial; author's calculations.

The FDIC's actions put a noticeable dent in commercial banks' capital, defined broadly as total assets less total liabilities.

debt ratings.[4] These inputs are used to determine an institution's risk category, which in turn sets its premium level. This analysis omits some factors that affect the premiums banks actually pay, so the results only approximate the impact of the assessment changes implemented by the FDIC.[5]

The FDIC's actions directly address the need to restore the DIF. However, they put a noticeable dent in commercial banks' capital, defined broadly as total assets less total liabilities. Capital serves as a critical cushion that banks maintain to absorb losses.

For the commercial banking industry, the total assessment amounts to 0.17 percent of capital per calendar quarter under the baseline, 0.31 percent under step 1 and 0.33 percent under step 2. The assessments under all three methods, on average, constitute a smaller percentage of capital for banks headquartered in the Eleventh District than for institutions based elsewhere (*Chart 2*).

Grouping banks by size reveals additional details of the assessment system's impact. This approach divides banks into six groups based on assets: less than $100 million, $100 million to $500 million, $500 million to $1 billion, $1 billion to $5 billion, $5 billion to $10 billion and over $10 billion.

In general, banks in the two largest asset-size groups pay the least in assessments as a share of capital.

Outside the Eleventh District, banks with assets greater than $10 billion have the lowest average rates as a percent of capital under the baseline method and steps 1 and 2. Banks in the $1 billion to $5 billion group have the highest assessments.

Inside the Eleventh District, the lowest assessment rates relative to capital are in the $5 billion to $10 billion group. Rates are slightly higher in the largest asset group and noticeably higher in asset groups less than $5 billion.

The Special Assessment

Steps 1 and 2 represent the FDIC's response to deteriorating conditions in the industry. Projections indicated, however, that premiums collected from the new assessments wouldn't be enough to restore the DIF to mandated levels in the required time frame, leading the FDIC to propose a special assessment.

The original 20-basis-point proposal would have averaged 1.65 percent of commercial bank capital nationwide and 1.67 percent in the Eleventh District, but it triggered an outcry from smaller banks, concerned that sound community banks with high relative levels of deposits would bear an unfair burden.

For example, a well-capitalized bank paying the minimum premium under the current calculation method would pay almost three times as much in this single assessment as it would for a whole year's premiums.

The FDIC subsequently modified the

special assessment, calculating it as 5 basis points multiplied by adjusted assets instead of deposits.

The FDIC capped the dollar amount at 10 basis points times the bank's deposit assessment base. If the FDIC finds a need for further special assessments, it can levy similar 5-basis-point supplements at the end of September and December.

The special assessment as adopted equals approximately 0.46 percent of capital for all banks and 0.45 percent for district banks.

The revision significantly reduces funds collected for the DIF, but it imposes a lighter burden on banks, provided the FDIC doesn't implement the September and December assessments.

Basing the special assessment on assets instead of deposits also treats banks of different sizes more uniformly. In the Eleventh District, the original 20-basis-point plan would have resulted in a maximum difference in average assessment rates across size categories of 76 basis points. Under the adopted method, the range is 11 basis points.

Why the Differences?

The observation that banks in the two largest size groups tend to have lower assessments than those in smaller groups is consistent with larger banks' relatively lower levels of deposits—which translates into lesser premiums in an assessment system based on deposits. This applies to banks both in and out of the Eleventh District (*Chart 3*).

Eleventh District banks have higher relative levels of deposits, so we would expect their assessments to be higher than banks elsewhere—but that isn't the case. The reason involves the condition of the banks.

The FDIC places insured institutions in one of four risk categories. In the Eleventh District, a greater percentage of banks falls into the lowest risk category—a function of district banks' generally higher safety and soundness ratings and levels of capital. Ninety-three percent of Eleventh District banks are in the FDIC's lowest risk category, compared with 86 percent of banks elsewhere. Because of these factors, they tend to have lower assessments.

Overall, applying the scenarios to year-end 2008 data suggests a generally lighter impact in the Eleventh District than elsewhere. Expressed as a percent of capital, deposit insurance premiums for district banks were less than assessments for banks elsewhere in all asset groups and under the baseline, step 1 and step 2. The special assessment was similar or lighter for district banks.

The condition of Eleventh District banks offsets their relatively higher concentration of deposits, reducing assessments and freeing up capital.

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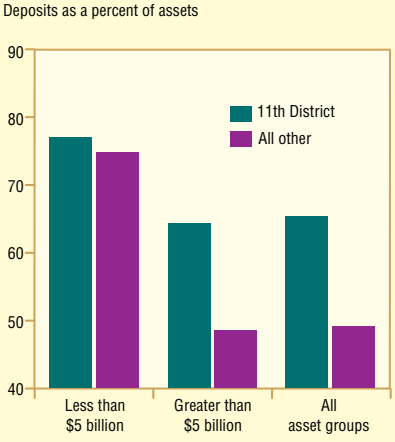
Chart 3

Eleventh District Banks Depend More on Deposits



SOURCES: Federal Deposit Insurance Corp.; Federal Reserve's National Examination Database; SNL Financial; author's calculations.

Notes

[1] The Federal Reserve Bank of Dallas is the main office of the Eleventh Federal Reserve District, which comprises Texas, southern New Mexico and northern Louisiana.

[2] DIF data for 2009 are preliminary and unaudited.

[3] Adjusted assets are total assets, less tier 1 capital; tier 1 capital includes common stockholders' equity, qualifying perpetual preferred stock, certain minority interests and trust preferred securities.

[4] Safety and soundness ratings are from the Federal Reserve's National Examination Database. Long-term debt ratings are from SNL Financial.

[5] Among factors not considered in this analysis are the effects of a one-time credit available to some banks, potential case-by-case adjustments made by the FDIC to the assessments of large banks, and an institution's possible migration between risk categories during the quarter.

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