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Division of Insurance and Research

February 1, 2011

MEMORANDUM TO: The Board of Directors

FROM: Arthur J. Murton
Director
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SUBJECT: Final Rule on the Deposit Insurance Assessment Base, Assessment Rate Adjustments, Dividends, Assessment Rates and Large Bank Pricing Methodology

Staff recommends that the Board of Directors (FDIC or Board) adopt the attached final rule relating to the deposit insurance assessment base, assessment rate adjustments, deposit insurance assessment rates, dividends, and large bank pricing methodology and authorize its publication in the Federal Register.

I. Background

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) revised the statutory authorities governing the FDIC's management of the Deposit Insurance Fund (the DIF or the fund). Dodd-Frank granted the FDIC the ability to achieve goals for fund management that it has sought to achieve for decades but lacked the tools to accomplish: maintaining a positive fund balance even during a banking crisis and maintaining moderate, steady assessment rates throughout economic and credit cycles. It also changed the basis for the deposit insurance assessment base from deposits to assets less capital.

Based upon a historical analysis of fund losses, staff developed a comprehensive, long-range management plan for the DIF, which was set out in a Notice of Proposed Rulemaking on Assessment Dividends, Assessment Rates and the Designated Reserve Ratio adopted by the Board in October 2010 (the October NPR). The plan is designed to: (1) reduce the pro-cyclicality in the existing risk-based assessment system by setting moderate, steady assessment rates throughout economic and credit cycles; and (2) maintain a positive fund balance even

Concur: ____________________
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during a banking crisis by setting an appropriate target fund size and a strategy for assessment rates and dividends.

In the October NPR, the Board proposed setting the Designated Reserve Ratio (DRR) at 2 percent, adopting a moderate assessment rate schedule to take effect when the fund reserve ratio exceeds 1.15 percent, and suspending dividends when the fund reserve ratio exceeds 1.5 percent.[1] In lieu of dividends, the Board proposed adopting progressively lower assessment rate schedules when the reserve ratio exceeds 2 percent and 2.5 percent. In December 2010, the Board adopted a final rule setting the DRR at 2 percent (the DRR final rule), but deferred action on the other subjects of the October NPR (dividends and assessment rates) until this final rule.

In a notice of proposed rulemaking adopted by the FDIC Board on November 9, 2010 (the Assessment Base NPR), the Board proposed to amend the definition of an institution's deposit insurance assessment base consistent with Dodd-Frank's general redefinition of the assessment base as average consolidated total assets minus average tangible equity, make additions, deletions and changes to the existing assessment rate adjustments, and modify the current deposit insurance assessment rate schedule and those proposed in the October NPR in light of the assessment base required by Dodd-Frank. The FDIC's goal was to determine a rate schedule that would have generated approximately the same revenue as that generated under the current rate schedule in the second quarter of 2010 under the current assessment base.

Also on November 9, 2010, largely as a result of changes made by Dodd-Frank and the Assessment Base NPR, the Board reissued a proposal (the Large Bank NPR) originally adopted in April 2010 (the April NPR) to revise the risk-based system for all large insured depository institutions, taking into account comments received on the April NPR.

The FDIC sought comments on every aspect of the proposed rules. The FDIC received a total of 55 written comments on the October NPR, the Assessment Base NPR and the Large Bank NPR, although some were duplicative. Comments are discussed in the relevant sections below.

The proposed final rule covers all of the proposals in the October NPR (except for the proposals related to the DRR), the Assessment Base NPR and the Large Bank NPR. The preamble to the final rule describes the rule in detail and discusses comments received on the NPRs. A brief summary of the final rule and discussion of its effects follow.

The final rule provides that it will become effective April 1, 2011.

[1] 12 U.S.C. § 1817(e)(2), as amended by § 332 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

II. Brief Summary of the Final Rule and Its Effects

A. Assessment Base

Dodd-Frank requires the FDIC to amend its regulations to redefine the assessment base as average consolidated total assets minus average tangible equity, but does not define these terms. The final rule would require that all insured depository institutions report average consolidated total assets in conformance with Call Report requirements, except that institutions with assets of $1 billion or more and all newly insured depository institutions would report average *daily* balances during the calendar quarter. In response to comments, the final rule provides that institutions with less than $1 billion in assets report average weekly balances during the calendar quarter, unless they choose to report daily averages. Once an institution reports using daily averages, however, it would have to continue to do so.

The final rule would use Tier 1 capital as the measure for tangible equity. The final rule would require institutions to report the average of month-end balances of Tier 1 capital, but would allow institutions with less than $1 billion in average consolidated total assets to report the end-of-quarter amount of Tier 1 capital as a proxy for average tangible equity.

An insured depository institution that owns other insured depository institutions would calculate its average consolidated total assets and tangible equity capital without consolidating its insured depository institution subsidiaries. An insured depository institution with subsidiaries that are not insured depository institutions would incorporate data from those subsidiaries into its consolidated total assets and average tangible equity. The final rule clarifies that data for subsidiaries would be for the same quarter as that reported by the parent institution to the extent practicable, but in no case could data from the subsidiaries differ by more than one quarter.

As allowed by Dodd-Frank, the final rule would deduct low risk, liquid assets from the assessment base for banker's banks. A banker's bank could deduct the sum of its average balances due from Federal Reserve Banks (reserve balances) plus its average federal funds sold. The amount of this deduction, however, could not exceed the sum of the bank's average deposit liabilities from commercial banks and other depository institutions in the United States plus its average federal funds purchased. The final rule makes a conforming change requiring that averages be calculated daily or weekly depending on the way the institution calculates its average consolidated total assets. The final rule would also clarify that funds resulting from government capital infusion programs, FDIC stock ownership, and employee compensation plan stock ownership will not disqualify a bank from being considered a banker's bank.

In response to comments, the final rule would include fiduciary assets and revenue in addition to custodial and safekeeping assets and revenue in defining a custodial bank and in calculating such a bank's assessment base deduction. Commenters have convinced staff that fiduciary accounts have a custodial component, which, in many cases, is the primary reason for the account. The final rule would define a custodial bank as an insured depository institution having previous calendar year-end fiduciary account and custody and safekeeping account assets of at least $50 billion or an insured depository institution deriving at least 50 percent of its revenue from fiduciary accounts and custody and safekeeping accounts over the previous calendar year.

As allowed by Dodd-Frank, the final rule would deduct certain low risk, liquid assets from the assessment base for custodial banks. In response to comments, low risk assets would be determined without regard to explicit maturity. Low risk assets would be assets with a Basel risk weighting of 0 percent, regardless of maturity, plus 50 percent of those assets with a Basel risk weighting of 20 percent, again regardless of maturity, subject to the limitation that the value of these assets could not exceed the daily or weekly average value of those deposits classified as transaction accounts and identified by the institution as being directly linked to a fiduciary or custody and safekeeping account. Unlike the Assessment Base NPR, the final rule limits the deduction to transaction accounts, rather than all deposit accounts, because deposits generated in the course of providing custodial services (regardless of whether there is a fiduciary aspect to the account) are used for payments and clearing purposes, as opposed to deposits held in non-transaction accounts, which may be part of a wealth management strategy.

The FDIC received several other comments. The following are some of the major comments received that staff, after review, recommends should not result in changes to the rule: eliminate goodwill from the assessment base; eliminate transactions between affiliated companies from the assessment base; cap assessments at a percentage of an institution's insured deposits; allow banks with less than $10 billion in assets to report end-of-quarter Tier 1 capital rather than an average of month-ends (the final rule would allow only insured depository institutions with less than $1 billion to report in this manner); and allow all institutions (not just banker's banks) to deduct federal funds sold from the assessment base.

B. Adjustments to Assessment Rates

The current assessment rate schedule incorporates adjustments for types of funding that either pose heightened risk to the DIF or that help offset risk to the DIF. Because the magnitude of these adjustments is calibrated to a domestic deposit assessment base, the final rule would recalibrate the unsecured debt and brokered deposit adjustments, and eliminate the secured liability adjustment. The final rule would also add a depository institution debt adjustment. These changes should more accurately reflect the risk that these funding mechanisms pose to the DIF.

Specifically, the final rule would change the assessment rate reduction for long-term unsecured liabilities so that the effect of the assessment system on an institution's cost of borrowing long-term unsecured debt will remain unchanged. The final rule would also change the cap on the adjustment from 5 basis points to the lesser of 5 basis points or 50 percent of an institution's initial base assessment rate to ensure that no institution's assessment rate is zero or close to zero. In addition, the final rule would remove Qualified Tier 1 capital from the definition of long-term unsecured liabilities for small institutions, since it is already deducted from the assessment base. The final rule would also eliminate debt that is redeemable within one year of the reporting date from qualifying as long-term, since such a redemption option negates the benefit to the DIF of long-term debt.

The final rule would also create a new adjustment (the Depository Institution Debt Adjustment) that would apply a 50 basis point charge to every dollar of long-term unsecured debt held by an insured depository institution that was issued by another insured depository institution. This adjustment is intended to offset the benefit received by institutions that issue long-term, unsecured liabilities when those liabilities are held by other insured depository institutions, since the risk of this debt remains in the banking system. The final rule, however, based on comments, would allow an institution to exclude from its debt calculation an amount equal to no more than 3 percent of its Tier 1 capital.

The final rule would retain the brokered deposit adjustment of 25 basis points times the ratio of brokered deposits in excess of 10 percent of domestic deposits to the new assessment base. The adjustment would be recalibrated to the new assessment base. For small institutions, the adjustment would continue to apply only to institutions in Risk Categories II, III, and IV. For large institutions, based on comments, the final rule would provide an exemption from the adjustment for institutions that are well-capitalized and have a composite CAMELS rating of 1 or 2. The final rule would maintain the 10 basis points cap on the brokered deposit adjustment.

The final rule would eliminate the secured liability adjustment.

The FDIC received several other comments. The following are some of the major comments received that staff, after review, recommends should not result in changes to the rule: increase the cap on the unsecured debt adjustment; exclude sweeps from brokered deposits; and reduce the cap on the brokered deposit adjustment to 6.5 basis points.

C. Dividends

To increase the probability that the fund reserve ratio will reach a level sufficient to withstand a future crisis, the final rule would suspend dividends indefinitely, consistent with the FDIC's long-term, comprehensive plan for fund management. In lieu of dividends, the final rule would adopt progressively lower assessment rate schedules when the reserve ratio exceeds 2 percent and 2.5 percent, as discussed below.

D. Assessment Rate Schedules

An analysis of the statutory factors that the Board must consider when setting assessment rates is contained in the final rule. Based on this analysis, including the historical analysis discussed above, the final rule would adopt the assessment rate schedules proposed in the Assessment Base NPR. Initial and total base assessment rates would become effective April 1, 2011 and are shown in Table 1 below.

Table 1
Initial and Total Base Assessment Rates*

	Risk Category I	Risk Category II	Risk Category III	Risk Category IV	Large and Highly Complex Institutions
Initial base assessment rate	5–9	14	23	35	5–35
Unsecured debt adjustment**	(4.5)–0	(5)–0	(5)–0	(5)–0	(5)–0
Brokered deposit adjustment	……	0–10	0–10	0–10	0–10
TOTAL BASE ASSESSMENT RATE	2.5–9	9-24	18-33	30-45	2.5–45

* Total base assessment rates do not include the depository institution debt adjustment.
**The unsecured debt adjustment cannot exceed the lesser of 5 basis points or 50 percent of an insured depository institution's initial base assessment rate; thus for example, an insured depository institution with an initial base assessment rate of 5 basis points will have a maximum unsecured debt adjustment of 2.5 basis points and cannot have a total base assessment rate lower than 2.5 basis points.

Based on second and third quarter 2010 data, this rate schedule should result in approximately the same assessment revenue that the FDIC would otherwise have collected using the assessment rate schedule under the Restoration Plan adopted by the Board on October 19, 2010.

Effective beginning the quarter after the fund reserve ratio first meets or exceeds 1.15 percent, initial base assessment rates would range from 3 basis points to 30 basis points. Under these rates, the average assessment rate would approximately equal the long-term moderate, steady assessment rate—5.3 basis points—that would have been needed to maintain a positive fund balance throughout past crises.

The final rule also sets out two assessment rate schedules that would come into effect without further action by the Board when the fund reserve ratio meets or exceeds 2 percent and 2.5 percent. Staff's historical analysis revealed that reducing the 5.3 basis point weighted average assessment rate by 25 percent when the reserve ratio reached 2 percent and by 50 percent when the reserve ratio reached 2.5 percent would have allowed the fund to remain positive during prior banking crises and would have successfully limited rate volatility.

The final rule would retain the Board's flexibility to adopt actual rates that are higher or lower than total base assessment rates without the necessity of further notice-and-comment rulemaking. However, based on comments, the Board could not increase or decrease rates from one quarter to the next by more than 2 basis points (rather than the current and proposed 3 basis points); and cumulative increases and decreases could not be more than 2 basis points higher or lower than the total base assessment rates (again, rather than the current and proposed 3 basis points).

The FDIC received several other comments. The following are the major comments received that staff, after review, recommends should not result in changes to the rule: the 4 basis point range of rates in Risk Category I should be reduced when the industry becomes prosperous again; the Board should lower rates if the reserve ratio is returning to 1.15 percent more quickly than currently expected; the FDIC should return the balance of pre-paid assessments earlier than June 30, 2013. Staff is not recommending that the final two comments be rejected entirely. The Board may wish to consider these actions in the future. Staff is, however, recommending no change to the final rule as the result of the comments.

E. Large Bank Pricing

As proposed in the Large Bank NPR, the final rule would eliminate risk categories and the use of long-term debt issuer ratings for calculating risk-based assessments for large institutions, generally, those with at least $10 billion in assets. Instead, assessment rates would be calculated using a scorecard that combines CAMELS ratings and certain forward-looking financial measures to assess the risk a large institution poses to the DIF. One scorecard would apply to most large institutions and another to institutions that are structurally and operationally complex or that pose unique challenges and risks in the case of failure (highly complex institutions).[2] Each scorecard assesses certain risk measures to produce two scores—a performance score and a loss severity score—that are ultimately combined and converted into an initial base assessment rate.

The scorecards use quantitative measures that are readily available and useful in predicting a large institution's long-term performance. Large institutions and highly complex institutions that pose higher risk over the long term would pay higher assessments when they assume these risks—rather than paying large assessment rates when conditions deteriorate—thus mitigating the pro-cyclicality of the current system.

As discussed in the Large Bank NPR, over the 2005 to 2008 period, the new measures predicted the performance of large institutions in 2009 significantly better than using weighted-average CAMELS component ratings alone or the risk measures included in the existing financial ratios method.

[2] The final rule makes a technical change to the definition of a highly complex institution to avoid including certain non-complex institutions by requiring, among other things, that for an institution to be defined as a processing bank or trust company, one type of highly complex institution, it must have total fiduciary assets of $500 billion or more.

The FDIC would retain its ability to take additional information into account to make a limited adjustment to an institution's total score (the large bank adjustment), which would be used to determine an institution's initial base assessment rate. However, the FDIC would not adjust assessment rates until the guidelines governing the large bank adjustment are updated and approved by the Board.

Based on comments, staff recommends eliminating the non-core funding to total liabilities ratio from the loss severity score since liability composition is explicitly considered in the remaining loss severity measure.

Also, based upon comments, staff re-estimated runoff assumptions used in the loss severity score for insured and uninsured deposits, federal funds purchased, and repurchase agreements using a large sample that included small institutions over a one-year period leading up to failure. Based on the re-estimate, staff recommends reducing the growth rate for insured deposits from 32 percent to 10 percent, while increasing the run-off rate for uninsured deposits from 28.6 percent to 58 percent.

In addition, staff recommends removing the reference to FICO and other credit bureau scores in the definition of subprime loans, which are included in the higher risk assets ratio. The definition in the final rule would delete the reference to FICO and other credit bureau scores. Credit scores are based on credit scoring models that are controlled by credit rating bureaus; thus, the models may change materially at the discretion of the credit rating bureaus. There also may be inconsistencies among the various models that the credit rating bureaus use. The final rule would focus on credit history as a characteristic of a subprime borrower, but, to avoid underreporting of subprime loans, the definition would include loans that an institution itself identifies as subprime based upon similar borrower characteristics.

Staff recommends the following additional, technical, changes in the final rule: the leveraged loan definition would exclude any loan that is $1 million or less and would remove the total liabilities to assets ratio test; and both held-to-maturity and available-for-sale securities would be included at fair value in the balance sheet liquidity ratio.

The FDIC received many other comments. The following are some of the major comments received that staff, after review, recommends should not result in changes to the rule: give more weight to loss severity; do not assume foreign deposits will be ring fenced; allow more time to comment and more time to comply with new reporting requirements; eliminate or reduce the 15 point potential adjustment of an institution's score. These comments and other less significant comments are discussed in the preamble.

Many commenters opposed the large bank pricing rule arguing that the system is not risk-based because the effect of new assessment base mandated by Dodd-Frank is not offset in the rates. Staff believes that the final rule preserves and improves the risk-based assessment system. As described in the preamble, the final rule complies with the FDIC's statutory obligation to establish a risk-based system, using the new assessment base. Under the new assessment base and large bank pricing system, large institutions will hold approximately 78 percent of the assessment base and pay about 79 percent of total assessments. Congress expressly intended this result and viewed the new assessment base as a better measure of risk than the previous base of domestic deposits.

F. Effect of the Final Rule

Based upon second and third quarter 2010 data, the FDIC should collect approximately the same revenue under the revised assessment system and assessment base as it would have without the revisions.

While the rule is overall revenue neutral, it would, in aggregate, increase the share of assessments paid by large institutions, consistent with the express intent of Congress. Based upon September 30, 2010 data, the share of the assessment base held by institutions with assets greater than $10 billion would increase from 70 percent to 78 percent, as mentioned above, and their share of overall dollar assessments would increase commensurately from 70 percent to 79 percent. The share of the assessment base held by institutions with assets greater than $100 billion would increase from 49 percent to 58 percent, and their share of overall dollar assessments would increase commensurately from 48 percent to 57 percent.

In aggregate, large institutions would pay 12 percent more, due primarily to the change in the assessment base. Because of the combined effect of the change in the assessment base and increased risk differentiation among large banks in the new large bank pricing system, many large institutions would experience a significant change in their overall assessment. The weighted average assessment change, up or down, for large banking companies would be about 31 percent. The combined effect of changes in this final rule would result in 59 large institutions paying lower dollar assessments and 51 large institutions paying higher dollar assessments, based upon September 30, 2010 data.

In aggregate, small institutions would pay 30 percent less, due primarily to the change in the assessment base. The combined effect of changes in this final rule would result in only 84 of 7,661 small institutions paying higher assessments, again based upon September 30, 2010 data.

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