BIF Assessment Rates for the Second Semiannual Assessment Period of 1999

MEMORANDUM TO:	The Board of Directors
FROM:	Arthur J. Murton, Director Division of Insurance
SUBJECT:	BIF Assessment Rates for the Second Semiannual Assessment Period of 1999

Recommendation

The staff recommends that the Board maintain the existing Bank Insurance Fund (BIF) assessment rate schedule of 0 to 27 basis points (bp) per year. Based upon year-end 1998 data and projected ranges for the relevant variables as of year-end 1999, this rate schedule would result in an average annual assessment rate of approximately 0.10 bp and would comply with the statutory requirements for the Board to establish a risk-based assessment system and set assessments only to the extent necessary to maintain the target Designated Reserve Ratio (DRR), currently 1.25 percent.

Summary

The Federal Deposit Insurance Act (FDI Act) governs the authority of the Board to set BIF assessment rates and directs the Board to establish a risk-based assessment system for insured depository institutions and set assessments to the extent necessary to maintain the reserve ratio at 1.25 percent. The reserve ratio for the BIF stood at 1.38 percent (unaudited) as of December 31, 1998, and it is likely that the reserve ratio will remain above 1.25 percent throughout 1999 unless insurance losses or deposit growth depart dramatically from recent experience. As indicated in the semiannual overview of risks provided to the Board on April 8, 1999, there does not appear to be a strong potential for large insurance losses over the near term. Likewise, despite a surge in BIF-insured deposit growth during the fourth quarter of 1998, there is little indication that such a pace will be maintained throughout 1999.

Thus, it does not appear that additional assessment revenue will be needed to maintain the target DRR through the second semiannual period of 1999, and the staff consequently recommends no changes to the rate schedule. Some institutions will pay premiums under this schedule even though the reserve ratio exceeds the target DRR; however, the view of the staff is that the current schedule is consistent with the statutory requirement to establish a risk-based assessment system.

Analysis

In setting assessment rates since recapitalization of the BIF, the Board has considered: (1) the balance between revenues and expenditures over time, (2) the statutory requirement to maintain the DRR, currently 1.25 percent[1], and (3) all other relevant statutory provisions. These are considered in turn.

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[1]The Board is required to 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. These factors directly affect the reserve ratio prospectively and thus

are considered as elements of the requirement to set rates to maintain the reserve ratio at the target DRR.

Long-Run Considerations

Based on a thorough review of FDIC experience and consideration of statutory changes designed to moderate future deposit insurance losses (**e.g.**, prompt corrective action authority, national depositor preference and the least-cost resolution requirement), analysis conducted by FDIC staff at the time of the BIF recapitalization concluded that an effective average assessment rate of 4 to 5 bp annually would be appropriate to achieve long-run balance between BIF revenues and expenses (where expenses include monies needed to prevent dilution due to deposit growth). Thus, in 1995, the "base" rate schedule for the BIF was established at 4 to 31 bp annually. Given conditions of slow deposit growth and minimal insurance losses, which reduced the need for assessment revenue, the Board shifted the effective annual rate schedule downward to 0 to 27 bp as of 1996.[2] The Board did not alter the base rate schedule, which remains today at 4 to 31 bp. In recommending that the Board maintain the base schedule at 4 to 31 bp, the staff previously expressed the view that a rising BIF reserve ratio was not necessarily indicative of a long-run trend, given the historical volatility of deposit growth and insurance losses. Staff continues to hold this view. The fourth quarter of 1998 provided fresh evidence of the potential for volatility, as BIF-insured deposits grew at an annual rate of 14.4 percent, the highest rate since quarterly reporting was adopted in 1991, causing the BIF reserve ratio to drop from 1.41 percent as of September 30, 1998, to 1.38 percent as of year-end 1998.

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[2]The FDIC may alter the existing rate structure and may change the base BIF rates (currently 4 to 31 bp) 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 bp, as deemed necessary to maintain the target DRR.

Maintaining the Target DDR Over the Next Assessment Period

The BIF reserve ratio stood at 1.38 percent as of December 31, 1998 (unaudited), the latest date for which complete data are available. In view of the current and projected levels of the BIF reserve ratio, the current rate schedule appears to be consistent with the statutory requirement to maintain the target DRR of 1.25 percent through year-end 1999.

Currently, conditions in the financial institutions industry are strong and the outlook is generally favorable. However, there are several areas of concern that the FDIC continues to monitor. Among these are the uncertain effects of the Year 2000 (Y2K) computer problem. Another area of concern is the increased involvement of insured institutions in new and potentially risky lending markets, including sub-prime and high-loan-to-value lending, along with recent signs of deteriorating underwriting standards and other risky practices at some insured institutions. In addition, several commercial real estate markets are experiencing intense competition and appear vulnerable to an oversupply of commercial space. Finally, continued uncertainties in the global economy and the prospect of continued financial market volatility perpetuate concerns raised by the major financial disturbances of late 1998.

Taking appropriate steps to address these concerns continues to be a priority for the FDIC. The top priority is Y2K, and the Board is well aware of the numerous efforts underway to address this issue. The staff continues to explore ways to address the remaining risks through various means, including the risk-based premium system. Refinements to the current pricing process are being considered that would involve the development of new screens based on Call Report and market information to help identify "outlier" institutions, those with atypically high-risk profiles as compared to others paying the same insurance premium. When such institutions are identified and a review of supervisory information reveals specific concerns regarding risk management practices, steps would be taken to ensure that management is given the opportunity and incentives to moderate their risk taking. Failure to address any known deficiencies in risk management practices within a reasonable period of time may result in higher premiums for some institutions.

The staff will return to the Board in the near future with specific recommendations for refinements to the risk-based premium system. The proposed refinements will not involve changes to the existing rate schedule and will pertain only to the risk classifications of outlier institutions. Staffs of the four banking agencies are generally supportive of this approach. Regardless of the final form of our recommendations, premiums would be unaffected for the vast majority of institutions.

For purposes of maintaining the target DRR, in view of the current level of the BIF reserve ratio, the staff's judgment is that maintaining the current assessment rate schedule for the second semiannual period of 1999 is appropriate. Following is an analysis of the anticipated effect of changes in the fund balance and the rate of insured deposit growth on the reserve ratio through December 31, 1999.

1. Fund Balance

The BIF unaudited balance was $29.612 billion on December 31, 1998 (Table 2). For a given assessment rate schedule, changes in the balance over the short run are determined largely by changes in insurance losses and interest income.

Insurance Losses. Insurance losses consist of two components: a contingent liability for future failures and an allowance for losses on institutions in receivership. In Table 1, potential changes in contingent liabilities for the twelve months ending on December 31, 1999, reflect the range of current estimates from the Failure Projection Working Group (FPWG) plus any adjustments for potential losses on failures that already have occurred since December 31, 1998. The resulting range for changes in contingent liabilities is $100 million to $300 million.

As of December 31, 1998, receivables from bank resolutions had an estimated net recovery value of $748 million. An estimated range of approximately +5 percent to –5 percent was applied to the net recovery value of closed banks to determine the high and low estimates for the change in the allowance for losses detailed below.

Table 1

Changes in Contingent Liabilities and Allowance for Losses (1)

December 31, 1998 to December 31, 1999

	Low Loss Estimate	**High Loss Estimate**
Contingent Liability for Future Losses	$100 million	$300 million
Allowance for Losses: Closed Banks (2)	($40) million	$40 million
Total Provision for Losses	$60 million	$340 million

Notes:

1. *Both projections reflect the information available as of March 31, 1999, regarding future economic conditions.*
2. *Assumes a range of approximately -5 percent to +5 percent of the estimated net recovery value of bank resolutions, $748 million as of December 31, 1998 (rounded up to the nearest $10 million).*

Interest Income. The average BIF investment portfolio for the twelve months ending December 31, 1999, is estimated to be approximately $28.8 billion. Given a range for the yield of 5.91 percent to 6.02 percent through the second semiannual period of 1999, based on the possibility of a shift in the level of interest rates of plus or minus 100 bp, interest income is projected to be between $1.703 billion and $1.737 billion for the twelve months ending December 31, 1999.

Table 2 summarizes the effects on the fund balance of the low and high estimates that define the ranges assumed for interest income and insurance losses.

Table 2

Fund Balance (1)

($ in millions)

	Low Projected Balance	**High Projected Balance**
Assessments (2)	29	29
Interest Income (3)	1,703	1,737
Total Revenue	1,732	1,766
Operating Expenses	810	810
Provision for Losses	340	60
Total Expenses & Losses	1,150	870
Net Income	582	896
Fund Balance (Unaudited) – 12/31/98	29,612	29,612
Projected Fund Balance – 12/31/99	30,194	30,508

Notes:

1. *Projected income and expense figures are for the twelve months from January 1, 1999, through December 31, 1999.*
2. *Assumes that the current assessment rate schedule remains in effect through December 31, 1999.*
3. *Portfolio yield is estimated to be between 5.91 percent (low) and 6.02 percent (high), reflecting a shift in the level of interest rates of + or - 100 bp. The average invested fund balance is estimated to be approximately $28.8 billion.*

2. Insured Deposits

Since 1988, annual growth of BIF-insured deposits has been as high as 7.1 percent and annual shrinkage as much as 2.1 percent (see Figure 1). After shrinking annually from 1991 through 1994, insured deposits grew by 3.0 percent in 1995, 2.8 percent in 1996, 2.5 percent in 1997, and 4.1 percent in 1998. Insured deposits shrank slightly in the second and third quarters of 1998, but grew by an annualized rate of 14.4 percent in the fourth quarter. Although high fourth-quarter growth rates are generally expected, this represents the largest one-quarter growth since quarterly reporting of insured deposits was adopted in 1991, and contributed to a 3 bp decline in the BIF reserve ratio from 1.41 as of September 30, 1998.

The high growth rate in deposits in the fourth quarter can be attributed to several factors, all of which are associated with financial market volatility. Among these is the shifting of money by investors from equity holdings to bank deposits, which are often considered a safe haven during periods of turmoil in the financial markets. Another factor is that bank borrowings became a cheaper option than capital markets for corporate borrowers in the fourth quarter, due to reduced demand and increasing yield spreads over treasury bonds in capital markets. This resulted in significant growth in commercial loans in the fourth quarter, and deposits were one of the primary funding sources for this growth. Also, the policy of monetary easing that occurred late in the year increased liquidity in the market and led to short-term deposit growth. Some of the more serious concerns about financial market volatility have subsided, and preliminary indicators of deposit growth in the first quarter of this year do not suggest a continuation of the growth that occurred in the fourth quarter of 1998.

Considering the experience of the last five years taken together, the best judgment of the staff is that BIF-insured deposits are likely to experience a growth rate in the range of 0 percent to +5 percent between year-end 1998 and year-end 1999.

Figure 1

(Growth rates are annual)

3. BIF Reserve Ratio

Based on the projected BIF balance and the growth of the insured deposit base, the staff projects the BIF reserve ratio to be within the range of 1.34 to 1.42 percent at December 31, 1999 (Table 3). The low estimate, which produces a 4 bp decrease below the December 31, 1998 ratio, reflects an assumed strong increase in the insured deposit base (+5 percent through the second semiannual period of 1999) and slow growth in the fund balance. The low estimate also reflects the highest losses from possible near-term failures as projected by the FPWG; the estimate is not intended to represent a "worst-case" scenario. The high estimate for the reserve ratio, which produces an increase of 4 bp above the December 31, 1998 level, reflects zero growth in the BIF-insured deposit base through the second semiannual period of 1999 and a strong increase in the BIF balance due to low insurance losses and high interest income.

Table 3

Projected BIF Reserve Ratios

($ in millions)

	December 31, 1998
Fund Balance (Unaudited)	$29,612
Estimated Insured Deposits	$2,141,268
BIF Ratio	1.38%

Low	**High**

	Estimate (1)	**Estimate** (2)
	December 31, 1999	**December 31, 1999**
Projected Fund Balance	$30,194	$30,508
Estimated Insured Deposits	$2,248,331	$2,141,268
Estimated BIF Ratio	1.34%	1.42%

Notes:

1. *The low estimate refers to the scenario of lower interest income (portfolio yield: 5.91 percent), a higher provision for losses ($340 million) and a higher insured deposit growth rate (+5 percent).*
2. *The high estimate refers to the scenario of higher interest income (portfolio yield: 6.02 percent), a lower provision for losses ($60 million) and a lower insured deposit growth rate (zero percent).*

As indicated in Table 3, even if the low estimate were to be realized, the current rate schedule would be sufficient to maintain the DRR through year-end 1999.

Other Factors

Risk-based assessment system. The staff recommends retaining the current spread of 27 bp between the highest- and lowest-rated institutions as well as the rate spreads between adjacent cells in the assessment rate matrix. 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. The current rate spreads also are consistent with the historical variation in bank failure rates across cells of the assessment rate matrix.

Given these considerations, in combination with the expected revenue needs of the fund, as reviewed earlier, the staff recommends retaining the existing BIF assessment rate schedule for the second semiannual assessment period of 1999. The proposed assessment rate schedule, ranging from 0 to 27 bp per year, appears in Table 4. Table 5 summarizes the distribution of institutions across the risk-based assessment matrix. Estimated annual assessment revenue from this schedule is expected to be $29 million, and the average annual assessment rate is estimated to be 0.10 bp.

Table 4

Proposed Assessment Rate Schedule

Second Semiannual 1999 Assessment Period

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**

Table 5

BIF Assessment Base Distribution (1)

Deposits as of December 31, 1998

Supervisory Subgroup and Capital Groups in Effect January 1, 1999

Capital Group		**A**		**B**		**C**	
1. Well	Number	8,602	95.0%	261	2.9%	36	0.4%
	Base ($billion)	2,931.7	97.8%	40.7	1.4%	2.0	0.1%
2. Adequate	Number	111	1.2%	14	0.2%	14	0.2%
	Base ($billion)	17.7	0.6%	1.4	0.1%	1.7	0.1%
3. Under	Number	5	0.1%	2	0.0%	11	0.1%
	Base ($billion)	0.4	0.0%	0.2	0.0%	0.5	0.0%

Estimated annual assessment revenue	$29 million
Assessment Base	$2,996 billion
Average annual assessment rate (bp)	0.10 basis points

Notes:

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

Matrix migration. With 99.1 percent of the number of institutions and 99.8 percent of the assessment base in the three lowest assessment risk classifications of "1A," "1B," and "2A," the current distribution in the rate matrix reflects little fundamental difference from the previous period when the percentages were 99.2 percent and 99.8 percent, respectively. The slightly lower number of institutions in these three categories (down 214) reflects continuation of industry consolidation trends, as the overall total declined by 209 institutions. There are 82 institutions outside of the "1A,, "1B," and "2A" classifications, a slight increase from 77 during the previous period.

Only 454 institutions are currently classified outside of the lowest assessment risk classification compared to 457 from the previous period. Of the 457 institutions that were previously classified outside of the "1A" assessment risk classification, 113 institutions migrated into the "1A" risk classification in the current distribution (Table 6). Of the 8,808 institutions that were classified "1A" as of the previous assessment period, 142 institutions migrated out of the "1A" risk classification. Overall, the supervisory subgroup assignment was upgraded since the previous period for 75 institutions with an assessment base of $7.0 billion, and was downgraded for 107 institutions with an assessment base of $28.4 billion.

Table 6

BIF Migration To and From Assessment Risk Classification "1A" (1)

Institutions entering "1A"	Number	Base($billion)
Due to capital group reclassification only	56	32.6
Due to supervisory subgroup reclassification only	57	5.4
Due to both	0	0.0
Total	113	38.0
Institutions leaving "1A"	Number	Base($billion)
Due to capital group reclassification only	60	9.3
Due to supervisory subgroup reclassification only	77	26.8
Due to both	5	0.3
Total	142	36.4

Notes:

1. *Reflects BIF-insured institutions that moved in and out of assessment risk classification "1A" from the second semiannual assessment period of 1998 to the first semiannual assessment period of 1999. The numbers only include institutions that were rated in both periods.*

Impact on bank earnings and capital. 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. The estimated annual revenue from the existing rate schedule is $29 million, up slightly from the $23 million estimate from the previous period. In recommending that the Board maintain this schedule, the staff has considered the impact on earnings and capital and found no unwarranted adverse effects.

Refunds for first semiannual period of 1999. As discussed above, if the reserve ratio on December 31, 1999, exceeds the DRR, the Board is required to refund such excess amount, up to the amount paid for the period from January 1 to June 30. However, this refund may not be made to institutions that exhibit certain weaknesses described in the Deposit Insurance Funds Act of 1996 (Funds Act). In the 1996 rulemaking lowering the SAIF assessment rates, the FDIC interpreted the Funds Act as requiring refunds only to those institutions classified as "1A" for purposes of the FDIC's risk-related premium system. Since BIF-insured institutions classified as "1A" would pay no assessments to the BIF under the proposed rate schedule, they would receive no refund for the second semiannual period of 1999.

FICO Assessment. The 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. The Funds Act also requires the rate on BIF-assessable deposits to be one-fifth the rate for deposits assessed by the SAIF until January 1, 2000, or earlier if the insurance funds are merged, after which all institutions will pay a pro-rata share. The FICO rate on BIF-assessable deposits for the second semiannual period of 1999 (subject to quarterly adjustment) will be determined using March 1999 Call Report and Thrift Financial Report data, on or about May 20.

Staff Contacts

Richard Jones, Chief, Assessments Implementation Section, Assessments Branch, Division of Insurance (202) 898-6592; Jules Bernard, Counsel, Legal Division (202) 898-3731.