BIF Assessment Rates for the First Semiannual Assessment Period of 2001

MEMORANDUM TO:	Board of Directors
FROM:	Arthur J. Murton, Director Division of Insurance
SUBJECT:	BIF Assessment Rates for the First Semiannual Assessment Period of 2001

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. This rate schedule complies 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 1.34 percent (unaudited) as of June 30, 2000, and it is likely that the reserve ratio will remain above 1.25 percent through the first half of 2001 unless insurance losses or deposit growth depart significantly from recent experience. Thus, it does not appear that additional assessment revenue will be needed to maintain the target DRR through the first semiannual period of 2001, 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. Based upon the first half of 2000 data and projected ranges for the relevant variables as of June 30, 2000, this rate schedule would result in an average annual assessment rate of approximately 0.14 bp.

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, and (3) all other relevant statutory provisions.

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 to moderate 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. 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. Recent events support this view and demonstrate the volatility of the reserve ratio.

Maintaining the Target DRR Over the Next Assessment Period

The BIF reserve ratio stood at 1.34 percent as of June 30, 2000 (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.

Currently, conditions in the financial institutions industry are generally strong, and the near-term outlook is generally favorable. However, there are several areas of concern that the FDIC is monitoring. There are signs that commercial credit quality is declining, including recent increases in corporate bond default rates, net CAMELS downgrades, Shared National Credit classifications, adversely classified assets and increasing commercial and industrial loan loss rates, albeit from historically low levels. In addition, there is concern about margin pressure; insured institutions continue to enter potentially risky lending lines of business, such as subprime consumer and high-loan-to-value mortgage lending, in an attempt to maintain earnings. There is also the potential impact of increasing reliance on noncore funding sources. Banks appear more exposed to rising interest rates as a result of a greater proportion of long-term assets funded with volatile liabilities. There continues to be significant financial stresses on the agricultural sector. Recent failures also highlight the potential for financial institutions and the insurance fund to experience unanticipated losses.

Taking appropriate steps to address these concerns continues to be a priority for the FDIC. The staff is addressing these risks through various means, including the enhancements to the risk-based premium system (RBPS) that became effective with the first semiannual assessment period of 2000. The enhancements are intended to provide a more flexible, forward-looking system that keeps pace with new and emerging risks. Call Report information is used to identify institutions with atypical risk characteristics among those in the best-rated premium category, and a review is conducted to determine whether there are unresolved concerns regarding risk management practices. Where such concerns are present, the institutions are given an opportunity to address the cited deficiencies with risk management practices before higher premiums are assessed.

During the last assessment cycle, 175 BIF-insured institutions were flagged by the new Call Report screens and six institutions were notified that they would be candidates for reclassification. It has not yet been determined whether the six institutions have adequately addressed their risk-management concerns. In this cycle, the screens identified 162 BIF-insured institutions for review, and the staffs of the four banking agencies met on October 18, 2000, to begin discussing the candidates for notification. Decisions will be finalized early in December, and staff will continue to pursue related efforts to address current concerns.

With regard to maintaining the target DRR through the next assessment cycle, the staff's judgment is that the current assessment rate schedule for the first semiannual period of 2001 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 June 30, 2001.

1. Fund Balance

The BIF unaudited balance was $29.78 billion on June 30, 2000. 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, and unrealized gains and losses on available-for-sale (AFS) securities.

Insurance Losses. Insurance losses consist of two components: a contingent liability for future failures and an allowance for losses on institutions that have already failed. Potential changes in contingent liabilities for the twelve months ending June 30, 2001, reflect the range of midyear 2000 estimates from the Financial Risk Committee (FRC) plus any adjustments for: (1) potential losses on failures that have occurred since June 30, 2000; and (2) potential failures identified subsequent to the FRC's estimates. The resulting range for changes in contingent liabilities is $100 million to $600 million.

Table 1 projects low and high estimates for the provision for losses based on the changes in contingent liabilities and an adjustment for the net recovery value of closed banks in receivership as of June 30, 2000.

Table 1

Changes in Contingent Liabilities and Allowance for Losses (1)

June 30, 2000 to June 30, 2001

	Low Loss Estimate	High Loss Estimate
Contingent Liability for Future Losses	$100 million	$600 million
Allowance for Losses: Closed Banks (2)	($20 million)	$20 million
Total Provision for Losses	$80 million	$620 million

Notes:

1. Both projections reflect the information available as of September 30, 2000, regarding future economic conditions.
2. Assumes a range of approximately –5 percent to +5 percent of the estimated net recovery value of bank resolutions, $425 million as of June 30, 2000 (rounded to the nearest $5 million).

Interest Income and Unrealized Gains and Losses on AFS Securities. The average BIF investment portfolio for the twelve months ending June 30, 2001, is estimated to be approximately $29.6 billion. Based on the possibility of a shift in the level of interest rates of plus or minus 100 bp for new investments, interest income is projected to be between $1.850 billion and $1.872 billion for the twelve months ending June 30, 2001. 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 change in market value of the securities dominates the effect of changes in interest income. Therefore, in Table 2, the higher interest rate scenario drives the low projected fund balance.

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

Table 2

Fund Balance (1)

($ in millions)

	Low Projected Balance	High Projected Balance
Assessments (2)	43	43
Interest Income (3)	1,872	1,850
Total Revenue	1,915	1,893
Operating Expenses	800	800
Provision for Losses	620	80
Total Expenses & Losses	1,420	880
Net Income	495	1,013
Unrealized Gain (Loss) on AFS Securities (3)	(176)	286
Comprehensive Income (Loss) (4)	319	1,299
Fund Balance (Unaudited) – 6/30/00	29,780	29,780
Projected Fund Balance – 6/30/01	30,099	31,079

Notes:

1. Projected income and expense figures are for the twelve months from June 30, 2000, through June 30, 2001.
2. Assumes that the current assessment rate schedule remains in effect through June 30, 2001.
3. Portfolio yield is estimated to be between 6.25 percent (high projected balance) and 6.33 percent (low projected balance), reflecting a shift in the level of interest rates of + or – 100 bp. Note: Because of the significant percentage of AFS securities held, the magnitude of the change in market value of these securities offsets the interest income changes. In the table, compare Interest Income with Unrealized Gain (Loss) on AFS Securities. The average invested fund balance is estimated to be approximately $29.6 billion.
4. 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).

2. Insured Deposits

Since 1988, annual growth of BIF-insured deposits has been as high as 7.1 percent and as low as an annual shrinkage of 2.1 percent (see Figure 1, next page). After shrinking annually from 1991 through 1994, insured deposits grew between 2.5 percent and 3.0 percent from 1995 to 1997, and 3.8 percent in 1998. After minimal growth in 1999 (1.1 percent), insured deposits grew at a 6.4 percent annual rate in the first six months of 2000.

It is too soon to determine the exact causes of strong deposit growth in the first half of the year. The removal of Y2K concerns may have played a role early in the year, and it appears that stock market volatility in combination with a favorable interest rate environment has made CDs relatively more attractive to investors. However, signals are mixed. Deposit growth was slower in the second quarter than the first, suggesting a return to normalcy, but rates on CDs continued to rise through the third quarter, reaching a five-year high in September. Third-quarter numbers for deposit growth will not be available until next month.

Considering the experience of the last five years ending in June, the best judgment of the staff is that BIF-insured deposits are likely to experience a growth rate in the range of +2 percent to +7 percent between June 2000 and June 2001. The high end of this range reflects the possibility that deposits will remain attractive to investors over the period as well as the potential for insured deposit growth arising from plans by a large investment banking firm to sweep cash management accounts into BIF-insured deposits. These plans were implemented during June 2000.

Figure 1

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 1.27 percent to 1.37 percent at June 30, 2001 (Table 3). The low estimate, which produces a 7 bp decrease from the

June 30, 2000 ratio, reflects an assumed stronger increase in the insured deposit base (+7 percent through the first semiannual period of 2001) and a downward adjustment to the fund balance for unrealized losses on AFS securities (see Table 2). The low estimate also reflects the highest losses from possible near-term failures as projected by staff; the estimate is not intended to represent a "worst-case" scenario. The high estimate for the reserve ratio, which produces an increase of 3 bp above the June 30, 2000 level, reflects +2 percent growth in the BIF-insured deposit base through the first semiannual period of 2001 and a stronger increase in the BIF balance due to lower insurance losses and an adjustment for unrealized gains on AFS securities.

Table 3

Projected BIF Reserve Ratios

($ in millions)

	June 30, 2000
Fund Balance (Unaudited)	$29,780
Estimated Insured Deposits	$2,222,825
BIF Ratio	1.34%

	Low Estimate (1) June 30, 2001	**High Estimate** (2) June 30, 2001
Projected Fund Balance	$30,099	$31,079
Estimated Insured Deposits	$2,378,423	$2,267,282
Estimated BIF Ratio	1.27%	1.37%

Notes:

1. The low estimate refers to the scenario of higher interest rates (portfolio yield: 6.33 percent, because of unrealized losses on AFS securities-see note 3 in Table 2), a higher provision for losses

   ($620 million) and a higher insured deposit growth rate (+7 percent).

2. The high estimate refers to the scenario of lower interest rates (portfolio yield: 6.25 percent, because of unrealized gains on AFS securities-see note 3, Table 2), a lower provision for losses ($80 million) and a lower insured deposit growth rate (+2 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 June 30, 2001. Recent events, however, have underscored the potential for unanticipated insurance losses. Note that under the pessimistic scenario, the BIF could sustain additional insurance losses of approximately $200 million without falling below the DRR as of June 30, 2001.

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 proposed assessment rate schedule, ranging from 0 to 27 bp per year, appears in Table 4. 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.

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 $43 million, the same as in 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.

Table 4

Proposed Assessment Rate Schedule

First Semiannual Assessment Period of 2001

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 Assessment Base Distribution and Matrix Migration

Table 5 summarizes the distribution of institutions across the risk-based assessment matrix.

Table 5

BIF Assessment Base Distribution (1)

Deposits as of June 30, 2000

Supervisory Subgroup and Capital Groups in Effect July 1, 2001

Capital Group		**A**		**B**		**C**	
1. Well	Number	8,139	93.0%	359	4.1%	58	0.7%
	Base ($billion)	3,045.4	97.0%	60.9	1.9%	7.0	0.2%
2. Adequate	Number	159	1.8%	15	0.2%	10	0.1%
	Base ($billion)	23.7	0.8%	1.7	0.1%	1.0	0.0%
3. Under	Number	3	0.0%	0	0.0%	9	0.1%
	Base ($billion)	0.1	0.0%	0	0.0%	0.6	0.0%

Estimated annual assessment revenue $ 43 million

Assessment Base $3,140.5 billion

Average annual assessment rate (bp) 0.14 basis points

Notes:

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

With 98.9 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, 2000, the current distribution in the rate matrix reflects little difference from the previous period (as of January 1, 2000) when the percentages were 99.1 percent and 99.8 percent, respectively. The slightly lower number of institutions in these three categories (down 113) reflects continuation of industry consolidation trends, as the overall total declined by 100 institutions. There are 95 institutions outside of the "1A," "1B," and "2A" classifications, a slight increase from 82 during the previous period.

Only 613 institutions are currently classified outside of the lowest assessment risk classification, up from 561 in the previous period. Of the 561 institutions that were previously classified outside of the "1A" assessment risk classification, 153 institutions migrated into the "1A" risk classification in the current distribution (Table 6, below). Of the 8,291 institutions that were classified "1A" as of the previous assessment period, 222 institutions migrated out of the "1A" risk classification.

Overall, the supervisory subgroup assignment was upgraded since the previous period for 96 institutions with an assessment base of $11.5 billion and was downgraded for 149 institutions with an assessment base of $27.7 billion.

Table 6

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

Institutions entering "1A"	Number	Base ($billion)
Due to capital group reclassification only	69	24.5
Due to supervisory subgroup reclassification only	80	10.6
Due to both	4	0.1
Total	153	35.2
Institutions leaving "1A"	Number	Base ($billion)
Due to capital group reclassification only	102	13.7
Due to supervisory subgroup reclassification only	114	20.9
Due to both	4	0.8
Total	220	35.4

Notes:

1. *Reflects BIF-insured institutions that moved in and out of assessment risk classification "1A" from the first semiannual assessment period of 2000 to the second semiannual assessment period of 2000. The numbers only include institutions that were rated in both periods.*

Other Issues

Refunds for first semiannual period of 2001. According to the Deposit Insurance Funds Act of 1996 (Funds Act), if the reserve ratio at the end of an assessment period exceeds the DRR, the Board is required to refund such excess amount, to certain insured depository institutions. However, this refund may not exceed the amount paid in that assessment period, and refunds may not be made to institutions that exhibit certain weaknesses (financial, operational, or compliance) or are not well-capitalized. The FDIC interprets 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" currently pay no assessments to the BIF under the proposed rate schedule they are ineligible to receive any refund for the first semiannual period of 2001.

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. All institutions are assessed the same rate by FICO, as provided for in the Funds Act. The FICO rate for the first annual assessment period of 2001 (subject to quarterly adjustment) will be determined using September 30, 2000, Call Report and Thrift Financial Report data in December 2000.

Staff Contacts

Karen A. Wigder, Chief, Assessments Evaluation Section, Division of Insurance (202) 898-3810, or Claude Rollin, Senior Counsel, Legal Division (202) 898-8741. For FICO assessment information, please contact Richard Jones, Chief, Assessments Implementation Section, Division of Insurance, at (202) 898-6592.