BIF Assessment Rates for the Second Semiannual Assessment Period of 2002

MEMORANDUM TO:	Board of Directors
FROM:	Arthur J. Murton, Director Division of Insurance
SUBJECT:	BIF Assessment Rates for the Second Semiannual Assessment Period of 2002

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. 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 1.26 percent (unaudited) as of December 31, 2001. It is unclear whether the current rate schedule will be adequate to maintain the statutory target DRR of 1.25 percent for the remainder of the year. However, if the ratio falls below 1.25 percent, the Board would have two semiannual assessment periods to bring the ratio back to the target. Therefore, staff recommends maintaining the existing assessment rate schedule for this assessment period.

Based on year-end 2001 data and projected ranges for the relevant variables at December 31, 2002, this rate schedule would result in an average annual assessment rate of approximately 0.20 bp.

Statutory Requirements and Recommendation for Assessment Rate Schedule

The 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 . . . . [1]

Because the BIF reserve ratio is above 1.25 percent as of December 31, 2001, the Board can raise semiannual assessment rates for the second half of 2002 only pursuant to clause (I), to maintain the BIF at 1.25 percent. The statutory provisions that require the FDIC to return the fund to 1.25 percent when the fund 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 re-establish the designated reserve ratio within one year "after such rates are set". The statute does not define when "rates are set" and legislative history provides no guidance on this issue. Based on a plain reading of the statute, it seems reasonable to use the date on which the Board acts to establish rates for the upcoming semiannual period. This would comport with the intent of this provision of section 7 that the FDIC be given one year (i.e., two semiannual periods) to increase the reserve ratio to the designated reserve ratio without being required to impose the minimum assessment of 23 basis points.

Thus, for example, if the BIF ratio were to fall below 1.25 percent as of March 31, 2002 (and remain below 1.25 percent as of June 30, 2002), the one-year period to re-establish the reserve ratio would begin in November 2002, when the Board sets the rates effective January 1, 2003. (The March 31, 2002, reserve ratio will not be known or published until after the Board has set rates in early May for the semiannual period beginning July 1, 2002.) This means that, if the BIF reserve ratio used to set the January 1, 2003, rates is below 1.25 percent, the FDIC must do one of two things. The FDIC must set assessment rates to achieve the 1.25-percent ratio by November 2003, which would allow two semiannual periods to re-establish the 1.25-percent ratio-the periods beginning January 1, 2003, and July 1, 2003 (in addition to any amounts collected during the second half of 2002)-or the FDIC must establish a recapitalization schedule of 15 years or less and charge 23 basis point minimum average assessments.

Therefore, although it is unclear whether the BIF reserve ratio will remain above the statutory target for the remainder of 2002, staff recommends no change to the assessment rate schedule for this assessment period.

ANALYSIS

In setting assessment rates since recapitalization of the BIF, the Board has considered: (1) the probability and likely amount of loss to the fund posed by individual institutions; (2) the statutory requirement to maintain the DRR, currently 1.25 percent, and (3) all other relevant statutory provisions.[2]

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 funds 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.[3] 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. The continued decline in the reserve ratio supports this view and demonstrates the volatility of the reserve ratio.

Banking and Economic Conditions

The risk posed to the BIF is partly a function of current and future economic conditions as well as

the condition of the aggregate banking industry.

The U.S. economy shows signs of emerging from the recession that began in April 2001. Recent economic data-including job growth, manufacturing activity, housing starts, and consumer confidence-have generally been stronger than analysts' expectations, raising hopes for a synchronized global economic recovery led by the U.S. Amid the recent good news, however, there remain a number of factors that call into question whether the U.S. economy will be able to generate a robust recovery in 2002. Concerns include: weak corporate profits, weak business investment, overcapacity in key industry sectors, a glut of office and industrial space in some markets, and high debt loads for consumers and businesses. It is possible that these factors could result in either: 1) a slow-growth recovery, or 2) a "double-dip" recession, either of which could result in a continuation of rising credit losses and slow loan growth that would impair the earnings of FDIC-insured institutions.

Bank earnings have continued to be generally solid in the recession. Commercial banks earned a record $74.3 billion in 2001, helped by securities gains and stable-to-rising interest margins in a falling interest rate environment. Loss provisions rose, particularly for large-bank commercial and industrial loans, helping to reduce return on assets for commercial banks to 1.16 percent. Credit card loan losses also rose in tandem with a record 1.45 million personal bankruptcy filings. To the extent that credit problems tend to lag the business cycle, bank credit losses may continue to rise for a number of quarters in the future. However, at this time there are only a very small number of institutions that report low ratios of capital to assets or high levels of nonperforming loans to total loans.

The single most likely source of significant insurance losses related to the failure of FDIC-insured institutions in the near-term is subprime consumer lending. Some 128 FDIC-insured institutions with 6.2 percent of industry assets are currently identified by the FDIC as having subprime consumer or mortgage loans greater than 25 percent of Tier 1 capital. This group has contributed disproportionately to recent bank failures and additions to the FDIC Problem Bank List.

Projections for the BIF Reserve Ratio Over the Next Assessment Period

The BIF reserve ratio stood at 1.26 percent as of December 31, 2001 (unaudited), the latest date for which complete data are available. 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, 2002.

1. Fund Balance

The BIF unaudited balance was $30.439 billion on December 31, 2001. Changes in the balance over the short run are determined largely by insurance losses, 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 December 31, 2002 reflect the range of December 31, 2001 estimates from the Financial Risk Committee (FRC) plus any adjustments for: (1) estimated losses on failures that have occurred since December 31, 2001; and (2) potential failures identified subsequent to the FRC's estimates. The resulting range for changes in contingent liabilities is $200 million to $3.5 billion.

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 December 31, 2001.

Given the increased size of the BIF loss reserve, it is also relevant to consider the possibility that some of the losses may not materialize. In such a case, some reserves would be reversed and the BIF balance would rise. Table 1 does not reflect this possibility, but it is discussed below in conjunction with projections for the BIF ratio.

Table 1
Potential Changes in Contingent Liabilities and Allowance for Losses (1)
December 31, 2001 to December 31, 2002

	Low Loss Estimate	**High Loss Estimate**
Contingent Liability for Future Losses	$200 million	$3,500 million
Allowance for Losses: Closed Banks (2)	($50 million)	$50 million
Total Provision for Losses	$150 million	$3,550 million

Notes:
(1) Both projections reflect the information available as of March 31, 2002, regarding future economic conditions.
(2) Assumes a range of approximately -5 to +5 percent of the estimated net recovery value of bank resolutions, $1 billion as of March 31, 2002, rounded to the nearest $5 million.

Interest Income and Unrealized Gains and Losses on AFS Securities. In order to estimate interest income for the year, staff has tried to identify a likely range of potential interest rate movements over the next year, based on current interest rate levels and the economic outlook. Likely scenarios for shifts in the level of interest rates of plus 150 bp or minus 50 bp for new investments were deemed to be reasonable. 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. 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
Projected Fund Balance (1)
($ in millions)

	Low Projected Balance	**High Projected Balance**
Assessments (2)	70	70
Interest Income (3)	1,655	1,659
Total Revenue	1,725	1,729
Operating Expenses	750	750
Provision for Losses	3,550	150
Total Expenses & Losses	4,300	900
Net Income	(2,575)	829
Unrealized Gain (Loss) on AFS Securities (3)	(256)	75

Comprehensive Income (Loss) (4)	(2,831)	904
Fund Balance (Unaudited) - 12/31/01	30,439	30,439
Projected Fund Balance - 12/31/02	27,608	31,343

Notes:
(1) Projected income and expense figures are for the twelve months ending December 31, 2002.
(2) Assumes that the current assessment rate schedule remains in effect through December 31, 2002.
(3) Reflects a shift in the level of interest rates of + 150 bp or - 50 bp from the level of interest rates as of the beginning of March 2002. Note: Because of the significant percentage of AFS securities held, the magnitude of the change in market value of these securities more than offsets the interest income changes. In the table, compare Interest Income with Unrealized Gain (Loss) on AFS Securities. Unrealized Gain (Loss) on AFS securities includes $109 million in gains during January and February 2002.
(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 1990, annual growth of BIF-insured deposits has been as high as 7.0 percent and as low as an annual shrinkage of 2.1 percent (see Figure 1). After shrinking annually from 1991 through 1994, insured deposits grew between 2.5 percent and 4.0 percent from 1995 to 1998. After minimal growth in 1999 (1.1 percent), insured deposits grew by 7 percent in 2000, which was the highest annual growth rate since 1990. In 2001, BIF-insured deposits grew 4.74 percent. Sweep activity, equity market declines, investor flight to safety, and an increase in the money supply resulting from Federal Reserve Bank actions have factored into the recent increase in insured deposits. Fourth quarter insured deposits grew 0.2 percent versus an average of 1.5 percent in the first three quarters. Although interest rates remain low, continued stock market volatility and investors' concerns for safety suggest that deposits may remain an attractive investment as we approach the upcoming assessment period.

It takes approximately $19 billion in estimated insured deposit growth to create a 1 basis point change in the BIF reserve ratio, all other things held constant. With the reserve ratio a fraction above 1.26 percent, it would take approximately $26 billion in insured deposit growth to reduce the fund to the Designated Reserve Ratio level, all else being equal. As of year-end 2001, $26 billion represents just over 1 percent of estimated insured deposits. Using the low estimate for the fund balance at December 31, 2002, the reserve ratio would be 1.15 percent with no deposit growth at all. Assuming the high estimate for the fund balance is realized, deposits would have to grow no more than 4.1 percent, which is near their five-year average, to maintain the reserve ratio at 1.25 percent.

Considering the experience of the last five years and current market conditions, 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 +6 percent between December 2001 and December 2002. The high end of this range reflects the potential for continued rapid deposit growth caused by stock market volatility, investor concern for safety and accommodative monetary policy.

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 1.08 percent to 1.28 percent at year-end 2002 (Table 3). The low estimate, which produces an 18 bp decrease from the December 31, 2001 ratio, reflects an assumed stronger increase in the insured deposit base (+6 percent) and a downward adjustment to the fund balance for an assumed reduction in the aggregate amount of unrealized gains 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. As indicated in Table 3, if the low estimate were to be realized, the current rate schedule would not be sufficient to maintain the DRR through December 31, 2002.

Table 3 Projected BIF Reserve Ratios ($ in millions)			
		December 31, 2001	
Fund Balance (Unaudited)		$30,439	
Estimated Insured Deposits		$2,408,878	
BIF Ratio		1.26%	
	Low Estimate (1) December 31, 2002		**High Estimate (2) December 31, 2002**
Projected Fund Balance	$27,608		$31,343
Estimated Insured Deposits	$2,553,410		$2,457,056
Estimated BIF Ratio	1.08%		1.28%

Notes:
(1) The low estimate refers to the scenario of higher interest rates (because of unrealized losses on AFS securities-see note 3 in Table 2), a higher provision for losses ($3,550 million) and a higher insured deposit growth rate (+6 percent).
(2) The high estimate refers to the scenario of lower interest rates (because of unrealized gains on AFS securities-see note 3, Table 2), a lower provision for losses ($150 million) and a lower insured deposit growth rate (+2 percent).

The high estimate produces a 2 bp increase above the December 31, 2001 level, reflecting +2 percent growth in the BIF-insured deposit base and a stronger increase in the BIF balance due to lower insurance losses and an upward adjustment for an assumed increase in the aggregate amount of unrealized gains on AFS securities.

The high end of the projected range for the year-end BIF ratio, 1.28 percent, probably is understated. It does not reflect the possibility that some expected losses may fail to materialize. Under these circumstances, some amount of the loss reserves would be recovered and the BIF ratio would rise.

Such a possibility has not been an important consideration in past Board decisions regarding premiums because the BIF loss reserve typically has been so small that any potential reversals would be insignificant. With the BIF reserve at $1.25 billion as of March 31, 2002, this is no longer the case.

The loss reserve represents the staff's best estimate of BIF losses. It reflects the staff's view of those potential losses that are "probable and estimable," as required by generally accepted accounting principles. Nonetheless, estimates sometimes are inaccurate. If some losses do not materialize, the BIF ratio would rise by approximately one basis point for every $240 million in loss reserves that are reversed, other things equal.

The latest information available regarding the reserve ratio is the March 31, 2002 BIF fund balance of $30.697 billion. Data on insured deposits are not yet available; however, if the growth rate of

insured deposits approaches 2 percent in the first quarter, the reserve ratio would be at 1.25 percent.

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 generally 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 $70 million, $18 million more than 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 2002
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 assessment matrix.

Table 5
BIF Assessment Base Distribution (1)
Deposits as of December 31, 2001
Supervisory Subgroup and Capital Groups in Effect January 1, 2002

Capital Group		A		B		C	
1. Well	Number	7,722	92.5%	387	4.6%	62	0.7%
	Base ($billion)	3,467.0	96.7%	65.3	1.8%	20.5	0.6%
2. Adequate	Number	134	1.6%	17	0.2%	11	0.1%
	Base ($billion)	28.1	0.8%	1.2	0.0%	1.9	0.1%
3. Under	Number	3	0.0%	1	0.0%	7	0.1%
	Base ($billion)	0.3	0.0%	1	0.0%	0.5	0.0%

Estimated annual assessment revenue	$ 70 million
Assessment Base	$3,585.8 billion
Average annual assessment rate (bp)	0.20 basis points

Notes:

(1) "Number" reflects the number of BIF members, including BIF-Oakar

institutions; "Base" reflects all BIF-assessable deposits.

With 98.7 percent of the number of institutions and 99.3 percent of the assessment base in the three lowest assessment risk classifications of "1A," "1B," and "2A," as of January 1, 2002, the current distribution in the rate matrix reflects little fundamental difference from the previous semiannual assessment period. The current distribution reflects slight deterioration in the best-rated premium category. Since the previous assessment period, 185 institutions migrated into the "1A" risk classification (see Table 6), and 199 institutions migrated out of the "1A" risk classification. Only 622 institutions are classified outside of the lowest assessment risk classification.

Overall, the supervisory subgroup assignment was upgraded since the previous period for 118 institutions with an assessment base of $18.5 billion and was downgraded for 157 institutions with an assessment base of $33 billion.

Table 6
BIF Migration To and From Assessment Risk Classification "1A" (1)

Institutions entering "1A"	Number	Base ($billion)
Due to capital group reclassification only	86	29.1
Due to supervisory subgroup reclassification only	95	15.2
Due to both	4	1.1
Total	185	45.4
Institutions leaving "1A"	Number	Base ($billion)
Due to capital group reclassification only	81	18.4
Due to supervisory subgroup reclassification only	115	13.5
Due to both	3	0.7
Total	199	32.6

Notes:
(1) Reflects BIF-insured institutions that moved in and out of assessment risk classification "1A" from the second semiannual assessment period of 2001 to the first semiannual assessment period of 2002. The numbers only include institutions that were rated in both periods.

Other Issues

Refunds for second semiannual period of 2002. 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 second semiannual period of 2002.

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 second annual assessment period of 2002 (subject to quarterly adjustment) will be determined using March 31, 2002 Call Report and Thrift Financial Report data in June 2002.

Staff Contacts

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Concur: ____________________ ____________________

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[1] Section 7(b)(2)(A) of the FDI Act (12 U.S.C. § 1817(b)(2)(A)).

[2] 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.

[3] 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.