**Federal Deposit Insurance Corporation**
550 17th Street NW, Washington, DC 20429
Division of Insurance and Research

November 15, 2004

**MEMORANDUM TO:** The Board of Directors

**FROM:** Arthur J. Murton, Director
Division of Insurance and Research

**SUBJECT**: BIF Assessment Rates for the First Semiannual Assessment Period of 2005

## Recommendation

The staff recommends that the Board maintain the existing Bank Insurance Fund (BIF) assessment rate schedule of 0 to 27 basis points (bp) [1] per year. This rate schedule complies with the statutory requirements of the Federal Deposit Insurance Act for the Board to establish a risk-based assessment system and set assessments only to the extent necessary to maintain the BIF at the Designated Reserve Ratio (DRR) of 1.25 percent.

Concur:

William F. Kroener, III
General Counsel

[1] Although the current effective rate schedule is 0 to 27 basis points, the base rate schedule, established in 1995, is still 4 to 31 basis points. The FDIC may alter the existing rate structure and may change the base BIF rates 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 basis points, as deemed necessary to maintain the target DRR.

**Summary**

Staff believes that the BIF reserve ratio will remain above the DRR throughout the assessment period. Therefore, staff recommends maintaining the existing assessment rate schedule. Based on June 30, 2004 data and projected ranges for the relevant variables at June 30, 2005, this rate schedule would result in an average annual assessment rate of approximately 0.19 basis points (bp).

Staff has considered a range of plausible events that could produce significant movements in the BIF reserve ratio. Our methodology provides ranges for estimated insurance losses that are primarily based on estimated changes to the contingent liability for anticipated failures (contingent loss reserve), changes in interest income and the market value of available-for-sale (AFS) securities due to changes in interest rates, and growth in insured deposits.

**ANALYSIS**

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

[2] The Board reviews and weighs 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.

**Projections for the BIF Reserve Ratio over the Next Assessment Period**

Staff's best estimate for the BIF reserve ratio as of June 30, 2005 is 1.30 percent. The lower and upper bounds of the likely range for the BIF reserve ratio as of June 30, 2005 are 1.24 percent and 1.36 percent, respectively. Although the lower bound of the estimated range is slightly below the statutory requirement of 1.25 percent, staff believes that the ratio most likely will be closer to the best estimate of 1.30 percent.

The following is an analysis of the anticipated effect of changes in the fund balance and the rate of insured deposit growth on the projected reserve ratio as of June 30, 2005.

**1. Fund Balance**

Staff evaluates three significant inputs in estimating potential changes to the fund balance. First, staff estimates the impact of probable insurance losses, which are primarily losses from failed institutions. Second, staff estimates the amount of interest income that the fund will receive through June 30, 2005. Third, staff projects unrealized gains and losses on available-for-sale (AFS) securities through June 30, 2005.

**A. Insurance Losses**

Insurance losses primarily consist of two components: a contingent liability for anticipated failures (contingent loss reserve) and an allowance for losses on banks that have already failed. The Financial Risk Committee (FRC) recommends the amount of the contingent loss reserve each quarter. This recommendation represents the FRC's best estimate of "probable and estimable" BIF losses from potential bank failures, as required by generally accepted accounting principles. Actual results could differ from these estimates. As of June 30, 2004, the

BIF loss reserve stood at $129 million, declining slightly to $128 million as of September 30, 2004.

Staff has estimated a likely range of insurance losses based on projected changes in the contingent loss reserve for the period ending June 30, 2005. These projections are influenced by several factors, including: (1) the shifting of problem banks among different risk categories within the reserve, (2) the reduction in problem banks due to improved financial conditions, mergers, or failures, and (3) the addition of new problem banks. To capture the effects of these changes, staff uses a migration approach, which estimates the probabilities of banks entering into or leaving the contingent loss reserve as well as the probability of banks moving between loss reserve risk categories. These probabilities are based on the recent history of changes to the reserve. Other factors driving changes in the contingent loss reserve are changes in expected failure rates and changes in rates of loss in the event of failure. For purposes of estimating the contingent loss reserve, staff assumes that failure and loss rates remain constant through the period.

Based on consideration of the above factors, staff estimates that potential loss provisions for failures for the twelve months ending June 30, 2005 will range from -$81 million to $414 million, with a best estimate of $68 million.[3] Table 1 shows the range of potential loss provisions for failures as well as adjustments for net losses/recoveries on resolution receivables, adjustments for litigation losses, and adjustments for other contingencies.

[3] Staff estimates that the balance of the contingent loss reserve as of June 30, 2005 will range from $49 million to $431 million, with a best estimate of $172 million.

**Table 1**
**Potential Provisions and Adjustments for Loss Allowances**
**For the Twelve Months Ending June 30, 2005**

| | Low (High Provision) Estimate | Best Estimate | High (Low Provision) Estimate |
|---|---|---|---|
| Provision Related to Future Failures (1) | $414 million | $68 million | -$81 million |
| Adjustment for Closed Banks' Net Recoveries (2) | -$29 million | -$49 million | -$69 million |
| Adjustment for Litigation Losses (3) | $13 million | $0 | -$13 million |
| Adjustment for Other Contingencies (4) | $18 million | $0 | -$18 million |
| **Potential Provision for Losses*** | **$416 million** | **$19 million** | **-$180 million** |

* Figures may not add to totals due to rounding.

*Notes:*

(1) Includes provisions required to bring the contingent loss reserve to estimated June 30, 2005 levels after accounting for a) actual losses sustained in the third quarter of 2004 ($0), and b) estimated losses sustained through June 2005 ($25 million under the Best Estimate). Changes in the contingent loss reserve occur because of failures, mergers, improvement in problem institutions' conditions, deterioration of existing problem institutions, and new problem institutions.

(2) Estimates include a third quarter 2004 decrease of $49 million in estimated losses on prior failures. Low and high estimates assume a range around the best estimate of -5% to +5% of the estimated net recovery value of bank resolution receivables totaling $395 million as of June 30, 2004.

(3) Range is based on the standard deviation of changes in the year-end contingent liability for litigation losses for the period 1998 to 2003.

(4) Range is based on the standard deviation of changes in the year-end contingent liability for representations, warranties, asset securitization guarantees, and assistance agreements for the period 1998 to 2003.

Staff believes that the range provided by the statistical migration analysis adequately represents the most likely range of additional provisions needed to cover insurance losses from future failures. However, the bounds of this range do not represent "best case" and "worst case" scenarios, and larger or smaller provisions could occur.

FDIC staff economists, working with academic researchers, have developed and are currently refining an alternative approach to measure risks posed to the insurance funds. This approach, referred to as the Loss Distribution Model or LDM, employs many of the same techniques and methods used in credit risk and economic capital models employed by large financial companies to measure and manage risk. The LDM provides estimates of failure-related

losses that are most likely given current industry conditions, as well as failure-related losses that might result from changes in the condition of the economy and the industry.[4]

Using the LDM, staff developed alternative BIF loss provisions related to future failures for the 12 months ending June 30, 2005 that range from -$125 million to $504 million, with a best estimate of $75 million that represents the mean of the LDM-produced distribution of possible losses. These results are close to those of the statistical migration analysis shown in Table 1 and lead to a similar projected range (and best estimate) for the reserve ratio as of June 30, 2005.

Banks in general appear to be well positioned to withstand considerable financial stress from unlikely economic shocks. Staff has considered economic stress events as they relate to specific risk concerns enumerated in the industry outlook contained in Tab 1. To determine the potential insurance fund implications of these concerns, staff has developed several stress event simulations, each of which demonstrates that banks are well positioned to withstand a significant degree of financial adversity.

Subprime Lending Risk: Staff believes that subprime lending continues to be the most likely source of near-term losses to the insurance funds. Subprime lenders make up 51 percent of the assets of institutions on the contingent loss reserve list for BIF-insured institutions.

[4] The failure component of the model estimates the probability of failure for each insured institution using a statistical approach based on predictive variables such as examination ratings, problem asset ratios, capital levels, and profitability measures. The loss component estimates the loss-given-failure based on historical loss experience, the types of assets held, and the liability structure (priority of receivership claims) of each individual institution. The deposit growth component estimates deposit levels in each insured institution based on previous deposit growth rates, examination ratings, and quarters-in-existence. These three components produce initial period parameter estimates of failure probabilities, losses, and deposit exposures. The economic component of the model then forecasts changes in these parameters using statistical relationships between the parameters and changes in economic variables, including the term structure of interest rates, regional and national bank stock price indices, and regional house price indices. Finally, a computer simulation using a wide variety of different economic scenarios produces a distribution of possible failures and related insurance fund losses, which are discounted back from the time of failure to the present time.

Using periods of historically poor performance for various categories of consumer loans, staff subjected subprime lending institutions to instantaneously higher consumer loan loss rates sustained for two years. Based on financial data ending in the second quarter of 2004, these simulations produced failed BIF-insured institution assets of only $1.0 billion (one half of 1 percent of bank assets considered) over two years, compared to $2.5 billion when the simulation was performed using data from the second quarter of 2003.

Mortgage Lending Risk: Prospects for rising interest rates may cause some concern over the future performance of banks engaged in mortgage lending activities. Rising rates could place pressure on the net interest margins of some mortgage lending institutions by raising funding costs against fixed-rate loan portfolios and securities holdings. Higher rates could also suppress mortgage origination volumes and the value of home prices in the face of weaker sales activity.

Using periods of historically significant declines in both net interest margins and mortgage loan performance, staff subjected institutions with mortgage lending concentrations to a two-year period of higher loan loss rates and declining net interest margins. Based on data from the second quarter of 2004, these simulations produced failed BIF-insured institution assets of only $0.6 billion (one tenth of 1 percent of bank assets considered). Simulations using second-quarter 2003 data produced failed assets of $0.2 billion.

Commercial Real Estate Mortgage Lending Risks: Rising interest rates could also have an adverse impact on commercial real estate loan performance as debt servicing burdens on variable rate loans increase. Institutions with heavy commercial real estate loan concentrations are most vulnerable to any rise in commercial real estate loan losses.

Using periods of historically significant declines in commercial real estate values, staff subjected institutions with commercial real estate mortgage lending concentrations to a two-year

period of higher loan loss rates. Based on data from the second quarter of 2004, the worst case simulation, which drew on the experience of New England banks during the late 1980s, produced failed BIF-insured institution assets of $11.6 billion over two years (1 percent of bank assets considered). Results using second-quarter 2003 data were $13.9 billion in failed assets. By contrast, this same simulation produced just under $40 billion in failed BIF-insured institution assets using year-end 1991 data.

Based on the above analyses, combined with signs of improving overall economic conditions, staff believes that widespread deterioration in banking industry performance is unlikely in the next one-to-two years.[5] However, if the stress conditions described above were to persist beyond a two-year horizon, it is possible that the effects on bank performance could be more severe. Furthermore, the historical experiences underlying the stress scenarios may be less applicable in the future. For example, greater "democratization" of credit, larger securitization volumes, and higher household debt levels in recent years could have altered the magnitude of stress on bank conditions from potential future problems in residential mortgage or commercial real estate sectors. Thus, conclusions drawn from the stress scenario analyses should be treated with some degree of caution.

**B. Interest Income and Unrealized Gains and Losses on AFS Securities**

Staff relied upon expert forecasts as detailed in the *Blue Chip Financial Forecasts* to develop interest rate projections and analyze the potential effect of changes in interest rates on interest income and unrealized gains and losses on AFS securities. The forecasts defined as our "best estimate" were the consensus forecasts through the second quarter of 2005 as detailed in

[5] Staff also simulated the effects of a historically-derived stress scenario on current non-real-estate commercial and industrial (C&I) loan specialists. The simulation resulted in a very small balance of failed BIF institution assets over two years.

the September issue of the *Blue Chip Financial Forecasts*. Adopting the experts' consensus forecasts also allows for forecasted yield curves that change in shape over time.[6]

Along with forecasting yield curves based upon the experts' forecasts, staff also calculated upper and lower bounds for interest rates using the historical differences between the experts' forecasts and the actual interest rates. These bounds vary over the assessment period and change in shape over time, as opposed to being parallel shifts in rates. The bounds are consistent with the notion that the projections represent the most likely scenarios and that the actual rates may be above or below the projections. In general, the projections indicate rising rates for the period under consideration. Charts showing the projected rates, upper bound, and lower bound are included as Appendix A to this case.

Table 2 shows projections for low, best, and high estimates for interest income and unrealized gains and losses on AFS securities using the forecast rates and upper and lower bounds.[7] 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 resulting change in market value of these securities dominates the effect of changes in interest income.

[6] Staff also developed alternative interest rate projections using actual forward rates available as of approximately the same time that the projections in the September *Blue Chip Financial Forecasts* were generated.. Forward rates are yields on future securities of varying maturities derived from the term structure of interest rates. (The term structure of interest rates refers to the relationship between yields on comparable securities but different maturities.) Staff developed upper and lower bounds using historical differences between actual interest rates and corresponding forward rates. The projections using forward rates were similar to the *Blue Chip* experts' consensus forecasts and result in a projected range and best estimate for the reserve ratio as of June 30, 2005 that are very similar to the results using the *Blue Chip* projections.

[7] The projections incorporate actual results for the third quarter of 2004.

**Table 2**
**Potential Interest Income and**
**Unrealized Gains (Losses) on AFS Securities**
**June 30, 2004 to June 30, 2005 ($ in millions)**

| | Low Estimate (1) | Best Estimate (1) | High Estimate (1) |
|---|---|---|---|
| Interest Income (2) | 1,631 | 1,626 | 1,581 |
| Unrealized Gain (Loss) on AFS Securities (2) | -463 | -295 | -106 |
| **Net Fund Contribution from Investment Activities** | **1,168** | **1,331** | **1,475** |

*Notes:*

(1) The Low Estimate is calculated using upper bound interest rates, the Best Estimate is calculated using the projected rates, and the High Estimate is calculated using the lower bound rates. Because the level of interest rates is assumed to be generally higher in the Low Estimate scenario than in the other two, overall interest revenue is also higher in that scenario. However, the Low Estimate also assumes more failures and higher resolution outlays, which results in a smaller balance invested during the period and partially offsets the effect of higher interest rates on investment income.

(2) Figures include actual investment income and unrealized gains/losses on AFS securities for the third quarter of 2004 and projected investment income and gains/losses for the remaining period through June 30, 2005.

Staff's best estimate reflects recent trends in market interest rates as well as expert forecasts. Short-term Treasury yields have increased since May as the Federal Reserve raised the target for the federal funds rate by 100 basis points. Long-term Treasury yields declined during the same period amid concerns over rising oil prices, weaker consumer spending and lackluster job reports. Despite this recent decline in long-term interest rates, experts continue to forecast a gradual increase in long-term Treasury yields, accompanied by a slightly sharper increase in short-term yields over the nine-month period ending in June 2005 as the economy regains its momentum. Some depreciation in the value of AFS securities should be expected if interest rates rise at a pace similar to staff's best estimate. As the remaining maturity of the existing AFS portfolio shortens, previously identified unrealized gains will also dissipate. Over the longer term, higher yields on Treasury securities will boost overall interest earnings as securities reprice upward and as maturing securities are reinvested at higher rates.

## C. Projected Fund Balance

Table 3 summarizes the effects on the fund balance of the low, best, and high estimates assumed for insurance losses, interest income, and unrealized gains and losses on AFS securities. The projection also assumes that the current assessment rate schedule will remain in effect through June 30, 2005.

**Table 3**
**Projected Fund Balance** (1)
($ in millions)

| | Lower Bound | Best Estimate | Upper Bound |
|---|---|---|---|
| Assessments (2) | 84 | 84 | 84 |
| Interest Income (3) | 1,631 | 1,626 | 1,581 |
| Total Revenue | 1,715 | 1,710 | 1,665 |
| Operating Expenses (4) | 848 | 848 | 848 |
| Provision for Losses | 416 | 19 | -180 |
| Total Expenses & Losses | 1,264 | 867 | 668 |
| Net Income | 451 | 843 | 997 |
| Unrealized Gain (Loss) on AFS Securities (3) | -463 | -295 | -106 |
| Comprehensive Income (Loss) (5) | -12 | 548 | 891 |
| Fund Balance – 6/30/04 | 34,110 | 34,110 | 34,110 |
| Projected Fund Balance – 6/30/05 | 34,098 | 34,658 | 35,001 |

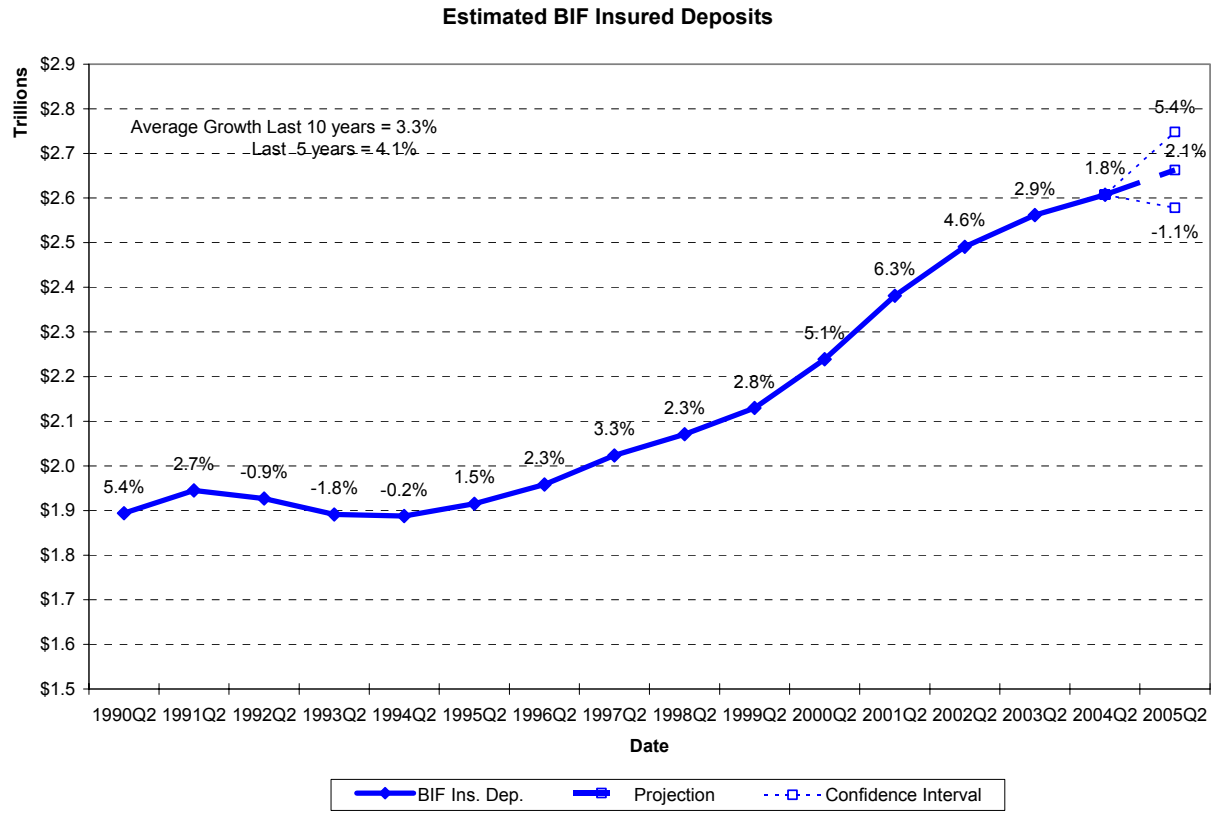
*Notes:*

(1) Projected income and expense figures are for the twelve months ending June 30, 2005.
(2) Assumes that the current assessment rate schedule remains in effect through June 30, 2005.
(3) See notes to Table 2 for an explanation of changes in interest revenue and unrealized gains (losses) on AFS securities.
(4) Projected operating expenses are based on estimates of expenditures for the second half of 2004 and preliminary budget projections for the first half of 2005. Expenses are allocated across FDIC-managed funds based on the allocation of actual 2003 expenses for budgeted items.
(5) 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) above.

## 2. Insured Deposits

Figure 1 shows that BIF-insured deposit growth rates since 1990, measured as of June of each year from the previous June, have been as high as 6.3 percent and as low as -1.8 percent. After declining in 1992, 1993, and 1994, BIF-insured deposits grew at annual rates between 1.5 percent and 3.3 percent in 1995-99. The pace of growth picked up in the next three years: 5.1 percent in 2000, 6.3 percent in 2001, and 4.6 percent in 2002. Improved stock market conditions helped to reduce growth to 2.9 percent in 2003 and 1.8 percent in 2004.

**Figure 1**




Staff's best estimate for insured deposit growth over the four quarters from June 2004 through June 2005 is 2.1 percent, which reflects a continuing moderate rate of insured deposit growth in line with recent trends. The estimate also takes into account the likely slowdown in deposit growth due to an expected rise in long-term interest rates, which may make alternative

investment opportunities more attractive than bank deposits. If insured deposit growth were to return to its historical average of approximately 3 percent, the earnings capacity of the fund would be insufficient to cover this rate of growth (even in the absence of significant insurance losses) and the reserve ratio would gradually decline.

It takes approximately $20 billion in insured deposit growth to reduce the BIF reserve ratio by 1 basis point, all else constant. Based upon the June 30, 2004 fund balance, it would take an increase of $121.3 billion in insured deposits (4.7 percent growth) over the June 2004 level to reduce the reserve ratio to the DRR of 1.25 percent, all else equal. The staff's best estimate indicates that deposit growth over the next four quarters will be significantly lower than that figure.

Based on projections using a statistical model, the best judgment of the staff is that BIF-insured deposits are likely to experience a growth rate in the range of -1.1 percent to +5.4 percent between June 2004 and June 2005.[8] Staff believes the most likely scenario is that insured deposits will grow at the midpoint of this range (2.1 percent), which will bring total BIF-insured deposits to $2.66 trillion**.** Future conditions that could result in insured deposit growth at the high end of the range of our forecast may include a depressed stock market with high volatility. In contrast, a rising stock market and strong U.S. economic growth could result in insured deposit growth at the low end of the range of the forecast.

[8] The model is a regression model where the current growth rate in insured deposits is estimated as a linear function of the previous growth rate in insured deposits, the current and previous growth rates of total (insured and uninsured) domestic deposits, as well as the current yields on 3-month Treasury bills and 10-year Treasury notes. The range corresponds to a 95% confidence level. In other words, if the process generating insured deposit growth in the future is the same as in the past, we can be sure with 95% confidence that the actual growth rate in insured deposits over the four-quarter projection period will lie within this range. The growth rate predicted by the model (thus, the most likely rate) is the midpoint of this range.

### 3. BIF Reserve Ratio

Based on the projected BIF balance and the growth of the insured deposit base, the best estimate of the BIF reserve ratio as of June 30, 2005 is 1.30 percent (Table 4). The best estimate assumes modest loss provisions for future failures, moderately rising Treasury yields, and insured deposit growth of 2.1 percent over the four quarters ending June 30, 2005.

Staff projects the lower and upper bounds of the likely range to be 1.24 percent and 1.36 percent, respectively (Table 4). The lower bound, which reflects a 7 bp decrease from the actual June 30, 2004 ratio, assumes a strong increase in insured deposits (5.4 percent growth) and higher interest rates that reduce the fund balance by raising unrealized losses on AFS securities (Table 3). The lower bound also incorporates the high insurance loss estimate as projected by staff. Although the estimate reflects staff's view of a reasonably possible adverse scenario, it is not intended to represent a "worst case" scenario.

**Table 4**
**Projected BIF Reserve Ratios**
($ in millions)

| | **June 30, 2004** | | |
|---|---|---|---|
| Fund Balance | $34,110 | | |
| Estimated Insured Deposits | $2,607,472 | | |
| BIF Ratio | 1.31% | | |
| | **Lower Bound (1) June 30, 2005** | **Best Estimate (2) June 30, 2005** | **Upper Bound (3) June 30, 2005** |
| Projected Fund Balance | $34,098 | $34,658 | $35,001 |
| Estimated Insured Deposits | $2,747,879 | $2,662,936 | $2,577,992 |
| Estimated BIF Ratio | 1.24% | 1.30% | 1.36% |

*Notes:*
(1) The Lower Bound refers to the scenario of higher loss provisions (Low Estimate in Table 1), the higher end of the range for interest rates (Low Estimate in Table 2), and insured deposit growth of 5.4 percent.
(2) The Best Estimate refers to a baseline scenario of moderate loss provisions (Best Estimate in Table 1), moderately rising interest rates (Best Estimate in Table 2), and insured deposit growth of 2.1 percent.
(3) The Upper Bound refers to the scenario of lower loss provisions (High Estimate in Table 1), the lower end of the range for interest rates (High Estimate in Table 2), and a 1.1 percent decline in insured deposits.

The upper bound produces a 5 bp increase in the reserve ratio relative to June 30, 2004 levels. This estimate assumes a contraction of 1.1 percent in the BIF-insured deposit base,

reverse provisions for failure-related losses, and a more modest increase in interest rates, which results in smaller unrealized losses on AFS securities.

Staff's best estimate of the reserve ratio for June 30, 2005 is 5 bp higher than the DRR and is only 1 bp lower than the reserve ratio at June 30, 2004. The most significant factor influencing the reserve ratio's relative stability is projected modest growth in insured deposits, which helps to offset other factors that would tend to place downward pressure on the ratio, including the following:

- Interest rates remain at very low levels but have begun to move higher in line with improving economic conditions. Unrealized gains on AFS securities will decline even in a stable interest rate environment because these gains disappear as securities move closer to their maturity dates. With rates moving higher, reductions in unrealized gains (or increases in unrealized losses) can be expected to accelerate.
- A significant part of the increase in the BIF fund balance in 2003 and the first half of 2004 represented reversals of provisions for insurance losses. Although staff remains optimistic about industry prospects, reserves for anticipated losses are already at relatively low levels and preclude substantial reversals to loss provisions going forward.

As a result of these considerations, staff believes that the BIF reserve ratio is likely to decrease only slightly over the four quarters ending in June 2005. Since the BIF reserve ratio is currently greater than 1.25 percent and since almost the entire expected range for the BIF ratio is equal to or greater than the DRR of 1.25 percent, staff believes that it is reasonable to maintain the existing BIF rate schedule. In the unlikely event the BIF reserve ratio declines below the statutory DRR of 1.25 percent, the Board would have two semiannual assessment periods to bring the ratio back to the target.

**Risk-Based Assessment System**

Staff recommends retaining the current spread of 27 bp between the assessments paid by the best- and worst-rated institutions as well as the rate spreads between adjacent cells in the assessment rate matrix. The proposed assessment rate schedule appears in Table 5. 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 and existing statutory provisions. The current rate spreads also generally are consistent with the historical variation in bank failure rates across cells of the assessment rate matrix.

**Table 5**
**Proposed Assessment Rate Schedule**
**First Semiannual Assessment Period of 2005**
**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 |

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 $84 million, which is $7 million more than the annual amount projected six months ago. In recommending that the Board maintain this schedule, staff has considered the impact on bank earnings and capital and found no unwarranted adverse effects.

**The Assessment Base Distribution and Matrix Migration**

Table 6 summarizes the current distribution of institutions across the assessment matrix.

**Table 6**
**BIF Assessment Base Distribution (1)**
**Assessable Deposits as of June 30, 2004**
**Supervisory Subgroup and Capital Groups in Effect July 1, 2004**

| Capital Group | | A | | B | | C | |
|---|---|---|---|---|---|---|---|
| **1. Well** | Number | 7,343 | 92.6% | 421 | 5.3% | 84 | 1.1% |
| | Base ($billion) | $4,048 | 93.3% | $46 | 1.1% | $16 | 0.4% |
| **2. Adequate** | Number | 60 | 0.8% | 4 | 0.1% | 10 | 0.1% |
| | Base ($billion) | $222 | 5.1% | $1 | 0.0% | $1 | 0.0% |
| **3. Under** | Number | 2 | 0.0% | 0 | 0.0% | 2 | 0.0% |
| | Base ($billion) | $0 | 0.0% | $0 | 0.0% | $1 | 0.0% |

| | |
|---|---|
| Estimated annual assessment revenue | $84 million |
| Assessment Base | $4,334 billion |
| Average annual assessment rate (bp) | 0.19 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 99.5 percent of the assessment base in the three lowest assessment risk classifications of "1A," "1B," and "2A," as of July 1, 2004, the current distribution in the rate matrix reflects little fundamental difference from the previous semiannual assessment period. The current distribution reflects a slight increase in the percentage of institutions in the best-rated premium category. Since the previous assessment period, 170 institutions migrated into the "1A" risk classification (Table 7), and 131 institutions migrated out of the "1A" risk classification. Only 583 institutions are classified outside of the best risk classification.

**Table 7**
**BIF Migration To and From Assessment Risk Classification "1A"**

| Institutions entering "1A" | Number | Base ($billion) |
|---|---|---|
| Due to capital group reclassification only | 43 | 7.7 |
| Due to supervisory subgroup reclassification only | 125 | 87.8 |
| Due to both | 2 | 0.3 |
| Total | 170 | 95.8 |
| **Institutions leaving "1A"** | **Number** | **Base ($billion)** |
| Due to capital group reclassification only | 44 | 221.6 |
| Due to supervisory subgroup reclassification only | 85 | 14.1 |
| Due to both | 2 | 0.1 |
| Total | 131 | 235.8 |

*Notes:* The table reflects BIF-insured institutions that moved in and out of assessment risk classification "1A" from the first semiannual assessment period of 2004 to the second semiannual assessment period of 2004. The numbers only include institutions that were rated in both periods. The table does not reflect other assessment risk classification migrations that are not either to or from "1A."

Overall, the supervisory subgroup component of the risk classification was upgraded since the previous period for 147 institutions, with an assessment base of $90.9 billion, and was downgraded for 107 institutions, with an assessment base of $16.1 billion.

## Other Issues

**Refunds for second semiannual period of 2004.** 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 2004.

**FICO Assessment.** The Deposit Insurance Funds Act of 1996 (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

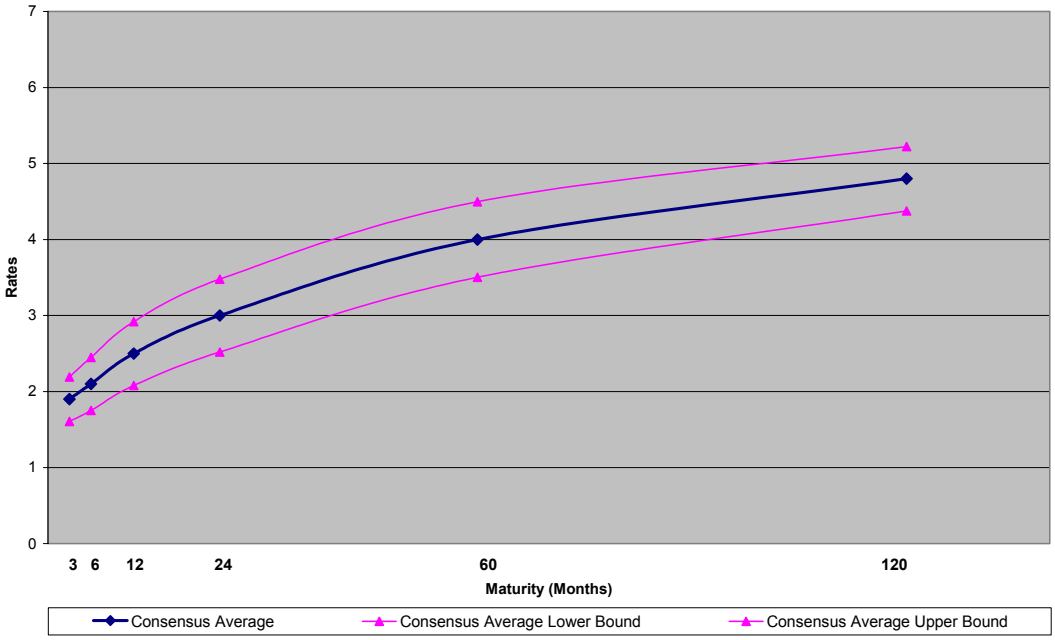
Funds Act, and the FICO rate is updated quarterly. The FICO rate for the second quarterly payment in the second semiannual assessment period of 2004 will be determined using September 30, 2004 Call Report and Thrift Financial Report data.

**STAFF CONTACTS**

For information about deposit insurance assessments, please contact Matthew Green, Chief, Fund Analysis Section, Division of Insurance and Research, at (202) 898-3670, or Joe DiNuzzo, Counsel, Legal Division (202) 898-7349. For FICO assessment information, please contact Richard Jones, Chief, Deposit Insurance Pricing Section, Division of Insurance and Research, at (202) 898-6592.

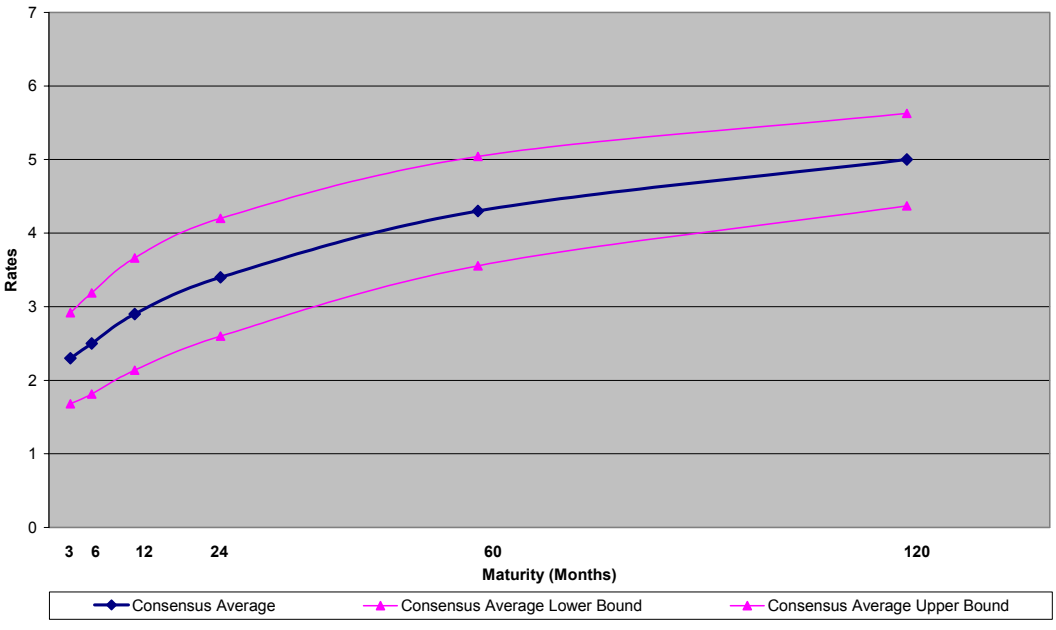
# Appendix A – Interest Rate Assumptions

**Figure 1: Estimated Yield Curve and Interval for Fourth Quarter 2004**



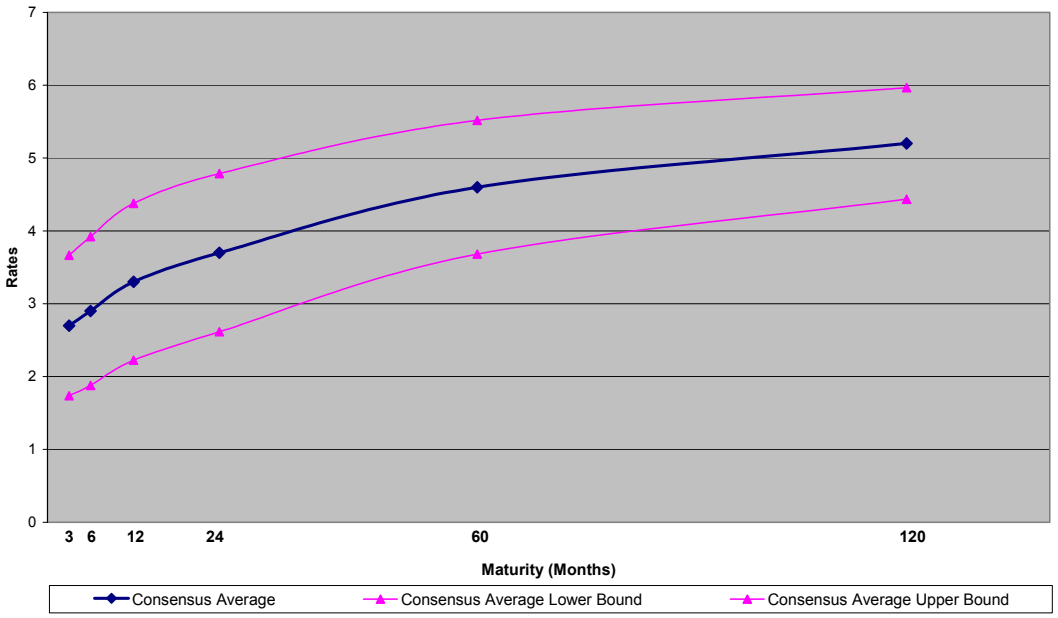

Source: Blue Chip Financial Forecasts, March 1990-September 2004.

**Figure 2: Estimated Yield Curve and Interval for First Quarter 2005**




Source: Blue Chip Financial Forecasts, March 1990-September 2004.

**Figure 3: Estimated Yield Curve and Interval for Second Quarter 2005**




Source: Blue Chip Financial Forecasts, March 1990-September 2004.

Concur:

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John M. Brennan
Deputy to the Chairman