



May 6, 2003

MEMORANDUM TO: The Board of Directors

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

SUBJECT: BIF Assessment Rates for the Second
Semiannual Assessment Period of 2003

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.

Summary

The reserve ratio for the BIF stood at 1.27 percent as of December 31, 2002. Although not all first quarter Call Reports have been filed yet, the best available information indicates that the BIF reserve ratio remained above 1.25 percent as of March 31, 2003. Staff believes there is a reasonable probability that the reserve ratio will fall below 1.25 percent during the upcoming semiannual assessment period if additional premium income is not collected. However, if the ratio does fall below 1.25 percent, the Board would have two semiannual assessment periods to bring the ratio back to the DRR. Therefore, staff recommends maintaining the existing

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 bp, as deemed necessary to maintain the target DRR.

assessment rate schedule for this assessment period. Based on December 31, 2002, data and projected ranges for the relevant variables at December 31, 2003, this rate schedule would result in an average annual assessment rate of approximately 0.20 bp.

Staff has considered a range of plausible events that could produce significant movements to the BIF reserve ratio. In this case, the staff has taken a somewhat different approach than in prior cases submitted to the Board; however, this new approach does not result in a different recommendation than the prior methodology would have produced. The previous methodology provided a range of adverse scenarios, with little upside, and no best estimate. Our new methodology provides ranges for estimated insurance losses, primarily based on estimated changes to the contingent loss reserve for financial institution failures; changes in both interest income and in the market value of available-for-sale (AFS) securities resulting from changes in interest rates; and growth of insured deposits. The ranges resulting from the new methodology are statistically meaningful and are narrower than ranges presented with the prior methodology.

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 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.

Current BIF Reserve Ratio

The BIF reserve ratio was 1.27 percent as of December 31, 2002, the latest date for which complete data are available. Some data are available that give a preliminary indication of the BIF reserve ratio as of March 31, 2003. The fund balance, which is the numerator of the reserve ratio, rose by \$332 million to \$32.382 billion (unaudited), up from \$32.050 billion on December 31, 2002. This increase was primarily supported by significant unrealized gains on available-for-sale securities. As in prior periods, interest income and assessment income more than covered basic operating expenses.

Final data on the level of insured deposits, the denominator for the reserve ratio, are not available at this time because not all March 31, 2003, Call Reports have been filed. Beginning on May 1, staff conducted a telephone survey to determine insured deposits at 11 of the largest insured financial institutions.³ The survey results combined with preliminary information from Call Reports already received indicate that BIF-insured deposits declined by approximately 0.15 percent in the first quarter and stood at about \$2.524 trillion as of March 31, 2003. While this information does not provide an exact amount of insured deposits, it does provide a reasonable estimate of first quarter insured deposit growth.

The information preliminarily indicates that the BIF reserve ratio stood at approximately 1.28 percent as of March 31, 2003. Final data will be published later this quarter after all March 31, 2003 Call Reports are received and edited.

³ As required by the Paperwork Reduction Act, staff applied for and received approval from the Office of Management and Budget to conduct a telephone survey of the largest institutions that have a 45-day deadline to submit their Call Reports.

Projections for the BIF Reserve Ratio over the Next Assessment Period

Staff's best estimate for the BIF reserve ratio as of December 31, 2003 is 1.24 percent. The lower and upper bounds of the likely range for the BIF reserve ratio as of December 31, 2003 are 1.15 percent to 1.30 percent, respectively. Although the lower bound of the estimated range, 1.15 percent, is well below the statutory requirement of 1.25 percent, staff believes the ratio most likely will be closer to the best estimate of 1.24 percent. As mentioned in the Summary, staff used a new methodology to prepare this case. The previous methodology would have reflected a range for the reserve ratio of 1.08 percent to 1.27 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 reserve ratio as of December 31, 2003.

1. Fund Balance

Staff evaluates three significant inputs in estimating changes to the fund balance. First, staff estimates the impact of insurance losses, which are primarily losses from failed institutions. Second, staff estimates the amount of interest income that the fund will receive during the year. Third, staff projects the level of unrealized gains and losses on available-for-sale (AFS) securities that will be present at the end of the period.

A. Insurance Losses

Insurance losses primarily consist of two components: a contingent liability for future failures and an allowance for losses on banks that have already failed. The Financial Risk Committee (FRC) recommends the amount of the contingent liability for failures each quarter, and this recommendation represents the FRC's best estimate of BIF losses from bank failures. It reflects the staff's view of those potential losses that are "probable and estimable," as required by generally accepted accounting principles. Actual results could differ from these estimates.

As of December 31, 2002 the BIF loss reserve stood at \$1,008 million. The BIF loss reserve declined to \$872 million as of March 31, 2003.

In prior cases submitted to the Board, a range of possible insurance losses was estimated by using a proportion of the FRC's two-year projected range of failed-institution assets. Beginning with this case, in addition to considering the FRC's projected range of failed-institution assets, staff is estimating a likely range of insurance losses based on projected changes in the contingent loss reserve. Several factors drive changes in the contingent loss reserve for the twelve months ending December 31, 2003. These factors include: (1) the shifting of problem banks among different risk categories within the reserve, (2) the movement of banks out of the reserve due to improved financial conditions, mergers, or failures, and (3) the addition of new problem bank assets to the reserve. To adequately capture the effects of these changes, staff estimates the probabilities of banks moving within categories, entering, or leaving the contingent loss reserve. These probabilities are based on the recent history of changes to the reserve.

Based on this analysis, staff estimates that the contingent loss reserve balance will range from \$785 million to \$1.7 billion at year-end 2003. Table 1 shows the range of potential loss provisions based on changes in the contingent loss reserve, adjustments for net losses/recoveries due to the resolution of closed banks, adjustments for litigation losses, and adjustments for other contingencies. As a baseline scenario, staff assumes that the current balance of the contingent loss reserve correctly provides for probable and estimable losses from future failures, so that no additional provisions would be required for the remainder of 2003. Therefore, in staff's best estimate of the reserve ratio, a zero provision is assumed.

Table 1
Potential Provisions and Adjustments for Loss Allowances
For the Year Ending December 31, 2003

	Higher Provision	Lower Provision
Provision Related to Future Failures (1)	\$1,198 million	(\$79 million)
Adjustment for Closed Banks Net Recoveries (2)	\$25 million	(\$25 million)
Adjustment for Litigation Losses (3)	\$14 million	(\$14 million)
Adjustment for Other Contingencies (4)	\$19 million	(\$19 million)
Potential Provision for Losses	\$1,256 million	(\$137 million)

Notes:

- (1) Includes provisions required to account for the differences between the actual balance of the contingent loss reserve on December 31, 2002 (\$1,008 million) and the December 31, 2003, balance estimated by statistical analysis. Changes in the contingent loss reserve occur from reductions in reserves after failures, reductions in reserves from improvement in institutions' conditions, and additions of reserves due to institutions' deterioration.
- (2) Assumes a range of -5% to +5% of the estimated net recovery value of bank resolutions, \$505 million as of December 31, 2002.
- (3) Based on the standard deviation of changes in the contingent liability for litigation losses for the period 1998 to 2002.
- (4) Based on the standard deviation of changes in the contingent liability for representations, warranties, asset securitization guarantees, and assistance agreements for the period 1998 to 2002.

Staff believes that the range provided by the statistical 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. This statistical analysis is based on our most recent five years' historical reserving experience. To the extent that the industry outlook may be more favorable than during the period on which the analysis is based, the range presented above may be somewhat pessimistic. Conditions in the banking industry appear relatively favorable at this time, and staff believes that current industry trends do not foreshadow widespread deterioration in the industry.

The level of insurance losses will depend on the future condition of the economy and its effect on the banking industry. Staff has considered various economic scenarios and believes that a slow-growth recovery is most likely. However, the source of this recovery may have to come from business sector spending rather than consumer spending, a mainstay of previous

economic growth. Furthermore, uncertainties such as concerns about corporate governance, oil price volatility, or the possibility of further terrorist attacks could adversely affect the speed of any economic recovery.

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

Staff has adopted a new methodology to identify a likely range of potential interest rate movements over the next year. In previous cases, staff modeled parallel shifts in interest rates (in the last two cases, plus 150 bp or minus 50 bp) to represent possible changes in interest rates over the assessment period. However, the prior methodology did not provide for the possibility of nonparallel yield curve shifts. Also, the shift magnitudes were designed to represent extreme changes in rates, but they were derived in a largely ad hoc manner. Furthermore, the same rates were applied throughout the entire assessment period, when in fact interest rates may change over time. Finally, the prior method precluded any estimation of the *expected* interest income and AFS unrealized gain/(loss) on AFS securities by providing only extreme bounds within which interest rates may fall.

The staff attempted to overcome these shortcomings by adopting a more analytical methodology for projecting interest rates. In particular, the interest rate projections were derived from a statistical model using experts' forecasts as detailed in the *Blue Chip Financial Forecasts*. Upon identifying the ten most accurate experts over the entire 2001-2002 period, staff developed a statistical model that produced projected interest rates⁴ for each quarter of 2003 based upon the experts' forecasts over the same period. This methodology produced forecasted yield curves that changed in shape over time.

⁴ The rates modeled were the Fed funds rate and the rates on the 3-month Treasury bill, the 6-month Treasury bill, the 1-year Treasury bill, the 2-year Treasury note, the 5-year Treasury note, and the 10-year Treasury note.

Along with calculating expected yield curves, staff also calculated bounds within which interest rates are likely to fall using the statistical model. 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 true rates may be above or below the projections.⁵

In general, the projections indicate stable or slightly rising rates for the period under consideration. The lower bound generally reflects rates that are as much as one percentage point lower than current rates, while the upper bound reflects rates that may be approximately one-quarter percentage point to two percentage points higher than current rates. Charts showing the projected rates, upper bound, lower bound, and comparisons with the March 2003 yield curve are included as Attachment 1 to this case. Using the projected rates, staff estimates future interest income and AFS unrealized gains/(losses).

Table 2 projects low, best, and high estimates for interest income and unrealized gains and losses on AFS securities using the forecast rates and the bounds. 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.

⁵ There are a few instances where the confidence bounds are truncated at a lower bound of 0.25.

Table 2
Potential Changes in Interest Income and Unrealized Gains (Losses) on AFS Securities
December 31, 2002 to December 31, 2003 (\$ in millions)

	Low Estimate (1)	Best Estimate (1)	High Estimate (1)
Interest Income	1,480	1,548	1,546
Unrealized Gain (Loss) on AFS Securities (2)	(372)	(255)	32

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. Net estimated failure resolution outlays equal \$5.411 billion for the Low Estimate, \$289.5 million in the Best Estimate, and \$6.3 million in the High Estimate. Although 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 actually lower in the Low Estimate due to a significantly smaller balance invested during the period.
- (2) Includes actual unrealized gains on AFS securities for the period January 1, 2003 through February 28, 2003 and projected gains/losses through December 31, 2003.

Staff does not anticipate dramatic changes in bond market rates. The slightly rising interest rate environment forecasted in the best estimate is consistent with (in fact, slightly lower than) the April consensus predictions in *Blue Chip Financial Forecasts*. The projected interest rates used for the best estimate are also consistent with a slow-growth economic recovery. In recent weeks, uncertainty about the direction of the economy has increased somewhat. If these uncertainties continue, or if growth fails to develop, market rates could remain steady or decline. In such a scenario, the potential negative impact to AFS securities would not be as great as projected in the best estimate. Nevertheless, as the remaining maturity of the AFS portfolio shortens, there is a strong likelihood that previously identified unrealized gains will be given back. In addition, falling interest rates would be detrimental to interest income in the long term.

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 December 31, 2003.

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

	Lower Bound	Best Estimate	Upper Bound
Assessments (2)	77	77	77
Interest Income (3)	1,480	1,548	1,546
Total Revenue	1,557	1,625	1,623
Operating Expenses (4)	800	800	800
Provision for Losses	1,256	0	(137)
Total Expenses & Losses	2,056	800	663
Net Income	(499)	825	960
Unrealized Gain (Loss) on AFS Securities (3)	(372)	(255)	32
Comprehensive Income (Loss) (5)	(871)	570	992
Fund Balance – 12/31/02	32,050	32,050	32,050
Projected Fund Balance – 12/31/03	31,179	32,620	33,042

Notes:

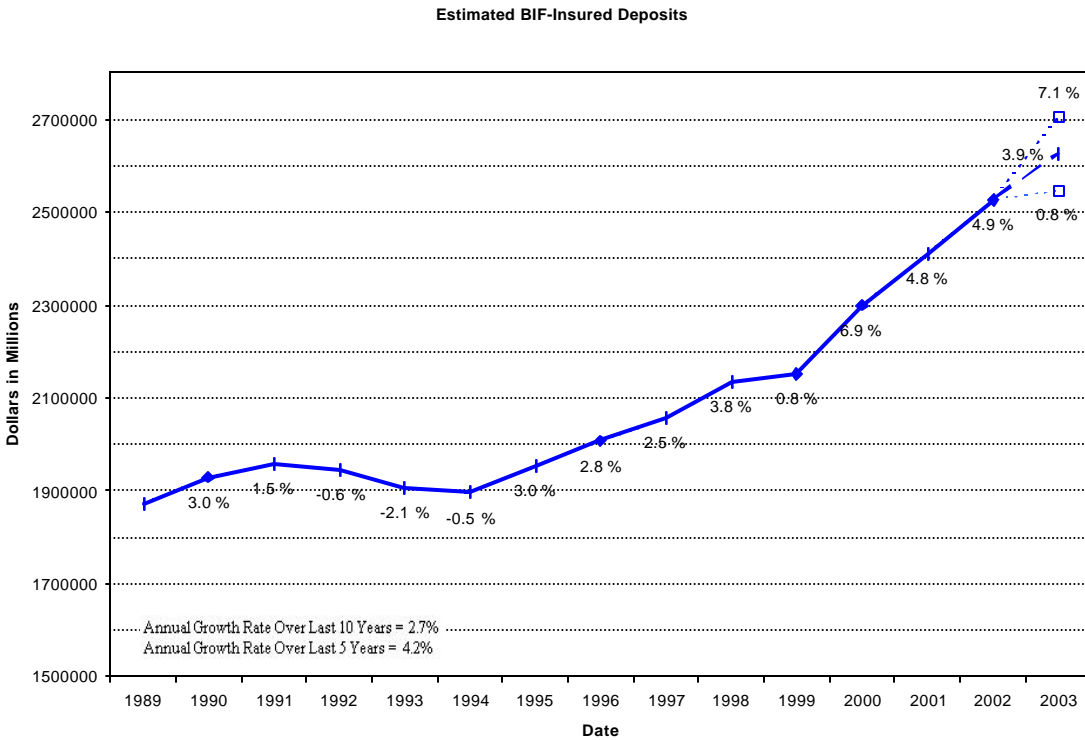
- (1) Projected income and expense figures are for the twelve months ending December 31, 2003.
- (2) Assumes that the current assessment rate schedule remains in effect through December 31, 2003.
- (3) See also Table 2 for an explanation regarding changes in interest revenue and unrealized gain (loss) on AFS securities under these projections.
- (4) Operating expenses for 2003 allocated to the BIF are estimated based on the FDIC's 2003 budget.
- (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

Since 1989, the annual growth rate for BIF-insured deposits has been as high as 6.9 percent and as low as negative 2.1 percent (Figure 1). After declining from 1992 through 1994, insured deposits grew between 2.5 percent and 3.8 percent from 1995 to 1998. After minimal growth in 1999 (0.8 percent), insured deposits grew by 6.9 percent in 2000, 4.8 percent in 2001, 4.9 percent in 2002, and are projected to grow at a rate of 3.9 percent in 2003. Equity market declines and volatility as well as a change in the way banks report uninsured deposits⁶ have factored into the recent strong growth in insured deposits.

⁶ Beginning with the March, 2002 Call Report, all banks were required to report their best estimate of uninsured deposits. Prior to March, 2002, reporting an estimate for uninsured deposits was voluntary. If uninsured deposits were not reported then they were estimated by the FDIC using other Call Report items. Insured deposits are estimated by subtracting estimated uninsured deposits from total domestic deposits.

Figure 1



It takes approximately \$20 billion in insured deposit growth to create a 1 basis point decline in the BIF reserve ratio, all other things held constant. Based upon the March 31, 2003 BIF balance, it would take about \$63.1 billion in insured deposit growth (2.5 percent) to reduce the BIF to the DRR level, all else being equal. Our estimates indicate that deposit growth over the next year will be greater than this figure. However, the fund balance is also likely to grow and the ultimate level of the reserve ratio will depend on how fast the fund grows relative to the growth of BIF-insured deposits.

Previous cases presented to the Board estimated insured deposit growth as falling within a range of +2 percent to +6 percent. For this case, staff developed a statistical model to project an expected rate of insured deposit growth.⁷ The model indicates that the likely rate of insured

⁷ 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 as well as the current and previous growth rates of total (insured and uninsured) deposits. The range (+0.8% to +7.1%) corresponds to a 95% confidence level. In other words, we can expect with 95% confidence that the actual growth rate in insured deposits over the year 2003 will lie within this

deposit growth for 2003 is 3.9 percent. This rate of growth would bring the total of BIF-insured deposits to \$2.626 trillion. The likely range of insured deposit growth is +0.8 percent to +7.1 percent. This range represents the confidence interval in the estimated model. Staff has backtested the model and believes that it provides a reasonable estimation of insured deposit growth. The model estimates future growth rates in insured deposits through historical growth rates in insured and total deposits and, as such, does not explicitly incorporate economic shocks into the projection. However, some events that could force insured deposits into the high range of our forecast are a depressed stock market with high volatility as well as monetary expansion. An upturn in the stock market could force insured deposits into the low range of our forecast.

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 at December 31, 2003, is 1.24 percent (Table 4, next page). The best estimate assumes a baseline of zero loss provisions, stable or slightly increasing interest rates, and an insured deposit growth rate of 3.9 percent.

The staff projects the lower bound and upper bound of the likely range to be 1.15 percent and 1.30 percent, respectively (Table 4, next page). The lower bound, which reflects a 12 bp decrease from the December 31, 2002, ratio, assumes a strong increase in the insured deposit base (+7.1 percent) and a higher interest rate scenario, resulting in a downward adjustment to the fund balance due to a reduction in the aggregate amount of unrealized gains on AFS securities (Table 3). The lower bound also incorporates the high loss estimate for insurance losses from possible near-term failures as projected by staff. The estimate reflects the

range. The growth rate predicted by the model (thus, the most likely rate) is the midpoint of this range (3.9 % annual growth).

staff's view of a reasonably possible adverse scenario. It is not intended to represent a "worst case" scenario.

The upper bound produces a 3 bp increase in the reserve ratio at December 31, 2003. This estimate assumes slower growth (+0.8 percent) in the BIF-insured deposit base, the low loss estimate for the provision for losses, and lower interest rates, resulting in an upward adjustment to the aggregate amount of unrealized gains on AFS securities.

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

	December 31, 2002		
Fund Balance	\$32,050		
Estimated Insured Deposits	\$2,527,448		
BIF Ratio	1.27%		
	Lower Bound (1)	Best Estimate (2)	Upper Bound (3)
	December 31, 2003	December 31, 2003	December 31, 2003
Projected Fund Balance	\$31,179	\$32,620	\$33,042
Estimated Insured Deposits	\$2,707,000	\$2,626,000	\$2,548,000
Estimated BIF Ratio	1.15%	1.24%	1.30%

Notes:

- (1) The Lower Bound refers to the scenario of higher loss provisions (see Table 1), higher interest rates (Low Estimate in Table 2), and a higher insured deposit growth rate (+7.1 percent).
- (2) The Best Estimate refers to a baseline scenario of zero loss provisions, stable or moderately rising interest rates (Best Estimate in Table 2), and the insured deposit growth rate projected by staff (+3.9 percent).
- (3) The Upper Bound refers to the scenario of lower loss provisions (see Table 1), stable or moderately declining interest rates (High Estimate in Table 2), and a lower insured deposit growth rate (+0.8 percent).

As mentioned in the Summary, staff used a different methodology than that used in prior cases presented to the Board to produce the range shown in Table 4 above. If the previous method had been used, it would have shown a range from 1.08 percent to 1.27 percent, the same as that shown in the November 2002 case. The previous methodology provided a low end to the projected BIF range that incorporated what the FRC considered to be reasonably possible losses rather than likely insurance losses. Although the low end of the previous methodology remains a possible outcome, the revised methodology refines the estimation of losses due to failure in order to provide a more likely scenario. Also, unlike the previous methodology, the revised methodology considers the possibility that reserves for losses could be reduced due to

improvements in the conditions of financial institutions. In addition, the revised methodology refines the estimation of the impact that changes in interest rates have on comprehensive income and provides greater analysis of potential insured deposit growth. Staff believes that the methodology presented in this case provides a more likely range for the BIF reserve ratio.

Staff also calculated a number of alternate scenarios to the ones presented in Table 4. In one of the scenarios, staff assumed zero provision for losses, no change in interest rates, zero required cash flow for failed bank resolutions, and insured deposit growth of 4.2 percent, which is the five year average insured deposit growth rate. This scenario results in a reserve ratio of 1.248 percent at December 31, 2003. In this somewhat optimistic scenario, projected BIF growth is outstripped by moderate growth in insured deposits. This scenario illustrates that the BIF reserve ratio is currently at risk of falling below the DRR even in an environment where the condition of the banking industry is relatively favorable. This is being driven by projections of declining interest income and reduced unrealized gains on AFS securities.

If either the best estimate or lower bound indicated in Table 4 were to be realized, the current rate schedule would not be sufficient to maintain the reserve ratio above the DRR through December 31, 2003. However, there is considerable uncertainty about the state of the economy and which direction interest rates might move. In the short-term, adverse economic developments might lead to declining interest rates, which would likely add value to the BIF's AFS securities. Such a scenario would boost the fund balance and would be more likely to maintain the fund above the DRR. However, the long-term impact of such a scenario could be reduced interest income for the fund and an adverse effect on the condition of the banking industry.

Given that the BIF reserve ratio is currently greater than 1.25 percent and that there is much uncertainty about the direction of interest rates, staff believes that it is reasonable to maintain the existing BIF rate schedule. Although a moderate decline in the BIF reserve ratio

will push it below the statutory DRR of 1.25 percent, the Board would have two semiannual assessment periods to bring the ratio back to the target.

If the Board desires greater protection against the chance that the reserve ratio may fall below the DRR, an alternative approach would be to increase the effective rate schedule uniformly by a small amount. If additional assessments are collected and prove to be in excess of an amount necessary to maintain the reserve ratio above the DRR, the FDIC would be required to refund any excess amounts to those institutions classified as “1A” for purposes of the FDIC’s risk-related premium system.

Statutory Requirements Regarding the Assessment Rate Schedule

The Federal Deposit Insurance 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 ...⁸

Because the BIF reserve ratio is above 1.25 percent as of December 31, 2002, the Board can raise semiannual assessment rates for the second half of 2003 only pursuant to clause (I), to maintain the BIF at 1.25 percent. The statutory provisions that require the FDIC to return the ratio to 1.25 percent when the ratio 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 restore it to 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

⁸ Section 7(b)(2)(A) of the FDI Act (12 U.S.C. § 1817(b)(2)(A)).

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 final Call Report data show that the BIF reserve ratio fell below 1.25 percent as of March 31, 2003 (and remained below 1.25 percent as of June 30, 2003), the one-year period to re-establish the reserve ratio to 1.25 percent would begin in November 2003, when the Board sets the rates that become effective on January 1, 2004. The FDIC must do one of two things if the BIF reserve ratio used to set the January 1, 2004, rates is below 1.25 percent. The FDIC must either: (1) set assessment rates to achieve the 1.25 percent by November 2004, which would allow two semiannual periods to re-establish the 1.25 percent—the periods beginning January 1, 2004 and July 1, 2004 (in addition to any amounts collected during the second half of 2003), or (2) the FDIC must establish a recapitalization schedule of 15 years or less and charge 23 basis point minimum average assessments.

Statutory Requirements Regarding Refunds

The Federal Deposit Insurance Act, as amended by the Deposit Insurance Funds Act of 1996 (Funds Act), provides that if the reserve ratio at the end of an assessment period exceeds the DRR, the Board is required to refund the excess amount to certain insured depository institutions.⁹ However, refunds to depository institutions may not exceed the assessments they 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.

⁹ Section 7(e)(2) of the FDI Act (12 U.S.C. § 1817(e)(2)).

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
Second Semiannual Assessment Period of 2003
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 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 \$77 million, which is \$12 million less than the annual amount that was projected six months ago. In recommending that the Board maintain this schedule, the 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 December 31, 2002
Supervisory Subgroup and Capital Groups in Effect January 1, 2003

Capital Group		A		B		C	
1. Well	Number	7,470	91.7%	441	5.4%	97	1.2%
	Base (\$billion)	3,738	96.7%	87	2.3%	23	0.6%
2. Adequate	Number	106	1.3%	13	0.2%	10	0.1%
	Base (\$billion)	15	0.4%	2	0.0%	2	0.1%
3. Under	Number	1	0.0%	0	0.0%	5	0.1%
	Base (\$billion)	0	0.0%	0	0.0%	1	0.0%

Estimated annual assessment revenue	\$77 million
Assessment Base	\$3,867.1 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 98.4 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, 2003, the current distribution in the rate matrix reflects little fundamental difference from the previous semiannual assessment period. The current distribution reflects some shrinkage in the best-rated premium category. Since the previous assessment period, 167 institutions migrated into the "1A" risk classification (Table 7), and 185 institutions migrated out of the "1A" risk classification. Only 673 institutions are classified outside of the best risk classification.

Overall, for all BIF-insured institutions, the supervisory subgroup component of the risk classification was upgraded since the previous period for 110 institutions with an assessment base of \$59.8 billion and was downgraded for 145 institutions with an assessment base of \$32.0 billion.

Table 7
BIF Migration to and from Assessment Risk Classification "1A"

Institutions entering "1A"	Number	Base (\$billion)
Due to capital group reclassification only	77	20.0
Due to supervisory subgroup reclassification only	88	58.1
Due to both	2	0.3
Total	167	78.4
Institutions leaving "1A"	Number	Base (\$billion)
Due to capital group reclassification only	77	10.0
Due to supervisory subgroup reclassification only	102	27.7
Due to both	6	0.9
Total	185	38.6

Notes:

Reflects BIF-insured institutions that moved in and out of assessment risk classification "1A" from the second semiannual assessment period of 2002 to the first semiannual assessment period of 2003. The numbers only include institutions that were rated in both periods.

Other Issues

Refunds for first semiannual period of 2003. 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 2003.

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, and the FICO rate is updated quarterly. The FICO rate for the first quarterly payment in second semiannual assessment period of 2003 will be determined using March 31, 2003 Call Report and Thrift Financial Report data.

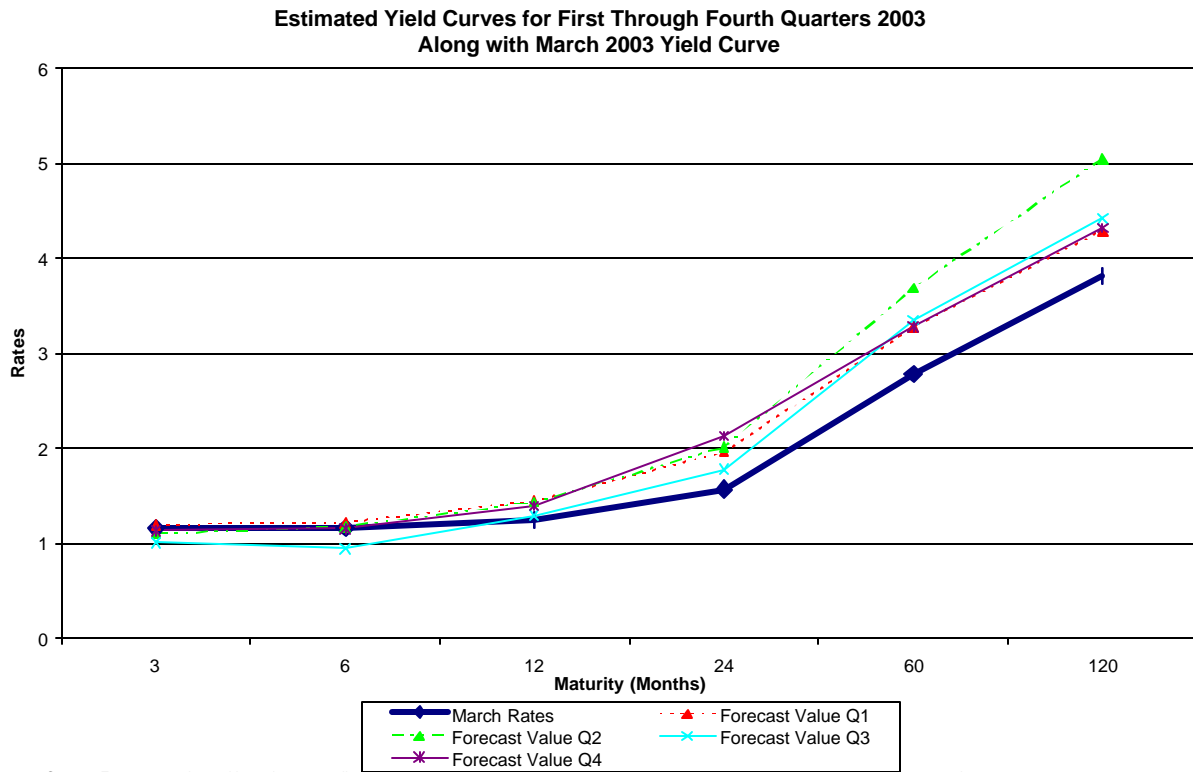
Staff Contacts

Chris Newbury, Chief, Fund Analysis Section, Division of Insurance and Research, at (202) 898-3504, 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.

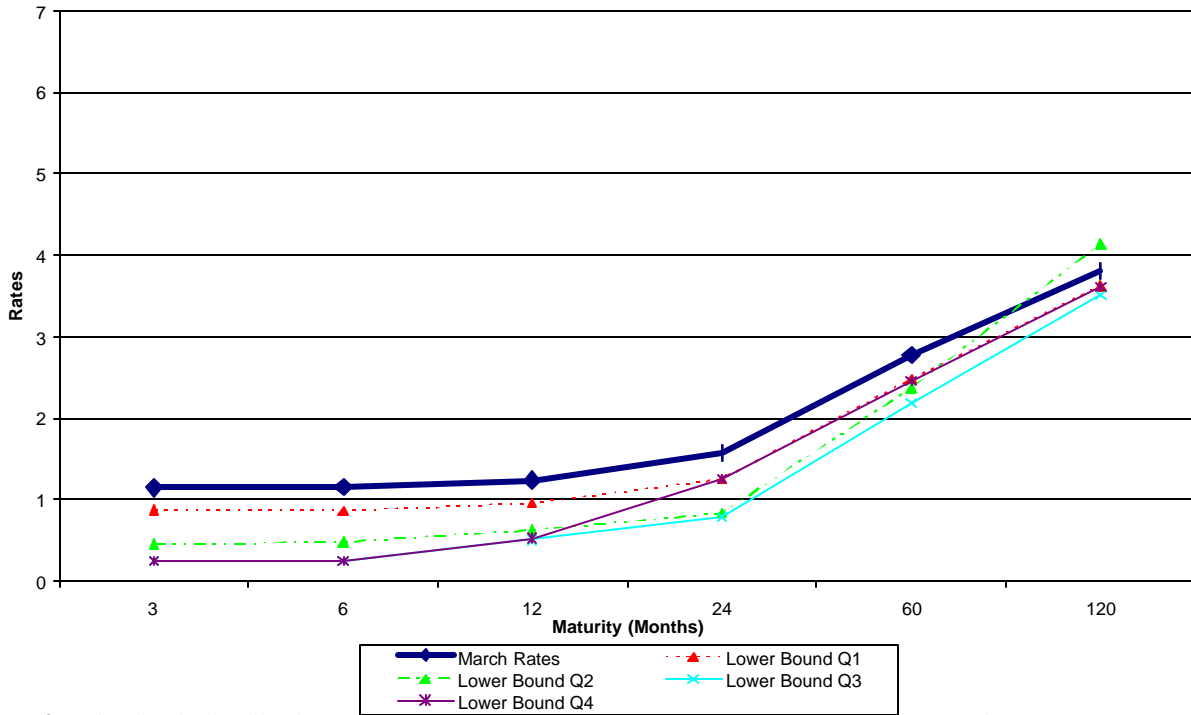
Concur:

John M. Brennan
Deputy to the Chairman

Attachment 1 – Interest Rate Scenarios

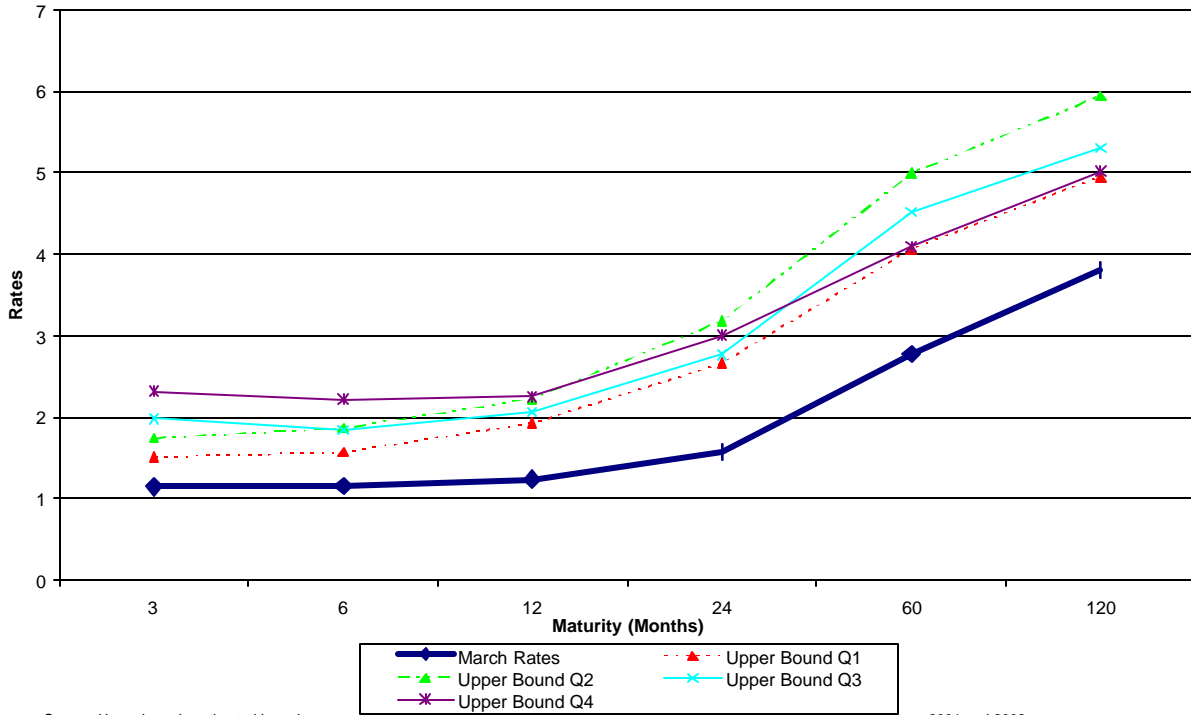


**Lower Bound Estimates for the Yield Curves for First Through Fourth Quarters 2003
Along with March 2003 Yield Curve**



Source: Lower bounds estimated based upon predictions of the most accurate experts in the Blue Chip Financial Forecasts for the years 2001 and 2002. Lower bounds truncated at 0.25.

**Upper Bound Estimates for the Yield Curves for First Through Fourth Quarters 2003
Along with March 2003 Yield Curve**



Source: Upper bounds estimated based upon predictions of the most accurate experts in the Blue Chip Financial Forecasts for the years 2001 and 2002.