



May 5, 2006

MEMORANDUM TO: The Board of Directors

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

SUBJECT: DIF Assessment Rates for the Second
Semiannual Assessment Period of 2006

SUMMARY AND RECOMMENDATION

The staff recommends that for the second semiannual period of 2006, the Board maintain a rate schedule for the Deposit Insurance Fund (DIF) of 0 to 27 basis points (bp)¹ per year, the same schedule that has been in effect for both the Bank Insurance Fund (BIF) and Savings Association Insurance Fund (SAIF). 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 insurance fund at the Designated Reserve Ratio (DRR) of 1.25 percent.

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 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.

Concur:

Douglas H. Jones
Acting General Counsel

The FDIC merged the BIF and the SAIF to form the DIF on March 31, 2006, in accordance with the Federal Deposit Insurance Reform Act of 2005 (Reform Act).² The Reform Act and the Federal Deposit Insurance Reform Conforming Amendments Act of 2005 (Conforming Amendments Act)³ also made significant changes to the assessment rate-setting provisions in section 7 of the Federal Deposit Insurance Act.⁴ Among other changes, the Reform Act replaces the fixed DRR of 1.25 percent with a range for the DRR from 1.15 percent to 1.50 percent of estimated insured deposits. The Board must designate the DRR before the beginning of each calendar year. The Reform Act requires that by November 5, 2006, the FDIC prescribe final regulations to implement these changes, which will become effective when the final regulations take effect.⁵

The Reform Act contains *transition provisions* specifically preserving the FDIC's authority to set and collect deposit insurance assessments under the regulations in effect before the effective date of the revised assessment rules. These provisions specify that during the interim period between the funds merger and the effective date of new assessment regulations, the existing assessment regulations shall apply to all DIF members, even though the regulations still refer to BIF members and SAIF members.⁶

Therefore, for the second semiannual period of 2006, as a result of the recent funds merger, there will no longer be separate rates applicable to BIF and SAIF members. Instead, one set of assessment rates will apply to all DIF members, i.e., all FDIC-insured institutions.

² Federal Deposit Insurance Reform Act of 2005, § 2102, Pub. L. No.109-171, 120 Stat. 9.

³ Federal Deposit Insurance Conforming Amendments Act of 2005, Pub. L. No. 109-173, 119 Stat. 3601.

⁴These changes will be codified in 12 U.S.C. 1817(b).

⁵ Reform Act §§ 2104(e), 2105(b)

⁶ Reform Act § 2109(b).

The reserve ratio for BIF and SAIF combined stood at 1.25 percent as of December 31, 2005 (unaudited), the latest date for which complete data are available.⁷ While data are incomplete, an early estimate indicates that the DIF reserve ratio stood at 1.23 percent as of March 31, 2006.

The staff's single point estimate for the reserve ratio as of December 31, 2006, is 1.20 percent (assuming no increase in premium rates). Staff believes that insured deposit growth will likely contribute to a decline in the reserve ratio between now and December 31, 2006. Although the combined fund balance rose in each quarter between January 1, 2005, and December 31, 2005, insured deposits grew faster in all four quarters. Insured deposits are projected to continue outpacing fund growth during the year ending December 31, 2006.

Still, there is significant uncertainty about future insured deposit growth. For example, if insured deposits increase faster than last year's pace (7.5 percent), the reserve ratio would likely fall below 1.20 percent by December 31, 2006. On the other hand, if insured deposits grow at 3 percent or less, the reserve ratio would likely remain at or above the 1.25 percent target. Staff's projected lower and upper bounds for the December 2006 reserve ratio of 1.16 percent and 1.25 percent, respectively, primarily reflect the broad range of possible outcomes for insured deposit growth.

Given the uncertainty underlying the factors affecting future changes in the reserve ratio, the Board would be justified in either maintaining the current rate schedule or increasing rates. Staff recommends that the Board maintain the current rate schedule for two reasons:

⁷ The Conforming Amendments Act removed the restriction on SAIF-member exit fees, which were taken into the income of the DIF on March 31, 2006. Had these funds been added to the BIF and SAIF combined fund as of December 31, 2005, the combined reserve ratio as of December 31, 2005 would be higher by close to one basis point, or 1.26 percent.

First, the most recent reserve ratio based on complete data is 1.25 percent. While the staff's point estimate for the reserve ratio at December 31, 2006, is below the DRR, the projected upper bound for the reserve ratio is 1.25 percent.

Second, the Reform Act permits the FDIC to manage the DIF reserve ratio within a range that extends above and below 1.25 percent once new regulations become effective. At that time, the FDIC will have authority to charge every insured institution a risk-based premium regardless of the level of the reserve ratio. Most institutions, however, will have assessment credits provided for under the Reform Act that will offset premium charges. These credits will not be available for the second semiannual period of 2006 and could not be used to offset increased assessment rates. Staff therefore believes that the impending changes to the assessment system accompanying the new regulations argue against changing premium rates at this juncture.

Staff recognizes that, even with flexibility to manage the reserve ratio within a range once the new assessment regulations are in effect, premium rates in 2007 and possibly 2008 would likely have to be higher than they otherwise would need to be if assessment credits were not available or if the Board raised rates for the second half of this year. The staff believes that the premium increase next year may be substantial absent a significant slowing in insured deposit growth. The burden of the higher premium rates in the next couple of years would fall primarily on newer banks and other banks that have grown rapidly since 1996, i.e., those banks with few or no assessment credits. The higher rates, however, would also accelerate the drawdown of credits industry-wide and shorten the length of time before insured institutions would have to pay their entire premiums in cash.

Based on December 31, 2005 data, the recommended rate schedule would result in an average annual assessment rate of approximately 0.05 basis points (bp).

Alternatively, the Board may wish to achieve a higher reserve ratio as of the effective date of the new assessment regulations (i.e., at the start of 2007), when assessment credits also would become available. For each one basis point increase in the projected December 31, 2006 reserve ratio above the staff's best estimate of 1.20 percent, the FDIC would need to raise annual premium rates for the second half of 2006 by 1.3 basis points (0.65 basis point semiannual rate). This would amount to just over \$400 million in additional revenue. Thus, for example, should the Board want to achieve a December 31, 2006 reserve ratio of 1.23 percent, an annual rate increase of 4 basis points would increase assessment revenue in the second half of 2006 by about \$1.25 billion. Reaching the desired year-end reserve ratio would still depend on whether staff's other assumptions underlying its best estimate (e.g., for insured deposit growth and losses) are realized.

Staff has considered a range of plausible events that could produce significant movements in the DIF reserve ratio. Our methodology provides ranges for: (1) estimated insurance losses primarily based on changes to the contingent liability for anticipated failures (contingent loss reserve); (2) interest income and changes in the market value of available-for-sale (AFS) securities due to changes in interest rates, and (3) growth in insured deposits.

ANALYSIS

In setting assessment rates, the Board must consider: (1) the probability of failure 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.⁸

⁸ By statute, the Board must 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

Projections for the DIF Reserve Ratio in the Second Semiannual Assessment Period of 2006

Staff's point estimate for the DIF reserve ratio as of December 31, 2006, is 1.20 percent. The lower and upper bounds of the likely range for the reserve ratio as of December 31, 2006, are 1.16 percent and 1.25 percent, respectively.

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 December 31, 2006.

1. Fund Balance

Staff evaluates three significant inputs to project the fund balance. First, staff estimates the effect 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 December 31, 2006. Third, staff projects unrealized gains and losses on available-for-sale (AFS) securities through December 31, 2006.

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" losses from potential bank failures, as required by generally accepted accounting principles. Actual results could differ from these estimates. As of December 31, 2005, the loss

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.

reserve for BIF and SAIF combined stood at \$5.4 million. As of March 31, 2006, the loss reserve for the DIF had increased to \$9.3 million.

Staff has estimated a likely range of insurance losses based on projected changes in the contingent loss reserve for the period ending December 31, 2006. 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 group of banks included in 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 loss rates in the event of failure. For purposes of projecting changes to 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 December 31, 2006 will range from \$1 million to \$241 million, with a best estimate of \$93 million.⁹ Table 1 shows the range of potential loss provisions for failures as well as provisions for net losses/recoveries on resolution receivables, litigation losses, and other contingencies.

⁹ Staff estimates that the balance of the contingent loss reserve as of December 31, 2006 will range from \$7 million to \$225 million, with a best estimate of \$82 million.

Table 1
Potential Provisions and Adjustments for Loss Allowances
For the Twelve Months Ending December 31, 2006

	Low (High Provision) Estimate	Best Estimate	High (Low Provision) Estimate
Provision Related to Future Failures (1)	\$241 million	\$93 million	\$1 million
Provision for Closed Banks' Net Recoveries (2)	-\$21 million	-\$48 million	-\$75 million
Other Provisions (3)	\$16 million	-\$1 million	-\$18 million
Potential Provision for Losses*	\$236 million	\$44 million	-\$91 million

* Figures may not add to totals due to rounding.

Notes:

- (1) Includes provisions required to bring the contingent loss reserve to estimated December 31, 2006 levels after accounting for a) actual losses sustained in the first quarter of 2006 (\$0), and b) estimated losses sustained through December 2006 (\$16 million best estimate). Changes in the contingent loss reserve occur because of failures, mergers, improvement in existing problem institutions' conditions, deterioration of existing problem institutions, and the addition of new problem institutions to the problem institutions list.
- (2) The best estimate includes a provision of -\$48 million for the first quarter of 2006 due primarily to lower estimated losses on receivables from 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 \$534 million as of December 31, 2005.
- (3) The range is based on the standard deviation of changes in the year-end contingent liability for litigation losses and other contingent liabilities (e.g., representations, warranties, and asset securitization guaranties) for the period 1998 to 2005.

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.

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. To determine the potential insurance fund implications of these concerns, staff has run several two-year stress event simulations based on data through December 31, 2005, affecting institutions specializing in residential mortgages, subprime loans, commercial real

estate mortgages, commercial and industrial loans, and consumer loans. The results of each simulation, which were derived from historical stress events, demonstrate that banks are well positioned to withstand a significant degree of financial adversity. In no case did the stress simulation results raise any significant concerns.

Therefore, staff believes that widespread deterioration in banking industry performance is unlikely in the next one-to-two years. However, if the stress conditions analyzed 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, an introduction of new and higher risk mortgage products, larger securitization volumes, and higher household debt levels in recent years could increase the magnitude of stress on bank conditions from potential future problems in the consumer, residential mortgage, and commercial real estate sectors. Thus, conclusions drawn from stress scenario analyses should be treated with some degree of caution.

The Effects of Hurricanes Katrina and Rita on the Deposit Insurance Fund

All institutions in the areas affected by Hurricanes Katrina and Rita are either well- or adequately-capitalized for purposes of prompt corrective action. The FDIC has narrowed its focus from an initial group of 120 institutions in the affected area to a small group of institutions which we continue to monitor closely. The prospects for the financial institutions most affected will depend in large measure on efforts underway to rebuild and revitalize the communities these institutions serve. At this point, staff has not made an adjustment either to the point estimate or the range of projected insurance loss provisions shown in Table 1.

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 used as the “best estimate” were the consensus forecasts through the fourth quarter of 2006 as detailed in the March issue of the *Blue Chip Financial Forecasts*. Adopting the experts’ consensus forecasts allows for forecasted yield curves that change in shape over time.¹⁰

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 suggest moderately 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 “best estimate” rates and upper and lower bounds. Because of the significant percentage of AFS securities held in the insurance

¹⁰ Staff also developed alternative interest rate projections using actual forward rates available as of approximately the same time that the projections in the March *Blue Chip Financial Forecasts* were generated. Forward rates are expected yields on securities of varying maturities for specific future points in time that are derived from the term structure of interest rates. (The term structure of interest rates refers to the relationship between current yields on comparable securities with different maturities.) Staff developed upper and lower bounds using historical differences between actual interest rates and corresponding forward rates. The projections using forward rates indicate only small changes in short-term interest rates with virtually no change in long-term interest rates over the assessment period. Much uncertainty remains about future short and long term rates, and expert opinion varies on the steepness of future yield curves. Given recent market information and uncertainty regarding the outlook for long-term interest rates, staff believes the *Blue Chip* consensus forecasts are reasonable. However, use of the forward rates would produce similar projections for the reserve ratio to those based on the *Blue Chip* forecasts.

fund portfolio at this time, when interest rates change, the magnitude of the resulting change in market value of these securities outweighs the effect of changes in interest income.

Table 2
Potential Interest Income and
Unrealized Gains (Losses) on AFS Securities
January 1, 2006 to December 31, 2006 (\$ in millions)

	Low Estimate (1)	Best Estimate (1)	High Estimate (1)
Interest Income (2)	2,220	2,210	2,194
Unrealized Gain (Loss) on AFS Securities (2)	-291	-139	14
Net Fund Contribution from Investment Activities	1,929	2,071	2,208

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. Higher interest rates generally correspond to lower unrealized gains (higher unrealized losses) on AFS securities. On the other hand, because interest rates are 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 first quarter of 2006 and projected investment income and gains/losses for the remaining period through December 31, 2006.

Staff's best estimate reflects recent trends in market interest rates as well as expert forecasts. Since the Board last considered semiannual assessment rates, short-term Treasury yields have increased as the Federal Reserve raised the target for the federal funds rate by 75 basis points. Long-term Treasury yields were largely unchanged over the same period, due in part to continued foreign capital inflows to the U.S. and historically low and stable long-term inflationary expectations. These diverging trends in short-term and long-term interest rates led to a further flattening of the yield curve. The economy is forecast to grow at its long-run, sustainable pace for the remainder of 2006, while the futures market predicts at least one more federal funds rate increase this year, based on inflation concerns. Many forecasters are expecting that long-term interest rates, at the least, will rise in response to a higher federal funds rate, thus maintaining a relatively flat yield curve through year end. However, additional steepening of the

yield curve could be forthcoming as part of an ongoing global increase in long-term interest rates.

Some reduction 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 the proceeds from 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 December 31, 2006.

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

	Lower Bound	Best Estimate	Upper Bound
Assessments (2)	28	28	28
Exit Fees Earned (3)	346	346	346
Interest Income (4)	2,220	2,210	2,194
Total Revenue	2,594	2,584	2,568
Operating Expenses (5)	931	931	931
Provision for Losses	236	44	-91
Total Expenses & Losses	1,167	975	840
Net Income	1,427	1,609	1,728
Unrealized Gain (Loss) on AFS Securities (4)	-291	-139	14
Comprehensive Income (Loss) (6)	1,136	1,470	1,742
Fund Balance – 12/31/05	48,597	48,597	48,597
Projected Fund Balance – 12/31/06	49,733	50,067	50,339

Notes:

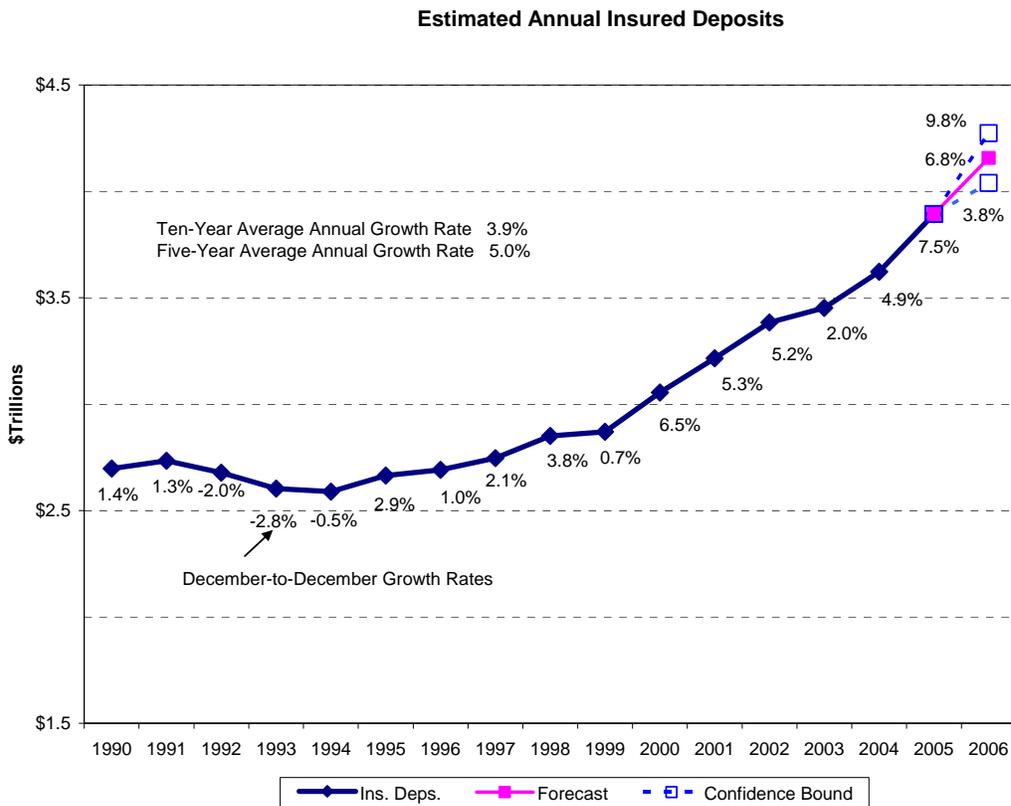
- (1) Projected income and expense figures are for the twelve months ending December 31, 2006. Figures may not sum exactly to totals due to rounding.
- (2) Assumes that the current assessment rate schedule remains in effect through December 31, 2006.
- (3) The Reform Act removed the restriction on SAIF-member exit fees, which were taken into the income of the DIF on March 31, 2006.
- (4) See notes to Table 2 for an explanation of changes in interest revenue and unrealized gains (losses) on AFS securities.
- (5) Projected operating expenses are based on the Board approved 2006 budget for FDIC ongoing operations.
- (6) 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 (4) above.

2. Insured Deposits

Figure 1 shows the level of insured deposits and the corresponding year-end growth rates since 1990, including the forecast and confidence interval for year-end 2006. Over the period, 1990-2005, annual growth in year-end insured deposits ranged from -2.8 percent to 7.5 percent. After declining for three straight years from year-end 1991 to year-end 1994, the annual growth in insured deposits picked up in the mid-1990s and hit a 14-year high of 6.5 percent in 2000. Improved stock market conditions and historically low short-term interest rates helped reduce growth to 2.0 percent in 2003. However, by 2004, insured deposits growth had rebounded to 4.9

percent and in 2005, reached a 19-year high of 7.5 percent. The high growth in insured deposits may result partly from an increase in short-term interest rates, triggered by a tightening in monetary policy by the Federal Reserve. An increase in short-term interest rates relative to long-term rates makes short-term investment instruments, such as bank deposits, more attractive to investors. Short-term interest rates have been rising incrementally since the second half of 2004 while long-term rates remained largely unresponsive to a gradual increase in the Federal funds rate.

Figure 1



Staff's best estimate for insured deposit growth over the four quarters ending December 2006 is 6.8 percent. This estimate, based on analysis of historical data, is 1.8 percentage points higher than the average growth rate in insured deposits over the past five years.

Based on a statistical forecast model, the best judgment of the staff is that growth in insured deposits is likely to range between 3.8 and 9.8 percent between December 2005 and December 2006.¹¹ Staff's point estimate of 6.8 percent growth is the midpoint of this range, which will bring total insured deposits to about \$4.2 trillion.¹² In the last 12-month period, insured deposits grew more rapidly than the long-term historical experience upon which staff based its model. If this recent rapid growth continues, insured deposits may grow at a rate closer to the upper end of our forecast range. Additionally, staff notes that in previous periods of Federal Reserve tightening, insured deposit growth has strengthened as short-term rates rise. Another factor that could result in higher insured deposit growth would be a lackluster stock market performance coupled with stock price volatility. In contrast, a rising stock market could result in a lower growth rate for insured deposits.

¹¹ Specifically, the statistical forecast model explains growth in insured deposits as dependent on current and last quarter growth in domestic deposits (both insured and uninsured) as well as on last quarter's growth in insured deposits. The range corresponds to a 95 percent confidence interval. That is, to the extent that insured deposits can be described by their past growth and by growth in domestic deposits, staff is 95 percent certain that actual growth of insured deposits for the year ending December 31, 2006 will lie in this range. The growth rate predicted by the model, i.e., the point estimate, is the midpoint of this range. Thus, it is considered the most likely growth rate for insured deposits.

¹² The forecast does not explicitly account for the effect of the Reform Act provision raising the insurance coverage limit on retirement accounts from \$100,000 to \$250,000. The increase in coverage became effective on April 1, 2006. There is considerable uncertainty about the provision's effect on aggregate estimated insured deposits and the reserve ratio. Regulatory reporting changes that will help capture the magnitude of any increase in estimated insured deposits will be implemented beginning in the second quarter. Based on the very limited information currently available, staff anticipates that the retirement account coverage limit increase may reduce the reserve ratio by between one-half and one basis point.

3. DIF Reserve Ratio

Based on the projected DIF balance and the growth of the insured deposit base, the best estimate of the DIF reserve ratio as of December 31, 2006 is 1.20 percent (Table 4). The best estimate assumes modest loss provisions for future failures, moderately rising Treasury yields, and insured deposit growth of 6.8 percent over the four quarters ending December 31, 2006.

Staff projects the lower and upper bounds of the likely range to be 1.16 percent and 1.25 percent, respectively (Table 4). The lower bound, which reflects a 9 bp decrease from the actual December 31, 2005 ratio, assumes a strong increase in insured deposits (9.8 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 higher insurance losses for future failures. 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 DIF Reserve Ratios
(\$ in millions)

	December 31, 2005		
Fund Balance	\$48,597		
Estimated Insured Deposits	\$3,892,545		
DIF Ratio	1.25%		
	Lower Bound (1)	Best Estimate (2)	Upper Bound (3)
	December 31, 2006	December 31, 2006	December 31, 2006
Projected Fund Balance	\$49,733	\$50,067	\$50,339
Estimated Insured Deposits	\$4,272,997	\$4,156,172	\$4,039,346
Estimated DIF Ratio	1.16%	1.20%	1.25%

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 9.8 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 6.8 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 insured deposit growth of 3.8 percent.

The upper bound estimate of the reserve ratio for December 31, 2006 is the same as the DRR and the reserve ratio at December 31, 2005. This estimate assumes an increase of 3.8 percent in DIF-insured deposits, very low loss provisions for future failures, and a small unrealized gain on AFS securities.

Staff's point estimate of the reserve ratio for December 31, 2006 is 5 bp lower than the DRR and also represents a 5 bp decline from the December 31, 2005 ratio. Staff believes that a couple of factors will contribute to a decline in the reserve ratio between now and December 31, 2006:

- The most significant factor influencing the reserve ratio's projected decline is the projected strong growth in insured deposits. Staff's point estimate is for insured deposits to rise 6.8 percent, 1.8 percentage points higher than the past five-year average for DIF-insured deposits.
- Interest rates continue to move higher. 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 continue.

As a result of these considerations, staff believes that the DIF reserve ratio is likely to decrease over the four quarters ending in December 2006. Nonetheless, there is significant uncertainty about factors affecting the reserve ratio, especially future insured deposit growth. If DIF-insured deposits increase faster than the rate experienced during the past 12 months, the reserve ratio would likely fall below the staff's point estimate of 1.20 percent. On the other hand, if insured deposits increase at 3 percent or less, the reserve ratio will remain at or above the 1.25 percent target assuming the fund balance increases as projected. Therefore, staff believes

that the 1.16-to-1.25 percent range for the December 2006 reserve ratio appropriately reflects these uncertainties.

Assessment Rates for the Next Semiannual Assessment Period

1. Statutory Requirements Regarding the Assessment Rate Schedule

The FDIC merged the BIF and the SAIF to form the DIF on March 31, 2006, in accordance with section 2102 of the Reform Act. The Reform Act and the Conforming Amendments Act also made significant changes to the assessment rate-setting provisions in section 7 of the Federal Deposit Insurance Act. In particular, section 2105 of the Reform Act replaces the fixed DRR of 1.25 percent with a range for the DRR from 1.15 percent to 1.50 percent of estimated insured deposits, which the Board must designate before the beginning of each calendar year.

The Reform Act specifies that the changes made therein to the FDIC assessment statutes will take effect when the final regulations implementing those changes become effective. The Reform Act requires the FDIC to prescribe such final regulations by November 5, 2006. Also, section 2109(b) of the Reform Act contains *transition provisions* specifically preserving the FDIC's authority to set and collect deposit insurance assessments under the regulations in effect before the effective date of the revised assessment rules. These provisions specify that during the interim period between the funds merger and the effective date of new assessment regulations, the existing assessment regulations shall apply to all DIF members, even though the regulations still refer to BIF members and SAIF members. Staff is in the process of developing proposed regulations to restructure the risk-based assessment system.

Therefore, for the second semiannual period of 2006, as a result of the recent funds merger, there will no longer be separate rates applicable to BIF and SAIF members. Instead, one set of assessment rates will apply to all DIF members, i.e., all FDIC-insured institutions.

2. Assessment Rate Recommendation

Table 5 summarizes the current distribution of institutions across the assessment matrix.

Table 5
DIF Assessment Base Distribution (1)
Assessable Deposits as of December 31, 2005
Supervisory Subgroup and Capital Groups in Effect January 1, 2006

Capital Group		A		B		C	
1. Well	Number	8,358	94.5%	373	4.2%	50	0.6%
	Base (\$billion)	\$6,091	98.6%	\$69	1.1%	\$5	0.1%
2. Adequate	Number	54	0.6%	7	0.1%	1	0.0%
	Base (\$billion)	\$9	0.2%	\$1	0.0%	\$0	0.0%
3. Under	Number	0	0.0%	0	0.0%	2	0.0%
	Base (\$billion)	\$0	0.0%	\$0	0.0%	\$0	0.0%

Assessment Base	\$6,175 billion
Estimated assessment revenue 1/1/06 to 12/31/06	\$ 28 million
Average assessment rate (bp) 1/1/06 to 12/31/06	0.05 basis points

Notes:

(1) "Number" reflects the number of DIF members; "Base" reflects all DIF-assessable deposits.

Staff recommends maintaining the current assessment rate schedule rather than raising rates at this time for several reasons:

First, the DIF reserve ratio has not fallen below 1.25 percent as of December 31, 2005, the date of the most recent reserve ratio based on complete information. While data are incomplete, an early estimate indicates that the DIF reserve ratio stood at 1.23 percent as of March 31, 2006. While staff's single point estimate for the reserve ratio is 1.20 percent as of December 31, 2006 (assuming no additional premium income is collected), staff's range of estimates includes the possibility that the fund will be as high as 1.25 percent. As previously

discussed, uncertainties about factors affecting the reserve ratio, especially future insured deposit growth, result in a fairly wide range of possible outcomes for the December 2006 ratio.

Second, the Reform Act permits the FDIC to manage the DIF reserve ratio within a range that extends above and below 1.25 percent once new regulations become effective. At that time, the FDIC will have authority to charge every insured institution a risk-based premium regardless of the level of the reserve ratio. Most institutions, however, will have assessment credits provided for under the Reform Act that will offset premium charges. These credits will not be available for the second semiannual period of 2006 and could not be used to offset increased assessment rates. Staff therefore believes that the impending changes to the assessment system accompanying the new regulations argue against changing premium rates at this juncture.

Staff recognizes that, even with flexibility to manage the reserve ratio within a range once the new assessment regulations are in effect, premium rates in 2007 and possibly 2008 would likely have to be higher than they otherwise would need to be if assessment credits were not available or if the Board raised rates for the second half of this year. The staff believes that the premium increase next year may be substantial absent a significant slowing in insured deposit growth. The burden of the higher premium rates in the next couple of years would fall primarily on newer banks and other banks that have grown rapidly since 1996, i.e., those banks with few or no assessment credits. The higher rates, however, would also accelerate the drawdown of credits industry-wide and shorten the length of time before insured institutions would have to pay their entire premiums in cash.

Alternatively, the Board may wish to achieve a higher reserve ratio as of the effective date of the new assessment regulations (at the start of 2007), when assessment credits also would become available. For each one basis point increase in the projected December 31, 2006 reserve

ratio above the staff's best estimate of 1.20 percent, the FDIC would need to raise annual premium rates for the second half of 2006 by 1.3 basis points (0.65 basis point semiannual rate). This would amount to just over \$400 million in additional revenue. Thus, for example, should the Board want to achieve a December 31, 2006 reserve ratio of 1.23 percent, an annual rate increase of 4 basis points would increase assessment revenue in the second half of 2006 by about \$1.25 billion. Reaching the desired year-end reserve ratio would still depend on whether staff's other assumptions underlying its best estimate (e.g., for insured deposit growth and losses) are realized.

3. Spread between Assessment Rates

Staff's recommendation would also retain 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 current (and proposed) assessment rate schedule appears in Table 6.

Table 6
Proposed Assessment Rate Schedule
Second Semiannual Assessment Period of 2006
DIF-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 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.

DIF assessments for the first half of 2006 were about \$12 million. Retaining the current assessment base schedule would generate approximately \$16 million during the second semiannual period of 2006.

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. In recommending that the Board maintain the existing rate schedule, the staff has considered the effect on bank earnings and capital and found no unwarranted adverse effects.

4. Matrix Migration

With 99.3 percent of the number of institutions and 99.9 percent of the assessment base in the three lowest assessment risk classifications of "1A," "1B," and "2A," as of January 1, 2006, 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, 163 institutions migrated into the "1A" risk classification (Table 7), and 127 institutions migrated out of the "1A" risk classification. Only 487 institutions are classified outside of the best risk classification.

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

Institutions entering "1A"	Number	Base (\$billion)
Due to capital group reclassification only	37	7.7
Due to supervisory subgroup reclassification only	125	49.6
Due to both	1	0.1
Total	163	57.3
Institutions leaving "1A"	Number	Base (\$billion)
Due to capital group reclassification only	44	9.0
Due to supervisory subgroup reclassification only	83	22.8
Due to both	0	0
Total	127	31.8

Notes: The table reflects DIF-insured institutions that moved in and out of assessment risk classification "1A" from the second semiannual assessment period of 2005 to the first semiannual assessment period of 2006. 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."

More broadly, considering all institutions, the supervisory subgroup component of the risk classification was upgraded since the previous period for 145 institutions with an assessment base of \$50.6 billion and was downgraded for 94 institutions with an assessment base of \$23.2 billion.

Other Issues

Refunds for first semiannual period of 2006. Since DIF-insured institutions classified as "1A" currently pay no assessments to the DIF under the proposed rate schedule, they are ineligible to receive any refund for the first semiannual period of 2006.

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

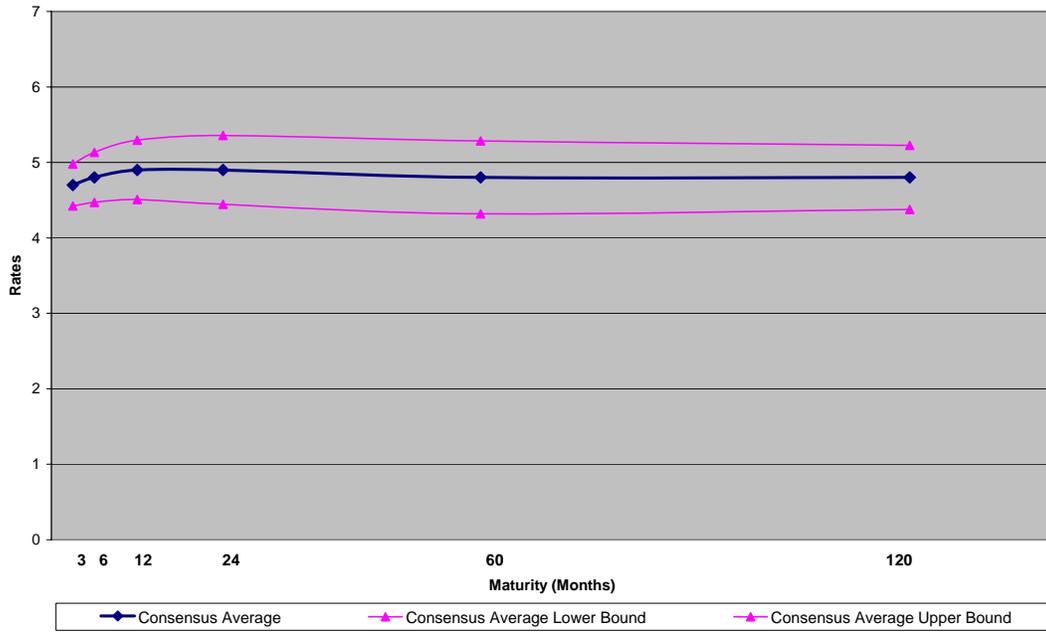
BIF rate schedule. All institutions are assessed the same rate by FICO, as provided for in the Funds Act, and the FICO rate is updated quarterly. The FICO rate for the first quarterly payment in the second semiannual assessment period of 2006 will be determined using March 31, 2006 Call Report and Thrift Financial Report data.

STAFF CONTACTS

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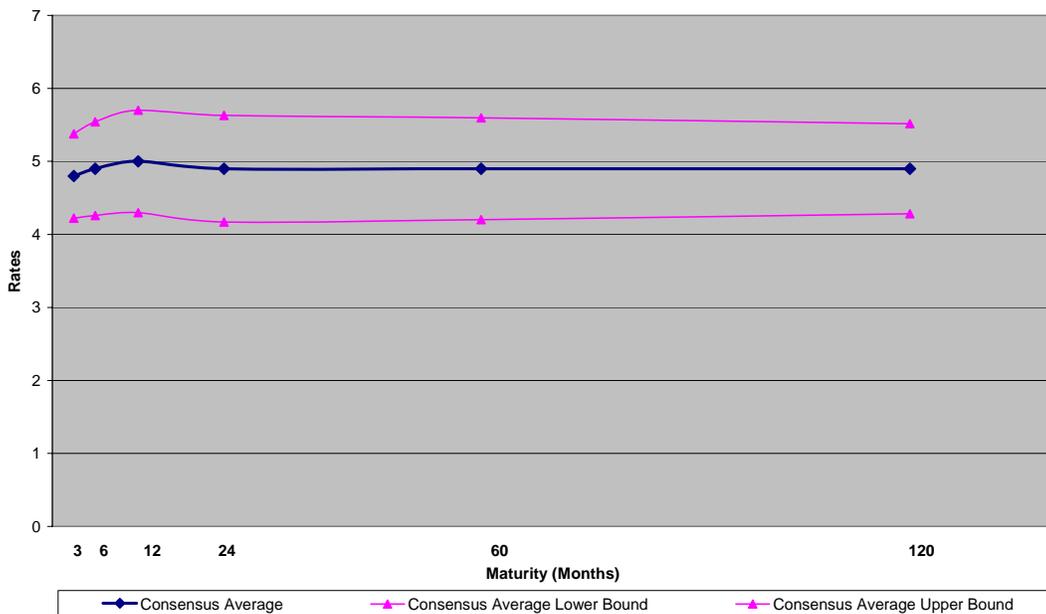
Appendix A – Interest Rate Assumptions

Figure 1: Estimated Yield Curve and Interval for Second Quarter 2006



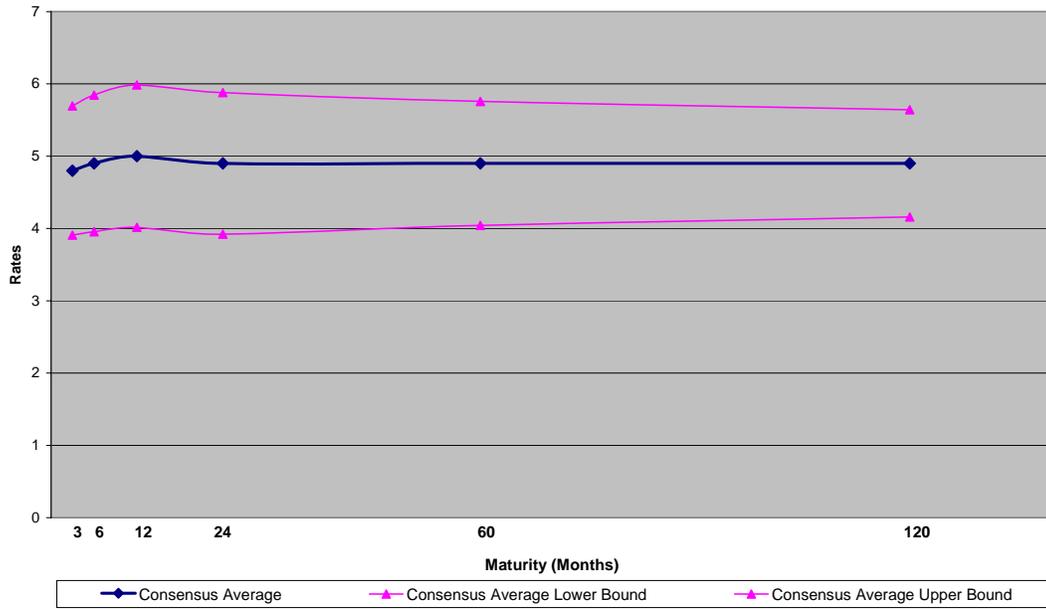
Source: Blue Chip Financial Forecasts, March 1990-March 2006.

Figure 2: Estimated Yield Curve and Interval for Third Quarter 2006



Source: Blue Chip Financial Forecasts, March 1990-March 2006.

Figure 3: Estimated Yield Curve and Interval for Fourth Quarter 2006



Source: Blue Chip Financial Forecasts, March 1990-March 2006.