SAIF Assessment Rates for the First Semiannual Assessment Period of 2001

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

Recommendation

The staff recommends that the Board maintain the existing Savings Association Insurance Fund (SAIF) assessment rate schedule of 0 to 27 basis points (bp) per year. This rate schedule complies with the statutory requirements for the Board to establish a risk-based assessment system and set assessments only to the extent necessary to maintain the target Designated Reserve Ratio (DRR), currently 1.25 percent.

Summary

The Federal Deposit Insurance Act (FDI Act) governs the authority of the Board to set SAIF assessment rates and directs the Board to establish a risk-based assessment system for insured depository institutions and set assessments to the extent necessary to maintain the reserve ratio at 1.25 percent. The reserve ratio for the SAIF stood at 1.44 percent (unaudited) as of June 30, 2000. Staff projections indicate that the reserve ratio is likely to remain at or above 1.25 percent through the first half of 2001, if insurance losses and deposit growth vary within their recent, moderate ranges. Thus, it does not appear that additional assessment revenue will be needed to maintain the target DRR through the first semiannual period of 2001, and the staff consequently recommends no changes to the rate schedule.

Some institutions will pay premiums under the schedule even though the reserve ratio equals or exceeds the target DRR; however, the view of the staff is that the current schedule is consistent with the statutory requirement to establish a risk-based assessment system. Based upon June 30, 2000 data and projected ranges for the relevant variables as of mid-year 2001, this rate schedule would result in an average annual assessment rate of approximately 0.29 bp.

ANALYSIS

In setting assessment rates since capitalization of the SAIF, the Board has considered: (1) the balance between revenues and expenditures over time, (2) the statutory requirement to maintain the DRR, currently 1.25 percent, and (3) all other relevant statutory provisions.

Long-Run Considerations

Based on a thorough review of FDIC experience and consideration of statutory changes designed to moderate future deposit insurance losses (e.g., prompt corrective action authority, national depositor preference and the least-cost resolution requirement), previous analysis conducted by FDIC concluded that an effective SAIF assessment rate of 4 to 5 bp annually would be appropriate to achieve long-run balance between SAIF revenues and expenses (where expenses include monies needed to prevent dilution due to deposit growth). Thus, upon capitalization in 1996, the "base" rate schedule for the SAIF was established at 4 to 31 bp annually. Given conditions of slow to moderate deposit growth and minimal insurance losses, which reduced the need for assessment revenue, the Board simultaneously shifted the effective annual rate schedule downward to 0 to 27 bp. The Board did not alter the base rate schedule, which remains today at 4 to 31 bp. In recommending that the Board maintain the base schedule at 4 to 31 bp, the staff previously has expressed the view that the recent experience of a rising SAIF reserve ratio is not necessarily indicative of a long-run trend, given the historical volatility of deposit growth and insurance losses. Recent events demonstrate the volatility of the reserve ratio and further support this view.

Maintaining the Target DRR Over the Next Assessment Period

The SAIF reserve ratio stood at 1.44 percent as of June 30, 2000 (unaudited), the latest date for which complete data are available. In view of the current and projected levels of the SAIF reserve ratio, the current rate schedule appears to be consistent with the statutory requirement to maintain the target DRR of 1.25 percent.

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

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

During the last assessment cycle, 26 SAIF-insured institutions were flagged by the new Call Report screens and no institutions were notified that they would be candidates for reclassification. In the current cycle, the screens identified 31 SAIF-insured institutions for review, and the staffs of the four banking agencies met on October 18, 2000, to begin discussing the candidates for notification. Decisions will be finalized early in December, and staff will continue to pursue related efforts to address current concerns.

With regard to maintaining the target DRR through the next semiannual assessment period, the staff's judgment is that the current assessment rate schedule is appropriate. Following is an analysis of the anticipated effect of changes in the fund balance and the rate of insured deposit growth on the reserve ratio through June 30, 2001.

1. Fund Balance

The unaudited SAIF balance was $10.5 billion on June 30, 2000. For a given assessment rate schedule, changes in the balance over the short run are determined largely by changes in insurance losses and interest income, and unrealized gains and losses on available-for-sale (AFS) securities.

Insurance Losses. Insurance losses consist of two components: a contingent liability for future failures and an allowance for losses on institutions that have already failed. Potential changes in contingent liabilities for the twelve months ending June 30, 2001, reflect the range of midyear 2000 estimates from the Financial Risk Committee (FRC) plus any adjustments for potential losses on failures that have occurred since June 30, 2000. The resulting range for changes in contingent liabilities is $20 million to $150 million.

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

Table 1

Changes in Contingent Liabilities and Allowance for Losses(1)

June 30, 2000 to June 30, 2001

	Low Loss Estimate	High Loss Estimate
Contingent Liability for Future Losses	$20 million	$150 million
Allowance for Losses: Closed Institutions (2)	$0	$0
Total Provision for Losses	$20 million	$150 million

Notes:

1. *Both projections reflect the information available as of September 30, 2000, regarding future economic conditions.*
2. *Assumes a range of approximately –5 percent to +5 percent of the estimated net recovery value of thrift resolutions. As of June 30, 2000, the estimated net recovery value of thrift resolutions was $0.*

Interest Income and Unrealized Gains and Losses on AFS Securities. The average SAIF investment portfolio for the twelve months ending June 30, 2001, is estimated to be approximately $10.6 billion. Based on the possibility of a shift in the level of interest rates of plus or minus 100 bp for new investments, interest income is projected to be between $652 million and $666 million for the twelve months June 30, 2001. Because of the significant percentage of AFS securities held in the insurance fund portfolio at this time, when interest rates change, the magnitude of the change in market value of the securities dominates the effect of changes in interest income. Therefore, in Table 2, the higher interest rate scenario drives the low projected fund balance.

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

Table 2

Fund Balance (1)

($ in millions)

	Low Projected Balance	High Projected Balance
Assessments (2)	22	22
Interest Income (3)	666	652
Total Revenue	688	674
Operating Expenses	100	100
Provision for Losses	150	20
Total Expenses & Losses	250	120
Net Income	438	554
Unrealized Gain (Loss) on AFS Securities (3)	(69)	109
Comprehensive Income (4)	369	663
Fund Balance (Unaudited) – 6/30/00	10,538	10,538
Projected Fund Balance – 6/30/01	10,907	11,201

Note:

1. *Figures are for the twelve months from June 30, 2000, through June 30, 2001.*
2. *Assumes that the current assessment rate schedule remains in effect through June 30, 2001.*
3. *Portfolio yield is estimated to be between 6.14 percent (high projected balance) and 6.27 percent (low projected balance), reflecting a shift in the level of interest rates of + or – 100 bp. Note: Because of the significant percentage of AFS securities held, the magnitude of the change in market value of these securities offsets the interest income changes. In the table, compare Interest Income with Unrealized Gain (Loss) on AFS Securities. The average invested fund balance is estimated to be approximately $10.6 billion.*
4. *Comprehensive Income is used instead of Net Income due to the magnitude of the change in market value of AFS securities that occurs with fluctuations in interest rate. See note (3).*

2. Insured Deposits

Although the total amount of SAIF-insured deposits has declined since the inception of the fund in 1989, insured-deposit growth in recent years has been mixed. Through 1993, insured deposits declined by an average annual rate of 5.7 percent. Since then, SAIF-insured deposits have fallen in some years and risen in others, although the changes from year to year have not been significant. SAIF-insured deposits fell slightly in 1999 and rose 4.2 percent at an annual rate in the first half of 2000.

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

In past Board cases, staff has suggested a range of insured deposit growth from 0 to +4 percent. In light of recent experience, the view of the staff is that stronger deposit growth cannot be ruled out. Thus, the staff projects SAIF-insured deposit growth in the range of 0 percent to +5 percent between June 30, 2000 and June 30, 2001.

Figure 1

3. SAIF Reserve Ratio

Based on the projected SAIF balance and the projected growth of the insured-deposit base, the staff expects the SAIF reserve ratio to be within the range of 1.42 to 1.53 percent at

June 30, 2001 (Table 3). The low estimate, which produces a 2 bp decrease in the reserve ratio from June 30, 2000, reflects an assumed stronger increase in the insured deposit base (+5 percent through the first semiannual period of 2001) and a downward adjustment to the fund balance for unrealized losses on AFS securities (see Table 2). The low estimate also reflects the highest losses from possible near-term failures as projected by the FRC; the estimates are not intended to represent a "worst-case" scenario. The high estimate for the reserve ratio, which produces a 9 bp increase from the June 30, 2000 levels, reflects zero growth in the SAIF-insured deposit base through the first semiannual period of 2001 and stronger growth in the SAIF balance due to lower insurance losses and an adjustment for unrealized gains on AFS securities.

The staff expects that the actual reserve ratio at midyear 2001 will exceed 1.25 percent. As indicated in Table 3, even if the low estimate were to be realized, the current rate schedule will be sufficient to maintain the DRR through midyear 2001.

Table 3

Projected SAIF Reserve Ratios ($ in millions)

	June 30, 2000
Fund Balance (Unaudited)	$10,538
Estimated Insured Deposits	$730,774
SAIF Ratio	1.44%

	Low Estimate (1)	**High Estimate** (2)
	June 30, 2001	**June 30, 2001**
Projected Fund Balance	$10,907	$11,201
Estimated Insured Deposits	$767,313	$730,774
Estimated SAIF Ratio	1.42%	1.53%

Notes:

1. *The low estimate refers to the scenario of higher interest rates (portfolio yield: 6.14 percent, unrealized losses on AFS securities-see Note 3 in Table 2), a higher provision for losses ($150 million) and a higher insured deposit growth rate (+5 percent).*
2. *The high estimate refers to the scenario of lower interest rates (portfolio yield: 6.27 percent, unrealized gains on AFS securities-see note 3, Table 2), a lower provision for losses ($20 million) and a lower insured deposit growth rate (zero percent).*

It should be noted also that the SAIF could withstand approximately $1.3 billion more in losses than the pessimistic scenario without falling below the DRR as of June 30, 2001.

Risk-based assessment system. The staff recommends retaining the current spread of 27 bp between the highest- and lowest-rated institutions as well as the rate spread between adjacent cells in the assessment rate matrix. The proposed assessment rate schedule, ranging from 0 to 27 bp per year, appears in Table 4. The Board previously determined that the current rate spreads provide appropriate incentives for weaker institutions to improve their condition and for all institutions to avoid excessive risk-taking, consistent with the goals of risk-based assessments.

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 $22 million, up from $17 million in the previous period. In recommending that the Board maintain this schedule, the staff has considered the impact on earnings and capital and found no unwarranted adverse effects.

Table 4

Proposed Assessment Rate Schedule

First Semiannual Assessment Period of 2001

SAIF-Insured Institutions

Capital Group	A	B	C
1. Well	**0 bp**	**3 bp**	**17 bp**
2. Adequate	**3 bp**	**10 bp**	**24 bp**
3. Under	**10 bp**	**24 bp**	**27 bp**

The Assessment Base Distribution and Matrix Migration

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

Table 5

SAIF Assessment Base Distribution (1)

Deposits as of June 30, 2000

Supervisory Subgroup and Capital Groups in Effect July 1, 2000

Capital Group		A		B		C	
1. Well	Number	1,232	90.1%	88	6.4%	14	1.0%
	Base ($billion)	756.5	95.6%	22.3	2.8%	3.9	0.5%
2. Adequate	Number	22	1.6%	8	0.6%	3	0.2%
	Base ($billion)	4.6	0.6%	2.0	0.3%	2.3	0.3%
3. Under	Number	0	0.0%	0	0.0%	1	0.1%
	Base ($billion)	0	0.0%	0	0.0%	0.1	0.0%

Estimated annual assessment revenue $22 million

Assessment Base $ 792 billion

Average annual assessment rate (bp) 0.29 basis points

Notes:

1. *"Number" reflects the number of SAIF members (excludes BIF Oakars). "Base" reflects all SAIF-assessable deposits.*

With 98.1 percent of the number of institutions and 98.9 percent of the assessment base in the three lowest assessment risk classifications of "1A," "1B," and "2A," the current distribution in the rate matrix reflects little fundamental difference from the previous period when the percentages were 98.6 percent and 99.4 percent, respectively. The slightly lower number of institutions in these three categories (down 37) reflects continuation of industry consolidation trends, as the overall total also declined by 30 institutions. There are 26 institutions outside of the "1A," "1B," and "2A" classifications, up from 19 in the previous period.

Only 136 institutions are currently classified outside of the lowest assessment risk classification compared to 117 from the previous period. Of the 117 institutions that were previously classified outside of the "1A" assessment risk classification, 16 institutions migrated into the "1A" risk classification in the current distribution (Table 6). Of the 1,271 institutions that were classified "1A" as of the previous assessment period, 38 institutions migrated out of the "1A" risk classification. Overall, the supervisory subgroup assignment was upgraded since the previous period for 9 institutions with an assessment base of $520 million and was downgraded for 33 institutions with an assessment base of $10.6 billion.

Table 6

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

Institutions entering "1A"	Number	Base ($billion)
Due to capital group reclassification only	9	1.6
Due to supervisory subgroup reclassification only	7	0.4
Due to both	0	0
Total	16	2.0
Institutions leaving "1A"	Number	Base ($billion)
Due to capital group reclassification only	12	2.6
Due to supervisory subgroup reclassification only	26	7.1
Due to both	0	0.0
Total	38	9.7

Notes:

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

Other Issues

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 SAIF rate schedule. The Funds Act also required that, as of January 1, 2000, all BIF- and SAIF-insured institutions will pay the same rates on their assessable deposits. The FICO rate on SAIF-assessable deposits for the first semiannual period of 2001 (subject to quarterly adjustment) will be determined using September 30, 2000, Call Report and Thrift Financial Report data in December 2000.

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