SAIF Assessment Rates for the First Semiannual Assessment Period of 2002

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

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 1.40 percent (unaudited) as of June 30, 2001. Staff projections indicate that the reserve ratio is likely to remain at or above 1.25 percent through June 30, 2002 if insurance losses and deposit growth vary within expected ranges. Thus, it does not appear that additional assessment revenue will be needed to maintain the target DRR through the first semiannual period of 2002, and the staff consequently recommends no changes to the rate schedule.

Some institutions will pay premiums under the schedule even though the reserve ratio 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, 2001 data and projected ranges for the relevant variables at June 30, 2002, this rate schedule would result in an average annual assessment rate of approximately 0.40 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 funds 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 expressed the view that a rising SAIF reserve ratio was not necessarily indicative of a long-run trend, given the historical volatility of deposit growth and insurance losses. The recent decline in the reserve ratio supports this view and demonstrates the volatility of the reserve ratio.

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 funds; 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.

Maintaining the Target DRR Over the Next Assessment Period

The SAIF reserve ratio stood at 1.40 percent as of June 30, 2001 (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.

Many backward looking measures of bank and thrift financial condition indicate that the industry has continued its strong performance; however, there were indications prior to the events of September 11, 2001 that the economy was slowing, and many theorize that the economic fallout from the attacks will intensify this trend. This would likely cause measures of bank and thrift health to weaken during the upcoming assessment period and would likely increase losses to the SAIF. The magnitude of the increase is difficult to quantify without knowing the depth or duration of economic weakness. Another uncertainty is the growth rate of insured deposits. Strong deposit growth coupled with a substantial increase in losses could drop the SAIF reserve ratio during the assessment period, but staff projections show that it is likely the ratio will stay above 1.25 percent.

The FDIC may alter the existing rate structure and may change the base SAIF rates (currently 4 to 31 bp) by rulemaking with notice and comment. Without a notice-and-comment rulemaking, the Board has authority to increase or decrease the effective rate schedule up to a maximum of 5 bp, as deemed necessary to maintain the target DRR.

Thrifts' asset quality has deteriorated moderately over the past year. Net charge-offs are up 50 percent over year-ago levels, but are still low by historical standards. Over the past year, noncurrent loans have increased faster than loan loss reserves, causing the industry's coverage ratio to fall to 1.15x. Delinquencies across all loan types increased during the second quarter.

Despite the concerns noted above, there are reasons to believe that the industry is capable of withstanding significant stress. The thrift industry ROA was 1.06 percent during the second quarter, up from 0.95 percent measured during the first quarter and a year ago. Declining interest rates have created a good environment for selling fixed-rate assets and have increased the thrift industry's net interest income. The industry earned a record $3.4 billion during the second quarter, the result of increases in both securities gains and net operating income. The industry's leverage capital ratio is 7.76 percent, approximately the same as a year ago.

Estimated SAIF-insured deposits grew 4.7 percent during the year ending June 30, 2001, while the SAIF grew by 2.4 percent, causing the reserve ratio to drop from 1.43 percent to 1.40 percent. This deposit growth rate is high by historical SAIF standards, and staff believes that rapid deposit growth may continue through the end of 2001 and into 2002. The potential drivers of this trend include stock market volatility, accommodative monetary policy and investor flight to safety.

Despite concerns regarding the potential for higher SAIF losses and accelerating deposit growth, the staff believes it is unlikely that the reserve ratio will fall below 1.25 percent during the upcoming assessment period. 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, 2002.

1. Fund Balance

The unaudited SAIF balance was $10.792 billion on June 30, 2001. 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, 2002 reflect the range of June 30, 2001 estimates from the Financial Risk Committee (FRC) plus any adjustments for potential losses on failures that have occurred since June 30, 2001. The resulting range for changes in contingent liabilities is $125 million to $625 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, 2001.

Table 1
Potential Changes in Contingent Liabilities and Allowance for Losses (1)
June 30, 2001 to June 30, 2002

	Low Loss Estimate	High Loss Estimate
Contingent Liability for Future Losses	$100 million	$400 million
Allowance for Losses: Closed Banks (2)	$25 million	$225 million
Total Provision for Losses	$125 million	$625 million

Notes:
(1) Both projections reflect the information available as of September 30, 2001, regarding future economic conditions.
(2) Where point estimates for net recovery value are available, this reflects an allowance for variation of +/- 5% around the point estimate. Where point estimates are not available, this reflects the estimated range of net recovery values for the resolution.

Interest Income and Unrealized Gains and Losses on AFS Securities. The average SAIF investment portfolio for the twelve months ending June 30, 2002 is estimated to be approximately $10.4 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 $612 million and $625 million for the twelve months ending June 30, 2002. 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
Projected Fund Balance (1)

($ in millions)

	Low Projected Balance	High Projected Balance
Assessments (2)	34	34
Interest Income (3)	625	612
Total Revenue	659	646
Operating Expenses	120	120
Provision for Losses	625	125
Total Expenses & Losses	745	245
Net Income	86	401
Unrealized Gain (Loss) on AFS Securities (3)	(32)	108
Comprehensive Income (Loss) (4)	(118)	509
Fund Balance (Unaudited) - 6/30/01	10,792	10,792
Projected Fund Balance - 6/30/02	10,674	11,301

Note:

(1) Projected figures are for the twelve months from June 30, 2001, through June 30, 2002.

(2) Assumes that the current assessment rate schedule remains in effect through June 30, 2002.

(3) Portfolio yield is estimated to be between 5.88 percent (high projected balance) and 6.01 percent (low projected balance), reflecting a shift in the level of interest rates of + or - 100 bp from the level of interest rates as of the beginning of September 2001. Note: Because of the significant percentage of AFS securities held, the magnitude of the change in market value of these securities more than offsets the interest income changes. In the table, compare Interest Income with Unrealized Gain (Loss) on AFS Securities. The average invested fund balance is estimated to be approximately $10.4 billion. Unrealized Gain (Loss) of AFS securities includes $37 million in gains for July and August 2001.

(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 increased by 4.7 percent during the twelve months ending on June 30, 2001, just below the 4.9 percent growth rate recorded in 2000.

Insured deposit volume continued to grow in the first half of 2001, albeit at a slower pace than in 2000. Recent deposit growth was most likely influenced by stock market volatility and an increase in money supply resulting from Federal Reserve Bank actions. The Federal Reserve has continued to lower short-term interest rates through 2001, which could make insured deposits less attractive due to lower rates; however, continued stock market volatility and investors' concerns for safety suggest that deposits may remain an attractive investment as we approach the upcoming assessment period.

It takes about $5.5 billion in estimated insured deposit growth to create a 1 basis point change in the SAIF reserve ratio, all other things held constant. With the reserve ratio currently at 1.40 percent, it would take approximately $82.5 billion in insured deposit growth to reduce the fund to the Designated Reserve Ratio level, all else equal. As of June 30, 2001, $82.5 billion is about 11 percent of estimated insured deposits. It is unlikely that deposit growth alone could drive the reserve ratio below 1.25 percent during the upcoming assessment period. Significant insurance losses in addition to sustained rapid deposit growth would be required to cause the reserve ratio fall below its target in the near term.

In the last recommendation to the Board regarding SAIF assessment rates, the staff suggested a range of insured deposit growth from +1 to +5 percent. In light of recent experience, the view of the staff is that at least some deposit growth should be expected and stronger deposit growth cannot be ruled out. Thus, the staff projects SAIF-insured deposit growth in the range of +2 percent to +7 percent between June 30, 2001 and June 30, 2002.

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 1.29 percent to 1.43 percent at June 30, 2002 (Table 3). The low estimate, which produces a 11 bp decrease in the reserve ratio from June 30, 2001, reflects an assumed stronger increase in the insured deposit base (+7 percent) and a downward adjustment to the fund balance for an assumed reduction in the aggregate mount of unrealized gains on AFS securities (see Table 2). The low estimate also reflects the highest losses from possible near-term failures as projected by the FRC; the estimates are not intended to represent a "worst-case" scenario. The high estimate for the reserve ratio, which produces a 3 bp increase from the June 30, 2001 levels, reflects lower growth (+2 percent) in the SAIF-insured deposit base, stronger growth in the SAIF balance due to lower insurance losses, and an upward adjustment for the assumed increase in the aggregate amount of unrealized gains on AFS securities.

Table 3

Projected SAIF Reserve Ratios
($ in millions)

		June 30, 2001	
Fund Balance (Unaudited)		$10,792	
Estimated Insured Deposits		$772,896	
SAIF Ratio		1.40%	
	Low Estimate (1) June 30, 2002		**High Estimate (2) June 30, 2002**
Projected Fund Balance	$10,647		$11,301
Estimated Insured Deposits	$826,999		$788,354
Estimated BIF Ratio	1.29%		1.43%

Note:

(1) The low estimate refers to the scenario of higher interest rates (portfolio yield: 6.01 percent, unrealized losses on AFS securities-see Note 3 in Table 2), a higher provision for losses ($625 million) and a higher insured deposit growth rate (+7 percent).

(2) The high estimate refers to the scenario of lower interest rates (portfolio yield: 5.88 percent, unrealized gains on AFS securities-see Note 3, Table 2), a lower provision for losses ($125 million) and a lower insured deposit growth rate (+2 percent).

Staff expects that the actual reserve ratio at year-end 2001 will exceed 1.25 percent. Even if the low estimate were to be realized, the current rate schedule will be sufficient to maintain the DRR through June 30, 2002. It should be noted also that the SAIF could withstand approximately $377 million more in losses than the pessimistic scenario without falling below the DRR at June 30, 2002.

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 (see Table 4). The Board previously determined that the current rate spreads provide appropriate incentives for weaker institutions to improve their condition and for all institutions to avoid excessive risk-taking, consistent with the goals of risk-based assessments. The current rate spreads also generally are consistent with the historical variation in bank failure rates across cells of the assessment rate matrix.

In setting assessment rates to achieve and maintain the reserve ratio at the target DRR, the Board is required to consider the effects of assessments on members' earnings and capital. The estimated annual revenue from the existing rate schedule is $34 million, just below the $35 million recorded in the previous period. The staff has considered the impact on earnings and capital of the current rate schedule and found no unwarranted adverse effects.

Note: In contrast to refund provisions for BIF members, refunds for SAIF members generally are not permitted.

Table 4
Proposed Assessment Rate Schedule
First Semiannual Assessment Period of 2002
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 assessment matrix.

Table 5
SAIF Assessment Base Distribution (1)
Deposits as of June 30, 2001
Supervisory Subgroup and Capital Groups in Effect July 1, 2001

Capital Group		A		B		C	
1. Well	Number Base ($billion)	1,167 813.0	88.6% 94.5%	105 29.7	8.0% 3.4%	13 2.1	1.0% 0.2
2. Adequate	Number Base ($billion)	12 6.3	0.9% 0.7%	8 2.7	0.6% 0.3%	8 5.0	0.6% 0.6%
3. Under	Number Base ($billion)	1 0.0	0.1% 0.0%	1 0	0.1 0.0%	2 1.9	0.2% 0.2%

Estimated annual assessment revenue	$ 34 million
Assessment Base	$860.7 billion
Average annual assessment rate (bp)	0.40 basis points

Notes:

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

With 97.5 percent of the number of institutions and 98.6 percent of the assessment base in the three lowest assessment risk classifications of "1A," "1B," and "2A," as of July 1, 2001, the current distribution in the rate matrix reflects little fundamental difference from the previous semiannual assessment period. The current distribution reflects slight deterioration in the best-rated premium category. Since the previous assessment period, 29 institutions migrated into the "1A" risk classification (see Table 6), and 34 institutions migrated out of the "1A" risk classification. Only 150 institutions are currently classified outside of the lowest assessment risk classification.

Overall, the supervisory subgroup assignment was upgraded since the previous period for 29 institutions with an assessment base of $12.1 billion and was downgraded for 36 institutions with an assessment base of $27.6 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	7	1.3
Due to supervisory subgroup reclassification only	22	8.7
Due to both	0	0.0

Total	29	10.0
Institutions leaving "1A"	Number	Base ($billion)
Due to capital group reclassification only	7	4.0
Due to supervisory subgroup reclassification only	25	25.7
Due to both	2	0.2
Total	34	29.9

Notes:
(1) Reflects SAIF-insured institutions that moved in and out of assessment risk classification "1A" from the first semiannual assessment period of 2001 to the second semiannual assessment period of 2001. 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 would pay the same rates on their assessable deposits. The FICO rate on SAIF-assessable deposits for the first semiannual period of 2002 (subject to quarterly adjustment) will be determined using September 31, 2001, Call Report and Thrift Financial Report data in December 2001.

Staff Contacts

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