SAIF Assessment Rates for the Second Semiannual Assessment Period of 2002

MEMORANDUM TO:	Board of Directors
FROM:	Arthur J. Murton, Director Division of Insurance
SUBJECT:	SAIF Assessment Rates for the Second 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 1.36 percent (unaudited) as of December 31, 2001. Staff projections indicate that the reserve ratio is likely to remain at or above 1.25 percent through December 31, 2002 if insurance losses and deposit growth do not reach the most pessimistic assumptions included in this analysis. Thus, it does not appear that additional assessment revenue will be needed to maintain the target DRR through the second semiannual period of 2002, and the staff consequently recommends no changes to the rate schedule.

Based upon December 31, 2001 data and projected ranges for the relevant variables at December 31, 2002, this rate schedule would result in an average annual assessment rate of approximately 0.25 bp.

ANALYSIS

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

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. [2]

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.

Banking and Economic Conditions

The risk posed to the SAIF is partly a function of current and future economic conditions as well as the condition of the industry.

The U.S. economy shows signs of emerging from the recession that began in April 2001. Recent economic data-including job growth, manufacturing activity, housing starts, and consumer confidence-have generally been stronger than analysts' expectations, raising hopes for a synchronized global economic recovery led by the U.S. Amid the recent good news, however, there remain a number of factors that call into question whether the U.S. economy will be able to generate a robust recovery in 2002. Concerns include: weak corporate profits, weak business investment, overcapacity in key industry sectors, a glut of office and industrial space in some markets, and high debt loads for consumers and businesses. It is possible that these factors could result in either: 1) a slow-growth recovery, or 2) a "double-dip" recession, either of which could result in a continuation of rising credit losses and slow loan growth that would impair the earnings of FDIC-insured institutions.

The earnings of savings institutions have continued to be generally solid in the recession. The thrift industry earned a record $13.3 billion in 2001, helped by securities gains and stable-to-rising interest margins in a falling interest rate environment. Loss provisions rose to $2.8 billion in 2001, a 38 percent increase over last year. Credit card loan losses also rose in tandem with a record 1.45 million personal bankruptcy filings. To the extent that credit problems tend to lag the business cycle, credit losses may continue to rise at savings institutions for a number of quarters in the future. However, at this time there are only a very small number of institutions that report low ratios of capital to assets or high levels of nonperforming loans to total loans.

While many economists and analysts see improvement on the horizon, a continued cautious approach is warranted in the banking sector. The number of problem thrifts and problem thrift assets continues to rise as credit quality deteriorates. Considerable exposure remains in the commercial and industrial loan sector, and many subprime lenders are still showing significant weakness.

Projections for the SAIF Reserve Ratio Over the Next Assessment Period

The SAIF reserve ratio stood at 1.36 percent as of December 31, 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. 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 December 31, 2002.

1. Fund Balance

The unaudited SAIF balance was $10.935 billion on December 31, 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 December 31, 2002 reflect the range of December 31, 2001 estimates from the Financial Risk Committee (FRC) plus any adjustments for potential failures identified subsequent to the FRC's estimates. The resulting range for changes in contingent liabilities is $200 million to $1 billion.

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 December 31, 2001.

Table 1
Potential Changes in Contingent Liabilities and Allowance for Losses (1)
December 31, 2001 to December 31, 2002

	Low Loss Estimate	**High Loss Estimate**
Contingent Liability for Future Failures	$200 million	$1,000 million
Allowance for Losses: Closed Institutions (2)	($30 million)	$30 million
Total Provision for Losses	$170 million	$1,030 million

Notes:
(1) Both projections reflect the information available as of March 31, 2002, regarding future economic conditions.
(2) Assumes a range of approximately -5 to +5 percent of the estimated net recovery value of bank resolutions, $618 million as of March 31, 2002, rounded to the nearest $5 million.

Interest Income and Unrealized Gains and Losses on AFS Securities. In order to estimate interest income for the year, staff has tried to identify a likely range of potential interest rate movements over the next year, based on current interest rate levels and the economic outlook. Likely scenarios for shifts in the level of interest rates of plus 150 bp or minus 50 bp for new investments were deemed to be reasonable. 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. 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
Projected Fund Balance (1)
($ in millions)

	Low Projected Balance	**High Projected Balance**
Assessments (2)	22	22
Interest Income (3)	573	567

Total Revenue	595	589
Operating Expenses	120	120
Provision for Losses	1,030	170
Total Expenses & Losses	1,150	290
Net Income	(555)	299
Unrealized Gain (Loss) on AFS Securities (3)	(76)	25
Comprehensive Income (Loss) (4)	(631)	324
Fund Balance (Unaudited) - 12/31/01	10,935	10,935
Projected Fund Balance - 12/31/02	10,304	11,259

Notes:
(1) Projected figures are for the twelve months from December 31, 2001, through December 31, 2002.
(2) Assumes that the current assessment rate schedule remains in effect through December 31, 2002.
(3) Reflects a shift in the level of interest rates of + 150 bp or - 50 bp from the level of interest rates as of the beginning of March 2002. 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. Unrealized Gain (Loss) on AFS securities includes $36 million in gains for January and February 2002.
(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 deposits have been increasing since 1996 (see Figure 1). SAIF-insured deposits increased by 6.2 percent during the twelve months ending on December 31, 2001, more than the 5.2 percent growth rate recorded in 2000. In contrast to BIF-insured deposit growth, SAIF fourth quarter 2001 growth was a strong 3 percent. SAIF-insured deposit growth exceeded BIF-insured deposit growth for the first time since inception in 2001. Although interest rates remain low, 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 approximately $6 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 1.36 percent, it would take approximately $73 billion in insured deposit growth to reduce the fund to the Designated Reserve Ratio level, all else equal. As of December 31, 2001, $73 billion is just over 9 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 +2 to +7 percent. In light of recent experience, the view of the staff is that differences between BIF- and SAIF-insured deposit growth trends are unpredictable and diminishing, and distinguishing between the two is increasingly meaningless. Thus, the staff projects SAIF-insured deposit growth in the range of +2 percent to +6 percent between December 31, 2001 and December 31, 2002, the same range used for BIF-insured deposits.

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 1.21 percent to 1.38 percent at December 31, 2002 (Table 3). The low estimate, which produces a 15 bp decrease in the reserve ratio from December 31, 2001, reflects an assumed stronger increase in the insured deposit base (+6 percent) and a downward adjustment to the fund balance for an assumed reduction in the aggregate amount 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 2 bp increase from the December 31, 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)			
		December 31, 2001	
Fund Balance (Unaudited)		$10,935	
Estimated Insured Deposits		$801,849	
SAIF Ratio		1.36%	
	Low Estimate (1) December 31, 2002		**High Estimate (2) December 31, 2002**
Projected Fund Balance	$10,304		$11,259
Estimated Insured Deposits	$849,960		$817,886
Estimated SAIF Ratio	1.21%		1.38%

Notes:
Notes: (1) The low estimate refers to the scenario of higher interest rates, (because of unrealized losses on AFS securities-see Note 3 in Table 2), a higher provision for losses ($1,030 million) and a higher insured deposit growth rate (+6 percent).
(2) The high estimate refers to the scenario of lower interest rates (because of unrealized gains on AFS securities-see Note 3, Table 2), a lower provision for losses ($170 million) and a lower insured deposit growth rate (+2 percent).

Staff expects that the actual reserve ratio at year-end 2002 will exceed 1.25 percent. As indicated in Table 3, if the low estimate were to be realized, the current rate schedule would not be sufficient to maintain the DRR through December 31, 2002. Staff believes that such a scenario is possible, but not likely, because the low estimate requires sustained rapid deposit growth, high losses and a substantial increase in interest rates to occur during the assessment period.

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 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 $22 million, somewhat 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.

Table 4 Proposed Assessment Rate Schedule

Second 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)
Assessable Deposits as of December 31, 2001
Supervisory Subgroup and Capital Groups in Effect January 1, 2002

Capital Group		**A**		**B**		**C**	
1. Well	Number Base ($billion)	1,163 858.3	90.4% 95.7%	80 29.7	6.2% 3.3%	18 4.9	1.4% 0.5%
2. Adequate	Number Base ($billion)	11 1.3	0.9% 1.7	9 1.2	0.7% 0.2%	3 1.0	0.2% 0.1%
3. Under	Number Base ($billion)	0 0.0	0.0% 0.0%	1 0	0.1% 0.0%	2 0.3	0.2% 0.0%

Estimated annual assessment revenue	$ 22 million
Assessment Base	$ 897.3 billion
Average annual assessment rate (bp)	0.25 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 99.2 percent of the assessment base in the three lowest assessment risk classifications of "1A," "1B," and "2A," as of January 1, 2002, the current distribution in the rate matrix reflects little fundamental difference from the previous semiannual assessment period. The current distribution reflects slight improvement in the best-rated premium category. Since the previous assessment period, 38 institutions migrated into the "1A" risk classification (see Table 6, next page), and 16 institutions migrated out of the "1A" risk classification. Only 124 institutions are currently classified outside of the lowest assessment risk classification.

Overall, the supervisory subgroup assignment was upgraded since the previous period for 38 institutions with an assessment base of $9.3 billion and was downgraded for 16 institutions with an assessment base of $5.3 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	6	4.7
Due to supervisory subgroup reclassification only	32	4.6

Due to both	0	0.0
Total	38	9.3
Institutions leaving "1A"	Number	Base ($billion)
Due to capital group reclassification only	6	1.3
Due to supervisory subgroup reclassification only	10	4.0
Due to both	0	0.0
Total	16	5.3

Notes:
(1) Reflects SAIF-insured institutions that moved in and out of assessment risk classification "1A" from the second semiannual assessment period of 2001 to the first semiannual assessment period of 2002. 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 second semiannual period of 2002 (subject to quarterly adjustment) will be determined using March 31, 2002 Call Report and Thrift Financial Report data in June 2002.

Staff Contacts

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Concur: ____________________ ____________________

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[1] 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.
[2] 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.