FDIC
Federal Deposit Insurance Corporation
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Division of Insurance

November 6, 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 2003

Recommendation

The staff recommends that the Board maintain the existing Savings Association Insurance Fund (SAIF) assessment rate schedule of 0 to 27[1] 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 reserve ratio for the SAIF stood at 1.38 percent (unaudited) as of June 30, 2002. Staff projections indicate that the reserve ratio is likely to remain at or above 1.25 percent through June 30, 2003, 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 first semiannual period of 2003, and the staff recommends no changes to the rate schedule.

[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 SAIF 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.

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, 2002, data and projected ranges for the relevant variables at June 30, 2003, 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 insured institutions; (2) the statutory requirement to maintain the DRR, currently 1.25 percent, and (3) all other relevant statutory provisions.[2]

<u>Projections for the SAIF Reserve Ratio Over the Next Assessment Period</u>

The SAIF reserve ratio stood at 1.38 percent as of June 30, 2002 (unaudited), the latest date for which complete data are available. The projected range for the SAIF reserve ratio through June 30, 2003, is 1.23 percent to 1.39 percent. Although the low end is slightly below the statutory requirement of 1.25 percent, the current rate schedule should be sufficient, as the low projection is less likely to occur than a more moderate decline in the ratio. Factors such as a likely slow-growth economic recovery, the industry's resilience so far to the recent recession and tepid recovery, and slower deposit growth in recent quarters all lend support to this conclusion.

[2] The Board is required to review and weigh the following factors when establishing an assessment schedule: a) the probability and likely amount of loss to the fund posed by individual institutions; b) case resolution expenditures and income; c) expected operating expenses; d) the revenue needs of the 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.

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, 2003.

1. Fund Balance

Insurance losses, interest income and unrealized gains and losses on available-for-sale (AFS) securities are significant factors that determine changes in the fund balance over the short run.

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. Estimated changes in contingent liabilities for the twelve months ending June 30, 2003, were based upon the Financial Risk Committee's (FRC) third quarter estimates of possible failed thrift assets using June 30, 2002, asset figures. These estimates were adjusted, where necessary, for: (1) estimated losses on failures that have occurred since June 30, 2002; and (2) potential failures identified subsequent to the FRC's estimates. The resulting range for changes in contingent liabilities is $200 million to $1.0 billion. Table 1 projects low and high estimates for potential increases in the total provision for losses based on changes in contingent liabilities and adjustments for the net recovery value of closed banks in receivership.

Table 1
Potential Changes in Contingent Liabilities and Allowance for Losses (1)
June 30, 2002 to June 30, 2003

	Low Loss Estimate	High Loss Estimate
Contingent Liability for Future Failures	$200 million	$1,000 million
Allowance for Losses: Closed Institutions (2)	($15 million)	$15 million
Potential Increase in Provision for Losses	$185 million	$1,015 million

Notes:

(1) Both projections reflect the information available as of September 30, 2002, regarding future economic conditions.

(2) Assumes a range of approximately –5 to +5 percent of the estimated net recovery value of bank resolutions, $275 million as of September 30, 2002, rounded to the nearest $5 million.

The level of insurance losses will partly depend on the future condition of the economy and its effect on the thrift industry. Staff has considered several future economic scenarios and believes a slow-growth economic recovery is most likely in the coming months. However, there is some risk that a shock to the economy, such as the outbreak of war, another corporate governance scandal, an oil price spike, or another terrorist attack, could lead consumers to stop spending, a mainstay of this recovery so far. Given these possibilities, a double dip recession cannot be ruled out.

The single most likely source of significant insurance losses related to the failure of FDIC-insured institutions in the near-term is subprime consumer lending. Some 128 FDIC-insured institutions with 6.5 percent of industry assets are currently identified as having subprime consumer or mortgage loans greater than 25 percent of Tier 1 capital. This group has a significant number of problem institutions and has contributed disproportionately to recent financial institution failures.

For purposes of determining adequacy of the current contingent liability, staff has conducted financial stress tests that incorporate a variety of economic scenarios on consumer specialty lenders, including subprime consumer lenders. Given the most likely economic scenario of a slow-growth recovery, staff believes the change in total provisions is less likely to resemble the high loss estimate than the low loss estimate in Table 1.

Interest Income and Unrealized Gains and Losses on Available-for-Sale (AFS) Securities. In order to estimate interest income for the year, staff has identified a likely range of potential interest rate movements over the next year. Given current interest rate levels and the economic outlook, scenarios for shifts in the level of interest rates of plus 150 bp or minus 50 bp for new investments appear reasonable. Table 2 (next page) projects low and high estimates for interest income and unrealized gains and losses on AFS securities. 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 these securities dominates the effect of changes in interest income.

Table 2
Potential Changes in Interest Income and Unrealized Gains (Losses) on AFS Securities (1)
June 30, 2002 to June 30, 2003 ($ in millions)

	Higher Interest Rates and Failure Resolution Outlays (2)	Lower Interest Rates and Failure Resolution Outlays
Interest Income	603	570
Unrealized Gain (Loss) on AFS Securities (3)	(117)	50

Notes:
(1) Both projections reflect 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 September 2002.
(2) Although the level of interest rates is assumed to be 200 bp higher in the "Higher Failure" scenario, overall interest revenue is actually lower than in the "Higher Failure" scenario due to a significantly smaller balance being invested during the period.
(3) Includes actual unrealized gains on AFS securities for the period July 1, 2002, through August 31, 2002, and projected gains/losses through June 30, 2003.

With a slow-growth economic recovery likely into the second half of next year, staff does not anticipate dramatic changes in bond market rates. If market rates hold relatively steady, the AFS securities' accounting treatment will have less of an impact on changes in the fund balance than it has in the recent past.

Projected Fund Balance. Table 3 summarizes the effects on the fund balance of the low 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 June 30, 2003.

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

	Low Projected Balance	High Projected Balance
Assessments (2)	23	23
Interest Income (3)	603	570
Total Revenue	626	593
Operating Expenses	120	120
Provision for Losses	1,015	185
Total Expenses & Losses	1,135	305
Net Income	(509)	288
Unrealized Gain (Loss) on AFS Securities (3)	(117)	50
Comprehensive Income (4)	(626)	338
Fund Balance (Unaudited) – 6/30/02	11,323	11,323
Projected Fund Balance – 6/30/03	10,697	11,661

Notes:

(1) Projected figures are for the twelve months from June 30, 2002, through June 30, 2003.
(2) Assumes that the current assessment rate schedule remains in effect through June 30, 2003.
(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 September 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 the relative change in Interest Income with the relative change in Unrealized Gain (Loss) on AFS Securities. See also Table 2, footnote (2) for an explanation regarding changes in interest revenue under these two scenarios.
(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).

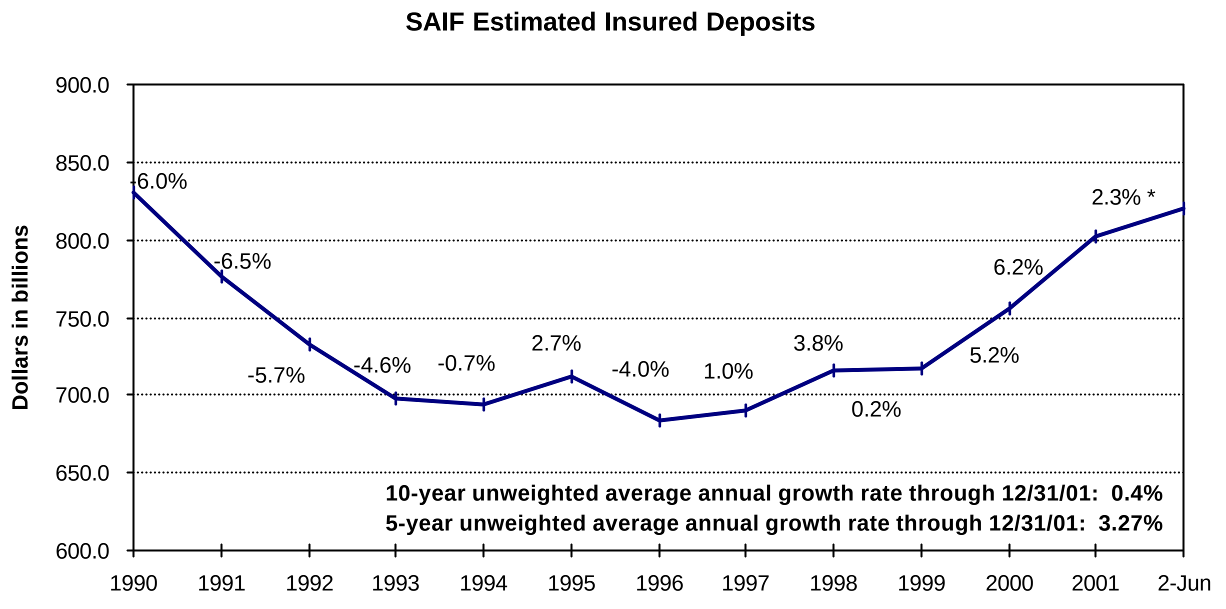
2. Insured Deposits

Although the total amount of SAIF-insured deposits is lower now than at the inception of the fund in 1989, insured deposits have been increasing since 1996 (Figure 1, next page). SAIF-insured deposits increased by 2.3 percent during the six months ending on June 30, 2002. In contrast to BIF-insured deposits, which declined during the second quarter of 2002, SAIF insured deposits grew by 0.95 percent.

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 at 1.38 percent on June 30, 2002, it would take approximately $89 billion in insured deposit growth to reduce the fund to the Designated Reserve Ratio level, all else being equal. As of June

30, 2002, $89 billion is over 10 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.

Figure 1



* Growth rate is for the six months ended June 30, 2002.

In light of recent strong growth in SAIF-insured deposits, staff believes the five-year average growth rate is more indicative of likely future trends than the ten-year average. Also, deposit growth differences between commercial banks and thrifts are unpredictable and diminishing. Thus, the staff projects SAIF-insured deposit growth in the range of +2 percent to +6 percent between June 30, 2002, and June 30, 2003, the same range used to project BIF-insured deposits. Although interest rates remain low, continued stock market volatility and investors' concerns for safety suggest that insured deposits may remain an attractive investment as we approach the upcoming assessment period. Moderate growth in insured deposits appears likely in the coming year.

2. 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 1.23 percent to 1.39 percent at June 30, 2003 (Table 4). The low estimate, which represents a 15 bp decrease in the reserve ratio from June 30, 2002, assumes a strong increase in the insured deposit base (+6 percent) and a higher interest rate scenario, resulting in a downward adjustment to the fund balance due to a reduction in the aggregate amount of unrealized gains on AFS securities (Table 3). The low estimate incorporates the high loss estimate for insurance fund losses from possible near-term failures as projected by the staff; the estimates are not intended to represent a "worst-case" scenario.

The high estimate represents a 1 bp increase in the reserve ratio from June 30, 2002. It assumes slower growth (+2 percent) in the SAIF-insured deposit base, the low-loss estimate for insurance losses, and lower interest rates, resulting in an upward adjustment to the aggregate amount of unrealized gains on AFS securities.

Table 4
Projected SAIF Reserve Ratios
($ in millions)

	June 30, 2002	
Fund Balance (Unaudited)	$11,323	
Estimated Insured Deposits	$820,463	
SAIF Ratio	1.38%	
	Low Estimate (1) **June 30, 2003**	**High Estimate** (2) **June 30, 2003**
Projected Fund Balance	$10,697	$11,661
Estimated Insured Deposits	$869,861	$836,872
Estimated SAIF Ratio	1.23%	1.39%

Notes:

(1) The low estimate refers to the scenario of higher interest rates, (see Note 3 in Table 2), a higher provision for losses ($1,015 million) and a higher insured deposit growth rate (+6 percent).

(2) The high estimate refers to the scenario of lower interest rates (see Note 3, Table 2), a lower provision for losses ($185 million) and a lower insured deposit growth rate (+2 percent).

Staff expects that the actual reserve ratio at June 30, 2003, will exceed 1.25 percent. As indicated in Table 4, if the low estimate were to be realized, the current rate schedule would not be sufficient to maintain the DRR through June 30, 2003. Staff believes that such a scenario is possible, but not likely, because the low estimate requires sustained rapid deposit growth, high insurance losses, and a substantial increase in interest rates to occur during the assessment period. Even if the SAIF reserve ratio falls below the starting target DRR of 1.25 percent, the Board would have two semiannual assessment periods to bring the ratio back to the target.

Risk-based assessment system. The staff recommends retaining the current spread of 27 bp between the assessments paid by the best- and worst-rated institutions as well as the rate spreads between adjacent cells in the assessment rate matrix. The proposed assessment rate schedule appears in Table 5. The Board previously determined that the current rate spreads provide appropriate incentives for weaker institutions to improve their condition and for all institutions to avoid excessive risk-taking, consistent with the goals of risk-based assessments and existing statutory provisions. The current rate spreads also generally are consistent with the historical variation in bank failure rates across cells of the assessment rate matrix.

Table 5
Proposed Assessment Rate Schedule
First Semiannual Assessment Period of 2003
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**

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 $23 million, which is $1 million more than the annual amount that was projected six months ago. In recommending that the Board maintain this schedule, the staff has considered the impact on thrift earnings and capital of the current rate schedule and found no unwarranted adverse effects.

The Assessment Base Distribution and Matrix Migration

Table 6 summarizes the current distribution of institutions across the assessment matrix.

Table 6
SAIF Assessment Base Distribution (1)
Assessable Deposits as of June 30, 2002
Supervisory Subgroup and Capital Groups in Effect July 1, 2002

Capital Group		A		B		C	
1. Well	Number	1,139	90.7%	78	6.2%	17	1.4%
	Base ($billion)	879.0	95.0%	38.4	4.1%	5.5	0.6%
2. Adequate	Number	7	0.6%	6	0.5%	7	0.6%
	Base ($billion)	1.8	0.2%	0.5	0.1%	0.5	0.1%
3. Under	Number	0	0.0%	0	0.0%	2	0.2%
	Base ($billion)	0.0	0.0%	0.0	0.0%	0.1	0.0%

Estimated annual assessment revenue	$23 million
Assessment Base	$925.7 billion
Average annual assessment rate (bp)	0.25 basis points

Notes:

(1) “Number” reflects the number of SAIF members (excludes BIF-Oakar institutions). “Base” reflects all SAIF-assessable deposits.

With 97.5 percent of the number of institutions and 99.3 percent of the assessment base in the three lowest assessment risk classifications of “1A,” “1B,” and “2A,” as of July 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, 20 institutions migrated into the "1A" risk classification (Table 7, next page), and 17 institutions migrated out of the "1A" risk classification. Only 117 institutions are currently classified outside of the best risk classification.

Overall, for all SAIF-insured institutions, the supervisory subgroup component of the risk classification was upgraded since the previous period for 18 institutions with an assessment base of $30.1 billion and was downgraded for 20 institutions with an assessment base of $18.3 billion.

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

Institutions entering "1A"	Number	Base ($billion)
Due to capital group reclassification only	5	0.5
Due to supervisory subgroup reclassification only	15	29.7
Due to both	0	0.0
Total	20	30.2
Institutions leaving "1A"	**Number**	**Base ($billion)**
Due to capital group reclassification only	4	0.5
Due to supervisory subgroup reclassification only	13	18
Due to both	0	0.0
Total	17	18.5

Notes:

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

Other Issues

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 SAIF 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 2003 will be determined using September 30, 2002 Call Report and Thrift Financial Report data.

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