November 6, 2009

MEMORANDUM TO: The Board of Directors

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

Sandra L. Thompson
Director
Division of Supervision and Consumer Protection

SUBJECT: Final Rule on Prepaid Assessments

SUMMARY OF RECOMMENDATIONS

Staff recommends that:

1. The FDIC Board of Directors (FDIC or Board) authorize publication of the attached Final Rule on Prepaid Assessments (final rule) that would require insured institutions to prepay, on December 30, 2009, their estimated quarterly risk-based assessments for the fourth quarter 2009 and for all of 2010, 2011 and 2012. Staff estimates that total prepaid assessments would amount to approximately $45 billion.

2. The Board delegate to the Director, Division of Supervision and Consumer Protection, with the concurrence of the Director, Division of Insurance and Research, the authority to: (1) exempt an insured institution from the prepayment requirement if staff determines that the prepayment would adversely affect the safety and soundness of the institution; (2) act on an application for exemption filed by an insured institution if staff determines that the prepayment would significantly impair the institution's liquidity, or would otherwise create extraordinary hardship; (3) postpone determination of exemption applications if necessary beyond the deadlines imposed under the final rule but no later than January 14, 2010, and postpone the due date for the required prepayment; and (4) act on an application requesting that the FDIC withdraw an exemption.

BACKGROUND AND PROJECTIONS

On September 29, 2009, the Board adopted an Amended Restoration Plan to allow the Deposit Insurance Fund (Fund or DIF) to return to a reserve ratio of 1.15

Concur: ______________________
Michael Bradfield
General Counsel

percent within eight years, as mandated by statute. At the same time, the Board adopted higher annual risk-based assessment rates effective January 1, 2011.[1]

Liquidity Needs Projections

While the Amended Restoration Plan and higher assessment rates address the need to return the DIF reserve ratio to 1.15 percent, the FDIC must also consider its need for cash to pay for projected failures. In June 2008, before the number of bank and thrift failures began to rise significantly and the crisis worsened, total assets held by the DIF were approximately $55 billion and consisted almost entirely of cash and marketable securities (i.e., liquid assets). As the crisis has unfolded, liquid assets of the DIF have been used to protect depositors of failed institutions and have been exchanged for less liquid claims against the assets of failed institutions. As of September 30, 2009, although total assets had increased to almost $63 billion, cash and marketable securities had fallen to approximately $23 billion. The pace of resolutions continues to put downward pressure on cash balances. While most of the less liquid assets in the DIF have value that will eventually be converted to cash when sold, the FDIC's immediate need is for more liquid assets to fund near-term failures.

Staff's projections of the Fund's liquidity include assumptions concerning failed-institution resolution strategies, such as the increasing use of loss sharing -- especially for larger institutions -- which reduce the FDIC's immediate cash outlays, as well as the anticipated pace at which assets obtained from failed institutions can be sold. If the FDIC took no action under its existing authority to increase its liquidity, staff projects that the FDIC's liquidity needs would exceed liquid assets on hand beginning in the first quarter of 2010. Through 2010 and 2011, liquidity needs could significantly exceed liquid assets on hand.

Proposed Rule

On September 29, 2009, the FDIC, using its statutory authority under sections 7(b) and 7(c) of the FDI Act (12 U.S.C. 1817(b)-(c)), adopted a notice of proposed rulemaking with request for comment to amend its assessment regulations to require all institutions to prepay, on December 30, 2009, their estimated risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011, and 2012, at the same time that institutions pay their regular quarterly deposit insurance assessments for the third quarter of 2009 (the proposed rule or NPR).[2, 3] Under the NPR, an institution would initially account for the prepaid assessment as a prepaid expense (an asset). The Fund would initially account for the amount collected as both an asset (cash) and an offsetting liability (deferred revenue). An institution's quarterly risk-based deposit insurance assessments

[1] 74 FR 51063 (Oct. 2, 2009).

[2] Section 7(b)(3)(E) of the Federal Deposit Insurance Act (12 U.S.C. § 1817(b)(3)(E)); Section 7(b)(2) of the Federal Deposit Insurance Act (12 U.S.C. § 1817(b)(2)).

[3] 74 FR 51063 (Oct. 2, 2009).

thereafter would be paid from the amount the institution had prepaid until that amount was exhausted or until December 30, 2014, when any amount remaining would be returned to the institution.

Under the proposed rule, the FDIC would exercise its supervisory discretion to exempt an institution from the prepayment requirement if the FDIC determined that the prepayment would adversely affect an institution's safety and soundness. In addition, an institution could apply to the FDIC for an exemption from the prepayment requirement if the institution demonstrated that the prepayment would significantly impair the institution's liquidity, or otherwise created significant hardship. The FDIC requested comment on all aspects of the proposed rule.

FINAL RULE

The FDIC received more than 800 comments on the NPR, of which approximately 680 were form letters. The vast majority of the commenters supported the FDIC meeting its upcoming liquidity needs by requiring prepaid risk-based assessments. The FDIC also received comments on a number of other issues. Section V of the attached final rule contains a summary of the comments and staff's proposed responses.

The final rule is similar to the proposed rule but contains modifications to benefit institutions. The final rule would:

1. Amend the assessment regulations to require insured institutions to prepay their estimated quarterly regular risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011, and 2012 on December 30, 2009 (prepayment period);

2. Allow the FDIC to exercise its discretion as supervisor and insurer to exempt an institution from the prepayment requirement if the FDIC determines that the prepayment would adversely affect the safety and soundness of the institution;

3. Permit an insured depository institution to apply to the FDIC for an exemption from the prepayment requirement if the prepayment would significantly impair the institution's liquidity, or otherwise create extraordinary hardship;

4. Permit an institution that has been exempted on the FDIC's initiative to file an application requesting that the FDIC withdraw the exemption;

5. Allow the FDIC to postpone determination of exemption applications, if necessary, beyond the deadlines imposed under the final rule, but not later than January 14, 2010, and postpone the due date for the required prepayment; and

6. Return to the institution any amount of the prepaid assessment not exhausted after collection of the amount due from the institution on June 30, 2013.

Calculation of Estimated Prepaid Assessment Amount

For purposes of estimating an institution's assessments for the prepayment period and calculating the amount that an institution would prepay on December 30, 2009 (prepaid amount), the institution's assessment rate would be its total base assessment rate in effect on September 30, 2009.[4] Since the FDIC has already increased annual assessment rates uniformly by 3 basis points beginning in 2011, an institution's total base assessment rate for purposes of estimating its assessments for 2011 and 2012 would be increased by an annualized 3 basis points beginning in 2011.[5] Again for purposes of calculating the prepaid amount, an institution's third quarter 2009 assessment base would be increased quarterly at a 5 percent annual growth rate through the end of 2012. Changes to data underlying an institution's September 30, 2009, assessment rate or assessment base received by the FDIC after December 24, 2009, would not affect an institution's prepayment amount.[6, 7] The FDIC would collect the prepaid assessments for the prepayment period on December 30, 2009, along with the institution's regular quarterly deposit insurance assessments for the third quarter of 2009.[8]

An institution's prepaid assessment would be set as described in the previous paragraph and would be applied to the institution's risk-based assessments beginning with the fourth quarter of 2009. Events during the prepayment period, such as slower deposit growth or changes in CAMELS ratings, could cause an institution's actual assessments to differ from the estimated assessments used to determine the prepaid amount. Assessment billing would account for events that occur during the prepayment period and could result in an institution either paying assessments in cash before the prepayment period has concluded or ultimately receiving a rebate of unused amounts. An institution's quarterly certified statement invoice would include (1) the regular quarterly risk-based assessment due for the corresponding quarter based on the assessment base and assessment rate applicable to that quarter, (2) the amount of the prepayment that would be applied toward the risk-based assessment for that quarter, and (3) the amount (if

[4] An institution's risk-based assessment rate may change during a quarter when a new CAMELS rating is transmitted, or a new long-term debt-issuer rating is assigned. 12 CFR 327.4(f). For purposes of calculating an institution's prepaid assessment, the FDIC would use the institution's CAMELS ratings and, where applicable, long-term debt-issuer ratings, and the resulting assessment rate in effect on September 30, 2009.

[5] 74 FR 51063 (Oct. 2, 2009).

[6] Thus, for purposes of calculating the prepaid assessment, the FDIC would take into account mergers and consolidations that are recorded in the FDIC's computer systems as of December 24, 2009. If a merger is recorded by this date, the assessment for the acquired institution would be paid by the acquirer at the acquirer's rate.

[7] An institution's failure to file its third quarter of 2009 report of condition would not exempt it from the requirement to prepay under this rulemaking.

[8] The amount and calculation of each insured depository institution's prepaid assessment would be included on its quarterly certified statement invoice for the third quarter of 2009, which will be available on FDIC*connect* no later than 15 days prior to the December 30, 2009, payment date.

any) of any remaining prepaid amount. An insured depository institution could continue to request review or revision (as appropriate) of its regular risk-based assessment each quarter under sections 327.4(c) and 327.3(f) of the FDIC regulations.

Requiring prepaid assessments would not preclude the FDIC from changing assessment rates or from further revising the risk-based assessment system during 2009, 2010, 2011, 2012, or thereafter, pursuant to notice-and-comment rulemaking under 12 U.S.C. § 1817(b)(1). Prepaid assessments made by insured depository institutions would continue to be applied against quarterly assessments as they may be so revised until the prepaid assessment is exhausted or the prepayment is returned, whichever comes first.

Implementing Prepaid Assessments

The FDIC would begin to offset prepaid assessments on March 30, 2010, representing payment of the regular quarterly risk-based deposit insurance assessment for the fourth quarter of 2009. Any prepaid assessment not exhausted after collection of the amount due on June 30, 2013, would be returned to the institution (rather than December 30, 2014, as provided in the proposed rule). If the FDIC determines its liquidity needs allow, it could return any remaining prepaid assessment to the institution sooner.

Accounting and Risk-Weight for Prepaid Assessments

1. Accounting for Prepaid Assessments

Under the final rule, each institution should record the entire amount of its prepaid assessment as a prepaid expense (asset) as of December 30, 2009. Notwithstanding the prepaid assessment, each institution should record the estimated expense for its regular risk-based assessment each calendar quarter. However, the offsetting entry to the expense for a particular quarter would depend on the method of payment for that quarter's expense. As of September 30, 2009, each institution should have accrued an expense (a charge to earnings) for its estimated regular quarterly risk-based assessment for the third quarter of 2009, which is a quarter for which assessments would not have been prepaid, and a corresponding accrued expense payable (a liability). On December 30, 2009, each institution would pay both its assessment for the third quarter of 2009, thereby eliminating the related accrued expense payable, and the entire amount of its prepaid assessments, which it should record as a prepaid expense (asset).

As of December 31, 2009, each institution should record (1) an expense (a charge to earnings) for its estimated regular quarterly risk-based assessment for the fourth quarter of 2009, and (2) an offsetting credit to the prepaid assessment asset because the fourth quarter assessment of 2009 would have been prepaid.[9]

[9] Some institutions record the estimated expense and an accrued expense payable for their regular risk-based assessments monthly during each calendar quarter rather than quarterly as of quarter-end. On December 30, 2009, when such an institution would pay under the final rule both its assessment for the third quarter of 2009 and the entire amount of its prepaid assessments, it should eliminate the accrued expense payable recorded for the third quarter 2009 assessment as well as the accrued expense payable recorded for the first two months of its estimated fourth quarter 2009 assessment and it should record the

Each quarter thereafter, an institution should record an expense (a charge to earnings) for its regular quarterly risk-based assessment for that quarter and an offsetting credit to the prepaid assessment asset until this asset is exhausted. Once the asset is exhausted, the institution should record an expense and an accrued expense payable each quarter for its regular assessment payment, which would be paid, in cash, in arrears at the end of the following quarter.

2. Risk Weighting of Prepaid Assessments

The federal banking agencies' risk-based capital rules permit an institution to apply a zero percent risk weight to claims on U.S. Government agencies.[10] Staff believes the prepaid assessment imposed under this rule qualifies for a zero percent risk weight.

For the same reasons, staff believes that Temporary Liquidity Guarantee Program (TLGP) nondeposit debt obligations should receive a zero percent risk weight consistent with the risk weight proposed for prepaid assessments. When the FDIC determined that a depository institution could apply a 20 percent risk weight to debt covered by the TLGP, the determination referenced the 20 percent risk weight that has traditionally been applied to assets covered by the FDIC's deposit insurance. Because insured deposits are fully backed by the full faith and credit of the United States government and no insured depositor has ever or will ever take a loss, staff will review reducing the risk weight on insured deposits to zero percent consistent with the treatment of other government-backed obligations.

Restrictions on Use of Prepaid Assessments

Under the final rule, prepaid assessments would only be used to offset regular quarterly risk-based deposit insurance assessments. Prepaid assessments would not be used, for example, for the following:

- To offset FICO assessments (which are governed by section 21(f) of the Federal Home Loan Bank Act, 12 U.S.C. 1441(f));
- To offset any future special assessments under FDI Act section 7(b)(5);
- To offset any future systemic risk assessments under FDI Act section 13(c)(4)(G)(ii);
- To offset Temporary Liquidity Guarantee Program assessments under 12 C.F.R. 370;
- To pay assessments for quarters prior to the fourth quarter of 2009;

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remaining amount of its prepaid assessments (i.e., the entire amount of the prepaid assessments less then accrued expense payable for the first two months of the fourth quarter 2009 assessment) as a prepaid expense (asset). As of December 31, 2009, this institution should record (1) an expense (a charge to earnings) for the third month of its estimated fourth quarter 2009 assessment and (2) an offsetting credit to the prepaid assessment asset.

[10] 12 CFR Part 3, Appendix A (OCC); 12 CFR Parts 208 and 225, Appendix A (Federal Reserve Board); 12 CFR Part 325, Appendix A (FDIC); and 12 CFR Part 567, Appendix C (OTS).

- To pay civil money penalties; or
- To offset interest owed to the FDIC for underpayment of assessments for assessment periods prior to the fourth quarter of 2009.

Staff would apply an institution's remaining one-time assessment credits under Part 327 subpart B before applying its prepaid assessment to its regular quarterly risk-based deposit insurance assessments.[11]

Exemptions for Certain Insured Depository Institutions

The final rule would make a few modifications to the exemption process proposed in the NPR. These modifications are intended to benefit institutions. They would impose stricter deadlines on FDIC staff (in order to provide institutions with earlier notice and greater opportunity to plan), would allow staff to postpone determination of exemption applications if necessary (on condition of postponing the due date for the prepaid assessment), and would give exempted institutions an opportunity to file an application requesting that the FDIC withdraw their exemption.

Because of the tight time frame that would be necessary under the final rule, staff recommends that the Board delegate decisions necessary to the exemption process to the Director, Division of Supervision and Consumer Protection, with the concurrence of the Director, Division of Insurance and Research. Staff would provide the Board with a report of exemptions that staff grants on its own initiative, exemption applications received, and their disposition by January 30, 2010.

Under the final rule, the FDIC would exercise its discretion as supervisor and insurer to exempt an institution from the prepayment requirement if the FDIC determines that the prepayment would adversely affect the safety and soundness of the institution. FDIC staff would consult with the institution's primary federal regulator in making this determination, but the FDIC would retain the ultimate authority to exercise such discretion. FDIC staff would notify any institution determined to be exempt from the prepaid assessment as soon as possible, but in no event later than November 23, 2009. A separate set of deadlines applies to institutions that file applications for exemption and is described in the following paragraphs. Staff does not believe that the exemptions that would be granted under the final rule would prevent the FDIC from meeting its current liquidity needs.

In addition, an insured depository institution could apply to the FDIC for an exemption from the prepayment requirement if the prepayment would significantly impair the institution's liquidity, or would otherwise create extraordinary hardship.[12] The

[11] One-time assessment credits would not reduce an institution's prepaid assessment.

[12] The NPR stated that "an insured depository institution could apply to the FDIC for an exemption from all or part of the prepayment requirement if the prepayment would significantly impair the institution's liquidity, or would otherwise create significant hardship. The FDIC would consider exemption requests on a case-by-case basis and expects that only a few would be necessary." 74 FR 51,063, 51,065 (Oct. 2, 2009). The final rule uses the phrase "extraordinary hardship" rather than "significant hardship" to clarify

FDIC would consider exemption requests on a case-by-case basis and staff expects that only a few institutions would find an exemption necessary.

Written applications for exemption from the prepayment obligation should be submitted to the Director of the Division of Supervision and Consumer Protection on or before December 1, 2009, by electronic mail or fax.[13] In order for an application to be accepted and considered by staff, the application would have to contain a full explanation of the need for the exemption with supporting documentation, to include current financial statements, cash flow projections, and any other relevant information that the FDIC deems appropriate.

Any application for exemption would be deemed to be denied unless staff notifies the applying institution by December 15, 2009, that either: (1) the institution is exempt from the prepaid assessment or (2) the FDIC has postponed determination of whether the institution is exempt until no later than January 14, 2010. Staff expects that it would postpone few, if any, determinations. However, if the FDIC does postpone a determination, the institution would not have to pay its prepaid assessment on December 30, 2009. If the FDIC ultimately denied the institution's request for an exemption, staff would notify the institution of the denial and of the date by which the institution would have to pay the prepaid assessment. That date would be no less than 15 days after the date of the notice of denial.

Under the final rule, an institution that the FDIC has exempted from prepayment on the grounds that prepayment would adversely affect the safety and soundness of the institution could request that the FDIC allow the institution to nevertheless pay the prepaid amount. If the FDIC, after consulting with the institution's primary federal regulator, determines that exemption is not necessary, it would notify the institution that the exemption has been withdrawn. Again, the FDIC would retain the ultimate authority to make this determination.

Written applications requesting that the FDIC withdraw an exemption should be submitted to the Director of the Division of Supervision and Consumer Protection on or before December 1, 2009, by electronic mail or fax.[14] In order for an application requesting that the FDIC withdraw an exemption be accepted and considered by the FDIC, the application would have to contain a full explanation of the reasons the exemption is not needed with supporting documentation, to include current financial

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that the FDIC expects that few exemptions will be necessary other than for those institutions exempted through the FDIC's own initiative.

The final rule also eliminates the option of a partial prepayment exemption since staff determined that it would be infeasible to determine partial prepayments.

[13] Applications for exemption should be submitted by either electronic mail (prepaidassessment@fdic.gov) or fax (202-898-6676).

[14] Applications requesting that the FDIC withdraw an exemption should be submitted by either electronic mail (prepaidassessment@fdic.gov) or fax (202-898-6676).

statements, cash flow projections, and other relevant information that the FDIC deems appropriate. Any application requesting that the FDIC withdraw an exemption would be deemed denied unless the FDIC notifies the applying institution by December 15, 2009 that the exemption has been withdrawn.

Other than through an application requesting that the FDIC withdraw an exemption, determinations of eligibility for exemption made by the FDIC would be final and would not be subject to further agency review. Determinations by the FDIC on applications requesting that an exemption be withdrawn would also be final and would not be subject to further agency review.

Any exempted institution and any institution where the FDIC has postponed determination of the request for exemption would still pay its third quarter 2009 risk-based assessment on December 30, 2009.

Transfer of Prepaid Assessments

An insured depository institution would be permitted to transfer any portion of its prepaid assessment to another insured depository institution, provided that the institutions meet certain requirements as set forth in the final rule. This aspect of the draft final rule is similar to the procedural requirements associated with the transfer of the one-time assessment credit provided by the Federal Deposit Insurance Reform Act of 2005, Pub. L. No. 109-171, 120 Stat. 9, and implemented by regulation. See 12 CFR 327.34(c).

Prepaid assessments would not be transferred to any entity that is not an insured depository institution. Prepayment assessment would not be pledged to either an insured depository institution or an entity that is not an insured depository institution.

In the event that an insured depository institution merges with, or is consolidated into, another insured depository institution, the surviving or resulting institution would be entitled to any unused portion of the disappearing institution's prepaid assessment not otherwise transferred.[15]

[15] As noted above, the parties to a transfer agreement would have to provide notice to the FDIC.

Disposition in the Event of Failure or Termination of Insured Status

In the event that an insured depository institution's insured status is terminated, any amount of the prepaid assessment remaining (other than any amounts needed to satisfy its assessment obligations not yet offset against the prepaid amount) would be refunded to the institution.[16] In the event of failure of an insured depository institution, any amount of the prepaid assessment remaining (other than any amounts needed to satisfy its assessment obligations not yet offset against the prepaid amount) would be refunded to the institution's receiver.

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[16] See 12 CFR 327.6 (2009).