April 8, 2010

MEMORANDUM TO: The Board of Directors

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

SUBJECT: Notice of Proposed Rulemaking on Assessments

SUMMARY OF RECOMMENDATIONS

Staff recommends that the FDIC Board of Directors (FDIC or Board) authorize publication of the attached Notice of Proposed Rulemaking on Assessments (NPR) with a 60 day comment period that would, among its most important features:

Revise the assessment system applicable to large banks by:

- Eliminating risk categories and the use of long-term debt issuer ratings for large institutions;
- Combining CAMELS ratings and forward-looking financial measures into one of two scorecards—one for most large institutions and another for large institutions that are structurally and operationally complex or that pose unique challenges and risks in case of failure (Highly Complex Institutions);
- Allowing the FDIC to take additional information into account in making limited adjustments to scores; and
- Using the scorecard to determine assessment rates.

Alter assessment rates applicable to all insured depository institutions to ensure that the revenue collected under the new assessment system would approximately equal that under the existing assessment system and also ensuring that the lowest rate applicable to both small and large institutions would be the same;

Concur: _____
Michael Bradfield
General Counsel

Retain the Board's flexibility to raise assessment rates up to 3 basis points above or below base assessment rates without the necessity of further rulemaking.

I. Overview of the Large Bank Pricing Proposal

Staff proposes that the assessment system applicable to large institutions be revised to better capture risk at the time an institution assumes the risk, to better differentiate institutions during periods of good economic and banking conditions based on how they would fare during periods of stress or economic downturns, and to better take into account the losses that the FDIC may incur if an institution fails.

Staff has carefully considered the measurements that should be used to assess large banks' risk. The attached proposal includes quantitative measures that are readily available and statistically significant in predicting an institution's long-term performance. Staff believes that other considerations—such as stress testing, underwriting characteristics, and risk management practices—are also important in the risk assessment of large institutions, and they should be factored into the risk-based assessment system. While staff has identified some key metrics for these additional considerations, staff proposes that the Board seek further input in a request for comments included in this proposed rulemaking. Staff anticipates that any final rule issued pursuant to this NPR would be followed by discussions with the industry on ways to improve the system adopted, as well as coordination with other regulators. Ultimately, staff anticipates that a further round of rulemaking may be needed to improve the large bank assessment system adopted pursuant to this rulemaking.

Staff recommends that the Board eliminate risk categories for large institutions to allow the FDIC to draw finer distinctions among large institutions based upon the risk that they pose. For all large institutions, staff proposes that the Board eliminate use of long-term debt issuer ratings. Staff has found that debt issuer ratings, particularly for the largest institutions, do not respond quickly to an institution's changing risk profile. Staff proposes that the FDIC continue to rely upon CAMELS ratings and financial measures to determine assessment rates.

Staff proposes that CAMELS ratings and certain financial measures be combined into two scorecards—one for most large institutions and another for large institutions that are structurally and operationally complex or that pose unique challenges and risks in case of failure (Highly Complex Institutions). Each scorecard would consist of a performance component, which would measure an institution's financial performance and its ability to withstand stress, and a loss severity component, which would correspond to the level of potential losses in case of failure. Most of the data underlying these measures are publicly available, but some are gathered during the examination process. Under the proposal, the FDIC would have limited ability to adjust each component where necessary to produce accurate relative risk rankings.

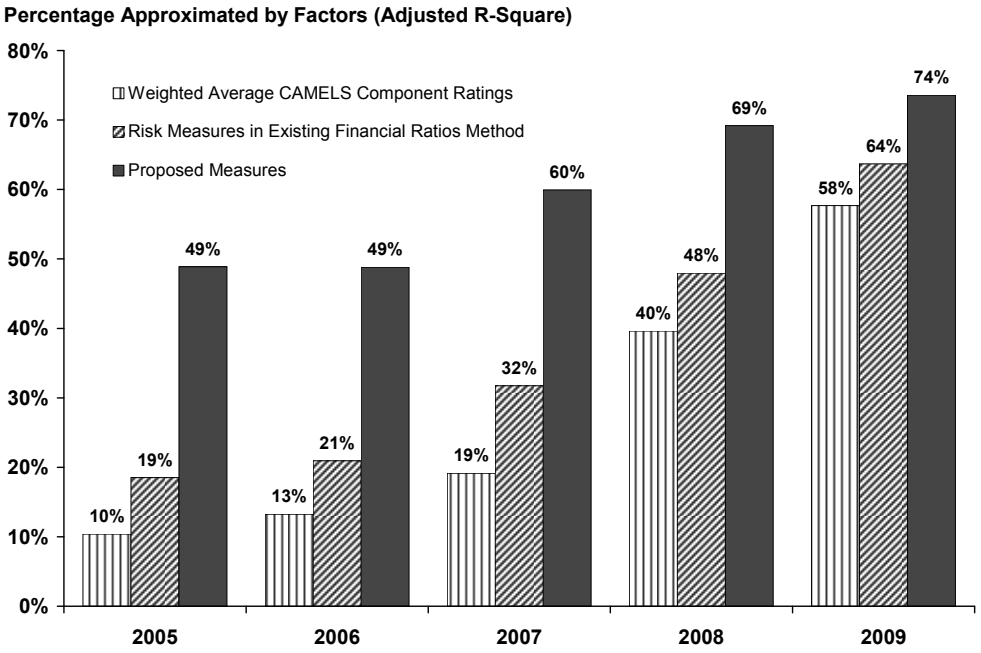
Because some of the financial measures contained in the proposal focus on long-term risk, they should mitigate the pro-cyclicality of the current system. Over the long

term, institutions that pose higher long-term risk will pay higher assessments when they assume these risks—usually during economic expansions—rather than facing large assessment increases when conditions deteriorate. In doing so, they should provide incentives for institutions to avoid excessive risk during economic expansions.

As shown in Chart 1, the proposed measures were useful in predicting long-term performance of large institutions over the 2005 to 2009 period. The chart contrasts the predictive values of the proposed measures with weighted-average CAMELS component ratings and with the existing financial ratios method. (The financial ratios method is based on a statistical model that predicts downgrades of small banks within 12 months, but the method also applies to large Risk Category I banks). The proposed measures predict the proper rank ordering of risk for large institutions as of the end of 2009 (based on a consensus view of staff analysts) significantly better than do the other two methods and, thus, better than the current system used for most large Risk Category I institutions, which combines weighted-average CAMELS composite scores, the financial ratios method and long-term debt issuer ratings. (As noted above, debt issuer ratings, particularly for the largest institutions, do not respond quickly to an institution's changing risk profile.) For example, in 2006, the proposed measures would have predicted staff analysts' year-end 2009 risk ranking of large institutions nearly two and one-half times better than the risk measures in the existing financial ratios method, which applies to large banks without debt ratings.

Chart 1

Various Measures' Ability to Predict Current Expert Judgment Risk Ranking[1]



II. Risk-based Assessment System for Large Insured Depository Institutions

A "large institution" would continue to be defined under the proposal as an insured depository institution with $10 billion or greater in total assets for at least four consecutive quarters. The proposal would apply to all large institutions regardless of whether they are defined as new.[2] Insured branches of foreign banks would not be defined as large institutions.

A. Scorecard for Large Institutions (Other than Highly Complex Institutions)

The scorecard method that staff is proposing would use risk measures to derive an assessment rate reflective of the risk that an institution poses to the insurance fund. The

[1] The rank ordering of risk for large institutions as of the end of 2009 (based on a consensus view of staff analysts) is largely based on the information available through the FDIC's Large Insured Depository Institution (LIDI) program. Large institutions that failed or received significant government support over the period are assigned the worst risk ranking and are included in the statistical analysis. Appendix 1 to the NPR describes the statistical analysis in detail.

[2] In almost all cases, an institution that has had $10 billion or greater in assets for four consecutive quarters will have CAMELS ratings. However, in the rare event that a large institution has not yet received CAMELS ratings, it would be given a weighted average CAMELS rating of 2 for assessment purposes until actual CAMELS ratings are assigned.

scorecard would have two components. The first component would be a performance score, which would be calculated based on a combination of CAMELS ratings and other financial measures. The performance score would measure an institution's financial performance and its ability to withstand stress. The FDIC would have limited ability to alter an institution's performance score based upon quantitative or qualitative measures not adequately captured in the scorecard.

The second component would combine loss severity measures into a single score. The FDIC would also have a limited ability to alter an institution's loss severity score based upon quantitative or qualitative measures not adequately captured in the scorecard. An institution's initial base assessment rate would be calculated through a combination of an institution's performance score and loss severity score.

Table 3 shows the large institution scorecard measures and the possible range of scores.

Table 3

Scorecard for Large Institutions

Components	Scorecard Measures	Score
CAMELS	*Weighted Average CAMELS*	*25-100*
Ability to Withstand Asset-Related Stress	Tier 1 Common Capital Ratio (Tier 1 Common Capital/Total Average Assets less Disallowed Intangibles)	0-100
	Concentration Measure Higher Risk Concentrations; or Growth-Adjusted Portfolio Concentrations	0-100
	Core Earnings/Average Total Assets	0-100
	Credit Quality Measure Criticized and Classified Items/Tier 1 Capital and Reserves; or Underperforming Assets/Tier 1 Capital and Reserves	0-100
	Subtotal	0-100
	Outlier Add-ons	
	Criticized and Classified Items/Tier 1 Capital and Reserves; or Underperforming Assets/Tier 1 Capital and Reserves	30
	Higher Risk Concentrations	30
	Total ability to withstand asset-related stress score	*0-160*
Ability to Withstand Funding-Related Stress	Core Deposits/Total Liabilities	0-100
	Unfunded Commitments/Total Assets	0-100
	Liquid Assets/Short-term Liabilities (liquidity coverage ratio)	0-100
	Total ability to withstand funding-related stress score	*0-100*
Total Performance Score		*0-100*
Potential Loss Severity	Potential Losses/Total Domestic Deposits (loss severity measure)	0-100
	Secured Liabilities/Total Domestic Deposits	0-100
Total loss severity score		*0-100*

1. Performance Score

The first component of the scorecard for large institutions would be the performance score. The performance score for large institutions would be the weighted average of three inputs: (1) weighted average CAMELS rating; (2) ability to withstand asset-related stress measures; and (3) ability to withstand funding-related stress measures. Table 4 shows the weight given to each of these three inputs.

Table 4

Performance Score Inputs and Weights

Performance Score Inputs	Weight
CAMELS Rating	30%
Ability to Withstand Asset-Related Stress	50%
Ability to Withstand Funding-Related Stress	20%

a. Weighted Average CAMELS score

The weighted average of an institution's CAMELS component ratings would be calculated using the weights that are applied in the current rule as shown in Table 5.

Table 5

Weights for CAMELS Components

CAMELS Component	Weight
C	25%
A	20%
M	25%
E	10%
L	10%
S	10%

A weighted average CAMELS rating would be converted to a score that ranges from 25 to 100. The score would increase at an increasing rate as the weighted average CAMELS rating increases.[3]

[3] Weighted average CAMELS ratings between 1 and 3.5 would be assigned a score between 25 and 100 using an equation that normalizes the weighted average CAMELS score to the same range as the other components described below in order that it can be added to these components, resulting in a performance score. This conversion from a weighted average CAMELS rating to a score is a non-linear conversion. Other conversions used in this proposal would be linear. The non-linear conversion recognizes that the difference between higher CAMELS ratings (e.g., a CAMELS 3 versus a CAMELS 4) represents a greater difference in risk than the difference between lower CAMELS ratings (e.g., a CAMELS 1 versus a CAMELS 2).

b. Ability to Withstand Asset-Related Stress Component

The ability to withstand asset-related stress component would contain measures that are most relevant to assessing a large institution's ability to withstand asset-related stress. These measures would be the following:

- Tier 1 common capital ratio;
- Concentration measure (the higher of the higher-risk concentrations measure or growth-adjusted portfolio concentrations measures);
- Core earnings/average total assets; and
- Credit quality measure (the higher of the criticized and classified items/Tier 1 capital and reserves or underperforming assets/Tier 1 capital and reserves).

In general, these measures proved to be the most statistically significant measures of an institution's ability to withstand asset-related stress, as described in Appendix 1 to the NPR. Appendix B to the NPR describes these measures in detail and gives the source of the data used to determine them.

Each risk measure within the ability to withstand asset-related stress portion of the scorecard would be converted linearly to a score between 0 and 100 where 100 equals the highest risk and 0 equals the lowest risk for that measure.[4] Table 6 gives the cutoff values for each measure and shows the weight assigned to the measure to derive a score for an institution's ability to withstand asset-related stress. Most of the minimum and maximum cutoff values for each risk measure equal the 10^{th} and 90^{th} percentile values of the measure among large institutions based upon data from the period between the first quarter of 2000 and the fourth quarter of 2009.[5,6] The concentration measure score would equal the higher of the two scores that make up the concentration measure score, as would the credit quality score.[7] Each score would be multiplied by its respective weight and the resulting weighted score for each measure would be summed to arrive at an ability to withstand asset-related stress score, which could range from 0 to 100.

[4] This process, in effect, normalizes all the ratios to the same range of values and allows the numbers to be added together.

[5] Cutoff values are rounded to one decimal point.

[6] The measures in which the 10^{th} and 90^{th} percentiles would not be used would be the higher-risk concentration measure and the criticized and classified asset ratio due to data availability. Data on the higher-risk concentration measure are available consistently since second quarter 2008, and criticized and classified assets are only available since first quarter 2007. For the higher-risk concentration measure, the 85^{th} percentile value is used as a maximum cutoff value. The maximum cutoff value for the criticized and classified asset ratio is close to but does not equal the 90^{th} percentile value. These alternative cutoff values are partly based on recent experience.

[7] The higher-risk concentration measure gauges concentrations that are currently deemed to be high risk. The growth-adjusted portfolio concentration measure does not solely consider high-risk portfolios, but considers all portfolio concentrations.

Table 6

Cutoff Values and Weights for Ability to Withstand Asset-related Stress Measures

Scorecard Measures	Cutoff Values		Weight
	Minimum	Maximum	
Tier 1 Common Capital Ratio	5.8	12.9	15%
Concentration Measure:			35%
Higher Risk Concentrations; or	0.0	3.2	
Growth-Adjusted Portfolio Concentrations	7.6	154.7	
Core Earnings/Average Total Assets	0.0	2.3	15%
Credit Quality Measure:			35%
Criticized and Classified Items/Tier 1 Capital and Reserves; or	6.5	100.0	
Underperforming Assets/ Tier 1 Capital and Reserves	2.3	35.1	

Staff recognizes that extreme values for some measures should have an additional effect on the final scorecard total. For extreme values of certain measures reflecting particularly high risk, this score could increase through an outlier add-on. Specifically, if an institution's ratio of criticized and classified items to Tier 1 capital and reserves exceeded 100 percent or its ratio of underperforming assets to Tier 1 capital and reserves exceeded 50.2 percent, the ability to withstand asset-related stress component score would be increased by 30 points. Additionally, if the higher risk concentration measure exceeded 4.8, the ability to withstand asset-related stress component score would be increased by 30 points. These increases (outlier add-ons) would be determined separately and could increase the ability to withstand asset-related stress score by up to 60 points; thus, the ability to withstand asset-related stress component score could be as high as 160 points.[8]

[8] The statistical analysis shows that a significant amount of criticized and classified items or underperforming assets, or concentrations in high risk portfolios are the most significant measures that help differentiate the risk profiles of large institutions and predict an institution's long-term performance. In addition, recent experience suggests that a small number of institutions with very high levels of criticized and classified items or underperforming assets, or high risk portfolio concentrations are particularly vulnerable to unexpected asset-related stress. The value that triggers the outlier add-on for the criticized and classified items to Tier 1 capital and reserves was determined using staff's judgment. The value that triggers the outlier add-on for the underperforming assets to Tier 1 capital and reserves is the 95th percentile value for the distribution of values of that measure for large institutions from 2000 to 2009. The value that triggers the outlier add-on for the higher risk concentration measure is the 90th percentile value for the distribution of values of that measure for large institutions from second quarter 2008 to fourth quarter 2009. A lower value was chosen for this measure due to a short history of available data.

Table 7 illustrates how the ability to withstand asset-related stress score would be calculated for a hypothetical bank, Bank A.

Table 7

Ability to Withstand Asset-Related Stress Component for Bank A

Scorecard Measures	Value	Score	Weight	Weighted Score
Tier 1 Common Capital Ratio	7.62	74.37	15%	11.15
Concentration Measure:		78.13	35%	27.35
Higher Risk Concentrations; or	2.50	78.13		
Growth-Adjusted Portfolio Concentrations	45.00	25.42		
Core Earnings/Average Total Assets	0.50	78.26	15%	11.74
Credit Quality Measure:		100.00	35%	35.00
Criticized and Classified Items/Tier 1 Capital and Reserves; or	104.32	100.00		
Underperforming Assets/Tier 1 Capital and Reserves	33.76	95.91		
Subtotal				85.24
Outlier Add-ons				
Criticized and Classified Items/Tier 1 Capital and Reserves; or	104.32	30.00		30.00
Underperforming Assets/Tier 1 Capital and Reserves	33.76			-
Higher Risk Concentrations	2.50	0.00		-
Total ability to withstand asset-related stress score				115.24

Bank A's higher risk concentrations score (78.13) is higher than its growth-adjusted portfolio concentration score (25.42). Thus, the higher risk concentration score is multiplied by the 35 percent weight to get a weighted score of 27.35 and the growth-adjusted portfolio concentration score would be ignored. Similarly, Bank A's criticized and classified items to Tier 1 capital and reserves ratio score (100) is higher than its underperforming assets to Tier 1 capital and reserves ratio score (95.91). Therefore, the criticized and classified items to Tier 1 capital and reserves ratio score would be multiplied by the 35 percent weight to get a weighted score of 35.00 and the underperforming assets to Tier 1 capital and reserves ratio score would be ignored. These weighted scores, along with the weighted scores for the Tier 1 common capital ratio (11.15) and core earnings to average total assets ratio (11.74), would be added together, resulting in the subtotal of 85.24. Because Bank A's criticized and classified items to Tier 1 capital and reserves ratio score is greater than 100, the criticized and classified items to Tier 1 capital and reserves ratio outlier add-on would be triggered. Bank A's higher risk concentrations measure score would not trigger the second outlier add-on. Thus, only the outlier add-on for the criticized and classified items to Tier 1

capital and reserves ratio would be added to the subtotal to arrive at the asset vulnerability component score of 115.24 for Bank A.

c. Ability to Withstand Funding-Related Stress

The ability to withstand funding-related stress component would contain three measures that are most relevant to assessing a large institution's ability to withstand such stress—a core deposits to total liabilities ratio, an unfunded commitments to total assets ratio and a liquid assets to short-term liabilities (liquidity coverage) ratio. These ratios are significant in predicting a large institution's long-term performance in the statistical test described in Appendix 1 to the NPR, which also gives the source of the data used to determine them.

Each risk measure would be converted to a score between 0 and 100, using the same methodology used in calculating the ability to withstand asset-related stress measure scores. The ability to withstand funding-related stress component score would be the weighted average of the three funding-related stress measure scores. Table 8 shows the cutoff values and weights for these measures.

Table 8

Cutoff Values and Weights for Ability to Withstand Funding-Related Stress Measures

Scorecard Measures	Cutoff Values		Weight
	Minimum	Maximum	
Core Deposits/Total Liabilities	3.2	79.1	40%
Unfunded Commitments/Total Assets	0.3	42.2	40%
Liquid Assets/Short-term Liabilities (liquidity coverage ratio)	5.6	170.9	20%

d. Calculation of Performance Score

The weighted average CAMELS score, the ability to withstand asset-related stress score, and the ability to withstand funding-related stress score would then be multiplied by their weights and the results would be summed to arrive at the performance score. This score would be capped at 100 under the proposal. In the example in Table 9, Bank A's performance score would be 81.70.

Table 9

Performance Score for Bank A

Performance Score Components	Weight	Score	Weighted Score
Weighted Average CAMELS Score	30%	65.15	19.54
Ability to Withstand Asset-Related Stress Score	50%	115.24	57.62
Ability to Withstand Funding-Related Stress Score	20%	22.69	4.54
Total Performance Score			81.70

The performance score could be adjusted, up or down, by a maximum of 15 points, based upon significant risk factors that are not adequately captured in the scorecard. The resulting score, however, could not be less than 0 or more than 100. Staff would use a process similar to the current large bank adjustment to determine the amount of the adjustment to the performance score. This discretionary adjustment is discussed in more detail below.

2. Loss Severity Score

The loss severity score would measure the relative magnitude of potential losses to the FDIC in the event of an institution's failure. The loss severity score would be based on two measures that are most relevant to assessing an institution's potential loss severity. The loss severity measure is the ratio of possible losses to the FDIC in the event of an institution's failure to total domestic deposits, averaged over three quarters. A standardized set of assumptions—based on recent failures—regarding liability runoffs and the recovery value of asset categories are applied to calculate possible losses to the FDIC. (Appendix D to the NPR describes the calculation of the measure in detail.) A loss severity measure is used as part of the current large bank adjustment. The second measure is the ratio of secured liabilities to total domestic deposits. (The greater an institution's secured liabilities relative to domestic deposits, the greater the FDIC's potential rate of loss in the event of failure, since secured liabilities have priority in payment over deposits at failure.) These measures are quantitative measures that are derived from readily available data. Appendix B defines these measures and gives the source of the data used to calculate them.

Each risk measure would be converted to a score between 0 and 100 in the same manner as the performance measures. The loss severity score would be the weighted average of these scores. Table 10 shows cutoff values and weights for these measures.

Table 10

Cutoff Values and Weights for Loss Severity Score Measures

Scorecard Measures	Cutoff Values		Weight
	Minimum	Maximum	
Potential Losses/Total Domestic Deposits (Loss Severity Measure)	0.0	30.1	50%
Secured Liabilities/Total Domestic Deposits	0.0	75.7	50%

In the example in Table 11, Bank A's loss severity score would be 36.04.

Table 11

Loss Severity Score for Bank A

Scorecard Measures	Ratio	Score	Weight	Weighted Score
Potential Losses/Total Domestic Deposits (Loss Severity Measure)	15.20	50.50	50%	25.25
Secured Liabilities/Total Domestic Deposits	16.34	21.59	50%	10.79
Total Loss Severity Score				36.04

Similar to the performance score, the loss severity score could be adjusted, up or down, a maximum of 15 points, based on other significant risk factors specific to the institution that are not adequately captured in the scorecard. The resulting score, however, could not be less than 0 or more than 100. Staff would use a process similar to the current large bank adjustment to determine the amount of the adjustment to the loss severity score. This discretionary adjustment is discussed in more detail below.

3. Initial Base Assessment Rate

Under the proposal, once the performance and loss severity scores were calculated, and potentially adjusted, these scores would be converted to an initial base assessment rate. First, the loss severity score would be converted to a factor between 0.8 and 1.2. Scores that fall at or below the minimum cutoff of 5 would receive a loss severity measure of 0.8 and scores that fall at or above the maximum cutoff of 85 would receive a loss severity score of 1.2. Again, a linear interpolation would be used to convert loss severity scores between the cutoffs into a loss severity measure. The conversion would be made using the following formula:

$$\text{Loss Severity Measure} = 0.8 + \left[(\text{Loss Severity Score} - 5) \times 0.005\right]$$

For example, if Bank A's loss severity score is 36.04, its loss severity measure would be 0.96, calculated as follows:

$$0.8 + [(36.04 - 5) * 0.005] = 0.96$$

Next, the performance score would be multiplied by the loss severity measure, which would increase or decrease the performance score by up to 20 percent. The result would be the total score. The total score would be capped at 100 under the proposal and would be rounded to two decimal places. For example, if Bank A's performance score is 81.70 and its loss severity measure were 0.96, its total score would be 78.43, calculated as follows:

$$81.70 * 0.96 = 78.43$$

A large institution with a total score of 30 or lower would pay the minimum initial base assessment rate and an institution with a total score of 90 or greater would pay the maximum initial base assessment rate.[9] For total scores between 30 and 90, initial base assessment rates would rise at an increasing rate as the total score increased. The initial base assessment rate (in basis points) would be calculated according to the following formula (assuming that the maximum initial base assessment rate was 40 basis points higher than the minimum rate):

$$Rate = \text{Minimum Rate} - 0.165289 + \left(68.02027 \times \left(\frac{Score}{100} \right)^5 \right)$$

For example, if Bank A's total score were 78.43, and the minimum and maximum initial base assessment rates were 10 basis points and 50 basis points, respectively, its initial base assessment rate would be 30.02 basis points, calculated as follows:

$$10 - 0.165289 + (68.02027 * ((78.43/100)^5) = 30.02$$

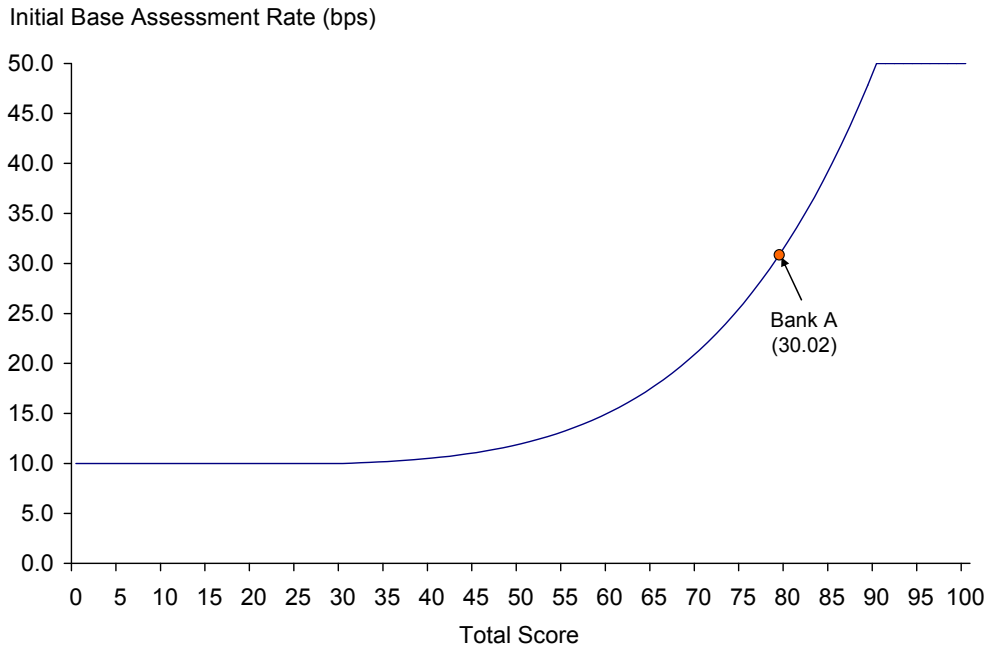
This calculation of an initial base assessment rate is based on an approximated statistical relationship between an institution's total score and its estimated three-year cumulative failure probability.

Chart 2 illustrates the initial base assessment rate based on a range of total scores and Bank A's assessment rate is indicated on the curve.

[9] The score of 30 and 90 equals about the 20th and about the 97th percentile values, respectively, based on scorecard results as of fourth quarter 2005 through fourth quarter 2006.

Chart 2

Proposed Initial Base Assessment Rates



The initial base assessment rate could be adjusted as a result of the unsecured debt adjustment, the secured liability adjustment and the brokered deposit adjustment (discussed below).

B. Scorecard for Highly Complex Institutions

As mentioned above, those institutions that are structurally and operationally complex or that pose unique challenges and risks in case of failure (highly complex institutions) would have a different scorecard under the proposal. A "highly complex institution" would be defined as: (1) an insured depository institution (excluding a credit card bank) with greater than $50 billion in total assets that is fully owned by a parent company with more than $500 billion in total assets, or fully owned by one or more intermediate parent companies that are fully owned by a holding company with more than $500 billion in assets, or (2) a processing bank and trust company with greater than $10 billion in total assets, provided that the information required to calculate assessment rates as a highly complex institution is readily available to the FDIC.[10] Under the proposal, highly complex institutions would have a scorecard with measures tailored to

[10] A parent company would be defined as a bank holding company under the Bank Holding Company Act of 1956 or a savings and loan holding company under the Home Owners' Loan Act. A credit card bank would be defined as bank with credit card plus securitized receivables exceed 50 percent of assets plus securitized receivables. A processing bank and trust company would be defined as an institution whose last 3 years' non-lending interest income plus fiduciary revenues plus investment banking fees exceed 50 percent of total revenues (and last 3 years' fiduciary revenues are non-zero).

the risks posed by these institutions, but the methodology involved would be the same for both scorecards.

The scorecard for highly complex institutions has four measures that do not appear in the scorecard for other large institutions (the senior bond spread, the institution's parent company's tangible common equity (TCE) ratio, the 10-day 99 percent Value at Risk (VaR) to Tier 1 capital ratio, and the short-term funding to total assets ratio). These measures were designed to measure vulnerability to changes in the market and would be incorporated into the calculation of a highly complex institution's assessment rate because of the institution's greater involvement in market activities.

The scorecard for highly complex institutions, like the scorecard for other large institutions, would contain a performance component and a loss severity component. However, the performance score for highly complex institutions would contain an additional component - the market indicators component. Table 12 shows the scorecard measures for highly complex institutions and the possible range of scores. Table 13 gives the weights associated with the four components of the performance scorecard for highly complex institutions.

Table 12

Scorecard for Highly Complex Institutions

Components	Scorecard Measures	Score
CAMELS	*Weighted Average CAMELS*	*25-100*
Market Indicator	Senior Bond Spread	0-100
	Outlier Add-ons	
	Parent Company Tangible Common Equity (TCE) Ratio	30
	Total market indicator score	*0-130*
Ability to Withstand Asset-Related Stress	Tier 1 Common Capital Ratio (Tier 1 Common Capital/Total Average Assets less Disallowed Intangibles)	0-100
	Concentration Measure Higher Risk Concentrations; or Growth-Adjusted Portfolio Concentrations	0-100
	Core Earnings/Average Total Assets	0-100
	Credit Quality Measure Criticized and Classified Items/Tier 1 Capital and Reserves Underperforming Assets/Tier 1 Capital and Reserves	0-100
	10-day 99% VaR/Tier 1 Capital	0-100
	Subtotal	0-100
	Outlier Add-ons	
	Criticized and Classified Items/Tier 1 Capital and Reserves; or Underperforming Assets/Tier 1 Capital and Reserves	30
	Higher Risk Concentrations Measure	30
	Total ability to withstand asset-related stress score	*0-160*
Ability to Withstand Funding-Related Stress	Core Deposits/ Total Liabilities	0-100
	Unfunded Commitments/Total Assets	0-100
	Liquid Assets/Short-term Liabilities (liquidity coverage ratio)	0-100
	Short-term Funding/Total Assets	0-100
	Subtotal	0-100
	Outlier Add-ons	
	Short-term funding/Total Assets	30
	Total ability to withstand funding-related stress score	*0-130*
Total Performance Score		*0-100*
Potential Loss Severity	Potential Losses/Total Domestic Deposits (Loss Severity Measure)	0-100
	Secured Liabilities/Total Domestic Deposits	0-100

Total loss severity score	*0-100*

Table 13

Performance Score Components and Weights

Performance Score Components	Weight
CAMELS Rating	20%
Market Indicators	10%
Ability to Withstand Asset-Related Stress	50%
Ability to Withstand Funding-Related Stress	20%

The additional component, the market indicator component, would be added to the performance scorecard for highly complex institutions. The market indicator component would contain only one measure, the senior bond spread score, and one outlier add-on. Staff used the senior bond spread because this measure can be compared consistently across institutions. The senior bond spread would be converted linearly to a score between 0 and 100. The minimum and maximum cutoff values for the market indicator measure are shown in Table 14. The market indicator component score could be adjusted by up to 30 points if the institution's parent company's tangible common equity (TCE) ratio fell below 4 percent since the market generally perceives a parent company to be vulnerable if its TCE is less than 4 percent. Including the outlier add-on, the market indicator component score could be as high as 130 points.

Table 14

Cutoff Values and Weights for Market Indicator Measure

Scorecard Measures	Cutoff Values		Weight
	Minimum	Maximum	
Senior Bond Spread	0.6	3.8	100%

The scorecard for highly complex institutions would add one additional factor to the ability to withstand asset-related stress component—the 10-day 99 percent Value at Risk (VaR) to Tier 1 capital ratio—and one additional factor to the ability to withstand funding-related stress component—the short-term funding to total assets ratio. Table 15 and Table 16 show cutoff values and weights for ability to withstand asset-related stress measures and ability to withstand funding-related measures, respectively. Appendix B of the NPR describes these measures in detail and gives the source of the data used to calculate the measures.

Table 15

Cutoff Values and Weights for Ability to Withstand Asset-Related Stress Measures

Scorecard Measures	Cutoff Values		Weight
	Minimum	Maximum	
Tier 1 Common Capital Ratio	5.8	12.9	10%
Concentration Measure: Higher Risk Concentrations; or Growth-Adjusted Portfolio Concentrations	0.0 7.6	3.2 154.7	35%
Core Earnings/Average Total Assets	0.0	2.3	10%
Credit Quality Measure: Criticized and Classified Items/Tier 1 Capital and Reserves; or Underperforming Assets/ Tier 1 Capital and Reserves	6.5 2.3	100.0 35.1	35%
10-day 99% VaR/Tier 1 Capital and Reserves	0.1	0.5	10%

Table 16

Cutoff Values and Weights for Ability to Withstand Funding-Related Stress Measures

Scorecard Measures	Cutoff Values		Weight
	Minimum	Maximum	
Core Deposits/Liabilities	3.2	79.1	30%
Unfunded Commitments/Total Assets	0.3	42.2	30%
Liquid Assets/Short-term Liabilities	5.6	170.9	20%
Short-term Funding/Total Assets	0.0	19.1	20%

The scorecard for highly complex institutions includes an additional outlier add-on. The ability to withstand funding-related stress component score for highly complex institutions would be adjusted by 30 points if the ratio of short-term funding to total assets exceeded 26.9 percent. The use of short-term funding has proved to be highly unstable and staff has found an increased vulnerability, particularly for institutions that

are active market participants, when there is a heavy reliance on this type of funding. Including the outlier add-on, the ability to withstand funding-related stress component score for highly complex institutions could be as high as 130 points.[11]

To calculate the performance score for highly complex institutions, the weighted average CAMELS score, the market indicators score, the ability to withstand asset-related stress score, and the ability to withstand funding-stress score would be multiplied by their weights and the results would be summed to arrive at the performance score. The score would be capped at 100 under the proposal. The loss severity score for highly complex institutions would be calculated the same way as the loss severity score for other large institutions.

As is the case for other large institutions, the performance score and the loss severity score for highly complex institutions could be adjusted, up or down, by a maximum of 15 points each, based upon significant risk factors that are not adequately captured in the scorecard. The resulting scores, however, could not be less than 0 or more than 100. The FDIC would use a process similar to the current large bank adjustment to determine the amount of any adjustments. This discretionary adjustment is discussed in more detail below.

The initial base assessment rate for highly complex institutions would be calculated from the total score in the same manner as for other large institutions as described above. As in the case of other large institutions, the initial base assessment rate could also be adjusted as a result of the unsecured debt adjustment, the secured liability adjustment, and the brokered deposit adjustment (discussed below).

C. Large Bank Adjustment to the Performance Score and Loss Severity Score

Under current rules, large institutions and insured branches of foreign banks within Risk Category 1 are subject to an assessment rate adjustment (the large bank adjustment). The large bank adjustment was designed to preserve consistency in the relative risk rankings of large institutions as indicated by assessment rates, to ensure fairness among all large institutions, and to ensure that assessment rates take into account all available information that is relevant to the FDIC's risk-based assessment decision. Staff proposes that a large bank adjustment be retained, which would be imposed in the same manner (and subject to the same notice requirements) as under the current rule.[12]

---

[11] Historical analysis shows that a significant amount of short-term funding can increase the risk profile of an institution. External funding sources can be a critical source of liquidity but short-term funding exposes an institution to near-term price risk and rollover risk. These risks increase for an institution during periods of market disruption or when the institution itself is experiencing financial distress. The add-on is triggered when the level of short-term funding to total assets ratio exceeds 26.9%. This is the 95th percentile of this measure among large institutions based upon data from the period between the third quarter of 1999 and the second quarter of 2009.

[12] 12 CFR 327.9(d)(4).

As proposed, the FDIC could adjust the performance score and/or the loss severity score for all large institutions, up or down, by a maximum of 15 points each, based upon significant risk factors that are not adequately captured in the scorecard. In determining whether to make such a large bank adjustment, the FDIC may consider such information as financial performance and condition information, and other market or supervisory information. The FDIC would also consult with an institution's primary federal regulator and, for state chartered institutions, state banking supervisor. Appendix E of the NPR lists some, but not all, criteria that could be considered in determining whether or not a discretionary adjustment is necessary.

In general, the proposed adjustments to the performance and loss severity scores would have a proportionally greater effect on the assessment rate of those institutions with a higher total score.

Notifications involving an upward adjustment to an institution's assessment rate would be made in advance of implementing such an adjustment so that the institution has an opportunity to respond to or address the FDIC's rationale for proposing an upward adjustment. Adjustments would be implemented after considering the institution's response to this notification along with any subsequent changes either to the inputs or other risk factors that relate to the FDIC's decision.

The FDIC acknowledges the need to clarify and make technical changes to its adjustment guidelines for large institutions to ensure consistency with this rulemaking.[13]

D. Liability-based Adjustments

The proposed rule would continue to allow for adjustments to an institution's initial base assessment rate as a result of certain long-term unsecured debt, secured liabilities and brokered deposits. These adjustments are currently provided for in the 2009 assessments rule, except that the brokered deposit adjustment currently applies only to institutions in Risk Categories II, III and IV. The proposal would extend the brokered deposit adjustment to all large institutions since the adjusted brokered deposit ratio (which took brokered deposits and growth into account for large Risk Category I institutions) would no longer apply. The unsecured debt adjustment, secured liability adjustment and brokered deposit adjustment would be applicable to both large institutions and highly complex institutions under the proposal.

E. Calculation of Total Assessment Rate

After making the adjustments just described, the resulting assessment rate would be the total assessment rate. Under the proposal, unlike the current rule for both large and small institutions, a large institution's total assessment rate could not be more than 50 percent lower than its initial base assessment rate. This change would ensure that all

[13] 72 FR 27122 (May 14, 2007).

institutions pay assessments even if the minimum initial base assessment rate is set at 5 basis points or less.

F. Updating Scorecard

Staff proposes that the FDIC have the flexibility to update the minimum and maximum cutoff values and weights used in each scorecard annually, without notice-and-comment rulemaking. In particular, staff could add new data each year to its analysis and could, from time to time, exclude some earlier years from its analysis. Updating the minimum and maximum cutoff values and weights would allow staff to use the most recent data, thereby improving the accuracy of the scorecard method.

On the other hand, if, as a result of its review and analysis, staff concludes that *additional* or *alternative* measures should be used to determine risk-based assessments or that a new method should be used to differentiate risk among large institutions and highly complex institutions, such changes would be made through notice-and-comment rulemaking.

Financial ratios for any given quarter would continue to be calculated from the report of condition filed by each institution or data collected through the FDIC's LIDI program as of the last day of the quarter.[14] CAMELS component rating changes would continue to be effective as of the date that the rating change is transmitted to the institution for purposes of determining assessment rates.[15]

III. Assessment Rates

As discussed above, staff proposes a wider range of assessment rates than under the current assessment system. To maintain approximately the same total revenue under the proposed rule as under the current system, staff proposes that the Board adopt new initial and total base assessment rate schedules set out in Tables 17 and 18, effective January 1, 2011.

Under the proposed rule, the range of initial base assessment rates for small institutions and insured branches of foreign banks in Risk Category I would be uniformly 2 basis points lower than under the current assessment system; the initial base assessment rate for institutions in Risk Category II would be unchanged; while the proposed initial base assessment rate for small institutions and insured branches in Risk categories III and IV would be somewhat higher. For large and highly complex institutions the minimum rate in the proposed range of rates would be 2 basis points lower than the current Risk

[14] Reports of condition include Reports of Income and Condition and Thrift Financial Reports.

[15] Pursuant to existing supervisory practice, the FDIC does not assign a different component rating from that assigned by an institution's primary federal regulator, even if the FDIC disagrees with a CAMELS component assigned by an institution's primary federal regulator, unless: (1) the disagreement over the component rating also involves a disagreement over a CAMELS composite rating; and (2) the disagreement over the CAMELS composite rating is not a disagreement over whether the CAMELS composite rating should be a 1 or a 2. The FDIC has no plans to alter this practice.

Category I minimum assessment rate and the maximum rate in the range would be slightly higher than the current maximum Risk Category IV assessment rates.

Staff also proposes that the Board simultaneously set actual total assessment rates uniformly 3 basis points higher than the proposed rates in accordance with the Amended Restoration Plan that it adopted on September 29, 2009.[16]

[16] 74 FR 51062 (Oct. 2, 2009). Under current rules, the FDIC has discretion to increase or decrease assessment rates in effect up to 3 basis points above or below total base assessment rates without the need for additional rulemaking. This proposed rule would not affect this provision.

Table 17

Proposed Initial and Total Base Assessment Rates
for Small Institutions and Insured Branches of Foreign Banks

	Risk Category I	Risk Category II	Risk Category III	Risk Category IV
Initial base assessment rate…….	10–14	22	34	50
Unsecured debt adjustment……..	–5–0	–5–0	–5–0	–5–0
Secured liability adjustment…….	0–7	0–11	0–17	0–25
Brokered deposit adjustment……	…....	0–10	0–10	0–10
TOTAL BASE ASSESSMENT RATE	5–21bp	17–43bp	29–61bp	45–85bp

All amounts for all risk categories are in basis points annually. Total base rates that are not the minimum or maximum rate will vary between these rates. All rates shown would increase 3 basis points on January 1, 2011, pursuant to the FDIC Amended Restoration Plan adopted on September 29, 2009. 74 FR 51062 (Oct. 2, 2009).

Table 18

Proposed Initial and Total Base Assessment Rates
for Large Institutions

	Large Institutions
Initial base assessment rate…….	10–50
Unsecured debt adjustment……..	–5–0
Secured liability adjustment…….	0–25

Brokered deposit adjustment……	0-10
TOTAL BASE ASSESSMENT RATE	5–85

All amounts are in basis points annually. Total base rates that are not the minimum or maximum rate will vary between these rates. All rates shown would increase 3 basis points on January 1, 2011, pursuant to the FDIC Amended Restoration Plan adopted on September 29, 2009. 74 FR 51062 (Oct. 2, 2009).

Based upon the analysis and projections below, staff has concluded that the proposed assessment rate structure (including the previously announced 3 basis point uniform increase in assessment rates beginning January 1, 2011) should satisfy the FDIC's revenue and liquidity needs. Under the proposal, for the fourth quarter 2009 assessment period, total base assessment rates would have been lower for about 52 percent of large institutions and 76 percent of small institutions.[17] The rates would have been higher for about 48 percent of large institutions and 9 percent of small institutions.[18] The rates would have remained the same for 15 percent of small institutions.

Fund Balance and Reserve Ratio Projections

In September 2009, staff projected that both the Fund balance and the reserve ratio as of September 30, 2009, would be negative, owing, in part, to an increase in provisioning for anticipated failures. Staff also projected the Fund balance and reserve ratio for each quarter over the next several years using the then most recently available information on expected failures and loss rates and statistical analyses of trends in CAMELS downgrades, failure rates and loss rates. Staff projected that, over the period 2009 through 2013, the Fund could incur approximately $100 billion in failure costs; the FDIC projected that most of these costs would occur in 2009 and 2010.

It was partly as a result of these projections that the FDIC increased risk-based assessment rates uniformly by 3 basis points effective January 1, 2011. Despite this increase, staff projected that the Fund balance would become significantly negative in 2010 and would remain negative until first quarter 2013. According to these projections, the reserve ratio would return to the statutorily mandated minimum reserve ratio of 1.15 percent in the first quarter of 2017.

As projected, the Fund balance and reserve ratio as of September 30, 2009, and December 31, 2009, were negative. (The Fund balance on December 31, 2009 was negative $20.9 billion; the reserve ratio was -0.39 percent.) In February 2010, staff

[17] For the purpose of this analysis, large institutions are those with total assets of $10 billion or greater as of December 31, 2009. The estimates in the text regarding the effect of the proposal on assessment rates, the effect on industry capital and earnings discussed later in the text and the Regulatory Flexibility Act analysis discussed later in the text, are based in part on approximations of a few risk measures.

[18] 12 U.S.C. 1817(b)(2)(D) provides that "No insured depository institution shall be barred from the lowest risk category solely because of size."

reexamined its projections using the most recently available information on expected failures and loss rates, and statistical analyses of trends in CAMELS downgrades, failure rates and loss rates. This reexamination resulted in no material changes to staff's projections. However, these projections are subject to considerable uncertainty. Losses could be less than or exceed projected amounts, for example, if conditions affecting the national or regional economies, prove less or more severe than is currently anticipated.

Effect on Industry Capital and Earnings

The proposed changes involve increases in premiums for some institutions and reductions in premiums for other institutions. Because overall revenue remains almost constant, the effect on aggregate earnings and capital is small. Projections show that imposition of the new premiums will increase aggregate capital by 2 one-hundredths of one percent (0.02 percent) over one year. For 6,042 institutions, assessment rates would decrease and earnings and capital would increase; for 771 institutions, assessment rates would increase and earnings and capital would decline. For institutions whose initial earnings are positive, the change in premiums will increase earnings by an average of 0.87 percent (on an asset weighted basis). For institutions whose initial earnings are negative, the change in premiums will increase losses by an average of 0.85 percent (on an asset weighted basis).[19]

Imposition of the proposed assessment rates would make a critical difference for two institutions, whose Tier 1 capital ratio would fall below 2 percent over a one-year horizon (assuming the proposed rule were adopted for 2010). No institution's equity-to-capital ratio would fall below 4 percent over a one-year horizon.[20]

[19] The proposed changes to assessment rates would not take effect until January 1, 2011. For two reasons, the analysis in the text examines the effect on earnings and capital had proposed rates been in effect on January 1, 2010. First, it is difficult to project 2011 institution income so far in advance. Second, as discussed in the text, because overall assessment revenue under the proposed system would remain approximately the same as the current system, the effect on earnings and capital is small for almost all institutions. This conclusion holds true for 2011, as well, because both current and proposed assessment rates will increase uniformly by three basis points beginning January 1, 2011. (A detailed analysis of the projected effects of the payment of proposed assessment on the capital and earnings of insured institutions is contained in Appendix 3.)

[20] In setting assessment rates, the FDIC's Board of Directors of the FDIC is authorized to set assessments for insured depository institutions in such amounts as the Board of Directors may determine to be necessary. 12 U.S.C. 1817(b)(2)(A). In so doing, the Board shall consider: (1) the estimated operating expenses of the DIF; (2) the estimated case resolution expenses and income of the DIF; (3) the projected effects of the payment on the capital and earnings of insured depository institutions; (4) the risk factors and other factors taken into account pursuant to 12 U.S.C. 1817(b) (1) under the risk-based assessment system, including the requirement under such paragraph to maintain a risk-based system; and (5) any other factors the Board of Directors may determine to be appropriate. 12 U.S.C. 1817(b)(2)(B). As reflected in the text, in making its projections of the Fund balance and liquidity needs, and in making its recommendations regarding assessment rates, the Board has taken into account these statutory factors.

Staff Contacts:

Lisa Ryu, DIR, Chief, Large Bank Pricing Section (202) 898-3538
Heather L. Etner, DIR, Financial Analyst, Banking and Regulatory Policy Section (202) 898-6796
Robert L. Burns, DSC, Chief, Exam Support and Analysis [(704) 333-3132 x 4215]
Christopher Bellotto, Legal, Counsel (202) 898-3801
Sheikha Kapoor, Legal, Senior Attorney (202) 898-3960