May 3, 2006

MEMORANDUM TO: The Board of Directors

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

Fred Selby
Director, Division of Finance

Douglas H. Jones
Acting General Counsel

SUBJECT: Notice of Proposed Rulemaking to Implement Dividend Requirements

RECOMMENDATION:

We recommend that the Board of Directors ("Board") issue a notice of proposed rulemaking to amend Part 327 of the FDIC's rules and regulations to implement the dividend requirements in the recently enacted Federal Deposit Insurance Reform Act of 2005 ("Reform Act")[1] and the Federal Deposit Insurance Reform Conforming Amendments Act of 2005 ("Amendments Act")[2] for an initial two-year period. The proposed rule would sunset on December 31, 2008. It is further recommended that, during 2007, the FDIC plan to undertake a second notice-and-comment rulemaking beginning with an Advanced Notice of Proposed Rulemaking to explore alternative methods for distributing future dividends.

As discussed more fully below, we recommend that the Board: make its annual determination regarding dividends by May 15th of each year, which will allow for the consideration of complete data on the reserve ratio as of the end of the prior year; calculate the aggregate amount of the dividend based on the statutory formulae; for this initial two-year period, provide for the allocation of dividends based on an institution's 1996 assessment base ratio, as determined pursuant to the regulations implementing the one-time credit; plan to undertake further notice-and-comment rulemaking on dividends to explore more comprehensive allocation methods; provide procedures for the notification and payment of dividends; and provide an appeals process for administrative challenges to the amounts of dividends that culminates in review by the Assessment Appeals Committee ("AAC").

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[1] The Reform Act was included as Title II, Subtitle B, of the Deficit Reduction Act of 2005, Pub. L. No. 109-171, 120 Stat. 9, which was signed into law by the President on February 8, 2006.

[2] Pub. L. No. 109-173, 119 Stat. 3601, which was signed into law by the President on February 15, 2006.

BACKGROUND:

The Reform Act requires the FDIC to prescribe final regulations, within 270 days of enactment, to implement the dividend requirements, including regulations governing the method for the calculation, declaration, and payment of dividends and administrative appeals of individual dividend amounts. See Reform Act §§ 2107(a) and 2109(a)(3).[3]

Section 7(e)(2) of the Federal Deposit Insurance Act ("FDI Act") requires that (absent certain limited circumstances, discussed below) the FDIC declare a dividend from the DIF when the reserve ratio at the end of a calendar year exceeds 1.5 percent. In that event, the FDIC must declare the amount in the Deposit Insurance Fund ("DIF") in excess of the amount required to maintain the reserve ratio at 1.5 percent as dividends to be paid to insured depository institutions.

The FDI Act also requires that under most circumstances the FDIC dividend amounts from the fund when the reserve ratio at the end of a calendar year exceeds 1.35 percent, but is no greater than 1.5 percent. In that event, the FDIC must generally declare one-half of the amount in the DIF in excess of the amount required to maintain the reserve ratio at 1.35 percent as dividends to be paid to insured depository institutions. However, the Board may suspend or limit dividends to be paid, if the Board determines in writing, after taking a number of statutory factors into account, that:

1. the DIF faces a significant risk of losses over the next year; and

2. it is likely that such losses will be sufficiently high as to justify a finding by the Board that the reserve ratio should temporarily be allowed --

    a. to grow without requiring dividends when the reserve ratio is between 1.35 and 1.5 percent; or

    b. to exceed 1.5 percent.[4]

If the Board decides to suspend or limit dividends, it must submit, within 270 days of making the determination, a report to the Committee on Banking, Housing, and Urban Affairs of the Senate and to the Committee on Financial Services of the House of

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[3] Reform Act § 2109 also requires the FDIC to prescribe, within 270 days, rules on the designated reserve ratio, changes to deposit insurance coverage, the one-time assessment credit, and assessments. An interim final rule on deposit insurance coverage was published on March 23, 2006. See 71 Fed. Reg. 14629. A notice of proposed rulemaking on the one-assessment credit and a notice of proposed rulemaking on operational changes to the FDIC's assessment regulations are both being considered by the Board of Directors at the same time as this notice on dividends. Additional rulemakings on the designated reserve ratio and risk-based assessments are expected to be proposed in the near future.

[4] This provision would allow the FDIC's Board to suspend or limit dividends in circumstances where the reserve ratio has exceeded 1.5 percent, if the Board made a determination to continue a suspension or limitation that it had imposed initially when the reserve ratio was between 1.35 and 1.5 percent.

Representatives. The report must include a detailed explanation for the determination and a discussion of the factors required to be considered.[5]

The FDI Act directs the FDIC to consider each insured depository institution's relative contribution to the DIF (or any predecessor deposit insurance fund) when calculating such institution's share of any dividend. Predecessor deposit insurance funds are the BIF and the SAIF, as those were the deposit insurance funds in existence after 1996 and prior to enactment of the Reform Act, and which merged into the DIF. That merger was effective on March 31, 2006.

More specifically, when allocating dividends among insured depository institutions, the Board must consider:

1. the ratio of the assessment base of an insured depository institution (including any predecessor) on December 31, 1996, to the assessment base of all eligible insured depository institutions on that date;

2. the total amount of assessments paid on or after January 1, 1997, by an insured depository institution (including any predecessor) to the DIF (and any predecessor fund);[6]

3. that portion of assessments paid by an insured depository institution (including any predecessor) that reflects higher levels of risk assumed by the institution; and

4. such other factors as the Board deems appropriate.

The FDI Act does not define the term "predecessor" for purposes of the distribution of dividends to insured depository institutions.

The FDI Act expressly requires the FDIC to prescribe by regulation the method for calculating, declaring, and paying dividends. As with the one-time assessment credit, the dividend regulation must include provisions allowing a bank or thrift a reasonable opportunity to administratively challenge the amount of dividends it is awarded. Any review by the FDIC pursuant to these administrative procedures is to be considered final and not subject to judicial review.

ANALYSIS:

As part of this rulemaking, the FDIC must establish the process for the Board's annual determination of whether a declaration of a dividend is required and the Board's

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[5] See Section 5 of the Amendments Act.

[6] This factor is limited to deposit insurance assessments paid to the DIF (or previously to the Bank Insurance Fund ("BIF") or the Savings Association Insurance Fund ("SAIF")) and does not include assessments paid to the Financing Corporation ("FICO") used to pay interest on outstanding FICO bonds, although the FDIC collects those assessments on behalf of FICO. Beginning in 1997, the FDIC collected separate FICO assessments from both SAIF and BIF members.

consideration, to the extent appropriate, of whether circumstances indicate that a dividend should be limited or suspended. In addition, the FDIC must set forth the procedures for calculating the aggregate amount of any dividend, allocating that aggregate amount among insured depository institutions considering the factors provided, and paying such dividends to individual insured depository institutions. Furthermore, these regulations must allow an insured depository institution a reasonable opportunity to challenge the amount of its dividend.

I. Annual Determination of Whether Dividends Are Required/Declaration of Dividends

The FDI Act requires the FDIC to determine whether at the end of each calendar year the reserve ratio of the DIF equals or exceeds 1.35 percent or exceeds 1.5 percent, thereby triggering a dividend requirement.

If the reserve ratio equals or exceeds 1.35 percent of estimated insured deposits, then the FDIC generally is required to declare the amount that is equal to one-half the amount in excess of the amount required to maintain the reserve ratio at 1.35 percent as dividends to be paid to insured depository institutions.[7] As a practical matter, when the reserve ratio is at or only slightly above 1.35 percent, the aggregate amount of a potential dividend would be relatively small, and an individual institution's share would be very small. Nonetheless, the statute expressly provides that the Board may elect to suspend or limit such dividends only in certain circumstances, as discussed further below.

If the reserve ratio exceeds 1.5 percent of estimated insured deposits, then the FDIC generally is required to declare the amount in the DIF in excess of the amount required to maintain the reserve ratio at 1.5 percent as dividends to be paid to insured depository institutions.

In order to limit or suspend the payment of dividends when the reserve ratio is at or above 1.35 percent, the Board must determine in writing that a significant risk of losses to DIF exists over the next year and that it is likely that such losses will be high enough to justify allowing the reserve ratio either to grow temporarily without requiring dividends or to exceed the upper end of the range for the reserve ratio (that is, 1.5 percent). The statute directs the Board to consider certain factors in making a determination to limit or suspend dividends:

- national and regional conditions and their effect on insured depository institutions;
- potential problems affecting institutions or a specific group or type of institutions;
- the degree to which the contingent liability of the FDIC for anticipated failures adequately addresses funding levels in the DIF; and

[7] The FDIC, thus, would have to determine how much is necessary to maintain the reserve ratio at 1.35 percent, once the dividend requirement is triggered by the year-end reserve ratio.

- any other factors the Board deems appropriate.

As noted above, if the Board elects to suspend or limit dividends pursuant to this authority, it must report to Congress within 270 days of that decision giving a detailed explanation, including a discussion of the statutory factors required to be considered.

A determination to limit or suspend dividends will have to be reviewed annually and must be justified to renew or make a new determination to limit or suspend dividends. Each year, if the decision is to continue to limit or suspend dividends, the Board must report to Congress. If the FDIC cannot justify renewal or a new determination, it is required to provide cash dividends based on the amount of the reserve ratio.

Staff recommends that the Board make its determination regarding dividends by no later than May 15th of each year, which will allow for the Board's consideration of the dividend determination using complete data for the reserve ratio for the preceding December 31st. Depending on circumstances, such determinations could include: (1) a determination that no dividend is required because the reserve ratio is below 1.35 percent as of the end of the preceding calendar year; (2) a declaration of a dividend; or (3) a determination that a dividend would otherwise be required, but that circumstances warrant the limitation or suspension of that dividend, to be followed by the required report to Congress.

Absent a Board determination that dividends should be limited or foregone, the aggregate amount of a dividend must be calculated as set forth in the statute. If the reserve ratio is between 1.35 percent and 1.5 percent, the FDIC must dividend half of the amount in excess of the amount required to maintain the reserve ratio at 1.35 percent. If the reserve ratio exceeds 1.5 percent, the FDI Act requires the FDIC to dividend the excess of the amount required to maintain the reserve ratio at 1.5 percent.[8]

II. Allocation of Dividends

Staff recommends initially adopting a simple system for allocating future dividends. Staff proposes that this system remain in place for two years with a definite sunset date (December 31, 2008). During the two-year lifespan of the initial dividend regulations, staff recommends that the FDIC undertake another rulemaking, beginning with the issuance of an advance notice of proposed rulemaking, seeking industry comment on more comprehensive alternatives for allocating future dividends.

[8] In most circumstances, if the reserve ratio exceeds 1.5 percent, the FDIC would declare a dividend of the excess, as determined by the FDIC, above 1.5 percent. At the same time, the FDIC would generally expect to declare a dividend of half of the amount necessary to maintain the reserve ratio at 1.35 percent, unless the Board makes a determination that suspension or limitation of that dividend is justified under section 7(e)(2)(E) of the FDI Act. That might happen, for example, if based on its consideration of the various statutory factors, the Board determines that it is appropriate to set the designated reserve ratio at 1.5 percent and set assessments to maintain the reserve ratio at that point. Reform Act §§ 2104(a) and 2105(a) (to be codified at 12 U.S.C. 1817(b)(2) and (3), respectively).

Specifically, staff recommends that, initially, any dividends be awarded simply in proportion to an institution's 1996 assessment base ratio (including any predecessors' 1996 ratios), discussed more fully below. The FDI Act requires that the FDIC consider this ratio when allocating dividends.

The FDI Act also requires that the FDIC consider the total amount of assessments paid after 1996 and the portion of assessments that reflects higher levels of risk. No institution while in the lowest risk category (often referred to as "the 1A category") has paid any deposit insurance assessments since the end of 1996. All assessments paid since then have reflected higher levels of risk -- that is, since year-end 1996 when the BIF and SAIF were both fully capitalized with reserve ratios in excess of the statutory minimum of 1.25 percent, only those insured depository institutions that exhibited financial, operational, or compliance weaknesses ranging from moderately severe to unsatisfactory, or that were not well capitalized (as defined in section 38 of the FDI Act), were required to pay assessments.

Within the proposed initial two-year period, any assessments that institutions pay that do not reflect higher levels of risk are likely to be small in comparison to the assessments that institutions paid to capitalize the deposit insurance funds, for which the 1996 assessment base is intended to act as a proxy. As a result, staff is recommending that any such payments not be included in the interim allocation method.[9]

Under the FDI Act, the Board also has discretion to consider such factors as it deems appropriate when allocating dividends. In staff's view, other factors support an initially simple allocation based upon institutions' 1996 ratio. As a practical matter, it appears unlikely that the reserve ratio of the DIF will equal or exceed 1.35 percent in the near future given the combined fund's reserve ratio of 1.25 percent[10] as of December 31, 2005, the continuing trend of high insured deposit growth rates, and the $4.7 billion one-time credit, which will tend to constrain net assessment income. Staff believes that it is important to obtain and consider carefully public comment before instituting a more comprehensive allocation scheme that may not change for many years. Such a small likelihood of a dividend does not justify adoption of a more complex scheme within the relatively short timeframe required by the statute.

1996 Assessment Base Ratio

As noted above, the FDI Act sets forth three specific factors for consideration in distributing dividends. The first factor is the ratio of the assessment base of an insured depository institution (including any predecessor) on December 31, 1996, to the assessment base of all eligible insured depository institutions on that date. This factor essentially parallels the basis for distribution of the one-time assessment credit.

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[9] It is in large part because post-2006 payments may become material over time that the FDIC proposes adoption of an interim rule, with the expectation that in 2007 the process of developing a more comprehensive long-term rule will begin.

[10] When the funds from the SAIF exit fee escrow account are included, the combined reserve ratio for December 31, 2005, would be 1.26 percent.

The 1996 assessment base ratio for each insured depository institution will have been determined under the one-time assessment credit regulations and will continue in effect for dividend purposes, subject to subsequent adjustments for transactions that result in the combination of insured depository institutions, thereby recognizing "predecessor" institutions as time goes by.

Predecessor Insured Depository Institutions

The FDI Act does not define the term “predecessor” for purposes of the distribution of dividends to individual insured depository institutions. In addition, unlike the term "successor" used in the context of the one-time assessment credit, the FDI Act does not expressly charge the FDIC with defining "predecessor." Nonetheless, in order to implement the dividend requirements, the FDIC must define "predecessor" for these purposes when it is used in connection with an insured depository institution and the distribution of dividends.

Staff recommends adopting a definition of “predecessor” that is consistent with both general principles of corporate law and the proposed definition of “successor” in the one-time assessment credit notice of proposed rulemaking. Therefore, a “predecessor” would be defined as an institution that combined with another institution through merger or consolidation and did not survive as an entity. As with the definition of "successor" in the one-time assessment credit notice of proposed rulemaking, staff recommends that the FDIC seek comment on whether a predecessor should include an institution that combined with another institution through a *de facto* merger. In addition, if the FDIC were to adopt an alternative definition of "successor" for purposes of the one-time assessment credit rule, such as a definition that takes into account deposit or branch sales, staff recommends that the FDIC seek comment on whether that alternative should similarly be applied to the definition of "predecessor" for purposes of dividends.

III. Notification and Payment of Dividends

Staff recommends that the FDIC advise each institution of its dividend amount as soon as practicable after the Board's declaration of a dividend on or before May 15th. Depending on circumstances, notification would take place through a special notice of dividend or, at the latest, with the institution's next assessment invoice. To allow time for requests for review of dividend amounts given that there will be a finite pool declared by the Board, staff recommends that the individual dividend amounts be used to offset each institution's assessment for the second calendar quarter beginning after the declaration of the dividend. To the extent that there is any remaining dividend amount, it would be paid to the institution at the same time. Staff further recommends that the settlement be handled through the Automated Clearinghouse consistent with existing procedures for underpayment or overpayment of assessments. Thus, in the event that the institution owes assessments in excess of the dividend amount, there will be a net debit (resulting in payment to the FDIC). Conversely, if the FDIC owes an additional dividend amount in excess of the assessment to the institution, there will be a net credit (resulting in payment from the FDIC).

If an institution requests review of the amount of its dividend (as discussed below), and that request is not finally resolved prior to the dividend payment date, staff recommends that the FDIC credit the institution with the dividend amount on the notice or invoice. To the extent that a dividend amount is in dispute between institutions, staff recommends that the FDIC freeze the availability of the amount in dispute. If the institution prevails on its request for review, then any additional amount of dividend will be remitted to the institution, with interest, with the next quarterly assessment.

IV. Requests for Review of Dividend Amounts

Like the regulations governing the one-time assessment credit, the FDI Act requires the FDIC to include in its dividend regulations provisions allowing an insured depository institution a reasonable opportunity to challenge administratively the amount of its dividend. The FDIC's determination under such procedures is to be final and not subject to judicial review.

It is recommended that the proposed rule largely parallel the procedures for requesting revision of computation of a quarterly assessment payment as shown on the quarterly invoice. As with the one-time credit notice of proposed rulemaking, staff recommends shorter timeframes in this appeals process so that requests for review may be resolved by the time payment of dividends is due to the extent possible. An institution would have 30 days from the date of the notice or invoice advising the institution of its dividend amount to request review of the computation. Under the proposed rule, an institution could request review if (1) it disagrees with the computation of the dividend as stated on the notice or invoice, or (2) it believes that the notice or invoice does not fully or accurately reflect appropriate adjustments to the institution's 1996 assessment base ratio since the FDIC's final determination of that ratio under the one-time credit proposed rule. For example, the institution may believe that its 1996 assessment base ratio has not been adjusted to reflect its acquisition of an eligible insured depository institution. Staff recommends that, if an institution does not submit a timely request for review, the institution be barred from subsequently requesting review of its dividend amount.

The proposed rule would require that a request for review be submitted to the Division of Finance and include documentation sufficient to support the change sought by the institution. In addition, the requesting institution would have to identify all other institutions of which it knew or had reason to believe would be directly and materially affected by granting the request for review and provide those institutions with copies of the request for review, supporting documentation, and the FDIC's procedures for these requests for review.

The FDIC shall make reasonable efforts, based on its official systems of records, to determine that such institutions have been identified and notified. These institutions would then have 30 days to submit a response and any supporting documentation to the FDIC's Division of Finance, copying the institution making the original request for review. Staff recommends that, if an institution is identified and notified through this process and does not submit a timely response, the institution be foreclosed from subsequently disputing the information submitted by any other institution on the transaction(s) at issue in the review process. The FDIC may request additional information as part of its review, and the proposed rule would require the institution to supply that information within 21 days of the date of the FDIC's request for additional information.

As previously noted, it is recommended that the FDIC temporarily freeze the distribution of the dividend amount in dispute for the institutions involved in the challenge until the challenge is resolved.

The proposed rule requires a written response from the FDIC's Director of the Division of Finance ("Director") --

(1) within 60 days of receipt by the FDIC of the request for revision;
(2) if additional institutions have been notified by the requesting institution or the FDIC, within 60 days of the date of the last response to the notification; or
(3) if additional information has been requested by the FDIC, within 60 days of receipt of the additional information,

whichever is later. Whenever feasible, the response is to notify the institution of the determination of the Director as to whether the requested change is warranted. In all instances in which a timely request for review is submitted, the Director will make a determination on the request as promptly as possible and notify the institution in writing of the determination. Notice of the procedures applicable to reviews will be included with the notice of dividend or assessment invoice providing notification of the dividend.

Under the proposed rule, an institution that disagrees with the determination of the Director may appeal its dividend determination to the AAC. An appeal would have to be filed within 15 calendar days from the date of the Director's written determination. Notice of the procedures applicable to appeals will be included with that written determination. The AAC's determination would be final and not subject to judicial review.

CONCLUSION:

For the reasons discussed above, we recommend that the Board adopt the proposed rule to implement the dividend requirements of section 7(e)(2) of the FDI Act, as amended by the Reform Act. As recommended, the rule would sunset after two years, before the payment of dividends is likely, and after there has been adequate time to develop a more comprehensive allocation system through the rulemaking process.

Staff members knowledgeable about this case: Munsell W. St. Clair, Donna M. Saulnier, and Kymberly K. Copa.

Attachments

RESOLUTION

WHEREAS, section 7(e)(2) of the Federal Deposit Insurance Act (FDI Act), as amended by the Federal Deposit Insurance Reform Act of 2005 (Reform Act), requires the FDIC to make certain findings or to declare certain amounts as dividends to be paid to insured depository institutions if, at the end of a calendar year, the reserve ratio of the Deposit Insurance Fund equals or exceeds 1.35 percent of estimated insured deposits, or it exceeds 1.50 percent of estimated insured deposits; and

WHEREAS, such statute requires the FDIC to prescribe by regulation, after notice and opportunity for comment, the method for the calculation, declaration, and payment of dividends, and section 2109(a)(3) of the Reform Act requires that regulations implementing the dividend requirement be prescribed not later than 270 days after the date of enactment; and

NOW, THEREFORE, BE IT RESOLVED, that the Board hereby authorizes publication in the Federal Register of the attached notice of proposed rulemaking through which part 327 would be amended to implement the dividend requirement enacted by the Reform Act.

BE IT FURTHER RESOLVED, that the Board hereby delegates authority to the Executive Secretary, or his designee, and the General Counsel, or his designee, to make technical, nonsubstantive, or conforming changes to the attached notice and to take such other actions and issue such other documents incident and related to the foregoing as they deem necessary or appropriate to fulfill the Board’s objective in connection with this matter.