Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990
Division of Insurance and Research

October 27, 2006

MEMORANDUM TO: The Board of Directors

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

SUBJECT: Setting the Designated Reserve Ratio

SUMMARY AND RECOMMENDATION

The Federal Deposit Insurance Reform Act of 2005 (the Reform Act) eliminates the current fixed designated reserve ratio (DRR) of 1.25 percent[1] and directs the FDIC's Board of Directors (Board) to set and publish annually a DRR for the Deposit Insurance Fund (DIF) within a range of 1.15 percent to 1.50 percent of estimated insured deposits.[2] The Reform Act also requires that the Board prescribe final regulations designating the reserve ratio after notice and opportunity for comment not later than 270 days after enactment of the Act.[3] Thereafter, any change to the DRR must also be made by regulation after notice and opportunity for comment.[4] The FDIC must set the DRR in accordance with its analysis of statutorily prescribed factors: risk of losses to the DIF; economic conditions generally affecting insured institutions; preventing sharp swings in assessment rates, and other factors consistent with these three factors.[5]

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[1] Section 2104 of the Reform Act, Pub. L. No. 109-171, 120 Stat. 9.

[2] Section 2105 of the Reform Act, to be codified at 12 U.S.C. 1817(b)(3)(A) (i), (B).

[3] Section 2109(a) of the Reform Act.

[4] Section 2105 of the Reform Act, to be codified at 12 U.S.C. 1817(b)(3)(A) (ii).

[5] The Reform Act provides:

(C) FACTORS- In designating a reserve ratio for any year, the Board of Directors shall--

(i) take into account the risk of losses to the Deposit Insurance Fund in such year and future years, including historic experience and potential and estimated losses from insured depository institutions;

(ii) take into account economic conditions generally affecting insured depository institutions so as to allow the designated reserve ratio to increase during more favorable economic conditions and to decrease during less favorable economic conditions, notwithstanding the increased risks of loss that may exist during such less favorable conditions, as determined to be appropriate by the Board of Directors;

Concur: _______________
Douglas H. Jones
Acting General Counsel

On July 11, 2006, the Board authorized publication of the proposed rule setting the DRR at 1.25 percent in the Federal Register and invited comments. Staff now recommends that the Board adopt the final rule setting the DRR at 1.25 percent. Staff's analysis of the statutory factors, and the comments received, is set forth in the Supplementary Information section of the attached notice of final rule, and is summarized below. In sum, staff's view is that the best way to balance all of the statutory factors and preserve the FDIC's new flexibility to manage the DIF is to maintain the DRR at 1.25 percent.

<u>Statutory factors</u>

1. <u>Risk of Losses to the DIF</u>

In the proposal, staff's best estimate of potential loss provisions for 2006 related to future failures was $93 million. So far this year no banks have failed. In addition, loss provisions anticipated for next year are expected to remain low. These estimates suggest that near-term losses to the insurance fund would not significantly alter the reserve ratio.

2. <u>Economic Conditions Affecting FDIC-Insured Institutions</u>

U.S. economic growth appears to be moderating in the second half of 2006. Consensus estimates of U.S. economic growth are in the 2.0 to 2.5 percent range for the second half of 2006, compared to growth of 3.2 percent reported for 2005. While the cumulative effects of higher interest rates, higher energy prices and slower home price appreciation are expected to slow consumer spending, exports and nonresidential investment appear poised to make up a larger portion of net growth in the economy. This rebalancing of economic activity should be consistent with stability in the outlook for bank credit quality, and problem loan ratios are likely to move up modestly over time from today's historic low levels. Possible exceptions to this generally positive credit outlook include certain subsectors of residential real estate loan portfolios, where higher interest rates and a leveling off of home price increases could contribute to a higher incidence of credit distress.

The condition of the banking industry remains strong. Earnings have set records each of the last five years, capital measures are still near historically high levels, and asset quality indicators remain solid. For the first half of 2006, the industry's annualized return on assets (ROA) remained high at 1.34 percent. The aggregate equity-to-asset ratio was 10.27 percent as of June 30, 2006, and more than 99 percent of all insured institutions met or exceeded the requirements of the highest regulatory capital standards. The ratio of noncurrent loans to total loans is its lowest since institutions began reporting that data 23 years ago. No insured institutions have failed in over two years, extending the longest period without a failure since the creation of the

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> (iii) seek to prevent sharp swings in the assessment rates for insured depository institutions; and
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> (iv) take into account such other factors as the Board of Directors may determine to be appropriate, consistent with the requirements of this subparagraph.

Section 2105(a) of the Reform Act (to be codified at 12 U.S.C. 1817(b)(3)(C)).

FDIC in 1933. Therefore, banks and thrifts generally appear to be well positioned to withstand the financial stress that may arise from potential economic shocks in the next few years.

3. Prevent Sharp Swings in Assessment Rates

The Reform Act directs the FDIC's Board to consider preventing sharp swings in assessment rates for insured depository institutions. Strong insured deposit growth has contributed to a decline in the reserve ratio from 1.31 percent at year-end 2004 to 1.23 percent as of June 30, 2006. If recent robust insured deposit growth continues, there will be further downward pressure on the reserve ratio. This downward pressure could be offset by raising assessment rates; however, the availability of assessment credits will temporarily limit future revenue. Raising the reserve ratio to a DRR of 1.25 percent within a reasonably short time frame could require (depending upon insured deposit growth) a temporary, substantial increase in assessment rates, which would exhaust most of the credits rapidly. Increasing the reserve ratio more gradually could result in less substantial increases in rates.

4. Other Factors

Staff has identified certain "other factors" that the Board may choose to consider in setting the DRR. In staff's view, these factors favor maintaining the DRR at 1.25 percent.

Transition to a new assessment system

Staff recommends against altering the DRR from the current 1.25 percent partly because the assessment system is about to undergo several significant changes. These changes include: (a) Adoption of a new risk-based assessment system; (b) Application of the one-time assessment credits that will be available to those institutions that contributed in earlier years to the build-up of the insurance funds, which will limit assessment revenue in the near term; and (c) The change to a system where the reserve ratio will be managed within a range from a system where a hard target for the reserve ratio applied.

Midpoint of the normal operating range for the reserve ratio

The Reform Act in effect establishes a normal operating range for the reserve ratio of 1.15 percent to 1.35 percent within which the Board has considerable discretion to manage the size of the insurance fund.[6] The current DRR of 1.25 percent is the midpoint of the normal operating range and staff believes that, at the commencement of the new assessment system, it would be reasonable to leave the DRR at the middle of this range.

[6] The Reform Act authorizes the Board to set the DRR at no less than 1.15 percent and no greater than 1.50 percent. The FDIC must adopt a restoration plan when the reserve ratio falls below 1.15 percent. When the reserve ratio exceeds 1.35 percent, the Reform Act generally requires the FDIC to begin to pay dividends. Because there is no requirement to achieve a specific reserve ratio within a given time frame, these provisions in effect establish a normal operating range for the reserve ratio of 1.15 percent to 1.35 percent within which the Board has considerable discretion to manage the size of the insurance fund.

Historical experience

Historical experience with a DRR of 1.25 percent indicates that it has worked well under varying economic conditions in ensuring an adequate insurance fund and maintaining a sound deposit insurance system.

Role of the DRR

The manner in which the Board evaluates the statutory factors may depend on its view of the role of the DRR, which may change over time. Staff has identified two potential general roles for the DRR: a signal of the reserve ratio that the Board would like the fund to achieve; and a signal of the Board's expectation of the change in the reserve ratio under the assessment rate schedule adopted by the Board.

Comments

The FDIC received 16 comments directly addressed to the proposed rule for setting the DRR.[7] These comments generally fell into several main groups: the DRR should be set at the low end of the range; the DRR should be raised gradually over time; the reserve ratio should be raised gradually; the DRR should not be set at the minimum of the range; the DRR should be a rough guide to the DIF reserve ratio; and further economic rationale should be provided for setting the DRR at 1.25.

One individual set out several arguments for setting the DRR at 1.50 percent, including:

- greater risk in the banking industry;

- strong insured deposit growth;

- inadequacy of a 1.25 percent DRR as evidenced by the FDIC fund falling from 1.24 percent in 1981 to a negative number in 1991; and

- the number of times the reserve ratio has been above 1.50 percent during the FDIC's history.

Several other commenters suggested setting the DRR below 1.25 percent. Arguments in support of this suggestion included:

- a lower rate would provide the industry with time to recapitalize the fund without facing sharp swings in assessment rates, particularly for those institutions which will not have credits;

[7] Several other commenters also addressed the DRR, at least in passing, in comments directed to other FDIC rulemakings, particularly the rulemaking that proposed substantive improvements to the risk-based assessment system. 71 FR 41910 (July 24, 2006). All of the comments received that relate to the DRR have been considered in adopting this final rule and are available on the FDIC's website at http://www.fdic.gov/regulations/laws/federal/index.html.

- the FDIC is unrealistic in its optimism about the economy, and Congress expected the FDIC to set the DRR at the lower end of the range when institutions generally would face difficulty making payments, such as in difficult economic times, while setting the DRR higher when the economy was good and payments could be made more easily;

- the banking industry is financially healthy;

- the risk of fund losses is low, at least in part due to prompt corrective action requirements and other new supervisory and enforcement tools that enhance safety and soundness;

- Congress intended for the FDIC to determine an appropriate level for the DRR annually, rather than allowing the reserve ratio to meet the DRR over a period of a few years;

- the number of bank failures has been low;

- hardship on new growth institutions would be lessened; and

- the risk to the industry is lower now than in 1991 when Congress set the DRR at 1.25.

Other commenters suggested that increases in the DRR be phased in gradually:

- starting with a DRR of 1.20 percent and phasing in an increase to 1.25 percent over a five-year period; and

- allowing an initial drift toward 1.15 percent, with a phased-in move to 1.25 percent over time.

One comment from a banking industry trade group, however, stated that “it would not be prudent” to set the target at the minimum of 1.15 percent.

Several commenters suggested that, if the DRR were set at 1.25 percent initially, or wherever it is set, the FDIC should increase the reserve ratio gradually over a period of no less than three years, or three to five years, to avoid unnecessary surges in assessment rates. More generally, the FDIC should pursue a slow and steady approach.

Several commenters viewed the DRR as useful only for guidance in setting assessments, suggesting that the DRR:

- is a very rough guide to a long-run equilibrium for the reserve ratio, and not a primary driver of premiums in the short-run;

- should be analyzed each year to determine whether it is reasonable given the actual risk of loss to the DIF;

- should not be viewed as requiring the imposition of higher assessments, but rather the FDIC should consider economic factors and the condition of the banking industry generally to determine whether to lower the DRR or whether it will be restored through deposit base changes, growth in investment earnings, low levels of expected failures, and similar factors.

Three commenters sought greater analytical justification for setting the DRR at 1.25 percent, asserting that the FDIC's rationale was:

- unclear;
- not sufficiently explained, requesting more thorough analysis within two years; and
- not based on actual risk and market conditions.

Balancing the statutory factors

Staff believes that the statutory analysis conducted in the proposed rulemaking is correct. Based upon that analysis, and for the reasons that follow, staff recommends that the Board set the DRR at 1.25 percent.

In staff's view, the best way to balance all of the statutory factors (including the "other factors" identified above) and to preserve the FDIC's new flexibility to manage the DIF is to maintain the DRR at 1.25 percent. Several factors that the Board must (or may) consider – preventing sharp swings in assessment rates, the transitional nature of the assessment system, maintaining a DRR at the midpoint of the reserve ratio's normal operating range, the historical experience with a DRR of 1.25 percent, as well as the intent of the new legislation to provide the FDIC with flexibility to manage the reserve ratio within a range – all support or are consistent with maintaining the current DRR of 1.25 percent.

Several commenters argued that the present good health of the industry argues in favor of a DRR lower than 1.25 percent. A goal of the Reform Act, however, is to allow the fund to rise when conditions are good so that it could decline when conditions are less favorable without the need to raise assessments sharply. In fact, the Reform Act directs the FDIC to consider allowing the DRR to *increase* under favorable economic conditions. Generally favorable economic conditions and the strong condition of the industry provide little justification for lowering the DRR.

Further, most of the comments seeking to have the DRR set lower than 1.25 percent appear to be concerned with the assessment rates that will be charged, and the resulting amount of assessments that will be collected, if the DRR is set at 1.25 percent. This issue will be addressed in the risk-based assessments final rule being presented to the FDIC Board of Directors along with this DRR final rule case.

Staff notes that how the Board will use the DRR may change over time. Staff views the role of the DRR as a signal of the level that the DIF should achieve. We do not expect the DIF to reach this level within the first year of the new system. As required by the Reform Act, the

FDIC will determine the appropriate DRR annually. Section 2105 of the Reform Act, to be codified at 12 U.S.C. 1817(b)(3)(A).

Staff recommends that the Board adopt the final rule setting the DRR at 1.25 percent.

Staff Contacts

Division of Insurance and Research:

Munsell St. Clair
Senior Policy Analyst
(202) 898-8967

Legal Division:

Christopher Bellotto
Counsel
(202) 898-3801

Attachments

RESOLUTION

WHEREAS, section 7(b)(3) of the Federal Deposit Insurance Act (FDI Act), as amended by the Federal Deposit Insurance Reform Act of 2005 (Reform Act), directs the Board of Directors (Board) of the FDIC to set and publish annually a designated reserve ratio (DRR) for the Deposit Insurance Fund within a range of 1.15 percent to 1.50 percent of estimated insured deposits; and

WHEREAS, section 2109(a)(1) of the Reform Act requires the FDIC to prescribe by regulation, after notice and opportunity for comment, the designated reserve ratio not later than 270 days after the date of enactment of the Reform Act; and

NOW, THEREFORE, BE IT RESOLVED, that the Board hereby authorizes publication in the Federal Register of the attached final rule amending Part 327 to set the DRR as required by the Reform Act and the FDI 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.