FDIC
Federal Deposit Insurance Corporation
801 17th Street NW, Washington, DC 20429-9990
Division of Insurance and Research

October 31, 2006

MEMORANDUM TO: The Board of Directors

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

SUBJECT: Final Rule on Risk-Based Assessments

INTRODUCTION

The Federal Deposit Insurance Reform Act of 2005 (the Reform Act) requires that the FDIC's Board of Directors provide by regulation, after notice and opportunity for comment, for deposit insurance assessments under section 7(b) of the Federal Deposit Insurance Act (the FDI Act) as amended by the Reform Act. Staff recommends that the Board authorize publication of the attached final rule, which would: (1) create a new risk differentiation system; (2) establish a new base assessment rate schedule; and (3) set assessment rates effective January 1, 2007.

RECOMMENDATIONS

In July, the Board approved a proposal for a new risk-based assessment system that was published in the Federal Register.[1] The FDIC has received and reviewed numerous comments on the proposal. Staff's recommended final rule on risk-based assessments is attached. The recommended approach relies on the same three sources of information on risk—supervisory ratings, financial ratios and long-term debt issuer ratings—contained in the proposal. In general, FDIC's proposal to use these sources of information received favorable comment. The recommended final rule also reflects some changes to the proposal that were made in response to concerns raised by the public and by the Board.

For all institutions in Risk Category I assessment rates will depend on CAMELS component ratings. Comments generally supported using CAMELS component ratings to set rates. For most institutions in Risk Category I, these CAMELS component ratings will be combined with financial ratios to determine assessment rates. For large institutions with long-term debt issuer ratings, CAMELS component ratings will be combined with debt ratings to determine assessment rates.

[1] 71 Fed. Reg. 41,909.

Concur: ________________
Douglas H. Jones
Acting General Counsel

Using supervisory, financial, and market data to differentiate risk for assessment purposes has been under discussion for many years. For example, the FDIC discussed using these kinds of data in its August 2000 options paper, its April 2001 Recommendations Paper on Deposit Insurance Reform, and a December 2003 Banking Review article on pricing deposit insurance.[2] Examiners and supervisors in the banking agencies have used financial ratios to monitor institutions off-site for years, and research papers have been published describing how financial ratios are used for this purpose.

A formulaic approach to assessing the risk of large complex institutions cannot, however, always adequately measure risk for assessment purposes. For example, while debt issuer ratings are readily available for many large insured institutions and are widely used by market participants to determine credit risk and institutions' funding costs, there are some limitations to these ratings. Therefore, we recommend that FDIC review other market information (such as debt spreads), as well as additional supervisory and financial information, to determine whether a limited adjustment to an institution's assessment rate is needed. In addition, adjustments to premiums may be necessary to reflect loss severity (as several comments noted) and stress considerations. All of this additional information should help to ensure that institutions with similar risks pay similar rates. The FDIC will propose and seek comment on guidelines for making adjustments before implementing this provision of the final rule.

Staff's recommended final rule responds in particular to comments concerning: (1) the use of specific financial ratios, (2) the proposed definition of new institutions, (3) the use of assessment rate subcategories for large institutions, (4) the use of a watch list to alert large institutions about possible assessment rate increases, and (5) the Board's authority to change assessment rates without further notice-and-comment rulemaking. Many comments expressed concern about the volatile liabilities ratio. The recommended final rule eliminates this ratio without materially reducing the effectiveness of the pricing approach. The final rule also alters the definition of a new institution from 7 years in the proposal to 5 years and creates exceptions to the rule. One of these exceptions will allow a newly chartered institution within a holding company to be treated as an established institution provided certain supervisory standards are met. Another exception covers federally insured credit unions that convert to bank or thrift charters. Moreover, the final rule delays the effective date of the new institution provisions until 2010. Before 2010, new institutions generally will be assessed as established institutions. The final rule also eliminates assessment rate subcategories for large institutions in response to comments expressing concerns that institutions could face changes in premiums out of proportion to changes in risk. Like other institutions, large institutions will see only small changes in premiums for small changes in risk measures. The proposed rulemaking requested comment on the use of a watch list, and received favorable responses. If additional information warrants a limited adjustment to a large institution's assessment rate, the recommended final rule provides that the FDIC will first give the institution notice and an opportunity to respond and take action. In response to comments, the final rule also limits the Board's authority to change assessment rates without further notice-and-comment rulemaking to three basis points above or

[2] Eric P. Bloecher, Gary A. Seale, and Robert D. Vilim, "Options for Pricing Federal Deposit Insurance," *FDIC Banking Review* 15(4), 1-17 (2003).

below the base assessment rate schedule, provided that no rate can be negative and provided that the Board cannot change rates more than three basis points at a time.

The FDIC received comments questioning the need for risk differentiation among the 95 percent of the industry assigned to Risk Category I. Some comments stated that the proposed pricing methods were overly complicated, especially since, in their view, there are not meaningful differences in risk among these institutions. While the derivation of the pricing method is complex, is application is straightforward, and the industry (including the Independent Community Bankers Association) responded positively to the pricing calculator that the FDIC made available to allow institutions to easily test how their ratios and ratings would affect their assessment rates. The recommended final rule also simplifies the pricing methodology for large institutions with assets between $10 billion and $30 billion.

One of the major purposes of the FDIC's five-year deposit insurance reform effort was to give the FDIC the authority to make assessment rates reflect differences in risk that exist among the 1- and 2-rated, well-capitalized institutions, which make up the majority of the industry. All the banking agencies testified in support of giving the FDIC this authority, and Congress granted it in the Reform Act. Staff has undertaken many analyses that reveal meaningful differences in risk among the 95 percent of institutions in Risk Category I. By pricing this risk as recommended, the FDIC will reduce the extent to which safer banks are asked to subsidize riskier banks.

<u>Rate Schedule</u>

As the FDIC stated in the proposal, strong insured deposit growth has pushed down the reserve ratio. In combination with temporary limits on assessment revenue from the use of credits, fast insured deposit growth makes higher assessment rates necessary initially. The recommended final rule sets the minimum assessment rate at 5 basis points. If insured deposit growth averages about 5 percent a year, and insurance losses remain low, the Deposit Insurance Fund reserve ratio would reach a 1.25 percent designated reserve ratio (DRR) in the middle of 2009.[3] If insured deposits grow at a 6 percent annual rate, the reserve ratio should reach 1.25 percent by the end of that year.

Under the recommended assessment rates, most institutions would pay nothing in 2007 because of credits. Based upon current deposit levels, the credits of over 2,600 institutions would last at least two years if these institutions were charged the minimum rate of 5 basis points. Some commenters expressed concern that new institutions and institutions with few or new credits would have to pay substantially more than their competitors. But Congress intended that credits offset higher premiums for those institutions that built up the funds through high premiums in the past.

The Supplementary Information Section of the attached recommended final rule contains an analysis of the statutory factors that the Board must take into consideration when setting

[3] In a separate memorandum and recommended final rule, staff has recommended a DRR of 1.25 percent.

assessments. In sum, staff is of the opinion that its recommendation is consistent with these factors.

Staff Contacts

Division of Insurance and Research:

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

Legal Division:

Christopher Bellotto
Counsel
(202) 898-3801

Attachment

<u>RESOLUTION</u>

WHEREAS, section 2109(a)(5) of the Federal Deposit Insurance Reform Act of 2005 (the Reform Act) directs the Board of Directors (Board) of the FDIC to prescribe regulations, after notice and opportunity for comment, providing for assessments under section 7(b) of the Federal Deposit Insurance Act, as amended by the Reform Act; and

NOW, THEREFORE, BE IT RESOLVED, that the Board hereby authorizes publication in the <u>Federal</u> <u>Register</u> of the attached final rule through which part 327 would be amended to provide for assessments 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 final rule 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.