October 14, 2010

MEMORANDUM TO: The Board of Directors

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

Bret D. Edwards
Director
Division of Finance

SUBJECT: Restoration Plan and Notice of Proposed Rulemaking on Assessment Rates, Dividends and the Designated Reserve Ratio

SUMMARY OF RECOMMENDATIONS

Staff recommends that the FDIC Board of Directors (FDIC or Board):

1. Adopt the attached Restoration Plan, which would supersede the existing Restoration Plan, to ensure that the Deposit Insurance Fund (DIF or fund) reserve ratio reaches 1.35 percent by September 30, 2020, and authorize publication of the attached Restoration Plan in the Federal Register. The Restoration Plan provides, among other things, that the FDIC will:

   - Forego the uniform 3 basis point increase in assessment rates scheduled to go into effect on January 1, 2011; and

   - Pursue rulemaking in 2011 regarding the method that will be used to offset the effect on small institutions (those with assets of less than $10 billion) of the statutory requirement that the reserve ratio reach 1.35 percent by September 30, 2020 (rather than 1.15 percent by the end of 2016) consistent with the goal that regular assessments on all institutions be maintained.

2. Authorize publication with a 30-day comment period of the attached Notice of Proposed Rulemaking that would, among its most important features, propose:

   - A lower assessment rate schedule to take effect when the fund reserve ratio reaches 1.15 percent;

Concur: _____
Richard J. Osterman, Jr.
Acting General Counsel

- That, in lieu of dividends, progressively lower assessment rate schedules will take effect as the fund reserve ratio reaches 2 percent and 2.5 percent;

- That the FDIC not award dividends when the fund reserve ratio exceeds 1.5 percent; and

- That the Designated Reserve Ratio (DRR) be set at 2 percent.

SUMMARY

The FDIC has experienced two banking crises in the years following the Great Depression. In both of these crises, the balance of the insurance fund became negative, hitting a low of negative $20.9 billion in December 2009, despite high assessment rates and, in the most recent crisis, other extraordinary measures—including a special assessment—that the FDIC was forced to adopt as losses mounted.

In the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), Congress revised the statutory authorities governing the FDIC's management of the fund. The FDIC now has the ability to achieve goals for deposit insurance fund management that it has sought to achieve for decades but has lacked the tools to accomplish: maintaining a positive fund balance even during a banking crisis and maintaining steady assessment rates throughout economic and credit cycles.

Among other things, Dodd-Frank: (1) raises the minimum DRR to 1.35 percent (from the former minimum of 1.15 percent) and removes the upper limit on the DRR (which was formerly capped at 1.5 percent) and therefore on the size of the fund;[1] (2) requires that the fund reserve ratio reach 1.35 percent by September 30, 2020 (rather than 1.15 percent by the end of 2016, as formerly required);[2] (3) requires that, in setting assessments, the FDIC "offset the effect of [requiring that the reserve ratio reach 1.35 percent by September 30, 2020 rather than 1.15 percent by the end of 2016] on insured depository institutions with total consolidated assets of less than $10,000,000,000";[3] (4) eliminates the requirement that the FDIC provide dividends from the fund when the reserve ratio is between 1.35 percent and 1.5 percent;[4] and (5) continues the FDIC's authority to declare dividends when the reserve ratio at the end of a calendar year is at least 1.5 percent, but grants the Board sole discretion in determining whether to suspend or limit the declaration or payment of dividends.[5]

Given these changes, staff considers the present moment optimal for implementing a comprehensive, long-range fund management plan, while the need for a sufficiently large fund and stable premiums is most apparent. Memories of the last two

[1] Pub. L. No. 111-203, §334(a), 124 Stat. 1376, 1539 (to be codified at 12 U.S.C. § 1817(b)(3)(B)).

[2] Pub. L. No. 111-203, §334(d), 124 Stat. 1376, 1539 (to be codified at 12 U.S.C. § 1817(nt))

[3] Pub. L. No. 111-203, §334(e), 124 Stat. 1376, 1539 (to be codified at 12 U.S.C. § 1817(nt)).

[4] Pub. L. No. 111-203, §332(d), 124 Stat. 1376, 1539 (to be codified at 12 U.S.C. § 1817(e)).

[5] Pub. L. No. 111-203, §332, 124 Stat. 1376, 1539 (to be codified at 12 U.S.C. § 1817(e)(2)(B)).

crises will fade and the need for a strong fund will become less apparent. Action now will establish standards for prudent fund management throughout the economic and credit cycle and better position the FDIC to resist expected future calls to reduce assessment rates or pay larger dividends at the expense of prudent fund management.

Staff has attempted to craft such a comprehensive, long-range management plan for the DIF. The FDIC sought industry input in developing this plan at a September 24, 2010 roundtable organized by the FDIC. At the roundtable, bank executives and industry trade group representatives uniformly favored steady, predictable assessments and found high assessment rates during crises objectionable.[6] The proposed plan is designed to the reduce pro-cyclicality in the existing system and achieve moderate, steady assessment rates throughout economic and credit cycles while also maintaining a positive fund balance even during a banking crisis, by setting an appropriate target fund size and a strategy for assessment rates and dividends.

The plan covers the near term, governed by the statutory requirement that the fund reserve ratio reach 1.35 percent by 2020, the medium term, when the reserve ratio has recovered to pre-crisis levels, and the long term, when the reserve ratio is sufficiently large that the fund would be able to withstand a crisis similar in magnitude to that of the late 1980s and early 1990s and the current crisis.

Restoration Plan

Based upon updated income, loss and reserve ratio projections, staff has concluded that expected losses for the period 2010 through 2014 will be lower than projected in June 2010. While the range of reasonably possible losses is large, staff now projects that losses during this period will be $52 billion, down from $60 billion as projected in June. The primary reason for lowering expected losses is that losses thus far in 2010 have been considerably less than projected and are expected to remain lower than previously projected for the remainder of the year. Expected losses in 2011 and beyond remain relatively unchanged (although the timing of expected losses has changed somewhat). Given this lower loss projection, staff estimates that the fund reserve ratio will reach 1.15 percent by the fourth quarter of 2018, even without the 3 basis point uniform increase in rates presently scheduled to take effect January 1, 2011.

Under Dodd-Frank, the FDIC is required to offset the effect on small institutions (those with less than $10 billion in assets) of the statutory requirement that the fund reserve ratio increase from 1.15 percent to 1.35 percent by September 30, 2020. Thus, assessment rates applicable to all insured depository institutions (IDIs) initially need be set only high enough to reach 1.15 percent; the mechanism for reaching 1.35 percent by the statutory deadline of September 30, 2020, and the manner of offset can be determined separately. Assessing large IDIs for that offset can be done in several ways, consistent with maintaining a risk-based assessment system for all IDIs. Under staff's most recent projections, current assessment rates, without the uniform 3 basis point increase, should

[6] The proceedings of the roundtable can be viewed in their entirety at: http://www.vodium.com/MediapodLibrary/index.asp?library=pn100472_fdic_RoundTable.

allow the reserve ratio to reach 1.15 percent with time to spare. Given the continuing stresses on IDI earnings and the additional time afforded by Dodd-Frank, staff recommends that the Board forego increasing rates at this time. Because of the uncertainty inherent in projecting reserve ratios eight years in advance, however, staff recommends against lowering assessment rates now.

Staff also recommends that the Restoration Plan state that the FDIC will pursue rulemaking next year to offset the effect on small IDIs of Dodd-Frank's requirement that the reserve ratio increase from 1.15 percent to 1.35 percent by September 30, 2020. Given the length of time before the reserve ratio is expected to reach 1.15 percent, determining the manner in which the offset is made is not urgent.

Historical Analysis of Loss, Income and Reserve Ratios

Using historical fund loss and simulated income data from 1950 to the present, staff has undertaken an analysis to determine how high the reserve ratio would have had to have been before the onset of the two crises that occurred during this period to have maintained both a positive fund balance and stable assessment rates throughout the crises. The analysis, which is described in detail below, concludes that a moderate, long-term average industry assessment rate, combined with an appropriate dividend or assessment rate reduction policy, would have been sufficient to have prevented the fund from becoming negative during the crises, though the fund reserve ratio would have had to have exceeded 2 percent before the onset of the crises.

Assessment Rates and Dividends

Once the reserve ratio reaches 1.15 percent, staff believes that assessment rates (other than those necessary to effectuate the offset) can be reduced to a moderate level. Staff is proposing a lower assessment rate schedule to take effect when the fund reserve ratio exceeds 1.15 percent.[7] (Any assessments needed to offset the effect on small IDIs of Dodd-Frank's requirement that the reserve ratio increase from 1.15 percent to 1.35 percent by September 30, 2020 would be in addition to these rates.) Assuming low losses once the current crisis abates (and no dividends, as recommended in the next paragraph), staff projects that the reserve ratio would reach 2 percent in 2027. That is 17 years from now, which is approximately the time between the worst of the crisis of the late 1980s and early 1990s and the beginning of the current crisis.[8]

As just discussed, to increase the probability that the fund reserve ratio will reach a level sufficient to withstand a future crisis, staff is also proposing to suspend dividends permanently when the fund reserve ratio exceeds 1.5 percent. In lieu of dividends, staff

[7] Under section 7 of the Federal Deposit Insurance Act, the FDIC has authority to set assessments in such amounts as it determines to be necessary or appropriate. In setting assessments, the FDIC must consider certain enumerated factors, including the operating expenses of the DIF, the estimated case resolution expenses and income of the DIF, and the projected effects of assessments on the capital and earnings of IDIs.

[8] Sixteen years elapsed from the worst of the crisis of the late 1980s and early 1990s to 2007.

is proposing that the FDIC adopt progressively lower assessment rate schedules when the reserve ratio exceeds 2 percent and 2.5 percent. These lower assessment rate schedules would serve much the same function as dividends but would provide more stable and predictable effective assessment rates, an objective that representatives at the September 24, 2010 roundtable organized by the FDIC placed value highly.

Designated Reserve Ratio

In the past, for several reasons, staff has recommended a DRR of 1.25 percent. This recommendation has been made largely because 1.25 percent has been approximately the historical average reserve ratio and the mid-point between the former minimum DRR of 1.15 percent and the former reserve ratio of 1.35 percent that triggered dividends. The analysis discussed above suggests that a DRR of 2 percent or more would be an appropriate long-range target. Staff is recommending that the Board propose to set the DRR at 2 percent. However, staff believes that a 2 percent DRR should be viewed as a long-range, *minimum* goal. Achieving a 2 percent reserve ratio prior to past crises would barely have prevented the fund from becoming negative. A larger fund would have allowed the FDIC to have maintained a positive balance and the fund would have remained positive even had losses been higher.

Furthermore, staff believes that it is essential to consider the DRR along with appropriate assessment policies to ensure the fund will grow to a level *above* 2 percent. Doing so will pave the way for the FDIC to achieve the goals of maintaining a positive fund balance during the next crisis and limiting pro-cyclicality in the deposit insurance assessment system. In staff's view, a positive fund balance is beneficial to the long-term interests of the FDIC, the banking industry and to public confidence. No private insurance company would ever plan on becoming insolvent. Staff believes that it would be unwise to plan on imposing higher premiums during a banking crisis, since we cannot foresee the particular circumstances the industry will be in and the potentially damaging effects higher premiums could have.

RESTORATION PLAN

Overview

In October 2008, the Board adopted a Restoration Plan to return the DIF to its statutorily mandated minimum reserve ratio of 1.15 percent within five years.[9] In February 2009, given the extraordinary circumstances facing the banking industry, the Board amended its Restoration Plan to extend the restoration period from five to seven years.[10] Congress amended the statute governing establishment and implementation of a restoration plan in May 2009 to allow the FDIC up to eight years to return the DIF

[9] 73 FR 61598 (Oct. 16, 2008).

[10] 74 FR 9564 (Mar. 4, 2009).

reserve ratio to 1.15 percent, absent extraordinary circumstances.[11] The Board amended its Restoration Plan consistent with the statutory change.[12]

As discussed earlier, Dodd-Frank requires the FDIC to establish a reserve ratio of not less than 1.35 percent for any year and requires the FDIC to take "such steps as may be necessary" to increase the level of the DIF to 1.35 percent of estimated insured deposits by September 30, 2020.[13] Given staff's updated projections (discussed in more detail below), and changes in the law, staff recommends that the Board adopt a new Restoration Plan that will: provide that the reserve ratio will reach 1.35 percent by September 30, 2020; forego the uniform 3 basis point increase in initial assessment rates that was adopted on September 29, 2009; maintain initial assessment rates for all IDIs at their current levels; and pursue rulemaking in 2011 regarding the method that will be used to reach 1.35 percent by September 30, 2020 and offset the effect on small IDIs of doing so.

Loss, Income and Reserve Ratio Projections

For purposes of the Restoration Plan and rate recommendations, staff has projected the fund balance and reserve ratio for each quarter over the next several years 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. Under these projections, fund failure costs for the five-year period 2010 through 2014 are approximately $52 billion, $8 billion less than projected failure costs for the same period in staff's June 2010 projections. Beyond five years, projections for the fund balance and reserve ratio assume a low level of failures and associated losses.[14] Staff continues to believe that the number of failures and the associated costs will peak in 2010 and that the DIF balance will continue to increase in the coming quarters. Most of the projected costs are already reflected in the DIF balance. Approximately $16.8 billion of the $52 billion in projected failure costs from 2010 through 2014 had been realized as of June 30, 2010. Also, as of that date, an additional $27.5 billion of projected losses was accounted for in the DIF balance as the contingent loss reserve. Thus, of the approximately $52 billion in projected losses over the five-year period, only about $7.5 billion are projected as future expenses of the fund, which compares with projected 2010 assessment revenue of over $13 billion.

Assessment Rates

The current Restoration Plan maintains assessment rates at their current levels through the end of 2010 and imposes a uniform 3 basis point increase in assessment rates

[11] 12 U.S.C. §1817(b)(3)(E)(ii), as amended by the Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, §204(b), 123 Stat. 1632, 1649.

[12] 74 FR 51062 (Oct. 2, 2009).

[13] Pub. L. No. 111-203, §334(a), 124 Stat. 1376, 1539 (to be codified at 12 U.S.C. § 1817(b)(3)(B)).

[14] The projections assume that domestic deposits increase at an annual rate of 5 percent, producing assessment income over the 2010 to 2014 period of $71 billion; more than half of these assessments have been pre-paid.

effective January 1, 2011. The new loss and reserve ratio projections are lower than those prepared last fall and spring and, along with the additional time provided by Dodd-Frank to meet the minimum (albeit higher) required reserve ratio, in staff's view, eliminate the need for the rate increase scheduled to take effect in 2011.[15]

Under staff's projections, maintaining current assessment rates without the 3 basis point uniform increase would return the fund to a positive balance by the fourth quarter of 2011 and the reserve ratio to 1.15 percent by the fourth quarter of 2018. As discussed earlier, Dodd-Frank requires that the FDIC offset the effect on small IDIs of increasing the reserve ratio from 1.15 percent to 1.35 percent. Therefore, assessment rates applicable to all IDIs need be set only high enough to reach 1.15 percent by the statutory deadline of September 30, 2020; the mechanism for reaching 1.35 percent by that date and the manner of offset can be determined through a separate notice-and-comment rulemaking.

Under staff's most recent projections, current assessment rates, without the uniform 3 basis point increase, should allow the reserve ratio to reach 1.15 percent with time to spare. Increasing assessment rates by 3 basis points would return the fund to a positive balance no earlier and the reserve ratio to 1.15 percent six quarters earlier (by the second quarter of 2017), which might be perceived as inconsistent with the extended time frame granted by Dodd-Frank. Moreover, foregoing the assessment rate increase lessens the pro-cyclical effect of meeting the statutory deadline. (Foregoing the assessment rate increase should not significantly weaken the liquidity position of the FDIC. Staff projects that the DIF will have sufficient liquid assets to resolve failing IDIs throughout the next five years.)

Loss and reserve ratio projections made so far into the future are subject to considerable uncertainty, however. Losses could differ from projected amounts if financial stresses facing larger IDIs or conditions affecting the national or regional economies prove more or less severe than currently anticipated. For example, DIF loss estimates may increase if the current weak economic recovery deteriorates into a second recession. Nevertheless, because the statutory deadline is 10 years away, and because staff projects that the statutory deadline should be met well in advance, the Board will have ample opportunity to raise assessment rates in the future if necessary to meet the statutory deadline. Also because of the uncertainty of long-range projections, staff recommends against lowering assessment rates below current rates now.

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[15] In setting assessment rates, the FDIC's Board of Directors is authorized to set assessments for IDIs 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 IDIs; (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, staff has taken into account these statutory factors. (The FDIC is making no change to the assessment rate schedule now in effect and, thus, is not affecting industry capital or earnings.)

Additional Rulemaking in 2011

Staff recommends that the Restoration Plan state that the Board will pursue rulemaking in 2011 regarding the method that will be used to offset the effect on small IDIs of the statutory requirement that the reserve ratio reach 1.35 percent by September 30, 2020. Staff estimates that 0.2 percent of estimated insured deposits in the first quarter of 2019 (the difference between 1.35 percent and 1.15 percent of estimated insured deposits) would require an assessment of approximately $16.5 billion (or about 20 basis points of large IDIs' domestic deposits).

Given the length of time before the reserve ratio is expected to reach 1.15 percent, determining the manner in which the effect on small IDIs of the statutory requirement that the reserve ratio reach 1.35 percent by September 30, 2020 is offset is not urgent, but it should be considered before the passage of time eliminates some options.

Staff will continue to update the Board semi-annually on loss and income projections for the fund under the proposed Restoration Plan.

HISTORICAL ANALYSIS OF LOSS, INCOME AND RESERVE RATIOS

For purposes of developing a long-term fund management strategy, staff undertook an analysis to evaluate the tradeoffs between assessment rates and policies that either award dividends or reduce assessment rates by creating a simulated deposit insurance fund covering the years 1950 to 2010.[16] The analysis varied assessment rates, dividends and rate reductions to determine what would have happened to the simulated fund's balance over time.

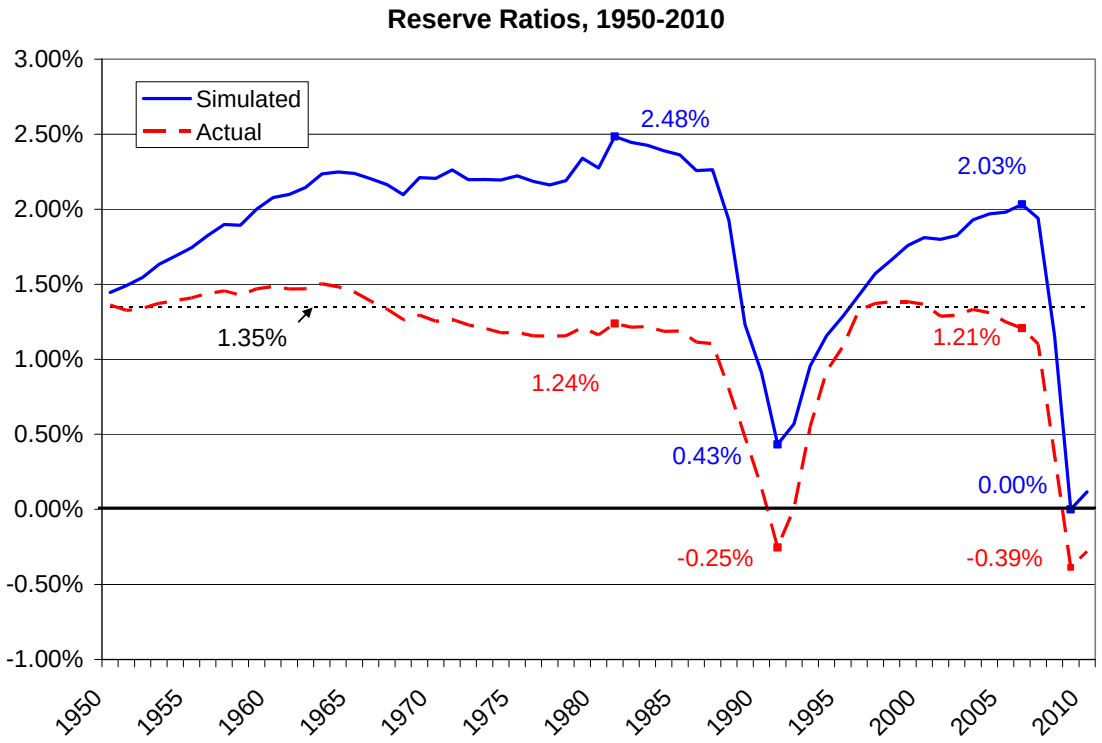
[16] The historical fund analysis uses actual FDIC historical assessment base and fund expense data and historical interest rate data from the Board of Governors of the Federal Reserve System. FDIC historical data are altered in only one respect: for the year 2007, the FDIC coverage level is assumed to be $250,000 because all depositors in failed banks during the current crisis were covered at that level. Projected data from June 30, 2010 to 2040 are based on September 2010 FDIC estimates for losses, expenses and insured deposit and assessment base growth (using adjusted total domestic deposits). Implied forward interest rates (as of September 27, 2010) from Bloomberg are used for the years after 2010. The analysis uses a modeled investment portfolio. After reviewing available historical FDIC portfolio data, a "default" investment portfolio was constructed with the following mix of Treasury securities: 35 percent in 6-month securities; 25 percent in 1-year securities; 25 percent in 3-year securities; and 15 percent in 5-year securities. This portfolio mix is retained unless the FDIC's provision for losses increases for two consecutive years. In that event, all income (proceeds from maturing securities, as well as net assessment and interest income) is invested in 6-month Treasury securities. The modeled portfolio therefore becomes shorter term as anticipated losses rise. When the fund's income exceeds expenses for two years, the fund's investments are returned to the default portfolio mix. The analysis examined fund performance over time using multiple combinations of different assessment rates and dividend policies.

The simulated fund does not include the costs of FSLIC and RTC failures during the 1980s and early 1990s. Their inclusion would have required a much higher reserve ratio to keep the fund balance positive during the late 1980s and early 1990s.

Supplementary material explaining the analysis can be found in the Appendix to the notice of proposed rulemaking.

As a starting point, the analysis sought to determine what constant average nominal assessment rate across the entire 60-year period would have maintained a positive fund balance during both crisis periods, assuming a policy that provided no dividends.[17] The result is a moderate rate of 7.44 basis points, which would have allowed the fund's reserve ratio to reach 2.48 percent (in 1981) before the crisis of the 1980s and early 1990s, and 2.03 percent (in 2006) before the current crisis. (See Charts A and B.) Failure to reach these reserve ratios would have resulted in a negative balance. Assessment rate volatility was by design completely eliminated.

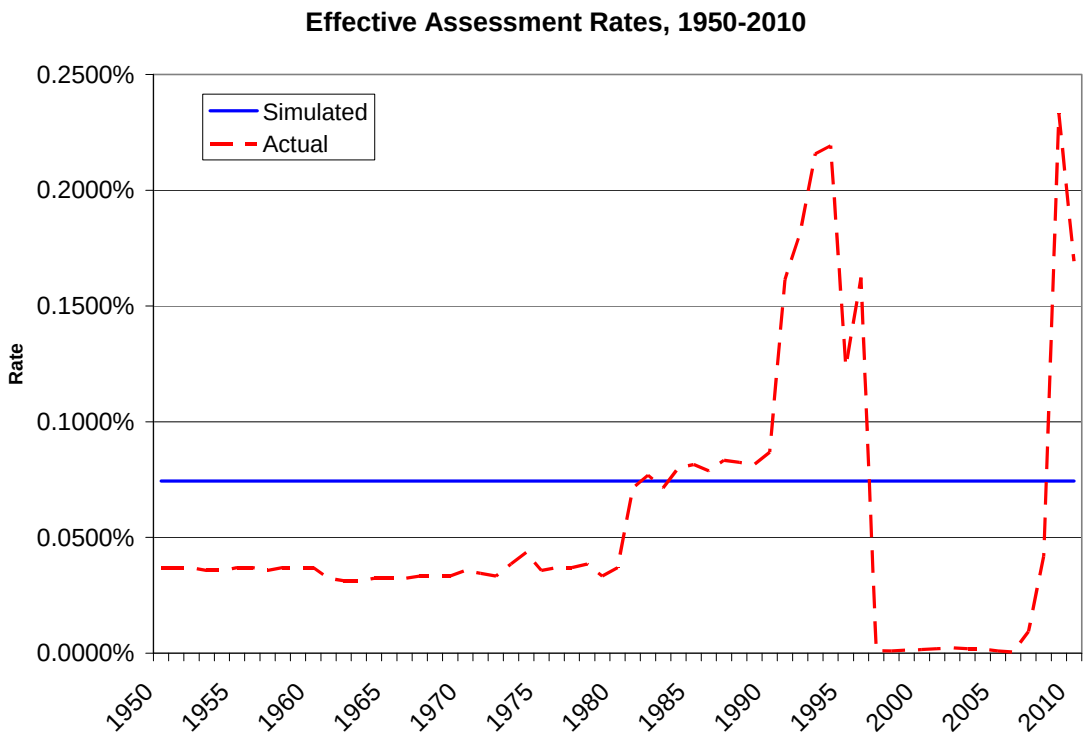
Chart A



No dividends, with 7.44 basis point average nominal assessment rate

[17] All assessment rates represent an industry-wide average.

Chart B

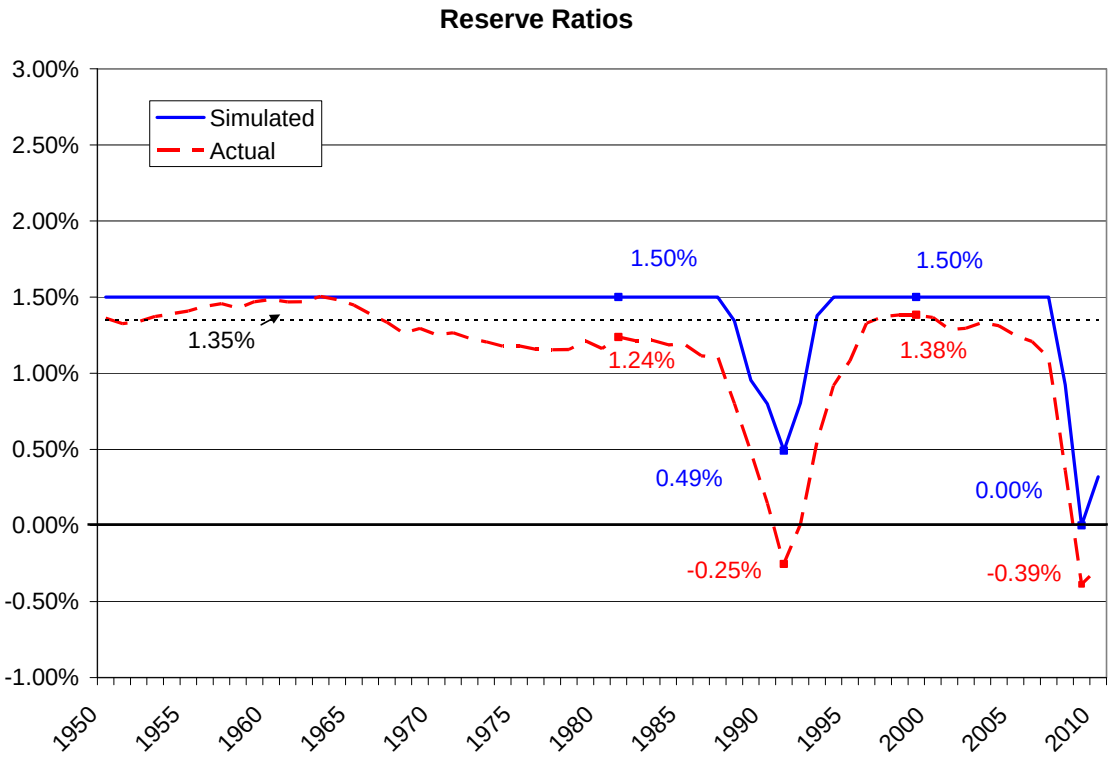


No dividends, with 7.44 basis point average nominal assessment rate

During most years since 1950, however, there has been either a credit or dividend policy provided for by statute (although since 1985 no recurring credits or dividends have been awarded). As amended by Dodd-Frank, the Federal Deposit Insurance Act (FDI Act) continues to authorize the FDIC to dividend 100 percent of the amount in the fund in excess of the amount required to maintain the reserve ratio at 1.5 percent, but provides the FDIC with sole discretion to suspend or limit these dividends. The analysis (given its method and assumptions) sought to evaluate the consequences had the full amount of dividends possible under Dodd-Frank been granted from 1950-2010. (See Charts C and D.) Granting dividends in this way necessitates a constant average nominal assessment rate of 21.96 basis points to maintain a positive fund balance during both periods of crisis. Such a rate is historically very high, and corresponds most closely to the rates charged to recapitalize the fund after a crisis. This policy would have also resulted in substantial premium volatility and pro-cyclical average effective assessment rates.[18] In some years, the effective assessment rate would have been negative.

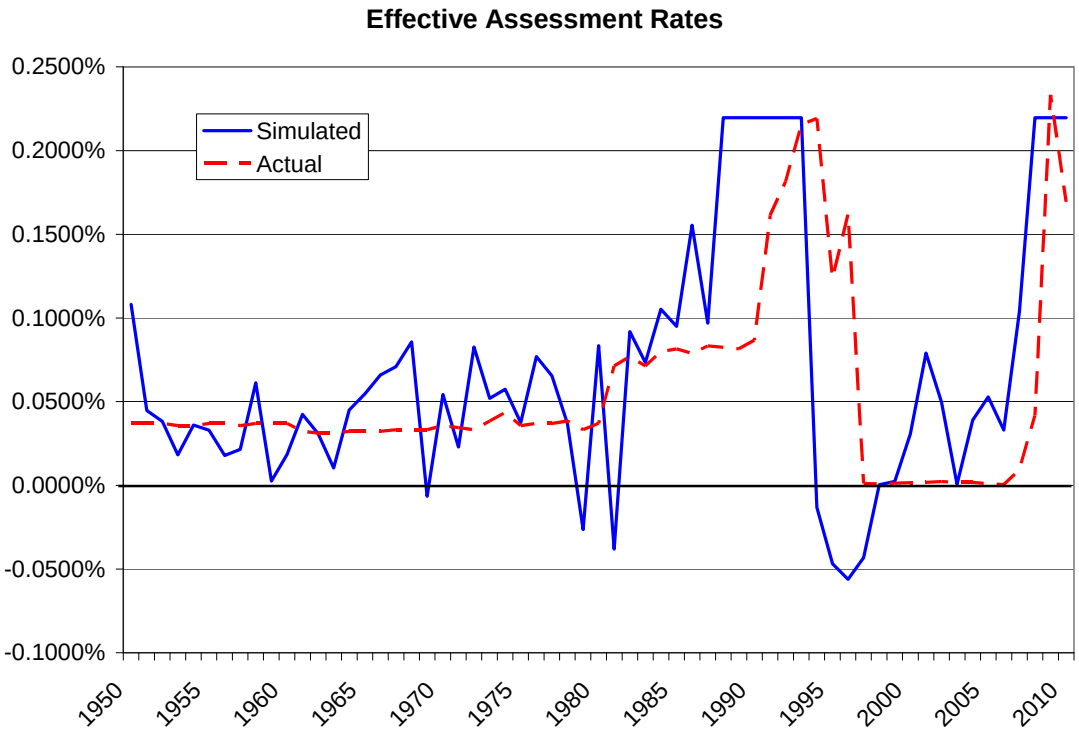
[18] Average effective assessment rates are calculated by subtracting dividends paid from assessments received.

Chart C



Dividends equal to 100 percent of the amount in the fund in excess of the amount required to maintain the reserve ratio at 1.5 percent, with 21.96 basis point average nominal assessment rate

Chart D



Dividends equal to 100 percent of the amount in the fund in excess of the amount required to maintain the reserve ratio at 1.5 percent, with 21.96 basis point average nominal assessment rate

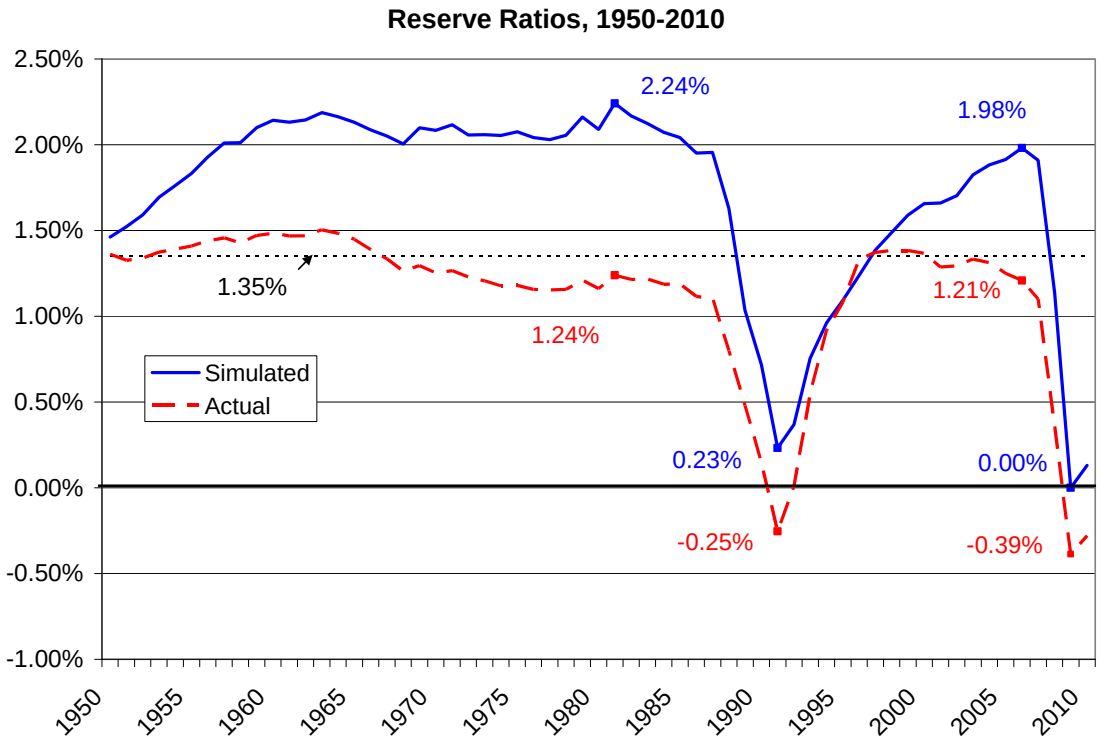
The analysis was therefore extended to examine options that limited dividends or reduced assessment rates in lieu of dividends, in keeping with the broad set of goals for fund management. The analysis examined multiple options with different levels of dividend or assessment rate reduction, and found that many options would still have required relatively high assessment rates. However, staff did identify two options that would achieve the goals of maintaining a positive fund balance even during a banking crisis and maintaining moderate, steady assessment rates throughout economic and credit cycles.

One option awards dividends as a percentage of the amount in the fund in excess of the amount required to maintain the reserve ratio at a specified level. The analysis above has already shown that granting dividends equal to 100 percent of the amount in the fund in excess of the amount required to maintain the reserve ratio at 1.5 percent would have required a very high constant average nominal assessment rate of 21.96 basis points. However, granting dividends equal to 25 percent of the amount in the fund in excess of the amount required to maintain the reserve ratio at 2 percent and increasing dividends to 50 percent of the amount in the fund in excess of the amount required to maintain the reserve ratio at 2.5 percent permitted a significantly lower constant average nominal assessment rate to maintain a positive fund balance.

This dividend method, however, introduces a potential problem—the possibility that an IDI could receive a dividend that approaches 100 percent of its assessment. The nearer a dividend comes to 100 percent of an IDI's assessment, the more it introduces moral hazard and reduces or eliminates the FDIC's ability to control and price for risk taking. To avoid this problem, dividends are limited such that no IDI could receive a dividend greater than 50 percent of its annual assessment.

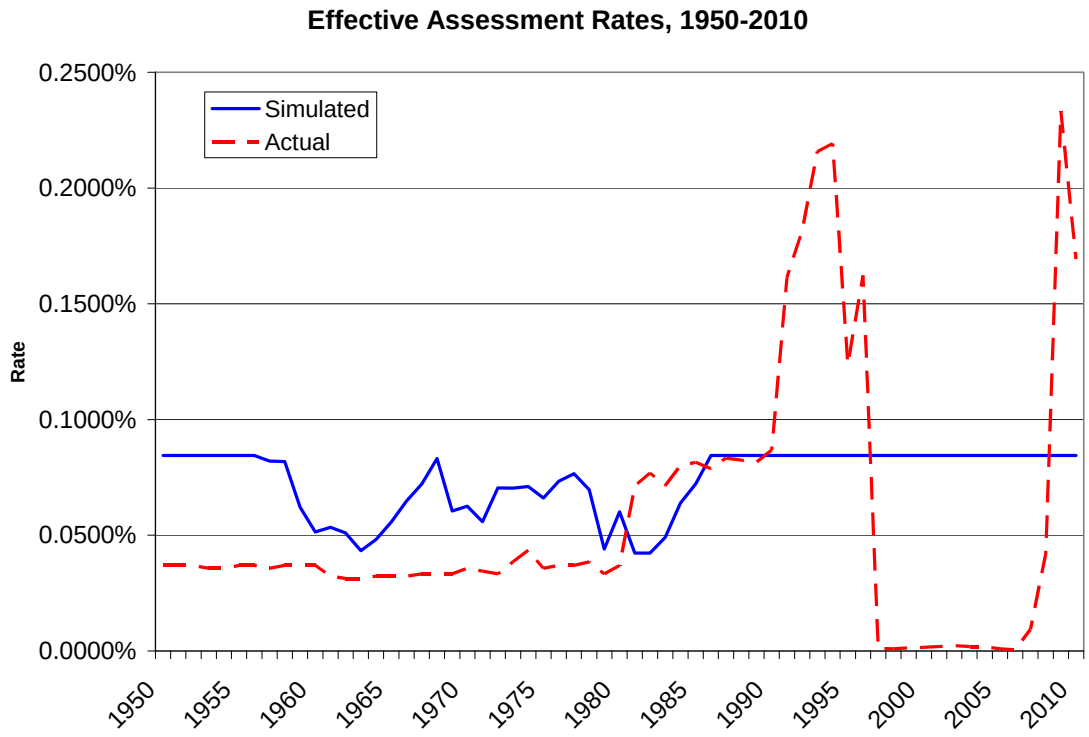
The analysis (reflected in Charts E and F) shows that this option results in a moderate constant nominal assessment rate of 8.45 basis points across the entire 60-year period. The reserve ratios necessary to maintain a positive fund balance are 2.24 percent before the crisis of the 1980s and early 1990s and 1.98 percent before the current crisis. These ratios are, of course, significantly higher than the level that the DRR has been set historically, but should be sufficient to withstand a future crisis similar in depth to those the FDIC has experienced. Pro-cyclicality is limited, but this option generates moderate premium volatility.

Chart E



Dividends equal to 25 percent of the amount in the fund in excess of the amount required to maintain the reserve ratio at 2.0 percent or 50 percent of the amount in the fund in excess of the amount required to maintain the reserve ratio at 2.5 percent, with 8.45 basis point average nominal assessment rate

Chart F

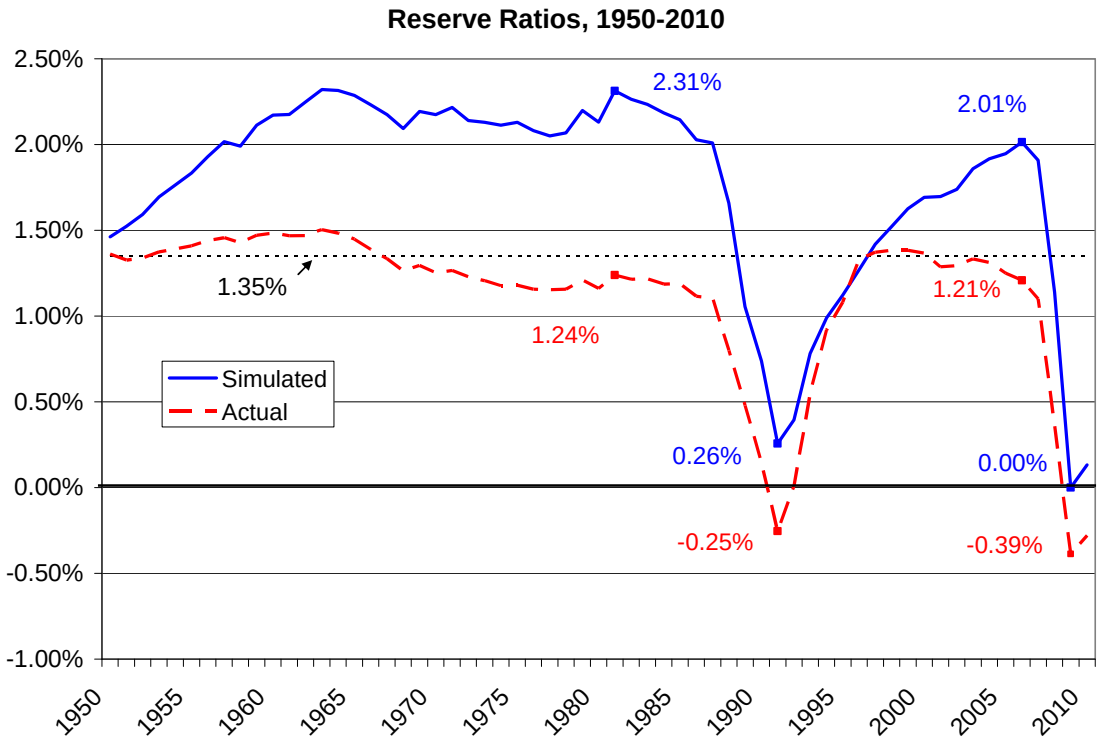


Dividends equal to 25 percent of the amount in the fund in excess of the amount required to maintain the reserve ratio at 2.0 percent or 50 percent of the amount in the fund in excess of the amount required to maintain the reserve ratio at 2.5 percent, with 8.45 basis point average nominal assessment rate

The second option that achieves the goals of maintaining a positive fund balance even during a banking crisis and maintaining moderate, steady assessment rates throughout economic and credit cycles would, in lieu of a dividend, reduce the long-term industry average nominal assessment rate by 25 percent when the reserve ratio reached 2 percent, and by 50 percent when the reserve ratio reached 2.5 percent.

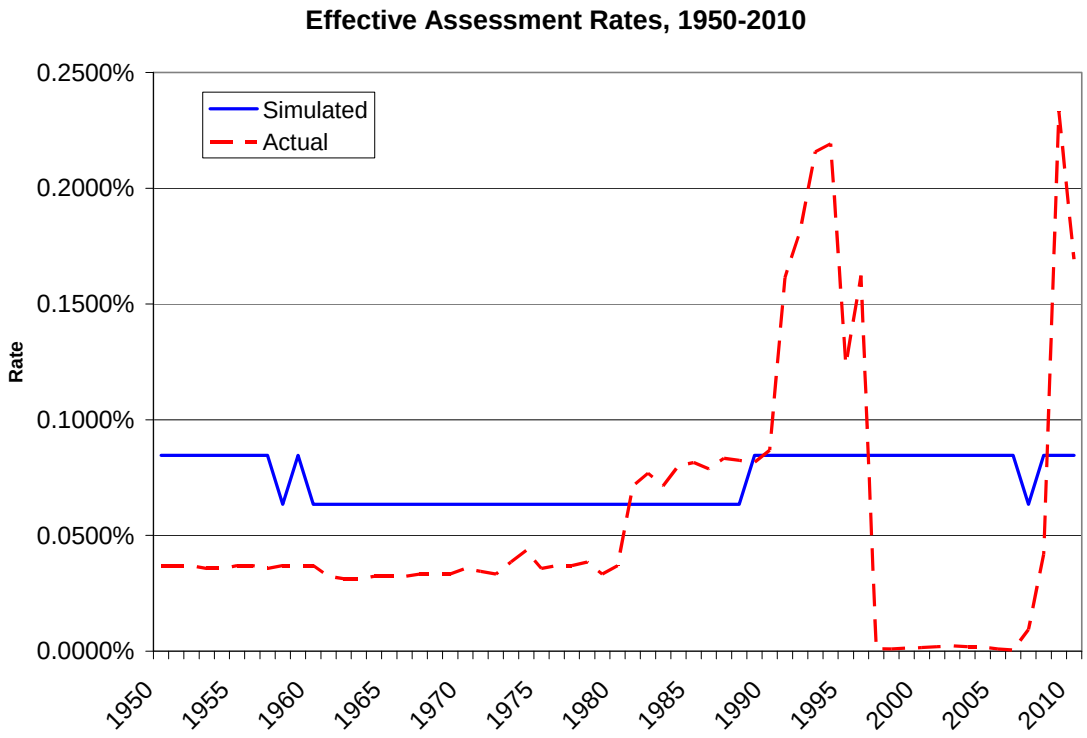
The analysis (reflected in Charts G and H) shows that this option results in a moderate constant nominal assessment rate of 8.47 basis points during the entire 60-year period (except when reduced as the result of the fund exceeding the 2 percent threshold), almost identical to the rate required under the immediately preceding option (limiting dividends). The reserve ratios necessary to maintain a positive fund balance are 2.31 percent before the crisis of the 1980s and early 1990s and 2.01 percent before the current crisis, very similar to the ratios required under the option that would limit dividends. Premium volatility and pro-cyclicality are both successfully minimized, and premium volatility is significantly lower than under the option that would limit dividends.

Chart G



Effective assessment rate reduced by 25 percent when reserve ratio reaches 2 percent and 50 percent when reserve ratio reaches 2.5 percent, with 8.47 basis point average nominal assessment rate

Chart H



Effective assessment rate reduced by 25 percent when reserve ratio reaches 2 percent and 50 percent when reserve ratio reaches 2.5 percent, with 8.47 basis point average nominal assessment rate

One final concern is whether the fund recovers sufficiently, both in magnitude and in time, to withstand another crisis. Extending the analysis into the future, using estimates based on implied forward interest rates and assuming current FDIC assessment rates and loss projections until the reserve ratio reaches 1.15 percent (approximately the fourth quarter of 2018) and low losses and an 8.47 basis point average nominal assessment rate thereafter, the reserve ratio reaches 2 percent in 2027.[19] This would bring the fund to a level able to withstand past crises in 17 years, approximately the length of time between the depth of the crisis of the late 1980s and early 1990s (in 1991) and the beginning of the current crisis (in 2008).

However, the average rates assumed in the previous paragraph between now and 2018 are much higher than 8.47 basis points, which, if the proposed comprehensive plan is implemented, would be approximately the average rate in effect in the event a future banking crisis causes the fund balance to fall to or near zero. Starting at a reserve ratio of zero, assessment rates of 8.45 to 8.47 basis points (the rates under the option that limits dividends and the one that lowers rates) it would take 25 years for the simulated fund to

[19] Because of the offset requirements of Dodd-Frank discussed earlier, the fund reserve ratio is assumed to reach 1.35 percent immediately upon reaching 1.15 percent.

reach a level of 2 percent. However, allowing the reserve ratio to exceed 2 percent should reduce the chance that the reserve ratio during a crisis would fall all the way to zero.

ASSESSMENT RATES AND DIVIDENDS

Dividends

To increase the probability that the fund reserve ratio will reach a level sufficient to withstand a future crisis, staff recommends that the FDIC propose to suspend dividends permanently whenever the fund reserve ratio exceeds 1.5 percent. In lieu of dividends, and pursuant to the FDIC's authority to set risk-based assessments, staff recommends that the FDIC propose progressively lower assessment rate schedules when the reserve ratio exceeds 2 percent and 2.5 percent, as discussed below. These lower assessment rate schedules would serve much the same function as dividends in preventing the DIF from growing unnecessarily large but, as discussed above, would provide more stable and predictable effective assessment rates, a feature that industry representatives said was very important at the September 24, 2010 roundtable organized by the FDIC.

Assessment rates

Current assessment rates

Current initial base assessment rates are set forth in Table 1 below.

Table 1

Current Initial Base Assessment Rates[20]

Risk Category					
	I*		II	III	IV
	Minimum	Maximum			
Annual Rates (in basis points)	12	16	22	32	45

* Rates for institutions that do not pay the minimum or maximum rate will vary between these rates.

[20] For purposes of determining assessment rates, each IDI is placed into one of four risk categories (Risk Category I, II, III or IV), depending upon supervisory ratings and capital levels. 12 CFR 327.9. Within Risk Category I, there are different assessment systems for large and small IDIs, but the possible range of rates is the same for all IDIs in Risk Category I.

These initial assessment rates are subject to adjustment. An IDI's total base assessment rate can vary from its initial base assessment rate as the result of an unsecured debt adjustment and a secured liability adjustment. The unsecured debt adjustment lowers an IDI's initial base assessment rate using its ratio of long-term unsecured debt (and, for small IDIs, certain amounts of Tier 1 capital) to domestic deposits.[21] The secured liability adjustment increases an IDI's initial base assessment rate if the IDI's ratio of secured liabilities to domestic deposits is greater than 25 percent (the secured liability adjustment).[22] In addition, IDIs in Risk Categories II, III and IV are subject to an adjustment for large levels of brokered deposits (the brokered deposit adjustment).[23]

After applying all possible adjustments, the current minimum and maximum total base assessment rates for each risk category are set out in Table 2 below.

Table 2

Initial and Total Base Assessment Rates

	Risk Category I	Risk Category II	Risk Category III	Risk Category IV
Initial base assessment rate…….	12–16	22	32	45
Unsecured debt adjustment……..	(5)–0	(5)–0	(5)–0	(5)–0
Secured liability adjustment…….	0–8	0–11	0–16	0–22.5
Brokered deposit adjustment……	…....	0–10	0–10	0–10
TOTAL BASE ASSESSMENT RATE	7–24	17–43	27–58	40–77.5

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.

[21] Unsecured debt excludes debt guaranteed by the FDIC under its Temporary Liquidity Guarantee Program.

[22] The initial base assessment rate cannot increase more than 50 percent as a result of the secured liability adjustment.

[23] 12 CFR 327.9(d)(7).

The Board may uniformly adjust the total base rate assessment schedule up or down by up to 3 basis points without further rulemaking.[24]

Proposed assessment rates once the reserve ratio reaches 1.15 percent

As discussed earlier, under Dodd-Frank, the FDIC is required to offset the effect on small institutions (those with less than $10 billion in assets) of the statutory requirement that the fund reserve ratio increase from 1.15 percent to 1.35 percent by September 30, 2020. Thus, assessment rates applicable to all IDIs need be set only high enough to reach 1.15 percent. The Restoration Plan postpones until 2011 rulemaking regarding the method that will be used to reach 1.35 percent by the statutory deadline of September 30, 2020, and the manner of offset.

When the reserve ratio reaches 1.15 percent, staff recommends that the Board propose lowering assessment rates so that the average assessment rate would approximately equal the long-term moderate, steady assessment rate—approximately 8.5 basis points, as discussed above—that would have been needed to maintain a positive fund balance throughout past crises. Based on staff's analysis of weighted average assessment rates paid immediately prior to the current crisis (when the industry was relatively prosperous, and had both good CAMELS ratings and substantial capital), weighted average rates during times of industry prosperity tend to be somewhat less than 1 basis point greater than the minimum rate applicable to Risk Category I.[25] Thus, to achieve approximately an 8.5 basis point average assessment rate during prosperous times, current initial base rates would have to be set 4 basis points lower than current initial base assessment rates. Consequently, staff recommends that the Board propose that, when the fund reserve ratio first meets or exceeds 1.15 percent, the initial base and total base assessment rates set forth in Table 3 will take effect beginning the next quarter without the necessity of further action by the Board. These rates would remain in effect unless and until the reserve ratio met or exceeded 2 percent. The unsecured debt

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[24] Specifically:

> The Board may increase or decrease the total base assessment rate schedule up to a maximum increase of 3 basis points or a fraction thereof or a maximum decrease of 3 basis points or a fraction thereof (after aggregating increases and decreases), as the Board deems necessary. Any such adjustment shall apply uniformly to each rate in the total base assessment rate schedule. In no case may such Board rate adjustments result in a total base assessment rate that is mathematically less than zero or in a total base assessment rate schedule that, at any time, is more than 3 basis points above or below the total base assessment schedule for the Deposit Insurance Fund, nor may any one such Board adjustment constitute an increase or decrease of more than 3 basis points.

12 CFR 327.10(c).

[25] The first year in which rates applicable to Risk Category I spanned a range (as opposed to being a single rate) was 2007, when initial assessment rates ranged between 5 and 7 basis points. During that year, weighted average annualized industry assessment rates for the first three quarters varied between 5.41 and 5.44 basis points. (By the end of 2007, deterioration in the industry became more marked and weighted average rates began increasing.) 0.4 basis points is 20 percent of the 2 basis point difference between the minimum and maximum rates. 20 percent of the 4 basis point difference between the current minimum and maximum rates is 0.8 basis points. Thus, by analogy, in 2007 the current assessment schedule would have produced average assessment rates of about 12.8 basis points.

adjustment could not exceed the lesser of 5 basis points or 50 percent of an IDI's initial base assessment rate. The Board would retain its current authority to uniformly adjust the total base rate assessment schedule up or down by up to 3 basis points without further rulemaking.

Table 3

Initial and Total Base Assessment Rates
Effective for the Quarter Beginning Immediately after the Quarter in which the Reserve Ratio Meets or Exceeds 1.15 Percent

	Risk Category I	Risk Category II	Risk Category III	Risk Category IV
Initial base assessment rate…….	8–12	18	28	40
Unsecured debt adjustment*……..	(5)–0	(5)–0	(5)–0	(5)–0
Secured liability adjustment…….	0–6	0–9	0–14	0–20
Brokered deposit adjustment……	…….	0–10	0–10	0–10
TOTAL BASE ASSESSMENT RATE	4–18	13–37	23–52	35–70

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.
* The unsecured debt adjustment could not exceed the lesser of 5 basis points or 50 percent of an IDI's initial assessment rate; thus, for example, an IDI with an initial assessment rate of 8 would have a maximum unsecured debt adjustment of 4 basis points and could not have a total base assessment rate lower than 4 basis points.

Proposed assessment rates once the reserve ratio reaches 2.0 percent

In lieu of dividends, staff recommends that the Board propose that, so long as the fund reserve ratio at the end of the prior quarter meets or exceeds 2 percent, but is less than 2.5 percent, the initial base and total base assessment rates set forth in Table 4 would come into effect without the necessity of further action by the Board. If, however, after reaching a reserve ratio of 1.15 percent, the fund reserve ratio subsequently falls below 2 percent at the end of a quarter, the initial base and total base assessment rates set forth in Table 3 would take effect beginning the next quarter without the necessity of further action by the Board. However, the assessment rates in Table 4 would not apply to any

new depository institutions; these IDIs would remain subject to the assessment rates in Table 3, until they no longer were new depository institutions.[26] Under the proposal, the unsecured debt adjustment could not exceed the lesser of 5 basis points or 50 percent of an IDI's initial base assessment rate. The Board would retain its current authority to uniformly adjust the total base rate assessment schedule up or down by up to 3 basis points without further rulemaking.

Table 4

Initial and Total Base Assessment Rates
Effective for any Quarter when the Reserve Ratio for the Prior Quarter Meets or Exceeds 2 Percent (but Is Less than 2.5 Percent)

	Risk Category I	Risk Category II	Risk Category III	Risk Category IV
Initial base assessment rate…….	6–10	16	26	38
Unsecured debt adjustment*……..	(5)–0	(5)–0	(5)–0	(5)–0
Secured liability adjustment…….	0–5	0–8	0–13	0–19
Brokered deposit adjustment……	…….	0–10	0–10	0–10
TOTAL BASE ASSESSMENT RATE	3–15	11–34	21–49	33–67

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.

* The unsecured debt adjustment could not exceed the lesser of 5 basis points or 50 percent of an IDI's initial assessment rate; thus, for example, an IDI with an initial assessment rate of 6 would have a maximum unsecured debt adjustment of 3 basis points and could not have a total base assessment rate lower than 3 basis points.

[26] Subject to exceptions, a new insured depository institution is a bank or savings association that has been federally insured for less than five years as of the last day of any quarter for which it is being assessed. 12 CFR 327.8(m). Under the proposal, other assessment rules related to new depository institutions would generally remain unchanged. For example, subject to the exceptions contained in the regulation, a new institution that is well capitalized would continue to be assessed the Risk Category I maximum initial base assessment rate in Table 3 for the relevant assessment period. 12 CFR 327.9(d)(9). Also, for example, a new institution would not be subject to the unsecured debt adjustment. 12 CFR 327.9(d)(5).

Compared to Table 3, the proposed assessment rates in Table 4 should approximately reduce weighted average assessment rates by 25 percent, consistent with the analysis reflected in Chart H above. Based upon staff's historical simulations, these rates should allow the fund to remain positive during a crisis of the magnitude of the prior two crises without significantly increasing pro-cyclicality or premium volatility.

Proposed assessment rates once the reserve ratio reaches 2.5 percent

Again in lieu of dividends, and to reduce the low probability of the fund growing unreasonably large, staff recommends that the Board propose that the initial base and total base assessment rates set forth in Table 5 would apply if the fund reserve ratio at the end of the prior quarter meets or exceeds 2.5 percent, without the necessity of further action by the Board. If, however, after reaching a reserve ratio of 1.15 percent, the fund reserve ratio subsequently falls below 2.5 percent at the end of a quarter, the rates set forth in Tables 3 or 4, whichever is applicable, would take effect beginning the next quarter without the necessity of further action by the Board. Again, however, the assessment rates in Table 5 would not apply to any new depository institutions; these IDIs would remain subject to the assessment rates in Table 3, until they no longer were new depository institutions. Under the proposal, the unsecured debt adjustment could not exceed the lesser of 5 basis points or 50 percent of an IDI's initial base assessment rate. The Board would retain its current authority to uniformly adjust the total base rate assessment schedule up or down by up to 3 basis points without further rulemaking.

Table 5

Initial and Total Base Assessment Rates
Effective for any Quarter when the Reserve Ratio
for the Prior Quarter Meets or Exceeds 2.5 Percent

	Risk Category I	Risk Category II	Risk Category III	Risk Category IV
Initial base assessment rate…….	4–8	14	24	36
Unsecured debt adjustment*……..	(4)–0	(5)–0	(5)–0	(5)–0
Secured liability adjustment…….	0–4	0–7	0–12	0–18
Brokered deposit adjustment……	…….	0–10	0–10	0–10
TOTAL BASE ASSESSMENT RATE	2–12	9–31	19–46	31–64

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.
* The unsecured debt adjustment could not exceed the lesser of 5 basis points or 50 percent of an IDI's initial assessment rate; thus, for example, an IDI with an initial assessment rate of 6 would have a maximum unsecured debt adjustment of 3 basis points and could not have a total base assessment rate lower than 3 basis points.

Compared to Table 3, the proposed assessment rates in Table 5 should approximately reduce weighted average assessment rates by 50 percent, consistent with the analysis reflected in Chart H above and should allow the fund to remain positive during a crisis of the magnitude of the prior two crises without significantly increasing pro-cyclicality or premium volatility.

Capital and earnings analysis

Staff has analyzed the effect of its proposed rate schedules on the capital and earnings of IDIs.[27] Staff anticipates that when the reserve ratio exceeds 1.15 percent, and

[27] In setting assessment rates, the FDIC's Board of Directors is authorized to set assessments for IDIs 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 IDIs; (4) the risk factors and other factors taken into account pursuant to 12 U.S.C. §1817(b) (1)

particularly when it exceeds 2 or 2.5 percent, the industry is likely to be prosperous. Consequently, staff has examined the effect of the proposed lower rates on the industry at the end of 2006, when the industry was prosperous. Reducing average assessment rates by 4 basis points then (the approximate effect of reducing assessment rates from the current rate schedule to the one proposed when the reserve ratio reaches 1.15 percent) would have increased average after-tax income by 1.25 percent and average capital by 0.14 percent. Reducing average assessment rates by an additional 2 basis points (the effect of reducing assessment rates from the proposed rate schedule when the reserve ratio reaches 1.15 percent to the proposed rate schedule when the reserve ratio reaches 2 percent) would have increased average after-tax income by 0.62 percent and average capital by 0.07 percent. Similarly, reducing average assessment rates by an additional 2 basis points (the effect of reducing assessment rates from the proposed rate schedule when the reserve ratio reaches 2 percent to the proposed rate schedule when the reserve ratio reaches 2.5 percent) would have increased average after-tax income by 0.61 percent and average capital by 0.07 percent.

Effect of upcoming rulemakings

Dodd-Frank also requires the FDIC to amend its regulations to define an IDI's assessment base (with some possible exceptions) as "the average consolidated total assets of the insured depository institution during the assessment period … minus … the sum of … the average tangible equity of the insured depository institution during the assessment period …."[28] This assessment base will be more than 50 percent larger than the current assessment base, at least initially. Before the expiration of the comment period on this proposed rule, staff plans to recommend that the Board adopt and publish a notice of proposed rulemaking to define the assessment base. Staff anticipates that the notice will also include proposed changes to the risk-based pricing system necessitated by the change in assessment base.

The net effect of this proposal will, in staff's view, necessitate that the FDIC also adjust the proposed new assessment rates. In staff's view, the adjustments should seek to ensure that the revenue collected under the new assessment system will approximately equal that under the existing assessment system.

For several reasons, however, it is neither possible nor advisable to attempt to make the new assessment system or changes to the assessment rate schedules proposed above perfectly revenue neutral. First, for simplicity, staff recommends using whole numbers, when possible, when it establishes point assessment rates or the maximum and minimum of an assessment rate range. Second, the FDIC does not presently collect all of the information it needs to determine the exact revenue effect of many of the changes it anticipates proposing. Third, in response to the new assessment base, changes to the adjustments and possible changes to the large IDI assessment system, some IDIs may

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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, the FDIC has taken into account all of these statutory factors.

[28] Pub. L. No. 111-203, §331(b), 124 Stat. 1376, 1538 (to be codified at 12 U.S.C. § 1817(nt)).

alter their funding structure and behavior—in ways that are not presently predictable—to minimize assessments.

DESIGNATED RESERVE RATIO

The Board is required under current law to set and publish annually a DRR for the DIF.[29] In 2009, the Board set the DRR for 2010 at 1.25 percent, unchanged from the target set in 2008.

The Board must set the DRR in accordance with its analysis of the following statutory factors: risk of losses to the DIF; economic conditions generally affecting IDIs; preventing sharp swings in assessment rates; and any other factors that the Board may determine to be appropriate and consistent with these three factors.[30] The analysis that follows considers each statutory factor, including one "other factor": maintaining the DIF at a level that can withstand substantial losses.

As discussed above, Dodd-Frank eliminates the previous requirement to set the DRR within a range of 1.15 percent to 1.50 percent, directs the Board to set the DRR at a minimum of 1.35 percent (or the comparable percentage of the assessment base as amended by Dodd-Frank) and eliminates the maximum limitation on the DRR.[31] Dodd-Frank retains the requirement that the Board set and publish a DRR annually.[32]

While Dodd-Frank retains the requirement that the Board set a DRR annually, it does not direct the Board how to use the DRR. In effect, Dodd-Frank permits the Board to set the DRR as it sees fit so long as it is set no lower than 1.35 percent. Neither the FDI Act nor the amendments under Dodd-Frank establish a statutory role for the DRR as a trigger, whether for assessment rate determination, recapitalization of the fund, or dividends.

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[29] 12 U.S.C. 1817(b)(3).

[30] Specifically, in setting the DRR for any year, the Board must consider the following factors:

> (1) The risk of losses to the DIF in the current and future years, including historic experience and potential and estimated losses from IDIs.
>
> (2) Economic conditions generally affecting IDIs so as to allow the DRR 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 the Board determines to be appropriate.
>
> (3) That sharp swings in assessment rates for IDIs should be prevented.
>
> (4) Other factors as the FDIC's Board may deem appropriate, consistent with the requirements of the Reform Act.

12 U.S.C. 1817(b)(3)(B).

[31] Pub. L. No. 111-203, § 334(a), 124 Stat. 1376, 1539 (to be codified at12 U.S.C. 1817(b)(3)(B)).

[32] 12 U.S.C. 1817(b)(3)(A).

Staff recommends that the Board set the DRR at 2 percent.[33] As the historical analysis above demonstrates, the recommended DRR is the minimum reserve ratio needed to withstand a future banking crisis. A 2 percent reserve ratio prior to past crises would barely have prevented the fund from becoming negative. A larger fund would have allowed the FDIC to have maintained a positive balance and the fund would have remained positive even had losses been higher. Consequently, staff views a 2 percent DRR as a long-range, *minimum* target.

Analysis of Statutory Factors

Risk of losses to the DIF

During 2009 and 2010, losses to the DIF have been high. As of June 30, 2010, both the fund balance and the reserve ratio continue to be negative after reserving for probable losses from anticipated bank failures. During the current downturn the fund balance has fallen below zero for the second time in the history of the FDIC. The FDIC reported a negative fund balance in the early 1990s during the last banking crisis. Staff projects that, over the period 2010 through 2014, the fund could incur approximately $52 billion in failure-resolution costs. Staff projects that most of these costs will occur in 2010 and 2011.

In staff's view, the high losses experienced by the DIF during the crisis of the 1980s and early 1990s and during the current economic crisis (and the potential for high risk of loss to the DIF over the course of future economic cycles) suggest that the Board should, as a long-range, minimum goal and in conjunction with the recommended dividend and assessment rate policy, set a DRR at a level that would have maintained a zero or greater fund balance during both crises so that the DIF will be better able to handle losses during periods of severe industry stress.

Economic conditions affecting FDIC-insured institutions

U.S. economic growth, which started in the second half of 2009, remains low. Leading economic indicators have fallen slightly after rising steadily since the spring of 2009. Continued weakness in labor and real estate markets coupled with concern about rising public debt levels have increased uncertainty in the economic outlook and heightened financial market volatility. Consensus forecasts call for the economy to grow at a slower pace in the second half of 2010 compared with the first half of the year, as fiscal stimulus measures wane.

The slow and uncertain pace of economic recovery creates a challenging operating environment for IDIs. Industry-wide loans outstanding continued to fall in the second quarter. As of June 30, there were 829 IDIs on the problem list, representing more than 10 percent of all IDIs. Through October 1, 129 IDIs have failed this year, making this year's total likely to match or exceed the 140 failures that occurred in 2009.

[33] The 2 percent DRR is expressed as a percentage of estimated insured deposits.

IDIs continue to experience significant credit distress, although loan losses and delinquencies may have peaked. Despite this, the financial performance of IDIs has shown signs of improvement. The industry reported aggregate net income of $26 billion in second quarter 2010, compared to an aggregate net loss of $4.4 billion a year ago. Almost 80 percent of IDIs were profitable in the quarter, and almost two-thirds reported year-over-year earnings growth.

Although these short-term economic conditions can inform the Board's decision on setting the DRR, they become less relevant in setting the DRR when, as now, the DIF is negative. In this context, staff believes that the DRR should be viewed in a longer-term perspective. Twice within the past 30 years, serious economic dislocations have resulted in a significant deterioration in the condition of many IDIs and in a consequent large number of IDI failures at high costs to the DIF. In staff's view, the DRR should, therefore, be viewed as a minimum goal needed to achieve a reserve ratio that can withstand these periodic economic downturns and their attendant IDI failures. Taking these longer-term economic realities into account, a prudent and consistent policy would set the DRR at a minimum of 2 percent, since that is the lowest level that would have prevented a negative fund balance at any time since 1950.

Preventing sharp swings in assessment rates

Current law directs the Board to consider preventing sharp swings in assessment rates for IDIs. Setting the DRR at 2 percent as a minimum goal rather than a final target would signal that the Board plans for the DIF to grow in good times so that funds are available to handle multiple bank failures in bad times. This plan would help prevent sharp fluctuations in deposit insurance premiums over the course of the business cycle. In particular, it would help reduce the risk of large rate increases during crises, when IDIs can least afford an increase.

Maintaining the DIF at a level that can withstand substantial losses

Setting the DRR as a minimum goal and adopting the recommended dividend and assessment rate policy, which would allow the fund to grow sufficiently large in good times, would increase the likelihood that the DIF would remain positive during bad times. Having adequate funds available when entering a financial crisis would reduce the likelihood that the FDIC would need to increase assessment rates, levy special assessments on the industry or borrow from the U.S. Treasury.

Balancing the statutory factors

In staff's view, the best way to balance all of the statutory factors (including the "other factor" identified above of maintaining the DIF at a level that can withstand the substantial losses associated with a financial crisis) is to set the DRR at 2 percent.

Staff contacts

Division of Insurance and Research:

Munsell St. Clair
Acting Chief, Fund Analysis and Pricing
(202) 898-8967

Division of Finance:

Donna Saulnier
Deputy Director, Assessment Policy and Operations
(703) 562-6167

Legal Division:

Christopher Bellotto
Counsel
(202) 898-3801