DRAFT

[6714-01-D]

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 327

RIN 3064-AD02

Deposit Insurance Assessments – Designated Reserve Ratio

AGENCY: Federal Deposit Insurance Corporation.

ACTION: Notice of Proposed Rulemaking with Request for Comment.

SUMMARY: Under the Federal Deposit Insurance Reform Act of 2005, the Federal Deposit Insurance Corporation (FDIC) must by regulation set the Designated Reserve Ratio (DRR) for the Deposit Insurance Fund (DIF) within a range of 1.15 percent to 1.50 percent of estimated insured deposits. In this rulemaking, the FDIC seeks comment on the proposal to establish the DRR for the DIF at 1.25 percent of estimated insured deposits.

DATES: Comments must be submitted on or before [Insert date 60 days after date of publication in FEDERAL REGISTER].

ADDRESSES: Interested parties are invited to submit written comments to the FDIC by any of the following methods:

- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- Agency Web Site: http://www.fdic.gov/regulations/laws/federal/propose.html. Follow the instructions for submitting comments on the FDIC website.
- E-mail: comments@FDIC.gov. Include "DRR" in the subject line of the message.
- Mail: Robert E. Feldman, Executive Secretary, Attention: Comments/Legal ESS, Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, D.C. 20429.
- Hand Delivery/Courier: Comments may be hand-delivered to the guard station located at the rear of the FDIC's 17th Street building (accessible from F Street) on business days between 7 a.m. and 5 p.m.

Instructions: All submissions received must include the agency name and use the title "Part 327 – Designated Reserve Ratio." The FDIC may post comments on its Internet site at: http://www.fdic.gov/regulations/laws/federal/propose.html. Comments may be

inspected and photocopied in the FDIC Public Information Center, 3501 N. Fairfax Dr., Arlington, Virginia, between 9 a.m. and 4:30 p.m. on business days.

FOR FURTHER INFORMATION CONTACT: Munsell St. Clair, Senior Policy Analyst, Division of Insurance and Research, (202) 898-8967; or Christopher Bellotto, Counsel, Legal Division, (202) 898-3801, Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, D.C. 20429.

SUPPLEMENTARY INFORMATION:

The Federal Deposit Insurance Reform Act of 2005 (the Reform Act) amends section 7(b)(3) of the Federal Deposit Insurance Act (the FDI Act) to eliminate the current fixed designated reserve ratio (DRR) of 1.25 percent.[1] Section 2105 of the Reform Act directs the FDIC 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] 12 U.S.C. 1817(b)(3)(B), (D). Under section 2109(a)(1) of the Reform Act, the Board must prescribe final regulations setting the DRR after notice and opportunity for comment not later than 270 days after enactment of the Reform Act. Thereafter, any change to the DRR must also be made by regulation after notice and opportunity for comment.

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

[2] To be codified at 12 U.S.C. 1817(b)(3)(B), (D).

While the Reform Act requires the Board to set a DRR annually, it does not direct the Board how to use the DRR. There is no longer a requirement for the reserve ratio to meet the DRR within a particular timeframe. In effect, the Reform Act permits the Board to manage the reserve ratio within a range. In contrast to the prior law, the Reform Act does not establish a role for the DRR as a trigger, whether for assessment rate determination, recapitalization of the fund, assessment credit use, or dividends.

The FDIC sets forth below background information, its analysis of the statutory factors that must be considered in setting the DRR and its proposal to set the initial DRR for the DIF at 1.25 percent, the current DRR.

I. Background

In setting the DRR for any year, section 2105(a), amending section 7(b)(3) of the FDI Act, directs the Board to 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 insured depository institutions.

(2) Economic conditions generally affecting insured depository institutions. (In general, the Board should consider allowing the DRR to increase during more favorable economic conditions and decrease during less favorable conditions.)

(3) That sharp swings in assessment rates for insured depository institutions should be prevented.

(4) Other factors as the Board may deem appropriate, consistent with the requirements of the Reform Act.[3]

The DRR may not exceed 1.50 percent of estimated insured deposits nor be less than 1.15 percent of estimated insured deposits. Any future change to the DRR shall be made by regulation after notice and opportunity for comment. In soliciting comment on any proposed change in the DRR, the FDIC must include in the published proposal a thorough analysis of the data and projections on which the proposal is based.[4]

The analysis of the statutory factors begins in part II. The manner in which the FDIC's Board evaluates the statutory factors may depend on its view of the role of the DRR, which may change over time. The FDIC 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.

[3] To be codified at 12 U.S.C. 1817(b)(3)(C). The Reform Act provides:

> (C) FACTORS- In designating a reserve ratio for any year, the Board of Directors shall--
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> > (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;
> >
> > (iii) seek to prevent sharp swings in the assessment rates for insured depository institutions; and
> >
> > (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 of the Reform Act (to be codified at 12 U.S.C. 1817(b)(3)(C)).

1. Signaling a goal for the reserve ratio

One role for the DRR would be to serve as a signal of the reserve ratio that the Board would like the fund to achieve. Using the DRR in this manner could convey useful information to insured institutions and others about future deposit insurance assessment rates. Suppose, for example, the Board sets the DRR at 1.25 percent, intending it to be a target for the reserve ratio. If the actual reserve ratio was 1.30 percent, the industry and the public could reasonably infer that the Board would be less likely to raise assessment rates in the near term than either to leave them unchanged or lower them.

A key consideration in using the DRR to signal a goal for the reserve ratio is the amount of time that the Board would allow to achieve the desired ratio. As noted earlier, by eliminating the current fixed DRR and certain assessment rules triggered by the fixed DRR, the Reform Act permits the Board to manage the reserve ratio within a range. There is no statutorily required timeframe for a reserve ratio to achieve a specific DRR.[5] Nonetheless, a DRR viewed as a reserve ratio target to achieve over time would convey to the public that the Board would generally want to avoid a sustained, significant deviation of the reserve ratio from the DRR.

The staff's best estimate is that the reserve ratio is likely to be less than 1.25 percent at year-end 2006 primarily due to strong insured deposit growth. If the Board considers the DRR to be a goal for the reserve ratio and adopts the proposal to set the DRR at 1.25

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

percent, it would need to determine how soon the reserve ratio should return to 1.25 percent. The use of one-time credits required by the Reform Act will limit assessment revenue initially.[6] Therefore, if the Board chooses to raise the reserve ratio to the DRR quickly and insured deposit growth is expected to remain strong, then a substantial increase in assessment rates might be required. The magnitude of the necessary assessment rate increase would likely diminish the more time that the Board allows the reserve ratio to climb back to its target.

2. Anticipating changes in the reserve ratio

Another role for the DRR would be to signal the Board's expectation of the change in the reserve ratio under the assessment rate schedule adopted by the Board.

For example, the Board may use the DRR to anticipate how the reserve ratio may move in response to changing economic conditions given the premium rate schedule adopted. Should deteriorating economic conditions precipitate an increase in bank failures that reduces the fund balance under the assessment rate schedule in effect, the Board could lower the DRR as the reserve ratio falls. Should improving economic conditions lead to a reduction in the fund's contingent loss reserve (estimated liability for anticipated

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[5] However, the Board must adopt a restoration plan when the fund falls below 1.15 percent. Section 2108 of the Reform Act (to be codified at 12 U.S.C. 1817(b)(3)(E)).

[6] Section 7(e)(3) of the Federal Deposit Insurance Act, as amended by the Reform Act, requires that the Board provide by regulation an initial, one-time assessment credit to each "eligible" insured depository institution (or its successor) based on the assessment base of the institution as of December 31, 1996, as compared to the combined aggregate assessment base of all eligible institutions as of that date, taking into account such other factors the Board may determine to be appropriate. The aggregate amount of one-time credits is to equal the amount that the FDIC could have collected if it had imposed an assessment of 10.5

failures), the Board could raise the DRR in recognition of the boost to the fund balance. In these two instances, using the DRR to signal expected changes in the reserve ratio is consistent with a statutory factor (discussed below) under which the Board would consider increasing the DRR during more favorable economic conditions and decreasing during less favorable ones.[7]

Assuming that insured deposit growth remains strong while institutions use their one-time assessment credits, the Board could adopt an assessment rate schedule under which the reserve ratio would likely decline temporarily. In recognition of the anticipated decline in the reserve ratio, the Board could lower the DRR for one or more years. As the depletion of the credits results in greater revenue and an increase in the reserve ratio, the Board could then raise the DRR.

Setting the DRR to anticipate the actual direction of change in the reserve ratio under a given assessment rate schedule would, however, convey little information about future changes in assessment rates. The Reform Act requires regulatory action for any further change in the DRR (subsequent to the initial determination under this rulemaking), with notice and opportunity for comment. Furthermore, in soliciting comment on any proposed change in the DRR, the FDIC must include in the published proposal a thorough analysis of the data and projections on which the proposal is based. While the

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basis points on the combined assessment base of the Bank Insurance Fund and Savings Association Insurance Fund as of December 31, 2001. 12 U.S.C. 1817(e)(3).

[7] The reserve ratio may not necessarily rise (fall) under more (less) favorable economic and industry conditions. For example, the current economic outlook is generally good and industry conditions remain strong. Because of strong insured deposit growth and a low contingent loss reserve with little room for further reduction, there have been several consecutive quarterly declines in the reserve ratio.

FDIC can meet these requirements for changing the DRR in order to reflect expected near-term changes in the reserve ratio, the notice-and-comment process and accompanying analysis may be more useful in the context of changes to a DRR that serves as a longer term target for the reserve ratio.

II. Proposed Designated Reserve Ratio

The FDIC must set the DRR in accordance with its analysis of the statutory factors listed above: risk of losses to the DIF; economic conditions generally affecting insured institutions; preventing sharp swings in assessment rates; and any other factors that the Board may determine to be appropriate and consistent with these three factors.

The analysis that follows considers each statutory factor, including several "other factors."

Risk of Losses to the DIF

The FDIC has estimated that potential loss provisions in 2006 related to future failures will range from $1 million to $241 million, with a best estimate of $93 million.[8] (The

[8] The FDIC has estimated a likely range of insurance losses based on projected changes in the contingent loss reserve during 2006. These projections are influenced by several factors, including: (1) the shifting of problem banks among different risk categories within the reserve; (2) the reduction in problem banks due to improved financial conditions, mergers, or failures; and (3) the addition of new problem banks. To capture the effects of these changes, the FDIC uses a migration approach, which estimates the probabilities of banks entering into or leaving the group of banks included in the contingent loss reserve as well as the probability of banks moving between loss reserve risk categories. These probabilities are based on the recent history of changes to the reserve. Other factors driving changes in the contingent loss reserve are changes in expected failure rates and changes in rates of loss in the event of failure; however, for purposes

bounds of this range do not represent "best case" and "worst case" scenarios, and larger or smaller losses could occur.) These estimates suggest that near-term losses to the insurance fund would not significantly alter the reserve ratio.

The FDIC also considered economic stress events and their potential implications for losses to the insurance fund by running several two-year stress event simulations, affecting institutions specializing in residential mortgages, subprime loans, commercial real estate mortgages, commercial and industrial loans, and consumer loans. The results of each simulation, which were derived from historical stress events, demonstrate that banks are well positioned to withstand a significant degree of financial adversity. In no case did the stress simulation results raise any significant concerns.

Economic Conditions Affecting FDIC-Insured Institutions

The performance of the economy and banking industry remains strong. The consensus expectation is that real economic growth will run near its long-run average of 3.0 to 3.5 percent in 2006, but will ease moderately in 2007 as higher interest rates continue to weigh on economic activity, especially the housing sector. A slower pace of home price appreciation may impede growth in consumer spending, but it is unclear by how much. Corporate balance sheets remain strong and real nonresidential investment is forecast to grow by 9 percent in 2006.[9]

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of projecting changes to the contingent loss reserve, the FDIC assumes that failure and loss rates remain constant.

[9] Growth forecast from Macroeconomic Advisers. Although the economy should stay in strong shape over the medium term, a number of downside risks exist, including further energy price spikes, an abrupt decline in U.S. financial or housing markets, or an abrupt decline in the foreign-exchange value of the dollar.

In the banking industry, earnings have set five consecutive annual records, capital is at historically high levels, and asset quality remains solid. For 2005, aggregate return on assets (ROA) remained high at 1.30 percent, marking the fourth successive year where ROA was over 1.28 percent. The aggregate equity-to-asset ratio of 10.38 percent at year-end 2005 was the highest since 1939. No insured institutions have failed in two years, extending the longest period without a failure since the creation of the FDIC in 1933. Therefore, banks in general appear to be well positioned to withstand the financial stress that may arise from potential economic shocks in the next few years.

Prevent Sharp Swings in Assessment Rates

The Reform Act directs the FDIC's Board to consider preventing sharp swings in the assessment rates for insured depository institutions.

In the current environment, maintaining a DRR of 1.25 percent is more likely to be consistent with relative premium stability if the Board also allows a period of a few years for the reserve ratio to meet the DRR. As discussed above, the reserve ratio is expected to be below 1.25 percent at the end of 2006. The use of assessment credits will temporarily limit future assessment income. Therefore, there may be further downward pressure on the reserve ratio if recent robust insured deposit growth continues. The downward pressure is expected to reverse itself once institutions begin to use up their assessment credits. Raising the reserve ratio to a DRR of 1.25 percent quickly could

require (depending on insured deposit growth) a substantial increase in assessment rates that would exhaust most of the credits rapidly. Once the DRR is achieved, there could be a substantial reduction in rates. Increasing the reserve ratio more gradually toward the DRR could result in less substantial increases (followed by less substantial reductions) in rates, consistent with this statutory factor.

Other Factors

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

1. Transition to a new assessment system

The assessment system is about to undergo significant change. Once proposed risk-based assessment regulations are finalized and become effective, all insured institutions will pay deposit insurance assessments regardless of the level of the reserve ratio. These proposed regulations also will change how the FDIC differentiates among insured institutions for risk in assigning assessment rates.

Furthermore, to provide institutions a transition to the new system, one-time assessment credits will be available to those institutions that contributed in earlier years to the build-up of the insurance funds. The application of these credits to assessments will limit assessment revenue in the near term. If insured deposit growth remains strong, this may

place temporary downward pressure on the reserve ratio, which is expected to reverse itself once banks begin to use up their credits.

Finally, as described above, the FDIC will be changing 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.

Therefore, the FDIC staff believes that the changes facing the FDIC and insured institutions as a new assessment system is implemented argue against altering the DRR from the current 1.25 percent.

2. Midpoint of the normal operating range for the reserve ratio

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 timeframe, 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.[10] The current DRR of 1.25 percent is the midpoint of the normal operating range.

[10] Based on March 31, 2006 aggregate insured deposits of $4.002 trillion, a 20 basis point range for the reserve ratio would be equivalent to an $8 billion range for the fund balance.

The FDIC believes that at the commencement of the new assessment system, it would be reasonable to leave the DRR at the middle of this range.

3. 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. The FDIC believes that more experience with managing the fund under the new framework established by the Reform Act will be of benefit in determining whether the DRR should be raised or lowered from 1.25 percent.

Balancing the statutory factors

In the FDIC's view, the best way to balance all of the statutory factors (including the "other factors" identified above that the Board may choose to consider) and to preserve the FDIC's new flexibility to manage the DIF is to maintain the DRR at 1.25 percent. The FDIC recognizes that the Reform Act directs its Board to consider allowing the DRR to increase in favorable economic conditions and that the present economic conditions are favorable. However, several other 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.

III. Request for Comment

The Board invites comments on all aspects of the proposed rule setting the DRR at 1.25 percent of estimated insured deposits. Interested persons are invited to submit written comments during the 60-day comment period.

IV. Paperwork Reduction Act

The proposed rule will set the Designated Reserve Ratio for the Deposit Insurance Fund. It will not involve any new collections of information pursuant to the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*). Consequently, no information has been submitted to the Office of Management and Budget for review.

V. Regulatory Flexibility Act

Pursuant to 5 U.S.C. 605(b) the FDIC certifies that the proposed rule would not have a significant economic impact on a substantial number of small businesses (*i.e.*, insured depository institutions with $165 million or less in assets) within the meaning of the Regulatory Flexibility Act (5 U.S.C. 601, *et seq*.). The proposed rule, if finalized, will set the Designated Reserve Ratio (DRR) at 1.25 percent of estimated insured deposits, which is unchanged from the present Designated Reserve Ratio. Under the Federal Deposit Insurance Reform Act of 2005, the DRR provides no trigger for assessment

determinations, recapitalization of the insurance fund, assessment credit use, or dividends. Consequently, retaining the DRR at 1.25 will not have a significant economic impact on a substantial number of small businesses.

VI. The Treasury and General Government Appropriations Act, 1999 – Assessment of Federal Regulations and Policies on Families

The FDIC has determined that the proposed rule will not affect family well-being within the meaning of section 654 of the Treasury and General Government Appropriations Act, enacted as part of the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999 (Public Law 105-277, 112 Stat. 2681).

List of Subjects in 12 CFR Part 327

Bank deposit insurance, Banks, banking, Savings associations

For the reasons stated in the preamble, the Board of Directors of the Federal Deposit Insurance Corporation proposes to amend part 327 of Title 12 of the Code of Federal Regulations as follows:

Part 327 – Designated Reserve Ratio

Subpart A—In general

1. The authority citation for part 327 continues to read as follows:

Authority: 12 U.S.C. 1441, 1441b, 1813, 1815, 1817-1819; Pub. L. 104-208, 110

Stat. 3009-479 (12 U.S.C. 1821).

2. In section 327.4 of Subpart A add paragraph (g) to read as follows:

§ 327.4(g) Designated reserve ratio

The designated reserve ratio for the Deposit Insurance Fund is 1.25 percent.

By order of the Board of Directors.

Dated at Washington, D.C. this ____ day of ____, 2006.

Federal Deposit Insurance Corporation.

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Robert E. Feldman,
Executive Secretary.