Table 1.1

Percentage Change in Income
Under the Rate Schedule Adopted in this Rule
(All FDIC-Insured Institutions, $Millions)

Percentage Change	Number	Percent	Assets	Percent
Below -50%	61	0.7	$8,108	0.1
-25% to -50%	86	1.0	29,587	0.3
-15% to -25%	125	1.4	24,119	0.2
-10% to -15%	228	2.6	63,876	0.6
-5% to -10%	1,091	12.4	384,871	3.3
0% to -5%	6,696	76.3	10,958,217	95.1
Missing	491	5.6	54,468	0.5

Notes:
(1) Income refers to income before taxes and extraordinary items, gross of loan loss provisions.
(2) The effects do not take into account the availability of one-time assessment credits in order to determine the effect on income once credits have been used up.
(3) Most banks with results categorized as "Missing" already have negative pre-tax income The percentage change cannot therefore be calculated.
(4) Insured branches of foreign banks were not included in the analysis.

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FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 327

RIN 3064–AD02

Deposit Insurance Assessments—Designated Reserve Ratio

AGENCY: Federal Deposit Insurance Corporation.

ACTION: Final rule.

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. In this rulemaking, the FDIC establishes the DRR for the DIF at 1.25 percent.

DATES: *Effective Date:* January 1, 2007.

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, NW., Washington, DC 20429.

SUPPLEMENTARY INFORMATION:

I. Background

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.[2] 12 U.S.C. 1817(b)(3)(A), (B). 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.[3]

In setting the DRR for any year, section 2105(a) of the Reform Act, 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.[4] The

[1] Section 2104 of the Reform Act, Public Law 109–171, 120 Stat. 9.

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

[3] Thereafter, any change to the DRR must be made by regulation after notice and opportunity for comment. Section 2105 of the Reform Act, to be codified at 12 U.S.C. 1817(b)(3)(A) (ii).

[4] 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—

(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

Continued

DRR may not exceed 1.50 percent nor be less than 1.15 percent.[5]

II. The Final Rule

Statutory Analysis

In July 2006, the FDIC published a proposed rule that would set the DRR at 1.25 percent. In its proposal, the FDIC analyzed the statutory factors that must be considered in setting the DRR. The FDIC also identified three ''other factors'' that it considered.

1. Risk of Losses to the DIF

In the proposal, the FDIC's best estimate of potential loss provisions for 2006 related to future failures was $93 million. 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. 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.

So far this year no banks have failed. In addition, loss provisions anticipated for next year are expected to remain low. These estimates suggest that near-term losses to the insurance fund would not significantly alter the reserve ratio.

2. Economic Conditions Affecting FDIC-Insured Institutions

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

The condition of the banking industry remains strong. Earnings have set records each of the last five years, capital measures are still near historically high levels, and asset quality indicators remain solid. For the first half of 2006, the industry's annualized return on assets (ROA) remained high at 1.34 percent. The aggregate equity-to-asset ratio was 10.27 percent as of June 30, 2006, and more than 99 percent of all insured institutions met or exceeded the requirements of the highest regulatory capital standards. The ratio of noncurrent loans to total loans is its lowest since institutions began reporting that data 23 years ago. No insured institutions have failed in over two years, extending the longest period without a failure since the creation of the FDIC in 1933. Therefore, banks and thrifts generally appear to be well positioned to withstand the financial stress that may arise from potential economic shocks in the next few years.

3. Prevent Sharp Swings in Assessment Rates

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

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

4. Other Factors

The FDIC's Board also considered certain ''other factors'' in its decision to propose setting the DRR at 1.25 percent.

a. *Transition to a new aassessment system.* The FDIC noted that 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, 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.

b. *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 time frame, these provisions in effect establish a normal operating range for the reserve ratio of 1.15 percent to 1.35 percent within which the Board has considerable discretion to manage the size of the insurance fund. The FDIC noted that the current DRR of 1.25 percent is the midpoint of the normal operating range.

c. *Historical experience.* The FDIC also observed that 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 and concluded that more experience with managing the fund under the new framework established by the Reform Act will be of benefit in

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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)).

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

determining whether the DRR should be raised or lowered from 1.25 percent.

5. Role of the DRR

The FDIC also noted that 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 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.

III. Comments on the Proposed Rule

The FDIC received 16 comments directly addressed to the proposed rule for setting the DRR.[6] These comments generally fell into several main groups: the DRR should be set at the low end of the range; the DRR should be raised gradually over time; the reserve ratio should be raised gradually; the DRR should not be set at the minimum of the range; the DRR should be a rough guide to the DIF reserve ratio; and further economic rationale should be provided for setting the DRR at 1.25.

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

- Greater risk in the banking industry;
- Strong insured deposit growth;
- Inadequacy of a 1.25 percent DRR as evidenced by the FDIC fund falling from 1.24 percent in 1981 to a negative number in 1991; and
- The number of times the reserve ratio has been above 1.50 percent during the FDIC's history.

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

- A lower ratio would provide the industry with time to recapitalize the fund without facing sharp swings in assessment rates, particularly for those institutions which will not have credits;
- The FDIC is unrealistic in its optimism about the economy, and Congress expected the FDIC to set the DRR at the lower end of the range when institutions generally would face difficulty making payments, such as in difficult economic times, while setting the DRR higher when the economy was good and payments could be made more easily;
- The banking industry is financially healthy;
- The risk of fund losses is low, at least in part due to prompt corrective action requirements and other new supervisory and enforcement tools that enhance safety and soundness;
- Congress intended for the FDIC to determine an appropriate level for the DRR annually, rather than allowing the reserve ratio to meet the DRR over a period of a few years;
- The number of bank failures has been low;
- hardship on new growth institutions would be lessened; and
- The risk to the industry is lower now than in 1991 when Congress set the DRR at 1.25.

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

- Starting with a DRR of 1.20 percent and phasing in an increase to 1.25 percent over a five-year period; and
- Allowing an initial drift toward 1.15 percent, with a phased-in move to 1.25 percent over time.

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

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

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

- Is a very rough guide to a long-run equilibrium for the reserve ratio, and not a primary driver of premiums in the short-run;
- Should be analyzed each year to determine whether it is reasonable given the actual risk of loss to the DIF;
- Should not be viewed as requiring the imposition of higher assessments, but rather the FDIC should consider economic factors and the condition of the banking industry generally to determine whether to lower the DRR or whether it will be restored through deposit base changes, growth in investment earnings, low levels of expected failures, and similar factors.

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

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

IV. The Final Rule

The FDIC believes that the statutory analysis conducted in the proposed rulemaking is correct. Based upon that analysis, and for the reasons that follow, the FDIC has determined to set the DRR at 1.25 percent.[7]

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

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

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

How the FDIC will use the DRR may change over time. The FDIC views the role of the DRR as a signal of the level that the DIF should achieve; however,

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

[7] The final rule adds paragraph (g) of 327.4 (Subpart A) to the revised part 327 as set forth in the final rule on Operational Changes to Assessments (RIN 3064–AD03) published elsewhere in this issue of the **Federal Register**.

the FDIC does not expect the DIF to reach this level within the first year of the new system. As required by the Reform Act, the FDIC will determine the appropriate DRR annually. Section 2105 of the Reform Act, to be codified at 12 U.S.C. 1817(b)(3)(A).

V. Effective Date

The final rule setting the DRR at 1.25 percent will become effective on January 1, 2007.

VI. 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.

VII. Regulatory Flexibility Act

Pursuant to 5 U.S.C. 605(b), the FDIC certifies that the final rule will 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 (RFA) (5 U.S.C. 601, *et seq.*). The final rule sets the Designated Reserve Ratio (DRR) at 1.25 percent, 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 percent will not have a significant economic impact on a substantial number of small insured institutions. No comments were received concerning the proposal's RFA certification.

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

The FDIC has determined that the final 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 (Pub. L. 105–277, 112 Stat. 2681).

IX. Small Business Regulatory Enforcement Fairness Act

The Office of Management and Budget has determined that the final rule is not a ''major rule'' within the meaning of the relevant sections of the Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA) (5 U.S.C. 801, *et seq.*). As required by SBFERA, the FDIC will file the appropriate reports with Congress and the General Accounting Office so that the final rule may be reviewed.

List of Subjects in 12 CFR Part 327

Bank deposit insurance, Banks, banking, Savings associations.

■ For the reasons stated above, the Board of Directors of the Federal Deposit Insurance Corporation hereby amends part 327 of Title 12 of the Code of Federal Regulations as follows:

PART 327—ASSESSMENTS

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

Authority: 12 U.S.C. 1441, 1813, 1815, 1817–1819, 1821; Sec. 2101–2109, Pub. L. 109–171, 120 Stat. 9–21, and Sec. 3, Pub. L. 109–173, 119 Stat. 3605.

Subpart A—In General

■ 2. In § 327.4 of subpart A, add paragraph (g) to read as follows:

§ 327.4 Assessment rates.

* * * * *

(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, DC this 2nd day of November 2006.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.

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