

FDIC Proposed DIF Restoration Plan and New Risk-Based Assessment Rules

Introduction

The FDIC has published a Notice of Proposed Rulemaking and Request for Comments on a Deposit Insurance Fund (DIF) Restoration Plan and new Risk-Based Assessment rules. Comments are due to the FDIC by November 17, 2008.

DIF Restoration Plan

As of June 30, 2008, the ratio of funds in the DIF to insured deposits (reserve ratio) fell to 1.01 percent. The dip in the reserve ratio is due in large part to the size of actual and projected losses in the DIF for 2008 because of bank failures. It is estimated that the DIF will incur \$13 billion in losses due to bank failures this year – with the failure of the \$30 billion Indy Mac Bank alone costing the DIF \$9 billion in losses. FDIC currently projects another \$27 billion in losses through 2013 for total projected losses of \$40 billion from 2008-2013. FDIC predicts that the reserve ratio will decline further through early 2009 to reach a low of between 0.65 to 0.70 percent.

When the reserve ratio of the DIF dips below 1.15 percent, the law requires the FDIC to adopt a DIF restoration plan that results in at least a 1.15 percent reserve ratio within 5 years. The FDIC is proposing a DIF restoration plan that maintains a target designated reserve ratio of 1.25 percent and that results in a 1.26 percent reserve ratio by the end of the 5-year plan. The FDIC has chosen to create a plan that reaches a 1.26 percent reserve ratio instead of a 1.15 percent reserve ratio as a hedge against greater losses due to bank failures. The plan includes increases in deposit insurance premiums and the manner in which the premiums are assessed, as detailed further below.

The FDIC has the authority to extend beyond five years the time in which to restore the DIF. The FDIC can extend the time “due to extraordinary circumstances.” The FDIC has made a “systemic risk” finding twice since the beginning of September to approve the acquisition of Wachovia and to implement the temporary liquidity guarantee program. It is arguable that the FDIC should delay the time for DIF restoration based on the same economic facts that led the FDIC Board to invoke systemic risk twice.

Proposed Assessment Rate Increase

Current Rates

FDIC insured institutions are placed in four risk categories based on a combination of capital levels and three supervisory ratings created for the assessment regulation. Most FDIC insured institutions fall within the lowest risk group, Category I, which contains well-capitalized banks with only a few minor weaknesses. Category I banks are further stratified for purposes of assigning an assessment rate within the range of rates for Category I banks. The FDIC employs a financial ratio method for small institution and

debt issuer method for large institutions (assets of at least \$10 billion) to place banks along this continuum.

Currently, banks in Risk Category I pay an annualized rate of between 5 and 7 basis points. That means that Category I institutions that pose the least risk pay 5 basis points and those that pose the greatest risk within the favored Category I pay 7 basis points. Risk Category II banks pay 10 basis points. Category III banks pay 25 basis points, and Category IV banks pay 40 basis points. The assessment base is all domestic deposits in a bank.

Proposed Rates

The FDIC proposes two different increases. The first will be a temporary rate effective for the first quarter of 2009 only based on the current assessment system, including the current formulations used to distinguish among Category I banks. Category I banks would pay between 12 to 14 basis points; II's would pay 17 basis points; III's would pay 35 basis points; and IV's would pay 50 basis points. These rates would be applied to domestic deposit balances as of March 31, 2009, and the assessments would be due by June 30, 2009.

The second increase, effective for the second quarter of 2009 and going forward, would include changes to the factors/financial ratios used to distinguish among Category I banks. The proposal also calls for base rates between 10 and 14 basis points for Category I banks. The base rate of a bank can be lowered, if a large institution has a certain amount of unsecured liabilities, and in the case of a small institution, if the bank has a certain level of Tier I capital (above 10 percent) and unsecured liabilities. However, the proposal also provides for an upward adjustment, or surcharge, for secured liabilities (including Federal Home Loan Bank Advances) above a threshold amount. A brokered deposit formula will also be added to the factors that determine a bank's rate between 10 and 14 basis points within Risk Category I. When downward and upward adjustments are included, the range of assessment rates for Category I banks is 8 -21 basis points; for Category II: 18-40 bps; for Category III: 28-55 bps; for Category IV: 43-77.5 bps.

Changes to Assessment Formula for Risk Category I Banks

Brokered Deposits

For Category I banks, the proposal would adjust the financial ratio method of determining an institution's place within the Category I risk continuum by adding an additional sixth financial measure tied to the ratio of brokered deposits to domestic deposits and rapid asset growth.

The brokered deposit ratio would only affect premiums for an institution that has brokered deposits in amount greater than 10% of the bank's domestic deposits **and** that has had aggregate asset growth equal to or greater than 20% over the last four years. FDIC is proposing to add this factor because it asserts that a number of costly failures involved institutions with high rates of brokered deposits and rapid asset growth. The

brokered deposit ratio would be used in combination with the other five financial ratio factors and the CAMELS supervisory factor to assess a Category I institution a base rate between 10 and 14 basis points.

For Category II, III and IV institutions with 10% or more brokered deposits, regardless of asset growth, the FDIC would impose an upward adjustment or surcharge to their base premiums. The highest surcharge would be 10 basis points. [describe how the surcharge is calculated]

The proposal uses the statutory definition of brokered deposits, which would include sweep accounts and deposits received through a network on a reciprocal basis (e.g., reciprocal CDARs). The FDIC seeks comments on whether these two types of deposits should be included in the definition of brokered deposits for purposes of determining this proposed brokered deposit ratio. The FDIC also seeks comments on whether high cost deposits received through a listing service or the Internet should be added to the definition of brokered deposits. These deposits are not included within the statutory definition.

Large Institution Changes

The FDIC proposes to add the financial ratio method as a third factor to the risk assessment method used for banks over \$10 billion that that issue debt rated by credit rating agencies. The current method for these banks consists of two parts: a CAMELS component rating and debt-agency rating. The proposal calls for a new large bank method, which would consist of three equally weighted parts: CAMELS rating, the debt-agency rating and the financial ratios. The FDIC has found using the current method without a financial ratio component results in assessment rates for larger institutions “that have not responded in a timely manner” to deteriorations in these institutions’ financial conditions.

Currently, the FDIC assessment regulation permits the FDIC to adjust the assessment rate of a large institution either way by one-half basis point without notice. The proposed rule would permit the FDIC to make a one basis point adjustment either way. These types of adjustments do not result in an assessment higher than the maximum rate for Category I banks nor lower than the lowest rate for Category I banks. The FDIC uses the large bank adjustment to ensure fairness among large banks and to take into account all available information to assess the bank’s risk.

Downward Adjustment of Base Rate for Unsecured Liabilities and High Tier 1 Capital

The FDIC proposes to lower an institution’s base assessment rate using its ratio of long-term unsecured debt (and for small institutions, certain amounts of Tier 1 capital) to domestic deposits. Any adjustment would be limited to two basis points. The adjustment is available to institutions in all risk categories. Both unsecured debt and high capital levels reduce the bank’s risk to the FDIC.

For these purposes, long-term debt means debt with at least one year remaining on its maturity. The term would include senior unsecured debt, subordinated debt and the unsecured portion of secured debt.

For a large institution, the unsecured debt adjustment would be determined by multiplying the institution's long-term unsecured debt as a percentage of domestic deposits by 20 basis points. Thus, a large institution with a ratio of long-term unsecured debt to domestic deposits of 10 percent or greater would receive the maximum downward adjustment of 2 basis points (10% of 20 basis points).

For a small institution, the unsecured debt adjustment would factor in a certain amount of Tier 1 capital in addition to long-term unsecured debt. The amount of qualified Tier 1 capital would be the sum of one-half the amount between 10 percent and 15 percent of adjusted average assets (between 2 and 3 times the minimum Tier 1 leverage ratio requirement to be a well-capitalized institution) and the full amount of Tier 1 capital exceeding 15 percent of adjusted average assets (above 3 times the Tier 1 minimum leverage ratio requirement to be a well-capitalized institution). The sum of qualified Tier 1 capital and long-term unsecured debt as a percentage of domestic deposits would be multiplied by 20 basis points to produce the unsecured debt adjustment (maximum 2 basis points).

Surcharge for Secured Liabilities

The FDIC also proposes an upward adjustment of the base rate (or surcharge) based on an institution's ratio of secured liabilities to domestic deposits. The surcharge would be assessed with respect to institutions in all risk categories. For purposes of this surcharge, secured liabilities include Federal Home Loan Bank advances, securities sold under repurchase agreements, secured Federal funds purchased and other secured borrowings.

A ratio of secured liabilities to domestic deposits in excess of 15 percent would result in an upward adjustment. For an institution that had a ratio of secured liabilities to domestic deposits greater than 15 percent, the secured liability adjustment or surcharge would be calculated by multiplying the institution's base assessment rate by the secured-liabilities-to-domestic-deposits ratio less the 15% threshold. So for example, for an institution which has a secured liabilities-to-domestic-deposits ratio of 25 percent and an initial base assessment rate of 10 basis points, the surcharge would be one basis point, calculated as $10 \text{ bp} \times (0.25 - 0.15)$ or $10 \text{ bp} \times .10$. The adjustment could be no more than 50% greater than the initial base rate, determined after any large institution adjustment and any unsecured debt adjustment. Thus, the maximum surcharge for a Category I bank is 7 basis points (50% of 14).

The FDIC asserts that under current rules, which do not assess a surcharge for secured liabilities, substituting secured liabilities for unsecured liabilities (including subordinated debt) raises the FDIC's loss in the event of failure without providing increased

assessment revenue. Substituting secured liabilities for deposits can also lower an institution's franchise value in the event of failure, which increases the FDIC's losses as it seeks to sell the bank and its deposits, all else equal. The FDIC cites the Indy Mac Bank's heavy reliance on FHLB advances as evidence of how advances can increase resolution costs in the event of bank failure. The FDIC asserts that because of the FHLBank of San Francisco's superior lien on Indy Mac's best assets, the resolution costs for Indy Mac increased from \$4 billion to \$9 billion.

Others argue that FHLBank advances are a critical and stable source of liquidity. They argue that since liquidity risk is the most significant challenge facing the banking industry at this time, FHLBank advances that do not increase institution risk should be treated differently than other secured liabilities.

Assessment Credits

Institutions with assessment credits because of pre-1996 assessments will be allowed to use the credits to offset assessment liabilities. The FDIC could have restricted the use of the assessment credits because the DIF has dipped below a 1.15 percent reserve ratio. As a practical matter, the vast majority of credits have already been used up.

Impact of New Assessments on the Banking Industry

The FDIC estimates that the average assessment rate will rise to 13.5 basis points beginning in April 2009 and 12.6 basis points beginning in 2010 and thereafter. Before accounting for the pre-1996 assessment credits, the current average assessment rate is 6.3 basis points. The FDIC estimates that if a flat increase were adopted without the adjustments and surcharges, the current rates (5 to 7 bp for Category 1) would have to be increased uniformly by 7.6 basis points in order to produce the same amount of assessment income. The FDIC estimates that under the system it proposes to use for the second quarter of 2009 forward, 85 percent of the institutions, with 74 percent of domestic deposits, would pay a lower rate than if the FDIC increased rates a uniform 7.6 basis points.

We estimate that about 25% of community banks would be subject to some upward adjustment of their base assessment rate due to the secured liability surcharge. We estimate a similar percentage for the entire banking industry. [how did we get this estimate?]

FDIC Assessment Calculator

To determine the impact of the new assessment rate on your institution, please use FDIC's rate calculator.

Here is a link to the FDIC rate calculator:

<http://www.fdic.gov/deposit/insurance/initiative/index.html>

Table of Proposed Assessment Rates Beginning in 2nd Quarter 2009

	Risk Category I	Risk Category II	Risk Category III	Risk Category IV
Initial base assessment rate	10 – 14	20	30	45
Unsecured debt adjustment	-2 – 0	-2 – 0	-2 – 0	-2 – 0
Secured liability adjustment	0 – 7	0 – 10	0 – 15	0 – 22.5
Brokered deposit adjustment		0 – 10	0 – 10	0 – 10
Total base assessment rate	8 – 21.0	18 – 40.0	28 – 55.0	43 – 77.5