November 23, 2005

MEMORANDUM TO: The Board of Directors

FROM: Mitchell L. Glassman, Director
Division of Resolutions and Receiverships

William F. Kroener, III
General Counsel

SUBJECT: Advance Notice of Proposed Rulemaking ("ANPR") on Large-Bank Deposit Insurance Determination Modernization Proposal

RECOMMENDATION

We recommend that the Board of Directors approve the attached ANPR and authorize its publication in the *Federal Register*. The ANPR seeks public comment for a period of ninety days on the best means to facilitate the process for determining the insurance status of depositors of large insured depository institutions in the event of failure. This group of institutions currently is proposed to include only the 145 insured institutions with total number of deposit accounts over 250,000 *and* total domestic deposits of at least $2 billion ("Covered institutions").

BACKGROUND

Claims Modernization Initiative

The FDIC is exploring new methods to modernize its insurance determination process to ensure that the failure of any insured depository institutions in the country can be managed to minimize disruption to depositors and communities and maximize recoveries for the deposit insurance fund. The ability of the FDIC to determine the insured status of deposit accounts rapidly is essential for it to handle failures in the most cost effective and least disruptive fashion.

The current modernization initiative was prompted by the growth of Covered institutions. Consolidation in the banking industry is causing the FDIC to explore new methods to modernize how it identifies insured deposits in the event of the failure of a Covered institution. While the industry is very strong today and no serious problems are believed to be on the horizon, now is the appropriate time to start preparing so the FDIC can be ready if problems do eventually arise.

The claims modernization initiative has several components. First, streamline the business processes of the FDIC's internal system used to facilitate a deposit insurance determination. This effort will incorporate better technology to enhance automation. This work is well under way. Under the current plan, the completion of the modernization of the FDIC's internal systems will coincide with the implementation of one or more of the options proposed in the ANPR, or alternatives to these options.

Historically the FDIC has taken responsibility for making an insurance determination at the time of failure based on the failed institution's records. A precise deposit insurance determination requires a specialty system to analyze depositor data and apply the insurance rules. Under current law, an insured depository institution is not required to calculate the amount of funds exceeding the $100,000 insurance limit. The options proposed in the ANPR reflect the belief that the business model whereby the FDIC takes virtually complete responsibility for an insurance determination may no longer be appropriate for Covered institutions.

Today, the FDIC obtains depositor data only from insured institutions in danger of failing. As part of its normal practice it may receive depositor data in the weeks or months prior to failure. These data are obtained for the sole purpose of determining the insurance status of individual depositors and estimating the total amount of insured funds in the institution. The receipt of such depositor data is necessary for the FDIC to carry out its insurance function. The options provided in this ANPR would not alter the FDIC's policy regarding the receipt of depositor information in preparation for the resolution of a troubled insured institution, but they would ensure the immediate availability of important data for the largest institutions, which is especially important if there is a very rapid closing of one of these institutions.

<u>Complexity of Covered Institutions</u>

As part of this project, FDIC staff last year visited four insured institutions whose total assets ranged in size from $25 billion to $250 billion. The purpose of these meetings was to better understand deposit operations of large institutions and solicit ideas for improving the FDIC's claims process. Larger institutions, especially those initiating recent merger activity, are considerably more complex, have more deposit accounts, greater geographic dispersion, more diversity of systems and possible legacy merger issues. These visits confirmed the complexity of the deposit systems at these institutions and underscored the need to avoid interrupting deposit operations in the event of failure. In most instances it is likely that the most cost effective resolution of a large institution will involve placing the institution into a bridge bank. A bridge bank could not succeed if the FDIC shut down the deposit operations of the failed institution pending the results of a deposit insurance determination.

Further, for planning purposes, it is not appropriate to assume a Covered institution will be closed on a Friday. History indicates the largest institutions for which the FDIC provided assistance collapsed in the middle of the week. A non-Friday closure of a Covered institution means that, to successfully operate a bridge bank, the deposit operations of the failed bank must be continued the next day. To accommodate this tight schedule, changes in how the FDIC has dealt with deposit insurance determinations will be required.

THE ANPR

The ANPR seeks comment on the best way to improve the deposit insurance determination process. The ANPR presents three options for comment.

- Option 1 would require Covered institutions to have installed on their computer systems a routine that, in the event of failure, would automatically place a temporary hold on a portion of the balances in large deposit accounts. The percentage hold amount would be determined by the FDIC at the time of failure, depending mainly on estimated losses to uninsured depositors. These holds would be placed immediately prior to the institution reopening for business as a bridge bank, generally expected to be the next business day. The institution also would need to be able to automatically remove these holds and debit the account, if necessary, depending on the results of the FDIC's insurance determination. The insurance determination would be facilitated by the institution providing the FDIC, in the event of failure, with depositor data (name, address, tax identification number, etc.) in a standard format, including a unique identifier for each depositor and the insurance category of each account.

- Option 2 is similar to Option 1, except the standard data set would include only information the institution currently possesses. This option would not require a unique identity for each depositor or that the institution supply the insurance category for each account.

- Option 3 would require that, in addition to Option 1 or Option 2, the largest 10 or 20 Covered institutions (in terms of the number of deposit accounts) know the insurance status of their depositors at any given point in time and have the capability to automate the placement of hard holds and debit uninsured funds as specified by the FDIC upon failure.

The options outlined here cannot be implemented without some regulatory and financial burden. The options seek to minimize these costs while at the same time ensuring we can effectively carry out the FDIC's mandates to make insured funds available quickly to depositors and provide a least-cost resolution for Covered institutions. We are seeking comment on the potential industry costs and feasibility of implementing the options listed in the ANPR. We also are interested in comments on whether there are other ways to accomplish these goals that might be more effective or less costly or burdensome. In other words, what approach or combination of approaches (which may include new alternatives) most effectively meets this cost/benefit tradeoff?

Implementation of these or similar options will require that the FDIC amend its regulations. If that is the case, the FDIC will be required to publish a Notice of Proposed

Rulemaking and afford the opportunity for additional public comment before a final decision is made.

COST MITIGATING FACTORS

A large majority of Covered institutions either purchase deposit software from or have their deposit operations serviced by four large vendors. FDIC staff visited these vendors to discuss the options outlined in the ANPR. All of the vendors expressed a strong preference for Option 2—the provisional hold capability along with the standard data set that did not include new data. Options 1 and 3 were considered to be considerably more expensive and difficult to implement.

The substantial concentration of the deposit software/servicing business should help mitigate potential implementation costs. We would expect a deposit servicer to be able to incorporate the provisional hold and standard data set features into its internal software and have this functionality apply to all institutions it services. A vendor that licenses its software to insured institutions would make changes to its basic software so the functionality can be included in a future update, although each Covered institution also would incur additional implementation costs. In many cases it is the software vendor's responsibility to ensure its system complies with applicable regulations. When these contractual arrangements apply it is the software vendor that must bear the expense of the proposed changes, although costs could be passed on to its customers via future service price changes. Some Covered institutions use proprietary software or have contacts with software vendors not providing for regulatory compliance. These institutions may need to craft individual solutions for meeting the proposed requirements or purchase the solution from its software vendor.

Based on our vendor interviews FDIC staff received insights into the potential costs of Option 2. As a consequence, we believe the costs involved in implementing Option 2 will be modest. The ANPR specifically asks about implementation costs of all options, so more cost data should be forthcoming if the decision is made to publish the request for comment.

Staff contacts: James Marino (x87151)
Christopher Hencke (x88839)

Attachment

RESOLUTION

WHEREAS, in view of the significant industry consolidation in recent years, the Federal Deposit Insurance Corporation ("FDIC") is exploring new methods to modernize its deposit insurance determination process.

WHEREAS, this modernization effort is part of on-going refinement of the FDIC's mission to minimize disruption to depositors and communities, and maximize recoveries for the deposit insurance fund in the event one of the largest insured institutions should fail.

WHEREAS, the Board of Directors ("Board") of the FDIC believes the appropriate next step in considering new methods to modernize the deposit insurance determination process is to obtain public comment on possible rulemaking options.

NOW, THEREFORE, BE IT RESOLVED, that the Board hereby authorizes the publication of the attached Advance Notice of Proposed Rulemaking in the *Federal Register* for a comment period of ninety days.

BE IT FURTHER RESOLVED, that the Board hereby directs the Executive Secretary, or his designee, to cause the attached document to be published in the *Federal Register* in a form and manner satisfactory to the General Counsel, or his designee, and the Executive Secretary, or his designee.

BE IT FURTHER RESOLVED, that the Board hereby authorizes the Executive Secretary or his designee, and the General Counsel, or his designee, to make such technical, non-substantive changes to the text of the *Federal Register* notice document, and to take such other actions and issue such other documents incident and related to the foregoing as they deem necessary or appropriate to fulfill the Board's objectives in connection with the matter.