

Economic Conditions and Emerging Risks in Banking
A Report to the FDIC Board of Directors
November 1, 2005

Background

This report provides a summary view of emerging risks in the banking and thrift industries. It is intended to serve as background for the Board’s consideration of the deposit insurance premium rate case that follows. The report combines the perspectives of FDIC economists, risk analysts, examiners, and case managers working through the FDIC Risk Analysis Center. A previous version of this report was presented to the FDIC National Risk Committee on October 25.

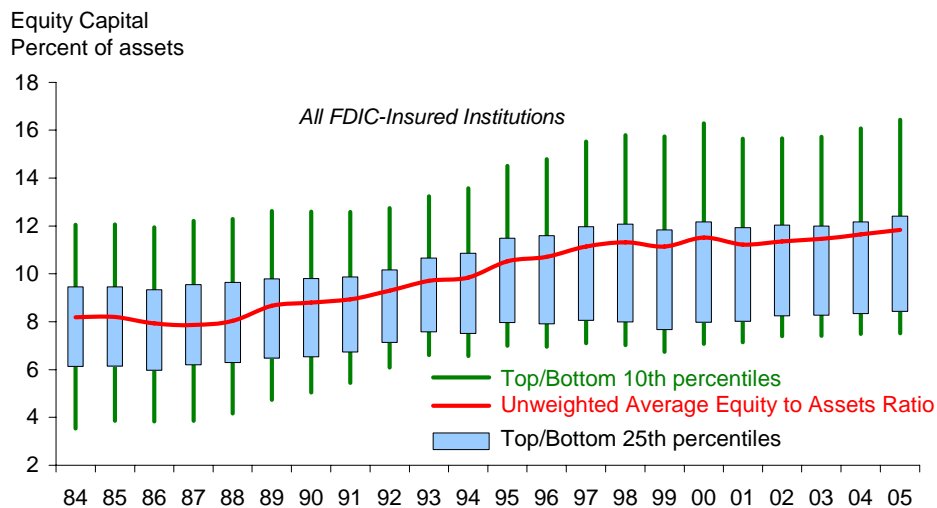
Performance of the U.S. Economy and Banking Industry Remains Strong

The four-year U.S. economic expansion continues to support strong loan performance and mortgage-led loan growth at FDIC-insured institutions. Banks have reported four consecutive years of record earnings, and have recently enjoyed earnings growth derived from securities gains, reduced loan loss provision expenses, and improved overhead efficiency. Continued strength in credit quality appears likely to translate into record industry earnings again in 2005 despite weakness in net interest margins (NIMs) related to a flattening yield curve.

Overall, the industry remains healthy, with strong credit quality, stable earnings and capital ratios at historic highs (Chart 1). The number of banks on the Problem Financial Institution List also remains low. As of October 1, 2005, there were 67 institutions on the list with \$7.86 billion in assets. There have been no bank or thrift failures since June 25, 2004.

Chart 1

Strong banking industry capital offers a buffer against future increases in credit losses.



Source: FDIC 2005 data point as of June 30

Despite this robust financial performance, FDIC analysts and examiners continue to monitor economic conditions and emerging risks in banking that could lead to deteriorating financial performance in future quarters.

Recent Hurricanes Pose Challenges for Banks and Economy

The most immediate identifiable sources of concern at this time are the intermediate-term effects of Hurricanes Rita and, especially, Katrina. The large-scale destruction of property and business activity in the Gulf Coast region, along with the displacement of hundreds of thousands of people, have created stresses for some local financial institutions.

Table 1

Bank headquarters and branches are located throughout the designated Katrina disaster zone.

Number of Offices as of June 30, 2005 in FEMA-Designated Counties

"Red" Counties and Parishes*	Main Offices	Branches	Total Offices	Office Deposits (\$000)
Alabama (3 Counties)	9	173	182	8,480,851
Louisiana (30 Parishes)	92	919	1,011	42,453,378
Mississippi (15 Counties)	19	193	212	6,683,617
Total 48 Counties and Parishes	120	1,285	1,405	57,617,846
"Yellow" Counties and Parishes*				
Alabama (3 Counties)	3	23	26	759,353
Louisiana (34 Parishes)	70	491	561	15,752,837
Mississippi (37 Counties)	43	513	556	18,099,504
Total 78 Counties and Parishes	116	1,027	1,143	34,611,694
Total 122 "Red" and "Yellow" Counties and Parishes*	236	2,312	2,548	92,229,540

* "Red" counties and parishes are those initially designated by FEMA as eligible for both public and individual assistance. "Yellow" counties and parishes are those initially designated as eligible for public assistance only.

Sources: Federal Emergency Management Agency (FEMA), FDIC Call/Thrift Financial Reports, Summary of Deposits Survey

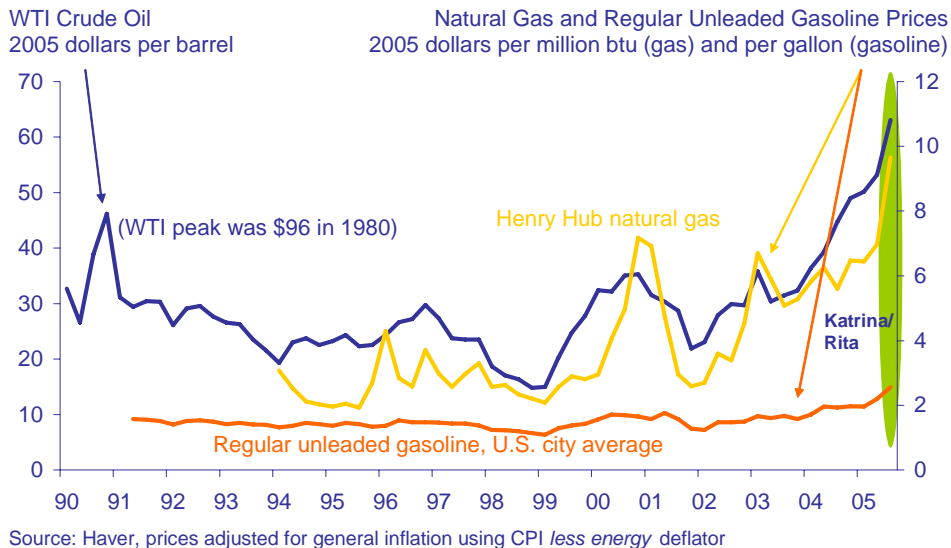
The FDIC has been working closely with other regulators and government officials to overcome the immediate operational challenges faced by the hardest hit institutions. Some institutions in areas affected by hurricanes have already reported the impact on earnings while others are still assessing their exposure. The longer term effects on credit quality and franchise value will take time to fully evaluate. FDIC Regional and Field Office personnel are in regular contact with the affected institutions as they work with their borrowers.

The hurricanes have also altered the U.S. economic outlook. Energy prices, which had already risen significantly during the first eight months of 2005, rose briefly to record levels in the immediate aftermath of the hurricanes (Chart 2). High prices for natural gas are expected to persist through much of the winter, and could adversely affect consumer spending. Higher energy prices are also contributing to the re-emergence of inflationary pressures as a policy concern, prompting market expectations that short-term interest rates will continue to rise in coming quarters. Federal spending on disaster assistance and rebuilding is expected to provide as much as \$100 billion in aid to the Gulf Coast region;

however, this spending could create pressure to reduce other federal expenditures or expand the federal budget deficit.

Chart 2

Real energy prices spiked after Katrina and Rita, and may remain elevated through the spring.



Outlook for U.S. Economy Calls for Stable—Though Moderating—Growth

While these shocks to the economic picture will continue to merit our attention, they are unfolding against a backdrop of an otherwise strong U.S. economy. Corporate profits have been somewhat higher than expected in recent quarters, while growth in jobs and disposable incomes have also been relatively strong.

Prior to the hurricanes, forecasters had been projecting that the U.S. economy would grow at a pace of about 4 percent in the second half of 2005. The expected net effect of these shocks has been that the pace of growth would slow to between 3 and 3.5 percent for the second half. However, preliminary estimates show that the economy continued to expand at a rate of 3.8 percent in the third quarter. While higher interest rates and energy prices are expected to moderate growth going into next year, rebuilding along the Gulf Coast is also expected to boost economic activity at the margin and help to maintain the pace of economic growth near its current level.

Risks to the Economic Outlook

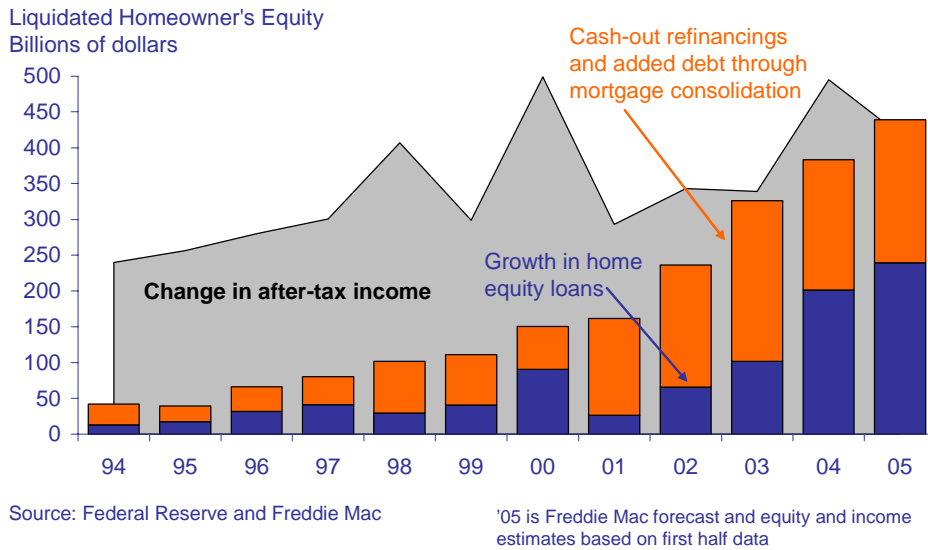
Intermediate-term risks to the economic outlook generally revolve around the boom in home prices and continued U.S. dependence on inflows of foreign capital.

Housing Boom. Home prices have risen sharply in many markets along the east and west coasts in recent years, particularly in 2004 and 2005. While the increase in housing prices has not been uniform across the nation, low interest rates and non-traditional mortgage financing vehicles have allowed more borrowers to be active in markets experiencing

rapid price increases. U.S. homeowners have taken on some \$1.7 trillion in new mortgage debt over the past two years through home purchases and by extracting equity from homes they already own. Early estimates suggest that the amount of equity extracted from U.S. homes in 2005 could actually exceed growth in disposable incomes (Chart 3).

Chart 3

Cashed-out home equity may exceed growth in disposable income this year.

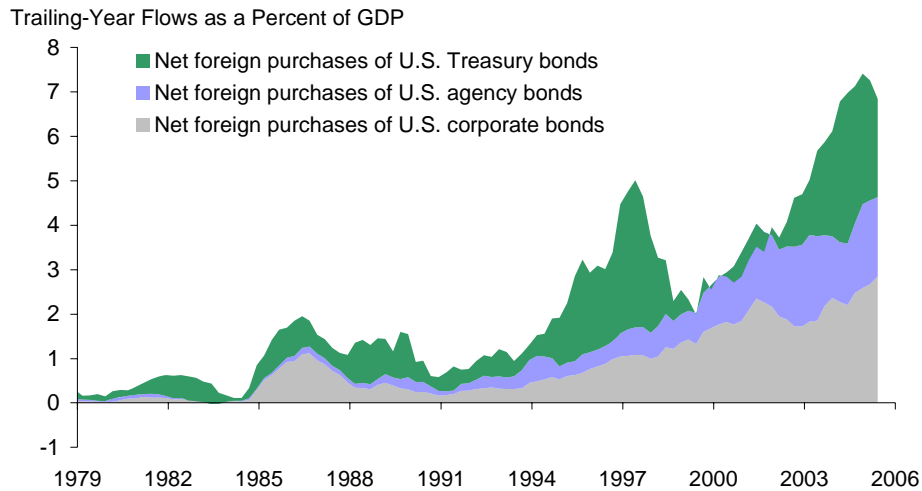


Rising interest rates and declining affordability will likely slow the pace of home price increases in current boom markets. It is not unlikely that some local markets could experience home price declines. One effect of a home price slowdown would be to limit the ability of homeowners to trade up or extract equity from their homes, thereby slowing housing market activity, mortgage lending volumes and consumer spending. Another effect could be to boost levels of problem mortgage loans from current, historically low levels.

Dependence on Foreign Sources of Capital. Increased borrowing by the U.S. household and government sectors in recent years has been facilitated by large inflows of capital from overseas investors. The U.S. current account deficit totaled \$668 billion in 2004, and appears likely to exceed that level in 2005. In one sense, the popularity of U.S. Treasury and agency securities among foreign official and private investors reflects their confidence in the ongoing stability of the U.S. economy and financial markets (Chart 4). However, the sheer volume of these global financial imbalances creates concerns that foreign investors will eventually seek to rebalance their portfolios toward non-dollar assets, thereby placing downward pressure on the dollar and upward pressure on U.S. inflation and interest rates. Given the strong and reasonably balanced growth the U.S. economy is enjoying at present, analysts continue to look to such shocks as potential sources of instability in the intermediate-term outlook.

Chart 4

Foreign investors have recently shown strong interest in U.S. bonds – Treasuries in particular.



Source: U.S. Department of the Treasury.

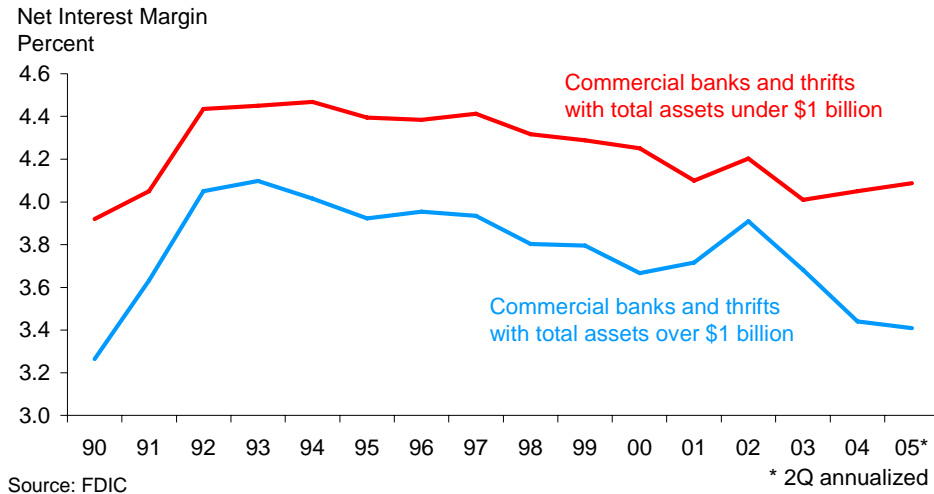
A Flattening Yield Curve Has Pressured Bank Net Interest Margins

After the U.S. economic expansion began producing consistent growth in jobs and business investment in early 2004, the Federal Reserve undertook a program of gradually raising short term interest rates. Since June 2004, the federal funds rate target has been raised 12 times, by a total of 300 basis points. However, in part because of continued strong demand for U.S. Treasury and agency debt by foreign investors, long-term U.S. interest rates have been slower to rise. The result has been a significant flattening of the Treasury yield curve. The average spread between 10-year U.S. Treasury yields and the federal funds rate has shrunk from 3.72 percent as recently as May 2004 to just 0.58 percent in September 2005.

The flattening yield curve, along with heightened competition for loans and deposits, has put downward pressure on the average net interest margin of FDIC-insured institutions. The industry’s average NIM during the second quarter of 2005 was 3.51 percent, down from 3.73 percent in the fourth quarter of 2003 and the lowest level recorded since 1990 (Chart 5). Recent earnings releases by public banking companies indicate the expectation of continued margin pressure during the third quarter of 2005 and beyond. Although larger institutions have been affected to a greater degree by the narrowing of margins, we note that their earnings are supplemented by higher levels of non-interest income and that they continue to perform very well in general.

Chart 5

Large institutions, in particular, have seen narrowing net interest margins as the yield curve has flattened.



Credit Losses Remain Low, But Competition Has Led to a Greater Appetite for Risk

Credit quality remained very strong through mid-2005, as delinquency and loss rates remain low across nearly every lending category. Noncurrent loans measured just 0.71 percent of total loans in the second quarter, the lowest level since the inception of that data series in 1984.¹ Notwithstanding this strong loan performance at present, FDIC analysts and examiners are monitoring a number of areas where there is potential for higher loan losses in future quarters.

The challenges associated with relatively slow revenue growth, intense competition among financial services providers, and historically low interest rates have led a number of banks to become more aggressive with their products in both commercial and consumer lending (Chart 6). Examiners continue to indicate that some institutions are responding to competitive pressure by lowering loan rates, loosening underwriting standards and making more frequent policy exceptions. While these trends do not necessarily indicate the presence of excessive risk exposures, they merit continued supervisory monitoring—particularly as recently-originated loans begin to season in 2006.

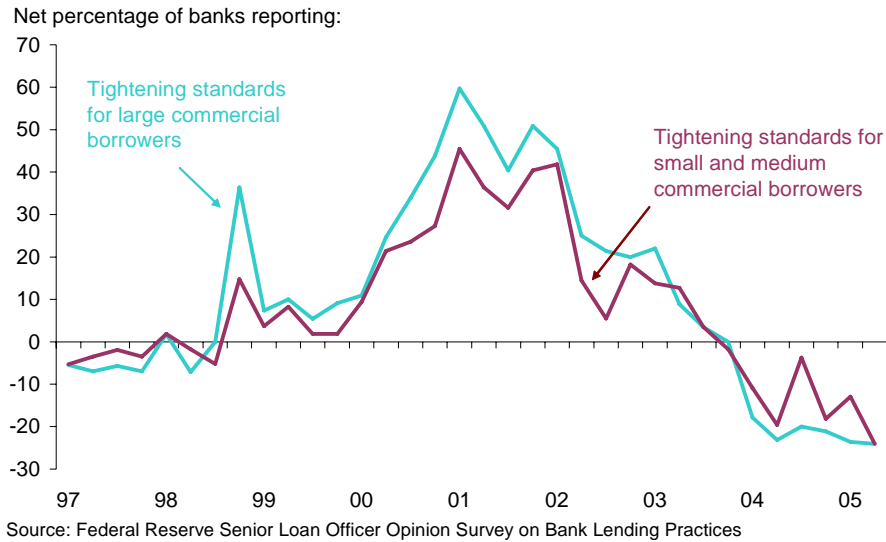
Commercial Lending. During 2001 and 2002, large banks saw the performance of their commercial loan portfolios deteriorate during a wave of corporate bankruptcies. Beginning in 2003, the performance of these portfolios improved markedly due to the economic recovery, aggressive loss recognition and loan restructuring, and a paring back of risk exposures to the corporate sector. The improvement in loan performance within

¹ Noncurrent loans include loans 90 days or more past due or in nonaccrual status.

large-bank commercial portfolios has been one of the single largest sources of earnings improvement for the industry during the last three years.

Chart 6

After an extended period of tightening, C&I lenders have begun to loosen standards in recent quarters.

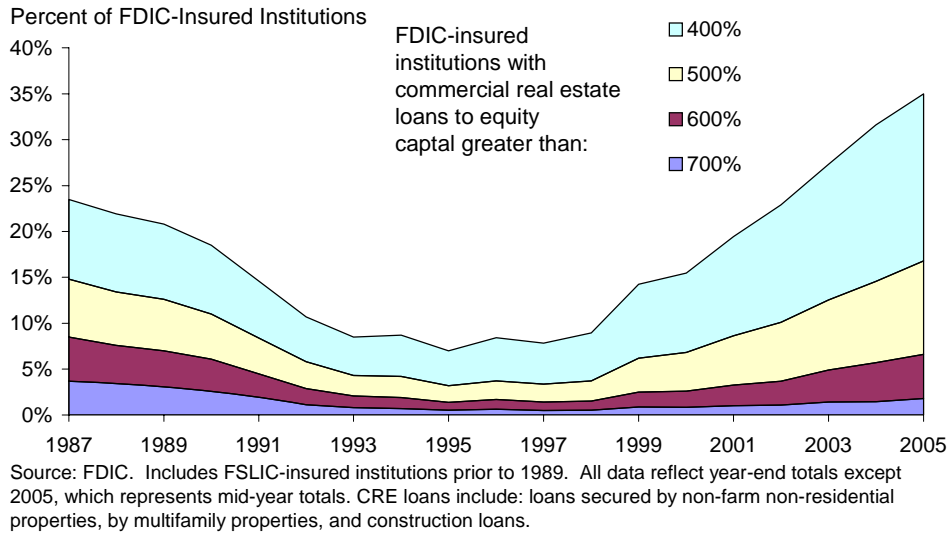


The near-term outlook for commercial credit remains neutral to positive. While we note significant credit distress in certain industries, such as autos and airlines, those weaknesses must be balanced against the high profit margins that many other sectors currently enjoy. That said, the noticeable decline in commercial loan underwriting standards in recent quarters points to the likelihood that C&I credit losses will move higher in the intermediate to long term.

Commercial Real Estate Lending. Since the beginning of this decade, FDIC analysts have pointed to a long-term rise in the number of insured institutions with high concentrations of commercial real estate loans (CRE) to equity capital (Chart 7). This trend continued through mid-2005. While the rising prevalence of such concentrations raises some credit risk concerns, we also note that risk selection and underwriting in this cycle appear to be markedly improved from the late-1980s cycle, when commercial real estate losses contributed to a number of bank and thrift failures. As in other loan categories, credit losses in commercial real estate remain at historically low levels at present. While analysts note generally improving conditions in many CRE markets, they also note that rising interest rates will increase debt service costs for borrowers and could also have an adverse effect on property valuations as market cap rates rise. These factors will warrant continued monitoring of CRE concentrations, loan performance and market conditions by FDIC analysts and examiners.

Chart 7

The prevalence of high CRE concentrations to capital now exceeds levels of the late-1980s.



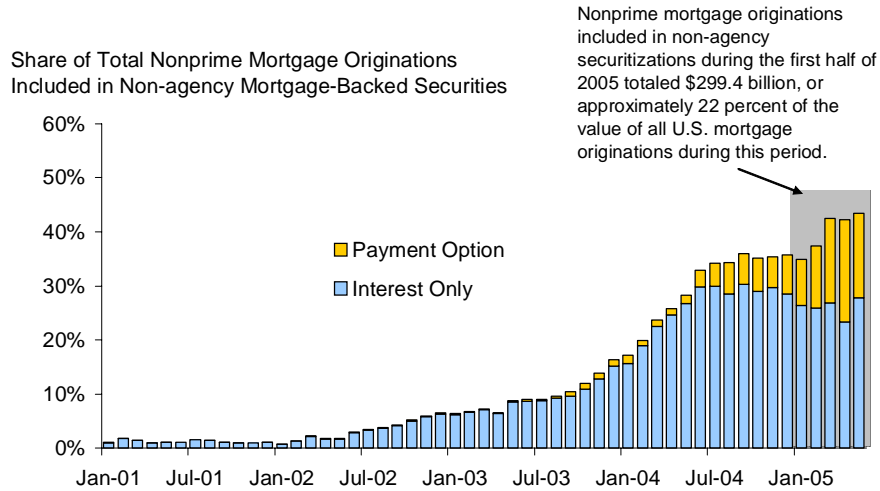
Mortgage and Consumer Lending. Despite the fact that mortgage credit losses at FDIC-insured institutions remain near historic lows at present, innovations in mortgage lending products are receiving greater attention from a risk management perspective. Analysts and examiners have noted a significant shift toward non-traditional mortgage loan products in 2004 and 2005 as lenders have sought to meet volume and revenue growth targets. Among these fast-growing loan products are subprime and low-documentation loans, interest-only loans designed to minimize monthly payments, and “payment option” mortgages that also give borrowers the option of skipping payments and adding accrued interest to their loan balances. Chart 8 depicts the rapid increase in interest-only and payment option mortgages included in private mortgage-backed securitizations, reflecting the general trend among most classes of mortgage lenders during the last two years.

While these structures have been useful in helping borrowers cope with rising home prices, they raise concerns that credit losses on poorly underwritten loans could increase significantly as interest rates rise and the home price boom eventually cools. Any such increase in mortgage loan losses is not likely to materialize until recently originated loans begin to season in 2006 and 2007. In addition, the ultimate impact of higher mortgage loan losses, should they materialize, will be mitigated to the extent that securitization has helped to spread mortgage credit risks across many diverse holders throughout the financial system.

The FDIC has been working on an interdivisional basis (through its Risk Analysis Center) and interagency basis to evaluate the risks posed by these products to individual institutions, and to provide supervisory guidance to the industry.

Chart 8

Non-traditional mortgage structures make up an increasing portion of non-prime originations.



Source: LoanPerformance

Consumer lending specialists have also experienced relatively strong loan performance and financial results in recent quarters, reflecting the effects of low interest rates and growth in disposable incomes. We note, however, that consumer lenders expect higher losses in the near-term due to an observed spike in personal bankruptcy filings that took place just ahead of the mid-October implementation of the bankruptcy reform legislation. Over the longer term, the effects of rising interest rates and energy prices could adversely affect consumer loan performance. However, as with mortgage risks, the prevalence of consumer loan securitization will help to limit the exposure of individual institutions to the possibility of higher consumer loan losses.

Financial Market View of Banking Sector is Generally Favorable

Although bank stocks have underperformed the S&P 500 thus far in 2005, price indications from the financial markets indicate a reasonably positive view towards publicly-traded FDIC-insured banks. Among the concerns cited by analysts about the sector are heightened competition, limited revenue growth, margin pressure, and reputation risk. Moreover, analysts do not expect that banks will be able to sustain strong credit quality indefinitely. The fixed income market has a positive view of the banking industry as evidenced by relatively tight spreads on bank subordinated debt and credit default swaps. The rating agencies have issued few downgrades of insured institutions so far in 2005 (Moody’s has issued only 23 downgrades of 837 banks and bank holding company issuers this year).

Other Supervisory Issues

FDIC examiners also note a number of other operational issues that continue to merit supervisory attention.

Bank Secrecy and Anti-Money Laundering (BSA/AML) Compliance. Significant industry and regulatory attention continues to focus on the industry's anti-money laundering programs. High-profile cases have intensified bankers' efforts to ensure that appropriate policies, controls, and detection processes are in place. The FDIC is working with other bank supervisors and government agencies to facilitate consistent approaches to policy development, examination coverage, training and outreach.

Settlement of Credit Derivatives Trades. Accepted market practice up to the present time has allowed the booking assignments for credit derivatives without the prior written consent of the originating counterparty. As the number of credit derivatives trades has expanded rapidly in recent years, so has the backlog of trades in which the originating counterparty has not been notified. This backlog is thought to have the potential to impair the participants' ability to manage counterparty credit risk, and could also raise concerns with the ultimate legality of the contracts. Should an increase in defaults spark a wave of credit events, this uncertainty could contribute to a heightened potential for financial instability.

The Federal Reserve Bank of New York convened a meeting on September 15th with financial services regulators from the US, UK, and Switzerland and 14 major investment and commercial banks to discuss concerns relating to the dramatic growth in unconfirmed credit derivatives trades. This meeting set in motion the development of a protocol to simplify the process of transferring trades as well as a process for measuring and reporting unconfirmed transactions.

Information Technology Risk. Insured institutions are challenged to manage operational risks associated with identity theft, even when strong GLBA 501(b) information security programs are in place. Technology incidents such as "phishing," "pharming," and Internet account-takeover indicate the need for continued electronic authentication, monitoring, and detection by financial institutions.

Reputation Risk. Large insured institutions continue to be featured in negative headlines about fraudulent transactions, consumer complaints, foreign debacles, and failure to protect customer information. These reports can be damaging to the industry's image and potentially erode confidence in insured institutions. They can also be costly to earnings and a significant diversion of management's attention.



Federal Deposit Insurance Corporation

550 17th Street NW, Washington, D.C. 20429-9990

Risk Analysis Center

November 1, 2005

TO: The Board of Directors

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

Christopher J. Spoth
Acting Director
Division of Supervision and Consumer Protection

Subject: Semiannual Report: Economic Conditions and Emerging Risks in Banking

Please find attached our semi-annual report entitled “Economic Conditions and Emerging Risks in Banking.”

This report (also referred to as the “Risk Case”) is prepared by staff two times each year, in May and November. The Risk Case is presented to the Board in conjunction with its consideration of the deposit insurance premium matrix for the ensuing six-month period (or the “Rate Case”). The purpose of the Risk Case is to provide a broad context as to economic conditions, banking industry trends, and supervisory perspectives on the condition of the industry.

It was prepared by analysts from the Division of Insurance and Research (DIR) and the Division of Supervision and Consumer Protection (DSC), working in tandem under the auspices of the FDIC Risk Analysis Center. A previous version of this report was presented to the FDIC National Risk Committee on October 25th.

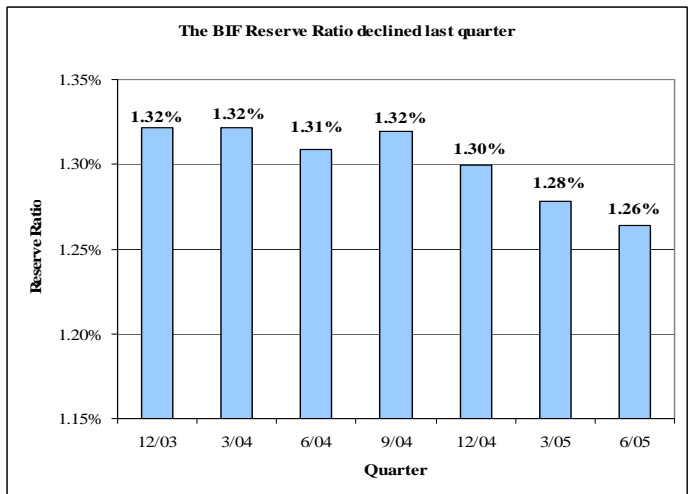
Staff will make a brief presentation highlighting these trends and then address questions before the Board considers the semi-annual Rate Case.

Attachments

Current Status of the Funds

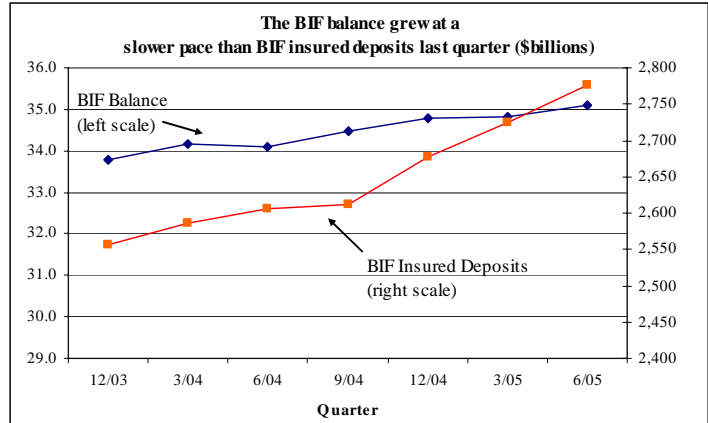
At the present time, both the Bank Insurance Fund (BIF) and Savings Association Insurance Fund (SAIF) reserve ratios are above the Designated Reserve Ratio (DRR) of 1.25 percent.

The BIF reserve ratio was 1.26 percent as of June 30, 2005, the latest date for which complete data are available. In the quarter ending September 30, 2005, the fund balance, which is the numerator of the reserve ratio, rose by \$240 million to \$35.334 billion (unaudited), from



\$35.094 billion on June 30, 2005. During the third quarter, income from interest and other sources exceeded operating expenses and provisions for insurance fund losses by \$276 million, which was partially offset by an unrealized loss on available-for-sale securities of \$36 million. The contingent liability for anticipated failures increased from \$2 million on June 30th to \$4 million on September 30th.

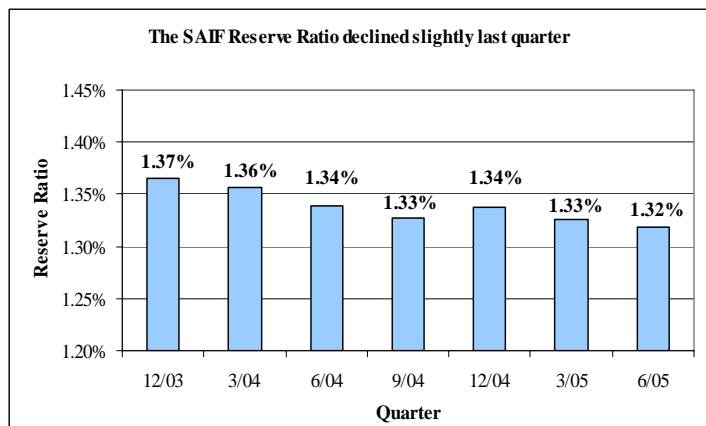
Final data on insured deposits, the denominator for the reserve ratio, are not available at this time because not all September 30, 2005 Call Reports have been filed. Staff conducted a telephone survey at the beginning of November to



determine the amount of insured deposits at some of the largest financial institutions.

This survey, combined with preliminary Call Report and Thrift Financial Report information, provide a reasonable and timely estimate of third quarter 2005 insured deposit growth. This estimate shows BIF-insured deposits rose in the quarter ending September 30, 2005 by 1.6 percent to \$2.82 trillion. This level of insured deposits results in an estimated BIF reserve ratio as of September 30, 2005 of 1.25 percent, which is a 1 bp decline from the June 2005 ratio.

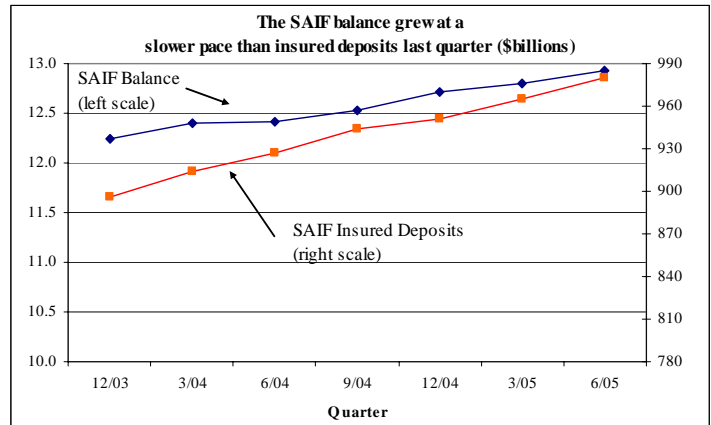
The SAIF reserve ratio was 1.32 percent as of June 30, 2005. During the third quarter, the fund balance rose by \$110 million to \$13.039 billion (unaudited), from \$12.929 billion on June 30, 2005. For the period, income



from interest and other sources exceeded operating expenses and provisions for insurance fund losses by \$121 million, which was partially offset by an unrealized loss on

available-for-sale securities of \$11 million. The contingent liability for anticipated failures increased from \$0.6 million at June 30th to \$1 million at September 30th.

Survey results and preliminary data from Call Reports and Thrift Financial Reports also were used to estimate SAIF-insured deposit growth. These estimates show SAIF-insured deposits for the quarter ending



September 30, 2005 rose by 2.8 percent to \$1.0 trillion. This level of insured deposits results in an estimated SAIF reserve ratio as of September 30, 2005 of 1.29 percent, which is a 3 bp decline from the June ratio.

In the assessment rate cases presented to the Board in May 2005, staff’s best estimate was that the BIF reserve ratio at December 31, 2005 would be 1.26 percent, down from the December 31, 2004 ratio of 1.30 percent, while the SAIF reserve ratio would decline by 3 basis points, from 1.34 percent to 1.31 percent.¹ Based on the preliminary estimates for September 30, the BIF and the SAIF reserve ratios have both declined by 5 bp since December 31, 2004. In preparing the May assessment rate cases, staff assumed that during the four quarters of 2005 there would be modest positive provisions for insurance losses for BIF and a very slight negative provision for SAIF. So

¹ Staff projected lower and upper bounds for the December 31, 2005 BIF reserve ratio of 1.20 percent and 1.31, percent, respectively. For SAIF, staff projected a lower bound of 1.26 percent and upper bound of 1.36 percent for the year-end 2005 reserve ratio.

far, however, both BIF and SAIF have benefited from negative provisions for losses for the 9 months ending in September 2005.

On the other hand, preliminary estimates of insured deposit growth for the 9 months ending in September 2005 have been significantly higher than anticipated for BIF for the 12-month period through December 31, 2005 (about 5.4 percent over 9 months, compared to a 4.9 percent 12-month growth projection from December 31, 2004 through December 31, 2005 in the May Board case). SAIF also has experienced significantly higher growth than anticipated (6.0 percent growth over 9 months, compared to a 4.9 percent 12-month growth projection).



November 4, 2005

MEMORANDUM TO: The Board of Directors

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

SUBJECT: BIF Assessment Rates for the First
Semiannual Assessment Period of 2006

SUMMARY AND RECOMMENDATION

The staff recommends that the Board maintain the existing Bank Insurance Fund (BIF) assessment rate schedule of 0 to 27 basis points (bp)¹ per year. This rate schedule complies with the statutory requirements of the Federal Deposit Insurance Act for the Board to establish a risk-based assessment system and set assessments only to the extent necessary to maintain the BIF at the Designated Reserve Ratio (DRR) of 1.25 percent.

The reserve ratio for the BIF stood at 1.26 percent as of June 30, 2005 (unaudited), the latest date for which complete data are available. While data are incomplete, an early estimate indicates that the reserve ratio stood at 1.25 percent as of September 30, 2005.

¹ Although the current effective rate schedule is 0 to 27 basis points, the base rate schedule, established in 1995, is still 4 to 31 basis points. The FDIC may alter the existing rate structure and may change the base BIF rates by rulemaking with notice and comment. Without a notice-and-comment rulemaking, the Board has authority to increase or decrease the effective rate schedule uniformly up to a maximum of 5 basis points, as deemed necessary to maintain the target DRR.

Concur:

William F. Kroener, III
General Counsel

The staff's single point estimate for the reserve ratio as of June 30, 2006, is 1.22 percent (assuming no additional premium income is collected). Staff believes several factors will contribute to a decline in the reserve ratio between now and June 30, 2006. First, and most significant, is growth in insured deposits. Although the fund balance rose in each quarter between July 1, 2004, and June 30, 2005, insured deposits grew faster in all but one quarter. Insured deposits are projected to continue outpacing fund growth during the year ending June 30, 2006. Second, with interest rates projected to move higher, additional unrealized losses on available-for-sale securities are expected. Even in a stable interest rate environment, unrealized gains will disappear as securities move closer to their maturity dates. Finally, reserves for anticipated insurance losses are already at very low levels and preclude any material reversals to loss provisions going forward.

Nonetheless, there is significant uncertainty about factors affecting the reserve ratio, especially future insured deposit growth. For example, if BIF-insured deposits increase at the pace of the past 12 months, the reserve ratio will fall below 1.22 percent by next June. On the other hand, if insured deposits grow at the slower pace observed in the two prior 12-month periods, the reserve ratio likely would remain at or above the 1.25 percent target. Staff's projected lower and upper bounds for the June 2006 reserve ratio of 1.18 percent and 1.26 percent, respectively, primarily reflect the broad range of possible outcomes for insured deposits.

Given the uncertainty underlying the factors affecting future changes in the reserve ratio, the Board would be justified in either maintaining the current rate schedule or increasing rates. Staff recommends that the Board maintain the current rate schedule for three reasons:

First, the most recent reserve ratio based on complete data is above 1.25 percent. While the staff's point estimate for the reserve ratio at the June 30, 2006, is below the DRR, the

projected range for the reserve ratio includes plausible outcomes that meet or exceed 1.25 percent.

Second, if the reserve ratio is less than the DRR as of December 31, 2005, the FDIC would still have two full semiannual periods from when the Board next sets rates (in May of 2006) to return the reserve ratio to 1.25 percent, i.e., until June 30, 2007. Staff believes that, under reasonably likely circumstances, retaining the current rates would not significantly increase the rates that the Board would have to charge if the Board were required to raise rates six months from now.

Finally, deposit insurance reform legislation, if enacted, would merge the BIF and the SAIF. Based on the staff's projected ranges for the BIF and SAIF reserve ratios, the combined fund reserve ratio would be between 1.20 percent and 1.29 percent (with a point estimate of 1.24 percent) if there is no increase in BIF premium rates in January 2006. Depending on the provisions of the final legislation and the date of enactment, the BIF may not exist by the end of the January to June 2006 semiannual assessment period. The fund merger and other changes to the system expected under reform legislation argue against changing BIF premium rates at this juncture.

Based on June 30, 2005 data and projected ranges for the relevant variables at June 30, 2006, the recommended rate schedule would result in an average annual assessment rate of approximately 0.1 basis points (bp).

If the Board desires greater protection against the chance that the reserve ratio may fall below the DRR, an alternative approach would be to increase assessment rates. However, if the reserve ratio at the end of June 2006 exceeds the DRR, the FDIC would be required to refund the excess amount to certain insured depository institutions.

Staff has considered a range of plausible events that could produce significant movements in the BIF reserve ratio. Our methodology provides ranges for: (1) estimated insurance losses primarily based on changes to the contingent liability for anticipated failures (contingent loss reserve); (2) interest income and changes in the market value of available-for-sale (AFS) securities due to changes in interest rates, and (3) growth in insured deposits.

ANALYSIS

In setting assessment rates since the capitalization of the BIF, the Board must consider: (1) the probability of failure and likely amount of loss to the fund posed by individual insured institutions; (2) the statutory requirement to maintain the fund at the DRR, currently 1.25 percent, and (3) all other relevant statutory provisions.²

Projections for the BIF Reserve Ratio over the Next Assessment Period

Staff's point estimate for the BIF reserve ratio as of June 30, 2006, is 1.22 percent. The lower and upper bounds of the likely range for the BIF reserve ratio as of June 30, 2006, are 1.18 percent and 1.26 percent, respectively.

The following is an analysis of the anticipated effect of changes in the fund balance and the rate of insured deposit growth on the projected reserve ratio as of June 30, 2006.

² By statute, the Board must review and weigh the following factors when establishing an assessment schedule: a) the probability and likely amount of loss to the fund posed by individual institutions; b) case resolution expenditures and income; c) expected operating expenses; d) the revenue needs of the fund; e) the effect of assessments on the earnings and capital of fund members; and f) any other factors that the Board may deem appropriate.

1. Fund Balance

Staff evaluates three significant inputs to project the fund balance. First, staff estimates the effect of probable insurance losses, which are primarily losses from failed institutions. Second, staff estimates the amount of interest income that the fund will receive through June 30, 2006. Third, staff projects unrealized gains and losses on available-for-sale (AFS) securities through June 30, 2006.

A. Insurance Losses

Insurance losses primarily consist of two components: a contingent liability for anticipated failures (contingent loss reserve) and an allowance for losses on banks that have already failed. The Financial Risk Committee (FRC) recommends the amount of the contingent loss reserve each quarter. This recommendation represents the FRC's best estimate of "probable and estimable" BIF losses from potential bank failures, as required by generally accepted accounting principles. Actual results could differ from these estimates. As of June 30, 2005, the BIF loss reserve stood at \$1.6 million, increasing to \$4.3 million as of September 30, 2005.

Staff has estimated a likely range of insurance losses based on projected changes in the contingent loss reserve for the period ending June 30, 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, staff 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. For purposes of projecting changes to the contingent loss reserve, staff assumes that failure and loss rates remain constant through the period.

Based on consideration of the above factors, staff estimates that potential loss provisions for failures for the twelve months ending June 30, 2006 will range from \$2 million to \$195 million, with a best estimate of \$65 million.³ Table 1 shows the range of potential loss provisions for failures as well as provisions for net losses/recoveries on resolution receivables, litigation losses, and other contingencies.

Table 1
Potential Provisions and Adjustments for Loss Allowances
For the Twelve Months Ending June 30, 2006

	Low (High Provision) Estimate	Best Estimate	High (Low Provision) Estimate
Provision Related to Future Failures (1)	\$195 million	\$65 million	\$2 million
Provision for Closed Banks' Net Recoveries (2)	-\$47 million	-\$67 million	-\$87 million
Other Provisions (3)	\$17 million	\$0	-\$17 million
Potential Provision for Losses*	\$165 million	-\$2 million	-\$102 million

* Figures may not add to totals due to rounding.

Notes:

- (1) Includes provisions required to bring the contingent loss reserve to estimated June 30, 2006 levels after accounting for a) actual losses sustained in the third quarter of 2005 (\$0), and b) estimated losses sustained through June 2006 (\$4 million under the Best Estimate). Changes in the contingent loss reserve occur because of failures, mergers, improvement in existing problem institutions' conditions, deterioration of existing problem institutions, and the addition of new problem institutions to the problem institutions list.
- (2) The best estimate includes a third quarter 2005 provision of -\$67 million due primarily to lower estimated losses on receivables from prior failures. Low and high estimates assume a range around the best estimate of -5% to +5% of the estimated net recovery value of bank resolution receivables totaling \$403 million as of June 30, 2005.
- (3) Range is based on the standard deviation of changes in the year-end contingent liability for litigation losses and other contingent liabilities (e.g., representations, warranties, and asset securitization guaranties) for the period 1998 to 2004.

³ Staff estimates that the balance of the contingent loss reserve as of June 30, 2006 will range from \$4 million to \$176 million, with a best estimate of \$62 million.

Staff believes that the range provided by the statistical migration analysis adequately represents the most likely range of additional provisions needed to cover insurance losses from future failures. However, the bounds of this range do not represent “best case” and “worst case” scenarios, and larger or smaller provisions could occur.⁴

Banks in general appear to be well positioned to withstand considerable financial stress from unlikely economic shocks. Staff has considered economic stress events as they relate to specific risk concerns enumerated in the industry outlook contained in Tab 1. To determine the potential insurance fund implications of these concerns, staff has run several two-year stress event simulations based on data through June 30, 2005, 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.

Therefore, staff believes that widespread deterioration in banking industry performance is unlikely in the next one-to-two years. However, if the stress conditions analyzed were to persist beyond a two-year horizon, it is possible that the effects on bank performance could be more severe. Furthermore, the historical experiences underlying the stress scenarios may be less applicable in the future. For example, greater “democratization” of credit, an introduction of

⁴ FDIC staff economists, working with academic researchers, have developed an alternative approach to measure risks posed to the insurance funds. This approach, referred to as the Loss Distribution Model or LDM, employs many of the same techniques and methods used in credit risk and economic capital models employed by large financial companies to measure and manage risk. The LDM provides estimates of failure-related losses that are most likely given current industry conditions, as well as failure-related losses that might result from changes in the condition of the economy and the industry. Using the LDM, staff developed alternative BIF loss provisions related to future failures. The results are close to those of the statistical migration analysis shown in Table 1 and lead to a similar projected range (and best estimate) for the reserve ratio as of June 30, 2006.

new and higher risk mortgage products, larger securitization volumes, and higher household debt levels in recent years could increase the magnitude of stress on bank conditions from potential future problems in the consumer, residential mortgage, and commercial real estate sectors. Thus, conclusions drawn from stress scenario analyses should be treated with some degree of caution.

The Effects of Hurricane Katrina on the Deposit Insurance Funds

Staff believes it is too early to make a reasonable estimate of the effects of Hurricane Katrina on the deposit insurance fund balances. There remains substantial uncertainty about the ultimate effects of Katrina on the credit quality of Gulf Coast financial institution loan portfolios. The economic dislocations as well as the adverse effects on collateral values and the repayment capacity of borrowers resulting from the hurricane may stress the balance sheets of several financial institutions in the region. It will take some time to determine to what degree the expected influx of insurance payments and financial assistance from Government and private sources will reduce the stress on the affected banks and mitigate risks to the deposit insurance funds. Staff continues to evaluate a range of possible outcomes for economic damage, insurance proceeds, and Government assistance. At this point, staff deems that an adjustment either to the point estimate or the range of projected insurance loss provisions shown in Table 1 would be premature.

B. Interest Income and Unrealized Gains and Losses on AFS Securities

Staff relied upon expert forecasts as detailed in the *Blue Chip Financial Forecasts* to develop interest rate projections and analyze the potential effect of changes in interest rates on

interest income and unrealized gains and losses on AFS securities. The forecasts used as the “best estimate” were the consensus forecasts through the second quarter of 2006 as detailed in the September issue of the *Blue Chip Financial Forecasts*. Adopting the experts’ consensus forecasts allows for forecasted yield curves that change in shape over time.⁵

Along with forecasting yield curves based upon the experts’ forecasts, staff also calculated upper and lower bounds for interest rates using the historical differences between the experts’ forecasts and the actual interest rates. These bounds vary over the assessment period and change in shape over time, as opposed to being parallel shifts in rates. The bounds are consistent with the notion that the projections represent the most likely scenarios and that the actual rates may be above or below the projections. In general, the projections indicate rising rates for the period under consideration. Charts showing the projected rates, upper bound, and lower bound are included as Appendix A to this case.

Table 2 shows projections for low, best, and high estimates for interest income and unrealized gains and losses on AFS securities using the forecast “best estimate” rates and upper and lower bounds. Because of the significant percentage of AFS securities held in the insurance fund portfolio at this time, when interest rates change, the magnitude of the resulting change in market value of these securities outweighs the effect of changes in interest income.

⁵ Staff also developed alternative interest rate projections using actual forward rates available as of approximately the same time that the projections in the September *Blue Chip Financial Forecasts* were generated. Forward rates are expected yields on securities of varying maturities for specific future points in time that are derived from the term structure of interest rates. (The term structure of interest rates refers to the relationship between current yields on comparable securities with different maturities.) Staff developed upper and lower bounds using historical differences between actual interest rates and corresponding forward rates. The projections using forward rates incorporate only a small increase in short-term interest rates with virtually no change in long-term interest rates over the assessment period. However, projections using more current forward rates (early October 2005) indicate an increase in short-term rates that is largely comparable to the consensus forecast. In addition, Federal funds futures prices as of early October imply an increase in the short-term interest rates similar to that of the consensus forecast. Much uncertainty remains about how long-term interest rates will respond to an increase in the federal funds rate over the assessment period, with experts sharply divided over the probability of a steeper vs. a flatter yield curve. Given recent market information and uncertainty regarding the outlook for long-term interest rates, staff believes the *Blue Chip* consensus forecasts are reasonable. However, use of the forward rates would produce similar projections for the reserve ratio to those based on the *Blue Chip* forecasts.

Table 2
Potential Interest Income and
Unrealized Gains (Losses) on AFS Securities
July 1, 2005 to June 30, 2006 (\$ in millions)

	Low Estimate (1)	Best Estimate (1)	High Estimate (1)
Interest Income (2)	1,617	1,604	1,588
Unrealized Gain (Loss) on AFS Securities (2)	-328	-205	-80
Net Fund Contribution from Investment Activities	1,289	1,399	1,508

Notes:

- (1) The Low Estimate is calculated using upper bound interest rates, the Best Estimate is calculated using the projected rates, and the High Estimate is calculated using the lower bound rates. Higher interest rates generally correspond to lower unrealized gains (higher unrealized losses) on AFS securities. On the other hand, because interest rates are generally higher in the Low Estimate scenario than in the other two, overall interest revenue is also higher in that scenario. However, the Low Estimate also assumes more failures and higher resolution outlays, which results in a smaller balance invested during the period and partially offsets the effect of higher interest rates on investment income.
- (2) Figures include actual investment income and unrealized gains/losses on AFS securities for the third quarter of 2005 and projected investment income and gains/losses for the remaining period through June 30, 2006.

Staff's best estimate reflects recent trends in market interest rates as well as expert forecasts. Since the Board last considered semiannual assessment rates, short-term Treasury yields have increased as the Federal Reserve raised the target for the federal funds rate by 125 basis points. Long-term Treasury yields were virtually unchanged over the same period, largely due to continued foreign capital inflows to the U.S. and historically low and stable long-term inflationary expectations. These diverging trends in short-term and long-term interest rates led to a further flattening of the yield curve. Experts forecast a gradual and largely parallel increase in short-term and long-term Treasury yields over the nine-month period ending in June 2006 as the economy continues to grow at a robust pace and short-term inflationary concerns loom larger. Some reduction in the value of AFS securities should be expected if interest rates rise at a pace similar to staff's best estimate. As the remaining maturity of the existing AFS portfolio shortens, previously identified unrealized gains will also dissipate. Over the longer term, higher yields on

Treasury securities will boost overall interest earnings as securities reprice upward and as the proceeds from maturing securities are reinvested at higher rates.

C. Projected Fund Balance

Table 3 summarizes the effects on the fund balance of the low, best, and high estimates assumed for insurance losses, interest income, and unrealized gains and losses on AFS securities. The projection also assumes that the current assessment rate schedule will remain in effect through June 30, 2006.

Table 3
Projected Fund Balance (1)
(\$ in millions)

	Lower Bound	Best Estimate	Upper Bound
Assessments (2)	43	43	43
Interest Income (3)	1,617	1,604	1,588
Total Revenue	1,660	1,647	1,631
Operating Expenses (4)	828	828	828
Provision for Losses	165	-2	-102
Total Expenses & Losses	993	826	726
Net Income	667	821	905
Unrealized Gain (Loss) on AFS Securities (3)	-328	-205	-80
Comprehensive Income (Loss) (5)	339	616	825
Fund Balance – 6/30/05	35,094	35,094	35,094
Projected Fund Balance – 6/30/06	35,433	35,710	35,919

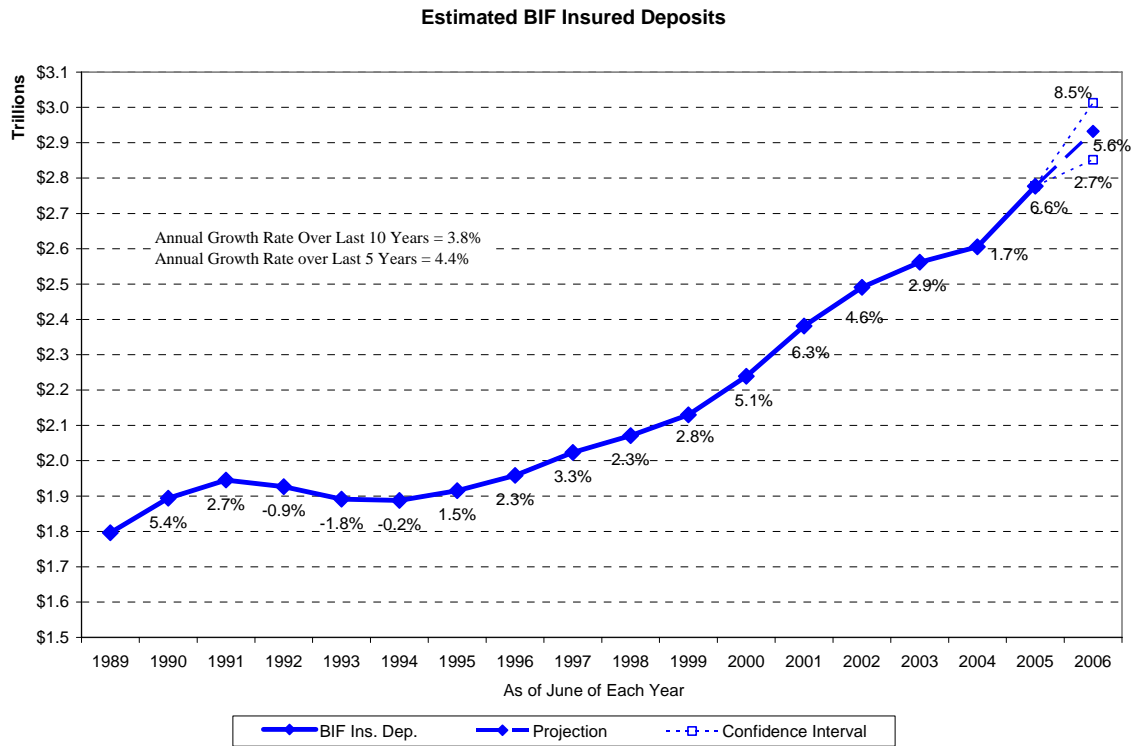
Notes:

- (1) Projected income and expense figures are for the twelve months ending June 30, 2006. Figures may not sum exactly to totals due to rounding.
- (2) Assumes that the current assessment rate schedule remains in effect through June 30, 2006.
- (3) See notes to Table 2 for an explanation of changes in interest revenue and unrealized gains (losses) on AFS securities.
- (4) Projected operating expenses are based on the Board approved 2005 budget for July through December, and the most current projected budget for January through June 2006.
- (5) Comprehensive Income is used instead of Net Income due to the magnitude of the change in market value of AFS securities that occurs with fluctuations in interest rates. See note (3) above.

2. Insured Deposits

Figure 1 shows that BIF-insured deposit growth rates since 1990, measured at June of each year compared to the previous June, have been as high as 6.6 percent and as low as -1.8 percent. After declining in 1992, 1993, and 1994, BIF-insured deposits grew at annual rates between 1.5 percent and 3.3 percent in 1995-99. The pace of growth picked up in the next three years: 5.1 percent in 2000, 6.3 percent in 2001 and 4.6 percent in 2002. Improved stock market conditions and historically low short-term interest rates helped reduce growth to 2.9 percent in 2003. Deposit growth further slowed to 1.7 percent in 2004, but accelerated significantly in 2005, growing by 6.6 percent. The high growth in insured deposits may result partly from an increase in short-term interest rates, following monetary policy actions by the Federal Reserve. An increase in short-term interest rates relative to long-term rates makes short-term investment instruments such as bank deposits more attractive to investors. Short-term interest rates have been rising steadily since the second half of 2004 while long-term rates remained largely unresponsive to a gradual increase in the Federal funds rate.

Figure 1



Staff’s best estimate for insured deposit growth over the four quarters ending June 2006 is 5.6 percent. This estimate, based on an analysis of historical data, is 1.2 percentage points higher than the average growth rate in BIF-insured deposits over the past five years. The current earnings capacity of the fund is not sufficient to prevent the projected rate of insured deposit growth (even in the absence of significant insurance losses) from causing a gradual decline in the reserve ratio.

Based upon the June 30, 2005 fund balance, it takes approximately \$22 billion in insured deposit growth (0.8 percent) to reduce the BIF reserve ratio by 1 basis point (bp). The staff’s point estimate indicates that insured deposits will increase by \$155 billion over the next four quarters.

Based on projections using a statistical model, the best judgment of the staff is that BIF-insured deposits are likely to experience a growth rate in the range of 2.7 percent to 8.5 percent between June 2005 and June 2006.⁶ Staff's point estimate is based on growth at the midpoint of this range (5.6 percent), which will bring total BIF-insured deposits to \$2.9 trillion. Insured deposits grew more rapidly over the most recent reported 12-month period (June 2004 to June 2005) than the long-term historical experience upon which staff based its model. If this recent rapid growth continues, insured deposits may grow at a rate closer to the upper end of our forecast range. Additionally, staff notes that in previous periods of Federal Reserve tightening, insured deposit growth has strengthened as short-term rates rise. Another factor that could result in higher insured deposit growth would be a lackluster stock market performance coupled with stock price volatility. In contrast, a rising stock market and strong U.S. economic growth could result in a lower growth rate for insured deposits.

3. BIF Reserve Ratio

Based on the projected BIF balance and the growth of the insured deposit base, the best estimate of the BIF reserve ratio as of June 30, 2006 is 1.22 percent (Table 4). The best estimate assumes modest loss provisions for future failures, moderately rising Treasury yields, and insured deposit growth of 5.6 percent over the four quarters ending June 30, 2006.

Staff projects the lower and upper bounds of the likely range to be 1.18 percent and 1.26 percent, respectively (Table 4). The lower bound, which reflects an 8 bp decrease from the actual June 30, 2005 ratio, assumes a strong increase in insured deposits (8.5 percent growth) and

⁶ Specifically, the statistical model explains growth in insured deposits as dependent on current and last quarter growth in domestic deposits (both insured and uninsured) as well as on last quarter's growth in insured deposits. The range corresponds to a 95 percent confidence interval. That is, to the extent that insured deposits can be described by their past growth and by growth in domestic deposits, staff is 95 percent certain that actual growth of insured deposits for the year ending June 30, 2006 will lie in this range. The growth rate predicted by the model, i.e., the point estimate, is the midpoint of this range. Thus, it is considered the most likely growth rate for insured deposits.

higher interest rates that reduce the fund balance by raising unrealized losses on AFS securities (Table 3). The lower bound also incorporates higher insurance losses for future failures.

Although the estimate reflects staff's view of a reasonably possible adverse scenario, it is not intended to represent a "worst case" scenario.

Table 4
Projected BIF Reserve Ratios
(\$ in millions)

	June 30, 2005		
Fund Balance	\$35,094		
Estimated Insured Deposits	\$2,777,086		
BIF Ratio	1.26%		
	Lower Bound (1)	Best Estimate (2)	Upper Bound (3)
	June 30, 2006		
Projected Fund Balance	\$35,433	\$35,710	\$35,919
Estimated Insured Deposits	\$3,012,843	\$2,932,247	\$2,851,651
Estimated BIF Ratio	1.18%	1.22%	1.26%

Notes:

- (1) The Lower Bound refers to the scenario of higher loss provisions (Low Estimate in Table 1), the higher end of the range for interest rates (Low Estimate in Table 2), and insured deposit growth of 8.5 percent.
- (2) The Best Estimate refers to a baseline scenario of moderate loss provisions (Best Estimate in Table 1), moderately rising interest rates (Best Estimate in Table 2), and insured deposit growth of 5.6 percent.
- (3) The Upper Bound refers to the scenario of lower loss provisions (High Estimate in Table 1), the lower end of the range for interest rates (High Estimate in Table 2), and insured deposit growth of 2.7 percent.

The upper bound produces no change in the reserve ratio from June 30, 2005. This estimate assumes an increase of 2.7 percent in the BIF-insured deposit base, very low loss provisions for future failures, and a more modest increase in interest rates, which results in smaller unrealized losses on AFS securities.

Staff's point estimate of the reserve ratio for June 30, 2006 is 3 bp lower than the DRR and represents a 4 bp decline from the June 30, 2005 ratio. Staff believes several factors will contribute to a decline in the reserve ratio between now and June 30, 2006:

- The most significant factor influencing the reserve ratio's projected decline is the projected strong growth in insured deposits. Staff's point estimate is for insured deposits to rise 5.6 percent, higher than the past five-year average for BIF-insured deposits.

- Interest rates continue to move higher. Unrealized gains on AFS securities will decline even in a stable interest rate environment because these gains disappear as securities move closer to their maturity dates. With rates moving higher, reductions in unrealized gains (or increases in unrealized losses) can be expected to continue.
- Although staff remains optimistic about industry prospects, reserves for anticipated losses are already at very low levels and preclude any material reversals to loss provisions going forward.

As a result of these considerations, staff believes that the BIF reserve ratio is likely to decrease over the four quarters ending in June 2006. Nonetheless, there is significant uncertainty about factors affecting the reserve ratio, especially future insured deposit growth. If BIF-insured deposits increase at the rate experienced during the past 12 months, the reserve ratio will fall below the staff's point estimate of 1.22 percent. On the other hand, if insured deposits increase at rates of either of the two previous 12-month periods (1.7 percent in June 2003 – June 2004 or 2.9 percent in June 2002 – June 2003), the reserve ratio will remain at or above the 1.25 percent target assuming the fund balance increases as projected. Therefore, staff believes that the 1.18- to-1.26 percent range for the June 2006 reserve ratio appropriately reflects these uncertainties.

Assessment Rates for the Next Semiannual Assessment Period

1. Statutory Requirements Regarding the Assessment Rate Schedule

The Federal Deposit Insurance Act (FDI Act) requires that the Board set semiannual assessment rates:

[W]hen necessary, and only to the extent necessary -- (I) to maintain the reserve ratio of each deposit insurance fund at the designated reserve ratio; or (II) if the reserve ratio is

less than the designated reserve ratio, to increase the reserve ratio to the designated reserve ratio⁷

Because the BIF reserve ratio was above 1.25 percent as of June 30, 2005, the Board can raise semiannual assessment rates for the first half of 2006 only pursuant to clause (I), to maintain the BIF at 1.25 percent. The statutory provisions that require the FDIC to return the ratio to 1.25 percent when the ratio falls below that target have not been activated.

If the reserve ratio falls below 1.25 percent, section 7 of the FDI Act requires that the FDIC restore it to the DRR no later than one year after “such rates are set.”⁸ The statute does not define when “rates are set” and legislative history provides no guidance on this issue. A reasonable interpretation of the assessment provisions of section 7 of the FDI Act is that “rates are set” on the date of the Board meeting at which the Board votes to approve rates for the ensuing semiannual period. Also, it is consistent with the intent of the statute that the FDIC be given one year to restore the reserve ratio to the DRR to conclude that the one-year period begins with the first semiannual period following the Board meeting at which the rates are set. Thus, for example, if the BIF reserve ratio falls below 1.25 percent as of December 31, 2005, the one-year period to re-establish the reserve ratio to 1.25 percent would begin when the rates set by the Board in May 2006 become effective (that is, July 1, 2006).

Under the section 7 assessment provisions, the FDIC must do one of two things if the December 31, 2005, BIF reserve ratio (which is the ratio used to set the July 1, 2006, rates) is below 1.25 percent. The FDIC must either: (1) set assessment rates to achieve the 1.25 percent target by June 30, 2007, which would allow two semiannual periods to re-establish the 1.25 percent ratio—the periods beginning July 1, 2006 and January 1, 2007—in addition to any

⁷ 12 U.S.C. 1817(b)(2)(A).

⁸ Id. at 1817(b)(3)(A)(i).

amounts collected during the first half of 2006, or (2) the FDIC must establish a recapitalization schedule of 15 years or less culminating in a reserve ratio equal to the DRR.⁹

2. Assessment Rate Recommendation

Table 5 summarizes the current distribution of institutions across the assessment matrix.

Table 5
BIF Assessment Base Distribution (1)
Assessable Deposits as of June 30, 2005
Supervisory Subgroup and Capital Groups in Effect July 1, 2005

Capital Group		A		B		C	
1. Well	Number	7,301	94.0%	352	4.5%	47	0.6%
	Base (\$billion)	\$4,570	98.0%	\$72	1.5%	\$13	0.3%
2. Adequate	Number	50	0.6%	5	0.1%	7	0.1%
	Base (\$billion)	\$8	0.2%	\$1	0.0%	\$0	0.0%
3. Under	Number	0	0.0%	0	0.0%	3	0.0%
	Base (\$billion)	\$0	0.0%	\$0	0.0%	\$0	0.0%

Assessment Base

\$4,665 billion

Estimated assessment revenue 7/1/05 to 6/30/06

\$ 43 million

Average assessment rate (bp) 7/1/05 to 6/30/06

0.09 basis points

Notes:

(1) "Number" reflects the number of BIF members, including BIF-Oakar institutions; "Base" reflects all BIF-assessable deposits.

Staff recommends maintaining the current assessment rate schedule rather than raising rates at this time for several reasons:

First, the BIF reserve ratio has not fallen below 1.25 percent as of June 30, the date of the most recent reserve ratio based on complete information. While data are incomplete, an early estimate indicates that the reserve ratio stood at 1.25 percent as of September 30, 2005. While staff's single point estimate for the reserve ratio is 1.22 percent as of June 30, 2006 (assuming no additional premium income is collected), staff's range of estimates includes the possibility that the fund will be as high as 1.26 percent. As previously discussed, uncertainties about factors

⁹ Id. at 1817(b)(3)(A)(i) and (ii).

affecting the reserve ratio, especially future insured deposit growth, result in a fairly wide range of possible outcomes for the June 2006 ratio.

Second, under current law, if the BIF reserve ratio were to fall below 1.25 percent as of December 31, 2005, the FDIC would still have two full semiannual periods—until June 30, 2007—to return the reserve ratio to 1.25 percent. Staff considered the potential differences in premiums for the 12 months ending June 2007 depending on whether the Board maintains the current rate schedule through June 2006 or raises premiums effective January 2006. If the staff's point estimate for the June 2006 reserve ratio is realized, premium rates for the July 2006 to June 2007 period would need to be approximately 2 bp higher if the Board maintains the current rate schedule for the January to June 2006 period than if the Board increases rates beginning in January 2006, under reasonable assumptions. Alternatively, if insured deposits rise at the upper end of the projected range for the year ending June 2006 (8.5 percent), premium rates for the following 12 months (assuming the current schedule is maintained for January to June 2006) would need to be about 4 basis points higher than if the Board raised premiums sooner, under reasonable assumptions.¹⁰ In staff's opinion, these potential differences in rates are not large enough to justify an increase in rates now.

Third, deposit insurance reform legislation, if enacted, would merge the BIF and the SAIF. Based on the staff's projected ranges for the BIF and SAIF reserve ratios, the combined fund reserve ratio would be between 1.20 percent and 1.29 percent, with a point estimate of 1.24 percent, without any increase in BIF premium rates for the January to June 2006 semiannual

¹⁰ If insured deposits are projected to rise more slowly than the fund's investment returns (less expenses and losses) between June 2006 and June 2007, then the differences in premium rates would be smaller.

assessment period.¹¹ Depending on the provisions of the final legislation and the date of enactment, the BIF may not exist by the end of the January to June 2006 period.

The legislation would also permit the FDIC to manage the combined fund reserve ratio within a range that extends above and below 1.25 percent. While it would allow the FDIC to charge all institutions a risk-based premium, it would award initial assessment credits to institutions that paid high premiums to build up the insurance funds in the early-to-mid 1990s. Staff therefore believes that the changes to the system expected under reform legislation argue against changing BIF premium rates at this juncture.

If the Board desires greater protection against the chance that the reserve ratio may fall below the DRR, an alternative approach would be to increase assessment rates. However, if the reserve ratio at the end of June 2006 exceeds the DRR, the FDIC would be required to refund the excess amount to certain insured depository institutions.¹²

3. Spread between Assessment Rates

Staff's recommendation would also retain the current spread of 27 bp between the assessments paid by the best- and worst-rated institutions as well as the rate spreads between adjacent cells in the assessment rate matrix. The current (and proposed) assessment rate schedule appears in Table 6.

¹¹ This assumes that the current SAIF escrow funds are included in the combined fund balance, as the proposed legislation would allow.

¹² Refunds must not exceed the excess assessments paid by institutions during that semiannual period. Also, refunds may not be made to institutions that exhibit financial, operational, or compliance weaknesses, or institutions that are not "well capitalized."

Table 6
Proposed Assessment Rate Schedule
First Semiannual Assessment Period of 2006
BIF-Insured Institutions

Capital Group	A	B	C
1. Well	0 bp	3 bp	17 bp
2. Adequate	3 bp	10 bp	24 bp
3. Under	10 bp	24 bp	27 bp

The Board previously determined that the current rate spreads provide appropriate incentives for weaker institutions to improve their condition and for all institutions to avoid excessive risk-taking, consistent with the goals of risk-based assessments and existing statutory provisions.

BIF assessments for the second half of 2005 were about \$27 million. Retaining the current assessment base schedule would generate approximately \$16 million during the first semiannual period of 2006.

In setting assessment rates to achieve and maintain the reserve ratio at the target DRR, the Board is required to consider the effects of assessments on members' earnings and capital. In recommending that the Board maintain the existing rate schedule, the staff has considered the effect on bank earnings and capital and found no unwarranted adverse effects.

4. Matrix Migration

With 99.2 percent of the number of institutions and 99.7 percent of the assessment base in the three lowest assessment risk classifications of "1A," "1B," and "2A," as of July 1, 2005, the current distribution in the rate matrix reflects little fundamental difference from the previous semiannual assessment period. The current distribution reflects a slight increase in the percentage of institutions in the best-rated premium category. Since the previous assessment period, 146 institutions migrated into the "1A" risk classification (Table 7), and 115 institutions

migrated out of the "1A" risk classification. Only 464 institutions are classified outside of the best risk classification.

Table 7
BIF Migration To and From Assessment Risk Classification "1A"

Institutions entering "1A"	Number	Base (\$billion)
Due to capital group reclassification only	38	8.5
Due to supervisory subgroup reclassification only	107	13.5
Due to both	1	0.3
Total	146	22.3
Institutions leaving "1A"	Number	Base (\$billion)
Due to capital group reclassification only	38	6.6
Due to supervisory subgroup reclassification only	75	43.1
Due to both	2	0.4
Total	115	50.2

Notes: The table reflects BIF-insured institutions that moved in and out of assessment risk classification "1A" from the first semiannual assessment period of 2005 to the second semiannual assessment period of 2005. The numbers only include institutions that were rated in both periods. The table does not reflect other assessment risk classification migrations that are not either to or from "1A."

More broadly, considering all institutions, the supervisory subgroup component of the risk classification was upgraded since the previous period for 121 institutions with an assessment base of \$15.4 billion and was downgraded for 80 institutions with an assessment base of \$43.8 billion.

Other Issues

Refunds for second semiannual period of 2005. Since BIF-insured institutions classified as "1A" currently pay no assessments to the BIF under the proposed rate schedule, they are ineligible to receive any refund for the second semiannual period of 2005.

FICO Assessment. The Deposit Insurance Funds Act of 1996 (Funds Act) separates the Financing Corporation (FICO) assessment from the FDIC assessment, so that the amount assessed on individual institutions by the FICO is in addition to the amount paid according to the BIF rate schedule. All institutions are assessed the same rate by FICO, as provided for in the Funds Act, and the FICO rate is updated quarterly. The FICO rate for the first quarterly payment in the first semiannual assessment period of 2006 will be determined using September 30, 2005 Call Report and Thrift Financial Report data.

STAFF CONTACTS

For information about deposit insurance and FICO assessments, please contact Matthew Green, Chief, Fund Analysis and Pricing Section, Division of Insurance and Research, at (202) 898-3670, or Joe DiNuzzo, Counsel, Legal Division, at (202) 898-7349.

Appendix A – Interest Rate Assumptions

Figure 1: Estimated Yield Curve and Interval for Fourth Quarter 2005

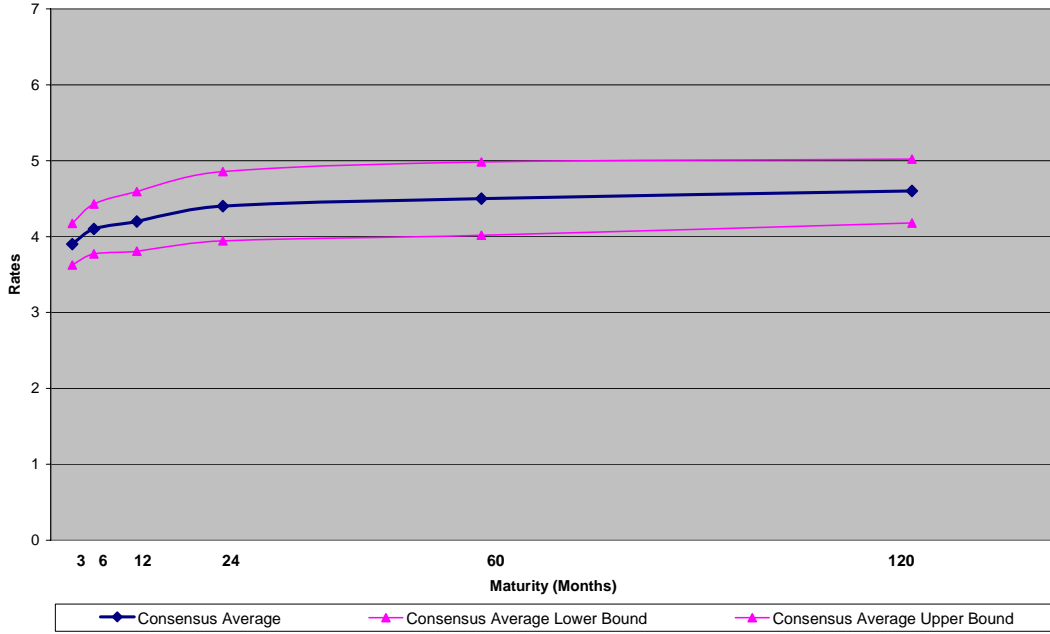


Figure 2: Estimated Yield Curve and Interval for First Quarter 2006

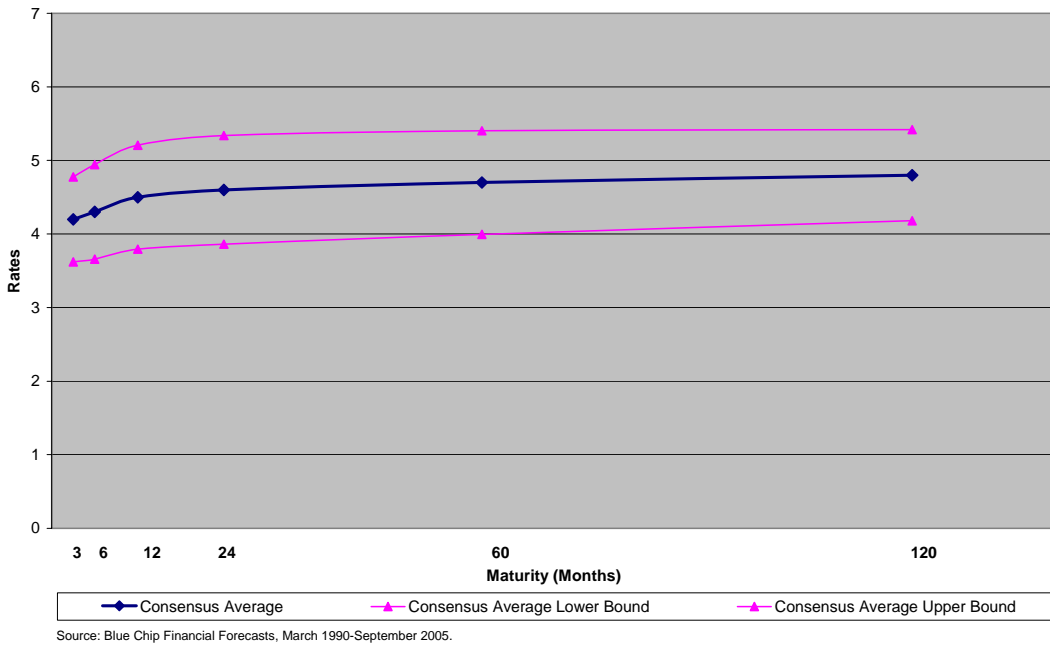
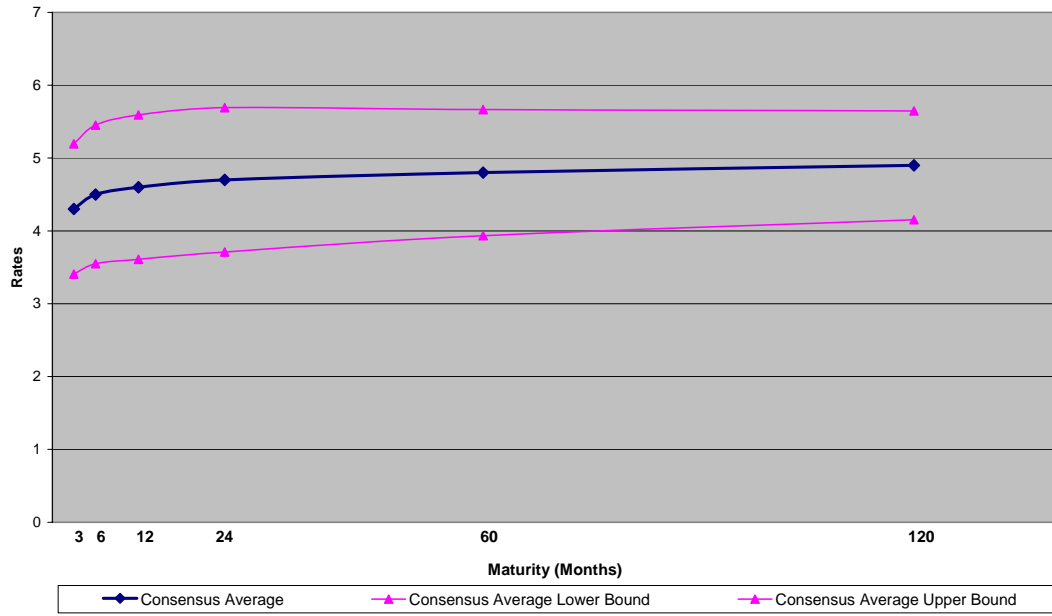


Figure 3: Estimated Yield Curve and Interval for Second Quarter 2006



Source: Blue Chip Financial Forecasts, March 1990-September 2005.

Concur:

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