FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990
Deputy to the Chairman and CFO

October 3, 2006

TO: The Board of Directors

FROM: Steven O. App
Deputy to the Chairman and
Chief Financial Officer

SUBJECT: Proposed FDIC Corporate Investment Policy

RECOMMENDATION

That the Board of Directors approve the proposed updated FDIC Corporate Investment Policy. (See Attachment 2.)

SUMMARY

Three years have passed since the Board of Directors approved the current Corporate Investment Policy (Existing Policy). Consistent with the CFO's past practice as well as industry best practices, and recognizing that there has been considerable turnover on the Board of Directors, staff is presenting for the Board of Directors' consideration an updated Corporate Investment Policy (Proposed Policy). The Proposed Policy has been revised to reflect the merger of the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) into the Deposit Insurance Fund (DIF), which occurred on March 31, 2006. While there are extensive language changes between the Existing Policy and the Proposed Policy, these changes primarily were made to eliminate certain redundancies and to clarify certain aspects of the Existing Policy. There are no changes of substance between the Existing Policy and the Proposed Policy, other than a minor addition to include an explicit objective concerning controlling the need for selling any securities designated available-for-sale (AFS). This explicit objective is consistent with the U.S. Department of the Treasury's (Treasury) Operating Circular, which governs federal agencies investing in the Treasury's Bureau of Public Debt's Government Account Series (GAS) nonmarketable Treasury securities. The Treasury's Circular stipulates that federal agency investors purchasing GAS Treasury securities should use their best efforts to plan their investment purchases such that the agency is able to hold all longer-term securities until their stated maturity. (See Attachment 1 for a comparison of the key elements of the Existing and Proposed Policies.)

ANALYSIS AND DISCUSSION

The following investment statistics with respect to the DIF highlight the importance of the DIF's investment portfolio to the overall fund and hence the necessity for having a sound policy governing the management of this portfolio. As of August 31, 2006, the DIF's investment portfolio totaled $48.687 billion, which represents 97.7 percent of the DIF's $49.854 billion (unaudited) fund balance. Interest revenue earned on DIF investment securities in 2005 and over the last eight months comprises approximately 96 percent to 97 percent of DIF's total revenue (excluding a one time, special revenue item in 2006), respectively, and is expected to total between $2.2 billion and $2.4 billion in calendar year 2006. In sum, given the magnitude of the funds under management and their importance to the financial condition of the DIF, the periodic review of a sound investment policy is clearly warranted.

The Board of Directors adopted the Existing Policy in November 2003. At the time of adoption, the Corporation was managing both the BIF and the SAIF, although the Existing Policy was crafted with sufficient flexibility so that it could still be applied in the event of the anticipated BIF/SAIF merger. As with the Existing Policy, the Proposed Policy states the legal basis for investing the Corporation's funds, and delineates the DIF investment objectives, investment guidelines, delegated authority, the role of the Investment Advisory Group (IAG), reporting requirements, and provisions concerning other Corporate investment portfolios. The Proposed Policy maintains the overall objective that the Corporation will attempt to hold all investments to maturity, and provides broad guidelines to be followed by the CFO when establishing and implementing the more specific quarterly (or more frequent, if necessary) investment strategies for the DIF portfolio. All security-specific limitations contained in the Existing Policy remain in the Proposed Policy. Moreover, the Proposed Policy continues the requirement that the CFO provide quarterly reports to the Board of Directors on the status and recent investment experience of the Corporate portfolio(s), the current and prospective investment strategies, and the reasons for any significant changes in either investment experience or strategy.

There are quite a few language changes between the Existing Policy and the Proposed Policy, but these changes are not of substance. For example, in the Existing Policy, the legal basis for the Corporation being able to invest its funds is discussed in the section titled "General Policy Statement", which also included an overall investment objective. In the Proposed Policy, that section is now titled "Legal Basis for the Corporate Investment Program" and the general investment objective has been moved to the Proposed Policy's next section. Additionally, the Existing Policy's Investment Objectives section has been re-titled and broken into two sections now titled "Deposit Insurance Fund Investment Objectives" and "Composition of the DIF Portfolio." Similarly, the Existing Policy's section titled "Corporate Investment Portfolio Parameters" is being retained for the Proposed Policy, but has been re-titled "Other Corporate Investment Portfolios" and has been moved to the last section of the document; the Proposed Policy deemphasizes this section because the DIF portfolio is the only portfolio now being actively managed by the Corporation[1] and the CFO does not anticipate the need to create any new segregated portfolios for the foreseeable future.[2] Also, as a consequence of creating the

[1] The FDIC also invests the FRF-FSLIC portfolio but these funds are invested only in overnight investments.
[2] The SAIF Exit Fee Escrow Portfolio is an example in the recent past of a segregated portfolio where the provisions of the Corporate Investment Policy were used to guide the investment of its funds.

Proposed Policy's section "Composition of the DIF Portfolio" that discusses managing the DIF portfolio's Primary and Secondary Reserve, the Liquidity and Fund Volatility discussion in the Existing Policy was deemed redundant; therefore, that discussion has been deleted from the Proposed Policy.

One other notable, albeit non-substantive, change to the Proposed Policy was the elimination of the objective to maintain adequate portfolio liquidity. This objective was a bit of a misnomer in that all of the DIF portfolio's GAS Treasury securities are readily liquid; that is, they may be sold back to the Bureau of Public Debt on any business day at current market prices. However, if an entity governed by generally accepted accounting principles sells a security that it had designated as held-to-maturity (HTM) (that is, at the time of the security's purchase, the entity asserted and continues to assert that it has the positive intent and ability to hold the security to its maturity), under Statement of Financial Accounting Standards No. 115 (SFAS No. 115), such a sale normally calls into question that entity's ability to hold its other HTM securities to maturity. The practical consequence is that, going forward, the entity would have to mark-to-market all of its security holdings.[3] Selling a DIF portfolio HTM security and having to mark-to-market the entire DIF portfolio would result in much greater fund balance volatility. The actual objective under the Existing Policy was to control fund balance volatility by managing the DIF portfolio's Primary Reserve so as to avoid having to sell an HTM security to meet the DIF's funding needs. The Proposed Policy more accurately depicts this objective.

Finally, it should be noted that the passage of deposit insurance reform now allows the Board of Directors to manage the reserve ratio within a range and grants it greater flexibility in determining the level of deposit insurance premiums. The Existing Policy was crafted when the designated reserve ratio of 1.25 percent was a hard target, that is, the law essentially required that if the reserve ratio fell below 1.25 percent, the Board would have to charge premiums sufficient to raise the reserve ratio to 1.25 percent within one year (or, if a longer time frame was necessary, no less than 23 basis points per year). Given the flexibility granted the Board to manage the reserve ratio within a range and allow for more stable premiums over time, there is

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[3] Among other things, SFAS No. 115 provides that debt securities in an investment portfolio may be classified as AFS or HTM. To be classified as HTM, an entity must have the positive intent and ability to hold the security to its maturity. Any securities designated AFS must be marked-to-market while any securities designated HTM must be reported at amortized cost in financial reports prepared in accordance with generally accepted accounting principles. Thus, from an accounting perspective, AFS securities' reported carrying values will be more volatile than HTM securities, because their reported values will fluctuate as a result of ongoing changes in market yields. Their fluctuating values would also make the DIF fund balance more volatile. But HTM securities do have a potentially significant disadvantage compared to AFS securities. Under most situations (except for some very limited, specific situations outlined in SFAS No. 115), the sale of just *one* HTM security will result in the *entire* portfolio of HTM securities being reclassified as AFS securities and marked-to-market going forward. In essence, by selling an HTM security, the entity can no longer assert the positive intent and ability to hold its securities to maturity. While SFAS No. 115 does not specify how long an entity is precluded from designating securities as HTM following a sale of an HTM security, the Securities and Exchange Commission (SEC) guidance for publicly registered companies that sell an HTM security provides that the HTM classification may not be reestablished for a period of two years. Hence, if the FDIC sold an HTM security and the auditors agreed with the application of this SEC guidance, then the entire DIF portfolio would have to be marked-to-market for a minimum period of two years. The sale of a DIF portfolio AFS security prior to maturity, on the other hand, does not trigger any changes in accounting treatment. Finally, it should be noted that accounting guidelines allow for the sale of very short-maturity HTM securities—that is, those maturing within three months—without calling into question an entity's ability to hold its other HTM securities to maturity. Accordingly, such short-maturity HTM securities are included in the DIF portfolio's Primary Reserve.

now potentially greater tolerance for some degree of fund balance volatility. In light of this change, staff contemplated requesting a somewhat more radical change to the Existing Policy that would have called for the DIF to designate all of its investment securities as AFS. As noted in the attached May 31, 2006, memorandum to the Board of Directors (see Attachment 3), this approach was considered, but ultimately put on hold for now until the effects of other changes wrought by deposit insurance reform become clearer (including a new system of risk-based assessments and one-time assessment credits). The essential argument for delay of this “all AFS” proposal is that staff believes it would be imprudent to introduce an additional source of fund balance volatility at a time when several other changes will be occurring simultaneously. However, as noted in this same memorandum, staff is committed to studying this issue again in the future and possibly recommending that the Corporate Investment Policy be amended.

In conclusion and as noted above, it is prudent for the Board of Directors to periodically review and approve its Corporate Investment Policy. Such periodic review and approval is consistent with Risk Standard 2 of the *Risk Standards for Institutional Investment Managers and Institutional Investors*,[4] which states in part that “[a]ll policies, definitions, guidelines and investment documentation should be reviewed and updated as appropriate and more often if significant market events or changes in strategy occur.” Moreover, when the Existing Policy was last reviewed and approved in November 2003, the membership of the FDIC Board of Directors was significantly different. Therefore, staff is presenting the attached Proposed Policy for the Board of Directors’ consideration.

STAFF CONTACTS

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[4] The *Risk Standards for Institutional Investment Managers and Institutional Investors* were established by the Risk Standards Working Group, a group of leading investment industry professionals. The 20 standards provide guidance that institutional investors and institutional investment managers may use when planning their investment-related risk measurement and risk management practices.

ATTACHMENT 1

DIFFERENCES BETWEEN EXISTING AND PROPOSED CORPORATE INVESTMENT POLICIES	
EXISTING POLICY	**PROPOSED POLICY**
General Policy Statement Existing Policy sets forth the legal basis and requirements for the Corporate investment program.	***Legal Basis for the Corporate Investment Program*** *No changes of substance, but minor language changes.* This section has now been re-titled since the preponderance of the discussion revolves around the legal basis for the investment program. Additionally, the one investment objective that appeared in this section in the Existing Policy has been moved to the DIF Investment Objectives section directly below it.
Investment Objectives Existing Policy includes four *general investment objectives* (attempting to hold all securities to maturity, minimizing costs, improving investment and cash management techniques, and measuring investment performance). There are also specific objectives with respect to the BIF and SAIF investment portfolios' Primary Reserves (maintain adequate liquidity, control fund balance volatility, and maximize investment returns subject to overriding liquidity considerations) and Secondary Reserves (seek to eliminate HTM sales, seek to maximize returns).	***Deposit Insurance Fund (DIF) Investment Objectives and Composition of DIF Portfolio*** *No changes of substance, but re-titled and broken into two sections, as well as extensive clarifying language changes.* Under the DIF Investment Objectives section, the Proposed Policy includes the general investment objective that had been in the Existing Policy's "General Policy Statement" section and eliminates references to maintaining liquidity as all GAS Treasury securities may be sold back to the Bureau of Public Debt on any business day at current market prices. Under the "Composition of the DIF Portfolio, the Proposed Policy stipulates that the DIF portfolio will have a Primary Reserve (as under the Existing Policy, the Primary Reserve consists of overnight investments, AFS securities, and HTM securities maturing within three months) and a Secondary Reserve (all other HTM securities, again, no change from the Existing Policy), and now more accurately depicts the objective to control fund balance volatility by managing the DIF portfolio's Primary Reserve. The Proposed Policy also specifically stipulates an objective to seek to control the need for any AFS security sales, in compliance with the Treasury's Operating Circular, which governs federal agencies investing in the Bureau of Public Debt's GAS Treasury Security Program.

DIFFERENCES BETWEEN EXISTING AND PROPOSED CORPORATE INVESTMENT POLICIES	
EXISTING POLICY	**PROPOSED POLICY**
Investment Guidelines – Liquidity and Fund Volatility Existing Policy contains a discussion on the Primary reserve (overnight investments, AFS securities and HTM securities maturing within three months) and Secondary Reserve (all HTM securities with maturities greater than three months) for the deposit insurance funds' investment portfolios.	***Investment Guidelines – Liquidity and Fund Volatility*** *Section deleted as it was redundant.*
Investment Guidelines – Maturity Considerations Existing Policy contains a 12-year maximum maturity limitation and notes that the CFO may also establish additional maturity or other limitations on AFS securities in the Primary Reserve. With respect to the Secondary Reserve, the Existing Policy stipulates a long run objective of maintaining a laddered maturity distribution to mitigate reinvestment risk. Finally, with respect to the aggregate portfolio, the Existing Policy stipulates that at the time of purchase, not more than 50 percent of the portfolio (measured by par value) shall contain securities having maturity dates that fall within all calendar years between year six and year twelve.	***Investment Guidelines – Maturity Considerations*** *No changes of substance, but minor language changes.*
Corporate Investment Portfolio Parameters Existing Policy stipulates that the principal investment portfolios of the Corporation are the Bank Insurance Fund and the Savings Association Insurance Fund. It states that the Corporation shall maintain records and make investment decisions for each separate portfolio of managed funds. Also, to the extent the business activities of the Corporation result in the need to create pools of funds that must be segregated and invested separately from the deposit insurance fund(s), the CFO may establish such separate portfolios, and must establish a written investment strategy that is consistent with the Corporate Investment Policy, as well as report to the Board of Directors on each portfolio.	***Other Corporate Investment Portfolios*** *No changes of substance, but clarifying language changes.* Re-titled Other Corporate Investment Portfolios, this section has been moved to the end of the Proposed Policy, as the CFO does not anticipate establishing any segregated portfolios for the foreseeable future. This section now stipulates that the DIF portfolio is the Corporation's principal investment portfolio.

DIFFERENCES BETWEEN EXISTING AND PROPOSED CORPORATE INVESTMENT POLICIES	
EXISTING POLICY	**PROPOSED POLICY**
Roles and Responsibilities Existing Policy sets forth responsibilities of the CFO, Division of Finance Director, and their designees.	***Authorities Delegated to the CFO and DOF Director*** *No changes of substance, but minor language changes.* This section has now been re-titled since the preponderance of the discussion revolves around delegated authorities. Additionally, the Proposed Policy now specifically delineates that the Division of Finance Director may sell HTM securities maturing within three months (does not trigger adverse accounting treatment) and clarifies the requirement that only the CFO or his/her designee may sell an HTM with more than three months to maturity.
Investment Advisory Group Existing Policy establishes the composition and responsibilities of the IAG.	***Investment Advisory Group*** *No changes of substance, but minor language changes.*
Reporting Requirements Existing Policy sets forth the CFO's quarterly reporting requirements to the Board of Directors.	***Reporting Requirements*** *No changes of substance, but minor language changes.*

ATTACHMENT 2

FEDERAL DEPOSIT INSURANCE CORPORATION
CORPORATE INVESTMENT POLICY

Legal Basis for the Corporate Investment Program

All Corporate investments are made in accordance with provisions of Section 13(a) of the Federal Deposit Insurance Act (12 U.S.C. Section 1823(a)), which requires: 1) that funds held in the Deposit Insurance Fund that are not otherwise employed shall be invested in obligations of the United States or in obligations guaranteed as to principal and interest by the United States; and 2) the approval of the Secretary of the Treasury for purchases and sales of securities at any one time aggregating in excess of $100,000.

On a daily basis, the U.S. Department of the Treasury's Bureau of Public Debt (BPD) offers non-marketable U.S. Treasury securities at current market prices with no transaction fees or costs to the Corporation. Known as Government Account Series (GAS) Treasury securities, the Secretary of the Treasury has restricted federal agencies with investment authority, including the FDIC, to buying and selling such GAS Treasury securities. Accordingly, by buying and selling these GAS Treasury securities through the BPD, the Corporation meets the requirement of obtaining the approval of the Secretary of the Treasury for purchases and sales of securities at any one time aggregating in excess of $100,000.

Deposit Insurance Fund (DIF) Investment Objectives

In managing the DIF investment portfolio, the Corporation's stated objectives include:

- Managing money in a professional manner, consistent with maintaining confidence in the deposit insurance program and with the Corporation's strategic objective that the Deposit Insurance Fund remains viable.

- Holding all DIF investments to maturity, including both securities designated as held-to-maturity (HTM) as well as any securities designated as available-for-sale (AFS). (A portion of the DIF investment portfolio may be designated as AFS under Statement of Financial Accounting Standards No. 115.) Sales of such securities may be consummated to meet DIF funding needs. Moreover, purchases and sales for infrequent portfolio restructuring may be warranted. To the extent that security sales are deemed necessary, all of the DIF portfolio’s AFS securities shall be sold before selling any HTM securities, but HTM securities should not be sold for the purpose of portfolio restructuring.

- Managing the investment program at the lowest reasonable cost, without compromising standards of quality, security, or control.

- Striving continuously to improve investment and cash management techniques, including periodically measuring and assessing its investment performance.

Composition of the DIF Portfolio

The DIF portfolio shall consist of both a Primary Reserve and a Secondary Reserve.

Primary Reserve

The Primary Reserve shall consist of:

- Overnight investment securities that will be the primary source of liquidity for the DIF.

- Investment securities that are designated AFS.

- Investment securities designated as HTM with remaining maturities of three months or less.

Specific investment objectives related to the DIF’s portfolio’s Primary Reserve include, in order of priority:

- Seek to control fund balance volatility by managing the amounts, types, maturities, and/or modified durations of AFS security purchases.

- Seek to control the need for any AFS security sales.

- Seek to avoid the need for any HTM security sales.

- Seek to maximize investment returns, subject to the above objectives.

Secondary Reserve

The Secondary Reserve shall consist of all investment securities designated HTM that are not included in the Primary Reserve.

Specific investment objectives related to the DIF portfolio’s Secondary Reserve include, in order of priority:

- Seek to avoid the need for any HTM security sales.

- Seek to maximize investment returns.

Investment Guidelines

Permissible Investments

The DIF portfolio will be invested in any of the non-marketable U.S. Treasury securities offered by the BPD to federal agency investors, including but not limited to:

- Conventional non-callable Treasury bills, notes, bonds, and special certificates.

- Treasury Inflation-Protected Securities (TIPS).

- Zero-coupon securities created under the Treasury Separate Trading of Registered Interest and Principal of Securities (STRIPS) program.

- Conventional callable Treasury bonds.

- Other securities that may be offered by the BPD to federal agency investors.

In addition, any of these securities may be purchased on a when-issued basis, in accordance with existing BPD practices.

From time to time, the Chief Financial Officer (CFO), with the advice of the Investment Advisory Group (IAG), may establish certain limitations with respect to investments in any of the permissible security types.

Maturity Considerations

- *Primary Reserve:* All AFS securities held in the DIF portfolio's Primary Reserve will have remaining maturities of twelve years or less. Moreover, to mitigate fund balance volatility, the CFO, with the advice of the IAG, may establish certain limits on the amount, types, maturities, and/or modified durations of AFS securities. Factors that may be considered in setting such limits include current and anticipated market conditions, fund balance characteristics, and other relevant data.

- *Secondary Reserve:* All securities held in the DIF portfolio's Secondary Reserve will have remaining maturities of twelve years or less. As a long-run strategic objective, the Secondary Reserve should generally be managed to mitigate reinvestment risk by maintaining a laddered maturity distribution (subject to near-term funding needs and Treasury market conditions), or by employing other applicable risk management techniques approved by the CFO.

- *Aggregate Portfolio:* At the time of purchase of any longer-term investment security, not more than 50 percent of the DIF portfolio (measured by par value) shall contain securities having maturity dates that fall within *all* calendar years between year six and year twelve.

  (For compliance measurement purposes, the sixth calendar year shall begin five years from the subsequent January 1^{st}. For the purposes of this provision, a "longer-term investment security" is defined as a security with a maturity date falling within the sixth through twelfth calendar years. Moreover, to the extent that callable securities' premiums are amortized to their first call date (given the virtual certainty that they will be called on their first call dates), then such first call dates would be used for determining portfolio maturity distributions and compliance with applicable policy maturity limitations.)

Authorities Delegated to the CFO and DOF Director

In accordance with the authority delegated to the CFO under Article VI of the Corporation's Bylaws, and consistent with 31 U.S.C. Section 902 of the Chief Financial Officers Act, the CFO or his/her designees are responsible for the management and implementation of the Corporate investment program. Article VI of the Corporation's Bylaws provides that the Director of the Division of Finance (DOF Director) has been delegated responsibility to receive, deposit, disburse, manage, safely keep, and account for all funds of the Corporation under the general supervision of the CFO. In accordance with these authorities, the DOF Director is thus responsible for implementing the investment strategy and for managing day-to-day financial transactions. The DOF Director or his/her designees are authorized to invest and reinvest the funds of the Corporation, sell investments designated as AFS prior to their stated maturity, sell securities designated as HTM so long as the securities have remaining maturities of three months or less, and perform all related incidental acts. Securities designated as HTM that have more than three months to their stated maturity may only be sold with the specific approval of the CFO or his/her designee.

Investment Advisory Group

An Investment Advisory Group consisting of the CFO, the DOF Director, and three members (not directly involved in the Corporate and liquidation funds investment operations) appointed by the Chairperson, shall convene four times per year, preferably at least once each calendar quarter. The CFO shall chair the IAG. The IAG shall review the overall investment, Treasury securities market, and economic outlooks; review the most recent quarter's investment performance; review cash flow projections for the DIF portfolio; and review any actions that constitute exceptions to this policy. The IAG shall also advise the CFO on target amounts or percentages to be held in the primary reserves for the DIF portfolio where applicable; and advise the CFO on the investment strategies within the constraints set by this investment policy. Minutes shall be kept of the IAG's meetings.

The Division of Finance shall be responsible for preparing briefing materials for the IAG. These materials shall include, at a minimum:

- DIF portfolio status report.
- DIF portfolio cash flow forecasts.
- A summary of the execution of the IAG's instructions since its prior meeting.
- A recommended investment strategy for the DIF portfolio for the subsequent period.

In the event market conditions or cash flow projections require a reassessment of investment strategies between regularly scheduled IAG meetings, the Division of Finance shall notify the CFO who shall determine in his or her sole discretion whether an interim IAG meeting should be held.

Reporting Requirements

The CFO will report quarterly to the Board of Directors on:

- The status and recent investment experience of the DIF portfolio.
- The current and prospective investment strategies.
- Any limitations on the size of the Primary Reserve.
- The principal reasons for any significant changes in either investment experience or strategy.
- Any actions taken that constitute exceptions to this policy.

Other Corporate Investment Portfolios

The principal investment portfolio of the Corporation is the DIF portfolio. The business activities of the Corporation may result in the need to create pools of funds that must be segregated and invested separately from the DIF portfolio because of restrictions on use, maturity, availability, or for other reasons. As deemed appropriate, the CFO may establish an individual investment portfolio to segregate the investment activity for investable funds that are subject to specific restrictions. The CFO will establish a written investment strategy for any such portfolio that is consistent with this policy. The CFO shall report to the Board of Directors on each such portfolio, including the written investment strategy for any such portfolio.

ATTACHMENT 3

May 31, 2006

MEMORANDUM TO: The Board of Directors

FROM: Steven O. App
Deputy to the Chairman and
Chief Financial Officer

Frederick S. Selby
Director, Division of Finance

SUBJECT: Designating and Valuing Securities Held in the
Deposit Insurance Fund's (DIF) Investment Portfolio

Executive Summary

The Investment Advisory Group (IAG), the group charged with overseeing the management of the DIF's investment portfolio, recently met to discuss the merits of designating all existing and future investment securities of the DIF as available-for-sale (AFS). The effect of this change would be to make the DIF's fund balance, and therefore its reserve ratio, potentially more volatile going forward. The IAG deferred a decision about whether to adopt this proposed change until such time as the new insurance assessment system, called for under the recently enacted deposit insurance reform legislation, is in place for a sufficient period of time.

Discussion

At present, the FDIC designates the DIF's investments in Treasury securities as either AFS or held-to-maturity (HTM) in order to ensure adequate levels of AFS securities are available to fund cash needs associated with potential bank and thrift failures. The portfolio's AFS security balance reflects the level of potential bank and thrift failure activity and the related estimated resolution funding needs. Participation in Financial Risk Committee meetings, discussions with Divisions of Resolutions and Receivership staff, discussions among the IAG members, and occasional special presentations to the IAG are all taken into consideration when establishing target AFS security balances. Furthermore, the IAG believes that a cushion to cover unexpected failures (that is, for failures related to institutions not currently on the problem bank list) is prudent given that it may take time to build up sufficient cash reserves and AFS security balances to fund such unanticipated resolutions.

Nevertheless, as the AFS security portion of the DIF investment portfolio grows from time to time, it interjects additional volatility into the fund balance. This volatility is based upon changes in Treasury yields, the shape of the Treasury yield curve, and the amount and average duration of the AFS security portion of the DIF's investment portfolio. To help balance the investment objectives of maximizing investment income while controlling fund balance volatility, AFS security maturity limits and other control techniques are used to help mitigate and control associated fund balance volatility. To calculate the DIF fund balance (the numerator of the reserve ratio), the FDIC values investment securities that are designated AFS at market value, which approximates fair value, and those that are designated HTM at amortized historical cost, consistent with generally accepted accounting principles. Specifically, in applying Statement of Financial Accounting Standard (SFAS) No.115, the FDIC has consistently demonstrated the positive intent and, more importantly, the ability to hold all HTM-designated securities to maturity, as represented to and opined on by the Government Accountability Office (GAO) for the last 12 consecutive years. Moreover, the fact that FDIC has never sold an HTM security corroborates our ability to hold such securities to maturity.

In a 2005 audit, the Office of Inspector General (OIG) recommended that the FDIC's Chief Financial Officer consider also including in its financial reports an alternate reserve ratio calculation that values the HTM portion of the investment portfolio at market rather than amortized historical cost.[5] The report noted that the recommendation would be most appropriate for a situation where the Board is permitted greater flexibility in the decisions related to the need to levy insurance assessments, than the situation prevalent at the time of the audit where the Board's discretion to make such decisions was quite limited and the Designated Reserve Ratio (DRR) of 1.25% represented a "hard target." While management opted not to immediately adopt the OIG's recommendation because of the limited discretion that the Board enjoyed at that time with respect to such matters, it noted in its response to the OIG's audit that if the then pending deposit insurance reform legislation provision was enacted that replaced the fixed DRR with a target reserve ratio that could vary within an acceptable range, then the OIG's recommendation would merit further consideration.

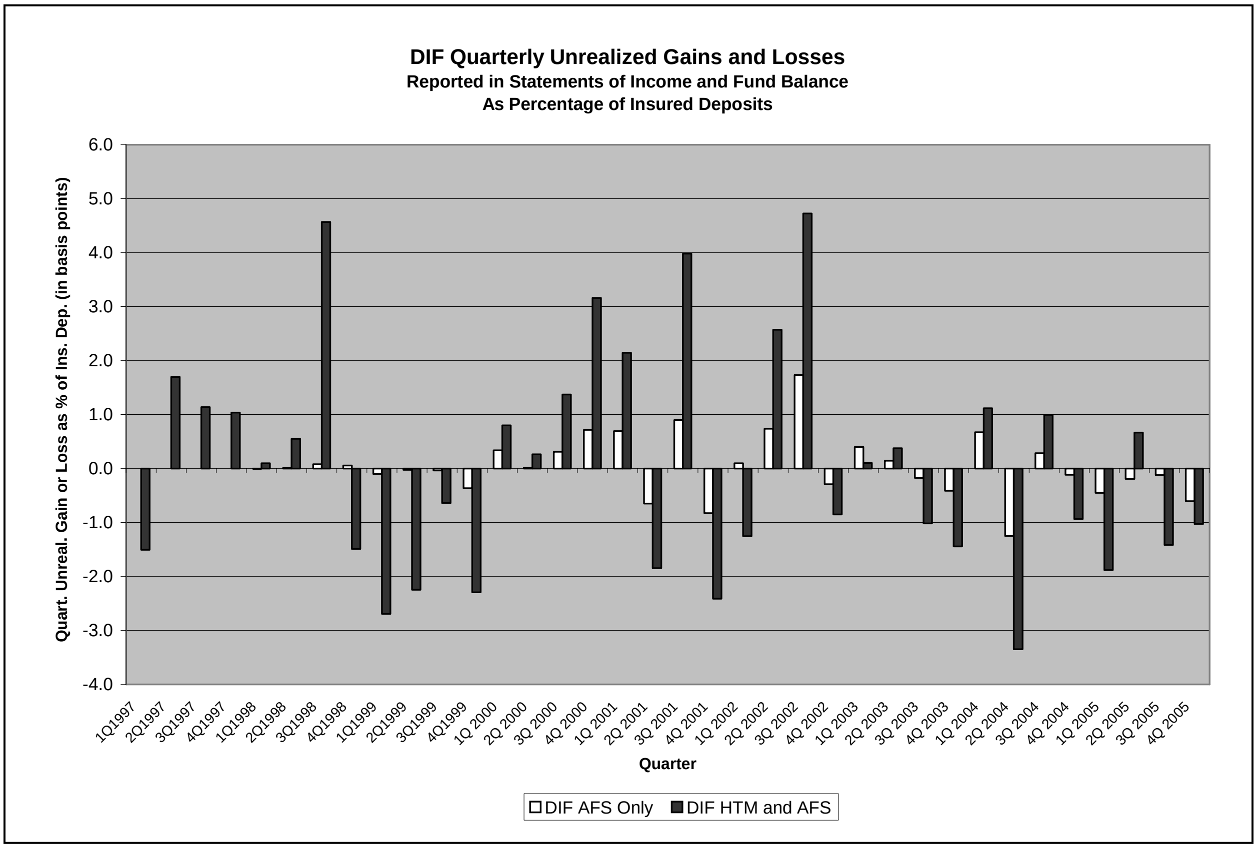
In light of the passage of deposit insurance reform legislation earlier this year, the IAG recently met and discussed the advantages and disadvantages of designating all existing and future DIF investment securities as AFS, the effect of which would be to continuously mark to market the entire DIF investment portfolio. While several arguments can be made in support of this proposed change, the IAG decided to defer this decision for several reasons, not the least of which was that it would make the DIF fund balance, and by implication, its reserve ratio much more volatile at the very same time the FDIC would be transitioning to a system of new deposit insurance rules that by themselves could result in greater variability in the reserve ratio.

As noted above, marking all DIF investments to market would make the reserve ratio more volatile by increasing the volatility of the fund balance as reported on the statement of financial position. Volatility would increase because the DIF's investment securities, which make up the lion's share of its current fund balance, would be much more sensitive to movements in interest rates. This would occur even though the unrealized gains (or losses) on the portfolio would not actually be realized, absent the need to liquidate investment securities to fund an actual bank or thrift failure.

The chart below compares, by quarter for the past nine years, the effect on the combined Bank Insurance Fund and Savings Association Insurance Fund reserve ratio (the hypothetical reserve ratio of the DIF had it existed during that period) of marking only AFS investments (our current practice) with marking all investments (both AFS and HTM) to market (as proposed). As the

[5] OIG Audit No. 05-025, The FDIC's Investment Policies.

data below indicate, marking all DIF's investments to market would have introduced significantly more volatility with respect to the portfolio's valuation, and, by implication, its related reserve ratio. For example, adoption of the proposed change would have caused approximately a four and one-half basis point swing in the combined reserve ratio for the third quarter of 1998.[6]



In addition to the volatility that the proposed change would likely add to the DIF's reserve ratio, it should be noted that adoption of this change would also severely limit the FDIC's freedom to designate newly purchased securities as either AFS or HTM at the time of purchase going forward. Specifically, by choosing to reclassify all existing HTM securities to AFS, FDIC would lose its discretion to classify all of its newly purchased investment securities as HTM for at least two years from the reclassification date.[7] Hence, the adoption of this change would have repercussions for the DIF fund balance and its related reserve ratio for a considerable period beyond the date the proposed change was adopted.

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[6] Calculated as the quarterly change in the DIF HTM and AFS less the quarterly change in the AFS only, divided by estimated insured deposits.

[7] Accounting literature, including Statement of Financial Accounting Standards No. 115, does not cite a specific two-year period before securities could be designated HTM. However, in practice, the Securities and Exchange Commission has permitted entities to reestablish HTM security classifications only after a two-year period from the reclassification date.

Conclusion

Marking all of the DIF's investment securities to market would make the reserve ratio much more volatile at a time of transition to a system of new deposit insurance rules. Hence, the IAG decided to defer a decision on this proposal at this time. The IAG will revisit this decision once the new insurance assessment system is in place for a sufficient period of time.