November 21, 2006

MEMORANDUM TO: The Board of Directors

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

Douglas H. Jones
Acting General Counsel

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

RECOMMENDATION

We recommend that the Board of Directors approve the attached ANPR and authorize its publication in the *Federal Register*. The ANPR seeks public comment for a period of ninety days on the best means to facilitate the process for determining the insurance status of depositors of large insured depository institutions in the event of failure. As currently contemplated, the options discussed in the ANPR would apply only to the 152 insured depository institutions with more than 250,000 deposit accounts and more than $2 billion in domestic deposits, as well as seven additional institutions with total assets over $20 billion, less than 250,000 deposit accounts and at least $2 billion in domestic deposits.

BACKGROUND

In December 2005 the FDIC issued a prior advance notice of proposed rulemaking on this subject ("2005 ANPR").[1] This ANPR is a follow-up to that issuance.

The ability to determine the insured status of deposit accounts rapidly is essential to handle failures in the most cost effective and least disruptive fashion. Unfortunately, banks normally do not track the insured status of their depositors. Today, the FDIC obtains depositor data only from insured institutions in danger of failing. These data are obtained for the sole purpose of determining the insurance status of individual depositors and estimating the total amount of insured funds in the institution. The receipt of such depositor data is necessary for the FDIC to carry out its insurance function.

The claims modernization initiative has several components. First, streamline the business processes of the FDIC's internal system used to facilitate a deposit insurance determination. This effort will incorporate better technology to enhance automation.

[1] "Large-Bank Deposit Insurance Determination Modernization Proposal, Advance Notice of Proposed Rulemaking," 70 FR 73652, December 13, 2005.

This work is well under way. Additionally, the completion of the modernization of the FDIC's internal systems will coincide with the implementation of the approach suggested in this ANPR, or alternatives to this proposal.

The approach suggested in this ANPR would not alter the FDIC's policy regarding the receipt of depositor information in preparation for the resolution of a troubled insured institution, but it would ensure the immediate availability of important data for the largest institutions. Covered Institutions currently are not required to know the insurance status of depositors or inform them of this status when a new account is opened. The FDIC is interested in comments on whether Covered Institutions should be encouraged or required to know the insurance status of each *new* deposit account and/or notify customers of this status when a new account is opened.

THE 2005 ANPR

Three Options

The 2005 ANPR presented three options for comment.

- Option 1 would have required the Covered Institutions to:
    - Identify the owner(s) of each account by using a unique identifier.
    - Identify the deposit insurance ownership category of each deposit account.
    - Supply to the FDIC a standard data set mapped and formatted to FDIC specifications and reconciled to the institution's actual trial balance.
    - Calculate and place provisional holds automatically in the event of failure.
    - Remove provisional holds to be replaced by FDIC-supplied holds/debits as reflected by the deposit insurance determination results.

- Option 2 was similar to Option 1, except the standard data set would include only information the institution currently possessed. This option would not have required a unique identifier for each depositor or that the institution provide the insurance category for each account.

- Option 3 would have required the largest 10 or 20 Covered Institutions (in terms of the number of deposit accounts) to know the insurance status of their depositors and to have the capability to automate the placement of hard holds and debit uninsured funds as specified by the FDIC upon failure.

Summary of Comments

The FDIC received 28 comment letters in response to the 2005 ANPR. Sixty-four percent of the comment letters indicated opposition due to the view that implementation costs of the options outweighed any potential benefits, high potential costs and regulatory burdens, or the options simply are not needed. Some commenters were expressly supportive of one or more of the options, but in some cases indicated concern over costs.

Two commenters indicated support because the 2005 ANPR options were viewed as addressing the concept of too-big-to-fail ("TBTF") and enhancing market discipline.

Differentiation between options. While the majority of commenters opposed the FDIC moving forward, many clearly differentiated between the three options listed in the 2005 ANPR. Option 3 was viewed as extremely burdensome. Of the Option 1 requirements of supplying a unique depositor ID and the insurance category of each account, the insurance category requirement was viewed as significantly more burdensome.

Estimated costs. No trade organization provided specific cost estimates on the 2005 ANPR options, other than to say the costs would be "high" or "very substantial." Four of the 14 large-institution responders provided cost estimates for one or more of the options. These estimates generally were characterized as being "rough" and frequently contained caveats. These estimated costs were fairly modest when compared to other deposit insurance expenses, such as a one basis point assessment.

Too big to fail and market discipline. Several commenters raised the issue of TBTF, effectively expressing the concern that uninsured depositors of a large institution could be made whole in the event of failure, regardless of expected losses in the failed institution.

The cost/benefit tradeoff. Any option will impose industry costs, but benefits also will accrue. The staff believes the FDIC must balance these costs and benefits. In this regard:

- The Federal Deposit Insurance Corporation Improvement Act's (FDICIA) least-cost requirement mandates that uninsured depositors be exposed to losses. Also, FDICIA's legislative history and the nature of the systemic risk exception provide a clear message that uninsured depositors of large institutions are to be treated on par with those of any size. Meeting these mandates is an important benefit of the options presented in the ANPR.

- The FDIC's legal mandates have direct implications for TBTF and market discipline. If financial markets perceive uninsured depositors in large institutions will be made whole in the event of failure, economic resources will be misallocated.

- Many market observers believe there are substantial benefits of improved market discipline that accrue even without serious industry distress or bank failures. Effective market discipline also limits the size of troubled institutions and results in a more rapid course toward failure. Both serve to mitigate overall resolution losses. Lower resolution losses benefit insured institutions through lower insurance assessments.

- In the absence of one or more of the options outlined in the ANPR or alternatives to this proposal, the staff is concerned that the resolution of a Covered Institution could be accomplished only through a significant departure from its normal claims procedures. This departure could involve leaving the bank closed until an insurance determination is made or the use of shortcuts to speed the opening of the bridge institution. The use of shortcuts or other mechanisms to facilitate depositor access to funds will imply disparate treatment among depositors within the failed institution and certainly different treatment relative to the closure of a non-Covered Institution.

- An abbreviated claims process—especially one deviating significantly from the FDIC's normal policies and procedures—risks reducing or destroying an important asset of the receivership. Preservation of franchise value in the event of failure of a Covered Institution will be an important benefit of the proposed options.

THE 2006 ANPR

The strong industry opposition and high costs of Option 3 make it unlikely to be the most cost-effective option. In addition, the less costly options appear to meet the primary objective of the FDIC. Although the 2005 ANPR generated only limited data on the costs of Options 1 and 2, these costs are almost certainly low enough to merit moving forward—particularly given the substantial benefit to the FDIC in being able to meet its statutory mandate for least-cost resolutions and the uniform application of insurance limits, plus additional benefits associated with enhanced market discipline.

The 2006 ANPR proposes dividing Covered Institutions into two tiers with the following requirements. Non-Covered Institutions would not be subject to any requirements.

- Tier 1 would include the most complex of the Covered Institutions with requirements to:

  - Identify the owner(s) of each account by using a unique identifier.
  - Supply to the FDIC a standard data framework (where the format and content of the data structure for this framework will be developed in cooperation with insured institutions).
  - Supply to the FDIC a standardized data structure to compute a trial balance or supply the institution's actual closing trial balance.
  - Calculate and place provisional holds automatically in the event of failure.
  - Remove provisional holds to be replaced by the FDIC-supplied holds/debits as reflected by the deposit insurance determination results.

- Tier 2 would include the remainder of Covered Institutions. Requirements for this tier would be similar to Tier 1, except a unique depositor ID would not be required.

Implementation of these or similar options would require the FDIC to amend its regulations. In that case, the FDIC would be required to publish a Notice of Proposed Rulemaking for public comment before a final decision is made.

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Attachments