October 9, 2006

MEMORANDUM TO: The Board of Directors

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

Fred Selby
Director, Division of Finance

Douglas H. Jones
Acting General Counsel

SUBJECT: Final Rule to Implement the One-time Assessment Credit

Recommendation

The Federal Deposit Insurance Reform Act of 2005 ("Reform Act") made numerous revisions to the deposit insurance assessment provisions of the FDI Act.[1] Specifically, the Reform Act amended the Federal Deposit Insurance Act to require that the FDIC's Board of Directors ("Board") provide by regulation an initial, one-time assessment credit to each eligible insured depository institution (or its successor) based on the assessment base of the institution as of December 31, 1996. In May of this year the FDIC issued a proposed rule to implement the one-time assessment credit.[2] The comment period for the proposed rule ended on August 16, 2006.

Upon review of the comments received on the proposed rule, the staff recommends that the Board authorize publication in the Federal Register of the attached proposed final rule to implement the one-time assessment credit required by the FDI Act.

Background

In the proposed rule, the Board proposed to: rely on the 1996 assessment base figures contained in the Assessment Information Management System (AIMS)[3]; define *successor* as the resulting institution in a merger or consolidation, while seeking comment on

[1] The Reform Act was included as Title II, Subtitle B, of the Deficit Reduction Act of 2005, Public Law 109-171, 120 Stat. 9, which was signed into law by the President on February 8, 2006.

[2] 71 Fed. Reg. 28808 (May18, 2006).

[3] The current Assessment Information Management Systems (AIMS) contains records from quarterly reports of condition data from institutions with bank and thrift charters. The FFIEC Central Data Repository (FFIEC-CDR) for banks and the Thrift Financial Report for thrifts provide AIMS with the values of the deposit line items that are used in the calculation of an institution's assessment base.

alternative definitions; automatically apply each institution's credit against future assessments to the maximum extent allowed consistent with the limitations in the FDI Act; and provide an appeals process for administrative challenges to individual institution's credit amounts that culminates in review by the FDIC's Assessment Appeals Committee. (A full description of the proposed rule is provided in the attached draft Federal Register notice.)

We received twenty-six comments on the proposed rule. Most of the comments focused to some extent on the definition of *successor.* Five institutions and one trade association supported the proposed definition of *successor*, which relies on traditional principles of corporate law. Five institutions appeared to support including a *de facto* merger rule to recognize purchase-and-assumption transactions that may be viewed by some as the functional equivalent of a merger or consolidation. Four national trade associations supported adding a *de facto* merger rule. Six institutions and a trade association commented in favor of a definition that would link credits to deposits (the so-called *follow-the-deposits* approach), arguing that assessments are paid on deposits and rights and responsibilities associated with those deposits transfer when they are sold. One institution raised the question of *stripped charters*, where one institution might acquire the assets and liabilities of another, while a third institution would merely merge with the charter of the acquired institution. Two United States Senators filed a joint comment letter asking the FDIC to reexamine its definition of successor, expressing their concern that the proposed rule "provides absolutely no opportunity for a bank that purchased deposits to receive credits for those deposits, whether deposits are easily traceable, or whether awarding credits to the selling bank would create a windfall for that selling bank and create a new free rider on the Fund."

Six letters suggested that the FDIC phase in the one-time credit and some suggested three approaches for phasing in the application of credits: allowing institutions to use fifty percent of credits against assessments; allowing institutions to use a certain number of basis points of credit to offset assessments in any one year; or implementing a graduated credit schedule to offset assessments. These commenters argued that the proposal to apply credits to quarterly assessments to the maximum extent allowed by law would disproportionately adversely affect institutions chartered since 1996. One trade association supported the proposed rule, under which the FDIC would automatically offset quarterly assessments with the maximum amount of credits available and allowed by law. Another trade association suggested that the FDIC allow institutions to elect to restrict the application of their credits to budget for future expected expenses.

One institution took the position that credits should not expire unused if an institution terminated after the effective date of the final rule; rather, that institution recommended that any remaining credit from that institution be redistributed among all eligible institutions. One institution opposed allowing the transfer of credits except to successors. Two trade associations supported the transferability described in the proposed rule.

The Final Rule

Upon considering the comments on the proposed rule, the staff recommends adoption of the attached proposed final rule. Under the recommended final rule, the FDIC would rely on the 1996 assessment base figures as contained in AIMS in determining the aggregate amount of the one-time assessment credit and each institution's share of that aggregate amount; define *successor* as the resulting institution in a merger or an insured depository institution that acquired a portion of another insured depository institution's 1996 assessment base ratio under the de facto rule defined in the final rule; automatically apply each institution's credit against future assessments to the maximum extent allowed by the statute; and provide an appeals process for administrative challenges to individual institution's credit amounts that culminates in review by the AAC.

The following is a summary of the discussion of the main issues addressed in the preamble to the proposed final rule.

1. Eligible Insured Depository Institutions and their Successors

Under the statute, to be eligible to receive a share of the one-time assessment credit, an insured depository institution must have been in existence on December 31, 1996, and paid a deposit insurance assessment prior to that date or be a *successor* to such an institution. As the comments reflect, the principal issue in this rulemaking has been the definition of "successor." In the proposed rule, the FDIC proposed to define successor for purposes of the one-time credit as the resulting institution in a merger or consolidation occurring after December 31, 1996. We requested specific comment on whether to include in the definition of "successor" a regulatory definition of a de facto merger to recognize that the results of some transactions, which are not technically or legally mergers or consolidations, may largely mirror the results of a merger or consolidation. A number of approaches were possible and the staff carefully considered the alternatives presented in the proposed rule and the comments on them. The proposed final rule defines successor as (1) the resulting institution in a merger or consolidation or (2) as an insured depository institution that acquired part of another insured depository institution's 1996 assessment base ratio under a de facto rule, as described below.

Staff believes this definition is consistent with the purpose of the one-time credit -- that is, to recognize the contributions that certain institutions made to capitalize the Bank Insurance Fund and Savings Association Insurance Fund, now merged into the Deposit Insurance Fund Thus, a resulting institution in a merger occurring after December 31, 1996, will be considered a successor to an eligible insured depository institution. This definition also is consistent with traditional principles of corporate law. 15 William Meade Fletcher et al., Fletcher Cyclopedia of the Law of Private Corporations §§ 7041-7100 (perm. ed., rev. vol. 1999).

Under the statute, Congress has provided the FDIC with broad discretion to define "successor" considering any factors that the Board deems appropriate. Several commenters noted and the staff recognizes the consolidation of the industry, the numerous transactions that have occurred since 1996, and that parties would not have taken into account future credits when structuring transactions. Accordingly, under the proposed final rule "successor " is defined as the acquiring, assuming or resulting institution in a merger[4] or the acquiring institution under a de facto rule**.** The de facto rule applies to any transaction in which an insured depository institution assumes substantially all of the deposit liabilities and acquires substantially all of the assets of any other insured depository institution.

For these purposes, the proposed final rule considers an assumption and acquisition of at least 90 percent of the transferring institution's deposit liabilities and assets at the time of transfer as substantially all of that institution's assets and deposit liabilities. Any successor institution qualifying under that threshold would be entitled to a pro rata share, based on the deposit liabilities assumed, of the transferring institution's remaining 1996 assessment base ratio at the time of the transfer.

Staff recognizes that including a de facto rule in the definition of successor departs, to a certain extent, from the clear, bright line that a strictly applied merger definition would provide. However, in keeping with the comments we received in favor of defining mergers to include de facto mergers, we believe this approach is fairer than excluding de facto transactions from the definition of successor. It is also consistent with Congressional intent in giving the FDIC broad discretion to define successor institutions for purposes of the one-time assessment credit. As some commenters point out, the insurance fund benefited from certain of these transactions by avoiding failure of an insured depository institution and associated losses.

Staff believes that the merger and consolidation approach for successor is the most consistent with the purpose of the one-time assessment credit; however, a strict merger definition would exclude certain transactions that are also consistent with the purpose of the one-time credit. A de facto rule recognizes that a transfer of at least 90 percent of an institution's assets and deposit liabilities indicates a substantial divestiture of the transferring institution's business. We recognize some institutions that assumed deposit liabilities would not qualify, but a lower threshold would be less consistent with the purpose of the one-time credit in recognizing past contributions by institutions.

Some commenters that would benefit from a "follow the deposits" approach argue that the adopted definition of "successor" is not consistent with congressional intent.

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[4] The definition of merger in the final rule specifically excludes transactions in which an insured depository institution either directly or indirectly acquires the assets of, or assumes liability to pay any deposits made in, any other insured depository institution where there is not a legal merger or consolidation of the two insured depository institutions.

Contrary to the contention of some commenters, Congress's broad delegation of authority to the FDIC to define "successor" does not evidence Congressional intent either to expand or contract the group of qualified institutions. Rather, the broad delegation ensured that the FDIC could consider the full range of facts and circumstances in developing a definition of successor.

As indicated in the proposed rule, if there is no successor to an institution that would have been eligible for the one-time assessment credit before the effective date of the final rule, because an otherwise eligible institution ceased to be an insured depository institution before that date, then that portion of the aggregate one-time credit amount will be redistributed among the eligible institutions. On the other hand, if there is no successor to an eligible insured depository institution that ceases to exist after the effective date of the final rule, that institution's credits will expire unused.

2. Notice of Credit Amount

The proposed final rule indicates that, as soon as practicable after the Board's adoption of the final rule, the FDIC will notify each insured depository institution of its 1996 assessment base ratio and preliminary determination of its share of the one-time assessment credit. The Statement of One-Time Credit ("Statement"): would inform each institution of its current, preliminary 1996 assessment base ratio; itemize the 1996 assessment bases to which the institution is believed to have claims pursuant to the definition of successor; provide the preliminary amount of the institution's one-time credit based on the institution's 1996 assessment base ratio as applied to the aggregate amount of the credit; and explain how the ratios and resulting amounts were calculated generally. The FDIC would provide the Statement through FDICconnect and by mail in accordance with existing practices for assessment invoices. The Statement and any subsequent assessment invoices advising of the credit amount or an adjustment to the assessment base ratio would also advise institutions of their right to challenge the calculation and the procedures to follow.

3. Requests for Review Involving Credits

Under the proposed final rule, within 30 days from the date the FDIC makes available the Statement or an adjusted invoice, an institution may request review if it: (1) disagrees with the FDIC's determination of eligibility or ineligibility for the credit; (2) disagrees with the computation of the credit amount on the initial Statement or any subsequent invoice; or (3) believes that the Statement or a subsequently updated invoice does not fully or accurately reflect appropriate adjustments to the institution's 1996 assessment base ratio. One commenter requested that this time frame be extended to parallel the assessment appeals process. Because institutions have had access to the online search tool since May, staff does not believe the 30-day deadline for requests for review will be

overly burdensome. In addition, compressing the schedule for reviews is necessary to resolve as many requests as possible before the collection of assessments for the first calendar quarter of 2007, thereby allowing most institutions to offset those assessments with available credits.

Under the proposed final rule, the request for review must be filed with the Division of Finance (“DOF”) and be accompanied by any documentation supporting the institution's claim. If an institution does not submit a timely request for review, the institution is barred from subsequently requesting review of its one-time assessment credit amount. In addition, the requesting institution must identify all other institutions of which it knew or had reason to believe would be directly and materially affected by granting the request for review and provide those institutions with copies of the request for review and supporting documentation, as well as the FDIC's procedures for these requests for review. These institutions then have 30 days to submit a response and any supporting documentation to the DOF, copying the institution making the original request for review. If an institution identified and notified through this process does not submit a timely response, that institution would be: (1) foreclosed from subsequently disputing the information submitted by any other institution on the transaction(s) at issue in the review process; and (2) foreclosed from any appeal of the decision by the DOF Director.

The proposed final rule would require a written response from the DOF Director, or his or her designee: (1) within 60 days of receipt by the FDIC of the request for revision; (2) if additional institutions have been notified by the FDIC, within 60 days of the last response; or (3) if additional information has been requested by the FDIC, within 60 days of receipt of any additional information due to such request, whichever is later. The requesting institution, or an institution materially affected by the Director's decision, that disagrees with that decision may appeal its credit determination to the AAC. The AAC's determination will be final and not subject to judicial review.

4. Application or Use of Credits

The one-time assessment credits offset the collection of deposit insurance assessments beginning with the collection of assessments for the first assessment period of 2007. Under the proposed final rule, the FDIC would track each institution's one-time credits and automatically apply them to that institution's assessment to the maximum extent allowed by law. For 2007 assessment periods, all credits available to an institution may be used to offset the institution’s insurance assessment, subject to certain statutory limitations. For 2008, 2009, and 2010, the final rule, consistent with the statute, would provide that credits may not be applied to more than 90 percent of an institution's assessment. By statute, for an institution that exhibits financial, operational, or compliance weaknesses ranging from moderately severe to unsatisfactory, or is not adequately capitalized at the beginning of an assessment period, the amount of any credit that may be applied against that institution's assessment for the period may not exceed the amount the institution would have been assessed had it been assessed at the average

assessment rate for all institutions for the period. Also, under the statute, the FDIC may impose a limit on the use of credits in a *restoration plan* when the reserve ratio falls below 1.15 percent of estimated insured deposits. During the time a restoration plan is in effect, the FDIC is required to apply one-time credit amounts against any assessment imposed on an institution for any assessment period in an amount equal to the lesser of: (1) the amount of the assessment, or (2) the amount equal to three basis points of the institution's assessment base.

Four comment letters on behalf of de novo institutions suggest that the FDIC should allow credits to offset assessments only on a graduated scale. These commenters argue that, if the credit regulation is implemented as proposed, "it would have an immediate negative impact on rates paid on consumer savings accounts by new growth institutions because they will be required to bear the burden on the cost of deposit insurance not just for their own institution, but also for utilizing assessment credits." In the staff's view, any such impact would be short-term. Moreover, the purpose of the credits, as previously discussed, is to recognize past payments by depository institutions to build the fund, so, by definition, institutions that did not pay assessments will be treated differently. As these commenters acknowledge, the proposal to apply credits against assessments to the maximum extent allowed by law is easily understood and simple to administer. In addition, the better reading of the statute indicates that there was no congressional intent to allow the FDIC to restrict further the use of credits, except in specifically enumerated circumstances. The FDI Act, as amended by the Reform Act, requires the FDIC to apply credit amounts to future assessments, mandates certain limits on the use of credits at specific times or in specific circumstances, and expressly provides the FDIC with the discretion to restrict the use of credits only during a restoration plan and only to a limited extent.

One commenter recommended that institutions be allowed to adjust their use of credits to budget for future expected expenses. Staff believes this flexibility in using credits would be undesirable because of its potential operational complexities for the FDIC. Also, the application of the credit against an institution's future assessments other than to the maximum extent allowed consistent with the limitations in the FDI Act would reduce the economic benefit of the credit to the institution.

5. Transfer of Credits

In addition to the transfer of credits to successors, the proposed final rule allows transfers of credits and adjustments to 1996 assessment base ratios by express agreement between insured depository institutions prior to the FDIC's final determination of an eligible insured depository institution's 1996 assessment base ratio and one-time credit amount pursuant to the final rule. While the statute does not expressly address transferability, the proposed final rule would recognize that it is possible that such agreements might already be part of deposit transfer contracts drafted in anticipation of deposit insurance reform legislation, which was pending in Congress over several years. Alternatively, institutions

involved in a dispute over successorship, their 1996 assessment base ratio, and their shares of the one-time credit might reach a settlement over the disposition of the one-time credit. Given the FDIC's role in administering credits, it is most efficient to allow the FDIC to recognize these contractual provisions or settlements. In either case, for the FDIC to recognize the transfer, the final rule would require institutions to notify the FDIC and submit a written agreement signed by legal representatives of the involved institutions. Upon the FDIC's receipt of the agreement, appropriate adjustments would be made to the institutions' affected one-time credit amounts and 1996 assessment base ratios.

Similarly, after an institution's credit share has been finally determined and no request for review is pending with respect to that credit amount, the FDIC would recognize an agreement between insured depository institutions to transfer any portion of the one-time credit from an eligible institution to another institution. Nothing in the statute suggests that such transfers are precluded. In addition, no compelling reasons to prevent such transfers have been raised by the commenters. Because credits do not earn interest, there may be some desire among eligible insured depository institutions to sell credits that could not otherwise be used promptly. The same rules for notification to the FDIC and adjustments to invoices would apply as under the prior discussion, except that the FDIC would not adjust institutions' 1996 assessment base ratios. Except as provided in the preceding paragraph, adjustments to 1996 ratios would be made only to reflect mergers or consolidations occurring after the effective date of the final rule.

Conclusion

For the reasons discussed above, we recommend that the Board adopt the proposed final rule to implement the one-time assessment credit required by the FDI Act and authorize publication of the final rule in the Federal Register.

Attachments

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