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
Assessment Dividend Requirements

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 FDI Act to require the FDIC to prescribe regulations to implement assessment dividend requirements, including regulations governing the method for the calculation, declaration, and payment of dividends and administrative appeals of individual dividend amounts. In May of this year, the FDIC published a proposed rule to implement the dividend requirements of the Reform Act.[2] The comment period for the proposed rule ended on August 16, 2006.

Upon review of the comments received on the proposed rule, we recommend that the Board authorize publication in the Federal Register of the attached proposed final rule to implement the assessment dividend requirements of the FDI Act, as amended by the Reform Act. The final rule would sunset on December 31, 2008. It is further recommended that, during 2007, the FDIC undertake a second notice-and-comment rulemaking beginning with an advanced notice of proposed rulemaking to explore alternative methods for distributing future dividends.

Background

Section 7(e)(2) of the FDI Act, as amended by the Reform Act, requires that the FDIC, under most circumstances, declare dividends from the Deposit Insurance Fund ("DIF") when the reserve ratio at the end of a calendar year exceeds 1.35 percent, but is no greater than 1.5 percent. In that event, the FDIC must generally declare one-half of the amount

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[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. 28804 (May 18, 2006).

in the DIF in excess of the amount required to maintain the reserve ratio at 1.35 percent as dividends to be paid to insured depository institutions. However, the Board may suspend or limit dividends to be paid, if the Board determines in writing, after taking a number of statutory factors into account, that the DIF faces a significant risk of losses over the next year; and it is likely that such losses will be sufficiently high as to justify a finding by the Board that the reserve ratio should temporarily be allowed to grow without requiring dividends when the reserve ratio is between 1.35 and 1.5 percent or exceeds 1.5 percent.[3]

In addition, the statute requires that the FDIC, absent certain limited circumstances, declare a dividend from the DIF when the reserve ratio at the end of a calendar year exceeds 1.5 percent. In that event, the FDIC must declare the amount in the DIF in excess of the amount required to maintain the reserve ratio at 1.5 percent as dividends to be paid to insured depository institutions. The FDI Act directs the FDIC to consider each insured depository institution's relative contribution to the DIF (or any predecessor deposit insurance fund) when calculating such institution's share of any dividend.

If the Board decides to suspend or limit dividends, it must submit, within 270 days of making the determination, a report to the Senate and House Banking Committees. The report must include a detailed explanation for the determination and a discussion of the factors required to be considered.

In May, the FDIC proposed a temporary rule for dividends that would sunset after two years, which would allow the FDIC to undertake a more comprehensive rulemaking. The proposed rule: described a process for the Board's annual determination of whether a declaration of a dividend is required and consideration, to the extent appropriate, of whether circumstances indicate that a dividend should be limited or suspended; set forth the procedures for calculating the aggregate amount of any dividend, allocating that aggregate amount among insured depository institutions considering the statutory factors provided, and paying such dividends to individual insured depository institutions; and provided insured depository institutions with a reasonable opportunity to challenge the amount of their dividends.

A summary of the proposed rule is provided in the preamble to the attached proposed Federal Register notice.

Comments on the Proposed Rule

We received ten comment letters on the proposed rule, six from insured depository institutions, one from a coalition of seven institutions, and three from banking industry

[3] This provision would allow the FDIC's Board to suspend or limit dividends in circumstances where the reserve ratio has exceeded 1.5 percent, if the Board made a determination to continue a suspension or limitation that it had imposed initially when the reserve ratio was between 1.35 and 1.5 percent.

trade associations. Commenters focused on the proposed temporary allocation method, the definition of "predecessor," and the timing for dividend declaration and payment. Three institutions and three trade groups supported the proposed temporary allocation method for dividends during the life of the rule; whereas, four letters from institutions opposed it, instead supporting an allocation method that immediately takes into account payments made under the new assessments system. One trade association recommended that, if a dividend becomes likely in the next two years, the FDIC accelerate the adoption of the planned, more comprehensive rule.

Three institutions and one trade association supported the proposed definition of “predecessor,” which relied on whether the resulting institution acquired another institution through merger or consolidation. One trade association favored a “follow-the-deposits” approach to the definition. A number of commenters indicated that the definition of "predecessor" essentially should parallel the definition of "successor" for purposes of the one-time assessment credit rule.

One institution suggested that the declaration of dividends could be moved earlier to March 31st. A trade association commented that the FDIC should provide for the payment of dividends prior to the time of the assessment collection for the second calendar quarter beginning after the declaration of the dividend. It further commented that requests for review should not delay the payment of dividends.

The Final Rule

Upon considering the comments, staff recommends a final rule similar to the proposed rule with changes to the provisions for the payment of dividends, the definition of *predecessor*, and the time period for appealing an FDIC decision on a request to review a dividend determination. Consistent with the proposal, this rule is temporary; it will take effect on January 1, 2007, and will sunset on December 31, 2008

Procedures

As proposed, the FDIC would determine annually whether the reserve ratio at the end of the prior year equals or exceeds 1.35 percent of estimated insured deposits or exceeds 1.5 percent, thereby triggering a dividend requirement. At the same time, if a dividend is triggered, the FDIC would determine whether it should limit or suspend the payment of dividends based on the statutory factors. Any determination to limit or suspend dividends would be reviewed annually and would have to be justified to renew or make a new determination to limit or suspend dividends. Each decision to limit or suspend dividends must be reported to Congress. Any declaration with respect to dividends would be made on or before May 15th for the preceding calendar year. This timing allows for the Board's consideration of final data for the end of the preceding year regarding the reserve ratio of the DIF, as well as analysis of what amount is necessary to maintain the fund at the required level and whether circumstances warrant limiting or suspending the payment of dividends. If the FDIC does not limit or suspend the payment of dividends or does not renew such a determination, then the aggregate amount of the dividend would be determined as provided by the statute.

Consistent with the proposal, the final rule would adopt a simple system for allocating any dividends that might be declared during this two-year period. Any dividends awarded before January 1, 2009, would be distributed simply in proportion to an institution's 1996 assessment base ratio (including any predecessors' 1996 ratios). Four commenters suggest that this approach does not consider all the statutory factors. The staff disagrees. As reflected in the proposed rule, the FDIC considered all the statutory factors for distribution, including payments made since year-end 1996. Because of statutory constraints, deposit insurance assessment payments since that date reflect higher levels of risk. In addition, payments to be made under the new risk-based assessments system during the limited life of this rule are likely to be small when compared to the payments made by the industry before 1997. Also, the staff does not believe that it is likely that the reserve ratio of the DIF will trigger a dividend over the next two years. However, as part of the more comprehensive rulemaking to be undertaken next year, the FDIC would consider again all payments made, including payments under the new system from its inception.

Definition of Predecessor

As indicated by the comments, another significant issue for this rulemaking was the definition of "predecessor." The proposed final rule adopts a definition of "predecessor" that simply cross references the definition of “successor” for purposes of the one-time assessment credit rule. In effect, a predecessor is the mirror image of successor. As noted above, a number of commenters agreed that the definitions of "predecessor" and "successor" raise the same issues and should be parallel. The FDIC is simultaneously issuing a final rule on the one-time credit. An analysis of the "successor" issue is contained in that final rule. Notably, the definition of successor in the one-time credit final rule expressly includes a *de facto* rule, defined as 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.

Notice and Payment

As proposed, the FDIC would advise each institution of its dividend amount as soon as practicable after the Board's declaration of a dividend on or before May 15th. That is the earliest practical time for the declaration of dividends given the data availability and the statutory analysis required. Staff agrees, however, that earlier payment of dividends than in the proposed rule should be workable. To allow time for requests for review of dividend amounts, the FDIC had proposed that the individual dividend amounts be paid to institutions at the time of the assessment collection for the second calendar quarter beginning after the declaration of the dividend. In contrast, under the proposed final rule, the individual dividend amounts generally will be paid to institutions no later than 45 days after the issuance of the special notice, which will allow the FDIC to freeze payment of an individual institution's dividend amount, if that amount is in dispute

Depending on the timing of the Board's declaration, which could occur prior to May 15th, and the expiration of the 30-day period for requesting review, it is possible that dividends could be paid at the same time as the collection of the quarterly assessment and would offset those payments. Dividends will be paid through the Automated Clearing House (ACH). Although it is expected in most instances that dividends will be paid after the first quarter assessment payment, if they are paid at the time of assessment payments, offsets will be made. If the institution owes assessments in excess of the dividend amount, there will be a net debit (resulting in payment to the FDIC). Conversely, if the FDIC owes an additional dividend amount in excess of the assessment to the institution, there will be a net credit (resulting in payment from the FDIC). We will notify institutions whether dividends will offset the next assessment payments with the next invoice.

Under the final rule, the FDIC would freeze the payment of the disputed portion of dividend amounts involved in requests for review. In the absence of such action, institutions would receive the amount indicated on the notice. Any adjustment to an individual institution's dividend amount resulting from its request for review will be handled through ACH in the same manner as existing procedures for underpayment or overpayment of assessments.

Reviews

As set forth in the proposed rule, an institution may request review of its dividend amount by submitting documentation sufficient to support the change sought to the Division of Finance within 30 days from the date of the notice or invoice advising each institution of its dividend amount. Review may be requested if (1) an institution disagrees with the computation of the dividend as stated on the invoice, or (2) it believes that the notice or invoice does not fully or accurately reflect appropriate adjustments to the institution's 1996 assessment base ratio, such as for the acquisition of another institution through merger. If an institution does not submit a timely request for review, it would be barred from subsequently requesting review of that dividend amount.

At the time of the request for review, the requesting institution also must notify 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, supporting documentation, and the FDIC's procedures for these requests for review.

In addition, under the proposed final rule the FDIC will make reasonable efforts, based on its official systems of records, to determine that such institutions have been identified and notified. These institutions will 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 was identified and notified through this process and does not submit a timely response, that institution would be foreclosed from subsequently disputing the information submitted by any other institution on the transaction(s) at issue in the review process.

The 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 are notified by the requesting institution or the FDIC, within 60 days of the date of the last response to the notification; or (3) if the FDIC has requested additional information, within 60 days of its receipt of the additional information, whichever is latest.

If a requesting institution disagrees with the determination of the Director, that institution may appeal its dividend determination to the FDIC's Assessments Appeals Committee (AAC). The proposed final rule would extend to thirty calendar days the time for filing an appeal of the Director's written determination. The AAC's determination is final and not subject to judicial review.

Conclusion

For the reasons discussed above, we recommend that the Board adopt the attached proposed final rule to implement the dividend requirements of section 7(e)(2) of the FDI Act, as amended by the Reform Act. As recommended, the rule would sunset after two years, before the payment of dividends is likely, and after there has been adequate time to develop a more comprehensive allocation system through the rulemaking process.

Attachments

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