FDIC
Federal Deposit Insurance Corporation
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Division of Insurance and Research

February 26, 2009

MEMORANDUM TO: The Board of Directors

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

SUBJECT: Final Rule on Risk-Based Assessments;
Amended Restoration Plan; and
Interim Rule on Emergency Special Assessment

SUMMARY OF RECOMMENDATIONS

1. Staff recommends that the FDIC authorize publication of the attached Final Rule ("Final Rule") that would make changes to the risk-based assessment system and set assessment rates as of April 1, 2009.

2. Staff recommends that the FDIC establish and implement the attached Amended Restoration Plan ("Amended Restoration Plan") to extend the restoration period from five years to seven years due to extraordinary circumstances.

3. Staff recommends that the FDIC authorize publication of the attached Emergency Special Assessment Interim Rule and Request for Comment ("Interim Rule") that would a) impose an emergency special assessment of 20 basis points on all insured depository institutions on June 30, 2009 and, b) after June 30, 2009, permit the FDIC Board of Directors ("Board") to impose an emergency special assessment of up to 10 basis points at the end of any calendar quarter whenever the FDIC estimates that the Deposit Insurance Fund (DIF or the fund) reserve ratio will fall to a level that that the Board believes would adversely affect public confidence or to a level close to zero or negative.

BACKGROUND

Recent and anticipated failures have significantly increased losses to the DIF, resulting in a decline in the reserve ratio. The reserve ratio has declined from 1.19 percent as of March 31, 2008, to 1.01 percent as of June 30, 0.76 percent as of September 30, and 0.40 percent (preliminary) as of December 31. This is the lowest reserve ratio for a combined bank and thrift insurance fund since 1993. Staff expects a higher rate of insured institution failures in the next

Concur: ____________________
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Acting General Counsel

few years compared to recent years and a further decline in the reserve ratio before it begins to rise.

Because the fund reserve ratio fell below 1.15 percent as of June 30, 2008, and was expected to remain below 1.15 percent, the Federal Deposit Insurance Reform Act of 2005 required the FDIC to establish and implement a Restoration Plan to restore the reserve ratio to no less than 1.15 percent within five years, absent extraordinary circumstances.

On October 7, 2008, the FDIC established a Restoration Plan for the DIF.[1] The Restoration Plan called for the FDIC to set assessment rates such that the reserve ratio would return to 1.15 percent within five years. In the FDIC's view, this required an increase in assessment rates. Since rates were already three basis points above the base rate schedule, a new rulemaking was required. Consequently, on October 7, 2008, the Board adopted a notice of proposed rulemaking (NPR) with request for comments on revisions to the assessment regulations. The NPR proposed that, effective January 1, 2009, assessment rates would increase uniformly by seven basis points for the first quarter 2009 assessment period. Effective April 1, 2009, the NPR proposed to alter the way in which the FDIC's risk-based assessment system differentiates for risk and set new deposit insurance assessment rates. Also effective on April 1, 2009, the NPR proposed to make technical and other changes to the rules governing the risk-based assessment system. The proposed rule was published concurrently with the Restoration Plan on October 16, 2008, with a comment period scheduled to end on November 17, 2008.

On November 7, 2008, the FDIC Board approved an extension of the comment period until December 17, 2008, on the parts of the proposed rulemaking that would become effective on April 1, 2009. The comment period for the proposed seven basis point rate increase for the first quarter of 2009, with its separate proposed effective date of January 1, 2009, was not extended and expired on November 17, 2008. The final rule on the rate increase for the first quarter of 2009 was approved as proposed by the FDIC Board on December 16, 2008.

THE FINAL RULE

The FDIC received almost 5,000 comments on the parts of the NPR that would become effective on April 1, 2009. FDIC staff has reviewed and considered these comments. Staff's recommended Final Rule on risk-based assessments is attached. The recommended approach would make the same basic changes to the assessment system described in the NPR. These changes include:

1) expanding the range between minimum and maximum initial assessment rates for institutions in Risk Category I;
2) adding a new financial ratio – the adjusted brokered deposit ratio – to the financial ratio method for institutions in Risk Category I;

[1] 73 FR 61598.

3) adding the financial ratios method assessment rate to the assessment rate formula for large institutions with a long-term debt issuer rating (the large bank method);
4) increasing the maximum possible Risk Category I large bank adjustment;
5) providing for an unsecured debt adjustment for institutions in all risk categories;
6) providing for a secured liability adjustment for institutions in all risk categories;
7) providing for a brokered deposit adjustment for institutions in Risk Category II, III, and IV; and,
8) establishing new assessment rates for each risk category.

The Final Rule also reflects a number of changes from the NPR that were made in response to comments by the public.

Assessment Rate Schedule

Assessment Rates Beginning April 1, 2009

1. Assessment Rate Schedule, Ability to Adjust Rates, and Effective Date

To implement the changes to risk-based assessments described below and to increase revenue while the Restoration Plan is in effect, the Final Rule would establish new initial base assessment rates for each risk category as of April 1, 2009. Estimated losses from projected institution failures have risen considerably since the NPR was published last fall. Furthermore, certain changes from the NPR made in response to public comments would have the effect of reducing total assessment revenue generated under the proposed rates. Consequently, initial base assessment rates as of April 1, 2009, which are set forth in Table 1 below, are slightly higher than proposed in the NPR.[2]

As under the NPR, the rates reflect a proposed increase in the spread between minimum and maximum initial base assessment rates in Risk Category I from two basis points to an initial range of four basis points.

[2] In the NPR, the FDIC noted that:

> [A]t the time of the issuance of the final rule, the FDIC may need to set a higher base rate schedule based on information available at that time, including any intervening institution failures and updated failure and loss projections. A higher base rate schedule may also be necessary because of changes to the proposal in the final rule, if these changes have the overall effect of changing revenue for a given rate schedule. In order to fulfill the statutory requirement to return the fund reserve ratio to 1.15 percent, the base rate schedule in the final rule could be substantially higher than the proposed base assessment rate schedule (for example, if projected or actual losses at the time of the final rule greatly exceed the FDIC's current estimates).

73 Fed. Reg. 61,560, 61,572-61,573 (Oct. 16, 2008).

Table 1
Initial Base Assessment Rates

	Risk Category				
	I		II	III	IV
	Minimum	Maximum			
Annual Rates (in basis points)	12	16	22	32	45

As discussed in greater detail below, under the Final Rule, several adjustments could be made to an institution's base assessment rate in descending order, as presented in the following table. After applying all possible adjustments, minimum and maximum total base assessment rates for each risk category are as set forth below.

Table 2
Total Base Assessment Rates

	Risk Category I	Risk Category II	Risk Category III	Risk Category IV
Initial base assessment rate	12 – 16	22	32	45
Unsecured debt adjustment	-5 – 0	-5 – 0	-5 – 0	-5 – 0
Secured liability adjustment	0 – 8	0 – 11	0 – 16	0 – 22.5
Brokered deposit adjustment		0 – 10	0 – 10	0 – 10
Total base assessment rate	7 – 24.0	17 – 43.0	27 – 58.0	40 – 77.5

Based on the information currently available, staff proposes adoption of a Final Rule that would set actual rates at the proposed total base assessment rate schedule above. These proposed rates and other revisions to the assessment rules would take effect for the quarter beginning April 1, 2009, and would be reflected in the fund balance as of June 30, 2009 and in the invoices for the assessment due September 30, 2009.

Staff believes that the assessment rate schedule set forth in this recommended Final Rule, combined with other actions being taken as explained below, should provide sufficient revenue to cover losses rising from a large volume of institution failures and raise the insurance fund's reserve ratio over time. Under the rates shown in table 1, the year-end 2013 reserve ratio is projected to be 0.58 percent. (In contrast, staff projects that the minimum initial assessment rate would have to be 20 basis points beginning in the second quarter of 2009 in order to increase the reserve ratio to 1.15 percent by the end of 2013.) The Final Rule would continue to allow the FDIC Board to adopt actual rates that are higher or lower than total base assessment rates without the necessity of further notice and comment rulemaking, provided that: (1) the Board cannot increase or decrease total rates from one quarter to the next by more than three basis points without further notice-and-comment rulemaking; and (2) cumulative increases and decreases cannot be more than three basis points higher or lower than the total base rates without further notice-and-comment rulemaking.

The FDIC received comments from several industry trade groups and many banks regarding the proposed increases in assessment rates. Many of the letters were critical of the proposed assessment rate increases. Commenters argued that lower rates would be more appropriate given the current economic conditions. Further, many commenters urged the FDIC to take advantage of the flexibility that Congress provided to extend the restoration period beyond five years under "extraordinary circumstances." Several commenters also urged the FDIC to withdraw the proposed rule and delay increasing assessment rates and overhauling the assessment system until the end of 2009.

Staff agrees that significant increases in deposit insurance premium rates in times of economic and financial stress are not desirable. However, staff believes that it is important that the fund not decline to a level that could undermine public confidence in federal deposit insurance. In staff's view, the rates that it recommends for the Final Rule, combined with the 20 basis point special assessment that staff recommends imposing on June 30, 2009 (and possible additional special assessments of up to 10 basis points thereafter), pursuant to the recommended Interim Rule discussed below, balance these goals.

2. Assessment Revenue Needs under the Restoration Plan

The FDIC projected last fall that adoption of a rate schedule with a minimum initial rate of ten basis points would increase the reserve ratio to above 1.25 percent by the end of 2013. However, a deepening recession and continued severe problems in the housing and construction sectors, financial markets and commercial real estate, contribute to staff's expectation of significantly higher losses for the insurance fund compared to the projections of last October included in the proposed rule. The insurance fund balance and reserve ratio are likely to decline further in 2009 before beginning a gradual recovery in subsequent years from the effects of new revenue and a declining rate of bank failures. Even under the rates recommended in the Final Rule, staff projects that the reserve ratio may decline to close to zero – or may turn negative – by or before the end of 2009. Accordingly, as discussed below, staff recommends adoption of an Interim Rule that would impose a 20 basis point special assessment on June 30, 2009 (and possible additional special assessments of up to 10 basis points thereafter) to ensure that the fund reserve ratio does not decline to a level that could undermine public confidence in federal deposit insurance.

Staff's best estimate is that institution failures could cost the insurance fund approximately $65 billion from 2009 to 2013, after incurring approximately $18 billion in estimated costs for failures in 2008. Staff bases its loss projections on: analysis of specific troubled institutions and risk factors that may adversely affect other institutions; analysis of recent and expected loss rates given failure; analyses of the effects of further housing price declines and a significant economic downturn in specific geographic areas on loan losses and bank capital; and recent and historic supervisory rating downgrade and failure rates. Staff also assumes that insured deposits would increase by seven percent in 2009 and by five percent thereafter. The annual average growth rate in insured deposits was 6.7 percent over the past five years and 5.3 percent over the past ten years.

Staff recognizes that there is considerable uncertainty about its projections for losses and insured deposit growth, and that changes in assumptions about these and other factors could lead to different assessment revenue needs and rates. Under the terms of the Restoration Plan (and the amended Restoration Plan that staff is recommending (discussed below)), the FDIC must update its projections for the insurance fund balance and reserve ratio at least semiannually while the Restoration Plan is in effect and adjust rates as necessary. In the event that losses exceed or fall below the FDIC's best estimate or insured deposit growth is more or less rapid than expected, the Board will be able to adjust assessment rates.

The Supplementary Information Section of the attached recommended Final Rule contains an analysis of the statutory factors that the Board must consider when setting assessments. In sum, staff is of the opinion that its recommendation is consistent with these factors.

Appendix 2 to the Final Rule contains an analysis of the effect of the risk-based assessment rates adopted in the rule on the capital and earnings of insured institutions based on a range of projected industry earnings. Given the assumptions in the analysis, for the industry as a whole, projected total assessments in 2009 would result in capital that would be 0.4 to 0.5 percent lower than if the FDIC did not charge assessments. Based on the range of projected industry earnings, the proposed assessments would cause 8 to 12 institutions whose equity-to-assets ratio would have exceeded four percent in the absence of assessments to fall below that percentage and 6 to 9 institutions to fall below two percent.

For profitable institutions, assessments in 2009 would result in pre-tax income that would be between six and eight percent lower than if the FDIC did not charge assessments. For unprofitable institutions, pre-tax losses would increase by an average of three to five percent. Appendix 2 also provides an analysis of the range of effects on capital and earnings for these groups of institutions.

Assessment System Changes

Risk Category I: Financial Ratios Method

As under the NPR, the Final Rule would add a new financial ratio, the adjusted brokered deposit ratio, into the financial ratio method for institutions in Risk Category I. The adjusted brokered deposit ratio would measure the extent to which brokered deposits (in excess of 10 percent of domestic deposits) are funding rapid asset growth. Generally speaking, the greater an institution's asset growth and the greater its percentage of brokered deposits, the greater will be the increase in its initial base assessment rate. The Final Rule would also increase the spread between minimum and maximum rates in Risk Category I from two basis points to an initial range of four basis points, and update the uniform amount and the pricing multipliers for the weighted average CAMELS component ratings and financial ratios.

The FDIC received numerous comments regarding the adjusted brokered deposit ratio proposed in the NPR. Generally, commenters recommended: 1) increasing the asset growth threshold that would trigger the adjustment; 2) excluding from the ratio brokered deposits that an insured depository institution receives through a deposit placement network on a reciprocal basis ("reciprocal deposits"); and 3) excluding from the ratio brokered deposits that are swept into an insured institution by a non-depository institution. After considering these comments, staff recommends that the Final Rule adopt the ratio as proposed in the NPR with two notable changes. First, the Final Rule would raise the asset growth threshold from that proposed in the NPR. Second, the ratio would exclude certain reciprocal deposits.

1. Asset Growth Threshold

The NPR specified that the adjusted brokered deposit ratio would affect only those established Risk Category I institutions whose total gross assets are more than 20 percent greater than they were four years previously, after adjusting for mergers and acquisitions. The FDIC received several comments arguing that the minimum asset growth rate required to trigger the ratio should be greater than 20 percent. The comments disputed the characterization of 20 percent cumulative asset growth over four years as "rapid." FDIC staff recommends adoption of a Final Rule that would 1) raise the minimum 4-year asset growth threshold from 20 percent to 40 percent, and 2) increase from 40 percent to 70 percent the asset growth rate required to make an institution's adjusted brokered deposit ratio equal to its ratio of brokered deposits to domestic deposits less the 10 percent threshold.

2. Reciprocal Deposits

The NPR provided that reciprocal deposits would be included in the adjusted brokered deposit ratio. The FDIC received over 3,300 comment letters, including many form letters, arguing that certain reciprocal deposits should not be included in the adjusted brokered deposit ratio. To support this position, commenters argued that such deposits are a stable source of funding. According to the comments, these deposits are local deposits and not out-of-market funds. Further, according to the comments, the interest rate on these deposits reflects that of local markets since the insured institution that originates the deposit sets the interest rate, rather than a third-party broker. FDIC staff recommends adoption of a Final Rule that would exclude certain reciprocal deposits from the adjusted brokered deposit ratio. Reciprocal deposits would be defined as deposits that an insured depository institution receives through a deposit placement network on a reciprocal basis, such that: (a) for any deposit received, the institution (as agent for depositors) places the same amount with other insured depository institutions through the network; and (b) each member of the network sets the interest rate to be paid on the entire amount of funds it places with other network members. FDIC staff feels that this change would recognize that reciprocal deposits as defined may be a more stable source of funding for healthy banks than other types of brokered deposits and that they may not be as readily used to fund rapid asset growth. As discussed below, staff recommends that reciprocal deposits not be excluded from the brokered deposit adjustment for institutions in Risk Categories II, III, and IV.[3]

[3] Many of these comment letters also argued that these reciprocal deposits should not be included in the brokered deposit adjustment applicable to institutions in Risk Categories II, III and IV. The brokered deposit adjustment for these risk categories is discussed below.

3. Brokered Deposits in Sweep Accounts

The FDIC also received several comments arguing that brokered deposits that consist of balances swept into an insured institution by a nondepository institution, such as balances swept into an insured institution from a brokerage account at a broker-dealer, should be excluded from the adjusted brokered deposit ratio.[4] Commenters argued that these sweep accounts are stable, relationship-based accounts. Commenters also stated that the aggregate flows in and out of the sweep accounts tend to offset one another and are thus predictable. Staff is not persuaded by these arguments. It is staff's view that deposits swept from broker-dealers can and have contributed to high rates of insured depository institution asset growth and, thus, fall squarely within the type of brokered deposits that the adjusted brokered deposit ratio was meant to capture. Staff recommends adoption of a Final Rule that would continue to include such deposits in the adjusted brokered deposit ratio.

Risk Category I: Large Bank Method

The recommended Final Rule would adopt the NPR's methodology for establishing assessment rates for large institutions that are currently subject to the supervisory and debt ratings method. In particular, the assessment rate for a large institution with a long term debt issuer rating would be determined using a combination of the institution's weighted average CAMELS component ratings, its long term debt issuer ratings (converted to numbers and averaged) and the financial ratios method assessment rate, each equally weighted. The new method would be known as the large bank method.

Staff's proposed methodology is such that, using June 30, 2008 data, the percentages of large institutions in Risk Category I (other than new institutions less than five years old) that would have been charged the minimum and maximum initial base assessment rates would be the same as the percentages of small institutions that would have been charged these rates (25 percent at the minimum rate and 15 percent at the maximum rate).[5] This methodology would be used in future periods, but could lead to different percentages of institutions being charged the minimum and maximum rates.

A commenting bank argued that:

> Structuring the rules with a goal to maintain parity between large and small banks would be in violation of [12 U.S.C. § 1817(b)(2)(D)]. Arbitrarily establishing

[4] Many of these comment letters also argued that these swept deposits should not be included in the brokered deposit adjustment applicable to institutions in Risk Categories II, III and IV. The brokered deposit adjustment for these risk categories is discussed below.

[5] A "new" institution, as defined in 12 CFR 327.8(l), is generally one that is less than 5 years old, but there are several exceptions, including, for example, an exception for certain otherwise new institutions in certain holding company structures. 12 CFR 327.9(d)(7). The calculation of percentages of small institutions, however, was determined strictly by excluding institutions less than 5 years old, rather than by using the definition of a "new" institution and its regulatory exceptions, since determination of whether an institution meets an exception to the definition of "new" requires a case-by-case investigation.

> targets for percentages of institutions that fall into a given assessment rate is inconsistent with not only the governing statute but the whole concept of risk-based pricing.… The fact that, under objective criteria, large banks may have a greater percentage of institutions that qualify for the lowest rate is not an indication that the rule is flawed and needs to change, but may just be a factual representation of the strength of large banks.[6]

FDIC staff disagrees with the commenter. Under the debt ratings method, the percentage of large Risk Category I institutions that were charged the minimum assessment rate changed little over time despite significant deterioration in the financial condition of these institutions. The recalibration of the percentages of large institutions that would have been charged the minimum and maximum rates applicable to Risk Category is intended to better reflect the actual risk posed by large institutions.

Adjustments for Large Institutions and Insured Branches of Foreign Banks in Risk Category I

The Final Rule would adopt the NPR's proposal to increase the maximum possible large bank adjustment from 0.5 basis points to one basis point. Like the NPR, the Final Rule provides that the adjustment would be made to an institution's initial base assessment rate before any other adjustments were made. The adjustment could not: (1) decrease any rate so that the resulting rate would be less than the minimum initial base assessment rate; or (2) increase any rate above the maximum initial base assessment rate.

Staff recommends amending the maximum size of the adjustment for two primary reasons. First, while the current one-half basis point is generally sufficient to preserve consistency in the orderings of risk indicated by assessment rates and to ensure fairness, there have been circumstances where more than a half a basis point adjustment would have been warranted. Second, it is staff's view that an increase in the maximum size of the adjustment is warranted in order to maintain the proportion between the maximum adjustment and the difference between the minimum and maximum rates. Under the Final Rule, the spread between the minimum and maximum initial base assessment rates would increase from two basis points to four basis points. As a result of this increase, a half basis point large bank adjustment would represent 12.5 percent of the difference between the minimum and maximum rates, instead of 25 percent as under the current system. Increasing the maximum adjustment to one basis point would maintain the 25 percent ratio and would also minimize the potential number of instances where the large bank adjustment is insufficient to fully and accurately reflect the risk that an institution poses.

A few commenters objected to the increase in the large bank adjustment, arguing that the adjustment is arbitrary and subjective. FDIC staff disagrees and recommends that the Final Rule adopt the provision as proposed in the NPR. The large bank adjustment recognizes the need for subjective, expert judgment-based risk assessments for large banks. Because large institutions

[6] 12 U.S.C. § 1817(b)(2)(D) provides that, "No insured depository institution shall be barred from the lowest-risk category solely because of size."

are usually complex and often have unique operations, an entirely formulaic approach, while objective, has yielded a distribution of assessment rates that is not sufficiently reflective of the risk. While the decision to apply an adjustment cannot be reduced to a formula, the set of data that the FDIC reviews is consistent from one institution to the next and the FDIC strives to make its decisions based on the data as consistent as possible—and the reasons for the decisions as clear as possible—for the institutions affected.

Adjustments for Unsecured Debt for all Risk Categories

The recommended Final Rule, like the NPR, would lower an institution's base assessment rate (after making any large bank adjustment) below its initial base rate based upon its ratio of long-term unsecured debt (and, for small institutions, certain amounts of Tier 1 capital) to domestic deposits (the unsecured debt adjustment). The Final Rule clarifies that unsecured debt would not include any senior unsecured debt that the FDIC has guaranteed under the Temporary Liquidity Guarantee Program. The FDIC received several comments on the proposed unsecured debt adjustment. In response to these comments, FDIC staff recommends changes, as described below, to the unsecured debt adjustment provisions of the NPR.

1. Maximum Unsecured Debt Adjustment

Under the NPR, the maximum decrease in an institution's base assessment rate due to the unsecured debt adjustment was limited to two basis points. Several commenters argued that the proposed maximum two basis point reduction in base assessment rates was arbitrary and too low. Some commenters also noted that the maximum proposed unsecured debt adjustment was much smaller than the maximum proposed secured liability adjustment. After considering these comments, FDIC staff agrees that a maximum two basis point reduction is too small. Accordingly, the Final Rule would more than double the maximum possible unsecured debt adjustment to five basis points to ensure that institutions retain an incentive to issue unsecured debt.

2. Unsecured Debt Adjustment for Large Institutions

The NPR proposed to calculate a large institution's unsecured debt adjustment by multiplying the institution's long-term unsecured debt as a percentage of domestic deposits by 20 basis points. Some commenters argued that the proposed 20 basis point multiplier should be increased. FDIC staff agrees. Spreads on depository institution unsecured debt have, on average, approximately doubled since the NPR was published. The recommended Final Rule would, therefore, double the size of the multiplier to 40 basis points, partly to reflect the recent increase in debt spreads and partly to create a sufficient incentive to issue unsecured debt.

3. Unsecured Debt Adjustment for Small Institutions

The Final Rule would allow small institutions to factor a certain amount of Tier I capital (qualified Tier 1 capital) into the unsecured debt adjustment. Under the NPR, the adjustment would include the sum of one-half of the amount of Tier 1 capital between 10 percent and 15 percent of adjusted average assets and the full amount of Tier 1 capital exceeding 15 percent of adjusted average assets. One commenter, an industry trade group, recommended that the unsecured debt adjustment for small institutions include larger amounts of Tier 1 capital. The trade group argued that small institutions should be rewarded for their additional capital and that the proposal did not sufficiently reward them. FDIC staff agrees that small institutions should receive more credit for Tier 1 capital and has so provided in the recommended Final Rule.

Adjustment for Secured Liabilities for All Risk Categories

The Final Rule would raise an institution's base assessment rate based upon its ratio of secured liabilities to domestic deposits (the secured liability adjustment). The secured liability adjustment would apply after any large bank adjustment or unsecured debt adjustment. The Final Rule would adopt the adjustment as proposed in the NPR, with one exception. The NPR specified that the adjustment would apply only if an institution's ratio of secured liabilities to domestic deposits was greater than 15 percent. To ensure that the adjustment applies only to those institutions that rely heavily on secured funding and whose assessments do not adequately compensate the FDIC for its loss exposure, FDIC staff recommends adoption of a Final Rule that would raise the ratio of secured liabilities to domestic deposits that triggers the adjustment from 15 percent to 25 percent.

The vast majority of commenters on this topic opposed the secured liability adjustment. Many commenters argued that the true risk of a bank lies in the quality of its assets, rather than how the assets are funded. Over 1,100 commenters raised concerns about the effect of the adjustment on Federal Home Loan Bank advances. In addition, commenters also discussed the effect of the proposal on the use of repurchase agreements as well as the covered bond market. Despite these comments, staff continues to believe that the adjustment is warranted. The purpose of the secured liability adjustment is to remedy an inequity. Under the final rule adopted in 2006, an institution with secured liabilities in place of deposits pays a smaller deposit insurance assessment than an institution without secured liabilities, even if both pose the same risk of failure and would cause the same losses to the FDIC in the event of failure. Substituting secured liabilities for deposits can also lower an institution's franchise value in the event of failure, which increases the FDIC's losses, all else equal.[7] A risk-based system should take this likelihood into account. These arguments apply equally whether an institution's secured liabilities consist of FHLB advances, repurchase agreements, or other forms of secured borrowing.

Adjustment for Brokered Deposits for Risk Categories II, III, and IV

The Final Rule provides that an institution in Risk Category II, III, or IV would be subject to an assessment rate adjustment for brokered deposits (the brokered deposit adjustment). This adjustment would be limited to those institutions whose ratio of brokered deposits to

[7] Overall, whether substituting secured liabilities for deposits increases, decreases, or leaves unchanged the FDIC's loss given failure also depends on how the substitution affects the proportion of insured and uninsured deposits, but FDIC's assessment revenue will always decline with a substitution.

domestic deposits is greater than 10 percent; asset growth rates would not affect the adjustment. FDIC staff recommends adoption of a Final Rule that would adopt the brokered deposits adjustment provisions as proposed in the NPR.

Most of the comments relating to the adjusted brokered deposit ratio (for institutions in Risk Category I) are also applicable here. As discussed above, FDIC staff found comments recommending the exclusion of certain reciprocal deposits from the adjusted brokered deposit ratio to be persuasive. For the brokered deposit adjustment, however, FDIC staff holds a different view. When an institution's condition declines and it falls out of Risk Category I, the statutory and market restrictions on brokered deposits become much more relevant. These restrictions can cause severe liquidity problems for institutions that rely heavily on brokered deposits. For this reason, FDIC staff continues to recommend, consistent with the NPR, that the brokered deposit adjustment include all reciprocal deposits in determining the amount of brokered deposits above 10 percent of an institution's domestic deposits.

Insured Branches of Foreign Banks

The Final Rule would make conforming changes, identical to those proposed in the NPR, to the pricing multipliers and uniform amount for insured branches of foreign banks in Risk Category I. In addition, the Final Rule would discuss the application of the new adjustments to insured branches of foreign banks.

New Institutions

As proposed in the NPR, the Final Rule would make conforming changes to the treatment of new insured depository institutions. For assessment periods beginning on or after January 1, 2010, new institutions in Risk Category I would be assessed at the maximum initial base assessment rate applicable to Risk Category I institutions, as under the final rule adopted in 2006. Effective for assessment periods beginning before January 1, 2010, until a Risk Category I new institution received CAMELS component ratings, it would have an initial base assessment rate that is two basis points above the minimum initial base assessment rate applicable to Risk Category I institutions, rather than one basis point above the minimum rate, as under the final rule adopted in 2006. The recommended Final Rule would also discuss the application of the new adjustments to new institutions.

Technical and other changes

The Final Rule would, consistent with the NPR, make technical changes and one minor non-technical change to assessment rules.

AMENDED RESTORATION PLAN

In the NPR, the FDIC recommended increasing assessment rates to a level that was projected to restore the reserve ratio to the minimum threshold of 1.15 percent within five years of the implementation of the Restoration Plan.

The FDIC received many comments regarding the proposed increases in assessment rates. Many of the commenters were critical, and several urged the FDIC to take advantage of FDI Act provisions that allow the FDIC to take longer than five years to restore the reserve ratio to 1.15 percent in "extraordinary circumstances." In recognition of the current severe strains on banks and the financial system, staff has concluded that the problems facing the financial services sector and the economy at large constitute such extraordinary circumstances. Since the NPR was published, earnings and capital levels of insured institutions have continued to decline and the credit markets remain under significant stress. Industry losses in fourth quarter of 2008 were the largest in the 25 years that insured institutions have reported quarterly earnings.

Given the enormous stresses on financial institutions and the likelihood of a prolonged and severe economic recession, staff recommends amending the Restoration Plan to provide as follows:

1. The Restoration Plan is extended to seven years;

2. The Final Rule will be published in the Federal Register;

3. The FDIC will adopt an Interim Rule a) imposing a 20 basis point emergency special assessment on June 30, 2009, and b) after June 30, 2009, permitting the Board to impose an emergency special assessment of up to 10 basis points at the end of any calendar quarter if the reserve ratio of the DIF is estimated to fall to a level that that the Board believes would adversely affect public confidence or to a level which shall be close to zero or negative;

4. The FDIC projects that the rates adopted in the Final Rule combined with the emergency special assessment should return the fund reserve ratio to 1.15 percent within seven years;

5. At least semiannually hereafter, the FDIC will update its loss and income projections for the fund and adjust rates as needed;

6. Institutions may continue to use assessment credits (for regular quarterly assessments and for special assessments) without additional restriction (other than those imposed by law); and

7. The amended Restoration Plan shall be implemented immediately.

EMERGENCY SPECIAL ASSESSMENTS INTERIM RULE

Emergency Special Assessment

Staff projects that the reserve ratio will fall to close to zero or become negative in 2009 unless the FDIC receives more revenue than regular quarterly assessments will produce, given the rates adopted in the Final Rule. Staff believes that it is important that the fund not decline to a level that could undermine public confidence in federal deposit insurance. Even though the

FDIC has significant authority to borrow from the Treasury to cover losses, staff is concerned that a fund balance and reserve ratio that are near zero or negative could create public confusion about the FDIC's ability to move quickly to resolve problem institutions and protect insured depositors. Staff views the Treasury line of credit as available to cover unforeseen losses, not as a source of financing projected losses.

Under the Interim Rule, staff proposes that on June 30, 2009, the FDIC impose an emergency special assessment equal to 20 basis points of an institution's assessment base on all insured depository institutions.[8] The special assessment would be collected September 30, 2009, at the same time that the risk-based assessments for the second quarter of 2009 are collected. The assessment base for the special assessment would be the same as the assessment base for the second quarter risk-based assessment.

Staff projects that a 20 basis point special assessment would increase the reserve ratio by approximately 32 basis points. The staff's current projections indicate that assessments based on the rates adopted in the Final Rule should begin gradually raising the reserve ratio in 2010.

Staff has analyzed the effect of a 20 basis point special assessment on the capital and earnings of insured institutions. Given the assumptions in the analysis, for the industry as a whole, the special assessment in 2009 would result in year-end 2009 capital that would be approximately 0.7 percent lower than in the absence of a special assessment. Based on the range of projected industry earnings, a 20 basis point special assessment would cause 9 to 13 institutions (with $3 billion to $5 billion in aggregate assets) whose equity-to-assets ratio would have exceeded 4 percent in the absence of such an assessment to fall below that percentage and 3 to 4 institutions (with about $1 billion in aggregate assets) to fall below 2 percent.

For profitable institutions, the special assessment in 2009 would result in pre-tax income that would be between 10 percent and 13 percent lower than if the FDIC did not charge such the special assessment. For unprofitable institutions, pre-tax losses would increase by an average of between 3 percent and 6 percent.

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[8] 12 U.S.C. 1817(b)(5) provides:

> Emergency special assessments.--In addition to the other assessments imposed on insured depository institutions under this subsection, the Corporation may impose 1 or more special assessments on insured depository institutions in an amount determined by the Corporation if the amount of any such assessment is necessary—
>
> (A) to provide sufficient assessment income to repay amounts borrowed from the Secretary of the Treasury under [12 U.S.C. 1824(a)] in accordance with the repayment schedule in effect under section [12 U.S.C. 1824(c)] during the period with respect to which such assessment is imposed;
>
> (B) to provide sufficient assessment income to repay obligations issued to and other amounts borrowed from insured depository institutions under section [12 U.S.C. 1824(d)]; or
>
> (C) for any other purpose that the Corporation may deem necessary.

Further Special Assessments

Staff recognizes that there is considerable uncertainty about its projections for losses and insured deposit growth, and, therefore, of future fund reserve ratios. To further ensure that the fund reserve ratio does not decline to a level that could undermine public confidence in federal deposit insurance, the Interim Rule would also permit the Board to impose an emergency special assessment of up to 10 basis points on all insured depository institutions if, after June 30, 2009, the reserve ratio of the DIF is estimated to fall to a level that that the Board believes would adversely affect public confidence or to a level which shall be close to zero or negative.

Near the end of each quarter, staff would project the reserve ratio for that quarter from available data on, or estimates of, insurance fund assessment income, investment income, operating expenses, other revenue and expenses, and loss provisions (including provisions for anticipated failures). To estimate insured deposits, staff would rely on the average quarterly rate that insured deposits grew over the previous four quarters. If the Board believes that the estimated reserve ratio will fall to a level that would adversely affect public confidence or to a level close to zero or negative at the end of a calendar quarter, the Board may, by vote, impose an emergency special assessment of up to 10 basis points on all insured depository institutions. The FDIC would announce the imposition and rate of any such special assessment no later than the last day of the quarter. The FDIC would collect the special assessment approximately three months later, at the same time that risk-based assessments are collected.

The assessment base for any such special assessment would be the base for the risk-based assessment for the quarter ending on the date the special assessment is imposed. Staff suggests that September 30, 2009, be the earliest possible date for such a special assessment. Staff also recommends that the FDIC be required to publish notice in the Federal Register after announcement of the imposition of any special assessment.

Staff projects that the combination of regular quarterly assessments and the 20 basis point special assessment will prevent the fund reserve ratio from falling to a level that would adversely affect public confidence or to a level close to zero or negative. However, in order to take advantage of the most current data, staff will not make its estimates of quarter-end reserve ratios for purposes of such a special assessment, nor would the Board determine whether to impose such a special assessment, until shortly before the end of each quarter.