FDIC
Federal Deposit Insurance Corporation
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Division of Insurance and Research

March 1, 2016

MEMORANDUM TO: The Board of Directors

FROM: Diane Ellis Diane Ellis
Director, Division of Insurance and Research

SUBJECT: Final Rule on Implementing the Dodd-Frank Requirement to Increase the Reserve Ratio from 1.15 Percent to 1.35 Percent

SUMMARY AND RECOMMENDATION

Staff recommends that the FDIC Board of Directors (the Board) adopt the attached final rule and authorize its publication in the Federal Register.

The final rule implements three provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) that: (1) raise the minimum reserve ratio for the Deposit Insurance Fund (DIF or fund) to 1.35 percent (from the former minimum of 1.15 percent); (2) require that the DIF reserve ratio reach 1.35 percent by September 30, 2020; and (3) require that, in setting assessments, the FDIC "offset the effect of [the increase in the minimum reserve ratio from 1.15 percent to 1.35 percent] on insured depository institutions with total consolidated assets of less than $10,000,000,000."

In a notice of proposed rulemaking adopted by the Board on October 22, 2015, and published in the Federal Register on November 6, 2015 (NPR), the FDIC sought comment on every aspect of the proposed rule and on alternatives.[1] The FDIC received a total of eight comment letters. Staff considered all comments in developing the final rule. Comments are discussed in the relevant sections that follow.

As proposed in the NPR, the final rule imposes a surcharge on the regular quarterly deposit insurance assessments (regular assessments) of insured depository institutions with total assets of $10 billion or more (large banks). The final rule provides that the surcharge will equal an annual rate of 4.5 basis points applied to the institution's assessment base (with certain adjustments).

Staff recommends that the final rule become effective on July 1, 2016. If the reserve ratio reaches 1.15 percent before that date, surcharges will begin July 1, 2016. If the reserve

[1] See 80 FR 68780 (Nov. 6, 2015).

Concur:

Charles Yi
General Counsel

ratio has not reached 1.15 percent by that date, surcharges will begin the first day of the calendar quarter after the reserve ratio reaches 1.15 percent. (Lower regular assessment rates will take effect the quarter after the reserve ratio reaches 1.15 percent.) Staff expects that surcharges will commence in the second half of 2016 and that they should be sufficient to raise the reserve ratio to 1.35 percent in approximately eight quarters; i.e., before the end of 2018. Surcharges will continue through the quarter that the reserve ratio first reaches or exceeds 1.35 percent, but not later than December 31, 2018.

If, contrary to staff's expectations, the reserve ratio does not reach 1.35 percent by December 31, 2018 (provided it is at least 1.15 percent), the final rule provides that the FDIC will impose a shortfall assessment on any bank that was subject to the surcharge (large bank).

To satisfy the Dodd-Frank Act requirement that the FDIC offset the effect of the increase in the reserve ratio from 1.15 percent to 1.35 percent on insured depository institutions with total assets of less than $10 billion, the final rule provides assessment credits (credits) to these institutions (small banks) for the portion of their regular assessments that contribute to growth in the reserve ratio between 1.15 percent and 1.35 percent.[2]

The final rule adopts the proposal in the NPR with a few changes. First, the NPR proposed that the assessment bases of large banks be increased (for purposes of the surcharge) by the entire regular assessment bases of affiliated small banks.[3] In response to a comment, the final rule adds to a large bank's surcharge base each quarter only the amount of any net increase in affiliated small banks' aggregate assessment bases in excess of 10 percent per annum from December 31, 2015. Second, the final rule provides that after the reserve ratio reaches 1.38 percent (rather than 1.40 percent as proposed in the NPR), the FDIC will automatically apply a small bank's credits to reduce its regular assessment up to the entire amount of the assessment, rather than limiting credit use to an annual rate of 2 basis points as proposed in the NPR.

DISCUSSION

Policy Objectives

Both the Dodd-Frank Act and the Federal Deposit Insurance Act (FDI Act) grant the FDIC broad authority to implement the requirement to achieve the 1.35 percent minimum reserve ratio. In particular, under the Dodd-Frank Act, the FDIC is authorized to take such steps as may be necessary for the reserve ratio to reach 1.35 percent by September 30, 2020. Furthermore, under the FDIC's special assessment authority in section 7(b)(5) of the FDI Act, the FDIC may impose special assessments in an amount determined to be necessary for any purpose that the FDIC may deem necessary.

[2] As used in this final rule, the term "bank" has the same meaning as "insured depository institution" as defined in section 3 of the FDI Act, 12 U.S.C. 1813(c)(2). In general, but with some exceptions, a "small institution" is an insured depository institution with assets of less than $10 billion or an insured branch of a foreign institution.

[3] As used in the final rule, the term "affiliate" has the same meaning as defined in section 3 of the FDI Act, 12 U.S.C. 3(w)(6), which references the Bank Holding Company Act ("any company that controls, is controlled by, or is under common control with another company"). 12 U.S.C. 1841(k).

The purpose of the final rule is to meet the Dodd-Frank Act requirements in a manner that appropriately balances several considerations, including the goal of reaching the minimum reserve ratio reasonably promptly in order to strengthen the fund and reduce the risk of pro-cyclical assessments, the goal of maintaining stable and predictable assessments for banks over time, and the projected effects on bank capital and earnings. The primary mechanism described below for meeting the statutory requirements – surcharges on regular assessments – will ensure that the reserve ratio reaches 1.35 percent without inordinate delay (likely in 2018) and will ensure that assessments are allocated equitably among banks responsible for the cost of reaching the minimum reserve ratio.

Background

The Dodd-Frank Act gave the FDIC greater discretion to manage the DIF than it had previously, including greater discretion in setting the target reserve ratio, or designated reserve ratio (DRR), which the FDIC must set annually.[4] The FDIC Board has set a 2 percent DRR for each year starting with 2011.[5] The Board views the 2 percent DRR as a long-term goal.

By statute, the FDIC also operates under a Restoration Plan while the reserve ratio remains below 1.35 percent.[6] The Restoration Plan, originally adopted in 2008 and subsequently revised, is designed to ensure that the reserve ratio will reach 1.35 percent by September 30, 2020.

In February 2011, the FDIC adopted a final rule that, among other things, contained a schedule of deposit insurance assessment rates that apply to regular assessments that banks pay. The FDIC noted when it adopted these rates that, because of the requirement making banks with $10 billion or more in assets responsible for increasing the reserve ratio from 1.15 percent to 1.35 percent, "assessment rates applicable to all insured depository institutions need only be set high enough to reach 1.15 percent" before the statutory deadline of September 30, 2020. The February 2011 final rule left to a later date the method for assessing banks with $10 billion or more in assets for the amount needed to reach 1.35 percent.[7]

In the February 2011 final rule, the FDIC also adopted a schedule of lower regular assessment rates that will go into effect once the reserve ratio of the DIF reaches 1.15 percent. These lower regular assessment rates will apply to all banks' regular assessments. Regular

[4] 12 U.S.C. 1817(b)(3)(A)(i).

[5] A DRR of 2 percent was based on a historical analysis as well as on the statutory factors that the FDIC must consider when setting the DRR. In its historical analysis, the FDIC analyzed historical fund losses and used simulated income data from 1950 to 2010 to determine how high the reserve ratio would have to have been before the onset of the two banking crises that occurred during this period to maintain a positive fund balance and stable assessment rates.

[6] 12 U.S.C. 1817(b)(3)(E).

[7] The Restoration Plan originally stated that the FDIC would pursue rulemaking on the offset in 2011, but in 2011 the Board decided to postpone rulemaking until a later date.

assessments paid under the schedule of lower rates are intended to raise the reserve ratio gradually to the long-term goal of 2 percent.[8]

Staff expects that, under the current assessment rate schedule, the DIF reserve ratio will reach 1.15 percent in the first half of this year.

Description of the Final Rule

Surcharges

Surcharge Rate and Duration

As proposed in the NPR, to implement the requirements of the Dodd-Frank Act and pursuant to the FDIC's authority in section 7 of the FDI Act, the final rule adds a surcharge to the regular assessments of banks with $10 billion or more in assets. Also as proposed in the NPR, the final rule provides that the surcharge will begin the quarter after the DIF reserve ratio first reaches or exceeds 1.15 percent and will continue until the reserve ratio first reaches or exceeds 1.35 percent, but no later than the fourth quarter of 2018.[9] The final rule provides that, for each quarter, the FDIC will notify banks that will be subject to the surcharge and inform those banks of the amount of the surcharge within the timeframe that applies to notification of regular assessment amounts.[10]

As proposed in the NPR, the final rule provides that the annual surcharge rate will be 4.5 basis points, which staff expects will be sufficient to raise the reserve ratio from 1.15 percent to 1.35 percent in 8 quarters, before the end of 2018.

Comments Received

The FDIC received several comments on the surcharge rate and estimated surcharge period. In a joint comment letter, three trade groups stated that a "strong" majority of large banks that they surveyed favored an alternative discussed in the NPR of charging lower surcharges over a longer period and imposing a shortfall assessment only if the reserve ratio has not reached 1.35 percent by a date nearer the statutory deadline. Specifically, the trade groups proposed an annual surcharge of no more than 2.25 basis points to reach 1.35 percent in 14

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[8] On June 16, 2015, the Board adopted a notice of proposed rulemaking that would revise the risk-based pricing methodology for established small institutions. See 80 FR 40838 (July 13, 2015). On January 21, 2016, the Board adopted a second notice of proposed rulemaking that would revise parts of the proposal adopted by the Board in 2015. The revised proposal would leave the overall range of initial assessment rates and the assessment revenue expected to be generated unchanged from the current assessment system for established small institutions. See 81 FR 6108 (Feb. 4, 2016).

[9] As discussed below, the final rule will become effective on July 1, 2016. If the reserve ratio reaches 1.15 percent before that date, surcharges will begin July 1, 2016. If the reserve ratio has not reached 1.15 percent by that date, surcharges will begin the first day of the calendar quarter after the reserve ratio reaches 1.15 percent.

[10] As with regular assessments, surcharges will be paid one quarter in arrears, based on the bank's previous quarter data and will be due on the 30th day of the last month of the quarter.

quarters, and a shortfall, if needed, to be assessed in the first quarter of 2020.[11] A few other commenters supported the three trade groups' proposal.

One commenter supported an alternative discussed in the NPR of foregoing surcharges entirely and, if the reserve ratio does not reach 1.35 percent by a deadline sometime near the statutory deadline, imposing a delayed shortfall assessment at the end of the following quarter.

On the other hand, the joint comment letter submitted by the three trade groups did note that a few large banks surveyed supported the proposed surcharge rate and timeline in the NPR, while a few others favored a one-time assessment once the reserve ratio first reaches 1.15 percent (an alternative also discussed in the NPR). One bank in its comment letter also preferred a one-time assessment just after the reserve ratio first reaches or exceeds 1.15 percent in order to raise the reserve ratio closer to 1.35 percent (but not all the way to 1.35 percent) sooner than would occur under the proposal. Another trade group preferred charging surcharges over a shorter timeframe – four quarters – but found that the proposal in the NPR and a one-time assessment just after the reserve ratio first reaches or exceeds 1.15 percent were also reasonable options.

In staff's view, the final rule strikes an appropriate balance among these options after considering: (1) the statutory deadline for reaching the minimum reserve ratio; (2) the importance of strengthening the fund's ability to withstand a spike in losses; (3) the goal of reducing the risk of larger assessments for the entire industry in a future period of stress; and (4) the effects on the capital and earnings of surcharged banks.

Staff expects that surcharges will result in the reserve ratio reaching 1.35 percent in 2018. Reaching the statutory target reasonably promptly and in advance of the statutory deadline has benefits. First, it strengthens the fund so that it can better withstand an unanticipated spike in losses from bank failures or the failure of one or more large banks.

Second, it reduces the risk of the banking industry facing unexpected, large assessment rate increases in a future period of stress. Once the reserve ratio reaches 1.35 percent, the September 30, 2020 deadline in the Dodd-Frank Act will have been met and will no longer apply. If the reserve ratio later falls below 1.35 percent, even if that occurs before September 30, 2020, the FDIC will have a minimum of eight years to return the reserve ratio to 1.35 percent, reducing the likelihood of a large increase in assessment rates. In contrast, if a spike in losses occurs before the reserve ratio reaches 1.35 percent, the Dodd-Frank Act deadline will remain in place, which could require that the entire banking industry – including banks with less than $10 billion in assets, if the reserve ratio falls below 1.15 percent – pay for the increase in the reserve ratio within a relatively short time. The final rule, therefore, reduces the risk of higher assessments being imposed at a time when the industry might not be as healthy and prosperous and could less afford to pay.

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[11] The trade groups noted that leaving the current assessment rate schedule in place when the reserve ratio reaches 1.15 percent would be roughly equivalent to an annual surcharge of no more than 2.25 basis points to reach 1.35 percent in 14 quarters.

In addition, large banks will account for future surcharges in the quarterly report of condition and income (Call Report) and other banking regulatory reports based on generally accepted accounting principles (GAAP) as quarterly expenses, as they do for regular assessments, effectively spreading the cost of the requirement over approximately eight quarters in a simple, predictable manner.

In contrast, a longer surcharge period or a delayed one-time assessment without surcharges would reduce the fund's ability to withstand a spike in losses and increase the risk of larger assessments for the entire industry in a future period of stress.

Five comment letters also stated that, rather than imposing a separate surcharge at a uniform rate, the FDIC should implement surcharges in a risk-based manner.[12] One commenter argued that a risk-based surcharge would provide incentives to manage risk. Some commenters suggested foregoing a surcharge and instead leaving in place the current risk-based assessment rate schedule when the reserve ratio reaches 1.15 percent, rather than the lower one that is scheduled to go into effect. One commenter also recommended that surcharges be integrated into risk-based assessments in a way that maintains banks' incentives to hold long-term unsecured debt.[13]

The final rule uses a flat-rate surcharge. As one commenter acknowledged, while the FDI Act requires that regular assessments be risk-based, no such requirement exists for special assessments.[14] In fact, the most recent special assessment, imposed in 2009, was also a flat-rate assessment, and, in 1996, Congress imposed a flat-rate special assessment on banks that held deposits insured by the Savings Association Insurance Fund. In addition, nothing in the Dodd-Frank Act requires a risk-based assessment to raise the minimum reserve ratio from 1.15 percent to 1.35 percent.

Banks subject to the surcharge will continue to pay risk-based regular deposit insurance assessments. As a result, they will still have the incentives they now have to prudently manage risk and to issue long-term unsecured debt.

Moreover, because banks' risk profiles change over time, aggregate assessments using a risk-based surcharge would be more prone to vary than will a flat-rate surcharge. This variance would reduce the predictability of surcharge revenue and create additional uncertainty regarding the needed rates and the time required for the reserve ratio to reach 1.35 percent. Banks themselves would have less predictable surcharge assessments.

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[12] Suggested methods for implementing a risk-based surcharge included a surcharge based on a multiple of a bank's initial base assessment rate, a variable-rate surcharge, or imposing the surcharge only on the weakest or riskiest banks.

[13] A bank's total base assessment rate can vary from its initial base assessment rate as the result of three possible adjustments. One of these adjustments, the unsecured debt adjustment lowers a bank's assessment rate based on the bank's ratio of long-term unsecured debt to the bank's assessment base. 12 CFR 327.9(d).

[14] Compare 12 U.S.C. 1817(b)(1), requiring a risk-based deposit insurance assessment system, with 12 U.S.C. 1817(b)(5), which allows the FDIC to impose special assessments and contains no requirement that they be risk-based.

Banks Subject to the Surcharge

As proposed in the NPR, the final rule provides that the banks subject to the surcharge (large banks) will be determined each quarter based on whether the bank was a "large institution" or "highly complex institution" for purposes of that quarter's regular assessments.[15] Generally, this includes institutions with total assets of $10 billion or more; however an insured branch of a foreign bank whose assets equal or exceed $10 billion will also be considered a large bank and will be subject to the surcharge.[16]

Comments Received

The FDIC received two comments from trade groups on which banks should be subject to the surcharge. One commenter suggested that the surcharge should not apply to mid-size banks and should only apply to highly complex banks, while another commenter proposed that the surcharge be restricted to only the largest banks, those considered "too big to fail," or those controlling a large share of industry assets. As an alternative to their suggestions, both commenters proposed that the FDIC increase the $10 billion deduction from large banks' assessment bases for the surcharge (discussed below), for example, to $25 billion or $50 billion, which would effectively exempt banks with total assets under these threshold amounts from surcharges.

Staff has identified no compelling basis to distinguish between large banks based on any particular asset size or other profile. Further, the final rule is consistent with the statutory language. The Dodd-Frank Act requires the FDIC to "offset the effect of [the increase in the minimum reserve ratio] on insured depository institutions with total consolidated assets of less than $10,000,000,000," and unlike other parts of the Act, there is no indication that section 334(e) should apply only to banks of a certain size or that engage in certain activities. The apparent purpose of the Act's requirement was to insulate banks with less than $10 billion in total assets from the cost of the increase in the minimum reserve ratio. The final rule appropriately meets this requirement.

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[15] In general, a "large institution" is an insured depository institution with assets of $10 billion or more as of December 31, 2006 or a small institution that reports assets of $10 billion or more in its quarterly reports of condition for four consecutive quarters. If an institution classified as large reports assets of less than $10 billion in its quarterly reports of condition for four consecutive quarters, the FDIC will reclassify the institution as small beginning the following quarter. In general, a "highly complex institution" is: (1) an insured depository institution (excluding a credit card bank) that has had $50 billion or more in total assets for at least four consecutive quarters that is controlled by a U.S. parent holding company that has had $500 billion or more in total assets for four consecutive quarters, or controlled by one or more intermediate U.S. parent holding companies that are controlled by a U.S. holding company that has had $500 billion or more in assets for four consecutive quarters; or (2) a processing bank or trust company. If an institution classified as highly complex fails to meet the definition of a highly complex institution for four consecutive quarters (or reports assets of less than $10 billion in its quarterly reports of condition for four consecutive quarters), the FDIC will reclassify the institution beginning the following quarter.

[16] For purposes of the final rule, an insured branch of a foreign bank whose assets for the most recent quarter equaled or exceeded $10 billion will also be considered a large bank and will be subject to the surcharge. A large bank also includes a small institution if, while surcharges were in effect, the small institution was the surviving institution or resulting institution in a merger or consolidation with a large bank or if the small institution acquired all or substantially all of the assets or assumed all or substantially all of the deposits of a large bank.

The FDIC is cognizant of the concerns of large banks near the $10 billion threshold. As a practical matter, the $10 billion deduction from large banks' assessment bases for the surcharge has the effect of shifting the burden of the surcharges towards larger banks. While, as discussed later, the purpose of the $10 billion deduction is to avoid a "cliff effect" for banks near the $10 billion asset threshold, it has the concomitant effect of benefitting large banks closer in size to the $10 billion asset threshold relatively more than larger banks, since the relative effect of the $10 billion deduction decreases as asset size increases. Based on data as of December 31, 2015, the simple average effective surcharge rate (the surcharge rate if applied to a bank's regular quarterly deposit insurance assessment base) for banks with assets between $10 billion and $50 billion will be approximately half the simple average effective rate for banks with assets greater than $100 billion. In fact, with lower regular assessment rates scheduled to take effect when the reserve ratio reaches 1.15 percent, more than half (36 out of 67) of large banks with total assets between $10 billion and $50 billion and roughly one-third of all large banks are expected to pay an effective assessment rate, even with the surcharge, that is lower than their current assessment rate.

Banks' Assessment Bases for the Surcharge

Under the final rule, each large bank's surcharge base for any given quarter will equal its regular quarterly deposit insurance assessment base (regular assessment base) for that quarter with certain adjustments.

The first adjustment under the final rule differs from the NPR, but is similar to an alternative method of determining the surcharge base on which the NPR requested comment. The NPR would have added the entire regular assessment bases of affiliated small banks to the surcharge bases of large bank affiliates, but sought comment on an alternative that would add only the amount of any increase in the regular assessment bases of affiliated small banks. In response to a joint comment letter from three trade groups and after balancing all the considerations expressed in the NPR, the final rule adds to a large bank's surcharge base each quarter only the cumulative net increase in the aggregate regular assessment bases of affiliated small banks above the aggregate regular assessment bases as of December 31, 2015 of affiliated small banks that is in excess of an effective annual rate of 10 percent.[17]

Adding cumulative growth in excess of an effective annual rate of 10 percent in the regular assessment bases of affiliated small banks to the assessment bases of their large bank affiliates limits the ability of large banks to reduce their surcharges (and potentially shift costs to other large banks) either by transferring assets and liabilities to existing or new affiliated small banks or by growing the businesses of affiliated small banks instead of the large bank without unduly constraining the normal growth of the affiliated small banks.[18]

Including only the amount of any cumulative net increase that is in excess of an effective annual rate of 10 percent in the aggregate regular assessment bases of affiliated small banks,

[17] As of December 31, 2015, 19 banking organizations had both large and small banks.

[18] As noted in the NPR, however, some large banks may be able to shift the burden of the surcharge by transferring assets and liabilities to a nonbank affiliate, or by shrinking or limiting growth.

rather than their entire assessment bases as proposed in the NPR, will have only a very small effect on total surcharge revenue and is unlikely to increase the number of quarters that surcharges are in effect.

The second adjustment is as proposed in the NPR. It deducts $10 billion from a large bank's regular assessment base (as increased by the first adjustment) to produce the surcharge base. Deducting $10 billion from each large bank's assessment base for the surcharge avoids a "cliff effect" for banks near the $10 billion asset threshold, thereby ensuring equitable treatment. Otherwise, a bank with just over $10 billion in assets would pay significant surcharges, while a bank with $9.9 billion in assets would pay none. The $10 billion reduction reduces incentives for banks to limit their growth to stay below $10 billion in assets, or to reduce their size to below $10 billion in assets, solely to avoid surcharges.

In a banking organization that includes more than one large bank, both (1) the $10 billion deduction, and (2) the cumulative net increase in affiliated small banks' regular assessment bases exceeding a 10 percent effective annual rate will be apportioned among all large banks in the banking organization in proportion to each large bank's regular assessment base for that quarter.[19]

Comments Received

The FDIC received one joint comment letter from three trade groups related to the first adjustment. As proposed in the NPR, the first adjustment would have added the entire regular assessment bases of affiliated small banks to the surcharge bases of large bank affiliates. The joint comment letter opposed adding any portion of the assessment bases of small bank affiliates to large banks, but argued that, if any addition were to occur, it should be limited to no more than any increase in the assessment bases of small bank affiliates above "normal growth" after surcharges begin.[20] As described above, the final rule uses the net increase in excess of a 10 percent effective annual rate in the aggregate regular assessment bases of affiliated small banks above their aggregate regular assessment bases as of December 31, 2015.

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[19] As of December 31, 2015, 9 banking organizations had multiple affiliated large banks.

[20] The joint comment letter argued that the proposed addition of the entire regular assessment bases of affiliated small banks to the surcharge bases of large bank affiliates "would abrogate the intent of [Sec.] 334 [of the Dodd-Frank Act] by imposing de facto assessment surcharges on small banks affiliated with large banks, albeit indirectly by assessing their larger affiliates," and, therefore, these small banks would not receive a full offset for their contribution towards raising the reserve ratio from 1.15 percent to 1.35 percent. In fact, however, small bank affiliates of large banks will not pay any surcharge assessment and will be entitled to credits on the same basis as all other small banks.

The joint comment letter also argued that Sec. 334 of the Dodd-Frank Act does not authorize the FDIC to augment large banks' assessment bases with those of their small bank affiliates. In fact, however, the Dodd-Frank Act and the FDI Act give the FDIC broad authority to determine the amount of any special assessments, including the surcharges, and thus an appropriate assessment base for the surcharge. See Public Law 111-203, 334(e), 124 Stat. 1376, 1539 (12 U.S.C. 1817(note)); 12 U.S.C. 1817(b)(5). The FDI Act contains no provisions mandating any particular assessment base for a special assessment.

The FDIC received three comments related to the second adjustment, the deduction of $10 billion from a large bank's assessment base and apportioning the deduction among all large banks in the banking organization. Two commenters proposed a larger deduction (discussed above). A joint comment letter submitted by three trade groups proposed that bank holding companies with multiple large banks be allowed to deduct $10 billion for each large bank, arguing that limiting large banks in a bank holding company to a single $10 billion deduction "discriminates against banking organizations with multiple affiliated large banks."

The provisions in the final rule regarding the second deduction are unchanged from those proposed in the NPR. Allocation of the $10 billion deduction among affiliated large banks ensures that banking organizations of a similar size (in terms of large bank assessment bases) pay a similar surcharge. Thus, a banking organization with multiple large banks will not have an advantage over other similarly sized banking organizations that have only one large bank because, instead of deducting $10 billion from each large bank in the organization, the deduction will be apportioned among the multiple affiliated large banks.

Moreover, allowing each large bank in a banking organization to take a $10 billion deduction could, in effect, penalize the large majority of banking organizations that do not have more than one large bank by increasing the risk that surcharges would last longer than envisioned under the proposal.

Shortfall Assessment

Staff expects that surcharges combined with regular assessments will raise the reserve ratio to 1.35 percent before December 31, 2018. It is possible, however, that unforeseen events could result in higher DIF losses or faster insured deposit growth than expected, or that banks may take steps to reduce or avoid quarterly surcharges. While not expected, these events or actions could prevent the reserve ratio from reaching 1.35 percent by the end of 2018. In this case, provided the reserve ratio is at least 1.15 percent, the final rule provides that the FDIC will impose a shortfall assessment on large banks.[21]

The provisions in the final rule regarding the shortfall assessment are as proposed in the NPR. If the reserve ratio has not reached 1.35 percent by the end of 2018, the final rule provides that the FDIC will impose a shortfall assessment on large banks on March 31, 2019 and collect it on June 30, 2019. The aggregate amount of the shortfall assessment will equal 1.35 percent of estimated insured deposits on December 31, 2018 minus the actual fund balance on that date.

If a shortfall assessment is needed, the final rule provides that it will be imposed on any bank that was a large bank in any quarter during the period that surcharges are in effect (the surcharge period). Each large bank's share of any shortfall assessment will be proportional to the average of its surcharge bases (the average surcharge base) during the surcharge period. If a

[21] The final rule also contains provisions identical to those proposed in the NPR describing how a shortfall assessment would be imposed in the unlikely event that the reserve ratio is below 1.15 percent on December 31, 2018.

bank was not a large bank during a quarter of the surcharge period, its surcharge base will be deemed to equal zero for that quarter.[22, 23]

A large bank's share of the total shortfall assessment will equal its average surcharge base divided by the sum of the average surcharge bases of all large banks subject to the shortfall assessment. Using an average of surcharge bases ensures that anomalous growth or shrinkage in a large bank's assessment base will not subject it to a disproportionately large or small share of any shortfall assessment.

Comments Received

In addition to the comments discussed above regarding the duration of the surcharge and timing of any required corresponding shortfall assessment, the FDIC received two other comments on the shortfall assessment. One commenter suggested that the shortfall assessment, in addition to the surcharges, should only be applied to "highly complex" banks. Another commenter stated that the shortfall assessment and surcharges should be risk-based.

For the reasons discussed previously in connection with the surcharge assessment, the shortfall assessment in the final rule is as proposed in the NPR. If a shortfall assessment is necessary, the expected revenue based on the calculation method adopted will be much more predictable than the expected revenue from a risk-based method. In previous special assessments, the FDIC used a uniform rate, rather than a risk-based rate, and large banks will continue to pay risk-based regular assessments. Moreover, as also noted above, neither the statute nor its legislative history suggests that only highly complex banks should be responsible for raising the reserve ratio from 1.15 percent to 1.35 percent. The statute requires that the FDIC offset the effect of the increase in the minimum reserve ratio on banks with less than $10 billion in consolidated assets.

Credits for Small Banks

While the reserve ratio remains between 1.15 percent and 1.35 percent, some portion of the regular assessments paid by small banks will contribute to increasing the reserve ratio. To meet the Dodd-Frank Act requirement to offset the effect on small banks of raising the reserve ratio from 1.15 percent to 1.35 percent, the final rule provides that the FDIC will provide assessment credits to these banks for the portion of their regular assessments that contribute to the increase from 1.15 percent to 1.35 percent.[24] The provisions in the final rule governing how

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[22] Thus, for example, if a large bank were subject to a shortfall assessment because it had been subject to a surcharge for only one quarter of the surcharge period, the bank's surcharge base for seven quarters would be deemed to be zero and its average surcharge base would be its single positive surcharge base divided by eight (assuming that the surcharge period had lasted eight quarters).

[23] The final rule also contains provisions regarding the banks that are subject to a potential shortfall in the event of mergers, consolidations or other acquisitions.

[24] Small banks will not be entitled to any credits for the quarter in which a shortfall is assessed because large banks will be responsible for the entire remaining amount needed to raise the reserve ratio to 1.35 percent.

credits are calculated and awarded are as proposed in the NPR. The final rule provides that the FDIC will apply credits to reduce future regular deposit insurance assessments.

Aggregate Amount of Credits

As proposed in the NPR, to determine the aggregate amount of credits awarded small banks, the final rule provides that the FDIC will first calculate 0.2 percent of estimated insured deposits (the difference between 1.35 percent and 1.15 percent) on the date that the reserve ratio first reaches or exceeds 1.35 percent.[25] The amount that small banks contributed to this increase in the DIF through regular assessments – and the resulting aggregate amount of credits to be awarded small banks – will equal the small banks' portion of all large and small bank regular assessments during the "credit calculation period" times an amount equal to the increase in the DIF calculated above less surcharges. (The "credit calculation period" covers the period beginning the quarter after the reserve ratio first reaches or exceeds 1.15 percent through the quarter that the reserve ratio first reaches or exceeds 1.35 percent (or December 31, 2018, if the reserve ratio has not reached 1.35 percent by then).) Surcharges will be subtracted from the increase in the DIF calculated above before determining the amount by which small banks contributed to that increase because surcharges are intended to increase the reserve ratio above 1.15 percent, not to maintain it at 1.15 percent.

Staff projects that the aggregate amount of credits will total approximately $1 billion, but the actual amount of credits may differ.

The FDIC received only one comment on the proposed method of determining the aggregate amount of small bank credits. That comment, from a trade group, supported the proposal.

Individual Small Banks' Credits

As proposed in the NPR, credits will be awarded to any bank, including a small bank affiliate of a large bank, that was a small bank at some time during the credit calculation period. An individual small bank's share of the aggregate credit (a small bank's credit share) will be proportional to its credit base, defined as the average of its regular assessment bases during the credit calculation period.[26]

By making a small bank's credit share proportional to its credit base rather than, for example, its actual assessments paid, the final rule reduces the chances that a riskier bank assessed at higher than average rates will receive credits for these higher rates. The final rule thus reduces the incentive for banks to take on higher risk.

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[25] If the reserve ratio does not reach 1.35 percent by December 31, 2018, the amount calculated will be the increase in the DIF needed to raise the DIF reserve ratio from 1.15 percent to the actual reserve ratio on December 31, 2018; that amount equals the DIF balance on December 31, 2018 minus 1.15 percent of estimated insured deposits on that date.

[26] The final rule contains provisions related to the calculation of a small bank's credit base in the event of merger or consolidation.

The FDIC received no comments on this part of the proposal.

Successors

The final rule provides that, if any bank acquires a bank with credits through merger or consolidation after the DIF reserve ratio reaches 1.35 percent, the acquiring bank will acquire the credits of the acquired small bank. Other than through merger or consolidation, credits are not transferable.[27] Also, credits held by a bank that fails or ceases being an insured depository institution will expire. These provisions are as proposed in the NPR.

Use of Credits

The final rule provides that after the reserve ratio reaches 1.38 percent (and provided that it remains at or above 1.38 percent), the FDIC will automatically apply a small bank's credits to reduce its regular deposit insurance assessment up to the full amount of the bank's credits or assessment, whichever is less.[28] In response to comments, this portion of the final rule differs from the proposal in two ways. First, the final rule allows credit use as long as the reserve ratio is at or above 1.38 percent, rather than when it is at or above 1.40 percent as proposed in the NPR. Under the FDI Act, the Board is required to adopt a restoration plan if the reserve ratio falls below 1.35 percent. Allowing credit use only when the reserve ratio is at or above 1.38 percent should provide sufficient cushion for the DIF to remain above 1.35 percent in the event of rapid growth in insured deposits and ensure that credit use alone will not result in the reserve ratio falling below 1.35 percent. Allowing credit use before the reserve ratio reaches this level, however, would create a greater risk of the reserve ratio falling below 1.35 percent, triggering the need for a restoration plan.[29]

[27] A joint comment letter from three trade groups recommended that the FDIC allow a small bank to sell or transfer its credits. The final rule does not adopt this recommendation because of the small amount of expected credits, the short period they are expected to last, and the low number of banks that used transfer provisions in the past. The credits to be awarded pursuant to this final rule are expected to be relatively small (approximately $1 billion in credits compared to approximately $4.7 billion in credits awarded pursuant to the Federal Deposit Insurance Reform Act of 2005 (Reform Act). See 71 FR 61374 (Oct. 18, 2006) implementing one-time assessment credits awarded pursuant to the Reform Act. Credits awarded under the Reform Act also lasted considerably longer than the credits to be awarded under the final rule are expected to last. Over 50 percent of banks still had credits remaining under the Reform Act after five quarters and over 20 percent had credits remaining after eight quarters, while virtually all banks are expected to use up credits awarded under the final rule in five quarters or less. In addition, although the credits awarded under the Reform Act were transferrable, 71 FR at 61377, only one-half percent of banks (36 banks) actually transferred them (other than through merger). Similarly, although the FDIC allowed banks to transfer unused portions of approximately $45.7 billion in assessments that were prepaid at the end of 2009, 74 FR, 59056, 59060 (Nov. 17, 2009), only 20 banks actually transferred any of their prepaid assessment amounts (again, other than through merger). While credits are not transferrable under the final rule, the final rule provides that all banks may use credits to fully offset their assessments, and the final rule provides that credits may be used earlier than proposed in the NPR – when the reserve ratio reaches 1.38 percent, rather than 1.40 percent.

[28] Any credits in excess of a bank's assessment will be used to fully offset a bank's entire deposit insurance assessments in future quarters until credits are exhausted, as long as the reserve ratio exceeds 1.38 percent.

[29] Also, allowing credit use before the reserve ratio reaches 1.35 percent, as one trade group suggested, would delay the reserve ratio's reaching 1.35 percent and would add complexity because credits would have to be estimated and later adjusted, since the actual amount of credits will not be known until the reserve ratio reaches 1.35 percent.

Second, the final rule provides that credits available to an institution may be used to offset the institution's entire quarterly regular assessment, rather than limiting credit use to an annual rate of 2 basis points as proposed in the NPR.

Also, the final rule includes provisions regarding notices of credits and allowing a small bank that disagrees with the FDIC's computation of, or basis for, its credits to request review or appeal. These provisions are unchanged from those proposed in the NPR. The FDIC received no comments on this part of the proposal.

Economic Effects

Staff estimates that the FDIC will collect approximately $10 billion in surcharges and award approximately $1 billion in credits to small banks, although actual amounts could vary from these estimates. Staff projects that a shortfall assessment will be unnecessary. For all or almost all large banks, the effective surcharge annual rate measured against large banks' regular assessment base will be less than the nominal surcharge rate of 4.5 basis points because of the $10 billion deduction. Staff projects that the net effect of the lower assessment rates going into effect when the reserve ratio reaches 1.15 percent and the imposition of the surcharge will result in lower assessments for approximately one-third of all large banks.

As discussed above, the benefits of the final rule will be to quickly strengthen the fund's ability to withstand an unanticipated spike in losses and reduce the risk of larger assessments for the entire industry. Under the final rule, the cost of raising the minimum reserve ratio will be spread over approximately eight quarters and calculated in a simple, predictable manner.

Capital and Earnings Analysis

Consistent with section 7(b)(2)(B) of the FDI Act, staff estimated the effects of a surcharge on the equity capital and earnings of large banks as of December 31, 2015. As of that date, there were 108 large banks.

The analysis revealed no significant capital effects from the surcharge. All large banks continue to maintain a 4 percent leverage ratio, at a minimum, both before and after the imposition of the surcharge.

The annual surcharge also represents only a small percentage of bank earnings for most large banks. On average, the annual surcharge represents about 2.4 percent of large banks' pre-tax earnings before extraordinary items. The annual surcharge represents more than 5 percent of annual income for less than 10 percent of large banks and the maximum it represents at any single bank is about 10 percent of annual earnings.[30]

[30] Four large banks were excluded from the income analysis. One is an insured branch of a foreign bank and does not report income in its Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks. The other three reported negative income for the 12 months ending December 31, 2015.

Alternatives Considered

In the NPR, the FDIC solicited comment on a number of alternatives. The FDIC received several comments on each of the alternatives. Comments are discussed in the relevant sections above.

Implementation of the Final Rule

Staff recommends that the final rule become effective on July 1, 2016. If the reserve ratio reaches 1.15 percent before that date, surcharges will begin July 1, 2016. If the reserve ratio has not reached 1.15 percent by that date, surcharges will begin the first day of the calendar quarter after the reserve ratio reaches 1.15 percent.

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