

FEDERAL DEPOSIT INSURANCE CORPORATION**12 CFR Part 327**

RIN 3064-AB58

Assessments**AGENCY:** Federal Deposit Insurance Corporation.**ACTION:** Final rule.

SUMMARY: The Board of Directors (Board) of the Federal Deposit Insurance Corporation (FDIC) is amending the FDIC's regulation on assessments to establish a new assessment rate schedule of 4 to 31 basis points for institutions whose deposits are subject to assessment by the Bank Insurance Fund (BIF). In addition, the Board is amending the assessment schedule to widen the existing assessment rate spread from 8 basis points to 27 basis points. The Board is further amending the assessments regulation to establish a procedure for adjusting the rate schedule semiannually as necessary to maintain the designated reserve ratio (DRR) at 1.25 percent.

The Board is adopting the new assessment schedule to satisfy the requirements of section 7(b) of the Federal Deposit Insurance Act that, once the reserve ratio of the BIF reaches the DRR of 1.25 percent of total estimated insured deposits, rates be set to maintain the DRR. The new schedule will apply to the semiannual period in which the DRR has been achieved (which is expected to occur in the second quarter of 1995) and to semiannual periods thereafter, subject to modification semiannually by the FDIC. Specifically, the new assessment schedule, which will reduce BIF assessment rates for all but the riskiest institutions, will become effective on the first day of the month after the month in which the DRR is achieved. Assessments collected at the previous assessment schedule that exceed the amount due under the new schedule will be refunded, with interest, from the effective date of the new schedule.

EFFECTIVE DATE: September 15, 1995.

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SUPPLEMENTARY INFORMATION:**I. Background**

On February 16, 1995, the Board published for public comment a proposal to lower the assessment rate schedule for BIF members to 4 to 31 basis points from the current schedule of 23 to 31 basis points. The Board further proposed to amend the assessment rate matrix to widen the existing rate spread from 8 basis points to 27 basis points. 60 FR 9270 (Feb. 16, 1995). The Board is now adopting the proposed amendments with minor modifications.

Under the assessment schedule currently in effect, BIF members have been assessed rates for FDIC insurance ranging from 23 basis points for institutions with the best assessment risk classification to 31 basis points for the riskiest institutions. This assessment schedule was based on the requirements of section 7(b)(2)(E) of the Federal Deposit Insurance Act (FDI Act), 12 U.S.C. 1817(b)(2)(E). That provision was enacted as part of section 302 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) (Pub. L. 102-242, 105 Stat. 2236, 2345) which completely revised the assessment provisions of the FDI Act by requiring the FDIC to: (1) Establish a system of risk-based assessments; (2) establish assessment rates sufficient to provide revenue at least equivalent to that generated by an annual 23 basis point rate until the BIF reserve ratio¹ achieves the DRR of 1.25 percent² of total estimated insured deposits; (3) when the reserve ratio remains below the DRR of 1.25 percent, set rates to achieve that ratio within one year or establish a recapitalization schedule to do so within 15 years; and (4) once the DRR is achieved, set rates to maintain the reserve ratio at the DRR.

Due to the health of the banking industry, current projections indicate that the BIF may have recapitalized sometime during the second quarter of 1995, although recapitalization has not yet been verified. The actual month of recapitalization cannot be confirmed until data from the June 30, 1995, Reports of Condition and Income (call reports) is processed, which the FDIC expects to occur early in September. Accordingly, to implement the statutory provisions which will apply once the

¹The reserve ratio is the dollar amount of the BIF fund balance divided by the estimated insured deposits of BIF members.

²The DRR of 1.25 percent is equivalent to \$1.25 for each \$100 of estimated insured deposits.

DRR is reached, the Board is adopting an assessment rate schedule for BIF members of 4 to 31 basis points that will become effective the first day of the month after the month in which the DRR is achieved. Assessments collected at the previous rate schedule that exceed the amounts due under the new schedule after the DRR has been achieved will be refunded in one or more payments, with interest, from the effective date of the new schedule (or, in the case of June 30 overpayments, from June 30 or, if later, the actual payment date). As proposed, the Board is further adopting a process to adjust rates semiannually without a new notice-and-comment rulemaking proceeding, using an adjustment factor of 5 basis points.

At the request of Board Member Jonathan Fiechter and interested outside parties, the Board held a hearing at FDIC headquarters in Washington, D.C. on March 17, 1995, to provide the opportunity for interested parties to express orally their views on the proposals to decrease assessment rates for members of the BIF while retaining the existing 23 to 31 basis point assessment schedule for members of the Savings Association Insurance Fund (SAIF), on the competitive impact of the disparity between BIF and SAIF rates, and on possible solutions for recapitalizing the SAIF and paying the interest on Financing Corporation bonds. Every person or organization that requested an opportunity to testify was accommodated.

A total of twenty witnesses were heard by the full FDIC Board during the day-long hearing. They included the American Bankers Association (ABA), the Independent Bankers Association of America (IBAA), America's Community Bankers, the Savings Association Insurance Fund Industry Advisory Committee, the National Association of Home Builders, representatives of several bank and thrift state associations, individual bank and thrift executives, a private sector attorney, and an independent consultant. The written testimony of each witness as well as the hearing record are included in the FDIC's public comment file on the two proposals.

In total, the FDIC received over 3,200 comments on the BIF proposal (together with the comments received on the Board's proposal to retain the existing assessment rate schedule for members of the Savings Association Insurance Fund), including the testimony from the public hearing. After taking account of duplicates, 2,891 comments were tabulated representing 2,310 individual BIF member respondents, 454

individual SAIF member respondents, 61 trade associations and 66 other individuals/organizations.

Following is a discussion of: (1) The statutory framework for setting assessment rates, (2) the new assessment rate spread, (3) the new assessment rate schedule, (4) the method for applying the schedule in the semiannual period during which the DRR is achieved, and (5) the process for limited adjustment of the new schedule in future semiannual periods. A summary of the comments received is included with the specific issue(s) addressed by the parties submitting comments.

II. Statutory Framework for Setting Assessment Rates

A. Introduction

Section 7(b) of the FDI Act governs the Board's authority for setting assessment rates for members of the BIF. 12 U.S.C. 1817(b). Section 7(b)(1) (A) and (C) require that the FDIC maintain a risk-based assessment system, setting assessments based on (1) the probable risk to the fund posed by each insured depository institution taking into account different categories and concentrations of assets and liabilities and any other relevant factors; (2) the likely amount of any such loss; and (3) the revenue needs of the fund. Section 7(b)(2)(A) of the FDI Act requires the Board to set semiannual assessments to maintain the BIF reserve ratio at the DRR once the BIF is recapitalized,³ taking into consideration the fund's: (1) Expected operating expenses; (2) case resolution expenditures and income; (3) the effect of assessments on members' earnings and capital; and (4) any other factors that the Board may deem appropriate. Section 7(b)(2)(A)(iii) further directs the Board to impose on each institution a minimum assessment of not less than \$1,000 semiannually. When the reserve ratio remains below the DRR, the statute explicitly directs the Board to set rates that will at a minimum generate revenue equivalent to the amount generated by an average assessment rate of 23 basis points. FDI Act, section 7(b)(2)(E).

For the first time since the current provisions of section 7(b) were enacted in 1991, the determination that the BIF has achieved the DRR is imminent and, therefore, the minimum 23 basis point average assessment requirement will no

³The DRR of the BIF currently is 1.25 percent of estimated insured deposits. FDI Act, section 7(b)(2)(A)(iv). The Board may increase the DRR to such higher percentage as the Board determines to be justified for a particular year by circumstances raising a significant risk of substantial future losses to the fund. However, the Board is not authorized to decrease the DRR below 1.25 percent. *Id.*

longer apply. Accordingly, the Board must now establish an assessment schedule that satisfies the directive of section 7(b)(1) to establish a risk-based assessment system, based on the statutory factors which must be considered in that determination; and the directive of section 7(b)(2) to maintain the BIF reserve ratio at 1.25 percent, considering the statutory factors which must inform that decision. As a practical matter, there is significant overlap between the factors to be considered under section 7(b)(1) and those to be considered under section 7(b)(2). For example, in determining risk-based assessments, the Board must consider the probability and likely amount of losses to the fund. When setting assessments to maintain the reserve ratio at the DRR, the Board must consider the same underlying data but denominated as "case resolution expenditures". Thus, these determinations are interdependent and any decision concerning an appropriate assessment schedule will consider and balance all of the statutory factors that underlie these two directives.

In the current favorable economic environment even with assessment rates as low as prudently possible consistent with the Board's fiduciary responsibilities to the insurance fund, the FDIC recognizes that the reserve ratio may grow beyond 1.25 percent as a result of the impact on the fund balance of revenues generated from risk-based assessments, the \$1,000 semiannual minimum assessment, and investment income. Under these circumstances, any new assessment schedule adopted by the Board must be the result of balancing the directive to maintain a risk-based assessment system (and the statutory factors attendant thereto) and the directive to set rates to maintain the DRR (and the statutory factors attendant thereto). As discussed more fully below, the statute and the legislative history provide little guidance as to how to weigh the wide range of statutory factors that go into this decision. The following sections address the Board's interpretation of the interplay of the directives of section 7(b) and include a discussion of comments received on the related issues in the proposal.

B. Maintain "At" the DRR

The Board is adopting the proposed interpretation of the statutory requirement to maintain the reserve ratio at the DRR in which the Board views the DRR as a target. Pursuant to section 7(b)(2)(A)(i) of the FDI Act, the Board must set semiannual assessments to maintain the reserve ratio of the BIF

at the DRR taking into consideration the following factors: (1) Expected operating expenses; (2) case resolution expenditures and income; (3) the effect of assessments on members' earnings and capital; and (4) any other factors the Board may deem appropriate.⁴ Section 7(b)(2)(A)(iii) limits the Board's discretion to set assessment rates by imposing a minimum semiannual assessment of \$1,000 per BIF member.⁵

As stated in the proposal, the Board views the DRR as a target around which the actual reserve ratio would fluctuate, rather than as a rigid ceiling above which the reserve ratio could not rise even slightly.⁶ The Board based this interpretation on (1) the impossibility of controlling the economic factors which affect the size of the BIF; (2) the legislative history of section 7(b); and (3) the other statutory directives of section 7(b) that the FDIC establish a system of risk-based assessments and impose a minimum semiannual assessment of \$1,000 (either of which may cause the reserve ratio to exceed 1.25 percent in the current economic circumstances). The Board further stated that in the event the reserve ratio exceeds the DRR due to economic factors beyond its control (such as the level of investment income) or as a result of effectuating other statutory directives (such as the requirement to have a risk-based assessment system), the Board considers that it will have complied with the statute because the Board will have set rates to maintain the reserve ratio at 1.25 percent in

⁴The directive to "set rates to maintain the reserve ratio at the designated reserve ratio" was enacted as part of the amendments to section 7 made by the FDIC Assessment Rate Act of 1990 (Assessment Rate Act). Pub. L. 101-508, 104 Stat. 1388, 1388-14. The Assessment Rate Act is Subtitle A of Title II of the Omnibus Budget Reconciliation Act of 1990. See, discussion of legislative history in the proposed regulation. 60 FR 9270 at 9272 (Feb. 16, 1995).

⁵As enacted in FDICIA, section 7(b)(2)(A)(iii) of the FDI Act provides that the semiannual assessment for each member of a deposit insurance fund shall be not less than \$1,000. Accordingly, BIF members must pay the greater of their risk-based rate or \$2000 each year.

⁶Treating the DRR as a target would necessarily include the concept of fluctuations above and below the target. If the reserve ratio falls below 1.25% in a semiannual period, the Board could adjust the assessment schedule in the next semiannual period to restore the ratio. Section 7(b)(3)(A) of the FDI Act contemplates precisely that. That section provides that, after the DRR is achieved, if the reserve ratio falls below the DRR, the Board is required to set semiannual assessments sufficient to increase the reserve ratio to the DRR within one year or in accordance with a recapitalization schedule promulgated to restore the reserve ratio to the DRR within 15 years. Conversely, when the reserve ratio rises above the DRR for any period, the Board could adjust the assessment schedule downward to reflect the increase.

accordance with statutory requirements for a risk-based assessment system and a minimum semiannual assessment. The Board is adopting this interpretation with added discussion to clarify the need to balance the directives of section 7(b) and the statutory factors which must be considered in that balancing decision.

1. Comments

The appropriate interpretation of the directive to "maintain the reserve ratio at the designated reserve ratio" was one of the issues that elicited the greatest response from commenters. Of the 864 respondents that addressed this issue, 851 (813 BIF members, 30 trade associations, 4 SAIF members and 4 other individuals or organizations) believed that the DRR of 1.25 percent should be interpreted as a precise number or a ceiling and that all assessment revenue (and in some cases investment income) in excess of 1.25 percent should be returned to BIF members. Thirteen respondents (8 BIF members, 2 trade associations, 2 SAIF members and 1 other individual) agreed with the Board that the DRR is necessarily a target about which the reserve ratio will fluctuate. As noted above, the concept of the DRR as a precise number above which the BIF may not rise necessarily requires a mechanism to return excess assessments. See Section II.D below for a discussion of comments addressing the FDIC's authority to provide rebates. By contrast, the Center for Study of Responsive Law/Essential Information interpreted the statutory DRR as a floor and urged the FDIC to establish a higher range for the DRR with a target average of 1.63 percent using 1.25 percent as the floor and 2.0 percent as the ceiling.

Numerous commenters stated that the Board may not intentionally set assessments at a level which, based on its own projections, will increase the reserve ratio above the DRR. Accordingly, many have asserted that by setting the proposed assessment schedule at 4 to 31 basis points, the Board will have, in effect, knowingly set the rates to increase the DRR above 1.25 percent without making the required statutory finding to increase the DRR. This assertion was based on a misreading of a chart publicly distributed at the Board meeting on the proposals indicating that under the proposed rate schedule, the reserve ratio would rise to 1.30 percent in 1995 and 1.33 percent in 1996 and remain above the DRR until the year 2001. The projections in the chart did not reflect the possibility of semiannual changes

that the Board might make to the assessment schedule.

For example, the primary argument of the ABA is that the Board cannot intentionally set assessments to generate assessment income which its own predictions show will increase the reserve ratio above the DRR. According to the ABA, to do so would render meaningless the requirement that the Board must make a determination that circumstances raising a significant risk of substantial future losses to the fund justify an increase in the DRR. Similarly, the IBAA stated that in light of its own projections, FDIC appears to be managing the fund at a level higher than 1.25 percent.

2. The Board's Rationale for Interpreting the DRR as a Target

As described more fully below, the Board continues to believe that viewing the DRR as a target to be maintained over time is the correct position because: (1) It reflects the inconstancy of economic factors which make it impossible for the FDIC to maintain the reserve ratio precisely at 1.25 percent; (2) it better comports with Congress' view of the DRR as a target as indicated by the legislative history and the practical impact of Congress' elimination of the FDIC's rebate authority in section 7(d); and (3) it gives effect to other provisions of section 7(b), most importantly, the requirement for a risk-based assessment system. A discussion of each of these elements of the Board's rationale follows.

(a) *Management of Reserve is Imprecise.* The first element upon which the Board based its interpretation of the "maintain at" requirement is the FDIC's inability to control economic factors which affect the size of the reserve ratio, thereby making it impossible to manage the BIF precisely at 1.25 percent. Changes in the reserve ratio are a function of the amount of insured deposits, investment earnings, assessment revenue (which, in turn, is a function of the risk profile of the industry and revenue received from the statutory minimum assessment), and revenue from corporate-owned and other assets, none of which is in the complete control of the FDIC. In addition, operating expenses and insurance losses, including the provision for future losses, will vary. Even with regard to the elapsed time between the setting of rates for an upcoming semiannual assessment period and the end of that period, there is a potential for variations in all of these factors, thus making it impossible to manage the reserve ratio precisely at the DRR.

Moreover, Congress must have understood that the reserve ratio cannot be maintained precisely at 1.25 percent because such an interpretation would require that amounts in excess of 1.25 percent be returned to the industry. In the current economic environment, the fund will likely grow beyond the DRR as a result of investment income and revenue generated by the risk-based assessment system. Thus, an interpretation which requires the FDIC to maintain the reserve ratio precisely at 1.25 percent would necessarily require a mechanism for providing assessment credits (known as rebates) to BIF members for amounts in excess of 1.25 percent. However, as discussed more fully in Section II.D below, in FDICIA Congress deleted the FDIC's authority in section 7(d), 12 U.S.C. 1817(d), to provide rebates. In addition, Congress can be presumed to have been aware that at no time in its 62-year history has the FDIC rebated investment income to the industry, including the period from 1989-1990 which was the only time that the FDIC had the authority to rebate investment income. Indeed, even if the FDIC's last-existing rebate authority had not been removed on January 1, 1994, investment income could not be rebated and could cause the reserve ratio to rise even with minimal assessments.

(b) *Legislative History.* The second element upon which the Board based its interpretation of the "maintain at" requirement is the legislative history of section 7(b). Section 208 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) amended section 7(b) of the FDI Act to establish a DRR and set the level at 1.25 percent. Pub. L. 101-73, 103 Stat. 183, 206. Prior to FIRREA, beginning in 1980, the FDI Act required or authorized the Board to adjust the amount of assessment income transferred to the insurance fund, and thereby to increase or decrease the rebate amount, based on the actual reserve ratio of the fund within a range from 1.10 percent to 1.40 percent, with 1.25 percent as the target.⁷ FIRREA also prescribed minimum annual assessment rates which could be increased from the scheduled levels, "if necessary to restore the fund's ratio of reserves to insured deposits to its *target level* within a reasonable period of time." [Emphasis added.] H.R. Conf. Rep. No. 222, 101st Cong., 1st Sess. 396 (1989).

The legislative history of Congressional hearings in the year prior

⁷ Consumer Checking Account Equity Act of 1980, enacted as Title III of the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. 96-221, 94 Stat. 132, 148.

to enacting FIRREA is replete with references to the 1.25 percent reserve ratio as a target. Thus, when the DRR was established, Congress viewed the DRR as a target level.

The next year, in 1990, the Senate Banking Committee clearly considered the DRR a target as is demonstrated in the section-by-section analysis of S. 3045, the language of which was almost identical to the Administration bill, S.3093, which was ultimately enacted as the Assessment Rate Act of 1990. That analysis repeatedly referred to 1.25 percent as the "target level". Finally, FDICIA section 104, Recapitalizing the Bank Insurance Fund, amended the assessment rate provisions of section 7(b)(1)(C) (in effect December 19, 1991, through December 31, 1993) as follows:

If the reserve ratio of the Bank Insurance Fund equals or exceeds the fund's designated reserve ratio under subparagraph (B), the Board of Directors shall set semiannual assessment rates for members of that fund as appropriate to maintain the reserve ratio at the designated reserve ratio. [Emphasis added.]

This language is particularly compelling because its genesis was in S. 543, the same bill which removed the FDIC's rebate authority and which was the source of FDICIA's amendments to section 7 of the FDI Act. Thus Congress appears to have recognized that the reserve ratio would not remain precisely at a target DRR and could exceed that level.

(c) *Other Statutory Directives of Section 7(b)*. The third element upon which the Board has based its interpretation of the "maintain at" directive consists of the other mandates of section 7(b): to have an effective risk-based assessment system and to impose a minimum semiannual assessment of \$1,000.

The Board believes that to be effective, the risk-based assessment system must incorporate a range of rates that provides an incentive for institutions to control risk-taking behavior while at the same time covering the long-term costs of the obligations undertaken by the deposit insurer.

Specifically, section 7(b)(1)(C) of the FDI Act required the FDIC to establish a risk-based assessment system for calculating an institution's assessments based on:

(i) The probability that the deposit insurance fund will incur a loss with respect to the institution, taking into consideration the risks attributable to—

(I) Different categories and concentrations of assets;

(II) Different categories and concentrations of liabilities, both

insured and uninsured, contingent and noncontingent;

(III) Any other factors the Corporation determines are relevant to assessing such probability;

(ii) The likely amount of any such loss; and

(iii) The revenue needs of the deposit insurance fund.

Within the scope of these broad factors, the FDIC was granted complete discretion to design a risk-based assessment system.⁸ See, *i.e.*, S. Rep. No. 167, 102d Cong., 1st Sess., 57 (1991).

It is clear from the legislative history of FDICIA that Congress viewed the flat-rate assessment system as providing perverse incentives for institutions to undertake risky activities funded by insured deposits because they were not being charged for that risk, in effect penalizing well-managed institutions. S. Rep. No. 167, 102d Cong., 1st Sess. 56 (1991). By contrast, risk-based assessments were intended to reduce risk to the BIF by encouraging banks to confine themselves to safe and sound activities and decreasing the subsidization of risky banks by more prudent institutions. *Id.*

The ABA has asserted that a risk-based assessment system is unnecessary when the BIF does not need assessment income and that the requirement for such a system applies only to determining the spread between the highest and lowest rates in the assessment schedule. Once the spread is determined, then the appropriate schedule is based solely on the revenue needs of the fund. The Board disagrees with this interpretation because it gives effect only to the statutory requirement that the revenue needs of the fund be taken into account when establishing or revising risk-based assessment rates. Such an interpretation would ignore the compelling legislative history indicating Congress' firm determination that banks be assessed on the basis of the risk that their activities pose to the BIF and that they be subject to appropriate economic disincentives to risky behavior.

In summary, the Board believes that to be effective, the risk-based

assessment system must incorporate a range of rates that provides an incentive for banks to control risk-taking while at the same time taking into account the long-term costs of the risks borne by the deposit insurer. The Board is well aware that the assessment income generated by an effective risk-based assessment system and the minimum semiannual assessment may, in the current economic situation, cause the reserve ratio to rise above the target DRR of 1.25 percent. Even so, as discussed more fully below, this does not eliminate the necessity for the Board to balance the directives of section 7(b) to have an effective risk-based assessment system while at the same time setting rates that will maintain the reserve ratio at the target DRR by giving full consideration to the enumerated statutory factors that are the determinants of the assessment schedule.

C. Balancing

As discussed below, the main purpose of S. 543 (the bill that contained the language of current section 7(b)) was to assure that the BIF would be recapitalized so that taxpayer funds would not be at risk. Accordingly, while the statute is specific with respect to the actions the Board must take to set rates when the reserve ratio is below the DRR, neither the statute nor the legislative history provides guidance with respect to how the FDIC is to balance the various requirements of section 7(b) once the DRR is achieved. Nor does the legislative history provide guidance as to the appropriate timeframe for forecasting losses so that the reserve ratio can be maintained at 1.25 percent, thereby ultimately protecting the taxpayers.

It is clear from the legislative history that in enacting FDICIA, Congress was focused almost entirely on a future where the reserve ratio would be below the DRR, and that the main goal of S. 543 was to assure that the taxpayers would not be required to rescue the banking industry as they so recently had been called upon to do with the S&L industry. For example, on May 29, 1991, Robert Glauber, Under Secretary of the Treasury testified before the House Ways and Means Committee "The Administration's projections are that the BIF will decline substantially over the next five years, reaching a negative net worth of over \$22 billion by the end of 1996." S. Hrg. No. 30, 102d Cong., 1st Sess. 8 (1991). The report of the Senate Banking Committee on S. 543 cited Congressional Budget Office projections indicating that the BIF could be recapitalized within 15 years without imposing premiums as high as 30 basis

⁸ One statutory restraint, however, is that the system must be designed so that as long as the BIF reserve ratio remains below the DRR, the total amount raised by semiannual assessments on members cannot be less than the total amount resulting from a flat rate of 23 basis points. FDI Act, section 7(b)(2)(E). Although this provision will cease to be effective when the BIF reaches the DRR, it may again become operative if the reserve ratio remains below the DRR at some future time. The Board interprets the minimum assessment provision of section 7(b)(2)(E), which requires weighted average assessments of 23 basis points, as applying only when the reserve ratio remains below the DRR for at least a year.

points or more. However, the Committee declined to cap premiums at 30 basis points in the event those projections proved too optimistic. S. Rep. No. 167, 102d Cong., 1st Sess. 30 (1991). Similarly, Senator John Kerry expressed concern at the requirement of the bill that the banking industry pay back any Treasury borrowings, stating that that funding approach could prove to be impossible. *Id.* at 230. S. 543 itself contained an elaborate scheme for expedited congressional authorization to extend the 15-year recapitalization schedule if necessary.

The following remarks of Congressman Gerald Kleczka during floor debate in the House reflect the skepticism that banks would be able to recapitalize the BIF:

Mr. Chairman, one of the Members of the House a short time ago asked, Where are we going to look to bail out the banks? And he answered it himself by saying the banks.

Well, I say to you, that is total nonsense. The bank bailout, whether or not this bill passes, has already started. The bank insurance fund, the FDIC, is broke. This legislation asks for a \$70 billion Treasury loan, which in my estimation will never be repaid by the banks.

In fact, with the pending bank failures on the line today, it is estimated that \$70 billion will not last through the end of next year. At that point we are going to loan them more money, more money, and to say that this is not going to turn into another S&L crisis, I say, hold on, you are in for a rough ride, because I say that is what is going to happen. 137 Cong. Rec. H8939 (daily ed. Nov. 1, 1991).

Until now, the Board's discretion in setting risk-based assessments has been limited by the 23 basis-point minimum average assessment requirement and the concomitant need to moderate the detrimental impact of a very high rate on weak institutions which taken together were the most crucial determinants of the assessment schedule. Once the DRR is achieved, however, the 23 basis-point minimum requirement will become inapplicable. Therefore, the Board for the first time must decide as a prudent insurer what assessment schedule would achieve an effective risk-based assessment system based on long-term deposit insurance experience as well as short-term loss predictions consistent with its obligation to protect the BIF (and ultimately the taxpayers).

The statute is silent with respect to the appropriate timeframe the Board should use to project losses. Although section 7 requires the Board to set assessments semiannually to maintain the reserve ratio at the DRR, to assert—as did various commenters—that the Board is limited to reviewing the next

six months when setting rates is without foundation in either the statute or the legislative history and disregards the recent past history of bank failures, the rapid deterioration and collapse of seemingly healthy institutions, and the increasing volatility of numerous economic factors affecting both the industry and the BIF. Moreover, such a position ignores Congress' primary goal in enacting FDICIA—that the fund not decrease to the point that taxpayer funds are needed to rescue the BIF.

In fact, the legislative history of FDICIA indicates that Congress intended the FDIC to set premiums in much the same manner as private insurance companies, where the insured's premium is a function of the risk posed to the insurer. For example, in his opening remarks at the Senate Banking Committee hearing on risk-based premiums on April 19, 1991, Senator Alan Dixon stated, "I think it is fundamentally important for the Federal Deposit Insurance Corporation to price its product like every other insurance company—that is, according to risk of loss." S. Hrg. No. 355, 102d Cong., 1st Sess. 1197 (1991). Accordingly, the Board believes it appropriate as part of its process for setting assessments to look to the practices of private sector insurers to inform its decisionmaking. As manager/administrator of the deposit insurance fund, the Board has a fiduciary obligation to manage the fund in a prudent manner to preserve the fund on behalf of both the banking industry and the taxpayers, who are ultimately the insurers of last resort for the banking industry.

Standard private sector insurance involves one party, the insured, who seeks protection against a specific risk by paying a premium to another party, the insurer, who agrees to compensate the insured for any losses resulting from the risk specified in the contract.⁹ However, federal deposit insurance differs from private insurance because deposit insurance is intended to be a pledge or guarantee meant to convey confidence to prevent the spread of bank runs and because it provides an unconditional guarantee to depositors that their insured funds are safe regardless of the risks undertaken by an insured depository institution.¹⁰

Private insurance companies typically operate through a self-sustaining fund by basing the level of capital needed in reserve on actuarial assessments of past and potential losses. The insurer charges different premium rates to

different clients based upon an assessment of their risk of loss.¹¹ Private insurers uniformly underwrite specified risks that are similar in quality and variety by using historical data to set premium rates to cover long-term costs of any given risk category.¹² In banking, however, the difficulty for the deposit insurer is determining when the revenues of any particular category are sufficient to cover expected costs.¹³ In casualty insurance, for example, the events insured against are independent of each other and are uncorrelated over time. By contrast, bank failures are not evenly distributed or uncorrelated but tend to be clustered as a function of economic conditions or shocks.¹⁴ This makes it more difficult to set rates so that the long-run revenues are sufficient to cover the long-run costs of each risk category.

In the absence of legislative direction, the Board believes that it is compelled to give effect to the statutory directive to have a meaningful risk-based assessment system and the directive to set rates to maintain the reserve ratio at the DRR, by balancing the various statutory factors which underlie those directives and which, ultimately, are the determinants of an appropriate assessment schedule. Neither of these directives, nor any single statutory factor, may be given effect at the expense of the other. Thus, for example, in weighing the requirement to set assessments at a target DRR, the "revenue needs of the fund" factor may not be interpreted, as has been suggested by some commenters,¹⁵ in such a way that the risk-based assessment system becomes meaningless when the fund attains the DRR.

D. Rebates

The Board is adopting its proposed interpretation that the Board lacks rebate authority because that authority was eliminated by Congress in FDICIA. As discussed below, this position is based on: (1) The statutory history of sections 7 (d) and (e); (2) the fact that Congress repealed the rebate authority in section 7(d); and (3) the legislative history indicating that Congress

¹¹ *Id.* at 28.

¹² *Id.*

¹³ FDIC, A Study of the Desirability and Feasibility of a Risk-Based Deposit Insurance Premium System, A report pursuant to Section 220(b)(1) of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, submitted to the United States Congress by the Federal Deposit Insurance Corporation, at 11 (1990).

¹⁴ *Id.*

¹⁵ See, discussion of ABA comments at Section IV.A., *infra*.

⁹ Congressional Budget Office, Reforming Federal Deposit Insurance, (1990) xv.

¹⁰ *Id.* at xvi.

intended that lower rates would be the substitute for rebates.

In the proposal, the Board reviewed the FDIC's authority to provide rebates of amounts by which the reserve ratio exceeds the DRR based on both former and current statutory provisions in FDI Act sections 7(d) and 7(e) respectively, and the legislative history of those provisions. Based on that review, the Board proposed a statutory interpretation that: (1) The FDIC's authority to provide rebates was eliminated by Congress in FDICIA effective with the adoption of the statutorily mandated risk-based assessment system on January 1, 1994; and (2) section 7(e) does not provide rebate authority, but rather pertains to the method of providing refunds of assessment overpayments.¹⁶

In FDICIA, Congress provided for establishment of a risk-based assessment system that, after the DRR was achieved, would provide the FDIC with the flexibility to set a broader range of assessment rates. In 1990, Congress had already provided the FDIC with the authority to adjust assessment rates upward to ensure that the BIF received sufficient revenue.¹⁷ In FDICIA, Congress intended that same rate adjustment authority to operate in lieu of providing rebates in the event that the established rates resulted in collection of excess assessment revenue. Therefore, Congress eliminated the rebate provisions of section 7(d) in their entirety as being obsolete because the ability to adjust rates would take the place of a rebate mechanism. This is clear from the following discussion of section 212(e)(3) in the Senate Report on S. 543:

Section 212(e)(3) replaced current section 7(d) with a new section 7(d) recodifying current section 7(b)(9). The deleted text, providing for assessment credits to insured institutions when deposit insurance fund reserve ratios exceed designated reserve ratios, is obsolete in light of the standards for establishing assessments set forth in new section 7(b)(2)(A)(i) [setting rates to maintain at the DRR]. Under section 7(b)(2)(A)(i), funds that, under current section 7(d), would have been rebated to insured depository institutions through assessment credits will now be *rebated through reduced assessments*.

¹⁶ Section 7(e) provides that the FDIC:

(1) May refund to an insured depository institution any payment of assessments in excess of the amount due to the Corporation or (2) may credit such excess toward the payment of the assessment next becoming due from such depository institution and upon succeeding assessments until the credit is exhausted.

¹⁷ See, discussion of Assessment Rate Act, *infra*, note 4.

138 Cong. Rec. S2073 (daily ed. Feb. 21, 1992). (Emphasis added.)

In response to the Board's proposed interpretation regarding the FDIC's rebate authority, a total of 482 respondents generally disagreed with the FDIC's position; one trade association appeared to accept the interpretation and it requested a legislative change to restore the rebate authority. Of those in disagreement, seven BIF members, four trade associations and one individual explicitly disagreed with that interpretation, asserting that the FDIC did, in fact, have authority to provide rebates. A total of 400 commenters (383 BIF members, 3 SAIF members, 12 trade associations and 2 other commenters) largely without any discussion of the FDIC's legal authority, indicated that when the BIF reserve ratio exceeds the DRR as a result of assessment income, the FDIC should return to BIF members all assessments above 1.25 percent because those funds could be better used servicing local communities. In addition, 48 commenters (46 BIF members and 2 trade associations) responded that assessment income in excess of 1.25 percent other than the \$1,000 statutory semiannual minimum should be returned. Finally, 21 commenters (15 BIF members and 6 trade associations) asserted that when the reserve ratio exceeds the DRR, the FDIC should return both assessments and investment income above 1.25 percent.

Based on its interpretation of the DRR as a ceiling on the amount of funds that may lawfully be retained in the BIF, the ABA has asserted that all amounts (including investment income) in excess of a reserve ratio of 1.25 percent must be rebated to the industry. The ABA has argued that returning excess reserve amounts by means of lowering subsequent assessments is merely one method of accomplishing the statutory intent to return funds; where that method does not suffice to accomplish that goal, the statute should be interpreted to find an alternative method. Accordingly, notwithstanding the statutory history of section 7(e) and the repeal of section 7(d), it argued that the FDIC could rely on an interpretation of the plain meaning of section 7(e) to implement the statutory purpose.

The New York Clearing House (Clearing House) stated that the FDIC has rebate authority pursuant to the plain meaning of section 7(e) and that there is no legislative history to indicate that that section should be interpreted other than in accordance with a plain reading. Further, the rebate authority is

particularly important because the Clearing House does not believe that the FDIC will be able to maintain the reserve ratio at 1.25 percent by semiannual rate adjustments only, without some form of rebate mechanism. Citicorp also criticized the FDIC's interpretation, indicating that the inability to provide rebates when the reserve ratio exceeds 1.25 percent makes the determination of the proper rate schedule all the more critical.

The IBAA similarly argues that, without such authority, the FDIC will be unable to manage the BIF at the DRR as required and that the FDIC's interpretation ignores the discretion to set rates given to it by Congress in connection with the risk-based assessments system. The IBAA and the Bankers Roundtable noted that although the authority of section 7(d) was removed, the statute does not expressly prohibit the FDIC from providing rebates pursuant to some other authority.

The Board is unconvinced by the alternative interpretation offered by commenters that rebate authority exists in section 7(e), which authorizes the FDIC to refund or credit to an insured institution any assessment payment in excess of the amount due to the FDIC. The Board does not believe it can ignore unequivocal action by the Congress to eliminate rebate authority by, in effect, re-creating that authority through a new interpretation of section 7(e) absent some indication in the legislative history that Congress intended section 7(e)¹⁸ to serve as a substitute for section 7(d) of the FDI Act.

Moreover, the FDIC has not located any legislative history indicating that Congress intended section 7(e) to take the place of section 7(d). Therefore, for the reasons discussed above, the Board continues to believe that the better interpretation of the statute is that the FDIC has no authority to grant rebates and that to do so would be in violation of the statute and contrary to legislative history.

III. New Rate Spread

The Board is adopting without modification the proposal to increase the rate spread from 8 basis points in the current assessment schedule to 27 basis points in the new schedule.

As discussed in Section II.B.2(c), the fundamental goals of risk-based assessment rates are to reflect the risks posed to the insurance fund by

¹⁸ Section 7(e) has been consistently interpreted by the FDIC since 1950 to provide authority to refund erroneous overpayments of assessments. The FDIC has never interpreted that section as providing rebate authority.

individual insured institutions and to provide institutions with incentives to control risk taking. In the existing assessment schedule, the maximum rate spread is 8 basis points. See Table 1. Institutions rated 1A pay an annual rate of 23 basis points while institutions rated 3C pay 31 basis points. There is a substantial question as to whether 8 basis points represents a sufficient spread for achieving these goals.

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Table 1

**Assessment Rate Schedules
Second Semiannual 1995 Assessment Period
BIF-Insured Institutions**

New Rates (27 bp rate spread)

Capital Category	Supervisory Risk Subgroup		
	Group A	Group B	Group C
1. Well	4 bp	7 bp	21 bp
2. Adequate	7 bp	14 bp	28 bp
3. Under	14 bp	28 bp	31 bp

Estimated Assessment Revenue: \$1.1 Billion
Average Assessment Rate: 4.4 bp

Current Rates (8 bp rate spread)

Capital Category	Supervisory Risk Subgroup		
	Group A	Group B	Group C
1. Well	23 bp	26 bp	29 bp
2. Adequate	26 bp	29 bp	30 bp
3. Under	29 bp	30 bp	31 bp

Estimated Assessment Revenue: \$5.46 Billion
Average Assessment Rate: 23.2 bp

Adjustment Factor

Given the assessment base as of March 31, a 5 basis point adjustment factor will generate approximately \$1.18 billion in additional revenue.

**Distribution Among Insurance Groups*
BIF-Insured Institutions**

Capital Group		Supervisory Risk Subgroup					
		A		B		C	
1. Well	NUMBER:	9,766	91.8%	557	5.2%	142	1.3%
	BASE(\$B):	2,220.3	94.8%	59.6	2.5%	16.8	0.7%
2. Adequate	NUMBER:	79	0.7%	23	0.2%	35	0.3%
	BASE(\$B):	45.0	1.9%	3.7	0.1%	3.8	0.1%
3. Under	NUMBER:	5	.04%	5	.04%	26	0.2%
	BASE(\$B):	1.2	.05%	1.0	.05%	2.6	0.1%

*Based on 3-31-95 data.

As discussed in the proposal, the current assessment rate spread for BIF institutions has been criticized widely by bankers, banking scholars and regulators as overly narrow, and there is considerable empirical support for this criticism. Using a variety of methodologies and different sample periods, the vast majority of relevant studies of deposit insurance pricing have produced results that are consistent with the conclusion that the rate spread between healthy and troubled institutions should exceed 8 basis points.¹⁹ While the precise estimates vary, there is a clear consensus from this evidence that the rate spread should be widened.

FDIC research likewise suggests that a substantially larger spread would be necessary to establish an "actuarially fair" assessment rate system. Insurance premiums are actuarially fair when the discounted value of the premiums paid over the life of the insurance contract is expected to generate revenues that equal expected discounted costs to the insurer from claims made by the insured over the same period. A 1994 FDIC study used a "proportional hazards" model to estimate the expected lifetime of banks that were in existence as of January 1, 1993. The study estimated the actuarially fair premium that each bank must pay annually so that the cost of each bank failure to the FDIC would equal the revenue collected through insurance assessments. The estimates indicated a rate spread for 1A versus 3C institutions on the order of magnitude of 100 basis points.²⁰

In the proposal, the Board expressed concern that rate differences between adjacent cells in the current matrix do not provide adequate incentives for institutions to reduce the risk they pose to BIF by improving their condition,

which is a fundamental goal of risk-based assessments. Larger differences are consistent with historical variations in failure rates across cells of the matrix, viewed in connection with the preponderance of evidence regarding actuarially fair premiums.²¹ The precise magnitude of the differences is open to debate, given the sensitivity of any estimates to small changes in assumptions and to selection of the sample period. However, the Board believes that larger rate differences between adjacent cells of the matrix are warranted. Accordingly, the Board proposed for comment an increase in the spread between the lowest and highest rates in the assessment schedule to 27 basis points from the current 8 basis point spread.

Of the 357 commenters (332 BIF members, 4 SAIF members, 16 trade associations and 5 other organizations/individuals) who addressed the issue of the increased spread, 298 respondents supported the proposal. Of those, 217 respondents (including 9 trade associations and 203 BIF members) expressly approved of the increase to 27 basis points; an additional 70 respondents (including 1 trade association and 69 BIF members) indicated support for increasing the spread but didn't specifically mention the proposed increase to 27 basis points. Forty commenters (including 4 trade associations and 35 BIF members) expressed the opinion that the proposed spread was too great; by contrast, 12 commenters, all of whom were BIF members, thought the spread should be wider than proposed. Finally, 18 commenters (including 2 trade associations and 12 BIF members) expressed reservations about the increased weight given to the subjective supervisory ratings in determining an institution's risk classification.

Among the commenters supporting the proposed increase, numerous respondents expressed the opinion that the proposal would provide BIF members with greater incentive to control risk while at the same time rewarding well-managed institutions for limiting risk. For example, Banc One Corporation noted, "Prudent, healthy institutions should not have to pay for ill-advised activities and high-risk institutions." The New York Clearing House stated that "the larger spread is more actuarially equitable, in that it reduces the burden that the strongest institutions must bear to support the weakest." The Bankers Roundtable indicated its support for incentive-based regulation coupled with a strong spread

between the lower- and higher-risk institutions. The Roundtable noted that "risk-based premiums should address all the strengths of an institution, not merely capital. As the schedules now contemplate and as other regulators who examine and evaluate institutions assess, strong management and strong internal risk control systems are important as well."

Forty commenters opposed the proposed 27 basis-point spread. For example, the ABA asserted that the current spread should be retained because it provides a strong incentive for banks to move into the lower-risk categories as evidenced by the increase in 1A institutions between 1993 and 1995 from 60 percent to 90 percent of the industry. The ABA also indicated concern about the emphasis on the supervisory rating because of its subjectivity. America's Community Bankers expressed similar reservations and indicated that it would be better to give more weight to capital because it is both a more objective and more controllable factor. Orange National Bancorp commented that examiners have too much individual discretion in assigning risk classifications. It recommended that a standard model for such evaluations be implemented if one is not already in place. The California Bankers Association (CBA) opposed the increased spread because of the belief that it too closely correlates with local economic conditions that are beyond the control of the institution. Thus, adverse local economic conditions may result in higher risk classifications at a time when the institution can least afford it. The CBA further noted that "[a] primary objective of deposit insurance should be to spread uncontrollable risk among similarly situated institutions. To impose *additional* premiums when that risk is actually realized is analogous to charging a person a universal health insurance rate, and then increasing that rate when the person actually becomes sick and requires care." (Emphasis in original.) The CBA proposed as an alternative a narrowing of the spread to mitigate the penalties imposed on a bank for falling into a higher risk category due to the effects of a local economic downturn.

By contrast, the twelve commenters who indicated that the spread should be wider indicated that the proposed assessment schedule did not adequately reflect the true risk to the BIF. Several commenters raised concerns about the insufficient distinction between the riskiness of low-risk banks. For example, Wells Fargo Bank stated that

¹⁹ For a representative sampling of academic studies on this issue, see Estimating the Value of Federal Deposit Insurance, The Office of Economic Analysis, Securities and Exchange Commission (1991); Berry K. Wilson, and Gerald R. Hanweck, A Solvency Approach to Deposit Insurance Pricing, Georgetown University and George Mason University (1992); Sarah Kendall and Mark Levonian, A Simple Approach to Better Deposit Insurance Pricing, Proceedings, Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago (1991); R. Avery, G. Hanweck and M. Kwast, An Analysis of Risk-Based Deposit Insurance for Commercial Banks, Proceedings, Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago (1985).

²⁰ See, Gary S. Fissel Risk Measurement, Actuarially Fair Deposit Insurance Premiums and the FDIC's Risk-Related Premium System, FDIC Banking Review (1994), at 16-27, Table 5, Panel B. Single-copy subscriptions of this study are available to the public free of charge by writing to FDIC Banking Review, Office of Corporate Communications, Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, D.C. 20429.

²¹ *Id.*, at Tables 2 and 5.

"[n]inety percent of banks should not be included in the lowest risk category."

A number of commenters indicated support for the proposal that the nine-cell matrix should remain in place pending an in-depth review of the risk classification system. Expressing its support for deposit insurance rates as an appropriate incentive for banks to control risky activities, the IBAA recommended that the FDIC implement the premium reduction before considering modifications to the nine-cell matrix. The ABA indicated that bankers support keeping the risk classification system simple, and it would not, therefore, support any revisions to the matrix involving the creation of more categories or a new, super-capitalized category. In Citicorp's view, "any change in the number of cells will create disputes while producing very little additional equity" without greater explanation of the underlying rationale for any increase. Citicorp called for frequent reviews an institution's risk so that the risk classification is based on current evaluations.

The Board is adopting the proposed increase in the spread from 8 to 27 basis points without modification. Having carefully considered the comments on the proposal, the Board nonetheless continues to believe that the assessment rate matrix should be adjusted in the direction of an actuarially fair rate structure, as described above. In addition, as in the proposal, the Board has decided not to adopt changes to the nine-cell assessment rate structure at this time. Accordingly, as proposed, the new rate matrix retains the existing nine cells.

While the Board appreciates the concern expressed in the comments regarding the additional weight placed on supervisory evaluations as a result of the increased rate spread, the use of such evaluations as a risk measure is well-established. Historically, deteriorations in supervisory ratings are associated with a substantially higher incidence of failure.

When the Board adopted the existing 8-point rate spread in 1992, it expressed the conviction that widening the spread was desirable but declined to do so because of the potential hardship for troubled institutions and possible additional losses for the insurance fund.²² At that time, however, a wider

rate spread would only have been accomplished through an increase in the assessment rate paid by weaker institutions. In contrast, under the new schedule the Board is now adopting, the rate spread will be widened by means of a reduction in the rates applicable to stronger institutions.

Under the new schedule, all BIF-insured institutions except those with assessment risk classification 3C will enjoy a reduction in their assessment rates, with a consequent beneficial impact on earnings and capital. The only adverse effect on earnings and capital conceivably could result from the increase in the rate spread from 8 basis points to 31 basis points. Under the current assessment schedule, weaker institutions are competing with institutions that pay an assessment rate of 23 basis points. Under the new schedule, where all but institutions in the 3C category will pay reduced rates, the weaker institutions will be competing with a large group of BIF members that will be paying a rate of only four basis points. In principle, if the BIF members classified as 1A pass along their reduced assessments to their customers, the weaker institutions may be forced to pay more for deposits or charge less for loans to stay competitive.

The FDIC performed an analysis simulating the effects of the wider rate spread on all insured institutions under the assumption that the weaker institutions would have to absorb the entire increase in spread in the form of a higher cost of funds. The result was that apart from institutions that have already been identified by the FDIC's supervisory staff as likely failures, the wider spread is expected to have a minimal impact in terms of additional failures.

A widening of the spread to 27 basis points is consistent with the implications of the best empirical evidence on this issue and with the Board's previously stated conviction. Moreover, the increased differences between adjacent cells in the matrix provides additional incentive for weaker institutions to improve their condition and for all institutions to avoid excessive risk-taking. This is consistent with the Board's desire to create adequate incentives through the

rate spread in 1993, the Board expressed its conviction that widening the rate spread was desirable in principle, but chose to retain for the time being, the 8 point rate spread. The Board expressed concern that widening the rate spread while keeping assessment revenue constant, might unduly burden the weaker institutions which would be subject to greatly increased rates. However, the Board retained the right to revisit the issue at some future date. 58 FR 34357 (June 25, 1993).

assessment rate structure to encourage behavior that will protect the deposit insurance fund against excessive losses.

Nonetheless, the Board remains unwilling at this time to increase further the maximum rate other than by means of the adjustment factor discussed below, without further study regarding the overall insurance pricing structure for the industry.

IV. New Assessment Schedule

In light of its interpretation of section 7(b) discussed above and based on its consideration of the required statutory factors, the Board is adopting in the final rule its proposed new assessment rate schedule ranging from a rate of 4 basis points for institutions with a risk classification of 1A to 31 basis points for institutions rated 3C (see Table 1) and, as noted above, a spread of 27 basis points. As discussed below, the adoption of this schedule reflects the Board's determination that the FDIC's insurance responsibilities require it to look beyond the immediate timeframe in estimating losses and the revenue needs of the fund, and to take account of the variability of the factors influencing the BIF reserve ratio, variability that can be substantial even within a single assessment period.

A. Comments

The FDIC received 1401 comments (1364 BIF members, 11 SAIF members, 14 trade associations and 12 other organizations or individuals) that either expressed general support for the proposed decrease in rates or specifically mentioned support for the proposed schedule of 4 to 31 basis points. However, 347 commenters (320 BIF members, 3 SAIF members, 22 trade associations, 1 organization and 1 individual) expressed dissatisfaction with the rates specifically. As discussed in Section II.B.1, most of the commenters argued that the proposed rates are too high to comply with the FDIC's requirement to maintain the BIF at its DRR. Eleven commenters stated that the proposed schedule was too low. Finally, forty commenters (7 BIF members, 23 SAIF members, 1 trade association and 9 other organizations/individuals) urged the FDIC not to decrease BIF rates.

Those commenters who were satisfied with the proposed rate structure generally were pleased that they will enjoy the benefit of a very large decrease in assessments in the near future and expressed pride that the BIF will be recapitalized much earlier than expected and without taxpayer assistance.

²²In the FDIC's 1993 proposal for the existing statutorily mandated risk-based premium system, the Board sought comment on whether the assessment rate spread embodied in the existing system, *i.e.*, 8 basis points, should be widened. Of the 96 commenters addressing this issue, 75 favored a wider rate spread. In adopting the existing 8 point

Of the commenters who indicated that the proposed assessment schedule was too high, 115 (including 12 trade associations and 102 BIF members) stated specifically that the rate either for institutions with a 1A risk classification or for all institutions should be 0 basis points (the ABA position); 87 commenters (including 2 trade associations and 84 BIF members) asserted that the rate for 1A institutions should be decreased to 2 basis points (the IBAA position). Many cited the statements in the proposal indicating that it was likely that the BIF reserve ratio could be maintained at 1.25 percent in the second half of 1995 solely as a result of investment income as support for their position that the proposed rate schedule is too high, at least with respect to 1A institutions.

In fact, the ABA argued that when the BIF does not need assessment income to remain at 1.25 percent, the FDIC may not assess any BIF members, *i.e.*, assessing a zero rate on all such regardless of risk. The ABA's position is that the risk-based assessment spread is determined independently from the revenue needs of the fund; that spread is simply moved up or down in order to generate the required revenue to offset expenses, *i.e.*, the rate schedule itself is solely a function of the amount of revenue needed to maintain the BIF at 1.25 percent. Thus, where no income is needed, there is no need for the risk-based assessment system. However, the ABA argues that beneficial incentives for bank performance will still operate because riskier banks will not know in advance whether the revenue needs of the BIF will require imposition of an assessment, so unless they improve their performance, they will face the prospect of paying higher assessment rates than their peers. Moreover, they argue that a zero rate serves as an incentive to manage banks well.

Some commenters also criticized the historical basis on which expected losses are forecast by the FDIC. Several commenters asserted that the statute requires the Board to set assessments based on the revenue needs of the BIF for the succeeding six month period, not on a historical basis. Finally, many commenters indicated that the use of the historical average fails to take into account the fundamental changes that have occurred since FDICIA, *i.e.*, least-cost resolutions, prompt corrective action, cross-guaranty authority, and depositor preference statutes.

On the other hand, some of the commenters argued that the BIF rates should not be decreased at all. Among these was the Center for Study of Responsive Law/Essential Information,

which thought the loss projections were completely inadequate for the potential risks facing the industry. They interpreted the statutory DRR as a floor, and urged the FDIC to establish a higher range for the DRR with a target average of 1.63 percent using 1.25 percent as the floor and 2.0 percent as the ceiling.

In view of the numerous comments on the propriety of the average rate implied by the proposal, the Board finds it appropriate to provide here a detailed summary of the analysis and reasoning that served as a basis for its decision to adopt the proposed rate schedule in the final rule. Accordingly, this section considers in depth the analysis supporting the approach adopted by the Board for satisfying the requirements to maintain the reserve ratio at 1.25 percent and to have a risk-based assessment system.

B. Review and Balancing of Statutory Factors

As discussed in Section II, pursuant to the directive of section 7(b)(1) to have a risk-based assessment system and the directive of section 7(b)(2)(A)(ii) to maintain the reserve ratio at the DRR, the Board is required to review and weigh the following factors when establishing an assessment schedule:

- (1) The probability and likely amount of loss to the fund;
- (2) Case resolution expenditures and income;
- (3) Expected operating expenses;
- (4) The effect of assessments on members' earnings and capital;
- (5) The revenue needs of the fund; and
- (6) Any other factors that the Board may deem appropriate.

1. Analytical Framework

(a) *Summary.* In principle, the requirements to maintain the reserve ratio at the DRR and to have assessments for individual institutions based on risk to the fund complement and reinforce each other. Maintenance of a particular reserve ratio requires the FDIC to attempt to match fund revenue and expense over time. An important element of that requirement comes from a risk-based assessment system that equates revenue with "expected cost" over a long period. The estimation of expected insurance losses is thus important both in the structuring of risk-based assessments and maintaining a given reserve ratio over a period of time.

The following subsections outline the FDIC's analysis and the use of that analysis for informing the decision of the Board regarding BIF assessment rates. Subsection (b) discusses in general terms the selection of a time

period over which to estimate insurance losses, and the relation of this question to the statutory requirements to maintain the BIF at its target DRR and to have a system of risk-based assessments. Subsection (c) describes the increase in volatility of key economic variables characteristic of the post-1980 period and reviews the increase in banking-industry risk that also occurred during this period. The basic conclusion is that a return to the relative stability of the 1950-1980 period is unlikely and, thus, the FDIC is likely to experience continued volatility in insurance losses in the years ahead. Subsection (d) provides a brief discussion of the risks in banking today and a historical perspective on the risks associated with highly rated and well capitalized banks. The information presented indicates that a meaningful assessment of risks posed by insured institutions must look beyond the immediate timeframe. Subsection (e) discusses the average assessment rates that would have maintained the fund at a given reserve ratio at various times in the FDIC's history, and sets out how it would be destabilizing to the banking industry for the FDIC to attempt to maintain continuous equality of the BIF to its DRR by trying to equate revenues and expenses during every six-month period. The analysis indicates that an average effective assessment rate in the range of four to 13 basis points would have matched revenue and expense over most of the FDIC's history. It also indicates that recent changes in business conditions, including several statutory changes, strongly suggest that a rate at the low end of that range should be adopted. Subsection (f) discusses the implications of volatility in insured deposits for the rate-setting process.

(b) *The Planning Horizon for Rate Setting.* An important part of the rate-setting process is the desire to equate revenues with expenses over a period of time. The answer to the question "over what period of time?" has important ramifications for the way the FDIC sets assessments and manages its reserve ratio, as well as for the banking industry. This matching of revenue and expense encompasses most of the statutory factors required to be considered by the Board in that it seeks to determine the revenue needs of the fund in light of the probability and likely amount of losses, expected case resolution expenses and income, and the amount of operating expenses.

Purely for expositional purposes, it is useful to consider an extreme case where revenues and expenses are balanced over a very short horizon, say

one day. One could imagine that each morning banks would be billed electronically for the cost of any bank failures expected to occur that day. In this extreme case, the BIF could be managed to within very close to its DRR on a virtually continuous basis (ignoring uncertainties about the level of insured deposits).

In this example the FDIC's insurance function would be that of allocating current costs across banks through billings and collections on a pay-as-you-go basis. The word "insurance" is normally associated with the concept of spreading risk. This risk spreading can be over time, across the insured parties, or both, depending on the type of insurance. A pay-as-you-go system in which the cost of the insured event is borne entirely at the time the event occurs does not accomplish the spreading of risk over time.

Whether the spreading of risk over time is important in banking is an empirical question that is discussed below in subsection (e) of this section. If the FDIC had operated on a yearly pay-as-you-go basis during the post-1980 period, for example, assessments would have been as high as 62 basis points in 1991. Rates at that level would have adversely affected the earnings and capital of the industry and the soundness of the FDIC insurance fund.

In general, one can say that the shorter the planning horizon over which one tries to equate revenues and expenses, the more certainty there will be about loss estimates, and the easier it will be to manage the reserve ratio to any given level. On the other hand, the shorter this planning horizon, the less the FDIC's business would resemble the risk-spreading function of an insurer and the greater the risk that high and volatile insurance premiums would adversely affect the earnings and capital of the banking industry and the soundness of the insurance fund.

Attempting to equate revenues and expenses over a longer period has the risk-spreading advantages classically associated with insurance. Assessments are collected when times are good to pay for problems when times are bad, and there can be some measure of stability to the assessment rates, thereby avoiding the adverse effects on bank earnings and capital discussed above. Under this regime, the intent would be to maintain the insurance fund at the DRR on average over the planning horizon, rather than continuously.

The choice of a planning period for equating revenues and expenses is therefore a fundamental decision for the FDIC as manager and fiduciary of sound deposit insurance funds. Relevant to the judgment is whether it is consistent with the FDIC's mission that the entire cost of banking problems be paid by the banking industry during the assessment period in which they occur. As discussed below, the use of a pure pay-as-you-go approach is inconsistent with the FDIC's mandate to charge assessments that reflect the probability and like amount of loss to the insurance funds because this approach ignores the risks that exist beyond a six-month horizon. In addition, the pay-as-you-go approach, if adopted as a general rule, would result in adverse effects on bank earnings and capital during times of stress in banking.

(c) *Increased Economic Volatility and Bank Stability.* The economic environment affecting banks began to change during the 1970s and the pace of change accelerated during the 1980s. The result is that banking is a riskier and more demanding business today than ever before. This subsection documents some major changes in the banking environment that have occurred during the last 15 to 20 years. Part (i) contains a discussion of the increased volatility of certain key macroeconomic

variables that directly and indirectly affect banking risk. Part (ii) contains a more specific discussion of developments in the financial services industry and in the characteristics of insured banks.

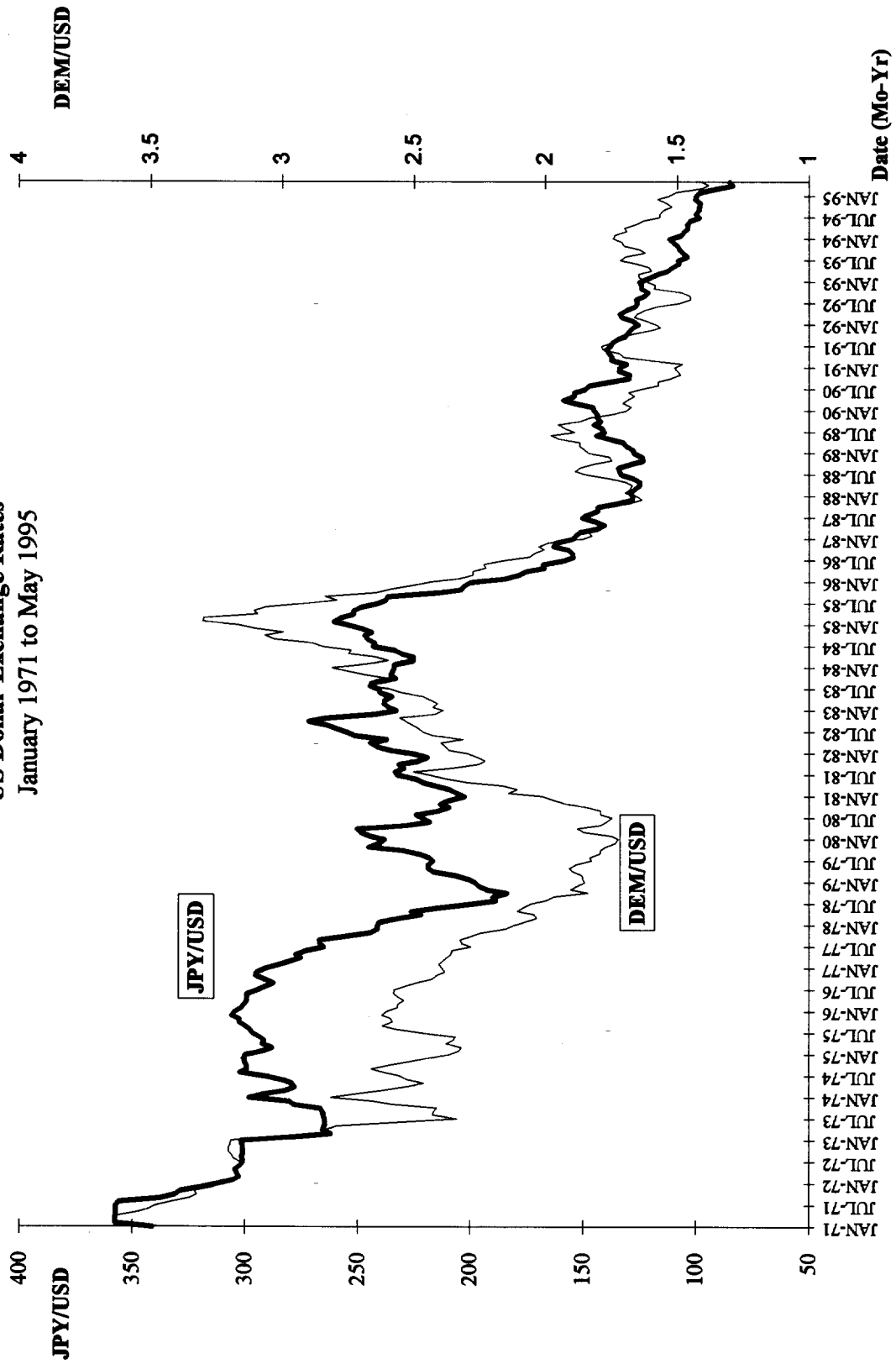
(i) *Key economic variables.* For about twenty years beginning in the early 1950s, the U.S. economy and the commercial banking industry enjoyed a period of relative stability. Key economic variables such as inflation, interest rates and exchange rates displayed remarkable stability, and in part as a result, bank failures were few. This period of stability began to end in the 1970s.

An important change in the nature of economic volatility resulted from the movement to a floating exchange rate system from a fixed rate system that occurred in 1973. As international trade expanded in the post World War II era, the maintenance of fixed exchange rates required adjustments to trading relationships and domestic economic policies of trading nations that were not optimal. Thus, the change substituted volatility in interest rates and commodities prices for increased volatility in exchange rates. However, as explained below, subsequent events have tended to increase the volatility in other financial and economic variables beyond the levels experienced in the fixed exchange rate environment.

With the Smithsonian Agreement (see Figure 1 for the German mark (DEM) and Japanese yen (JPY) in 1971 to 1973), exchange rates among all of the major currencies were realigned and permitted to float without upper and lower bounds. These developments predictably gave rise to considerably greater exchange rate volatility at a time when world trade was also expanding rapidly.

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Figure 1
German Mark and Japanese Yen
US Dollar Exchange Rates
January 1971 to May 1995



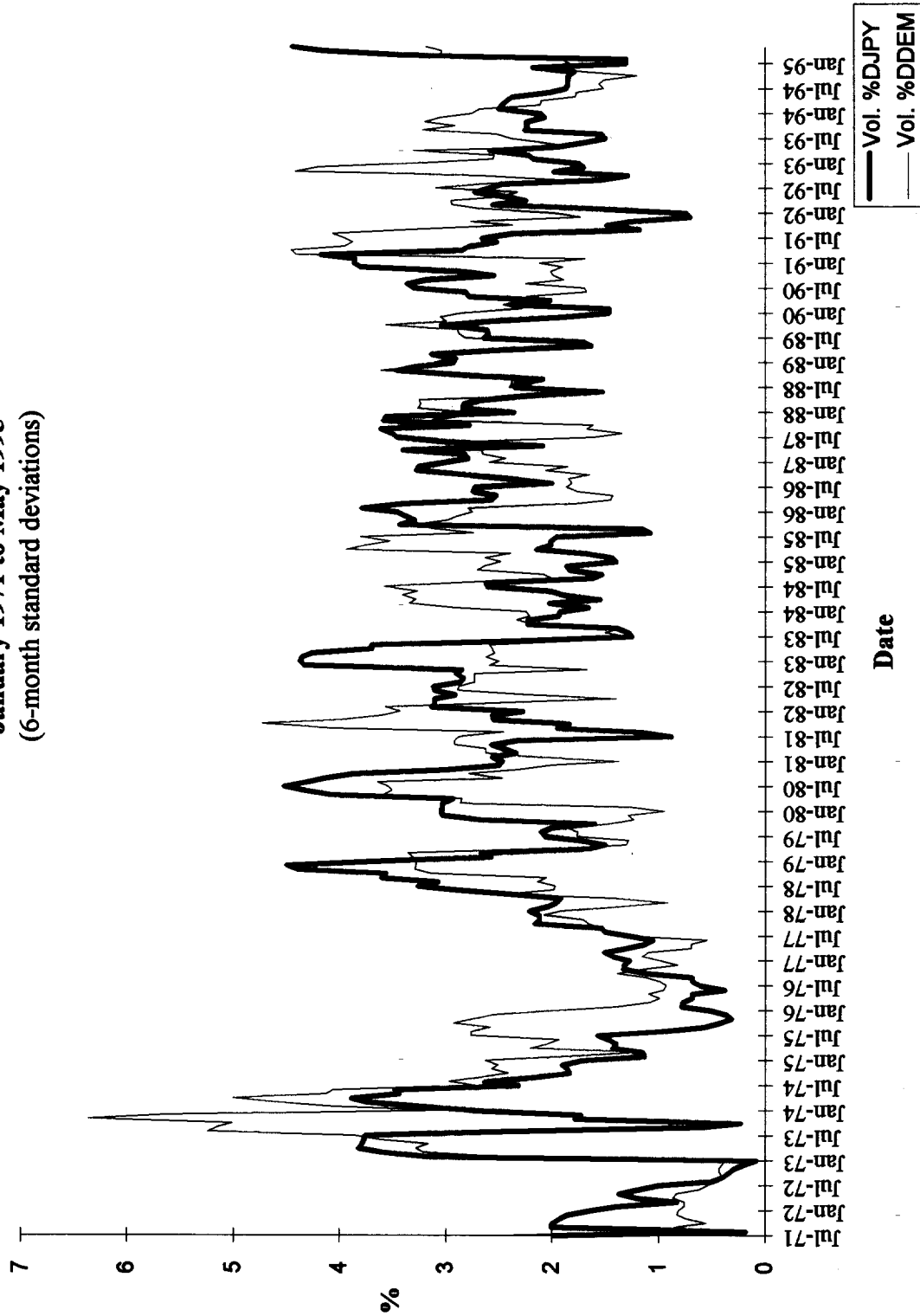
Markets for forward and futures exchange rate contracts developed in order for firms to manage more effectively exchange rate risks and markets for combined currency and interest rate swaps have followed this trend. The Chicago Mercantile Exchanged formed the International Money Market (IMM) and began offering the first foreign exchange futures contract on major currencies in 1972.²³ The volatility that gave rise to these contracts can be seen in Figure 2, comparing the volatility in the dollar exchange rate with the German mark and the Japanese yen.²⁴

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²³ These contracts were also the first financial futures contracts offered in the U.S.

²⁴ Volatility is measured in each period as the standard deviation of the monthly percentage change of each exchange rate. The standard deviation is measured using observations over the prior six months.

Figure 2
Volatility of Exchange Rates
January 1971 to May 1995
(6-month standard deviations)



Since 1970, there have been periods of relative calm in exchange rates (*e.g.*, 1976–77) interspersed with periods of substantial volatility, some considerably extended, and periods with volatility varying among currencies. For example, the first oil embargo in 1973 resulted in increased volatility for the mark, but a decrease for the yen. In the European Monetary System currency crisis in late summer and early fall of 1992, the yen actually showed a decline in volatility, but the mark, the most appreciated European currency at the time, showed a sharp increase in volatility. More recently, the change in monetary policy by the Federal Reserve in February 1994 resulted in a depreciation of the dollar relative to the mark, increased volatility in exchange rates, and sharp increases in foreign and domestic interest rates (see Figure 2 for exchange rate volatility from January to May 1995). Without the well-developed markets for forwards

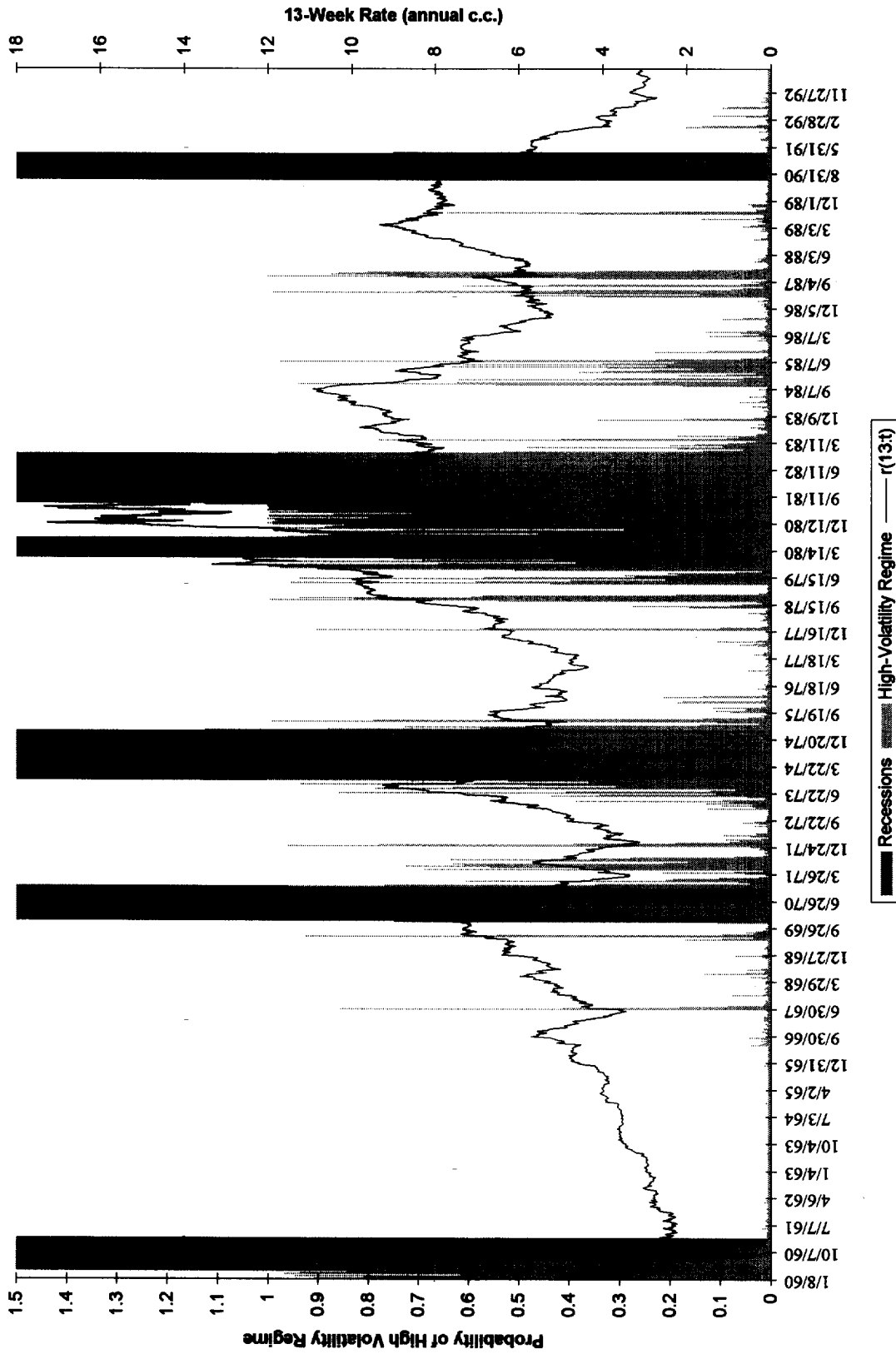
and futures contracts for foreign exchange, such volatility would be less manageable and would significantly lessen foreign trade.

A second source of volatility, not unrelated to the adoption of a floating exchange rate system, is in the levels and term structure of interest rates. Foreign exchange rates and interest rates among countries are related through arbitrage opportunities to borrow and lend in different currencies. Banks are active participants in foreign markets and international deposit and loan markets for their own account and those of their customers. Banks that are lending and borrowing abroad face risks of exchange rate changes that affect the dollar value of their loans and liabilities denominated in foreign currencies. The interest rates banks and other investors are willing to accept for loans and pay on borrowings are affected by their expectations of future exchange rates.

The more uncertain and volatile are exchange rates, the greater the opportunities for losses and the greater the need for hedging assets and liabilities from exchange rate risk. The greater volatility experienced in exchange rates is translated into greater interest rate volatility as banks and other investors attempt to hedge positions in loan and deposit markets and arbitrage among interest rate differentials that arise among debts denominated in various currencies. An example of the relationship of the link between exchange rate volatility and interest rate volatility was during the period of adjustment in 1973 to the new exchange rate regime and the rise in U.S. interest rate volatility during this same period (see Figure 1 for the rapid appreciation of the DEM and JPY during this period and interest rate volatility in Figure 3).

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Figure 3
Recessions, High-Volatility Regime Probabilities, and 13-Week Tbill Rates



Volatility in the level of interest rates can be seen in Figure 3 for the 3-month T-bill rate (the darker connected line). In this figure, the dark bars are periods of recession (peak to trough) as designated by the National Bureau of Economic Research. Volatility is presented in this figure as the computed likelihood of being in a high interest rate volatility regime (the light, spiked areas measured on the left axis); that is, a period where the standard deviation of daily interest rate changes is statistically expected to be higher than average. As can be seen, the period of the 1960s was relatively calm with the exception of the recession of 1969 to 1970. After this period, interest rates became more volatile, as did general economic activity. During the 1970s, several oil embargo shocks in 1973 and 1978 resulted in accelerating inflation and contributed considerably to interest rate volatility. The Federal Reserve dramatically changed monetary policy in October 1979 by switching from an interest rate target to a monetary aggregates target, such as nonborrowed reserves, with the objective of reducing inflation. The result of this policy was a highly volatile interest rate period from October 1979 until late 1982.²⁵

²⁵ The stock market crash in October 1987 is also clearly evident in Figure 3 with a period of high

Correspondingly, it was about this time when the volume of interest rate futures contracts was beginning to grow on the Chicago Mercantile Exchange and the Chicago Board of Trade.²⁶ Soon afterwards, over-the-counter interest rate forwards and swaps were introduced on a meaningful scale and their growth accelerated by 1986, coinciding only incidentally with the period of the collapse in world oil prices.

Another source of volatility is in the term structure of interest rates. The importance of the volatility in the term structure stems from the need to have accurate estimates of future short-term interest rates. Expected future short-term interest rates form the basis for the valuation of interest rate swaps,

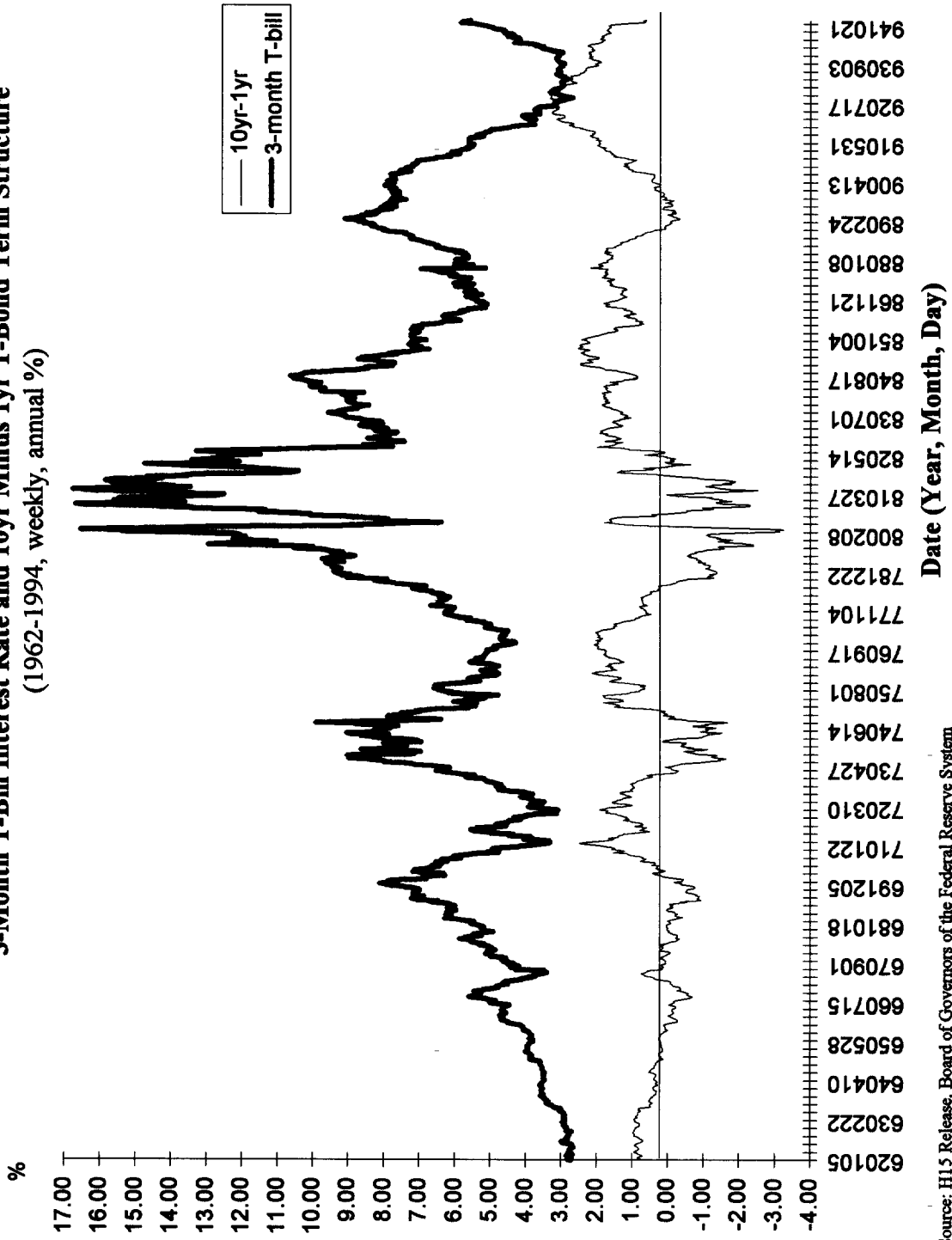
volatility occurring at this time. What is also interesting is that a period of high interest rate volatility occurred in early 1987 coinciding with an apparent change in monetary policy. It is important to note that changes in monetary policy tend to evoke periods of greater interest rate volatility and possible adverse effects on bank earnings.

²⁶ The development of interest rate futures contracts was given a boost in 1974 with the creation of the Commodity Futures Trading Commission. The CFTC was given exclusive responsibility over futures markets. As a by-product of this legislation, cash settlement of futures contracts was permitted. The provision of federal law superseded state laws that prohibited contracts settled in cash because they were considered wagers and were treated as illegal gambling.

forward, futures, and options on future interest rates, and options on futures contracts. Volatility in the term structure can also give rise to volatility of bank earnings to the extent that banks face gaps between interest sensitive assets and interest sensitive liabilities. The causes of this volatility in interest rates have been linked to expectations of changes in future short-term interest rates fed by the volatility in the rate of inflation and inflation expectations. Figure 4 shows the 3-month T-bill rate and the difference between the 10-year T-bond rate and the 1-year T-bond rate as a proxy for the steepness in the yield curve. It is clear that the yield curve has been volatile and at times has become inverted (periods such as 1972 through late 1974, and early 1978 through 1982 when the 1-year T-bond yield was higher than the 10-year yield), requiring considerable caution in funding long positions in long-term assets or fixed rate assets with short-term, variable rate liabilities. In periods of substantial volatility in the term structure, simple methods of interest rate risk management, such as duration gap management, become incomplete methods of managing interest rate risk.

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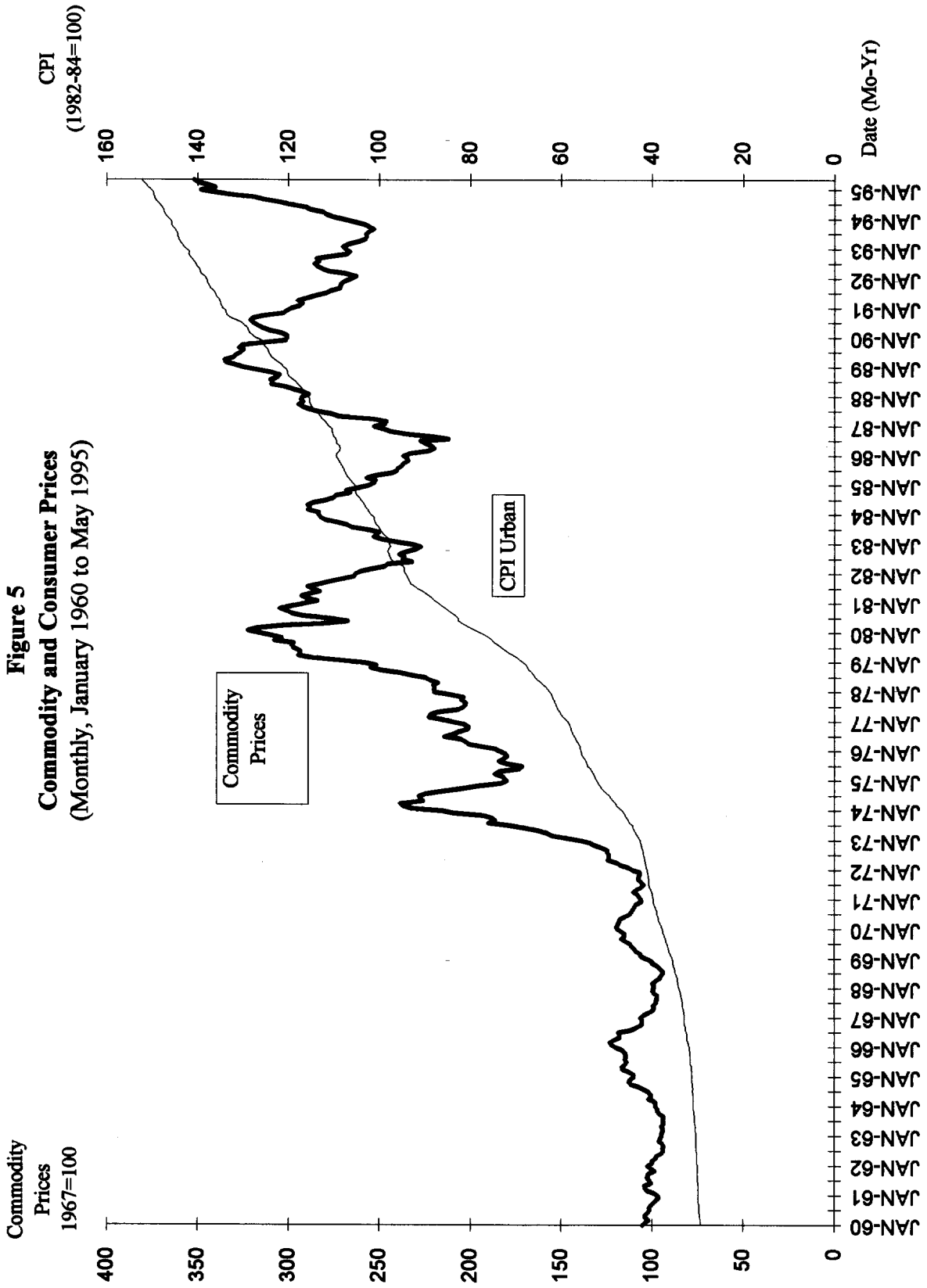
Figure 4
3-Month T-Bill Interest Rate and 10yr Minus 1yr T-Bond Term Structure
 (1962-1994, weekly, annual %)



Source: H15 Release, Board of Governors of the Federal Reserve System

A final source of increased volatility is that arising from general economic activity. To a considerable extent, the volatility in general economic activity can be traced to real shocks, such as the oil embargoes of the 1970s, wars, dissolution of the Soviet Union, and the fiscal and monetary policies of the major industrialized nations. These shocks have caused considerable volatility in commodity prices and real output. The record inflation of the 1970s was followed by a period of slower inflation, but greater commodity price volatility. Figure 5 presents commodity prices (CRB Raw Materials Spot Prices) compared with the Consumer Price Index (All Urban Areas). Although the oil shocks of the 1970s resulted in considerable inflation in commodities and consumer prices, the volatility that also resulted in commodity prices has not abated during the 1980s or early 1990s.

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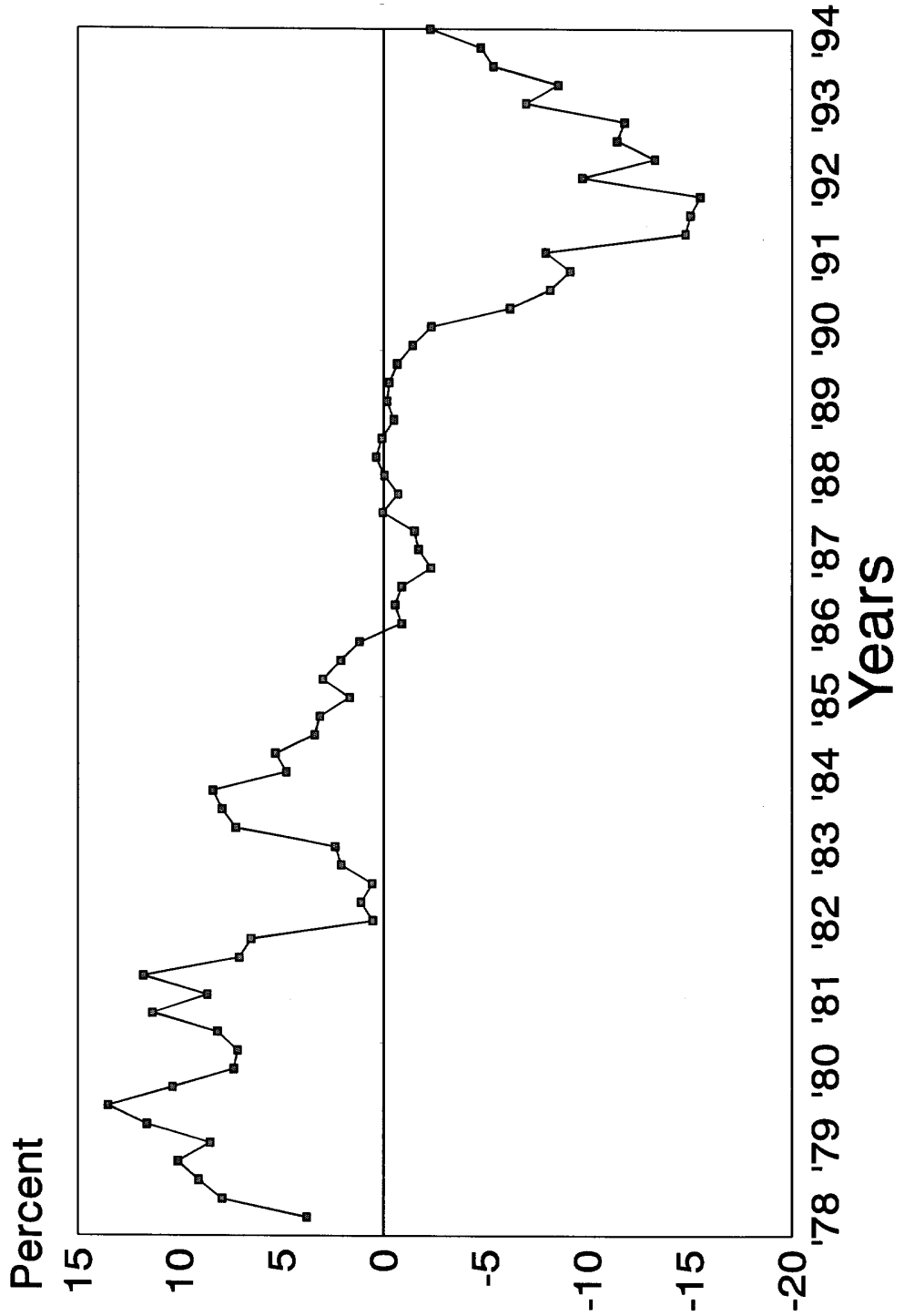
The volatility of prices and general economic activity can have a substantial impact on banking performance, as the experience of the 1980s makes clear. The sectoral inflation and subsequent deflation of agricultural prices in the late 1970s and early- to mid-1980s was a major contributor to the failure of hundreds of agricultural banks. Similarly, the boom and subsequent collapse of oil prices caused significant problems for banks in states whose economies had important energy sectors. The real-estate problems of the 1980s and early 1990s caused major problems for many banks. These problems can be traced in part to unanticipated changes in regional economic conditions, as the behavior of real estate prices departed sharply from past patterns (Figure 6).

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Figure 6

RUSSELL-NECREIF PROPERTY INDEX

Appreciation Component



(ii) *Trends in the banking industry since 1980.* Since 1980, the business of banking has changed considerably. As noted above, risks have increased as interest rates, exchange rates and commodity prices have become more volatile and as economic shocks have been transmitted more widely *via* the globalization of markets. Meanwhile, competition in the financial marketplace has greatly intensified. The traditional intermediation function of banks has assumed a smaller role in aggregate economic activity, largely because financial and technological innovations have increased the funding

options for firms that formerly were restricted to bank loans. Banks have been forced to seek new sources of income and to implement untested business strategies, and such experimentation carries inherent risks.

The major trends affecting the banking industry since 1980 are summarized in an accompanying series of charts. The charts emphasize the substantial increase in banking risk as compared to earlier periods, and the role of competition and innovation as forces driving this development.

Dramatic evidence that banking has become riskier is observable in the annual rates of bank failure (Figure 7).

While annual bank failures exceeded single digits only rarely between 1940 and 1980, failure rates rose rapidly thereafter to a record high of 200 in 1988 (221 including assistance transactions). A similar picture emerges from the data on FDIC insurance losses relative to insured deposits (Figure 8). Annual insurance losses were extremely low on average prior to 1980, less than half a basis point of insured deposits, and were quite stable; losses for the 1980–94 period exceeded 14 basis points on average and were highly variable.

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Figure 7
Number of Failures of Insured Banks
1960 - 1994

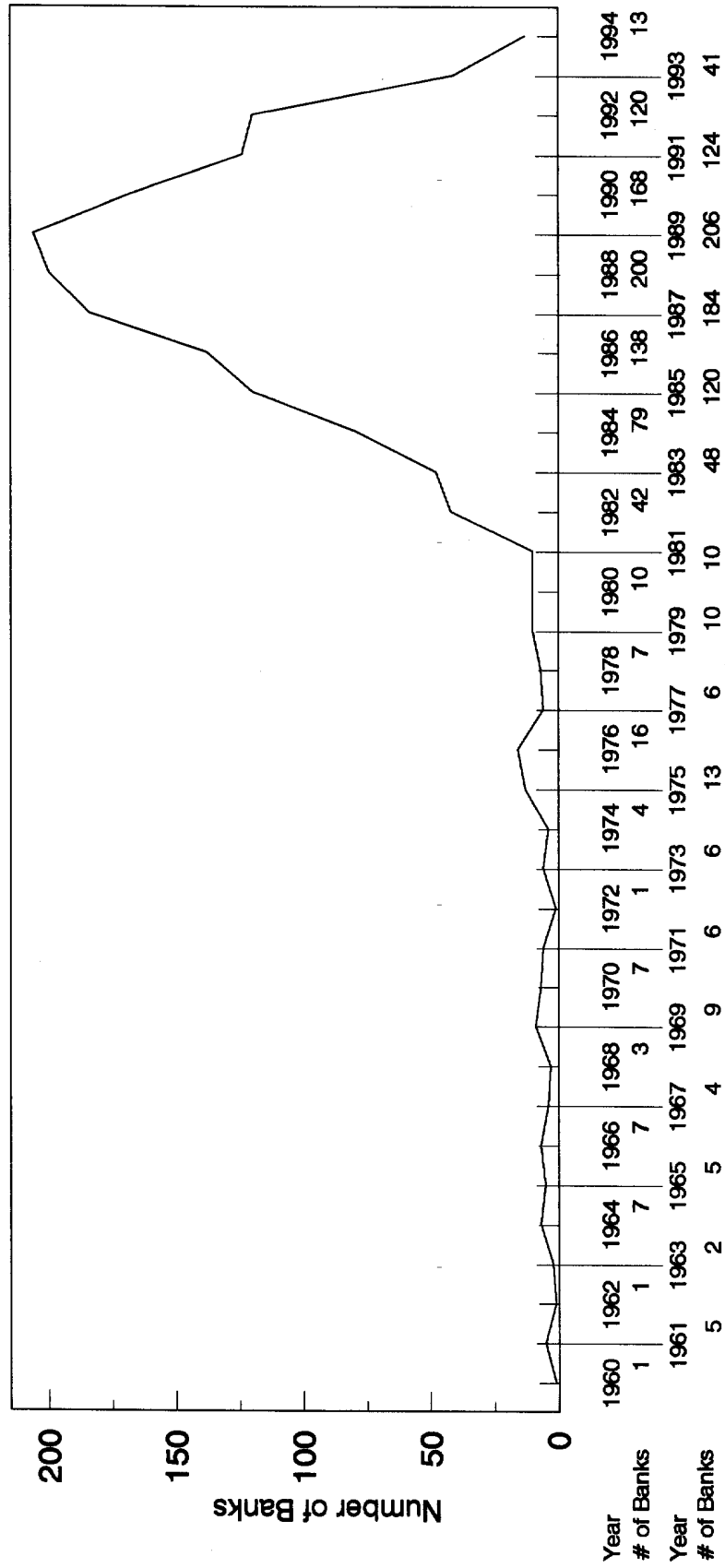
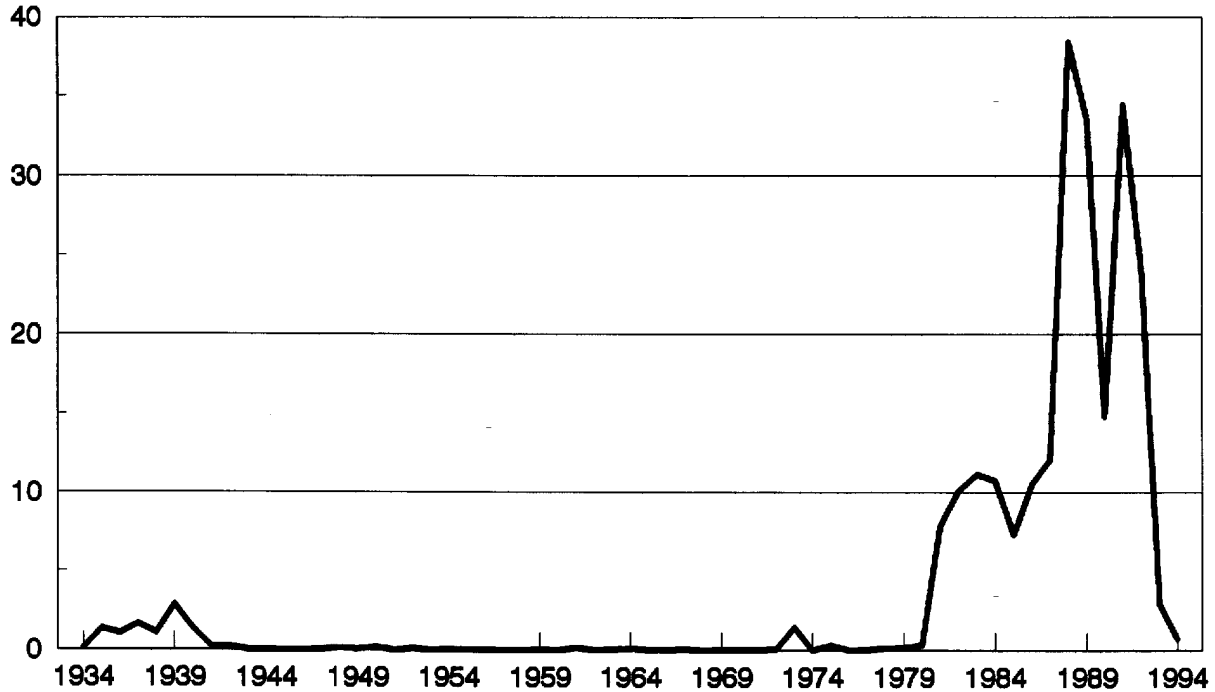


Figure 8

**Insurance Losses to Insured Deposits
1934 to 1994**

Losses to Insured Deposits (basis points)



Source: FDIC Annual Reports

Summary Statistics (basis points)

	1934-1994	1934-1979	1980-1994
Mean	3.80	0.28	14.61
Median	0.09	0.03	10.77
Standard Deviation	8.54	0.59	11.85

Losses/ Insured Deposits	Year
38.4	1988
34.4	1991
33.5	1989
24.1	1992
14.8	1990

Net loan charge-offs as a percent of average total loans have trended upward since the early 1970s, accelerating rapidly beginning in 1980 and reaching a peak of 1.57 percent in 1991 (Figure 9). Over the same period, bank stocks substantially underperformed the S&P 500 (Figure 10).

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Figure 9
Net Charge-offs
As a Percent of Average Loans

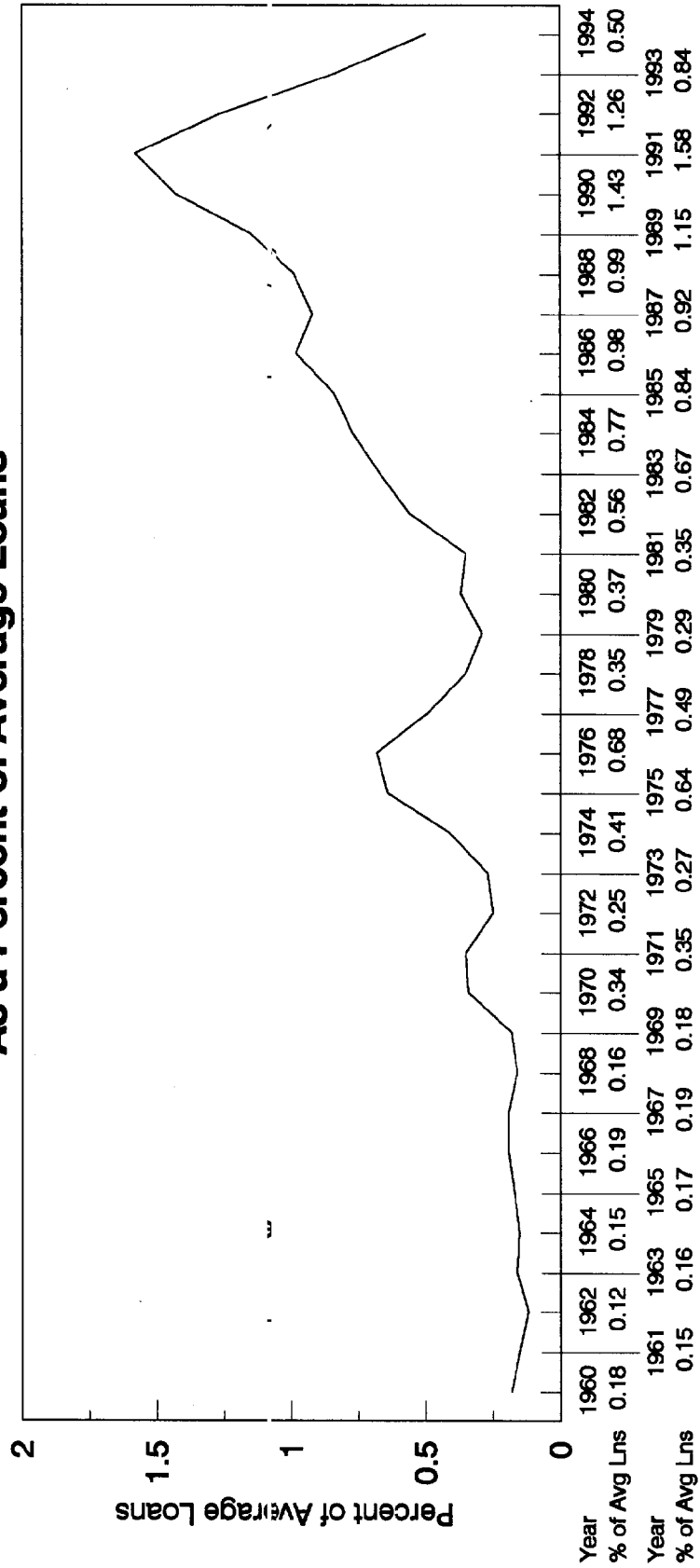
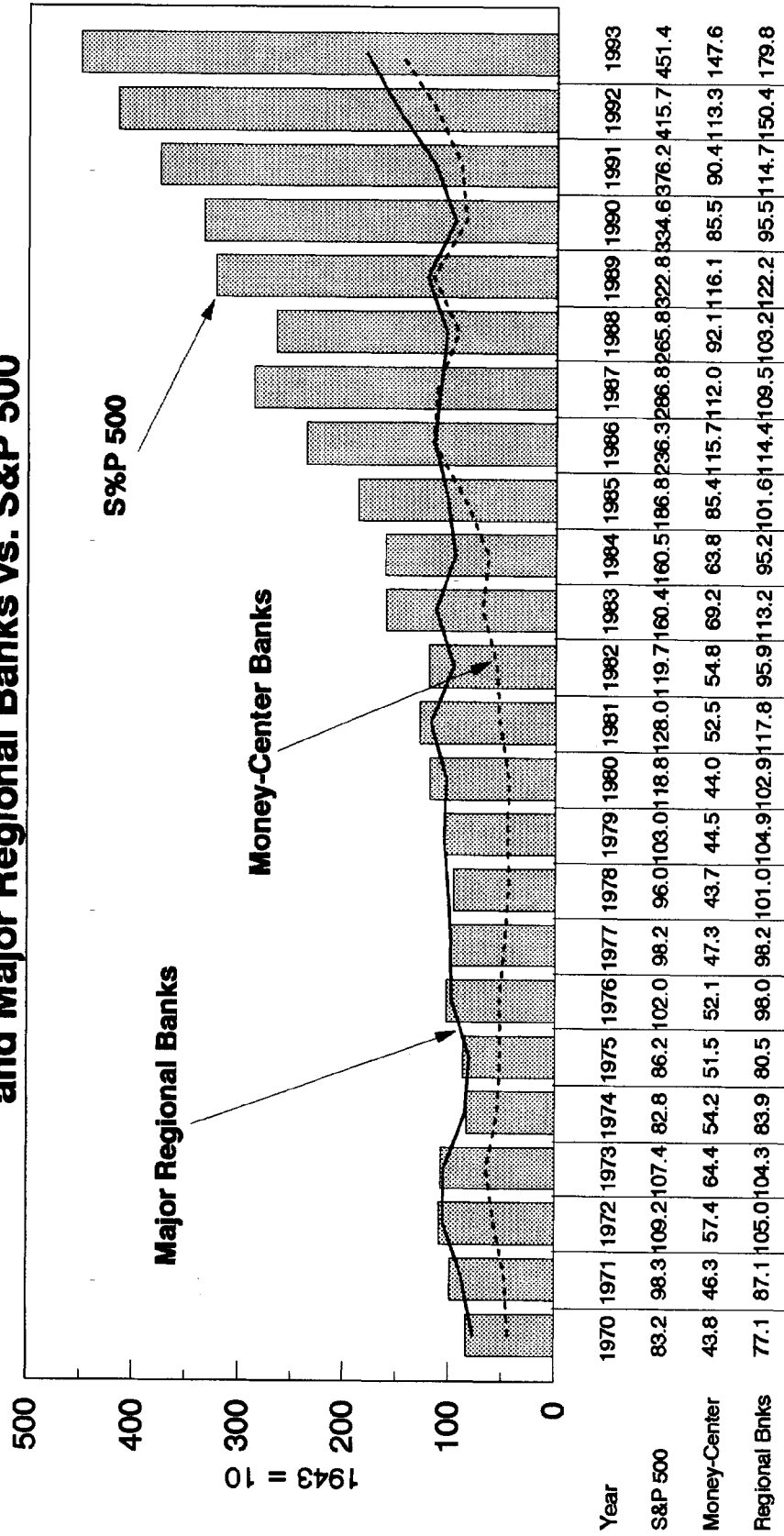


Figure 10
Stock Market Indexes of Money-Center Banks
and Major Regional Banks vs. S&P 500



The effects of increased competition and innovation are inextricably intertwined. Both have played a role in the banking industry's declining share of financial-sector assets since 1980 (Figure 11). Innovation has transformed the commercial paper market into a formidable competitor for banks. Figure 12 shows that the ratio of commercial paper outstanding to bank commercial and industrial loans (C&I loans) has increased four-fold since 1980. Meanwhile, the ratio of finance-company business loans to bank C&I loans has more than doubled over the same period, and most of this growth has occurred since 1982 (Figure 13).

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Figure 11
Commercial Banks' Share of
Financial-Sector Assets

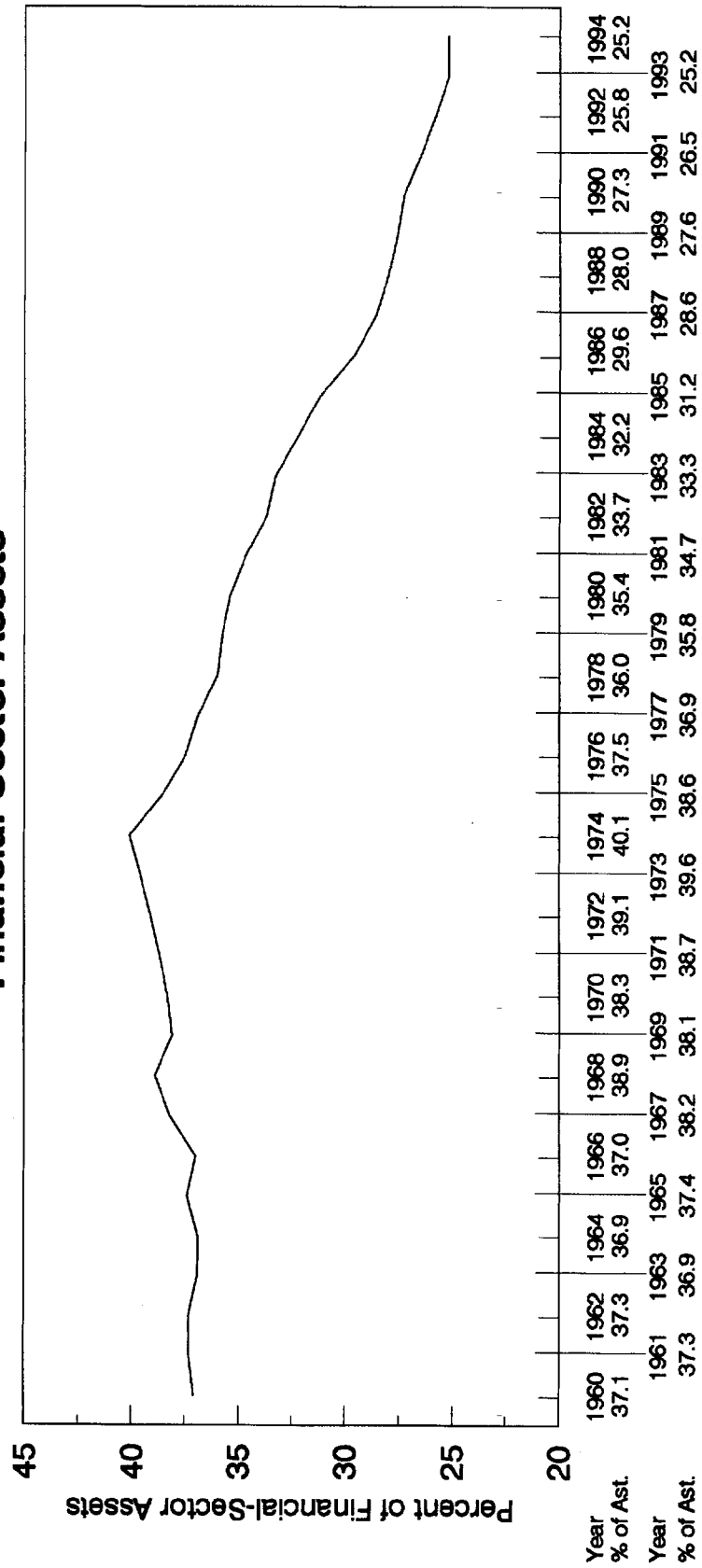


Figure 12
Commercial Paper of Nonfinancial Firms
As a Percent of Bank C&I Loans

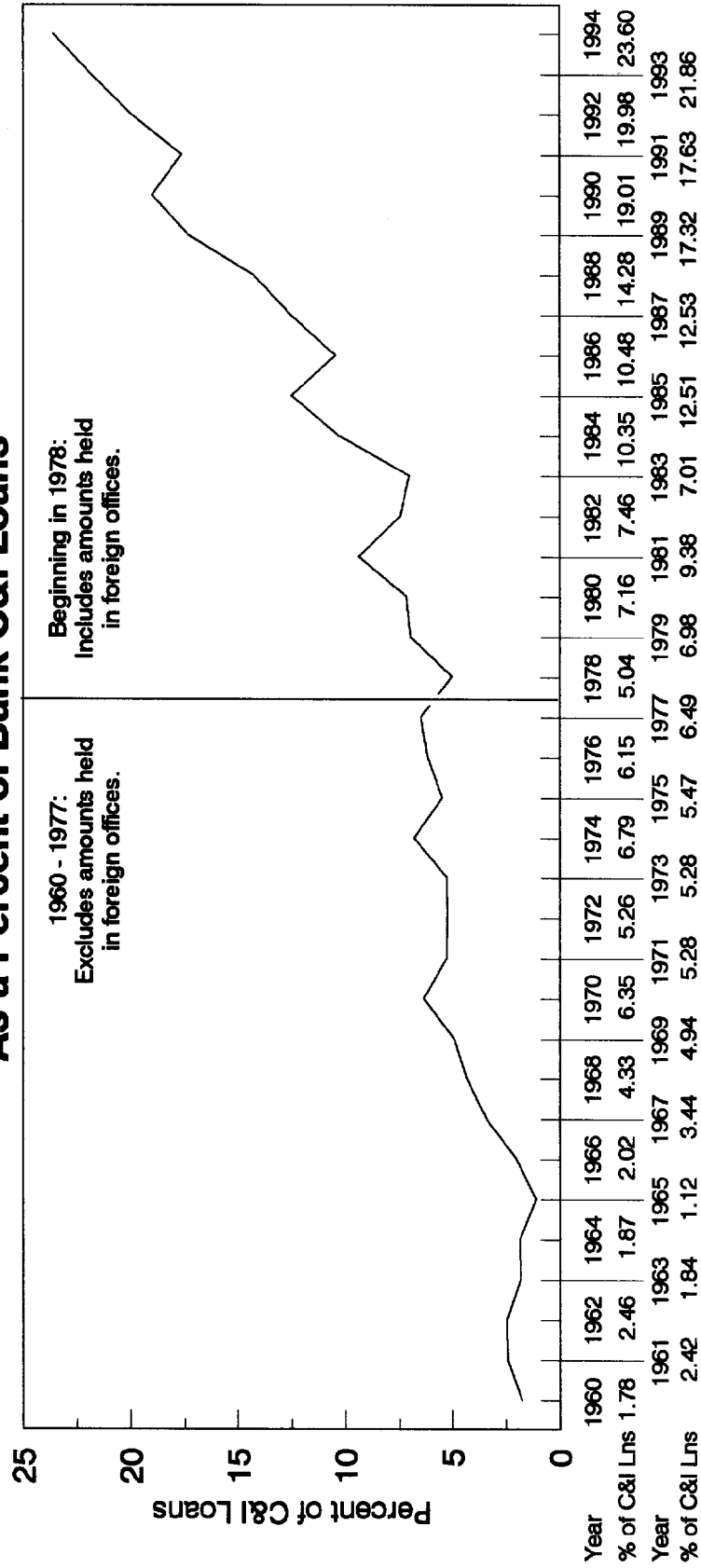
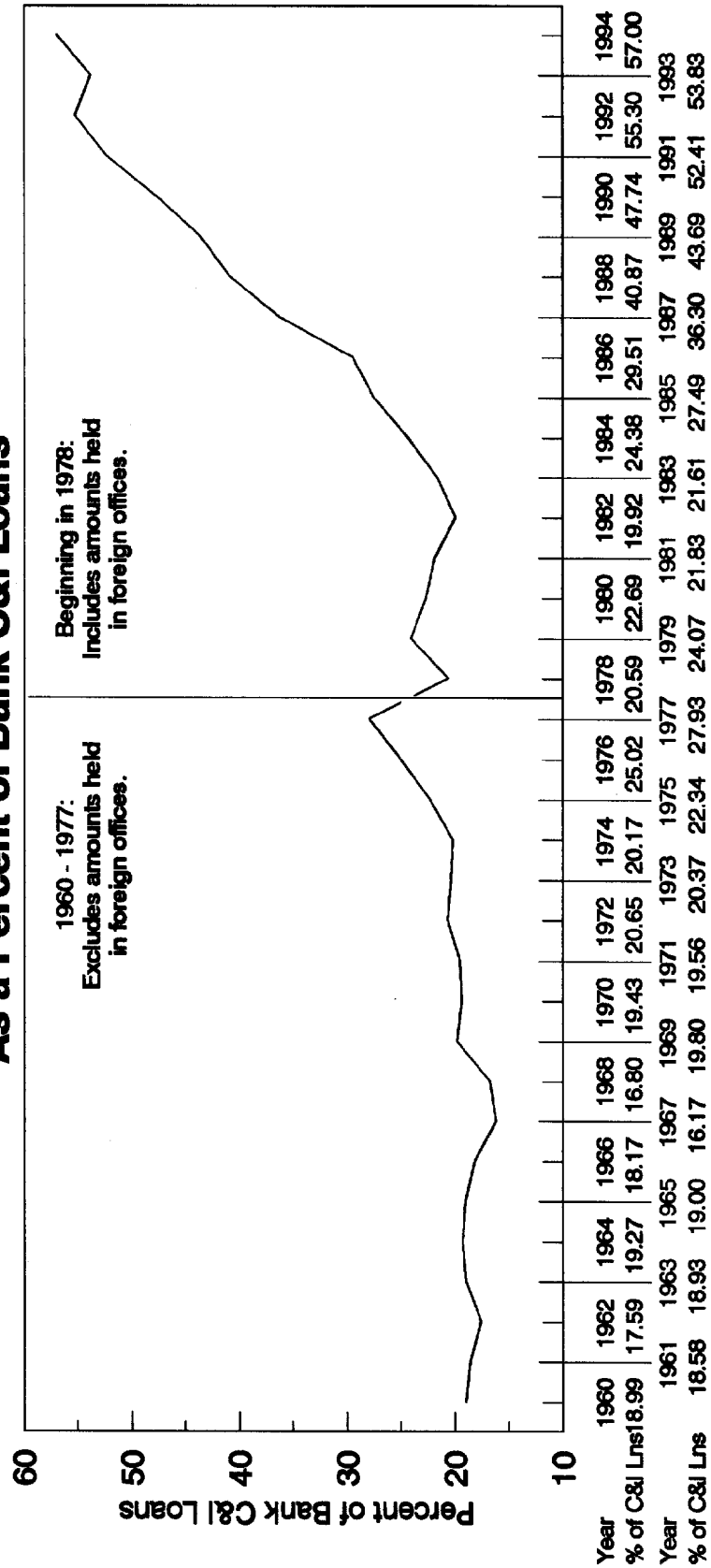


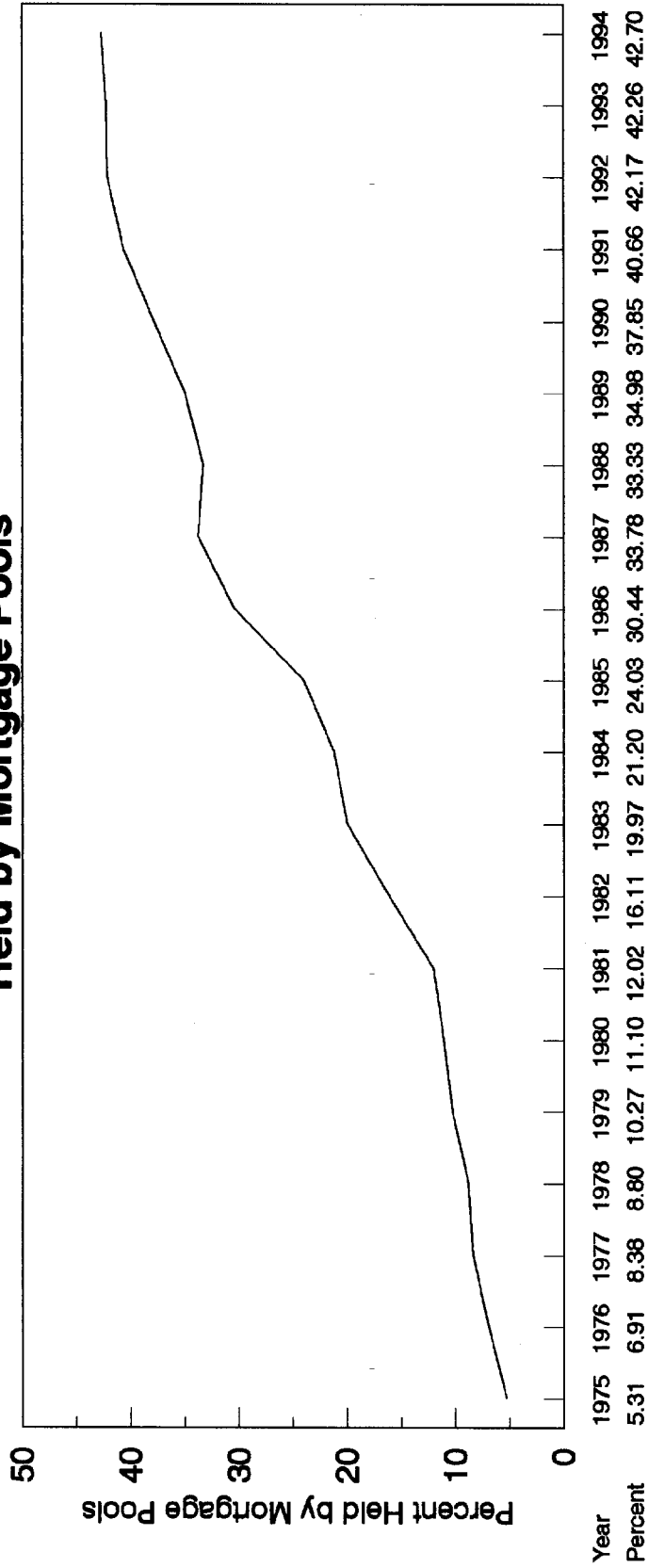
Figure 13
Finance Company Business Loans
As a Percent of Bank C&I Loans



The growth in securitization of loans represents another dimension of the competitive pressures faced by banks. By increasing the liquidity and efficiency of the credit markets, securitization produces a narrowing of the spreads available to traditional lenders such as banks and thrifts. The outstanding example of this process occurs in the mortgage market, where the proportion of consumer mortgages pooled for resale (or "securitized") has grown from about 10 percent in 1980 to more than 40 percent as of year-end 1993 (Figure 14).

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Figure 14
Percent of 1-4 Family Mortgages
Held by Mortgage Pools*

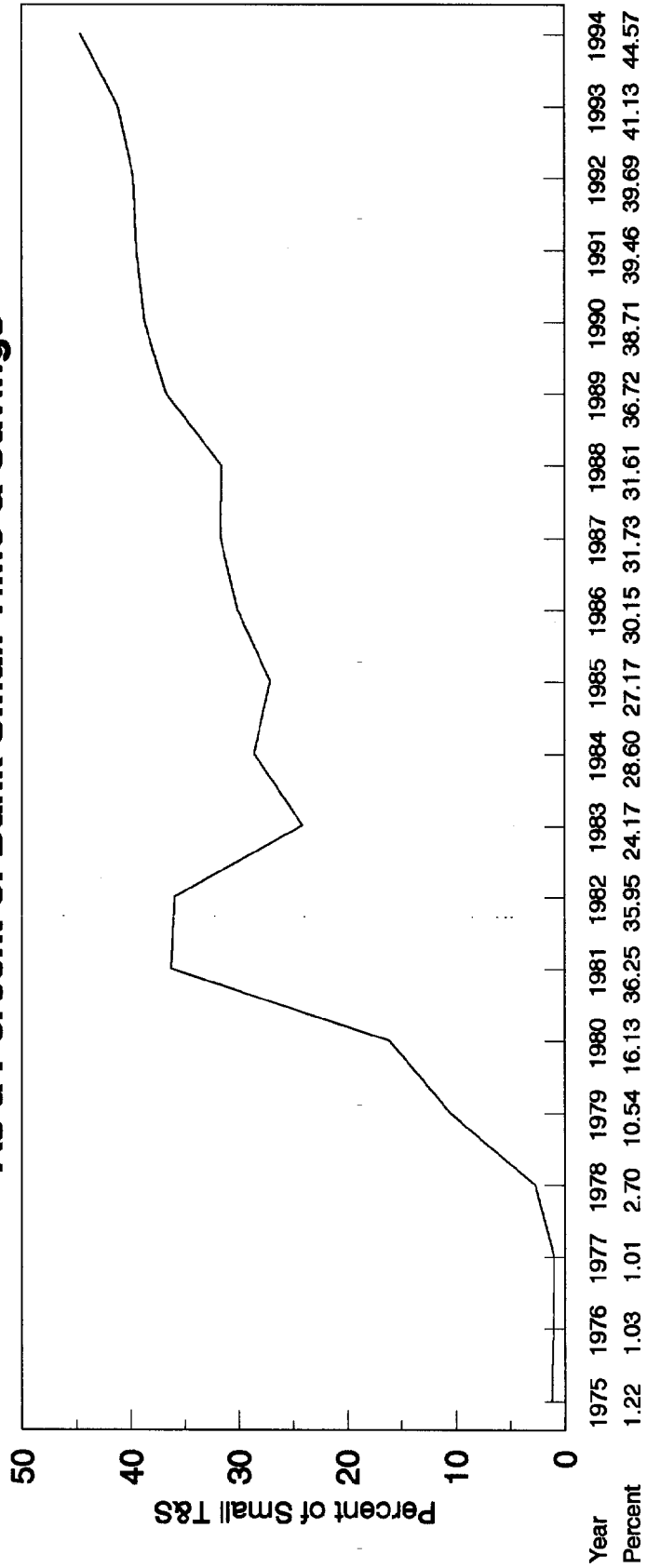


* Includes GNMA, FNMA, and FmHA.

On the liability side, banks have faced increasing competition from many nonbank financial institutions. Foremost among these have been the money-market mutual funds (MMMFs), which rose from obscurity in 1975 to prominence by 1981: the ratio of MMMF balances to comparable commercial bank deposits (small time and savings deposits) was virtually zero during the mid-1970s, but reached nearly 35 percent by 1981 (Figure 15). After declining briefly to 25 percent in the early 1980s, this ratio grew steadily thereafter, exceeding 40 percent by the end of 1993.

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Figure 15
Money-Market Mutual Funds
As a Percent of Bank Small Time & Savings



These developments have forced changes in the business strategies of commercial bankers. Faced with diminished opportunities for C&I lending, banks have shifted into real-estate lending in recent years (Figure 16). This new portfolio composition has exacerbated the adverse effects on banks of downturns in regional real estate markets. Noninterest income also has become more important for bankers (Figure 17), and off balance-sheet activities have grown substantially in recent years. The dollar amount of these activities was roughly 60 percent of the comparable amount for on balance-sheet activities in 1984, but this figure grew to 120 percent by the end of the decade. Taken together with the periodic, large-scale movements in and out of particular lending markets (LDC, HLT, commercial real-estate development, and the like), these portfolio shifts suggest that many banks have embarked on a widening search for new profit opportunities in response to the competitive pressures undermining their traditional niche in the financial marketplace.

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Figure 16
C&I Loans and Real-Estate Loans
As a Percent of Total Loans

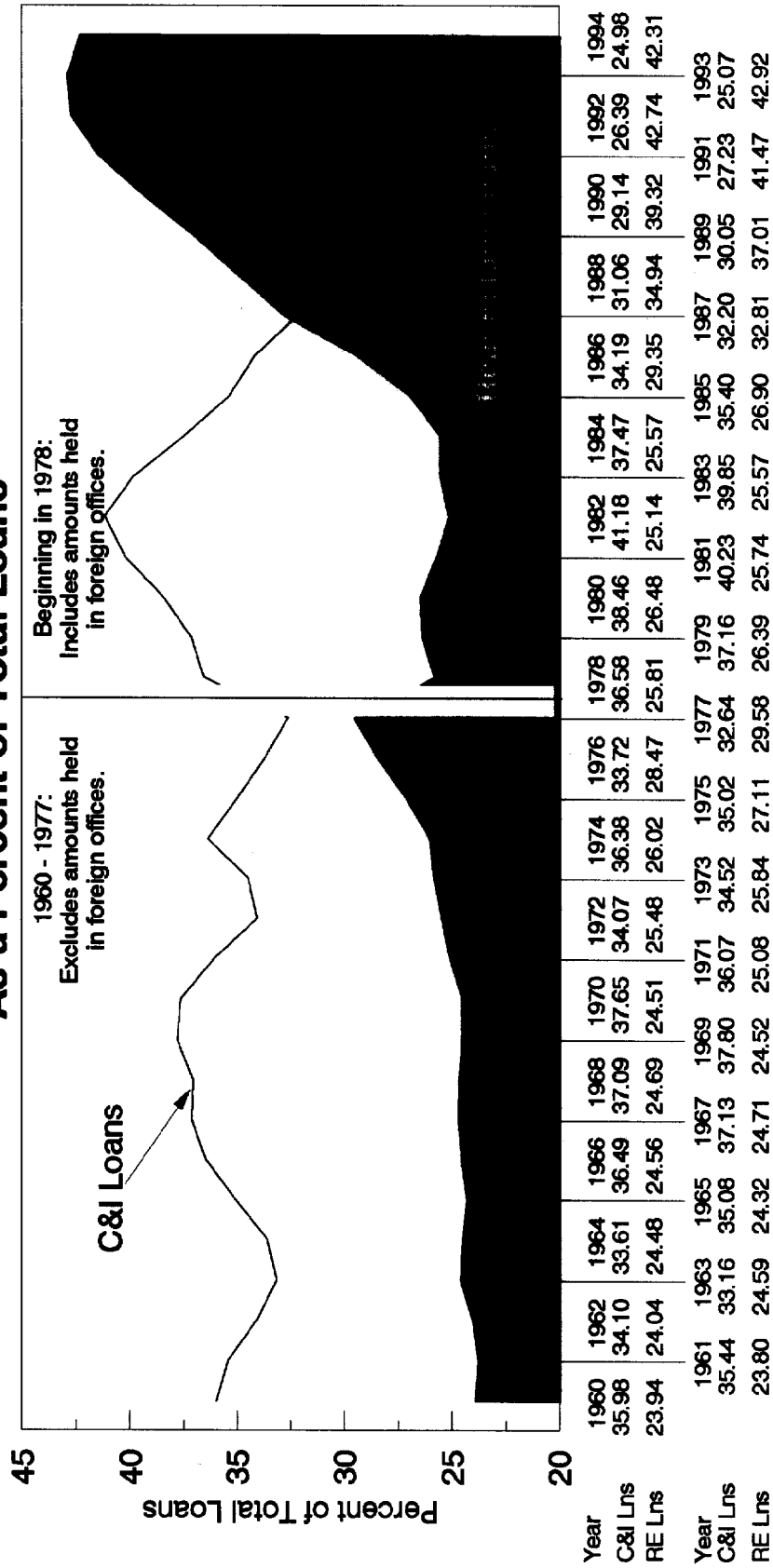
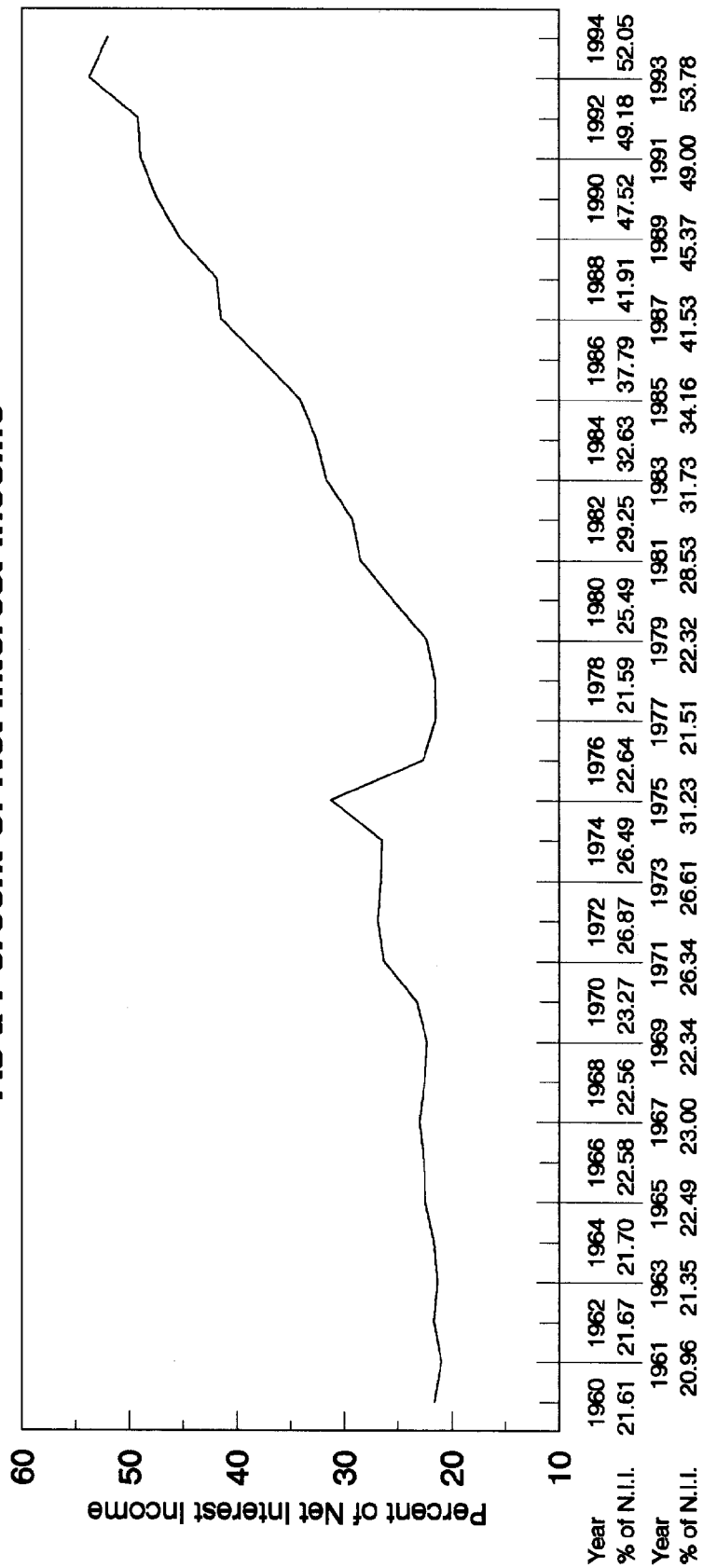


Figure 17
Noninterest Income
As a Percent of Net Interest Income



Innovations in information systems technology have effectively integrated network development, telecommunication technology and computing into a tool for expansion in twenty-four hour global trading, market monitoring and sophisticated risk management. These developments have permitted a global markets presence for major banking companies and have expanded the opportunities for global market developments in exchange-traded products and dealing in over-the-counter bilateral contracts. Advances in telecommunications, in particular, have permitted the rapid and inexpensive transmission of market information and the globalization of markets. The result may be a banking environment that is more complex and less transparent than at any time since the 1920s.

At present, there is no indication that the forces discussed above are abating. Nor are there reasons to expect that the degree of competition or the pace of innovation will reverse course in the foreseeable future. To the contrary, the relentless decline of information costs in recent years augurs, if anything, stronger competition for banks, occurring on new fronts and originating from new sources. In view of these realities, it is reasonable to assume that the FDIC will continue to experience a

substantial amount of volatility in insurance losses in the coming years.

(d) *Risks in Banking Today.* The banking industry at present is in good health, with high earnings, high capitalization, and few problem institutions. The risks that currently confront the industry do not pose an imminent threat, but several general concerns can be identified.

Market participants continue to anticipate significant volatility in interest rates and exchange rates, as evidenced by the explosive growth of derivative instruments expressly designed to hedge against this volatility. Competition from nonbank sources remains intense and likely will increase for the reasons cited above, putting pressure on banks' interest-rate margins. The industry is restructuring through mergers and is adjusting to the changing rules with respect to interstate banking and branching. While these developments in general bode well for the deposit insurance funds, major structural changes in an industry usually are accompanied by some costly mistakes by individual firms. Finally, the possibility of an economic slowdown later in 1995 and 1996,²⁷

²⁷ The consensus forecast reported by Blue Chip Economic Indicators as of July 1995 was for slower GDP growth in late 1995 and 1996 than prevailed in 1994.

reports of potential problems in the agricultural sector, and continuing economic weakness in California must be considered.

Some historical perspective is also useful for assessing current banking risks. Information problems are inherent in evaluating the condition of banking institutions, and the uncertainty is compounded in attempting to identify emerging problems. History shows that a substantial percentage of bank failures have been unanticipated as early as two years prior to failure. The FDIC examined 1,286 bank-failure cases from 1982-1994 in order to determine the CAMEL ratings of the institutions prior to failure. Table 2 displays the relevant results. Two years prior to failure, almost 47 percent of the institutions had composite CAMEL ratings of 1 or 2.²⁸ Of the 1,189 cases for which CAMEL ratings could be obtained 3 years prior to failure, over 60 percent of the institutions (which accounted for almost 75 percent of failed-bank assets in the sample) were rated 1 or 2.

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²⁸ Not all institutions were examined precisely two years prior to failure. The results reflect the ratings in the examination database as of two years prior, but the date of examination varies across institutions. Nonetheless, these data represent the current rating of the institution as of two years prior to failure, based upon the latest examination.

Table 2

Rating of Failed Banks Prior to Failure

1980-1994
(\$ billions)

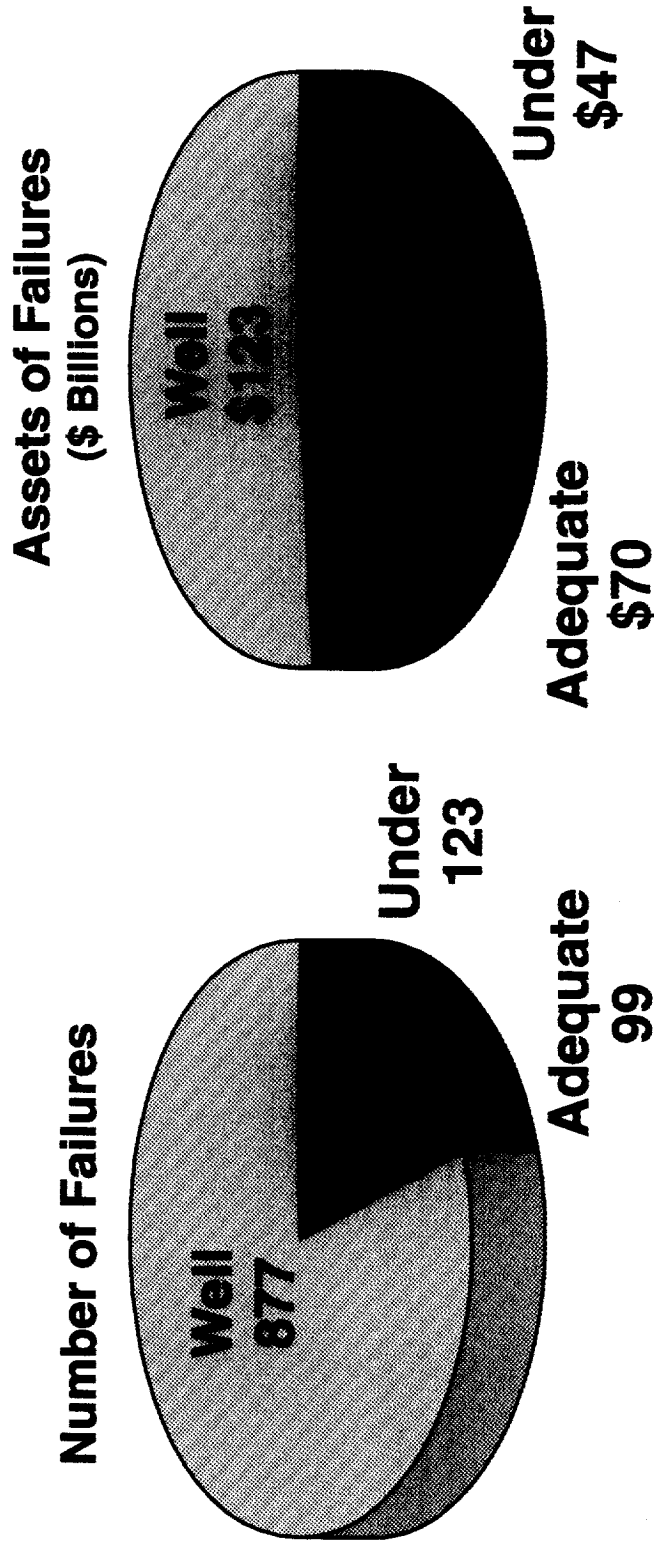
Rating	2 years prior		3 years prior	
	No. (%)	Assets (%)	No. (%)	Assets (%)
1 or 2	598 (47%)	\$137 (50%)	743 (62%)	\$196 (74%)
3	240 (19%)	\$ 66 (24%)	218 (18%)	\$ 35 (13%)
4 or 5	448 (34%)	\$ 69 (26%)	228 (20%)	\$ 33 (13%)
ALL	1286 (100%)	\$272 (100%)	1189 (100%)	\$264 (100%)

Similarly, Figure 18 indicates that the vast majority of banks that failed between 1987 and 1994 were well capitalized three years prior to failure. Moreover, 80 percent of failed-bank assets over this period originated from institutions that were well or adequately capitalized three years before failure.

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Figure 18

Failed BIF Members, 1987-1994: 3-Year Lagged Capital Category



Note: For purposes of this chart, "adequately-capitalized" institutions are those with equity-to-assets ratios of four percent or more. For "well-capitalized" the cutoff is five percent.

The track record of models developed to project bank failures illustrates the same issue: these models exhibit a high degree of imprecision. Table 3 presents annual forecast errors from two types of failure projection models employed by the FDIC. The "actuarial" model groups banks into 25 cells of a matrix based on current performance characteristics. Failures are projected for each cell according to the three-year historical failure experience of banks with characteristics matching the criteria for

the cell. Projections for a one-year horizon are based on the one-year failure experience of banks that would have qualified for the cell at any time during the previous three years, those for a two-year horizon are based on the two-year historical experience, and so on. The one- and two-year projection errors for failed-bank assets from this model over the past 7 years have been large by any reasonable standard, regularly exceeding 50 percent and occasionally approaching 100 percent.

The "pro forma" model has fared no better. This model assumes that an institution's current portfolio composition will be maintained in the future and that the recent relationship between nonperforming loans and subsequent charge-offs will prevail as well. The one- and two-year projection errors from this model have never been lower than 80 percent.

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Table 3

Failure Forecasts
Actuarial Model
 (Failed Bank Assets in Millions)

Forecast Based on Year-End	First Year			Second Year		
	Forecast	Actual	Percentage Difference	Forecast	Actual	Percentage Difference
1987	22,459	35,698	58.9%	60,589	29,168	-51.9%
1988	18,822	29,168	55.0%	34,263	15,660	-54.3%
1989	26,306	15,660	-40.5%	42,908	63,119	47.1%
1990	56,650	63,119	11.4%	73,712	44,197	-40.0%
1991	69,412	44,197	-36.3%	102,171	3,539	-96.5%
1992	24,952	3,539	-85.8%	33,806	1,395	-95.9%
1993	4,805	1,395	-71.0%	1,826	N/A	N/A
Total/Avg.	223,406	192,776	-13.7%	349,275	157,078	-55.0%

Pro-Forma Model
 (Failed Bank Assets in Millions)

Forecast Base on Year-End	First Year			Second Year		
	Pessimistic Forecast	Actual	Percentage Difference	Optimistic Forecast	Actual	Percentage Difference
1992	19,534	3,539	-81.9%	18,905	3,539	-81.3%
1993	8,331	1,395	-83.3%	7,613	1,395	-81.7%
Total/Avg.	27,865	4,934	-82.3%	26,518	4,934	-81.4%
Forecast Based on Year-End	Second Year			Second Year		
	Pessimistic Forecast	Actual	Percentage Difference	Optimistic Forecast	Actual	Percentage Difference
1992	3,985	1,395	-65.0%	2,747	1,395	-49.2%
1993	10,497	N/A	N/A	3,336	N/A	N/A
Total/Avg.	14,482	1,395	-90.4%	6,083	1,395	-77.1%

Similar conclusions emerge from an analysis of the failure projections made by the FDIC's supervisory staff. These projections list, on an individual bank basis, the banks with over \$100 million in assets that are deemed to have a greater than 50 percent probability of failing during each of the next eight quarters. Since 1992, assets in failing institutions have ranged from 18 percent to 80 percent of those listed as being likely to fail within one year under this approach. The forecast errors are substantially higher when a two-year horizon is used. This illustrates that predicting the identity and timing of the failures of specific institutions is even more difficult than predicting the total volume of assets in failed banks.

In short, indicators such as CAMEL ratings, capital categories, and failure projections appear to be driven largely by the current condition of insured institutions and not by underlying risks that are difficult to identify and predict. The record shows that these risks cannot be ignored even for institutions that currently appear healthy. These findings serve to emphasize that any meaningful assessment of the risks posed to the deposit insurance funds by

insured institutions must look beyond a six-month period.

Another important point that emerges from Table 3 relates to the volatility of forecasting errors in predicting bank failures. While the total volume of assets in banks failing from 1988 through 1994 was just 13.7 percent shy of the total amounts projected over that period using a one-year forecast horizon, the errors in any given year were much larger, ranging from an 86 percent overprediction for 1992 to a 59 percent underprediction in 1987. Thus, while it may be possible to discern trends in bank failures over a reasonably long period, there is considerable uncertainty regarding the timing of these failures.

(e) *Rate Setting—Historical Context and Current Conditions.* The considerations described in the subsection (c) suggest that financial services and banking experienced a fundamental increase in risk during the 1980s, and that the pressures that brought about this increase in risk have not abated. Banking today remains a highly competitive and demanding business. Opportunities for geographic expansion and diversification will most likely increase the safety-and-soundness

of the banking system but, like other fundamental changes in the "rules of the game" governing depositories, could result in costly mistakes by some institutions.

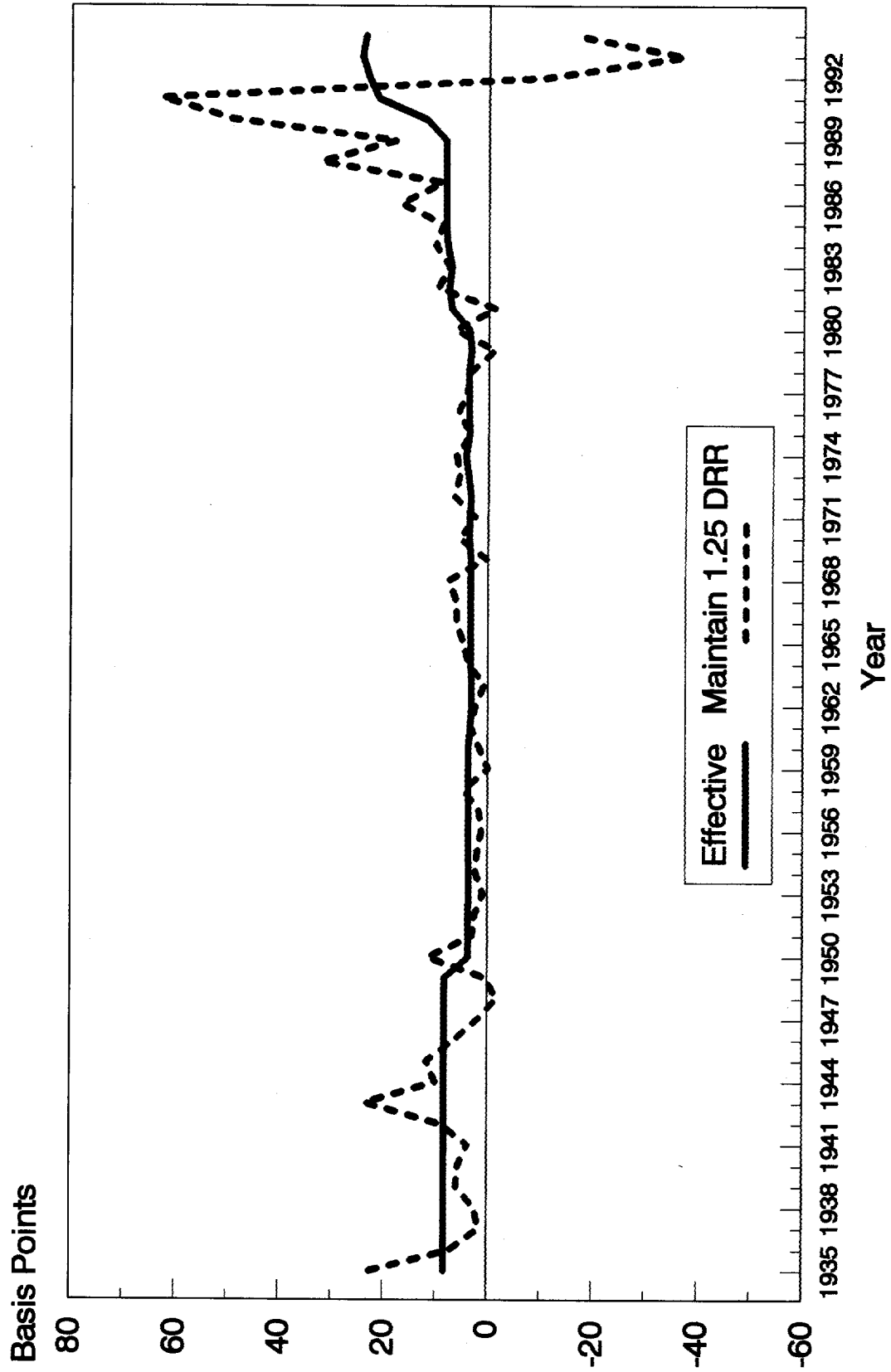
This section provides information on the FDIC's loss experience since 1935. Information on hypothetical "breakeven assessments" is provided for two scenarios: Pay-as-you-go versus a long-run average cost assessment structure. Information on the pay-as-you-go approach is used to evaluate the desirability of that approach, with the result being an unfavorable evaluation.

Table 4 shows assessments that would have been needed to maintain the BIF at 1.25 percent of insured deposits on an annual basis since 1949. These account for the effects of investment income, operating expenses and changes in the amount of insured deposits in the banking system. Figure 19 shows that these "pay-as-you-go" assessments are much more volatile than the actual assessments that were charged by the FDIC, because of the tendency of bank failures to be "bunched" as a function of economic shocks, rather than being evenly distributed over time.

TABLE 4.—BIF PREMIUM RATES AND RATIOS: EFFECTIVE, PAY-AS-YOU-GO, AND FIXED RATE SCENARIOS

Year	Effective		Pay-as-you-go		Fixed assessments		
	Assessment rate	BIF ratio	Assessment rate	BIF ratio	4.5 bp ratio	7 bp ratio	13 bp ratio
1994	23.60	1.15	-16.7	1.25	-0.42	1.42	1.16
1993	24.40	0.69	-37.3	1.25	-0.56	1.11	0.80
1992	23.00	-0.01	-10.8	1.25	-0.92	0.60	0.23
1991	21.25	-0.36	62.8	1.25	-0.93	0.44	0.04
1990	12.00	0.21	49.0	1.25	-0.05	1.20	0.76
1989	8.33	0.70	17.7	1.25	0.59	1.75	1.26
1988	8.33	0.80	32.3	1.25	0.78	1.89	1.33
1987	8.33	1.10	8.9	1.25	1.16	2.21	1.60
1986	8.33	1.12	16.9	1.25	1.23	2.18	1.54
1985	8.33	1.19	8.8	1.25	1.38	2.31	1.60
1984	8.00	1.19	10.2	1.25	1.44	2.32	1.56
1983	7.14	1.22	7.6	1.25	1.52	2.35	1.54
1982	7.69	1.21	9.8	1.25	1.57	2.38	1.49
1981	7.14	1.24	-1.4	1.25	1.65	2.45	1.46
1980	3.70	1.16	6.5	1.25	1.56	2.27	1.29
1979	3.33	1.21	-1.3	1.25	1.60	2.32	1.21
1978	3.85	1.16	3.3	1.25	1.52	2.19	
1977	3.70	1.15	4.1	1.25	1.51	2.16	
1976	3.70	1.16	5.8	1.25	1.52	2.15	
1975	3.57	1.18	3.3	1.25	1.54	2.17	
1974	4.35	1.18	6.2	1.25	1.54	2.14	
1973	3.85	1.21	5.5	1.25	1.57	2.17	
1972	3.33	1.23	6.4	1.25	1.60	2.19	
1971	3.45	1.27	2.4	1.25	1.65	2.24	
1970	3.57	1.25	5.5	1.25	1.63	2.19	
1969	3.33	1.29	0.3	1.25	1.66	2.22	
1968	3.33	1.26	7.5	1.25	1.60	2.12	
1967	3.33	1.33	6.1	1.25	1.68	2.20	
1966	3.23	1.39	6.0	1.25	1.73	2.24	
1965	3.23	1.45	4.7	1.25	1.79	2.30	
1964	3.23	1.48	3.7	1.25	1.81	2.31	
1963	3.13	1.50	0.7	1.25	1.82	2.30	
1962	3.13	1.47	2.4	1.25	1.77	2.21	
1961	3.23	1.47	3.3	1.25	1.75	2.16	
1960	3.70	1.48	1.6	1.25	1.75	2.14	
1959	3.70	1.47	-0.1	1.25	1.71	2.07	
1958	3.70	1.43	4.5	1.25	1.64	1.96	
1957	3.57	1.46	1.7	1.25	1.66	1.95	
1956	3.70	1.44	1.2	1.25	1.62	1.88	
1955	3.70	1.41	2.0	1.25	1.58	1.80	
1954	3.57	1.39	2.3	1.25	1.54	1.73	
1953	3.57	1.37	0.9	1.25	1.51	1.67	
1952	3.70	1.34	2.5	1.25	1.46	1.57	
1951	3.70	1.33	3.0	1.25	1.43	1.51	
1950	3.70	1.36	11.5	1.25	1.41	1.45	
1949	8.33	1.57	0.4	1.25	1.57	1.57	

Figure 19
**Effective Assessment Rates and
Rates to Maintain BIF at 1.25 Reserve Ratio**

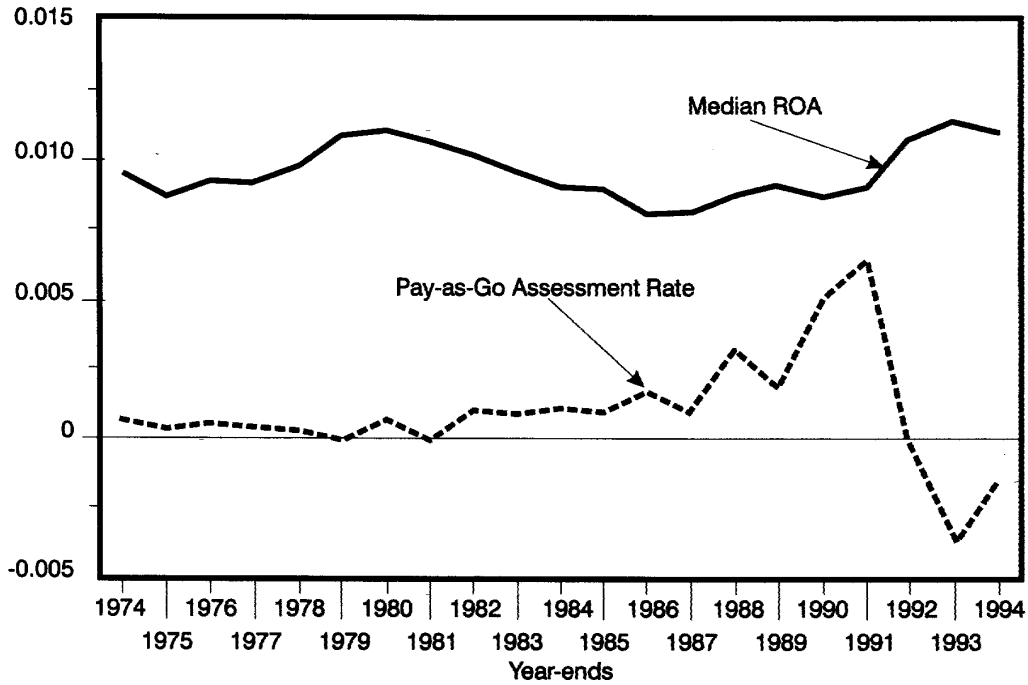


Pay-as-you-go assessments have the undesirable effect that the banking industry must pay the most for its insurance at precisely the time it can least afford it. For example, as indicated in Figure 20, in 1988 through 1991, when the banking industry was experiencing its greatest difficulties since the 1930s, pay-as-you go assessments would have drastically reduced bank income. In 1988, median bank return-on-assets (ROA) would have been reduced by 37 percent; in 1989 by 19 percent; in 1990 by 57 percent; and in 1991 by 71 percent. These sharp reductions in income could have significantly impaired the recovery and recapitalization of the banking industry and increased the FDIC's costs from bank failures. Thus, the Board's obligation to consider the impact on bank earnings and capital of an assessment rate structure would virtually preclude it from adopting a rigid pay-as-you-go rate-setting approach.

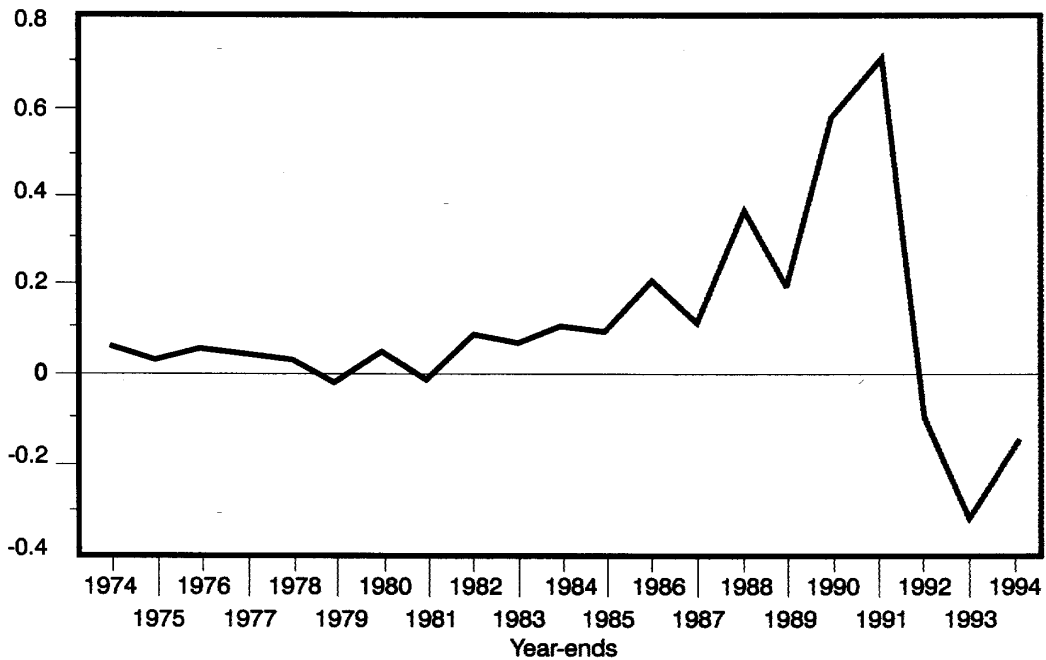
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Figure 20

**Bank Profitability and Assessment Cost
(All Commercial and Savings Banks)**



**Ratio of Pay-as-Go Rate to Median ROA
(All Commercial and Savings Banks)**



For these reasons, there is likely to be considerable pressure brought to bear on the FDIC during periods when the banking industry is under stress not to charge assessments high enough to maintain the DRR. If the reserve ratio falls below the DRR, the FDIC is required by law to increase assessments to regain the DRR within one year. However, if the drop is such that the DRR cannot be attained after a year of increased assessments, the FDIC is mandated to impose assessments equivalent to a minimum average weighted rate of 23 basis points which would be in effect until the DRR is attained—potentially for up to 15 years. While the requirement to charge an average rate of at least 23 basis points is less onerous for the industry and the insurance fund than a strict pay-as-you-go rule, it may be cause for concern. Although BIF institutions absorbed the increase in effective annual assessment rates to 23 basis points as of 1992 with no known direct casualties, it is notable that a strong recovery was emerging in the banking industry at the same time, in part because of a more favorable interest rate environment. It is questionable whether such increases could have been absorbed without a discernable adverse impact during a downturn or at the trough of a banking cycle such as 1988–89.

A strict pay-as-you-go approach results in substantial adverse effects on industry earnings and capital at the time the industry can least afford additional costs. It ignores the real risks that exist in banking beyond a six-month time horizon and, thus, appears to conflict with the Board's duty to consider fully the probability and likely amount of insurance losses and case resolution expenditures. Further, because such an approach would likely be abandoned during times of banking difficulties, it is likely to result in periodic episodes where the fund falls below its DRR and the FDIC is operating in "recapitalization mode," or in even more severe straits.²⁹ For these reasons, the Board regards the pay-as-you-go approach as seriously flawed.

²⁹ For example, in 1991 the BIF reserve ratio reached a negative 0.36 percent of insured deposits.

The alternative basis for setting BIF assessments, and the basis adopted by the Board, is to look beyond the immediate time frame in estimating the revenue needs of the fund. For illustrative purposes Table 4 shows the assessments that would have equated revenues to costs over certain periods in the FDIC's history. The analysis begins at year-end 1949, after the FDIC had retired its initial Treasury capital contribution. From 1950 through 1980, a period of relative stability in banking compared to more recent times, an assessment rate of roughly 4.5 basis points would have balanced costs and revenues over the period. From 1980 through 1994 the required assessment rate would have been roughly 13 basis points, and for the entire 1950–1994 period the required rate would have been seven basis points. Under all these scenarios the reserve ratio of the fund would have fluctuated considerably and would have been "maintained" in a long-run average sense.

The FDIC's historical loss experience thus suggests that an effective assessment in the range of 4.5 basis points to 13 basis points would be expected to balance revenues and expenses over a relatively long period of time. There are several factors that cause the Board to adopt an effective average assessment rate at the low end of the range suggested by historical experience.

Recent developments suggest that the FDIC's expected cost resulting from a given level of banking risk may be smaller now than it was in the 1980s. Prompt corrective action has strengthened the regulators' hands in closing nonviable institutions promptly. The least-cost resolution process mandated by FDICIA has reduced the number of instances where the FDIC is permitted to protect uninsured depositors in bank failures. The nationwide depositor preference statute has placed the FDIC and the depositors ahead of all nondeposit creditors in receiverships of failing banks, although it remains to be seen whether, as the markets gain more experience with depositor preference, bank liabilities will shift as a bank approaches failure in ways that would reduce the FDIC's cost savings. Sectoral price inflation and

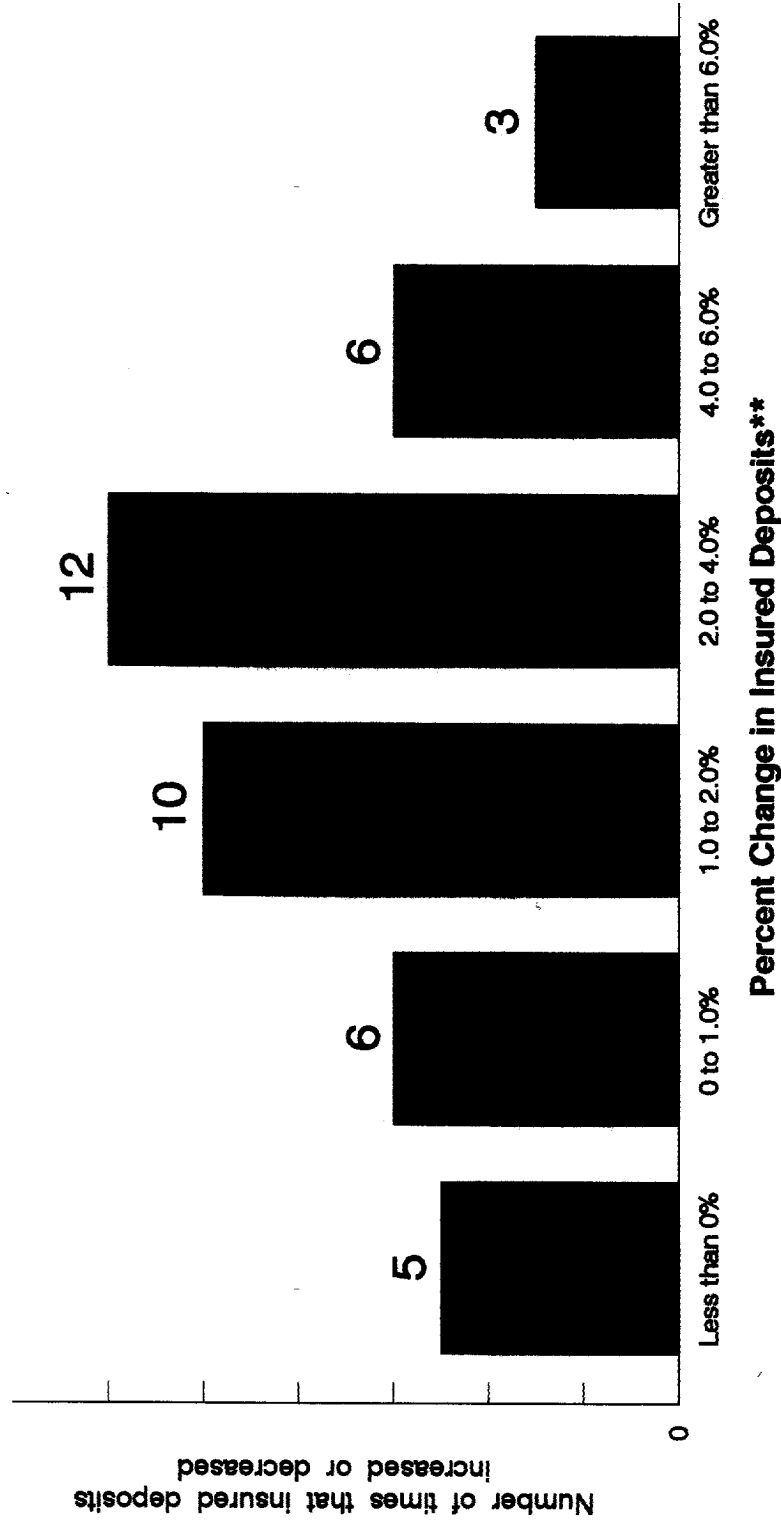
the danger of subsequent deflation appear less of a concern now than in the 1980s. While underlying risks are still significant, the banking industry will face any new episode of problems with higher capital ratios than it enjoyed in the 1980s. Finally, the BIF balance and reserve ratio are much higher than they were during most of the 1980s, resulting in higher levels of investment income that will reduce the effective assessment rate needed to balance revenues and expenses.

The net result of these changed conditions is that a purely historical analysis of long-term expected costs should be substantially tempered by a judgment about the effect of these changes on expected losses. Since we have not had a significant episode of bank failures since the imposition of these changes, there is little empirical basis for speculation about the magnitude of cost reductions likely to occur. Nevertheless, it is the judgment of the Board that an effective assessment rate for the banking industry at the lower end of the 4.5 to 13 basis-point range suggested by historical experience is likely to cover expected losses to the BIF over a reasonable time horizon. The Board expects that this judgment will be revisited on a semiannual basis in light of changing conditions.

(f) *Rate Setting—Planning for Volatility in Insured Deposits.* The FDIC sets assessment rates to be effective for a subsequent six-month period. An element of uncertainty about the reserve ratio that will result from a given rate schedule arises from the possibility for insured deposits to grow or shrink over the six-month period at rates different than originally expected.

Figures 21 and 22 provide some perspective on this issue. Figure 21 displays the frequency of various percentage changes in insured deposits at commercial banks occurring during six-month intervals, quarterly from 1984 through the first quarter of 1995. The impacts of these percentage changes on the BIF reserve ratio, applied to an assumed BIF ratio of 1.25 percent of BIF-insured deposits as of the first quarter of 1995, are displayed in Figure 22.

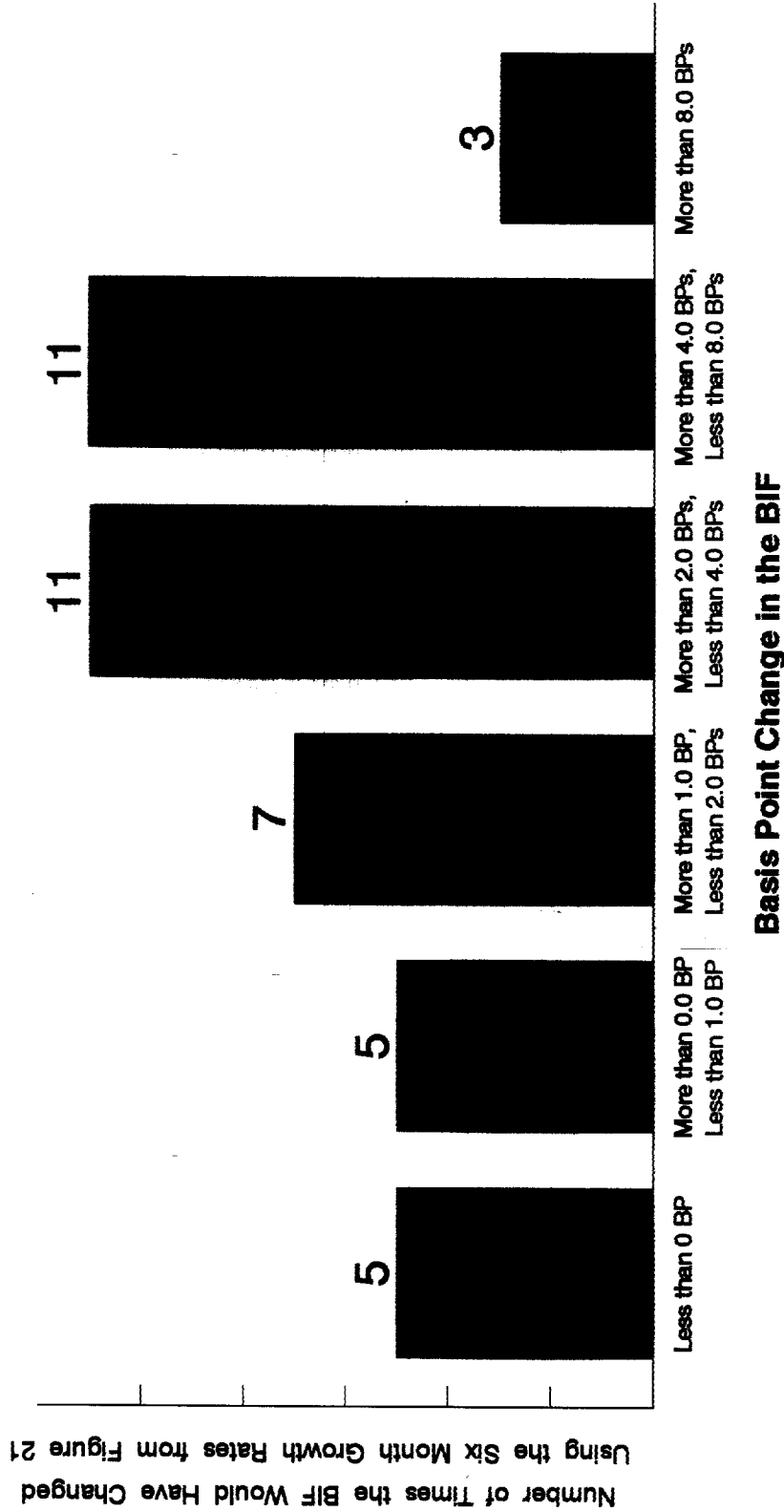
Figure 21
Insured Deposits: Historical Growth* Experience Over the Past 10 Years
(Figure 22 shows the potential impact on the BIF)



* Percentage changes in estimated insured deposits at commercial banks were calculated for each 6-month period from 1984Q2 - 1995Q1. The resulting absolute changes, not annualized, are displayed here.

** Prior to March 31, 1991 the call report information used to estimate insured deposits were reported only on June 30. Insured deposits for the intervening quarters are derived assuming that the ratio of insured deposits to total deposits remained unchanged from its June 30 value.

Figure 22
The Potential Impact* of Deposit Growth on the BIF
 (Shows the Basis Point change the BIF would experience using historical insured-deposit growth rates from Figure 21)



*Downward impact of the six-month percent changes in insured deposits from Figure 21 on a 1.25 percent BIF reserve ratio, measured in basis points of insured deposits.

The 1984–1985 period described in Figures 21 and 22 can be divided into two subperiods. From 1984 to mid-1991, there was healthy, sustained growth in insured deposits. Since mid- to late 1991, however, insured deposits have for all intents and purposes not grown at all. It is uncertain how much the dramatic reduction in assessments resulting from the new rate schedule in the final rule will stimulate growth in BIF-insured deposits.

The experience of the 1984–1995 period indicates that changes in insured deposits can subject the BIF reserve ratio to considerable variation relative to the DRR. For example, during three six-month periods since 1984, insured deposits increased at rates that if applied today, would reduce the BIF reserve ratio by more than eight basis points, to less than 1.17 percent, other things constant.

The import of these facts is that if the FDIC set assessment rates so that the BIF

were expected to end the subsequent six-month period at the DRR, based on a modest expected growth in insured deposits, then actual growth in insured deposits could deviate sufficiently from expected growth that the FDIC could end the assessment period with a reserve ratio of considerably less than the DRR. This attests to the difficulty of precisely managing the reserve ratio and suggests maintenance of the DRR may require the FDIC to allow for the possibility of unexpected changes in insured deposits.

2. Summary of Application of Statutory Factors

(a) *Financial Factors: Probability and Likely Amount of Insurance Losses; Case Resolution Expenditures and Income; Operating Expenses; Revenue Needs of the Fund.* As discussed in Section IV.B.1 above, the Board believes that its insurance responsibilities require it to look beyond the immediate

timeframe in setting assessment rates. The probability and likely amount of losses and case resolution expenses are determined by risk factors that operate over a far longer horizon than six months. Accordingly, the Board's duty to assess risk-based assessments in accordance with these statutory factors require it to price the risk of adverse events that may occur beyond the immediate horizon.

Projected income and expense for the second half of 1995 are presented in Table 5. Total income from assessments and investments of about \$1.1 billion is expected to exceed total insurance losses and operating expenses in the range of \$302 million to \$352 million. The BIF reserve ratio is expected to be between 1.27 percent and 1.31 percent at June 30, 1995, depending on the timing of the proposed refund of overpayments and the growth in insured deposits during the second quarter.

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Table 5

BIF Assessment Rates Factors to be Considered

Second Semiannual Assessment Period, 1995

BIF Ratio at June 30* (Percent)	1.27 to 1.31
Expected Income (\$Millions)	1,149
Assessment Income (\$Millions)	510
Net Interest Income (\$Millions)	576
Expected Insurance Losses and Change in Provisions for Future Losses (\$Millions)	-200 to 600
Expected Operating Expenses (\$Millions)	252
Estimated BIF-Insured Deposits at December 31** (\$Billions)	1,890 to 1,985
BIF Ratio at December 31*** (Percent)	1.24 to 1.36

* Range reflects effective date for new assessment schedule of May 1 versus June 1, and annual insured deposit growth rate of +2 percent versus -2 percent for second quarter.

** Lower bound assumes annual growth of insured deposits of -2 percent for second quarter and 0 percent growth for second half. Upper bound assumes annual growth of 6 percent for last 3 quarters of 1995, based on quarterly volatility from 1984:Q2 to 1995:Q1, as shown in Figure 21 *Federal Register* notice.

*** Reflects ranges for all preceding items in Table 2.

The Board considered a range of assumptions about these factors in an effort to estimate the BIF reserve ratio at year-end 1995 that would result from the new rate schedule. Insurance losses and increases in the reserve for future failures during the second half of 1995 were assumed to range from a negative \$200 million to a positive \$600 million. This range reflects the possibility that institutions for which the FDIC has established a loss reserve would recover during the second half of 1995 or, alternatively, that currently unidentified institutions would develop problems during this period that would require the FDIC to establish a loss reserve. The range of variability considered for this factor is modest relative to the variations in the reserves that have occurred in recent years. BIF-insured deposits are assumed to grow at an annualized rate of between zero and six percent during the last three quarters of 1995. While six percent growth appears unlikely at this time, it is not outside the range of historical experience, as indicated in Figure 21. Under these assumptions, the BIF reserve ratio would be between 1.24 percent and 1.36 percent at year-end 1995.

The rule adopted by the Board thus is expected to result in an excess of revenue over expense for the second half of 1995. The Board based this decision on two general factors. First is the requirement to set assessment rates to account for the probability and likely amount of insurance losses. As just discussed, this requires the Board to consider the possibility of adverse events that may not occur during the immediate timeframe. The FDIC's experience during two very different times—the relatively stable period from 1950 to 1980, and the more volatile post-1980 period—suggests that an assessment in the range of 4 to 13 basis points would, on average, meet the revenue needs of the fund over a long period of time in light of the probability and amount of losses, case resolution expenditures, income, and operating expenses that have characterized the FDIC's past experience.

The Board has considered other factors governing the probability and likely amount of losses and case resolution expenditures that are likely to occur in future years. As discussed in more detail in Section IV.B.1(e), these include recent statutory changes (prompt corrective action, least-cost resolution and depositor preference), the currently reduced likelihood of problems arising from sectoral inflations and subsequent deflations, and the high capital ratios generally prevailing in banking. These factors tend to reduce

the probability and likely amount of losses and caused the Board to adopt an effective assessment rate at the low end of the historically suggested range.

Another factor driving the selection of an assessment rate at the low end of the historical range was the investment income deriving from the current BIF balance. The investment income of the BIF will be substantially higher than it was during most of the last ten years. This reduces the need for assessment income to meet the revenue needs of the insurance fund. It is anticipated that the Board will revisit this issue on a semiannual basis by considering further adjustments in assessment rates if the BIF continues to grow in light of the Board's obligation to maintain the BIF at the target DRR.

The second general factor governing the selection of the rates adopted by the Board is the need to allow for the possibility of unanticipated changes in insured deposits or loss reserves that may occur during a semiannual period. The BIF ratios projected to occur at midyear and year-end 1995, respectively, are projections based on a reasonable range of estimates of the growth in BIF insured deposits during 1995. It must be emphasized that the level of BIF-insured deposits for neither date are known at this time. As discussed in subsection (f) above, based on the historical variability in semiannual changes in insured deposits, it is conceivable that the BIF ratio might not reach the DRR at year-end even under the new rate schedule. As indicated in Figure 22, it is within the range of the historical experience of the past 10 years that insured deposits can change by enough in a six-month period to move the BIF reserve ratio by as much as eight basis points.

Similarly, in evaluating the probability and likely amount of insurance losses, the Board considered the uncertainty inherent in predicting the level of the FDIC's reserve for future failures. This reserve is determined using a methodology agreed to by the U.S. General Accounting Office and is intended to estimate the cost of failures that can reasonably be anticipated over a subsequent 18-month period. The provision for insurance losses has displayed considerable volatility in recent years, ranging from a \$15.4 billion addition to the reserve in 1991 to a \$7.7 billion reduction in the reserve in 1993.

The net effect of variability in insured deposits and losses, and additions to the loss reserve, can be of considerable practical import in light of the Board's duty to maintain the DRR. For example, as indicated in Table 5, an annualized

growth in BIF insured deposits of six percent over the last three quarters of 1995, in conjunction with insurance losses and additions to reserves of \$600 million during the second half of 1995, would result in the BIF falling short of the DRR at year-end. The new rate schedule provides a level of comfort that unanticipated changes in insured deposits will not cause the BIF to fall below the DRR.

(b) *Impact on Earnings and Capital.* In deciding against adopting a strict pay-as-you-go policy for setting assessments, the Board considered the adverse effects on banking industry earning and capital of such a policy. As discussed in subsection (e), such a policy has the undesirable effect of sharply increasing the assessment costs of insured institutions at a time when they can least afford such increases. Subsection (e) describes how a pay-as-you-go policy applied during the 1980s would have had a severe adverse impact on the earnings and capital of the banking industry during the years 1988–1991.

The Board considered the near-term impact of adopting the 4 to 31 basis point rate matrix. Because assessment rates for most BIF members will decline under the new assessment schedule, the impact on earnings and capital will be positive. Lower assessment costs will reduce expenses by approximately \$4.4 billion per year. Based on the industry's year-end 1994 average tax rate of 33 percent, after-tax profits will increase by approximately \$3 billion per year. BIF members may pass some portion of the cost savings on to their customers through lower borrowing rates, lower service fees, and higher deposit rates. Their ability to do so will be affected by factors such as the level of competition faced by banks. As discussed in Section III above, the potential adverse effect on weaker institutions resulting from the decreased assessment rate paid by their competitors is likely to be minimal in terms of the number of additional failures.

(c) *Other Factors the Board Deems Appropriate.* When setting assessment rates to maintain the reserve ratio at the DRR, section 7(b)(2)(A)(ii) authorizes the Board to consider "any other factors that the Board of Directors may deem appropriate". The statute does not limit the discretion of the Board to determine those factors which are appropriate to consider in the rate-setting process. Although the statute specifically lists other criteria, such as case resolution expenditures, which must be included in its determination, the Board is free to take into account economic and other data which it deems relevant. Accordingly, the Board has incorporated

into its balancing process a review of variables particular to the financial services industry such as interest and exchange rate volatility and nonbank competition as well as projections for the economy in general.

The proposal reviewed the propriety of including under this factor consideration of the competitive disparity arising from the differential in assessments for members of the BIF and SAIF. The Board is adopting without change the interpretation of "other factors" which was set forth in the proposal.

The proposal discussed the interplay of the "other factors" provision with section 7(b)(2)(B), which requires the Board to set semiannual assessments for members of each fund "independently" from semiannual assessments for members of the other insurance fund. Read together, these provisions do not specifically prohibit Board consideration of the impact of BIF rates on SAIF members as long as the rates are set independently. However, the proposal indicated the potential conflict with section 7(b)(2)(A)(i) which requires the Board to set rates to maintain the BIF reserve ratio. If the Board were to take into consideration the impact on the SAIF when it set BIF rates (*i.e.*, setting BIF rates higher than otherwise necessary to minimize the disparity between BIF and SAIF rates), and, as a result, the reserve ratio continued to increase in excess of the DRR, it might be considered a violation of the statute.

Although a total of 591 commenters indicated that the Board should not take into account the impact on the SAIF and its members when setting the rates for BIF members, few of those comments provided any legal analysis. Those that did, (including the ABA, ABA State Association Division, IBAA, Citicorp, New York Clearing House, the California Bankers Association, GreenPoint Bank and Bank of Boston) concurred with the analysis set forth in the proposal. A number of these commenters indicated that "other" factors should be interpreted only to encompass factors that relate to the condition of the BIF.

By contrast, the Savings Association Insurance Fund Industry Advisory Committee (SAIFIAC) indicated that the FDIC "has an equal duty and responsibility to each Fund * * * [which] dictates that any proposal to lower BIF rates must be coupled formally with both a regulatory determination that the SAIF PROBLEM MUST BE DEALT WITH, and a proposal for a solution." (Emphasis in original.) SAIFIAC further indicated its belief that the proposal declined to take into

account the impact on SAIF because that impact could not be quantified.

The Board continues to believe that setting BIF rates higher than otherwise would be warranted would likely cause an increase in the BIF reserve ratio above in the DRR in violation of the statute. Accordingly, the Board is adopting the interpretation of "other factors" as proposed.

3. Conclusions

The principal conclusion of the foregoing analysis is that the exercise of the FDIC's insurance responsibilities require it to look beyond the immediate period in pricing risk. A pure pay-as-you-go pricing system can expose the banking industry to unduly high and volatile insurance assessments that can adversely affect the soundness of the banking system and the BIF. Moreover, the FDIC's experience with bank failures makes it clear that a meaningful evaluation of the risk associated with even highly rated and well-capitalized institutions must look beyond a six-month period. Accordingly, the Board will undertake to look beyond the immediate period in determining the revenue needs of the BIF.

The second principal conclusion is that the Board's duty to maintain the DRR as a target requires it to take account of the substantial variability of a number of factors influencing the revenue needs of the fund. Insured deposits display enough variability to cause the BIF reserve ratio to fluctuate considerably relative to the DRR. Insurance losses are extremely difficult to predict, and the FDIC's policy of establishing loss reserves for failures expected to occur as much as 18 months in the future magnifies the problem of prediction. This is because the prediction of the BIF's income in the second half of 1995 necessarily must allow for the possibility of changes in the reserve for future failures that may not occur until year-end, for failures anticipated to occur through mid-1997.

In light of the imprecision inherent in the measurement of banking risk—whether through examination ratings, capital measures or models used to project bank failures—the Board does not intend to specify a time period over which the FDIC will attempt to estimate its expenses for the purpose of setting assessment rates. Instead, rate-setting will be undertaken as an evolving process in which historical analysis tempered by informed judgment about current conditions, including the investment income deriving from the balance in the BIF, is revisited on a semiannual basis.

The historical analysis presented above suggests that an effective average assessment rate in the range of 4.5 to 13 basis points would be expected to meet the revenue needs of the fund over the very long term. The factors outlined above have convinced the Board that the lower end of the assessment range is reflective of the risks currently facing the BIF and, moreover, takes adequate account of the variability in insured deposits, losses, and additions to the reserve for future failures that may affect the adequacy of the BIF relative to the DRR over the second half of 1995. The Board is, accordingly, adopting the 4 to 31 basis point rate matrix as originally proposed.

In adopting the 4 to 31 basis point rate schedule, the Board emphasizes its expectation that the rate-setting process going forward will evolve continuously. For example, even assuming no change in the FDIC's risk exposure to potential bank failures, the attempt to balance revenues and costs over a longer horizon is consistent with semiannual adjustments to reflect changes in the fund balance. Increases in the BIF balance, due either to shocks or to favorable industry conditions that persist beyond the period that could be expected, would increase investment income and make it less likely that the fund would fall short of the DRR over any given future horizon, other things equal. In response to this, and depending upon other relevant factors, the Board may deem it appropriate in subsequent semiannual periods to reduce assessments below the level that previously had been expected to be necessary to meet the revenue needs of the funds.

V. Application and Adjustment of New Assessment Schedule

The Board is adopting the proposal to apply the new assessment rate schedule in the semiannual period during which the DRR is achieved, with refunds of any overpayments from the first day of the month following the month in which the DRR is achieved. Under the final rule, overpayments will be refunded with interest at a rate that corresponds to the rate of interest earned by the FDIC on the overpayments.

In addition, the Board is adopting, with two clarifications, the proposed process for modifying the new assessment rate schedule by means of an adjustment factor of 5 basis points, as necessary to maintain the reserve ratio at 1.25 percent without the necessity of engaging in separate notice-and-comment rulemaking proceedings for each adjustment.

A. Semiannual Period During Which DRR Is Achieved

In the proposal, the Board interpreted the language and legislative history of section 7(b)(2)(E) of the FDI Act—that is, the requirement to assess a minimum average rate of 23 basis points—as prohibiting the Board from decreasing the assessment rates paid by BIF members until after the FDIC is able to confirm that the reserve ratio has, in fact, reached the DRR, regardless of projections for BIF recapitalization. If the Board were to decrease the rates based on projections for BIF recapitalization, the reserve ratio would “remain” below the DRR at the time of the Board’s action and the minimum-assessments provision of section 7(b)(2)(E) would continue to apply. Accordingly, the Board proposed to decrease assessment rates once the FDIC has been able, based on a review of the relevant quarterly reports of condition (call reports) necessary to determine the amount of estimated insured deposits,³⁰ that the DRR has in fact been achieved. The rate reduction would be effective on the first day of the month following the month in which the DRR is attained. The Board further proposed to refund, with interest from the date the new rates take effect, any overpayments of assessments under the new rate schedule resulting from the delay in confirming attainment of the DRR.

Of the 356 commenters addressing these elements of the proposal, 343 expressed support for the process of implementing the new rates and refunding overpayments. Of these, 286 respondents expressly mentioned support for refunding the assessments with interest from the date the new rates become effective.

One commenter thought that, for overpayments in the first semiannual assessment period of 1995, interest should be paid from the date the FDIC received the assessment in January, rather than from the date the new rates take effect. Eight commenters

³⁰The reserve ratio is the dollar amount of the BIF fund balance divided by the estimated insured deposits of BIF members. Although data for the fund balance is accounted for on a monthly basis, the amount of estimated insured deposits is based on data from the quarterly reports of condition (call reports). Because it appears that the BIF recapitalized in the second quarter, the amount of estimated insured deposits would be determined by the information on the June call reports which are due on July 30 (or for some institutions, August 14). Due to the customary time lag involved in verifying the information from the call reports, it is probable that the determination that the DRR has been achieved will not be made until mid-September. Moreover, because the fund balance is determined only on a monthly, rather than a daily basis, the date on which the Board ascertains that the DRR has been attained is the last day of the month.

disapproved of the proposed process, believing rates should be dropped more quickly.

Numerous commenters urged that the determination be made as quickly as possible. For example, the IBAA urged the FDIC to “make the necessary determinations as soon as humanly possible so that banks will enjoy the benefits of premium reduction as early as possible.” The ABA urged the FDIC to reduce assessments in the third quarter “if the weight of the evidence shows that the BIF will have reached the DRR before June 30.” The ABA’s position is that waiting for confirmation of data from the June 30 call reports would merely unnecessarily complicate the whole process of changing rates.³¹

The FDIC has carefully considered the comments addressing these issues. However, the Board continues to believe, given the statutory language of section 7(b)(2)(E) and the relevant legislative history, that the FDIC does not have authority to lower assessment rates until it is certain that the DRR has been attained. Accordingly, as proposed, the Board has decided not to apply the new rate schedule until the first day of the month after the month in which the DRR has actually been reached. In the event it is determined that the DRR has been reached before the September 30 assessment payment date, as is expected, the Board will promptly notify BIF members that the amount of the September 30 payment will be adjusted to reflect the new rate schedule. In order to avoid any additional overpayment or confusion, the final rule provides that the FDIC also may delay collection of the assessments that would otherwise be due on September 30 (or such later payment date that next follows the effective date of the new rate schedule). If this occurs, it is very likely that the FDIC would also delay for a brief period the date of the associated invoice, which is provided one month prior to the collection date (for example, the invoice date for a September 30 collection date is August 30).

Because the new assessment rate schedule will apply from the first day of

³¹The ABA reiterated this view in a May 19, 1995, meeting with FDIC staff members, which the ABA had requested to discuss the proposal. At the meeting, the ABA urged that the FDIC quickly act to reduce BIF rates to a level no higher than that necessary to bring the BIF to its DRR. FDIC staff stated the Board’s position reflected in the proposal that the FDIC is precluded from reducing rates until it has been able to determine that the DRR has in fact been reached. A summary of the ABA meeting is included in the public comment file on the proposal, along with other oral and written comments submitted by the ABA and other respondents.

the month after the month in which the DRR was achieved, it is likely to be determined that many BIF members have overpaid their assessments. For example, if the DRR is determined to have been achieved on May 31 and the new assessment schedule becomes retroactively effective on June 1, it is likely that all institutions except those paying the highest rates will have overpaid their assessment for the first semiannual period of 1995. Similarly, most institutions will have overpaid their assessments paid on June 30, 1995, for the July-September quarter of the second semiannual period.

In such instances, the FDIC will refund the overpayment with interest from the effective date of the new assessment rate schedule, in the case of overpayments for the first semiannual period, and from the payment date, in the case of overpayments for the second semiannual period. The FDIC anticipates that it will provide such refunds electronically by means of credits sent through the Automated Clearing House (ACH) system, but may do so by check or in more than one payment. In the case of electronic refunds, it is anticipated that the same routing transit numbers and accounts used for direct-debit assessments collection will be used for the electronic credits.

Under the proposal, the interest rate to be paid by the FDIC on overpayments resulting from a change in the BIF rate schedule would have been the rate normally applicable to assessment over- or underpayments in general. However, under the unique circumstances applicable here, the Board has decided to pay an interest rate that corresponds to the rate actually earned by the FDIC on the overpayments. Because the FDIC knew that it was highly likely that the June 30 collection of assessments at the existing rates would result in significant overpayments for all but the riskiest institutions, the Board believes that it is fair and appropriate to pay an interest rate that returns to the overpaying institutions the amount of interest actually earned by the FDIC on their overpayments. Accordingly, the final rule incorporates a special interest rate that is the arithmetic average of the overnight simple interest rate received by the FDIC on its U.S. Treasury investments during the relevant period (including weekends and holidays at the rate for the previous business day). For example, had the relevant period been June 1995, the applicable rate would have been 6 percent.

The FDIC recognizes that, once the new assessment rate schedule becomes effective, insured institutions may have

questions regarding the application of the new rate schedule and the mechanics of the refund process, including how and when refunds will be made. Accordingly, the FDIC will be providing additional, more specific information regarding these matters to insured institutions.

B. Semiannual Periods after the DRR is Achieved: the Adjustment Factor

As to the semiannual assessment periods after the DRR is achieved and the new rate schedule has become effective, the Board is adopting the proposed adjustment factor, with two clarifications.

Under the proposal, the new assessment rate schedule, once activated, would continue to apply to succeeding semiannual periods, with modification as necessary in future periods to maintain the reserve ratio at the target DRR by means of an adjustment factor of up to and including an aggregate of plus-or-minus 5 basis points or fraction thereof. The proposal limited to this 5 basis-point range the amount by which the Board could adjust the assessment rate schedule without engaging in a notice-and-comment rulemaking proceeding. Such adjustments would be applied to each cell in the rate schedule uniformly; they could not be applied only to selected risk classifications. For example, if the Board were to adjust the rate schedule by a reduction of 2 basis points, then the assessment rate applicable to each assessment risk classification would be reduced by 2 basis points (from, say, 4 to 2 basis points, 7 to 5 basis points, 14 to 12 basis points, and so on). Thus, the differences between the respective cells in the rate schedule would remain unchanged. Similarly, such adjustments would neither expand nor contract the 27-basis point spread between the lowest- and highest-risk classifications.

The 5 basis-point maximum would limit the extent to which the rate schedule could be adjusted over time without triggering a new notice-and-comment rulemaking proceeding. Thus, for example, if the rate for 1A banks were 4 basis points, no matter how many times the assessment schedule were adjusted up or down, the rate for 1A banks could not be increased over time to a rate higher than 9 basis points without a new notice-and-comment rulemaking proceeding. The same limitations would apply to rate reductions.

Under the proposal, the adjustment factor for any particular semiannual period would be determined by (1) the amount of assessment income necessary to maintain the reserve ratio at 1.25

percent (taking into account operating expenses and expected losses and the statutory mandate for the risk-based assessment system) and (2) the particular risk-based assessment schedule that would generate that amount considering the risk composition of the industry at the time. The Board proposed to adjust the assessment rate schedule every six months by the amount, up to and including the maximum aggregate adjustment factor of 5 basis points, necessary to maintain the reserve ratio at the DRR. Such adjustments would be adopted in a Board resolution that reflects consideration of the following statutory factors: (1) Expected operating expenses; (2) projected losses; (3) the effect on BIF members' earnings and capital; and (4) any other factors the Board determined to be relevant.

The Board resolution would be adopted and announced at least 45 days prior to the date the invoice is provided for the first quarter of the semiannual period for which the adjusted rate schedule would take effect. Thus, the rate schedule applicable to the November 30 invoice would be announced no later than October 16 and the schedule applicable to the May 30 invoice would be announced by April 15. If the amount of the adjustment under consideration by the FDIC would result in an adjusted schedule exceeding the 5 basis-point maximum, then the Board would initiate a notice-and-comment rulemaking proceeding to be completed prior to the invoice date.

A total of 75 commenters addressed the issues of the proposed process to adjust the rates and the amount of the adjustment factor. Of the 61 comments in support of the process (including 8 trade associations and 47 BIF members), 41 indicated that the size of the adjustment factor (5 basis points) was appropriate. The ABA (as well as the ABA State Association Division) supported the process only so long as the purpose of the adjustment was to maintain the reserve ratio at the DRR. A number of commenters, including Signet Banking Corporation and Wells Fargo Bank, supported the proposed adjustment process but noted that it should be used both for rate increases and decreases. (The proposal intended that the adjustment process would be used both for increases and decreases.) NationsBank also supported the proposal but indicated any adjustments should be made not more frequently than annually.

Other commenters expressed concern about the lack of opportunity for comment, particularly where an increase in rates could have a significant

effect on BIF members. For example, the IBAA opposed the use of the proposed adjustment process for increases but not for decreases in the assessment schedule because of the lack of opportunity to comment on assumptions made by the FDIC concerning expected expenses, loss rates, investment income, and other factors. The IBAA indicated that this is particularly important in a case where the FDIC would raise the schedule by the full amount of the adjustment factor (5 basis points) which would represent more than double the proposed 4 basis-point rate for institutions in the 1A risk classification. Chemical Bank opposed both the process and the size of the adjustment factor for both increases and decreases in the rate, noting that an increase of 5 basis points would represent more than a doubling of the rate for most banks. The Bankers Roundtable also expressed concerns with permitting the FDIC to raise assessments without notice and comment where an increase could significantly increase costs to the banks. To provide the FDIC with some flexibility, it proposed an alternative process whereby the use of the adjustment factor at the FDIC's sole discretion would be limited to 2 basis-point changes; changes above 2 basis points but less than 5 basis points could be imposed after an abbreviated comment period (two-three weeks); changes above 5 basis points would go through the normal comment period.

Banc One Corporation opposed the proposed adjustment process based on the erroneous belief that it would permit the Board to raise the assessment schedule by as much as 9 basis points from one semiannual period to another without the opportunity for notice and comment. Instead, Banc One favored limiting the adjustment factor to an increase or decrease of 1 basis point only. The New York Clearing House opposed the adjustment process, noting that an increase of 5 basis points would represent a 125 percent increase for banks with risk classification 1A. However, the Clearing House also misunderstood the proposed process, believing that the schedule could be increased sharply "in only a few years without ever seeking public comment".

The Board has decided to adopt the proposed rate-adjustment process, with two clarifications. First, given the apparent confusion regarding the maximum extent to which the rate schedule could be adjusted without triggering a new rulemaking proceeding, § 327.9(b)(1) of the final rule clarifies that the maximum adjustment level of plus-or-minus 5 basis points is intended to apply as an aggregate amount, over

time, taking into account both increases and decreases, but that no one adjustment may constitute an increase or decrease of more than five basis points. This clarification reflects the Board's intent to seek public comment on, for example, a proposed increase of 3 basis points for a semiannual period following an earlier period for which the Board, by resolution, adjusted the rate schedule upward by 3 basis points, or a proposed decrease of 6 basis points after a previous increase of three basis points, but not to seek public comment on an increase of 5 basis points following an intervening decrease of 2 basis points.³² Similarly, language also has been added to this paragraph to expressly state the Board's intent, as indicated in the proposal, that any adjustment apply uniformly to each rate in the schedule.

Second, the final rule also expressly reflects the FDIC's intent promptly to make public the basis for any Board decision to adjust the rate schedule. Under § 327.9(b)(2) of the final rule, with this clarification, the Board will announce the semiannual assessment schedule for the next semiannual period, with the amount and basis for any adjustment from the then-existing schedule, no later than 45 days before the invoice date for the first quarter of that next semiannual period (that is, by October 16 or April 15, as applicable).

The Board fully understands concerns regarding the possibility of assessment rate increases without the benefit of full notice-and-comment rulemaking. However, the Board notes that the adjustment applies to decreases as well as to increases and that, in the current

economic environment, the former could be more common than the latter. Moreover, the Board's discretion in applying the adjustment factor is not unfettered. The maximum amount of the adjustments is limited to an increase or decrease of 5 basis points, either at any one time or over time, and in adopting an adjustment the Board must satisfy the criteria enumerated in § 327.9(b) of the final rule, which reflect the statutory rate-setting factors referred to above. Moreover, as with any of its decisions, the Board may act only after due deliberation and in a reasonable manner. As previously indicated, the basis for any adjustment adopted by the Board will be made public promptly after the Board's decision.

Furthermore, while the Board appreciates these concerns, it also recognizes that frequent rate adjustments may be necessary to maintain the reserve ratio at the DRR, and is mindful of the costs involved—both to the industry and the FDIC—of engaging in a formal rulemaking proceeding each and every time even a minor adjustment in the assessment rate schedule is needed. The Board believes—as do 61 of the 75 commenters addressing this issue—that an acceptable balance of the competing concerns is achieved by the approach taken in the final rule.

The Board has noted the suggestion made by the Bankers Roundtable that the final rule include a modified adjustment procedure under which adjustments of between 2 and 5 basis points be subject to an abbreviated notice-and-comment period of 2 to 3 weeks. However, the Board is concerned that such a short period would not allow sufficient time for interested parties both to become aware of a proposed adjustment and still file timely comments. In addition, an abbreviated comment period involves the same costs as a non-abbreviated period, both to interested parties and to the FDIC.

The adjustment factor is expected to provide the Board with the flexibility to raise a maximum additional \$1.2-\$1.4 billion in the near term without undertaking an additional rulemaking. The 5 basis-point maximum appears modest when viewed historically, as the loss-to-insured deposits ratio has been quite variable; the standard deviation was 8.5 basis points for the 1934–94 period (Figure 8) and 11.9 basis points for 1980–94. In view of the currently favorable banking environment, however, a 5 basis-point adjustment factor should be sufficient to maintain the target DRR in the near term.

VI. Technical Amendments

In addition to the amendments discussed above, the Board is further amending the assessments regulation to delete the BIF Recapitalization Schedule currently set forth in 12 CFR 327.9(d). Because the DRR has already been or soon will be reached, this schedule is no longer needed. Moreover, the schedule, which calls for BIF to reach the DRR in 2002, is now obsolete.

In addition, the final rule substitutes the term “institution” for the outdated term “bank” in § 327.9(a).

VII. Paperwork Reduction Act

No collections of information pursuant to section 3504(h) of the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*) are contained in this notice. Consequently, no information has been submitted to the Office of Management and Budget for review.

VIII. Regulatory Flexibility Act

The Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) does not apply to a rule of particular applicability relating to rates, wages, corporate or financial structures or reorganizations thereof. *Id.* at 601(2). Accordingly, the statute does not apply to the proposed changes in the assessment rate schedule, the structure of that schedule and future adjustments thereto. In any event, to the extent an institution's assessment is based on the amount of its domestic deposits, the primary purpose of the Regulatory Flexibility Act, that agencies' rules do not impose disproportionate burdens on small businesses, is fulfilled.

IX. Riegle Community Development and Regulatory Improvement Act of 1994

Section 302(b) of the Riegle Community Development and Regulatory Improvement Act of 1994, Public Law 103–325, 108 Stat. 2160 (1994), requires that, in general, new and amended regulations that impose additional reporting, disclosure, or other new requirements on insured depository institutions shall take effect on the first day of a calendar quarter. This restriction is inapplicable to the final rule, which does not impose such additional or new requirements.

List of Subjects in 12 CFR Part 327

Assessments, Bank deposit insurance, Banks, banking, Financing Corporation, Savings associations.

For the reasons stated in the preamble, the Board is amending part 327 of title 12 of the Code of Federal Regulations as follows:

³²The following hypothetical examples illustrate this concept. *Example 1.* (a) On April 15, 1996, the Board adjusts the assessment rate schedule upward by 3 basis points to 7-to-34 basis points. Notice-and-comment rulemaking is not required because the increase does not exceed the 5 basis-point adjustment maximum. (b) On October 16, 1996, the Board again increases the adjusted schedule by 3 basis points, to 10-to-37 basis points. Such action requires notice-and-comment rulemaking because it would result in an aggregate increase of more than 5 basis points. *Example 2.* (a) On April 15, 1996, the Board increases the rate schedule by 3 basis points to 7-to-34 basis points. Notice and comment rulemaking is not required. (b) On October 16, 1996, the Board decreases the previously-adjusted schedule by 2 basis points to 5-to-32 basis points. Rulemaking is not required because the change, in the aggregate, does not result in an increase or decrease of more than 5 basis points. (The change, in the aggregate, is a net increase of one basis point.) (3) On April 15, 1997, the Board adjusts rate schedule upward by 5 basis points. Such action requires notice-and-comment rulemaking because it would result in an aggregate increase of more than 5 basis points, taking into consideration the previous adjustments. In addition, notice-and-comment rulemaking would be required for any single step in either of these examples which by itself, without aggregation, would constitute an increase or decrease of more than 5 basis points.

PART 327—ASSESSMENTS

1. The authority citation for part 327 continues to read as follows:

Authority: 12 U.S.C. 1441, 1441b, 1817-1819.

2. Section 327.8 is amended by adding a new paragraph (i) to read as follows:

§ 327.8 Definitions.

(i) As used in § 327.9, the following terms have the following meanings:

(1) *Adjustment factor.* The maximum number of basis points by which the Board may increase or decrease Rate Schedule 2 set forth in § 327.9(a).

(2) *Assessment schedule.* The set of rates based on the assessment risk classifications of § 327.4(a) with a difference of 27 basis points between the minimum rate which applies to institutions classified as 1A and the maximum rate which applies to institutions classified as 3C.

3. Section 327.9 is amended by revising paragraph (a), removing paragraph (b), redesignating paragraph (c) as paragraph (d), and adding new paragraphs (b) and (c) to read as follows:

§ 327.9 Assessment rate schedules.

(a) *BIF members.* Subject to § 327.4(c), the annual assessment rate for each BIF member other than an institution specified in § 327.31(a) shall be the rate in the following Rate Schedules applicable to the assessment risk classification assigned by the Corporation under § 327.4(a) to that BIF member. Until the BIF designated reserve ratio of 1.25 percent is achieved, the rates set forth in Rate Schedule 1 shall apply. After the BIF designated reserve ratio is achieved, the rates set forth in Rate Schedule 2 shall apply. The schedules utilize the group and subgroup designations specified in § 327.4(a):

RATE SCHEDULE 1

Capital group	Supervisory subgroup		
	A	B	C
1	23	26	29
2	26	29	30
3	29	30	31

RATE SCHEDULE 2

Capital group	Supervisory subgroup		
	A	B	C
1	4	7	21
2	7	14	28
3	14	28	31

(b) *Rate adjustment; announcement—*
 (1) *Semiannual adjustment.* The Board may increase or decrease Rate Schedule 2 set forth in paragraph (a) of this section up to a maximum increase of 5 basis points or a fraction thereof or a maximum decrease of 5 basis points or a fraction thereof (after aggregating increases and decreases), as the Board deems necessary to maintain the reserve ratio at the BIF designated reserve ratio. Any such adjustment shall apply uniformly to each rate in the schedule. In no case may such adjustments result in a negative assessment rate or in a rate schedule that, over time, is more than 5 basis points above or below Rate Schedule 2, nor may any one such adjustment constitute an increase or decrease of more than 5 basis points. The adjustment factor for any semiannual period shall be determined by:

(i) The amount of assessment revenue necessary to maintain the reserve ratio at the designated reserve ratio; and

(ii) The assessment schedule that would generate the amount of revenue in paragraph (b)(1)(i) of this section considering the risk profile of BIF members.

(2) In determining the amount of assessment revenue in paragraph (b)(1)(i) of this section, the Board shall take into consideration the following:

(i) Expected operating expenses;

(ii) Case resolution expenditures and income;

(iii) The effect of assessments on BIF members' earnings and capital; and

(iv) Any other factors the Board may deem appropriate.

(3) *Announcement.* The Board shall:

(i) Adopt the semiannual assessment schedule and any adjustment thereto by means of a resolution reflecting consideration of the factors specified in paragraph (c)(2)(i) through (iv) of this section; and

(ii) Announce the semiannual assessment schedule and the amount and basis for any adjustment thereto not later than 45 days before the invoice date specified in § 327.3(c) for the first quarter of the semiannual period for which the adjusted assessment schedule shall be effective.

(c) *Special provisions.* The following provisions apply only with respect to the first time the BIF designated reserve ratio is achieved after 1994:

(1) Notwithstanding the provisions of § 327.3(c)(2) or § 327.3(d)(2), the Corporation may modify the time of the direct debit of the assessment payment which next occurs after the Board determines that the designated reserve ratio has been achieved;

(2) Notwithstanding the provisions of § 327.7(a)(3), if, as a result of the new rate schedule having gone into effect, an institution has overpaid its assessment, the Corporation shall provide interest on any such overpayment, as follows:

(i) For the first semiannual period of 1995, beginning on the date the new rate schedule goes into effect; and

(ii) For the second semiannual period of 1995, beginning on the date of the overpayment; and

(3) Notwithstanding the provisions of § 327.7(b)(3), the interest rate applicable to overpayments described in paragraph (c)(2) of this section shall be the arithmetic average of the overnight simple interest rates received by the Corporation on its U.S. Treasury investments for the period during which the Corporation held the overpayment amount.

* * * * *

By order of the Board of Directors.
 Dated at Washington, DC, this 8th day of August 1995.

Federal Deposit Insurance Corporation.
Jerry L. Langley,
Executive Secretary.
 [FR Doc. 95-20170 Filed 8-15-95; 8:45 am]
 BILLING CODE 6714-01-P

12 CFR Part 327
RIN 3064-AB59

Assessments; Retention of Existent Assessment Rate Schedule for SAIF-Member Institutions

AGENCY: Federal Deposit Insurance Corporation (FDIC).
ACTION: Final rule.

SUMMARY: This final rule retains the existing assessment rate schedule applicable to members of the Savings Association Insurance Fund (SAIF). The effect of this final rule is that the SAIF assessment rates to be paid by depository institutions whose deposits are subject to assessment by the SAIF will continue to range from 23 cents per \$100 of assessable deposits to 31 cents per \$100 of assessable deposits, depending on risk classification.

EFFECTIVE DATE: This final rule becomes effective September 15, 1995.

FOR FURTHER INFORMATION CONTACT: James R. McFadyen, Senior Financial Analyst, Division of Research and Statistics, (202) 898-7027, or Valerie Jean Best, Counsel, Legal Division, (202) 898-3812, Federal Deposit Insurance Corporation, Washington, D.C. 20429.

SUPPLEMENTARY INFORMATION: The Board of Directors of the FDIC (Board) is retaining the existing assessment rate