September 28, 2009

MEMORANDUM TO:	The Board of Directors
FROM:	Arthur J. Murton Director Division of Insurance and Research
SUBJECT:	Special Assessment, Restoration Plan and Proposal for Maintaining Fund Liquidity

# **SUMMARY**

Staff recommends that:

- 1. The FDIC not impose additional special assessments in 2009.
- 2. The FDIC maintain assessment rates at their current levels through the end of 2010 and immediately adopt a uniform 3 basis point increase in assessment rates effective January 1, 2011.
- 3. The FDIC establish and implement the attached Amended Restoration Plan to extend the restoration period from seven to eight years.
- 4. The FDIC authorize publication of the attached Prepaid Assessments Notice of Proposed Rulemaking and Request for Comment that would require insured institutions to prepay, on December 30, 2009, their estimated quarterly risk-based assessments for the fourth quarter 2009 and for all of 2010, 2011 and 2012. Staff estimates that total prepaid assessments would amount to approximately \$45 billion.

# **BACKGROUND AND PROJECTIONS**

# **Restoration Plan**

In October 2008, the Board adopted a Restoration Plan to return the Deposit Insurance Fund (DIF or the Fund) to its statutorily mandated minimum reserve ratio of 1.15 percent within five years.<sup>1</sup> In February 2009, given the extraordinary circumstances facing the banking industry, the Board amended its Restoration Plan to allow the Fund seven years to return to 1.15 percent.<sup>2</sup> In May 2009, Congress amended the statute governing establishment and

Concur:

Michael Bradfield General Counsel

<sup>&</sup>lt;sup>1</sup> 73 FR 61598 (Oct. 16, 2008). <sup>2</sup> 74 FR 9564 (Mar. 4, 2009).

implementation of the Restoration Plan to allow the FDIC up to eight years to return the DIF reserve ratio back to 1.15 percent, absent extraordinary circumstances.<sup>3</sup>

## The May 2009 Special Assessments Final Rule

In May 2009, to prevent the Fund balance from falling to a level close to or below zero, the Board adopted a final rule imposing a 5 basis point special assessment on each insured depository institution's total assets minus Tier 1 capital as of June 30, 2009, to be collected on September 30, 2009.<sup>4</sup> The amount of the special assessment for any institution, however, could not exceed 10 basis points of an institution's assessment base for the second quarter 2009 riskbased assessment. The final rule also provided that if, after June 30, 2009, the reserve ratio of the DIF were estimated to fall to a level that the Board believes would adversely affect public confidence or to a level that shall be close to or below zero at the end of any calendar quarter, the Board, by vote, may impose up to two additional special assessments in 2009 of up to 5 basis points each on all insured depository institutions based on each institution's total assets minus Tier 1 capital reported on the report of condition for that calendar quarter. Any single additional special assessment would, again, not exceed 10 basis points of the institution's assessment base for the corresponding quarter's risk-based assessment. The earliest possible date for imposing any such additional special assessment under the final rule would be September 30, 2009, with collection on December 30, 2009. The latest possible date for imposing any such additional special assessment under the final rule would be December 31, 2009, with collection on March 30, 2010.

The final rule also provided that:

Near the end of the third and fourth quarters of 2009, if there is a reasonable possibility that the reserve ratio has declined to a level that could undermine public confidence in federal deposit insurance or to a level which shall be close to or below zero, staff will estimate the reserve ratio for that quarter from available data on, or estimates of, insurance fund assessment income, investment income, operating expenses, other revenue and expenses, and loss provisions (including provisions for anticipated failures). Because no data on estimated insured deposits will be available until after the quarter-end, the FDIC will assume that estimated insured deposits will increase during the quarter at the average quarterly rate over the previous four quarters.<sup>5</sup>

Fund Balance/Reserve Ratio Projections

<sup>&</sup>lt;sup>3</sup> 12 U.S.C. §1817(b)(3)(E), as amended by the Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, §204(b), 123 Stat. 1649.

<sup>&</sup>lt;sup>4</sup> 74 FR 25639 (May 29, 2009).

<sup>&</sup>lt;sup>5</sup> 74 FR 25639, 25642.

Pursuant to these requirements, staff estimates that both the Fund balance and the reserve ratio as of September 30, 2009, will be negative. This reflects, in part, an increase in provisioning for anticipated failures. In contrast, cash and marketable securities available to resolve failed institutions remain positive.

Staff has also projected the Fund balance and reserve ratio for each quarter over the next several years using the most recently available information on expected failures and loss rates and statistical analyses of trends in CAMELS downgrades, failure rates and loss rates. Staff projects that, over the period 2009 through 2013, the Fund could incur approximately \$100 billion in failure costs. Staff projects that most of these costs will occur in 2009 and 2010. Approximately \$25 billion of the \$100 billion amount has already been incurred in failure costs so far in 2009. Staff projects that most of these costs will occur in 2009 and 2010.

If the Board imposes no further special assessments and leaves existing risk-based assessment rates in place, staff projects that the Fund balance would become significantly negative in 2010 and may remain negative until 2013. According to these projections the reserve ratio would not return to the statutorily mandated minimum reserve ratio of 1.15 percent until late 2018.

These projections are subject to considerable uncertainty. Losses could be less than or exceed projected amounts, for example, if conditions affecting the national or regional economies, prove less or more severe than is currently anticipated. Staff's current projection of \$100 billion in failure costs from 2009 through 2013 is higher than staff's projection in May of \$70 billion over the same period. Projected failures have increased due to further deterioration in the condition of insured institutions, as reflected in the increasing number of problem institutions. Asset quality problems among insured institutions are not expected to abate in the near-term.

### Liquidity Needs Projections

The projections in the preceding paragraphs address the effect of projected failures on the Fund balance (its net worth, which is assets minus liabilities), not the cash balance of the Fund, which provides needed liquidity. Staff has also estimated the FDIC's need for cash to pay for projected failures. At the beginning of this crisis, in June 2008, total assets held by the DIF were approximately \$55 billion, and consisted almost entirely of cash and marketable securities (i.e., liquid assets). As the crisis has unfolded, the liquid assets of the DIF have been used to protect depositors of failed institutions and have been exchanged for less liquid claims against the assets in failed institutions. As of June 30, 2009, while total assets of the DIF had increased to almost \$65 billion, cash and marketable securities had fallen to about \$22 billion. The pace of resolutions continues to put downward pressure on cash balances. While the less liquid assets in the DIF have value that will eventually be converted to cash when sold, the FDIC's immediate need is for more liquid assets to fund near-term failures.

Staff 's projections take into account recent trends in resolution methodologies, such as the increasing use of loss sharing—especially for larger institutions—which reduce the FDIC's immediate cash outlays, and the anticipated pace at which assets obtained from failed institutions

can be sold. If the FDIC took no action under its existing authority to increase its liquidity, the FDIC's projected liquidity needs would exceed its liquid assets on hand beginning in the first quarter of 2010. Through 2010 and 2011, liquidity needs could significantly exceed liquid assets on hand.

These projections are also subject to considerable uncertainty. Liquidity needs could exceed projected amounts if, for example, conditions affecting the national or regional economies, prove more severe than currently anticipated. Higher failure rates than projected would increase liquidity needs; lower failure rates would decrease liquidity needs. The liquidity needs projections are particularly influenced by assumptions regarding the types of resolution methods that will be employed, and the rate at which retained assets can be sold and converted into liquid assets.

# **RECOMMENDATIONS**

To ensure that the reserve ratio returns to 1.15 percent within the statutorily mandated period of time, to meet the FDIC's liquidity needs without imposing additional burdens on the industry during a period of stress, and to ensure that the deposit insurance system remains directly industry-funded, staff recommends that the Board:

- 1. Impose no further special assessments under the final rule adopted in May 2009;
- 2. Maintain assessment rates at their current levels through the end of 2010 and thereafter adopt a uniform 3 basis point increase in assessment rates effective January 1, 2011;<sup>6</sup>
- 3. Extend the Amended Restoration Plan to eight years; and
- 4. Require all institutions to prepay, on December 30, 2009, their estimated risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011, and 2012, at the same time that institutions pay their regular quarterly deposit insurance assessments for the third quarter of 2009. An institution would initially account for the prepaid assessments as a prepaid expense (an asset); the Fund would initially account for the amount collected as both an asset (cash) and an offsetting liability (deferred revenue). An institution's quarterly risk-based deposit insurance assessment thereafter would be offset by the amount prepaid until that amount is exhausted or until December 30, 2014,

<sup>&</sup>lt;sup>6</sup> In setting assessment rates, the FDIC's Board of Directors is authorized to set assessments for insured depository institutions in such amounts as the Board of Directors may determine to be necessary. 12 U.S.C. §1817(b)(2)(A). In so doing, the Board shall consider: (1) the estimated operating expenses of the DIF; (2) the estimated case resolution expenses and income of the DIF; (3) the projected effects of the payment on the capital and earnings of insured depository institutions; (4) the risk factors and other factors taken into account pursuant to 12 U.S.C. §1817(b) (1) under the risk-based assessment system, including the requirement under such paragraph to maintain a risk-based system; and (5) any other factors the Board of Directors may determine to be appropriate. 12 U.S.C. §1817(b)(2)(B). As reflected in the text, in making its projections of the Fund balance and liquidity needs, and in making its recommendations regarding assessment rates, staff has taken into account these statutory factors.

when any amount remaining would be returned to the institution. Staff estimates that total prepaid assessments would amount to approximately \$45 billion.

These recommendations are discussed in more detail below.

#### Special Assessments

Imposing an additional special assessment as provided for in the May 2009 final rule would bring in approximately \$5.5 billion in revenue to the Fund; imposing two (one at the end of September, one at the end of December) would bring in approximately \$11 billion in revenue. Given staff's projections, neither amount would prevent the Fund from becoming significantly negative or prevent the Fund's liquidity needs from exceeding its liquid assets on hand in 2010. Even combining these special assessments with higher risk-based assessment rates would not solve these problems, unless rates were set very high or more was collected in special assessments. Furthermore, any additional special assessment or immediate, large increase in assessment rates would impose a burden on an industry that is struggling to maintain positive earnings overall.

An alternative—borrowing from the Treasury or the Federal Financing Bank (FFB) would also increase the liquid assets available to fund future resolutions but would not increase the Fund balance as there would be a corresponding liability recorded. Nevertheless, the FDIC has several options for returning the reserve ratio to the statutorily mandated 1.15 percent and meeting its liquidity needs.

#### **Restoration Plan and Assessment Rates**

Staff projects that failures will peak in 2009 and 2010 and that industry earnings will have recovered sufficiently by 2011 to absorb a 3 basis point increase in deposit insurance assessments. Adopting a uniform increase in assessment rates of 3 basis points now, effective January 1, 2011, should ensure that the prepaid assessments would address current liquidity needs without materially impairing the capital or earnings of insured institutions. Advance adoption of the rate increase also should help institutions plan for future assessment expenses.

Under staff's projections, maintaining assessment rates at their current levels through the end of 2010 and immediately adopting a uniform 3 basis point increase in assessment rates effective January 1, 2011, would return the Fund to a positive balance in 2012 and the reserve ratio to 1.15 percent by the first quarter of 2017, one quarter later than the eight-year time frame under the proposed amendment to the Amended Restoration Plan. However, projections that far into the future are subject to considerable uncertainty. In any event, the Board could raise rates in the latter part of the eight-year period, if necessary to meet the eight-year time frame.

The industry reported aggregate income of just \$5.5 billion in the first quarter of 2009 and reported a loss of \$3.7 billion in the second quarter. During the current crisis, the industry's pre-provision income has generally remained strong; poor earnings have been driven primarily by high provisions for loan losses. Combined loan-loss provisions in the most recent five quarters exceeded \$300 billion. However, there have been recent indications that the economy

may have stopped contracting. A peak in loan charge-offs approximately one year after the economic trough would be consistent with prior downturns. Under this scenario, by 2011, as conditions improve, staff believes that provisions will be lower, industry earnings will be much stronger, and capital will be increasing. Consequently, a 3 basis point increase in initial assessment rates should have no material effect on capital and earnings of insured institutions.

## Notice of Proposed Rulemaking on Prepaid Assessments

To meet the FDIC's liquidity needs, staff proposes that the Board issue a Notice of Proposed Rulemaking (NPR) to require insured depository institutions to prepay their estimated risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011, and 2012. For purposes of calculating an institution's prepaid amount for the fourth quarter of 2009 and for all of 2010, that institution's assessment rate would be its total base assessment rate in effect on September 30, 2009.<sup>7</sup> That rate would be increased by 3 basis points in 2011 and 2012. Again for purposes of calculating the prepaid amount, an institution's third quarter 2009 assessment base would be increased quarterly at a 5 percent annual growth rate through the end of 2012. Staff proposes that the FDIC collect the prepaid assessments for the fourth quarter of 2009 and for all of 2010, 2011, and 2012 on December 30, 2009, along with the regular quarterly deposit insurance assessments for the third quarter of 2009.

Each institution would record the entire amount of its prepaid assessment as a prepaid expense (asset) as of December 30, 2009. As of December 31, 2009, and each quarter thereafter, each institution would record an expense (charge to earnings) for its regular quarterly assessment for the quarter and an offsetting credit to the prepaid assessment until the asset is exhausted. Once the asset is exhausted, the institution would record an expense and an accrued expense payable each quarter for its regular assessment, which would be paid in arrears to the FDIC at the end of the following quarter. If the prepaid assessment is not exhausted by December 30, 2014, any remaining amount would be returned to the institution.

The federal banking agencies' risk-based capital rules permit an institution to apply a zero percent risk weight to claims on U.S. Government agencies.<sup>8</sup> FDIC staff believes the prepaid assessment would qualify for a zero risk weight.

Upon further consideration, for the same reasons, FDIC staff believes that Temporary Liquidity Guarantee Program (TLGP) nondeposit debt obligations should also receive a zero percent risk weight consistent with the risk weight proposed for prepaid assessment assets. When FDIC staff determined that an institution may apply a 20 percent risk weight to debt covered by the TLGP, the determination referenced the 20 percent risk weight that has

<sup>&</sup>lt;sup>7</sup> An institution's risk-based assessment rate may change during a quarter when a new CAMELS rating is transmitted, or a new long-term debt-issuer rating is assigned. 12 CFR 327.4(f). For purposes of calculating the prepaid assessment, the FDIC will use the institution's CAMELS ratings and, where applicable, the long-term debt-issuer ratings, and the resulting assessment rate in effect on September 30, 2009.

<sup>&</sup>lt;sup>8</sup> See 12 CFR pt. 3, Appendix A (OCC); 12 CFR pts. 208 and 225, Appendix A (Federal Reserve Board); 12 CFR pt. 325, Appendix A (FDIC); and 12 CFR pt. 567, Appendix C (OTS).

traditionally been applied to assets covered by the FDIC's deposit insurance. Insofar as insured deposits are fully backed by the full faith and credit of the United States government and no insured depositor has ever or will ever take a loss, staff will also review reducing the risk weight on insured deposits to zero percent consistent with the treatment of other government backed obligations. The NPR will ask commenters to provide their views on the appropriateness of a different risk weight and the effect that any change would have on risk-weighted assets.

Although the FDIC's immediate liquidity needs would be resolved by the inflow of approximately \$45 billion in cash from the prepaid assessments, it would not initially affect the DIF balance. The DIF would initially account for the amount collected as both an asset (cash) and an offsetting liability (deferred revenue). An institution's quarterly risk-based deposit insurance assessment thereafter would be recognized by the DIF as revenue and offset by the amount prepaid until that amount is exhausted or until December 30, 2014, when any amount remaining would be returned to the institution. Unlike a special assessment, prepaid assessments would not immediately affect the DIF balance or depository institutions' earnings.

Staff is proposing prepaid assessments as a means of collecting enough cash to meet upcoming liquidity needs to fund future resolutions. Staff believes that this proposal has significant advantages compared to additional or higher special assessments. Additional or higher special assessments could severely reduce industry earnings and capital at a time when the industry is under stress. In addition, staff believes that most of the prepaid assessment would be drawn from available cash and excess reserves, which should not significantly affect depository institutions' current lending activities.

In staff's view, requiring that institutions prepay assessments is also preferable to borrowing from the U.S. Treasury or the Federal Financing Bank (FFB). Prepayment of assessments ensures that the deposit insurance system remains directly industry-funded. Additionally, staff believes that, unlike borrowing from the Treasury or the FFB, requiring prepaid assessments would not count toward the public debt limit. Finally, collecting prepaid assessments would be the least costly option to the Fund for raising liquidity as there would be no interest cost. However, staff recommends that the FDIC seek comment on these and other options in the NPR.

## Other Details for Proposed Prepaid Assessments

The attached NPR proposes that prepaid assessments could only be used to offset regular quarterly risk-based deposit insurance assessments. Under the proposal, prepaid assessments could not be used to offset other payments to the FDIC, such as FICO assessments, TLGP assessments, any future special assessments under FDI Act section 7(b)(5), or any future systemic risk assessments under FDI Act section 13(c)(4)(G)(ii).

The proposed rule would allow the FDIC to exercise its discretion as supervisor and insurer to exempt an institution from the prepayment requirement if the FDIC determines that the prepayment would adversely affect the safety and soundness of the institution. The FDIC would consult with the institution's primary federal regulator in making this determination, but would

retain the ultimate authority to exercise such discretion. Determinations of eligibility for exemption made by the FDIC would be final and not subject to further agency review.

In addition, an insured depository institution could apply to the FDIC for an exemption from the prepaid requirement if the prepayment would significantly impair the institution's liquidity or would otherwise create significant hardship. The FDIC would consider exemption requests on a case-by-case basis. Based on currently available data, staff does not expect the number of exemptions to significantly affect the amount of prepaid assessments that the FDIC would receive.

An insured depository institution would be permitted to transfer any portion of its prepaid assessment to another insured depository institution, provided that the institutions complied with certain notification requirements. This aspect of the proposal is similar to the procedural requirements associated with the transfer of the one-time assessment credit provided by the Federal Deposit Insurance Reform Act of 2005.<sup>9</sup>

In the event that an insured depository institution merged with, or consolidated into, another insured depository institution, the surviving or resulting institution would be entitled to use any unused portion of the disappearing institution's prepaid assessment not otherwise transferred. In the event that an institution's insured status terminates, any amount of its prepaid assessment remaining (other than any amounts needed to satisfy assessment obligations not yet offset against the prepaid amount) would be refunded to the institution. In the event of the failure of an insured depository institution, any amount of its prepaid assessment remaining (other than any amount of its prepaid assessment remaining (other than any amount of its prepaid assessment remaining (other than any amount of its prepaid assessment remaining (other than any amount of its prepaid assessment remaining (other than any amount of its prepaid assessment remaining (other than any amount of its prepaid assessment remaining (other than any amount of its prepaid assessment remaining (other than any amounts needed to satisfy assessment obligations not yet offset against the prepaid amount) would be refunded to the receivership estate.<sup>10</sup>

Requiring prepaid assessments would not preclude the FDIC from changing assessment rates or from further revising the risk-based assessment system during 2009, 2010, 2011, 2012, or thereafter, pursuant to notice-and-comment rulemaking under 12 U.S.C. 1817(b)(1). Prepaid assessments made by insured depository institutions would continue to be applied against quarterly risk-based assessments as they may be so revised.

#### Other Issues

Staff proposes that the NPR request comment on all aspects of this proposal and specifically request comment on the following questions:

- 1. As an alternative to prepaid assessments, should the FDIC meet its liquidity needs by imposing one or more special assessments?
- 2. Should the FDIC pursue one or more of the other alternatives to the prepaid assessments, such as borrowing from Treasury or the FFB?

<sup>&</sup>lt;sup>9</sup> Pub. L. No. 109-171, 120 Stat. 9, and implemented by regulation. See 12 CFR 327.34(c).

<sup>&</sup>lt;sup>10</sup> See 12 CFR 327.6 (2009).

- 3. Should prepaying assessments be voluntary rather than mandatory as currently contemplated, and, if so, how would the FDIC ensure that it receives sufficient cash to fund resolutions of failed insured depository institutions? (If prepayment of assessments were optional, the FDIC believes that it would affect the accounting treatment as a prepaid expense.)
- 4. For purposes of calculating the prepaid assessment, should the FDIC estimate the growth in the assessment base at a rate other than 5 percent for 2009, 2010, 2011 and 2012? Should the FDIC use different assessment rate assumptions than those proposed?
- 5. As proposed, the FDIC would require prepayment of estimated assessments for the fourth quarter of 2009 and for all of 2010, 2011 and 2012 based on its current liquidity needs projections. Should the FDIC require prepayment of estimated assessments over a different period or in installments?
- 6. Should the FDIC's Amended Restoration Plan incorporate a provision requiring a special assessment or a temporarily higher assessment rate schedule that brings the reserve ratio back to a positive level within a specified time frame (one year or less) from January 1, 2011, when the FDIC projects industry earnings will have recovered?

# Staff contacts:

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