

FDIC Proposed Rules to Implement the Federal Deposit Insurance Reform Act of 2005

By:
Charlotte M. Bahin
Lord Bissell & Brook LLP

After years of working to have deposit insurance reform legislation enacted by Congress, the Federal Deposit Insurance Reform Act of 2005 (the “Reform Act”) was signed into law in February 2006. During the almost ten-year debate, a number of controversial elements divided the Federal Deposit Insurance Corporation (“FDIC”), Members of Congress, the two Administrations and the industry. Compromise was reached on several important elements, and the law contains changes to a number of provisions affecting deposit insurance including the level of coverage, the amount of premiums to be charged, and appropriate level for the designated reserve ratio for the new combined Deposit Insurance Fund. While the Reform Act represents sweeping change in a number of areas, the amendments are the natural evolution from earlier changes made in 1989, 1991 and 1996.

Background

One of the fundamental changes granted the FDIC flexibility in establishing the designated reserve ratio and in determining the appropriate level of premiums necessary to protect the insurance fund. A companion bill to the Reform Act made technical amendments to the statute and requires a number of studies to be done. Congress included an aggressive rulemaking schedule in the statute, requiring that the necessary rules be issued by November 2006. The major changes include:

- After 25 years of no increases in the deposit insurance coverage levels, the coverage level for retirement accounts was raised to \$250,000, and beginning in 2011, the FDIC (and the NCUA) may increase the coverage levels for other accounts every five years to an inflation indexed amount.
- The Bank Insurance Fund and the Savings Association Insurance Fund were merged into a single fund, the Deposit Insurance Fund (“DIF”).
- The 1.25 percent designated reserve ratio (“DRR”) was replaced with a more flexible range that permits the FDIC to establish the DRR at a point between 1.15 percent and 1.5 percent. The DRR is to be established on an annual basis.
- The FDIC may manage how the DRR varies within the range. If the DRR falls below or is expected within six months to fall below 1.15 percent, the agency must adopt a restoration plan that requires the DRR to return to 1.15 percent within five years. If the reserve ratio exceeds 1.35 percent, the FDIC must dividend to the industry half of the amount necessary to maintain the fund at 1.35 percent, unless the FDIC suspends dividends, after considering certain factors. If the DRR exceeds 1.5 percent, the FDIC must dividend to the industry the amounts above the amount necessary to maintain the DIF at 1.5 percent.
- The elimination of any connection between the DRR and the assessment rates, granting the FDIC the discretion to price deposit insurance assessments according to the risk of the institutions.

- A grant of a one-time assessment credit of about \$4.7 billion in recognition of past contributions to the funds.

The timing of the collection of the assessments would change to the end of each quarter rather than in advance. The FDIC has proposed changes to the risk-based assessment system that will allow the agency to impose assessments that are much more sensitive to the risk presented by the institution. Further, the proposal would differentiate between small and large banks - those with under \$10 million in assets and those with more than \$10 million in assets. The assessment base is proposed to be based on average daily deposits for banks with \$300 million or more in assets. Finally, the Reform Act removes the prohibition from assessing healthy institutions when the fund is at or above the DRR and expected to maintain the DRR. Additional operational issues are addressed in the proposals issued to implement the statute, including new required signage and advertising materials for use by banks.

The FDIC has issued proposed rules to implement all of the changes requiring regulations. The agency plans to present the initial invoices for deposit insurance assessments to the industry in June 2007. The comment letter due date for the proposals to establish the reserve ratio and the risk-based assessment framework is September 22, 2006. The comment period for the proposal to implement the one time assessment credit closed in mid August.

Controversy Over the Proposals

As the FDIC has issued the proposals for comment, several elements of these proposals have become controversial. In addition, the FDIC chairman and staff have indicated in speeches and meetings that the industry as a whole should expect that deposit insurance assessments will be high in the short term.

Assessment Credits. The statute requires the FDIC determine the aggregate amount of the one-time assessment credit, which institutions are eligible to receive credits, and the amount of each eligible institution's credit. The amount of each eligible institution's credit is dependent on how the agency defines "successor" for these purposes. Further, the FDIC must establish the procedures for the application of assessment credits and provide a reasonable opportunity for banks to challenge administratively the amount of credit. The determination of the applicability of the assessment credit after such a challenge will be final and not subject to judicial review. The statute also includes additional limitations on the application of the assessment credits based on the health and capitalization of the institution and the deposit insurance fund. The FDIC proposes that the assessment credits be transferable.

The aggregate amount of the one-time assessment credit that will be distributed among the eligible institutions has been determined to be \$47 billion. The statute provides that the calculation to be used to reach the number is based on assessment rate of 10.5 basis points on the combined assessment rate for the BIF and the SAIF as of December 31, 2001.

For purposes of the proposal, an eligible institution is defined as one in existence on December 31, 1996 that paid assessments prior to that date or its successor. The amount of credit each institution will receive depends on the institution's assessment base on December 31, 1996

divided by the total of all eligible institution assessment bases combined on that date. The FDIC has proposed that the successors to institutions in existence on December 31, 1996 be determined by following the charters of those institutions rather than the deposits.

The controversy with this proposal is that there are a number of institutions currently operating that were not in existence on December 31, 1996, and are not successors to institutions that were in existence on that date, that have grown very quickly and therefore have very large assessment bases. These institutions have never paid a deposit insurance premium and will not get the benefit of an assessment credit, based on the current proposal. In addition, one of the proposed changes to the risk-based assessment regulation is to require that de novo institutions - those that have been in existence less than seven years - will be assessed at a higher rate than more mature institutions. Depending on the age of these institutions, the assessment they are charged may be even higher. These rapidly growing, newer institutions have written to the FDIC about their concerns with the credit allocation. Further, several members of the Senate Committee on Banking Housing and Urban Development have weighed in with the FDIC.

The FDIC has created a calculator for institutions to use in determining their assessment credit. It can be found on the FDIC website.

Establishment of the Designated Reserve Ratio. A second area that is generating comment is the FDIC's proposal to establish the DRR for the Deposit Insurance Fund at 1.25 percent. The Reform Act requires that the FDIC set a designated reserve ratio that may not exceed 1.5 percent of estimated insured deposits or be less than 1.15 percent of estimated insured deposits. Any changes to the DRR must be made by regulation after notice and comment. The FDIC must take several factors into account as they establish the DRR, including the risk of losses to the DIF in current and future years; the economic conditions generally affecting insured depository institutions; that sharp swings in assessment rates should be prevented; and other factors the FDIC considers appropriate.

A significant change made by the Reform Act was to separate the level of the DRR from the establishment of assessment rates. The FDIC does not have to bring the DRR up to a particular level within a specified time frame. The agency can use the DRR for different roles rather than as a trigger for determining whether deposit insurance assessments are necessary. One of the roles for the DRR would be to signal what the FDIC believes the optimal reserve ratio should be. The agency believes this would be useful to the industry in planning for future assessments.

Because the proposal issued by the FDIC has a DRR of 1.25 percent, one of the concerns expressed is how quickly the agency believes that goal should be achieved. The required use of the assessment credits will limit the assessment revenue and if the agency decides that the DRR is to be 1.25 percent and the current rate of deposit growth continues, increased assessments may be necessary to reach the DRR within a short time. The view of commenters is that the FDIC should not impose higher assessments just to reach the proposed DRR of 1.25 percent more quickly. A slower build up of the DRR is suggested.

Risk-Based Assessments. Since 1991, the FDIC has been required to have a risk-based deposit insurance system in place. The current system places institutions into risk categories based on

two criteria: capital levels and supervisory ratings. The current matrix used to determine the risk based assessment for institutions contains nine cells. About 95 percent of the industry is in the IA category and does not pay assessments.

The proposal consolidates the nine cells into four. Risk category 1 would have minimum and maximum assessment rates of two to four basis points. Based on data as of June 30, 2006, about 45 percent of institutions in Risk Category 1 would pay the minimum rate. An exception is proposed for de novo institutions or institutions less than seven years old. These institutions would be treated differently and would pay the maximum assessment rate as a result of their unique risk characteristics. This group represents 11 percent of all institutions.

The proposal uses a combination of CAMELS component ratings and financial ratios to determine risk-based assessment rates for small institutions. Additional information would be considered for larger institutions. For example, the information might include market data, financial performance and conditions data and stress considerations. The proposal is complex and one of the criticisms is that it is not transparent enough for institutions to use to determine their assessments. Another controversy is over whether de novo institutions should be required to pay higher assessments. The FDIC cites studies that indicate that de novos have a riskier profile.

Impact of These Changes on Banks

From a compliance and operations perspective, insured institutions need to be aware of several of the changes and from a budget perspective. Institutions need to watch the final rules that the FDIC will issue establishing the reserve ratio, the risk based premium framework and implementing the one time assessment credit. Disclosures and signage in the bank and its branches will have to change and the impact of having a deposit insurance premium for the first time in ten years will have to be factored into the budgeting process.