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HISTORY OF THE FDIC'S REBATE AUTHORITY

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The authority of the FDIC to rebate certain assessment income was established under the Federal Deposit Insurance Act of 1950 and remained in effect until January 1, 1994, when the FDIC's permanent risk-based deposit insurance pricing system became effective. A brief history of the rebate authority follows.

Background

The establishment of federal deposit insurance under the Banking Act of 1933 and the corresponding improvement in bank supervision and management contributed to a period of recovery and prosperity in banking that witnessed few bank failures. Beginning in 1934, the investment income generated from the deposit insurance fund covered a increasing portion of the losses and operating expenses of the FDIC. As early as 1942, the losses and operating expenses were covered completely by investment and other income, leaving the full amount of deposit insurance assessment income to accumulate in the deposit insurance fund. While the deposit insurance fund grew from $292 million in 1934 to $1.2 billion in 1949, the ratio of the deposit insurance fund to insured deposits -- the reserve ratio -- remained stable; the reserve ratio was 1.61 percent at year-end 1934, and 1.57 percent at year-end 1949.[1]

The growing deposit insurance fund and stable reserve ratio led to discussions on whether and how the deposit insurance assessment rate could be lowered; this issue was among those addressed in the Federal Deposit Insurance Act (FDI Act) of 1950.[2] However, because the FDIC had not been tested by a major business depression during this period, the adequacy of its deposit insurance fund remained unknown. Rather than reducing the deposit insurance assessment rate, which was set by statute at 1/12 of 1 percent, or 8.33 basis points, the FDI Act of 1950 altered the assessment process by establishing a system to provide credits to insured banks in years in which assessment income exceeded losses and expenses. The intent was to provide a flexible means of reducing assessments paid by banks in normal years, while retaining the ability to utilize the full assessment when needed in bad years.

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[1]Table 1, column A (attached), shows the reserve ratio -- the ratio of the deposit insurance fund to estimated insured deposits -- for the Bank Insurance Fund from 1934 through 1996.

[2]The FDI Act of 1950 created a separate body of deposit insurance law known as the "Federal Deposit Insurance Act" by removing the existing deposit insurance law from Section 12B of the Federal Reserve Act. The rebate or assessment credit system was one of several revisions to the deposit insurance law enacted by the FDI Act.

The Assessment Credit System

Two provisions of Section 7 of the FDI Act expressly addressed the return of assessments to insured banks. Section 7(d) established an assessment credit scheme designed to rebate a portion of assessment income after subtracting operating expenses and insurance losses -- net assessment income -- to banks. The assessment credit scheme of Section 7(d) provided that the FDIC would retain in the deposit insurance fund 40 percent of the net assessment income received in a given year and that the balance -- 60 percent of net assessment income -- would be credited pro rata to insured banks to be applied toward the payment of their deposit insurance assessment for the following semiannual assessment period(s). Net assessment income was defined as gross assessment income less: (1) operating costs and expenses; (2) additions to reserves to provide for insurance losses; and (3) insurance losses sustained plus losses from preceding years in excess of reserves. In the event that current assessment income was insufficient to cover operating costs, reserves, and losses, any shortfall was to be funded from assessments due in subsequent years. The assessment credit formula returned current net assessment income only; there was no rebate of investment income.

The second provision under the FDI Act, found in Section 7(e), provided the FDIC with the authority to use alternative methods to return to banks overpayments of assessments not due to the FDIC, that is, assessments made in error. Under Section 7(e), the FDIC may provide either a refund or a credit against future assessments to return funds to which it is not entitled. This provision has remained unchanged since its enactment in 1950 with the exception that in 1989 the term "insured bank" was changed to "insured depository institution" to reflect the assumption of insurance responsibility for thrift institutions by the FDIC.

Modifications to the Assessment Credit System

Over time, the assessment credit system has been modified. Under the Act of July 14, 1960, the percentage of net assessment income retained in the deposit insurance fund was reduced from 40 percent to 33.33 percent, thereby increasing the percentage rebated to insured banks. In 1980, the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) restored the percentage of net assessment income retained in the deposit insurance fund to 40 percent of net assessment income. DIDMCA also tied the amount of the rebate to the status of the reserve ratio in the following manner:

- If the reserve ratio was less than 1.10 percent, the FDIC Board of Directors (Board) was required to increase the percentage of net assessment income retained in the deposit insurance fund to an amount (not to exceed 50 percent of net assessment income) that would restore the reserve ratio to at least 1.10 percent.

- o If the reserve ratio exceeded 1.25 percent, the Board was authorized to reduce the percentage of net assessment income retained by the deposit insurance fund by an amount that would result in maintaining the reserve ratio at not less than 1.25 percent.

- o Finally, if the reserve ratio exceeded 1.40 percent, the Board was required to reduce the percentage of net assessment income retained by the deposit insurance fund by an amount that would result in maintaining the reserve ratio at not more than 1.40 percent.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) established the Savings Association Insurance Fund (SAIF) to replace the defunct Federal Savings and Loan Insurance Fund and renamed the deposit insurance fund the Bank Insurance Fund (BIF). A designated reserve ratio (DRR) with an initial target level of 1.25 percent was established for each deposit insurance fund under FIRREA.[3] FIRREA specified certain flat annual assessment rates to be in effect for each deposit insurance fund through 1991. FIRREA also provided the Board with limited authority to increase assessment rates as needed to protect the fund and restore its reserve ratio to the target level within a reasonable amount of time.

FIRREA also authorized the Board to increase the DRR target level to 1.50 percent as justified by circumstances that raise a significant risk of substantial future losses to the deposit insurance fund. If the DRR was increased above 1.25 percent, the excess above the 1.25 percent was to segregated in a "supplemental reserve." The income from any supplemental reserves was to be distributed annually to the members of the respective insurance fund through an Earnings Participation Account.[4] To the extent that the supplemental reserves were not needed to satisfy the following year's projected DRR, those amounts were to be returned to insured banks. FIRREA also barred any assessment credits until the DRR was achieved. If forecasts indicated that the DRR would be achieved the following year, the Board was required to provide assessment credits for the following year equal to the lesser of (1) the amount necessary to reduce the fund ratio to the DRR, or (2) 100 percent of the net assessment income to be received in that following year.

By providing the FDIC with the authority to adjust assessment rates upward to ensure that the funds received sufficient revenue, the FDIC Assessment Rate Act of 1990 introduced greater flexibility in the timing and amount of assessment rates. It also eliminated the 1.50 percent DRR

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[3]Under FIRREA, deposit insurance assessments and the DRR for the BIF and the SAIF must be set independently.

[4]The distribution of earnings on supplemental reserves to fund members through an Earnings Participation Account was the first time Congress had provided any mechanism for returning investment income to the industry. All other rebates or assessment credits were intended for current net assessment revenue only.

ceiling and the requirement that the investment income on any supplemental reserves be distributed annually.

In 1990, the FDIC Assessment Rate Act introduced greater flexibility in the timing and amount of assessment rates. The FDIC was provided with the authority to adjust assessment rates upward to ensure that the funds received sufficient revenue. The 1.50 percent DRR ceiling and the Earnings Participation Accounts and requirement that the investment income on any supplemental reserves be distributed annually were eliminated.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) fundamentally changed the assessment process by (1) establishing a system of risk-based deposit insurance premiums; (2) imposing a minimum level of assessments on insured institutions to be in effect if the deposit insurance fund reserve ratio was less than the DRR[5] ; and (3) requiring the Board to set rates semiannually to maintain the reserve ratio at the DRR, once the DRR had been achieved. FDICIA also eliminated the provision for supplemental reserves established under FIRREA; as the Board had not increased the DRR above 1.25 percent, that provision never became effective. The Congress viewed the rebate authority as being obsolete in view of the flexibility granted to the Board to set risk-based premiums. Therefore, FDICIA removed Section 7(d) from the FDI Act, effective January 1, 1994, when the FDIC's permanent risk-based pricing system took effect. The Congress appears to have intended that reduced assessments would operate in lieu of rebates.[6]

Effective Premiums Under the Rebate Authority

The FDIC utilized its rebate authority from 1950 through 1984. By providing assessment credits, the effective assessment rate paid by insured banks was lower than the statutory annual assessment rate of 8.33 basis points. The effective assessment rate paid by insured banks during this period is shown in Table 1, column B (attached).

Insurance losses and expenses began to increase during the early 1980s; by 1984 they had risen to a point where there was little net assessment income to rebate. Due to the size of loss allowances approved by the Board, the banking industry did not receive an assessment credit in 1985. Similarly, deteriorating economic conditions and rising insurance losses from the increased number of bank failures kept the banking industry from receiving assessment credits from 1986 through 1993.

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[5]Prior to the recapitalization of the BIF in May 1995 and the full capitalization of the SAIF in December 1996, the minimum assessment was equivalent to a weighted average of 23 basis points for BIF-assessable deposits and 18 basis points for SAIF-assessable deposits.

[6]See, discussion of Section 212(e)(3) in the Senate Report on S.543 (which became the language of Section 302(a) of FDICIA). 138 Cong. Rec. S2073 (daily ed. Feb. 21, 1992.).

Current Issues

The elimination of the assessment credit system and the ability to rebate current assessment revenue became a point of discussion as the BIF approached recapitalization in early 1995. Under FIRREA, the average annual assessment rate for deposits insured by the BIF was required to be 23 basis points until the BIF had recapitalized fully. However, after the BIF reserve ratio reached the statutorily mandated DRR of 1.25 percent of estimated insured deposits, the Board was required by statute to set assessment rates to (1) "maintain" the fund reserve ratio at the DRR and (2) reflect the risk posed to the insurance fund by individual institutions, that is, risk-based assessment rates.[7] As a result, the Board faced potentially conflicting statutory directives. Moreover, regardless of the assessment rates set by the Board, it was likely given the state of the current economy that the investment income alone could cause the BIF to continue to grow so that its reserve ratio would exceed the DRR.

In the discussions that ensued, it was argued by some that the reserve ratio should be maintained precisely at the DRR, and that the FDIC should return assessments -- current and past -- to do so. However, the FDIC argued that this view was inconsistent with the statutory history of Sections 7(d) and 7(e) and Congressional intent.[8] In the August 1995 final rulemaking that lowered BIF assessment rates, the Board adopted an interpretation of the statutory directive to maintain the reserve ratio at the DRR, where the DRR was viewed as a target around which the actual reserve ratio would fluctuate. In this way, the potentially conflicting statutory directives were addressed.

The Deposit Insurance Funds Act of 1996 (Funds Act) effectively reestablished rebate authority for the BIF, under the terminology of "refunds." Under the Funds Act, at the end of each semiannual period the FDIC is required to refund any balance in the fund that exceeds the amount required to meet the DRR, subject to two limitations. First, the amount of the refund cannot exceed the assessments paid by a member during the semiannual period; and second, refunds cannot be paid to institutions that are not well capitalized or that "exhibit financial, operational, or compliance weaknesses ranging from moderately severe to unsatisfactory." The first condition precludes the FDIC from paying refunds to institutions subject to an assessment rate of zero. The second condition bars refunds to all but the best-rated institutions -- those rated 1A -- under the risk-based premium system. Since the beginning of 1996, the assessment rate for BIF members rated 1A has been zero, so the refund authority could not be utilized. The Funds Act also provides for the possible merger of the two insurance funds, after which all insured

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[7]As well, a minimum semiannual assessment of $1,000 per insured institution was required by statute. This requirement was eliminated by the Deposit Insurance Funds Act of 1996.

[8]The FDIC no longer had the authority to rebate current assessment revenue, as Section 7(d) had been eliminated under FDICIA; Section 7(e) applied only to assessments made in error and did not constitute a rebate authority. <u>See</u>, discussions in 69 FR 9274 (February 16, 1995) and 60 FR 42685 (August 16, 1995).

institutions would be eligible for refunds, subject to the above limitations.

August 25, 1997

Note:
This memo was prepared August 1997. Table 1 is no longer available, but the information can be found in the in the FDIC's *Annual Report* (statistical table "Insured Deposits and the Bank Insurance Fund") available online at:
http://www.fdic.gov/about/strategic/report/1996/table4.html

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History of the FDIC's Deposit Insurance Assessment System

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The development of optimal policies regarding the adequacy of the deposit insurance funds and related assessment issues will benefit from an examination of the historical background in which these policies have been addressed over the course of the FDIC's existence. The purpose of this memo is to provide an historical overview of the development of federal deposit insurance and the underlying assessment system. This overview is intended to serve as a framework for the informed consideration of FDIC assessment policies.

Federal Deposit Insurance: 1933 - 1950

Section 8 of the Banking Act of 1933 established the Federal Deposit Insurance Corporation through an amendment to Section 12(b) of the Federal Reserve Act. As amended, Section 12(b) provided for two deposit insurance plans: a temporary plan that was initiated on January 1, 1934, and a permanent plan that was to become effective on July 1, 1934. The necessary capital to establish the FDIC was provided by the U.S. Treasury, which contributed $150 million, and the 12 Federal Reserve district banks, each of which subscribed to Class B capital stock in an amount equal to one-half of its surplus as of January 1, 1933.

Under the temporary plan, deposit insurance coverage was established at $2,500 per depositor of each insured institution, although six months later, on July 1, 1934, the Congress increased coverage to $5,000. Banks were assessed an amount equal to one-half of 1 percent, or 50 basis points, of insured deposits for deposit insurance. One-half of the assessment was payable at once, while the remaining half was payable upon call by the FDIC. Membership in the Temporary Deposit Insurance Fund was required of Federal Reserve-member banks as of January 1, 1934; other banks were authorized to join upon appropriate certification of their solvency and examination by, and approval of, the FDIC. The Congress twice extended the life of the Temporary Deposit Insurance Fund – for an additional year, followed by an additional two months.

A revised permanent plan for deposit insurance, enacted by the Banking Act of 1935, became effective in August of that year.[1] Under the permanent deposit insurance

[1] The "new" permanent deposit insurance plan enacted by the Banking Act of 1935 differed significantly from the "original" permanent deposit insurance plan. Mandatory membership in the Federal Reserve System was no longer required for participation in federal deposit insurance. Deposit insurance coverage was not increased as planned, but was maintained at $5,000; the "original" permanent plan would have

plan, deposit insurance coverage remained at $5,000 per depositor. The annual deposit insurance assessment rate was reduced and the assessment base was expanded, which resulted in an assessment rate of one-twelfth of 1 percent, or 8.33 basis points of *total (adjusted) deposits*.[2] During Congressional hearings on the revised permanent plan, the FDIC had argued that an annual average rate of one-third of 1 percent, or 33.3 basis points, of total deposits would have been required to cover the losses on deposit balances in failed banks from 1865 - 1934. When the "crisis" years in which losses were exceptionally high were eliminated from this calculation, the rate that reflected the relevant loss experience was reduced to one-twelfth of 1 percent of total deposits.[2] This annual rate of 8.33 basis points of total (adjusted) deposits was adopted by the Banking Act of 1935 and became the statutorily determined price for deposit insurance coverage.

The Banking Act of 1935 also revised other provisions of the existing deposit insurance law with the intent to conserve the resources of the deposit insurance fund while allowing the banking industry to continue to strengthen its capital and reserve positions. For example, the Act introduced stricter entrance standards for new banks seeking deposit insurance coverage and expanded the authority of the FDIC over the actions of existing banks and the handling of bank failures.

The establishment of federal deposit insurance, in conjunction with improved bank supervision and management, contributed to a period of recovery and prosperity in banking that witnessed few bank failures. As a result, the deposit insurance fund grew. Beginning in 1934, the investment income generated from the deposit insurance fund covered an increasing portion of the losses and operating expenses of the FDIC. As early as 1942, the losses and operating expenses were covered completely by investment and other income, leaving the full amount of deposit insurance assessment income to accumulate in the deposit insurance fund. While the deposit insurance fund grew from $292 million in 1934 to $1.2 billion in 1949, the ratio of the deposit

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covered 100 percent of the net amount due to a depositor not exceeding $10,000, 75 percent of the net amount exceeding $10,000 but not exceeding $50,000, and 50 percent of the net amount exceeding $50,000. The assessment rate was set at one-twelfth of 1 percent of total (adjusted) deposits; under the "original" permanent plan participating banks were to subscribe to stock in the Corporation equal in amount to one-half of 1 percent of their total deposits, and under certain conditions were to have been subject to assessments of one-fourth of 1 percent of their deposits. <u>See</u>, FDIC 1935 *Annual Report*, pp. 7 - 11.

[2]The assessment base is defined in the FDIC's rules and regulations as total (adjusted) deposits. Total domestic deposits – demand deposits and time and savings deposits – are adjusted for items such as unposted credits, unposted debits, and a float allowance of 16 2/3 percent for demand deposits and 1 percent for time and savings deposits. <u>See</u>, 112 CFR 327.4(b). Data on these deposits currently are reported by banks in the Report of Income and Condition (Call Report), by thrifts in the Thrift Financial Report (TFR), and by insured branches of foreign banks in the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks.

[3]Federal Deposit Insurance Corporation, *The First Fifty Years: A History of the FDIC, 1933-1983,*

insurance fund to insured deposits – the reserve ratio – remained stable, reflecting the rapid growth in insured deposits during the 1940s. The reserve ratio was 1.61 percent at year-end 1934, and 1.57 percent at year-end 1949.[4]

As the deposit insurance fund approached and then exceeded $1 billion, many observers felt that the fund was sufficient to meet foreseeable economic contingencies. At this time, the Congress mandated that the FDIC repay its original capital subscriptions. Between 1947 and 1948, the FDIC repaid in full the $289 million initially subscribed by the U.S. Treasury and the Federal Reserve Banks. Also at this time, based on 15 years of experience, the FDIC supported certain revisions to the deposit insurance law; these were adopted under the Federal Deposit Insurance Act of 1950.

The Federal Deposit Insurance Act of 1950

Enacted on September 21, 1950, the Federal Deposit Insurance Act of 1950 (FDI Act) created a separate body of deposit insurance law, known as the "Federal Deposit Insurance Act," by removing the existing deposit insurance law from Section 12B of the Federal Reserve Act. The FDI Act increased deposit insurance coverage from $5,000 to $10,000, in part to reflect the increase in the level of general prices over the previous 15 years and to maintain the real value of coverage provided to depositors. The assessment base continued to be measured by total (adjusted) deposits, although modifications to the calculation of the base were introduced.

The assessment rate of 8.33 basis points was retained by the FDI Act. Concerns about the level of premiums and a growing deposit insurance fund were addressed through a system of assessment credits, or rebates. This system is discussed at length below. Assessments are addressed in Section 7 of the FDI Act and Part 327 of the FDIC Rules and Regulations.

The Assessment Credit System

The continued growth of the deposit insurance fund led to discussions on whether and how the deposit insurance assessment rate could be lowered. During Congressional hearings preceding the passage of the FDI Act, it was argued that the effective assessment rate should be one that just maintained the deposit insurance fund at $1 billion.[5] The FDIC had not been tested by a major business depression during

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(Washington, D.C.: FDIC, 1983), 57.

[4]Table 1, column A (attached), shows the reserve ratio – the ratio of the deposit insurance fund to estimated insured deposits – for the Bank Insurance Fund from 1934 through 1996.

[5]*The First Fifty Years*, 58.

this period, and the adequacy of its deposit insurance fund remained unknown. Because the FDIC was concerned that the accumulated earnings of the fund might not be sufficient to cover the losses from expected bank failures, it was reluctant to see the assessment rate reduced below the statutorily mandated rate of 8.33 basis points per year. As noted in the FDIC's 1950 *Annual Report*[6]:

> The studies of the Corporation had not determined that the accumulated fund was adequate, nor had they determined what would be an adequate fund. In judging the adequacy of the fund its relation to the Corporation's potential liability as an insurer must be given consideration. When compared with the [billions] of deposits in insured banks, the margin of protection is not large.

As a compromise, the FDI Act granted the FDIC the authority to rebate certain assessment income, thereby lowering effective assessment rates. Rather than reducing the deposit insurance assessment rate, the FDI Act altered the assessment process by establishing a system to provide credits to insured banks in years in which assessment income exceeded losses and expenses. The intent was to provide a flexible means of reducing assessments paid by banks in normal years, while retaining the ability to utilize the full assessment when needed in bad years. The assessment credit system remained in place until the permanent risk-based deposit insurance system became effective January 1, 1994, although no credits were given after 1984 because of mounting losses.

Two provisions of Section 7 of the FDI Act expressly addressed the return of assessments to insured banks. Section 7(d) established an assessment credit scheme designed to rebate a portion of assessment income after subtracting operating expenses and insurance losses – net assessment income – to banks. The assessment credit scheme of Section 7(d) provided that the FDIC would retain in the deposit insurance fund 40 percent of the net assessment income received in a given year and that the balance – 60 percent of net assessment income – would be credited pro rata to insured banks to be applied toward the payment of their deposit insurance assessment for the following semiannual assessment period(s). Net assessment income was defined as gross assessment income less: (1) operating costs and expenses; (2) additions to reserves to provide for insurance losses; and (3) insurance losses sustained plus losses from preceding years in excess of reserves. In the event that current assessment income was insufficient to cover operating costs, reserves, and losses, any shortfall was to be funded from assessments due in subsequent years. The assessment credit formula returned current net assessment income only; there was no rebate of investment income.

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[6]Federal Deposit Insurance Corporation, *1950 Annual Report*, (Washington, D.C.: FDIC, 1950), 5.

The second provision under the FDI Act, found in Section 7(e), provided the FDIC with the authority to use alternative methods to return to banks overpayments of assessments not due to the FDIC, that is, assessments made in error. Under Section 7(e), the FDIC may provide either a refund or a credit against future assessments to return funds to which it is not entitled. This provision has remained unchanged since its enactment in 1950 with the exception that in 1989 the term "insured bank" was changed to "insured depository institution" to reflect the assumption of insurance responsibility for thrift institutions by the FDIC.

Modifications to the Assessment Credit System. Over time, the assessment credit system was modified. Under the Act of July 14, 1960, the percentage of net assessment income retained in the deposit insurance fund was reduced from 40 percent to 33.33 percent, thereby increasing the percentage rebated to insured banks. In 1980, the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) restored the percentage of net assessment income retained in the deposit insurance fund to 40 percent of net assessment income.

The assessment credit system was linked specifically to the deposit insurance fund's reserve ratio under DIDMCA. The amount of the rebate was tied to the status of the reserve ratio in the following manner. If the reserve ratio was less than 1.10 percent, the FDIC Board of Directors (Board) was required to increase the percentage of net assessment income retained in the deposit insurance fund to an amount (not to exceed 50 percent of net assessment income) that would restore the reserve ratio to at least 1.10 percent. If the reserve ratio exceeded 1.25 percent, the Board was authorized to reduce the percentage of net assessment income retained by the deposit insurance fund by an amount that would result in maintaining the reserve ratio at not less than 1.25 percent. Finally, if the reserve ratio exceeded 1.40 percent, the Board was required to reduce the percentage of net assessment income retained by the deposit insurance fund by an amount that would result in maintaining the reserve ratio at not more than 1.40 percent.

On August 9, 1989, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) was enacted. The primary goal of FIRREA was to address the financial crisis facing the thrift industry. The duties of the FDIC were expanded as the law made fundamental changes in the way banks and savings associations were supervised and insured. Several modifications affected the deposit insurance fund and the assessment process.

FIRREA established the Savings Association Insurance Fund (SAIF) to replace the defunct Federal Savings and Loan Insurance Fund and renamed the existing bank deposit insurance fund the Bank Insurance Fund (BIF). A designated reserve ratio (DRR) with an initial target level of 1.25 percent was established for each deposit insurance fund. FIRREA gave the FDIC the authority to administer both insurance funds, specifying that deposit insurance assessments and the DRR for the BIF and the SAIF were to be set independently.

FIRREA granted the Board limited authority to increase assessment rates as needed to protect the fund(s) and specified certain flat annual assessment rates that were to be in effect for each deposit insurance fund through 1991. In 1990 the assessment rate was increased from 8.33 basis points to 12 basis points. For the first six months of 1991 the assessment rate was increased to 19.5 basis points and for the last six months the rate was increased to 23 basis points.[7]

The Board was directed to restore the reserve ratio of the deposit insurance funds to the DRR within a reasonable amount of time, and a recapitalization schedule for the BIF was established. The BIF recapitalization schedule, capitalization of the SAIF, and assessment rates for the BIF and the SAIF are discussed in a separate section of this paper.

FIRREA also authorized the Board to increase the DRR target level to 1.50 percent as justified by circumstances that raise a significant risk of substantial future losses to the deposit insurance fund. If the DRR was increased above 1.25 percent, the amount above the 1.25 percent was to be segregated in a "supplemental reserve." The income from any supplemental reserves was to be distributed annually to the members of the respective insurance fund through an Earnings Participation Account.[8] To the extent that the supplemental reserves were not needed to satisfy the following year's projected DRR, those amounts were to be returned to insured banks.

FIRREA also barred any assessment credits until the DRR was achieved. If forecasts indicated that the DRR would be achieved the following year, the Board was required to provide assessment credits for the following year equal to the lesser of (1) the amount necessary to reduce the fund ratio to the DRR, or (2) 100 percent of the net assessment income to be received in that following year.

In 1990, the FDIC Assessment Rate Act introduced greater flexibility in the timing and amount of assessment rates. The FDIC was provided with the authority to adjust assessment rates upward to ensure that the funds received sufficient revenue. The 1.50 percent DRR ceiling and the requirement that the investment income on any supplemental reserves be distributed annually were eliminated.

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[7]The 1991 rate changes reflect the flexibility granted under the FDIC Assessment Rate Act, which is discussed below.

[8]The distribution of earnings on supplemental reserves to fund members through an Earnings Participation Account was the first time Congress had provided any mechanism for returning investment income to the industry. All other rebates or assessment credits were intended for current net assessment revenue only.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) fundamentally changed the assessment process by: (1) establishing a system of risk-based deposit insurance premiums; (2) imposing a minimum level of assessments on insured institutions to be in effect if the deposit insurance fund reserve ratio was less than the DRR;[9] and (3) requiring the Board to set rates semiannually to maintain the reserve ratio at the DRR, once the DRR had been achieved.[10] FDICIA also eliminated the provision for Earnings Participation Accounts and supplemental reserves established under FIRREA.[11] The Congress viewed the rebate authority as being obsolete in view of the flexibility granted to the Board to set risk-based premiums. FDICIA removed Section 7(d) from the FDI Act, effective January 1, 1994, when the FDIC's permanent risk-based pricing system took effect. The Congress appears to have intended that reduced assessments would operate in lieu of rebates.[12]

Effective Premiums Under the Rebate Authority. The FDIC utilized its rebate authority from 1950 through 1984. By providing assessment credits, the effective assessment rate paid by insured banks was lower than the statutory annual assessment rate of 8.33 basis points. The effective assessment rate paid by insured banks during this period is shown in Table 1, column B (attached).

Insurance losses and expenses began to increase during the early 1980s; by 1984 they had risen to a point where there was little net assessment income to rebate. Due to the size of loss allowances approved by the Board, the banking industry did not receive an assessment credit in 1985. Similarly, deteriorating economic conditions and rising insurance losses from the increased number of bank failures kept the banking industry from receiving assessment credits from 1986 through 1993.

Current Status of the FDIC's Rebate Authority. The elimination of the assessment credit system and the ability to rebate current assessment revenue became a point of discussion as the BIF approached recapitalization in early 1995. Under FIRREA, the average annual assessment rate for deposits insured by the BIF was required to be 23 basis points until the BIF had recapitalized fully. However, after the BIF reserve ratio reached the statutorily mandated DRR of 1.25 percent of estimated

[9] Prior to the recapitalization of the BIF in May 1995 and the full capitalization of the SAIF in December 1996, the minimum assessment was equivalent to a weighted average of 23 basis points for BIF-assessable deposits and 18 basis points for SAIF-assessable deposits.

[10] A more complete discussion of the risk-based deposit insurance system can be found in a later section of this paper.

[11] As the Board had not increased the DRR above 1.25 percent, the provision authorizing Earnings Participation Accounts and supplemental reserves never became effective.

[12] See, discussion of Section 212(e)(3) in the Senate Report on S.543 (which became the language of Section 302(a) of FDICIA). 138 Cong. Rec. S2073 (daily ed. Feb. 21, 1992.).

insured deposits, the Board was required by statute to set assessment rates that would both (1) "maintain" the fund reserve ratio at the DRR and (2) reflect the risk posed to the insurance fund by individual institutions, that is, risk-based assessment rates.[13] As a result, the Board faced potentially conflicting statutory directives. Moreover, regardless of the assessment rates set by the Board, it was likely, given the state of the current economy, that the investment income alone could cause the BIF to continue to grow so that its reserve ratio would exceed the DRR.

In the discussions that ensued, it was argued by some that the reserve ratio should be maintained precisely at the DRR, and that the FDIC should return assessments – current and past – to do so. However, the FDIC argued that this view was inconsistent with the statutory history of Sections 7(d) and 7(e) and Congressional intent.[14] In the August 1995 final rulemaking that lowered BIF assessment rates, the Board adopted an interpretation of the statutory directive to maintain the reserve ratio at the DRR, where the DRR was viewed as a target around which the actual reserve ratio would fluctuate. In this way, the potentially conflicting statutory directives were addressed.

The Deposit Insurance Funds Act of 1996 (Funds Act) effectively reestablished rebate authority for the BIF, under the terminology of "refunds." Under the Funds Act, at the end of each semiannual period the FDIC is required to refund any balance in the fund that exceeds the amount required to meet the DRR, subject to two limitations. First, the amount of the refund cannot exceed the assessments paid by a member during the semiannual period; and second, refunds cannot be paid to institutions that are not well capitalized or that "exhibit financial, operational, or compliance weaknesses ranging from moderately severe to unsatisfactory." The first condition precludes the FDIC from paying refunds to institutions subject to an assessment rate of zero basis points. The second condition bars refunds to all but the best-rated institutions – those rated 1A – under the risk-based premium system. Since the beginning of 1996, the assessment rate for BIF members rated 1A has been zero, so the refund authority could not be utilized. The Funds Act also provides for the possible merger of the two insurance funds, after which all insured institutions would be eligible for refunds, subject to the above limitations.

Risk-Based Deposit Insurance Premiums

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[13] As well, a minimum semiannual assessment of $1,000 per insured institution was required by statute. This requirement was eliminated by the Deposit Insurance Funds Act of 1996.

[14] The FDIC no longer had the authority to rebate current assessment revenue, as Section 7(d) had been eliminated under FDICIA; Section 7(e) applied only to assessments made in error and did not constitute a rebate authority. See, discussions in 60 FR 9274 (February 16, 1995) and 60 FR 42685 (August 16, 1995).

Section 302(a) of FDICIA required the FDIC to implement a risk-based pricing system for deposit insurance by January 1, 1994. In doing so, the FDIC began with a transitional system that was in effect from January 1, 1993, through December 31 of that year. The current, permanent risk-based premium system became effective on January 1, 1994.[15]

Prior to FDICIA, the deposit insurance assessment rate was a flat rate: all banks were assessed the same annual rate for deposit insurance coverage. In general, a flat-rate pricing system produces two undesirable effects. First, well-managed, well-capitalized banks subsidize the deposit insurance coverage of riskier banks. This is in contrast to most private insurance arrangements where lower-risk groups are rewarded with lower premium rates. Second, a flat-rate system allows banks to increase their risk to the insurance funds without incurring any additional premium expenses. More frequent and more costly bank failures can result. There is widespread agreement that a properly designed risk-based deposit insurance pricing system would mitigate the inequities and incentives toward greater risk-taking found under a flat-rate pricing system.[16]

In designing the risk-based pricing system the FDIC's goal was to create a system that: was fair and easily understood; was not unduly burdensome to weak institutions; maintained adequate revenue; and increased the financial incentive for insured institutions to operate in a safe-and-sound manner. The system's risk classifications and assessment rate schedules are described below.

Under the risk-based system, an insured depository institution's deposit insurance premium is related to the degree of risk that the institution poses to the deposit insurance fund. Risk-based premiums are determined on the basis of capital and supervisory ratings. The capital measure provides an objective, numerical standard; by improving their capital position in a defined manner, weak institutions can achieve an immediate financial reward. For the capital measure, institutions are assigned to one of three capital groups: "well-capitalized," "adequately capitalized," or "undercapitalized," utilizing the numerical standards for capital (consisting of total risk-based, Tier 1 risk-based, and leverage capital ratios) that were set by FDICIA for

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[15]Section 302(f) of FDICIA provided that the FDIC may issue regulations governing the transition from the flat-rate assessment system to the risk-based system required under Section 302(a). On September 15, 1992, the Board approved a transitional risk-based system; the final rule was published in the *Federal Register* of October 1, 1992. The permanent system, which made limited changes to the transitional system, was adopted by the Board on June 13, 1993, and became effective with the assessment period beginning January 1, 1994. See, 57 FR 45263 (October 1, 1992) and 58 FR 34357 (June 25, 1993).

[16]See, for example, Christine E. Blair and Gary S. Fissel, "A Framework for Analyzing Deposit Insurance Pricing," *FDIC Banking Review* 4 (Fall 1991), 25-37, for a discussion of various approaches to risk-based pricing.

prompt corrective action purposes.[17] Capital groups are determined by the FDIC from financial data reported on the institution's Report of Condition (Call Report) or Thrift Financial Report (TRF) as of June 30 for the assessment period beginning the following January, and December 31 for the assessment period beginning the following July.[18]

The capital measure is supplemented by a measure of the institution's supervisory risk that incorporates examination results and other risk-related information. Within each capital group, institutions are assigned to one of three subgroups: A, B, or C, on the basis of supervisory evaluations provided by the institution's primary federal regulator. Ratings as of September 30 are used for the assessment period beginning the following January, March 31 for the assessment period beginning the following July. The risk-based system has nine combinations of capital groups and supervisory subgroups, called assessment risk classifications, to which varying assessment rates are applied.

Initially, banks and thrifts that were rated "well-capitalized" and "supervisory subgroup A"– the best-rated or "1A" institutions – were assessed 23 basis points annually for deposit insurance. The riskiest institutions – those rated "undercapitalized" and "supervisory subgroup C" or "3C" institutions – were assessed 31 basis points annually for deposit insurance. Under the flat-rate pricing system, all institutions had been paying 23 basis points of assessable deposits for deposit insurance coverage. FDICIA required that the Board maintain an average annual assessment rate of 23 basis points until the BIF was recapitalized fully. Given the distribution of banks across the risk-based premium matrix, the Board was able to meet this requirement using the original risk-based premium matrix, where the best-rated institutions continued to pay 23 basis points annually and the riskiest institutions were charged 31 basis points annually. In choosing 31 basis points, the Board sought an adequate incentive for weak institutions to improve, without causing additional bank failures. This matrix had a rate spread of 8 basis points between rates charged the best-rated banks and the riskiest banks and is shown in Table 2a.

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[17]The capital groups for risk-based premium purposes are as follows:

Well -Capitalized: Total risk-based ratio: 10.0 percent or greater AND Tier 1 risk-based ratio: 4.0 percent or greater AND Leverage ratio: 5.0 percent or greater.

Adequately Capitalized: Total risk-based ratio: 8.0 percent or greater AND Tier 1 risk-based ratio: 4.0 percent or greater AND Leverage ratio: 4.0 percent or greater.

Undercapitalized: Total risk-based ratio: less than 8.0 percent OR Tier 1 risk-based ratio: less than 4.0 percent OR Leverage ratio: less than 4.0 percent.

[18] Deposit insurance premiums are assessed semiannually and collected quarterly through the FDIC's quarterly assessment system. Assessment operations will be discussed in a future Appendix to this paper.

Table 2a

Original Risk-Based Deposit Insurance Rate Matrix
(basis points)

	Supervisory Risk Subgroup		
	A	B	C
Capital Group			
1. Well-Capitalized	23	26	29
2. Adequately Capitalized	26	29	30
3. Undercapitalized	29	29	31

However, as both insurance funds have become capitalized fully, risk-based assessment rates have been lowered and the rate spread between the best-rated and the riskiest institutions was increased to 27 basis points. The best-rated banks and thrifts currently pay nothing for deposit insurance, while the riskiest institutions are assessed 27 basis points annually. The current risk-based deposit insurance rate matrix is presented in Table 2b.

Table 2b

Current Risk-Based Deposit Insurance Rate Matrix
(basis points)

	Supervisory Risk Subgroup		
	A	B	C
Capital Group			
1. Well-Capitalized	0	3	17
2. Adequately Capitalized	3	10	24
3. Undercapitalized	10	24	27

Over time, the distribution of insured depository institutions – BIF-insured and SAIF-insured alike – across the risk-based assessment matrix has changed, reflecting the improved economic conditions and performance enjoyed by the industry. When the permanent system was implemented, 85 percent of all banks and 79 percent of all savings associations were in the "best-rated" cell of the risk-based premium matrix, that is were rated well-capitalized and in supervisory subgroup A. Currently, over 95 percent of all banks and over 90 percent of all savings associations are considered best-rated for purposes of deposit insurance premiums.

Deposit insurance assessment base. FDICIA replaced the language of Section 7 of the FDI Act. In so doing, the specific statutory language that defined the assessment base as total (adjusted) deposits was eliminated. In the absence of a statutory definition, the FDIC Board has the flexibility to modify the assessment base definition. In 1992 the FDIC issued an advanced notice of proposed rulemaking seeking comment on the definition of the assessment base. No further formal action has been taken on the issue. For purposes of risk-based deposit insurance assessments, the assessment base continues to be defined as total (adjusted) deposits.

Recapitalization of the BIF, Capitalization of the SAIF and Related Assessment Issues

Section 7(b) of the FDI Act, as amended by FDICIA, requires the FDIC to maintain the reserve ratio of each fund, defined as the ratio of fund balance to estimated insured deposits, at the statutorily mandated level of 1.25 percent. The DRR of 1.25 percent represents a minimum reserve ratio; the Board is authorized by statute to increase the DRR should there be circumstances that raise a significant risk of substantial future losses to the fund. As of September 30, 1997, the BIF had a fund balance of $27.97 billion and a reserve ratio of 1.38 percent. As of September 30, 1997, the SAIF had a fund balance of $9.25 billion and a reserve ratio of 1.35 percent.

Recapitalization of the BIF. During the 1980s and early 1990s the BIF incurred significant losses from the resolution of bank failures. These losses, in conjunction with additions to reserves for future losses, caused the BIF to become significantly undercapitalized; the reserve ratio of the BIF fell from 1.22 percent in 1983 to a negative 0.36 percent by year-end 1991. In September 1992, as required by FDICIA, the Board established a recapitalization schedule and set deposit insurance premiums so as to increase the reserve ratio of the BIF to the DRR. Under the risk-based deposit insurance system, which became effective in January 1993, annual deposit insurance assessment rates ranged from 23 basis points – 23 cents per $100 of assessable deposits – for the best-rated institutions to 31 basis points for the riskiest institutions.[19]

Improved economic conditions allowed the BIF to recapitalize quickly. Although the original recapitalization schedule had projected that the BIF would not recapitalize fully until the year 2006, the BIF reached the DRR of 1.25 percent in May 1995. The Board then lowered BIF assessment rates to a range of 4 to 31 basis points. The average annual BIF assessment rate fell from 23.2 basis points to 4.4 basis points. Subsequent growth of the BIF and improvement in the condition of the industry led the

[19] Because conditions affecting the insurance funds change over time, the Board reevaluates the condition of the insurance funds and sets deposit insurance assessment rates semiannually. Prior to reaching full capitalization, the statutorily mandated minimum average annual assessment rate was 23 basis points for BIF-insured institutions and 18 basis points for SAIF-insured institutions. (The minimum annual average SAIF assessment rate increases to 23 basis points on January 1, 1998.) Assessment rates for BIF- and SAIF-insured institutions were kept within the range of 23 to 31 basis points until the respective funds reached full capitalization at 1.25 percent.

Board to reduce BIF assessment rates further in November 1995, effective January 1, 1996, to a range of 0 to 27 basis points.[20]

The Deposit Insurance Funds Act and Capitalization of the SAIF.[21] On September 30, 1996, the SAIF had a balance of $4.2 billion and a reserve ratio of 0.59 percent. The fund was approximately $4.5 billion below that required to be capitalized fully at the DRR of 1.25 percent. SAIF assessment rates ranged from 23 to 31 basis points under the FDIC's risk-based assessment system, yielding an average annual assessment rate of 23.4 basis points. The SAIF reached full capitalization on October 1, 1996, as the result of the special assessment on SAIF-insured deposits that was authorized by the Deposit Insurance Funds Act of 1996.

The SAIF would have reached its DRR before the BIF, but SAIF premiums were diverted by law to other purposes, including the payment of interest on bonds issued by the Financing Corporation (FICO). Notably, the FICO had an annual draw of up to $793 million against SAIF assessments until the year 2019. Absent a legislative solution, the SAIF was not expected to capitalize fully until 2001. The Funds Act addressed both the undercapitalization of the SAIF and the FICO interest burden (see below).

The BIF-SAIF Premium Disparity. The lowering of BIF premiums to their current levels created a differential of approximately 23 basis points between SAIF and BIF assessment rates. Because of the FICO draw, it was expected that even after the SAIF became capitalized fully, SAIF rates would remain well above BIF rates until the last of the FICO bonds matures in 2019.

This prospect of a substantial, ongoing deposit insurance premium disparity for identical deposit insurance coverage created a strong incentive for institutions to shift deposits from SAIF to BIF insurance. Although conversions from SAIF insurance to BIF insurance generally were prohibited, a few institutions were successful in structuring affiliate relationships to facilitate the movement of deposits from SAIF insurance to BIF insurance, and other institutions were actively pursuing this strategy. In addition to eroding the SAIF assessment base, the migration of deposits also would have resulted in a dilution of the BIF.

The migration of deposits out of the SAIF would have accelerated the capitalization of the SAIF, but it would have exacerbated the problems facing the SAIF by reducing the fund's ability to diversify its risks. It was likely to be the stronger

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[20] See, 60 FR 42685 (August 16, 1995).

[21] See, FDIC Division of Research and Statistics, "Analysis of Issues Confronting the Savings Association Insurance Fund," March 1995 (photocopied), for a discussion of the problems facing the undercapitalized SAIF.

SAIF members that would have been successful in migrating deposits to the BIF. As a result, weaker thrifts and banks that own SAIF deposits would have been more exposed to the losses of an insurance fund that would have had a higher risk profile.

The FICO had a first claim on the current assessment revenue of SAIF-member savings associations, which hold approximately 60 percent of the total SAIF assessment base. Assessment revenue from so-called "Oakar" and "Sasser" institutions could not be used to meet the interest payments on FICO's obligations. An Oakar bank is a BIF-member bank that has acquired SAIF-insured deposits and pays deposit insurance premiums to both the BIF and the SAIF. A Sasser institution is a commercial bank or state savings bank that has changed its charter from a savings association to a bank but remains a SAIF member. SAIF assessments from Oakar and Sasser institutions were unavailable for the FICO obligation because under the law only assessments from insured institutions that were both savings associations and SAIF members could be used for the FICO interest payments. Since the SAIF was created in 1989, the FICO-available portion of the SAIF assessment base declined 11 percent per year, on average. Shrinkage in the FICO-available assessment base increased the likelihood of a FICO default.

Deposit Insurance Funds Act of 1996. In 1995, both Houses of the Congress began considering a legislative solution to the problems facing the SAIF. Initiated and supported by the FDIC, the Office of Thrift Supervision and the U.S. Department of the Treasury, a solution was crafted under which all financial institutions that benefit directly from FDIC insurance were asked to contribute. This legislation was enacted September 30, 1996, as the Deposit Insurance Funds Act of 1996. Among its major provisions are the following:

SAIF Special Assessment. The Funds Act imposed a one-time special assessment – set by the Board on October 8, 1996, at 65.7 basis points – on SAIF-assessable deposits, subject to certain reductions and exemptions. The special assessment, which was payable on November 27, 1996, raised $4.5 billion to bring the SAIF to full capitalization as of October 1, 1996.

The Board adopted guidelines to identify "weak" institutions that were exempt from paying the one-time special assessment, in order to limit risk to the SAIF. Certain other institutions also received exemption from the special assessment. Exempted institutions will continue to pay SAIF assessments at rates of 23 to 31 basis points per year for up to three years. For purposes of the special assessment, the Funds Act decreased by 20 percent the SAIF deposits of certain BIF-member Oakar institutions and converted savings associations. These Oakar institutions also receive a permanent 20 percent reduction in their SAIF-assessable deposits for future regular assessments. This resulted in a shift of insured deposits of approximately $24 billion from SAIF insurance to BIF insurance.

FICO Assessment. The Funds Act expanded FICO's assessment authority to all FDIC-insured institutions and separated the FICO rate-setting process from that of deposit insurance. As of January 1, 1997, the FICO assessment rate on SAIF-assessable deposits was set at 6.5 basis points, and the rate on BIF-assessable deposits was set at 1.3 basis points, or one-fifth of the SAIF rate, as required by the Funds Act. FICO rates for the first semiannual assessment period of 1998 are 6.28 basis points and 1.26 basis points for SAIF-assessable deposits and BIF-assessable deposits, respectively.

The Funds Act provides for a possible merger of the deposit insurance funds on January 1, 1999. As of this date, or on January 1, 2000, if the funds have not been merged, each insured institution will pay its pro rata share at a rate to be established by the FICO, subject to the approval of the Board. The pro rata rate presently is estimated at 2.4 basis points and may vary in the future due to growth or shrinkage of the combined SAIF and BIF assessment bases.

SAIF Assessment Rates. Full capitalization of the SAIF permitted the Board to lower SAIF assessment rates below the applicable statutory minimum of 18 basis points, subject to the revenue needs of the fund and the statutory requirement to maintain an effective risk-based premium system. However, the Funds Act requires that SAIF rates not be lower than BIF rates prior to January 1, 1999. The Funds Act also eliminated the $1,000 semiannual minimum assessment that existed under the prior statute.

On December 11, 1996, the Board adopted a rule that lowered SAIF assessment rates to a base range of 4 to 31 basis points, reflecting the expected long-range revenue needs of the SAIF. The Board also adopted an adjustment factor, identical to that already in place for the BIF, that would further permit the Board to adjust SAIF assessment rates within a 5-basis point range without notice and comment. An immediate reduction in SAIF assessment rates to a range of 0 to 27 basis points was adopted, based upon the current favorable condition of the thrift industry. The average annual SAIF assessment rate was reduced to 0.6 basis points.

Merger of the Funds and Charter Issues. The Funds Act calls for a merger of the BIF and the SAIF, effective January 1, 1999. However, a necessary condition for a merger is that there be no savings associations in existence. This would require the development of a charter that would be applicable to both banks and thrifts. On October 25, 1996, an FDIC Staff Study entitled *A Unified Federal Charter for Banks and Savings Associations* was published, which addressed the issues concerning the proposal to establish a single federal charter for banks and thrifts.

Throughout 1997, discussions on merging the deposit insurance funds and the related charter issue became subsumed within the broader issue of financial modernization. The FDIC testified before the House Committee on Banking and

Financial Services and two of its subcommittees on financial modernization. The FDIC's current position on financial modernization is discussed in the briefing document entitled *Bank Powers and Glass-Steagall Reform*.

Assessment policy and the adequacy of the funds.

In 1995, as the BIF approached recapitalization, the Board faced its first opportunity to set risk-based assessment rates free of the minimum average annual rate requirement.[22] Section 7(b) of the FDI Act governs the rate-setting process and directs the Board to maintain a risk-based assessment system whereby an institution's assessment is based in part on the probability that the deposit insurance fund will incur a loss with respect to that institution, and to set assessments to maintain the reserve ratio at the DRR when that ratio has been achieved.

In principle, the two broad statutory requirements to maintain the reserve ratio at the DRR and set assessment rates for individual institutions based on risk to the fund should complement and reinforce each other. Maintenance of a particular reserve ratio requires that the insurance fund's revenue and expenses be balanced over time. An important element of that balance comes from a risk-based assessment system that equates revenues with "expected cost" over a long period.

In preparation for reducing assessment rates for the BIF, the FDIC staff examined the analytical basis for setting assessment rates.[23] The analysis concluded that the process of setting assessment rates should be viewed as an evolving process in which historical analysis tempered by informed judgment about current conditions is revisited on a semiannual basis.

The analysis indicated that in setting semiannual premiums, the Board should, as a general rule, attempt to match expected revenues and costs over a time horizon that exceeds six months. A shorter time horizon likely would result in adverse effects on the earnings and capital of the banking industry during times of stress, because of the high and volatile premiums that result from such a system. As well, a meaningful assessment of the probability and amount of insurance losses, statutorily required in the setting of risk-based assessment rates, requires that the risk of events outside of a

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[22] As discussed above, prior to the recapitalization of the BIF and the full capitalization of the SAIF, the Board set risk-based BIF and SAIF assessment rate schedules that ranged from 23 to 31 basis points and maintained the average annual assessment rate at or above the relevant statutory minimum. Given the recapitalization of the BIF in 1995, and the subsequent full capitalization of the SAIF in 1996, the statutory constraint to maintain certain average annual assessment rates for each fund was lifted, although the law requires that a minimum annual assessment rate of 23 basis points will become operative if the reserve ratio remains below the DRR for at least one year.

[23] See, 60 FR 42685 (August 16, 1995).

semiannual assessment period be considered. Furthermore, the FDIC's experience with bank failures indicates that a meaningful assessment of the risk associated with even highly rated and well-capitalized institutions must look beyond such a short-term horizon.

The examination of the historical loss experience of the FDIC from 1950 through 1994 suggested that an effective premium in the range of 4.5 to 13 basis points would be expected to balance revenues and expenses over a relatively long period of time. An effective premium of approximately 4.5 basis points would have balanced revenues and expenses over the period from 1950 to 1980, while an effective premium of 13 basis points would have been required to balance revenues and expenses from 1981 to 1994. The judgment of the staff was that the lower end of the historical premium range was more reflective of the risks facing the BIF. On this basis, with the acknowledgment that deviations in the reserve ratio from the target DRR will occur as factors such as insured deposits and reserves for future failures change, the staff recommended and the Board adopted an assessment rate schedule of 4 to 31 basis points for the BIF that was made effective with the recapitalization of the BIF in May 1995.

Note:
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