Financial Services Management

New DIF Assessment System

CFO | Asset Liability Management Action Item

Cite

FDIC

Final Rule on the Deposit Insurance Assessment Base, Assessment Rate Adjustments, Dividends, Assessment Rates and Large Bank Pricing Methodology

Recommended Distribution

CFO, Corporate Treasury, Asset/Liability Management, Risk Management, Corporate Planning, Legal, Government Relations

Website

http://www.fdic.gov/news/board/2011rule1.pdf

Overview

The FDIC has finalized a series of proposals to overhaul how premiums are set for the Deposit Insurance Fund (DIF) to meet new goals to ensure the DIF is sufficient in the face of any future crises. The new system – which would come into play very quickly – changes the DIF assessment base from domestic deposits to assets, as required by the Tester Amendment to the Dodd-Frank Act.[1] This will shift the burden of assessments more to large banks, as Congress and the FDIC intend, although the FDIC believes the new system will remain in aggregate revenue-neutral in terms of total SIF assessments to meet the new goals. Large banks will also be governed by a new risk-based schedule designed to align DIF premiums better with the risk a big bank poses both in terms of probability of failure and loss to the DIF should it do so. The FDIC believes that about half of all large banks will see premiums rise and half will see them fall under the new scheme, but the

[1] See Client Report DEPOSITINSURANCE87, *Financial Services Management*, July 14, 2010.

impact is likely largely to be costly – often very costly – for the largest U.S. insured depositories.

Impact

This final rule follows several prior FDIC actions, including a final rule detailing the FDIC's plan to achieve a stable designated reserve ratio (DRR) for the DIF[2] and proposals to address DIF dividends and similar matters,[3] change the assessment base[4] and create the new risk-based premium (RBP) schedule for large banks.[5] The FDIC has stuck with the schedule for these actions (see below) included in these proposals, meaning that perhaps the most immediate impact of the final rule will be development of new systems at insured depositories to implement the revised DIF requirements. This will be particularly challenging at larger banks, although the FDIC defends this by noting that its initial RBP proposal was issued in April of 2010.[6]

It is likely that the final rule, like the proposals, will lead to steep increases at the very largest banks. The FDIC initially estimated this at at least $1 billion in added premiums for the three largest U.S. bank holding companies with significant retail operations, and this figure is unlikely to have significantly changed in the final rule.

Any institution experiencing these increased costs will likely revise its funding strategies in response, with this having significant market impact due to the size of the affected banks and the concentration of the U.S. banking system. As noted in prior FedFin reports, these implications will likely include a shift to insured and/or domestic deposits from wholesale liabilities. Since large-bank premiums are now based on assets, the cost of DIF premiums that previously encouraged use of wholesale funding sources has been eliminated. Since large banks will effectively pay for the privilege of insured-deposit funding for their assets even if this is not used, they will likely shift to insured deposits (which are often cheaper than comparable wholesale liabilities). This could lead to unanticipated competition against small banks, although they strongly support the FDIC's actions. Providers of wholesale funding sources may well see demand drop, with this particularly acute for providers of secured liabilities like the Federal Home Loan Banks. Diminished demand for advances from these Banks could exacerbate strategic earnings problems in the $1 trillion-plus Home Loan Bank System.

Reflecting the scope of these actions, the FDIC received many comments. Large banks protested the rules in part based on assertions that they disconnect DIF premiums from the risk an insured depository actually poses to the DIF. The FDIC refutes this in part by correlating its new RBPs with large banks that either

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[2] See Client Report DEPOSITINSURANCE90, *Financial Services Management*, October 26, 2010.
[3] See Client Report DEPOSITINSURANCE89, October 19, 2010.
[4] See Client Report DEPOSITINSURANCE92, *Financial Services Management*, November 17, 2010.
[5] See Client Report DEPOSITINSURANCE93, *Financial Services Management*, November 19, 2010.
[6] See Client Report DEPOSITINSURANCE84, *Financial Services Management*, April 21, 2010.

failed or received significant federal assistance during the crisis. The FDIC is also at pains to defend the legal rationale of the rule. It notes, for example, that the agency believes Congress dictated the change in the assessment base to assets because assets are on their face a source of risk to the DIF.

In addition to these broad strategic issues, the final rule has implications for financial markets and other insured-depository concerns. These include:

- new incentives to issue long-term unsecured debt. The final rule continues to reduce a bank's assessment base to some degree for these liabilities, with the FDIC arguing that large banks fearful of the cost of the new system can reduce it by shifting their funding strategies towards these holdings (which it argues better protects the bank against liquidity risk and, thus, the FDIC). Banks may counter that new DIF costs are so high as to make this reduction of minimal value, especially after taking into account the cost of long-term funding (likely increased by new limits on bank holding long-term debt from other insured depositories in this rule) and the limited deduction for low-risk institutions. The FDIC rejected requests to add other funding sources – e.g., foreign deposits – to those that reduce the assessment base, arguing that these generally flee a troubled bank and, in the case of foreign deposits, are "ring-fenced" in a failure;

- potential changes in the fed funds market. The final rule continues to exempt from the assessment base only fed funds sold by banker's banks. Commenters argued that this would give these institutions so great an advantage in this market that other institutions would abandon it. The FDIC rejected this on grounds that premiums related to the assessment base will vary for many reasons and thus not necessarily only affect fed funds sold;

- greater benefits for custodial banks, possibly leading some institutions to expand fiduciary and related activities;

- reduced reliance on brokered deposits, although the final rule provides less punitive treatment than proposed for large banking organizations. The FDIC finalized this provision despite a Dodd-Frank mandated study of brokered deposits, doing so pending any revisions warranted after this review is completed; and

- changes in bank asset composition. In the RBP scorecards discussed below, the FDIC has taken its own approach to identifying risky exposures that trigger higher premiums. Although revised to delete certain assets (e.g., small-business leveraged loans), the final rule still penalizes other products (e.g., interest-only mortgages). The FDIC thinks this warranted by their risk profile, although banks that believe they have appropriate risk mitigations in place will not see these reflected in their DIF premiums and thus may simply reduce or cease sanctioned assets.

What's Next

The FDIC adopted these new rules unanimously at a meeting on February 7.[7] Acting Comptroller Walsh supported the final rule, although he expressed concern about potential unintended consequences that may warrant revision down the road. The final rule is effective April 1, 2011, meaning that insured depositories will need to calculate premiums under it during the second quarter for payment to the FDIC no later than the end of the third quarter of 2011. However, it is possible that this schedule could be delayed because aspects of the rules require changes to call-report filings that may take time to finalize.

The FDIC has retained the flexibility to update minimum and maximum cut-off value for the scorecards discussed below once a year without further rulemaking, as long as the basic methodology remains unchanged.

Analysis

I. Designated Reserve Ratio

The FDIC has retained the DRR at two percent, but finalized other aspects of the DIF restoration plan. The final rule now also indefinitely (but not necessarily permanently) suspends any dividends from the DIF, with premiums to be downward adjusted once the DRR first exceeds two percent and, then. 2.5 percent. The final rule contains a DIF premium schedule that is intended to be revenue neutral. The FDIC board may not increase or decrease base assessments by more than two basis points (not three, as proposed) without formal action.

II. Assessment Base

A. Base

As required by the Dodd-Frank Act, this is the average consolidated total assets of an insured depository institution minus average tangible equity. In general, institutions will need to calculate assets on a daily basis, although banks with less than $1 billion in assets may do so weekly, with all insured institutions reporting on a methodology comparable to that now used on call reports. The FDIC rejected comments that urged it to deduct goodwill from

[7] See Client Report DEPOSITINSURANCE95, February 7, 2011.

the definition of assets for purposes of the assessment base. Tangible equity is defined in the rule as Tier 1 capital, although this will be reviewed once the Basel III rules are implemented.[8] In general, capital is calculated monthly, although smaller banks may do so at quarter-end. Capital for foreign insured branches is calculated as under current practice.

B. Banker's Banks

Like the proposed rule, the final rule will require a banker's bank to certify that it meets the definition of "banker's bank" as that term is used in a cited provision of law. The self-certification will be subject to verification by the FDIC. Unlike the proposal, banker's banks will not be ineligible for this exception if they have government funds (e.g., TARP or small-business related government capital). However, a banker's bank must conduct less than fifty percent of its business with affiliates.

Eligible banker's banks can exclude from assets for purposes of the assessment base the average amount of reserve balances passed through to the FRB, the average amount of FRB reserves held for the institution's own account and the average amount of the institutions (not agency) federal funds sold. However, these deductions may not exceed total deposits from commercial banks other than U.S. depository institutions and the average amount of purchased federal funds.

C. Custodial Banks

Custodial banks here are defined as insured depositories with year-end trust assets (fiduciary, custody and safekeeping assets) of at least $50 billion or those that derived more than fifty percent of revenue (interest income plus non-interest income) from trust activity over the previous calendar year.

Eligible custodial banks may use an assessment base that is their total assets less low-risk ones (regardless of maturity) that receive a zero percent risk weighting (e.g., government obligations) and half of assets with a Basel risk weighting of twenty percent (e.g., agency obligations). However, these deductions may not exceed total transaction-account deposits directly linked to fiduciary, custodial or safekeeping activities.

D. General Assessment-Base Adjustments

1. Unsecured Debt

This is equal to the amount of long-term unsecured liabilities an insured depository institution reports times the sum of 40 basis points plus the

[8] See Client Report CAPITAL173, *Financial Services Management*, January 7, 2011.

institution's initial base assessment rate divided by the amount of the institution's new assessment base. The cap on this adjustment is the lesser of five basis points or fifty percent of the initial base assessment rate. Instruments that count as Tier 1 capital are not considered unsecured debt. Eligible long-term unsecured debt must have at least one year remaining until maturity, unless investors have a redemption option exercisable within one year of the reporting date. The goal of this adjustment is to encourage reliance on unsecured long-term debt.

2. Depository-Institution Debt

Holdings of long-term debt that are issued by other depository institutions are subject to a fifty basis point assessment-based adjustment above amounts that are less than three percent of Tier 1 capital (the de minimis allowance included in the final rule). This adjustment is intended to protect the FDIC, which argues that long-term debt from one insured depository held by another does not provide the same protection as other unsecured long-term debt (see above). The adjustment does not apply to debt issued by a parent firm that controls an insured depository.

3. Secured Liabilities

Like the proposal, the final rule discontinues the current adjustment for secured liabilities.

4. Brokered Deposits

An adjustment remains for brokered deposits, but this now is scaled based on the ratio of domestic deposits to the new assessment base. This adjustment does not apply to large institutions (see below) that are well capitalized and have a CAMELS composite rating of 1 or 2, paralleling a similar prior exemption for small institutions. The final rule does not exclude certain deposits (e.g., sweeps or those obtained through reciprocal brokerage programs). The adjustment is capped at ten basis points.

III. Large-Bank Risk-Based Premiums

A. Covered Institutions

1. Large Banks

These are insured depositories with assets of $10 billion or more for four consecutive quarters, although insured branches of foreign institutions are excluded from this definition.

2. Highly-Complex Institutions

These are banks that (excluding any credit-card banks) has $50 billion or more in total assets controlled by a U.S. parent holding company with more than $500 billion in assets or that are processing banks or trust companies (an insured depository where non-lending interest, fiduciary revenue or investment-banking fees exceed fifty percent of total revenue) with either fiduciary assets of $500 billion and total assets of more than $10 billion.

B. Scorecards

As proposed, the new large-bank RBP scorecards delete prior rating-based requirements, consistent both with growing regulatory worries about credit ratings and the Dodd-Frank requirement that federal rules no longer reference them.[9]

The calculation methods discussed below can be revised by the FDIC based on quantitative and qualitative criteria discussed in the final rule. These factors include several concerns the FDIC found it difficult to quantify and also will take into account the views of a bank's primary regulator. The probability of failure scorecard (see below) is the strongest driver of RPBs, based on the FDIC's view that the loss-severity criteria have not yet been fully tested and that several additional criteria (e.g., certain off-balance sheet exposures) need to be reflected before more weight is given to this part of the total assessment score. Guidelines for making these adjustments will be issued for comment and the FDIC will not make them until this guidance is finalized. The FDIC also plans to publish aggregate statistics on adjustments once they are being made. Institutions will be given a chance to respond before any upward adjustment is made to their RBPs. As discussed, the FDIC has largely rejected comments that complained about aspects of the scorecards, but it notes that it will continue to assess them and revise them through rulemakings if needed.

1. Large Banks

Risk-based premiums will be debt by scorecards designed to estimate both probability of failure (performance) and loss to the FDIC upon failure (loss severity). The performance score includes factors such as CAMELS ratings (with the FDIC retaining the right to alter these if it strongly disagrees with a primary regulator), the ability to withstand stress under scenarios specified by the FDIC, capital ratios, a concentration measure, and liquidity. The final rule revises the proposal here in numerous respects to reduce reporting burden and/or inconsistencies among covered banks, although the continued reliance on internal models and/or examination reports may still result in varying scores for institutions with similar risk profiles. The FDIC expects to address this in its own revisions to the scorecard once all relevant factors are taken into account. The FDIC's approach to risk in these rules and the cost of higher DIF premiums may, as noted, lead some banks to alter asset composition to avoid exposures that are adversely treated by the FDIC.

[9] See Client Report **RATINGS37**, Financial Services Management, August 9, 2010.

The loss-severity score is derived from factors such as liability run-off and asset-recovery values, largely derived from the FDIC's experience in the recent crisis and its expectations about key issues (e.g., foreign deposit ring-fencing) going forward.

2. *Highly-Complex Institutions*

These institutions are subject to similar scorecards, but factors on them and their weighting reflects additional considerations (e.g., market risk, top twenty counterparty-related concentration risk).