

## FEDERAL DEPOSIT INSURANCE CORPORATION

### 12 CFR Part 327

RIN 3064-AD09

#### Assessments

**AGENCY:** Federal Deposit Insurance Corporation (FDIC).

**ACTION:** Notice of proposed rulemaking and request for comment.

**SUMMARY:** The Federal Deposit Insurance Reform Act of 2005 requires that the Federal Deposit Insurance Corporation (the FDIC) prescribe final regulations, after notice and opportunity for comment, to provide for deposit insurance assessments under section 7(b) of the Federal Deposit Insurance Act (the FDI Act). The FDIC is proposing to amend its regulations to create different risk differentiation frameworks for smaller and larger institutions that are well capitalized and well managed; establish a common risk differentiation framework for all other insured institutions; and establish a base assessment rate schedule.

**DATES:** Comments must be received on or before September 22, 2006.

**ADDRESSES:** You may submit comments, identified by RIN number, by any of the following methods:

- Agency Web site: <http://www.fdic.gov/regulations/laws/federal/propose.html>. Follow instructions for submitting comments on the Agency Web site.

- E-mail: [Comments@FDIC.gov](mailto:Comments@FDIC.gov). Include the RIN number in the subject line of the message.

- Mail: Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

- Hand Delivery/Courier: Guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7 a.m. and 5 p.m.

Instructions: All submissions received must include the agency name and RIN for this rulemaking. All comments received will be posted without change to <http://www.fdic.gov/regulations/laws/federal/propose.html> including any personal information provided.

#### FOR FURTHER INFORMATION CONTACT:

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#### SUPPLEMENTARY INFORMATION:

##### I. Background

On February 8, 2006, the President signed the Federal Deposit Insurance

Reform Act of 2005 into law; on February 15, 2006, he signed the Federal Deposit Insurance Reform Conforming Amendments Act of 2005 (collectively, the Reform Act).<sup>1</sup> The Reform Act enacts the bulk of the recommendations made by the FDIC in 2001. The Reform Act, among other things, gives the FDIC, through its rulemaking authority, the opportunity to better price deposit insurance for risk.<sup>2</sup>

##### A. The Risk-Differentiation Framework in Effect Today

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) required that the FDIC establish a risk-based assessment system. To implement this requirement, the FDIC adopted by regulation a system that places institutions into risk categories<sup>3</sup> based on two criteria: Capital levels and supervisory ratings. Three capital groups—well capitalized, adequately capitalized, and undercapitalized, which are numbered 1, 2 and 3, respectively—are based on leverage ratios and risk-based capital ratios for regulatory capital purposes. Three supervisory subgroups, termed A, B, and C, are based upon the FDIC's consideration of evaluations provided by the institution's primary federal regulator and other information the FDIC deems relevant.<sup>4</sup> Subgroup A consists of financially sound institutions with only a few minor weaknesses; subgroup B consists of institutions that demonstrate weaknesses which, if not corrected, could result in significant deterioration of the institution and increased risk of

<sup>1</sup> Federal Deposit Insurance Reform Act of 2005, Public Law 109-171, 120 Stat. 9; Federal Deposit Insurance Conforming Amendments Act of 2005, Public Law 109-173, 119 Stat. 3601.

<sup>2</sup> Pursuant to the Reform Act, current assessment regulations remain in effect until the effective date of new regulations. Section 2109 of the Reform Act. The Reform Act requires the FDIC, within 270 days of enactment, to prescribe final regulations, after notice and opportunity for comment, providing for assessments under section 7(b) of the Federal Deposit Insurance Act. Section 2109(a)(5) of the Reform Act. Section 2109 also requires the FDIC to prescribe, within 270 days, rules on the designated reserve ratio, changes to deposit insurance coverage, the one-time assessment credit, and dividends. An interim final rule on deposit insurance coverage was published on March 23, 2006. 71 FR 14629. A notice of proposed rulemaking on the one-time assessment credit, a notice of proposed rulemaking on dividends, and a notice of proposed rulemaking on operational changes to part 327 were published on May 18, 2006. 71 FR 28809, 28804, and 28790. The FDIC is publishing an additional rulemaking on the designated reserve ratio simultaneously with this notice of proposed rulemaking.

<sup>3</sup> The FDIC's regulations refer to these risk categories as "assessment risk classifications."

<sup>4</sup> The term "primary federal regulator" is synonymous with the statutory term "appropriate federal banking agency." 12 U.S.C. 1813(q).

loss to the insurance fund; and subgroup C consists of institutions that pose a substantial probability of loss to the insurance fund unless effective corrective action is taken. In practice, the subgroup evaluations are generally based on a institution's composite CAMELS rating, a rating assigned by the institution's supervisor at the end of a bank examination, with 1 being the best rating and 5 being the lowest.<sup>5</sup> Generally speaking, institutions with a CAMELS rating of 1 or 2 are put in supervisory subgroup A, those with a CAMELS rating of 3 are put in subgroup B, and those with a CAMELS rating of 4 or 5 are put in subgroup C. Thus, in the current assessment system, the highest-rated (least risky) institutions are assigned to category 1A and lowest-rated (riskiest) institutions to category 3C. The three capital groups and three supervisory subgroups form a nine-cell matrix for risk-based assessments:

Capital group	Supervisory subgroup		
	A	B	C
1. Well Capitalized .....	1A	1B	1C
2. Adequately Capitalized.	2A	2B	2C
3. Undercapitalized ....	3A	3B	3C

##### B. Reform Act Provisions

The Federal Deposit Insurance Act, as amended by the Reform Act, continues to require that the assessment system be risk-based and allows the FDIC to define risk broadly. It defines a risk-based system as one based on an institution's probability of incurring loss to the deposit insurance fund due to the composition and concentration of the institution's assets and liabilities, the amount of loss given failure, and revenue needs of the Deposit Insurance Fund (the fund).<sup>6</sup>

At the same time, the Reform Act also grants the FDIC's Board of Directors the discretion to price deposit insurance according to risk for all insured institutions regardless of the level of the fund reserve ratio.<sup>7</sup>

<sup>5</sup> CAMELS is an acronym for component ratings assigned in a bank examination: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. A composite CAMELS rating combines these component ratings, which also range from 1 (best) to 5 (worst).

<sup>6</sup> 12 U.S.C. 1817(b)(1)(A) and (C). The Bank Insurance Fund and Savings Association Insurance Fund were merged into the newly created Deposit Insurance Fund on March 31, 2006.

<sup>7</sup> The Reform Act eliminates the prohibition against charging well-managed and well-capitalized institutions when the deposit insurance fund is at or above, and is expected to remain at or above, the designated reserve ratio (DRR). However, while the Reform Act allows the DRR to be set between 1.15

The Reform Act leaves in place the existing statutory provision allowing the FDIC to “establish separate risk-based assessment systems for large and small members of the Deposit Insurance Fund.”<sup>8</sup> Under the Reform Act, however, separate systems are subject to a new requirement that “[n]o insured depository institution shall be barred from the lowest-risk category solely because of size.”<sup>9</sup>

**II. Overview of the Proposal**

The Reform Act provides the FDIC with the authority to make substantive improvements to the risk-based assessment system. In this notice of proposed rulemaking, the FDIC proposes to improve risk differentiation and pricing by drawing upon established measures of risk and existing best practices of the industry and federal regulators for evaluating risk. The FDIC believes that the proposal will make the assessment system more sensitive to risk. The proposal should also make the risk-

based assessment system fairer, by limiting the subsidization of riskier institutions by safer ones.

The FDIC’s proposals are set out in detail in ensuing sections, but are briefly summarized here.

At present, an institution’s assessment rate depends upon its risk category. Currently, there are nine of these risk categories. The FDIC proposes to consolidate the existing nine categories into four and name them Risk Categories I, II, III and IV. Risk Category I would replace the current 1A risk category.

Within Risk Category I, the FDIC proposes one method of risk differentiation for small institutions, and another for large institutions. Both methods share a common feature, namely, the use of CAMELS component ratings. However, each method combines these measures with different sources of information. For small institutions within Risk Category I, the FDIC proposes to combine CAMELS component ratings with current financial ratios to determine an

institution’s assessment rate. For large institutions within Risk Category I, the FDIC proposes to combine CAMELS component ratings with long-term debt issuer ratings, and, for some large institutions, financial ratios to assign institutions to initial assessment rate subcategories. These initial assignments, however, might be modified upon review of additional relevant information pertaining to an institution’s risk.

The FDIC proposes to define a large institution as an institution that has \$10 billion or more in assets. Also, the FDIC proposes to treat all new institutions (established within the last seven years) in Risk Category I the same, regardless of size, and assess them at the maximum rate applicable to Risk Category I institutions.

The FDIC proposes to adopt a base schedule of rates. The actual rates that the FDIC may put into effect next year and in subsequent years could vary from the base schedule. The proposed base schedule of rates is as follows:

	Risk category				
	I*		II	III	IV
	Minimum	Maximum			
Annual Rates (in basis points) .....	2	4	7	25	40

\* Rates for institutions that do not pay the minimum or maximum rate would vary between these rates.

The FDIC proposes that it continue to be allowed, as it is under the present system, to adjust rates uniformly up to a maximum of five basis points higher or lower than the base rates without the necessity of further notice-and-comment rulemaking, provided that any single adjustment from one quarter to the next could not move rates more than five basis points.

**III. General Framework**

The FDIC proposes to consolidate the number of assessment risk categories from nine to four. The four new categories would continue to be defined based upon supervisory and capital evaluations, both established measures of risk.

The existing nine categories are not all necessary. Some of the categories contain few, if any, institutions at any given time. Table 1 shows the total number of institutions in each of the nine categories of the existing risk matrix as of December 31, 2005:

**TABLE 1.—NUMBER OF INSTITUTIONS BY ASSESSMENT CATEGORY AS OF DECEMBER 31, 2005**

Capital group	Supervisory subgroup		
	A	B	C
1 .....	8,358	373	50
2 .....	54	7	1
3 .....	0	0	2

Five of the nine categories contain among them a total of only 10 institutions. Table 2 shows the average percentage of BIF-member institutions that were (or, for the period before the risk-based system began, that would have been) in each of the nine categories of the existing risk matrix from 1985 to 2005:<sup>10</sup>

**TABLE 2.—PERCENTAGE OF INSTITUTIONS BY ASSESSMENT CATEGORY, 1985–2005\***

[BIF-member institutions]

Capital group	Supervisory subgroup		
	A	B	C
1 .....	83.72	6.08	0.91
2 .....	1.46	3.17	1.30
3 .....	0.05	0.21	2.55

\* Approximately 0.56 percent of institutions could not be classified because CAMELS data are unavailable.

Several of the categories contain very small percentages of institutions. In fact, for any given year from 1985 to 2005, the number of BIF-member institutions rated 3A (or, for the period before the risk-based system began, that would have been rated 3A) never exceeded 10 and the number of BIF-member institutions rated 3B (or, for the period before the risk-based system began, that

percent and 1.5 percent, it also generally requires dividends of one-half of any amount in the fund in excess of the amount required to maintain the reserve ratio at 1.35 percent when the insurance fund reserve ratio exceeds 1.35 percent at the end

of any year. The Board can suspend these dividends under certain circumstances. 12 U.S.C. 1817(e)(2).

<sup>8</sup> 12 U.S.C. 1817(b)(1)(D).

<sup>9</sup> Section 2104(a)(2) of the Reform Act (to be codified at 12 U.S.C. 1817(b)(2)(D)).

<sup>10</sup> Comparable data on SAIF-member (prior to August 1989, FSLIC-insured) institutions are not readily available back to 1985.

would have been rated 3B) never exceeded 81.

In addition, the failure rates for many of the categories are similar. Table 3 shows the average five-year failure rate for BIF-member institutions for each of the nine categories of the existing risk matrix for the five-year periods beginning in 1985 to 2000:<sup>11</sup>

**TABLE 3.—HISTORICAL FIVE-YEAR FAILURE RATES BY ASSESSMENT CATEGORY, 1985–2000 \***  
[BIF-member institutions]

Capital group	Supervisory subgroup		
	A	B	C
1 .....	0.77	2.67	6.78
2 .....	2.03	5.51	14.43
3 .....	2.30	7.10	28.84

\* Excludes failures where fraud was determined to be a primary contributing factor.<sup>12</sup>

The failure rates for 2A, 1B and 2B range from 2.03 percent to 5.51 percent. The failure rates for 1C and 2C are higher: 6.78 percent and 14.43 percent, respectively. The failure rates for 3A and 3B are based upon a very small sample, since the number of institutions that have been in these categories is so small. The failure rate for 3C institutions is 28.84 percent, which is markedly different from any of the other categories.

The FDIC proposes consolidating the existing categories based primarily on similarity of failure rates. The proposal also would combine the sparsely populated 3A and 3B categories with the 1C and 2C categories.<sup>13</sup> The proposed consolidation would create four new Risk Categories as shown in Table 4:

<sup>11</sup> The five-year failure rate is calculated by comparing the number of institutions that failed within five years to the number of institutions that were (or that would have been) in one of the 9 categories of the risk matrix at the beginning of the five-year period. The average failure rate is an average of rates using the years 1985 through 2000 as the initial years. The failure rates for the 3A and 3B risk categories are not particularly meaningful, since so few institutions have been in these categories.

<sup>12</sup> The validity of an institution's capital ratios depends wholly, and the validity of supervisory appraisals depends greatly, upon the accuracy of financial data supplied by the institution. Where undetected fraud is present, financial data is inaccurate, often highly so, and an institution is likely to be placed in the wrong risk category for deposit insurance purposes. For this reason, failures caused by fraud are excluded.

<sup>13</sup> While the five-year failure rate for 3A institutions is similar to that of 2A and 1B institutions, 3A institutions are undercapitalized and, therefore, pose greater risk.

**TABLE 4.—PROPOSED NEW RISK CATEGORIES**

Capital category	Supervisory subgroup		
	A	B	C
Well Capitalized .....	I		III
Adequately Capitalized .....		II	III
Undercapitalized .....		III	IV

The FDIC has analyzed failure rates for each of the proposed risk categories over the period 1985 to 2005. They are as follows:

**TABLE 5.—HISTORICAL FIVE-YEAR FAILURE RATES BY PROPOSED NEW RISK CATEGORY, 1985–2000 \***  
[BIF-member institutions]

Risk category	Failure rate
I .....	0.77
II .....	3.52
III .....	11.05
IV .....	28.84

\* Excludes failures where fraud was determined to be a primary contributing factor.

The proposed new categories appear to be well aligned with insurance risk, since the risk of failure increases with each successive category.

For clarity, the FDIC proposes to use the phrase "Supervisory Group" to replace "Supervisory Subgroup." The FDIC also proposes calling the capital categories "Well Capitalized," "Adequately Capitalized" and "Undercapitalized," rather than Capital Groups 1, 2 and 3. However, the definitions of the Supervisory Groups and Capital Groups will not change in substance.

Risk Category I would contain all well-capitalized institutions in Supervisory Group A (generally those with CAMELS composite ratings of 1 or 2); *i.e.*, those institutions that would be placed in the current 1A category. New Risk Category II would contain all institutions in Supervisory Groups A and B (generally those with CAMELS composite ratings of 1, 2 or 3), except those in Risk Category I and undercapitalized institutions.<sup>14</sup> Category III would contain all undercapitalized institutions in Supervisory Groups A and B, and institutions in Supervisory Group C

<sup>14</sup> Under current regulations, bridge banks and institutions for which the FDIC has been appointed or serves as conservator are charged the assessment rate applicable to the 2A category. 12 CFR 327.4(c). The FDIC proposes, instead, to place these institutions in Risk Category I and to charge them the minimum rate applicable to that category.

(generally those with CAMELS composite ratings of 4 or 5) that are not undercapitalized. Category IV would contain all undercapitalized institutions in Supervisory Group C; *i.e.*, those institutions that would be placed in the current 3C category.

As of December 31, 2005, the four new categories would have the numbers of institutions shown in Table 6:

**TABLE 6.—NUMBER OF INSTITUTIONS BY PROPOSED NEW RISK CATEGORY AS OF DECEMBER 31, 2005**

Risk category	Number of institutions
I .....	8,358
II .....	434
III .....	51
IV .....	2

The FDIC proposes that all institutions in any one risk category, other than Risk Category I, be charged the same assessment rate; there would be no further differentiation in assessment rates within each category. Over the past 11 years, only six to ten percent of institutions at any one time have been less than well capitalized or have exhibited supervisory weaknesses (that is, have been rated CAMELS 3, 4 or 5). CAMELS 3, 4 and 5-rated institutions are examined more frequently than other institutions; they must be examined at least annually and, in practice, are examined more frequently. Institutions are examined more frequently as their supervisory ratings deteriorate. As a result of these frequent, on-site examinations, supervisory evaluations (primarily CAMELS ratings) and capital levels provide a good measure of failure risk. In addition, there are few of these institutions, and the amount of differentiation that presently exists is unnecessary.

**IV. Risk Differentiation Within Risk Category I**

Risk Category I, at present, includes 95 percent of all insured institutions. The FDIC proposes to further differentiate for risk within this category. Within Risk Category I, the FDIC proposes one method for small institutions, and another for large institutions. Both methods share a common feature, namely, the use of CAMELS component ratings. However, each method combines these measures with different sources of information on risk.

For small institutions, the FDIC proposes to combine CAMELS component ratings with current

financial ratios. These ratios can provide updated information on an institution's risk profile between bank examinations and allow greater differentiation in risk.<sup>15</sup> For many years, the FDIC and other federal regulators have used financial ratios in offsite monitoring systems to aid in analyzing the financial condition of institutions. The FDIC has used financial ratios in its offsite monitoring system, known as the Statistical Camels Offsite Rating system (SCOR), to identify changes in risk profiles between bank examinations.<sup>16</sup>

For large institutions, the FDIC proposes to combine CAMELS component ratings with long-term debt issuer ratings, and, for institutions with between \$10 billion and \$30 billion in assets, financial ratios, to develop an insurance score and an assessment rate. Assessment rates might be adjusted based on considerations of additional market, financial performance and condition, and stress considerations. This approach is consistent with best practices in the banking industry for rating and ranking direct credit and counterparty credit risk exposures to include consideration of all relevant risk information, the use of standardized risk assessment processes and methodologies, the incorporation of judgment, where necessary, and the use of quality controls to ensure consistency and reasonableness of the ratings and risk rankings.

The FDIC proposes to define a large institution as an institution that has \$10 billion or more in assets and a small institution as an institution that has less than \$10 billion in assets. Also, as described below in Section VIII, the FDIC proposes to treat all new institutions in Risk Category I the same, regardless of size, and assess them at the maximum rate applicable to Risk Category I institutions.

**V. Risk Differentiation Among Smaller Institutions in Risk Category I**

*A. Proposal: Rely Upon Supervisory Ratings and Financial Ratios*

**1. Description of the Proposal**

For smaller institutions, the FDIC proposes to link assessment rates to a combination of certain financial ratios and supervisory ratings based on a statistical analysis relating these measures to the probability that an institution will be downgraded to

CAMELS 3, 4 or 5 within one year.<sup>17</sup> Few failures have occurred within the past few years, but, historically, the failure frequency of insured institutions is significantly higher for institutions with CAMELS composite ratings of 3 or worse, as Table 7 demonstrates. Thus, in general, the greater the risk that a CAMELS 1 or 2-rated institution will be downgraded to CAMELS 3, 4 or 5, the greater its risk of failure.

**TABLE 7.—HISTORICAL FIVE-YEAR FAILURE RATES BY CAMELS RATINGS GROUPS, 1985–2000 \***  
[BIF-member institutions]

Composite CAMELS	Percentage of CAMELS group failing
1 .....	0.39
2 .....	1.01
3 .....	3.84
4 .....	14.63
5 .....	46.92

\* Excludes failures in which fraud was determined to be a primary contributing factor. CAMELS ratings as of each year-end are used for failure rate calculations.

The FDIC used the financial ratios in its offsite monitoring system, SCOR, as the starting point for the financial information it would use to differentiate risk and selected six financial ratios. These financial ratios measure an institution's capital adequacy, asset quality, earnings and liquidity (the C, A, E and L of CAMELS). The financial ratios are:

- Tier 1 Leverage Ratio;
- Loans past due 30–89 days/gross assets;
- Nonperforming loans/gross assets;
- Net loan charge-offs/gross assets;
- Net income before taxes/risk-weighted assets; and
- Volatile liabilities/gross assets.

The Tier 1 Leverage Ratio has the definition used for regulatory capital purposes. Appendix 1 defines each of the ratios and discusses the choice of ratios in detail.

Because supervisory ratings capture important elements of risk that financial ratios cannot, the FDIC included in its analysis an additional measure of risk based upon an institution's component CAMELS ratings. CAMELS component ratings are supervisory evaluations of various risks. The component ratings provide a more detailed view of supervisory evaluations than composite ratings by themselves and are therefore useful for differentiating risk among institutions. Including all component

ratings accounts for risk management practices, as well as for supervisory assessments of capital adequacy, asset quality, earnings, liquidity and sensitivity to market risk, that the financial ratios by themselves may not fully capture.

The FDIC created a weighted average of an institution's CAMELS components by combining the components as follows:

CAMELS component	Weight (percent)
C .....	25
A .....	20
M .....	25
E .....	10
L .....	10
S .....	10

These weights reflect the view of the FDIC regarding the relative importance of each of the CAMELS components for differentiating risk among institutions in Risk Category I for deposit insurance purposes.<sup>18</sup> The FDIC and other bank supervisors do not use such a system to determine CAMELS composite ratings.

The FDIC determined how to combine the measures—the financial ratios and the weighted average CAMELS component rating—by statistically analyzing the relationship between the measures and the probability that an institution would be downgraded to CAMELS 3, 4 or 5 at its next examination.<sup>19</sup> The FDIC analyzed financial ratios and supervisory component ratings over the period 1984 to 2004 to cover both periods of stress and strength in the banking industry.<sup>20</sup> The FDIC then converted those probabilities of downgrade to specific assessment rates. This analysis and conversion produced the following multipliers for each risk measure:

Risk measures *	Pricing multiplier **
Tier 1 Leverage Ratio .....	(0.03)
Loans Past Due 30–89 Days/Gross Assets .....	0.37
Nonperforming Loans/Gross Assets .....	0.65

<sup>18</sup> Different weights might apply if this measure were being used to evaluate risk at all institutions, including those outside Risk Category I.

<sup>19</sup> The "S" rating was first assigned in 1997. Because the statistical analysis relies on data from before 1997, the "S" rating was excluded from the analysis. Appendix 1 contains a detailed description of the statistical analysis.

<sup>20</sup> 2005 had to be excluded because the analysis is based upon supervisory downgrades within one year and 2006 downgrades have yet to be determined.

<sup>15</sup> For CAMELS 1 and 2-rated institutions, examinations generally occur on a 12 or 18-month cycle. 12 U.S.C. 1820(d).

<sup>16</sup> Charles Collier, Sean Forbush, Daniel A. Nuxoll and John O'Keefe, "The SCOR System of Off-Site Monitoring: Its Objectives, Functioning, and Performance," FDIC Banking Review 15(3) (2003).

<sup>17</sup> This statistical analysis is described in more detail in Appendix 1.

Risk measures *	Pricing multiplier **
Net Loan Charge-Offs/ Gross Assets .....	0.71
Net Income before Taxes/ Risk-Weighted Assets .....	(0.41)
Volatile Liabilities/Gross As- sets .....	0.03
Weight Average CAMELS component rating .....	0.52

\* Ratios are expressed as percentages.  
\*\* Multipliers are rounded to two significant decimal places.

To determine an institution's insurance assessment rate, the FDIC proposes multiplying each of these risk measures (that is, each institution's financial ratios and weighted average CAMELS component rating) by the corresponding pricing multipliers. The sum of these products would be added to (or subtracted from) a uniform amount (1.37 based on an analysis using financial ratios and supervisory component ratings from the period 1984 to 2004) to determine an institution's assessment rate.<sup>21</sup> The uniform amount would be derived from the statistical

analysis and adjusted for assessment rates set by the FDIC.<sup>22</sup> The FDIC proposes that the rates resulting from this approach be subject to a minimum and maximum. A maximum rate would ensure that no institution in Risk Category I, all of which are well-capitalized and generally have supervisory ratings of 1 or 2, pays as much as an institution in a higher risk category. A minimum rate recognizes that the possibility of a supervisory rating downgrade to CAMELS 3, 4 or 5 is low for a significant portion of institutions in Risk Category I.

This approach would allow incremental pricing for Risk Category I institutions whose rates are between the minimum and maximum rates. Therefore, small changes in an institution's financial ratios or CAMELS component ratings should produce only small changes in assessment rates.<sup>23</sup>

To compute the values of the uniform amount and pricing multipliers shown above, the FDIC chose cutoff values for the predicted probabilities of downgrade such that, as of December 31, 2005: (1) 45 percent of smaller

institutions (other than new institutions) in Risk Category I would have been charged the minimum assessment rate; and (2) 5 percent of smaller institutions (other than new institutions) in Risk Category I would have been charged the maximum assessment rate.<sup>24</sup> The proposal to charge 45 percent of small Risk Category I institutions (excluding new institutions) the minimum rate reflects the FDIC's view that the current condition of the banking industry is generally favorable. The pricing multipliers and the uniform amount shown above and in Table 8 assume that the maximum annual assessment rate for institutions in Risk Category I would be 2 basis points higher than the minimum rate, as the FDIC proposes below.<sup>25</sup> Appendix 1 discusses the analysis in detail.

Table 8 gives assessment rates for three institutions with varying characteristics, assuming the pricing multipliers given above, and that annual assessment rates for institutions in Risk Category I range from a minimum of 2 basis points to a maximum of 4 basis points.<sup>26</sup>

TABLE 8.—ASSESSMENT RATES FOR THREE INSTITUTIONS \*

A	Pricing multiplier B	Institution 1		Institution 2		Institution 3	
		Risk measure value C	Contribution to assessment rate D	Risk measure value E	Contribution to assessment rate F	Risk measure value G	Contribution to assessment rate H
Uniform Amount .....	1.37	.....	1.37	.....	1.37	.....	1.37
Tier 1 Leverage Ratio (%) .....	(0.03)	9.6	(0.27)	8.6	(0.24)	8.4	(0.23)
Loans Past Due 30–89 Days/Gross Assets (%) .....	0.37	0.4	0.15	0.6	0.22	0.8	0.30
Nonperforming Loans/Gross Assets (%) .....	0.65	0.2	0.13	0.4	0.26	1.2	0.78
Net Loan Charge-Offs/Gross Assets (%) .....	0.71	0.1	0.10	0.1	0.06	0.3	0.21
Net Income before Taxes/Risk-Weighted Assets (%) .....	(0.41)	2.5	(1.02)	2.0	(0.79)	(0.5)	(0.21)
Volatile Liabilities/Gross Assets (%) .....	0.03	20.1	0.63	22.6	0.70	35.7	1.11
Weighted Average CAMELS Component Ratings .....	0.52	1.2	0.62	1.5	0.75	2.1	1.08
Sum of Contribution .....	.....	.....	1.71	.....	2.33	.....	4.41

<sup>21</sup> Appendix 1 provides the derivation of the pricing multipliers and the uniform amount to be added to compute an assessment rate. The rate derived would be an annual rate, but would be determined every quarter.

<sup>22</sup> The uniform amount would be the same for all smaller institutions in Risk Category I (other than insured branches of foreign banks and new institutions), but would change when the Board changed assessment rates or when the pricing multipliers were updated using new data.

<sup>23</sup> Incremental pricing raises questions about how accurately small differences in assessment rates between institutions reflect differences in the relative risks that they pose to the insurance fund. The alternative would be to charge a much larger group of institutions the same assessment rate, which could lead to sharper differences in rates for institutions poised between one set of rates and another. For this reason, the FDIC is proposing incremental pricing.

<sup>24</sup> The cutoff value for the minimum assessment rate is a predicted probability of downgrade of 3 percent. The cutoff value for the maximum assessment rate is 16 percent.

<sup>25</sup> The uniform amount also depends upon the actual level of the minimum assessment rate.

<sup>26</sup> These are the base rates for Risk Category I proposed in Section IX; under the proposal, as now, actual rates for any year could be as much as 5 basis points higher or lower without the necessity of notice-and-comment rulemaking.

TABLE 8.—ASSESSMENT RATES FOR THREE INSTITUTIONS \*—Continued

A	Pricing multiplier B	Institution 1		Institution 2		Institution 3	
		Risk measure value C	Contribution to assessment rate D	Risk measure value E	Contribution to assessment rate F	Risk measure value G	Contribution to assessment rate H
Assessment Rate .....	.....	.....	2.00	.....	2.33	.....	4.00

\* Figures may not multiply or add to totals due to rounding.

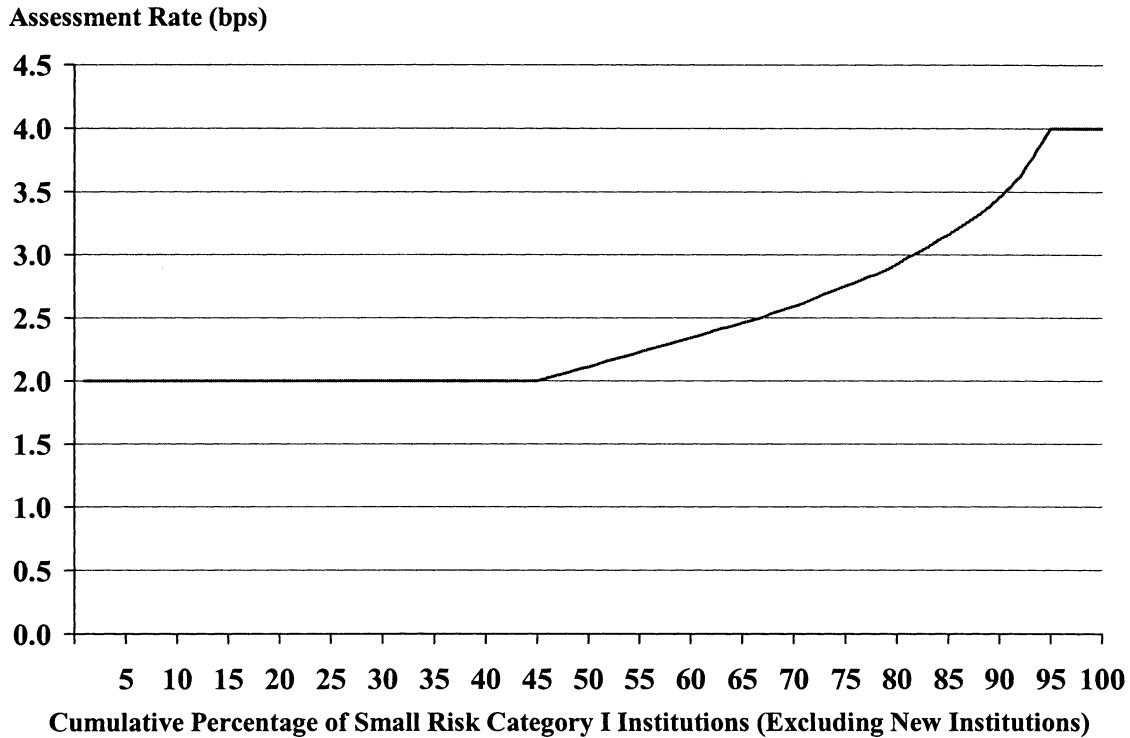
The assessment rate for an institution in the table is calculated by multiplying the pricing multipliers (Column B) times the risk measure values (Column C, E or G) to derive each measure's contribution to the assessment rate. The sum of the products (Column D, F or H) plus the uniform amount (first item in Column D, F or H) yields the total

assessment rate. For Institution 1 in the table, this sum actually equals 1.71, but the table reflects the assumed minimum assessment rate of 2 basis points. For Institution 3 in the table, the sum actually equals 4.41, but the table reflects the assumed maximum assessment rate of 4 basis points.

Chart 1 shows the cumulative distribution of assessment rates based on December 31, 2005 data, assuming that annual assessment rates for institutions in Risk Category I range from a minimum of 2 basis points to a maximum of 4 basis points. The chart excludes new institutions in Risk Category I.<sup>27</sup>

Chart 1

Cumulative Distribution of Assessment Rates Based on December 31, 2005 Data



A more detailed discussion of the analysis underlying this proposal is contained in Appendix 1.

For the final rule, the FDIC proposes to adopt updated cutoff values such

that, based on data as of June 30, 2006: (1) 45 percent of smaller institutions (other than new institutions) in Risk Category I would have been charged the minimum assessment rate; and (2) 5

percent of smaller institutions (other than new institutions) in Risk Category I would have been charged the maximum assessment rate. These updated cutoff values could alter the

<sup>27</sup> As discussed elsewhere, the FDIC proposes charging new institutions in Risk Category I the maximum assessment rate for the category. Thus,

when new institutions are included, the percentage of small insured institutions that are charged the minimum rate in Risk Category I is slightly under

40 percent and the percentage of institutions that are charged the maximum rate is slightly above 16 percent.

pricing multipliers and uniform amount. Using these same cutoff values in future periods could lead to different percentages of institutions being charged the minimum and maximum rates.

In addition, the FDIC proposes that it have the flexibility to update the pricing multipliers and the uniform amount annually, without notice-and-comment rulemaking. In particular, the FDIC intends to add data from each new year to its analysis and may, from time to time, drop some earlier years from its analysis. For example, some time during the next year the FDIC proposes to include data in the statistical analysis covering the period 1984 to 2005, rather than 1984 to 2004. Updating the pricing multipliers in this manner allows use of the most recent data, thereby improving the accuracy of the risk-differentiation method. Because the analysis will continue to use many earlier years' data as well, pricing multiplier changes from year to year should usually be relatively small.

On the other hand, as a result of the annual review and analysis, the FDIC may conclude that *additional* or *alternative* financial measures, ratios or other risk factors should be used to determine risk-based assessments or that a new method of differentiating for

risk should be used. In any of these events, changes would be made through notice-and-comment rulemaking.

The FDIC proposes that the financial ratios for any given quarter be calculated from the report of condition filed by each institution as of the last day of the quarter.<sup>28</sup> In a separate notice of proposed rulemaking, the FDIC has proposed that, for deposit insurance assessment purposes, changes to an institution's supervisory rating be reflected when the change occurs.<sup>29</sup> Under this proposal, if an examination (or targeted examination) led to a change in an institution's CAMELS composite rating that would affect the institution's insurance risk category, the institution's risk category would change as of the date the examination or targeted examination began, if such a date existed.<sup>30</sup> If there were no examination start date, the institution's risk category would change as of the date the institution was notified of its rating change by its primary federal regulator (or state authority). Both cases assume that the FDIC, after taking into account other information that could affect the rating, agreed with the primary federal regulator's CAMELS rating.<sup>31</sup> The FDIC proposes that, for small institutions in Risk Category I, a

similar rule apply for changes in CAMELS component ratings.<sup>32</sup>

2. Implications of the proposal

By combining both financial data and supervisory evaluations, this approach to risk differentiation provides a comprehensive and timely depiction of risk based on available data.<sup>33</sup> The pricing multipliers can be periodically updated to incorporate new financial and supervisory data. With the publication of pricing multipliers assigned to each risk measure, insured institutions could readily compute their deposit insurance assessments.

Tables 9 and 10 show the distribution of assessment rates by size (for institutions that have less than \$10 billion in assets) and by CAMELS composite rating over the period 1997 to 2005, assuming the application of the proposal over this period and that annual assessment rates for institutions in Risk Category I ranged from a minimum of 2 basis points to a maximum of 4 basis points.<sup>34</sup> The tables show that this approach would not result in significant differences in assessment rates based on size and that most CAMELS composite 1-rated institutions would pay the minimum rate, while most composite 2-rated institutions would not.

TABLE 9.—DISTRIBUTION OF ASSESSMENT RATES BY SIZE, 1997–2005

	Asset size			
	<=\$0.1B	\$0.1–\$0.5B	\$0.5B–\$1B	\$1B–\$10B
25th Percentile .....	2.0	2.0	2.0	2.0
Median .....	2.0	2.1	2.0	2.2
75th Percentile .....	2.8	2.7	2.6	2.8
95th Percentile .....	4.0	4.0	4.0	4.0

TABLE 10.—DISTRIBUTION OF ASSESSMENT RATES BY CAMELS COMPOSITE RATING, 1997–2005

	Composite CAMELS	
	1	2
25th Percentile .....	2.0	2.0
Median .....	2.0	2.5
75th Percentile .....	2.0	3.2
95th Percentile .....	3.0	4.0

<sup>28</sup> Reports of condition include Reports of Income and Condition and Thrift Financial Reports.

<sup>29</sup> 71 FR 28790, 28792 (May 18, 2006).

<sup>30</sup> Small institutions generally have an examination start date; very infrequently, however, a smaller bank's CAMELS rating can change without an examination, or there may be no examination start date.

<sup>31</sup> In the event of a disagreement, the FDIC would determine the date that the supervisory change occurred.

<sup>32</sup> An examination that begins before the proposed regulatory changes would be implemented (for example, before January 1, 2007) would be deemed to have begun on the first day of the first assessment period for which those changes are effective.

<sup>33</sup> As discussed in Appendix 1, historical data on costs from failures is consistent with the proposed method of risk differentiation.

<sup>34</sup> Although the pricing multiplier for the weighted average CAMELS component rating is

derived from data that excluded the "S" component, the "S" component is included for purposes of determining the weighted average CAMELS component ratings used to produce these tables. Appendix 2 discusses the derivation of the data in Tables 9 and 10 in greater detail.

3. Possible Variations on the Proposal

Variations on the FDIC's proposal are also possible. *For example:*

- The ratio of net income before taxes to risk-weighted assets and the ratio of net loan charge-offs to gross assets could be excluded. While higher earnings are statistically associated with lower probabilities of downgrades, higher earnings also can be a sign of increased risk.<sup>35</sup> Using risk-weighted assets to adjust earnings, as proposed, may not sufficiently capture those higher earnings that reflect greater risk taking. A second possible reason to eliminate these two ratios is that they are determined using four quarters of data and require adjustments to reflect mergers. Eliminating them would leave only balance sheet ratios, which are easier to calculate.

- Time deposits greater than \$100,000 could be excluded from the definition of volatile liabilities, as some have suggested that these deposits can have the same characteristics as core deposits.<sup>36</sup>
- Ratios might be averaged over some period to limit assessment rate changes.
- The weights assigned to each CAMELS component in determining the weighted average could be changed.
- A CAMELS composite rating could be used in place of a weighted average CAMELS component rating.<sup>37</sup>

Any changes in the financial ratios used or in the weighted average CAMELS component rating could result in changes to the pricing multipliers assigned to the risk measures actually used.<sup>38</sup> The FDIC seeks comment on

whether any variation on its proposal would be preferable.

*B. Alternative: Use Financial Ratios Alone To Differentiate for Risk*

1. Description of the Alternative

An alternative to the FDIC's proposal would be to use financial ratios alone to determine a small Risk Category I institution's assessment rate. The pricing multiplier to be assigned to each financial ratio would again be determined by statistically analyzing the relationship between these ratios and the probability that an institution would be downgraded to CAMELS 3, 4 or 5 at its next examination.<sup>39</sup> Using financial ratios from the period 1984 to 2004 produced the following multipliers:<sup>40</sup>

Financial ratio *	Pricing multiplier **
Tier 1 Leverage Ratio .....	(0.05)
Loans Past due 30–89 Days/Gross Assets .....	0.37
Nonperforming Loans/Gross Assets .....	0.74
Net Loan Charge-Offs/Gross Assets .....	0.88
Net Income before Taxes/Risk-Weighted Assets .....	(0.42)
Volatile Liabilities/Gross Assets .....	0.03

\* Ratios are expressed as percentages.  
 \* Multipliers are rounded to two significant decimal places.

Each ratio, as reported by an institution, would be multiplied by its pricing multiplier.<sup>41</sup> The sum of these products would again be added to or subtracted from a uniform amount (2.36 based on an analysis using financial ratios from the period 1984 to 2004) to determine an institution's assessment rate, subject to a minimum and maximum rate.<sup>42</sup>

To compute the values of the uniform amount and pricing multipliers shown above, the FDIC chose cutoff values for

the predicted probabilities of downgrade such that, as of December 31, 2005: (1) 43 percent of smaller institutions (other than new institutions) in Risk Category I would have been charged the minimum assessment rate; and (2) 5 percent of smaller institutions (other than new institutions) in Risk Category I would have been charged the maximum assessment rate.<sup>43</sup> The pricing multipliers and uniform amount shown above assume that the maximum annual

assessment rate for institutions in Risk Category I would be 2 basis points higher than the minimum rate, as the FDIC proposes below.<sup>44, 45, 46</sup>

If the alternative were adopted in a final rule, the FDIC would adopt updated cutoff values such that, based on data as of June 30, 2006: (1) 43 percent of smaller institutions (other than new institutions) in Risk Category I would have been charged the minimum assessment rate; and (2) 5 percent of smaller institutions (other

<sup>35</sup> If the ratio of net income before taxes to risk-weighted assets were not included as a risk measure, the ratio of liquid assets to gross assets might be added as a risk measure. This additional risk measure becomes statistically significant in explaining downgrades when the ratio of net income before taxes to risk-weighted assets is excluded, although its pricing multiplier would be small.

<sup>36</sup> However, time deposits greater than \$100,000 are more likely than smaller deposits to be withdrawn as the financial condition of the institution deteriorates (either to be replaced by insured deposits or paid off with the proceeds from high-quality assets), thus increasing the risk exposure of the insurance fund. Removing time deposits greater than \$100,000 from the definition of volatile liabilities would make volatile liabilities insignificant in explaining potential downgrades; therefore, volatile liabilities would no longer be used as a ratio.

<sup>37</sup> Doing so would mean that far fewer small Risk Category I CAMELS 2-rated institutions would pay the same assessment rates as (or lower assessment rates than) small Risk Category I CAMELS 1-rated institutions.

<sup>38</sup> New pricing multipliers for the risk measures under these variations would be determined in the same manner as the pricing multipliers in the proposal. (The derivation of pricing multipliers is described in Appendix 1.) The uniform amount to be added to the sum of the products of each institution's risk measures and pricing multipliers (used to determine the institution's assessment) could also change.

<sup>39</sup> The pricing multipliers for the ratios in the alternative would be determined in a manner similar to that used to derive the pricing multipliers in the proposal. The derivation of pricing multipliers is described in Appendix 1.

<sup>40</sup> These pricing multipliers differ from those in the proposal because excluding the weighted average CAMELS component rating changes the estimated relationships between financial ratios and the probability of downgrade.

<sup>41</sup> The financial ratios for any given quarter would be calculated from the report of condition filed by each institution as of the last day of the quarter.

<sup>42</sup> Appendix 1 provides the derivation of the pricing multipliers and the uniform amount to be added to compute an assessment rate. The rate derived would be an annual rate, but would be determined every quarter.

<sup>43</sup> The cutoff value for the minimum assessment rate would be a predicted probability of downgrade of 3 percent. The cutoff value for the maximum assessment rate would be 17 percent. The percentage of institutions that would have been charged the minimum assessment rate (43 percent) is slightly less than the percentage of institutions that would have been charged the minimum assessment rate under the proposal (45 percent) to ensure that the total assessment revenue collected under the proposal and under the alternative would be the same.

<sup>44</sup> The uniform amount also depends upon the actual level of the minimum assessment rate.

<sup>45</sup> Appendix 1 discusses the methodology underlying the proposed method and the alternative.

<sup>46</sup> As discussed elsewhere, the FDIC proposes charging new institutions in Risk Category I the maximum assessment rate for the category. Thus, when new institutions are included, the percentage of small insured institutions that are charged the minimum rate is about 38 percent and the percentage of institutions that are charged the maximum rate is slightly above 16 percent.



than new institutions) in Risk Category I would have been charged the maximum assessment rate. These updated cutoff values could alter the pricing multipliers and uniform amount. Using these same cutoff values in future years could lead to different percentages of institutions being charged the minimum and maximum rates.

Also, as under the proposal, the FDIC would propose to update the pricing multipliers assigned to the risk measures being used annually, without the necessity of notice-and-comment rulemaking. Again, however, if the FDIC's annual review and analysis conclude that additional or alternative

financial measures, ratios or other risk measures should be used to determine risk-based assessments, changes would be made through notice-and-comment rulemaking.

2. Comparison With the Proposal

While this approach to risk differentiation would not include supervisory evaluations, it would otherwise provide a comprehensive and timely depiction of risk based on available data.<sup>47</sup> As under the proposal, pricing multipliers can be periodically updated to incorporate new financial data and with the publication of pricing multipliers assigned to each risk measure, insured institutions can

readily compute their deposit insurance assessments.

Because this approach would also allow incremental pricing for Risk Category I institutions whose rates are between the minimum and maximum rates, small changes in an institution's financial ratios should produce only small changes in assessment rates.

Table 11 shows the percentage of institutions whose assessment rates would change by various amounts under the alternative method compared to the proposed method. The assessment rate for over 90 percent of institutions would change by one-quarter of a basis point or less.

TABLE 11.—COMPARISON OF ASSESSMENT RATES UNDER THE ALTERNATIVE AND THE PROPOSED METHOD USING YEAR-END 2005 DATA

	Higher under the alternative by			No Change	Lower under the alternative by		
	>0.5 bp	0.25–0.5 bp	0–0.25 bp		0–0.25 bp;	0.25–0.5 bp	>0.5 bp
Percent of Institutions ..	0.04	3.91	21.54	45.00	27.34	2.13	0.04

Tables 12 and 13 show the distribution of assessment rates by size and by CAMELS composite rating over the period 1997 to 2005, again assuming that annual assessment rates for institutions in Risk Category I ranged from a minimum of 2 basis points to a maximum of 4 basis points.<sup>48</sup> Table 12

shows that, like the proposal, using financial ratios alone to differentiate for risk and price would not result in significant differences in assessment rates based on size. Table 13 shows that, like the proposal, most CAMELS composite 1-rated institutions would pay the minimum rate, while most

composite 2-rated institutions would not. However, there is a higher likelihood that a CAMELS composite 2-rated institution would pay less than a CAMELS composite 1-rated institution than under the proposal.

TABLE 12.—DISTRIBUTION OF ASSESSMENT RATES BY SIZE, 1997–2005

	Asset size			
	<=\$0.1B	\$0.1–\$0.5B	\$0.5B–\$1B	\$1B–\$10B
25th Percentile .....	2.0	2.0	2.0	2.0
Median .....	2.1	2.1	2.1	2.2
75th Percentile .....	2.8	2.7	2.6	2.8
95th Percentile .....	4.0	4.0	4.0	4.0

TABLE 13.—DISTRIBUTION OF ASSESSMENT RATES BY CAMELS COMPOSITE RATING, 1997–2005

	CAMELS	
	1	2
25th Percentile .....	2.0	2.0
Median .....	2.0	2.5
75th Percentile .....	2.2	3.2
95th Percentile .....	3.2	4.0

3. Possible Variations

As with the FDIC's proposal, variations on the alternative method are

also possible, such as excluding the ratio of net income before taxes to risk-weighted assets and the ratio of loan charge-offs to gross assets. Again, any

changes in the financial ratios used could result in changes to the pricing multipliers to be used.<sup>49</sup>

<sup>47</sup> As discussed in Appendix 1, the accuracy of the proposed method and the alternative in predicting downgrades is very similar.

<sup>48</sup> Appendix 2 discusses the derivation of the data in Tables 12 and 13 in greater detail.

<sup>49</sup> New pricing multipliers for the risk measures under these variations would be determined in the same manner as the pricing multipliers in the alternative. (Derivation of pricing multipliers is described in Appendix 1.) The uniform amount and

pricing multipliers (used to determine an institution's assessment) could also change.

To incorporate supervisory perspectives that are not captured by financial ratios, the alternative method could also be combined with CAMELS component ratings, but in a manner different from the proposal. Instead of combining a weighted average CAMELS component rating with financial ratios through a statistical analysis, part of the assessment rate could be determined using solely financial ratios, as in the alternative, and the remainder using the weighted average CAMELS component rating. For example, the FDIC could determine a rate using financial ratios only and a rate using the weighted-average CAMELS component rating only and average the two rates to determine the institution's actual assessment rate.<sup>50</sup> This variation would more closely resemble the large Risk Category I institution risk differentiation method described in Section VI. If adopted, it would allow greater integration of the approaches.

Another variation could supplement the alternative by incorporating CAMELS component ratings in a more limited manner. For example, a small Risk Category I institution that had an "M" component rating of 3 or higher (or any CAMELS component of 3 or higher) might be charged the maximum assessment rate.

## VI. Risk Differentiation Among Larger Institutions in Risk Category I

### A. Proposal: Rely on Supervisory Ratings, Long-Term Debt Issuer Ratings, and for Some Institutions, Financial Ratios

#### 1. The Large Institution Risk Differentiation Proposal

The FDIC proposes to differentiate risk among large institutions using a combination of supervisory ratings, long-term debt issuer ratings, financial ratios for some institutions, and additional risk information. This approach shares two elements in common with the small institution approach: CAMELS component ratings, and financial ratios. The additional elements in the large institution approach are the explicit use of debt rating information and the consideration of additional risk information that is typically available for larger institutions. The debt rating information

element would be gradually phased in, and the financial ratio element would be gradually phased out, as an institution's assets increased from \$10 billion to \$30 billion.

The FDIC proposes to assign each large Risk Category I institution to one of six assessment rate subcategories. This assignment would be determined in two steps. In the first step, an insurance score would be derived. Cutoff insurance scores would initially be set for the minimum and maximum assessment rate subcategories so that similar proportions of the number of large and small institutions (excluding new institutions) are charged the minimum and maximum rates within Risk Category I. At the same time, cutoff insurance scores would be set for the four intermediate assessment rate subcategories. Thereafter, an institution's insurance score would determine its initial assessment rate subcategory assignment. In the second step, the FDIC would determine whether to adjust the initial assessment rating subcategory assignment based on considerations of additional information.

The FDIC proposes to derive an insurance score from a combination of supervisory and debt rating agency information, and an estimated probability of downgrade to a CAMELS composite 3, 4 or 5 as derived in the alternative method of risk differentiation for small Risk Category I institutions described in Section V(B)(1) (referred to hereafter as the financial ratio factor). The financial ratio factor would be gradually phased out as institution assets increased and would be fully phased out for institutions with \$30 billion or more in assets. Correspondingly, information from debt rating agencies would increase in importance as institution size increased from \$10 billion to \$30 billion. For institutions with \$30 billion or more in assets, the proposed insurance score would be derived solely from supervisory ratings and debt rating information.

The insurance scores would be used to assign institutions to an initial assessment rate subcategory. Although these initial subcategory assignments should in most cases provide a reasonable rank ordering of risk among large Risk Category I institutions, the FDIC would consider additional information to determine when adjustments to an institution's assessment rate subcategory are appropriate. Consideration of this additional information will allow the FDIC to develop more reasonable and consistent rank orderings of risk as indicated by institutions' Risk Category

I assessment rate subcategory assignments. Any modification would be limited to changing an institution's initial assessment rate subcategory assignment to the next higher or lower assessment rate. The risk factors that would be considered to determine if assessment rate subcategory adjustments were necessary are detailed further below.

The proposed approach is consistent with best practices in the banking industry for rating and ranking large direct credit and counterparty credit risk exposures. These practices include considering all relevant risk information, using standardized risk assessment processes and methodologies, incorporating judgment, where necessary, and using quality controls to ensure consistency and reasonableness of the ratings and risk rankings.

International groups, such as the Bank for International Settlements' Basel Committee on Banking Supervision, support these standards as applied to rating systems for large exposures:

Credit scoring models and other mechanical rating procedures generally use only a subset of available information. Although mechanical rating procedures may sometimes avoid some of the idiosyncratic errors made by rating systems in which judgment plays a large role, mechanical use of limited information also is a source of rating errors. Credit scoring models and other mechanical procedures are permissible as the primary or partial basis of rating assignments, and may play a role in the estimation of loss characteristics. Sufficient judgment and oversight is necessary to ensure that all relevant and material information, including that which is outside the scope of the model, is also taken into consideration, and that the model is used appropriately.<sup>52</sup>

The insurance score would be a weighted average of three elements: (1) A weighted average CAMELS component rating with a value between 1.0 and 3.0; (2) long-term debt issuer ratings converted to a numerical value between 1.0 and 3.0; and (3) for institutions with between \$10 billion and \$30 billion in assets, the financial ratio factor converted to a value between 1.0 and a 3.0. The result would be an insurance score with values ranging from 1.0 to 3.0. The weights applied to the supervisory rating element of the proposed approach would be constant across all size categories. For institutions with \$10 billion to \$30 billion in assets, the weights assigned to the long-term debt issuer rating and financial ratio factor would vary. Each

<sup>50</sup>To determine the half of the rate attributable to the weighted average CAMELS component rating, the FDIC would charge a portion of institutions a minimum rate and a portion a maximum rate. The FDIC would assess all other institutions at rates that increase as weighted-average CAMELS component ratings increase.

<sup>51</sup>To produce the same revenue as the proposal and the alternative described above, the percentage of institutions subject to the minimum and maximum rates would have to be adjusted.

<sup>52</sup>*International Convergence of Capital Measurement and Capital Standards*, June 2004, paragraph 417.

element of the proposed approach is discussed in detail below.

2. Supervisory Ratings

As noted in the small Risk Category I institution risk differentiation proposal, CAMELS component ratings provide both a more detailed description of risk and finer differentiations of risk than do composite ratings alone. For large Risk Category I institutions, the FDIC proposes to use these component ratings to derive a weighted average CAMELS component rating. This weighted average CAMELS component rating would be determined by multiplying the component rating value by an associated weight and summing the six products. The weights applied to individual CAMELS component ratings would be

the same as under the small Risk Category I institution proposal:

CAMELS component	Weight (percent)
C .....	25
A .....	20
M .....	25
E .....	10
L .....	10
S .....	10

As noted above, these weights reflect the view of the FDIC regarding the relative importance of each CAMELS component for differentiating risk among Risk Category I institutions for insurance purposes.

The weights proposed above would be appropriate for most large Risk Category I institutions. However, alternative

weights might be appropriate in certain instances. For example, one possible alternative would vary these weights depending upon an institution's primary business type. To illustrate, some institutions that are engaged in securities processing activities retain relatively little credit risk compared to other institutions. Risks in these institutions relate more to operational practices and controls. For these institutions, it might be appropriate to increase the weight for the "M" (Management) component (which includes operational risk considerations) relative to the "A" (Asset quality) component. The following table provides an example of CAMELS component weights that could be used for selected institution types.

Institution type *	C	A	M	E	L	S
Diversified Regional Institutions .....	25	20	25	10	10	10
Processing Institutions and Trust Companies .....	20	15	35	10	10	10
Residential Mortgage Lenders .....	20	20	25	10	10	15
Large Diversified Institutions .....	20	15	25	10	15	15
Non-diversified Regional Institutions .....	25	25	25	10	10	5

\* Under this alternative, large institutions might be grouped into institution types using the institution type grouping definitions shown in Appendix 3 to this document. This grouping includes institutions with operating characteristics or lending concentrations indicative of processing institutions and trust companies, residential mortgage lenders, non-diversified regional institutions, large diversified institutions, or diversified regional institutions.

Another possible weighting approach would be for the FDIC to vary component weights based on the relative importance of each significant business activity in which an institution is engaged. In such a system, each institution's unique combination of business activities (such as securities processing, fiduciary activities, consumer lending, real estate lending, wholesale lending) could lead to unique CAMELS component rating weights for each institution. The FDIC is seeking comment whether alternative CAMELS component weights should be considered.

3. Debt Rating Agency Information

The proposed approach would be based upon the long-term debt issuer ratings of insured institutions assigned by major rating agencies.<sup>53</sup> Debt issuer ratings of insured institutions' holding companies would not be used. While there are minor differences in definitions among rating agencies, a long-term debt issuer rating generally represents an opinion of the ability of an institution to meet its long-term financial obligations without respect to the characteristics of a firm's underlying obligations (such as the covenants of the

obligation or whether the obligation is collateralized or guaranteed). There are several advantages to using these long-term debt issuer ratings: (1) They differentiate risk among large insured institutions by assigning an institution to one of a number of risk classifications;<sup>54</sup> (2) they are available for all but a small number of large insured institutions;<sup>55</sup> and (3) they supplement supervisory ratings. Moreover, because long-term debt issuer ratings can be viewed as an opinion of the likelihood of default, they serve as a useful proxy for an institution's relative funding costs. There is an argument for aligning the risk rankings used for insurance pricing purposes with the relative prices institutions pay on their non-deposit funding sources.

To obtain a numerical representation of these ratings, the FDIC proposes to convert long-term debt issuer ratings to values between 1 and 3 in accordance with the conversion table shown in Appendix B. In this conversion table, the relative change in converted values

increases for lower rating grades. This pattern is consistent with historical bond default studies that show non-linear increases in default risk for lower-graded debt issues.<sup>56</sup>

The proposed process for differentiating risk in large institutions would only use current agency long-term debt issuer ratings, those that have been confirmed or newly assigned within the last 12 months. When only one current long-term debt issuer rating exists, that rating would be converted directly into a debt issuer score in accordance with Appendix B. Where two or more current long-term debt issuer ratings exist, the numerical conversion would be calculated as the average of the converted value of each current long-term debt issuer rating.

4. The Financial Ratio Factor

The proposal would use the financial ratio factor as previously defined in cases where a large institution has assets of \$10 billion to \$30 billion.<sup>57</sup> Considering aspects of both the small

<sup>53</sup> The major U.S. rating agencies are Moody's, Standard & Poor's, and Fitch.

<sup>54</sup> Including rating modifiers, there are 10 potential issuer ratings possible in the rating agencies; investment-grade rating scales.

<sup>55</sup> Most other market measures (equity indicators and most debt indicators) are not directly applicable to the insured entity because they are based on the equity and debt funding structure of the holding company.

<sup>56</sup> See, for example, Standard & Poor's Annual Global Corporate Default Study for 2005.

<sup>57</sup> The financial ratios used to derive the financial ratio factor are the tier 1 leverage ratio, loans past due 30-89 days to gross assets, nonperforming loans to gross assets, net loan charge-offs to gross assets, net income before taxes to risk-weighted assets, and volatility liabilities to gross assets.

and large institution risk differentiation approaches for institutions of this size reduces the potential for abrupt assessment rate changes when an institution grows above or shrinks below \$10 billion in assets.

The following process would be used to convert the financial ratio factor into the same 1.0 to 3.0 scale as the other two insurance score elements: (1) Institutions with a financial ratio factor equal to or less than the minimum assessment rate cutoff value for small Risk Category I institutions under the alternative financial ratio-only risk differentiation approach would be assigned a value of 1.0; (2) institutions with a financial ratio factor equal to or greater than the maximum assessment rate cutoff value for small Risk Category I institutions under the alternative financial ratio-only risk differentiation approach would be assigned a value of 3.0; and (3) for all other institutions, the financial ratio factor would be converted by: (a) Calculating the difference between the institution's financial ratio factor and the minimum assessment rate cutoff value determined in (1) above; (b) dividing the result by the difference between the maximum

and minimum assessment rate cutoff values determined in (1) and (2) above; (c) multiplying this ratio by the difference between the maximum and minimum insurance score values (*i.e.*, 3 minus 1); and (d) adding the minimum insurance score (*i.e.*, 1) to the result.<sup>58</sup>

As noted in the discussion of the alternative risk differentiation method for small Risk Category I institutions, the cutoff values applied in the process above will be updated based on data as of June 30, 2006 by finding the cutoff values that would charge: (1) 43 percent of smaller institutions (other than new institutions) in Risk Category I the minimum assessment rate; and (2) 5 percent of smaller institutions (other than new institutions) in Risk Category I the maximum assessment rate.

5. Weights Applied to the Large Risk Category I Insurance Score Elements

Weights would be applied to each of the above elements—the weighted average CAMELS component rating, long-term debt issuer ratings that have been converted to a numerical value, and the financial ratio factor—to derive an insurance score. The weight applied to the weighted average CAMELS

component rating would be 50 percent for all size categories. The weight applied to long-term debt issuer ratings would be 50 percent for all institutions with \$30 billion or more in assets. For institutions with \$10 billion to \$30 billion in assets, the weight applied to long-term debt issuer ratings would increase (and correspondingly, the weight applied to the financial ratio factor would decrease), as the institution's size increased.<sup>59</sup> Scaling the long-term debt issuer rating weights recognizes that, the larger the institution, the greater the relative importance of long-term debt issuer ratings to both its non-insured funding costs and its ability to engage in certain types of business, such as credit derivatives or other types of derivatives. While the financial ratio factor weight would decline as an institution assets increase, the financial ratios used to derive this factor could be among the considerations used to potentially adjust the ultimate risk assessment subcategory assignment as described further below. Table 14 shows the proposed weights for the various size categories of large Risk Category I institutions.

TABLE 14.—WEIGHTS UNDER THE PROPOSED APPROACH

Asset size category*	Weights applied to the:		
	Weighted average CAMELS component rating (percent)	Converted long-term debt issuer ratings (percent)	Financial ratio factor (percent)
>= \$30 billion .....	50	50	0
>= \$25 billion, < \$30 billion .....	50	40	10
>= \$20 billion, < \$25 billion .....	50	30	20
>= \$15 billion, < \$20 billion .....	50	20	30
>= \$10 billion, < \$15 billion .....	50	10	40
No long-term debt issuer rating .....	50	0	50

\* Applicable when a current (within last 12 months) long-term debt issuer rating is available for the insured institution. If no current rating is available, the last row of the table applies.

6. Insurance Score

After applying weights to the weighted average CAMELS component rating, the numerical representation of the long-term debt issuer rating, and financial ratio factor as converted to a 1.0 to 3.0 scale, the proposed approach would produce a number between 1.0 and 3.0. (Non-integer values are possible.) This number would serve as the basis for initially assigning an

institution to an assessment rate subcategory for that assessment period. The relationship between this insurance score and the insurance assessment rate subcategories is described below.

7. Example of an Insurance Score Calculation

For illustrative purposes, consider an institution with the following characteristics:

- CAMELS component ratings as of the assessment date are “222121.”
- The institution has a current long-term debt issuer rating of “A –” by both Standard and Poor's and Fitch and an “A3” rating by Moody's.
- The institution's assets as of the assessment date are \$18 billion.

Given these circumstances, the institution's insurance score would be calculated as illustrated in Table 15.

<sup>58</sup>This conversion process is described in detail in Appendix B.

<sup>59</sup>For any large institution that did not have a long-term debt issuer rating, the weighted average

CAMELS component rating and financial ratio factor would be weighted 50 percent each. Of the 117 institutions with over \$10 billion in assets as of year-end 2005, 17 did not have any current long-

term debt issuer ratings. Most of these 17 institutions are insured thrifts and all but two had less than \$30 billion in year-end 2005 assets.

TABLE 15.—ILLUSTRATIVE INSURANCE SCORE CALCULATION

Insurance score elements	Ratings	Weights (percent)	Input value	Element weight (percent)	Score contribution
Supervisory Ratings:					
Capital Adequacy .....	2.0	25	0.50	.....	.....
Asset Quality .....	2.0	20	0.40	.....	.....
Management .....	2.0	25	0.50	.....	.....
Earnings .....	1.0	10	0.10	.....	.....
Liquidity .....	2.0	10	0.20	.....	.....
Sensitivity to Market Risk .....	1.0	10	0.10	.....	.....
Weighted average CAMELS .....	.....	.....	1.80	50	0.90
Market Information:					
Long-term debt issuer rating .....	.....	.....	1.50	20	0.30
Financial Ratio Factor:					
(Estimated probability of downgrade equals 8.36%) ....	.....	.....	1.77	30	0.53
Insurance Score .....	.....	.....	.....	.....	1.73

- The weighted average CAMELS component rating portion of the insurance score is calculated as follows: The CAMELS component ratings are as assigned through the supervisory process. Multiplying the component ratings by their associated weights produces values of 0.50, 0.40, 0.50, 0.10, 0.20, and 0.10, respectively. The sum of these values, the weighted average CAMELS component rating, equals 1.80. The overall weight applied to the weighted average CAMELS component rating is 50 percent. Multiplying the weighted average CAMELS component rating by 50 percent equals 0.90, which is the contribution of the supervisory rating element to the insurance score.

- The long-term debt issuer rating portion of the insurance score is calculated as follows: The average of three current long-term debt issuer ratings converted to numerical values according Appendix B is 1.50. With \$18 billion in assets, the institution’s long-term debt issuer rating weight is 20 percent, per Table 14. The product of its converted long-term debt issuer rating and weight is 0.30.

- The financial ratio factor of the insurance score is calculated as noted above: (a) The difference between the institution’s estimated probability of downgrade of .0836 percent and the minimum assessment rate cutoff value of .03 percent equals .0536; (b) this result is divided by the difference between the maximum and minimum assessment rate cutoff values of .17 and .03 and equals .3829; (c) this ratio is multiplied by the difference between the maximum and minimum insurance score values of (3 minus 1) and equals .7657; and (d) this result is added to the minimum insurance score of 1 to obtain the converted value of 1.77 (rounded). The weight for the financial ratio factor,

per Table 14, is 30 percent. The product of the converted financial ratio factor and its associated weight is 0.53 (rounded).

- The combined insurance score is calculated as follows: The sum of the individual elements—the weighted average CAMELS component rating, the long-term debt issuer ratings, and the financial ratio factor (0.90 + 0.30 + 0.53)—produces an insurance score of 1.73 (rounded). The relationship between the insurance score and an institution’s assessment rate is described below.

*B. Proposal: Use the Insurance Score, Along With Consideration of Other Relevant Risk Information, To Assign an Institution to an Assessment Rate Subcategory*

1. Establishing Risk Category I Assessment Rate Subcategories for Large Institutions

As indicated earlier, the FDIC proposes using insurance scores to set cutoff scores for the minimum and maximum assessment rate subcategories. These cutoff scores would be set at levels that initially produce similar proportions of the number of large and small institutions (excluding new institutions) being charged the minimum and maximum rates within Risk Category I. The FDIC would set cutoff scores based on the distribution of insurance scores (for large institutions) and assessment rates (for small institutions) for the first quarter of 2007.<sup>60</sup> Using year-end 2005 information, the FDIC’s best estimate is that a cutoff insurance score of 1.45 or

lower would result in roughly 46 percent of large institutions (excluding new institutions) being charged the minimum assessment rate. Similarly, designating a cutoff score of greater than 2.05 would result in roughly 5 percent of large institutions (excluding new institutions) being charged the maximum assessment rate.

For large Risk Category I institutions whose insurance scores fall between the cutoff scores for the minimum and maximum assessment rates, the FDIC proposes to develop four additional assessment rate subcategories, bringing the total number of subcategories (including the minimum and maximum subcategories) to six. The cutoff score ranges for each of the four intermediate subcategories would be equal. Assuming cutoff scores for the minimum and maximum assessment rates of 1.45 and 2.05, respectively, cutoff scores for the intermediate subcategories would be 1.60, 1.75 and 1.90.

The FDIC proposes to set the base assessment rates for the four intermediate subcategories of Risk Category I (those being charged between the minimum and maximum base assessment rates) based on assessment rates applicable to small Risk Category I institutions (excluding insured branches of foreign banks and new institutions). To determine these rates, the FDIC would divide the institutions in small Risk Category I that are charged assessments between the minimum and maximum rates as of June 30, 2006 into four groups. Each of the four groups would contain the same proportion of institutions as the corresponding intermediate subcategory of large institutions as of June 30, 2006. Using year-end 2005 information as an estimate, the proportion of large institutions within these intermediate

<sup>60</sup> Thereafter, the proportions of large institutions that are charged the minimum and maximum assessment rates could differ from the proportions of small institutions that are charged the minimum and maximum assessment rates.

subcategories (in increasing assessment rate order) would be 38 percent, 30 percent, 18 percent, and 14 percent, respectively.

The FDIC would apply the average assessment rate from a small institution

group to the corresponding large institution intermediate subcategory. Again using year-end 2005 information and assuming a minimum assessment rate of 2 basis points and a maximum assessment rate of 4 basis points, Table

16 provides an estimate of insurance score cutoff points and associated assessment rates for each subcategory.

TABLE 16.—ASSESSMENT RATE EXAMPLE USING ASSESSMENT RATE SUBCATEGORIES

Insurance score	Assessment rate
<=1.45 .....	2 basis points (bp) (minimum rate).
>1.45 but <=1.60 .....	2.22 bp (average of the first 38 percent of small institution assessment rates in the incremental range).
>1.60 but <=1.75 .....	2.65 bp (average of the next 30 percent of small institution assessment rates in the incremental range).
>1.75 but <=1.90 .....	3.09 bp (average of the next 18 percent of small institution assessment rates in the incremental range).
>1.90 but <=2.05 .....	3.61 bp (average of the next 14 percent of small institution assessment rates in the incremental range).
>2.05 .....	4 bp (maximum rate).

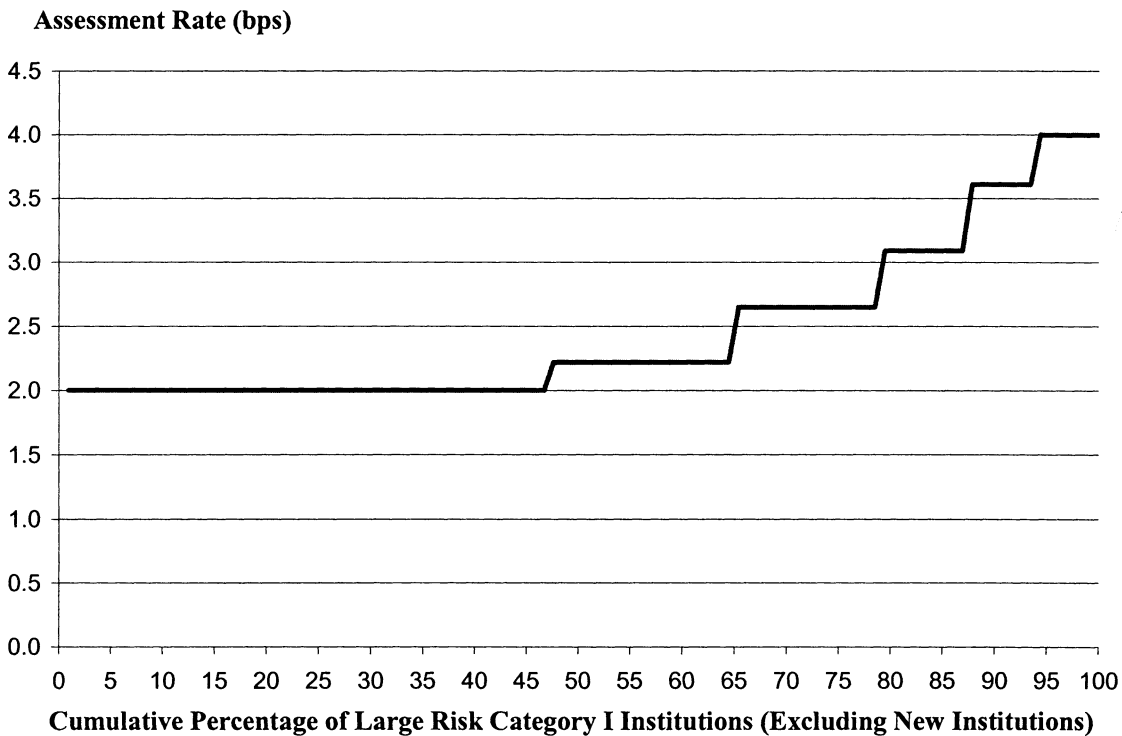
Chart 2 illustrates an estimate of the cumulative distribution of assessment rates for large Risk Category I

institutions as of year-end 2005 using the proposed subcategory approach assuming that annual assessment rates

for these institutions range from 2 basis points to 4 basis points.

Chart 2

Estimated Cumulative Distribution of Large Institution Assessment Rates  
Using a Subcategory Pricing Approach  
Based on December 31, 2005 Information



The proposed subcategory approach has the advantage of allowing the use of a “watch list” whereby institutions could be notified in advance when changes in an insurance score input, or consideration of other risk information,

would result in a change in the institution’s assessment rate subcategory assignment. Such advance notice would allow an institution to take action to improve its risk profile, in the case of a potential lowering of a subcategory

assignment, before its assessment rate increases. The FDIC seeks comment on the appropriateness of this possible “watch list” feature of the proposal.

## 2. Adjustments to an Institution's Initial Assessment Rate Subcategory Assignment

Consistent with best practices in the banking industry for rating and ranking large direct credit and counterparty credit risk exposures, the FDIC proposes to consider additional information and analyses to determine whether to adjust an institution's initial assessment rate subcategory assignment. Having the ability to make such adjustments, combined with quality controls to ensure the adjustments are justified and well supported, should promote greater consistency in subcategory assignments in terms of the relative levels of risk represented within each assessment rate subcategory. Any adjustment to an institution's initial assessment rate subcategory assignment (as determined by its insurance score) would be limited to the next higher or next lower assessment rate subcategory.

There are three broad categories of information that the FDIC proposes to consider in determining whether to make adjustments to an institution's initial assessment rate subcategory assignment. The types of information included in these categories, as well as the way the FDIC proposes to use this information, are discussed below. Appendix D contains a more detailed listing of the types of additional risk information that would be used to determine whether or not to adjust the initial assessment rate subcategory assignment as determined by an institution's insurance score.

*Other Market Information:* In addition to long-term debt issuer ratings, the FDIC proposes to consider other market information, such as subordinated debt prices, spreads observed on credit default swaps related to an institution's non-deposit obligations, equity price volatility observed on an institution's parent company stock, and debt rating agency "watch list" notices. These additional market indicators would be especially beneficial in assessing whether the insurance score accurately reflected the relative level of risk posed by an institution. For example, instances where an institution has been placed on a rating agency "watch" list with negative or positive implications, or instances when an institution's subordinated debt spreads are different from institutions with similar long-term debt issuer ratings, may provide evidence that the institution has more or less risk than other institutions in the same initial assessment rate subcategory.

*Financial Performance and Condition Measures:* Regulatory financial reports

contain a significant amount of information about the performance trends and condition of insured institutions. Most large institutions also file periodic reports with the Securities and Exchange Commission, which contain additional details and disclosures concerning operations and performance trends. The FDIC proposes to use performance indicators from these reports (e.g., capital levels, profitability measures, asset quality measures, liquidity and funding measures, interest rate risk measures, and market risk measures), as well as other financial performance and condition information and analyses developed by or obtained through the institution's primary federal regulator, to determine whether these measures were generally in line with or different from other institutions assigned to the same assessment rate subcategory.<sup>61</sup>

*Stress Considerations:* Under the proposal, the FDIC would also consider two additional kinds of information: how a large institution would perform when faced with adverse financial or economic conditions (ability to withstand stress), and the potential resolution costs implicit in the institution's business activities, asset composition, and funding structure (loss severity considerations). To evaluate an institution's ability to withstand stress, the FDIC would rely on information from internal stress-test models, information pertaining to the internal risk and performance characteristics of an institution's credit portfolios and other business lines, general balance sheet and financial performance measures, and other analyses developed by the institution that pertain to its projected performance during periods of economic or financial stress.

The following considerations illustrate how information pertaining to the ability to withstand stress would be evaluated: (1) To what extent does the institution identify stress conditions that it may be vulnerable to, given its credit exposures and banking activities? (2) does the institution consider reasonably plausible stress scenarios beyond those normally expected? (3) does the institution have the technical capability to measure its vulnerability to varying degrees of financial stress? (4) what level of protection is provided by the institution's current capital,

<sup>61</sup> The FDIC recognizes that institutions engaged in different types of banking activities may have different ranges of financial performance and condition measures. Therefore, any "peer comparisons" used to inform assessment rate subcategory adjustment decisions would involve institutions engaged in similar types of banking activities.

earnings, and liquidity positions against varying degrees of unanticipated stress conditions? If, based on these considerations, an institution's capital, earnings, and liquidity positions can be shown to be sufficient to withstand a considerable degree of financial stress, it would be viewed as less risky than an institution that can be shown to have only an adequate level of protection against moderate levels of financial stress. Such evaluations would help determine if there were meaningful differences in an institution's ability to withstand financial stress relative to other institutions in that assessment rate subcategory.

In the case of the loss severity considerations, the FDIC proposes to evaluate the nature of an institution's primary business activities, the expected costs that these activities would impose on the FDIC in the event the institution failed, the marketability and potential value of the institution's assets, and the implications of an institution's funding structure and priority of claims on potential insurance fund losses in the event of a failure. To analyze these factors, the FDIC would rely on the institution's description of its business lines, general balance sheet and funding information, and other analyses developed by or in consultation with the institution's primary federal regulator. Again, the level of risk indicated by such analyses would be compared to those of other institutions in the same assessment rate subcategory.

## 3. Assessment Rating Assignment Evaluation and Review Processes

In conjunction with its evaluation of assessment rate subcategory assignments, the FDIC would establish a variety of controls to ensure consistent and well supported insurance pricing decisions. These controls would include the following:

- Adjustments to the assessment rate subcategory assignment would be fully supported and documented. The justification for the adjustment would be internally reviewed to ensure that the ultimate assessment rate subcategory assignment was consistent with the risk characteristics generally represented within that subcategory assignment.

- The overall distribution of large institution assessment rate subcategory assignments would be subject to an additional review that ensured the risk rankings suggested by these assignments were logical.

- The FDIC would consult with institutions' primary federal regulators before finalizing assessment rate subcategory assignments.

• As discussed above, if a “watch list” feature were included in the proposal, the FDIC would provide prior notice before changing an institution’s assessment rate subcategory assignment.

#### 4. Timing of Evaluations

As discussed earlier, in a separate notice of proposed rulemaking, the FDIC has proposed that, for deposit insurance purposes, changes to an institution’s supervisory rating be reflected when the change occurs.<sup>62</sup> Under that proposal, if an examination (or targeted examination) led to a change in an institution’s CAMELS composite rating that would affect the institution’s insurance risk category, the institution’s risk category would change as of the date the examination or targeted examination began, if such a date existed. Otherwise, it would change as of the date the institution was notified of its rating change by its primary federal regulator (or state authority).<sup>63</sup>

The FDIC proposes that this rule apply to a large institution when a supervisory rating change results in the institution being placed in a different Risk Category. However, if, during a quarter, a supervisory rating change occurs that results in an large institution moving from Risk Category I to Risk Category II, III or IV, the institution’s assessment rate for the portion of the quarter that it was in Risk Category I would be based upon its insurance score for the prior quarter; no new insurance score would be developed for the quarter in which the institution moved to Risk Category II, III or IV.

When a large institution is moved to Risk Category I during a quarter as the result of a supervisory rating change, the FDIC proposes to assign an insurance score, associated subcategory (subject to adjustment as describe above) and assessment rate for the portion of the quarter that the institution was in Risk Category I as it would for other large institutions in Risk Category I, except that the assessment rate would only apply to the portion of the quarter that the institution was in Risk Category I.

When an institution remains in Risk Category I during a quarter, but a CAMELS component or a long-term debt issuer rating changes during the quarter that would affect its initial assignment to a subcategory, the FDIC proposes to assign separate insurance scores,

associated subcategories (subject to adjustments as describe above) and associated assessment rates for the portion of the quarter before and after the change. A long-term debt issuer rating change would be effective as of the date the change was announced. If an examination (or targeted examination) led to the change in an institution’s CAMELS component rating, the FDIC proposes that the change would be effective as of the date the examination or targeted examination began, if such a date existed. Otherwise, the change would be effective as of the date the institution was notified of its rating change by its primary federal regulator (or state authority).<sup>64</sup>

However, the FDIC is also considering a different rule for large institutions that remain in Risk Category I during a quarter, but whose CAMELS components or long-term debt issuer ratings change during the quarter. Because the FDIC will review each large institution at least quarterly for deposit insurance purposes, it will usually be aware of changes in an institution’s risk profile before they are reflected in changed CAMELS component ratings or long-term debt issuer ratings. Thus, the FDIC is considering an alternate rule whereby, when a large institution remains in Risk Category I during a quarter, the FDIC would assign an insurance score, associated subcategory (subject to adjustment as describe above) and assessment rate for the entire quarter using the supervisory ratings and agency ratings in place as of the end of the quarter. However, the FDIC proposes to also take into account information received after the end of the quarter if the information reflects upon an institution’s condition as of the end of the quarter.

### VII. Definitions of Large and Small Institutions and Exceptions

#### A. Proposal: Determine Whether an Institution Is Large or Small Based Upon Its Assets

As discussed above, for risk differentiation purposes, the FDIC proposes to define a Risk Category I institution as small if it has less than \$10 billion in assets and large if it has \$10 billion or more in assets. The selection of the \$10 billion asset size threshold stems from various considerations. First, institutions in this size category tend to have more

information available relating to risk. Many of these institutions have developed and adopted sophisticated risk measurement models and systems. In addition, approximately 85 percent of institutions that have over \$10 billion in assets have a long-term debt issuer rating by one of the three major U.S. rating agencies. Second, some types of complex activities engaged in by these larger institutions (e.g., securitization, derivatives, and trading) can be better evaluated by considering risk measurement and management information that is not considered under the proposed and alternative methods for small institutions.

Initially, the FDIC proposes to determine whether an institution is small or large based upon its assets as of December 31, 2006. Thereafter, a small Risk Category I institution would be reclassified as a large institution when it reported assets of \$10 billion or more for four consecutive quarters. This reclassification would become effective for subsequent quarters until it reported assets under \$10 billion for four consecutive quarters. Similarly, a large Risk Category I institution would be reclassified as a small institution when it reported assets of less than \$10 billion for four consecutive quarters. This reclassification would become effective for subsequent quarters until it reported assets over \$10 billion for four consecutive quarters.

#### B. Proposal: Allow Some Small Institutions To Request Treatment as a Large Institution

In addition, the FDIC proposes that any Risk Category I institution that has between \$5 billion and \$10 billion in assets could request treatment under the large institution risk differentiation approach.<sup>65</sup> Granting such a request would depend on whether the FDIC determines that it has sufficient information to evaluate the institution’s risk adequately using the large Risk Category I risk differentiation method. Once a request had been granted, an institution could again request treatment under a different approach after three years, subject to the FDIC’s approval.<sup>66</sup> The element weightings for institutions with between \$5 and \$10 billion in assets that request and are granted permission to be treated under

<sup>62</sup> 71 FR 28790, 28792.

<sup>63</sup> In either case, the FDIC, after taking into account other information that could affect the rating, would have to agree with the rating change. Otherwise, for purposes of deposit insurance risk classification, the rating change would change as of the date that the FDIC determined that the change occurred.

<sup>64</sup> In either case, the FDIC, after taking into account other information that could affect the rating, would have to agree with the rating change. Otherwise, for purposes of deposit insurance risk classification, the rating change would change as of the date that the FDIC determined that the change occurred.

<sup>65</sup> As of year-end 2005, there were 74 insured institutions with between \$5 and \$10 billion in assets.

<sup>66</sup> If an institution whose request to “opt-in” were granted and its assets subsequently fell below the \$5 billion threshold, the FDIC proposes that it would determine within one year whether to use the small or large institution risk differentiation approach.



the large institution risk differentiation approach would be the same as those shown in Table 14 for institutions with between \$10 billion and \$15 billion in assets.

*C. Proposal: For Risk Differentiation and Pricing Purposes, Treat Small Affiliates of Larger Institutions Separately*

In total, large institutions have approximately 200 affiliates that have less than \$10 billion in assets. The FDIC has considered various options for these smaller affiliates of large Risk Category I institutions, including whether to consider the large affiliate's insurance assessment rate when assigning a rate to the smaller affiliate, given statutory cross-guarantees,<sup>67</sup> and whether to use the small or large institution approach to differentiate risk in these small affiliates.

For a number of reasons, the FDIC proposes to treat these small affiliates separately, without regard to the insurance assessment rate assigned to the larger affiliate, and to use the small institution methodology for purposes of differentiating risk. First, the risk profiles of these institutions may be very different than the risk profiles of their larger affiliates. Second, the value of a cross-guarantee in the future is uncertain because the financial condition of affiliated institutions may, under certain circumstances, weigh against the FDIC's invoking cross-guarantees. Finally, less information is generally available for these smaller affiliates and some information, such as market information, may not be relevant.

*D. Proposal: Differentiate Risk in Insured Foreign Branches Using Weighted Supervisory Ratings*

1. Overview

The FDIC proposes to use the supervisory ratings of insured branches of foreign banks (referred to hereafter as insured branches) in Risk Category I to determine their deposit insurance assessment rates.<sup>68</sup> These branches do not report the information needed to use the small institution pricing models.<sup>69</sup> Hence, the FDIC must rely primarily on supervisory information to determine the relative risk of insured branches of foreign banks. Similar to the large institution risk differentiation approach, the supervisory ratings of insured

branches would be weighted to determine an insurance score. This insurance score would determine the insured branch's initial assessment rate subcategory assignment using the same minimum, maximum, and intermediate subcategory insurance score cutoff values detailed in the large institution differentiation proposal. Adjustments to these initial assessment rate subcategory assignments could be made based on consideration of additional risk information such as those shown in Appendix D (where applicable).

2. Current Treatment of Insured Branches

The International Banking Act of 1978 (the IBA)<sup>70</sup> amended the FDI Act and allowed U.S. branches of foreign banks to apply for deposit insurance. The Federal Deposit Insurance Corporation Improvement Act (FDICIA)<sup>71</sup> amended the IBA and prohibited retail deposit taking by U.S. branches of foreign banks. A foreign bank seeking to engage in retail deposit-taking activities in the U.S. is now required to establish an insured subsidiary bank. A grandfather provision in the IBA (as amended by FDICIA) permits insured branches in existence on the date of FDICIA's enactment to continue to accept insured deposits of less than \$100,000.<sup>72</sup> Of the branches grandfathered in 1991, only 13 remained as of year-end 2005.

The existing risk-based deposit insurance assessment system assigns insured branches an assessment risk classification in a manner similar to that used for all other insured depository institutions. Like other insured depository institutions, each insured branch is assigned an assessment risk classification. However, unlike other insured depository institutions, whose assessment risk classification is based, in part, on risk-based capital ratios, an insured branch's Capital category is determined by its asset pledge and asset maintenance ratios prescribed by Part 347 of the FDIC's Rules and Regulations. Like other insured depository institutions, insured branches are grouped into an appropriate supervisory subgroup based on the FDIC's consideration of supervisory evaluations provided by the institution's primary federal regulator. These supervisory evaluations result in the assignment of supervisory ratings referred to as ROCA ratings.<sup>73</sup>

3. Proposed Treatment of Insured Branches of Foreign Banks

Insured branches that would fall in the revised Risk Category II through IV based on their asset pledge and asset maintenance ratios and supervisory ratings would be treated in the same manner as other insured institutions in these risk categories. For insured branches that fall within Risk Category I, the FDIC proposes an approach similar to that applied for large Risk Category I institutions.

As noted above, these insured branches (all of which currently have less than \$10 billion in assets) do not report the information needed to use the proposed small Risk Category I institution risk differentiation and pricing method. Moreover, because insured branches operate as extensions of a foreign bank's global banking operations, they pose unique risks. These branches operate without capital of their own, as distinct from capital of their non-U.S. parent, their business strategies are typically directed by the foreign bank parent, they rely extensively on the foreign bank parent for liquidity and funding, and they often have considerable country and transfer risk exposures not typically found in other insured institutions of similar size. Insured branches also present potentially challenging concerns in the event of failure. Consequently, the FDIC proposes to use ROCA component ratings for purposes of differentiating risk among Risk Category I insured branches, combined with considerations of other relevant risk information.

The ROCA rating system for insured branches of foreign banks is analogous to the UFIRS used for commercial banks. Like the UFIRS, the ROCA components convey information about the supervisory assessments of an insured branch's condition in certain key risk areas. The ROCA rating system takes into consideration certain risk management, operational, compliance, and asset quality risk factors that are common to all branches.

The FDIC proposes to use ROCA component ratings as the basis for determining an insurance score for insured branches. This insurance score would be the weighted average of the ROCA component ratings. The weights applied to individual ROCA component ratings would be 35 percent, 25 percent, 25 percent, and 15 percent, respectively. These weights reflect the view of the FDIC regarding the relative importance

"5" rating (worst rating). Risk Category 1 insured branches of foreign banks would generally have a ROCA composite rating of 1 or 2 and component ratings ranging from 1 to 3.

<sup>67</sup> 12 U.S.C. 1815(e).

<sup>68</sup> As of year-end 2005, there were 13 insured branches.

<sup>69</sup> For example, insured branches of foreign banks do not report earnings and report only limited balance sheet information in their regulatory financial submissions (FFIEC form 002).

<sup>70</sup> Public Law 95-369, 92 Stat. 607 (1978).

<sup>71</sup> Public Law 102-242, 105 Stat. 2236 (1991).

<sup>72</sup> 12 U.S.C. 3104.

<sup>73</sup> ROCA stands for Risk Management, Operational Controls, Compliance, and Asset Quality. Like CAMELS components, ROCA component ratings range from 1 (best rating) to a

of each ROCA component for differentiating risk among foreign branches in Risk Category I for insurance purposes.

The insurance score would determine the insured branch's initial assignment to one of six assessment rate subcategories, as these categories are defined in the large institution risk differentiation proposal. As noted in that section, the cutoff values for the minimum, maximum, and interim assessment rate subcategories will be determined based on the distribution of insurance scores (for large institutions) and assessment rates (for small institutions) for the first quarter of 2007. Similar to the large institution risk differentiation proposal, the FDIC would be allowed to adjust an insured branch's initial assessment rate subcategory assignment to the subcategory being charged the next higher or lower assessment rate after consideration of additional risk information. The types of additional information the FDIC would consider in making these determinations are shown in Appendix D (where applicable to an insured branch).

#### VIII. New Institutions in Risk Category I

The FDIC proposes to exclude an institution in Risk Category I that is less than seven years old from evaluation under either the smaller or larger institution method of risk differentiation. On average, new institutions have a higher failure rate than established institutions. Financial information for newer institutions also tends to be harder to interpret and less meaningful. A new institution undergoes rapid changes in the scale and scope of operations, often causing its financial ratios to be fairly volatile. In addition, a new institution's loan portfolio is often unseasoned, and therefore it is difficult to assess credit risk based solely on current financial ratios.<sup>74</sup>

The FDIC proposes charging all new institutions in Risk Category I the same

rate, which would be the highest rate charged any other institution in this Risk Category. For this purpose, the FDIC proposes defining a new institution as one that is not an established institution. With two possible exceptions, an established institution would be one that has been chartered as a bank or thrift for at least seven years as of the last day of any quarter for which it is being assessed.

Where an established institution merges into a new institution, the resulting institution would continue to be new. Where an established institution consolidates with a new institution, the resulting institution would be new. However, under either of these circumstances, the FDIC proposes to allow the resulting institution to request that the FDIC determine that the institution is an established institution. The FDIC proposes to make this determination based upon the following factors:

1. Whether the acquired, established institution was larger than the acquiring, new institution, and, if so, how much larger;
2. Whether management of the acquired, established institution continued as management of the resulting institution;
3. Whether the business lines of the resulting institution were the same as the business lines of the acquired, established institution;
4. To what extent the assets and liabilities of the resulting institution were the assets and liabilities of the acquired, established institution; and
5. Any other factors bearing on whether the resulting institution remained substantially an established institution.

Where a new institution merges into an established institution or where an established institution acquires a substantial portion of a new institution's assets or liabilities, and the merger or acquisition agreement is entered into after the date that this notice of proposed rulemaking is adopted, the FDIC proposes to conduct a review to

determine whether the resulting or acquiring institution remains an established institution. The FDIC proposes to use the factors described above (necessary changes having been made) to make this determination.

However, where a new institution merges into an established institution or where an established institution acquires a substantial portion of a new institution's assets or liabilities, and the merger or acquisition agreement was entered into before the date that this notice of proposed rulemaking is adopted, the FDIC proposes a grandfather rule under which the resulting or acquiring institution would be deemed to be an established institution.

#### IX. Assessment Rates Proposal: Adopt a Base Schedule of Rates From Which Actual Rates May Be Adjusted Depending Upon the Revenue Needs of the Fund

##### A. Statutory Factors

In setting assessment rates, the FDIC's Board of Directors is required by statute to consider the following factors:

- (i) The estimated operating expenses of the Deposit Insurance Fund.
- (ii) The estimated case resolution expenses and income of the Deposit Insurance Fund.
- (iii) The projected effects of the payment of assessments on the capital and earnings of insured depository institutions.
- (iv) The risk factors and other factors taken into account pursuant to [12 U.S.C Section 1817(b)(1)] under the risk-based assessment system, including the requirement under [12 U.S.C Section 1817(b)(1)(A)] to maintain a risk-based system.
- (v) Any other factors the Board of Directors may determine to be appropriate.<sup>75</sup>

##### B. Description of the proposal

The FDIC proposes to adopt the following base schedule of rates:

- (i) The probability that the Deposit Insurance Fund will incur a loss with respect to the institution, taking into consideration the risks attributable to—
  - (I) Different categories and concentrations of assets;
  - (II) Different categories and concentrations of liabilities, both insured and uninsured, contingent and noncontingent; and
  - (III) Any other factors the Corporation determines are relevant to assessing such probability;
- (ii) The likely amount of any such loss; and
- (iii) The revenue needs of the Deposit Insurance Fund.
  - 12 U.S.C. 1817(b)(1)(C).

<sup>74</sup> Empirical studies show that new institutions exhibit a "life cycle" pattern and it takes close to a decade after its establishment for a new institution to mature. Despite low profitability and rapid growth, institutions that are three years or newer have, on average, a very low probability of failure lower than established institutions, perhaps owing to large capital cushions and close supervisory attention. However, after three years, new institutions' failure probability, on average, surpasses that of established institutions. New institutions typically grow more rapidly than established institutions and tend to engage in more high-risk lending activities funded by large deposits. Studies based on data from the 1980s showed that asset quality deteriorated rapidly for

many new institutions as a result, and failure probability (conditional upon survival in prior years) reached a peak by the ninth year. Many financial ratios of new institutions generally begin to resemble those of established institutions by about the seventh or eighth year of their operation. See Chiwon Yom, "Recently Chartered Banks' Vulnerability to Real Estate Crisis," FDIC Banking Review 17 (2005): 115 and Robert DeYoung, "For How Long Are Newly Chartered Banks Financially Fragile?" Federal Reserve Bank of Chicago Working Paper Series 2000-09.

<sup>75</sup> Section 2104 of the Reform Act (to be codified at 12 U.S.C. 1817(b)(2)(B)). The risk factors referred to in factor (iv) include:

	Risk category				
	I*		II	III	IV
	Minimum	Maximum			
Annual Rates (in basis points) .....	2	4	7	25	40

\* Rates for institutions that do not pay the minimum or maximum rate will vary between these rates.

All institutions in any one risk category, other than Risk Category I, would be charged the same assessment rate. For all institutions in Risk Category I (other than new institutions), the FDIC proposes base annual assessment rates between 2 and 4 basis points.

Under the present assessment system, the Board has adopted a base assessment schedule where it can uniformly adjust rates up to a maximum of five basis points higher or lower than the base rate schedule without the necessity of further notice-and-comment rulemaking, provided that any single adjustment cannot move rates more than five basis points.<sup>76</sup> The FDIC proposes to continue to allow the Board to adjust rates uniformly up to a maximum of five basis points higher or lower than the base rates without the necessity of further notice-and-comment rulemaking, provided that any single adjustment from one quarter to the next cannot move rates more than five basis points.<sup>77</sup>

Absent any action by the Board, the FDIC proposes that the base rates would be the actual rates once a final rule becomes effective.

As discussed earlier, the FDIC proposes charging all new institutions

in Risk Category I, regardless of size, the maximum rate for that quarter.

*C. Analysis of Statutory Factors*

1. Estimated Operating Expenses, Case Resolution Expenses and Income and Insured Deposit Growth

The base schedule of rates, combined with the ability to adjust the rates up or down within prescribed limits, provides the Board with flexibility to set rates that the FDIC believes are likely under most circumstances to keep the reserve ratio between 1.15 percent, the lower bound of the range for the designated reserve ratio, and 1.35 percent, the reserve ratio at which the FDIC must generally begin paying dividends from the fund. However, if insured deposits continue to grow at a fast pace, as they have for the past several quarters, the reserve ratio is likely to fall from its level of 1.23 percent as of March 31, 2006, all else being equal.<sup>78</sup> Most institutions will also have one-time assessment credits that they can use to offset their assessments during 2007, which will reduce assessment income significantly compared to what would be collected if credits were not available.

Thus, absent a significant slowdown in insured deposit growth and depending on the Board's decision as to how long it is willing to tolerate lower reserve ratios, there is a possibility that the Board may adopt rates for 2007 that are higher than the base schedule.<sup>79</sup> For example, suppose that:

1. At the same time or shortly after the Board adopts the proposed base rate schedule, the Board also adopts an actual rate schedule for 2007 that sets rates uniformly 5 basis points above the base rate schedule without the need for notice-and-comment rulemaking.

2. As credits are drawn down, the Board reduces rates for 2008 and 2009 so that they are uniformly 2 basis points higher than the base rate schedule.

3. In 2010 and 2011, the Board reduces rates to the base rate schedule.

Table 17 illustrates how these rates could affect the insurance fund reserve ratio. The projections indicate that, as assessment credits are drawn down, these assessment rates would cause the reserve ratio to rise in 2008 and again in 2009 from a low point reached either in 2006 or 2007. Whether (and how high) the reserve ratio would continue to rise would depend upon the rate of insured deposit growth.

TABLE 17.—PROJECTED RESERVE RATIOS UNDER A HYPOTHETICAL ASSESSMENT RATE SCHEDULE \*

Period	Rates	Insured deposit growth rate				
		4%	5%	6%	7%	8%
2007 .....	Base Schedule + 5 bps .....	1.22	1.21	1.19	1.18	1.17
2008 .....	Base Schedule + 2 bps .....	1.26	1.24	1.22	1.20	1.18
2009 .....	Base Schedule + 2 bps .....	1.32	1.29	1.26	1.23	1.20
2010 .....	Base Schedule .....	1.35	1.31	1.26	1.22	1.19
2011 .....	Base Schedule .....	1.37	1.33	1.27	1.22	1.17

\* Assumes modest insurance losses and flat operating expenses. The projected reserve ratio at year-end 2006 is 1.20 percent.

This example assumes that the Board adopts rates that do not require further notice-and-comment rulemaking. On the other hand, through additional notice-

and-comment rulemaking, the Board could choose to adopt actual rates for 2007 where the lowest rate was higher than 7 basis points (on an annualized

basis) or where rates were not uniformly adjusted from the base schedule. The Board may also change assessment rates during the course of 2007.

<sup>76</sup> In addition, no assessment rate may be negative. 12 CFR 327.9.

<sup>77</sup> And provided, again, that no assessment rate may be negative.

<sup>78</sup> Insured deposits rose almost 8.5 percent over the four quarters ending March 31, 2006.

<sup>79</sup> In a separate notice of proposed rulemaking, the FDIC has proposed assessing quarterly and in

arrears. Under this proposal, the FDIC's Board would be required to set rates no later than 30 days before providing invoices and provide invoices no later than 15 days before assessments were due. Assessments would be due March 30, June 30, September 30 and December 30. Thus, the Board would have to set rates for the first quarter of 2007 by May 16, 2007. Of course, the Board would retain the flexibility to set rates earlier, for example, when

it adopts a final rule later this year. 71 FR 28790, 28791. Rates, once set, would remain in effect until the FDIC's Board changed them, since one of the FDIC's primary goals in seeking deposit insurance reforms was to distribute assessments more evenly over time; that is, to keep assessment rates steady to the extent possible and to avoid sharp swings in assessment rates.

## 2. Effects on Capital and Earnings and Factors Under the Risk-Based Assessment System

Appendix 4 contains an analysis of the projected effects of the payment of assessments on the capital and earnings of insured depository institutions. In sum, the base schedule of rates or even a rate schedule that is uniformly 5 basis points higher than the base schedule is not expected to impair the capital or earnings of insured institutions materially.

The proposed base rate for Risk Category IV is substantially lower than the historical analysis discussed in Appendix 1 would suggest is needed to recover costs from failures. The lower rate is intended to decrease the chance of assessments being so large that they cause these institutions to fail.

## X. Request for Comment

The FDIC seeks comment on every aspect of this proposed rulemaking. In particular, the FDIC seeks comment on:

- With respect to the general assessment framework:
  1. Whether the existing 2B category, which has a five-year failure rate of 5.51 percent, should be:
    - a. Consolidated with the existing 1B and 2A categories, which have five-year failure rates of 2.67 percent and 2.03 percent, respectively, into new Risk Category II (as proposed);
    - b. Placed in its own separate new Risk Category; or
    - c. Placed into new Risk Category III, rather than Risk Category II; and
  2. Whether the existing 3A category, which has a five-year failure rate of 2.3 percent, should be:
    - a. Consolidated with the existing 3B, 1C and 2C categories, which have five-year failure rates of 7.10 percent, 6.78 percent and 14.43 percent, respectively, into new Risk Category III (as proposed); or
    - b. Consolidated with the existing 1B, 2B and 2A categories, which have five-year failure rates of 2.67 percent, 5.51 percent and 2.03 percent, respectively, into new Risk Category II.
- With respect to risk differentiation among smaller institutions in Risk Category I:
  3. Whether the FDIC's proposal or the alternative would be preferable or whether there are other approaches that would be more appropriate for differentiating risk among small Risk Category I institutions.
  4. Whether any variation on its proposal or on the alternative would be preferable, such as:
    - a. Using a different statistical approach or model;

b. Excluding any of the proposed risk measures, in particular the ratio of net income before taxes to risk-weighted assets and the ratio of net loan charge-offs to gross assets;

c. Adding the ratio of liquid assets to gross assets as a risk measure if the ratio of net income before taxes to risk-weighted assets is excluded;<sup>80</sup>

d. Excluding time deposits greater than \$100,000 from the definition of volatile liabilities, and, therefore, excluding volatile liabilities as a risk measure;<sup>81</sup>

e. Including Federal Home Loan Bank advances in the definition of volatile liabilities or, alternatively, charging higher assessment rates to institutions that have significant amounts of secured liabilities;

f. Averaging ratios over some period;

g. Changing the pricing multipliers proposed for the measures judgmentally;

h. Changing the weights proposed for the CAMELS component ratings used to calculate the weighted average CAMELS component rating, for example, weighting each component equally;

i. Using CAMELS composite ratings instead of weighted average CAMELS component ratings; and

j. Determining a portion of an institution's assessment rate using financial ratios and a portion using a weighted average CAMELS component rating, but combine financial ratios with CAMELS component ratings in a manner different from the proposal in order to have an approach that is more integrated with the large institution method.

5. Whether the FDIC should evaluate institutions with unusual business profiles or risk characteristics in a different manner, and, if so, which institutions should be so evaluated and on what basis.

6. Whether the FDIC should use additional relevant information to determine whether adjustments to assessment rates are appropriate.

• With respect to risk differentiation among large institutions and insured branches of foreign banks in Risk Category I:

7. Whether there are other approaches that would be more appropriate for differentiating risk among large Risk Category I institutions.

<sup>80</sup> If the ratio of net income before taxes to risk-weighted assets were not included as a risk measure, the ratio of liquid assets to gross assets becomes significant in explaining downgrades, although its pricing multiplier would be small.

<sup>81</sup> As discussed above, removing time deposits greater than \$100,000 from the definition of volatile liabilities would make volatile liabilities insignificant in explaining potential downgrades.

8. Whether the weights proposed for the CAMELS component ratings used to calculate the weighted average CAMELS are appropriate or whether alternative weights should be used, such as:

a. Weighting each CAMELS component equally;

b. Varying CAMELS component weightings by the primary business type of an institution;

c. Determining CAMELS component weightings for various business activities and then determining the relative importance of these activities within each institution (this process would result in potentially unique CAMELS weights for each large institution).

9. Whether it is appropriate to use long-term debt issuer ratings to differentiate risk among large Risk Category I institutions.

10. Whether the proposed numerical conversions of long-term debt issuer ratings are reasonable.

11. Whether using the estimated probability of downgrade to a CAMELS composite 3, 4 or 5 as derived in the alternative method of risk differentiation for small Risk Category I institutions is appropriate for institutions with between \$10 billion and \$30 billion in assets.

12. Whether other risk factors or risk measurement approaches should be considered in developing deposit insurance pricing alternatives.

13. Whether the proposed weights for the weighted average CAMELS component rating, long-term debt issuer ratings, and the financial ratio factor used to determine an insurance score are appropriate for all size categories or should be modified.

14. Whether the proposal to assign institutions initially to one of six assessment rate subcategories based on an insurance score, and use other relevant information to determine whether adjustments to these initial assignments are needed, is reasonable.

15. Whether an alternative to assessment rate subcategories is appropriate, such as tying assessment rates directly to the insurance score, and to what extent adjustments to the insurance score would be appropriate.

16. Whether the proposed number of six assessment rate subcategories (including minimum and maximum assessment rate subcategories) is appropriate, and if more or less subcategories are appropriate, to what extent should the FDIC have the ability to adjust assessment rate subcategory assignments (as determined by the insurance score) based on consideration of additional information.

17. Whether the proposed approach for converting insurance scores to assessment rate subcategories is reasonable. Considerations include: the appropriateness of defining insurance score cutoff points for the minimum and maximum assessment rates to ensure that initially similar proportions of small and large institutions are charged the minimum and maximum assessment rates; and the appropriateness of using increments of the insurance score between the minimum and maximum assessment rate cutoff scores to determine cutoff points for the four intermediate assessment rate subcategories.

18. Whether it would be appropriate to implement a "watch list" feature to provide advanced notice to large Risk Category I institutions when there is a pending change in an institution's assessment rate subcategory assignment.

19. Whether the proposal to develop and assign separate assessment rates for Risk Category I institutions whose subcategory assignments change during a quarter is appropriate, or whether in these circumstances assessment rates for the entire quarter should be based on quarter-end supervisory and agency ratings.

- With respect to the definitions of small and large Risk Category I institutions:

20. Whether the proposed definition of a large institution as one with at least \$10 billion in assets is appropriate.

21. Whether the FDIC's proposed method for determining whether an institution has changed its size class is appropriate.

22. Whether the proposal to use the small institution approach to differentiate risk for small institutions that are affiliates of large institutions, independently of the insurance score or assessment rate of the large affiliate, is appropriate.

23. Whether institutions with between \$5 and \$10 billion in assets should be allowed to request to be subject to the risk differentiation approach applied to large institutions.

24. Whether it is appropriate for the FDIC to determine when institutions under \$10 billion should be treated under the large institution risk differentiation approach for Risk Category I institutions. Any such determination would be made infrequently and would entail considerations of the types of business activities engaged in by the institution, the materiality of these activities, and whether the financial ratios used in the small institution proposed risk differentiation approach are sufficient to

accurately reflect the risk within these activities.

25. Whether the proposed approach for differentiating risk in insured branches of foreign banks is appropriate.

- With respect to the definitions of a new institution and an established institution:

26. Whether less than seven years old is the appropriate age to consider an institution new.

27. Whether, when an established institution merges into or consolidates with a new institution:

- a. The resulting institution should be considered new;

- b. The resulting institution should be allowed to request that the FDIC determine that it is established; and

- c. The factors that the FDIC proposes to use to determine whether the resulting institution in such a merger or consolidation should be considered established are the appropriate factors.

28. Whether, when a new institution merges into an established institution or when an established institution acquires a substantial portion of a new institution's assets or liabilities, and:

- a. The merger or acquisition agreement is entered into after the date that this notice of proposed rulemaking is adopted, the FDIC should conduct a review to determine whether the resulting or acquiring institution remains an established institution; and

- b. The merger or acquisition agreement is entered into before the date that this notice of proposed rulemaking is adopted, the resulting or acquiring institution should be deemed to be an established institution.

- With respect to assessment rates:

29. Whether the FDIC should adopt a permanent base schedule of rates and, if so, whether the proposed rates are appropriate.

30. Whether the difference between the proposed minimum and maximum assessment rates for institutions in Risk Category I should be wider (e.g., 3 basis points) or narrower (e.g., 1 basis point) than proposed in the base schedule.

31. Whether the FDIC should retain the authority to make changes within prescribed limits to assessment rates, as proposed, without the necessity of additional notice-and-comment rulemaking.

32. Whether all new institutions in Risk Category I should be charged the maximum rate.

## XI. Regulatory Analysis and Procedure

### A. Solicitation of Comments on Use of Plain Language

Section 722 of the Gramm-Leach-Bliley Act, Public Law 106-102, 113

Stat. 1338, 1471 (Nov. 12, 1999), requires the Federal banking agencies to use plain language in all proposed and final rules published after January 1, 2000. The FDIC invites your comments on how to make this proposal easier to understand. For example:

- Has the FDIC organized the material to suit your needs? If not, how could this material be better organized?

- Are the requirements in the proposed regulation clearly stated? If not, how could the regulation be more clearly stated?

- Does the proposed regulation contain language or jargon that is not clear? If so, which language requires clarification?

- Would a different format (grouping and order of sections, use of headings, paragraphing) make the regulation easier to understand? If so, what changes to the format would make the regulation easier to understand?

- What else could the FDIC do to make the regulation easier to understand?

### B. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) requires that each federal agency either certify that a proposed rule would not, if adopted in final form, have a significant economic impact on a substantial number of small entities or prepare an initial regulatory flexibility analysis of the proposal and publish the analysis for comment. See 5 U.S.C. 603, 604, 605. Certain types of rules, such as rules of particular applicability relating to rates or corporate or financial structures, or practices relating to such rates or structures, are expressly excluded from the definition of "rule" for purposes of the RFA. 5 U.S.C. 601. The proposed rule governs assessments and sets the rates imposed on insured depository institutions for deposit insurance. Consequently, no regulatory flexibility analysis is required.

### C. Paperwork Reduction Act

No collections of information pursuant to the Paperwork Reduction Act (44 U.S.C. 3501 et seq.) are contained in the proposed rule.

### D. The Treasury and General Government Appropriations Act, 1999—Assessment of Federal Regulations and Policies on Families

The FDIC has determined that the proposed rule will not affect family well-being within the meaning of section 654 of the Treasury and General Government Appropriations Act, enacted as part of the Omnibus Consolidated and Emergency

Supplemental Appropriations Act of 1999 (Pub. L. 105-277, 112 Stat. 2681).

**List of Subjects in 12 CFR Part 327**

Bank deposit insurance, Banks, banking, Savings associations

For the reasons set forth in the preamble, the FDIC proposes to amend chapter III of title 12 of the Code of Federal Regulations as follows:

**PART 327—ASSESSMENTS**

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

**Authority:** 12 U.S.C. 1441, 1813, 1815, 1817-1819, 1821; Sec. 2101-2109, Pub. L. 109-171, 120 Stat. 9-21, and Sec. 3, Pub. L. 109-173, 119 Stat. 3605.

2. Revise section 327.9 of subpart A to read as follows:

**§ 327.9 Assessment risk categories and rate schedules; adjustments procedures.**

(a) *Risk Categories.* Each insured depository institution shall be assigned to one of the following four Risk Categories based upon the institution's capital evaluation and supervisory evaluation as defined in this section.

(1) *Risk Category I.* All institutions in Supervisory Group A that are Well Capitalized;

(2) *Risk Category II.* All institutions in Supervisory Group A that are Adequately Capitalized, and all institutions in Supervisory Group B that are either Well Capitalized or Adequately Capitalized;

(3) *Risk Category III.* All institutions in Supervisory Groups A and B that are Undercapitalized, and all institutions in Supervisory Group C that are Well Capitalized or Adequately Capitalized; and

(4) *Risk Category IV.* All institutions in Supervisory Group C that are Undercapitalized.

(b) *Capital evaluations.* Institutions will receive one of the following three capital evaluations on the basis of data reported in the institution's Consolidated Reports of Condition and Income, Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks, or Thrift Financial

Report dated as of March 31 for the assessment period beginning the preceding January 1; dated as of June 30 for the assessment period beginning the preceding April 1; dated as of September 30 for the assessment period beginning the preceding July 1; and dated as of December 31 for the assessment period beginning the preceding October 1.

(1) *Well Capitalized.* (i) Except as provided in paragraph (b)(1)(ii) of this section, Well Capitalized institutions satisfy each of the following capital ratio standards: Total risk-based ratio, 10.0 percent or greater; Tier 1 risk-based ratio, 6.0 percent or greater; and Tier 1 leverage ratio, 5.0 percent or greater.

(ii) For purposes of this section, an insured branch of a foreign bank will be deemed to be Well Capitalized if the insured branch:

(A) Maintains the pledge of assets required under § 347.209 of this chapter; and

(B) Maintains the eligible assets prescribed under § 347.210 of this chapter at 108 percent or more of the average book value of the insured branch's third-party liabilities for the quarter ending on the report date specified in paragraph (b) of this section.

(2) *Adequately Capitalized.* (i) Except as provided in paragraph (b)(2)(ii) of this section, Adequately Capitalized institutions do not satisfy the standards of Well Capitalized under this paragraph but satisfy each of the following capital ratio standards: Total risk-based ratio, 8.0 percent or greater; Tier 1 risk-based ratio, 4.0 percent or greater; and Tier 1 leverage ratio, 4.0 percent or greater.

(ii) For purposes of this section, an insured branch of a foreign bank will be deemed to be Adequately Capitalized if the insured branch:

(A) Maintains the pledge of assets required under § 347.209 of this chapter; and

(B) Maintains the eligible assets prescribed under § 347.210 of this chapter at 106 percent or more of the average book value of the insured

branch's third-party liabilities for the quarter ending on the report date specified in paragraph (b) of this section; and

(C) Does not meet the definition of a Well Capitalized insured branch of a foreign bank.

(3) *Undercapitalized.* This group consists of institutions that do not qualify as either Well Capitalized or Adequately Capitalized under paragraphs (b)(1) and (b)(2) of this section.

(c) *Supervisory evaluations.* Each institution will be assigned to one of three Supervisory Groups based on the Corporation's consideration of supervisory evaluations provided by the institution's primary federal regulator. The supervisory evaluations include the results of examination findings by the primary federal regulator, as well as other information that the primary federal regulator determines to be relevant. In addition, the Corporation will take into consideration such other information (such as state examination findings, if appropriate) as it determines to be relevant to the institution's financial condition and the risk posed to the Deposit Insurance Fund. The three Supervisory Groups are:

(1) *Supervisory Group "A."* This Supervisory Group consists of financially sound institutions with only a few minor weaknesses;

(2) *Supervisory Group "B."* This Supervisory Group consists of institutions that demonstrate weaknesses which, if not corrected, could result in significant deterioration of the institution and increased risk of loss to the Deposit Insurance Fund; and

(3) *Supervisory Group "C."* This Supervisory Group consists of institutions that pose a substantial probability of loss to the Deposit Insurance Fund unless effective corrective action is taken.

(d) *Base Assessment Schedule.* The base annual assessment rate for an insured depository institution shall be the rate prescribed in the following schedule:

TABLE 1 TO PARAGRAPH (D)

	Risk category				
	I*		II	III	IV
	Minimum	Maximum			
Annual Rates (in basis points) .....	2	4	7	25	40

\* Rates for institutions that do not pay the minimum or maximum rate will vary between these rates.

(1) *Risk Category I Base Schedule.* The base annual assessment rates for all institutions in Risk Category I shall range from 2 to 4 basis points.

(2) *Small Institutions.* An insured depository institution in Risk Category I with assets of less than \$10 billion as of December 31, 2006 (other than an insured branch of a foreign bank or a new bank as defined in paragraph (d)(7) of this section) shall be classified as a small institution. Except as provided in paragraphs (4), (5) and (6) of this section, a small institution in Risk Category I shall have its assessment rate determined using the Small Institution Pricing Method described in paragraph (d)(2)(i) of this section.

(i) *Small Institution Pricing Method.* Each of six ratios and a weighted average of CAMELS component ratings will be multiplied by a corresponding pricing multiplier. The sum of these products will be added to a uniform amount. The resulting sum will equal an institution's assessment rate; provided, however, that no institution's assessment rate will be less than the minimum rate in effect for that quarter nor greater than the maximum rate in effect for that quarter. The six ratios are: (1) Tier 1 Leverage Ratio; (2) Loans past due 30–89 days/gross assets; (3) Nonperforming loans/gross assets; (4) Net loan charge-offs/gross assets; (5) Net income before taxes/risk-weighted assets; and (6) Volatile liabilities/gross assets. The ratios are defined in Table A.1 of Appendix A to this subpart. The weighted average of CAMELS component ratings is created by multiplying each component by the following percentages and adding the products: Capital adequacy—25%, Asset quality—20%, Management—25%, Earnings—10%, Liquidity—10%, and Sensitivity to market risk—10%.

Appendix A to this subpart describes the derivation of the pricing multipliers and uniform amount and explains how they will be periodically updated.

(ii) *Publication of uniform amount and pricing multipliers.* The FDIC will publish notice annually in the **Federal Register** of the uniform amount and the pricing multipliers.

(iii) *Changes to supervisory ratings.* If, during a quarter, a supervisory rating change occurs that results in a small institution moving from Risk Category I to Risk Category II, III or IV, the institution's base assessment rate for the portion of the quarter that it was in Risk Category I shall be determined using the small institution pricing method. For the portion of the quarter that the institution was not in Risk Category I, the institution's base assessment rate shall be determined under the base

assessment schedule for the appropriate Risk Category. If, during a quarter, a supervisory rating change occurs that results in a small institution moving from Risk Category II, III or IV to Risk Category I, the institution's base assessment rate for the portion of the quarter that it was in Risk Category I shall be determined using the small institution pricing method. For the portion of the quarter that the institution was not in Risk Category I, the institution's base assessment rate shall be determined under the base assessment schedule for the appropriate Risk Category. Subject to paragraph (d)(2)(iv) of this section, if, during a quarter, an institution's CAMELS component ratings change in such a way that it would change the assessment rate, the assessment rate for the period before that change shall be determined under the small institution pricing method using the CAMELS component ratings in effect during that period. Beginning on the date of the CAMELS component ratings change, the assessment rate for the remainder of the quarter shall be determined under the small institution pricing method using the CAMELS component ratings in effect after the change.

(iv) *Effective date for changes to CAMELS component ratings.* Any change to a CAMELS component rating that results in a change to the institution's base assessment rate shall take effect as follows.

(A) If an examination (or targeted examination) leads to the change in an institution's CAMELS component rating, the change will be effective as of the date the examination or targeted examination begins, if such a date exists.

(B) If an examination (or targeted examination) leads to the change in CAMELS component rating and no examination (or targeted examination) start date exists, the change will be effective as of the date the change to the institution's CAMELS component rating is transmitted to the institution.

(C) Otherwise, the change will be effective as of the date that the FDIC determines that the change to the institution's CAMELS component rating occurred.

(3) *Large Institution Pricing Method.* An insured depository institution with assets of \$10 billion or more as of December 31, 2006 (other than an insured branch of a foreign bank or a new bank as defined in paragraph (d)(7) of this section) shall be classified as a large institution. Large insured depository institutions in Risk Category I (subject to paragraph (d)(3) through (d)(6) of this section) and insured

branches of foreign banks in Risk Category I regardless of asset size shall have their assessment rates determined using the FDIC's Large Institution Pricing Method. Except for insured branches of foreign banks, an institution's assessment rate shall be determined by its insurance score, as defined in paragraph (d)(3)(i) or (ii) of this section based on the size of the institution, subject to rate adjustment under paragraph (d)(3)(ix) of this section. The assessment rate applicable to an insured branch of a foreign bank shall be determined by its insurance score as defined in paragraph (d)(3)(iii) of this section.

(i) *Insurance score for institutions with at least \$10 billion and less than \$30 billion in assets.* For institutions that have assets of at least \$10 billion and less than \$30 billion and that are not insured branches of foreign banks, the insurance score shall be a weighted average, based on the weights specified in paragraph (d)(3)(vii) of this section, of a weighted average CAMELS component rating, as determined under paragraph (d)(3)(iv) of this section, a long-term debt issuer rating converted to a numerical value, determined pursuant to paragraph (d)(3)(v) of this section, and the institution's financial ratio factor converted to a numerical value, determined pursuant to paragraph (d)(3)(vi) of this section.

(ii) *Insurance score for institutions with at least \$30 billion in assets.* For institutions that have assets of at least \$30 billion and that are not insured branches of foreign banks, the insurance score shall be a weighted average, based on the weights specified in paragraph (d)(3)(vii) of this section, of a weighted average CAMELS component rating, as determined under paragraph (d)(3)(iv) of this section, and a long-term debt issuer rating converted to a numerical value, determined pursuant to paragraph (d)(3)(iv) of this section.

(iii) *Insurance score for insured branches of foreign banks.* For insured branches of foreign banks, the insurance score shall be the weighted average ROCA component rating, as determined under paragraph (d)(3)(iv) of this section.

(iv) *Weighted average CAMELS component rating.* For institutions that are not insured branches of foreign banks, a weighted average CAMELS component rating shall be determined. The weighted average CAMELS component rating shall equal the sum of the products that result from multiplying CAMELS component ratings by the following percentages: Capital adequacy—25%, Asset quality—20%, Management—25%, Earnings—

10%, Liquidity—10%, and Sensitivity to market risk—10%. For insured branches of foreign banks, an institution's ROCA components shall be used in place of CAMELS components. The weighted average ROCA component rating shall equal the sum of the products that result from multiplying ROCA component ratings by the following percentages: Risk Management—35%, Operational Controls—25%, Compliance—25%, and Asset Quality—15%.

(v) *Long-term debt issuer rating converted to a numerical value.* Agency long-term debt issuer ratings shall be converted into numerical values between 1 and 3. The ratings must have been confirmed or newly assigned within 12 months before the end of the quarter for which an assessment rate is being determined. If no ratings for an

institution have been confirmed or assigned within that 12-month period, that institution will be treated as if it had no long-term debt issuer rating. The table for converting long-term debt issuer ratings to values between 1 and 3 is shown in Appendix B to this subpart.

(vi) *Financial Ratio Factor for Certain Large Institutions.* The financial ratio factor means the sum of six ratios that have each been multiplied by a coefficient, and a constant amount, converted to a value between 1 and 3. The six ratios are: Tier 1 Leverage Ratio; Loans past due 30–89 days/gross assets; Nonperforming loans/gross assets; Net loan charge-offs/gross assets; Net income before taxes/risk-weighted assets; and Volatile liabilities/gross assets. The ratios are defined in Table C.1 of Appendix C to this subpart.

Appendix C to this subpart describes the derivation of the coefficients and the constant amount, explains how they will be periodically updated and provides a formula for converting the financial ratio factor to a value between 1 and 3. The FDIC will publish notice annually in the **Federal Register** of the coefficients and constant amount.

(vii) *Weights.* (A) For large institutions that have assets of less than \$30 billion as of the end of a quarter, the following weights will be applied to the weighted average CAMELS component rating, the long-term debt issuer ratings converted to a numerical value, and the financial ratio factor converted to a numerical value to derive the insurance score under paragraph (d)(3)(i) of this section:

TABLE 1 TO PARAGRAPH (d)(3)(vii)

Asset size category*	Weights applied to the:		
	Weighted average CAMELS component rating (percent)	Converted long-term debt issuer ratings (percent)	Financial ratio factor (percent)
> = \$25 billion, < \$30 billion .....	50	40	10
> = \$20 billion, < \$25 billion .....	50	30	20
> = \$15 billion, < \$20 billion .....	50	20	30
<\$15 billion .....	50	10	40
No long-term debt issuer rating .....	50	0	50

\*Applicable when a current (within last 12 months) long-term debt issuer rating is available for the insured institution. If no current rating is available, the last row of the table applies.

(B) For institutions that have assets of at least \$30 billion in assets as of the end of a quarter, that are not insured branches of foreign banks, the following

weights will be applied to the weighted average CAMELS component rating and the long-term debt issuer ratings converted to a numerical value to derive

the insurance score under paragraph (d)(3)(ii) of this section.

TABLE 2 TO PARAGRAPH (d)(3)(vii)

Asset size category*	Weights applied to the:		
	Weighted average CAMELS component rating (percent)	Converted long-term debt issuer ratings (percent)	Financial ratio factor (percent)
> = \$30 billion .....	50	50	0
No long-term debt issuer rating .....	50	0	50

\*Applicable when a current (within last 12 months) long-term debt issuer rating is available for the insured institution. If no current rating is available, the last row of the table applies.

(viii) *Conversion to Assessment Rate Subcategory.* Risk Category I for large institutions is subdivided into six assessment rate subcategories. The FDIC will determine a cutoff insurance score (the minimum cutoff score) such that, if an institution has that score or a lower score, it will initially be assigned to the subcategory being assessed at the

minimum rate. Similarly, the FDIC will determine a cutoff insurance score (the maximum cutoff score) such that, if an institution has a score higher than the maximum cutoff score, it will initially be assigned to the subcategory being assessed at the maximum rate. These cutoff scores will be determined such that, for the first quarter of 2007,

excluding new institutions, as defined in paragraph (d)(7) of this section, approximately the same proportion of the number of large institutions in Risk Category I will initially be assigned to the subcategory being assessed at the minimum rate as the proportion of the number of small institutions being charged the minimum rates within Risk



Category I (as determined pursuant to Appendix A to this subpart) and approximately the same proportion of the number of large institutions in Risk Category I will initially be assigned to the subcategory being assessed at the maximum rate as the proportion of the number of small institutions being charged the maximum rate within Risk Category I (as determined pursuant to Appendix A to this subpart). The insurance score ranges for each of the four intermediate subcategories (designated 1, 2, 3 and 4, for each subcategory with successively higher insurance scores) shall be equal.

(ix) *Adjustments to initial assignment of assessment risk subcategory.* In determining the assessment risk subcategory of a large institution or an insured branch of a foreign bank, the FDIC may consider other relevant information in addition to the factors used to derive the insurance score under paragraph (d)(3)(i) through (iii) of this section. Relevant information includes other market information, financial performance and condition information, and stress considerations, as described in Appendix D to this subpart. The FDIC may adjust an institution's initial assignment to an assessment risk subcategory based on its insurance score to the subcategory with the next lower or higher assessment rate, based on a determination that the information used to derive the insurance score combined with the additional information considered under this paragraph (d)(3)(ix) of this section demonstrate that the institution's overall risk profile differs from other institutions initially assigned to the same assessment rate subcategory.

(x) *Base Schedule of Rates for intermediate Risk Category I subcategories.* Base assessment rates for each of the four intermediate subcategories of Risk Category I shall be determined using data as of June 30, 2006, in the following manner.

(A) The number of large institutions (excluding new institutions and insured branches of foreign banks) in each of the four intermediate subcategories labeled 1, 2, 3 and 4 will be divided by the total number of all large institutions (excluding new institutions and insured branches of foreign banks) in the four intermediate subcategories to produce individual percentages to correspond to each subcategory.

(B) Small institutions in Risk Category I (excluding new institutions and insured branches of foreign banks) that are charged base assessment rates between the minimum and maximum base assessments rates will be grouped into four groups. Each group will

contain institutions being charged increasingly higher base assessment rates and will be numbered 1, 2, 3 and 4. Each group will contain a percentage of small institutions in Risk Category I (excluding new institutions and insured branches of foreign banks) of those charged between the minimum and maximum assessment rates equal to the corresponding percentage from the intermediate subcategory, as determined in paragraph (3)(x)(A) of this section.

(C) The base assessment rate applicable to each intermediate subcategory of large Risk Category I institutions under paragraph (d)(3)(viii) of this section will equal the average base assessment rate applicable to the corresponding group of small Risk Category I institutions defined in paragraph (d)(3)(x)(B) of this section.

(xi) *Implementation of Supervisory Rating Change.* If, during a quarter, a supervisory rating change occurs that results in a large institution or an insured branch of a foreign bank moving from Risk Category I to Risk Category II, III or IV, the institution's assessment rate for the portion of the quarter that it was in Risk Category I shall be based upon its subcategory for the prior quarter; no new insurance score will be developed for the quarter in which the institution moved to Risk Category II, III or IV. If, during a quarter, a supervisory rating change occurs that results in a large institution or an insured branch of a foreign bank moving from Risk Category II, III or IV to Risk Category I, the institution's assessment rate for the portion of the quarter that it was in Risk Category I shall equal the rate applicable to its subcategory as determined under paragraph (d)(3) of this section. If, during a quarter, a large institution remains in Risk Category I, but a CAMELS component or a long-term debt issuer rating changes that would affect the institution's initial assignment to a subcategory, separate assessment rates for the portion of the quarter before and after the change shall be determined under paragraph (d)(3) of this section. A long-term debt issuer rating change will be effective as of the date the change was announced.

(xii) *Effective date for changes to CAMELS component ratings.* Any change to a CAMELS component rating that results in a change to the institution's assessment rate shall take effect:

(A) If an examination (or targeted examination) leads to the change in an institution's CAMELS component rating, the change will be effective as of the date the examination or targeted examination begins, if such a date exists.

(B) If an examination (or targeted examination) leads to the change in CAMELS component rating and no examination (or targeted examination) start date exists, the change will be effective as of the date the change to the institution's CAMELS component rating is transmitted to the institution.

(C) Otherwise, the change will be effective as of the date that the FDIC determines that the change to the institution's CAMELS component rating occurred.

(xiii) *Review.* All assignments to assessment rate subcategories will be subject to review under § 327.4(c) of this part.

(4) *Changes in Institution Size.* If, after December 31, 2006, a Risk Category I institution classified as small under this section reports assets of \$10 billion or more in its reports of condition for four consecutive quarters, the FDIC will reclassify the institution as large beginning the following quarter. If, after December 31, 2006, a Risk Category I institution classified as large under this section reports assets of less than \$10 billion in its reports of condition for four consecutive quarters, the FDIC will reclassify the institution as small beginning the following quarter.

(5) *Request for Large Institution Treatment.* Any institution in Risk Category I with assets of between \$5 billion and \$10 billion may request that the FDIC determine its assessment using the FDIC's Large Institution Pricing Method. The FDIC will approve such a request only if it determines that a sufficient amount of risk information from supervisory, market, and financial reporting sources exists to adequately evaluate the institution's risk using the requested method. Any such request must be made to the FDIC's Division of Insurance and Research. Any approved change will become effective within one year from the date of the request. If an institution whose request has been granted subsequently reports assets of less than \$5 billion in its report of condition, the FDIC will determine within one year of the date of the report whether to use the small or large institution pricing method based upon the criteria in this paragraph of this section.

(6) *Time Limit on Request for Large Institution Treatment.* An institution whose request for Large Institution Treatment is granted by the FDIC shall not be eligible to request a different method for determining its assessment for a period of three years from the first quarter in which its approved request becomes effective.

(7) *New and Established Institutions.*  
(i) A new institution is a bank or thrift

that has not been chartered for at least seven years as of the last day of any quarter for which it is being assessed. All new institutions shall be assessed the Risk Category I maximum rate for that quarter.

(ii) An established institution is a bank or thrift that has been chartered for at least seven years as of the last day of any quarter for which it is being assessed.

(iii) When an established institution merges into or consolidates with a new institution, the resulting institution is a new institution. The FDIC may determine, upon request by the resulting institution to the Director of the Division of Insurance and Research, that the institution should be treated as an established institution for deposit insurance assessment purposes, based on analysis of the following:

(A) Whether the acquired, established institution was larger than the acquiring, new institution, and, if so, how much larger;

(B) Whether management of the acquired, established institution continued as management of the resulting institution;

(C) Whether the business lines of the resulting institution were the same as the business lines of the acquired, established institution;

(D) To what extent the assets and liabilities of the resulting institution were the assets and liabilities of the acquired, established institution; and

(E) Any other factors the FDIC considers relevant in determining whether the resulting institution remains substantially an established institution.

(iv) If a new institution merges into an established institution or an established institution acquires a substantial portion of a new institution's assets or liabilities, and the merger or acquisition agreement is entered into after the effective date of this rule, the FDIC will conduct the analysis set out in paragraph (d)(7)(iii) of this section to determine whether the resulting or acquiring institution remains an established institution.

(v) If a new institution merges into an established institution or an established institution acquires a substantial portion of a new institution's assets or liabilities, and the merger or acquisition agreement was entered into before the

effective date of this rule, the resulting or acquiring institution shall be deemed to be an established institution for purposes of this section.

(vi) A new institution that has \$10 billion or more in assets as of the end of the quarter prior to the quarter in which it becomes an established institution shall be considered a large institution for the quarter in which it becomes an established institution and thereafter, provided that it remains in Risk Category I and subject to paragraphs (d)(4) through (6) of this section. A new institution that has less than \$10 billion in assets as of the end of the quarter prior to the quarter in which it becomes an established institution shall be considered a small institution for the quarter in which it becomes an established institution and thereafter, provided that it remains in Risk Category I and subject to paragraphs (d)(4) through (6) of this section.

(8) *Assessment rates for Bridge Banks and Conservatorships.* Institutions that are bridge banks under 12 U.S.C. 1821(n) and institutions for which the Corporation has been appointed or serves as conservator shall, in all cases, be assessed at the Risk Category I minimum rate.

(e) *Rate adjustments and procedures—(1) Adjustments.* The Board may increase or decrease the assessment schedules of this section up to a maximum increase of 5 basis points or a fraction thereof or a maximum decrease of 5 basis points or a fraction thereof (after aggregating increases and decreases), as the Board deems necessary. Any such adjustment shall apply uniformly to each rate in the base assessment schedule. In no case may such adjustments result in an assessment rate that is mathematically less than zero or in a rate schedule that, at any time, is more than 5 basis points above or below the base assessment schedule for the Deposit Insurance Fund, nor may any one such adjustment constitute an increase or decrease of more than 5 basis points.

(2) *Amount of revenue.* In setting assessment rates, the Board shall take into consideration the following:

- (i) Estimated operating expenses of the Deposit Insurance Fund;
- (ii) Case resolution expenditures and income of the Deposit Insurance Fund;

(iii) The projected effects of assessments on the capital and earnings of the institutions paying assessments to the Deposit Insurance Fund;

(iv) The risk factors and other factors taken into account pursuant to 12 U.S.C. 1817(b)(1); and

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

(3) *Adjustment procedure.* Any adjustment adopted by the Board pursuant to this paragraph will be adopted by rulemaking. Nevertheless, because the Corporation may set assessment rates as necessary to manage the reserve ratio, and because the Corporation must do so in the face of constantly changing conditions, and because the purpose of the adjustment procedure is to permit the Corporation to act expeditiously and frequently to manage the reserve ratio in an environment of constant change, but within set parameters not exceeding 5 basis points, without the delays associated with full notice-and-comment rulemaking, the Corporation has determined that it is ordinarily impracticable, unnecessary and not in the public interest to follow the procedure for notice and public comment in such a rulemaking, and that accordingly notice and public procedure thereon are not required as provided in 5 U.S.C. 553(b). For the same reasons, the Corporation has determined that the requirement of a 30-day delayed effective date is not required under 5 U.S.C. 553(d). Any adjustment adopted by the Board pursuant to a rulemaking specified in this paragraph will be reflected in an adjusted assessment schedule set forth in paragraph (d) of this section, as appropriate.

(4) *Announcement.* The Board shall announce the assessment schedule and the amount and basis for any adjustment thereto not later than 30 days before the quarterly certified statement invoice date specified in § 327.3(b) of this part for the first assessment period for which the adjustment shall be effective.

#### § 327.10 [Removed]

3. Remove § 327.10 of Subpart A.

4. Add Appendices A through D to subpart A to read as follows:

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**Appendix A to Subpart A**  
**Small Institution Pricing Method**

**I. Introduction**

Part 327.9(b)(i) provides that the assessment rate in a given quarter for a small institution in Risk Category I will be calculated under the Small Institution Pricing Method as follows: Each of six financial ratios and a weighted average of CAMELS component ratings will be multiplied by a corresponding pricing multiplier. The sum of these products will be added to a uniform amount. The resulting sum will equal an institution's assessment rate; provided, however, that no institution's assessment rate will be less than the minimum rate in effect for that quarter nor greater than the maximum rate in effect for that quarter. The uniform amounts and pricing multipliers will be updated annually.

The uniform amount and pricing multipliers are derived from:

- A model (the small institution model) that estimates the probability that a small Risk Category I institution will be downgraded to a composite CAMELS rating of 3 or worse within one year;
- Minimum and maximum downgrade probability cutoff values that will determine which institutions will be charged the minimum and maximum assessment rates in Risk Category I;
- The minimum assessment rate in effect for Risk Category I for the quarter, and
- A maximum assessment rate in effect for Risk Category I for the quarter that is two basis points higher than the minimum rate.

**II. The small institution model**

The small institution model is defined in equation 1a below.

Equation 1a

$$\begin{aligned}
 \text{Downgrade}(0,1)_{i,t} = & \beta_0 + \beta_1(\text{Tier 1 leverage ratio}_{i,t}) \\
 & + \beta_2(\text{Loans past due 30 to 89 days ratio}_{i,t}) \\
 & + \beta_3(\text{Nonperforming loan ratio}_{i,t}) \\
 & + \beta_4(\text{Net loan charge-off ratio}_{i,t}) \\
 & + \beta_5(\text{Net income before taxes ratio}_{i,t}) \\
 & + \beta_6(\text{Volatile liabilities ratio}_{i,t}) \\
 & + \beta_7(\text{Weighted average of the C, A, M, E and L component ratings}_{i,t})
 \end{aligned}$$

where  $\text{Downgrade}(0,1)_{i,t}$  (the dependent variable—the event being explained) is the incidence of downgrade from a composite rating of 1 or 2 to a rating of 3 or worse during an on-site examination for an institution  $i$  between 3 and 12 months after time  $t$ . Time  $t$  is the end of a year within the multi-year period over which the model was estimated (as

explained below). The dependent variable takes a value of 1 if a downgrade occurs and 0 if it does not.

The explanatory variables (regressors) in the model are six financial ratios and a weighted average of the “C,” “A,” “M,” “E” and “L” component ratings. The six financial ratios included in the model are:

- Tier 1 leverage ratio
- Loans past due 30-89 days/Gross assets
- Nonperforming loans/Gross assets
- Net loan charge-offs/Gross assets
- Net income before taxes/Risk-weighted assets
- Volatile liabilities/Gross assets

The financial ratios and the weighted average of the “C,” “A,” “M,” “E” and “L” component ratings (collectively, the regressors) are defined in Table A.1. The component rating for sensitivity to market risk (the “S” rating) is not available for years prior to 1997. As a result, and as described in Table A.1, the small institution model is estimated using a weighted average of five component ratings excluding the “S” component.

**Table A.1**  
Definitions of Regressors

<u>Regressor</u>	<u>Description</u>
Tier 1 Leverage Ratio (%)	Tier 1 capital for Prompt Corrective Action (PCA) divided by adjusted average assets based on the definition for prompt corrective action
Loans Past Due 30-89 Days/Gross Assets (%)	Total loans and lease financing receivables past due 30 through 89 days and still accruing interest divided by gross assets (gross assets equal total assets plus allowance for loan and lease financing receivable losses and allocated transfer risk).
Nonperforming Loans/Gross Assets (%)	Sum of total loans and lease financing receivables past due 90 or more days and still accruing interest, total nonaccrual loans and lease financing receivables, and other real estate owned divided by gross assets.
Net Loan Charge-Offs/Gross Assets (%)	Total charged-off loans and lease financing receivables debited to the allowance for loan and lease losses less total recoveries credited to the allowance to loan and lease losses for the most recent twelve months divided by gross assets.
Net Income before Taxes/Risk-Weighted Assets (%)	Income before income taxes and extraordinary items and other adjustments for the most recent twelve months divided by risk-weighted assets.
Volatile Liabilities/Gross Assets (%)	Sum of foreign office deposits, federal funds purchased and securities sold under agreements to repurchase, and time deposits \$100,000 or more held in domestic offices divided by gross assets.
Weighted Average of C, A, M, E and L Component Ratings	The weighted sum of the “C,” “A,” “M,” “E” and “L” CAMELS components, with weights of 28 percent each for the “C” and “M” components, 22 percent for the “A” component, and 11 percent each for the “E” and “L” components. (For the regression, the “S” component is omitted.)

The financial ratio regressors used to estimate the downgrade probabilities are obtained from quarterly Call Reports. The weighted average of the “C,” “A,” “M,” “E”

and “L” component ratings regressor is based on component ratings obtained from the most recent bank examination conducted within 24 months before the Call Report date.

The small institution model uses ordinary least squares (OLS) regression to estimate downgrade probabilities. The model is estimated with data from a multi-year period (as explained below) for all institutions in Risk Category I, except for institutions established within seven years before the Call Report date.

The OLS regression estimates coefficients,  $\beta_j$ , for a given regressor  $j$  and a constant amount,  $\beta_0$ , as specified in equation 1a. As shown in equation 1b below, these coefficients are multiplied by values of risk measures at time  $T$ , which is the date of the report of condition corresponding to the end of the quarter for which the assessment rate is computed. The sum of the products is then added to the constant amount to produce an estimated probability,  $d_{i,T}$ , that an institution will be downgraded to 3 or worse within 3 to 12 months from time  $T$ . The risk measures are financial ratios defined in Table A.1 and a weighted sum of six CAMELS component ratings, with weights of 25 percent each for the “C” and “M” components, 20 percent for the “A” component, and 10 percent each for the “E,” “L,” and “S” components.

#### Equation 1b

$$\begin{aligned}
 d_{i,T} = & \beta_0 + \beta_1(\text{Tier 1 leverage ratio}_{i,T}) \\
 & + \beta_2(\text{Loans past due 30 to 89 days ratio}_{i,T}) \\
 & + \beta_3(\text{Nonperforming loan ratio}_{i,T}) \\
 & + \beta_4(\text{Net loan charge-off ratio}_{i,T}) \\
 & + \beta_5(\text{Net income before taxes ratio}_{i,T}) \\
 & + \beta_6(\text{Volatile liabilities ratio}_{i,T}) \\
 & + \beta_7(\text{Weighted average of CAMELS component ratings}_{i,T})
 \end{aligned}$$

### **III. Minimum and maximum downgrade probability cutoff values**

The pricing multipliers are also determined by minimum and maximum downgrade probability cutoff values, which will be computed as follows:

- The minimum downgrade probability cutoff value will be the maximum downgrade probability among the forty-five percent of all small insured institutions (excluding new institutions) in Risk Category I with the lowest estimated downgrade probabilities, computed using values of the risk measures as of June 30, 2006.
- The maximum downgrade probability cutoff value will be the minimum downgrade probability among the five percent of all small insured institutions (excluding new institutions) in Risk Category I with the highest estimated downgrade probabilities, computed using values of the risk measures as of June 30, 2006.

#### IV. Derivation of uniform amount and pricing multipliers

The uniform amount and pricing multipliers used to compute the annual assessment rate in basis points,  $P_{it}$ , for any such institution  $i$  at a given time  $T$  will be determined from the small institution model, the minimum and maximum downgrade probability cutoff values, and minimum and maximum assessment rates in Risk Category I as follows:

##### Equation 2

$$P_{it} = \alpha_0 + \alpha_1 * d_{it}, \text{ subject to } P_{\min} \leq P_{it} \leq P_{\min} + 2$$

where  $\alpha_0$  and  $\alpha_1$  are a constant term and a scale factor used to convert  $d_{it}$  (the estimated downgrade probability for institution  $i$  at a given time  $T$  from the small institution model) to an assessment rate, respectively,  $P_{\min}$  is the minimum assessment rate in effect for Risk Category I for the quarter, expressed as an annual rate in basis points, and the number 2 in the restriction to equation 2 is expressed in basis points. ( $P_{it}$  is expressed as an annual rate, but the actual rate applied in any quarter will be  $\frac{P_{it}}{4}$ .)

Solving equation 2 for minimum and maximum assessment rates simultaneously, ( $P_{\min} = \alpha_0 + \alpha_1 * c_{\min}$  and  $P_{\min} + 2 = \alpha_0 + \alpha_1 * c_{\max}$ ), where  $c_{\min}$  is the minimum downgrade probability cutoff value and  $c_{\max}$  is the maximum downgrade probability cutoff value, results in values for the constant amount,  $\alpha_0$ , and the scale factor,  $\alpha_1$ :

##### Equation 3

$$\alpha_0 = P_{\min} - \frac{2c_{\min}}{c_{\max} - c_{\min}} \quad \text{and}$$

##### Equation 4

$$\alpha_1 = \frac{2}{c_{\max} - c_{\min}}$$

Substituting equations 1b, 3 and 4 into equation 2 produces an annual assessment rate for institution  $i$  at time  $T$ ,  $P_{it}$ , in terms of the uniform amount, the pricing multipliers and the ratios and weighted average CAMELS component rating referred to in 12 CFR 327.9(d)(2)(i):

Equation 5

$$\begin{aligned}
P_{iT} = & \left[ P_{\min} + \frac{2(\beta_0 - c_{\min})}{c_{\max} - c_{\min}} \right] + \frac{2}{c_{\max} - c_{\min}} \beta_1 (\textit{Tier 1 Leverage Ratio}_T) + \\
& \frac{2}{c_{\max} - c_{\min}} \beta_2 (\textit{Loans past due 30 to 89 days ratio}_T) + \\
& \frac{2}{c_{\max} - c_{\min}} \beta_3 (\textit{Nonperforming loan ratio}_T) + \frac{2}{c_{\max} - c_{\min}} \beta_4 (\textit{Net loan charge-off ratio}_T) + \\
& \frac{2}{c_{\max} - c_{\min}} \beta_5 (\textit{Net income before taxes ratio}_T) + \frac{2}{c_{\max} - c_{\min}} \beta_6 (\textit{Volatile liabilities ratio}_T) + \\
& \frac{2}{c_{\max} - c_{\min}} \beta_7 (\textit{Weighted average CAMELS component rating}_T)
\end{aligned}$$

again subject to  $P_{\min} \leq P_{iT} \leq P_{\min} + 2$

where  $P_{\min} + \frac{2(\beta_0 - c_{\min})}{c_{\max} - c_{\min}}$  equals the uniform amount,  $\frac{2}{c_{\max} - c_{\min}} \beta_j$  is a pricing multiplier for the associated risk measure  $j$ , and  $T$  is the date of the report of condition corresponding to the end of the quarter for which the assessment rate is computed.

#### V. Updating the small institution model, uniform amount, and pricing multipliers

The initial small institution model is estimated using year-end financial ratios and the weighted average of the “C,” “A,” “M,” “E” and “L” component ratings over the 1984 to 2004 period and downgrade data from the 1985 to 2005 period. The FDIC will annually re-estimate the small institution model with updated data and publish a new formula for determining assessment rates—equation 5—based on updated uniform amounts and pricing multipliers. The period covered by the analysis will be lengthened by one year each year; however, from time to time, the FDIC may drop some earlier years from its analysis.

If assessment rates are changed uniformly, the uniform amount,  $P_{\min} + \frac{2(\beta_0 - c_{\min})}{c_{\max} - c_{\min}}$ , will increase or decrease by the amount of the change, even without re-estimating the small institution model using updated data.

**Appendix B to Subpart A**  
**Numerical Conversion of Long-term debt issuer ratings**

Current Long-Term Debt Issuer Rating	Converted Value
Standard & Poor's	
AA or better	1.00
AA-	1.05
A+	1.15
A	1.30
A-	1.50
BBB+	1.80
BBB	2.20
BBB-	2.70
BB+ or worse	3.00
Moody's	
Aa2 or better	1.00
Aa3	1.05
A1	1.15
A2	1.30
A3	1.50
Baa1	1.80
Baa2	2.20
Baa3	2.70
Ba1 or worse	3.00
Fitch's	
AA or better	1.00
AA-	1.05
A+	1.15
A	1.30
A-	1.50
BBB+	1.80
BBB	2.20
BBB-	2.70
BB+ or worse	3.00

\*A current rating is defined as one that has been assigned or reviewed in the last 12 months. Stale ratings are not considered.



**Appendix C to Subpart A**  
**Financial Ratio Factor**

**I. Overview of the financial ratio factor**

Proposed section 327.9(d)(3)(i) provides that the financial ratio factor will be incorporated into the insurance score each quarter for large institutions in Risk Category I with less than \$30 billion in assets. The financial ratio factor will be calculated based on the alternative small institution model (the Alternative) that estimates the probability that a small Risk Category I institution will be downgraded to a composite CAMELS rating of 3 or worse within one year using six financial ratios. The estimated downgrade probability would be converted to the financial ratio factor as follows: The difference between the estimated downgrade probability of a given institution and the minimum assessment rate cutoff value for small institutions in Risk Category I as calculated under the Alternative is divided by the difference between the maximum and minimum assessment rate cutoff values for small institutions as calculated under the Alternative. This amount is then multiplied by two (the difference between the maximum and minimum possible financial ratio factor values) and added to one (the minimum possible financial ratio factor value). The resulting sum will equal an institution's financial ratio factor; provided, however, that no institution's factor will be less than one nor greater than three.

**II. Calculation of financial ratio factor**

The Alternative is defined in equation 1a below.

Equation 1a

$$\begin{aligned} \text{Downgrade}(0,1)_{i,t} = & \beta_0 + \beta_1(\text{Tier 1 leverage ratio}_{i,t}) \\ & + \beta_2(\text{Loans past due 30 to 89 days ratio}_{i,t}) \\ & + \beta_3(\text{Nonperforming loan ratio}_{i,t}) \\ & + \beta_4(\text{Net loan charge - off ratio}_{i,t}) \\ & + \beta_5(\text{Net income before taxes ratio}_{i,t}) \\ & + \beta_6(\text{Volatile liabilities ratio}_{i,t}) \end{aligned}$$

where  $\text{Downgrade}(0,1)_{i,t}$  (the dependent variable—the event being explained) is the incidence of downgrade from a composite rating of 1 or 2 to a rating of 3 or worse during an on-site examination for an institution  $i$  between 3 and 12 months after time  $t$ . Time  $t$  is the end of a year within the multi-year period over which the model was estimated (as explained below). The dependent variable takes a value of 1 if a downgrade occurs and 0 if it does not.

The explanatory variables (regressors) in the model are six financial ratios that are:

- Tier 1 leverage ratio

- Loans past due 30-89 days/Gross assets
- Nonperforming loans/Gross assets
- Net loan charge-offs/Gross assets
- Net income before taxes/Risk-weighted assets
- Volatile liabilities/Gross assets

The financial ratio regressors used to estimate the downgrade probabilities are obtained from quarterly reports of condition. The financial ratios are defined in Table C.1.

**Table C.1**  
Definitions of Financial Ratios

<u>Financial Ratios</u>	<u>Description</u>
Tier 1 Leverage Ratio (%)	Tier 1 capital for Prompt Corrective Action (PCA) divided by adjusted average assets based on the definition for prompt corrective action
Loans Past Due 30-89 Days/Gross Assets (%)	Total loans and lease financing receivables past due 30 through 89 days and still accruing interest divided by gross assets (gross assets equal total assets plus allowance for loan and lease financing receivable losses and allocated transfer risk).
Nonperforming Loans/Gross Assets (%)	Sum of total loans and lease financing receivables past due 90 or more days and still accruing interest, total nonaccrual loans and lease financing receivables, and other real estate owned divided by gross assets.
Net Loan Charge-Offs/Gross Assets (%)	Total charged-off loans and lease financing receivables debited to the allowance for loan and lease losses less total recoveries credited to the allowance to loan and lease losses for the most recent twelve months divided by gross assets.
Net Income before Taxes/Risk-Weighted Assets (%)	Income before income taxes and extraordinary items and other adjustments for the most recent twelve months divided by risk-weighted assets.
Volatile Liabilities/Gross Assets (%)	Sum of foreign office deposits, federal funds purchased and securities sold under agreements to repurchase, and time deposits \$100,000 or more held in domestic offices divided by gross assets.

The Alternative uses ordinary least squares (OLS) regression to estimate downgrade probabilities. The model is estimated using data from a multi-year period (as explained below) for all institutions in Risk Category I, except for institutions established within seven years before the Call Report date.

The OLS regression estimates coefficients,  $\beta_j$ , for a given regressor  $j$  and a constant amount,  $\beta_0$ , as specified in equation 1a. As shown in equation 1b below, these coefficients are multiplied by values of risk measures at time  $T$ , which is the date of the report of condition corresponding to the end of the quarter for which the assessment rate

is computed. The sum of the products is then added to the constant amount to produce an estimated probability,  $d_{i,T}$ , that an institution will be downgraded to 3 or worse within 3 to 12 months from time  $T$ .

#### Equation 1b

$$\begin{aligned}
 d_{i,T} = & \beta_0 + \beta_1(\text{Tier 1 leverage ratio}_{i,T}) \\
 & + \beta_2(\text{Loans past due 30 to 89 days ratio}_{i,T}) \\
 & + \beta_3(\text{Nonperforming loan ratio}_{i,T}) \\
 & + \beta_4(\text{Net loan charge-off ratio}_{i,T}) \\
 & + \beta_5(\text{Net income before taxes ratio}_{i,T}) \\
 & + \beta_6(\text{Volatile liabilities ratio}_{i,T}) \\
 & + \beta_7(\text{Weighted average of the C, A, M, E and L component ratings}_{i,T})
 \end{aligned}$$

#### **A. Minimum and maximum downgrade probability cutoff values**

The financial ratio factor will depend on minimum and maximum downgrade probability cutoff values for small institutions in Risk Category I, which will be computed as follows:

- The minimum downgrade probability cutoff value will be the maximum downgrade probability among the forty-three percent of all small insured institutions (excluding new institutions) in Risk Category I with the lowest estimated downgrade probabilities, computed using values of the risk measures as of June 30, 2006.
- The maximum downgrade probability cutoff value will be the minimum downgrade probability among the five percent of all small insured institutions (excluding new institutions) in Risk Category I with the highest estimated downgrade probabilities, computed using values of the risk measures as of June 30, 2006.

#### **B. Derivation of financial ratio factor**

The financial ratio factor for any institution  $i$  at a given time  $T$  will be determined from the Alternative, the minimum and maximum downgrade probability cutoff values, and minimum and maximum financial ratio factors as follows:

#### Equation 2

$$S_{i,T} = \alpha_0 + \alpha_1 * d_{i,T}, \text{ subject to } 1 \leq S_{i,T} \leq 3$$

where  $\alpha_0$  and  $\alpha_1$  are, respectively, a constant term and a scale factor used to convert  $d_{i,T}$  (the estimated downgrade probability for institution  $i$  at a given time  $T$  from the Alternative computed using equation (1b)) to a financial ratio factor.

Solving equation (2) for minimum and maximum financial ratio factors simultaneously, ( $1 = \alpha_0 + \alpha_1 * c_{\min}$  and  $3 = \alpha_0 + \alpha_1 * c_{\max}$ ), where  $c_{\min}$  is the minimum downgrade probability cutoff value and  $c_{\max}$  is the maximum downgrade probability cutoff value, results in values for the constant amount,  $\alpha_0$ , and the scale factor,  $\alpha_1$ :

Equation 3

$$\alpha_0 = 1 - \frac{2C_{\min}}{c_{\max} - c_{\min}} \quad \text{and}$$

Equation 4

$$\alpha_1 = \frac{2}{c_{\max} - c_{\min}}$$

Substituting equations 3 and 4 into equation 2 and rearranging the equation produces a financial ratio factor for institution  $i$  at time  $T$ ,  $S_{iT}$ , in terms of downgrade probability and minimum and maximum cutoff values, as well as the minimum and maximum financial ratio factors referred to in 12 CFR 327.9(d)(3)(vi):

Equation 5

$$S_{iT} = 1 + 2 * \left( \frac{d_{iT} - c_{\min}}{c_{\max} - c_{\min}} \right) \quad \text{again subject to } 1 \leq S_{iT} \leq 3$$

**C. Updating the Alternative model**

The initial Alternative model will be estimated using year-end financial ratios over the 1984 to 2004 period and downgrade data from the 1985 to 2005 period. The FDIC will annually re-estimate the Alternative model with updated data and publish a new formula for determining the financial ratio factor based on the updated model. The period covered by the analysis will be lengthened by one year each year; however, from time to time, the FDIC may drop some earlier years from its analysis.

**Appendix D to Subpart A**  
**Additional Risk Considerations**  
**For Large Risk Category I Institutions**

<b>Information Source</b>	<b>Examples of Associated Risk Indicators or Information</b>
<b>Market Information</b>	<ul style="list-style-type: none"> <li>• Subordinated debt spreads</li> <li>• Credit default swap spreads</li> <li>• Parent's equity price volatility</li> <li>• Market-based measures of default probabilities</li> <li>• Rating agency watch lists</li> <li>• Market analyst reports</li> </ul>
<b>Financial Performance and Condition Information</b>	<p><u>Capital Measures (Level and Trend)</u></p> <ul style="list-style-type: none"> <li>• Regulatory capital ratios</li> <li>• Capital composition</li> <li>• Dividend payout ratios</li> <li>• Internal capital growth rates relative to asset growth</li> </ul> <p><u>Profitability Measures (Level and Trend)</u></p> <ul style="list-style-type: none"> <li>• Return on assets and return on risk-adjusted assets</li> <li>• Net interest margins, funding costs and volumes, earning asset yields and volumes</li> <li>• Noninterest revenue sources</li> <li>• Operating expenses</li> <li>• Loan loss provisions relative to problem loans</li> <li>• Historical volatility of various earnings sources</li> </ul> <p><u>Asset Quality Measures (Level and Trend)</u></p> <ul style="list-style-type: none"> <li>• Loan and securities portfolio composition and volume of higher risk lending activities (e.g., sub-prime lending)</li> <li>• Loan performance measures (past due, nonaccrual, classified and criticized, and renegotiated loans) and portfolio characteristics such as internal loan rating and credit score distributions, internal estimates of default, internal estimates of loss given default, and internal estimates of exposures in the event of default</li> <li>• Loan loss reserve trends</li> <li>• Loan growth and underwriting trends</li> <li>• Off-balance sheet credit exposure measures (unfunded loan commitments, securitization activities, counterparty derivatives exposures) and hedging activities</li> </ul> <p><u>Liquidity and Funding Measures (Level and Trend)</u></p> <ul style="list-style-type: none"> <li>• Composition of deposit and non-deposit funding sources</li> <li>• Liquid resources relative to short-term obligations, undisbursed credit lines, and contingent liabilities</li> </ul> <p><u>Interest Rate Risk and Market Risk (Level and Trend)</u></p> <ul style="list-style-type: none"> <li>• Maturity and repricing information on assets and liabilities, interest rate risk analyses</li> <li>• Trading book composition and Value-at-Risk information</li> </ul>

Information Source	Examples of Associated Risk Indicators or Information
<b>Stress Considerations</b>	<p><u>Ability to Withstand Stress Conditions</u></p> <ul style="list-style-type: none"> <li>• Internal analyses of portfolio composition and risk concentrations, and vulnerabilities to changing economic and financial conditions</li> <li>• Stress scenario development and analyses</li> <li>• Results of stress tests or scenario analyses that show the degree of vulnerability to adverse economic, industry, market, and liquidity events. Examples include: <ul style="list-style-type: none"> <li>i. an evaluation of credit portfolio performance under varying stress scenarios</li> <li>ii. an evaluation of non-credit business performance under varying stress scenarios</li> <li>iii. an analysis of the ability of earnings and capital to absorb losses stemming from unanticipated adverse events</li> </ul> </li> <li>• Contingency or emergency funding strategies and analyses</li> <li>• Capital adequacy assessments</li> </ul> <p><u>Loss Severity Indicators</u></p> <ul style="list-style-type: none"> <li>• Nature of and breadth of an institution's primary business lines and the degree of variability in valuations for firms with similar business lines or similar portfolios</li> <li>• Ability to identify and describe discreet business units within the banking legal entity</li> <li>• Funding structure considerations relating to the order of claims in the event of liquidation (including the extent of subordinated claims and priority claims).</li> <li>• Extent of insured institutions assets held in foreign units</li> <li>• Degree of reliance on affiliates and outsourcing for material mission-critical services, such as management information systems or loan servicing, and products</li> </ul>

By order of the Board of Directors.  
Dated at Washington, DC, this 11th day of  
July, 2006.

Federal Deposit Insurance Corporation.  
**Valerie J. Best,**  
*Assistant Executive Secretary.*  
**BILLING CODE 6714-01-P**

**Note: The following appendix will not appear in the Code of Federal Regulations.**

**Appendix 1**  
**Proposed Method for Determining Insurance Assessments  
For Small, Well-Capitalized, Well-Managed Institutions**

This appendix provides a technical description of the proposed method for determining insurance assessments for small institutions in Risk Category I. The appendix provides background information, reviews the data and methodology used to estimate the model underlying the proposed method, discusses estimation results, explains the derivation of assessment rates, discusses alternative specifications considered, and evaluates the robustness of the results.

**I. Background**

The most conceptually straightforward approach to setting deposit insurance assessment rates is to charge an institution an amount equal to the expected loss that the FDIC faces from providing deposit insurance to that institution.<sup>82,83</sup> For the FDIC, the expected loss associated with an insured institution is a product of two factors—its probability of failure (PF) and the loss given failure (LGF).<sup>84</sup> LGF itself is the product of

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<sup>82</sup> See FDIC, *Options Paper* (2001) for further discussion on expected loss pricing.

<sup>83</sup> A private insurer might, under certain circumstances, also include a capital charge. Because losses to the Deposit Insurance Fund are volatile over time and may be greater than expected in a given period, the question may arise whether the FDIC should also charge an unexpected loss premium. A charge for unexpected losses may be particularly necessary where the occurrence of an insured event could exhaust existing capital, raising the question whether the FDIC should impose higher rates where the unexpected failure of a large institution could deplete the fund. However, an argument can be made that higher rates for this risk would effectively bar large institutions from the lowest-risk category. The Reform Act explicitly prohibits such a bar: “No insured depository institution shall be barred from the lowest-risk category solely because of size.” In addition, as a government agency, the FDIC is in a unique position to access additional capital over which it can spread unexpected losses. The FDIC can assess the banking industry after the fact, borrow up to \$30 billion from the U.S. Treasury, borrow on a secured basis from the Federal Financing Bank and the Federal Home Loan Banks, and borrow from the banking industry itself.

If the threatened failure of an institution poses a systemic risk, the general statutory requirement that the FDIC use the least-costly method of resolution may not apply. Thus, an institution that might pose a systemic risk may pose a higher loss given failure than other institutions. Nevertheless, the FDIC does not propose to routinely impose a higher charge on institutions that have the potential to pose a systemic risk. The law provides that losses resulting from a systemic risk determination (i.e., the amount in excess of the least-costly method) be recovered by charging an assessment on each institution’s average liabilities, specifically:

[T]he amount of each insured depository institution's average total assets during the assessment period, minus the sum of the amount of the institution’s average total tangible equity and the amount of the institution’s average total subordinated debt.

12 U.S.C. 1823(c)(4)(G)(ii) and 1824.

<sup>84</sup> In theory, the FDIC would want expected assessment revenue collected from the institution to equal the expected loss over the lifetime of the institution. In practice, the FDIC would, if it could, want assessment revenue collected from the institution over some period (e.g., three years) to equal the expected loss from the institution during that period.

two factors—the amount of insured deposits at risk (exposure) and the amount of loss as a percentage of exposure (severity).<sup>85</sup> Given sufficient historical information on insured institution failures, probability of failure and loss given failure can be used to predict expected losses from each insured institution for a specified time interval, and insurance assessment rates can be derived that will recover expected losses from individual institutions.

In practice, estimates of expected loss are sensitive to assumptions regarding the probability of failure, exposure and severity, and it is not always clear which assumptions are most appropriate.<sup>86</sup> In addition, setting an assessment based on expected losses is made more difficult by the very low frequency of failures in recent years. Expected losses would be based on PF and LGF estimates from an earlier period (the late 1980s and early 1990s) that had greater failure frequencies. Regulatory and economic conditions relevant to the banking industry have undergone significant changes in the past decade, making failure data from the earlier period less relevant to the current environment. Thus, the FDIC is proposing an alternative to expected loss pricing to set deposit insurance assessment rates.

For insured institutions in Risk Category I that have assets of less than \$10 billion, the FDIC proposes a risk measurement method similar to the FDIC's early warning system for small insured institutions, the Statistical CAMELS Off-site Rating (SCOR) system.<sup>87,88,89</sup> The FDIC uses the SCOR system to detect adverse changes in institutions' safety and soundness between on-site examinations and focuses on composite CAMELS 1 and 2-rated institutions, which are examined every 12 to 18 months.<sup>90</sup>

Like SCOR, the proposed risk measurement method for small Risk Category I institutions predicts the likelihood of deterioration in composite CAMELS ratings. Historically, the failure frequency of insured institutions has risen monotonically as CAMELS ratings have worsened. Thus, the proposed method serves as a reasonable proxy for a relative measure of failure probability among smaller institutions in Risk Category I.

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<sup>85</sup> Severity is a function of the recovery value of assets, administrative expenses and liability structure.

<sup>86</sup> Rosalind L. Bennett, "Evaluating the Adequacy of the Deposit Insurance Fund: A Credit-Risk Modeling Approach," *FDIC Working Paper Series 2001-02*.

<sup>87</sup> Charles Collier, Sean Forbush, Daniel A. Nuxoll, and John O'Keefe, "The SCOR System of Off-Site Monitoring: Its Objectives, Functioning, and Performance," *FDIC Banking Review* 15(3) (2003), 17-32.

<sup>88</sup> SCOR predicts CAMELS ratings three to six months after the Call Report date. Call Reports are available approximately 30 to 40 days after the financial reporting date ("as of" date) and are updated quarterly.

<sup>89</sup> The Federal Reserve has also developed an off-site early warning system that uses financial measures to predict CAMELS ratings.

<sup>90</sup> Examination frequency ranges from well under 12 months for institutions deemed supervisory concerns or problem institutions (CAMELS ratings of 3, 4 or 5) to 18 months for CAMELS 1 or 2-rated institutions with assets under \$250 million that are well managed, not subject to a formal enforcement proceeding or order by the FDIC, OCC, or Federal Reserve System and not acquired by another entity or person during the preceding 12-month period. 12 U.S.C. 1820 (d). (See <http://www.fdic.gov/regulations/safety/manual/section1-1.html>).



## II. Methodology

The premise underlying the proposed risk measurement method for small Risk Category I institutions is the same as the premise underlying SCOR: an institution's overall safety and soundness, as represented by its composite CAMELS rating, is related to its prior-period financial condition, as measured by financial ratios.<sup>91</sup> The proposal uses a model (the "small institution model") that estimates, based on financial ratios and a weighted average of the "C," "A," "M," "E" and "L" component ratings (the regressors, or explanatory variables), the probability that a small Risk Category I institution will be downgraded to a composite CAMELS rating of 3 or worse within one year.

The dependent variable (the event being explained) in the small institution model is the incidence of downgrade from a composite rating of 1 or 2 to a rating of 3 or worse during an on-site examination between 3 and 12 months after the date of a quarterly report of condition (Call Report) filed with an institution's primary federal regulator.<sup>92</sup> The financial ratio regressors used to estimate the downgrade probability are obtained from these quarterly Call Reports.<sup>93</sup> With two exceptions, these financial ratios are expressed as percentages of gross assets (net assets plus the loan loss reserves). The ratio of net income before taxes is measured as a percentage of risk-weighted assets, rather than of gross assets; the Tier 1 leverage ratio is defined in accordance with regulatory capital requirements. The weighted average of the "C," "A," "M," "E" and "L" component ratings regressor is based on component ratings obtained from examinations that were conducted within 24 months before the Call Report date. Component ratings from older examinations are excluded because they are not likely to accurately reflect the condition of an institution as of the date for which the financial ratios are computed.

As discussed in Section III, the small institution model was estimated using a panel dataset that consists of year-end financial ratios and supervisory component ratings from 1984 through 2004 and downgrade data from 1985 through 2005. The component rating for sensitivity to market risk ("S" rating) is not available for years prior to 1997. Therefore, the coefficient for the weighted average of the "C," "A," "M," "E" and "L" component ratings is estimated using a weighted average of five component ratings excluding the "S" component, as described in Table 1.1. However, a weighted average of all six component ratings, with weights of 25 percent each for the "C" and "M" components, 20 percent for the "A" component and 10 percent each for the "E," "L" and "S" components, is used to compute the assessment rate for each institution.<sup>94</sup> Table 1.1 describes these regressors in detail.

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<sup>91</sup> Smaller institutions do not use traded debt and equity instruments for funding, largely due to the high fixed costs associated with issuing marketable debt and equity, as well as costly demands for financial disclosure. Consequently, the FDIC does not rely on market measures to predict CAMELS ratings.

<sup>92</sup> The report of condition includes Reports of Conditions and Income for banks and Thrift Financial Reports for thrifts, both filed on a quarterly basis.

<sup>93</sup> Net income and net loan charge-offs used in the regression are annual values, adjusted for mergers and acquisitions that occurred over the prior year.

<sup>94</sup> The weighted average of five CAMEL component ratings excluding the "S" rating is very similar to the weighted average based on all six components over the 1997 to 2005 period, with a Pearson correlation between two measures in excess of 0.98.

**Table 1.1**

## Description of Explanatory Variables

Regressor	Description
Tier 1 Leverage Ratio (%)	Tier 1 capital for Prompt Corrective Action (PCA) divided by adjusted average assets based on the definition for prompt corrective action
Loans Past Due 30-89 Days/Gross Assets (%)	Total loans and lease financing receivables past due 30 through 89 days and still accruing interest divided by gross assets (gross assets equal total assets plus allowance for loan and lease financing receivable losses and allocated transfer risk).
Nonperforming Loans/Gross Assets (%)	Sum of total loans and lease financing receivables past due 90 or more days and still accruing interest, total nonaccrual loans and lease financing receivables, and other real estate owned divided by gross assets.
Net Loan Charge-Offs/Gross Assets (%)	Total charged-off loans and lease financing receivables debited to the allowance for loan and lease losses less total recoveries credited to the allowance for loan and lease losses for the most recent twelve months divided by gross assets.
Net Income before Taxes/Risk-Weighted Assets (%)	Income before income taxes and extraordinary items and other adjustments for the most recent twelve months divided by risk-weighted assets.
Volatile Liabilities/Gross Assets (%)	Sum of foreign office deposits, federal funds purchased and securities sold under agreements to repurchase, and time deposits \$100,000 or more held in domestic offices divided by gross assets.
The weighted average of the "C," "A," "M," "E" and "L" component ratings	The weighted sum of the "C," "A," "M," "E" and "L" CAMELS components, with weights of 28 percent each for the "C" and "M" components, 22 percent for the "A" component, and 11 percent each for each of the "E" and "L" components. (For the regression, the "S" component is omitted.)

Equation (1a) presents the proposed method in general form. The dependent variable,  $Downgrade(0,1)_{i,t}$ , is the incidence of downgrade from a composite rating of 1 or 2 to a rating of 3 or worse during an on-site examination for an institution  $i$  between 3 and 12 months after time  $t$ . Time  $t$  is the end of a year within the multi-year estimation period. The dependent variable takes a value of 1 if a downgrade occurs and 0 if it does not.<sup>95</sup>

<sup>95</sup> If an institution is not examined during the period over which downgrades are measured, it is excluded from an estimation sample. State and federal bank and thrift regulators who monitor institutions' conditions between on-site examinations have the opportunity to schedule an examination should an institution's condition deteriorate.

Equation 1a

$$\begin{aligned}
 \text{Downgrade}(0,1)_{i,t} = & \beta_0 + \beta_1(\text{Tier 1 leverage ratio}_{i,t}) \\
 & + \beta_2(\text{Loans past due 30 to 89 days ratio}_{i,t}) \\
 & + \beta_3(\text{Nonperforming loan ratio}_{i,t}) \\
 & + \beta_4(\text{Net loan charge-off ratio}_{i,t}) \\
 & + \beta_5(\text{Net income before taxes ratio}_{i,t}) \\
 & + \beta_6(\text{Volatile liabilities ratio}_{i,t}) \\
 & + \beta_7(\text{Weighted average of the C, A, M, E and L component ratings}_{i,t})
 \end{aligned}$$

Equation (1a) provides the basis for estimates of the probability of downgrade. As shown in equation (1b) below, these coefficients are multiplied by values of risk measures at time  $T$ , which is the date of the report of condition corresponding to the end of the quarter for which the assessment rate is computed. The sum of the products is then added to the constant amount to produce an estimated probability,  $d_{i,T}$ , that an institution will be downgraded to 3 or worse within 3 to 12 months from time  $T$ . The risk measures are financial ratios defined in Table 1.1 and a weighted sum of six CAMELS component ratings, with weights of 25 percent each for the “C” and “M” components, 20 percent for the “A” component, and 10 percent each for the “E,” “L,” and “S” components.

Equation 1b

$$\begin{aligned}
 d_{i,T} = & \beta_0 + \beta_1(\text{Tier 1 leverage ratio}_{i,T}) \\
 & + \beta_2(\text{Loans past due 30 to 89 days ratio}_{i,T}) \\
 & + \beta_3(\text{Nonperforming loan ratio}_{i,T}) \\
 & + \beta_4(\text{Net loan charge-off ratio}_{i,T}) \\
 & + \beta_5(\text{Net income before taxes ratio}_{i,T}) \\
 & + \beta_6(\text{Volatile liabilities ratio}_{i,T}) \\
 & + \beta_7(\text{Weighted average of CAMELS component ratings}_{i,T})
 \end{aligned}$$

The explanatory variables draw from the SCOR model, but also reflect policy considerations that may not be relevant to off-site monitoring systems. Among other things, in selecting financial variables for its assessment models, the FDIC attempted to ensure fair treatment across different types of insured institutions and to avoid introducing potential incentive conflicts.<sup>96</sup>

- The allowance for loan and lease losses and provisions for loan losses are excluded from the model. Higher loan-loss provisions and loan-loss allowances

<sup>96</sup> In addition to the changes discussed here, SCOR’s long-term assets measure, which comprises loans and long-term securities, is also excluded due to the lack of comparability of data for institutions that file Reports of Condition and Income versus Thrift Financial Reports.

tend to predict a higher (i.e., worse) CAMELS ratings and, if used in the model, could lead to higher insurance assessments. However, loan-loss reserves serve to protect the insurance fund against loss and, therefore, the FDIC does not want to give institutions an incentive to lower loan-loss provisions and loan-loss allowances.

- The non-performing loan ratio combines loans that are 90 or more days delinquent, loans that are no longer accruing interest and other real estate owned. As a result, the effect on the assessment rate would be identical whether an institution classifies loans as 90 or more days delinquent, non-accruing, or as other real estate owned.
- Including both non-performing loans and net charge-off rates in the model ensures that the FDIC does not create an incentive for an institution either to delay or to hasten charge-offs.
- Net income before taxes is divided by risk-weighted assets to account for low-risk business models that may also result in lower earnings and to avoid unintentionally rewarding high-risk strategies that boost earnings.
- Volatile liabilities do not include other borrowed money, which primarily consists of Federal Home Loan Bank (FHLB) advances, in order to avoid penalizing those institutions (particularly savings institutions) that have traditionally relied on advances.
- Volatile liabilities include time deposits in excess of \$100,000, among other items. These largely uninsured deposits may provide a long-term stable source of funding for many well-capitalized and well-managed institutions. However, they are more likely to be withdrawn as the financial condition of the institution deteriorates (either to be replaced by insured deposits or paid off with the proceeds from high-quality assets), thus increasing the risk exposure of the insurance fund.<sup>97</sup>

In addition to these financial ratios, the model also includes a weighted average of the “C,” “A,” “M,” “E” and “L” component ratings. As discussed previously, to estimate the model the weighted average is determined by assigning a 28 percent weight to each of the “C” and “M” components, a 22 percent weight to “A” component and an 11 percent weight to each of the E and L components. The weights are based on the view of the FDIC regarding the relative importance of these component ratings in determining assessment rates within Risk Category I institutions.

### III. Data and sample

The small institution model is estimated using year-end financial data from 1984 through 2004, and examination data from the 3-to-12 month period after the end of each of these years. The 1984 to 2004 period includes the regional and sectoral banking crises of the 1980s and early 1990s, and the subsequent period of very favorable financial institution conditions from the mid-1990s to the present. For all periods before 1990, the

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<sup>97</sup> For example, between March 2001 and January 2002 – the period leading up to the failure of Hamilton Bank – Hamilton Bank’s total deposits declined 27 percent, while its total uninsured deposits declined 50 percent. Andrew M. Davenport and Kathleen M. McDill, “The Depositor behind the Discipline: A Micro-level Case Study of Hamilton Bank,” *Journal of Financial Services Research* (forthcoming).

sample consists of commercial banks and FDIC-supervised savings banks. Starting in 1990, the sample also includes thrifts supervised by the Office of Thrift Supervision (OTS). The sample only includes examination ratings for OTS-supervised thrifts for the period after the dissolution of the Federal Savings and Loan Insurance Corporation and transfer of the thrift deposit insurance function to the FDIC.

The small institution model is estimated for all insured institutions, regardless of size, except new institutions (defined for modeling purposes as those established within seven years of a year-end Call Report date used in estimation) and institutions whose financial ratios make them outliers.<sup>98,99</sup> Estimates from the small institution model will be used to determine insurance assessments for small Risk Category I institutions.

New institutions are excluded because of their unique characteristics. A new institution undergoes rapid changes in the scale and scope of operations, causing its financial ratios to be fairly volatile. In addition, a new institution's loan portfolio is often unseasoned, and therefore current financial ratios are generally not a good indicator of future performance. Statistical tests of the small institution model show that the same financial ratios imply different risk levels for new institutions than for more established institutions and new institutions are typically riskier than established institutions.<sup>100</sup>

Because risk-weighted assets were not reported prior to 1990, the FDIC used a proxy measure for the pre-1990 period. For all institutions, the FDIC used the average ratio of risk-weighted assets to gross assets from 1990 forward for similarly sized institutions to estimate institutions' risk-weighted assets before 1990.<sup>101, 102</sup>

Table 1.2 shows descriptive statistics for each of seven regressors in the model. A comparison of standard deviations shows that the financial ratios vary significantly more over the sample period than do weighted averages of the "C," "A," "M," "E" and "L" component ratings

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<sup>98</sup> Outliers are defined as those institutions whose balance-sheet regressor ratios were less than or equal to -100 percent or greater than or equal to 100 percent, or whose income and expense regressor ratios were less than or equal to -5 percent or greater than or equal to 5 percent.

<sup>99</sup> For this analysis, new institutions are defined as new "brick and mortar" institutions and not institutions that have simply changed charters.

<sup>100</sup> Specifically, when a dummy variable is added to the small institution model to test the significance of new status, the coefficient for new status is usually statistically significant and positive, indicating greater risk. In addition, interaction terms of the dummy variable and equity and earnings are statistically significant, indicating that equity and earnings data for new institutions are not comparable to those of more established institutions. Furthermore, the predictive accuracy of the model improves when new institutions are excluded from the estimation sample.

<sup>101</sup> Institutions were placed into one of four groups based upon asset size: less than \$100 million, \$100 million to \$500 million, \$500 million to \$1 billion and \$1 billion to \$10 billion.

<sup>102</sup> The proposed model was also estimated using an alternative method of estimating risk-weighted assets for years prior to 1990. The alternative method assigns a zero percent weight to cash and Treasuries, a 20-percent weight to all securities other than Treasuries, a 50-percent weight to residential mortgages and a 100-percent weight to all other balance-sheet items. The choice of the risk-weighted asset measure had little effect on the coefficient of any explanatory variable.

**Table 1.2**

Descriptive Statistics of Explanatory Variables  
1984-2004

Regressor	Mean	Median	Standard deviation
Tier 1 Leverage Ratio (%)	9.53	8.77	3.54
Loans Past Due 30-89 Days/Gross Assets (%)	0.98	0.74	0.93
Nonperforming Loans/Gross Assets (%)	0.91	0.60	1.05
Net Loan Charge-Offs/Gross Assets (%)	0.19	0.09	0.34
Net Income before Taxes/Risk-Weighted Assets (%)	2.31	2.33	1.16
Volatile Liabilities/Gross Assets (%)	11.16	9.40	8.36
Weighted Average CAMELS Component Ratings	1.63	1.61	0.40

#### IV. Estimation and Evaluation

##### A. Estimation Results

The dependent variable in the proposed small institution model – a CAMELS downgrade – takes on values of either one or zero, depending on whether a downgrade occurred or not. This type of dependent variable is commonly known as a binary dependent variable. There is a wide array of statistical techniques designed for predicting binary dependent variables.

The statistical techniques that are most appropriate for binary dependent variables, logistic regression and probit analysis, are in a class of estimation techniques known as maximum likelihood estimation. Maximum likelihood estimation allows for nonlinear relationships between each regressor (explanatory variable) and the dependent variable (here, the incidence of downgrade). As a result, the effect of changes in a regressor on the probability of downgrade is not straightforward and depends upon the actual level of that regressor and all other regressors used in the model.

In the interest of simplicity, both the proposed model and the alternative model (which excludes CAMELS component ratings) are estimated using ordinary least squares (OLS) regression, a statistical technique that assumes a linear relationship between regressors and the probability of downgrade. With OLS regression, the effect of an increase in the value of a regressor upon an institution's downgrade probability is the same regardless of the level of that regressor or any other regressor in the model.

While OLS regression is not the standard technique for estimating a model with a binary dependent variable, the FDIC believes it produces acceptable results in this context for two reasons. First, models using OLS, logistic, and probit regressions produce highly similar risk rankings for those small Risk Category I institutions that are to be charged rates between the minimum and maximum. The Pearson's correlation statistic between predicted 2005 downgrade probabilities for the OLS, logistic, and probit models exceed 0.79 for the proposed small institution model and exceed 0.82 for the alternative model.

Second, concerns about using OLS regression instead of logistic or probit regression are partly mitigated by the large sample size employed in the estimation. The model uses nearly 96,000 observations over the period 1984 to 2004. An OLS regression assumes that the error terms ( $\epsilon_i$ ) are normally distributed, but the error terms in a probability model follow a Bernoulli distribution (and, therefore, are not normally distributed). While violation of the normality assumption in an OLS regression does not bias the resulting coefficients, normality is needed for the purpose of statistical inference. The distribution of error terms tends to converge to a normal distribution as sample size increases, however. Thus, the large sample size in the estimation suggests that OLS regression may be used to estimate downgrade probabilities without affecting the ability to infer the statistical significance of the regressors.<sup>103</sup>

Table 1.3 presents the OLS estimation results using a panel dataset beginning in 1984 and ending in 2004. Both the proposed small institution model and the alternative model have also been estimated over several shorter panel periods. Coefficients for each regressor are found to be highly stable both in value and significance in recent years. All regressors, other than the constant term, are statistically significant at a 1 percent level and have the expected signs. As expected, poorer asset quality -- measured by loans past due 30 to 89 days as a percent of gross assets, nonperforming loans as a percent of gross assets and net charge-offs as a percent of gross assets -- and greater reliance on volatile liabilities each increase the probability of an institution being downgraded from a CAMELS rating of 1 or 2 to a rating of 3 or worse. Higher earnings and a higher Tier 1 leverage ratio reduce the institution's downgrade probability. An institution with higher (worse) current CAMELS component ratings has a higher probability of being downgraded.

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<sup>103</sup> The robustness of the model was tested by using White-corrected standard errors that are adjusted to account for the presence of heteroskedasticity (non-fixed variance). Results do not change with the use of White-corrected standard errors.

**Table 1.3**

OLS Estimation Results: 1984 – 2004  
Estimated Coefficients

	Proposed Model	Alternative Model
Constant term	-0.008 (0.005)	0.056 *** (0.003)
Tier 1 Leverage Ratio (%)	-0.002 *** (0.000)	-0.003 *** (0.000)
Loans past Due 30-89 Days/Gross Assets (%)	0.024 *** (0.001)	0.025 *** (0.001)
Nonperforming Loans/Gross Assets (%)	0.041 *** (0.001)	0.050 *** (0.001)
Net Loan Charge-Offs/Gross Assets (%)	0.045 *** (0.002)	0.060 *** (0.002)
Net Income before Taxes/Risk Weighted Assets (%)	-0.026 *** (0.001)	-0.029 *** (0.001)
Volatile Liabilities/Gross Assets (%)	0.002 *** (0.000)	0.002 *** (0.000)
Weighted Average of the "C," "A," "M," "E" and "L" Component Ratings	0.033 *** (0.002)	
No. of Observations	95,943	102,235
Adjusted R-Square	0.13	0.15

Standard errors in parenthesis.

\*\*\* indicates significance at the 1% level

### ***B. Model Evaluation***

Chart 1.1 uses power curves to evaluate how well the proposed model and the alternative model predict downgrades. The alternative model uses only financial ratios to predict downgrade probabilities. The horizontal axis shows the cumulative percentage of total institutions scored by each method. For both models, institutions are sorted from those most likely to be downgraded to those least likely to be downgraded. Downgrade probabilities are computed by multiplying financial ratios and weighted average CAMELS component ratings as of year-end 2004 by coefficients estimated over the 1984 to 2003 period. The vertical axis shows the cumulative percentage of total actual downgrades in 2005. The closer the curve is to the upper-left corner of the graph, the



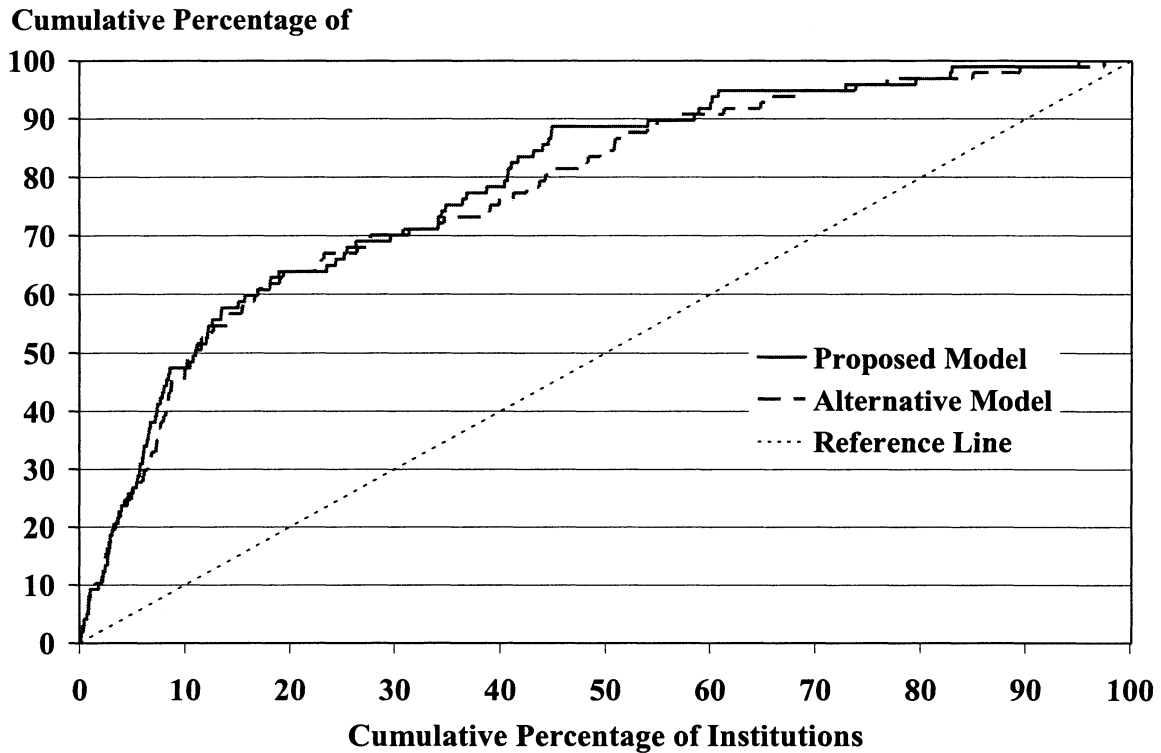
more accurate the particular method is at identifying downgrades. A diagonal line represents a system with no predictive power, where the number of downgrades identified is proportional to the percentile of observations.

Chart 1.1 shows that the proposed model and the alternative model differentiate the risk of small institutions in Risk Category I very similarly. For instance, the first 10 percent of the institutions ranked according to the proposed small institution model and alternative model accounted for 47 percent of the total downgrades in 2005 and the first 20 percent accounted for 64 percent of total downgrades.

The predictive accuracy can be also compared with a downgrade identification score that measures the area between an option's respective curve and a diagonal, reference line that goes through the origin. Based upon this score, the proposed model has slightly more predictive power (28.9) than the alternative model using financial ratios alone (27.6).

**Chart 1.1**

Power Curves Comparing the Proposed Model with the Alternative Model



**V. Assessment Rates**

As described previously, the proposed small institution model is estimated using financial ratios and a weighted average of the “C,” “A,” “M,” “E” and “L” component

ratings from 1984 to 2004 and downgrade data from 1985 to 2005.<sup>104</sup> Multiplying the value of each financial ratio and the weighted average CAMELS component rating as of year-end 2005 by the estimated coefficients from the 1984-2004 period produces a probability that a given institution would be downgraded in 2006.<sup>105</sup> These predicted “out-of-sample” downgrade probabilities provide the basis for determining assessment rates.<sup>106</sup> Assessment rates are derived as follows:

- Based on year-end 2005 data, the minimum assessment rate is applied to 45 percent of small insured institutions in Risk Category I (excluding new institutions) with the lowest downgrade probabilities according to the proposed small institution model. This percentage equates to a downgrade probability of 3 percent or less.<sup>107</sup> This downgrade probability, however, would not necessarily equate to the 45th percentile as of June 30, 2006, or in future years.
- Based on year-end 2005 data, the maximum assessment rate is applied to 5 percent of institutions with the highest downgrade probabilities according to the small institution model.<sup>108</sup> This percentage equates to the downgrade probability of 16 percent or greater. This downgrade probability, however, would not necessarily equate to the 95<sup>th</sup> percentile as of June 30, 2006, or in future years.
- All new institutions, i.e., those that have been chartered for less than seven years, are charged the maximum assessment rate.
- Assuming minimum and maximum assessment rates of 2 and 4 basis points, respectively, downgrade probabilities ( $d_{it}$ ) for all other institutions at time  $T$  are converted to assessment rates ( $P_{it}$ ) as follows:

Equation 2

$$P_{it} = \alpha_0 + \alpha_1 * d_{it}, \text{ subject to } 2 \leq P_{it} \leq 4$$

where  $\alpha_0$  is a constant term,  $\alpha_1$  is a scale factor used for conversion, and  $d_{it}$  is the downgrade probability for institution  $i$  at time  $T$ .<sup>109</sup>

<sup>104</sup> The alternative model was estimated in the same manner except for excluding supervisory component ratings.

<sup>105</sup> The coefficient of the weighted average of the “C,” “A,” “M,” “E” and “L” component ratings is multiplied by the weighted average CAMELS component rating, which includes the “S” component.

<sup>106</sup> Downgrade probabilities computed for a given year are referred to as “out-of-sample” when the estimation sample used to obtain coefficients does not include risk measures for that year.

<sup>107</sup> For the alternative model, 43 percent of small insured institutions in Risk Category I (excluding new institutions) with the lowest downgrade probabilities (3 percent or less) would be charged the minimum assessment rate.

<sup>108</sup> For the alternative model, 5 percent of institutions with the highest downgrade probabilities (17 percent or greater) would be charged the maximum assessment rate.

<sup>109</sup> The FDIC has proposed that assessment rates, including the minimum ( $P_{\min}$ ) and maximum assessment rates for Risk Category I, can be uniformly raised or lowered within limits by the FDIC’s Board without the necessity of notice-and-comment rulemaking. As a result, the assessment rate ( $P_{it}$ ) can be more generally expressed as  $P_{it} = \alpha_0 + \alpha_1 * d_{it}$ , subject to  $P_{\min} \leq P_{it} \leq P_{\min} + 2$  (maximum rate must remain 2 basis

- Solving equation (2) for minimum and maximum assessment rates simultaneously, ( $2 = \alpha_0 + \alpha_1 * 0.03$  and  $4 = \alpha_0 + \alpha_1 * 0.16$ ), results in a constant term,  $\alpha_0 = 1.5$ , a scale factor,  $\alpha_1 = 15.8$  and an assessment rate for institution  $i$  at time  $T$ ,  
Equation 3<sup>110</sup>

$$P_{iT} = 1.5 + 15.8 * d_{iT}$$

- Restating equation (1b), the downgrade probability for institution  $i$  at a given time  $T$  ( $d_{iT}$ ) is:  
Equation 4

$$d_{iT} = \beta_0 + \sum_{j=1}^7 \beta_j X_{ij,T}$$

where  $\beta_0$  is the constant term,  $\beta_j$  is the coefficient for regressor  $j$  and  $X_{ij,T}$  is the value of regressor  $j$  for institution  $i$  at time  $T$ .

- The assessment rate can be expressed directly in terms of financial ratios and the weighted average CAMELS component rating, each multiplied by a pricing multiplier ( $\tilde{\beta}_j$ ), with the resulting products added to a uniform amount ( $\tilde{\beta}_0$ ) as follows:  
Equation 5

$$P_{iT} = \tilde{\beta}_0 + \sum_{j=1}^7 (\tilde{\beta}_j X_{ij,T})$$

- Replacing  $d_{iT}$  in equation (3) with the right hand side of equation (4) and rearranging the resulting equation, the assessment rate for institution  $i$  at time  $T$  ( $P_{iT}$ ) using the proposed model is then:

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points above the minimum rate). The minimum assessment rate is  $P_{\min} = \alpha_0 + 0.03 * \alpha_1$  and the maximum assessment rate is  $P_{\min} + 2 = \alpha_0 + 0.16 * \alpha_1$ . Simultaneously solving minimum and maximum assessment rate equations results in  $\alpha_0 = P_{\min} - 0.5$  and  $\alpha_1 = 15.8$ . These results show that the constant term,  $\alpha_0$ , is a function of the minimum assessment rate while the scale factor,  $\alpha_1$ , would not change as long as the spread between minimum and maximum assessment rates remains unchanged.

<sup>110</sup> Due to the rounding of downgrade probabilities, the constant term and scale factor shown here appear slightly different from what would be obtained by solving minimum and maximum assessment rate equations.

Equation 6

$$P_{i,r} = (1.5 + 15.8 * \beta_0) + \sum_{j=1}^7 (15.8 * \beta_j) X_{ij,r}$$

where  $1.5 + 15.8 * \beta_0$  equals the uniform amount,  $\tilde{\beta}_0$ , and  $15.8 * \beta_j$  equals the pricing multiplier,  $\tilde{\beta}_j$ .

Table 1.4 illustrates the conversion of small institution model coefficients to pricing multipliers shown in equation (6), using the coefficients based on the 1984-2004 estimation sample. The uniform amount is calculated as  $\tilde{\beta}_0 = 1.5 + (15.8 * -0.008) = 1.37$ .

**Table 1.4**  
Converting Small Institution Model Coefficients to Pricing Multipliers

Risk Measures	Coefficients ( $\beta_j$ )	Conversion Formula	Pricing Multipliers
Tier 1 Leverage Ratio (%)	(0.002)		(0.03)
Loans Past Due 30-89 Days/Gross Assets (%)	0.024		0.37
Nonperforming Loans/Gross Assets (%)	0.041		0.65
Net Loan Charge-Offs/Gross Assets (%)	0.045	$15.8 * (\beta_j)$	0.71
Net Income before Taxes/Risk-Weighted Assets (%)	(0.026)		(0.41)
Volatile Liabilities/Gross Assets (%)	0.002		0.03
Weighted Average CAMELS Component Ratings	0.033		0.52

\* The scale factor in the conversion formula may be different from what would be derived from equations (2) through (6) due to rounding.

## VI. Alternative Approaches Considered to Measure Risk

The FDIC has, in recent years, considered several approaches to determine risk-based assessments.<sup>111</sup> This section discusses some of the alternatives considered.

### A. Alternative Proxies for Risk of Loss to the Insurance Fund

Federal bank and thrift regulators' off-site monitoring systems focus on institution safety and soundness, as measured by composite CAMELS ratings. Using CAMELS ratings as risk measures has several advantages. First, CAMELS ratings are determined

<sup>111</sup> See, for example, Eric P. Bloecher, Gary A. Seale, and Robert D. Vilim, "Options for Pricing Federal Deposit Insurance," *FDIC Banking Review* 15(4), 1-17 (2003).

using the uniform guidelines.<sup>112</sup> Second, CAMELS ratings are updated periodically (within 12 to 18 months). Third, CAMELS ratings are available for all insured institutions.

Using historical examination ratings, the FDIC investigated models designed to predict composite CAMELS ratings in addition to models designed to predict the likelihood of composite CAMELS ratings downgrades from ratings of 1 or 2 to 3, 4 or 5. The FDIC found that models that predict CAMELS levels produced results similar to models that predict downgrades. A model that predicts CAMELS ratings does not directly estimate the probability of downgrade, although the disparity between an institution's current and predicted CAMELS rating may imply a probability. To explicitly relate insurance assessment rates to the probability of downgrades, the FDIC chose a model that directly predicts a probability of CAMELS downgrade.

The FDIC also investigated models that predict institution failure. First, the FDIC used the explanatory variables in the proposed small institution model to predict institution failure. The FDIC found that most of the proposed model explanatory variables are significant predictors of institution failure within one year, as well as two-to-three years hence. Second, the FDIC compared institutions' risk rankings based on failure prediction models with rankings based on the small institution model. In general, the risk rankings are similar.

Finally, the FDIC compared institution risk rankings based on the small institution model with the results of models that predict failure-resolution costs as a percentage of failed-bank assets (loss rates). The risk rankings from these two types of models are not similar. This result is not unexpected since many of the factors that influence failure-resolution costs, such as the composition of institution liabilities, may not directly influence institution safety and soundness. The difference in risk rankings also suggests the FDIC would need to address expected failure-resolution costs through measures that are distinct from those described in this notice of proposed rulemaking. The FDIC is not recommending a separate consideration of expected loss rates on failed institution assets at this time.

The FDIC uses a downgrade probability model rather than failure prediction model primarily due to lack of recent failures.<sup>113</sup> While both downgrade probability and failure prediction models rely heavily on data from the late 1980s and early 1990s, CAMELS downgrades continue to occur – albeit with less frequency – while there have been few failures in recent years. Between 2000 and 2005, there were 1,425 instances of CAMELS 1 or 2-rated institutions being downgraded to ratings of 3 or worse. There were only 29 failures over the same period. As a result, CAMELS downgrades provide more updated information on the relationship between the regressors in the proposed small institution model and downgrades.

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<sup>112</sup> These guidelines are established by the Federal Financial Institutions Examination Council (FFIEC).

<sup>113</sup> The lack of recent data also affects models that predict failure-resolution costs, which are based on historical failure data.

### ***B. Alternative Regressors (Risk Measures) Used to Predict Downgrade***

The FDIC also considered alternative regressors (explanatory risk measures) to predict the probability of downgrade to a CAMELS composite rating of 3 or worse, the small institution model's dependent variable that serves as a proxy for risk of loss to the insurance fund. The alternative explanatory variables were evaluated to see if they added new or different information that would improve the model. Variations on measures already included in the model, such as different ratios to measure capital adequacy, were also tested.<sup>114</sup> The evaluation of potential regressors for the small institution model took into account potential incentive conflicts. For example, while including loan loss allowances would improve model accuracy, it could create a disincentive for an institution to set adequate loss reserves. Furthermore, some regressors intended to measure institution condition and performance may not adequately take into account differing business models. For example, measures of profitability based on the book value of assets do not account for differences in the relative riskiness of assets among institutions.

In addition to the regressors included in the proposed small institution model (shown in Table 1.1), the FDIC considered the following variables, among others

- Asset growth;
- Loan concentrations for consumer loans, commercial and industrial loans, residential real estate and commercial real estate;
- Income volatility (as measured by the standard deviation of the ratio of net income before extraordinary items and taxes to gross assets over the previous eight quarters);
- Operating efficiency (as measured by the ratio of the sum of expenses for salaries, employee benefits, premises, fixed assets and all other noninterest expenses to the sum of net interest income and total noninterest income); and
- Liquid assets (as measured by the sum of cash and balances due from depository institutions, securities, federal funds sold and securities purchased under resale agreements).

While often statistically significant, these alternative regressors do not, in general, add significantly to the explanatory power of the models.

Finally, the FDIC investigated alternative ways of measuring explanatory variables in the small institution model. These alternatives include lagged values and squared values of financial ratios to capture potentially more complex relationships between these measures and downgrade probability.<sup>115</sup> In general, these alternative measures are either statistically or economically insignificant or did not improve model accuracy.

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<sup>114</sup> The accuracy of the model was little affected by the capital measure used.

<sup>115</sup> Specifically, asset growth over the prior year and three previous years was considered, as well as the squared value of each growth measure. In addition, the squared values of nonperforming assets (as a percent of gross assets) over the prior year were considered.

### ***C. Prediction Time Horizon***

The proposed small institution model and the alternative model predict, as a proxy for risk of loss to the insurance fund, the probability of a CAMELS downgrade to 3 or worse *within one year* from the date of the values for the regressors. However, it could be argued that a deposit insurance assessment system should look forward more than one year. There are important differences between factors that contribute to risk in the short term (within one year) and those that contribute to risk in the long term. For example, very high rates of asset growth can, in some instances, lead to financial distress in the long term. On the other hand, low rates of asset growth are often experienced by institutions with current financial difficulties that are often restricting loan growth and retrenching lending practices.

The FDIC therefore tested explanatory variables in a model that would predict CAMELS downgrades over a longer period—two to three years. The FDIC also compared the explanatory variables in one-year and longer-term CAMELS downgrade models that would directly predict failure probability (as discussed in section A) in the short term and in the long term. The FDIC found that the explanatory variables used in the small institution model are, in general, statistically significant explanatory variables in both short-term and long-term CAMELS downgrade models, as well as in short and long-term failure prediction models.<sup>116</sup> However, an increase in the value of certain regressors, such as asset growth, lowers the downgrade probability over a one-year horizon, but increases the downgrade probability over a longer-term horizon. Model accuracy diminishes substantially as the forecast horizon lengthens.

## **VII. Model Validation**

The FDIC believes that the downgrade probabilities estimated using the proposed small institution model provide a reasonable basis for differentiating risk among insured institutions in Risk Category I. Downgrade probability, however, is a proxy for the probability that an institution will fail and, hence, is only indirectly related to insurance fund losses. This section investigates how well risk differentiation under the proposed small institution model is aligned with insurance fund losses over an historical period. The investigation relies on historical data on deposit growth and failure resolution costs to estimate historical failure rates as well as benchmark assessment rates: what assessment rates would have been needed to offset the costs of failure. Historical failure rates and benchmark assessment rates that rise monotonically from risk category to risk category (as defined by the proposal) would be consistent with risk differentiation; failure rates and benchmark assessment rates that change randomly from risk category to risk category would not.

While maintaining a single assessment rate for all other Risk Categories, the FDIC proposes incremental assessment rates for Risk Category I, subject to minimum

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<sup>116</sup> Generally, the size of coefficients for each explanatory variable becomes smaller as the forecast horizon lengthens.

and maximum rates.<sup>117</sup> As discussed in Section V, the minimum assessment rate is applied to all small insured institutions in Risk Category I, other than new institutions, with a downgrade probability of 3 percent or less while the maximum assessment rate is applied to those institutions with a downgrade probability of 16 percent or greater. All new institutions would be charged the maximum assessment rate. All other institutions in Risk Category I would be charged an incremental assessment rate, based on their estimated downgrade probabilities. With incremental assessment rates, many insured institutions will be assessed different assessment rates.

Benchmark rates provide a basis for measuring relative premium differences between risk groups; however, actual assessment rates will depend on aggregate revenue needs of the insurance fund. The FDIC must manage the balance of the fund, as a percentage of estimated insured deposits, within a range mandated by Congress. Estimated insured deposit growth, losses caused by insured institution failures, and returns on fund investments will primarily determine actual assessment rates.

#### ***A. Benchmark Assessment Rates: General Framework***

Benchmark assessment rates are defined as those rates the FDIC would have had to charge institutions in each of the proposed new Risk Categories, and in each subgroup (defined below) of Risk Category I, to recover the failure-resolution costs of each category. Equation 7 shows in more detail how one can estimate the benchmark assessment rate for a risk category or subgroup of institutions,  $r_0$ , using an actuarial approach:

##### Equation 7

$$r_0 \left[ D_0 + \frac{D_0(1+g_1)}{(1+i_1)} + \frac{D_0(1+g_2)^2}{(1+i_2)^2} + \dots + \frac{D_0(1+g_4)^4}{(1+i_4)^4} \right] = \left[ C_0 + \frac{C_1}{(1+i_1)} + \frac{C_2}{(1+i_2)^2} + \dots + \frac{C_4}{(1+i_4)^4} \right]$$

where  $D_0$  is the assessment base as of the starting time ( $t=0$ ),  $g_t$  is the growth rate in the assessment base over period  $t$ ,  $C_t$  is expected failure-resolution costs and  $i_t$  is the discount rate for period  $t$ . Equation (7) derives  $r_0$  by equating the present discounted value of expected future insurance assessments to the present discounted value of expected future failure-resolution costs over a five-year period. While equation (7) assumes the assessment rate remains constant for the five-year period, as a practical matter, institutions will pay varying assessment rates over time if they move into a different insurance risk category, or if the FDIC alters the assessment rate schedule.<sup>118</sup>

<sup>117</sup> Incremental rates avoid potentially large differences in assessment rates among institutions that have only small differences in risk characteristics, as well as large changes from period to period in an institution's rate when its financial condition or performance changes slightly.

<sup>118</sup> The FDIC also considered assessment systems that incorporate the movement of institutions into different insurance-risk categories over time. Specifically, the FDIC placed institutions into initial



The failure history of institutions insured by the Bank Insurance Fund (BIF) is used to estimate benchmark assessment rates. Failure-resolutions of several hundred thrifts insured by the FSLIC were delayed during the 1980s and early 1990s due to insufficient FSLIC insurance funds, substantially increasing final failure-resolution costs.<sup>119</sup> As a result, FSLIC-insured thrift failure dates and failure-resolution costs are not comparable to those of BIF-insured banks and thrifts during the 1980s and early 1990s. Moreover, the regulatory issues that influenced FSLIC-insured thrift failure resolutions have been addressed by subsequent legislation, making the thrift crisis an inappropriate basis for determining benchmark assessment rates for the fund.

In calculating benchmark assessment rates, domestic deposits are used as an estimate of the insurance assessment base; the assessment base for each of three risk subgroups in Risk Category I – groups that would be charged the minimum assessment rate, incremental assessment rate and maximum assessment rate – for future years is estimated using the historical average annual growth rate for the subgroup.<sup>120</sup> Failure-resolution costs are the costs incurred by the FDIC in resolving failures and do not include losses to uninsured creditors. Finally, the average annual yield on the insurance fund investment portfolio of U.S. Treasury securities is used as the discount rate. This discount rate is the opportunity cost to the insurance fund for incurring failure-resolution expenses. Treasury security interest rates include a risk premium for maturity or repricing risk, but do not include premiums for default and liquidity risk, as do private-sector debt securities.

### ***B. Fraud-related Failures***

Between 1989 and 2005, 726 BIF-member institutions failed or received FDIC open-bank assistance. Fraud was a primary contributing factor in 87 (12 percent) of these failures and fraud was present in an additional 187 failures (26 percent).<sup>121</sup> Fraud and insider abuse are difficult to detect through off-site monitoring systems.<sup>122</sup> As a result, the FDIC is unlikely to uncover fraud through the condition and performance measures it

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insurance-risk categories to form subgroups and followed their transitions across risk categories over a five-year period. Each subgroup was required to recover the present value of its failure-resolution costs through assessments (i.e., subgroups were revenue neutral). This system allowed for repricing of individual institutions' insurance risk annually, but held assessment rates for each risk category constant for the five-year period. This system yields a set of simultaneous equations; one for each risk category that must be solved to determine each risk category's assessment rate. The FDIC chose not to use this system for the analysis in this section primarily because it yielded counter-intuitive results; rates for low-risk categories were often negative. Negative rates occur when no (or very few) institutions within an initial low-risk cohort fail while still classified in that low-risk category.

<sup>119</sup> Timothy Curry and Lynn Shibut, "The Cost of Savings and Loan Crisis: Truth and Consequences," *FDIC Banking Review* 13(2), 26-35 (2000).

<sup>120</sup> An institution's assessment base equals its total domestic deposits minus regulatorily determined percentages for float, with other relatively minor technical adjustments.

<sup>121</sup> For failures that occurred in 1989 through 2005, the FDIC has identified the cases where fraud was the primary contributing factor that led to failure.

<sup>122</sup> Christine M. Brickman, "Fraud in the Banking Industry: Definition, Causes, and Defenses," *FDIC Banking Review* (forthcoming).

uses in the small institution model or other risk measures based on the CAMELS attributes.

Until the fraud is discovered, risk-measurement models will generally incorrectly assess the risk posed by an institution where fraud is occurring. Consequently, the models do not attribute fraud-related failure-resolution costs to the risk subgroups to which the fraudulent institutions are assigned. Rather, the models assign fraud-related failure-resolution costs to all insured institutions on a pro-rata basis (based on their share of the total assessment base).

### ***C. Insurance Risk Subgroups and Assessment Schedule***

To derive benchmark assessment rates as described above, the proposed small institution model and the alternative model are re-estimated for each year from 1984 through 2004, using all historical data from 1984 through each year. Downgrade probabilities were obtained for each institution for each year by multiplying the values of each regressor as of the end of each year by the coefficients estimated over prior years.<sup>123</sup> For each year, insured institutions in Risk Category I were assigned to one of three subgroups based on estimated downgrade probabilities. Risk Category I is divided into three subgroups based on what an institution would pay under the proposed small institution model -- those institutions that would pay the minimum rate, those that would pay the maximum rate, and those in between that would pay rates varying incrementally. (Risk Category I is also divided into these three subgroups for the alternative model.) For the subgroup that would be charged an incremental assessment rate, downgrade probabilities were converted to assessment rates for 1985 to 2005, based on the relationship between downgrade probabilities and assessment rates using year-end 2005 financial ratios and supervisory component ratings. Insured institutions that are less than seven years old are also placed in the maximum rate subgroup. All remaining institutions are assigned to proposed Risk Category II, III, or IV, depending on their CAMELS rating and capitalization

### ***D. Historically Derived Benchmark Assessment Rates***

Failure rates and baseline assessment rates for all BIF-member institutions are estimated for Risk Categories II through IV and the three Risk Category I subgroups. An institution's risk category or subgroup is determined as of the end of each year from 1985 to 2000 and a failure is deemed to occur if the institution fails within five years from that year. Table 1.5 presents historical average five-year failure rates for each of three subgroups in Risk Category I as well as those for other Risk Categories. For both the proposed model and the alternative model, failure rates generally rise from the lowest Risk Category (I – minimum) to the highest Risk Category (IV).

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<sup>123</sup> For example, the coefficients from the estimation sample using financial ratios and weighted averages of the "C," "A," "M," "E" and "L" component ratings from 1984 to 1995 (and downgrades from 1985 to 1996) are multiplied by financial ratios and supervisory component ratings at year-end 1996 to compute the probability that each institution would be downgraded over the next three to twelve-month period (that is, from April through the end of 1997). The process is repeated for all years.

**Table 1.5**  
 Historical Average Five-Year Failure Rates\*: 1985 – 2000  
 (BIF-Member Institutions with Assets Less Than \$10 Billion)

Assessment Category	Proposed Model	Alternative Model
I - Minimum Assessment Rate	0.06	0.05
I - Incremental Assessment Rate	0.44	0.42
I - Maximum Assessment Rate	3.75	3.76
II	3.52	3.52
III	11.04	11.04
IV	28.76	28.76

\* Excludes failures where fraud was determined to be a primary contributing factor. Failures within 5 years of group assignment.

Similarly, Table 1.6 presents the benchmark assessment rates for the proposed small institution model and the alternative model.<sup>124</sup> Benchmark assessment rates include fraud-related failure-resolution costs that were allocated to all institutions on a pro-rata basis. Due to the small number of failures that occur within the first two subgroups in Risk Category I, benchmark assessment rates can be influenced by a few high-loss failures. The average benchmark rates agree with prior expectations, increasing with the predicted probability of a CAMELS composite downgrade to 3 or worse.

**Table 1.6**  
 Benchmark Assessment Rates (annual, basis points): 1985 – 2000  
 (BIF-Member Institutions with Assets Less Than \$10 Billion,  
 Fraud Costs Shared by All Banks\*)

Assessment Category	Proposed Model	Alternative Model
I - Minimum Assessment Rate	1.27	1.38
I - Incremental Assessment Rate	1.68	1.60
I - Maximum Assessment Rate	5.69	5.58
II	9.32	9.32
III	28.78	28.78
IV	100.28	100.28

\* Failures in which fraud was determined to be a primary contributing factor. Failures within 5 years of group assignment.

<sup>124</sup> As explained earlier, these assessment rates—being historically derived—will not necessarily be the rates that the FDIC charges in the future.

### ***E. Individual Assessment Rates and Continuous Risk Measures***

The results in the previous two tables show that the risk of subgroups of institutions within Risk Category I generally rise from one subgroup to the next. These results do not necessarily extend to comparisons of risk among individual institutions in Risk Category I. As is the case with all predictions, there is statistical error in the measures of risk. Therefore, one cannot say with certainty that risk rankings based on estimated probability of downgrade will comport with actual downgrades. In particular, the models cannot with certainty measure relative risk among individual institutions for which assessments would vary incrementally. Nonetheless, avoiding significant changes in deposit insurance rates when a Risk Category I institution's risk varies slightly is, in the FDIC's view, a desirable feature of the proposed assessment system. Furthermore, the proposal would apply the same minimum rate to a significant percentage of institutions based on similarly low risk. While the FDIC acknowledges potential error in risk measurement, it believes that the historical failure rates and benchmark assessment rates shown in Tables A.5 and A.6, respectively, lend support to the risk rankings used for Risk Category I institutions.

**Note:** The following appendix will not appear in the Code of Federal Regulations.

#### **Appendix 2** **Distribution of Assessment Rates**

The distribution of assessment rates for the 1997-2005 period across asset size groups, and between CAMELS 1 and 2-rated institutions, is obtained using the following steps.

- The proposed small institution model and the alternative are re-estimated for every year from 1996 through 2004, using all historical data from 1984 through each year. Therefore, for 1996, the model is estimated using financial ratios and supervisory ratings from 1984 to 1996 and downgrade data from 1985 and 1997. For 1997, it is estimated using financial ratios and supervisory ratings from 1984 to 1997 and downgrade data from 1985 to 1998, and so on.
- Multiplying the values of each regressor as of the end of each year by the coefficients estimated over prior years produced out-of-sample downgrade probabilities. Thus, the coefficients from the estimation sample using financial ratios and supervisory component ratings from 1984 to 1996 (and downgrades from 1985 to 1997) are multiplied by financial ratios and CAMELS component ratings at year-end 1997 to compute the probability that each institution would be downgraded over the next three to twelve-month period (that is, from April through the end of 1998). The process is continued for each succeeding year.
- Downgrade probabilities were converted to assessment rates for year-ends 1997 to 2005, based on the relationship between downgrade probabilities and assessment rates for 2005, using steps described in Section V of Appendix 1. Tables 9, 10, 12 and 13 reflect the distribution of assessment rates for all institutions for all years from 1997 to 2005.

**Note: The following appendix will not appear in the Code of Federal Regulations.**

### **Appendix 3** **Large Institution Type Categories**

**Processing Banks and Trust Companies:** Institutions whose last 3 years' non-lending interest income plus fiduciary revenues plus investment banking fees exceed 50 percent of total revenues (and last 3 years' fiduciary revenues are non-zero).

**Residential Mortgage Lenders:** Institutions not described above whose mortgage loans plus mortgage-backed securities exceed 50 percent of total assets.

**Non-diversified Regional Institutions:** Institutions not described above if: 1) credit card plus securitized receivables exceed 50 percent of assets plus securitized receivables; or 2) residential mortgage loans, plus credit card loans, plus other loans to individuals exceeds 50 percent of assets.

**Large Diversified Institutions:** Institutions not described above with over \$100 billion in assets.

**Diversified Regional Institutions:** Institutions not described above with less than \$100 billion in assets.

**Note: The following appendix will not appear in the Code of Federal Regulations.**

### **Appendix 4** **Analysis of the Projected Effects of the Payment of Assessments On the Capital and Earnings of Insured Depository Institutions**

#### **I. Introduction**

This analysis estimates the effect of an increase in the annual deposit insurance assessment rates for all insured institutions on their tangible equity capital and profitability, assuming that actual rates adopted are 5 basis points higher than those in the proposed base rate schedule.<sup>125</sup> These are the highest rates that the Board may set in accordance the proposed base rate schedule, without further notice-and-comment rulemaking. Under the proposal, the Board could adopt lower rates.

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<sup>125</sup> Under the proposal, institutions in Risk Category I would pay rates that vary incrementally, subject to minimum and maximum rates. The proposed base rate schedule sets the Risk Category I minimum rate at 2 basis points and the maximum rate at 4 basis points. Proposed base rates for Risk Categories II, III, and IV are 7, 25, and 40 basis points, respectively. The proposal would allow the Board to adjust rates uniformly up to a maximum of five basis points higher or lower than the base rates without the necessity of further notice-and-comment rulemaking, provided that any single adjustment from one quarter to the next could not move rates more than five basis points. This analysis assumes rates are uniformly 5 basis points higher than the base rates. Furthermore, in this analysis, all institutions in Risk Category I pay a uniform rate of 7.5 basis points, which is approximately the average rate for that category when rates are set 5 basis points higher than the base rates. For Risk Categories II, III, and IV, it is assumed that institutions in those categories pay 5 basis points above the applicable rates in the proposed base rate schedule.

While an assessment rate increase would not take effect until 2007, the effect of the new rates is projected using March 2006 reports of condition, and rates are assumed to remain in effect for four quarters.<sup>126</sup> Furthermore, the analysis excludes the effect of any reduction in assessment costs from institutions' use of one-time credits authorized under the Act, in order to evaluate the effect on earnings and capital once the one-time credits have been exhausted.

## II. Analysis

While an increase in deposit insurance assessment rates will reduce institutions' profitability and capitalization, the reduction will not necessarily equal the full amount of the assessment increase. Two factors can reduce the effect of increased assessments on institutions' profits and capital. First, a portion of the assessment increase may be transferred to customers in the form of higher borrowing rates, increased service fees and lower deposit interest rates. Since information is not readily available on the extent to which institutions are able to share assessment costs with their customers, this analysis assumes that institutions bear the full after-tax cost of the assessment increase. Second, deposit insurance assessments are a tax-deductible operating expense; therefore, the increase in the assessment expense can be used to lower taxable income. This analysis considers the tax consequences of assessments and estimates the effective after-tax cost of assessments.<sup>127</sup>

Institutions' earnings retention and dividend policies also influence the extent to which increased assessments affect equity levels. If institutions maintain the same dollar amount of dividends, despite an increase in operating costs, equity (retained earnings) will decline by the full amount of the after-tax cost of the assessment. This analysis, instead, assumes that institutions will maintain dividend rates (that is, dividends as a fraction of net income) unchanged from those reported in the March 31, 2006 reports of condition.

The analysis indicates that the effect on institution profitability and capital is very small. Industry tangible equity capital of insured institutions as of March 31, 2006, is \$782.464 billion. March 31, 2007 tangible equity capital is projected to equal \$784.754 billion if the current assessment rates are maintained.<sup>128</sup> It would be \$2.214 billion lower, i.e., \$782.540 billion, if assessment rates are raised to 5 basis points above the proposed base rate schedule. The number of institutions projected to be undercapitalized by March 31, 2007 is unchanged from the number based on current assessment rates, if assessment rates are raised to this level.<sup>129</sup>

With an increase in assessment rates, the approximately \$4.763 billion in additional assessment costs to insured institutions is projected to lead to \$2.214 billion

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<sup>126</sup> Institution earnings and capital are projected using the same methodology currently used by the FDIC in determining the contingent loss reserve for potential insured-institution failures.

<sup>127</sup> The analysis does not incorporate any tax effects from an operating loss carry forward or carry back.

<sup>128</sup> Under current assessment rates, approximately 95 percent of insured institutions are charged nothing for deposit insurance.

<sup>129</sup> Undercapitalized institutions are defined as institutions with projected tangible equity capitalization of less than 2 percent by March 31, 2007.

less in tangible capital and \$1.336 billion less in dividends as of March 31, 2007, compared to amounts if current assessment rates applied. The remaining \$1.213 billion in additional assessment costs are projected to be offset by the tax benefit of deducting assessment expenses.

The effect of higher assessments on institution income is measured by the percentage change in income before taxes and extraordinary items, gross of loan loss provisions, due to the assessment rate increase (hereafter, income). This income measure is used in order to eliminate the potentially transitory effects of loan losses, extraordinary items and taxes on profitability. Institutions' March 31, 2006 income is adjusted to reflect the increase in operating costs (pre-tax) that might result from the proposed assessment rate increase.<sup>130</sup> The analysis indicates that the proposed increases in assessment rates will reduce institution income somewhat.<sup>131</sup> Table 4.1 shows that approximately 61.6 percent of institutions, with 91.4 percent of insured institution assets, are projected to experience a 0 to 5 percent reduction in income. In addition, 23.7 percent of institutions, with 6.1 percent of aggregate assets, are projected to incur a 5 to 10 percent reduction in income.<sup>132</sup>

**Table 4.1**  
Percentage Change in Income  
If Assessment Rates Are Raised 5 Basis Points Above the Proposed Assessment Rate Schedule  
(All FDIC-Insured Institutions, \$Millions)

Percentage Change	Number	Percent	Assets	Percent
Below -50%	93	1.1	\$27,730	0.2
-25% to -50%	123	1.4	43,685	0.4
-15% to -25%	233	2.7	49,907	0.5
-10% to -15%	371	4.2	101,933	0.9
-5% to -10%	2,080	23.7	682,812	6.1
0% to -5%	5,418	61.6	10,249,022	91.4
Missing	472	5.3	54,999	0.5

*Notes:*

- (1) Income refers to income before taxes and extraordinary items, gross of loan loss provisions.
- (2) Most institutions with results categorized as "Missing" already have negative pre-tax income. The percentage change cannot therefore be calculated.
- (3) Insured branches of foreign banks were not included in the analysis.

<sup>130</sup> Specifically, the proposed increase in semiannual assessment costs before taxes is deducted from institutions' income, as defined previously, for the first quarter of 2006.

<sup>131</sup> Because assessments are tax deductible, the after-tax effect on income should be smaller.

<sup>132</sup> In a separate analysis (not presented here), the economic effect of a smaller assessment rate increase -- specifically, an increase only to the proposed base rates -- was also analyzed. If assessment rates were to increase to the proposed base rates, projected income for approximately 89 percent of banks would decline by only between 0 to 5 percent.

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

RIN 3064-AD02

**Deposit Insurance Assessments—  
Designated Reserve Ratio****AGENCY:** Federal Deposit Insurance Corporation (FDIC).**ACTION:** Notice of Proposed Rulemaking with Request for Comment.**SUMMARY:** Under the Federal Deposit Insurance Reform Act of 2005, the FDIC must by regulation set the Designated Reserve Ratio (DRR) for the Deposit Insurance Fund (DIF) within a range of 1.15 percent to 1.50 percent of estimated insured deposits. In this rulemaking, the FDIC seeks comment on the proposal to establish the DRR for the DIF at 1.25 percent of estimated insured deposits.**DATES:** Comments must be submitted on or before September 22, 2006.**ADDRESSES:** Interested parties are invited to submit written comments to the FDIC by any of the following methods:

- Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.

- Agency Web site: <http://www.fdic.gov/regulations/laws/federal/propose.html>. Follow the instructions for submitting comments on the FDIC Web site.

- E-mail: [comments@FDIC.gov](mailto:comments@FDIC.gov).

Include "DRR" in the subject line of the message.

- Mail: Robert E. Feldman, Executive Secretary, Attention: Comments/Legal ESS, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

- Hand Delivery/Courier: Comments may be hand-delivered to the guard station located at the rear of the FDIC's 17th Street building (accessible from F Street) on business days between 7 a.m. and 5 p.m.

**Instructions:** All submissions received must include the agency name and use the title "Part 327—Designated Reserve Ratio." The FDIC may post comments on its Internet site at: <http://www.fdic.gov/regulations/laws/federal/propose.html>. Comments may be inspected and photocopied in the FDIC Public Information Center, 3501 N. Fairfax Dr., Arlington, Virginia, between 9 a.m. and 4:30 p.m. on business days.**FOR FURTHER INFORMATION CONTACT:** Munsell St. Clair, Senior Policy Analyst,

Division of Insurance and Research, (202) 898-8967; or Christopher Bellotto, Counsel, Legal Division, (202) 898-3801, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

**SUPPLEMENTARY INFORMATION:** The Federal Deposit Insurance Reform Act of 2005 (the Reform Act) amends section 7(b)(3) of the Federal Deposit Insurance Act (the FDI Act) to eliminate the current fixed designated reserve ratio (DRR) of 1.25 percent.<sup>1</sup> Section 2105 of the Reform Act directs the FDIC Board of Directors (Board) to set and publish annually a DRR for the Deposit Insurance Fund (DIF) within a range of 1.15 percent to 1.50 percent of estimated insured deposits.<sup>2</sup> 12 U.S.C.

1817(b)(3)(B), (D). Under section 2109(a)(1) of the Reform Act, the Board must prescribe final regulations setting the DRR after notice and opportunity for comment not later than 270 days after enactment of the Reform Act. Thereafter, any change to the DRR must also be made by regulation after notice and opportunity for comment.

While the Reform Act requires the Board to set a DRR annually, it does not direct the Board how to use the DRR. There is no longer a requirement for the reserve ratio to meet the DRR within a particular timeframe. In effect, the Reform Act permits the Board to manage the reserve ratio within a range. In contrast to the prior law, the Reform Act does not establish a role for the DRR as a trigger, whether for assessment rate determination, recapitalization of the fund, assessment credit use, or dividends.

The FDIC sets forth below background information, its analysis of the statutory factors that must be considered in setting the DRR and its proposal to set the initial DRR for the DIF at 1.25 percent, the current DRR.

**I. Background**

In setting the DRR for any year, section 2105(a), amending section 7(b)(3) of the FDI Act, directs the Board to consider the following factors:

(1) The risk of losses to the DIF in the current and future years, including historic experience and potential and estimated losses from insured depository institutions.

(2) Economic conditions generally affecting insured depository institutions. (In general, the Board should consider allowing the DRR to increase during more favorable

economic conditions and decrease during less favorable conditions.)

(3) That sharp swings in assessment rates for insured depository institutions should be prevented.

(4) Other factors as the Board may deem appropriate, consistent with the requirements of the Reform Act.<sup>3</sup>The DRR may not exceed 1.50 percent of estimated insured deposits nor be less than 1.15 percent of estimated insured deposits. Any future change to the DRR shall be made by regulation after notice and opportunity for comment. In soliciting comment on any proposed change in the DRR, the FDIC must include in the published proposal a thorough analysis of the data and projections on which the proposal is based.<sup>4</sup>

The analysis of the statutory factors begins in part II. The manner in which the FDIC's Board evaluates the statutory factors may depend on its view of the role of the DRR, which may change over time. The FDIC has identified two potential general roles for the DRR: a signal of the reserve ratio that the Board would like the fund to achieve; and a signal of the Board's expectation of the change in the reserve ratio under the assessment rate schedule adopted by the Board.

**1. Signaling a Goal for the Reserve Ratio**

One role for the DRR would be to serve as a signal of the reserve ratio that the Board would like the fund to achieve. Using the DRR in this manner could convey useful information to insured institutions and others about future deposit insurance assessment rates. Suppose, for example, the Board sets the DRR at 1.25 percent, intending it to be a target for the reserve ratio. If

<sup>3</sup> Section 2105 of the Reform Act (to be codified at 12 U.S.C. 1817(b)(3)(C)) provides:

(C) FACTORS—In designating a reserve ratio for any year, the Board of Directors shall—

(i) Take into account the risk of losses to the Deposit Insurance Fund in such year and future years, including historic experience and potential and estimated losses from insured depository institutions;

(ii) Take into account economic conditions generally affecting insured depository institutions so as to allow the designated reserve ratio to increase during more favorable economic conditions and to decrease during less favorable economic conditions, notwithstanding the increased risks of loss that may exist during such less favorable conditions, as determined to be appropriate by the Board of Directors;

(iii) Seek to prevent sharp swings in the assessment rates for insured depository institutions; and

(iv) Take into account such other factors as the Board of Directors may determine to be appropriate, consistent with the requirements of this subparagraph.

<sup>4</sup> Section 2105 of the Reform Act (to be codified at 12 U.S.C. 1817(b)(3)(D)).<sup>1</sup> Section 2104 of the Reform Act, Public Law 109-171, 120 Stat. 9.<sup>2</sup> To be codified at 12 U.S.C. 1817(b)(3)(B), (D).