With a forecast horizon exceeding six months, large unexpected changes in the reserve ratio are possible, given the historical volatility in deposit growth and insurance losses. However, the outlook for the first semiannual assessment period of 1996 is for continued growth in BIF and its reserve ratio. Little change is expected in the pace of insurance losses or operating expenses, with the result that investment income is expected to be sufficient to fund BIF expenditures through June 30.

Table 1 indicates that, under the current assessment schedule, the BIF reserve ratio would exceed 1.25 percent as of June 30, 1996, even assuming a severe negative growth scenario for the reserve ratio. For example, the reserve ratio at June 30 likely would be at least 1.28 percent even if losses plus new provisions for future losses total \$600 million for the first half of 1996 and insured deposits grow at an annual rate of 6 percent from mid-year 1995 through mid-year 1996. Table 1 indicates that under these same extreme assumptions, an assessment rate schedule of 0 to 27 basis points annually (4 basis points lower for all risk categories than the existing schedule) likely would maintain the reserve ratio at 1.25 percent through June 30.

In short, the FDIC's best estimate is that the BIF reserve ratio is highly likely to remain well above 1.25 percent for the first semiannual period of 1996 even if assessment revenue is minimal. Given these circumstances, it is the Board's view that assessment rates should be reduced by a substantial amount. The data reviewed above support a reduction in BIF assessment rates to the lowest levels that are consistent with an effective risk-based assessment system.

Finally, the Board notes that this reduction of BIF assessment rates is likely to have a positive impact on earnings and capital of insured institutions having deposits assessable by BIF.

2. Maintaining a Risk-Based Assessment System.

The FDI Act requires a risk-based assessment system. In adopting the current rate schedule, the Board explained its view that, to be effective, the risk-based assessment system must incorporate a range of rates that provides an incentive for institutions to control risk-taking behavior while at the same time covering the long-term costs of the obligations borne by the deposit insurer. 60 FR 42683 (August 16, 1995). The Board's decision to adopt a 4-point adjustment to the current rate schedule, thereby retaining rate differentials among the various assessment-risk

classifications, continues to reflect this view.

It should be noted that, under existing statutory provisions, BIF members are subject to a minimum assessment of \$1,000 for each semiannual period. (FDI Act section 7(b)(2)(iii)). Under this requirement, even those institutions posing the least risk of loss to BIF are statutorily required to pay semiannual assessments of at least that amount.

In light of its decision to reduce to zero the explicit assessment rate for those institutions in the most favorable assessment risk classification, the Board recognizes two concerns associated with the statutory minimum assessment: (1) the absence of an explicit assessment rate combined with a minimum semiannual assessment of only \$1,000 suggests that the risk posed to the insurance fund by such institutions is insignificant, but FDIC experience suggests otherwise; and (2) the marginal cost of deposit insurance for such institutions is zero (that is, insurance is provided on new deposits at zero additional cost).

The first concern arises because, historically, a significant percentage of failed institutions might have qualified for the most favorable assessment risk classification two or three years prior to failure. Figure 1 shows that, of the insured institutions that failed in the period beginning with 1980 and extending through 1994, nearly 35 percent were rated CAMEL 1 or 2 as of two years prior to failure, and approximately 55 percent were rated CAMEL 1 or 2 as of three years prior to failure. Moreover, of the BIF members that failed from the beginning of 1987 through 1994, 80 percent were well capitalized as of three years prior to failure (see Figure 2).

An argument for imposing only the minimum assessment on the least-risky institutions is that the reserve ratio is intended to provide for insurance losses arising from these types of failures; because BIF has been recapitalized through assessments, the protection received during periods when only the minimum assessment is paid may be viewed as "prepaid insurance."

An alternative view supports an explicit, risk-based assessment rate for even the least-risky institutions as an important element of a risk-based assessment system. However, as the Board noted in adopting the existing BIF assessment rate schedule in August, the FDIC is required by statute both to have a risk-based assessment system and to maintain the reserve ratio at the target DRR. The Board cannot ignore one in favor of the other but must, instead, balance the two in an appropriate

manner. The Board believes that the 4-point adjustment strikes such a balance.

Regarding the second concern noted above, among the implications of a zero marginal cost for deposit insurance is that the best-rated new institutions would receive insurance protection essentially premium-free without having contributed to the existing reserve ratio. The FDIC is analyzing this issue to determine whether new institutions should receive special assessment treatment for a period of time after they initially become insured. Without any operational track record and with no previous contribution to BIF, there is a question as to whether an essentially zero marginal rate is justified.

Another implication of a zero marginal assessment is that the largest institutions in the best category would pay the same dollar amount for deposit insurance as the smallest institutions. For example, an institution with \$10 billion in BIF-assessable deposits would pay the same amount (\$1,000 per semiannual period) as an institution with \$10 million in BIF-assessable deposits.

The Board does not minimize the foregoing concerns. Rather, given current industry conditions, the financial health of the BIF, low projected losses, and the statutory requirement to maintain the BIF reserve ratio at the target DRR, it is the judgment of the Board that the institutions posing the lowest risk to BIF should be assessed only the statutory minimum assessment. In particular, this decision does not reflect a judgment that such institutions pose a near-zero risk to BIF but instead a recognition that the existing BIF balance, in excess of \$25 billion, represents the significant prepayment BIF-assessable institutions have made for deposit insurance.

III. Board Resolution

The Resolution by which the Board adopted the adjustment to the current rate schedule is set out below.

Resolution

Whereas, section 7(b) of the Federal Deposit Insurance Act ("FDI Act") requires the Board of Directors ("Board") of the Federal Deposit Insurance Corporation ("FDIC") to establish by regulation a risk-based assessment system; and

Whereas, section 7(b) of the FDI Act requires that when the reserve ratio of the Bank Insurance Fund ("BIF") reaches the designated reserve ratio ("DRR") of 1.25 percent of estimated insured deposits, the Board shall set semiannual assessments for BIF