

### 1. Risk-Based Assessment Schedule

The fundamental goals of risk-based assessment rates are to reflect the risk posed to the insurance fund by insured institutions and to provide institutions with incentives to control risk taking. The maximum rate spread in the existing assessment rate matrix (see Table 1) is 8 basis points. Institutions rated 1A pay an annual rate of 23 basis points while institutions rated 3C pay 31 basis points. A concern is whether 8 basis points represents a sufficient spread for achieving these goals.

In the FDIC's proposal for the current risk-based premium system, the Board sought comment on whether the assessment rate spread embodied in the existing system, *i.e.*, 8 basis points, should be widened. Of the 96 commenters addressing this issue, 75 favored a wider rate spread. In the final rule, the Board expressed its conviction that widening the rate spread was desirable in principle, but chose to retain the proposed rate spread. The Board expressed concern that widening the rate spread while keeping assessment revenue constant, might unduly burden the weaker institutions which would be subject to greatly increased rates. However, the Board retained the right to revisit the issue at some future date. 58 FR 34357 (June 25, 1993).

The current assessment rate spread for BIF institutions has been criticized widely by bankers, banking scholars and regulators as overly narrow, and there is considerable empirical support for this criticism. Using a variety of methodologies and different sample periods, the vast majority of relevant studies of deposit insurance pricing have produced results that are consistent with the conclusion that the rate spread between healthy and troubled institutions should exceed 8 basis points.<sup>1</sup> While the precise estimates vary, there is a clear consensus from this evidence that the rate spread should be widened.

FDIC research likewise suggests that a substantially larger spread would be

necessary to establish an "actuarially fair" assessment rate system. Insurance premiums are actuarially fair when the discounted value of the premiums paid over the life of the insurance contract is expected to generate revenues that equal expected discounted costs to the insurer from claims made by the insured over the same period. A 1994 FDIC study used a "proportional hazards" model to estimate the expected lifetime of banks that were in existence as of January 1, 1993. The study estimated the actuarially fair premium that each bank must pay annually so that the cost of each bank failure to the FDIC would equal the revenue collected through insurance assessments. The estimates indicated a rate spread for 1A versus 3C institutions on the order of magnitude of 100 basis points.<sup>2</sup>

The Board is concerned also that rate differences between adjacent cells in the current matrix do not provide adequate incentives for institutions to improve their condition. Larger differences are consistent with historical variations in failure rates across cells of the matrix, viewed in connection with the preponderance of evidence regarding actuarially fair premiums.<sup>3</sup> The precise magnitude of the differences is open to debate, given the sensitivity of any estimates to small changes in assumptions and to selection of the sample period. However, the Board believes that larger rate differences between adjacent cells of the matrix are warranted.

The Board believes that the assessment rate matrix should be adjusted in the direction of an actuarially fair rate structure, as described above. Consistent with the results of the relevant studies on this topic, regardless of the sample period selected, the Board believes at this time that the highest-rated institutions pose a small but positive risk to the insurance fund and that the spread between the highest- and lowest-rated institutions should be widened.

The Board does not wish to adopt major changes in the assessment rate structure at this time. The proposed rate matrix retains the nine-cell structure. As noted above, in the final rule adopting the current assessment rate schedule, the Board expressed its conviction that

widening the rate spread was desirable but declined to do so because of the potential hardship for troubled institutions and possible additional losses for the insurance fund. The Board remains unwilling to increase the maximum rate other than by means of the adjustment factor discussed below, without further study regarding the proper insurance pricing structure for the industry.

Accordingly, FDIC staff currently are undertaking a comprehensive reevaluation of the risk-based assessment rate matrix, and will present recommendations to the Board in the near future. Any proposed changes to the risk-based assessment rate structure that may result from this process will be addressed in a separate future notice of proposed rulemaking.

In the interim, the Board believes that the proposed assessment schedule represents an equitable set of rate adjustments. It widens the rate spread between the lowest- and highest-rated institutions, consistent with the implications of the best empirical evidence on this issue and with the Board's previously stated conviction. Moreover, the rate differences between adjacent cells in the matrix are widened, providing additional incentive for weaker institutions to improve their condition and for all institutions to avoid excessive risk-taking. This is consistent with the Board's desire to create adequate incentives via the assessment rate structure to encourage behavior that will protect the deposit insurance fund against excessive losses.

### 2. Expected Operating Expenses and Case Resolution Expenses and Income

Operating expenses are projected to be approximately \$260 million for the second half of 1995 (See Table 2). Case resolution expenditures or "insurance losses" for the second half of 1995 are projected to be \$130 million. If the 1994 loss experience of \$70 million per semiannual period (estimated) continues in 1995, losses may be lower than the projected amount. Insurance losses in 1994 were less than one-quarter of the historical average, relative to insured deposits, and baseline assumptions indicate that losses will begin to revert toward the norm in 1996 (see Tables 2-4). See additional discussion of loss assumptions in Section III.B, below.

### 3. Impact on Earnings and Capital

Because assessment rates for most BIF members will decline, the impact on earnings and capital will be positive. Lower assessment costs will reduce expenses by approximately \$4.6 billion

<sup>1</sup> For a representative sampling of academic studies on this issue, see Estimating the Value of Federal Deposit Insurance, The Office of Economic Analysis, Securities and Exchange Commission (1991); Berry K. Wilson, and Gerald R. Hanweck, A Solvency Approach to Deposit Insurance Pricing, Georgetown University and George Mason University (1992); Sarah Kendall and Mark Levonian, A Simple Approach to Better Deposit Insurance Pricing, Proceedings, Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago (1991); R. Avery, G. Hanweck and M. Kwast, An Analysis of Risk-Based Deposit Insurance for Commercial Banks, Proceedings, Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago (1985).

<sup>2</sup> See, Gary S. Fissel Risk Measurement, Actuarially Fair Deposit Insurance Premiums and the FDIC's Risk-Related Premium System, FDIC Banking Review (1994), at 16-27, Table 5, Panel B. Single-copy subscriptions of this study are available to the public free of charge by writing to FDIC Banking Review, Office of Corporate Communications, Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, D.C. 20429.

<sup>3</sup> *Id.*, at Tables 2 and 5.