

per year. Based on the industry's year-end 1993 average tax rate of 31.5 percent, there will be an after-tax impact on profits of approximately \$3.15 billion per year. BIF members may pass some portion of the cost savings on to their customers through lower borrowing rates, lower service fees, and higher deposit rates. Their ability to do so will be affected by factors such as the level of competition faced by banks.

4. Other Factors—Consideration of the Impact on the SAIF of Decreased BIF Rates

A question has been raised concerning whether the Board may take into consideration the impact on SAIF in setting BIF rates. Based on recent projections, the BIF is expected to recapitalize between May 1 and July 31, 1995. By contrast, recent projections show that the SAIF will not recapitalize until 2002 because assessments to cover interest payments on bonds issued by the Financing Corporation (FICO) divert about \$780 million per year, or about 45 percent of total SAIF assessment revenue. In addition, the SAIF assessment base has been shrinking since the SAIF was created in 1989. The FICO will continue to divert SAIF assessments for interest payments on FICO bonds until 2019 when the bonds mature.

Section 7(b)(2)(A)(ii) of the FDI Act requires the Board to consider certain factors in setting assessment rates, one of which is "any other factors that the Board of Directors may deem appropriate". Section 7(b)(2)(B) of the FDI Act requires the Board to set semiannual assessments for members of each fund "independently" from semiannual assessments for members of the other insurance fund. Read together, these provisions do not specifically prohibit Board consideration of the impact of BIF rates on SAIF members as long as the rates are set independently.

However, section 7(b)(2)(A)(i) requires the Board to set rates to maintain the BIF reserve ratio. If the Board were to take into consideration the impact on the SAIF when it set BIF rates and, as a result, the reserve ratio continued to increase in excess of the DRR, it might be considered a violation of the statute. By contrast, an increase in the reserve ratio due to revenue generated from the minimum assessments and maintaining a risk-based assessment system would not be a violation because those provisions are mandated by the statute.

B. Need for Decreased Rates

As discussed in Section II, management of the reserve ratio is necessarily imprecise because the

factors affecting this ratio cannot be predicted with certainty. Changes in the reserve ratio are primarily a function of assessment revenues, investment income, operating expenses and insurance losses resulting from bank failures.

The BIF is expected to recapitalize between May 1 and July 31, 1995. It is unlikely that the BIF will recapitalize prior to the second quarter of 1995 because, after declining from 1992 through mid-year 1994, there are indications that insured deposits have begun to increase.

Other than the revenues that may be necessary to achieve and maintain the DRR of 1.25% in the second half of 1995, projections indicate that the BIF will require little or no assessment income to cover losses and expenses for that period. Investment income is expected to approach \$500 million for the second half of the year. As noted above, for the same period insurance losses are projected to be \$130 million, and operating expenses are projected to be approximately \$260 million. Thus, based on current projections, investment income alone should suffice to cover BIF obligations unrelated to the reserve ratio in the second half of 1995.

The proposed assessment rate schedule is the current, nine-cell matrix with assessment rates ranging from 4 basis points per year for the highest-rated institutions to 31 basis points for the lowest-rated institution (see Table 1, Proposed Rate Schedule). For purposes of maintaining the reserve ratio at 1.25%, the relevant fact is that the estimated 4.5 basis point average assessment rate resulting from this matrix will produce approximately \$1.1 billion of annual revenue for the BIF in the short run. If the proposed matrix takes effect at or near the beginning of the second semiannual period in 1995, the reserve ratio will reach nearly 1.3% by year-end, under current assumptions concerning insurance losses, operating expenses, insured deposit growth, and other relevant factors.

However, the staff's baseline assumptions imply that an average assessment rate of 4 to 5 basis points is necessary to maintain the BIF reserve ratio at 1.25% over a 5–7 year horizon (see Tables 2–4). While the baseline assumptions for insurance losses may be characterized as relatively pessimistic given current economic conditions, it is important to recognize that such conditions are rare in the banking industry's recent history. For 1994, the ratio of insurance losses to estimated insured deposits was approximately one-half of 1 basis point (estimated). This ratio had not previously fallen

below 1 basis point in any year since 1980, averaging 16 basis points for the 1981–93 period and exceeding 30 basis points in three of those years. Therefore, the staff's baseline loss assumptions may be considered rather optimistic relative to recent historical experience.

The proposed matrix would yield assessment revenue sufficient to finance losses equal to the 60-year annual average, nearly 4 basis points of estimated insured deposits, with a margin to absorb losses that moderately exceed the average. In view of the recent experience reviewed above, the staff believes this to be the minimum amount necessary to maintain the DRR consistently over the near-term future.

Given the increasing degree of competition faced by insured institutions, the increasing opportunities for risk-taking as a result of rapid financial innovation, and the increased variability of interest rates as well as other prices due to the globalization of markets and other factors, the staff believes that the loss experience in the banking industry is unlikely to revert to pre-1980 norms. Rather, the average yearly loss ratio is likely to exceed the 60-year average going forward, with large year-to-year variability.

Prudence requires that the Board be provided with the flexibility to adjust assessment rates in a timely manner in response to changing conditions. Accordingly, the Board proposes to increase or decrease the proposed assessment schedule by an adjustment factor of up to 5 basis points or fraction thereof. The adjustment factor is the maximum amount by which the Board could adjust the assessment rate schedule without going through an additional notice and comment rulemaking process. Such adjustments could only be made to the assessment schedule in its entirety, not to individual risk classification cells. Nor could the spread of 27 basis points be changed by means of the adjustment factor. Accordingly, by means of the adjustment factor, the Board could adjust the proposed assessment schedule of 4–31 basis points to a maximum assessment schedule of 9–36 basis points and a minimum assessment schedule of 0–27 basis points.

This adjustment factor would provide the Board with the flexibility to raise a maximum additional \$1.2–\$1.4 billion in the near term without undertaking a rulemaking. An adjustment factor of 5 basis points appears modest when viewed historically, as the loss-to-insured deposits ratio has been quite variable; the standard deviation was 8.6 basis points for the 1933–93 period and