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United States General Accounting Office  
Washington, DC 20548

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April 16, 2002

The Honorable Michael G. Oxley  
Chairman  
Committee on Financial Services  
House of Representatives

Subject: Responses to Questions Relating to H.R. 3717, Federal Deposit Insurance Reform Act of 2002

Dear Mr. Chairman:

This letter responds to your April 12, 2002, request that we answer questions relating to H.R. 3717, the Federal Deposit Insurance Reform Act of 2002. Among other things, H.R. 3717 proposes changes to the definition of the reserve ratio for the deposit insurance fund, as well as provides the Federal Deposit Insurance Corporation (FDIC) with the flexibility to set the fund's designated reserve ratio within a range.

Current law requires FDIC to maintain the deposit insurance fund balances (net worth) at a designated reserve ratio of at least 1.25 percent of estimated insured deposits. If the reserve ratio falls below 1.25 percent of estimated insured deposits, FDIC's Board of Directors is required to set semiannual assessment rates that are sufficient to increase the reserve ratio to the designated reserve ratio not later than 1 year after such rates are set, or in accordance with a recapitalization schedule of 15 years or less.

Your questions, along with our responses, follow.

***1. Would there be any impact on FDIC's GAAP prepared financial statements if the numerator of the reserve ratio were legislatively changed to add back any estimated liabilities for anticipated failures?***

No. FDIC prepares its annual financial statements in accordance with U.S. generally accepted accounting principles (GAAP). GAAP requires FDIC to report the fund balance (difference between total assets and total liabilities) including any estimated liabilities for anticipated failures in its Statement of Financial Position. Fund balance and estimated liabilities for anticipated failures are clearly identifiable line items in the Statement of Financial Position. The reserve ratio is legislatively defined and does not affect FDIC's financial statements.

**2. Recognizing that redefining a legislatively defined ratio may not impact FDIC's use of GAAP or its provisioning for losses in its financial statements, what is the effect of adding the estimated liabilities for future failures to net worth in the numerator of the reserve ratio and how would other provisions of the bill mitigate these effects?**

To the extent that estimated liabilities for anticipated failures exist, the redefined reserve ratio in H.R. 3717 would result in a higher reserve ratio than under current law. Further, if estimated liabilities for future failures exist, the redefined reserve ratio would not provide the best representation available on the deposit insurance fund's financial condition.

Under the current law, the numerator of the reserve ratio is the fund balance, which is a widely understood measure of net worth. By adding back any estimated liability for anticipated failures to net worth in the calculation of the reserve ratio, the numerator will no longer represent the fund's net worth, and the resulting reserve ratio may not be as readily understood as the currently defined ratio.

In addition, under H.R. 3717, a scenario could occur where the reserve ratio is at or exceeds 1.4 percent and FDIC has also recorded a large amount of estimated liabilities for anticipated failures. FDIC would be required to declare dividends and refund, in the form of dividends, the amount of excess fund balance over the amount of the designated reserve ratio. In this scenario, FDIC would be required to provide dividends even though it expects the reserve ratio to decline in the upcoming year when the anticipated failures are expected. This could result in FDIC refunding a portion of its fund balance in the form of dividends at a time when funds are needed to cover expected losses.

Similarly, under H.R. 3717, if the reserve ratio is at 1.35 percent and there are also large amounts of estimated liabilities for anticipated failures, FDIC would be required to declare dividends in an amount equal to 50 percent of the insurance premium income for that assessment period. In this scenario, FDIC would be required to reduce its insurance premium income, even when it expects the reserve ratio to decline in the upcoming year when the anticipated failures actually occur. This could result in FDIC refunding premiums in the form of dividends at a time when premium income is needed by the insurance fund to cover expected losses.

In addition, the impact of adding back the estimated liabilities for future failures to net worth in the calculation of the reserve ratio would have the effect of delaying premiums in the case where the estimated liability figure would have caused the reserve ratio to be below the designated reserve ratio. Delaying premiums creates the potential for volatility in the payment of premiums, possibly resulting in the banking industry paying high premiums when both banks and the economy can least afford it.

FDIC may be able to mitigate the delaying of premiums described above because under H.R. 3717, FDIC would have the flexibility to increase the designated reserve ratio up to 1.4 percent. Therefore, FDIC's decision on setting the designated reserve ratio higher could result in not having premium delays that otherwise would occur with a lower designated reserve ratio.

Lastly, under the current proposal, it appears that a potentially anomalous scenario could occur in the instance where FDIC sets the designated reserve ratio at 1.4 percent and the actual reserve ratio is between 1.35 and 1.4 percent. In this case, it appears that FDIC would be required to declare dividends in the amount of 50 percent of insurance premiums for that period, even though the fund's reserve ratio is still below the designated reserve ratio.

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Should you or your staff have any questions, please contact me at (202) 512-9406 or Lynda Downing, Assistant Director at (202) 512-9168. We can also be reached by e-mail at [franzelj@gao.gov](mailto:franzelj@gao.gov) and [downingl@gao.gov](mailto:downingl@gao.gov).

Sincerely yours,



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