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United States General Accounting Office  
Washington, DC 20548

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April 16, 2002

The Honorable John J. LaFalce  
Ranking Minority Member  
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. LaFalce:

This letter responds to your April 9, 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. Sections 7(l)(6) and 7(l)(7) of the Federal Deposit Insurance Act, which define, respectively, the Bank Insurance Fund Reserve Ratio and the Savings Association Insurance Fund Reserve Ratio, as "the ratio of the net worth of the [fund] to the value of the aggregate estimated insured deposits held in all [fund] members." What does the term net worth mean with respect to the deposit insurance funds? In particular, is the reserve for anticipated failures a liability that is to be deducted from the fund's assets to arrive at net worth for purposes of calculating the ratio?***

Currently, FDIC's net worth as defined by U.S. Generally Accepted Accounting Principles (GAAP) is the same as the net worth used for the reserve ratio calculation. Both the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) calculate net worth as the difference between total assets and total liabilities. BIF's and SAIF's net worth is called "Fund Balance" on each fund's annual audited

Statement of Financial Position that is prepared in accordance with GAAP. Included in total liabilities for both funds are any estimated liabilities for anticipated failures of insured institutions. Because the Federal Deposit Insurance Act currently calls for using net worth when calculating the reserve ratio, all liabilities, including the liability for anticipated failures, are deducted from the assets to arrive at net worth for calculating the reserve ratio.

**2. H.R. 3717 as reported out of the Sub-Committee on Financial Institutions would change the definition of the reserve ratio to add the reserve for anticipated failures into the numerator of the reserve ratio calculation. While the bill would also provide the FDIC with the flexibility to set the Designated Reserve Ratio (DRR) in a range, (i) the DRR may not be set higher than 1.4; and (ii) the FDIC is required to rebate one-half of assessments when the reserve ratio reaches 1.35 and all assessments and income in excess of the DRR when the reserve ratio reaches 1.4.**

**A. Would the reserve ratio as proposed to be revised in HR 3717 provide the best representation of the information available about the fund's true financial condition?**

Per H.R. 3717, any estimated liabilities for anticipated failures for BIF or SAIF would be added back to fund balance for purposes of calculating the reserve ratio. Therefore, the proposed definition of reserve ratio would not include the liabilities for estimated losses that FDIC has determined are probable to occur and are also estimable. To the extent that estimated liabilities for future failures exist and are not considered for the purposes of calculating the reserve ratio, the reserve ratio would not provide the best representation of the information available on the fund's financial condition.

**B. If the reserve ratio calculation were changed as proposed in HR 3717, how would the calculation be affected as anticipated failures increased? Would the reserve ratio become a more or less accurate reflection of the fund's true financial condition? What would be the impact on the fund if the reserve ratio reached 1.4 at the same time the FDIC had determined that the financial condition of the banking industry made a large reserve for anticipated failures appropriate?**

Under H.R. 3717, changes in the estimated liability for anticipated failures would have no impact on the reserve ratio. To the extent that estimated liabilities for future failures exist and are not considered for the purposes of calculating the reserve ratio, the reserve ratio would not provide the best representation of the information available on the fund's financial condition and would result in a higher reserve ratio than under current law.

Also, 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.

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 are expected. 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.

Finally, 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.

***C. What would be the impact on the timing of premium requirements if the fund sustained large losses? That is, would the premiums have to be paid after-the-fact, when the system is by definition weak, rather than being paid when the system is stronger to build up the reserve?***

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.

**3. Some have stated that the reserve for anticipated failures should be added to the numerator in the reserve ratio because the FDIC either (i) consistently overestimates the anticipated failures or (ii) does not have supporting data or analysis for its estimates. Each year, GAO audits the financial statements of the BIF and the SAIF; the GAO has consistently rendered unqualified opinions on those financial statements.**

**A. In your experience, has the FDIC consistently overestimated anticipated failures?**

No. As part of the annual financial statement audit, we have concluded that FDIC's estimates of its liabilities for anticipated failures were fairly stated, in all material respects, based on information available at the time. FDIC's estimates for anticipated failures are generally based on the most current information available at the time the estimates are made, however, when the bank failure actually occurs, the amount of loss will likely be different than originally expected.

**B. In your experience, what has been the quality of the supporting analysis by the FDIC of the reserve for anticipated failures?**

Each year, during our annual financial statement audit we review the methodology and information used by FDIC in determining the amount of the estimated liability for anticipated failures. FDIC provides us with the supporting documentation used in calculating the liability. We also perform detailed tests on the supporting analysis and calculations. Based on our annual audits of FDIC's estimates, we have concluded that FDIC's financial statements were fairly stated, in all material respects, based on information available at the time. The financial statements include FDIC's estimated liabilities for future failures.

**C. Is that supporting analysis based on the probability of failure and the probable loss given failure of specified individual institutions, rather than on portfolio analysis of all institutions, no matter what their rating?**

Yes. BIF and SAIF record an estimated liability for insured institutions that are deemed probable to fail within 1 year of reporting. On a quarterly basis, FDIC identifies five groups of insured institutions for analysis. The first group consists of institutions classified as having a 100 percent probability of failure. This determination is based on whether an institution already has a scheduled closing date, the institution has been classified as "critically undercapitalized," or the institution has been identified as an imminent failure. The remaining four groups are based on federal or state bank examinations, off-site ratings, and projected capitalization levels. These insured institutions are then classified in one of four groups: (1) CAMELS 4 with projected capital exceeding 2 percent, (2) CAMELS 4 with projected capital below 2 percent, (3) CAMELS 5 with projected capital exceeding 2 percent, or (4) CAMELS 5 with projected capital below 2 percent. Once the five

groups are established, FDIC applies a historical rate, or an adjusted historical rate if the circumstances warrant, to determine the amount of expected failed assets. FDIC also determines a loss experience rate based on failed institution assets that were unrecoverable by FDIC over the past 14 years. Different loss experience rates are used for the five different groups of institutions based on institution size, to reflect the historical loss experience for institutions of different sizes. The loss experience rate is multiplied by the expected failed assets for each institution in the five groups to derive the estimated liability for anticipated failures.

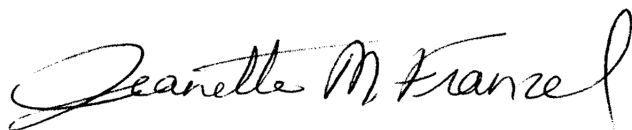
***D. Does the reserve for anticipated failures take into consideration institutions with CAMELS ratings other than 4 or 5?***

FDIC's current methodology for estimating losses for anticipated failures generally includes only insured institutions with CAMELS ratings of 4 and 5. Just recently, however, a very rare instance occurred where a CAMELS 2 institution was included in the reserve because fraud was identified.

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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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