



September 23, 2013

**MEMORANDUM TO:** The Board of Directors

**FROM:** Diane Ellis *Diane Ellis*  
Director  
Division of Insurance and Research

**SUBJECT:** Update of Projected Deposit Insurance Fund Losses, Income, and Reserve Ratios for the Restoration Plan

**SUMMARY**

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) requires that the Deposit Insurance Fund (DIF) reserve ratio reach 1.35 percent by September 30, 2020.<sup>1</sup> The FDIC is operating under a DIF Restoration Plan that provides, among other things, that the reserve ratio will reach 1.35 percent by the statutory deadline.<sup>2</sup> The Restoration Plan requires the FDIC to update DIF loss and income projections at least semiannually, which allows the FDIC to evaluate whether growth in the DIF is likely to be sufficient to meet the statutory requirements. This memorandum is the second semi-annual update for 2013.

The DIF balance has risen for fourteen consecutive quarters and stood at \$37.9 billion on June 30, 2013, resulting in a reserve ratio of 0.63 percent. Staff projects that, under the current assessment rate schedule, the DIF reserve ratio will reach 1.15 percent in 2019. Dodd-Frank requires the FDIC to offset the effect on institutions with total consolidated assets of less than \$10 billion of increasing the reserve ratio from 1.15 percent to 1.35 percent.<sup>3</sup> Staff intends to present a proposed rule to the Board of Directors (Board) to implement this requirement when the DIF reserve ratio is closer to 1.15 percent.

The outlook for the DIF reserve ratio depends on forecasts and assumptions for several financial measures, including (1) bank failures, (2) changes in bank risk profiles, which affect assessment rates, (3) growth in the assessment base, (4) fund investment income, (5) operating expenses, and (6) growth in estimated insured deposits. All of these forecasts and assumptions are subject to considerable uncertainty over a long-term horizon. Ongoing challenges to the recovery of the U.S. economy and banking sector also add uncertainty to the outlook for the DIF.

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<sup>1</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 334(d), 124 Stat. 1376, 1539 (2010) (codified at 12 U.S.C. § 1817(nt)).

<sup>2</sup> Adoption of Federal Deposit Insurance Corporation Restoration Plan, 75 Fed. Reg. 66293 (Oct. 27, 2010).

<sup>3</sup> Dodd-Frank Act, Pub. L. No. 111-203, § 334(e), 124 Stat. 1539 (codified at 12 U.S.C. § 1817(nt)).

## **BACKGROUND**

### *Revisions to the Restoration Plan*

In October 2010, the Board adopted a revised Restoration Plan to incorporate changes arising from the enactment of Dodd-Frank, which raised the minimum designated reserve ratio from 1.15 percent to 1.35 percent.<sup>4</sup> The new law also extended the allowable period of time to reach the new, higher minimum from the end of 2016 to September 30, 2020. Accordingly, the FDIC extended the period covered by the Restoration Plan to conform to Dodd-Frank. Because the outlook for bank failures had improved and because of the time that Dodd-Frank allowed for the reserve ratio to reach 1.35 percent, the FDIC decided to forego a 3 basis point increase in assessment rates that was scheduled to take effect at the start of 2011.<sup>5</sup>

### *Recent trends affecting the DIF*

The banking industry continues to recover at a gradual pace. The second quarter of 2013 marked the sixteenth consecutive quarter in which earnings posted a year-over-year increase. More than half of all banks, 53.8 percent, reported improvement in quarterly net income from one year ago, and only 8.2 percent were unprofitable, the lowest proportion since third quarter 2006. Lower loan loss provisions and higher trading income contributed to the second quarter's year-over-year improvement in earnings. Asset quality, as measured by the volume of noncurrent loans and leases, has improved for thirteen consecutive quarters. The average return on assets (ROA) rose to 1.17 percent from 0.99 percent a year ago, marking the industry's highest quarterly ROA since second quarter 2007.

The total number of institutions on the FDIC's Problem Institution List fell to 553 at June 30, 2013, from 612 at March 31, 2013, and 651 at the end of last year. The number of problem banks has declined for nine consecutive quarters and is now at its lowest level since September 2009. The improvement in the number of problem institutions reflects a continued decline in the rate of supervisory rating downgrades, as well as an increase in the rate of supervisory rating upgrades.

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<sup>4</sup> In October 2008, the Board adopted an initial five-year Restoration Plan to return the DIF to 1.15 percent, which was then the statutory minimum for the designated reserve ratio. 73 Fed. Reg. 61598 (October 16, 2008). The Board amended the Restoration Plan twice in 2009 in response to revisions in the outlook for bank failures and to account for legislative changes. 74 Fed. Reg. 9564 (March 4, 2009) and 74 Fed. Reg. 51062 (October 2, 2009). For more detail on the Amended Restoration Plans in 2009, see Memorandum to the Board of Directors from Arthur J. Murton (Director, Division of Insurance and Research) dated April 3, 2012 ([http://www.fdic.gov/news/board/2012/2012-04-23\\_notice\\_no5.pdf](http://www.fdic.gov/news/board/2012/2012-04-23_notice_no5.pdf)).

<sup>5</sup> 75 Fed. Reg. 66293. Because Dodd-Frank requires the FDIC to offset the effect on institutions with less than \$10 billion in total consolidated assets of the requirement that the reserve ratio reach 1.35 percent by September 30, 2020 (rather than 1.15 percent by the end of 2016), assessment rates applicable to all institutions need be set only high enough to reach 1.15 percent by September 30, 2020.

The rates at which 3-, 4-, or 5-rated institutions have failed have declined significantly since the spring of 2010. The number of bank failures declined from 157 in 2010 to 92 in 2011 and 51 in 2012. A total of 20 banks have failed from January through August of 2013, exactly half the number of failures during the first eight months of 2012.

However, challenges still remain for the industry. Revenue growth remains weak, reflecting modest loan growth and narrow margins. The average net interest margin fell to 3.26 percent, its lowest level since the fourth quarter of 2006. The prolonged low interest rate environment has created incentives for institutions to reach for yield, which leaves them more exposed to interest rate risk as rates rise.

The U.S. economic recovery has been underway for four years. Real gross domestic product (GDP) grew at a 1.8 percent average annualized rate in the first half of 2013, following 2.8 percent growth in 2012. In the first half of 2013, the housing sector continued to improve, consumer spending rose moderately, the unemployment rate declined, and business investment grew. Consensus forecasts expect GDP growth to accelerate in the second half of 2013 and into 2014. Further steady expansion of the U.S. economy should continue to support gradual improvement in the condition of FDIC-insured depository institutions.

The insurance fund has continued to grow in tandem with the improvement in U.S. banking industry performance. The DIF balance stood at \$37.9 billion at June 30, up from \$33.0 billion at the end of 2012 and \$22.7 billion four quarters ago.<sup>6</sup> Cumulatively, the DIF balance has risen by almost \$59 billion from its negative \$20.9 billion low point at the end of 2009. Assessment income and a decline in loss provisions for anticipated failures have contributed to the growth in the fund balance so far this year. At June 30, 2013, the contingent loss reserve was \$2.4 billion, down from \$3.2 billion at the end of 2012.

## **PROJECTIONS**

### *DIF balance and reserve ratio*

Staff has updated its projections for the DIF balance and reserve ratio. The projections are based on recently available information about banks expected to fail in the near term, on analyses of longer-term prospects for troubled banks, and on trends in CAMELS ratings, failure

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<sup>6</sup> Part of the increase in the DIF balance during 2012 was due to the release of funds previously set aside for debt guaranteed under the Temporary Liquidity Guarantee Program (TLGP). The TLGP, which began in October 2008 and ended on December 31, 2012, contributed \$9.3 billion in fees and surcharges to the DIF over the life of the program. The TLGP was announced on October 14, 2008, as part of the federal government's coordinated response to the financial crisis. The TLGP provided two limited guarantee programs: one that guaranteed newly-issued senior unsecured debt of insured depository institutions and their holding companies (the Debt Guarantee Program, or DGP), and another that guaranteed certain transaction accounts at insured depository institutions (the Transaction Account Guarantee Program, or TAG). The TAG expired at the end of 2010 and was replaced by a similar temporary program established under Dodd-Frank that expired on December 31, 2012. The last debt guarantees under the DGP also expired on that date.

rates, and loss rates. Last April, the staff projected that failures for the five-year period from 2013 through 2017 would cost \$5 billion.<sup>7</sup> The current projected total cost of failures for the same five years has been revised downward to \$4 billion, primarily because of lower recent and expected failure rates of troubled banks. The losses projected for these five years follow estimated losses of \$87 billion for banks that failed from 2008 through 2012. The staff expects that the pace of both examination rating downgrades and failures of troubled banks will continue to slow, and that ratings upgrades will outpace downgrades over the 2013 – 2017 period. Beyond five years, the projections assume a low level of failures and associated losses.

The DIF earned assessment income of \$12.4 billion in 2012. For 2013, staff currently project assessment income of approximately \$10 billion, down from just over \$11 billion projected last April. The lower estimate for 2013 revenue results from: (1) a larger-than-expected reduction in the industry average risk-based premium rate, which reflects improvement in banking industry performance and conditions, and (2) slower-than-anticipated growth in the total assessment base. The DIF projections assume that the average risk-based premium rate will continue to decline gradually over several years as the banking industry continues to strengthen.

The reserve ratio stood at 0.63 percent at June 30, 2013, up from 0.44 percent at the end of 2012.<sup>8</sup> Under the current assessment rate schedule, staff projects that the reserve ratio should reach 1.15 percent in 2019. Last April and in earlier updates, staff projected that the reserve ratio would reach 1.15 percent in 2018. A more conservative projection of future assessment revenue is responsible for the change from 2018 to 2019, which remains within the time frame of the Restoration Plan.

#### *Prepaid assessments and DIF cash balance*

To ensure that the DIF had sufficient liquidity to handle a high volume of failures, the Board issued a rule in 2009 that required insured depository institutions to prepay 13 quarters of estimated risk-based assessments.<sup>9</sup> The \$45.7 billion in assessments prepaid on December 30, 2009, resolved the FDIC's immediate liquidity needs. As required by the rule, the FDIC refunded in aggregate \$5.85 billion in remaining prepaid assessments at the end of June to almost 5,600 insured institutions. Based on staff's projections of the DIF's cash balance after the refund, current liquid assets together with future assessment cash collections and dividends from receiverships should be sufficient to meet all FDIC obligations during the next five years.

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<sup>7</sup> Memorandum to the Board of Directors from Arthur J. Murton (Director, Division of Insurance and Research) dated March 28, 2013 ([http://www.fdic.gov/news/board/2013/2013-04-11\\_notice\\_dis\\_mem.pdf](http://www.fdic.gov/news/board/2013/2013-04-11_notice_dis_mem.pdf)).

<sup>8</sup> December 31, 2012 was the last day of temporary full insurance authorized by Dodd-Frank on balances exceeding \$250,000 held in noninterest-bearing transaction accounts. The program's expiration added about 12 basis points to the reserve ratio this year by reducing total estimated insured deposits.

<sup>9</sup> The cash collected from the prepayment did not initially affect the DIF balance (i.e., the DIF's net worth). Rather, each quarter, the DIF recognized as revenue prepaid amounts used to cover each institution's quarterly risk-based assessment.

*Risks to the outlook for the DIF*

Projections for the DIF are subject to considerable uncertainty arising from the economic outlook. The rate of growth in the U.S. economy has been below trend for an extended period and most indicators suggest that below-trend growth will continue. Two key risks weigh on the outlook. First, recent fiscal tightening and uncertainty over future fiscal policy will continue to restrain short-term economic growth. Second, recent signs of slower growth in Asia and emerging markets and continued weakness in Europe could adversely affect U.S. financial markets and the U.S. economy. A slowdown in the U.S. economic recovery could result in more bank failures than projected and a decline in the value of failed bank assets. Furthermore, future assessment revenue could diverge from staff projections depending on changes in bank risk profiles and in industry assessment base growth.

Nonetheless, staff's best estimate is that the DIF balance remains on track to meet the requirements of the Restoration Plan and Dodd-Frank. Even if a slowdown in the economic recovery results in higher-than-expected fund losses, or assessment revenue is less than anticipated, the existing statutory framework should provide sufficient time to evaluate possible future adjustments to the Restoration Plan and assessment levels. Staff will continue to update the Board on a semiannual basis.

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