

MEMO

TO: The Board of Directors

FROM: Diane Ellis
Director, Division of Insurance and Research

DATE: December 14, 2021

RE: Designated Reserve Ratio for 2022

SUMMARY AND RECOMMENDATION

The Federal Deposit Insurance Act (FDI Act) requires that the FDIC Board of Directors (Board) designate a reserve ratio for the Deposit Insurance Fund (DIF or fund) and publish the designated reserve ratio, or DRR, before the beginning of each calendar year.¹ On November 17, 2020, the Board approved for publication a notice setting the DRR at 2 percent for 2021.² Staff recommends maintaining the DRR at 2 percent for 2022 and requests that the Board authorize publication of the attached notice to that effect in the Federal Register.

The Board must set the DRR in accordance with its analysis of certain statutory factors: risk of losses to the DIF; economic conditions generally affecting insured depository institutions; preventing sharp swings in assessment rates; and any other factors that the Board determines to be appropriate.³ Staff has identified one “other factor” for the Board’s consideration: viewing the DRR as a minimum goal that will allow the fund to grow sufficiently large during times of favorable banking conditions to increase the likelihood of the DIF remaining positive throughout periods of significant losses due to bank failures, consistent with the FDIC’s comprehensive, long-term fund management plan.

The manner in which the Board evaluates the statutory factors may depend on its view of the role of the DRR. Governing statutes do not direct the Board on how to use the DRR. Based on current circumstances and historical analysis, staff continues to view the DRR as a long-range, minimum goal for the reserve ratio, consistent with the comprehensive, long-range fund management plan contained in the October 2010 proposed rulemaking to raise the DRR to 2 percent (October 2010 NPR).⁴

¹ Section 7(b)(3)(A) of the FDI Act, 12 U.S.C. § 1817(b)(3)(A).

² 85 Fed. Reg. 74719 (Nov. 23, 2020). The DRR is expressed as a percentage of estimated insured deposits. The DRR was first set at 2 percent for 2011 in a final rule approved by the Board on December 14, 2010. See 75 Fed. Reg. 79286 (Dec. 20, 2010), codified at 12 C.F.R. § 327.4(g). The Board has set the DRR at 2 percent for every year since 2011.

³ Section 7(b)(3)(C) of the FDI Act, 12 U.S.C. § 1817(b)(3)(C).

⁴ 75 Fed. Reg. 66272 (Oct. 27, 2010).

Concur:

Nicholas J. Podsiadly
General Counsel

BACKGROUND

Governing statutes

Under the FDI Act, the FDIC has broad discretion to manage the DIF, including at what level to set the DRR. The required minimum reserve ratio is 1.35 percent, but there is no upper limit on the reserve ratio (and, thus, no statutory limit on the size of the fund).⁵ The FDI Act provides for dividends from the fund when the reserve ratio exceeds 1.5 percent, but grants the Board sole discretion in determining whether to suspend or limit the declaration or payment of dividends.⁶

The FDI Act also requires that the Board consider the appropriate level for the DRR annually and, if the Board is changing the DRR, to engage in notice-and-comment rulemaking and publish the new DRR before the beginning of the calendar year.⁷

While the FDI Act requires that the Board consider specific factors and other factors that the Board determines are appropriate, it grants the Board broad discretion to set the DRR, so long as it is set no lower than 1.35 percent. The FDI Act does not establish a statutory role for the DRR as a trigger, whether for assessment rate determinations, recapitalization of the fund, or dividends.

Comprehensive, long-range management plan for the DIF

In the October 2010 NPR that was finalized in separate rulemakings in December 2010 and February 2011, the FDIC set out a comprehensive, long-range management plan for the DIF that was designed: (1) to reduce pro-cyclicality in the risk-based assessment system by allowing moderate, steady assessment rates throughout economic and credit cycles; and (2) to maintain a positive fund balance even during a banking crisis by setting an appropriate target fund size and a strategy for assessment rates and dividends.⁸ The October 2010 NPR proposed setting the DRR at 2 percent. After consideration of comments received, a final rule adopted by the Board in December 2010 set the DRR at 2 percent.⁹ The Board has voted annually since then to maintain the 2 percent DRR.

During an economic and banking downturn, insured depository institutions (IDIs) can least afford to pay high deposit insurance assessment rates. Moreover, high assessment rates during a downturn reduce the

⁵ Section 7(b)(3)(B) of the FDI Act, 12 U.S.C. § 1817(b)(3)(B). Pursuant to the FDI Act, in September 2020, the Board adopted a Restoration Plan to ensure that the DIF reserve ratio reaches 1.35 percent within 8 years of establishment, because the reserve ratio was 1.30 percent as of June 30, 2020. Under the Restoration Plan, the FDIC will monitor deposit balance trends, potential losses, and other factors that affect the reserve ratio and provide updates to its loss and income projections at least semiannually. The Restoration Plan maintains the current schedule of assessment rates for all IDIs. See 85 Fed. Reg. 59306 (Sept. 21, 2020).

⁶ Section 7(e)(2)(B) of the FDI Act, 12 U.S.C. § 1817(e)(2)(B).

⁷ Section 7(b)(3)(A) of the FDI Act, 12 U.S.C. § 1817(b)(3)(A).

⁸ See 75 Fed. Reg. at 66272 (Oct. 27, 2010), describing the long-term plan; 75 Fed. Reg. 79286, 79287 (Dec. 20, 2010), finalizing the designated reserve ratio; and 76 Fed. Reg. 10672, 10674 (Feb. 25, 2011), finalizing components of the long-term plan related to dividends and assessment rates.

⁹ 75 Fed. Reg. 79286 (Dec. 20, 2010).

amount that banks can lend when the economy most needs new lending.¹⁰ For these reasons, it is important to reduce pro-cyclicality in the assessment system and allow moderate, steady assessment rates throughout economic and credit cycles.

It is also important that the fund not decline to a level that could risk undermining public confidence in Federal deposit insurance. Although the FDIC has significant authority to borrow from the Treasury to cover losses, the FDIC has viewed the Treasury line of credit as appropriate for covering unforeseen losses, not as a source of financing anticipated losses.

A 2 percent DRR is an integral part of the FDIC's comprehensive, long-range management plan for the DIF. A fund that is sufficiently large is a necessary precondition to maintaining a positive fund balance during a banking crisis and allowing for long-term, steady assessment rates.

In developing the long-range management plan, staff analyzed historical fund losses and income data from 1950 to 2010 to determine how high the reserve ratio would have had to have been before the onset of the two banking crises that occurred during this period to maintain a positive fund balance and stable assessment rates. The analysis, which was detailed in the October 2010 NPR, concluded that moderate, long-term average industry assessment rates, combined with an appropriate dividend or assessment rate reduction policy, would have been sufficient to prevent the fund from becoming negative during the crises.¹¹ Staff also found that the fund reserve ratio would have had to exceed 2 percent before the onset of the last two crises to achieve these results.¹² While the FDIC has not experienced any additional banking crises since the historical analysis was conducted, staff monitor conditions in the banking industry and factors that affect the reserve ratio, including growth in estimated insured deposits, growth in the assessment base, and sources of income for the DIF, on an ongoing basis.

Staff views the 2 percent DRR as a long-range, minimum goal, consistent with the level needed to withstand a future banking crisis of the magnitude of past crises. Because analysis shows that a reserve ratio higher than 2 percent increases the chance that the fund will remain positive during such a crisis, the 2 percent DRR should not be treated as a cap on the size of the fund.

¹⁰ As used in this memorandum, the term "bank" is synonymous with the term "insured depository institution" as it is used in section 3(c)(2) of the FDI Act, 12 U.S.C. 1813(c)(2).

¹¹ See 75 Fed. Reg. at 66273 (Oct. 27, 2010).

¹² The analysis set out in the October 2010 NPR sought to determine what assessment rates would have been needed to maintain a positive fund balance during the last two crises. This analysis used an assessment base derived from domestic deposits to calculate assessment income. The Dodd-Frank Wall Street Reform and Consumer Protection Act, however, required the FDIC to change the assessment base to average consolidated total assets minus average tangible equity. In the December 2010 final rule establishing a 2 percent DRR, staff undertook additional analysis to determine how the results of the original analysis would change had the new assessment base been in place from 1950 to 2010. Both the analyses in the October 2010 NPR and the December 2010 final rule show that the fund reserve ratio would have needed to be approximately 2 percent or more before the onset of the crises to maintain both a positive fund balance and stable assessment rates. The updated analysis in the December 2010 final rule, like the analysis in the October 2010 NPR, assumed, in lieu of dividends, that the long-term industry average nominal assessment rate would be reduced by 25 percent when the reserve ratio reached 2 percent, and by 50 percent when the reserve ratio reached 2.5 percent. Eliminating dividends and reducing rates successfully limits rate volatility whichever assessment base is used. See 75 Fed. Reg. at 79288.

ANALYSIS OF STATUTORY FACTORS

As discussed above, the FDI Act requires that the Board set and publish the DRR annually in accordance with its analysis of statutory factors.¹³ The analysis that follows considers each statutory factor, including one “other factor”: maintaining the DIF at a level that can withstand substantial losses and allowing it to grow sufficiently large during times of favorable banking conditions to increase the likelihood of the DIF remaining positive throughout periods of significant losses due to bank failures, consistent with the FDIC’s comprehensive, long-range fund management plan.

Risk of losses to the DIF

The DIF balance has risen for more than 10 years and stood at \$121.9 billion as of September 30, 2021, up from \$116.4 billion at September 30, 2020. As of September 30, 2021, the reserve ratio stood at 1.27 percent. Cumulatively, the DIF balance has risen by more than \$142 billion from its negative \$21 billion low point at the end of 2009. Primary factors contributing to the cumulative increase in the fund balance since 2009 include assessment income and a reduction in estimated losses associated with past and anticipated failures. Growth in the assessment base, driven in part by insured deposit growth, has contributed to increasing assessment revenue despite slight declines in the weighted average assessment rate for all IDIs in 2021. At September 30, 2021, the contingent loss reserve for anticipated failures was \$12 million, down from \$62 million at September 30, 2020. Operating expenses remained steady, while low investment returns on securities held by the DIF have not significantly contributed to the growth experienced in the fund balance.

In recent years, the DIF has experienced low losses from IDI failures. On average, four IDIs per year failed between 2016 and 2020, at an annual cost to the fund of about \$256 million.¹⁴ No IDIs have failed thus far in 2021, marking the seventh year in a row with few or no failures.

Future losses to the DIF remain uncertain and depend in part on the effects of the Coronavirus 2019 (COVID-19) pandemic on the economy and banking industry, described in more detail below. Thus far, the industry has remained a source of strength for the economy, in part, because banks’ stronger capital position has better positioned them to withstand losses compared to 2008. Banks continued to be strongly capitalized in the third quarter of 2021, holding higher levels and higher-quality capital than just prior to the 2008-2013 banking crisis.

¹³ Specifically, in setting the DRR for any year, the Board must consider the following factors:

- (1) The risk of losses to the DIF in the current and future years, including historic experience and potential and estimated losses from insured depository institutions;
- (2) Economic conditions generally affecting insured depository institutions so as to allow the DRR to increase during more favorable economic conditions and to decrease during less favorable economic conditions, notwithstanding the increased risks of loss that may exist during such less favorable conditions, as the Board determines to be appropriate;
- (3) That sharp swings in assessment rates for insured depository institutions should be prevented; and
- (4) Other factors as the Board may deem appropriate, consistent with the requirements of the Reform Act.

Section 7(b)(3)(C) of the FDI Act, 12 U.S.C. § 1817(b)(3)(C).

¹⁴ FDIC, Annual Report 2020, Assets and Deposits of Failed or Assisted Insured Institutions and Losses to the Deposit Insurance Fund, 1934 – 2020, page 145, available at <https://www.fdic.gov/about/financial-reports/reports/2020annualreport/2020ar-final.pdf>.

Potential future losses can lower the DIF and bring the reserve ratio further from its long-term goal. For example, DIF losses may increase if the quality of IDI assets deteriorates or capital markets become constrained, and income could be affected by the factors described previously. In staff's view, setting a long-term, minimum goal should take into consideration high losses incurred during historical crisis periods, so that the DRR can be set at a level that would improve the DIF's ability to handle losses during any future periods of banking industry stress and reduce the possibility of increased deposit insurance assessment rates during a banking downturn.

Economic conditions affecting FDIC-insured institutions

Economic conditions continued to improve in 2021. Following a 3.5 percent decline in gross domestic product (GDP) in 2020, GDP surpassed its pre-recession peak in the second quarter of 2021. However, economic growth slowed to 2.1 percent in the third quarter of 2021, as the rise in COVID-19 cases associated with the Delta variant, waning fiscal support, and supply constraints to production weighed on consumer and business spending. The unemployment rate was 4.6 percent in October 2021, which is down considerably from its peak in April 2020, but remains above pre-pandemic levels. The housing market's robust growth has continued into 2021, driven by strong demand, low mortgage rates, and limited housing supply, even as economic growth has slowed.

Financial market conditions remained stable in 2021, with continued appreciation in equity prices. The Treasury yield curve steepened, with higher yields on longer term treasuries, in part reflecting the outlook for higher inflation and tighter monetary policy. In November 2021, the Federal Reserve announced that it would maintain the target range for the federal funds rate between zero and 0.25 percent and began reducing the monthly pace of its net asset purchases by \$10 billion for Treasury securities and \$5 billion for agency mortgage-backed securities. The first interest rate hike is expected in 2022.

The economic outlook continues to strengthen, but remains uncertain. The November 2021 Blue Chip consensus forecast for GDP growth is 4.9 percent for the fourth quarter of 2021 and 5.5 percent for full-year 2021. The positive outlook for economic growth reflects expectations of increased consumer and business spending and a continued improvement in the labor market. Key risks to the economic outlook include the uncertain pace of economic recovery and possible downside risk due to a resurgence of the pandemic and accompanying restrictions in economic activity. Other risks include those stemming from supply chain pressures and inflation, and adverse global economic developments.

The financial performance and condition of the banking industry remain highly sensitive to economic developments. Banks entered into the pandemic in good financial health, with capital levels well above the beginning of the 2008-2013 banking crisis.

While economic stress related to COVID-19 impacted IDI earnings and lowered net interest margins in 2020, both have seen improvement in recent quarters. Third quarter 2021 net operating revenue rose due to higher net interest income and noninterest income. Additionally, the net interest margin has seen modest improvement, rising from historic lows to 2.56 percent. As of September 30, 2021, 0.94 percent of loan and lease balances were noncurrent, down from 1.17 percent from a year ago, and well below the peak of 5.46 percent in the first quarter of 2010.

The total number of institutions on the FDIC's Problem Institution List fell to 46, as of September 30, 2021, from 56, on September 30, 2020. The number of problem banks remains well below the peak of 888 institutions in March 2011. As noted above, no banks have failed thus far in 2021, marking the seventh year in a row with few or no failures.

The banking industry, however, faces some economic uncertainties that may affect certain bank loan portfolios such as commercial real estate and one-to-four family residential loans. Uncertainty regarding return

to work policies, end of loan deferral programs, and rising interest rates may adversely affect borrowers' ability to repay their debt. Higher interest rates and shifts in the yield curve also affect asset values and may pose challenges to bank profitability, particularly if borrowers default on loans due to higher interest rates. Risks for banks include severe credit and liquidity strains, as borrowers may struggle to pay debt amid any economic decline.

Although these near-term economic conditions and recent trends in banking industry performance can inform the Board's decision on the DRR, they become less relevant in setting the DRR when, as now, the DIF reserve ratio is below its statutory minimum of 1.35 percent. In this context, staff believes that the DRR should be viewed in a longer-term perspective. Twice within the past 40 years, serious economic dislocations have resulted in a significant deterioration in the condition of many IDIs and in a large number of bank failures at high cost to the DIF.

In staff's view, the DRR should, therefore, be viewed as a minimum goal needed to achieve a reserve ratio that can withstand these periodic economic downturns and elevated bank institution failures. Taking these longer-term economic realities into account, a prudent and consistent policy would set the DRR at a minimum of 2 percent, because that is the lowest level that would have prevented a negative fund balance at any time since 1950 without raising assessment rates during the crises.

Preventing sharp swings in assessment rates

The FDI Act directs the Board to consider preventing sharp swings in assessment rates for IDIs when setting the DRR.¹⁵ Setting the DRR at 2 percent as a minimum goal would signal that the Board plans for the DIF to grow during times of favorable banking conditions so that funds are available to absorb losses due to a significant rise in bank failures throughout periods of stress. This plan would help prevent sharp fluctuations in deposit insurance premiums over the course of the business cycle. In particular, it would help reduce the risk of large assessment rate increases during crises, when IDIs can least afford an increase.

Maintaining the DIF at a level that can withstand substantial losses

Staff again recommends, as it did in 2010 and every year since then, that the Board consider one additional factor when setting the DRR: viewing the DRR as a minimum goal that will allow the fund to grow sufficiently during times of favorable banking conditions to increase the likelihood of the DIF remaining positive throughout periods of significant losses due to bank failures. This aim is consistent with the FDIC's comprehensive, long-term fund management plan. Having adequate funds available when entering a financial crisis should reduce the likelihood that the fund will become negative or that the FDIC will need to increase assessment rates, levy special assessments on the industry, or borrow from the U.S. Treasury. Further, ensuring the DIF maintains a level that can withstand substantial losses directly supports the statutory requirement of preventing sharp swings in assessment rates.

¹⁵ Section 7(b)(3)(C)(iii) of the FDI Act, 12 U.S.C. § 1817(b)(3)(C)(iii).

Balancing the statutory factors

In staff's view, the best way to balance all of the statutory factors (including the additional factor identified above) is to maintain the DRR at 2 percent. Based on the analysis described above, staff continues to recommend viewing a 2 percent DRR as a long-range, minimum goal.

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