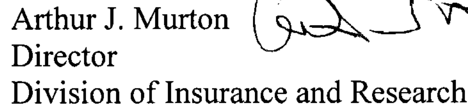
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990 Division of Insurance and Research

April 3, 2012

MEMORANDUM TO: The Board of Directors

FROM: Arthur J. Murton 
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 DIF reserve ratio reach 1.35 percent by September 30, 2020.[1] The FDIC is operating under a Deposit Insurance Fund (DIF) Restoration Plan that provides, among other things, that the reserve ratio will reach 1.35 percent by the statutory deadline.[2] 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 first semi-annual update for 2012.

The DIF balance has risen for eight consecutive quarters and stood at $11.8 billion at year-end 2011, resulting in a reserve ratio of 0.17 percent. Staff projects that, under current assessment rates, the DIF reserve ratio will reach 1.15 percent by the second half of 2018. Dodd-Frank requires the FDIC to offset the effect of increasing the reserve ratio from 1.15 percent to 1.35 percent on institutions with total consolidated assets of less than $10 billion.[3] Staff intends to present a proposed rule to the 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 and new emerging risks also add uncertainty to the outlook for the DIF.

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[1] 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)).

[2] Adoption of Federal Deposit Insurance Corporation Restoration Plan, 75 Fed. Reg. 66293 (Oct. 27, 2010).

[3] 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 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.[4] 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.[5]

In October 2010, the Board adopted a new 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. The new law also extended the allowable period of time to reach the 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.[6]

Recent Trends Affecting the DIF

Recent trends in banking industry performance have been generally favorable. The fourth quarter of 2011 was the eighth consecutive quarter of aggregate positive net income. Sixty-three percent of institutions reported improvement in quarterly net income from one year earlier, and the number of unprofitable institutions declined from year-earlier levels in each of the last nine quarters. Improving credit performance, leading to lower loan loss provisions, has been primarily responsible for most of the year-over-year improvement in earnings. Asset

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[4] 73 Fed. Reg. 61598 (October 16, 2008).

[5] In the Amended Restoration Plan adopted by the FDIC Board in February 2009 (74 Fed. Reg. 9564 (March 4, 2009)), the FDIC relied on the statutory authority in effect at the time to extend the period of time to reach 1.15 percent from five to seven years due to "extraordinary circumstances." The FDIC also imposed a special assessment through an accompanying interim rule. The rule was finalized in May, and the special assessment was charged on June 30, 2009, and collected on September 30, 2009.

Congress changed the law in May 2009 to allow the FDIC up to eight years to return the DIF reserve ratio to 1.15 percent, absent extraordinary circumstances (Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, § 204(b)). Therefore, in the Amended Restoration Plan adopted in September 2009 (74 Fed. Reg. 51062 (October 2, 2009)), the FDIC extended the period covered by the Plan to eight years, i.e., the end of 2016. The Amended Restoration Plan also included the FDIC's decision to forego any additional special assessments and instead to increase rates uniformly by 3 basis points, effective January 1, 2011.

[6] 75 Fed. Reg. 66293. Because Dodd-Frank requires the FDIC to offset the effect 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) on institutions with total consolidated assets of less than $10 billion, assessment rates applicable to all institutions need be set only high enough to reach 1.15 percent by September 30, 2020. Institutions with $10 billion or more in assets can be assessed separately for the increase from 1.15 percent to 1.35 percent by September 30, 2020.

quality, as measured by the volume of noncurrent loans and leases, has improved for seven consecutive quarters.

The total number of institutions on the FDIC's Problem Institution List fell to 813 at year-end 2011 from 844 on September 30. This is the third consecutive quarterly decline in the number of problem institutions. The improvement in the number of problem institutions reflects a decline during 2011 in the rate of supervisory rating downgrades from CAMELS ratings of 1 or 2 to CAMELS ratings of 3, 4, or 5, as well as an increase in the rate of supervisory rating upgrades.

The rates at which 3-, 4-, or 5-rated institutions have failed, calculated over trailing 12-month periods, have declined significantly since the spring of 2010, both in terms of institution numbers and assets. A total of 92 banks failed in all of 2011, down from 157 in 2010. The total assets of failures in 2011 – $35 billion – were significantly less than the $92 billion in total assets of failures in 2010.

The U.S. economic recovery has now lasted almost three years. Real GDP grew at an annual pace of 1.7 percent in 2011, following 3.0 percent growth in 2010. Consensus forecasts for U.S. real GDP growth in 2012 are in the range of 2.0 to 2.5 percent. This expected steady but slow expansion of the U.S. economy should be sufficient to support the continuing gradual improvement of the condition of FDIC-insured depository institutions.

The insurance fund has continued to recover as U.S. banking industry performance has improved. The DIF balance has increased for eight quarters in a row, following seven quarters of decline, and now stands at $11.8 billion. Cumulatively, the DIF balance has risen by almost $33 billion from its negative $20.9 billion low point at the end of 2009. The increase stems primarily from assessment income and a decline in anticipated bank failures, which has resulted in a decrease in the contingent loss reserve for the estimated cost of these failures. At year-end 2011, the contingent loss reserve was $6.5 billion, down from $17.7 billion one year earlier.

PROJECTIONS

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 rates, and loss rates. Last October, the staff projected that failures for the five-year period from 2011 through 2015 would cost $19 billion.[7] The current projected cost of failures for the same five years remains approximately the same. For the new five-year period beginning in 2012 and ending in 2016, staff projects that failures will cost the DIF $12 billion, following estimated losses of $88 billion for banks that failed from 2008 through 2011. The staff expects that the pace of ratings downgrades to CAMELS 3, 4, or 5, and the rate at which troubled banks fail, will

[7] Memorandum to the Board of Directors from Arthur J. Murton (Director, Division of Insurance and Research) dated September 27, 2011.

continue to slow, while the pace of upgrades will increase over the 2012-2016 period. Beyond five years, the projections assume a low level of failures and associated losses.

The DIF earned assessment income of $13.6 billion and $13.5 billion in 2010 and 2011, respectively, and is projected to earn a similar amount this year.[8]

The reserve ratio stood at 0.17 percent at the end of 2011. Under staff's projections, the reserve ratio should reach 1.15 percent in the second half of 2018, within the time frame of the Restoration Plan. The reserve ratio projections take into account the temporary increase in estimated insured deposits attributable to the Dodd-Frank provision that treats as insured deposits the entire balance of non-interest bearing transaction accounts. The projections assume that the balances above $250,000 in these accounts will no longer be insured deposits when the temporary higher coverage expires after December 31, 2012.

The DIF projections do not include $5.7 billion in assets set aside to pay claims under the FDIC's Temporary Liquidity Guarantee Program (TLGP).[9] These assets are primarily liquid assets from program participation fees, but also include the net value of TLGP claims on receiverships. The Transaction Account Guarantee Program component of the TLGP expired at the end of 2010 and was replaced by a similar temporary program established under Dodd-Frank. Approximately $140 billion in guaranteed debt, however, remained outstanding as of March 31, 2012, under the TLGP's Debt Guarantee Program. The last debt guarantees will expire on December 31, 2012 and the DIF will receive any remaining TLGP assets. As of December 31, 2011, $2.6 billion in TLGP assets were transferred to the DIF. The staff estimates that if the DIF receives the entire remaining balance of TLGP assets, the DIF reserve ratio will reach 1.15 percent in late 2017 or early 2018.

Staff has also projected the DIF's cash and liquid asset balance over the next five years. In the staff's view, current liquid assets (including funds attributable to prepaid assessments),

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[8] The projections incorporate the change in the assessment base required by Dodd-Frank, as well as changes to the assessment rate schedule and large bank pricing rules, which became effective April 1, 2011. As the FDIC intended, assessment income under the new rules has approximately equaled the revenue that would otherwise have been earned under the previous assessment base and rates. However, as Congress intended, the change in the assessment base shifted more of the overall assessment burden from community banks to the largest institutions, which rely less on domestic deposits for their funding than do smaller institutions. Banks with assets greater than $10 billion accounted for almost 80 percent of assessments in the second quarter of 2011 – the first quarter for which the new rules applied – up from 70 percent in the prior quarter, commensurate with the increase in their share of the assessment base. In aggregate, assessments for banks with under $10 billion in assets declined by 33 percent in the second quarter of 2011.

[9] The TLGP was announced on October 14, 2008 as part of the federal government's coordinated response to the financial crisis. The TLGP was intended to promote financial stability by preserving confidence in the banking system and encouraging lending in the interbank credit market, thus facilitating lending to creditworthy businesses and consumers. 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), and another that guaranteed certain transaction accounts at insured depository institutions (the Transaction Account Guarantee Program).

together with projected future assessment cash collections and dividends from failed bank receiverships, should be sufficient to meet all obligations arising from past or future bank failures during the next five years.[10]

The projections for the DIF are subject to considerable uncertainty arising from the potential for external shocks and a slowdown in the economic recovery. The current economic recovery has fallen short of previous recoveries as evidenced by persistently high unemployment and depressed real estate markets. The downturn has also weakened the fiscal condition of federal, state, and local governments. Some of the effects of external shocks that slowed growth in 2011 (e.g., supply chain disruptions following the Japanese earthquake, rising commodities prices, and concerns over the European debt crisis) have diminished. Nevertheless, U.S. economic growth remains vulnerable to potential instability in oil-producing regions and the effects of fiscal austerity pursued by governments in Europe. A slowdown in the economic recovery could result in bank failures rising above projections and failed bank assets declining in value. Such a decline in value could make both past and future failures more costly. Furthermore, future assessment revenue and estimated insured deposits could diverge from staff's projections depending on how banks adapt to the assessment rules adopted in 2011 and changes in bank risk profiles.

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 fund losses than projected, the existing statutory framework should provide sufficient time to evaluate the effect on the fund's recovery before considering future adjustments to the Restoration Plan and assessment levels. Staff will continue to update the Board on a semiannual basis.

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[10] To ensure sufficient DIF liquidity, the Board issued a final rule on November 12, 2009, that required insured depository institutions to prepay estimated risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011, and 2012. Institutions prepaid approximately $46 billion in assessments on December 30, 2009. The prepaid assessments resolved the FDIC's immediate liquidity needs, but the cash inflow did not initially affect the DIF balance (i.e., net worth). The DIF accounted for the amount collected as both an asset (cash) and an offsetting liability (deferred revenue). Each quarter, the DIF recognizes as revenue each institution's quarterly risk-based assessment, which is offset by the amount prepaid.