FDIC
Federal Deposit Insurance Corporation
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October 2, 2014

MEMORANDUM TO: The Board of Directors

FROM: 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.[1] 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.[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 under current assessment rates is likely to be sufficient to meet the statutory requirements. This memorandum is the second semi-annual update for 2014.

The DIF balance has risen for the past four and one-half years and stood at $51.1 billion on June 30, 2014, resulting in a reserve ratio of 0.84 percent. Staff projects that, under the current assessment rate schedule, the DIF reserve ratio will reach 1.15 percent in 2019. This represents no change from the update in April. 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 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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[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 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.[4] 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.[5]

Recent trends affecting the DIF

Recent trends in banking industry performance have been generally positive. The second quarter of 2014 marked the 18th time in the past 20 quarters in which earnings posted a year-over-year increase. More than half (57.5 percent) of institutions reported year-over-year earnings growth, while only 6.8 percent were unprofitable – the lowest proportion of unprofitable institutions since the first quarter of 2006. Higher net interest income, lower loan loss provisions and lower other expenses 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 17 consecutive quarters. At June 30, 2014, 2.24 percent of all loan and lease balances were noncurrent, the lowest percentage since the second quarter of 2008.

The total number of institutions on the FDIC's Problem Institution List fell to 354 as of June 30, 2014, from 467 at the end of 2013. The number of problem banks, which peaked at 888 in March 2011 and has declined in every quarter since then, is now at its lowest level since March 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. Fourteen banks failed from January through August of this year, down from 20 failures during the same eight-month period last year.

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[4] 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).

[5] 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.

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 3.15 percent for the second quarter of 2014, its lowest level since the third quarter of 1989. The prolonged low interest rate environment has created incentives for institutions to reach for yield by increasing the share of longer-term assets on their balance sheets. This reach for yield has helped average asset yields, but it has left banks more vulnerable to interest rate risk as rates rise.

The U.S. economic recovery has been underway for five years, although the recovery has been generally uneven throughout the country and across sectors. Moreover, the rate of growth in the U.S. economy over the past five years has been below the long-term trend. Nevertheless, in the first half of 2014, the housing sector continued to improve, consumer spending rose moderately, the unemployment rate declined, and business investment grew. Further expansion of the U.S. economy should enable continued gradual improvement of 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 $51.1 billion at June 30, 2014, up from $47.2 billion at the end of 2013, and $37.9 billion at June 30 of last year. Cumulatively, the DIF balance has risen by $72.0 billion from its negative $20.9 billion low point at the end of 2009. Assessment income and lower estimated losses have contributed to the growth in the fund balance. At June 30, 2014, the contingent loss reserve for anticipated failures was $1.5 billion, down from $2.4 billion at June 30, 2013.

PROJECTIONS

DIF balance and reserve ratio

Staff has updated its projections for the DIF balance and reserve ratio. The projections are based on 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. In the last update, the staff projected that failures for the five-year period from 2014 through 2018 would cost approximately $4 billion.[6] The current projected total cost of failures for the same five years remains at approximately $4 billion. In contrast, the losses projected for these five years follow estimated losses exceeding $83 billion for banks that failed from 2008 through 2013. 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

[6] Memorandum to the Board of Directors from Diane Ellis (Director, Division of Insurance and Research) dated March 28, 2014 (https://www.fdic.gov/deposit/insurance/2014-04-08_notice_dis_d_mem.pdf).

downgrades over the 2014 – 2018 period. Beyond five years, the projections assume a low level of failures and associated losses.

The DIF earned assessment income of $4.6 billion in the first half of 2014. For all of 2014, staff projects assessment income of just under $9 billion. Measures of financial performance and condition along with supervisory ratings determine a bank's risk-based premium rate. DIF assessment revenue projections assume that the industry average risk-based premium rate will decline gradually over the next couple of years as the banking industry continues to strengthen.

The reserve ratio stood at 0.84 percent at June 30, 2014, up from 0.78 percent at the end of 2013, and 0.64 percent at June 30 of last year. Under the current assessment rate schedule, staff projects that the reserve ratio should reach 1.15 percent in 2019, no change from the prior update in April. The projected reserve ratio timetable remains within the time frame of the Restoration Plan.

DIF cash balance

The DIF had liquid assets of $48.3 billion at June 30, 2014. Based on staff projections of the DIF future cash balance, 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.

Risks to the outlook for the DIF

Projections for the DIF are subject to considerable uncertainty arising from the economic outlook. Exposure to interest rate risk, reliance on short-term sources of funding, and limited opportunities for earnings growth will continue to challenge the industry. Additionally, key risks continue to weigh on the economic outlook as well, including the impact of rising interest rates as they return to more normal levels; fiscal challenges at federal, state, and local levels; and global economic risks. 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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