FDIC
Federal Deposit Insurance Corporation
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October 6, 2015

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) increased the minimum reserve ratio for the Deposit Insurance Fund (DIF) from 1.15 percent to 1.35 percent and required that the reserve ratio reach 1.35 percent by September 30, 2020.[1] The FDIC is operating under a DIF Restoration Plan while the reserve ratio remains below the minimum target.[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 semiannual update for 2015.

The DIF balance has risen for the past 5½ years and stood at $67.6 billion as of June 30, 2015, resulting in a reserve ratio of 1.06 percent. Under the current assessment rate schedule, staff projects that the DIF reserve ratio is most likely to reach 1.15 percent in the first quarter of 2016, but may reach that level as early as the fourth quarter of this year. Once the reserve ratio reaches 1.15 percent, lower regular assessment rates will go into effect under the final rule approved by the Board of Directors (Board) in 2011.[3] Dodd-Frank requires, however, that institutions with total assets of $10 billion or more bear the cost of increasing the reserve ratio from 1.15 percent to 1.35 percent.[4] Staff is concurrently presenting to the Board a proposed rule to implement this requirement.

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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] 76 Fed. Reg. 10672, 10718 (Feb. 25, 2011); 12 C.F.R. 327.10(b).

[4] Section 334(e) of Dodd-Frank provides: "In setting the assessments necessary to meet the requirements of subsection (d), the Corporation shall offset the effect of subsection (d) on insured depository institutions with total consolidated assets of less than $10,000,000,000." Dodd-Frank Act, Pub. L. No. 111-203, § 334(e), 124 Stat. 1539 (codified at 12 U.S.C. § 1817(nt)). (Subsection (d) raised the minimum DIF reserve ratio from 1.15 percent to 1.35 percent and requires that the reserve ratio reach this level by September 30, 2020.)

The outlook for the DIF reserve ratio depends on forecasts and assumptions for several financial measures, including: (1) losses from past and future bank failures; (2) changes in bank risk profiles, which affect assessment rates; (3) growth in the assessment base; (4) DIF investment income; (5) operating expenses; and (6) growth in estimated insured deposits. All of these forecasts and assumptions are subject to considerable uncertainty.

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, including the higher minimum designated reserve ratio and the extension of time to reach it from the end of 2016 to September 30, 2020.[5]

Recent trends affecting the DIF

Banking industry performance has generally been positive. The second quarter of 2015 marked the 21st time in the past 24 quarters in which earnings posted a year-over-year increase. In the second quarter of 2015, almost three-fifths of all banks (59 percent) reported improvement in quarterly net income from one year earlier. Only 6 percent of banks were unprofitable, down from 7 percent in second quarter 2014. Second quarter earnings were higher than year-earlier levels due a rise in net interest income and noninterest income, with improvement in servicing fee income. Asset quality, as measured by the volume of noncurrent loans and leases, has improved for 21 consecutive quarters. At June 30, 2015, 1.69 percent of loan and lease balances were noncurrent, the lowest percentage since year-end 2007.

The total number of institutions on the FDIC's Problem Institution List fell to 228 as of June 30, 2015, down from 291 at the end of 2014. 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 third quarter 2008. The improvement in the number of problem institutions reflects a continuing trend of supervisory rating upgrades exceeding downgrades. Bank failures also continue to decline. Six banks failed from January through September of this year, compared to fourteen bank failures over the same period last year.

However, the low interest-rate environment remains challenging for banks. Revenue growth is modest and margins continue to narrow despite banks' investments in longer-term

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[5] 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 (Oct. 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 (Mar. 4, 2009) and 74 Fed. Reg. 51062 (Oct. 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).

maturities to mitigate the effect of low rates. The average net interest margin for the industry has trended down by 70 basis points since second quarter 2010 and was 3.06 percent for the second quarter of 2015.

The economy has grown slowly over the past six years since the financial crisis. Recent U.S. economic indicators have been positive on net. The labor market continues to improve with steady payroll gains and a declining unemployment rate, although weaknesses remain. Inflation has been subdued for several quarters, with oil prices down from a year ago and a stronger dollar. On the other hand, the crisis in Greece and the decline in China's equity market, among other international developments, have contributed to volatility in financial markets and added economic uncertainty.

The DIF has continued to grow in tandem with the improvement in U.S. banking industry performance. The DIF balance stood at $67.6 billion at June 30, 2015, up from $62.8 billion at the end of 2014 and $51.1 billion at June 30 of last year. In addition to assessment income, the $16.5 billion increase in the DIF balance over the past four quarters reflects a reduction in estimated losses from prior bank failures. Many of the coverage periods of shared-loss agreements with acquirers of failed banks expired in late 2014, and total payments under these agreements were less than estimated. Estimates of future shared-loss payments on remaining agreements were also revised downward at the end of 2014 based on the FDIC's recent experience and generally improving market conditions. Cumulatively, the DIF balance has risen by more than $88 billion from its negative $21 billion low point at the end of 2009. At June 30, 2015, the contingent loss reserve for anticipated failures was $684 million, down from $1.5 billion at June 30, 2014.

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 2015 through 2019 would cost approximately $3 billion.[6] The current projected total cost of failures for the same five years is now approximately $2 billion. The losses projected for these five years follow estimated losses of $74 billion for banks that failed from 2008 through 2014. Staff expects that failure rates of troubled banks will remain at low levels and the number of troubled banks will decline as examination rating upgrades outpace downgrades over the next few years.

[6] Memorandum to the Board of Directors from Diane Ellis (Director, Division of Insurance and Research) dated April 7, 2015 (https://www.fdic.gov/news/board/2015/2015-04-21_notice_dis_b_mem.pdf).

The DIF earned assessment income of $4.5 billion in the first half of 2015. For all of 2015, staff projects almost $9 billion in assessment income. Measures of financial performance and condition along with supervisory ratings determine a bank's risk-based premium rate. Staff projects that the industry average risk-based premium rate will decline slightly over the next couple of quarters due to strengthening conditions in the banking industry. As previously mentioned, lower overall regular assessment rates for all banks will go into effect when the reserve ratio reaches 1.15 percent. Regular assessments are estimated to decline on average by almost 30 percent when the lower rates take effect. However, banks with $10 billion or more in assets will be responsible for the cost of increasing the reserve ratio from 1.15 percent to 1.35 percent.

The reserve ratio stood at 1.06 percent at June 30, 2015, up from 1.01 percent at the end of 2014 and .84 percent at June 30 of last year. Under the current assessment rate schedule, staff projects that the DIF reserve ratio is most likely to reach 1.15 percent in the first quarter of 2016, but may reach that level as early as the fourth quarter of this year. Last spring, staff projected that the reserve ratio would not reach 1.15 percent until late 2016 or the first half of 2017. The earlier dates in the new projection result primarily from continuing reductions in estimated losses associated with past and future bank failures, but also from slightly higher assessment revenue and slower insured deposit growth than estimated earlier this year.

DIF cash balance

The DIF had liquid assets of $58.9 billion at June 30, 2015. 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

Key risks weigh on the U.S. economic outlook. Such risks include the impact of increases in interest rates on economic growth; the risk of higher inflation from prolonged low interest rates; fiscal challenges at federal, state, and local levels; and global economic risks, such as a slowdown in key advanced and emerging market economies. A slowdown in the U.S. economic recovery could result in more bank failures than projected as well as a decline in the value of failed bank assets. Furthermore, future assessment revenue may differ from staff projections depending on changes in bank risk profiles and 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. Staff will continue to update the Board on a semiannual basis.

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