FDIC
Federal Deposit Insurance Corporation
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Division of Insurance and Research

February 29, 2016

MEMORANDUM TO: The Board of Directors

FROM: Diane Ellis Diane Ellis
Director
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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 first semiannual update for 2016.

The DIF balance has risen for the past 6 years and stood at $72.6 billion as of December 31, 2015, resulting in a reserve ratio of 1.11 percent. Under the current assessment rate schedule, staff projects that the DIF reserve ratio is likely to reach 1.15 percent in the first half 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 final rule to implement this requirement.

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

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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.)

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

The U.S. economy has grown slowly since the financial crisis, and recent economic indicators have been mixed. Real GDP rose 2.4 percent in 2015, as it did in 2014. Unemployment continued to decline in 2015 but wage growth was weak. Inflation in 2015 was subdued because of low oil and other commodity prices and a stronger dollar, factors that have also restrained business investment and corporate profits. The economic slowdown in China and other emerging markets has contributed to U.S. economic uncertainty and financial market volatility.

Banking industry performance generally has been positive. The fourth quarter of 2015 marked the 23rd time in the past 26 quarters in which earnings posted a year-over-year increase. In the fourth quarter of 2015, almost three-fifths of all banks (57 percent) reported improvement in quarterly net income from one year earlier. Only 9 percent of banks were unprofitable, down from 10 percent in fourth quarter 2014. Fourth quarter earnings were higher than a year earlier due to a rise in net interest income and noninterest income, along with an improvement in servicing fee income. Asset quality, as measured by the volume of noncurrent loans and leases, has improved for 23 consecutive quarters. At December 31, 2015, 1.55 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 183 as of December 31, 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

[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).

continuing trend of supervisory rating upgrades exceeding downgrades. Bank failures also continue to decline. Eight banks failed in 2015, compared to 18 in 2014.

However, the operating environment remains challenging for banks. Interest rates have been exceptionally low for an extended period, and there are signs of growing credit risk. Revenue growth has been modest and margins continue to narrow despite banks' investments in longer-term assets to mitigate the effect of low rates. The average quarterly net interest margin for the industry has trended down by 63 basis points since second quarter 2010 and was 3.13 percent for the fourth quarter of 2015.

The DIF has continued to grow in tandem with the improvement in U.S. banking industry performance. The DIF balance stood at $72.6 billion at December 31, 2015, up from $70.1 billion at September 30, 2015 and $62.8 billion at the end of 2014. Assessment income and a reduction in estimated losses from bank failures were primarily responsible for the $9.8 billion increase in the DIF balance during 2015. Cumulatively, the DIF balance has risen by more than $93 billion from its negative $21 billion low point at the end of 2009. At December 31, 2015, the contingent loss reserve for anticipated failures was $395 million, down from $1.8 billion at December 31, 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 $2 billion.[6] The current projection for the same five years is essentially unchanged. For the new five-year projection period beginning in 2016 and ending in 2020, staff projects that losses from failures will total about $1 billion. The losses projected for these five years follow estimated losses of $74 billion for banks that failed from 2008 through 2015. 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 near term.

The DIF earned assessment income of $8.8 billion in 2015. 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 in total by about one third when the lower rates take effect. However, additional revenue will come from banks with $10

[6] Memorandum to the Board of Directors from Diane Ellis (Director, Division of Insurance and Research) dated October 6, 2015 (https://www.fdic.gov/news/board/2015/2015-10-22_notice_dis_b_mem.pdf).

billion or more in assets, which are responsible for the cost of increasing the reserve ratio from 1.15 percent to 1.35 percent.

The reserve ratio stood at 1.11 percent at December 31, 2015, up from 1.09 percent at September 30 and 1.01 percent at the end of 2014. Staff projects that the DIF reserve ratio is likely to reach 1.15 percent in the first half of this year. Insured deposits grew faster in the fourth quarter than they have in recent fourth quarters and more rapidly than expected. Market volatility could continue to spur insured deposit growth and delay the date at which the reserve ratio reaches 1.15 percent until later in 2016.

DIF cash balance

The DIF had liquid assets of $63.7 billion at December 31, 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 to the U.S. economy include weakness in the energy sector and energy producing regions from lower oil prices, the effect of declining equity prices on business and consumer sentiment, and the effect of possible increases in interest rates on economic growth. A strong dollar and weak growth among major trading partners could continue to reduce U.S. exports and could slow the U.S. economy. A slowdown in the economy 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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