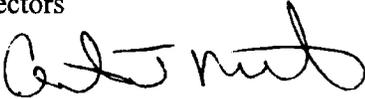




September 27, 2011

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 second semi-annual update for 2011.

After seven consecutive quarters of negative balances, the DIF became positive in the second quarter of 2011, standing at \$3.9 billion at June 30. Staff projects that current assessment rates will allow the DIF to reach 1.15 percent of estimated insured deposits in 2018. Staff intends to present the Board with a proposal at a later date that would implement section 334(e) of Dodd-Frank, which 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

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. Furthermore, the lingering effects of the financial crisis and challenges now facing the U.S. economy and banking system create additional uncertainty for the DIF even in the near term.

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 with 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 positive. The second quarter of 2011 was the sixth consecutive quarter of aggregate positive net income. Sixty 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 six 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 quality, as

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.

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

The total number of institutions on the FDIC's Problem Institution List fell to 865 at mid-year 2011 from 888 on March 31. This is the first decline in the number of problem institutions since the third quarter of 2006. 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 68 banks failed from January through August of 2011, down from 118 for the same eight-month period in 2010. The total assets of failures from January through August 2011 – \$19 billion – were significantly less than the \$81 billion in total assets of failures in the first eight months of 2010.

After data revisions, U.S. economic growth in the first half of 2011 came in significantly slower than initial expectations, at an annual pace of less than 1 percent. Balance-sheet restructuring on the part of households, financial institutions and, now, governments, as well as ongoing credit distress in U.S. mortgage markets, has slowed the recovery. In addition, rising prices for energy and other commodities and the supply-chain effects of the March 2011 earthquake in Japan appear to have taken a greater-than-expected toll on growth in the first half of the year. While these effects will diminish in the second half of the year, we will be left with persistently high U.S. unemployment and an economy that appears to be sensitive to new external shocks.

One such shock occurred in August 2011, when the controversy over the raising of the U.S. federal debt ceiling and a downgrade of U.S. sovereign debt by Standard & Poor's coincided with heightened concern over high levels of sovereign debt and slowing economic growth in Europe. A new round of global financial market turmoil associated with these events contributed to a weakening of some key U.S. economic indicators during the month. While the full effect of these events remains to be determined, developments in recent weeks have done little to dispel concerns about the direction of the global economy. Even if another U.S. recession is avoided, it seems likely that the ongoing repair of financial institution balance sheets will take place in the context of economic growth that is slower and more volatile than in previous recoveries.

Despite these economic challenges, the insurance fund has continued to recover as U.S. banking industry performance has improved. The DIF balance has increased for six quarters in a row, following seven quarters of decline, and now stands at \$3.9 billion. Cumulatively, the DIF balance has risen by almost \$25 billion from its negative \$20.9 billion low point at the end of 2009. The increase stems primarily from assessment income and fewer anticipated bank failures.

PROJECTIONS

Staff has updated its projections for the DIF balance and reserve ratio over the next several years. The projections are based on recently available information about banks expected to fail in the near term and on analyses of longer term prospects for troubled banks and trends in CAMELS ratings, failure rates, and loss rates. The projected cost of failures for the five-year period from 2011 through 2015 is \$19 billion, following estimated losses of \$79 billion for banks that failed in 2008, 2009, and 2010. Projected losses from failures over the 2011 to 2015 period are \$2 billion lower than what staff reported to the Board last April.⁷ Improved prospects for individual troubled banks, an expected continued decline in the pace of CAMELS rating downgrades, and a reduction in the rate at which troubled banks fail are responsible for the modest reduction in projected losses to the DIF over the next five years. Beyond five years, the projections assume a low level of failures and associated losses.

The projections incorporate the new assessment base (required by Dodd-Frank) and the assessment rate schedule adopted by the Board last February, which became effective April 1.⁸ Second quarter 2011 assessments were calculated using the new assessment base and rate schedule, as well as new risk-based pricing rules for large banks. As the FDIC intended, these assessments were approximately equal to the revenue that would otherwise have been earned under the previous assessment base and rates. The DIF is projected to earn approximately \$13.5 billion in assessment income this year, about the same as 2010 assessment revenue.⁹

Under staff's projections, the reserve ratio should reach 1.15 percent in 2018, within the time frame of the Restoration Plan.

The reserve ratio projections also 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.

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), together with projected future assessment cash collections and dividends from failed bank

⁷ Memorandum to the Board of Directors from Arthur J. Murton (Director, Division of Insurance and Research) dated April 4, 2011.

⁸ Assessments, Large Bank Pricing, 75 FR 10672 (February 25, 2011).

⁹ However, as Congress intended, the change in the assessment base has shifted some 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. Based on second quarter data, banks with assets greater than \$10 billion held almost 79 percent of the new assessment base, up from 72 percent using the old assessment base. Their share of overall dollar assessments increased commensurately to almost 80 percent under the new rules from 71 percent under the previous rules. In aggregate, assessments for banks with under \$10 billion in assets declined by more than 30 percent.

receiverships, should be sufficient to meet all obligations arising from past or future bank failures during the next five years.¹⁰

As noted above, the projections are subject to considerable uncertainty. In the staff's view, there are significant risks that renewed financial market turmoil and a slowing economy could result in bank failures rising above projections. The value of failed bank assets could also decline, raising the costs of both past and future failures to the DIF. Furthermore, future assessment revenue and estimated insured deposits could diverge from staff's projections depending on how banks adapt to the new assessment rules and how changes in bank risk profiles affect average risk-based rates over time. 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 current economic challenges do result in higher fund losses than projected, the existing statutory framework should provide sufficient time to evaluate their effects 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. Since the FDIC has already collected most of the \$13.5 billion in projected 2011 assessment revenue through the prepaid assessment, the revenue will not commensurately increase the DIF's liquidity.