



November 21, 2011

MEMORANDUM TO: The Board of Directors

FROM: Arthur J. Murton   
Director  
Division of Insurance and Research

SUBJECT: Designated Reserve Ratio for 2012

**Summary and Recommendation**

The Federal Deposit Insurance Act (FDI Act) requires that the FDIC Board of Directors (Board) designate a reserve ratio for the Deposit Insurance Fund (DIF) and publish the designated reserve ratio, or DRR, before the beginning of each calendar year.<sup>1</sup> On December 14, 2010, the Board approved for publication a Final Rule setting the DRR at 2 percent for 2011.<sup>2</sup> The staff recommends maintaining the DRR at 2 percent for 2012 and requests that the Board authorize the staff to publish the attached notice to that effect in the Federal Register.

The Board must set the DRR in accordance with its analysis of certain statutory factors: risk of losses to the DIF; economic conditions generally affecting insured depository institutions; preventing sharp swings in assessment rates; and any other factors that the Board determines to be appropriate.<sup>3</sup> Staff has identified one “other factor” for the Board’s consideration: maintaining the DIF at a level that can withstand substantial losses, consistent with the FDIC’s comprehensive, long-term fund management plan.

The manner in which the Board evaluates the statutory factors may depend on its view of the role of the DRR, which may change over time. Governing statutes do not direct the Board how to use the DRR. Based on current circumstances and a historical analysis, staff continues to view the DRR as a long-range, minimum target for the reserve ratio, consistent with the comprehensive, long-range fund management plan contained in the proposed rulemaking in October 2010 to raise the DRR to 2 percent (October 2010 NPR).

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<sup>1</sup> 12 USC 1817(b)(3)(A).

<sup>2</sup> 75 FR 79286 (Dec. 20, 2010). The DRR is expressed as a percentage of estimated insured deposits.

<sup>3</sup> 12 U.S.C. 1817(b)(3)(C).

Concur:

  
Michael H. Krimmingen  
General Counsel

## **Background**

### *Governing statutes*

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which was enacted on July 21, 2010, gives the FDIC much greater discretion to manage the DIF, including where to set the DRR. Among other things, Dodd-Frank: (1) raises the minimum DRR to 1.35 percent (from the former minimum of 1.15 percent) and removes the upper limit on the DRR (which was formerly capped at 1.5 percent) and consequently on the size of the fund;<sup>4</sup> (2) requires that the fund reserve ratio reach 1.35 percent by September 30, 2020 (rather than 1.15 percent by the end of 2016, as formerly required);<sup>5</sup> (3) requires the FDIC to offset the effect on institutions with total consolidated assets of less than \$10 billion of increasing the reserve ratio from 1.15 percent to 1.35 percent;<sup>6</sup> (4) eliminates the requirement that the FDIC provide dividends from the fund when the reserve ratio is between 1.35 percent and 1.5 percent;<sup>7</sup> and (5) continues the FDIC's authority to declare dividends when the reserve ratio is at least 1.5 percent, but grants the FDIC sole discretion in determining whether to suspend or limit the declaration or payment of dividends.<sup>8</sup>

The FDI Act continues to require that the Board consider the appropriate level for the DRR annually and, if changing the DRR, engage in notice-and-comment rulemaking before the beginning of the calendar year.<sup>9</sup>

In effect, Dodd-Frank provides the Board with broad discretion to set the DRR in consideration of specified factors and other factors that the Board determines are appropriate, so long as it is set no lower than 1.35 percent. Neither the FDI Act nor the amendments under Dodd-Frank establish a statutory role for the DRR as a trigger, whether for assessment rate determination, recapitalization of the fund, or dividends.

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<sup>4</sup> 12 U.S.C. § 1817(b)(3)(B).

<sup>5</sup> 12 U.S.C. § 1817(nt).

<sup>6</sup> 12 U.S.C. § 1817(nt). The Restoration Plan adopted by the Board on October 14, 2010, provides that the FDIC will pursue further rulemaking in 2011 regarding the method to implement the offset requirement. Staff, in pursuing this rulemaking, has analyzed several options and has concluded for a number of reasons (including the number of regulatory changes underway in the wake of the Dodd-Frank Act, uncertainty about future banking industry conditions, the state of the economy and the growth of the insurance fund), that it would be premature to issue a proposed rule this year. Consequently, staff recommends that the Board clarify by resolution that a notice of proposed rulemaking to implement the offset requirement will not be issued until after 2011. Because the reserve ratio is not projected to reach 1.15 percent for several years, the Board has flexibility in the timing of the rulemaking to implement the offset requirement. Staff will continue to consider both the appropriate approach to and timing of the offset rulemaking.

<sup>7</sup> 12 U.S.C. § 1817(e).

<sup>8</sup> 12 U.S.C. § 1817(e)(2)(B).

<sup>9</sup> 12 U.S.C. 1817(b)(3)(B).

*Comprehensive, long-range management plan for the DIF*

The October 2010 NPR proposed raising the DRR to 2 percent. After consideration of comments received, a final rule adopted by the Board in December 2010 set the DRR at 2 percent.

The October 2010 NPR also set out a comprehensive, long-range management plan for the DIF that was designed to: (1) reduce pro-cyclicality in the risk-based assessment system by allowing moderate, steady assessment rates throughout economic and credit cycles; and (2) maintain a positive fund balance even during a banking crisis by setting an appropriate target fund size and a strategy for assessment rates and dividends.<sup>10</sup>

During an economic and banking downturn, insured institutions can least afford to pay high deposit insurance assessment rates. Moreover, high assessment rates during a downturn reduce the amount that banks can lend when the economy most needs new lending. For these reasons, it is important to reduce pro-cyclicality in the assessment system and allow moderate, steady assessment rates throughout economic and credit cycles.<sup>11</sup>

It is also important that the fund not decline to a level that could risk undermining public confidence in federal deposit insurance. Furthermore, although the FDIC has significant authority to borrow from the Treasury to cover losses when the fund balance approaches zero, the FDIC has viewed the Treasury line of credit as available to cover unforeseen losses, not as a source of financing projected losses.

A 2 percent DRR is an integral part of the FDIC's comprehensive, long-range management plan for the DIF. A fund that is sufficiently large is a necessary precondition to maintaining a positive fund balance during a banking crisis and allowing for long-term, steady assessment rates.

In developing the long-range management plan, staff analyzed historical fund losses and income data from 1950 to 2010 to determine how high the reserve ratio would have to have been before the onset of the two banking crises that occurred during this period to maintain a positive fund balance and stable assessment rates. The analysis, which was detailed in the October 2010 NPR, concluded that moderate, long-term average industry assessment rates, combined with an appropriate dividend or assessment rate reduction policy, would have been sufficient to prevent the fund from becoming negative during the crises. Staff also found that the fund reserve ratio would have had to exceed 2 percent before the onset of the crises to achieve these results.

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<sup>10</sup> 75 FR 66262 (Oct. 27, 2010). Pursuant to the comprehensive plan, the FDIC also adopted a new Restoration Plan to ensure that the DIF reserve ratio reaches 1.35 percent by September 30, 2020, as required by Dodd-Frank. 75 FR 66293 (Oct. 27, 2010).

<sup>11</sup> At a September 24, 2010 roundtable organized by the FDIC, bank executives and industry trade group representatives uniformly favored steady, predictable assessments and found high assessment rates during crises objectionable. The proceedings of the roundtable can be viewed in their entirety at: [http://www.vodium.com/MediapodLibrary/index.asp?library=pn100472\\_fdic\\_RoundTable](http://www.vodium.com/MediapodLibrary/index.asp?library=pn100472_fdic_RoundTable).

Staff views the 2 percent DRR as the *minimum* level needed to withstand a future crisis of the magnitude of past crises. Because analysis shows that a reserve ratio higher than 2 percent increases the chance that the fund will remain positive during such a crisis, the 2 percent DRR should not be treated as a cap on the size of the fund.

The analysis set out in the October 2010 NPR sought to determine what assessment rates would have been needed to maintain a positive fund balance during the last two crises. This analysis used an assessment base derived from domestic deposits to calculate assessment income. Dodd-Frank, however, required the FDIC to change the assessment base to average consolidated total assets minus average tangible equity. In the December 2010 final rule establishing a 2 percent DRR, staff undertook additional analysis to determine how the results of the original analysis would change had the new assessment base been in place from 1950 to 2010. Both the analyses in the November 2010 NPR and the December 2010 final rule show that the fund reserve ratio would have needed to be approximately 2 percent or more before the onset of the crises to maintain both a positive fund balance and stable assessment rates.<sup>12</sup>

### **Analysis of Statutory Factors**

As discussed above, Dodd-Frank retains the requirement that the Board set and publish the DRR annually in accordance with its analysis of statutory factors.<sup>13</sup> The analysis that follows considers each statutory factor, including one "other factor": maintaining the DIF at a level that can withstand substantial losses, consistent with the FDIC's comprehensive, long-term fund management plan.

#### *Risk of losses to the DIF*

As banking industry performance has improved in recent quarters, so has the condition of the insurance fund. The DIF balance has increased for seven quarters in a row, following seven

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<sup>12</sup> 12 U.S.C. § 1817(nt). The updated analysis in the December 2010 final rule, like the analysis in the October 2010 NPR, assumed, in lieu of dividends, that the long-term industry average nominal assessment rate would be reduced by 25 percent when the reserve ratio reached 2 percent, and by 50 percent when the reserve ratio reached 2.5 percent. Eliminating dividends and reducing rates successfully limits rate volatility whichever assessment base is used.

<sup>13</sup> Specifically, in setting the DRR for any year, the Board must consider the following factors:

- (1) The risk of losses to the DIF in the current and future years, including historic experience and potential and estimated losses from insured depository institutions.
- (2) Economic conditions generally affecting insured depository institutions so as to allow the DRR to increase during more favorable economic conditions and to decrease during less favorable economic conditions, notwithstanding the increased risks of loss that may exist during such less favorable conditions, as the Board determines to be appropriate.
- (3) That sharp swings in assessment rates for insured depository institutions should be prevented.
- (4) Other factors as the FDIC's Board may deem appropriate, consistent with the requirements of the Reform Act.

12 U.S.C. 1817(b)(3)(B).

quarters of decline, and stood at \$7.8 billion on September 30. Cumulatively, the DIF balance has risen by almost \$29 billion from its negative \$20.9 billion low point at the end of 2009. The increase results primarily from assessment income and fewer anticipated bank failures.

Staff projects that the cost of failures for the five-year period from 2011 through 2015 will be \$19 billion, following estimated losses of \$79 billion for banks that failed in 2008, 2009, and 2010. 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. Beyond five years, the projections assume a low level of failures and associated losses.

In staff's view, high deposit insurance fund losses incurred during the crisis of the 1980s and early 1990s and during the more recent crisis suggest that the Board should set a DRR at a level that would have maintained a zero or greater fund balance during both crises. Adoption of this long-range, minimum goal would improve the DIF's ability to handle losses during any future periods of severe industry stress and reduce the possibility of increased deposit insurance assessment rates during a banking downturn.

#### *Economic conditions affecting FDIC-insured institutions*

U.S. economic growth during the first three quarters of 2011 was slower than most observers initially expected. Balance-sheet restructuring by households, financial institutions, and governments and ongoing credit distress in U.S. mortgage markets have slowed the recovery. The economy has shown signs of improvement as the adverse economic effects of the earthquake in Japan and higher oil prices have subsided, but weakness in labor and housing markets persists. In addition, continuing uncertainty about the resolution of European sovereign debt problems has hurt U.S. financial markets and business and consumer confidence. Further deterioration in global financial and economic conditions could place additional strain on the U.S. economy.

The economy will remain sensitive to external shocks, such as those that 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. These events led at that time to a new round of global financial market turmoil that contributed to weakening some key U.S. economic indicators. Even if another U.S. recession is avoided, it seems likely that 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, recent trends in banking industry performance have been generally positive. The third quarter of 2011 was the seventh consecutive quarter of aggregate positive net income. More than 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 seven 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 measured by the volume of noncurrent loans and leases, has improved for six consecutive quarters.

The total number of institutions on the FDIC's Problem Institution List fell to 844 at September 30, 2011 from 865 on June 30 and 888 on March 31. Prior to the second quarter decline in the number of problem institutions, there had not been a decline 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 74 banks failed from January through September of 2011, down from 127 for the same nine-month period in 2010. The total assets of failures from January through September 2011 – \$30 billion – were significantly less than the \$83 billion in total assets of failures in the first nine months of 2010.

Although near-term economic prospects can inform the Board's decision on the DRR, they become less relevant in setting the DRR when the DIF balance has only recently become positive. In this context, staff believes that the DRR should be viewed in a longer-term perspective. Twice within the past 30 years, serious economic dislocations have resulted in a significant deterioration in the condition of many insured depository institutions and in a consequent large number of insured depository institution failures at high costs to the DIF. In staff's view, the DRR should, therefore, be viewed as a minimum goal needed to achieve a reserve ratio that can withstand these periodic economic downturns and their attendant insured depository institution failures. Taking these longer-term economic realities into account, a prudent and consistent policy would set the DRR at a minimum of 2 percent, since that is the lowest level that would have prevented a negative fund balance at any time since 1950 without raising assessment rates during the crises.

#### *Preventing sharp swings in assessment rates*

Current law directs the Board to consider preventing sharp swings in assessment rates for insured depository institutions. Setting the DRR at 2 percent as a minimum goal rather than a final target would signal that the Board plans for the DIF to grow in good times so that funds are available to handle multiple bank failures in bad times. This plan would help prevent sharp fluctuations in deposit insurance premiums over the course of the business cycle. In particular, it would help reduce the risk of large rate increases during crises, when insured depository institutions can least afford an increase.

#### *Maintaining the DIF at a level that can withstand substantial losses*

As it did in 2010, staff recommends that the Board consider one additional factor when setting the DRR: viewing the DRR as a minimum goal that will allow the fund to grow sufficiently large in good times to increase the likelihood of the DIF remaining positive during bad times. This aim is consistent with the FDIC's comprehensive, long-term fund management

plan. Having adequate funds available when entering a financial crisis should reduce the likelihood that the fund will become negative or that the FDIC will need to increase assessment rates, levy special assessments on the industry or borrow from the U.S. Treasury.

*Balancing the statutory factors*

In staff's view, the best way to balance all of the statutory factors (including the additional factor identified above) is to maintain the DRR at 2 percent. Based on the staff analysis described above, staff continues to recommend viewing a 2 percent DRR as a long-range, *minimum* target.

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