



October 31, 2007

MEMORANDUM TO: The Board of Directors

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

SUBJECT: Designated Reserve Ratio for 2008

### Summary and Recommendation

The Federal Deposit Insurance Reform Act of 2005 (the Reform Act) eliminated the fixed designated reserve ratio (DRR) of 1.25 percent<sup>1</sup> and directed the FDIC's Board of Directors (Board) to set and publish annually a DRR for the Deposit Insurance Fund (DIF) within a range of 1.15 percent to 1.50 percent of estimated insured deposits.<sup>2</sup> In November of 2006, the Board approved a DRR of 1.25 percent for 2007. The staff recommends maintaining the DRR at 1.25 percent for 2008, and requests that the Board authorize the staff to publish the attached notice (to that effect) in the Federal Register.<sup>3</sup>

The FDIC must set the DRR in accordance with its analysis of statutorily prescribed factors: risk of losses to the DIF, economic conditions generally affecting insured institutions, preventing sharp swings in assessment rates, and other factors consistent with these three factors.<sup>4</sup> Staff has identified four "other factors" that the Board may choose to consider,

<sup>1</sup> Section 2104 of the Reform Act, Pub. L. No. 109-171, 120 Stat. 9 (codified at 12 U.S.C. 1817(b)(3)).

<sup>2</sup> 12 U.S.C. 1817(b)(3)(A) (i), (B).

<sup>3</sup> A change to the DRR would require rulemaking with notice and opportunity for comment. 12 U.S.C. 1817(b)(3)(A) (ii).

<sup>4</sup> The Reform Act provides:

(C) FACTORS- In designating a reserve ratio for any year, the Board of Directors shall--

- (i) take into account the risk of losses to the Deposit Insurance Fund in such year and future years, including historic experience and potential and estimated losses from insured depository institutions;
- (ii) take into account economic conditions generally affecting insured depository institutions so as to allow the designated reserve ratio 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 determined to be appropriate by the Board of Directors;

Concur: \_\_\_\_\_  
Sara A. Kelsey  
General Counsel

described below: (1) the new assessment system; (2) the normal operating range for the reserve ratio; (3) historical experience; and (4) preservation of flexibility to manage the fund. Staff's view is that the best way to balance all of the statutory factors is to maintain the DRR at 1.25 percent.

The statute does not specify a timeframe within which the reserve ratio should meet the DRR. It leaves determination of the timeframe to the Board. A reserve ratio above or below the DRR does not by itself require changes in assessment rates, nor does it affect the ability to use assessment credits or pay dividends from the DIF.

Staff continues to view the DRR as a signal of the level that the DIF should achieve over a timeframe determined by the Board. (However, how the Board decides to use the DRR may change over time.) Based on the assessment rate schedule in effect, the DIF is expected to reach the DRR in 2009.

## **Analysis of Statutory Factors**

### **1. Risk of Losses to the DIF**

In the first ten months of this year, three insured institutions failed – the first failures since June of 2004. Losses from failures this year and projected losses for the next two years are in line with average annual losses from failures in the past ten years, a period in which the fund suffered relatively low insurance losses. Staff does not anticipate insurance losses at a level that would prevent the reserve ratio from meeting the DRR in 2009. However, the economy and banking sector face a number of risks discussed below, which could result in losses to the DIF that are significantly higher than anticipated.

### **2. Economic Conditions Affecting FDIC-Insured Institutions**

U.S. economic growth is expected to slow over the remainder of 2007. The consensus forecast currently calls for 2.0 percent growth in real GDP for this year, well below both the economy's potential growth rate and the pace of the last three years. A sharp slowdown in residential construction activity, which is expected to continue through 2008, has been partly offset by a rebound in business investment and exports during the second quarter of 2007. However, the economy continues to face risks from troubles in the housing market, ongoing financial market turbulence and potentially weak prospects for consumer spending. A recent shift in monetary policy has been aimed at both restoring liquidity in short-term credit markets and offsetting potential adverse economic consequences of credit market turmoil. Although recession remains a possibility during 2008, most analysts expect that a strong global economy and lower U.S. interest rates will permit the U.S. expansion to continue at a slower pace.

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- (iii) seek to prevent sharp swings in the assessment rates for insured depository institutions; and
  - (iv) take into account such other factors as the Board of Directors may determine to be appropriate, consistent with the requirements of this subparagraph.

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

The condition of the banking industry remained strong through the first half of the year. Second quarter 2007 earnings were the fourth highest quarterly total on record, only 3.5 percent below the all-time high. At 1.21 percent, the return on assets for the industry also was high by historical standards. At present, nearly all institutions are “well capitalized” according to the standards for Prompt Corrective Action, and the industry’s leverage ratio remains above 8 percent. However, the outlook for banks and thrifts is not as favorable as in the recent past. Total noncurrent loans increased by \$6.4 billion during the second quarter of 2007, led by 1- to 4-family mortgages and construction and development (C&D) loans. In addition, some insured institutions may experience downward pressure on their earnings from slower asset growth, pressures on net interest margins, and financial market volatility.

### 3. Prevent Sharp Swings in Assessment Rates

The Reform Act directs the FDIC’s Board to consider preventing sharp swings in assessment rates for insured depository institutions. Strong insured deposit growth contributed to a decline in the reserve ratio from 1.31 percent at year-end 2004 to 1.20 percent as of March 31, 2007, although a slight decline in insured deposits caused the reserve ratio to move up to 1.21 percent in June. In the short term, the availability of assessment credits has limited the ability of assessment income to offset the downward pressure on the reserve ratio from overall strong insured deposit growth. The objective of having the reserve ratio reach the DRR in 2009 has allowed for a more moderate increase in assessment rates than would have been necessary to meet the DRR more quickly.

### 4. Other Factors

Staff has identified certain “other factors” that the Board may choose to consider in setting the DRR. In staff’s view, these factors favor maintaining the DRR at 1.25 percent.

#### *The new assessment system*

The assessment system has recently undergone several significant changes. These changes include: (a) adoption of new risk-based pricing methods and rates; (b) application of the one-time credits, which limit assessment revenue in the near term; and (c) the new flexibility to manage the reserve ratio within a range, rather than having to treat the reserve ratio as a hard target. Staff believes that it would be preferable to wait until these changes have had some time to take effect and be evaluated before considering potential future changes to the DRR.

#### *Midpoint of the normal operating range for the reserve ratio*

The Reform Act in effect establishes a normal operating range for the reserve ratio of 1.15 percent to 1.35 percent within which the Board has considerable discretion to manage the

size of the insurance fund.<sup>5</sup> The current DRR of 1.25 percent is the midpoint of the normal operating range and staff believes that, considering all the recent changes to the assessment system, it would be reasonable to leave the DRR at the middle of this range.

#### *Historical experience*

Historical experience with a DRR of 1.25 percent indicates that it has worked well under varying economic conditions in ensuring an adequate insurance fund and maintaining a sound deposit insurance system.

#### *Preserving flexibility to manage the DIF*

In setting the DRR, the Reform Act requires the Board to consider, among other factors, raising the DRR under more favorable economic conditions and lowering it under less favorable ones. The legislation also provides the Board with flexibility to manage the fund within a range, so that the Board, if it chooses, may respond to changing economic or industry conditions by leaving the DRR unchanged but adjusting the period of time during which the reserve ratio would remain below or above its target. Either alternative would be consistent with the Reform Act objective of enhancing the Board's ability to avoid having to increase assessments sharply at a time of significant stress on the economy and banking industry.

#### **Balancing the Statutory Factors**

In staff's view, the best way to balance all of the statutory factors (including the "other factors" identified above) is to maintain the DRR at 1.25 percent. Several factors that the Board must (or may) consider – preventing sharp swings in assessment rates, the recent changes to the assessment system, maintaining a DRR at the midpoint of the reserve ratio's normal operating range, the historical experience with a DRR of 1.25 percent, as well as the preservation of flexibility to manage the reserve ratio within a range – all support or are consistent with maintaining the current DRR of 1.25 percent.

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<sup>5</sup> The Reform Act authorizes the Board to set the DRR at no less than 1.15 percent and no greater than 1.50 percent. The FDIC must adopt a restoration plan when the reserve ratio falls below 1.15 percent, or is projected to fall below 1.15 percent within six months. When the reserve ratio exceeds 1.35 percent, the Reform Act generally requires the FDIC to begin to pay dividends. Because there is no requirement to achieve a specific reserve ratio within a given timeframe, these provisions in effect establish a normal operating range for the reserve ratio of 1.15 percent to 1.35 percent within which the Board has considerable discretion to manage the size of the insurance fund.