FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990 Division of Insurance and Research

April 4, 2011

MEMORANDUM TO: The Board of Directors

FROM: Arthur J. Murton Diane Ellis for
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 enables the FDIC to evaluate whether growth in the DIF is likely to be sufficient to meet the statutory requirements. This memorandum is the first semi-annual update for 2011.

Staff projects that current assessment rates will allow the DIF to become positive this year and to reach 1.15 percent of estimated insured deposits in 2018. Staff intends to present the Board with a proposal later this year 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]

Staff derived projections of the DIF reserve ratio from forecasts of various financial measures, which are subject to considerable uncertainty over a long-term horizon. These measures include not only forecasts of bank failures, but also assumptions about future changes in the risk profiles of insured depository institutions and growth in the assessment base, estimated insured deposits, and investment income.

Staff also projects that the DIF cash balance will be sufficient to meet obligations arising over the next five years from past and future institution failures.

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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] 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 also 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 conditions have been generally positive. The industry continued to recover throughout 2010, with four consecutive quarters of aggregate positive net income. In the fourth quarter of last year, 62 percent of institutions reported improvements in quarterly net income from one year earlier. The number of unprofitable institutions declined from year-earlier levels in each of the last five quarters through December 31, 2010. Improving credit performance, leading to lower loan loss provisions, has been primarily responsible for

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[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), 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 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. The FDIC will separately determine the method for reaching 1.35 percent and the manner of the offset through further rulemaking later this year.

most of the year-over-year improvement in earnings. Asset quality, as measured by noncurrent loans and leases, has improved for three consecutive quarters.

The total number of institutions on the FDIC's Problem Institution List rose to 884 at year-end 2010 from 860 in the third quarter and 702 at year-end 2009. However, the rate of increase in the number of problem banks has declined in each of the last four quarters. The slowdown in the increase in the number of problem institutions reflects a decline during 2010 in the rate of supervisory rating downgrades from CAMELS ratings of 1 or 2 to CAMELS ratings of 3, 4, or 5.

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. The number of bank failures has fallen in each of the last three quarters. A total of 157 institutions failed in 2010, up from 140 in 2009. However, the total asset size of 2010 failures – $92 billion – was significantly less than the $170 billion in total assets of 2009 bank failures.

Following seven quarters of decline, the DIF balance has increased for four consecutive quarters. The DIF balance stood at negative $7.4 billion at year-end 2010, up from negative $8.0 billion in the prior quarter and negative $20.9 billion at the end of 2009. The increase stems primarily from assessment income and an improving outlook for bank failures.

PROJECTIONS

Staff has updated its projections for the DIF balance and reserve ratio over the next several years based on the most recently available information about institutions expected to fail in the near term and on analyses of trends in CAMELS ratings, failure rates, and loss rates. The projected cost of failures for the five-year period from 2011 through 2015 is $21 billion, following estimated losses of $24 billion for banks that failed in 2010. Losses from failures occurring over the five-year period from 2010 through 2014 are approximately $7 billion lower than the $52 billion projection provided to the Board last October.[7] Staff's projections of both the pace of institution downgrades to CAMELS 3, 4, and 5 ratings, and the rates at which these institutions fail this year and in the next few years, are lower than in the October 2010 projections. Beyond five years, the projections assume a low level of failures and associated losses.

Staff projects that the DIF balance will continue to recover and turn positive this year. The DIF is projected to earn approximately $13 billion in assessment income this year.

Under staff's projections, the reserve ratio should reach 1.15 percent in 2018, within the time frame of the Restoration Plan and the deadline set by Dodd-Frank. The projections incorporate the new assessment base (required by Dodd-Frank) and the assessment rate schedule

[7] Memorandum to the Board of Directors from Arthur J. Murton (Director, Division of Insurance and Research) and Bret D. Edwards (Director, Division of Finance) dated October 14, 2010.

adopted by the Board on February 7, 2011, which became effective April 1, 2011. Staff estimates that revenue under the new assessment base and rate schedule will be approximately the same as revenue that would otherwise have been earned under the previous assessment base and rates.[8]

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, effective December 31, 2010. 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 receiverships, should be sufficient to meet all obligations arising from past or future institution failures during the next five years.[9]

As noted above, staff's projections are subject to considerable uncertainty. Bank failures could be higher than projected, and recoveries from the assets of banks already closed could be lower than projected, if, for example, the economic recovery stalls as a result of prolonged sharp increases in oil and other commodity prices. Furthermore, future assessment revenue and estimated insured deposits could diverge from staff's projections depending on how banks adapt to the assessment rules recently adopted. 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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[8] Assessments, Large Bank Pricing, 75 FR 10672 (February 25, 2011).

[9] 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 billion in projected 2011 assessment revenue through the prepaid assessment, the revenue will not commensurately increase the DIF's liquidity.