Federal Deposit Insurance Corporation
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April 7, 2015

MEMORANDUM TO: The Board of Directors

FROM: Diane Ellis
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) 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 2015.

The DIF balance has risen for the past five years and stood at $62.8 billion as of December 31, 2014, resulting in a reserve ratio of 1.01 percent. Staff projects that, under the current assessment rate schedule, the DIF reserve ratio will reach 1.15 percent in late 2016 or the first half of 2017. 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 effectively 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 intends to present a proposed rule to the Board later this year to implement this requirement.

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

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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); 12C.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.)

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.

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, which raised the minimum designated reserve ratio from 1.15 percent to 1.35 percent.[5] Dodd-Frank also extended the allowable period of time to reach the new, higher minimum from the end of 2016 to September 30, 2020. Accordingly, the FDIC extended the period covered by the Restoration Plan to conform to Dodd-Frank.

Recent trends affecting the DIF

Banking industry performance has continued to improve. In the fourth quarter of 2014, more than three-fifths of all banks (61 percent) reported improvement in quarterly net income from one year earlier. Only 9 percent of banks were unprofitable, down from 13 percent in fourth quarter 2013. While fourth quarter earnings were lower than year-earlier levels due primarily to increased litigation expenses for a few large institutions and a decline in mortgage related noninterest income, both net interest income and net operating revenue were higher compared to one year earlier. Asset quality, as measured by the volume of noncurrent loans and leases, has improved for 19 consecutive quarters. At December 31, 2014, 1.96 percent of all loan and lease balances were noncurrent, the first time that the rate has been below 2 percent since the first quarter of 2008.

The total number of institutions on the FDIC's Problem Institution List fell to 291 as of December 31, 2014, from 467 at the end of 2013. 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 year-end 2008. The improvement in the number of problem institutions reflects a continuing trend of supervisory rating upgrades exceeding downgrades. Eighteen banks failed during 2014, the smallest number of bank failures since 2007.

However, challenges still remain for the industry. Revenue growth remains weak, reflecting narrow margins and a reduction in mortgage related noninterest income. The average

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[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 (October 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 (March 4, 2009) and 74 Fed. Reg. 51062 (October 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).

net interest margin fell to 3.12 percent for the fourth quarter of 2014, its lowest level since the third quarter of 1989. The prolonged low interest rate environment has created incentives for institutions to boost yield by increasing the share of longer-term assets on their balance sheets, which has left banks more vulnerable to interest rate risk when rates rise.

Economic growth picked up in 2014. The U.S. economy ended the year with the strongest annual gain in four years. During 2014, the unemployment rate declined to the lowest rate since mid-2008, the housing sector improved modestly, consumer spending rose moderately, and business investment grew. Further expansion of the U.S. economy should enable continued gradual improvement of the condition of FDIC-insured depository institutions.

The insurance fund has continued to grow in tandem with the improvement in U.S. banking industry performance. The DIF balance stood at $62.8 billion at December 31, 2014, up from $54.3 billion at September 30, 2014 and $47.2 billion at the end of 2013. The $8.5 billion increase in the fourth quarter of 2014 was driven primarily by a reduction in estimated losses from prior bank failures, primarily reflected in lower losses from shared-loss agreements. Many shared-loss agreements with acquirers of failed banks expired in late 2014, and total payments under these agreements were less than estimated. Future shared-loss payments on remaining agreements are also expected to be lower than previously estimated based on the FDIC's recent experience and generally improving market conditions. Cumulatively, the DIF balance has risen by almost $84 billion from its negative $21 billion low point at the end of 2009. At December 31, 2014, the contingent loss reserve for anticipated failures was $1.8 billion, up from $1.2 billion at December 31, 2013.

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 2014 through 2018 would cost approximately $4 billion.[6] The current projected total cost of failures for the same five years is now approximately $3 billion. For the new five-year projection period beginning in 2015 and ending in 2019, staff projects that losses from failures will also total about $3 billion. The losses projected for these five years follow estimated losses of $75 billion for banks that failed from 2008 through 2014. 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 next few years.

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[6] Memorandum to the Board of Directors from Diane Ellis (Director, Division of Insurance and Research) dated October 2, 2014 (https://www.fdic.gov/news/board/2014/2014-10-21_notice_dis_b_mem.pdf).

The DIF earned assessment income of $8.7 billion in 2014. Measures of financial performance and condition along with supervisory ratings determine a bank's risk-based premium rate. DIF assessment revenue projections assume that the industry average risk-based premium rate will decline gradually over the next couple of years as the banking industry continues to strengthen.

The reserve ratio stood at 1.01 percent at December 31, 2014, up from 0.79 percent at the end of 2013. Under the current assessment rate schedule, staff projects that the reserve ratio should reach 1.15 percent in late 2016 or the first half of 2017. Last fall, staff projected that the reserve ratio would not reach 1.15 percent until 2019. The earlier projected date at which the reserve ratio reaches 1.15 percent results primarily from the reduction in estimated losses associated with past failures.

DIF cash balance

The DIF had liquid assets of $52.3 billion at December 31, 2014. 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

Projections for the DIF are subject to uncertainty arising from the economic and banking industry outlook. Narrow interest margins, lower mortgage-related income, and exposure to interest rate risk continue to challenge the industry. Additionally, a number of risks continue to weigh on the economic outlook, including the potential effects of monetary policy normalization and diverging policies of major central banks, longer-term fiscal challenges, global economic risks, and sharply lower oil prices. A slowdown in the U.S. economic recovery 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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