



August 31, 2016

MEMORANDUM TO: The Board of Directors

FROM: Diane Ellis *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 requires 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 second semiannual update for 2016.

The DIF balance has risen for the past 6½ years and stood at \$77.9 billion as of June 30, 2016, resulting in a reserve ratio of 1.17 percent. Because the reserve ratio has now surpassed 1.15 percent, lower regular assessment rates will go into effect under final rules approved by the Board of Directors (Board) in 2011 and in April of this year.³ As a result of the lower rates, staff projects that revenue from regular assessments will decline by about one-third. Dodd-Frank 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 To implement this requirement, the Board approved a final rule in March 2016 that imposes on large banks a surcharge of 4.5

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); 12 C.F.R. 327.10(b); 81 Fed. Reg. 32,180, 32,202 (May 20, 2016).

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.)

basis points of their assessment base, after making certain adjustments.⁵ Large banks will be subject to quarterly surcharges in addition to their lower regular risk-based assessments beginning in the third quarter of 2016. Staff projects that the reserve ratio will reach the 1.35 percent minimum target in 2018, after which surcharges will cease.

The outlook for the DIF reserve ratio depends on forecasts and assumptions for several financial measures, including: (1) losses from past and future bank failures; (2) changes in bank risk profiles, which affect assessment rates; (3) growth in the assessment base; (4) DIF investment income; (5) operating expenses; and (6) growth in estimated insured deposits. All of these forecasts and assumptions are subject to considerable uncertainty.

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, including the higher minimum designated reserve ratio and the extension of time to reach it from the end of 2016 to September 30, 2020.⁶

Recent trends affecting the DIF

The U.S. economy has grown slowly over the seven years since the financial crisis. In 2015, real GDP grew 2.4 percent. The Blue Chip consensus forecast for economic growth is 1.5 percent for 2016, reflecting recent mixed economic indicators. Weak business investment and slow inventory growth suggest that businesses are being cautious in light of poor prospects for growth worldwide. Unemployment has continued to decline in 2016, but the pace of decline has slowed. Inflation has been subdued due to low oil prices and a strong dollar.

Banking industry performance generally has been positive. The second quarter of 2016 marked the 25th time in the past 28 quarters in which earnings posted a year-over-year increase. In the second quarter of 2016, 60 percent of all banks reported improvement in quarterly net income from one year earlier. Only 4.5 percent of banks were unprofitable, down from 5.8 percent in the second quarter of 2015. Second quarter earnings were higher than a year earlier

⁵ 81 Fed. Reg. 16059 (Mar. 25, 2016); 12 C.F.R. 327.11(a). Generally, large banks are those with assets of \$10 billion or more. The assessment base for the surcharge will be a large bank's regular assessment base reduced by \$10 billion (and subject to adjustment for affiliated banks).

⁶ 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 (Oct. 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 (Mar. 4, 2009) and 74 Fed. Reg. 51062 (Oct. 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).

due to a rise in net interest income and noninterest income. Asset quality, as measured by the volume of noncurrent loans and leases, improved in the second quarter, following a slight deterioration in the previous quarter. At June 30, 2016, 1.50 percent of loan and lease balances were noncurrent, the lowest percentage since the end of 2007.

However, the operating environment remains challenging for banks. Interest rates have been exceptionally low for an extended period, and there are signs of growing credit risk. Revenue growth has been modest and margins continue to narrow despite banks' investments in longer-term assets to mitigate the effect of low rates. The average quarterly net interest margin for the industry has trended down by 68 basis points since the second quarter of 2010 and was 3.08 percent for the second quarter of 2016.

The total number of institutions on the FDIC's Problem Institution List fell to 147 as of June 30, 2016, down from 183 at the end of 2015. 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 the second quarter of 2008. The improvement in the number of problem institutions reflects a continuing trend of supervisory rating upgrades exceeding downgrades. The number of bank failures also continues to decline. Four banks have failed from January through August of this year compared to six over the same period last year.

The DIF has continued to grow in tandem with the improvement in U.S. banking industry performance. The DIF balance stood at \$77.9 billion at June 30, 2016, up from \$72.6 billion at the end of 2015 and \$67.6 billion at June 30, 2015. Assessment income has been responsible for most of the \$10.3 billion increase in the DIF balance over the past four quarters. Cumulatively, the DIF balance has risen by \$98.8 billion from its negative \$20.9 billion low point at the end of 2009. At June 30, 2016, the contingent loss reserve for anticipated failures was \$437 million, down from \$684 million at June 30, 2015.

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 2016 through 2020 would cost approximately \$1 billion.⁷ The current projected total cost of failures for the same five years remains approximately the same. The losses projected for these five years follow estimated losses of \$73 billion for banks that failed from 2008 through 2015. Staff

⁷ Memorandum to the Board of Directors from Diane Ellis (Director, Division of Insurance and Research) dated February 29, 2016 (https://www.fdic.gov/news/board/2016/2016-03-15_notice_dis_a_mem.pdf).

expects that failure rates of troubled banks will remain at low levels and the number of troubled banks to continue gradually declining in the near term.

The DIF earned assessment income of \$4.7 billion in the first half of 2016. For all of 2016, staff projects approximately \$10 billion in assessment income. While regular assessments are estimated to decline in total by about one third under the lower rate schedule, quarterly surcharges on banks with \$10 billion or more in assets will offset this decline.

The reserve ratio stood at 1.17 percent at June 30, 2016, up from 1.11 percent at the end of 2015 and 1.06 percent at June 30, 2015. Staff projects that surcharges will total approximately \$10 billion and, combined with regular assessments, will raise the reserve ratio to 1.35 percent in 2018. Once the reserve ratio first reaches or exceeds 1.35 percent, quarterly surcharges on large banks will cease. While staff projects the surcharges to last eight quarters, in the event that the reserve ratio does not reach 1.35 percent by the end of 2018, the March 2016 final rule requires large banks to pay a shortfall assessment in early 2019 to cover the gap.

Additionally, small banks will receive credits to offset the portion of their regular assessments that help to raise the reserve ratio from 1.15 percent to 1.35 percent. Provided the reserve ratio is at least 1.38 percent, the FDIC will automatically apply credits to reduce each small bank's regular assessment up to the entire amount of its assessment. Staff estimates that small banks will be awarded approximately \$1 billion in total credits.

DIF cash balance

The DIF had liquid assets of \$70.5 billion at June 30, 2016. 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

Key risks to the U.S. economic outlook include the effect of possible increases in interest rates on economic growth; fiscal challenges at federal, state, and local levels; and a slowing of growth in several advanced and emerging market economies. Weak productivity growth and an aging population also temper longer-term growth prospects. A slowdown in the U.S. economy 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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