



March 3, 2017

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 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 first semiannual update for 2017.

The DIF balance has risen for the past 7 years and stood at \$83.2 billion as of December 31, 2016, resulting in a reserve ratio of 1.20 percent. Because the reserve ratio surpassed 1.15 percent in the second quarter of last year, lower regular assessment rates went into effect beginning in the third quarter under final rules approved by the Board of Directors (Board) in 2011 and reaffirmed in 2016.³ As a result of the lower rates, revenue from regular assessments declined by about one-third. Large banks, however, became subject to temporary assessment surcharges beginning in the third quarter of last year. These surcharges were imposed to implement the Dodd-Frank requirement 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 projects that

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 See 12 C.F.R. 327.10(b); see also 76 Fed. Reg. 10672, 10718 (Feb. 25, 2011) and 81 Fed. Reg. 32180, 32202 (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.)

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, 2020.⁵

Recent trends affecting the DIF

The U.S. economy has expanded for nearly eight years at a modest pace of about 2 percent annually, on average. In 2016, real GDP slowed to 1.6 percent, reflecting the effects of a strong dollar and low oil prices on exports and investment. The Blue Chip consensus forecast for economic growth is 2.3 percent for 2017 and 2.4 percent for 2018.

Banking industry performance generally has been positive. The fourth quarter of 2016 marked the third consecutive quarter where earnings posted a year-over-year increase. In the fourth quarter of 2016, 59 percent of banks reported improvement in quarterly net income from one year earlier. Only 8.1 percent of banks were unprofitable, down from 9.6 percent in the fourth quarter of 2015. Fourth quarter earnings were higher than a year earlier on the strength of higher net interest income. Asset quality, as measured by the volume of noncurrent loans and leases, improved in the fourth quarter. At December 31, 2016, 1.4 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 through concentrations and looser underwriting. Revenue growth has been modest and net interest

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 (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).

margins remain narrow relative to historical levels despite banks' investments in longer-term assets to mitigate the effect of low rates. The average quarterly net interest margin for the industry has declined by 55 basis points since the fourth quarter of 2010, to 3.16 percent in the fourth quarter of 2016.

The total number of institutions on the FDIC's Problem Institution List fell to 123 as of December 31, 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. Five banks failed in 2016, compared to eight failures in 2015.

The DIF has continued to grow in tandem with the improvement in U.S. banking industry performance. The DIF balance stood at \$83.2 billion at December 31, 2016, up from \$72.6 billion at the end of 2015. Assessment income accounted for most of the \$10.6 billion increase in the DIF balance during 2016. Cumulatively, the DIF balance has risen by over \$104 billion from its negative \$20.9 billion low point at the end of 2009. At December 31, 2016, the contingent loss reserve for anticipated failures was \$477 million, compared to \$395 million at December 31, 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.⁶ The current projection for the same five years is essentially unchanged. For the new five-year projection period beginning in 2017 and ending in 2021, staff projects that losses from failures will also total approximately \$1 billion. The losses projected for these five years follow estimated losses of over \$72 billion for banks that failed from 2008 through 2016. Staff expects that failure rates of troubled banks will remain at low levels and that the number of troubled banks will continue to decline gradually in the near term.

The DIF earned assessment income of \$10 billion in 2016, up from \$8.8 billion in 2015. While income from regular assessments declined to \$7.6 billion in 2016 due largely to the lower regular assessment rates starting in the third quarter, surcharges of \$2.4 billion on banks with \$10

⁶ Memorandum to the Board of Directors from Diane Ellis (Director, Division of Insurance and Research) dated August 31, 2016 (https://www.fdic.gov/news/board/2016/2016-09-20_notice_dis_a_mem.pdf).

billion or more in assets offset the decline in regular assessments. Staff projects that revenue from regular assessments and surcharges will total approximately \$11 billion in 2017.

The reserve ratio stood at 1.20 percent at December 31, 2016, up from 1.17 percent at the end of June, and 1.11 percent at the end of 2015. Staff projects that surcharges, combined with regular assessments, will be sufficient to 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. In the event that the reserve ratio does not reach the 1.35 percent minimum target by the end of 2018, large banks will be required to pay a shortfall assessment in early 2019 to cover the gap.⁷

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.⁸

DIF cash balance

The DIF had liquid assets of \$75.3 billion at December 31, 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

The economic outlook is subject to considerable uncertainty, including the effects on economic growth of interest rate increases, potential changes in fiscal and trade policies, and possible further dollar appreciation. In the event of an economic slowdown, bank failures could rise above projections. 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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⁷ See 12 C.F.R. 327.11(b); see also 81 Fed. Reg. at 16070.

⁸ See 12 C.F.R. 327.11(c); see also 81 Fed. Reg. at 16071.