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

March 6, 2018

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 2018.

The DIF balance has risen for the past 8 years and stood at $92.7 billion as of December 31, 2017, resulting in a reserve ratio of 1.30 percent. Because the reserve ratio surpassed 1.15 percent in the second quarter of 2016, lower regular assessment rates went into effect beginning in the third quarter of 2016 under final rules approved by the Board of Directors (Board) in 2011 and reaffirmed in 2016.[3] Large banks, however, became subject to temporary assessment surcharges beginning in the third quarter of 2016. These surcharges were imposed to implement the statutory 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 the reserve

---

[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.)

ratio will reach the 1.35 percent minimum target in 2018, most likely in the second half of the year. After the reserve ratio reaches 1.35 percent, the 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 and unrealized gains and losses on investments; (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 grew in real terms by 2.3 percent in 2017, slightly above the post-recession trend, as headwinds from a strong dollar and low energy prices abated. Economic growth was broad based in 2017, supported by strong labor and housing markets, and high levels of business and consumer confidence. Business fixed investment increased, with capital expenditures aided by an improvement in the energy market. Additionally, stronger global economic growth and a weaker dollar supported exports. Forecasters expect these positive trends to continue in 2018. The Blue Chip consensus forecast is for real GDP growth to strengthen to 2.8 percent in 2018.

Banking industry performance generally has been positive. One-time charges arising from the new tax law were primarily responsible for the decline in fourth quarter 2017 net income from the fourth quarter of 2016. Fourth quarter net operating revenue (net interest income plus noninterest income), however, was higher than a year earlier due to higher net interest income. Asset quality, as measured by the volume of noncurrent loans and leases, improved in the fourth quarter. At year-end 2017, 1.2 percent of loan and lease balances were noncurrent, the lowest percentage since third quarter 2007.

[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).

While bank performance continues to be positive, the operating environment remains challenging for banks. There is evidence of growing credit risk from loan concentrations and looser underwriting. Revenue growth has been modest, and net interest margins remain narrow. The industry average quarterly net interest margin of 3.31 percent in the fourth quarter of 2017, although 15 basis points higher than the fourth quarter 2016, remains lower than pre-crisis levels.

The total number of institutions on the FDIC's Problem Bank List fell to 95 as of year-end 2017, down from 123 at the year-end 2016. The number of problem banks has declined in every quarter since peaking in March 2011 at 888 and is now at its lowest level since first quarter 2008. Eight banks failed last year, marking the third year in a row in which the number of failures remained in single digits.

The DIF has continued to grow in tandem with the improvement in U.S. banking industry performance. The DIF balance stood at $92.7 billion at December 31, up from $83.2 billion at the end of 2016. Assessment income of $10.6 billion accounted for most of the increase in the DIF balance in 2017. Cumulatively, the DIF balance has risen by $113.6 billion from its negative $20.9 billion low point at the end of 2009.

PROJECTIONS

DIF balance and reserve ratio

Staff projects that failures this year and next year will remain at low levels and cost the DIF approximately $500 million. The projections are based on available information about troubled banks and on trends in CAMELS ratings, failure rates, and loss rates. The losses estimated for 2018 and 2019 follow estimated DIF losses of nearly $73 billion for banks that failed from 2008 through 2017. Staff also expects that the number of troubled banks will continue to decline modestly this year.

The DIF earned assessment income of $10.6 billion in 2017, up from $10.0 billion in 2016. Assessment income includes surcharges on banks with $10 billion or more in assets, which accounted for $4.9 billion in 2017 and $2.4 billion in 2016. Staff estimates that assessment revenue will range between $9 and $11 billion in 2018. The amount of assessment income will depend on the quarter in which the reserve ratio reaches 1.35 percent, which will mark the last quarter for which surcharges are assessed.

The reserve ratio stood at 1.30 percent at December 31, 2017, up from 1.20 percent at the end of 2016. Staff projects that surcharges, combined with regular assessments, will be sufficient to raise the reserve ratio to 1.35 percent this year, most likely in the second half of the year – two years ahead of the September 30, 2020 statutory deadline. In the event that the reserve ratio does not reach the 1.35 percent minimum target by the end of this year, large banks will be required to pay a shortfall assessment early in 2019 to cover the gap.[6]

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.[7]

DIF cash balance

The DIF had liquid assets of $85.6 billion at December 31, 2017. 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 this year.

Risks to the outlook for the DIF

Key risks to the economic outlook include potential effects of rising interest rates on economic growth and asset values, and adverse global developments. 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.

<u>Staff contact</u>:

Robert Grohal
Chief, Fund Analysis and Pricing Section, Division of Insurance and Research
(202) 898-6939

[6] See 12 C.F.R. 327.11(b); see also 81 Fed. Reg. at 16070.

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