Federal Deposit Insurance Corporation
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December 12, 2019

MEMORANDUM TO: The Board of Directors

FROM: Diane Ellis
Director
Division of Insurance and Research

SUBJECT: Designated Reserve Ratio for 2020

Summary and Recommendation

The Federal Deposit Insurance Act (FDI Act) requires that the FDIC Board of Directors (Board) designate a reserve ratio for the Deposit Insurance Fund (DIF or fund) and publish the designated reserve ratio, or DRR, before the beginning of each calendar year.[1] On December 18, 2018, the Board approved for publication a notice setting the DRR at 2 percent for 2019.[2] Staff recommends maintaining the DRR at 2 percent for 2020 and requests that the Board authorize publication of the attached notice to that effect in the Federal Register.

The Board must set the DRR in accordance with its analysis of certain statutory factors: risk of losses to the DIF; economic conditions generally affecting insured depository institutions; preventing sharp swings in assessment rates; and any other factors that the Board determines to be appropriate.[3] Staff has identified one "other factor" for the Board's consideration: viewing the DRR as a minimum goal that will allow the fund to grow sufficiently large in good times to increase the likelihood of the DIF remaining positive during bad times, consistent with the FDIC's comprehensive, long-term fund management plan.

The manner in which the Board evaluates the statutory factors may depend on its view of the role of the DRR. Governing statutes do not direct the Board on how to use the DRR. Based on current circumstances and historical analysis, staff continues to view the DRR as a long-

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[1] 12 U.S.C. § 1817(b)(3)(A).

[2] 84 Fed. Reg. 21716 (Jan. 31, 2019). The DRR is expressed as a percentage of estimated insured deposits. The DRR was first set at 2 percent for 2011 in a final rule approved by the Board on December 14, 2010. See 75 Fed. Reg. 79286 (Dec. 20, 2010), codified at 12 C.F.R. § 327.4(g). The Board has set the DRR at 2 percent for every year since 2011.

[3] 12 U.S.C. § 1817(b)(3)(C).

Concur:

Nicholas J. Podsiadly
General Counsel

range, minimum target for the reserve ratio, consistent with the comprehensive, long-range fund management plan contained in the October 2010 proposed rulemaking to raise the DRR to 2 percent (October 2010 NPR).[4]

Background

Governing statutes

Under the FDI Act, the FDIC has broad discretion to manage the DIF, including at what level to set the DRR. The required minimum DRR is 1.35 percent, but there is no upper limit on the DRR (and, thus, no statutory limit on the size of the fund).[5] The FDI Act provides for dividends from the fund when the reserve ratio exceeds 1.5 percent, but grants the FDIC sole discretion in determining whether to suspend or limit the declaration or payment of dividends.[6]

The FDI Act also requires that the Board consider the appropriate level for the DRR annually and, if the Board is changing the DRR, to engage in notice-and-comment rulemaking and publish the new DRR before the beginning of the calendar year.[7]

While the FDI Act requires that the Board consider specific factors and other factors that the Board determines are appropriate, it grants the Board broad discretion to set the DRR, so long as it is set no lower than 1.35 percent. The FDI Act does not establish a statutory role for the DRR as a trigger, whether for assessment rate determinations, recapitalization of the fund, or dividends.

Comprehensive, long-range management plan for the DIF

In the October 2010 NPR that was finalized in separate rulemakings in December 2010 and February 2011, the FDIC set out a comprehensive, long-range management plan for the DIF that was designed: (1) to reduce pro-cyclicality in the risk-based assessment system by allowing moderate, steady assessment rates throughout economic and credit cycles; and (2) to maintain a positive fund balance even during a banking crisis by setting an appropriate target fund size and a strategy for assessment rates and dividends.[8] The October 2010 NPR proposed setting the DRR

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[4] 75 Fed. Reg. 66272 (Oct. 27, 2010).

[5] 12 U.S.C. § 1817(b)(3)(B).

[6] 12 U.S.C. § 1817(e)(2)(B). Among other things, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) required that the fund reserve ratio reach 1.35 percent by September 30, 2020 (rather than 1.15 percent by the end of 2016, as formerly required) and that the FDIC offset the effect of increasing the reserve ratio from 1.15 percent to 1.35 percent on institutions with less than $10 billion in total consolidated assets. *See* Pub. L. No. 111-203, § 334(d) and (e), 124 Stat. 1376, 1539 (2010); 12 U.S.C. § 1817(nt). The FDIC issued a final rule implementing these requirements in March 2016. *See* 81 Fed. Reg. 16059 (Mar. 25, 2016).

[7] 12 U.S.C. § 1817(b)(3)(A).

[8] *See* 75 Fed. Reg. at 66272 (Oct. 27, 2010), describing the long-term plan; 75 Fed. Reg. 79286 (December 20, 2010), finalizing the designated reserve ratio; and 76 Fed. Reg. 10674 (February 25, 2011), finalizing components of the long-term plan related to dividends and assessment rates.

at 2 percent. After consideration of comments received, a final rule adopted by the Board in December 2010 set the DRR at 2 percent.[9] The Board has voted annually since then to maintain the 2 percent DRR.

During an economic and banking downturn, insured depository institutions can least afford to pay high deposit insurance assessment rates.[10] Moreover, high assessment rates during a downturn reduce the amount that banks can lend when the economy most needs new lending. For these reasons, it is important to reduce pro-cyclicality in the assessment system and allow moderate, steady assessment rates throughout economic and credit cycles.[11]

It is also important that the fund not decline to a level that could risk undermining public confidence in federal deposit insurance. Although the FDIC has significant authority to borrow from the Treasury to cover losses, the FDIC has viewed the Treasury line of credit as appropriate for covering unforeseen losses, not as a source of financing projected losses.

A 2 percent DRR is an integral part of the FDIC's comprehensive, long-range management plan for the DIF. A fund that is sufficiently large is a necessary precondition to maintaining a positive fund balance during a banking crisis and allowing for long-term, steady assessment rates.

In developing the long-range management plan, staff analyzed historical fund losses and income data from 1950 to 2010 to determine how high the reserve ratio would have had to have been before the onset of the two banking crises that occurred during this period to maintain a positive fund balance and stable assessment rates. The analysis, which was detailed in the October 2010 NPR, concluded that moderate, long-term average industry assessment rates, combined with an appropriate dividend or assessment rate reduction policy, would have been sufficient to prevent the fund from becoming negative during the crises. Staff also found that the fund reserve ratio would have had to exceed 2 percent before the onset of the last two crises to achieve these results.[12]

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[9] 75 Fed. Reg. 79286 (Dec. 20, 2010).

[10] As used in this memorandum, the term "bank" is synonymous with the term "insured depository institution" as it is used in section 3(c)(2) of the FDI Act, 12 U.S.C. 1813(c)(2).

[11] At a September 24, 2010, roundtable organized by the FDIC, bank executives and industry trade group representatives uniformly favored steady, predictable assessments and found high assessment rates during crises objectionable. The proceedings of the roundtable can be viewed in their entirety at: http://www.vodium.com/MediapodLibrary/index.asp?library=pn100472_fdic_RoundTable.

[12] The analysis set out in the October 2010 NPR sought to determine what assessment rates would have been needed to maintain a positive fund balance during the last two crises. This analysis used an assessment base derived from domestic deposits to calculate assessment income. The Dodd-Frank Act, however, required the FDIC to change the assessment base to average consolidated total assets minus average tangible equity. In the December 2010 final rule establishing a 2 percent DRR, staff undertook additional analysis to determine how the results of the original analysis would change had the new assessment base been in place from 1950 to 2010. Both the analyses in the October 2010 NPR and the December 2010 final rule show that the fund reserve ratio would have needed to be approximately 2 percent or more before the onset of the crises to maintain both a positive fund balance and stable

Staff views the 2 percent DRR as the minimum level needed to withstand a future banking crisis of the magnitude of past crises. Because analysis shows that a reserve ratio higher than 2 percent increases the chance that the fund will remain positive during such a crisis, the 2 percent DRR should not be treated as a cap on the size of the fund.

Analysis of Statutory Factors

As discussed above, the FDI Act requires that the Board set and publish the DRR annually in accordance with its analysis of statutory factors.[13] The analysis that follows considers each statutory factor, including one "other factor": maintaining the DIF at a level that can withstand substantial losses and allowing it to grow sufficiently large in good times to increase the likelihood of the DIF remaining positive during bad times, consistent with the FDIC's comprehensive, long-range fund management plan.

Risk of losses to the DIF

The DIF balance has risen for almost 10 years and stood at $108.9 billion as of September 30, 2019, up from $100.2 billion at September 30, 2018. Cumulatively, the DIF balance has risen by nearly $130 billion from its negative $21 billion low point at the end of 2009. Primary factors contributing to the cumulative increase in the fund balance since 2009 include assessment income and a reduction in estimated losses associated with past and anticipated failures. At September 30, 2019, the contingent loss reserve for anticipated failures was $108 million, up from $106 million at September 30, 2018.

The DIF has continued to grow in tandem with improvements in U.S. banking industry performance. Third quarter net operating revenue was higher than a year earlier due to higher net interest income and noninterest income. Asset quality, as measured by the volume of

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assessment rates. The updated analysis in the December 2010 final rule, like the analysis in the October 2010 NPR, assumed, in lieu of dividends, that the long-term industry average nominal assessment rate would be reduced by 25 percent when the reserve ratio reached 2 percent, and by 50 percent when the reserve ratio reached 2.5 percent. Eliminating dividends and reducing rates successfully limits rate volatility whichever assessment base is used. See 75 Fed. Reg. at 79288.

[13] Specifically, in setting the DRR for any year, the Board must consider the following factors:

> (1) The risk of losses to the DIF in the current and future years, including historic experience and potential and estimated losses from insured depository institutions.
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> (2) Economic conditions generally affecting insured depository institutions so as to allow the DRR to increase during more favorable economic conditions and to decrease during less favorable economic conditions, notwithstanding the increased risks of loss that may exist during such less favorable conditions, as the Board determines to be appropriate.
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> (3) That sharp swings in assessment rates for insured depository institutions should be prevented.
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> (4) Other factors as the FDIC's Board may deem appropriate, consistent with the requirements of the Reform Act.

12 U.S.C. § 1817(b)(3)(C).

noncurrent loans and leases, improved in the third quarter. At September 30, 2019, 0.92 percent of loan and lease balances were noncurrent, the lowest percentage since the second quarter of 2007.

Revenue growth has improved, however, net interest margins have begun to narrow as the cost of funds grew faster than yields on earning assets. The industry average quarterly net interest margin of 3.35 percent in the third quarter of 2019 is now 10 basis points lower than the third quarter of 2018; however, it remains higher than quarterly net interest margins reported between 2013 and 2017.

The total number of institutions on the FDIC's Problem Institution List fell to 55 as of September 30, 2019, down from 71 on September 30, 2018. 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 the third quarter of 2007. Four banks have failed thus far in 2019, marking the fifth year in a row with few or no failures.

In staff's view, high deposit insurance fund losses incurred during the crisis of the 1980s and early 1990s and during the more recent crisis suggest that the Board should set a DRR at a level that would have maintained a positive fund balance during both crises. Adoption of this long-range, minimum goal would improve the DIF's ability to handle losses during any future periods of severe industry stress and reduce the possibility of increased deposit insurance assessment rates during a banking downturn.

Economic conditions affecting FDIC-insured institutions

The U.S. economy grew an average of 2.3 percent at an annual rate in the first three quarters in 2019, near the post-recession average, as consumer spending supported growth but business investment and government expenditures slowed. Economic growth has been supported by strong labor markets and high levels of consumer confidence. Through the first three quarters of 2019, net exports slightly impeded third quarter GDP while trade uncertainty weighs on the outlook. In light of developments that threaten the global economic outlook and a lack of inflation pressures in the United States, the Federal Reserve cut the fed funds rate by 25 basis points in September and 25 basis points in October. Both long-term and short-term interest rates have fallen in 2019 and the yield curve, which was inverted for much of second and third quarter, has flattened out. Forecasters expect recent economic trends to continue through 2019 and slow mildly in 2020. The October Blue Chip consensus forecast is for real GDP growth to be 1.7 percent in 2020.

Key risks to the economic outlook include global economic developments, including an economic slowdown in key European and Asian economies, trade policy uncertainty, and global geopolitical risks. In addition, lower interest rates and shifts in the yield curve can impact asset values and may pose challenges to bank profitability. In the event of an economic slowdown, bank failures could rise above projections.

Although near-term economic prospects and recent trends in banking industry performance can inform the Board's decision on the DRR, staff believes that the DRR should be viewed from a longer-term perspective. Twice within the past 30 years, serious economic dislocations have resulted in a significant deterioration in the condition of many insured depository institutions and in a large number of insured depository institution failures at high cost to the DIF. In staff's view, the DRR should, therefore, be viewed as a minimum goal needed to achieve a reserve ratio that can withstand these periodic economic downturns and their attendant insured depository institution failures. Taking these longer-term economic realities into account, a prudent and consistent policy would set the DRR at a minimum of 2 percent, because that is the lowest level that would have prevented a negative fund balance at any time since 1950 without raising assessment rates during the crises.

Preventing sharp swings in assessment rates

The FDI Act directs the Board to consider preventing sharp swings in assessment rates for insured depository institutions when setting the DRR. Setting the DRR at 2 percent as a minimum goal would signal that the Board plans for the DIF to grow in good times so that funds are available to handle multiple bank failures in bad times. This plan would help prevent sharp fluctuations in deposit insurance premiums over the course of the business cycle. In particular, it would help reduce the risk of large assessment rate increases during crises, when insured depository institutions can least afford an increase.

Maintaining the DIF at a level that can withstand substantial losses

Staff again recommends, as it did in 2010 and every year since then, that the Board consider one additional factor when setting the DRR: viewing the DRR as a minimum goal that will allow the fund to grow sufficiently large in good times to increase the likelihood of the DIF remaining positive during bad times. This aim is consistent with the FDIC's comprehensive, long-term fund management plan. Having adequate funds available when entering a financial crisis should reduce the likelihood that the fund will become negative or that the FDIC will need to increase assessment rates, levy special assessments on the industry, or borrow from the U.S. Treasury. Further, ensuring the DIF maintains a level that can withstand substantial losses directly supports the statutory requirement of preventing sharp swings in assessment rates.

Balancing the statutory factors

In staff's view, the best way to balance all of the statutory factors (including the additional factor identified above) is to maintain the DRR at 2 percent. Based on the analysis described above, staff continues to recommend viewing a 2 percent DRR as a long-range, minimum target.

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