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Division of Insurance and Research

December 12, 2019

MEMORANDUM TO: The Board of Directors

FROM: Diane Ellis
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SUBJECT: Update of Projected Deposit Insurance Fund Losses, Income, and Reserve Ratios

SUMMARY

As part of its fund management responsibilities, the FDIC regularly monitors the condition and performance of the Deposit Insurance Fund (DIF). The FDIC updates DIF loss and income projections and analyzes the factors that affect fund growth. On a periodic basis, FDIC staff provides an informational report to the Board of Directors on the state of the DIF.

The DIF balance has risen for almost 10 years and stood at $108.9 billion as of September 30, 2019, resulting in a reserve ratio of 1.41 percent.[1] The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) increased the minimum reserve ratio for the DIF from 1.15 percent to 1.35 percent and required the reserve ratio to reach 1.35 percent by September 30, 2020.[2] This requirement was met two years earlier than mandated when the reserve ratio reached 1.36 percent as of September 30, 2018.

Insured depository institutions pay deposit insurance assessments in accordance with the FDIC's long-term fund management plan adopted by the Board in 2011 and reaffirmed in 2016.[3] Pursuant to this plan, lower regular assessment rates went into effect in the third quarter of 2016, the quarter after the reserve ratio reached 1.15 percent.

The Dodd-Frank Act also mandated that banks[4] with $10 billion or more in assets bear the responsibility of increasing the DIF reserve ratio from 1.15 percent to 1.35 percent. This requirement was accomplished by imposing a temporary surcharge on large banks (generally those with $10 billion or more in assets). On September 30, 2018, the reserve ratio surpassed the 1.35 percent minimum and surcharges ceased.[5]

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[1] The DIF reserve ratio is measured as a ratio of the DIF balance to estimated insured deposits.

[2] See 12 U.S.C. 1817(b)(3)(B); see also 81 Fed. Reg. 16059 (Mar. 25, 2016).

[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] 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).

[5] See 12 C.F.R. 327.11(c); see also 81 Fed. Reg. 16069, 16065 (Mar. 25, 2016)

In accordance with the Dodd-Frank Act, small banks, generally those with less than $10 billion in assets, earned assessment credits to offset their contribution to growth in the reserve ratio from 1.15 percent to 1.35 percent. After the reserve ratio first reached or exceeded 1.35 percent, the FDIC calculated that small banks would receive $765 million in assessment credits. The FDIC began applying these small bank credits to offset quarterly deposit insurance assessments as of the second quarterly assessment period of 2019 (ending June 30, 2019), when the reserve ratio first reached or exceeded 1.38 percent.[6] By year end 2019, approximately $559 million of the credits will have been applied, and the remaining credits are expected to be applied or refunded by the end of 2020.[7]

Staff expects that the reserve ratio will remain near its current level and minimally increase in 2020, assuming assessment rates, investment returns on securities held by the DIF and estimated insured deposit growth remain at or near recent levels.

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) growth in estimated insured deposits; (5) DIF investment income and unrealized gains and losses on investments; and (6) operating expenses. All of these forecasts and assumptions are subject to uncertainty.

BACKGROUND

Comprehensive, long-range management plan for the DIF

In an October 2010 Notice of Proposed Rulemaking (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]

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[6] See 81 Fed. Reg. 16069, 16066 (Mar. 25, 2016). Under a final rule approved by the FDIC Board in November 2019, the FDIC will continue to automatically apply credits to reduce banks' quarterly assessments up to the entire amount of the assessment, as long as the reserve ratio is at least 1.35 percent, for up to four assessment periods. After applying the small bank credits for four assessment periods, the FDIC will remit the remaining balance of any small bank credits in lump-sum payments to each bank holding such credits. https://www.fdic.gov/news/board/2019/2019-11-19-notice-sum-e-mem.pdf.

[7] The FDIC applied $319.7 million in credits to the second quarter of 2019 assessment invoices (with payment due on September 30, 2019) and expects to apply $238.9 million in credits to the third quarter of 2019 assessment invoices (with payment due on December 30, 2019).

[8] *See* 75 Fed. Reg. 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.

Recent trends affecting the DIF

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 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.

Banking industry performance generally has been positive. 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 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 Bank List fell to 55 as of September 30, 2019, down from 71 as of 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.

The DIF has continued to grow in tandem with the improvement in U.S. banking industry performance. The DIF balance stood at $108.9 billion at September 30, 2019, up from $100.2 billion at September 30, 2018. Over the past four quarters ending September 30, 2019, most of the increase in the DIF balance was due to: assessment revenue of $5.0 billion, interest earned on investment securities of $2.1 billion, unrealized gains on U.S. Treasury securities of $2.0 billion, and a reduction in estimated losses associated with past and anticipated failures of $1.4 billion. Cumulatively, the DIF balance has risen by nearly $130 billion from its negative $21 billion low point at the end of 2009.

PROJECTIONS

DIF balance and reserve ratio

Staff projections for losses to the DIF due to bank failures are based on available information about troubled banks and on trends in CAMELS ratings, failure rates, and loss rates. The number of troubled banks is expected to remain at low levels through 2020. Losses from bank failures in 2019 and 2020 are also projected to remain low and cost the DIF approximately $350 million through 2020. The losses projected for 2019 and 2020 are in line with the FDIC's experience over the past five years where losses to the DIF due to bank failures have averaged approximately $500 million annually. In contrast, losses from bank failures cost the DIF more than $68 billion spanning from 2008 to 2013.

Through September 30, 2019, the DIF earned assessment revenue of $3.7 billion. For all of 2019, staff projects that total assessment revenue will be approximately $5.1 billion compared to $9.5 billion for 2018. For 2020, staff estimates that assessment revenue will amount to $6.0 billion. The reduction in assessment revenue in 2019 and future periods reflects the cessation of the large bank surcharge, the application of small bank credits, and the current risk profiles of insured depository institutions.

The reserve ratio stood at 1.41 percent as of September 30, 2019, up from 1.36 percent as of the end of 2018. Staff projects that the reserve ratio will remain stable or grow modestly over the coming year. The effects of reduced assessment revenue, relatively low investment returns on securities held by the DIF, and normal estimated insured deposit growth are projected to limit growth in the reserve ratio through 2020.

If, in the future, the FDIC projects that the reserve ratio will fall below 1.35 percent within six months, the FDIC would have eight years to restore the reserve ratio to the 1.35 percent minimum, and would be required to establish and implement a restoration plan to achieve this minimum.[9]

DIF cash balance

The DIF had total liquid assets of $105.7 billion at September 30, 2019. The current liquid assets together with anticipated future assessment cash collections and dividends from receiverships should be sufficient to meet all near-term FDIC obligations.

[9] Under the FDI, the FDIC may be granted more than 8 years to restore the reserve ratio to the 1.35 percent minimum if the Board finds that extraordinary circumstances warrant a longer timeframe. *See* 12 U.S.C. 1817(b)(3)(E).

Risks to the outlook for the DIF

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.

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