



May 7, 2007

**MEMORANDUM TO:** The Board of Directors

**FROM:** Arthur J. Murton, Director  
Division of Insurance and Research

**SUBJECT:** Outlook for the Deposit Insurance Fund (DIF)

### **SUMMARY**

The DIF reserve ratio stood at 1.21 percent as of December 31, 2006, the latest date for which complete data are available. While data are incomplete, an early estimate (subject to change) indicates that the DIF reserve ratio stood at 1.20 percent as of March 31, 2007.

The staff projects that the reserve ratio as of December 31, 2007, will be 1.20 percent. Because of the use of assessment credits provided by the Federal Deposit Insurance Reform Act of 2005 (Reform Act), assessment revenue is unlikely to prevent insured deposit growth from causing the reserve ratio to decline from year-end 2006. As credits are drawn down, however, assessment revenue is likely to help raise the reserve ratio in 2008.

The staff's best estimate for insured deposit growth in 2007 is approximately 5 percent. If this growth rate continues beyond 2007, the fund could reach the 1.25 percent designated reserve ratio (DRR) during 2009. If annual insured deposit growth this year and next averages 4 percent, the fund could reach the DRR by the start of 2009; growth averaging 6 percent over the next few years could raise the fund to the DRR by the end of 2009. These projections are based on the existing rate schedule of 5 to 43 basis points (bp) per year and assume a continuation of few failures and modest insurance losses. As provided for in our assessment regulations, rates set by the Board remain in effect until the Board changes them.

### **OUTLOOK**

Table 1 shows projected reserve ratios through the year in which the reserve ratio first reaches or exceeds the DRR of 1.25 percent assuming different average annual growth rates for insured deposits.

**Table 1**  
**Projected Reserve Ratios Assuming Different Growth Rates in Insured Deposits**  
**Under the Current Rate Schedule**

Period	Insured Deposit Growth Rate					
	3%	4%	5%	6%	7%	8%
2007	1.22%	1.21%	1.20%	1.19%	1.18%	1.17%
2008	1.27%	1.25%	1.22%	1.20%	1.18%	1.16%
2009			1.28%	1.25%	1.21%	1.18%
2010					1.25%	1.21%
2011						1.23%

Notes:

(1) The year-end 2006 reserve ratio was 1.21 percent.

(2) Projections of the fund balance components that result in the reserve ratios shown in this table for 5 percent insured deposit growth are provided below.

In developing these projections for the reserve ratio, the staff considered future changes to the fund balance from insurance losses (case resolution expenses), operating expenses, and assessment and investment revenue, as well as the outlook for insured deposit growth.

***1. Projected changes to the fund balance***

Table 2 shows projected changes to the fund balance over the next two years based on the current rate schedule. Future changes to the fund balance depend, in turn, on projections and assumptions for insurance losses, operating expenses, assessment revenue, and investment contributions. These components of fund balance changes are discussed below.

**Table 2**  
**Projected Changes to the Fund Balance Under the Current Rate Schedule**  
**(\$ in millions)**

Period	Beginning Fund Balance	Net Assessment Revenue	Investment Income	Loss Provisions	Operating Expenses	Ending Fund Balance
2007	50,165	648	2,358	16	988	52,166
2008	52,166	2,484	2,387	108	1,037	55,891

Note: Revenue and loss projections in this table, Table 3, and Table 5 assume that domestic deposits (the assessment base) and insured deposits both increase at an annual rate of 5 percent. Alternative domestic deposit growth assumptions would result in relatively small changes in projected fund balances.

a. *Insurance losses and operating expenses*

The staff's projections for the reserve ratio under the current rate schedule continue to assume few bank failures and low insurance losses. Insurance loss provisions are projected to total \$16 million this year, rising to \$108 million in 2008 and growing thereafter only in proportion to domestic (and insured) deposits.<sup>1</sup> These projected losses are considerably lower than the modest losses experienced over the past 10 years.

Banks in general appear to be well positioned to withstand financial stress from adverse economic events.<sup>2</sup> Nonetheless, the possibility remains that insurance losses may be higher than anticipated. Higher losses, in turn, would reduce the likelihood of raising the reserve ratio to the DRR within three years under the rate schedule adopted in this rule.

The reserve ratio projections based on the current rate schedule also assume that annual operating expenses increase by 5 percent annually over the next few years. For 2007, operating expenses are estimated at \$988 million.

b. *Investment contributions*

As shown in Table 2 above, projections of fund balances assume that annual investment contributions amount to approximately \$2.4 billion both in 2007 and 2008.<sup>3</sup> Investment contributions equal interest income plus (minus) unrealized gains (losses) on

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<sup>1</sup> The FDIC's contingent loss reserve at year-end 2006, which covers anticipated losses from failures in 2007, was \$111 million. However, the staff currently estimates that failures in 2007 will cost about \$19 million. The projected contingent loss reserve at year-end 2007 (to cover 2008 failures) is \$108 million. Therefore, the projected change in the contingent loss reserve and the cost of failures this year require only \$16 million in 2007 loss provisions (\$108 million + \$19 million - \$111 million). Projections for 2008 and beyond assume that losses from failures equal the balance of the contingent loss reserve at the start of each year.

Staff projected insurance losses by taking into account (1) the shifting of problem banks among different contingent loss reserve risk categories, (2) the reduction in problem banks due to improved financial condition, mergers, and failures, and (3) the addition of new problem banks. To capture the effects of these changes, staff estimated the probabilities of banks entering into or leaving the group of banks included in the contingent loss reserve as well as the probability of banks moving between loss reserve risk categories. These probabilities are based on the recent history of changes to the reserve.

<sup>2</sup> Two-year stress event simulations were run based on data through December 31, 2006, affecting institutions specializing in residential mortgages, subprime loans, commercial real estate mortgages, commercial and industrial loans, and consumer loans. The results of each simulation, which were derived from historical stress events, demonstrate that banks are well positioned to withstand a significant degree of financial adversity. In no case did the stress simulation results raise significant concerns for the insurance fund. However, the effects were not evaluated beyond a two-year horizon. Also, the historical experience underlying the stress scenarios may be less applicable in the future, so conclusions drawn from the stress analyses should be treated with some degree of caution.

<sup>3</sup> Projected investment contributions equal approximately 4.7 percent of the start-of-year fund balance in 2007 and 4.6 percent in 2008 and beyond.

available-for-sale securities. The projected investment yield remains in line with recent investment return experience.

Projections for 2007 and 2008 are based in part on expert forecasts for interest rates next year, as detailed in the Blue Chip Financial Forecasts. Short-term Treasury yields have been below the federal funds target rate of 5.25 percent since the third quarter of 2006 and have declined slightly through the first quarter of 2007. Long-term Treasury yields have remained in a fairly steady range between 4.5 percent and 5.0 percent throughout that time, resulting in an inverted yield curve for most of the last three quarters. Low longer-term interest rates reflect historically low and stable long-term inflationary expectations, heightened global demand for low-risk, long-term assets and, potentially, expectations of slower economic growth ahead. The economy is forecast to grow below its long-run average level for the remainder of 2007, and many economic forecasters expect long-term interest rates to rise modestly and short-term rates to remain lower than the federal funds target rate throughout 2007.

*c. Risk-based assessment revenue and assessment credits*

Table 3 below shows projected gross assessment revenue, assessment credit use, and net assessment revenue for 2007-2008 under the current rate schedule. As provided for in our assessment regulations, rates set by the Board remain in effect until the Board changes them.

**Table 3**  
**Assessment Revenue and Assessment Credit Use Under the Current Rate Schedule**  
**(\$ in millions)**

Period	Gross Revenue	Credits Used	Net Revenue	Effective Rate (bp)
2007	3,743	3,095	648	0.93
2008	3,934	1,451	2,484	3.40

Projected gross assessment revenue is derived by assigning each insured institution to a Risk Category, and assigning each institution in Risk Category I to the minimum rate, maximum rate, or a rate in between, generally using supervisory ratings, debt issuer ratings, and financial data as of December 31, 2006. Table 4 shows the distribution of institutions and assessment bases among the Risk Categories using these data.<sup>4</sup> For purposes of assessment revenue projections, the distribution of assessable

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<sup>4</sup> The projections assume that the assessment base increases at the same rate as estimated insured deposits. The assessment base equals domestic deposits with minor adjustments. Beginning in 2007, a standard float deduction will no longer be applied. (The December 31, 2006 assessment base used for these projections was also adjusted to exclude the float deduction.) In addition, institutions may elect to compute their assessment base each quarter using average daily deposit balances. Beginning in 2008, new institutions and institutions with more than \$1 billion in assets must use average daily deposits, while other institutions may elect to do so.

deposits among Risk Categories (and within Risk Category I) is generally assumed to remain constant.

**Table 4**  
**Distribution of Institutions and the Assessment Base Among Risk Categories**  
**(\$ in millions)**

Risk Category	Number of Institutions	Percent of Total Institutions	Assessment Base	Percent of Total Assessment Base
I - Minimum	3,296	38%	4,091,428	61%
I - Middle	4,427	51%	2,416,036	36%
I - Maximum	535	6%	154,723	2%
II	379	4%	85,892	1%
III	55	1%	7,702	0%
IV	1	0%	65	0%

Note: Estimates are generally based on supervisory ratings, debt issuer ratings, and financial data as of December 31, 2006.

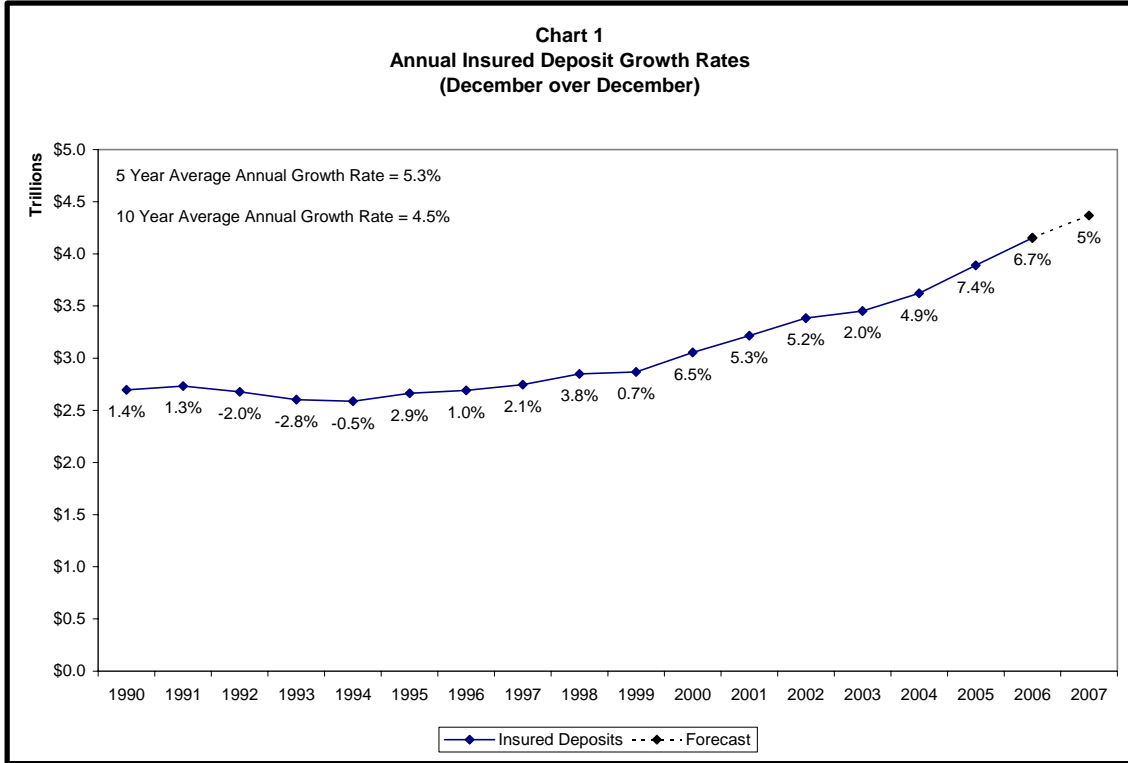
Assessment revenue projections reflect the use of assessment credits authorized under the Reform Act and distributed in accordance with the final rule adopted for assessment credits. In 2007, most institutions with credits will have them applied to offset either their entire assessment or an amount equal to their total credit, whichever is less.<sup>5</sup> Therefore, as indicated in Table 3, the effective rate applicable to the industry this year under this rate schedule is projected to be only 0.93 basis points. At the end of this year, staff projects that nearly two thirds of the \$4.7 billion total credit authorized under the Reform Act will have been drawn down. The effective rate is projected to rise to 3.4 basis points in 2008 as institutions exhaust their credits.

## ***2. Projected insured deposits***

Chart 1 shows levels of insured deposits and corresponding four-quarter growth rates since 1990, including forecasts through 2007. Over the 1990-2006 period, annual growth rates in insured deposits ranged between -2.8 percent and 7.4 percent. After three consecutive annual declines in insured deposits – from year-end 1991 to year-end 1994 – annual growth in insured deposits picked up in the mid-1990s and reached 6.5 percent in 2000. Growth slowed in the next few years, down to 2.0 percent in 2003. However, insured deposit growth then climbed to 4.9 percent in 2004 and 7.4 percent in 2005, before moderating slightly to 6.7 percent in 2006. Growth slowed in the second half of 2006 to an annualized rate of 5.7 percent from 7.7 percent in the first half. The high growth in insured deposits may have resulted partly from an increase in short-term

<sup>5</sup> In 2008, 2009 and 2010, credit use will be capped at 90 percent of an institution's assessment, as required by the Reform Act and implementing regulations. Additionally, certain banks not in Risk Category I are subject to restrictions on the use of credits.

interest rates from mid-2004 through the first half of 2006, triggered by a tightening in monetary policy by the Federal Reserve. Higher short-term interest rates relative to long-term rates makes short-term investment instruments, such as bank deposits, more attractive to investors.



The staff’s best estimate for insured deposit growth in 2007, based upon a statistical forecast model, is approximately 5 percent.<sup>6</sup> The projected growth rate in 2007 is close to the average annual growth rate for the five years ending in 2006.

Table 1 shows that if annual insured deposit growth in 2007 and over the next few years averages between 4 percent and 6 percent, the reserve ratio should reach the 1.25 percent DRR in the third year (2009) of the new assessment system. Growth averaging 4 percent should help the fund meet the 1.25 percent target by the start of 2009; growth averaging 6 percent should raise the fund to the DRR by the end of 2009. Table 1 also indicates that average annual growth of 7 percent or higher would make it unlikely to achieve a reserve ratio of 1.25 percent within three years. Yet, while insured deposits rose by more than 7 percent in 2005, the historical data suggest that it is very unlikely that

<sup>6</sup> The statistical model projects an insured deposit growth rate of 5.1% for 2007.

insured deposits will increase at an average annual growth rate as high as 7 percent for three consecutive years.<sup>7</sup>

### 3. Projected reserve ratios

Assuming insured deposit growth of 5 percent per year beginning in 2007, projections for 2007-2009 under the current rate schedule are as follows:<sup>8</sup>

**Table 5**  
**Projected Fund Balances, Insured Deposits, and Reserve Ratios**  
 (\$ in millions)

Period	Ending Fund Balance	Ending Insured Deposits	Ending Reserve Ratio
2006	50,165	4,143,658	1.21%
2007	52,166	4,350,840	1.20%
2008	55,891	4,568,382	1.22%
2009	61,261	4,796,802	1.28%

The table shows that the reserve ratio is expected to decline slightly this year as the use of assessment credits prevents the fund balance from rising in pace with insured deposits. However, with almost two thirds of the credits drawn down by the end of this year, assessment revenue should accelerate in 2008 and help the fund meet the DRR during 2009.

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<sup>7</sup> Rolling 12-quarter growth rates in insured deposits were calculated beginning with the March 1995 to March 1998 period and ending with the December 2003 to December 2006 period. The mean 12-quarter growth rate over this period was 4.0 percent (annualized), and the largest reported 12-quarter growth rate was 6.4 percent.

<sup>8</sup> The projections assume that the assessment base increases at the same rate as insured deposits.