



March 28, 2013

**MEMORANDUM TO:** The Board of Directors

**FROM:** Arthur J. Murton *Matthew P. Shea for Arthur J. Murton*  
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) requires that the Deposit Insurance Fund (DIF) reserve ratio reach 1.35 percent by September 30, 2020.<sup>1</sup> The FDIC is operating under a DIF Restoration Plan that provides, among other things, that the reserve ratio will reach 1.35 percent by the statutory deadline.<sup>2</sup> 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 is likely to be sufficient to meet the statutory requirements. This memorandum is the first semi-annual update for 2013.

The DIF balance has risen for twelve consecutive quarters and stood at \$33.0 billion on December 31, 2012, resulting in a reserve ratio of 0.45 percent. Staff projects that, under the current assessment rate schedule, the DIF reserve ratio will reach 1.15 percent in 2018. Dodd-Frank requires the FDIC to offset the effect on institutions with total consolidated assets of less than \$10 billion of increasing the reserve ratio from 1.15 percent to 1.35 percent.<sup>3</sup> Staff intends to present a proposed rule to the Board of Directors (Board) to implement this requirement when the DIF reserve ratio is closer to 1.15 percent.

The outlook for the DIF reserve ratio depends on forecasts and assumptions for several financial measures, including (1) bank failures, (2) changes in bank risk profiles, which affect assessment rates, (3) growth in the assessment base, (4) fund investment income, (5) operating expenses, and (6) growth in estimated insured deposits. All of these forecasts and assumptions are subject to considerable uncertainty over a long-term horizon. Ongoing challenges to the recovery of the U.S. economy and banking sector also add uncertainty to the outlook for the DIF.

---

<sup>1</sup> 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)).

<sup>2</sup> Adoption of Federal Deposit Insurance Corporation Restoration Plan, 75 Fed. Reg. 66293 (Oct. 27, 2010).

<sup>3</sup> Dodd-Frank Act, Pub. L. No. 111-203, § 334(e), 124 Stat. 1539 (codified at 12 U.S.C. § 1817(nt)).

## **BACKGROUND**

### *Revisions to the Restoration Plan*

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.<sup>4</sup> 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.<sup>5</sup>

In October 2010, the Board adopted a new Restoration Plan to incorporate changes arising from the enactment of Dodd-Frank, which raised the minimum designated reserve ratio from 1.15 percent to 1.35 percent. The new law also extended the allowable period of time to reach the new, higher minimum from the end of 2016 to September 30, 2020. Accordingly, the FDIC extended the period covered by the Restoration Plan to conform to Dodd-Frank. Because the outlook for bank failures had improved and because of the time that Dodd-Frank allowed for the reserve ratio to reach 1.35 percent, the FDIC decided to forego a 3 basis point increase in assessment rates that was scheduled to take effect at the start of 2011.<sup>6</sup>

### *Recent trends affecting the DIF*

The banking industry continues to recover at a gradual, steady pace. The fourth quarter of 2012 was the twelfth consecutive quarter of aggregate positive net income. Sixty percent of institutions reported improvement in quarterly net income from one year earlier, and the number of unprofitable institutions has declined from year-earlier levels in each of the last 13 quarters. Improving credit performance, leading to lower loan loss provisions, has been primarily responsible for most of the year-over-year improvement in earnings. Asset quality, as measured by the volume of noncurrent loans and leases, has improved for eleven consecutive quarters.

The total number of institutions on the FDIC's Problem Institution List fell to 651 at December 31, 2012, from 694 at September 30 and 813 at the end of 2011. The number of problem banks has declined for seven consecutive quarters and is now at its lowest level since the third quarter of 2009. The improvement in the number of problem institutions reflects a continued decline in the rate of supervisory rating downgrades, as well as an increase in the rate of supervisory rating upgrades.

---

<sup>4</sup> 73 Fed. Reg. 61598 (October 16, 2008).

<sup>5</sup> 74 Fed. Reg. 9564 (March 4, 2009) and 74 Fed. Reg. 51062 (October 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](http://www.fdic.gov/news/board/2012/2012-04-23_notice_no5.pdf)).

<sup>6</sup> 75 Fed. Reg. 66293. Because Dodd-Frank requires the FDIC to offset the effect on institutions with less than \$10 billion in total consolidated assets of the requirement that the reserve ratio reach 1.35 percent by September 30, 2020 (rather than 1.15 percent by the end of 2016), assessment rates applicable to all institutions need be set only high enough to reach 1.15 percent by September 30, 2020.

The rates at which 3-, 4-, or 5-rated institutions have failed, calculated over trailing 12-month periods, have declined significantly since the spring of 2010, both in terms of institution numbers and assets. A total of 51 banks failed in all of 2012, down from 92 in 2011. The total assets of failures in 2012 – \$11.6 billion – were significantly less than the \$34.9 billion in total assets of failures in 2011.

The U.S. economic recovery has been under way for nearly four years. Real gross domestic product (GDP) grew 2.2 percent in 2012, following 1.8 percent growth in 2011 and 2.4 growth in 2010. Over the past year, the housing sector began to improve, consumer spending rose moderately, the unemployment rate edged down, and business investment grew. Consensus forecasts for real GDP growth in 2013 range between 1.5 percent and 2.5 percent. Further steady expansion of the U.S. economy should continue to support gradual improvement in the condition of FDIC-insured depository institutions.

The insurance fund has continued to recover as U.S. banking industry performance has improved. The DIF balance stood at \$33.0 billion at the end of 2012, up from \$11.8 billion one year earlier. Cumulatively, the DIF balance has risen by almost \$54 billion from its negative \$20.9 billion low point at the end of 2009. During 2012, the DIF increased by \$5.9 billion from funds previously set aside for debt guaranteed under the Temporary Liquidity Guarantee Program (TLGP).<sup>7</sup> Other factors contributing to the 2012 increase in the DIF balance include \$12.4 billion in assessment income and a decline in loss provisions for past and anticipated future failures. At December 31, 2012, the contingent loss reserve was \$3.2 billion, down from \$6.5 billion one year earlier.

## **PROJECTIONS**

### *DIF balance and reserve ratio*

Staff has updated its projections for the DIF balance and reserve ratio. The projections are based on recently 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. Last October, the staff projected that failures for the five-year period from 2012 through 2016 would cost \$10 billion.<sup>8</sup> The current projected total cost of failures for the

---

<sup>7</sup> The TLGP, which began in October 2008 and ended on December 31, 2012, contributed \$9.3 billion in fees and surcharges to the DIF over the life of the program. The TLGP was announced on October 14, 2008, as part of the federal government's coordinated response to the financial crisis. The TLGP was intended to promote financial stability by preserving confidence in the banking system and encouraging lending in the interbank credit market, thus facilitating lending to creditworthy businesses and consumers. The TLGP provided two limited guarantee programs: one that guaranteed newly-issued senior unsecured debt of insured depository institutions and their holding companies (the Debt Guarantee Program, or DGP), and another that guaranteed certain transaction accounts at insured depository institutions (the Transaction Account Guarantee Program, or TAG). The TAG expired at the end of 2010 and was replaced by a similar temporary program established under Dodd-Frank that expired on December 31, 2012. The last debt guarantees under the DGP also expired on that date.

<sup>8</sup> Memorandum to the Board of Directors from Arthur J. Murton (Director, Division of Insurance and Research) dated October 2, 2012 ([http://www.fdic.gov/news/board/2012/2012-10-09\\_notice\\_dis-c\\_mem.pdf](http://www.fdic.gov/news/board/2012/2012-10-09_notice_dis-c_mem.pdf)).

same five years has declined to \$7 billion, primarily because of lower recent and expected failure rates of troubled institutions as well as a smaller average size of failing banks. For the new five-year period beginning in 2013 and ending in 2017, staff projects that failures will cost the DIF \$5 billion. The losses projected for these five years follow estimated losses of \$87 billion for banks that failed from 2008 through 2012. The staff expects that the pace of CAMELS ratings downgrades and the rate at which troubled banks fail will continue to slow, and that ratings upgrades will outpace downgrades over the 2013 – 2017 period. Beyond five years, the projections assume a low level of failures and associated losses.

The DIF earned assessment income of \$13.5 billion and \$12.4 billion in 2011 and 2012, respectively, and is projected to earn just over \$11 billion this year. The decreases in revenue result from improvements in banking industry performance and conditions reflected in measures that determine risk-based premium rates. The DIF projections assume that, under the current risk-based assessment rate schedule, the industry average premium rate will decline gradually over several years as banking industry conditions continue to strengthen.

The reserve ratio stood at 0.45 percent at December 31, 2012, up from 0.17 percent one year earlier. December 31 was the last day for which the Dodd-Frank Act provided temporary full insurance on balances exceeding \$250,000 held in noninterest-bearing transaction accounts. Expiration of this program will increase the reserve ratio by reducing total estimated insured deposits. Based on current deposit levels, staff estimates an increase of about 11 basis points. Under staff's projections, the reserve ratio should reach 1.15 percent in 2018, within the time frame of the Restoration Plan.

#### *Prepaid assessments and DIF cash balance*

To ensure that the DIF had sufficient liquidity to handle a high volume of failures, the Board issued a rule in 2009 that required insured depository institutions to prepay 13 quarters of estimated risk-based assessments.<sup>9</sup> The \$45.7 billion in assessments prepaid on December 30, 2009, resolved the FDIC's immediate liquidity needs. As required by the rule, any institution's remaining prepaid assessment will be returned to the institution by June 30, 2013. Staff estimates that the FDIC will refund in aggregate \$5.7 billion in remaining prepaid assessments at the end of June.

Based on staff's projections of the DIF's cash balance, which take into account this refund, current liquid assets together with future assessment cash collections and dividends from failed bank receiverships should be sufficient to meet all FDIC obligations during the next five years.

---

<sup>9</sup> The cash collected from the prepayment did not initially affect the DIF balance (i.e., the DIF's net worth). Rather, each quarter, the DIF has recognized as revenue prepaid amounts used to cover each institution's quarterly risk-based assessment.

*Risks to the outlook for the DIF*

Projections for the DIF are subject to considerable uncertainty arising from the economic outlook. The U.S. economy may grow at a below-trend rate for an extended period, and two key risks continue to weigh on the outlook. First, continued uncertainty about the European economic outlook could adversely affect U.S. financial markets and the U.S. economy. Second, recent changes to federal spending and taxes, as well as uncertainty about U.S. fiscal policy, also could affect economic growth. A slowdown in the U.S. economic recovery could result in more bank failures than projected and a decline in the value of failed bank assets. Furthermore, future assessment revenue and estimated insured deposits could diverge from staff projections depending on changes in bank risk profiles and on how banks adapt to, among other things, the assessment rules adopted in 2011.

Nonetheless, staff's best estimate is that the DIF balance remains on track to meet the requirements of the Restoration Plan and Dodd-Frank. Even if a slowdown in the economic recovery results in higher fund losses than projected, the existing statutory framework should provide sufficient time to evaluate the effect on the fund before future adjustments to the Restoration Plan and assessment levels would need to be considered. Staff will continue to update the Board on a semiannual basis.

Staff contacts:

Chad Boggan, Acting Chief, Fund Analysis and Pricing Section, Division of Insurance and Research, (202) 898-3828

Matthew Green, Associate Director, Division of Insurance and Research, (202) 898-3670