



November 30, 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 operates under a DIF Restoration Plan, approved by the Board of Directors (Board) in 2010, 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 second semiannual update for 2018.

The DIF balance has risen for almost 9 years and stood at \$100.2 billion as of September 30, 2018, resulting in a reserve ratio of 1.36 percent. Because the reserve ratio has exceeded 1.35 percent, the FDIC will no longer operate under the Restoration Plan beginning with the fourth quarter of 2018. If the reserve ratio falls below 1.35 percent in the future³, the FDIC would again establish and implement a restoration plan; however, under the Federal Deposit Insurance (FDI) Act, the FDIC would have 8 years to restore the reserve ratio to the 1.35 percent minimum, and possibly longer if the Board finds that extraordinary circumstances warrant a longer timeframe.⁴

The FDIC imposed quarterly surcharges to meet the Dodd-Frank requirement that banks with total assets of more than \$10 billion dollars bear the cost of increasing the reserve ratio from 1.15 percent to 1.35 percent. The assessment invoices for the third quarter of 2018 will be the last invoices that include the temporary assessment surcharges for large banks. The surcharges took effect in the third quarter of 2016, the quarter after the reserve ratio first exceeded 1.15

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 The FDIC must also establish and implement a restoration plan if the FDIC projects that the reserve ratio of the DIF, will within 6 months of such determination, fall below 1.35. 12 U.S.C. 1817(b)(3)(E)(i).

⁴ 12 U.S.C. 1817(b)(3)(E).

percent. Additionally, lower regular assessment rates also went into effect beginning in the third quarter of 2016 under final rules approved by the Board in 2011 and reaffirmed in 2016.⁵ The reduction in rates reduced assessments paid by small banks, generally those with less than \$10 billion in assets, on average by about one third. In accordance with Dodd-Frank, small banks will also receive credits to offset the effect on small banks of increasing the reserve ratio from 1.15 percent to 1.35 percent.⁶

Staff expects that the reserve ratio will remain stable or increase minimally in 2019, due primarily to lower assessment revenue resulting from the end of assessment surcharges on large banks, lower regular assessment rates for all banks that went into effect in 2016, relatively low interest rates on securities held by the DIF, and normal estimated insured deposit growth.

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, 2020.⁷

Recent trends affecting the DIF

The U.S. economy grew 3.3 percent through the first three quarters in 2018, above the post-recession average, as consumer spending rebounded and recent corporate tax cuts and fiscal stimulus took effect. Economic growth has been broad based, supported by strong labor markets, and high levels of business and consumer confidence. Business fixed investment

⁵ 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).

⁶ See 12 C.F.R. 327.11(c); see also 81 Fed. Reg. 16069, 16065 (Mar. 25, 2016)

⁷ 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).

increased, with capital expenditures aided by an improvement in the energy market. Net exports subtracted from third quarter GDP growth and trade uncertainty weighs on the outlook. With stronger economic growth, the Federal Reserve raised interest rates and continued the gradual removal of accommodative monetary policy. Longer-term interest rates rose and the yield curve flattened further. Forecasters expect positive economic trends to continue through 2018 and slow mildly in 2019. The October Blue Chip consensus forecast is for real GDP growth to be 2.64 percent in 2019.

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, 2018, 1.02 percent of loan and lease balances were noncurrent, the lowest percentage since second quarter 2007.

Revenue growth has improved, and net interest margins have begun to widen as interest rates rise. The industry average quarterly net interest margin of 3.45 percent in the third quarter of 2018, although 14 basis points higher than the fourth quarter 2017, remains lower than pre-crisis levels.

The total number of institutions on the FDIC's Problem Bank List fell to 71 as of September 30, 2018, down from 104 at September 30, 2017. 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. No banks have failed thus far in 2018, marking the fourth 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 \$100.2 billion at September 30, 2018, up from \$90.5 billion at September 30, 2017. Assessment revenue of \$8.2 billion accounted for most of the increase in the DIF balance through September 30, 2018. Cumulatively, the DIF balance has risen by over \$121 billion from its negative \$20.9 billion low point at the end of 2009.

PROJECTIONS

DIF balance and reserve ratio

Staff projects that failures for the remainder of this year and next year will cost the DIF approximately \$350 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 more than \$72 billion for banks that failed from 2008 through 2017. Staff also expects that, through 2019, the number of troubled banks will remain at low levels.

Through September 30, the DIF earned assessment revenue of \$8.2 billion in 2018, of which surcharges on banks with \$10 billion or more in assets accounted for \$3.8 billion. Since

the reserve ratio exceeded 1.35 percent as of September 30, 2018, large banks will no longer be assessed the surcharges. Thus, beginning in the fourth quarter of 2018, assessment revenue will only include earnings from regular risk-based assessments. For all of 2018, staff projects that total assessment revenue will total approximately \$9.6 billion. For 2019, staff estimates that assessment revenue will amount to \$6.0 billion. The lower assessment revenue projection is due primarily to the end of assessment surcharges on large banks and reflects the 2016 reduction in regular assessment rates for all banks.

The reserve ratio stood at 1.36 percent at September 30, 2018, up from 1.30 percent at the end of 2017. 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, even in a period of low losses due to bank failures.

Additionally, small banks will receive credits to offset the portion of their regular assessments that contributed to the increase in the reserve ratio from 1.15 percent to 1.35 percent. Credits are estimated to amount to approximately \$750 million dollars in aggregate. 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.⁸

DIF cash balance

The DIF had liquid assets of \$95.5 billion at September 30, 2018. 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, trade policy uncertainty, and adverse global developments. In the event of an economic slowdown, bank failures could rise above projections.

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⁸ See 12 C.F.R. 327.11(c); see also 81 Fed. Reg. at 16071.