FDIC Federal Deposit Insurance Corporation

MEMO

TO: The Board of Directors

FROM: Patrick Mitchell
Director, Division of Insurance and Research

DATE: November 16, 2023

RE: Designated Reserve Ratio for 2024

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 (the DIF or the Fund) and publish the designated reserve ratio, or DRR, before the beginning of each calendar year.[1] On October 18, 2022, the Board approved for publication a notice setting the DRR at 2 percent for 2023.[2] Based on the analysis set forth below, staff recommends maintaining the DRR at 2 percent for 2024 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 during times of favorable banking conditions to increase the likelihood of the DIF remaining positive throughout periods of significant losses due to bank failures, consistent with the FDIC's comprehensive, long-term fund management plan. This minimum goal reduces the risk of a large rate increase during a crisis, when insured depository institutions can least afford an increase.

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-range, minimum goal 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]

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[1] Section 7(b)(3)(A) of the FDI Act, 12 U.S.C. § 1817(b)(3)(A).
[2] 87 FR 64346 (Oct. 24, 2022). 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* FR 79286 (Dec. 20, 2010), codified at 12 C.F.R. § 327.4(g). Following analysis of the statutory factors, the Board has set the DRR at 2 percent for every year since 2011.
[3] Section 7(b)(3)(C) of the FDI Act, 12 U.S.C. § 1817(b)(3)(C).
[4] 75 FR 66272 (Oct. 27, 2010).

Concur:

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Harrel M. Pettway
General Counsel

BACKGROUND

Governing statutes

Under the FDI Act, the FDIC has broad discretion to manage the DIF, including the level at which to set the DRR. The required minimum reserve ratio is 1.35 percent, but there is no upper limit on the reserve ratio (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 Board 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 at 2 percent. After consideration of comments received and based on an analysis of the statutory factors, a final rule adopted by the Board in December 2010 set the DRR at 2 percent.[9] Following consideration of the statutory factors, the Board has voted annually since then to maintain the 2 percent DRR.

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[5] Section 7(b)(3)(B) of the FDI Act, 12 U.S.C. § 1817(b)(3)(B). Pursuant to the FDI Act, in September 2020, the Board adopted a Restoration Plan to ensure that the DIF reserve ratio reaches 1.35 percent within 8 years of establishment, because the reserve ratio was 1.30 percent as of June 30, 2020. *See* 85 FR 59306 (Sept. 21, 2020). On June 21, 2022, the Board amended the Restoration Plan and proposed an increase in initial base deposit insurance assessment rate schedules of 2 basis points, to improve the likelihood that the reserve ratio would be restored to at least 1.35 percent by September 30, 2028, and to support growth in the DIF in progressing toward the 2 percent DRR. *See* 87 FR 39518 (July 1, 2022) and 87 FR 39388 (July 1, 2022). On October 18, 2022, the Board finalized the 2 basis point increase in assessment rate schedules. The revised assessment rate schedules became effective January 1, 2023, and were applicable beginning the first quarterly assessment period of 2023. *See* 87 FR 64314 (Oct. 24, 2022).

[6] Section 7(e)(2)(B) of the FDI Act, 12 U.S.C. § 1817(e)(2)(B).

[7] Section 7(b)(3)(A) of the FDI Act, 12 U.S.C. § 1817(b)(3)(A).

[8] *See* 75 FR at 66272 (Oct. 27, 2010), describing the long-term plan; 75 FR 79286, 79287 (Dec. 20, 2010), finalizing the designated reserve ratio; and 76 FR 10672, 10674 (Feb. 25, 2011), finalizing components of the long-term plan related to dividends and assessment rates.

[9] 75 FR 79286 (Dec. 20, 2010) (December 2010 final rule).

During an economic and banking downturn, insured depository institutions (IDIs) can least afford to pay high deposit insurance assessment rates, enhancing the potential for reduced lending.[10] 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.

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 anticipated 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 DIF 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.[11]

Staff found that the Fund reserve ratio would have had to exceed 2 percent before the onset of the first crisis and increase to approximately 2 percent prior to the most recent crisis to maintain a positive fund balance and stable assessment rates.[12] The FDIC also believes a 2 percent DRR would complement enhanced prudential standards implemented after the global financial crisis, and together would help to improve the resiliency of the financial sector and could reduce the likelihood and severity of future crises.

Historically, the reserve ratio has never reached 2 percent. Nonetheless, staff continue to view the 2 percent DRR as a long-range, minimum goal, consistent with the 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.

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[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] See 75 FR at 66273 (Oct. 27, 2010).

[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 Wall Street Reform and Consumer Protection 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 before the onset of the 2008 crisis and greater than 2.25 percent before the crisis of the late 1980s and early 1990s to maintain both a positive fund balance and stable 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 FR at 79288.

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 during times of favorable banking conditions to increase the likelihood of the DIF remaining positive throughout periods of significant losses due to bank failures, consistent with the FDIC's comprehensive, long-range fund management plan.

Risk of losses to the DIF

The DIF balance stood at $117.0 billion as of June 30, 2023, down $7.5 billion from one year earlier. Increased loss provisions associated with the failures of Silicon Valley Bank, Signature Bank, and First Republic Bank reduced the DIF balance in the first half of 2023. The reduced DIF balance coupled with strong growth in insured deposits resulted in the reserve ratio declining 15 basis points from 1.25 percent as of December 31, 2022, to 1.10 percent as of June 30, 2023.[14] At June 30, 2023, the contingent loss reserve for anticipated failures was $220 million, up from $66 million at June 30, 2022.

In recent years, the DIF has experienced low losses from IDI failures, until 2023. On average, three IDIs per year failed between 2016 and 2022, at an annual cost to the fund of about $178 million.[15] Five banks failed thus far in 2023, following more than two years without a bank failure and eight years in a row with few or no failures. The total cost to the DIF from failures in 2023, excluding losses that will be recovered through the special assessment, described below, is estimated to be $18.1 billion.

The failures of Silicon Valley Bank on March 10, 2023, and Signature Bank on March 12, 2023, were due to sudden and unexpected liquidity needs as a result of large withdrawals of uninsured deposits. On March 12, 2023, the Secretary of the Treasury, acting on the recommendation of the FDIC Board and Board of Governors of the Federal Reserve System and after consultation with the President, invoked the systemic risk exception to

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[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;

(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;

(3) That sharp swings in assessment rates for insured depository institutions should be prevented; and

(4) Other factors as the Board may deem appropriate, consistent with the requirements of the Reform Act.

Section 7(b)(3)(C) of the FDI Act, 12 U.S.C. § 1817(b)(3)(C).

[14] The decline in the DIF balance does not include the cost of protecting uninsured deposits pursuant to the systemic risk determination announced following the failures of Silicon Valley Bank and Signature Bank in March 2023, as the FDIC is required by statute to recover those losses through special assessments. *See* 12 U.S.C. § 1823(c)(4)(G)(ii)(III).

[15] FDIC, Annual Report 2022, Assets and Deposits of Failed or Assisted Insured Institutions and Losses to the Deposit Insurance Fund, 1934-2022, page 178, available at https://www.fdic.gov/about/financial-reports/reports/2022annualreport/2022-arfinal.pdf.

allow the FDIC to complete its resolution of both Silicon Valley Bank and Signature Bank in a manner that fully protects depositors.[16]

The FDIC estimates the losses from the failures of Silicon Valley Bank and Signature Bank to be $18.7 billion; however, of that estimated loss, the FDIC estimates that approximately $16.3 billion was attributable to the cost of covering uninsured deposits pursuant to the systemic risk determinations made on March 12, 2023.[17] By statute, the FDIC is required to recover through one or more special assessments the estimated losses to the DIF incurred as a result of the actions of the FDIC pursuant to determinations of systemic risk.[18] Staff are separately and concurrently recommending the Board authorize publication of a final rule to implement a special assessment to recover the loss to the DIF associated with protecting uninsured depositors following the closures of Silicon Valley Bank and Signature Bank. Therefore, only the estimated loss from these two failures not attributable to covering uninsured deposits of $2.4 billion directly impact the DIF balance.

First Republic Bank was closed on May 1, 2023.[19] The FDIC estimates the cost to the DIF to be $15.6 billion. As with all failed bank receiverships, this estimate will be periodically adjusted and the final cost will be determined when the FDIC terminates the receivership.

The two other bank failures in 2023 were Heartland Tri-State Bank on July 28, 2023, and Citizens Bank on November 3, 2023. As of March 31, 2023, Heartland Tri-State Bank had approximately $139 million in total assets and $130 million in total deposits.[20] As of September 30, 2023, Citizens Bank had approximately $66 million in total assets and $59 million in total deposits.[21] The FDIC estimates the cost to the DIF from these two failures to be $69.0 million.

The combined estimated cost to the DIF from the five bank failures for this year is $18.1 billion.[22]

Based on currently available information about troubled banks, trends in CAMELS ratings, failure rates, and loss rates, FDIC staff project that failures for the five-year period ending in 2027 would cost the DIF approximately $4.4 billion. The total number of institutions on the FDIC's Problem Bank List rose to 43, as of June 30, 2023, from 40, on June 30, 2022. The number of problem banks remains well below the peak of 888 institutions in March 2011.[23]

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[16] 12 U.S.C. § 1823(c)(4)(G). *See also* FDIC PR-17-2023. "Joint Statement by the Department of Treasury, Federal Reserve, and FDIC," March 12, 2023, available at: https://www.fdic.gov/news/press-releases/2023/pr23017.html.
[17] The exact cost will be determined when the FDIC terminates the receiverships.
[18] 12 U.S.C. § 1823(c)(4)(G).
[19] FDIC PR-34-2023. "JPMorgan Chase Bank, National Association, Columbus, Ohio Assumes All the Deposits of First Republic Bank, San Francisco, California," May 1, 2023, available at: https://www.fdic.gov/news/press-releases/2023/pr23034.html. Estimated loss as of June 30, 2023.
[20] FDIC PR-58-2023. "Dream First Bank, National Association, of Syracuse, Kansas, Assumes All of the Deposits of Heartland Tri-State Bank of Elkhart, Kansas," July 28, 2023, available at: https://www.fdic.gov/news/press-releases/2023/pr23058.html.
[21] FDIC PR-91-2023. "Iowa Trust & Savings Bank, Emmetsburg, Iowa, Assumes All of the Deposits of Citizens Bank, Sac City, Iowa," November 3, 2023, available at: https://www.fdic.gov/news/press-releases/2023/pr23091.html.
[22] The combined estimated cost to the DIF does not include the cost of protecting uninsured deposits pursuant to the systemic risk determination announced following the two bank failures in March 2023.
[23] "Problem" institutions are institutions with a CAMELS composite rating of "4" or "5" due to financial, operational, or managerial weaknesses, or a combination of such issues. It is common for banks to move on or off this list each quarter.

Potential future losses can lower the DIF and bring the reserve ratio further from its long-term goal. In staff's view, setting a long-term, minimum goal should take into consideration high losses incurred during historical crisis periods, so that the DRR can be set at a level that would improve the DIF's ability to handle losses during any future periods of banking industry stress and reduce the possibility of increased deposit insurance assessment rates during a banking downturn.

Future losses to the DIF remain uncertain and depend, in part, on trends in inflation and interest rates and the possibility of an economic slowdown, among other factors, described in more detail below. Despite the period of stress earlier this year, the banking industry continues to be resilient. However, the banking industry continues to face significant downside risks from the effects of inflation, rising market interest rates, and geopolitical uncertainty.

Economic conditions affecting FDIC-insured institutions

Economic growth slowed after 2021 but has remained resilient, despite elevated inflation and interest rates, driven by business and consumer spending. U.S. GDP grew 2.1 percent at a real seasonally adjusted annualized rate in second quarter 2023, after 2.2 percent growth in first quarter 2023.[24] The September Blue Chip Economic Indicators consensus forecast for GDP growth is 2.1 percent for full year 2023.[25] Risks to the economic outlook include the effects of high inflation, higher interest rates, geopolitical uncertainty, bank credit tightening, and global economic slowdown. A weaker economy may reduce bank profitability, weaken credit quality and capital, and limit loan growth.

Financial market conditions improved over the second quarter of 2023 as banking sector stress abated and inflation and economic data came in better than expected. Bond and equity volatility declined slightly over the second quarter after spiking in March during the U.S. banking sector stress. Treasury yields rose across the board as markets expected interest rates to move higher and remain higher than anticipated.

Despite the period of stress earlier this year, the banking industry continues to be resilient. In the first and second quarters of 2023, net income remained high by historical measures, asset quality metrics remained favorable, and the industry remained well capitalized. However, banks reported tightening net interest margins and funding pressures for both quarters. The banking industry continues to face significant downside risks from the effects of inflation, rising market interest rates, and geopolitical uncertainty.

Furthermore, unrealized losses in the banking industry's securities portfolios remain elevated. Declines in medium- and long-term rates reduced the volume of these unrealized losses in fourth quarter 2022 and first quarter 2023, before unrealized losses increased again in second quarter 2023. Additional short-term interest rate increases combined with longer asset maturities may also affect bank balance sheets in coming quarters. As evidenced in the recent bank failures, unrealized losses can also significantly reduce a bank's liquidity position in the event of unexpected cash outflows that could force the bank to sell securities and realize losses, reducing its regulatory capital. Higher market interest rates may also erode real estate and other asset values, as well as hamper the loan repayment ability of borrowers with adjustable rate loans or in need of refinancing.

Although these near-term economic conditions and recent trends in banking industry performance can inform the Board's decision on the DRR, they become less relevant in setting the DRR when, as it is now, the DIF reserve ratio is below its statutory minimum of 1.35 percent. In this context, staff believes that the DRR should be viewed from a longer-term perspective. Twice within the past 40 years, serious economic dislocations have

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[24] Bureau of Economic Analysis.
[25] September 2023 Blue Chip Economic Forecast.

resulted in a significant deterioration in the condition of many IDIs and in a large number of bank failures at high cost to the DIF, and the three large bank failures earlier this year reduced the DIF balance and reserve ratio.

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 elevated bank institution failures. Taking these longer-term economic conditions into account, staff recommends setting the DRR at 2 percent, 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 IDIs when setting the DRR.[26] Setting the DRR at 2 percent as a minimum goal would signal that the Board plans for the DIF to grow during times of favorable banking conditions so that funds are available to absorb losses due to a significant rise in bank failures throughout periods of stress. 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 IDIs can least afford an increase.

Maintaining the DIF at a level that can withstand substantial losses

Staff 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 during times of favorable banking conditions to increase the likelihood of the DIF remaining positive throughout periods of significant losses due to bank failures. 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 goal.

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[26] Section 7(b)(3)(C)(iii) of the FDI Act, 12 U.S.C. § 1817(b)(3)(C)(iii).

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