



Federal Deposit Insurance Corporation

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Division of Insurance and Research

September 22, 2014

MEMORANDUM TO: The Board of Directors

FROM: Diane Ellis *Diane Ellis*
Director
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SUBJECT: Designated Reserve Ratio for 2015

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 (DIF) and publish the designated reserve ratio, or DRR, before the beginning of each calendar year.¹ On October 8, 2013, the Board approved for publication a notice setting the DRR at 2 percent for 2014.² The staff recommends maintaining the DRR at 2 percent for 2015 and requests that the Board authorize the staff to publish 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 in good times to increase the likelihood of the DIF remaining positive during bad times, consistent with the FDIC's comprehensive, long-term fund management plan.

The manner in which the Board evaluates the statutory factors may depend on its view of the role of the DRR, which may change over time. Governing statutes do not direct the Board on how to use the DRR. Based on current circumstances and historical analysis, staff continues to

¹ 12 U.S.C. § 1817(b)(3)(A).

² 78 FR 62633 (Oct. 22, 2013). Similarly, on December 11, 2012, the Board approved for publication a notice setting the DRR at 2 percent for 2013. 77 FR 74662 (Dec. 17, 2012). The DRR was first set at 2 percent in a final rule approved by the Board on December 14, 2010. See 75 FR 79286 (Dec. 20, 2010), codified at 12 C.F.R. § 327.4(g). The DRR is expressed as a percentage of estimated insured deposits.

³ 12 U.S.C. § 1817(b)(3)(C).

Concur:

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view the DRR as a long-range, minimum target 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

Background

Governing statutes

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which was enacted on July 21, 2010, gave the FDIC much greater discretion to manage the DIF, including where to set the DRR. Among other things, Dodd-Frank: (1) raised the minimum DRR to 1.35 percent (from the former minimum of 1.15 percent) and removed the upper limit on the DRR (which was formerly capped at 1.5 percent) and consequently on the size of the fund;⁵ (2) required that the fund reserve ratio reach 1.35 percent by September 30, 2020 (rather than 1.15 percent by the end of 2016, as formerly required);⁶ (3) required the FDIC to offset the effect on institutions with less than \$10 billion in total consolidated assets of increasing the reserve ratio from 1.15 percent to 1.35 percent;⁷ (4) eliminated the requirement that the FDIC provide dividends from the fund when the reserve ratio is between 1.35 percent and 1.5 percent;⁸ and (5) continued the FDIC's authority to declare dividends when the reserve ratio is at least 1.5 percent, but granted the FDIC sole discretion in determining whether to suspend or limit the declaration or payment of dividends.⁹

The FDI Act continues to require that the Board consider the appropriate level for the DRR annually and, if the Board is changing the DRR, engage in notice-and-comment rulemaking before the beginning of the calendar year.¹⁰

In effect, Dodd-Frank provided the Board with broad discretion to set the DRR in consideration of specified factors and other factors that the Board determines are appropriate, so long as it is set no lower than 1.35 percent. Neither the FDI Act nor the amendments under Dodd-Frank establish a statutory role for the DRR as a trigger, whether for assessment rate determination, recapitalization of the fund, or dividends.

⁴ 75 FR 66262 (Oct. 27, 2010).

⁵ 12 U.S.C. § 1817(b)(3)(B).

⁶ 12 U.S.C. § 1817(nt).

⁷ 12 U.S.C. § 1817(nt). Because the reserve ratio is not projected to reach 1.15 percent for several years, the Board has flexibility in the timing of the rulemaking to implement the offset requirement. Staff will continue to consider both the appropriate approach to and timing of the offset rulemaking.

⁸ 12 U.S.C. § 1817(e).

⁹ 12 U.S.C. § 1817(e)(2)(B).

¹⁰ 12 U.S.C. § 1817(b)(3)(A).

Comprehensive, long-range management plan for the DIF

The October 2010 NPR proposed raising the DRR to 2 percent. After consideration of comments received, a final rule adopted by the Board in December 2010 set the DRR at 2 percent.

The October 2010 NPR also set out a comprehensive, long-range management plan for the DIF that was designed to: (1) reduce pro-cyclicality in the risk-based assessment system by allowing moderate, steady assessment rates throughout economic and credit cycles; and (2) 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.¹¹

During an economic and banking downturn, insured institutions can least afford to pay high deposit insurance assessment rates. Moreover, high assessment rates during a downturn reduce the amount that banks can lend when the economy most needs new lending. 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.¹²

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 when the fund balance approaches zero, the FDIC has viewed the Treasury line of credit as available to cover unforeseen losses, not as a source of financing projected 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 management plan, staff analyzed historical fund losses and income data from 1950 to 2010 to determine how high the reserve ratio would have 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. Staff also found that the fund reserve ratio would have had to exceed 2 percent before the onset of the crises to achieve these results.

¹¹ 75 FR 66262 (Oct. 27, 2010). Pursuant to the comprehensive plan, the FDIC also adopted a new Restoration Plan to ensure that the DIF reserve ratio reaches 1.35 percent by September 30, 2020, as required by Dodd-Frank. 75 FR 66293 (Oct. 27, 2010).

¹² At a September 24, 2010, roundtable organized by the FDIC, bank executives and industry trade group representatives uniformly favored steady, predictable assessments and found high assessment rates during crises objectionable. The proceedings of the roundtable can be viewed in their entirety at: http://www.vodium.com/MediaopodLibrary/index.asp?library=pn100472_fdic_RoundTable.

Staff views the 2 percent DRR as the *minimum* level needed to withstand a future 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.

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. Dodd-Frank, 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 or more before the onset of the crises to maintain both a positive fund balance and stable assessment rates.¹³

Analysis of Statutory Factors

As discussed above, Dodd-Frank retains the requirement that the Board set and publish the DRR annually in accordance with its analysis of statutory factors.¹⁴ 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 in good times to increase the likelihood of the DIF remaining positive during bad times, consistent with the FDIC's comprehensive, long-term fund management plan.

¹³ 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 79288 (Dec. 20, 2010).

¹⁴ 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.
- (4) Other factors as the FDIC's Board may deem appropriate, consistent with the requirements of the Reform Act.

12 U.S.C. § 1817(b)(3)(C).

Risk of losses to the DIF

The DIF balance has increased for four and one-half years in a row, following seven quarters of decline, and stood at \$51.1 billion on June 30, 2014. Cumulatively, the DIF balance has risen by \$72 billion from its negative \$20.9 billion low point at the end of 2009. Of the total increase in the DIF balance, \$9.3 billion comes from fees and surcharges under the Temporary Liquidity Guarantee Program (TLGP).¹⁵ Other factors contributing to the recent increase in the fund balance include assessment income and a decline in estimated losses. At June 30, 2014, the contingent loss reserve for anticipated failures was \$1.5 billion, down from \$2.4 billion one year earlier.

The increase in the DIF balance reflects improvements in banking industry performance and condition. The second quarter of 2014 marked the 18th time in the past 20 quarters in which banking industry earnings posted a year-over-year increase. More than half (57.5 percent) of institutions reported year-over-year earnings growth while only 6.8 percent were unprofitable – the lowest proportion of unprofitable institutions since the first quarter of 2006. Asset quality, as measured by the volume of noncurrent loans and leases, has improved for 17 consecutive quarters. The total number of institutions on the FDIC’s Problem Institution List fell to 354 at June 30, 2014 from 553 at June 30, 2013. The number of problem banks has declined for 13 consecutive quarters and is now at its lowest level in over five years.

The rates at which 3-, 4-, or 5-rated institutions have failed, and their costs, have declined significantly since the spring of 2010. A total of 14 banks failed from January through August of 2014, down from 20 failures in the same eight-month period last year.

Although the banking industry’s financial condition has improved since the most recent crisis, challenges still remain. Revenue growth remains weak, reflecting modest loan growth and narrow margins. The average net interest margin fell to 3.15 percent for the second quarter 2014, its lowest level since the third quarter 1989. The prolonged low interest rate environment has created incentives for institutions to reach for yield by increasing the share of longer-term assets on their balance sheets. This reach for yield has helped average asset yields, but it has left banks more vulnerable to interest rate risk as rates rise.

In staff’s view, high deposit insurance fund losses incurred during the crisis of the 1980s and early 1990s and during the more recent crisis suggest that the Board should set a DRR at a level that would have maintained a positive fund balance during both crises. Adoption of this

¹⁵ The TLGP was announced on October 14, 2008, as part of the federal government’s coordinated response to the financial crisis. 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.

long-range, minimum goal would improve the DIF's ability to handle losses during any future periods of severe industry stress and reduce the possibility of increased deposit insurance assessment rates during a banking downturn.

Economic conditions affecting FDIC-insured institutions

The U.S. economic recovery has been underway for five years, although the recovery has been generally uneven throughout the country and across sectors. Moreover, the rate of growth in the U.S. economy over the past five years has been below the long-term trend. Nevertheless, in the first half of 2014, the housing sector continued to improve, consumer spending rose moderately, the unemployment rate declined, and business investment grew.

Key risks continue to weigh on the economic outlook, including the impact of rising interest rates as they return to more normal levels; fiscal challenges at federal, state, and local levels; and global economic risks. 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.

Although near-term economic prospects 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 the DIF balance is still recovering from the effects of the crisis. In this context, staff believes that the DRR should be viewed in a longer-term perspective. Twice within the past 30 years, serious economic dislocations have resulted in a significant deterioration in the condition of many insured depository institutions and in a consequent large number of insured depository institution failures at high costs to the DIF. 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 their attendant insured depository institution failures. Taking these longer-term economic realities into account, a prudent and consistent policy would set the DRR at a minimum of 2 percent, since that is 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

Current law directs the Board to consider preventing sharp swings in assessment rates for insured depository institutions. Setting the DRR at 2 percent as a minimum goal rather than a final target would signal that the Board plans for the DIF to grow in good times so that funds are available to handle multiple bank failures in bad times. 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 rate increases during crises, when insured depository institutions can least afford an increase.

Maintaining the DIF at a level that can withstand substantial losses

Staff again recommends, as it did in 2010 and every year since, 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 large in good times to increase the likelihood of the DIF remaining positive during bad times. 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.

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* target.

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