




June 8, 2010

MEMORANDUM TO: The Board of Directors

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

SUBJECT: Deposit Insurance Fund Loss, Income and Reserve Ratio
Projection Update for the Restoration Plan

SUMMARY

Pursuant to the Restoration Plan adopted by the FDIC Board in October 2008 and its subsequent amendments, staff is updating the Board on loss, income and reserve ratio projections for the Deposit Insurance Fund (DIF or the Fund). The Restoration Plan as amended maintains assessment rates at their current levels through the end of 2010 and applies a uniform 3 basis point increase in assessment rates effective January 1, 2011.

Under staff's current projections, as under those presented to the Board at its September 29, 2009 meeting, current assessment rates—increased uniformly by three basis points beginning January 1, 2011, as called for by the amended Restoration Plan—would return the Fund to a positive balance in 2012 and the reserve ratio to the statutory minimum target of 1.15 percent during the first quarter of 2017, one quarter beyond the eight-year time frame set forth in the statute. For two reasons, staff recommends that the Board defer a decision on whether to further raise assessment rates to meet the statutory deadline until later in the restoration plan period. First, projections made so far into the future are subject to considerable uncertainty. Deferring a decision on whether to raise rates until later should allow staff to produce projections that are subject to less uncertainty. Second, if a further assessment rate increase becomes necessary, delaying the increase until later in the restoration plan period should allow the industry more time to recover, so that the burden of increased rates will be easier to bear.

Staff also projects that the DIF's cash balance will be sufficient to fund the resolution of failing institutions throughout the next five-year period.

In accordance with the terms of the Restoration Plan, staff will continue to provide semiannual loss, income and reserve ratio projections.

BACKGROUND

In October 2008, the Board adopted a Restoration Plan to return the Fund to its statutorily mandated minimum reserve ratio of 1.15 percent within five years.¹ The Board thereafter

¹ 73 FR 61598 (Oct. 16, 2008).

amended the Restoration Plan twice, most recently in September 2009. Based upon staff's updated loss projections to the DIF of \$100 billion over the years 2009-2013, the Board extended the restoration plan period to eight years and called for a uniform 3 basis point increase in assessment rates effective January 1, 2011, to meet the Restoration Plan's goal of returning the reserve ratio to 1.15 percent by the end of 2016.²

To address the DIF's increasing liquidity needs, the Board also issued a notice of proposed rulemaking to require insured depository institutions (IDIs) to prepay estimated risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011, and 2012. This rule was finalized on November 12, 2009, and institutions prepaid approximately \$46 billion in assessments on December 30, 2009.³

Since the Board adopted the amended Restoration Plan, there have been 126 IDI failures—45 additional IDIs in 2009 and 81 IDIs in 2010 as of June 4, 2010—at a cost of approximately \$27 billion. Additionally, the number of problem IDIs has grown to 775 as of March 31, 2010. Despite these numbers, IDI earnings and other numbers are beginning to show signs of industry improvement. For the first quarter, the industry reported \$18 billion in net income, up from negative \$1.3 billion in the final quarter of 2009, with more than one-half the industry reporting higher net income than one year ago. Lower provisioning was the primary driver of the improved earnings numbers and this is consistent with the moderation seen in asset quality trends. For the fourth consecutive quarter, the combination of quarterly net charge-offs plus the quarterly increase in noncurrent loans declined.

Improvements, too, have been seen in the number of IDIs joining the problem bank list. While the number of IDIs on this list increased by 10 percent during the first quarter of 2010, this number was down markedly from the 27 percent jump in the number of IDIs that were added in the fourth quarter of 2009. The reduction in the rate of increase in the problem bank list reflects a decline in the rate of downgrade of institutions from CAMELS 1 or 2 ratings to CAMELS 3, 4 or 5 ratings. The downgrade rate during each of the first four months of 2010 was lower than the rate for any month in 2009. Like IDI failures, the number of problem institutions tends to lag behind economic recovery so signs of a slowdown in the growth of this number are a positive indicator that the industry could be slowly improving.

Likewise, after seven quarters of declines, the DIF showed a small improvement, ending the quarter at negative \$20.7 billion compared to negative \$20.9 billion (unaudited) at December

² 74 FR 51062 (October 2, 2009). In May 2009 Congress had amended the statute governing establishment and implementation of the Restoration Plan to allow the FDIC up to eight years to return the DIF reserve ratio to 1.15 percent, absent extraordinary circumstances. 12 U.S.C. §1817(b)(3)(E), as amended by the Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, §204(b), 123 Stat. 1649.

³ The FDIC's immediate liquidity needs were resolved by the inflow of approximately \$46 billion in cash from the prepaid assessments, but this inflow did not initially affect the DIF balance. The DIF accounted for the amount collected as both an asset (cash) and an offsetting liability (deferred revenue). An institution's quarterly risk-based deposit insurance assessments thereafter are recognized by the DIF as revenue and offset by the amount prepaid until that amount is exhausted or until June 30, 2013, after which any amount remaining will be returned to the institution.

31, 2009. This was due, in part, to a decline in contingent loss reserve balances of \$3.3 billion from year-end 2009. The contingent loss reserve declined for the first time in almost three years.

There are other signs of improvement. There have been more bidders and higher bids for failed institutions. Not only are failed IDIs with good deposit franchises attracting better prices, but there have also been higher-than-expected proceeds from asset sales. IDIs also show signs that their capital positions are improving as more IDIs have been able to raise capital in the past several weeks.

PROJECTIONS

Staff has projected the Fund balance and reserve ratio for each quarter over the next several years using the most recently available information on expected failures and loss rates and statistical analyses of trends in CAMELS downgrades, failure rates and loss rates. Under these projections, Fund failure costs for the five-year period 2010-2014 are approximately \$60 billion.⁴ Beyond five years, projections for the Fund balance and reserve ratio assume a continued low level of failures and associated losses. Over the period of the Restoration Plan, the projections show little change from those prepared last fall and thus do not indicate a need to change the Restoration Plan. Staff continues to believe that the number of failures and the associated costs will peak in 2010 and that the DIF balance will start to increase in the coming quarters. Most of the projected costs are already reflected in the DIF balance. Approximately \$6 billion of the \$60 billion amount was incurred in estimated failure costs during the first quarter of 2010. Also, at March 31, 2010, an additional \$41 billion of projected losses was accounted for in the DIF balance as the contingent loss reserve. Thus, of the \$60 billion in projected losses over the five-year period, only \$13 billion are projected as future expenses of the fund, which compares with projected 2010 assessment revenue of nearly \$14 billion.

The current Restoration Plan maintains assessment rates at their current levels through the end of 2010 and imposes a uniform 3 basis point increase in assessment rates effective January 1, 2011. The projections assume that domestic deposits increase at an annual rate of 5 percent producing assessment income over the 2010-2014 period of \$81.2 billion; approximately half of these assessments have been pre-paid.

Under staff's projections, maintaining the current Restoration Plan would return the Fund to a positive balance in 2012 and the reserve ratio to 1.16 percent by the first quarter of 2017.⁵ This is one quarter beyond the eight-year time frame set forth in the Restoration Plan, but remains unchanged from the time frame projected in September 2009 and presented to the Board in support of the Restoration Plan.

⁴ Staff's projection in September 2009 of approximately \$100 billion in losses over the period 2009-2013 included a projection of approximately \$60 billion over the period 2010-2013, consistent with the most recent projections.

⁵ These projections assume that the deposit insurance coverage limit will revert to \$100,000 on January 1, 2014, as the current statute dictates. The reserve ratio would be lower if the deposit insurance coverage limit remained at \$250,000.

These projections are subject to considerable uncertainty. Losses could differ from projected amounts if financial stresses facing larger institutions or conditions affecting the national or regional economies prove more or less severe than currently anticipated. For example, staff's projections for DIF losses may increase if the economic effects of the oil spill in the Gulf of Mexico spread beyond the Gulf Coast states or affect Gulf Coast economies more than currently anticipated. Similarly, DIF loss estimates may increase if European debt problems evolve to significantly affect U.S. IDIs directly, or indirectly by creating significant adverse effects on the global economy.

These projections also assume that the temporary increase in deposit insurance coverage limit to \$250,000 expires as planned. If coverage at this level is extended, staff expects that this would postpone the goal of achieving a reserve ratio of 1.15 percent by two quarters. In any event, the Board could raise rates in the latter part of the eight-year period, if necessary, to meet the eight-year time frame. Deferring any further assessment rate increases lessens the pro-cyclical effect of restoring the reserve ratio to 1.15 without weakening the liquidity position of the FDIC. Staff projects that the DIF cash balance will be sufficient for resolving failing institutions throughout the next five-year period. Staff will continue to update the Board on a semiannual basis.

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