




October 2, 2012

**MEMORANDUM TO:** The Board of Directors

**FROM:** 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 second semi-annual update for 2012.

The DIF balance has risen for ten consecutive quarters and stood at \$22.7 billion (unaudited) at June 30, 2012, resulting in a reserve ratio of 0.32 percent. Staff projects that, under current assessment rates, the DIF reserve ratio will reach 1.15 percent by the end of 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 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 second quarter of 2012 was the tenth consecutive quarter of aggregate positive net income. Sixty-three 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 11 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 nine consecutive quarters.

The total number of institutions on the FDIC's Problem Institution List fell to 732 at June 30, 2012, from 813 at year-end 2011. The number of problem banks has declined for five consecutive quarters and is now at its lowest level since the end of 2009. The improvement in the number of problem institutions reflects a continued decline in the rate of supervisory rating downgrades from CAMELS ratings of 1 or 2 to CAMELS ratings of 3, 4, or 5, as well as an increase in the rate of supervisory rating upgrades.

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<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, 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 43 banks failed from January through September of 2012, down from 74 for the same nine-month period in 2011. The total assets of the 43 failures in the first nine months of 2012 – \$9.5 billion – were significantly less than the \$30.4 billion in total assets of failed banks for the same period last year.

The U.S. economic recovery has been under way for over three years. Real GDP grew at an annual pace of 1.7 percent in the first half of 2012, following 1.8 percent growth in 2011. Consensus forecasts for U.S. real GDP growth for all of 2012 are in the range of 2.0 to 2.5 percent. This expected steady but slow expansion of the U.S. economy should be sufficient to support the continuing gradual improvement of 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 has increased for ten quarters in a row, and now stands at \$22.7 billion (unaudited). Cumulatively, the DIF balance has risen by almost \$44 billion from its negative \$20.9 billion low point at the end of 2009. Of the total increase in the DIF balance, \$6.6 billion comes from fees previously set aside for debt guaranteed under the Temporary Liquidity Guarantee Program (TLGP), reflecting the wind-down of the program.<sup>7</sup> Other factors contributing to the increase include assessment income and a decline in the contingent loss reserve for anticipated bank failures. At June 30, 2012, the contingent loss reserve was \$4.0 billion, down from \$10.3 billion one year earlier.

## **PROJECTIONS**

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 April, the staff projected that failures for the five-year period from 2012 through 2016 would cost \$12 billion.<sup>8</sup> The current projected total cost of failures for the same five years has declined to \$10 billion, primarily because of lower recent and expected

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<sup>7</sup> 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). There are \$1.7 billion in assets still set aside to pay TLGP claims. The TAG expired at the end of 2010 and was replaced by a similar temporary program established under Dodd-Frank that is scheduled to expire on December 31, 2012. The last debt guarantees under the DGP also will expire on that date.

<sup>8</sup> Memorandum to the Board of Directors from Arthur J. Murton (Director, Division of Insurance and Research) dated April 3, 2012.

failure rates of troubled institutions as well as a smaller average size of failing banks. The lower losses projected for these five years follow estimated losses of \$88 billion for banks that failed from 2008 through 2011. The staff expects that the pace of ratings downgrades to CAMELS 3, 4, or 5, and the rate at which troubled banks fail, will continue to slow, with ratings upgrades outpacing downgrades over the 2012-2016 period. Beyond five years, the projections assume a low level of failures and associated losses.

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

The reserve ratio stood at 0.32 percent at June 30, 2012. Under staff's projections, the reserve ratio should reach 1.15 percent by the end of 2018, within the time frame of the Restoration Plan.

The current reserve ratio reflects the temporary increase in estimated insured deposits attributable to the Dodd-Frank provision that insures the entire balance of non-interest bearing transaction accounts. The reserve ratio projections assume that the balances above \$250,000 in these accounts will no longer be insured deposits when the temporary higher coverage expires after December 31, 2012.

Staff has also projected the DIF's cash and liquid asset balance over the next five years. In the staff's view, current liquid assets (including funds attributable to prepaid assessments), together with projected future assessment cash collections and dividends from failed bank receiverships, should be sufficient to meet all obligations arising from past or future bank failures during the next five years.<sup>9</sup>

The projections for the DIF are subject to considerable uncertainty arising from the potential for external shocks and a slowdown in the economic recovery. The current economic recovery has fallen short of previous recoveries as evidenced by persistently high unemployment. Below-trend U.S. economic growth may be prolonged, and two key risks continue to weigh on the outlook. First, continuing uncertainty in Europe has contributed to volatility in global financial markets that could trigger increased volatility in U.S. financial

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<sup>9</sup> To ensure sufficient DIF liquidity, the Board issued a final rule on November 12, 2009 (74 Fed. Reg. 59056 (November 17, 2009)), that required insured depository institutions to prepay estimated risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011, and 2012. Institutions prepaid approximately \$46 billion in assessments on December 30, 2009. The prepaid assessments resolved the FDIC's immediate liquidity needs, but the cash inflow did not initially affect the DIF balance (i.e., net worth). The DIF accounted for the amount collected as both an asset (cash) and an offsetting liability (deferred revenue). Each quarter, the DIF recognizes as revenue each institution's quarterly risk-based assessment, which is offset by the amount prepaid. Any institution's prepaid assessment remaining on June 30, 2013, will be returned to the institution.

markets and adversely affect the U.S. economy. Second, the “fiscal cliff” at the start of 2013—the scheduled expiration of several tax cuts and the start of automatic federal spending cuts—appears to be affecting economic activity already as consumers and businesses face growing uncertainty. A slowdown in the economic recovery could result in bank failures rising above projections and failed bank assets declining in value. Such a decline in value could make both past and future failures more costly. Furthermore, future assessment revenue and estimated insured deposits could diverge from staff’s projections depending on how banks adapt to the assessment rules adopted in 2011 and changes in bank risk profiles.

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’s recovery before considering future adjustments to the Restoration Plan and assessment levels. Staff will continue to update the Board on a semiannual basis.

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