Federal Deposit Insurance Corporation

MEMO

TO: The Board of Directors

FROM: Diane Ellis
Director, Division of Insurance and Research

DATE: December 14, 2021

RE: Restoration Plan Semiannual Update

SUMMARY

The Federal Deposit Insurance Act (the FDI Act) requires that the FDIC's Board of Directors (Board) adopt a restoration plan when the Deposit Insurance Fund (the DIF or the fund) reserve ratio falls below 1.35 percent or is expected to within 6 months.[1] As of June 30, 2020, the reserve ratio had fallen below the statutory minimum and stood at 1.30 percent. On September 15, 2020, the Board adopted a Restoration Plan (Plan) to restore the DIF to at least 1.35 percent by September 30, 2028.[2] The Plan requires the FDIC to update its analysis and projections for the DIF balance and reserve ratio at least semiannually. This memorandum is the second semiannual update for 2021 following the establishment of the Plan in September 2020. Similar to the last update, staff recommend no changes to the Plan and will continue to update the Board semiannually, or more frequently as conditions warrant, to determine if changes to the Plan are necessary.

Under the Plan, detailed below, the FDIC is monitoring deposit balance trends, potential losses, and other factors that affect the reserve ratio. While subject to uncertainty, based on a range of reasonable estimates of future losses and normal depositor behavior in the long-term, staff continue to project that the reserve ratio would return to 1.35 percent before the end of the statutory 8-year period beginning upon the implementation of the Plan.

Extraordinary growth in insured deposits during the first and second quarters of 2020 caused the reserve ratio to decline below the statutory minimum as of June 30, 2020. Since the Board adopted the Plan, insured deposit growth decelerated compared to the extraordinary growth experienced in the first half of 2020. Banks experienced significant growth in insured deposits during the first quarter of 2021 due to subsequent additional fiscal stimulus and continued elevated savings rates. Since the first semiannual update was provided to the Board in June, insured deposits have grown in line with recent historical averages for the second and third quarters, resulting in a reserve ratio of 1.27 percent as of September 30, 2021.

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[1] 12 U.S.C. § 1817(b)(3)(E).

[2] *See* 85 FR 59306 (Sept. 21, 2020). Under the FDI Act, a restoration plan must restore the reserve ratio to at least 1.35 percent within 8 years of establishing the plan, absent extraordinary circumstances. 12 U.S.C. § 1817(b)(3)(E)(ii).

As infections receded following a rise in Coronavirus 2019 (COVID-19) cases over the summer months, coupled with progress on vaccinations, continued strengthening in indicators of economic activity, and waning fiscal support, the growth in insured deposits associated with the pandemic appears to have slowed through the third quarter of 2021. Although some uncertainty persists, including the recent rise in COVID-19 cases and the emergence of the Omicron variant, the overall economic outlook has strengthened relative to when the Plan was first adopted in September 2020, and the banking system continues to appear better positioned to withstand losses when compared to prior periods of stress.

As described below, while insured deposit balances may remain elevated to some extent in the near-term, recent trends in insured deposit growth have been at or below historical averages prior to the pandemic, indicating that growth rates may have begun to normalize. Whether the normalization of insured deposit growth continues and those insured deposits resulting from extraordinary growth will recede is uncertain, but staff expect more clarity in the future and will continue to monitor deposit trends.

BACKGROUND

As of June 30, 2020, the reserve ratio had fallen below the statutory minimum and stood at 1.30 percent.[3] The decline in the reserve ratio during the first half of 2020 was solely a result of extraordinary insured deposit growth resulting from actions taken by monetary and fiscal authorities, and by individuals, businesses, and financial market participants in response to the COVID-19 pandemic. On September 15, 2020, the Board adopted a Plan to restore the DIF to at least 1.35 percent by September 30, 2028, maintaining the assessment rate schedule in place at the time. As of the first semiannual update to the Board in 2021, insured deposits grew due to subsequent additional fiscal stimulus and continued elevated savings rates, resulting in the reserve ratio falling to a low of 1.25 percent as of March 31, 2021.[4]

Since then, the DIF balance continued to grow while quarterly insured deposit growth began to normalize, resulting in growth in the reserve ratio to 1.27 percent as of September 30, 2021. Table 1 shows the components of the reserve ratio for each quarter of 2021. Over this period, the DIF balance continued to grow and did not experience material losses. Assessment revenue declined, driven by lower assessment rates reflecting improvement in certain financial measures and in supervisory ratings. As of September 30, 2021, the DIF balance totaled a record $121.9 billion, up $2.6 billion from the end of the first quarter of 2021.

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[3] The reserve ratio is calculated as the ratio of the net worth of the Deposit Insurance Fund (fund balance) to the value of the aggregate estimated insured deposits at the end of a given quarter. *See* 12 U.S.C. § 1813(y)(3).

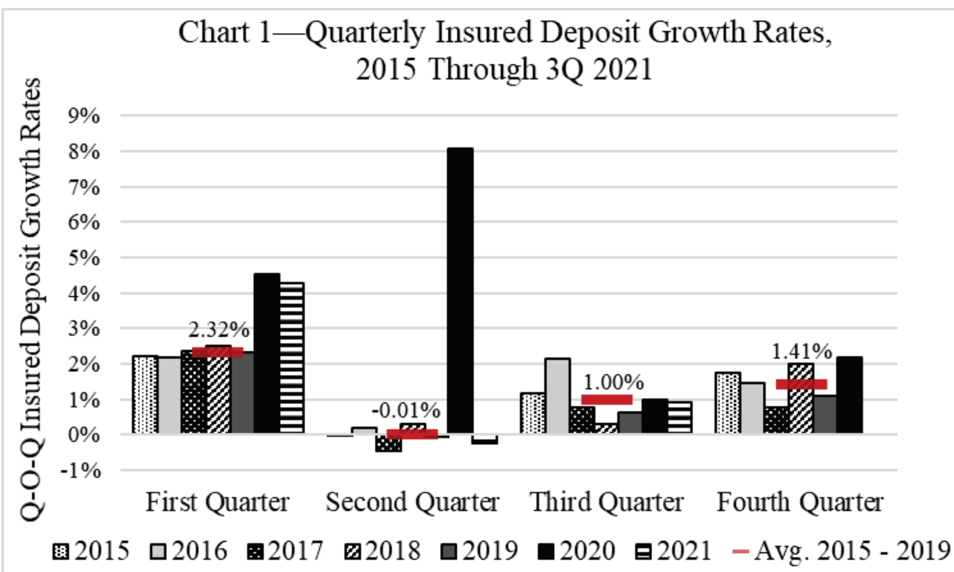
[4] Restoration Plan Semiannual Update, June 15, 2021, available at: https://www.fdic.gov/news/board-matters/2021/2021-06-15-notice-dis-a-mem.pdf.

Table 1–Fund Balance,
Estimated Insured Deposits, and Reserve Ratio
[dollar amounts in billions]

	1Q 2021	2Q 2021	3Q 2021
Beginning Fund Balance	$117.9	$119.4	$120.5
Plus: Net Assessment Revenue	$1.9	$1.6	$1.7
Plus: Investment Income[a]	*	*	$0.1
Less: Loss Provisions	($0.1)	*	($0.1)
Less: Operating Expenses	$0.5	$0.5	$0.5
Ending Fund Balance[b]	$119.4	$120.5	$121.9
Estimated Insured Deposits	$9,514.0	$9,490.2	$9,577.1
Q-O-Q Growth in Est. Insured Deposits	4.28%	(0.25%)	0.92%
Ending Reserve Ratio	1.25%	1.27%	1.27%

*Absolute value less than $50 million
[a]Includes unrealized gains/losses on available-for-sale securities.
[b]Components of fund balance changes may not sum to totals due to rounding.

In the first quarter of 2021, additional fiscal stimulus and continued elevated personal savings boosted insured deposits by 4.3 percent, nearly double the average quarterly growth rate of 2.3 percent from 2015 through 2019, illustrated in Chart 1. Insured deposit growth has since moderated, returning to pre-pandemic historical rates. In the second quarter of 2021, insured deposits declined by 0.2 percent, which is a larger decline than the average decline of 0.01 percent experienced in second quarters between 2015 and 2019. Insured deposits grew by 0.9 percent during the third quarter of 2021, slightly below the historical average.



For the first three quarters of 2021, insured deposits grew by $454 billion, with the vast majority of the growth occurring in the first quarter of 2021 due to the fiscal stimulus provided in January and again in March. While insured deposit balances may remain elevated to some extent in the near-term, recent trends in insured deposit growth have been at or below historical averages, indicating that growth rates may have begun to normalize.

THE RESTORATION PLAN

Under the FDI Act, when the reserve ratio falls below 1.35 percent the FDIC must establish and implement a restoration plan to restore the reserve ratio to at least 1.35 percent within 8 years of establishing the plan, absent extraordinary circumstances.[5] On September 15, 2020, the Board adopted a Restoration Plan to restore the DIF to at least 1.35 percent by September 30, 2028.[6]

The Plan requires the FDIC to update its analysis and projections for the fund balance and reserve ratio at least semiannually, which enables the FDIC to evaluate whether the increase of the reserve ratio is likely to reach 1.35 percent within the 8-year period. This memorandum is the second semiannual update for 2021 following establishment of the Plan in September 2020.

While subject to uncertainty, based on a range of reasonable estimates of future losses and normal depositor behavior in the long-term, the Plan described below would restore the reserve ratio to the required minimum level by September 30, 2028, within the timeframe required by law. The Plan provides that:

1. The FDIC will continue to monitor deposit trends, potential losses, and other factors that affect the reserve ratio.

2. The FDIC will maintain the current schedule of assessment rates for all insured depository institutions (IDIs).

3. At least semiannually, staff will update the Board on its analysis and projections for the fund balance and reserve ratio and, if necessary, recommend any modifications to the Plan, such as increasing assessment rates.

To determine whether the reserve ratio has reached the statutory minimum, the FDIC will rely on the reserve ratio as of September 30, 2028.[7]

SEMIANNUAL UPDATE

As stipulated by the Plan, below is an updated analysis with respect to each element of the Plan.

Deposit trends

The extraordinary growth in insured deposits during the first half of 2020 was largely a result of actions taken by monetary and fiscal authorities, and by individuals, businesses, and financial market participants in response to the COVID-19 pandemic. Since the Board adopted the Plan, insured deposits grew by 1.0 percent during the third quarter of 2020 and by 2.2 percent during the fourth quarter of 2020, a significant deceleration from the extraordinary growth experienced in the first half of 2020, but still above average. During the first quarter of 2021, insured deposits increased by 4.3 percent, driven by two additional rounds of fiscal stimulus. Since the first semiannual update, banks experienced typical insured deposit growth, as insured deposits

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[5] 12 U.S.C. § 1817(b)(3)(E).

[6] *See* 85 FR 59306 (Sept. 21, 2020). Under the FDI Act, a restoration plan must restore the reserve ratio to at least 1.35 percent within 8 years of establishing the plan, absent extraordinary circumstances. 12 U.S.C. § 1817(b)(3)(E)(ii).

[7] The reserve ratio is based on total estimated insured deposits at the end of a given quarter. The FDIC will rely on the reserve ratio as of September 30, 2028, the first quarter-end date for which the reserve ratio will be known after September 15, 2028, the end date of the 8-year period.

declined by 0.2 percent in the second quarter of 2021 followed by an increase of 0.9 percent in the third quarter of 2021. This moderation in insured deposit growth was attributable in part to a decline in support from fiscal stimulus programs and increases in consumer spending.

Since the first semiannual update, economic conditions continued to improve. Following a 3.5 percent decline in gross domestic product (GDP) in 2020, GDP surpassed its pre-recession peak in the second quarter of 2021. The unemployment rate was 4.6 percent in October 2021, which is down considerably from the high at the end of the February to April 2020 recession, but remains above pre-pandemic levels. However, economic growth slowed to 2.1 percent in the third quarter due in part to a rise in coronavirus cases, waning fiscal support, and supply constraints to production. These factors contributed to slower consumer spending in the third quarter. The personal savings rate has declined slightly below its pre-pandemic average to 7.3 percent as of October 2021 from a year-to-date high of 26.6 percent in March 2021. Lower personal savings contributed to the moderation in deposit growth, reflecting a decline in support from fiscal stimulus programs and increases in consumer spending driven by the continued economic recovery and higher inflation.

The economic outlook continues to strengthen, but remains uncertain. The November 2021 Blue Chip consensus forecast for GDP growth is 4.9 percent for the fourth quarter of 2021, and 5.5 percent for full-year 2021. The positive outlook for economic growth reflects expectations of increased consumer and business spending and continued improvement in the labor market, which reduces the incentive for precautionary savings. The outlook for savings and deposits remains uncertain and depends on the outlook for consumer spending and incomes. Any unexpected economic weakness or concerns about slower than expected economic recovery, and any resurgence of infections or reinstatement of restrictive measures to mitigate infections, may cause businesses and consumers to maintain caution in spending, and keep deposit levels elevated. Continued supply chain pressures and higher inflation may cause consumer spending to rise further as consumers pay more for a similar amount of goods, or may cause consumers to delay or forgo some purchases. Similarly, unexpected financial market stress could prompt another round of investor risk aversion that could lead to an increase in insured deposits. A significant increase in fiscal spending or further stimulus could also provide uncertainty to normalizing the level of insured deposits.

Going forward, staff expect normal depositor behavior in the long-term as economic conditions improve, the precautionary behavior exhibited by depositors continues to subside, and individuals and businesses redirect some deposits toward consumption and higher-yielding investments. Early fourth quarter deposit data monitoring indicates that seven weeks into the fourth quarter of 2021, estimated domestic deposits (including both insured and uninsured deposits) for domestically chartered commercial banks increased by 1.9 percent since September 30, 2021.[8]

The impact of continued uncertainty on deposit balances is difficult to predict. Under the Plan, the FDIC will continue to monitor deposit balance trends and their impact on the ability of the reserve ratio to return to 1.35 percent by September 30, 2028.

Potential losses

Losses from past and future bank failures affect the reserve ratio by lowering the fund balance. In recent years, the DIF has experienced low losses from IDI failures. On average, four IDIs per year failed between

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[8] Percent change for estimated weekly aggregate domestic deposits, which includes insured and uninsured deposits, at domestically chartered commercial banks only. This statistic is based on data that are reported weekly by a sample of banks and does not include deposits at other IDIs, including savings institutions. Federal Reserve, H.8 Data Release, Assets and Liabilities of Commercial Banks in the United States, data as of November 17, 2021, available at https://www.federalreserve.gov/releases/h8/current/default.htm.

2016 and 2020, at an average annual cost to the fund of about $256 million.[9] No banks have failed thus far in 2021, marking 13 consecutive months without a bank failure and the seventh year in a row with few or no failures.

The total number of institutions on the FDIC's Problem Bank List was 46 at the end of the third quarter of 2021, down significantly from the peak of 888 institutions in March 2011.[10] The number of troubled banks is currently expected to remain at low levels through 2022. At September 30, 2021, the contingent loss reserve for anticipated failures was $12 million, down from $62 million one year earlier.

Future losses to the DIF remain uncertain as the length and severity of the pandemic and the resulting potential economic and banking effects are still unclear, although prospects appear significantly more favorable compared to when the Plan was adopted in September of 2020. The uncertainties include, among others, the variable trends in COVID-19 infections and vaccinations, the length of time necessary for a full economic recovery, and evolving consumer behavior, which could have longer-term effects on the condition and performance of the banking industry.

The banking industry has remained a source of strength for the economy, in part, because the stronger capital position of banks has better positioned them to withstand losses compared to 2008. Banks continued to be strongly capitalized in the third quarter of 2021, holding a higher amount and quality of capital than just prior to the 2008-2013 banking crisis.

While many banks built substantial levels of reserves for potential losses in 2020, banks significantly reduced the pace of additional loan loss provisioning for most loan categories, with the industry reporting aggregate negative provisions in the first, second, and third quarters of 2021 as the economic outlook strengthened and the expectation for future credit losses declined significantly relative to 2020. However, reserve releases tapered off in the third quarter of 2021 and loan allowances remain above pre-pandemic levels implying some continued measure of conservativism in the midst of pandemic uncertainty. For example, some heightened credit risk remains, particularly related to businesses most acutely affected by the pandemic such as hospitality, travel, and certain commercial real estate sectors.

To anticipate declines in capital that could trigger losses from IDI failures, the FDIC also monitors other measures, such as earnings, asset quality, and supervisory ratings. As of June 30, 2021, quarterly loan balances grew for the first time since the second quarter of 2020 and continued to grow through September 30, 2021, reflecting a modest uptick in loan demand. The net interest margin for the industry improved for the first time since the beginning of the pandemic, as persistent low interest rates have been contributing to contraction in the average net interest margins to record lows. Asset quality and supervisory ratings generally remain strong. Asset quality indicators deteriorated modestly in 2020 but remain considerably better than those reported during prior recessions and have improved through 2021. As of September 30, 2021, 0.9 percent of loan and lease balances were noncurrent, down from a year ago, and well below the peak of 5.46 percent in the first quarter of 2010.

The banking industry remains resilient moving into the fourth quarter of 2021 despite the extraordinary challenges of the pandemic. Strong liquidity and capital levels at the end of 2021 should help to mitigate potential credit stress across loan portfolios. Under the Plan, the FDIC will continue to monitor these and other

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[9] FDIC, Annual Report 2020, Assets and Deposits of Failed or Assisted Insured Institutions and Losses to the Deposit Insurance Fund, 1934 – 2020, page 145, available at https://www.fdic.gov/about/financial-reports/reports/2020annualreport/2020ar-final.pdf.

[10] "Problem" institutions are institutions with a CAMELS composite rating of "4" or "5" due to financial, operational, or managerial weaknesses that threaten their continued financial viability.

data to project potential losses to the DIF and to assess their impact on the ability of the reserve ratio to return to 1.35 percent within 8 years of establishing the Plan.

Other factors that affect the reserve ratio

The FDIC also monitors other factors that affect the reserve ratio, including changes in IDI risk profiles, which influence assessment rates; growth in the assessment base; DIF investment income and unrealized gains and losses on investments; and operating expenses. Growth in the assessment base has contributed to increasing assessment revenue and growth in the DIF balance, which stands at an all-time high. Operating expenses remained steady, while low investment returns on securities held by the DIF have limited growth in the fund balance.

Assessment revenue is still the main contributor to growth in the DIF balance. However, improvement in banks' risk-based pricing profiles resulted in a modest decline in the industry's weighted average assessment rate over the last few quarters. The most recent weighted average assessment rate was slightly below the average assessment rate assumed in the analysis described below in Table 2. Should lower assessment rates persist, staff may update assumptions appropriately as circumstances warrant. Conversely, as interest rates stabilize or rise, staff may loosen its assumption of zero investment income to better reflect expected returns on the investment portfolio.

In future quarters, the weighted average assessment rate may increase or decrease as a result of changes in the risk profiles of institutions. While a decline in elevated insured deposit balances resulting from extraordinary growth would help increase the reserve ratio, it could reduce growth in the assessment base and constrain growth in the DIF. Investment returns on securities held by the DIF may remain low as a prolonged period of low interest rates continues, or could increase if market interest rates increase. Depending on how these combined factors affect growth in the reserve ratio, staff may recommend changes to the Plan in future updates.

<u>Current schedule of assessment rates</u>

In developing the Plan, staff projected the DIF balance and associated reserve ratio at the end of the 8-year period beginning upon implementation of the Plan, assuming different annual rates of insured deposit growth. Staff updated its analysis using data through September 30, 2021. While subject to uncertainty, staff continue to believe that the reserve ratio would reach the minimum level by the statutory deadline while maintaining the current assessment rate schedule.

Table 2 depicts the amount of losses that the DIF could absorb and still reach 1.35 percent within the 8-year period.[11] For example, if insured deposits grow at an annual rate of 2.5 percent over the next 7 years, the DIF could absorb losses of up to $21.2 billion and still reach the minimum reserve ratio requirement by September 30, 2028. Alternatively, if insured deposits grow at an annual rate of 4.5 percent over the next 7 years, the DIF would need an additional $1.0 billion for the reserve ratio to reach the 1.35 percent minimum.

[11] For simplicity, the analysis shown in Table 2 assumes that: (1) the assessment base grows 4.5 percent, annually; (2) the average assessment rate is 4.0 basis points; (3) interest income on the deposit insurance fund balance is zero; and (4) operating expenses grow at 1 percent per year.

Table 2–Projected Reserve Ratio at September 30, 2028
Assuming Different Rates of Insured Deposit Growth

Annual Insured Deposit Growth Rate [percent]	Industry Insured Deposits [billions of dollars]	DIF Reserve Ratio [percent]	DIF Balance needed to reach 1.35 percent reserve ratio [billions of dollars]	Amount available to absorb losses and reach 1.35 percent reserve ratio [billions of dollars]
2.5	11,384	1.53	153.1	21.2
3.0	11,779	1.48	158.4	15.9
3.5	12,185	1.43	163.9	10.5
4.0	12,603	1.38	169.5	4.8
4.5	13,033	1.34	175.3	(1.0)

It is reasonable that annual insured deposit growth could average less than 4.5 percent over the next 7 years for two main reasons. First, annualized growth has been less than 4.5 percent or negative during most (59 percent) quarters since quarterly reporting was adopted in 1991. Most importantly, as previously discussed, deposit growth could experience declines in the near-term now that direct stimulus payments have largely ended, as economic conditions continue to improve, and as the consumption and investment patterns of individuals and households exhibit less precautionary behavior. Additionally, insured deposits that resulted from extraordinary growth during the pandemic may recede as the economy recovers and spending normalizes, and any flow of such insured deposits out of the banking system would offset insured deposit growth to some extent.

For purposes of this analysis, staff estimated how much insured deposits would have grown between December 31, 2019, and September 30, 2021, assuming the pre-pandemic average annual rate of 4.5 percent. Insured deposit balances in excess of that growth rate are estimated to total $1.13 trillion, and represent the surge in insured deposits that occurred as a result of the pandemic. If this excess amount of insured deposits does not recede but also does not contribute to further growth, while the remaining balance of insured deposits continue to grow at the pre-pandemic average annual rate of 4.5 percent, staff estimate that total insured deposits would reach $12.63 trillion as of September 30, 2028. That balance would represent an implied average annual insured deposit growth rate of 4.03 percent between September 30, 2021, and September 30, 2028. Under this scenario losses would have to approach $4.8 billion to prevent the reserve ratio from reaching 1.35 percent by the end of the 8-year period.

Due to the uncertainties discussed earlier, losses from bank failures remain difficult to project. However, the banking industry remains well capitalized, the number of banks on the problem bank list remains low, and the banking industry has remained resilient through the economic uncertainties posed by the pandemic. As the effects of the pandemic on the banking industry and the economic outlook continue to become more apparent, staff will reassess its analysis of insured deposit growth, potential losses, and other factors that affect the reserve ratio.

<u>Future updates</u>

This memorandum is the second semiannual update following the adoption of the Plan. While subject to uncertainty, based on a range of reasonable estimates of future losses and normal depositor behavior in the long-term, staff continue to project that the reserve ratio would return to 1.35 percent before the end of the 8-year period beginning upon the implementation of the Plan. As COVID-19 infections receded following a rise in cases over the summer months, and with progress on vaccinations and continued strengthening in indicators of economic activity, insured deposits resulting from extraordinary growth during the pandemic may recede as the precautionary behavior exhibited by depositors subsides and individuals and businesses redirect deposits toward consumption and higher-yielding investments. The economic outlook has strengthened and appears more favorable than in September 2020 when the Plan was first adopted, and the banking system continues to appear better positioned to withstand losses when compared to prior periods of stress. However, several factors, such as slower than expected economic growth, inflationary pressures, supply chain disruptions, market volatility, adjustments in the stance of monetary policy, or additional fiscal stimulus could result in increased insured deposit growth or losses to the fund.

Losses could be higher or lower than anticipated if economic conditions worsen or financial stresses facing IDIs prove more or less severe. For example, DIF loss projections may increase if the quality of IDI assets quickly deteriorates or capital markets become severely constrained, and income could be affected by the factors described previously. Insured deposit growth could be higher or lower based on future economic conditions and the response of fiscal and monetary authorities and depositors. A reduction in the average assessment rate or a reduction in the aggregate assessment base, which could be driven by a future flow of insured deposits out of the banking system, could reduce assessment revenue and constrain growth in the DIF.

Future updates to the Board may include changes in assumptions that result in different assessment revenue needs. Consequently, in order to fulfill the statutory requirement that the reserve ratio returns to 1.35 percent before the end of the 8-year period, absent extraordinary circumstances, the FDIC may need to adopt higher assessment rates than those currently in effect. Under assessment regulations, any increase in assessment rates greater than two basis points would require notice and comment.[12]

Under the Plan, staff will continue to update its projections for the fund balance and reserve ratio at least semiannually while the Plan is in effect and to recommend rate adjustments as necessary. Staff continue to believe that frequent updates are necessary because loss and reserve ratio projections made so far into the future are subject to considerable uncertainty.

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[12] *See* 12 C.F.R. § 327.10(f).