FDIC Federal Deposit Insurance Corporation

MEMO

TO: The Board of Directors

FROM: Patrick Mitchell
Director, Division of Insurance and Research

DATE: October 18, 2022

RE: Designated Reserve Ratio for 2023

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 or fund) and publish the designated reserve ratio, or DRR, before the beginning of each calendar year.[1] On December 14, 2021, the Board approved for publication a notice setting the DRR at 2 percent for 2022.[2] Based on the analysis set forth below, staff recommends maintaining the DRR at 2 percent for 2023 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.

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,

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

[2] 86 FR 71638 (Dec. 17, 2021). 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).

Concur:

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Harrel M. Pettway
General Counsel

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

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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[4] 75 FR 66272 (Oct. 27, 2010).

[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). In June 2022, the Board amended the Restoration Plan to incorporate an increase in assessment rates. The proposed increase in assessment rates would increase the likelihood that the reserve ratio would be restored to 1.35 percent by September 30, 2028, and would 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).

[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 last two crises 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

[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 or more before the onset of the crises 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.

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.

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 has risen on an annual basis for more than 10 years and stood at $124.5 billion as of June 30, 2022, up from $120.5 billion as of June 30, 2021. As of June 30, 2022, the reserve ratio stood at 1.26 percent. Cumulatively, the DIF balance has risen by more than $145 billion from its negative $21 billion low point at the end of 2009. Primary factors contributing to the cumulative increase in the fund balance since 2009 include assessment income and a reduction in estimated losses associated with past and anticipated failures. At June 30, 2022, the contingent loss reserve for anticipated failures was $66 million, up from $35 million at June 30, 2021.

In recent years, the DIF has experienced low losses from IDI failures. On average, four IDIs per year failed between 2016 and 2020, at an annual cost to the fund of about $250 million.[14] No IDIs have failed since October 2020, making 2022 thus far as the eighth year in a row with less than ten failures. While the FDIC has not experienced any additional banking crises since the historical analysis was conducted, it would be imprudent for the FDIC to assume that banking crises are a thing of the past. The most recent banking crisis occurred despite extensive legislative changes to the banking and regulatory system that were made in response to the crisis of the late 1980s and early 1990s.

Future losses to the DIF remain uncertain and depend in part on rising inflation and interest rates and the possibility of a recession, among other factors, described in more detail below. Thus far, the industry has

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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;
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> (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;
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> (3) That sharp swings in assessment rates for insured depository institutions should be prevented; and
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> (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] FDIC, Annual Report 2021, Assets and Deposits of Failed or Assisted Insured Institutions and Losses to the Deposit Insurance Fund, page 190, available at https://www.fdic.gov/about/financial-reports/reports/2021annualreport/2021-arfinal.pdf.

remained a source of strength for the economy, in part, because banks' capital levels have better positioned them to withstand losses compared to 2008. Banks continued to be well capitalized in the second quarter of 2022, holding higher levels and higher-quality capital than just prior to the 2008-2013 banking crisis.

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.

Economic conditions affecting FDIC-insured institutions

Economic conditions weakened in the first half of 2022. Following a 5.7 percent increase in gross domestic product (GDP) in 2021, GDP fell 1.6 percent at a real seasonally adjusted annualized rate in first quarter 2022 and 0.6 percent in the second quarter. The decline in the first half of 2022 reflected higher inflation, reduced government support, supply chain disruptions, and the global effects of the invasion of Ukraine by Russia.

Financial market conditions also deteriorated in the first half of 2022, amid concerns about the effects of inflation and tighter monetary policy. The Treasury yield curve flattened in 2022 and inverted in July. The federal funds target range is 3 to 3.25 percent with the Federal Reserve's hiking the federal funds rate 75 basis points in June, July, and September 2022.[15] The Federal Reserve also began reducing the size of its balance sheet in June 2022.

The economic outlook is weak overall. The September 2022 Blue Chip economic consensus forecast for GDP growth is 1.2 percent for third quarter 2022 and 1.6 percent for full year 2022.[16] Growth forecasts have fallen and recession odds have increased. Key risks to the outlook include inflation, international disruptions from the Russian invasion of Ukraine, supply constraints in labor and production, and pandemic conditions.

The financial performance and condition of the banking industry remain highly sensitive to economic developments. Banks entered into the pandemic in good financial health, with capital levels well above the beginning of the 2008-2013 banking crisis.

Improvements in net interest margins and credit quality have resulted in strong bank performance in recent quarters. Second quarter 2022 net operating revenue rose year-over-year predominantly due to higher net interest income. Additionally, the net interest margin has improved, rising 29 basis points from one year earlier to 2.80 percent. As of June 30, 2022, 0.75 percent of loan and lease balances were noncurrent, down from 1.01 percent from a year ago, and well below the peak of 5.46 percent in the first quarter of 2010.

The total number of institutions on the FDIC's Problem Institution List fell to 40, as of June 30, 2022, from 51, on June 30, 2021. The number of problem banks remains well below the peak of 888 institutions in March 2011. As noted above, no banks have failed thus far in 2022.

The banking industry, however, faces some economic uncertainties that may affect certain bank loan portfolios such as commercial real estate and one-to-four family residential loans. Uncertainty regarding remote work policies, inflation, end of loan deferral programs, and rising interest rates may adversely affect borrowers' ability to repay their debt. Higher interest rates and shifts in the yield curve also affect asset values and may pose challenges to bank profitability, particularly if borrowers default on loans due to higher interest rates. Risks

[15] Federal Reserve FOMC Statements (June 15, 2022; July 27, 2022; September 21, 2022).
[16] September Blue Chip Economic Forecast.

for banks include severe credit and liquidity strains, as borrowers may struggle to pay debt amid any economic decline.

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 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.

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.[17] 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.

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

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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