MEMO

TO: The Board of Directors

FROM: Patrick Mitchell
Director, Division of Insurance and Research

DATE: April 18, 2023

RE: Restoration Plan Semiannual Update

RECOMMENDATION

Insured deposit growth coupled with growth in the Deposit Insurance Fund (the DIF or the Fund) balance resulted in the reserve ratio remaining unchanged at 1.26 percent from June 30, 2022, to September 30, 2022, before increasing by 1 basis point to 1.27 percent as of December 31, 2022.[1] Despite increased uncertainty in the banking industry and the recent failure of two large banks, staff project that the reserve ratio will reach the statutory minimum of 1.35 percent ahead of the deadline of September 30, 2028, set by statute, though the precise timing is unknown and depends on a number of factors, discussed below. Accordingly, staff recommend no changes to the Amended Restoration Plan at this time and will continue to update the Board semiannually, or more frequently as conditions warrant, to determine if changes to the Amended Restoration Plan are necessary.

BACKGROUND

The Federal Deposit Insurance Act (the FDI Act) requires that the FDIC's Board of Directors (Board) adopt a restoration plan when the DIF reserve ratio falls below the statutory minimum of 1.35 percent or is expected to within 6 months.[2] Extraordinary growth in insured deposits during the first half of 2020 resulting from actions taken by monetary and fiscal authorities, and by individuals, businesses, and financial market participants in response to the Coronavirus 2019 (COVID-19) pandemic caused the DIF reserve ratio to decline below the statutory minimum of 1.35 percent as of June 30, 2020. On September 15, 2020, the Board adopted a Restoration Plan to restore the DIF to at least 1.35 percent within eight years, as required by statute, and to maintain the assessment rate schedules in place at the time.[3]

On June 21, 2022, based on projections of the reserve ratio under different scenarios indicating that the reserve ratio was at risk of not reaching the statutory minimum of 1.35 percent by September 30, 2028, the Board amended the Restoration Plan (Amended Restoration Plan, or Plan).[4] In conjunction with the Amended Restoration Plan, the Board proposed, and subsequently finalized, an increase in initial base deposit insurance

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[1] The reserve ratio is calculated as the ratio of the net worth of the DIF (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).
[2] *See* 12 U.S.C. 1817(b)(3)(B) and (E).
[3] *See* 85 FR 59306 (Sept. 21, 2020).
[4] *See* FDIC Restoration Plan Semiannual Update, June 21, 2022. Available at: https://www.fdic.gov/news/board-matters/2022/2022-06-21-notice-sum-b-mem.pdf. *See also* 87 FR 39518 (July 1, 2022).

assessment rate schedules of 2 basis points, to improve the likelihood that the reserve ratio would be restored to at least 1.35 percent by September 30, 2028.[5] The revised assessment rate schedules became effective January 1, 2023, and are applicable to the first quarterly assessment period of 2023 (i.e., January 1 through March 31, 2023, with an invoice payment date of June 30, 2023). The Final Rule on Revised Deposit Insurance Assessment Rates (the final rule) included updated analysis and projections using data as of June 30, 2022.[6]

The Amended Restoration Plan requires the FDIC to update its analysis and projections for the DIF balance and reserve ratio at least semiannually and, if necessary, recommend modifications to the Amended Restoration Plan. This memorandum is the first semiannual update of 2023. Under the Plan, the FDIC is monitoring potential losses, deposit balance trends, and other factors that affect the reserve ratio.

SEMIANNUAL UPDATE FOR APRIL 2023

Table 1 shows the components of the reserve ratio for the second quarter of 2022—the date of the analysis and projections presented in the final rule—through the fourth quarter of 2022, the most recent data available. Because the most recent reported data was collected prior to the recent bank failures, the information in Table 1, as well as the projections and analysis presented below do not take into account the recent bank failures and actions undertaken by the federal government in response.

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

	2Q 2022	3Q 2022	4Q 2022
Beginning Fund Balance	$123.0	$124.5	$125.5
Plus: Net Assessment Revenue	$2.1	$2.1	$2.1
Plus: Net Investment Contributions and Other Income[a]	($0.3)	($0.7)	$1.1
Less: Loss Provisions	($0.1)	*	*
Less: Operating Expenses	$0.5	$0.5	$0.5
Ending Fund Balance[b]	$124.5	$125.5	$128.2
Estimated Insured Deposits	$9,912.2	$9,925.6	$10,068.0
Q-O-Q Growth in Est. Insured Deposits	(0.61%)	0.14%	1.43%
Ending Reserve Ratio	1.26%	1.26%	1.27%

*Absolute value less than $50 million
[a]Net investment contributions include interest earned on investments and unrealized gains/losses on available-for-sale securities, while other income includes realized gains on sale of investments, and all other income, net of expenses.
[b]Components of fund balance changes may not sum to totals due to rounding.

Following a 0.6 percent decline in the quarter ending June 30, 2022, insured deposits increased by 0.1 percent in the quarter ending September 30, 2022, and increased by 1.4 percent in the quarter ending December 31, 2022. As of December 31, 2022, annual insured deposit growth was 3.3 percent. While below the historical

[5] *See* 87 FR 39388 (July 1, 2022) and 87 FR 64314 (Oct. 24, 2022). The reserve ratio is based on total estimated insured deposits at the end of a given quarter. The FDIC will use data 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.
[6] *See* 87 FR at 64325 - 64329 (Oct. 24, 2022).

average of 4.5 percent from 1991 to 2019, the growth rate over the previous year is still meaningful since it was applied to a total balance of insured deposits that remains elevated from the pandemic response efforts.

Assessment revenue was the primary contributor to growth in the DIF in the second half of 2022. Assessments earned do not yet reflect the 2 basis point increase in initial base deposit insurance assessment rate schedules implemented by the final rule, which took effect on January 1, 2023. The weighted average assessment rate was approximately 4.0 basis points for the assessment period ending December 31, 2022. No bank failures occurred in 2022. Unrealized losses on available-for-sale securities in the DIF portfolio have constrained growth in the DIF balance, with unrealized losses of $603 million reducing investment and other income during the second half of 2022. However, interest income has begun to rise as yield on the investment portfolio has increased. As of December 31, 2022, the DIF balance totaled $128.2 billion, up $5.1 billion from one year earlier.

Insured deposit growth, coupled with growth in the DIF balance, resulted in the reserve ratio remaining unchanged from June 30, 2022, to September 30, 2022, at 1.26 percent, before increasing by 1 basis point to 1.27 percent as of December 31, 2022.

As stipulated by the Amended Restoration Plan, below is an updated analysis with respect to potential losses, deposit balance trends, and other factors that affect the reserve ratio.

Potential losses

Losses from past bank failures and reserves related to potential future bank failures affect the reserve ratio by lowering the fund balance. In recent years, the DIF has experienced low losses from bank failures, until 2023. On average, three banks per year failed between 2016 and 2022, at an average annual cost to the fund of about $178 million.[7] Two banks failed thus far in 2023, following more than two years without a bank failure and eight years in a row with few or no failures.

The failures of Silicon Valley Bank on March 10, 2023, and Signature Bank on March 12, 2023, were due to sudden and unexpected liquidity needs as a result of large withdrawals of uninsured deposits. The FDIC estimated the cost to the DIF for these failures to be $20 billion and $2.5 billion, respectively.[8] Of that estimated total cost of $22.5 billion, the FDIC estimated that approximately $19.2 billion was attributable to the cost of covering uninsured deposits pursuant to systemic risk determinations made on March 12, 2023.[9] By statute, the FDIC is required to recover through special assessments the estimated $19.2 billion of losses to the DIF incurred as a result of the actions of the FDIC pursuant to determinations of systemic risk, and plans to do so through notice-and-comment rulemaking in May 2023.[10] As a result, the $19.2 billion in losses to support uninsured

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[7] FDIC, Annual Report 2022, Assets and Deposits of Failed or Assisted Insured Institutions and Losses to the Deposit Insurance Fund, 1934-2022, page 178, available at: https://www.fdic.gov/about/financial-reports/reports/2022annualreport/2022-arfinal.pdf.
[8] FDIC PR-21-2023. "Subsidiary of New York Community Bancorp, Inc. to Assume Deposits of Signature Bridge Bank, N.A., From the FDIC." March 19, 2023, available at: https://www.fdic.gov/news/press-releases/2023/pr23021.html. See also FDIC PR-23-2023. "First-Citizens Bank & Trust Company, Raleigh, NC, to Assume All Deposits and Loans of Silicon Valley Bridge Bank, N.A., From the FDIC." March 26, 2023, available at: https://www.fdic.gov/news/press-releases/2023/pr23023.html.
[9] These loss estimates are subject to uncertainty and are likely to change. Staff are in the process of refining the estimate of the cost of the sale of the Silicon Valley Bridge Bank assets and liabilities to First-Citizens Bank & Trust Company based on the most current post-closing information available. Staff expect the revised loss estimate will be lower than previously reported and will release it publicly once finalized. Loss estimates for failed banks are updated as assets are sold, liabilities are extinguished, and receivership expenses are incurred
[10] 12 U.S.C. 1823(c)(4)(G).

deposits will not directly impact the DIF balance because the FDIC is required to collect a special assessment for those losses.

The remaining estimated loss from these two failures of $3.2 billion will directly impact the DIF balance, however, this estimated loss alone is not expected to have a material effect on the projected timeline for reaching the statutory minimum reserve ratio. Staff will provide an updated estimate to the Board that incorporates the effect of recent bank failure activity on the DIF, as well as updated reserves related to potential future bank failures; analyses of longer-term prospects for troubled banks; and trends in CAMELS ratings, failure rates, and loss rates. The next semiannual update for 2023 will provide clarity on how losses from past failures and reserves related to potential future failures will affect the reserve ratio.

While many banking metrics remain sound, uncertainty has increased and significant downside risks persist, with some large institutions experiencing significant funding stress. Future economic and banking conditions remain uncertain due to the effects of inflation and higher market interest rates. Economic growth slowed in 2022, and the economic outlook for 2023 is weaker, with many economists expecting a recession in 2023. The April Blue Chip Economic Indicators consensus forecast for GDP growth is 1.2 percent for full year 2023.[11] A weaker economy may reduce bank profitability, weaken credit quality and capital, and limit loan growth.

Furthermore, higher market interest rates have led to elevated unrealized losses in the banking industry's securities portfolios. Additional short-term interest rate increases combined with longer asset maturities may also affect bank balance sheets in coming quarters. As evidenced in the recent bank failures, unrealized losses can also significantly reduce a bank's liquidity position in the event of unexpected cash outflows that could force the bank to sell securities and realize losses, reducing its regulatory capital. Higher market interest rates may also erode real estate and other asset values, as well as hamper the loan repayment ability of borrowers with adjustable rate loans or in need of refinancing.

The downside risks described above could present challenges and could have longer-term effects on the condition and performance of the economy and the banking industry, which could exacerbate the risk of losses to the DIF. The increase in assessment rate schedules that became effective on January 1, 2023, will strengthen the DIF, increasing the likelihood that the reserve ratio will reach the statutory minimum of 1.35 percent by the statutory deadline and promoting public confidence in federal deposit insurance. Under the Plan, the FDIC will continue to monitor these and other 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.

Deposit trends

While the banking industry reported insured deposit growth that was below the pre-pandemic quarterly average in the third quarter of 2022, growth in the fourth quarter of 2022 was in line with the pre-pandemic quarterly average. The continued moderation in insured deposit growth, relative to the first half of 2020 and the first quarter of 2021, was consistent with a decline in personal savings with the end of direct federal government stimulus programs and elevated inflationary pressures over the past two years. In addition, higher interest rates over the past year have likely caused certain types of deposits to shift into higher-yielding alternatives.

Insured deposits increased by 3.3 percent over the last year, below the historical average of 4.5 percent. However, while recent insured deposit growth rates are below or closely aligned with historical averages, these growth rates are calculated based on a total balance of insured deposits that is still elevated from the pandemic response efforts, therefore further increasing insured deposit balances. In previous semiannual updates to the Board, staff estimated that excess insured deposits that flowed into banks as the result of actions taken by

[11] April 2023 Blue Chip Economic Forecast.

monetary and fiscal authorities, and by individuals, businesses, and financial market participants in response to the COVID-19 pandemic totaled approximately $1.13 trillion.[12] As of December 31, 2022, excess insured deposits were at approximately the same levels as September 30, 2021.

The outlook for insured deposit growth remains uncertain and depends on several factors, including the outlook for inflation, interest rates and consumer behavior. An economic slowdown and weaker labor market would reduce consumer incomes and high inflation would constrain consumer budgets. These factors could reduce consumer savings and deposit balances. On the other hand, concerns about slower than expected economic growth or employment may cause businesses and consumers to maintain caution in spending, and keep deposit levels elevated in order to have the ability to cover expenses or to increase precautionary savings. Higher interest rates may also inhibit growth of insured deposits in the banking system, particularly if market rates rise higher than rates paid on deposits. This could result in depositors shifting to higher-yielding alternatives outside of deposit accounts. Depositor behavior in light of the recent bank failures could also affect deposit trends in the near term. The magnitude and duration of that response at the time of this update remains uncertain.

Nearly two years have passed since the period of extraordinary growth in insured deposits prompted by the last round of fiscal stimulus, and while insured deposit growth continues to moderate, aggregate balances remain significantly elevated, as noted above. Staff will continue to closely monitor depositor behavior and the effects on insured deposits.

Other factors that affect the reserve ratio

The FDIC also monitors other factors that affect the reserve ratio, including changes in bank risk profiles, which influence assessment rates; growth in the assessment base; DIF investment income and unrealized gains and losses on investments; and operating expenses. Until the fourth quarter of 2022, a prolonged period of low investment returns coupled with elevated unrealized losses on available-for-sale securities in the DIF portfolio limited growth in the DIF balance. As of December 31, 2022, the DIF balance totaled $128.2 billion, up $5.1 billion from one year earlier. The assessment base has contributed to increasing assessment revenue and growth in the DIF balance while operating expenses remained steady.

Assessment revenue continues to be the main contributor to growth in the DIF balance. The weighted average assessment rate for all banks was approximately 4.0 basis points for the assessment period ending December 31, 2022, roughly equal to the weighted average assessment rate at the time the Restoration Plan was first established. Assessment rates do not yet reflect the 2 basis point increase in initial base deposit insurance assessment rate schedules adopted under the final rule, which became effective on January 1, 2023.

Growth in the fund balance has been limited by a prolonged period of low interest rates, coupled with elevated unrealized losses resulting from a rising interest rate environment; however, this headwind abated in the fourth quarter of 2022. Between the fourth quarter of 2021 and the third quarter of 2022, growth in the DIF was reduced by negative net investment contributions—defined for purposes of this update to include both interest income and unrealized gains or losses. In the third quarter of 2022, the DIF experienced an unrealized loss of nearly $1.1 billion and interest income of $332 million, resulting in a negative net investment contribution

[12] This estimate reflects the amount of insured deposits as of September 30, 2021, in excess of the amount that would have resulted if insured deposits had grown at the historical average rate of 4.5 percent since December 31, 2019. By September 30, 2021, deposit balances would have fully reflected the more significant actions taken by monetary and fiscal authorities in response to the COVID–19 pandemic. *See* FDIC Restoration Plan Semiannual Update, June 21, 2022. Available at: https://www.fdic.gov/news/board-matters/2022/2022-06-21-notice-sum-b-mem.pdf. *See also* FDIC Restoration Plan Semiannual Update, December 14, 2021. Available at: https://www.fdic.gov/news/board-matters/2021/2021-12-14-notice-dis-b-mem.pdf.

of $745 million. However, interest income increased in the fourth quarter of 2022 as yield on the investment portfolio has increased, and the DIF recognized a net reduction in unrealized losses for the first time in over two years, resulting in a positive net investment contribution of nearly $1.0 billion. For the second half of 2022, net investment contributions totaled $227 million, compared to negative $1.8 billion in the first half of 2022. While subject to changing market expectations of future interest rates and potential bank failures requiring the early sale of DIF investments, staff expect that in the near-term the DIF will earn a modest interest income that may be offset or supplemented by unrealized gains or losses.

Projections for fund balance and reserve ratio

Supported by the recently finalized increase in assessment rate schedules, staff project that the reserve ratio will reach the statutory minimum of 1.35 percent ahead of the statutory deadline. While subject to uncertainty, staff project that it is possible the reserve ratio could reach 1.35 percent as early as 2024 under favorable conditions including stable interest rates, low losses from bank failures (including the recent bank failures), and a continued moderation in insured deposit growth. However, it is also possible that the reserve ratio could remain below 1.35 percent for several additional years, given the uncertainty surrounding the losses to the DIF for the recent bank failures and reserves for potential future bank failures. Reaching the statutory minimum reasonably promptly and in advance of the statutory deadline strengthens the fund so that it can better withstand unexpected losses and reduce the likelihood of pro-cyclical assessments. In either case, given the increase in assessment rate schedules effective January 1, 2023, staff project that the reserve ratio will reach 1.35 percent by the statutory deadline of September 30, 2028.

FUTURE UPDATES

This memorandum is the first semiannual update in 2023. Staff project that the reserve ratio will reach the statutory minimum of 1.35 percent within the deadline set by statute, though the precise timing is uncertain and depends on a number of factors. Accordingly, staff recommend no changes to the Plan.

As noted in prior semiannual updates to the Board, loss and reserve ratio projections made so far into the future are subject to considerable uncertainty. The banking industry remains resilient but continues to face significant downside risks. Losses to the DIF could be higher or lower than anticipated if economic conditions worsen or downside risks facing banks prove more or less severe. Insured deposit growth could be higher or lower based on future economic conditions or if those deposits resulting from extraordinary growth begin to recede. Net investment contributions could be positive or negative in the near-term, and the magnitude of such movement is highly uncertain and depends on the timing and magnitude of interest rate changes as well as liquidity needs.

Under the Amended Restoration Plan, staff will continue to monitor potential losses, deposit balance trends, and other factors that affect the reserve ratio, and to update projections for the fund balance and reserve ratio at least semiannually while such Plan is in effect. Staff continue to believe that frequent updates are warranted to incorporate updated information and expectations related to recent developments in the financial system and the banking sector and because loss and reserve ratio projections made so far into the future are subject to considerable uncertainty.

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