August 19, 2022

Via Electronic Mail to comments@fdic.gov

Mr. James P. Sheesley
Assistant Executive Secretary
Federal Deposit Insurance Corporation
550 17th Steet N.W.
Washington, D.C.

RE: **Comment on *Assessments, Revised Deposit Insurance Assessment Rates (RIN: 3064-AF83)***

To whom it may concern,

The undersigned Associations[1] appreciate the opportunity to comment on the Federal Deposit Insurance Corporation's notice of proposed rulemaking to increase initial base deposit insurance assessment rates by 2 basis points until the Deposit Insurance Fund (DIF) achieves the FDIC's long-term goal of achieving a Designated Reserve Ratio (DRR) of 2 percent of insured deposits.[2] Although we support the continued strength and resiliency of the DIF, such an aggressive assessment rate increase is unwarranted.

The FDIC asserts that this increase is necessary to meet the statutory requirement of the Federal Deposit Insurance Act (FDIA) to return the DIF reserve ratio to 1.35 percent within eight years of falling below that mark and adopting a restoration plan, in this case, by September 15, 2028.[3] However, the analysis underlying this assertion includes outdated assumptions, particularly with respect to deposit levels and earnings on the DIF's investment portfolio, which is closely tied to interest rates. Furthermore, although the 1.35 percent statutory mandate is the

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[1] More information about the Associations is available in Appendix A.
[2] FDIC, Assessments, *Revised Deposit Insurance Assessment Rates*, 87 FR 39388 (Jul. 1, 2022), *available at* www.federalregister.gov/documents/2022/07/01/2022-13578/assessments-revised-deposit-insurance-assessment-rates (hereinafter, the *Proposal*).
[3] 12 U.S. C. 1817(b)(3)(e).

ostensible justification given for the assessment rate increase, the proposal would not limit the increase to achieving this objective; rather, it provides that the increase would remain in place at least until the DIF reserve ratio reaches 2 percent. This eleven-year-old goal is not mandated in the FDIA or any other statute and there is no statutory or regulatory provision that requires the FDIC to achieve it within any timeframe. Furthermore, like the FDIC's reserve ratio projection, the 2 percent DRR goal is based on demonstrably outdated analysis.

The proposal also ignores the likely detriments of the increase to the banking industry, the people and businesses who rely on it for credit, and the broader economy. Therefore, the FDIC should defer to the legislative intent, as demonstrated by the language, structure and legislative history of the FDIA's deposit assessment provisions, to avoid a dramatic increase in assessment rates. At least for the time being, the FDIC should maintain assessment rates at the current levels. The FDIC can revisit assessment rate levels at any time; if conditions later evolve to justify a rate increase, it can act at that time.

Part I of this letter shows that the FDIC based its DIF reserve ratio projections on assumptions that more recent data proves to be unrealistic and, if updated, demonstrate that there is no evidence to indicate that the FDIC will not comply with its statutory mandate to return the DIF reserve ratio to 1.35 percent by September 15, 2028. Part II examines the analytic and statutory basis for the DRR target of 2 percent—an aspirational goal established by the FDIC over a decade ago—and shows that this level no longer aligns with the condition of the banking industry or the legislative intent for the FDIA, and therefore does not justify an assessment rate increase at this time. Part III demonstrates that the magnitude of the increase that the FDIC is proposing is inconsistent with the legislative intent of assessment-rate related provisions of the FDIA, unnecessarily burdensome to banks, and will harm consumers and businesses, particularly small businesses without access to capital markets.

I. The empirical analysis underpinning the FDIC's proposal does not account for recent changes in deposit levels or interest rates; correcting the FDIC's projections to reflect these changes demonstrates that an assessment rate increase is unwarranted.

The FDIC premises its proposal on projections that the DIF reserve ratio will not return to 1.35 percent until the second quarter of 2027 or the third quarter of 2034, depending on the assumptions made, and that the FDIC is therefore at risk of failing to meet its statutory obligation to return the ratio to 1.35 percent by September 15, 2028. Both of the FDIC's projections assume that capital gains and interest earnings on the FDIC's portfolio of securities will be zero, and that deposits will continue to grow at a fairly robust pace. Based on current data and both market and Federal Reserve projections of future conditions, these two assumptions are unrealistic. Correcting these two assumptions in the FDIC's own projection methodology shows that there is no meaningful risk that the ratio will fail to return to 1.35 percent by the statutory deadline, and that it is in fact more likely it will do so several years early without any increase to the current assessment rates.

a. The factors that caused the reserve ratio to fall and remain below its statutory minimum, and which the FDIC assumes will continue, will soon disappear.

In the first and second quarters of 2020, bank deposits grew sharply as businesses and households sought the safety and liquidity of banks; businesses drew down lines of credit at banks and deposited the line draws; the Federal Reserve bought trillions of dollars of securities from nonbanks; and households and businesses deposited government stimulus checks. That growth was not driven by any directed effort by banks, but rather by the government's flooding the banking system with $2 trillion in stimulus monies—the largest economic rescue package in U.S. history. It is that growth which drove the DIF reserve ratio below its required level of 1.35 percent as of June 30, 2020. The FDIC adopted a restoration plan on September 15, 2020 and therefore must restore the ratio to the statutory minimum by September 15, 2028.

As of March 2022, the reserve ratio equaled 1.23 percent. The ratio remains low for two reasons. First, deposit growth continued longer than the FDIC expected, and deposits remain elevated. Second, as interest rates have risen, the DIF has suffered unrealized capital losses on the U.S. Treasury securities in which the reserves are invested—$1.7 billion in unrealized losses in the first quarter of 2022 alone and $3.9 billion cumulatively over the last eight quarters. For the reasons discussed below, both of these factors that are currently depressing the reserve ratio will disappear in the near-to-medium term.

i. Deposits remain elevated but have begun to decline and are likely to continue to decline.

In the proposal, the FDIC recognizes that deposit levels remain elevated but fails to acknowledge that they have begun and are likely to continue to decline. The ratio of deposits to loans at commercial banks at the end of the first quarter of 2021 was 166 percent compared with a 10-year pre-Covid average of 133 percent.[4] Median household savings and checking account balances are far higher than their 2019 average—for example, 60 to 80 percent higher at Bank of America.[5] The ratio of deposits to bank assets is 82 percent versus a 74 percent pre-Covid average.[6] And deposits currently make up 14 percent of household financial assets versus a pre-Covid average of 12 percent.[7] Especially germane for the FDIC, as of first quarter of 2022, the ratio of total insured deposits to the total assessment base was 48 percent, compared with 43 percent at the end of 2019.

Deposit levels have remained elevated for three reasons.[8] First, households remain flush with savings because of the inflow of government stimulus funds and a decline in spending: cumulative excess household savings equals $990 billion relative to an amount that keeps the

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[4] Federal Reserve Statistical Release Z.1.

[5] Bank of America Institute, Consumer Checkpoint (Jul. 7, 2022), *available at* https://business.bofa.com/content/dam/flagship/bank-of-america-institute/economic-insights/consumer-checkpoint-july-2022.pdf.

[6] Federal Reserve Statistical Release Z.1.

[7] *Id.*

[8] *See* Federal Reserve Board, "Understanding Bank Deposit Growth Under Covid" (Jun. 3, 2022); BPI, "QE May Raise Deposits at Banks Immediately, but Not Permanently" (Apr. 6, 2021).

savings rate constant at the pre-Covid level.[9] Second, with deposit rates and money market rates all essentially equal to zero up until March 2022, deposits have been an attractive place to keep excess liquidity (as returns for deposits are essentially equal to those for money market investments, but deposits offer superior payment services and deposit insurance). Third, when the Federal Reserve purchases a security from a nonbank, the purchase price is credited to the seller's bank account, and bank deposits are boosted temporarily. Between mid-February 2020 and the end of April 2022, the Federal Reserve purchased $4.6 trillion in Treasury securities and Agency MBS.[10]

All three of these conditions are reversing. Since March, the Federal Reserve has raised its target range for the federal funds rate 225 basis points, with substantial further tightening expected, and a more normal spread between money market rates and deposit rates has opened up. In response, depositors are shifting into money market mutual funds. Retail money funds grew $73.4 billion between December 2021 and May 2022, an 18 percent annual rate.[11] Covid-related fiscal support programs have ended and the household saving rate has been below average in recent months.[12] Lastly, quantitative easing has turned to quantitative tightening. Rather than purchasing securities, the Federal Reserve is allowing its holdings to mature without replacement, up to pre-specified limits. When the Federal Reserve does not roll over a maturing security, someone else buys the new security that the Treasury issues. If that someone else is not a bank, bank deposits go down.

Moreover, as noted above, there is much evidence that deposit balances are currently misaligned with historical norms, but insured balances and growth rates are likely to return to those norms going forward. In fact, we estimate that insured deposits declined at an annual rate of 2.4% in the second quarter of 2022. This estimate is based on Call Report data from banks that had filed Call Reports for the second quarter of 2022 on or before August 15, 2022 and reported the figures needed to calculate insured deposits in that quarter.[13] The banks included in this estimate held 92.7 percent of insurable deposits in first quarter 2022.

For all these reasons, as shown in Figure 1, deposit growth has decelerated, and deposits are now contracting. Indeed, the same week that the FDIC released this proposal, the OCC published its Semiannual Risk Perspective cautioning national banks that "…a reversal of fiscal stimulus, an increase in deposit substitutes, and increased economic development and business investment may drive a decline in deposits."[14]

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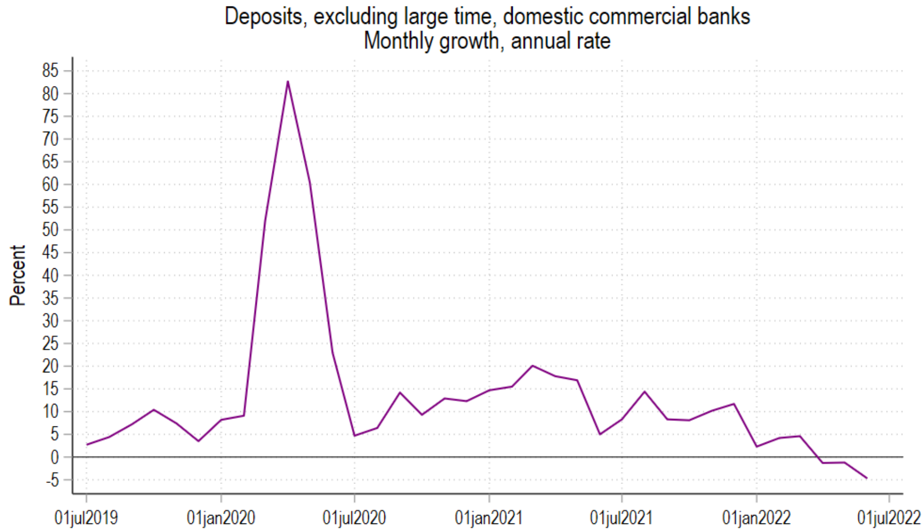
[9] Bureau of Economic Analysis, Personal Income and Outlays (May 2022), *available at* https://www.bea.gov/sites/default/files/2022-06/pi0522.pdf and BPI's calculations.
[10] Federal Reserve Statistical Release H.4.1.
[11] Federal Reserve Statistical Release H.6.
[12] Bureau of Economic Analysis, Personal Income and Outlays (May 2022), *available at* https://www.bea.gov/sites/default/files/2022-06/pi0522.pdf.
[13] From Call Report Schedule RC-O, only banks with over $1 billion in assets are required to report "estimated amount of uninsured deposits including related interest accrued and unpaid," which can be subtracted from total deposits net of exclusions to obtain estimated insured deposits.
[14] Office of the Comptroller of the Currency, Semiannual Risk Perspective at 24 (Jun. 23, 2022), *available at* https://www.occ.treas.gov/publications-and-resources/publications/semiannual-risk-perspective/files/pub-semiannual-risk-perspective-spring-2022.pdf.

Figure 1



Note: Data are from the Federal Reserve Statistical H.8. Final observation for June 2022 uses the average of the weekly observations.

The FDIC's assumption that deposits will continue to grow is not supported by current data.

ii. Interest rates are increasing and will lead to higher yields on the FDIC's portfolio of securities.

As noted above, the FDIC's reserve ratio projections also assume that investment income (interest yield and capital gains) on the securities in which the DIF is invested (which are U.S. Treasury securities, roughly equally divided between bills and notes with maturities of up to five years) will be zero over the forecast horizon. This assumption is unrealistic.

After remaining near zero since the beginning of the pandemic, interest rates have risen sharply in recent quarters. For example, the 3-year Treasury rate remained below ¼ percentage point through the beginning of 2021, rose to 1 percentage point by the end of 2021, and then jumped to 3 percent currently. (We estimate the duration of the FDIC's portfolio to be about 3 years.) The movement in the 3-year rate reflects an abrupt change in the level and expected path for the federal funds rate, the FOMC's monetary policy target. In June 2021, the median FOMC participant expected the federal funds rate to still be zero at the end of 2022 and about ½ percent at the end of 2023. In June 2022, the outlook was for the rate to rise to 2 percent by the end of 2022 and 2¾ percent by the end of 2023.

Higher interest rates will lead to a higher yield on the DIF investments, which will boost the DIF balance and therefore its reserve ratio. Now that interest rates are higher, as the DIF's portfolio of investments matures, the proceeds will be reinvested into higher-yielding securities;

indeed, about half is invested in securities with maturities of less than 1 year and half in securities with maturities between 1 and 5 years.[15]

Even if none of the securities in the portfolio matures, DIF income will rise as the unrealized losses currently reflected in the reserve ratio are erased. This is true because the portfolio is held "as available for sale" and therefore marked to market, so the unrealized losses on the securities will decline as they approach maturity and their market values return to par, as further explained in Appendix B.

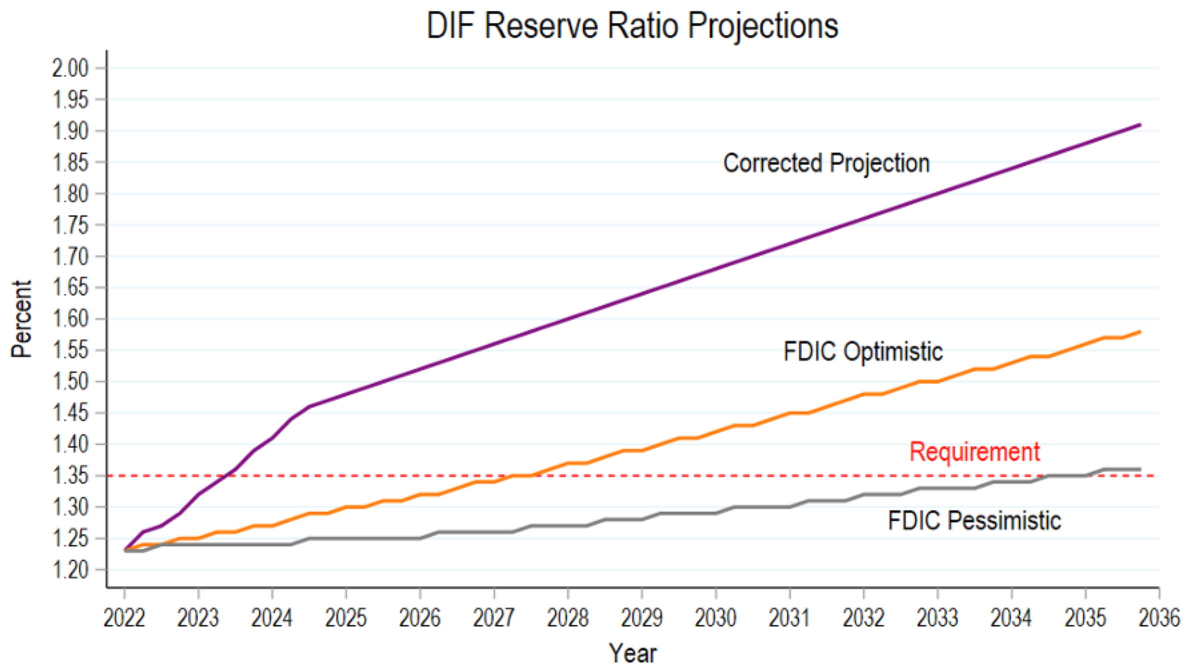
Consequently, the FDIC's assumption of no earnings from the DIF's U.S. Treasury securities portfolio over the next few years is unsupportable. The now-higher prevailing interest rates will increase returns to the DIF and, consequently, raise the DIF reserve ratio.

b. Using updated assumptions, the FDIC's own method for projecting the reserve ratio shows that there is no meaningful risk that the agency will fail to meet its statutory obligations.

Although the proposal does not describe in detail the methodology that the FDIC used to generate its reserve ratio projections, BPI was able to replicate the FDIC projections based on the information provided. A detailed description of the BPI process and methodology is provided as Appendix B to this letter. Using the FDIC's methodology but applying deposit level and investment yield assumptions that are more consistent with current data (and keeping other variables consistent with the FDIC's own analysis) the analysis shows that there is no meaningful risk that the reserve ratio will not return to the statutory minimum by the September 15, 2028 deadline. In fact, the best estimate is that the ratio will surpass the statutory minimum sometime in 2023, even absent any assessment rate increase, as shown in Figure 2 below.

[15] FDIC, *2021 Annual Report*, at 133, *available at* https://www.fdic.gov/about/financial-reports/reports/2021annualreport/2021-arfinal.pdf.

Figure 2



Note: Data are from the FDIC's March 2022 Quarterly Banking Profile; 'Restoration Plan Semiannual Update and Amended Restoration Plan,' memo to the FDIC Board of Directors from Patrick Mitchell, June 21, 2022, pp. 8-9; and BPI's calculations as described in Appendix B.

Specifically, with respect to deposit levels, the Corrected Projection assumes that deposits hold steady at the first quarter of 2022 level until the ratio of deposits to the assessment base equals its pre-Covid level;[16] at that point, deposits grow at the same rate as the assessment base (4½ percent annually).[17] In addition, the Corrected Projection sets the assessment rate to 3.75 basis points, halfway between the FDIC's two alternative assumptions of 3.5 and 4 basis points and essentially equal to the weighted-average assessment rate in the most recent assessment period for which data is available, ending March 31, 2022.[18]

With respect to interest rates, the Corrected Projection assumes that, starting in the third quarter of 2022, the sum of the interest yield and capital gains on the FDIC's portfolio will be 2½ percent (although a higher level—which would further accelerate the ratio increase—is probably closer to the correct level implied by market prices over the medium term). An assumption of 2½ percent is consistent with the expected overnight interest rate in the long run of the median FOMC participant in the projections provided at the June 2022 FOMC meeting. This is also largely consistent with the market outlook for interest rates embedded in the yield curve, as further discussed in Appendix C. By way of reference, in the second quarter of 2019, when the

[16] As noted above, initial data indicate that the level of insurable deposits actually fell in the second quarter of 2022, so this assumption that deposit levels remain constant for a period may underestimate the speed with which the reserve ratio returns to the statutory minimum.

[17] The increase in the assumed deposit growth rate from 0 to 4½ percent when the deposit – assessment base ratio is normalized causes the kink in the "corrected projection" line in 2024Q4.

[18] Memorandum from Patrick Mitchell, Director, FDIC Division of Insurance and Research, to the Board of Directors of the FDIC regarding "Restoration Plan Semiannual Update and Amended Restoration Plan" at 8-9 (Jun. 21, 2022), *available at* https://www.fdic.gov/news/board-matters/2022/2022-06-21-notice-sum-b-mem.pdf.

federal funds rate was 2½ percent, the sum of the FDIC's interest earnings and capital gains was 3 percent at an annual rate.

With these updated assumptions, the FDIC's own projection methodology shows that the reserve ratio reaches 1.35 percent in the third quarter of 2023—several years in advance of the statutory deadline. This conclusion assumes a conservative path for the level of deposits. If, consistent with recent trends, the level of deposits fell rather than remaining constant, the reserve ratio would reach 1.35 percent even earlier.

Furthermore, a simple 2½ percent assumption may in fact understate the likely investment yield. A more detailed analysis of the FDIC's historical yields and the anticipated path of interest rates over the next several years suggests that the FDIC is more likely to achieve an average annual investment yield of approximately 2.9%, which would return the DIF to 1.35 percent even sooner than the Corrected Projection shows (see Appendix C).

Even correcting only one of these assumptions significantly accelerates the return of the DIF reserve ratio to the statutory minimum. If we adjust only the deposit growth assumption as described above and retain the FDIC's assumption of an investment yield of zero percent, the DIF would return to 1.35 percent in the first quarter of 2024. If we adjust only the investment return assumption and retain the FDIC's more pessimistic deposit growth rate assumption of 4 percent, the DIF will return to 1.35 percent by the second quarter of 2025. Thus, the central justification the FDIC proffers for an increase in assessment rates—that it is necessary to comply with the statutory requirement—evaporates.

In addition to relying on its projections regarding the path of the DIF reserve ratio, the proposal repeatedly justifies an add-on to assessment rates to cover "uncertainties." For example, it states, "While the FDIC projects that the reserve ratio would reach the statutory minimum before the deadline in this Scenario, any number of uncertain factors—including unexpected losses, accelerated insured deposit growth, or lower weighted average assessment rates due to improving risk profiles of institutions—could materialize between now and the second quarter of 2027, and easily prevent the reserve ratio from reaching the minimum by the statutory deadline."[19] However, to the extent the factors that would affect the path DIF reserve ratio are uncertain, such uncertainty is generally to the upside. While case resolution costs could rise in the "uncertain" economic future, there is little to no chance that these would be significant considering the current health of the banking industry (discussed in detail in Section II below) and the fact that the number of banks on the FDIC's Problem Bank List is at an historic low. If assessment rates are lower than expected, this would only be because the banking industry is even healthier than at present, which would certainly bode well for the DIF. As to the possibility of acceleration in insured deposit growth, the more recent trend and arguments above demonstrate that the risk is to even slower deposit growth. Regardless, as discussed in greater detail below, in light of the legislative intent to avoid dramatic increases to assessment rates, uncertainty does not justify the burdensome assessment rate hike the FDIC is proposing.

[19] *Proposal* at 39398.

II. A 2 basis point assessment increase to bring the DIF reserve ratio to 2 percent is not statutorily required and is unjustifiable.

A dozen years ago, FDIC staff determined that the DIF balance would not have gone negative in 1991 and 2009-2011 if the fund's reserve ratio had been at least 2 percent.[20] Based on that analysis, the FDIC Board established a long-term, aspirational DRR goal for the reserve ratio at 2 percent. However, that analysis is practically irrelevant today, considering the momentous enhancements in prudential regulatory standards in the ensuing years, as well as considerable strengthening of soundness across the banking industry. There is no mandate in law for a DRR at 2 percent. Nor is there a legislated timetable for the DIF to reach any DRR, as there is for restoration of the fund to 1.35 percent should it ever fall short. Moreover, raising assessments over an extended period to achieve 2 percent can challenge a significant number of banks in times less benign than at present. Accordingly, accelerating movement of the reserve ratio to the aspirational 2 percent DRR is not an appropriate or statutorily sound justification for an aggressive 2 basis point assessment rate increase at this time.

In setting the DRR, the FDIC is subject to 12 U.S.C. 1817(b)(3)(C), which provides:

> In designating a reserve ratio for any year, the Board of Directors shall—
>
> (i) take into account the risk of losses to the Deposit Insurance Fund in such year and future years, including historic experience and potential and estimated losses from insured depository institutions;
> (ii) take into account economic conditions generally affecting insured depository institutions so as to allow the designated reserve ratio 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 determined to be appropriate by the Board of Directors;
> (iii) seek to prevent sharp swings in the assessment rates for insured depository institutions; and
> (iv) take into account such other factors as the Board of Directors may determine to be appropriate, consistent with the requirements of this subparagraph.

The Associations note that the current DRR goal of 2 percent was based on the FDIC's assessment of these factors as they existed in 2010-11, and they have evolved significantly in the interim. This is particularly true with respect to factor (i), risk of losses to the DIF.

With respect to the outlook for risk of losses to the DIF, regulatory capital standards are much more robust since the time when the FDIC first set the DRR target of 2 percent. For all banks in 2013, the minimum tier 1 capital ratio was increased from 4 percent to 6 percent; new regulatory minimums were set for a leverage ratio at 4 percent, a common equity tier 1 (CET1) ratio at 4.5 percent, and a common equity tier 1 capital conservation buffer at 2.5 percent; strict

[20] The FDIC analysis of the appropriate DRR level to protect the DIF is summarized in the 2010 proposal to set the DRR target to 2 percent. FDIC, *Assessment Dividends, Assessment Rates and Designated Reserve Ratio*, 75 FR 66272 (Oct. 27, 2010), *available at* www.govinfo.gov/content/pkg/FR-2010-10-27/pdf/2010-27036.pdf.

eligibility criteria were imposed on regulatory capital instruments; regulatory capital (the numerator in the capital ratio) was redefined and significantly narrowed to focus on ability to absorb losses; and the risk-weighted assets denominator for several of the standards was retuned for risk sensitivity; for internationally active banking organizations, a minimum supplementary leverage ratio was established to take into account off-balance-sheet exposures.[21] Later that year, the Federal Reserve clarified the market risk capital rule, which applies to banking organizations with significant trading activities.[22]

There have been even more substantial changes in capital standards for large banking organizations. Since 2012, bank holding companies with consolidated assets of at least $100 billion have been subject to annual Comprehensive Capital Analysis and Review (CCAR) stress testing.[23] An institution subject to this requirement must demonstrate that it would remain "well capitalized" over the stress horizon and submit a capital plan describing its internal capital adequacy processes. In 2020, the 2.5 percent of capital conservation buffer requirement was replaced with a buffer determined based on the institution's CCAR results.[24]

In response to the strengthened capital requirements, as well as experience with periods of turmoil, banks across the industry raised capital. The FDIC's analysis in support of the 2 percent DRR goal considered industry data from 2010 and prior years; so as not to bias results using data from the Great Recession, we computed average industry capitalization in the five years prior to that downturn against the most recent five-year average—though there was a short, severe recession in the last five years. Figure 3 demonstrates the strengthening of capital for all capital metrics since the pre-Great Recession period; figures in Appendix D show that the same is true across industry size categories.[25]

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[21] Federal Reserve System, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule; Final Rule*, 78 FR 62018 (Oct. 11, 2013), *available at* www.govinfo.gov/content/pkg/FR-2013-10-11/pdf/2013-21653.pdf.

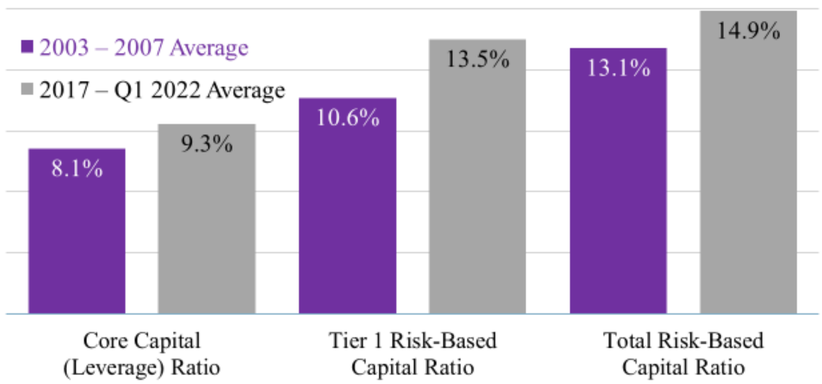
[22] Federal Reserve System, *Risk-Based Capital Guidelines; Market Risk*, 78 FR 76521 (Dec. 18, 2013), *available at* www.govinfo.gov/content/pkg/FR-2013-12-18/pdf/2013-29785.pdf.

[23] Federal Reserve System, *Supervisory and Company-Run Stress Test Requirements for Covered Companies*, 77 FR 62378 (Oct. 12, 2012), *available at* www.govinfo.gov/content/pkg/FR-2012-10-12/pdf/2012-24987.pdf.

[24] Federal Reserve, *Regulations Q, Y, and YY: Regulatory Capital, Capital Plan, and Stress Test Rules*, 85 FR 15576 (Mar. 18, 2020), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200304a2.pdf.

[25] Simple equity-capital-to-assets ratios for the industry and by assets size categories did not rise from the pre-Great-Recession period to at present. We have noted in the past that this capital ratio misrepresents the current strength of bank capital in that the assets denominators for most banks has been inflated by absorption of surge deposits invested primarily in low-risk, highly liquid assets.

Figure 3: Banking Industry Capitalization – Before the Great Recession vs. Now



Averages of banking industry quarterly figures provided on www.fdic.gov

In addition to higher capital standards, numerous other enhancements to prudential standards have encouraged banks to strengthen their balance sheets and risk management. Examples include interagency supervisory guidance on credit risk review systems,[26] counterparty credit risk management,[27] leveraged lending,[28] funding and liquidity management,[29] and model risk management.[30] Banking firms with more than $50 billion in assets must now have risk committees.[31] Global systemically important banks are now subject to enhanced requirements for risk management, leverage and liquidity management, resolution plans, credit exposure limits and reporting, and concentration limits.[32] Swap activities have been pushed out of banks and into separately capitalized affiliates[33] and bank holding companies have

[26] FDIC, Federal Reserve System, Office of the Comptroller of the Currency, and National Credit Union Administration, *Interagency Guidance on Credit Risk Review Systems*, 84 FR 55679 (Oct. 17, 2019), *available at* www.govinfo.gov/content/pkg/FR-2019-10-17/pdf/2019-22656.pdf.

[27] FDIC, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency and Office of Thrift Supervision, "Interagency Supervisory Guidance on Counterparty Credit Risk Management," (Jun. 29, 2011), www.fdic.gov/news/financial-institution-letters/2011/fil11053a.pdf.

[28] FDIC, "Final Guidance on Leveraged Lending," FIL-13-2013 (Mar. 27, 2013), *available at* www.fdic.gov/news/financial-institution-letters/2013/fil13013.pdf.

[29] FDIC, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Office of Thrift Supervision, National Credit Union Administration, and Conference of State Bank Supervisors, "Interagency Policy Statement on Funding and Liquidity," (Mar. 17, 2010), *available at* www.federalreserve.gov/boarddocs/srletters/2010/sr1006a1.pdf.

[30] FDIC, "Supervisory Guidance on Model Risk Management," FIL 22-2017, June 7, 2017, *available at* www.fdic.gov/news/financial-institution-letters/2017/fil17022a.pdf. *See also* Federal Reserve, "Guidance on Model Risk Management," SR 11-7 (Apr. 4, 2011) and OCC, "Supervisory Guidance on Model Risk Management" OCC 2011-12 (Apr. 4, 2011).

[31] 12 CFR § 252.22, March 27, 2014.

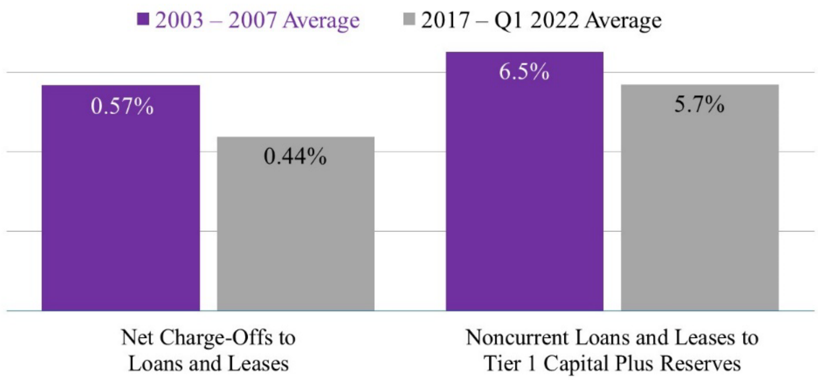
[32] Federal Reserve System, *Prudential Standards for Large Bank Holding Companies, Savings and Loan Holding Companies, and Foreign Banking Organizations*, 84 FR 59032 (Nov. 1, 2019), *available at* www.govinfo.gov/content/pkg/FR-2019-11-01/pdf/2019-23662.pdf.

[33] FDIC, Federal Reserve System, Office of the Comptroller of the Currency, *Margin and Capital Requirements for Covered Swap Entities*, 80 FR 74840 (Nov. 30, 2015), *available at* https://www.federalregister.gov/documents/2015/11/30/2015-28671/margin-and-capital-requirements-for-covered-swap-entities.

had to restructure or divest proprietary trading and hedge fund and private equity businesses.[34] Recently, the FDIC proposed guidance on third-party relationships.[35]

Figure 4 demonstrates how much better the industry is handling credit risk now than it was during the period the FDIC considered in setting the 2 percent DRR target: net charge-off rates are meaningfully lower than before, and reserves and capital plus reserves to cover potential credit problems are up. Appendix E shows that the same is true across industry asset size classes.

Figure 4: Banking Industry Asset Management – Before the Great Recession vs. Now



Averages of banking industry quarterly figures provided on www.fdic.gov

In addition to the reduced risk of failure, significant legal and regulatory changes have reduced the costs of bank failures that do occur. Authorities have added legal options for resolution of financial companies and their subsidiaries under "Orderly Liquidation Authority" established in 2010.[36] Since 2012, large institutions have been required to have verified resolution plans ("living wills").[37] Banks with more than two million deposit accounts are subject to FDIC's rule on recordkeeping for timely deposit insurance determination.[38]

In sum, numerous significant enhancements to bank prudential regulatory standards and bank capital and balance sheets' resilience mean that the risk of bank failures on a scale that would significantly reduce the DIF balance has been all but eliminated since the 2010 study that generated the current 2 percent DRR target. These developments call for reconsideration of a long-run DRR goal for the DIF reserve ratio of 2 percent. Correspondingly, these enhancements

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[34] FDIC, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Securities and Exchange Commission, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 79 FR 5536 (Jan. 31, 2014), *available at* www.govinfo.gov/content/pkg/FR-2014-01-31/pdf/2013-31511.pdf.

[35] FDIC, "Proposed Interagency Guidance on Third-Party Relationships: Risk Management," FIL-50-2021 (Jul. 13, 2021), *available at* www.fdic.gov/news/financial-institution-letters/2021/fil21050.html; OCC, "Third-Party Relationships: Risk Management Guidance," Bulletin 2013-29 (Oct. 30, 2013) (providing guidance to national banks and federal savings associations for assessing and managing risks associated with third-party relationships).

[36] Title II: Orderly Liquidation Authority in the Dodd-Frank Wall Street Reform and Consumer Protection Act, PL 111–203 (Jul. 21, 2010), *available at* www.congress.gov/111/plaws/publ203/PLAW-111publ203.pdf.

[37] Federal Reserve System, *Resolution Plans Required*, 76 FR 67323 (Nov. 1, 2011), *available at* www.govinfo.gov/content/pkg/FR-2011-11-01/pdf/2011-27377.pdf.

[38] 12 CFR §370.

make a 2 basis point assessment rate add-on to accelerate growth of the DIF reserve ratio to that DRR wholly inconsistent with 12 U.S.C. 1817(b)(3)(C).

III. The overall statutory framework Congress devised with respect to assessment rates demonstrates that the proposed dramatic increase is inconsistent with legislative intent, unnecessarily punitive to banks and could harm the economy.

The FDIC's proposal would result in a dramatic increase of more than 50 percent of the current weighted-average assessment rate of 3.7 basis points. Such a sharp adjustment is wholly inconsistent with the legislative language and spirit of the deposit rate-related provisions of the FDIA, which specifically directs the FDIC "to prevent sharp swings in the assessment rates for insured depository institutions".[39] Furthermore, as noted above, the FDIA requires the FDIC to maintain the DIF reserve ratio at or above 1.35 percent or to implement a restoration plan that will restore the ratio to 1.35 percent within eight years of the plan's adoption, but this eight-year grace period was not always in place. Previously, the FDIA provided the FDIC with only one year to restore the reserve ratio to the statutory minimum.[40] Congress later extended this period—first to five years,[41] and then to eight years, as it remains today.[42] Congress's specific decision to twice extend the restoration period shows that it did not intend for the FDIC to severely increase deposit rates to restore the reserve ratio to its statutory minimum on an aggressive timeframe; therefore, it would be inconsistent with legislative language and spirit for the FDIC to do so now. Instead, the FDIC should allow the ratio to return to the 1.35 percent minimum using the smallest increase that is reasonably likely to meet the statutory deadline. Under present conditions, as described in Section I above, no increase is necessary, and therefore none is appropriate.

Importantly, one of the reasons Congress decided to avoid dramatic snap increases in assessment rates was the likelihood that such increases would be procyclical. At a 2005 legislative hearing to consider changes to the DIF framework, including extending the restoration timeline from one to five years, then-Chairman of the FDIC Donald Powell noted that the then-existing statutory requirement to raise assessments to return the DIF to the statutory minimum within one year of a shortfall "could impose a significant drain on the net income of depository institutions when they can least afford it, thereby impeding credit availability and economic recovery" and describing the then-existing system as "pro-cyclical".[43] The timing of the currently proposed increase—higher payments would commence in March 2023—is increasingly

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[39] 12 U.S.C. 1817(b)(3)(C)(iii).

[40] Recapitalizing the Bank Insurance Fund in the Federal Deposit Insurance Improvement Act of 1991, Pub. L. No. 102-242, § 104(a) (1991), *available at* www.govinfo.gov/content/pkg/STATUTE-105/pdf/STATUTE-105-Pg2236.pdf.

[41] Deficit Reduction Act of 2005 Section 2108, Pub. L. No. 109–171, § 2108, *available at* www.govinfo.gov/content/pkg/PLAW-109publ171/pdf/PLAW-109publ171.pdf.

[42] 12 U.S. C. 1817(b)(3)(e).

[43] *See* Statement of Donald E. Powell, Chairman of the Federal Deposit Insurance Corporation, on Deposit Insurance Reform before the Committee on Financial Services of the U.S. House of Representatives, Subcommittee on Financial Institutions and Consumer Credit (Mar. 17, 2005), *available at* https://archives-financialservices.house.gov/media/pdf/031705dp.pdf.

likely to coincide with the beginning of a recession.[44] The proposal therefore risks causing exactly the type of procyclical increase that Congress sought to avoid, and is therefore entirely contrary to Congressional intent. Forgoing a procyclical increase, particularly when the DIF reserve ratio is projected to return to its statutory minimum without the need for any increases in assessments, will free up bank resources and better enable banks to maintain lending in support of economic activity during any economic downturn, thereby supporting the economy at large and, ultimately, the public.[45]

Congress also expressly discouraged dramatic rate increases in the factors that the FDIC must consider in setting the DRR, described in Section II above. Specifically, as noted above, the FDIA provides, "In designating a reserve ratio for any year, the Board of Directors shall […] seek to prevent sharp swings in the assessment rates for insured depository institutions." Far from preventing sharp swings, the proposal to increase base assessment rates by 2 basis points implements such a swing, and in doing so completely disregards this statutory requirement.

Furthermore, the FDIC has failed to appropriately consider the statutory factors required in setting assessment rates. Specifically, 12 U.S.C. 1817(b)(2)(B) provides:

> In setting assessments under subparagraph (A), the Board of Directors shall consider the following factors:
> (i) The estimated operating expenses of the Deposit Insurance Fund.
> (ii) The estimated case resolution expenses and income of the Deposit Insurance Fund.
> (iii) The projected effects of the payment of assessments on the capital and earnings of insured depository institutions.
> (iv) The risk factors and other factors taken into account pursuant to paragraph (1) under the risk-based assessment system, including the requirement under such paragraph to maintain a risk-based system.
> (v) Any other factors the Board of Directors may determine to be appropriate.

Specifically, the proposal gives inadequate attention to items factors (ii) and (iii). With respect to estimated DIF case resolution expenses, the same post-Global Financial Crisis developments outlined in Section II above with respect to the reduce risk of loss to the DIF likewise demonstrate that the probable expense associated with resolving any insured bank are far lower today than they were when FDIC set the 2 percent DRR target, the key discretionary justification provided for this proposal.

With respect to the projected effects of the payment of assessments on the capital and earnings of insured depository institutions, the FDIC understates the potential impact of the proposed increase. According to the proposal, "for the industry as a whole, the FDIC estimates

[44] *See* Michael T. Kiley, FEDS NOTES, *Financial and Macroeconomic Indicators of Recession Risk* (Jun. 21, 2022), *available at* https://www.federalreserve.gov/econres/notes/feds-notes/financial-and-macroeconomic-indicators-of-recession-risk-20220621.htm.

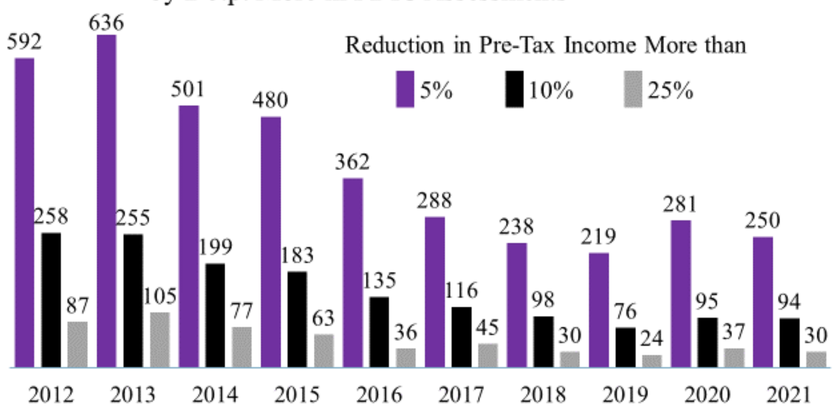
[45] A recent FDIC working paper provides additional evidence that increasing deposit insurance assessment rates reduces lending, worsening economic downturns. *See*, R. Hess and J. Rhee, FDIC CENTER FOR FIN. RES. WORKING PAPER SERIES, *The Procyclicality of FDIC Deposit Insurance Premiums* (Aug. 2022), *available at* www.fdic.gov/analysis/cfr/working-papers/2022/cfr-wp2022-10.pdf.

that the annual increase in assessments would average 1.0 percent of income, which includes an average of 0.9 percent for small banks and an average of 1.0 percent for large and highly complex institutions" and notes that relatively few banks would have suffered meaningful losses of income over the four-quarter period ending in first quarter 2022.

However, bank earnings were particularly strong during this recent four-quarter period, whereas the proposal would maintain the 2 basis point add-on for many years—ten according to the projection but this could turn out to be much longer. Over this period, there will almost surely be times less favorable than over the last four quarters. Accordingly, the analysis should consider the potential impact over a longer historical period.

Our analysis examined the impact of an extra 2 basis points in assessment rates in each of the last ten years. Figure 5 calculates the number of banks whose pre-tax income would have been reduced over 5 percent, 10 percent, and 25 percent over that period. Note that the impact would have troubled a lot more banks in some prior years. Appendix F shows that smaller banks would have suffered the most.

Figure 5: Banks that Would Have Been Significantly Impacted by 2 b.p. More in FDIC Assessments



Because it fails to appropriately consider the effects of the proposed increase on bank earnings and capital over the variety of economic conditions likely to exist during the period covered by the rate increase, the proposal is inconsistent with the statutory requirement to consider the projected effects of the payment of assessments on the capital and earnings of insured depository institutions when setting assessment rates.

The proposal to dramatically increase base assessment rates by 2 basis points disregards the statutory parameters Congress placed on the FDIC's assessment rate setting, in part because of the harm it would inflict on banks and the economy.

IV. **Conclusion**

Increasing base assessment rates by 2 basis points is unnecessary to enable the FDIC to comply with its statutory responsibilities and would be inconsistent with the legislative language and intent underlying the assessment rate provisions of the FDIA, which Congress designed to avoid significant assessment rate increases. The analyses underpinning both the FDIC's assertion that it is at risk of failing to meet the statutory requirement to return the DIF reserve ratio to 1.35 percent by September 15, 2028 and its designation of 2 percent as the long-term DRR goal are outdated and do not justify a rate increase at this time. In the absence of appropriate justification, the proposed increase would unduly burden banks and may harm the broader economy. The Associations therefore strongly oppose any increase to base assessment rates at this time.

* * * * *

The Associations appreciate your consideration of the views expressed in this letter. If you have any questions, please contact Katie Collard, Senior Vice President and Associate General Counsel, The Bank Policy Institute, by phone at (202) 589-2533 or by email at katie.collard@bpi.com.

Respectfully submitted,

Rob Nichols
President & CEO
The American Bankers Association

Rebeca Romero Rainey
President & CEO
The Independent Community Bankers Association

Greg Baer
President & CEO
The Bank Policy Institute

John Asbury
CEO, Atlantic Union Bankshares
Chairman, *The Mid-Size Bank Coalition of America*

Lindsey Johnson
President and CEO
The Consumer Bankers Association

Nicole A. Elam, Esq.
President & CEO
The National Bankers Association

Appendix A.

The American Bankers Association is the voice of the nation's $24 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard nearly $19.9 trillion in deposits and extend $11.4 trillion in loans.

The Bank Policy Institute is a nonpartisan public policy, research and advocacy group, representing the nation's leading banks and their customers. Our members include universal banks, regional banks and the major foreign banks doing business in the United States. Collectively, they employ almost 2 million Americans, make nearly half of the nation's small business loans and are an engine for financial innovation and economic growth.

The Consumer Bankers Association is the only national financial trade group focused exclusively on retail banking and personal financial services—banking services geared toward consumers and small businesses. As the recognized voice on retail banking issues, CBA provides leadership, education, research, and federal representation for its members. CBA members include the nation's largest bank holding companies as well as regional and super-community banks that collectively hold two-thirds of the total assets of depository institutions.

The Independent Community Bankers of America® is the nation's voice for community banks with its mission to create and promote an environment where community banks flourish. With nearly 50,000 locations nationwide, community banks constitute roughly 99 percent of all banks, employ nearly 700,000 Americans and are the only physical banking presence in one in three U.S. counties. Holding nearly $5.9 trillion in assets, over $4.9 trillion in deposits, and more than $3.5 trillion in loans to consumers, small businesses and the agricultural community, community banks channel local deposits into the Main Streets and neighborhoods they serve, spurring job creation, fostering innovation and fueling their customers' dreams in communities throughout America.

The MBCA is the voice of America's mid-size banks. The MBCA is honored to represent more than 100 banks that are devoted to driving positive change and helping their clients, employees and communities flourish. MBCA members range in size from about $10 billion to $100 billion in assets and average approximately $20 billion. Our banks collectively serve clients and communities through more than 13,000 branches in all 50 states, Washington, DC, and three U.S. territories. MBCA banks are typically the largest independent banks headquartered in their respective states. More information about MBCA and its member banks is available at www.midsizebanks.com.

Since 1927, the National Bankers Association has served as the leading trade association for the country's Minority Depository Institutions (MDIs). Our members include Black, Hispanic, Asian, Pacific Islander, Native American, and women-owned and -operated banks across the country, all working to help minority and low- and moderate-income communities who are underserved by traditional banks and financial service providers. Today, there are 140+ MDI banks located across 29 states, the District of Columbia, Puerto Rico, and Guam with combined total assets of $323.1 billion.

Appendix B.

Bank Policy Institute Research Paper*, he FDIC's Proposed Increase in Deposit Insurance Assessments May Be Based On Incorrect Projections*, July 13, 2022.

The FDIC's Proposed Increase in Deposit Insurance Assessments May Be Based On Incorrect Projections
07.13.22

Bill Nelson

202.589.2454

Bill.Nelson@BPI.com

On June 21, 2022, the FDIC published a proposal to increase sharply the assessments banks pay for deposit insurance. The assessments are used to build up a reserve that is in turn used to cover losses from insured bank failures. The proposal was prompted by the fact that the ratio of reserves to insured deposits (the "reserve ratio") had fallen to 1.23 percent, and the FDIC is required by law to maintain a minimum ratio of 1.35 percent or, if short of that target for any reason, adopt a plan to return to the minimum within eight years of the plan's adoption. Because the FDIC had adopted a plan in September 2020, shortly after the ratio first fell below 1.35 percent, it needs to return the ratio to 1.35 percent by September 2028. The proposal was premised on FDIC analysis indicating that the reserve ratio would not return to 1.35 percent until between the second quarter of 2027 and the third quarter of 2034, depending on the assumptions made, and that the FDIC was therefore at risk of failing to meet its statutory deadline.

In this note, we replicate the FDIC's projections and then change two assumptions. First, whereas the FDIC assumes that interest earnings and capital gains will be zero over the forecast horizon, we assume that starting in 2022Q3, they will sum to 2½ percent, which is roughly where rates are now and the Federal Open Market Committee's outlook for the overnight rate over the longer term. Second, whereas the FDIC assumes that deposits will grow at 3½ or 4 percent, we assume that the level of deposits will remain unchanged in the medium term, in line with the fact that deposits are currently contracting and that the factors that have boosted deposits over the past few years have all reversed.

Each of these changes shifts significantly the projected date earlier that the DIF reserve ratio will reach 1.35 percent, and together they move the projected date to the third quarter of next year. For example, using the FDIC's most pessimistic assumptions and simply assuming that interest earnings and capital gains will be 2½ percent of reserves instead of zero moves the projected date for reaching 1.35 rate nearly nine years earlier than the FDIC's projection, from 2034Q3 to 2025Q4. If, in addition, deposits are assumed to hold steady at their 2022Q1 level (and they are probably already below that level), the reserve ratio reaches 1.35 percent in the third quarter of next year rather than the third quarter of 2034.

In short, the FDIC appears not to have taken into account the significant changes that have taken place this year with respect to interest rates and deposits and the outlook for those variables. If the FDIC's projections are adjusted for those changes, the reason it proffers for such a sharp increase in assessments evaporates. Rather than doing poorly, the FDIC's reserve-ratio restoration plan is performing well. The FDIC reassesses the performance of its plan every six months. The Corporation should table its proposed increase and reconsider the situation six months down the road.

Background

The FDIC charges insured depository institutions (henceforth "banks") assessments that it uses to meet its operating expenses, pay bank failure costs, and maintain a reserve, the Deposit Insurance Fund (DIF). The assessments are calculated as a fraction of each bank's total liabilities, its "assessment base." The total fee for each bank is calculated by multiplying its assessment base times an assessment rate. The assessment rate equals a base rate of 2 basis points plus adjustments for financial condition, size, and complexity. For the assessment period ending March 31, 2022, the weighted-average assessment rate was 3.7 basis points. The DIF is invested in Treasury securities, roughly equally divided between bills and notes with maturities of up to five years.

The DIF reserve ratio is the ratio of the DIF to insured deposits. The Federal Deposit Insurance Act requires the FDIC to maintain the reserve ratio at or above 1.35 percent or to implement a restoration plan that will restore the ratio to 1.35 percent within 8 years. This 8-year restoration period is designed to avoid potentially procyclical assessment increases during periods of economic stress in which bank funds would be better spent supporting economic recovery.[1] In the first and second quarters of 2020, deposits increased sharply as businesses and households sought the safety and liquidity of bank deposits; businesses drew down their lines of credit at banks and deposited the line draws; the Federal Reserve bought trillions of dollars of securities from nonbanks; and households and businesses deposited government support checks. That growth drove the reserve ratio below its required level as of June 30, 2020. The FDIC adopted a restoration plan on September 15, 2020; so the ratio must be restored by September 15, 2028.

At the end of March 2022, the reserve ratio equaled 1.23 percent. The ratio is low for two reasons. First, as interest rates have risen, the FDIC has made capital losses on the Treasury securities in which the reserve is invested– unrealized losses rose over $1 billion in the first quarter alone. Second, deposit growth continued longer than the FDIC expected, and deposits remain elevated.

INTEREST RATES

After remaining near zero since the beginning of the pandemic, interest rates have risen sharply in recent quarters. For example, the 3-year Treasury rate remained below ¼ percentage point through the beginning of 2021, rose to 1 percentage point by the end of 2021, and then jumped to 3½ percent by June 2022. (The duration of the FDIC's portfolio is probably about 3 years.) The movement in the 3-year rate reflects the abrupt change in the level and expected path for the federal funds rate, the FOMC's monetary policy target. In June 2021 the median FOMC participant expected the federal funds rate to still be zero at the end of 2022 and about ½ percent at the end of 2023. In June 2022 the outlook was for the rate to rise to 2 percent by the end of 2022 and 2¾ percent by the end of 2023.

[1] *C.f.* Statement of Donald E. Powell, Chairman of the Federal Deposit Insurance Corporation, on Deposit Insurance Reform before the Committee on Financial Services of the U.S. House of Representatives, Subcommittee on Financial Institutions and Consumer Credit (Mar. 17, 2005) *available at* https://archives-financialservices.house.gov/media/pdf/031705dp.pdf (noting that the then-existing statutory requirement to raise assessments to return the DIF to the statutory minimum within one year of a shortfall "could impose a significant drain on the net income of depository institutions when they can least afford it, thereby impeding credit availability and economic recovery" and describing the then-existing system as "pro-cyclical").

For two reasons, the interest rates relevant for projecting FDIC interest income are current and expected market rates, not the yields of the securities when they were purchased. First, and most importantly, the FDIC maintains the securities as "available for sale" and therefore marks them to market. When interest rates change, the securities take a capital gain or loss, and then going forward the expected interest yield and capital or loss sum to the new market rates. Second, as discussed above, the maturities of the securities the FDIC holds are fairly short, so the portfolio will relatively quickly be reinvested into higher yielding securities.

Consequently, the FDIC's assumption that the interest yield and capital gains on the portfolio of securities making up the reserve fund will be zero is incorrect. Moreover, as discussed below, that assumption makes a large difference in the projected date that the reserve ratio reaches 1.35 percent. A comprehensive projection would include an interest rate assumption that blended current and expected rates across the maturities of the securities in and expected to be in FDIC's portfolio. Market quotes suggest that overnight rates are going to continue to rise in the coming months to 2½ percent this fall and 3½ percent by the first quarter of next year, and 3- and 5-year rates currently are both about 3 percent.

Why the yield on FDIC's portfolio of securities will be higher now that interest rates are higher

Now that interest rates are higher, as the FDIC's portfolio of investments matures, the proceeds will be reinvested into higher-yielding securities; indeed, half of the portfolio rolls over every business day. But even if none of the securities in the portfolio mature, the FDIC investment income would still rise along with market rates because the portfolio is marked to market, as illustrated in the following example.

Consider a 5-year note with a $100 par value that was issued when interest rates were 4 percent and expected to remain at 4 percent forever. Its quarterly coupon is $1 and its market value is equal to its par value of $100. But then interest rates rise to 8 percent and now everyone that rates will be 8 percent forever. The security experiences a -15.9 percent capital loss — the market value drops from $100 to $84.1.

If nothing changes, over time the market value of the security rises gradually back to $100 because just before it matures and pays $100 principal it has to be worth $100. This is called "pull to par." Over the next quarter, an investor earns 2 percent on the security (one-fourth of the prevailing annual rate of 8 percent), consisting of interest earnings and a capital gain. The coupon of $1 divided by the market price at the beginning of the quarter ($84.1) provides a 1.2 percent interest yield. In addition, the market prices rise to $84.8 because of pull to par, a capital gain of 0.8 percent. Combined, the investor earns 2 percent, or 8 percent at an annual rate, the new prevailing rate of interest.

For conservatism and simplicity, we assume that, starting in the current quarter (2022Q3) the sum of the interest yield and capital gains on the FDIC's portfolio will be 2½ percent starting although an assumption of 3 percent is probably closer to the correct level implied by market prices over the medium term. An assumption of 2½ percent is in line with the expected overnight interest rate in the long run of the median FOMC participant in the projections provided at the June 2022 FOMC meeting.[2] By way of reference, in 2019Q2 when the federal funds rate was 2½ percent, the sum of the FDIC's interest earnings and capital gains was 3 percent at an annual rate.

The FDIC has not published data on its portfolio's performance for the second quarter, but the change in interest rates that occurred over the quarter suggests interest earnings rose and the market value of its portfolio fell slightly, so for Q2 we maintain the FDIC's assumption that interest earnings and capital gains were zero.

[2] https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20220615.pdf

DEPOSITS

Deposits remain elevated but have begun to decline and are likely to continue to decline. The ratio of deposits to loans at commercial banks at the end of 2022Q1 was 166 percent compared with a 10-year pre-Covid average of 133 percent.[3] Median household savings and checking account balances at Bank of America remain 60 to 80 percent above their 2019 average.[4] The ratio of deposits to bank assets is 82 percent versus a 74 percent pre-Covid average. And deposits currently make up 14 percent of household financial assets versus a pre-Covid average of 12 percent. Especially germane for the FDIC, as of 2022Q1, the ratio of total insured deposits to the total assessment base was 48 percent compared with 43 percent in 2019Q4.

Deposit levels have remained elevated for three reasons.[5] First, households remain flush with savings because of the inflow of government relief funds and a decline in spending: Cumulative excess household savings equals $990 billion relative to an amount that keeps the savings rate constant at the pre-Covid level.[6] Second, with deposit rates and money market rates all essentially equal to zero up until March 2022, deposits have been an attractive place to keep excess liquidity (returns are essentially equal, but deposits offer superior payment services and money market investments are not insured). Third, when the Federal Reserve purchases a security from a nonbank, the purchase price is credited to the seller's bank account and bank deposits are boosted temporarily. Between mid-February 2020 and the end of April 2022, the Fed purchased $4.6 trillion in Treasury securities and Agency MBS.[7]

All three of these developments are reversing. Starting in March, the Federal Reserve has raised its target range for the federal funds rate 150 basis points with substantial further tightening expected, and a more normal spread between money market rates and deposit rates has opened up. In response, depositors are shifting into money market mutual funds.[8] Covid-related fiscal support programs have ended and the household saving rate has been below average in recent months.[9] Lastly, QE has turned to QT. Rather than purchasing securities, the Federal Reserve is allowing its holdings to mature without replacement, up to pre-specified limits. When the Fed does not roll over a maturing security, someone else buys the new security that the Treasury issues. If that someone else is not a bank, bank deposits temporarily go down.

For all these reasons, as shown in the exhibit, deposit growth has decelerated and deposits are now contracting. Indeed, last month the OCC cautioned national banks that "…a reversal of fiscal stimulus, an increase in deposit substitutes, and increased economic development and business investment may drive a decline in deposits."[10]

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[3] Federal Reserve Statistical Release Z.1.

[4] Bank of America Institute, Consumer Checkpoint, 7 July 2022. https://business.bofa.com/content/dam/flagship/bank-of-america-institute/economic-insights/consumer-checkpoint-july-2022.pdf

[5] See Federal Reserve Board blog post "Understanding Bank Deposit Growth Under Covid," June 3, 2022, and BPI blog post "QE May Raise Deposits at Banks Immediately, but Not Permanently," April 6, 2021.

[6] Bureau of Economic Analysis, Personal Income and Outlays, May 2022, and author's calculations.

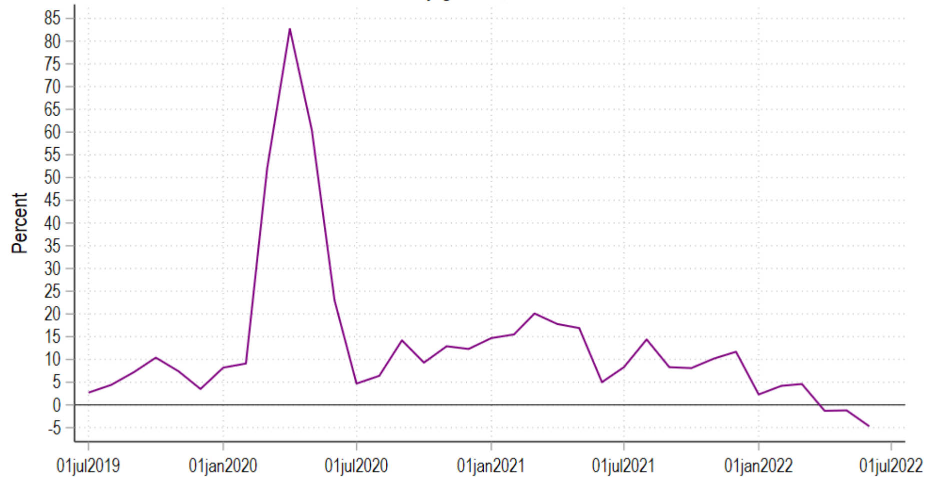
[7] Federal Reserve Statistical Release H.4.1.

[8] Retail money funds grew $73.4 billion between December 2021 and May 2022, an 18 percent annual rate. Federal Reserve Statistical Release H.6.

[9] Bureau of Economic Analysis, Personal Income and Outlays, May 2022.

[10] Office of the Comptroller of the Currency, Semiannual Risk Perspective, June 23, 2022, p. 24.

Deposits, excluding large time, domestic commercial banks
Monthly growth, annual rate



Note: Data are from the Federal Reserve Statistical H.8. Final observation for June 2022 uses the average of the weekly observations.

Projections

Each quarter, the DIF evolves. Assessments, interest earnings, and capital gains add to the fund. Operating expenses, bank failure costs, and capital losses drain the fund. To project the ratio of the DIF to insured deposits, it is necessary to project those inflows and outflows as well as the growth of deposits.

Projections						
Investment yield (interest plus net capital gain)	Deposit growth rate, percent	Assessment rate, basis points	Assessment base growth rate, percent	Insurance losses 2022-2026 $billions 5-year total	Operating expense growth rate, percent	Date reserve ratio reaches 1.35 percent
FDIC Projections						
0	4	3.5	4.5	1.8	1	**2034Q3**
0	3.5	4	4.5	1.8	1	**2027Q2**
Most Pessimistic FDIC Assumptions and Investment Yield Equal to 2½ percent						
2.5*	4	3.5	4.5	1.8	1	**2025Q4**
BPI Projection: Investment Yield 2½ percent, Deposit Growth equal to 0, and Assessment Rate Equal to FDIC Average						
2.5*	0**	3.75	4.5	1.8	1	**2023Q3**
*Equals zero in 2022Q2. **In 2024Q4, when deposits/assessment base equal pre-covid level, deposit growth rate equals the assessment base growth rate.						

MATCHING THE FDIC PROJECTIONS

As a first step, we replicate the FDIC's projections.[11] We take as a jumping off point at the end of 2022Q1 that insured deposits are $9,975 billion, the assessment base is $20,831 billion, and quarterly operating expenses are $453 million.[12] Following the FDIC, we assume that interest earnings and capital gains are zero, the assessment base grows at a 4.5 percent annual rate, operating expenses grow at a 1 percent annual rate, and failure costs will sum to $1.8 billion over 2022 to 2026. [13] [14]

When we combine those assumptions with the FDIC's two cases for deposit growth and the assessment rate, we get identical results. When deposit growth is 4 percent and the assessment rate is 3.5 basis points, the reserve ratio reaches 1.35 percent 2034Q3. When deposit growth is 3.5 percent and the assessment rate is 4 basis points, the reserve ratio reaches 1.35 percent in 2027Q2.

CORRECTED PROJECTIONS

Next, we correct the FDIC assumptions to reflect the current and expected future state of interest rates and deposit levels. Correcting the investment yield assumption alone has a significant effect. Using the FDIC's most pessimistic assumptions for deposit growth and the assessment rate (4 percent and 3.5 percent, respectively), when starting in the current quarter, the investment portfolio earns 2.5 percent rather than 0, the reserve ratio rises to 1.35 percent in 2025Q4.[15] That is, the reserve ratio reaches the statutory requirement nearly 9 years sooner than the FDIC projects and 3 years before the deadline.

Lastly, we also assume that deposits hold steady at their 2022Q1 level until the ratio of deposits to the assessment base equals its pre-Covid level, at that point, deposits grow at the same rate as the assessment base (4½ percent annual rate).[16] In addition, we set the assessment rate to 3.75 basis points, halfway between the FDIC's two alternative assumptions of 3.5 and 4 basis points and essentially equal to the weighted-average assessment rate in the most recent assessment period for which data is available, ending March 31, 2022.[17] Using these assumptions, the reserve ratio reaches 1.35 percent in the third quarter of next year.

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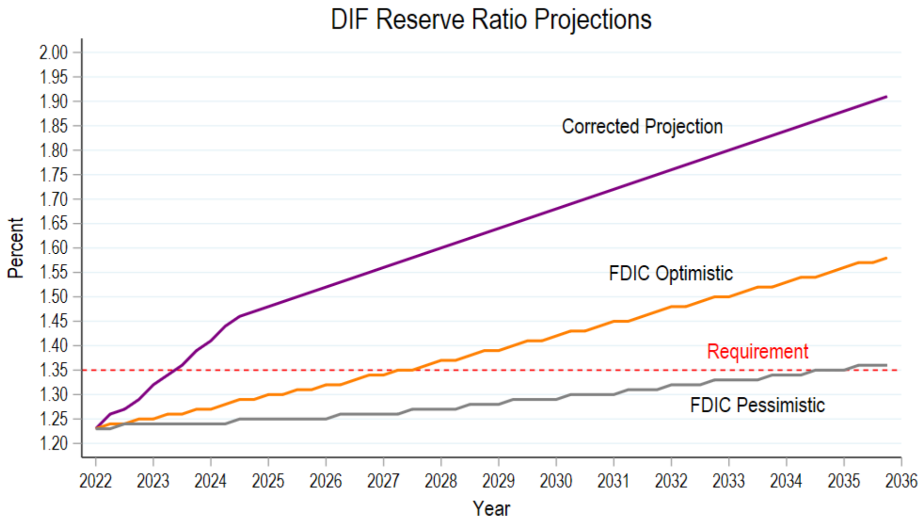
[11] BPI analysis is available upon request.
[12] 2022Q1 Quarterly Banking Profile p. 24.
[13] "Restoration Plan Semiannual Update and Amended Restoration Plan," memo to the FDIC Board of Directors from Patrick Mitchell, June 21, 2022, pp. 8-9.
[14] In order to match the FDIC's projected date that the reserve ratio equals 1.35 percent in the more pessimistic scenario, we need to assume that failure costs drop to zero after 2026. The drop in the failure cost is irrelevant for BPI projections because the reserve ratio is normalized before 2027. For those seeking to replicate these results, we also infer that the FDIC converted annual growth rates into quarterly growth rates using compounding rather than by dividing by four (which is fine).
[15] We maintain the FDIC's assumption that interest earnings and net capital gains were zero in 2022Q2.
[16] The increase in the assumed deposit growth rate from 0 to 4½ percent when the deposit – assessment base ratio is normalized causes the kink in the "corrected projection" line in 2024Q4.
[17] "Restoration Plan Semiannual Update and Amended Restoration Plan," memo to the FDIC Board of Directors from Patrick Mitchell, June 21, 2022, pp. 8-9.



Note: Data are from the FDIC's March 2022 Quarterly Banking Profile; 'Restoration Plan Semiannual Update and Amended Restoration Plan,' memo to the FDIC Board of Directors from Patrick Mitchell, June 21, 2022, pp. 8-9; and the author's calculations.

Conclusion

After the FDIC's projections are adjusted to reflect recent developments, the projections indicate that the DIF reserve ratio is on track to reach 1.35 percent by the middle of next year, more than 5 years before the statutory deadline and between 4 and 9 years earlier than the FDIC projected. As a result, the FDIC proposal to double the base assessment rate from 2 basis points to 4 basis points is not supported by the rationale the FDIC provides.

The revised projections are based on the FDIC's model with two adjustments. First, rather than assume that interest rates will be zero, the new projections assume that interest rates will be 2½ percent, in line with the FOMC's outlook. Second, rather than assume that deposits will grow at 3½ or 4 percent, the projections assume that deposits will be unchanged in the medium term. That assumption is conservative given the recent declines in deposits and the economic and financial forces that will be acting to hold deposits down for several quarters – higher interest rates, reduced saving rates, and QE turning to QT.

Given that the reason the FDIC gave for doubling the base assessment rate is incorrect, it would be imprudent for the FDIC to make such a large increase to the deposit assessment rate at this time. It would be more appropriate for the FDIC to reconsider the change after it has re-run its analysis in six months, at the time of its next required semiannual restoration plan update. At that point, the trajectory of deposit levels could be clearer, and the FDIC will have been able to observe its investment income at the higher level of prevailing interest rates.

Appendix C.

Bank Policy Institute Blog Post, *FDIC Investment Yield Projection,* August 11, 2022.

BANK POLICY INSTITUTE

FDIC Investment Yield Projection

Bill Nelson | August 11, 2022

On July 12, 2022, we published a note that redid the FDIC's recently published projections of the ratio of reserves to insured deposits with two changes to the FDIC's assumptions: (1) We assumed that deposits would remain unchanged rather than grow in the near term. (2) We assumed that the FDIC would earn 2.5 percent on its investment portfolio rather than zero. With those changes, the reserve ratio was forecast rise to its statutory requirement by the middle of next year, four to 12 years earlier than the FDIC's projection.

In that note, we did not prepare a projection of the yield on the FDIC's portfolio; we just asserted:

> For conservatism and simplicity, we assume that, starting in the current quarter (2022Q3) the sum of the interest yield and capital gains on the FDIC's portfolio will be 2½ percent…although an assumption of 3 percent is probably closer to the correct level implied by market prices over the medium term.

This note, by contrast, presents a projection of the investment yield of the FDIC's portfolio based on recent market quotes and confirms our previous logic. In particular, using a simple rule for the FDIC's investment strategy and the term structure of interest rates as of July 1, 2022, the FDIC's portfolio is expected to yield about 2.9 percent going forward.

Portfolio

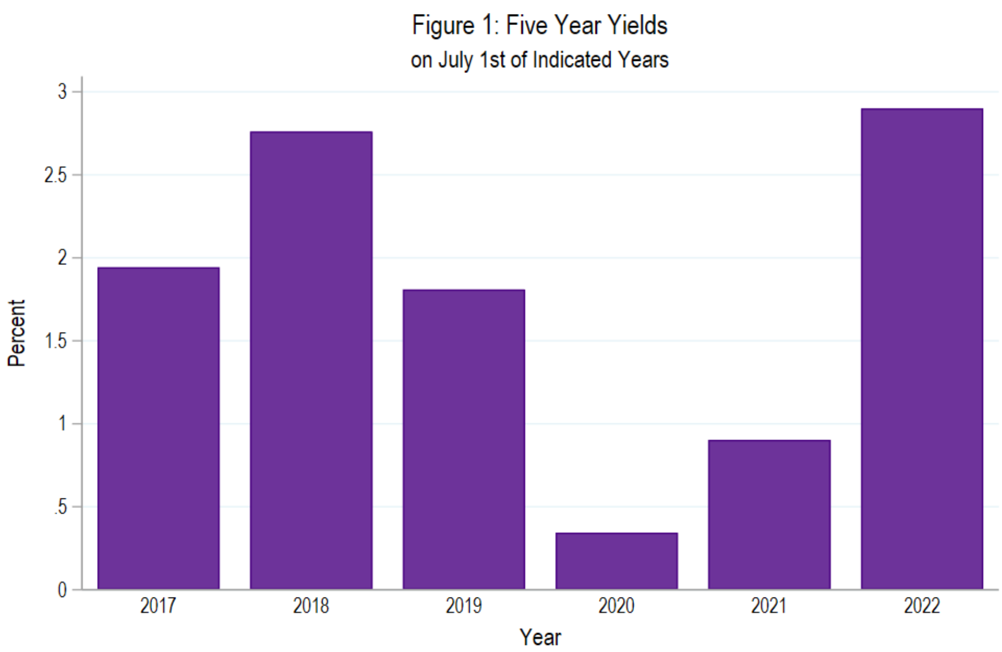
The FDIC does not provide the public detailed information on the securities it owns. The FDIC's Corporate Investment Policy (available here), indicates the Corporation invests in Treasury securities provided by the Treasury to government agencies. The FDIC's annual report (available here) indicates that the securities have maturities of up to five years with about half of the portfolio having maturities of one year or less. The FDIC marks its securities to market.

To roughly replicate these characteristics, we assume that the FDIC has purchased $100 in five-year Treasury notes and $300 in one-year bills each year on July 1. At any given time, such a portfolio would have $400 in securities with maturities of one year or less and $400 in securities with maturities of two to five years. The precise dollar level of the assumed purchases is immaterial to the projection since the total return would be the same regardless of the size of the portfolio.[1]

[1] If the FDIC were to provide more information on the composition of their portfolio, the projection reported below could be made more precise.

Interest rates

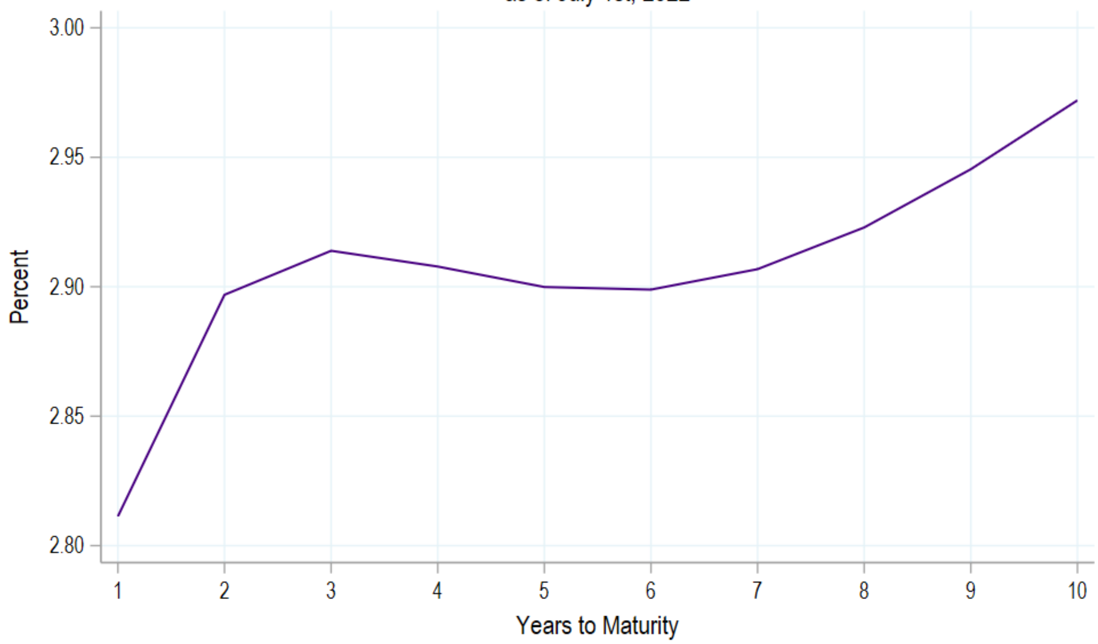
Interest rate data is taken from the Gurkaynak, Sack, and Swanson yield curve and forward rate database (available here). As can be seen in figure 1, the yield on the five-year notes that we assume the FDIC has been purchasing has varied considerably in recent years, reaching historic lows in 2020 and remaining low in 2021.



As shown in figure 2, beyond one year, the Treasury yield curve on July 1, 2022, was very flat at about 2.9 percent, indicating a market outlook that interest rates would average about that level in the future. We use the yield curve data to calculate expected Treasury interest rates for each July 1 out to 2027. To do so, we make the simplifying assumptions that each coupon rate is the average of the future one-year rates expected over the term of the security and that term premiums are zero.[2]

[2] The Federal Reserve itself produces two estimates of the term premium: (a) Federal Reserve Board estimates using the methodology of Kim and Wright (2005), and (b) Federal Reserve Bank of New York estimates using the methodology developed by Adrian, Crump, and Moench (2013). Both methods indicate term premiums are about zero currently.

Figure 2: Treasury Yield Curve
as of July 1st, 2022



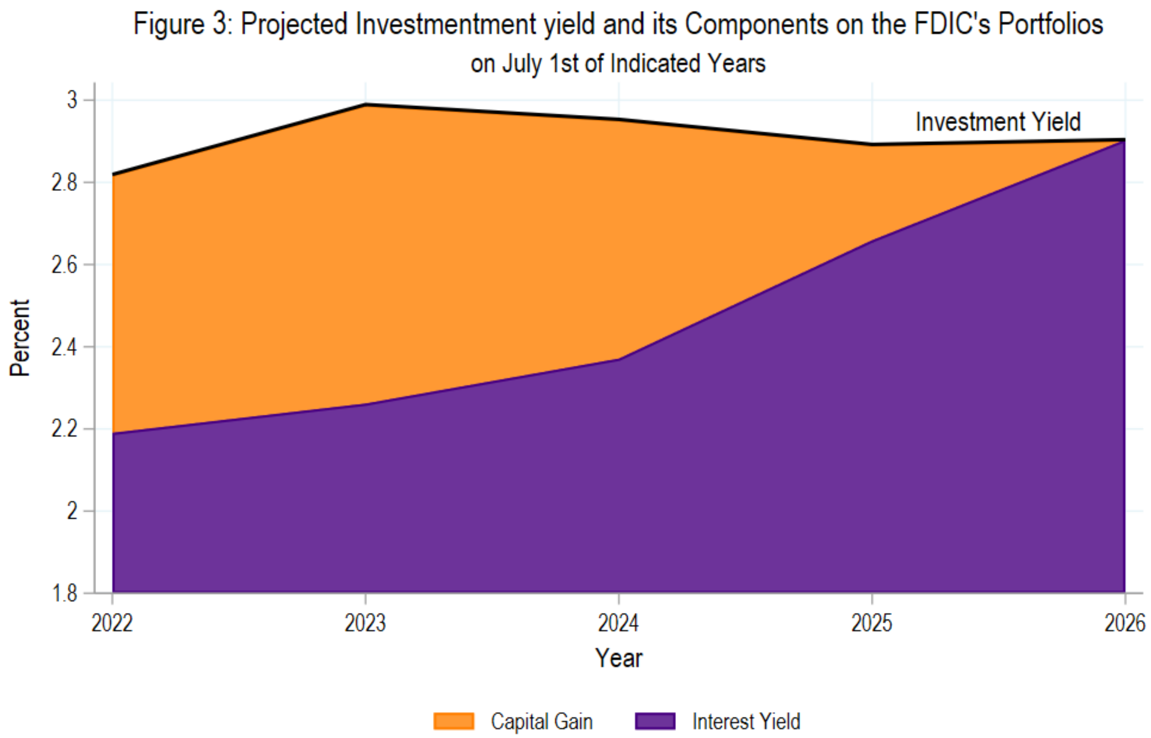
Investment Yield

Using these data and assumptions, we calculate the projected interest income and dollar capital gain or loss on the FDIC portfolio each year. The interest income is calculated as the sum of the yield on each security when issued times its par value. The dollar capital gain or loss is the sum of the dollar change in the market value of each of the security in the portfolio. For example, on July 1, 2023, the five-year note issued on July 1, 2021 will have a remaining maturity of three years, so its price depends upon the five-year yield in 2023 (which determines its coupon) and the three-year yield expected in 2023 (where we derive the expected yield using the yield curve on July 1, 2022). One year later, in 2024, the security will have a remaining maturity of two years and its value will depend on the five-year yield in 2021 and the two-year yield in 2024. The dollar capital gain or loss equals the change in price.

We project the yield over one-year periods starting on July 1 and based on the outlook for rates as of July 1, 2022 simply because July 1 is the first day of the second half of the year and July 1, 2022 is relatively recent. The projections are for annual rather than quarterly intervals for simplicity because the Gurkaynak, Sack, and Swanson data include Treasury yields with annual maturities, not part-year maturities. That is, the data include the two-year rate and the three-year rate but not the 2¼-year rate.

Figure 3 reports the interest yield and capital gain on the portfolio expected in each year. The interest yield is interest income divided by the value of the portfolio at the beginning of the period and the capital gain is defined similarly. In the near term, the interest return is held down by the low-yielding securities purchased in 2020 and

2021, but the portfolio experiences capital gains as the values of those securities rise toward par and then eventually the securities mature. By the end of the projection, expected capital gains and losses are zero.



The total investment yield on the portfolio is the sum of the interest yield and the capital gain. As shown in the exhibit, the expected yield is 2.9 percent over the next five years.

Conclusion

Our judgment that the investment yield on the FDIC's portfolio should be expected to be between 2.5 and 3 percent going by the market outlook is appropriate. Although not the point of this note, when we assume the investment yield will be 2.9 percent rather than 2.5 percent, the projected date when the reserve ratio reaches 1.35 percent moves from 2022Q3 to 2022Q2 as opposed to the FDIC's projections of 2025Q4 or 2034Q3, depending on assumptions.

Disclaimer: The views expressed do not necessarily reflect those of the Bank Policy Institute's member banks, the G30 or the G30 Working Group on Treasury Market Liquidity and are not intended to be, and should not be construed as, legal advice of any kind.

Appendix D. Historical Comparison of Bank Capitalization by Asset Size Class

Financial Ratio / Asset Size Class	2003 – 2007 Average*	2017 – Q1 2022 Average**
Core Capital (Leverage) Ratio		
More than $250 Billion	6.30%	8.49%
$10 – $250 Billion	8.66%	9.98%
$1 – $10 Billion	9.34%	10.62%
$100 Million – $1 Billion	9.77%	11.15%
Less than $100 Million	12.15%	13.37%
All Banks	8.12%	9.34%
Tier 1 Risk-Based Capital Ratio		
More than $250 Billion	8.26%	13.09%
$10 – $250 Billion	10.88%	13.50%
$1 – $10 Billion	12.72%	14.14%
$100 Million – $1 Billion	13.56%	15.76%
Less than $100 Million	18.18%	22.10%
All Banks	10.62%	13.51%
Total Risk-Based Capital Ratio		
More than $250 Billion	11.46%	14.60%
$10 – $250 Billion	13.42%	14.89%
$1 – $10 Billion	14.16%	15.17%
$100 Million – $1 Billion	14.72%	16.86%
Less than $100 Million	19.27%	23.16%
All Banks	13.08%	14.90%

* Five years prior to the 2008-2009 financial crisis
** Five years and a quarter, including the 2020 recession

Appendix E. Historical Comparison of Bank Financial Performance by Banks Asset Size Class

Financial Ratio / Size Class	2003 – 2007 Average*	2017 – Q1 2022 Average**
Net Charge-Offs to Loans and Leases		
More than $250 Billion	0.57%	0.43%
$10 – $250 Billion	0.76%	0.60%
$1 – $10 Billion	0.37%	0.20%
$100 Million – $1 Billion	0.25%	0.12%
Less than $100 Million	0.24%	0.15%
All Banks	0.57%	0.44%
Noncurrent Loans and Leases to Tier 1 Capital Plus Reserves		
More than $250 Billion	8.28%	5.80%
$10 – $250 Billion	6.50%	6.07%
$1 – $10 Billion	5.22%	4.93%
$100 Million – $1 Billion	5.16%	4.57%
Less than $100 Million	5.08%	4.93%
All Banks	6.51%	5.69%

* Five years prior to the 2008-2009 financial crisis

** Five years and a quarter, including the 2020 recession

Appendix F. Banks that Would Have Been Significantly Impacted by 2 basis points More in FDIC Assessments

Reduction in Pretax Income

Bank Asset Size Class	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
5 Percent of Pre-Tax Income										
Less than $1 Billion	570	616	486	462	348	283	228	211	260	241
$1-to-$5 Billion	17	17	12	16	11	3	9	6	10	8
$5-$10 Billion	3	1	2	1	1	0	0	0	5	1
Over $10 Billion	2	2	1	1	2	2	1	2	6	0
All Banks	592	636	501	480	362	288	238	219	281	250
10 Percent of Pre-Tax Income										
Less than $1 Billion	249	247	194	179	128	115	95	74	87	91
$1-to-$5 Billion	7	8	5	4	6	1	3	2	4	3
$5-$10 Billion	1	0	0	0	0	0	0	0	1	0
Over $10 Billion	1	0	0	0	1	0	0	0	3	0
All Banks	258	255	199	183	135	116	98	76	95	94
25 Percent of Pre-Tax Income										
Less than $1 Billion	83	103	76	63	34	45	30	24	32	28
$1-to-$5 Billion	3	2	1	0	2	0	0	0	1	2
$5-$10 Billion	1	0	0	0	0	0	0	0	1	0
Over $10 Billion	0	0	0	0	0	0	0	0	3	0
All Banks	87	105	77	63	36	45	30	24	37	30