December 17, 2008

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Re: RIN 3064-AD35
Proposed Rulemaking on Deposit Insurance Risk Assessment and Rates
(12 C.F.R. Part 327)

Discover Bank submits these comments in response to the FDIC's rulemaking notice and request for comments published on October 20, 2008 regarding proposed amendments to 12 C.F.R. Part 327 (the "Proposal").

Introduction

Discover Bank is one of the largest issuers of general purpose credit cards in the United States. Discover Bank, a subsidiary of Discover Financial Services, is chartered by the State of Delaware. Until June 2007, Discover Financial Services was a unit of Morgan Stanley. On June 30, 2007, Discover Financial Services was spun off from its former parent, Morgan Stanley, and became an independent company listed on the New York Stock Exchange.

As one of the nation's largest insured depository institutions, with deposits of $27.1 billion as of September 30, 2008, Discover Bank is vitally interested in the FDIC's Proposal to change the way the FDIC differentiates for risk in the risk-based assessment system and the proposed changes in the assessment rates. In this regard, Discover Bank supports the FDIC's efforts to improve the way the assessment system differentiates risk among insured depository institutions in order to make the assessment system more sensitive to risk. However, Discover Bank disagrees with the assessment of additional fees on brokered deposits as set forth in the Proposal as the requirements under the Proposal do not properly differentiate between those financial institutions that prudently use brokered deposits and those that use brokered deposits to finance unsafe and unsound banking practices.

Since the launch of the Discover Card, Discover Bank has been an innovator in providing lending products to consumers nationwide, focusing primarily on the "prime" consumer credit card market. Discover Bank was the first large credit card lender to offer a no-fee card and to provide rewards to cardmembers. These consumer benefits were fostered, in part, by a business model that focused on credit card lending (which made it unnecessary to establish bank branches) and funded lending activities through a combination of brokered deposits and retail deposits. For over two decades, the stability, pricing and flexibility provided by this funding has supported Discover Bank's ability to provide attractive, competitive lending products to consumers.

As discussed below, the Proposal inappropriately increases the costs of using the brokered deposit channel without regard to the actual risk to the insurance fund presented by a specific insured institution. This approach will unnecessarily result in increased consumer credit costs and a reduction in innovation in banking.

In addition, by imposing additional assessments on brokered deposits as proposed, the FDIC may create a negative perception of that channel and discourage its use, even though brokered deposits provide prudent cost-effective liquidity and funding diversification for banks with appropriate risk management infrastructure and controls. This potential consequence is even more significant in the current funding environment.

Further, there is already a legislative framework that addresses risks associated with use of brokered deposits. The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") adopted the current restrictions on the acceptance of brokered deposits by insured institutions. "Well capitalized" insured institutions can accept brokered deposits without restriction. "Adequately capitalized" insured institutions can accept brokered deposits only with a waiver from the FDIC. Discover Bank believes that this framework, the supervisory and examination framework used by the banking agencies, and the existing and proposed linkages between CAMELS ratings and assessment rates, give the FDIC sufficient tools to control the use of brokered deposits by riskier insured institutions and to increase assessments for such institutions.

<u>Discussion</u>

1. <u>Treatment of Brokered Deposits under the Proposal</u>

The Proposal contains a "Brokered Deposit Adjustment" to the premium assessment that is intended to recognize potential additional risk to an insured institution posed by the use of brokered deposits in certain circumstances. The adjustment for Risk Category I institutions would apply if an insured institution's brokered deposits exceed 10% of its domestic deposits and its assets had increased by more than 20% during the prior four years. For Risk Category II, III and IV institutions, the adjustment would apply if brokered deposits exceed 10% of domestic deposits, regardless of growth. The Proposal suggests that the rationale for imposing a "Brokered Deposit Adjustment" to the premium assessment is that (i) some recently failed institutions experienced rapid asset growth

before failure and may have funded that growth with brokered deposits and (ii) there is some correlation between rapid asset growth funded by brokered deposits and the probability of an institution's CAMELS rating being downgraded.

2. Prudent Use of Brokered Deposits Should Not Be Penalized

Discover Bank's lending activities have historically been funded by a combination of sales of asset-backed securities (backed by credit card receivables) and bank deposits, including deposits that qualify as brokered deposits under the Proposal. Discover Bank has obtained deposits through the brokered deposit market primarily through its relationships with large securities brokerage firms that offer certificates of deposit (CDs) to their retail customers.

Brokered CDs obtained through relationships with retail securities firms have certain characteristics that give them a stability not found in other deposit channels. First, brokered CDs are sold through the wealth management systems of retail securities firms that have brick-and-mortar characteristics similar to bank branch networks with the added benefit of providing access to higher net worth individuals. Access to individual investors across the country provides a diversified source of funding that is not dependent on local economic conditions and is flexible and cost effective as compared to many other funding sources.

Second, as a result of the limited early withdrawal features and the existence of a secondary market, retail brokered CDs provide a stable, reliable source of funding. In this regard, CDs issued in the retail brokered CD market permit early withdrawal only upon the death or adjudication of incompetence of the depositor. As an alternative to early withdrawal, CD holders can liquidate their CDs in a secondary market offered by most brokers to their customers. Because CD holders have a means to liquidate their CDs as an alternative to early withdrawal, an insured institution can issue CDs with longer maturities without the potential of facing early withdrawal demands. So, funds obtained in this market can be expected to remain with the issuing bank until maturity. In contrast, CDs issued directly by insured institutions typically have early withdrawal provisions. Thus, a bank funding itself directly is typically relying on funding that can be withdrawn either overnight with or without a penalty, or on seven days' advance notice in the case of NOW and money market deposit accounts.

This inherent stability in brokered CD funding creates a platform for this funding channel to be a strong funding and liquidity risk management tool. Although certain banks may have used brokered deposits to build assets in a manner that represented an unsafe and unsound practice, there are appropriate uses of the brokered deposit channel, particularly where used to fund prudently managed asset strategies. For banks like Discover Bank, the ability to issue stable, longer term CDs with appropriate maturity profiles for the institution's asset classes permits the bank to stagger maturities to manage liquidity and funding risks. The weekly rate posting process used in the brokered CD market facilitates the sale of CDs with maturity profiles consistent with a bank's maturity targets. As of September 30, 2008 , the weighted average maturity of Discover Bank's brokered

CDs was approximately 32 months, in sharp contrast to potentially riskier institutions that have used this market to grow rapidly through short term deposit funding.

This underscores that there is a broad spectrum of potential uses of the brokered deposit market, including uses that promote the stability and safety and soundness of the insured institution. The Proposal fails to take this into account, penalizing use of brokered deposits without properly considering how they are used. The inherent characteristics of the market are consistent with the view that the market itself is a stable, efficient source of funding that when prudently used can be an important component in a financial institution's overall funding program. In fact, studies referred to by other commenters on the Proposal indicate that the use of brokered deposits is not a predictor or indicator of bank weakness or failure.[1] As the FDIC has previously stated, brokered deposits are not the problem, it is how brokered deposits are used by the financial institution:

> In point of fact, the problem is not brokered deposits per se, but how these funds, like any other funds, are used. A dollar deposited in an insured institution is the same whether obtained directly from a local depositor or through the intermediation of a deposit broker. There may be differences in the cost and stability of that dollar deposit depending on its source. However, losses in banks do not occur, generally speaking, by virtue of the source of their deposit liabilities. Instead, the losses arise from the quality of and return on loans and investments made with those funds. Consequently, the focus of attention should be on the employment of brokered deposits rather than their source.[2]

And also:

> The prudent use of brokered deposits within legal requirements is entirely acceptable. Brokered deposits should be treated and assessed as any other funding alternative having its own special advantages and disadvantages. Furthermore, the acceptance of brokered deposits should not be grounds for criticism per se by virtue of the nature or origin of such deposits without considering the manner in which they are used and the impact of such use on the institution's overall condition and operations.[3]

3. <u>20% Four Year Growth Threshold is Inappropriate</u>

Under the Proposal, any Risk Category I institution would be subject to the Brokered Deposit Adjustment if the insured institution's brokered deposits exceed 10% of its

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[1] See comment letter on the Proposal submitted by Seward & Kissell.

[2] *Insured Brokered Deposits and Federal Depository Institutions: Hearing before the Subcommittee on General Oversight and Investigations of the House Committee on Banking, Finance and Urban Affairs*, 101st Cong., 1st Sess. (1989), at 98 (statement of L. William Seidman, Chairman of the FDIC).

[3] FDIC Interpretive Letter 95-24 (April 26, 1995).

domestic deposits and its assets had increased by more than 20% during the prior four years. The proposed “rapid asset growth” component of the brokered deposit ratio is an example of an area where a one size fits all approach is not appropriate. The proposed “growth over four years” test contains a single exception: asset growth that resulted from a merger or acquisition. Discover Bank believes that the 20% threshold does not serve as an appropriate proxy for identifying deterioration in an insured institution’s risk profile. First, the Proposal does not make a connection between either (i) the risks posed by the assets responsible for the growth of the financial institution or (ii) the strategies or other causes for that growth, and the additional assessment for use of brokered deposits. Second, the proposed 20% asset growth (over four years) standard represents only modest growth in banking assets. A 20% growth rate over four years represents the average growth rate of banks over the past 40 years. This is hardly the “rapid asset growth” the FDIC suggests is a matter of concern.

Moreover, the 20% threshold does not properly exclude asset growth due to certain corporate events that do not reflect adversely on the risk profile of the insured institution. In June 2007, Discover Financial Services spun off from Morgan Stanley and became its own stand alone publicly traded company. Prior to the spin-off, Discover Bank created a liquidity pool of $5 billion as part of its contingency funding plan, resulting in a significant net growth in bank assets. This liquidity pool has grown to $9 billion recently as management has increased contingency funding in light of market conditions. This growth would be counted toward whether the 20% asset growth threshold is exceeded, even though the growth had the effect of reducing the liquidity and funding risks of the bank and the liquidity pool was invested in government securities and other highly rated, liquid investments. By not taking into account the underlying reasons for the asset growth, the Proposal does not achieve its stated objective of differentiating between insured institutions with different risk profiles. Therefore, while we commend the FDIC for including an asset growth adjustment for mergers and acquisitions, we request that the FDIC also include adjustments for other corporate events such as spin-off transactions.

The 20% threshold also does not properly differentiate between asset growth due to changes in an insured institution’s business strategy and asset growth due to environmental factors that do not necessarily reflect changes in the risk of the insured institution. For example, in the current economic environment insured institutions have only been able to access the asset backed securities markets to a limited extent. This has resulted in growth in bank balance sheets that is not due to a material change in the risk profile of the organization, but rather is due to environmental factors that are causing assets to remain on balance sheet that historically would have been securitized. As such, this growth should not be included because it is not indicative of new or rapidly expanding business activities that could expose the bank to additional risks. For these reasons, if the FDIC adopts an asset growth test for the Brokered Deposit Adjustment, Discover Bank recommends that the test be structured so as not to include the growth of assets due to factors that do not reflect on the risk of the insured institution. For example, for a consumer lending financial institution, managed receivables may be a more appropriate measure of growth than balance sheet assets, particularly if structured with different growth thresholds for prime versus sub-prime loans.

4. <u>Impact of Proposal Resulting from FAS 140 Changes</u>

A. Brokered Deposit Adjustment

A further example of the flawed approach to the Brokered Deposit Adjustment under the Proposal is that it does not take into account changes in accounting rules that could impact asset growth. For example, the Financial Accounting Standards Board has issued proposed amendments to Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, as amended ("Statement No. 140") and FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities* ("FIN 46R") ("Proposed FAS 140 Changes") If adopted as proposed, the Proposed FAS 140 Changes would require that billions of dollars of off balance sheet securitized assets return to the balance sheets of insured institutions. This change would likely cause many major insured institutions to exceed the 20% growth threshold. However, this "growth" would not be the result of new or riskier asset strategies, but rather technical changes in accounting rules. Such "growth" should not result in a deposit insurance premium surcharge.

B. Secured Borrowings Adjustment

The Proposal also would raise an insured institution's base assessment rates based upon its ratio of secured liabilities to domestic deposits. However, the Proposal does not address the impact of the Proposed FAS 140 Changes, which could require banks with off balance sheet securitizations to consolidated onto their balance sheets both the securitized assets and the secured liabilities behind them. Under the Proposal, these secured liabilities on the balance sheet would trigger higher premiums. This seems to be an inappropriate result since, should the institution fail, the secured liabilities would be covered by the corresponding securitized assets, and therefore would not affect the FDIC in any way.

<u>Conclusion</u>

Discover Bank's principal concerns with the Proposal relate to its treatment of brokered deposits. The fact that some of the institutions that have failed over the past year have experienced rapid asset growth and growth in brokered deposits is not a basis for concluding that the failures were *attributable* to such deposit growth. The risk of failure is principally related to how an institution uses its capital and manages risk, as opposed to how deposits are raised. Thus, any deposit insurance differential based on growth attributable to brokered deposits should take into account the institution's lending activities and focus on whether the deposits are fueling lending that exposes the bank, and the deposit insurance system, to losses.

As described above:

- The brokered deposit market is a stable, flexible funding source that when used by well run insured institutions promotes sound funding and liquidity objectives.

- The 10%/20% test under the Proposal for the Brokered Deposit Adjustment does not identify riskier institutions with any degree of precision, and has the unintended consequence of deterring appropriate use of the brokered deposit market by insured institutions.

- While we commend the FDIC for including an asset growth adjustment for mergers and acquisitions, we request that the FDIC also include adjustments for other corporate events such as spin-off transactions and accounting changes.

For these reasons, Discover Bank believes that any Brokered Deposit Adjustment should be imposed only where the specific circumstances of an insured institution's use of brokered deposits warrants a risk premium. One way to do this would be to use deterioration in an institution's CAMELS ratings, such as the "Assets" component, following a period of rapid growth attributable to brokered deposits as a prerequisite to the application of a premium surcharge. Deterioration in capital levels could also be a factor. Another factor that could be used as a benchmark for use of brokered deposits could be the maturity profile of such deposits at a particular insured institution to distinguish between use of more volatile short-term brokered deposits from more stable longer-term brokered deposits. Only a tailored approach to additional assessments for brokered deposit use will accomplish the FDIC's stated objective under the Proposal of making the "risk-based system fairer, by limiting the subsidization of riskier institutions by safer ones."

Respectfully submitted,

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