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June 16, 2010

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

Attention: Comments

Re: Federal Deposit Insurance Corporation Notice of Proposed Rulemaking Relating to Assessments: RIN 3064-AD57

Dear Mr. Feldman:

The Clearing House Association L.L.C. ("The Clearing House")[1] appreciates the opportunity to comment on the Notice of Proposed Rulemaking issued by the Federal Deposit Insurance Corporation (the "FDIC") to revise the assessment system applicable to large depository institutions (the "NPR").[2] The Clearing House agrees with the FDIC that meaningful change in the current assessment system is appropriate. Moreover, we commend the FDIC for its conscientious research and its efforts to develop more accurate standards for evaluating risk. We respectfully submit, however, that the NPR has three fundamental flaws, and we urge the FDIC to withdraw the NPR and issue a new notice of proposed rulemaking after those flaws are remedied. A separate reason for issuing a new notice of proposed rulemaking is presented by the

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[1] The members of The Clearing House are: Bank of America, N.A.; The Bank of New York Mellon; Capital One, N.A.; Citibank, N.A.; Deutsche Bank Trust Company Americas; HSBC Bank USA, N.A.; JPMorgan Chase Bank, N.A.; The Royal Bank of Scotland, N.V.; UBS AG; U.S. Bank, N.A.; and Wells Fargo Bank, N.A.

[2] 75 Fed. Reg. 23516 (May 3, 2010).

material amendment to the Federal Deposit Insurance Act ("FDI Act") regarding the risk-based assessment system in the newly enacted financial reform legislation.

I. Executive Summary

As noted above, we believe that the NPR's approach to changing the assessment system has three fundamental flaws:

- First, the NPR does not satisfy the FDIC's statutory mandate – to base assessments on actual risk to the Deposit Insurance Fund (the "DIF"). Rather, the NPR principally addresses only one of the two elements of that risk, which is risk of failure. By failing to provide a comprehensive consideration of the second element, risk of loss upon failure, the NPR creates a distorted analysis of risk to the DIF.

- Second, the NPR is misguided in focusing its risk-reduction efforts on large banks, whereas the demonstrated real risk to the DIF is the high failure rate of small and medium-sized banks.

- Third, the NPR is apparently designed to shift even further the assessment burden onto large banks. This is unjustifiable based on the statutory standards and exacerbates the impact of the Tester Amendment (Senator Jon Tester, D-MT) included in Title III of the financial reform legislation.

In addition, the financial reform legislation, will require the FDIC to amend the basic definition of "assessment base" in the FDIC's regulations promulgated under the FDI Act. The changing legislative landscape further underscores the need for the FDIC to reassess the NPR's methodology.

Accordingly, we strongly recommend that the FDIC withdraw the NPR and issue a new notice of proposed rulemaking that addresses these three flaws so that actual risk to the DIF is more accurately incorporated in the assessment system. Doing so would also allow the FDIC to develop the assessment system in the context of the amendments to the FDI Act concerning the risk-based assessment system included in the financial reform legislation.

II. Discussion

A. The NPR Produces a Distorted Evaluation of Risk to the DIF.

1. Background

As the NPR correctly notes, the FDI Act requires that the assessment system be risk-based. It then defines a risk-based system as having *two* essential components: (i) the potential of failure of a bank as reflected in the probability of loss due to the composition and concentration of the institution's assets and liabilities *and* (ii) the likely amount of any loss on failure.[3]

2. Analysis

The NPR produces a distorted evaluation of risk to the DIF for two principal reasons. First, it focuses predominantly on the first of the two components of risk to the DIF – the potential that a bank will fail – without giving sufficient weight to the second component – the potential actual loss to the DIF if the bank fails. Second, the NPR's methodology for calculating loss on failure does not address its most essential component – the level of obligations subordinate to the FDIC's claim as subrogee of the insured depositors.

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[3] *See id.* at 23516.

With regard to the first reason, the analysis begins with the FDI Act's recognition that an accurate evaluation of loss to the DIF is dependent upon both risk of failure and loss upon failure. Just as absent failure there would be no loss, absent loss on failure the fact of failure would not create risk to the DIF.

The NPR, however, focuses almost entirely on risk of failure. The loss on failure standard is relegated to one element, referred to as a "loss severity measure", in the proposed loss severity score.[4] This approach not only prevents an accurate evaluation of risk of loss to the DIF but it distorts the assessment process among insured banks.

The second reason is even more important because, even if the NPR's loss severity measure was adequately weighted, it would still be highly distortive as a result of the inaccuracy of its calculation methodology.

The DIF's exposure in the event of a bank's failure is measured by the potential that (i) the excess of (x) the proceeds received by the FDIC from the sale or liquidation of the assets and franchise of the failed bank over (y) secured and other claims senior to the FDIC claims as subrogee of insured depositors are less than (ii) the sum of such FDIC claims and the other liabilities that rank *pari passu* with such FDIC claims. Accordingly, if a failed bank has substantial liabilities that are subordinate to the FDIC's claims, the DIF's exposure is eliminated or substantially reduced.

The following hypothetical illustrates this fundamental flaw. Assume two banks have identical asset bases and identical amounts of equity capital. The first bank's liabilities

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[4] *Id.* at 23522-23.

consist entirely of domestic deposits. The second bank's liabilities consist of 50% domestic deposits and 50% subordinated debt. The NPR would treat both banks as having identical risk to the DIF, whereas, in actuality, the first bank's risk is vastly greater.

Almost all large banks have very substantial liabilities that are subordinated to the FDIC's claims. For example, our member banks[5] have weighted average liabilities subordinated to potential FDIC claims equal to approximately 45%[6] of total liabilities. Assuming a hypothetical large bank with that liability structure (and with stated equity and loan loss reserves equal to 7% of assets), the DIF would have exposure only if the FDIC recoveries in the event of the hypothetical bank's failure represented less than 48% of the bank's assets.

In contrast, small and medium-sized banks generally have low amounts of liabilities that are subordinated to the FDIC's claims. Accordingly, the exposure of the DIF to loss is far lower in the case of large banks relative to small and medium-sized banks because of the differences in their liability structures. Of perhaps more importance, because the DIF's exposure in the event of the failure of a large bank is so low, the absolute risk of loss to the DIF is also very low.

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5 Includes all members of The Clearing House except UBS AG, which is not a U.S. depository institution. In the case of Royal Bank of Scotland, which also is not a U.S. depository institution, we have substituted its U.S. affiliate, RBS Citizens, N.A., which is a member of The Clearing House's affiliate, The Clearing House Payments Company L.L.C.

6 If we included only our largest member banks, the average percentage of subordinate liabilities would be even higher.

The following chart illustrates this situation:

FDIC LOSS

		Percentage of Net Liabilities Subordinate to the FDIC Claims[7]						
		0	10	20	30	40	50	60
Asset Recovery	100	0	0	0	0	0	0	0
	90	10	0	0	0	0	0	0
	80	20	10	0	0	0	0	0
	70	30	20	10	0	0	0	0
	60	40	30	20	10	0	0	0
	50	50	40	30	20	10	0	0
	40	60	50	40	30	20	10	0
	30	70	60	50	40	30	20	10

We believe that the box on the left in this chart encompasses most small and medium-sized banks, whereas the box on the right encompasses most larger banks. As this chart demonstrates, the risk to the DIF from the failure of a small or medium-sized bank is significant if the recovery rate is below 80%. In contrast, the risk to the DIF from the failure of a large bank is very low unless the recovery rate is below 50%.

The fact that the DIF suffered *no* loss in the largest failure of an insured depository institution in the history of the FDIC, Washington Mutual, was therefore not a coincidence or an anomaly. Because there were substantial liabilities subordinated to the FDIC,

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7 Net liabilities subordinate to the FDIC claims equal subordinate claims *less* secured and any other claims senior to the FDIC claims.

the FDIC was able to structure a bid package for Washington Mutual that resulted in no loss to the DIF.[8]

3. Additional Issues

We believe that there are three other flaws in the NPR's methodology for evaluating loss on failure.

First, there are flaws even within the NPR's loss severity score methodology. This methodology relies on two factors: the ratio of possible losses to total domestic deposits and the ratio of secured liabilities to total domestic deposits.[9] The first factor incorporates assumptions that are of questionable value and the second is incomplete.

The NPR's loss severity measure is based on a standardized set of assumptions – based on recent failures – regarding liability runoffs and the recovery value of asset categories. These assumptions are applied to the institution's balance sheet for a given quarter to measure possible losses to the FDIC in the event of the institution's failure. These assumptions, however, are based on failures of small banks, although these banks have balance sheets that have vastly different characteristics than large banks. These failed banks generally had heavy concentration in real estate loans and substantial reliance on brokered deposits. Moreover, the assumptions are derived using the FDIC's own internal metrics, which are not defined or elaborated on in the

8 The next largest institution that failed during this period, IndyMac, did cause significant losses to the DIF. That institution, however, was not only funded almost entirely by insured deposits, but by deposits generated through brokers ("brokered deposits"). Brokered deposits are structured to be fully insured, and, because of their high interest rate and lack of "stickiness", can hinder the FDIC's attempt to secure a purchaser of a failed institution. A 2009 analysis by Foresight Analytics, a California-based industry research firm, found that the 79 banks that had failed in the United States in the two years preceding the analysis had an average level of brokered deposits four times the national norm. *See* Eric Lipton and Andrew Martin, *For Banks, Wads of Cash and Loads of Trouble*, N.Y. TIMES, July 4, 2009, at A1.

9 75 Fed. Reg. at 23522.

NPR. Because of the significance that this criterion plays in determining risk of loss to the DIF, The Clearing House submits that the assumptions underlying this important measure should be transparent and the FDIC should provide sufficient statistical supporting analysis to validate its assumptions.

Second, the NPR includes an upward adjustment in the assessment rate based on the ratio of secured liabilities to domestic deposits and a downward adjustment for long-term unsecured debt, but does not take into account any other claim subordinate to the FDIC's claims. The resultant distortion of the outcome is further exacerbated by placing disproportionate weight on the presence of secured liabilities. As currently drafted, the NPR both includes a measure of the ratio of secured liabilities to total domestic deposits in determining the loss severity score *and* provides for an upward adjustment to the assessment rate as a result of certain secured liabilities.[10]

Third, we are also concerned by the NPR's authorization for an adjustment of the loss severity score (and/or performance score) by a maximum of 15 points each based upon "significant risk factors that are not adequately captured in the scorecard".[11] In view of the numerous specific criteria captured in the scorecard, we believe that no further adjustment is appropriate. At the very least, we believe that such an adjustment should not be made unless concurred in by the institution's primary banking regulator (as opposed to just consultation).

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10 *Id.* at 23523 & 23527.

11 *Id.* at 23527.

4. Summary

In summary, we urge the FDIC to withdraw the NPR republish a revised notice of proposed rulemaking that adequately takes into account risk of loss upon failure. This factor does not merely fail to provide any basis for imposing a new assessment arrangement on large banks. Rather, it represents a key reason for the FDIC to focus instead on small and medium-sized banks.

B. The Proposal's Focus on Large Banks Ignores the Real Risk to the DIF—The High Rate of Failure Among Small and Medium-Sized Banks.

With respect to risk of failure itself, The Clearing House respectfully submits that the NPR's focus is the opposite of what it should be. Rather than focus on the risk created to the DIF by large banks, the FDIC should revise its assessment approach to capture the actual, demonstrated risk to the DIF – improvident lending by small and medium-sized banks and their high rate of failure. The unstated assumption that permeates the NPR – that large banks inherently pose a greater risk to the DIF than do smaller banks – results in a distorted analysis of actual risk to the DIF and thereby creates the potential for further depletion of the DIF.

The FDI Act provides for differentiation between risk-based assessment systems for large and small banks.[12] This statutory authorization, however, is neutral; there is no suggestion that large (or small) banks create a greater risk for the DIF.

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12 *Id.*

1. Background

Beginning in 2008, the DIF suffered enormous losses. Total estimated losses to the DIF were $17.98 billion in 2008, $ 35.61 billion in 2009, and $6.3 billion to date in 2010, for an approximate total of $60.02 billion.[13] This contrasts sharply with approximate aggregate losses of only $190 million in the preceding five years. The consequences of these losses have included: (i) a sharply reduced DIF; (ii) the requirement for a new $100 billion line of credit from the U.S. Department of the Treasury; (iii) an increase in overall assessments; and (iv) a special assessment.

2. Analysis

We agree with the FDIC's process of reviewing data from past periods to better differentiate among institutions by taking a more forward-looking view of risk. This data demonstrates a total correlation between the size of the bank and the loss to the DIF, but the correlation is different than that suggested by the NPR. Remarkably, *all* the losses to the DIF since 2007 arose from the failure of depository institutions with under $50 billion in assets.

Accordingly, The Clearing House urges the FDIC to republish the NPR so as to effect a change in the assessment approach for small and medium-sized banks. Although we do not have access to the comprehensive data available to the FDIC, we believe that it is not difficult either to determine the cause of the risk created by small and medium-sized banks or to devise an assessment-based remedy. Indeed, the cause is foreshadowed by the language in the FDI Act itself, when it refers to the composition and concentration of assets.

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[13] FDIC, Historical Trends as of March 31, 2010, *available at* http://www.fdic.gov/bank/statistical/stats/2010mar/FDIC.pdf.

The dominant causes of bank failures since 2007, and therefore the heavy losses to the DIF, have been undue concentrations in commercial real estate lending and poorly underwritten residential real estate loans. There also was a significant correlation between bank failure and three factors (frequently in combination): (i) a high level of brokered deposits; (ii) a relatively recent charter; and (iii) a high level of organic growth.

We therefore recommend that the new NPR propose an assessment system based on these factors. In view of the fact that all the losses suffered by the FDIC have resulted from the failures of small and medium-sized banks, this new NPR could logically exclude large banks. Nonetheless, we believe it would be appropriate for the new assessment system to apply to all banks.

We recognize the FDIC's position that there would have been some large bank failures (although the number appears to be very small) absent Government assistance. Of course, this position applies to some small banks as well. Of much more importance, we submit that the actual loss to the DIF in the event of a large bank failure would have been negligible for the reasons described in Part II.A. of this letter. As described above, the loss upon failure risk is far greater for small banks than large banks.

III. The Shift of the Assessment Burden to Large Banks Is Unjustified and Exacerbates the Additional Burdens Imposed on Them by the Tester Amendment and Other Initiatives.

As we understand the NPR, an intended result is to shift more of the assessment onto large banks. Almost one-half of large banks would experience an increase in their rates

while the comparable figure for other banks would be only 9%.[14] For the reasons discussed above, this 500% disparity cannot be justified. Indeed, the actual record suggests that the burden should be shifted to smaller institutions.

Any attempt to shift the assessment burden to the large banks is even more inappropriate in light of the Tester Amendment included in the final financial reform legislation. This Amendment repudiates the basic FDIC formula of calculating assessments based on deposits, which has been in existence for the 76 years of the FDIC's existence. This alone justifies completely recalibrating the measures that comprise the assessment rate so that the combination of the assessment base and the assessment rate reflects risk of loss to the DIF. The assumption upon which the FDIC developed the several balance sheet components of the scorecard measures in the NPR is that the resulting assessment rate would be applied to a base of domestic deposits. When, however, the assessment rate is changed from domestic deposits to assets, the measures must be revised to eliminate any distortion created by "double counting".

Moreover, by substituting assets, the objective of the Tester Amendment is to increase significantly the assessment burden on large banks. This is directly inconsistent with the FDI Act's risk-based approach.

As a matter of basic fairness, the NPR's shifting of the assessment burden to the larger banks would seemingly be "piling on" when the Tester Amendment takes effect. Moreover, we respectfully submit that, although Congress has the right to depart from the risk standard it previously developed, the FDIC is not similarly empowered. The FDIC should

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[14] *See* 75 Fed. Reg. at 23528.

provide a compelling justification in any rule-making proposal that such a burden shift is consistent with a risk-based system.

Underlying the Tester Amendment, and possibly the NPR, may be a view that large banks benefitted disproportionately from the major Government support programs during the financial crisis. Without debating the validity of this proposition, it is important to note that The Clearing House did not oppose extending these programs, or making them more available, to smaller institutions. What we do believe is inappropriate is to shift, in perpetuity, a large portion of the assessment burden from small to large banks as a means of accomplishing "rough justice".

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We hope these comments have been helpful. If you have any questions about any matter discussed in this letter, please contact me at 212-612-9234.

Very truly yours,

JRA:kp