American Bankers Association
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Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Attention: Comments

RE: Notice of Proposed Rulemaking on Risk-Based Deposit Insurance Assessments for Established Small Banks (12 CFR §327), RIN 3064–AE37[1]

Dear Mr. Feldman:

The American Bankers Association (ABA) appreciates the opportunity to respond to the notice of proposed rulemaking on "risk-based deposit insurance assessments for established small banks" (proposal) from the Federal Deposit Insurance Corporation (FDIC).[2] ABA supports the stated primary purpose, to improve the risk-based deposit insurance assessment system for banks with less than $10 billion in assets (*small banks*) to more accurately reflect their risk to the FDIC's insurance fund.[3] We agree that the proposal generally supports this purpose; however we recommend changes for three elements that we believe do not align with this objective.[4]

This proposal follows another issued last June with the same purpose.[5] At the outset, we note and appreciate that several of the changes we recommended for the *small bank* assessments formula were incorporated into the current proposal,[6] including:

- a higher weighting for CAMELS component ratings and constraining "initial base assessment rates" within bands based on composite CAMELS ratings;

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1 81 *Federal Register* (23) 6108, February 4, 2016, available at www.gpo.gov/fdsys/pkg/FR-2016-02-04/pdf/2016-01448.pdf.

2 The American Bankers Association is the voice of the nation's $16 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $12 trillion in deposits and extend $9 trillion in loans.

3 Proposal, page 6108.

4 ABA's comments on the proposal focus on the proposed "financial ratios method" that would apply to "established" *small banks*, those in existence at least five years.

5 80 *Federal Register* (133) 40838, July 13, 2015, available at www.gpo.gov/fdsys/pkg/FR-2015-07-13/pdf/2015-16514.pdf.

6 ABA letter to the FDIC on "Notice of Proposed Rulemaking on Assessments," September 11, 2016, available at www.fdic.gov/regulations/laws/federal/2015/2015-assessments_3064–AE37-c_226.pdf.

- replacement of a factor for core deposits with one for brokered deposits;
- for banks that are "well capitalized" and CAMELS I or II, exclusion of reciprocal deposits from what would count as brokered; and
- application of a one-year asset growth factor only if growth exceeds ten percent.

As before, we continue to support several positive aspects included in both proposals:

- incorporation into assessments calculations changes in CAMELS component ratings when they occur during a quarter,[7] which will reduce volatility in banks' assessments;
- elimination of the risk categories and application of a uniform assessments formula across *small banks*,[8] which would avoid a jump in assessments under the current system when there is a decline in capital or composite CAMELS rating for a bank that is not "well capitalized" and CAMELS I or II; and
- calibration of any change in assessments pricing such that it would not result in a material change in aggregates assessments collected by the FDIC.[9]

However, also as before, we believe that *small bank* assessments may misprice risk to a meaningful degree if the revised assessments formula is adopted with (1) the proposed "loan mix index," (2) weighting for the tier 1 leverage ratio, and (3) factor for one-year asset growth above ten percent. Accordingly, we recommend fixes in the following discussion.

Loan Mix Index

ABA questions the value of the proposed loan mix index in forecasting bank failures. The index is calibrated heavily to experience from failures associated with the last recession.[10] Strong reliance on data from the recent period does not give due consideration to evolution in technology, credit markets, business models, and bank products, all of which will affect bank failure characteristics going forward.

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[7] "[T]he FDIC proposes that, if a bank's CAMELS composite or component ratings change during a quarter in a way that changes the institution's initial base assessment rate, then its assessment rate would be determined separately for each portion of the quarter in which it had different CAMELS composite or component ratings." (Proposal, page 6116).

[8] Proposal, page 6114.

[9] Proposal, pages 6114 and 6116.

[10] "[C]harge-off rates from 2008 through 2014, during the recent banking crisis, have a much greater influence on the weighted-average charge-off rate than do charge-off rates from the years before the crisis, when few failures occurred." (Proposal, page 6113)

Moreover, history has seen significant variance in economic and bank failure cycles. In the early 1980s, many agricultural banks failed. Similarly, for many residential mortgage lenders in the late 1980s and early 1990s. The "weighted charge-off rate percent" in the proposed index suggests that banks heavily into commercial and industrial lending and leasing were more at risk in the last spate of bank failures. This variation demonstrates the flaw of assuming that the future will follow the path of any single past period.

In addition, the Call Report loan balance categories that the proposed index would use are broad classes of credit that were not intended to differentiate relative risk levels.[11] As an example, the category of automobile loans to individuals overlooks the easily discernable differences in credit quality between prime and subprime automobile loans. As another, commercial and industrial loans and leases are decomposed only into domestic and foreign; there is no breakout for asset-based lending or other risk mitigants, such as collateral and guarantees (*i.e.*, so loans fully secured by cash on deposit or government securities would count the same as unsecured loans). As a result, the weightings in the proposed index overstate risk exposure for obviously higher quality loan portfolios and understate for lower quality portfolios.

Finally, the proposed index is based on the questionable premise that the risk in a bank's loan portfolio depends primarily on the types of loans it makes and holds. ABA fundamentally disagrees. To the contrary, every period of elevated bank closures has been characterized by failures of banks with certain loan concentrations, yet many competitors with similar portfolio concentrations did not fail. Moreover, even the most recent period of trouble saw failures of banks with divergence assortments of loans, so the type of concentration must not have been the determining factor.

ABA contends that the quality of credit underwriting, portfolio management and risk hedging is more relevant to the asset quality for an individual bank than the types of loan concentration in its portfolio. As a corollary, to "more accurately reflect risk" in a bank's loans, a loan portfolio risk measure must consider evidence of the bank's ability to manage the risk.

ABA proposes that ***FDIC should develop a factor for loan portfolio risk based on the performance over time – such as over the past five years – of loan asset quality measures, such as delinquencies, non-performing assets, and net charge-offs.*** Our point is that banks with extended histories of strong asset quality – whether through diligent and conservative loan underwriting, careful portfolio management, or effective risk mitigation – should be evaluated as

[11] Under "Call Report Form" FFIEC 031 or FFIEC 041 posted to www.ffiec.gov/ffiec_report_forms.htm, see Schedule RC-C. ABA is not suggesting changes to the Call Report to further disaggregate the loan categories on Schedule RC-C. The proposal notes that "[to] avoid unnecessary burden, the proposal will not require established *small banks* to report any new data in their Reports of Condition and Income (Call Reports)" (page 6111) We agree that new and additional reporting is not called for, as we propose an alternative loan portfolio risk measure where none would be needed.

lower risk, regardless of the types of loans they specialize in, whereas those that demonstrated less stable control of asset quality should be evaluated as higher risk.

We recognize that the proposed assessments formula would employ factors for nonperforming loans and leases and other real estate owned. These factors involve data only for the contemporaneous quarter, and, as such, provide perspective on the near-term outlook for the bank. The factor we propose would gauge the bank's asset quality into the future, in line with the three-year horizon of the statistical estimation of the assessments formula,[12] using data over a longer past period that reveals the level of competence of asset quality management through varying environments.

One last point warrants mention. FDIC assessments pricing should incent sound banking. The proposed index, however, would not follow this principle. Certainly, *small banks* have ample reason to manage loan portfolio asset quality, but clearly **the proposed loan mix index is not incentive-compatible**. Instead, the index would create financial incentives for *small banks* to consider modifying their loan portfolios. ABA recommends that the FDIC should avoid policies that encourage banks to concentrate in certain loan categories and move out of others, as doing so could lead a number of *small banks* to lower standards to compete for favored types of credit, and unjustifiably tighten standards for other types.

Weighting for Tier 1 Leverage

The tier 1 leverage ratio is weighted –0.056 in the current assessments formula, but the weighting would jump to –1.201 in the proposed formula – a 21½-fold increase.[13] In consequence, this would become a very major factor in the revised assessment pricing.

ABA recognizes that, in the recent bank failure cycle, many of the banks that failed held sufficient capital to satisfy the regulatory standards of "well capitalized" before they failed, but then declined sharply in the severe recession. In fact, almost all banks met the "well capitalized" standards before the problems set in,[14] and ***the preponderance of these banks did not fail.***[15]

[12] The Statistical Model estimates the probability of an insured depository institution failing within three years …" (Proposal, page 6153)

[13] Values observed in the calculators posted under "current assessment rate calculator for small institutions" and "assessment rate calculator for small institutions under the proposed rule," respectively, on www.fdic.gov/deposit/insurance/calculator.html.

[14] According to the *FDIC Quarterly Banking Profile*, at least 99 percent of banks were "well capitalized" through 2006 and 2007.

[15] For example, 99.3 percent of the 8,681 banks in existence at the end of 2006 were "well capitalized," and 94.0 percent of these were not among the 519 failures since then. (Calculated using data from various issues of the *FDIC Quarterly Banking Profile*.)

Thus, factors other than strong capital should dominate the measurement of a bank's failure risk, and thus its assessments.

We note the statistics in the proposal that support a high weighting for the tier 1 leverage ratio. These may primarily reflect the near-term effect of weak capital in unsound banks. Unquestionably, a bank whose capital is depleted when management is not prepared to deal with problems may fail in the near future. We therefore understand a high weighting for tier 1 leverage for banks that are not well managed and well capitalized.

On the other hand, we do not believe that there is valid statistical evidence that well managed banks with strong capital are significantly weakened by not holding more and more capital.

To the contrary, we suspect that holding excessive capital can be counterproductive for many banks. For example, a *small bank* that fully and effectively employs its capital in a vibrant local market should not be viewed as less sound than one that holds excessive capital due to the lack of opportunities in a weak market.

To the point, *small banks* with broad, well-established customer bases that they actively serve with loans and services, and otherwise invest safely in local civic operations, will be able to sustain themselves through good and troubled business cycles and unexpected misfortunes if they hold strong, but not necessarily excessive, capital. If such banks are assessed as less sound because they effectively employ their capital instead of holding excessive amounts, this must be a false measurement.

A more meaningful factor is the strength of the bank's asset portfolio and management's ability to deal with stress and liquidity issues. Clearly, a well-managed bank with a strong portfolio has a better chance to survive a troubled period, all else equal.

Considering these factors, ABA recommends a different weighting paradigm for the tier 1 leverage ratio than as proposed. ***We support a higher weighting for banks that do not meet all of the standards to be classified as "well capitalized" and at the same time have composite CAMELS ratings of I or II. For banks that are "well capitalized" and CAMELS I or II, we propose that the weighting be much lower, in line with the current assessments formula.***

Moreover, we believe that there should be an upper limit above which there is no penalty for not holding additional capital. ***ABA recommends that the weighting for tier 1 leverage for a "well capitalized, CAMELS I or II bank should be zero above a ratio of eight percent.***

As a final point, ABA advises against the consequences of overweighting the tier one leverage ratio in assessments pricing, in that *small banks* would be incented by lower FDIC premiums to hold back from making loans or offering services. This reaction can undermine the banks' soundness, and, thus, fail to protect the FDIC insurance fund.

One-Year Asset Growth

The proposed asset growth factor would apply only when growth (adjusted for acquisitions and mergers) over four consecutive quarters exceeds ten percent. ABA appreciates the change from the earlier proposal, where any growth would raise assessments. However, we believe that, even with a ten percent threshold, an asset growth factor would yield false measurements of risk exposure in a number of common scenarios. For examples, relatively rapid short-term asset growth would not raise a bank's risk exposure when it is the result of failure of a competitor, that bank selling out to another that is not appreciated locally, addition of a strong loan officer, or an influx of deposits that are then invested in high-quality securities.

The FDIC must realize that economic growth is cyclical and a well-run bank grows with its local market. Thus, a reliable asset growth benchmark would have to vary across geography and time based on some business index that is available and applicable across jurisdictions. In practice, this measure, if it could be constructed, would be unreasonably complex.

Even so, CAMELS component ratings can provide a more balanced and tested evaluation of the asset portfolio. These appraisals are determined by professional reviewers following scrutiny ***in the bank*** of loan files, policies and procedures, and actual practice in managing risks. ***ABA recommends that a better measure than excess asset growth can be found in the A (for "asset quality") and S (for "sensitivity to market risk") components of CAMELS.*** On this point, we note that faster growth naturally triggers sooner and/or closer supervisory attention. Thus, if a bank has not handled growth well, this will be reflected in the CAMELS component ratings.

The one-year asset growth and brokered deposits factors in the proposed assessments formula would replace the "adjusted brokered deposits ratio" – which uses four-year asset growth – in the current formula. Bankers advise that rapid growth is least sound when it is prolonged and financed by "hot money." We conclude that linking the two as in the current formula may provide a better risk measure.

Conclusion

Risk-based assessments that reflect individual banks' risk to the FDIC insurance fund are not only a desirable goal, this is a statutory requirement.[16] No workable system for setting assessments for *small banks* is perfect; there must be compromises so that the assessment system is not impractically complex and cumbersome. Nonetheless, three elements of the proposed assessments formula, the loan mix index, weighting of tier 1 leverage, and excess asset growth factor, are demonstrably deficient in that they would misjudge risk exposure in banks. ABA has

[16] 12 U.S.C. §1817(b)(1)(A) and (C).

recommended alternatives that we believe would better align assessments pricing with risk-taking.

Truly risk-based assessments must effectively differentiate risk-taking among insured institutions to the point that there are incentives for good banking.[17] Otherwise, risk will be mispriced so that some low-risk banking will be penalized while some more risky practices are rewarded. The proposed loan mix index, tier 1 leverage weighting, and excess asset growth elements of the proposal would not incent *small banks* to fully employ their capital by growing lending and services. Instead, together these elements would incent *small banks* to restrain lending for certain types of loans and otherwise limit growth so as to build capital-to-assets ratios. These are not incentives for safer, sounder banking.

ABA recognizes the merits of instituting a revised assessments system in the same quarter as the scheduled decline in assessments after the FDIC insurance fund reaches a 1.15 percent of insured deposits.[18] This timing would lessen the impact on banks whose assessments rise as a result of the change. However, the revisions we recommend will require additional research to develop and appropriately weight in the assessments formula. We suggest that ***a delay in implementing the revised small bank assessments system would be preferable to not allowing sufficient time to fully complete the research and development.***

ABA appreciates that FDIC staff have been willing to meet with bankers who could present their case directly. We also appreciate that the FDIC has posted assessments calculators for the current and proposed *small bank* assessments systems, which have allowed affected banks to evaluate the impact of the proposed changes and provide feedback. We look forward to working with FDIC staff to achieve the ends that the proposal seeks. Please contact the undersigned if you have any questions regarding ABA's response to the proposal.

Sincerely,

Robert W. Strand

Robert W. Strand

[17] The FDIC acknowledged this truth in the 2015 *small bank* assessments proposal: "A risk-based assessment system reduces the subsidy that lower-risk banks provide higher-risk banks and provides incentives for banks to monitor and reduce risks that could increase potential losses to the [FDIC insurance fund]." (80 *Federal Register* 40838, July 13, 2015, at page 40838)

[18] Proposal, page 6117.