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Executive Secretary  
Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street, N.W.  
Washington, D.C. 20429

From: Mr. Arturo Carrión  
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Re: Proposed FDIC Premium Increase

RIN: 3064-AD35

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On October 16, 2008 the Federal Deposit Insurance Corporation's (the "FDIC") requested comments on a proposal to increase deposit insurance premiums under 12 C.F.R. 327. If adopted, the proposal would increase the annual assessment rate for Risk Category I institutions from its current level of 5 to 7 basis points to an assessment rate of 10 to 14 basis points, plus certain adjustments. In addition, assessments for Risk Category II institutions would increase from 10 basis points to 20 basis points, plus adjustments. Among the adjustments are adjustment related to brokered deposits.

We are presenting these comments to the proposed regulation in order to describe the unique situation brokered deposits play in the Puerto Rico banking industry. We respectfully understand that generally the use of brokered deposits in Puerto Rico does not represent added risks to the insurance fund and to the FDIC and therefore should not be factored in the new assessment adjustments.

The reason for the high percentage use of brokered deposits in Puerto Rico is a result of a particular set of circumstances unique to Puerto Rico. In a nutshell, brokered deposits in the Puerto Rico banking industry have been used to substitute other deposit funding sources that disappeared as a result of changes to the U.S. Internal Revenue Code (the "Code"). These specific amendments to the Code affected only Puerto Rico. Here is some background on the subject.

One of the factors that had promoted the development of the manufacturing sector in Puerto Rico has been the various federal tax incentives available until recently under certain sections of the Code. United States corporations operating in Puerto Rico have been subject to special tax provisions since the Revenue Act of 1921. Prior to enactment of the Tax Reform Act of 1976, under Section 931 of the Code, United States

corporations operating in Puerto Rico (and meeting certain source of income tests) were taxed only on income arising from sources within the United States.

The Tax Reform Act of 1976 created Section 936 of the Code, which revised the tax treatment of United States corporations operating in Puerto Rico by taxing such corporations on their worldwide income in a manner similar to that applicable to any other United States corporation but providing such corporations a full credit for the federal tax on their business and qualified investment income in Puerto Rico. The credit provided an effective 100% federal tax exemption for operating and qualifying investment income from Puerto Rico sources. This treatment of investment income from Puerto Rico sources under Section 936 of the Code created incentives that significantly increased the amount of funds these corporations deposited in Puerto Rico banks and branches of foreign banks in Puerto Rico. The incentives created by Section 936 added more liquidity to the banking industry as a whole and promoted the economic development of the island. Particularly, it enabled local banks to enter into business transactions that in the past were exclusively done by branches of large foreign banks in Puerto Rico and other multinational institutions such as insurance companies and pension funds.

However, as a result of amendments to Section 936 made in 1996 (the “1996 Amendments”), the tax credit was phased out over a ten-year period for companies that were operating in Puerto Rico in 1995 and was no longer available for corporations that established operations in Puerto Rico after October 13, 1995. The 1996 Amendments also eliminated the credit previously available for income derived from certain qualified investments in Puerto Rico. The 1996 Amendments effectively meant the end of this source of funding for Puerto Rico, and in ten years 936 funds went from approximately \$9 billion to zero. This situation, unique to Puerto Rico, confronted the Puerto Rico banking industry with the challenge of effectively substituting such a large source of funding and liquidity in a relatively short period of time. The bulk of these funds were replaced by the issuance of deposits. There is empirical data which supports the conclusion that deposits from 936 Corporations were actually substituted by brokered deposits. Figure 1 shows the decrease of deposits from 936 Corporations and the subsequent increase in brokered deposits.

Another factor that has affected the ability of Puerto Rico banks to increase their deposit gathering activities to substitute the 936 funds was the development of a local investment company industry over the past 15 years. Since 1993 many securities firms in Puerto Rico sponsored the creation of investment companies under the local Investment Companies Act which are also exempt from the federal Investment Companies Act of 1940. Most of these new investment companies offer tax advantageous products that compete directly with bank deposits. This industry has grown to \$14.6 billion in total assets as of June 30, 2008.

In general terms, the use of brokered deposits in Puerto Rico has been to fund typical lending activities, and not risk taking in esoteric financial products and to substitute other sources of liquidity, like Section 936 funds, which were phased out as

explained above. This use does not represent added risks because this funding source has been used for the same banking activities that were previously funded with the other sources. Puerto Rico is a deposit poor island, increasing the assessment on Puerto Rico banks would have the effect of over-penalizing local banks. Assessments should be based on the risk (credit, interest rate, operational) profile of particular institutions and not by metrics that have no causal relationships. The new assessment will effectively act as a tax on the Puerto Rico economy, because local Banks will likely end up passing this cost on to its clients. Puerto Rico has been in a recession for the past two years, the last thing the island needs is another drag on the economy.

FIGURE 1

### Commissioner of Financial Institutions Total 936 Funds and Brokered Deposits

