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THE CLEARING HOUSE®
Advancing Payment Solutions Worldwide

December 17, 2008

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

Attn: Comments

Re: RIN 3064-AD35: Notice of Proposed Rule Making–Assessments

Dear Mr. Feldman:

The Clearing House Association L.L.C. ("The Clearing House"), an association of major commercial banks,[1] appreciates the opportunity to comment on the Federal Deposit Insurance Corporation (the "FDIC") notice of proposed rulemaking on risk-based deposit insurance assessments and the FDIC's proposed restoration plan (the "Proposal"). 73 Fed. Reg. 61560 (Oct. 16, 2006). The Clearing House understands the FDIC's need to increase its deposit-insurance assessments in light of the extraordinarily high deposit-insurance losses in the current year. As we discuss below, however, we are concerned that certain aspects of the Proposal are excessive and would produce unintended negative effects on our members and their customers.

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

I. Recapitalization of the Deposit Insurance Fund ("DIF")

Our member banks are prepared to do their part to maintain a strong and well-capitalized deposit-insurance system. We strongly agree that a financially sound DIF is essential to support the country's financial system, and our member banks recognize that bank premiums have funded all this support since the FDIC's creation. Nonetheless, the FDIC must balance its efforts to rebuild the DIF quickly against the consequences that would occur from unnecessarily diverting resources from financial institutions that could use them to meet customer credit needs.

Our nation is faced with the most severe economic crisis it has experienced in many decades. Central to the current economic crisis is a severe disruption in the credit markets that has included the collapse of banks, thrifts, investment banks, insurance companies and other financial-services companies. We appreciate that the FDIC considered these circumstances and the current strength of the financial-services industry when incorporating in its restoration plan the full five-year range for rebuilding the DIF authorized by Congress.

We respectfully submit, however, that, given the circumstances, the five-year period should be extended as contemplated by Congress. In the Federal Deposit Insurance Act, Congress expressly provided the FDIC with flexibility to extend the period in which the DIF must be restored to 1.15 percent beyond five years on account of "extraordinary circumstances."[2] The current economic crisis is presumably what Congress considered as it is without question extraordinary. In fact, the FDIC has invoked its systemic-risk authority, which prior to September had never previously been used, to provide guaranties on transaction deposits and senior unsecured debt.[3] In addition, the Secretary of the Treasury (after consultation with the President) and the Board of Governors of the Federal Reserve System (the "Federal Reserve") each made comparable systemic-risk determinations for these guaranties.

Accordingly, The Clearing House agrees with several other observers and strongly urges the FDIC to extend the period for restoration of the DIF to at least seven years

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2 Section 7(b)(3)(E)(ii) of the Federal Deposit Insurance Act, 12 U.S.C. § 1817(b)(3)(E)(ii).

3 Section 13(c)(4)(G) of the Federal Deposit Insurance Act, 12 U.S.C. § 1823(c)(4)(G).

(which may need to be further extended in the event of a protracted economic crisis) and, as discussed below, to delay any increase in assessments beyond the first quarter of 2009 until the effect on the DIF of recent government intervention programs can be analyzed. If the FDIC decides to go forward with immediate increases in the assessment rate, The Clearing House strongly recommends that the FDIC adopt more modest increases commensurate with a longer restoration period.

The Clearing House appreciates that a strong DIF is essential to maintaining depositor confidence and supports changes to the premium calculation that truly reflect the risk of loss to the FDIC. Our member banks are, however, deeply concerned that the aggressive recapitalization proposed by the FDIC, although well intentioned, would unnecessarily restrict their ability to lend in the context of the current extraordinary disruption of the financial markets. In addition, we believe that the assessment rates contemplated by the Proposal fail to consider, and thereby potentially undermine, efforts by Congress and the Department of the Treasury (the "Treasury") to support bank liquidity and stimulate lending in the economy.

Congress instructed the FDIC, when setting assessment rates, to 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."[4] The deeply troubled economic conditions prevalent today clearly are in line with this Congressional intent.

Despite this, just yesterday the FDIC approved raising the existing assessment schedule uniformly by 7 basis points for the first quarter of 2009. As a result, Category I banks (considered to be the healthiest) that are well-capitalized and have CAMELS ratings of 1 or 2 will pay between 12 and 14 basis points for this period. Even at the minimum base assessment rate, such a large increase will have a significant effect on earnings and capital, and therefore lending capacity, at the most financially sound institutions. By way of example, if a large bank,

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[4] Section 1817(b)(3)(C)(ii) of the Federal Deposit Insurance Act, 12 U.S.C. § 1817(b)(3)(C)(ii).

"Bank X", has $750 billion in assessable deposits, applying the FDIC's proposed minimum assessment rate (12 basis points), it is paying at least $900 million a year in assessments. Each basis point increase in the deposit assessment would cost Bank X $75 million. When the FDIC applies the proposed risk-based assessments, in the best case scenario Bank X is paying at least 8 basis points, which would total $600 million per year. The Proposal allows the FDIC to charge up to 21 basis points, which would cost Bank X over $1.5 billion per year.

Other metrics further demonstrate the effect of this increase. For example, if Bank X were able to earn 1.20% pre tax on this deposit base, the Proposal would reduce Bank X's earnings, at the 12 basis point rate, by 10%. For many banks that are struggling to produce earnings in the current environment, the percentage loss of earnings would considerably higher. In addition, Bank X's lending capacity would be reduced by approximately $6 billion annually assuming a 10x multiplier and a 33 1/3% effective tax rate.

The effect is comparably significant even at smaller institutions. For instance, at a bank, "Bank Y", with $50 billion in assessable deposits, applying the minimum assessment rate for Category I institutions, Bank Y will pay $15 million in deposit assessments for the first quarter of 2009. Each basis point increase in assessments would cost Bank Y $5 million a year. Under the Proposal, beginning in April 2009, Bank Y could pay between $40 million to $105 million per year in assessments.

Such a large increase in deposit-insurance assessments more than doubles current premiums and is anticipated to rebuild the reserve ratio to 1.15 percent in <u>four</u> years, not five. Indeed, the FDIC expects the assessment income to be so large that the reserve ratio will reach 1.21 percent in five years. This dramatic increase in assessment rates would run counter to current government policy objectives, including programs involving the DIF itself.

The Emergency Economic Stabilization Act ("EESA") signed into law on October 3, 2008 raised deposit insurance levels to $250,000. Congress, while authorizing this coverage, specifically excluded the increase in coverage from the calculation of the DIF ratio. Furthermore, on October 14, the FDIC created the Temporary Liquidity Guarantee Program (the

"Guarantee Program"), which extended deposit insurance coverage to all non-interest bearing transaction deposit accounts while also leaving this increased coverage out of the DIF ratio. These actions strongly support a policy objective to avoid an unduly onerous insurance premium increase.

Moreover, under the Guarantee Program, the FDIC established a 10 basis-point surcharge that applies to non-interest bearing transaction deposit accounts not otherwise covered by the $250,000 deposit insurance limit. The amount collected by this surcharge is added to each participant's deposit-insurance premium.

In light of these new programs and the worsening economic climate, The Clearing House respectfully submits that the analysis on which the FDIC based the assessments in the Proposal is out of date and that the Proposal has effectively been overtaken by these developments. Both the transaction deposit guaranty and $250,000 coverage limit are set to expire on December 31, 2009, suggesting that a comprehensive review of the nation's deposit-insurance system will occur next year in the context of the then-current economy. Accordingly, The Clearing House strongly urges the FDIC to remove any increase in assessments from the final rule and to make any significant change to the assessment system only after a full review of these issues within the context of this comprehensive review.

If the FDIC decides to move forward with increases in the assessment rates, we urge the FDIC to take full advantage of the discretion afforded to it by Congress to design and administer the deposit-insurance system to avoid pro-cyclical deposit-insurance assessment increases. A gradual increase in the assessment schedule over the next few years would be more appropriate, considering the present economic recession and financial turmoil will likely ebb over time. By contrast, the significant increase contemplated by the Proposal is inconsistent with government efforts to shore up bank capital and bank liquidity under the Guarantee Program and the Capital Purchase Program ("CPP") under the Troubled Asset Relief Program, established pursuant to the EESA. Our member banks strongly support their obligation to strengthen FDIC resources, but propose doing so in a way that is less pro-cyclical and that keeps more resources available for credit extensions.

II. Calculation of Assessments

Our member banks support the FDIC's objective to charge riskier banks a higher assessment for deposit insurance, fostering market discipline through the deposit insurance cost that a bank pays. However, we believe that the Proposal falls short of achieving this objective because the measures of risk contemplated by the Proposal are misdirected and do not adequately evaluate risk in the event of a failure. The FDIC's risk of loss in the event of the failure of a depository institution is a function of two principal factors. The first is the amount of recoveries on the unencumbered assets, i.e., assets that are not pledged and are therefore available to the FDIC to pay deposit liabilities. The second is the aggregate amount of equity and liabilities that are subordinate to the claims of depositors.

For the reasons discussed more fully below, The Clearing House has several concerns with the Proposal's approach for calculating assessments, including reducing the assessment rate based on amounts of unsecured debt and increasing the rate based on amounts of secured debt. A fundamental flaw to this approach is that it ignores the value of a wide-range of unencumbered assets in the determination of loss, while disproportionately penalizing institutions for holding what is arguably one of the few viable sources of funding and liquidity in today's difficult markets. Accordingly, The Clearing House recommends that the FDIC abandon the adjustments for assessment rates for unsecured and secured liabilities. Instead, we urge the FDIC to adopt a simpler approach that bases assessments on (1) the amount of insured deposits (as opposed to assessable deposits) and (2) the unencumbered assets available to pay insured deposits in the event of a liquidation (as opposed to the adjustments based on secured/unsecured liabilities). The Proposal uses substitutes for unencumbered assets—secured liabilities and unsecured liabilities—that we believe are significantly flawed for several reasons that we outline below. If the FDIC decides to move forward with the Proposal's changes to the assessment system based on secured and unsecured assets, we strongly urge the FDIC to consider the following recommendations in the final rule.

Unsecured Liabilities. The Clearing House recognizes the FDIC's preference that a bank be funded with unsecured liabilities that would be subordinated to claims of depositors in receivership, thereby providing a cushion that can reduce the FDIC's loss in the event of a failure. In addition, our member banks agree in principle that the presence of unsecured debt obligations reduces risks to the DIF and therefore justifies a reduced assessment rate. However, we believe that the Proposal is too limited and undervalues the risk mitigation of other unsecured obligations.

As an initial matter, the FDIC's multiplier (20 basis points) that it proposes to apply to the ratio of long-term unsecured debt to total deposits at a large institution discounts the risk mitigation effect of the unsecured debt by 80 percent. We believe that this multiplier is excessively low. The benefit of unsecured debt is further underestimated in the Proposal because the FDIC measures it against total deposits, and not only insured deposits, which are the true proxy for the FDIC's risk. Therefore, The Clearing House recommends that the FDIC adjust upward the multiplier for unsecured debt and measure that amount against only an institution's insured deposits, not full deposit base.

In addition, we suggest raising the proposed cap on assessment-rate reductions for unsecured liabilities. The FDIC sets in the Proposal an arbitrary limit of 2 basis points with no stated legal or economic rationale. Meanwhile, the FDIC itself recognizes that the greater the amount of unsecured liabilities, the lower its risk of loss. Indeed, it is not inconceivable that a bank could present essentially zero risk to the FDIC. The FDIC exacerbates this issue by applying a significantly disproportionate cap on rate increases for secured obligations. Consequently, the Proposal can lead to the result of increased rates based on secured debt, even though there may in fact be unsecured debt to offset the secured debt attracting no benefit. This could result in institutions paying significantly higher assessment rates, regardless of their relative risk.

Finally, as we mentioned above, The Clearing House suggests that the FDIC use all unencumbered assets of an institution as a measure of risk in calculating premiums and not, as the Proposal currently contemplates, merely provide for a downward adjustment for only for long-term unsecured debt instruments. Indeed, at many institutions, including our member banks, there are substantial unencumbered assets that afford the FDIC protection in the event of a receivership. The same factors that the FDIC cites as support for reducing deposit-insurance premiums for unsecured liabilities operate for a wider range of unencumbered assets as well. Consequently, we recommend that the FDIC abandon the adjustments for secured and unsecured debt and instead adopt an approach that bases assessments on an evaluation of an institution's unencumbered assets. Our member banks would welcome the opportunity to discuss with staff at the FDIC alternatives for how such calculations and reporting could be performed.

Nonetheless, if the FDIC retains the downward adjustment, we believe that all unsecured debt should be included in determining the adjustment. In fact, short-term debt absorbs loss upon failure just as well as long-term debt. In addition, we strongly urge the FDIC to factor into account additional unsecured obligations that serve as a cushion to FDIC losses in the event of default. We believe there is no reason for excluding additional types of junior unsecured obligations (regardless of term or structure) when they will in fact reduce a deposit holder's loss in the event of default. Applying a small credit only to a narrow set of unsecured liabilities while significantly penalizing a wide range of secured liabilities often used as prudent funding sources creates a serious disparity in the assessments paid by financial institutions.

Secured Liabilities. The Clearing House strongly opposes the upward adjustment in the assessment rate based on the ratio of secured liabilities to domestic deposits contemplated by the Proposal. This adjustment, unlike the one for unsecured debt, is not discounted. In addition, it is capped at 50% of the adjusted base assessment rate. For healthy Category I institutions with the highest assessment rate, this would result in a penalty of seven basis points on account of holding secured liabilities. This amount is unreasonably disproportionate to the risk reduction afforded for unsecured debt. If the FDIC decides to push forward with these adjustments, as opposed to adopting a simpler approach like we recommend above, we strongly recommend that the FDIC equally and fully include the effect of both forms of debt in the calculation.

The Proposal also ignores the fact that a bank that uses assets to obtain stable, secured funding may increase its loss given default but it also diminishes its probability of default. Punishing a financially healthy bank that has little probability of default with as much as a seven basis-point upward adjustment to its assessment is entirely contrary to the notion of risk-based assessment.

In addition, including secured lending as a risk factor is contrary to many well-established programs that have implied government support. Banks routinely borrow secured funds from the Federal Home Loan Banks ("FHLBs"), and this funding is an important part of their liability structure. More recently, banks have become regular borrowers from the Federal Reserve Banks through programs like the Term Auction Facility. The Proposal specifically mentions both of these types of secured borrowing as raising the risk to the DIF. It also lists repurchase agreements that are routinely used by our member banks to obtain low-cost funding by using excess securities.

The Proposal thereby threatens to contract substantially this crucial source of liquidity at a time when it is most needed. The FHLBs and the Federal Reserve Banks have been important sources of funding for banks since the freeze in the capital markets. Penalizing banks for accessing these important funding sources seems imprudent and inconsistent with market realities. Higher assessments for holding secured liabilities will encourage financial institutions either to decrease their lending activities or to seek out less reliable, more expensive sources of alternative funding. In either scenario, the cost of funding for borrowers will increase. Such unintended consequences are in direct tension with mandates by Congress, and indeed the FDIC itself, for banks to make more credit available at a reasonable cost in order to mitigate the current recessionary trends.

In fact, on November 10, 2008, the FDIC, Treasury and the Federal Reserve issued an Interagency Statement on Meeting Needs of Creditworthy Borrowers stating that, "[a]t this critical time, it is imperative that all banking organizations and their regulators work together to ensure that the needs of creditworthy borrowers are met." Surely banks could continue to use these funding sources, but they would be more expensive because of the increased assessment costs. As a result, the cost of credit would increase at this critical time when credit needs to be more reasonable.

The treatment of secured debt in the Proposal also would render covered bonds less attractive at a time when the FDIC itself has been fostering covered bonds as an alternative funding vehicle. Given the virtual closing of the securitized asset finance market, it is highly undesirable to adopt an assessment scheme that will penalize the use of the covered bond alternative.

Finally, our member banks are seriously concerned that the treatment of secured debt in the Proposal will result in sharp increases in assessments when amendments take effect to Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 140). Beginning in 2010, FAS 140 will require banks to report on their balance sheets assets in their off-balance sheet special-purpose vehicles and variable-interest entities, which often include securitized assets. As a result, the associated secured liabilities will come onto banks' balance sheets. Under the Proposal, including these secured liabilities when determining the adjustment to assessment rates, in addition to the secured funding discussed above, will cause several of our member banks to cross the 10% threshold for secured liabilities that triggers an upward adjustment to assessments.

Brokered Deposits. The FDIC requested comments on whether deposits resulting from balances swept into an insured depository institution from customer brokerage accounts at an affiliated broker-dealer should be excluded from the definition of "brokered deposits" for purposes of the assessment calculation. 73 Fed. Reg. at 61,566. Our member banks strongly encourage the FDIC to exclude these deposits from its brokered deposit assessment calculation because they do not involve the risk that the FDIC perceives accompanies brokered deposits in general. Under these sweep programs, a broker-dealer affiliated with one or more insured depository institutions offers its clients a brokerage account where the client can elect to have excess funds in the account automatically invested, or swept, into deposit accounts at the affiliated depository institution. These deposits are generally reported as "brokered deposits" on the depository institution's Call Report or Thrift Financial Report.

The broker-dealer establishes the deposit account on the books of the affiliated depository institution in its name, as agent and custodian for the customer, with "pass-through" deposit insurance. The broker-dealer maintains records of the deposit accounts held by each of its customers consistent with FDIC requirements and sends the customer periodic account statements, including with respect to the deposit accounts and year-end tax-reporting statements. Although the customer of the broker-dealer is legally not a customer of the affiliated depository institution, the customer has a long-term relationship with the financial group of which the broker-dealer and the depository institutions are part.

The excess cash in a customer's brokerage account is automatically swept daily into the affiliated depository institution, resulting in a continual flow of funds. Even though withdrawals are made by customers on a daily basis, the flow of deposits into the depository institution tends to keep the level of total deposits fairly constant. As a result, this deposit base tends to be stable, behaving like core deposits. Deposits obtained under these programs generally pay interest at rates that are at or below prevailing money-market mutual fund rates. Thus, the deposits are not high rate or rate sensitive. These attributes make them less like brokered deposits and more like core deposits. These funds are not "hot money," which the FDIC considers exceptionally risky. They represent a product choice of an established customer relationship. Accordingly, The Clearing House strongly urges the FDIC to exclude these deposits from the definition of "brokered deposits" for purposes of the brokered deposit adjustment in the Proposal.

In addition, our member banks urge the FDIC to consider excluding from the "brokered deposits" definition balances swept into an insured depository institution from customer brokerage accounts at unaffiliated broker-dealers. Financial institutions, including some of our member banks, operate sweep programs under which cash balances are swept from an account at an unaffiliated broker-dealer into deposit accounts at one or more third-party depository institutions, with "pass through" deposit insurance. There is no price competition among participating banks. Thus, as in the sweep program described above, deposits that are placed in these programs generally pay interest at rates that are at or below prevailing rates so these deposits also are not high rate or rate sensitive. In addition, these programs provide a stable source of deposits for well-capitalized banks and do not present the moral hazards typically associated with brokered deposits. Consequently, The Clearing House recommends the FDIC exclude these deposits as well when determining the brokered deposit adjustment.

Inequitable Treatment of Large Institutions. The Proposal indicates that, as of June 30, 2008, 45 percent of large banks would have been charged the minimum assessment rate under the current system of risk calculation methodology, versus 28 percent of small banks. The Proposal also states that the anticipated impact of the new risk measurements will be that only 25 percent of large banks may qualify for the minimum rate, consistent with the same percentage for smaller banks. As a result, the Proposal clearly makes it more difficult for a large bank to be eligible for the lowest assessment rates. We urge the FDIC to recognize that the largest institutions should not be penalized solely on the basis of size with no relation to risk.

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Thank you for considering the views expressed in this letter. If you would like additional information regarding this letter, or if it would be helpful to meet with representatives of our member banks, please contact me at (212) 612-9205.

Sincerely,

Norman R. Nelson