To: Federal Deposit Insurance Corporation (FDIC)

From: Elizabeth S. Macnair, Ph.D.

Via: E-mail: Comments@FDIC.gov.

RE: RIN 3064–AD35

Assessments; Proposed Rule; Establishment of FDIC Restoration Plan;

Sirs,

I would like to comment on the "Assessments Proposed Rule; Establishment of FDIC Restoration Plan' and appreciate your attention.

Please let me frame my comments by providing information about myself. I am an economist and former risk manager and senior vice-president at Citigroup, as of February 2008, via voluntary separation. As such, while not uniquely suited to comment on the proposed rulemaking, I am intimately familiar with both bank operations and processes and the factors ultimately leading to the current financial crisis.

Let me first state, that I applaud all efforts contained within the Restoration Plan proposal, in the thoroughness with which the assessment rule changes were approached, the fairness of each proposal, and the balance of easily grasped and implementable adjustment with scientific and statistical accuracy with which they were derived. By and large I agree with both the measures proposed and the reasoning behind the proposal, and in particular both the *adjusted brokered deposit ratio* addition to the financial ratios method and the *brokered deposit adjustment*.

However, I would like to comment on two of the proposed adjustments for your consideration; namely the:

- *Unsecured debt adjustment* to decrease an institution's assessment;
- *Secured liability adjustment* to increase an institution's assessment.

In the first case, the u*nsecured debt adjustment*, while I understand the FDIC's intent allowing for a decrease is to assess against risks to institutions' insured deposits and the DIF, however, I question whether the FDIC has fully calculated the risks of unsecured debt in today's complex structured finance market. In documenting this adjustment the proposal states:

> "Consequently, greater amounts of long-term unsecured claims provide a cushion that can reduce the FDIC's loss in the event of failure. The FDIC's proposed definition of a long-term senior unsecured liability, however, ignores features that may affect whether the liability would, in fact, reduce the FDIC's loss in the event of failure. The definition would include liabilities with put options or other provisions that would allow the holder to accelerate payment (for example, if capital fell below a certain level). Any kind of put or acceleration feature could undermine the long-term nature of the liability. The FDIC is particularly interested in comment on whether

long-term senior unsecured liabilities should exclude those liabilities with put or other acceleration provisions."

These types of unsecured liabilities should be definitively excluded from the possibility of decreasing assessments.

In addition, I strongly encourage the FDIC to adopt the s*ecured liability adjustment*. However, I would like to raise the possibility of increasing the 50% maximum assessment increase owing to the proposed adjustment, even better to do away with the maximum altogether.

My reasons for these suggestions are similar, because the structured investment vehicles (SIVs) generating these synthetic liabilities are so closely tied in bank practice, susceptibility to market volatility, and to the dire straits we find ourselves in today. As is well known, the synthetic liabilities generated by banks at the swirling center of the current financial crisis were derived from credit risk transfer instruments, such as credit default swaps (CDS), and from senior unsecured debt obligations (DO).

However, while synthetic liabilities may be the vehicle, they are not the driver of the liquidity crisis. Indeed, economic expansion over the past 10 years would not have been possible without them. Underlying the growth of an entire industry supporting synthetic liabilities and synthetic securitization was the Federal Reserve's sustained "easy money" policies suppressing interest rates and the inevitable decreases in deposits rates. The decreases in deposits rates would otherwise have forced a contraction in lending based on standard bank balance sheet accounting of lending ratios to deposits. Instead, these securities allowed banks to expand lending. Other positive outcomes have been the record bank profits, record stock market gains, and expansion of the mortgage market allowing more Americans to become homeowners than ever before.

However, SIVs remain at the center of the crisis and we do not yet know whether the economic gains made will be sustained, or whether we will fall back to our 1998 levels of GDP or lower. Economists would say that nominal growth is never sustainable over the long run. Further, over the long run we will undoubtedly know all the contributing factors to this crisis, but several factors are already coming to consensus:

- Financial institutions off-balance-sheet conduits and SIVs which held the long-term complex structured finance products and financed them by issuing short-term maturity instruments. The maturity mismatch liquidity risk this created was severely underestimated by financial institutions and severely under-reserved.
- Derivatives valuation is notoriously troublesome and credit default swaps (CDS) and debt obligations (DO) are very young securities. Unfortunately, only after the fact do we understand that the risk premium for market risk (depreciation in real estate values) and liquidity risk was too low by far, if these premia were even considered.
- The "originate-to-distribute" (OTD) model and competitive pressures encouraging imprudency in lending practices and erosions in credit standards, whereby mortgage loans become merely a

conduit into the secondary derivatives market, greater securitization, and even higher lending levels, and losing sight of the fact that mortgage assets bear risk in and of themselves.

- The SEC's loosening of leverage ratios of debt to net capital up to 40% in 2004 added fuel to the flame of the securitization process through the derivatives market which may have contributed to instability in the real estate market.
- Failures in bank prudency and regulatory oversight that failed to recognize how SIV structures address these risks by accelerating payment and by short sales, and how these would greatly exacerbate and accelerate the liquidity risk in the inevitable event of a downturn.

Although after the fact asset price bubbles may seem "irrational," John Maynard Keynes provides an explanation through his description of "animal spirits." He once cautioned against such a strategy by warning that "The market can stay irrational longer than you can stay solvent."

As such, I would hope the FDIC will revisit the unsecured debt adjustment to decrease an institution's assessment by excluding SIVs, or by removing the adjustment altogether, and the 50% cap on the secured liability adjustment to increase an institution's assessment by more than 50%, or by removing the cap altogether.

Thank you for your time and attention to my comments. Please feel free to contact me at any time regarding questions or comments you may have.

Respectfully submitted,

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