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October 20, 2008

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

Re: FDIC Notice of Proposed Rulemaking, RIN 3064-AD35

Dear Mr. Feldman:

The California Bankers Association ("CBA") is pleased to submit these preliminary comments to the FDIC on its proposed rulemaking to adopt a new financial ratio to assess FDIC deposit insurance. CBA is a non-profit association established in 1891 that represents most of the FDIC-insured depository financial institutions in the state of California. CBA regularly offers comments to regulatory proposals that significantly affect the business of banking.

CBA and its members applaud the steps that the FDIC has taken during these turbulent times. We recognize the FDIC's leadership in raising the deposit insurance ceiling, insuring transaction accounts, and taking necessary steps to restore the Deposit Insurance Fund (DIF). We also acknowledge and applaud the FDIC's role in helping to shape the Administration's efforts to restore stability in the nation's financial markets.

The FDIC is taking the current action pursuant to the Federal Deposit Insurance Reform Act of 2005 (the "Reform Act"), which gives the agency the authority to prescribe regulations to better price deposit insurance for risk. The Reform Act, which amends the Federal Deposit Insurance Act, defines a risk-based system as one based on an institution's probability of causing a loss to the deposit insurance fund due to the composition and concentration of its assets and liabilities, the amount of loss given failure, and revenue needs of the DIF.

Pursuant to its new authority, the FDIC proposes to incorporate into the risk analysis an institution's reliance on brokered deposits to fund rapid asset growth. An institution's risk factor for purposes of deposit insurance premiums would be elevated if its total assets increased by more than 20% over four years (after adjusting for mergers and acquisitions) and its brokered deposits made up more than 10% of domestic deposits. The FDIC cites as reasons for applying the risk factor the fact that recent failed institutions had experienced rapid asset growth funded partly by brokered deposits, and that there was a significant correlation among asset growth, brokered deposits, and the probability of an institution's CAMELS rating being downgraded within a year.

The FDIC specifically asked whether an institution's CDARS reciprocal deposits should be excluded from the proposed risk calculation.[1] It also asked, if such deposits should be excluded, how that should be effected since such deposits are not segregated in the CALL report and the TFR. CBA's comments are limited to these questions.

The fundamental question is how reciprocal deposits affect the *probability of loss* to the DIF. The FDIC's position on institutions' over-reliance on brokered deposits is that: (1) they are expensive to secure in terms of fees charged and rates paid, and thus motivate institutions to seek higher yielding and riskier assets; and (2) the institution has a tenuous relationship with holders of brokered deposits because they are primarily rate-driven, are less likely to reside in the institution's community, and less likely to use the institution's other products and services. In short, they are not stable customers.

If for purposes of deposit insurance premiums reciprocal deposits should not be treated as traditional brokered deposits, reciprocal deposits must be shown to have characteristics that are more like core deposits than brokered deposits. Indeed, CBA and its members contend that they do. With respect to the first factor, rates on CDARS deposits are set by the institution (not by a deposit broker) largely under the same circumstances as other local deposits. In contrast, rates paid to secure traditional brokered deposits are subject to regional or national market factors.

Therefore, the FDIC's legitimate concern that over-reliance on high-cost, non-core funding sources such as brokered deposits could drive institutions to make riskier loans has little application to reciprocal deposits. Deposits gathered through CDARS are somewhat more costly to the institution than non-CDARS (non-brokered) deposits because of the service/licensing charge, but the extra cost is more than offset by the advantages to the institution that uses CDARS, as discussed below.

As to the second factor (stable funding), the primary advantage to CDARS is that it allows institutions to serve their own local customers more effectively by providing them with access to insured deposits in excess of the deposit insurance ceiling at a single institution. It is more appropriate to view CDARS not as a means to gather deposits from outside of an institution's local market but rather as a means to draw on the deposit insurance of other CDARS institutions to retain *local* deposits and maintain relationships primarily with existing customers.

Like core deposits, which the FDIC does not recognize as a risk factor, CDARS reciprocal deposits typically have high reinvestment rates. According to Promontory Financial Group, the proprietor of CDARS, the average reinvestment rate for all CDARS reciprocal deposits is over 83%. This is because CDARS deposits are overwhelmingly gathered within each institution's local markets. Because these depositors tend to reside and work near the institution's offices, they are much more likely to use multiple banking products and services and less likely to move deposits to other institutions based on rate alone. These are individuals, businesses, nonprofits, and local governments with large deposits that, without FDIC insurance,

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[1] In this letter, reciprocal deposits refers to CDARS reciprocal deposits as CDARS is the only current provider of such services. However, our comments would apply generally to this type of deposit-taking arrangement without regard to a specific provider that may come into the market.

may be compelled to split deposits among several institutions. In essence, CDARS depositors are the same as established core depositors if FDIC insurance had no ceiling.

As funds gathered through CDARS are not high-cost, and because they are stable, they do not pose the same risks to the DIF as traditional brokered deposits. Indeed, CDARS reciprocal deposits may reduce the FDIC's exposure by helping banks retain important, large-dollar deposit accounts. Especially in these troubled times, smaller institutions that are the typical users of reciprocal deposits stand at risk of seeing excess, uninsured deposits leave the institution. Again, these are overwhelmingly local customers. Without access to reciprocal deposits, these customers may be motivated to spread funds to institutions with which they otherwise have no relationship.

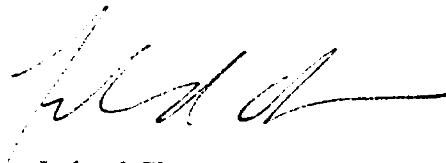
Discouraging use of CDARS would compel banks that need liquidity to obtain it elsewhere, decreasing franchise value as they rely more on non-core funding. Unlike institutions that rely on traditional brokered deposits, institutions using CDARS enjoy solid customer relationships. This *raises* franchise value, which is important not only to the institution but to the FDIC in the event it is required to arrange a sale of the institution.

Moreover, through CDARS, financial institutions can hold large dollar customers without having to pledge any collateral, leaving banks not only in a better liquidity position but also relieving the FDIC in the event of a failure from being saddled with assets committed to third parties. Finally, unlike some other sources of funding, CDARS deposits can be terminated by the FDIC without prepayment penalty.

The FDIC also asked how it could treat reciprocal deposits differently from brokered deposits as they are not distinguished in the CALL reports and the TFR. We do not believe this is a significant obstacle. It would not be difficult for institutions that use reciprocal deposits to report them separately in any format specified by the FDIC. In the alternative the FDIC could, through this rulemaking or through an interpretation, clarify that reciprocal deposits should not be reported as brokered deposits.

The CBA and its members appreciate this opportunity to submit these comments. If you have any questions, please do not hesitate to contact me.

Sincerely,



Leland Chan