THE FINANCIAL SERVICES ROUNDTABLE

Impacting Policy. Impacting People.

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STEVE BARTLETT
PRESIDENT AND
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July 2, 2010

Via email to: comments@FDIC.gov

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

Re: RIN # 3064-AD57: Proposed Rule to Revise the Assessment System

Dear Mr. Feldman:

The Financial Services Roundtable[1] ("Roundtable") appreciates this opportunity to comment on the Federal Deposit Insurance Corporation's ("FDIC") Proposed Rule to Revise the FDIC's Assessment System for Large Institutions ("Proposed Rule") published in the Federal Register on May 3, 2010 (pages 23516 to 23556).

I. GENERAL COMMENTS

In general, the Roundtable shares the FDIC's belief that the Deposit Insurance Fund ("DIF") must be well protected and that assessments to the DIF must take into account the losses that the FDIC will incur if an institution fails. However, the Roundtable has significant concern that the Proposed Rule is far too complex to be administered fairly or consistently across all insured depository institutions to which it will apply. Further, the numerous factors, weights, cutoff values, scores, and assumptions reflect a backward-looking analysis of the 2005 to 2009 period, which focuses on an extraordinary period of time in our economy impacted by numerous negative economic factors. Not only is the past not prologue, but large and highly complex institutions perform quite differently than small banks, in large part because large institutions are

[1] The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $85.5 trillion in managed assets, $965 billion in revenue, and 2.3 million jobs.

more complex, have a much greater geographical spread, including, in some cases, a global presence, and differ greatly from one to another.

Further, the proposed statistical analysis of failure potential is based on the relationship of financial factors to the FDIC's single point-in-time (2009) subjective assessment of "performance." Not only does this suffer from a lack of transparency, it also bases its factor selection on past years' performance criteria which may have no bearing on potential future failure criteria. This lack of transparency carries forward to the use of Run-Off Rate assumptions (Table D.1) and Asset Loss Rate assumptions (Table D.2), whose accuracy we have no way of validating since the FDIC has provided no statistical supporting analysis.

Additionally, the derivation of the factors, weights, cutoff values, scores, and assumptions the FDIC proposes to use in establishing DIF premium rates for large institutions and highly complex institutions is highly opaque and difficult if not impossible to apply. Consequently, because outsiders cannot judge the reasonableness and reliability of the factors, weights, cutoff values, scores, and assumptions set out in the Proposed Rule, bankers and others cannot be confident that DIF premium rates calculated under the Proposed Rule will be fair or consistently applied across all large and highly complex institutions or will even be relevant to future events.

II. SPECIFIC COMMENTS

A. Request to Withdraw the Proposed Rule

The FDIC should withdraw the Proposed Rule and reissue a revised proposed rule at a later date to reflect the substantial expansion of the DIF assessment base in the current draft of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA"). Sec. 331(b) of the DFA legislation[2] materially alters the assessment base for FDIC-insured institutions, from total domestic deposits to average consolidated total assets of the insured depository institution, minus average tangible equity capital during the assessment period. In the case of a custodial bank, the FDIC may take other factors into consideration in establishing the bank's deposit-insurance assessment base.

We note that DFA does not provide a definition of "average consolidated total assets" nor is this term defined in either the FDIA or the FDIC's regulations. Appendix D to 12 CFR Sec. 225 does provide a definition of this term by referring to total assets as reported on the Fed's Y-9C report. Total assets of a bank holding company, as reported on Form Y-9C, are its global assets, not just its U.S. assets. As such, without further clarification, the use of "consolidated total assets" is far too broad for the purpose of calculating assessments to the DIF. Further, so as to not assess goodwill, the assessment base should be expressed as average consolidated <u>tangible</u> assets minus average tangible equity capital.

[2] Section reference is to the base text which was amended in the DFA conference committee.

Based on the FDIC's Quarterly Banking Profile ("QBP") for the first quarter of 2010, the assessment base for the DIF will increase by approximately three-fifths, or $4.5 trillion, rising from approximately $7.7 trillion to $12.2 trillion. Assuming the FDIC maintains the same total premium-income targets for the DIF, premium assessment rates, expressed in basis points, to produce the targeted amount of income will decline significantly due to DFA's substantial increase in the DIF assessment base. This statutory increase in the DIF assessment base will take effect before the January 1, 2011, effective date of the Proposed Rule.

In particular, DFA's increase of the DIF assessment base invalidates the DIF premium rates cited throughout the text of the Proposed Rule as well as the rates and rate ranges in Tables 17, 18, and 19 as well as in Chart 2. Further, the premium-rate schedule in the proposed 12 C.F.R. 327.10, Assessment Rate Schedules (FR page 23542), substantially overstates the premium rates the FDIC should charge given DFA's expansion of the DIF assessment base.

Since, according to the first quarter 2010 QBP, banks and thrifts with more than $10 billion of assets accounted for 77.7% of the assets of all banks and thrifts at March 31, 2010, it is reasonable to assume that the assessment base for "large" banks, as defined in the Proposed Rule, will increase by at least $3.5 trillion. This substantial increase in the assessment base of large banks may lead to dramatic changes in how large financial institutions structure themselves which in turn will greatly alter their risk characteristics and therefore the basis on which the FDIC evaluates those risk characteristics for deposit-insurance assessment purposes.

For example, some banking companies may shift foreign branches and the assets funded by those branches into foreign-chartered bank subsidiaries of a parent U.S. bank or financial holding company. Likewise, other provisions in DFA direct banking companies to shift some of their derivatives activities from their insured bank subsidiaries into affiliated non-bank subsidiaries. The effect of both of these possibilities will be to materially shrink not only the assessment base of large, insured banks but also the mix of assets, liabilities, and risks in these shrunken banks. Any shrinkage in the DIF assessment base due to the restructuring of insured-bank entities within holding companies further invalidates the DIF premium rates and assumed premium income set forth in the Proposed Rule.

An additional reason the FDIC should withdraw the Proposed Rule relates to a House-passed small-business bill that would allow all but the 100 largest banks to amortize losses on bad real estate loans over six to ten years instead of recognizing those losses immediately. The FDIC should consider the impact of this loss deferral, should it become law, on the size of the DIF assessment base and the impact on DIF insolvency losses and premium rates of keeping weak banks open, which would be the effect of this forbearance provision.

The FDIC noted in the Proposed Rule (FR page 23517) that it "anticipates a further round of rulemaking may be needed to improve the large bank assessment system adopted pursuant to this rulemaking." The enactment of DFA ensures that there will have to be another round of rulemaking. Given that certainty and the fact that DFA has invalidated many of the premium-rate and rate ranges set out in the Proposed Rule, the FDIC should withdraw the Proposed Rule and start anew in developing an assessment system for large insured institutions.

B. Accounting Rules Changes

The Proposed Rule does not take into consideration recently proposed changes in accounting rules which have the effect of broadening the application of mark-to-market accounting.

On May 26, twenty-three days after the Proposed Rule was issued for comment, the Financial Accounting Standards Board ("FASB") issued for comment "an Exposure Draft of a proposed Accounting Standards Update (ASU) intended to improve accounting for financial instruments." If adopted as FASB has proposed, or with only minor modifications, this ASU could materially impact not only bank balance sheets, especially for large, highly complex banks, but also how they manage the risks they assume.

Specifically, this ASU would not only impact the size of the assessment base for individual insured depository institutions, but also the aggregate size of the banking industry's assessment base that the FDIC uses to determine assessment rates, which will produce the amount of premium income the FDIC believes the DIF must collect. As it is, recent changes in Financial Accounting Standards 166 and 167 have increased DIF's premium income.

Further, the implementation of this ASU could materially alter bank business strategies, thereby invalidating the cutoff values, weights, pricing multipliers, and scores the FDIC has developed for determining the premium rate for "highly complex institutions." The impact of the ASU might be especially significant for the "scorecard measure" for the ratio of unfunded commitments to total assets (FR page 23540) as the ASU could affect both the numerator as well as the denominator of that fraction.

For this reason alone, the FDIC should withdraw the Proposed Rule and reissue the rule only after the FDIC staff has fully evaluated the impact of this ASU on the DIF assessment base and the scorecard measures for highly complex institutions.

C. Liquid Assets

The definition of liquid assets must include agency MBS. The definition of "liquid assets" set forth in a table on FR page 23545, while including "agency securities (securities issued by the U.S. Treasury, U.S. government agencies, and U.S. government-sponsored enterprises)," does not explicitly include mortgage-backed securities ("MBS"). The definition of "liquid assets" should be expanded to explicitly include agency MBS (i.e., MBS issued by Fannie Mae, Freddie Mac, and Farmer Mac).

D. Brokered Deposits

Low-risk banks, i.e., those banks placed in Category I for deposit-insurance assessment purposes, currently are not subject to a "brokered deposit adjustment" – see Table 2 on FR page 23517. The FDIC proposes to continue that exemption for small institutions as well as insured branches of foreign banks – see Table 17 on FR page 23528 – but to subject large institutions and highly complex institutions to a brokered deposit adjustment as high as 10 basis points – see Table 18 on FR page 23528.

The Proposed Rule provides no explanation or data-based reasoning for including in the calculation of the premium rate for large institutions and highly complex institutions a factor for brokered deposits (including reciprocal deposits) when the ratio of such deposits to total domestic deposits exceeds 10%. Further, as the FDIC notes in its discussion of Table 1.2 on FR page 23551 (OLS Stepwise Regression Results) and Table 1.3 on FR page 23552 (Logistic Stepwise Regression Results), the risk measure identified as "brokered deposits/total domestic deposits" in both tables does not meet the test of being "statistically significant." That lack of statistical significance strongly argues against reflecting brokered deposits in the calculation of the premium rate for large and highly complex financial institutions.

Such a finding is not surprising given how few large banks have failed in recent years and how unrepresentative those failures are of large and highly complex institutions. Of the 250 banks and thrifts that failed at some cost to the FDIC from 2007 to June 18, 2010, only eight had total assets of more than $10 billion.

It also is important to keep in mind that shifting the DIF assessment base from domestic deposits to total consolidated (global) assets will tilt banks towards funding themselves with domestic deposits since non-deposit liabilities will now effectively be subject to a deposit-insurance assessment as if they were insured deposits even though those liabilities will not be protected against loss. That tilt toward deposit funding will be further enhanced by the secured liability adjustment in calculating the premium rate for large and highly complex institutions; that adjustment will make secured funding more expensive relative to deposits.

Given these incentives for large and highly complex institutions to increase their reliance on deposit funding, these institutions most likely will have to increase their reliance on brokered deposits, and especially reciprocal deposits. If large and highly complex institutions are then penalized for using brokered deposits, they will be forced to compete more aggressively for retail deposits by offering higher interest rates on those deposits. Community banks would then have to offer higher rates to retain their deposits, which would be harmful to community-bank profitability. For this reason alone, the FDIC should maintain its present practice of not including a brokered deposit adjustment in the premium rate for large and highly complex institutions that the FDIC would classify as a Category I institution under its present premium rate-setting rule.

The Proposed Rule's treatment of brokered deposits for large and highly complex institutions classified as Category I institutions is especially punitive given their negative treatment in CAMELS ratings, in the Proposed Rule's Scorecard, and the brokered-deposit premium surcharge in calculating risk-based premiums. As a result, what is not a factor of risk under current rules is penalized three times over in the proposed rule.

Finally, we note that Section 1506 of the DFA directs the FDIC to conduct a study and report to the Congressional banking committees on the definition of core deposits for purposes of calculating the insurance premiums of banks and the potential impact to the Deposit Insurance Fund of revising the definitions of brokered deposits and core deposits to better differentiate between them. The results of this study could impact the deposit assessment system. The Roundtable believes that the opportunity to provide information on use of brokered deposits in connection with the FDIC study would be beneficial. Given the diversity in depository institutions' use of brokered deposits, any definition of brokered deposits and factors based on brokered deposits should be far more nuanced in the analysis of the risks associated with such deposits. In short, the definition of brokered deposits should not be so broad as to sweep in both good and bad practices associated with brokered deposits.

E. Appeals Process

Clarification is needed as to the process by which a large institution may appeal premium rates assessed under a rule applicable only to large institutions. While current FDIC regulations (12 C.F.R. Sec. 327.4(c)) provide for appealing the FDIC determination of a premium rate ("requests for review"), the Proposed Rule should expand on the procedures applicable to appeals. Currently, both the existing regulation and the Proposed Rule state that "[n]otice of the procedures applicable to appeals will be included with the written determination." Due to the complexity of the premium-rate calculations for large and highly complex institutions and the time it takes to prepare such an appeal, the Proposed Rule should spell out in detail the procedures and timetable for such an appeal.

F. Additional Notice-and-Comment

The Proposed Rule, after revision to reflect the DFA legislation, should provide for a notice-and-comment period for any changes in the assessment process, and specifically in the "scorecard," after the initial adoption of a new premium-assessment process. In the Proposed Rule, the FDIC proposes (FR page 23527) that it "have the flexibility to update the minimum and maximum cutoff values and weights used in each scorecard annually, without notice and comment rulemaking." The updating process the FDIC proposes would encompass not only adding in fresh data as another year of data becomes available but also "updating the minimum and maximum cutoff values and weights . . , thereby improving the accuracy of the scorecard method."

It makes sense to automatically update the scorecard data with annual data, as it becomes available, while simultaneously dropping the older data. However, any changes in the minimum and maximum cutoff values and weights should be subject to notice-and-comment rulemaking as those changes reflect judgment calls about the magnitude of any change in the minimum and maximum cutoff values and weights. As the Proposed Rule notes on FR page 23519:

> In general, a risk measure value reflecting lower risk than the cutoff value that results in a score of 0 would also receive a score of 0, where 0 equals the lowest risk for that measure. A risk measure value reflecting higher risk than the cutoff value that results in a score of 100 would also receive a score of 100, where 100 equals the highest risk for that measure.

Clearly, where the minimum and maximum cutoff values and weights are set is critically important to the accuracy and fairness of the entire premium rate-setting process. For example, the minimum and maximum cutoff values for the Senior Bond Spread shown in Table 14 (FR page 23526) will need to be adjusted as the credit cycle varies. Given the importance of this spread (the Market Indicator in the Scorecard for Highly Complex Institutions, Table 12, FR page 23525) in calculating the premium rate for highly complex institutions, the FDIC should seek public comment on the appropriate minimum and maximum values for a particular point in time in the credit cycle. In fact, the FDIC should be strongly desirous of having public input as to the appropriate minimum and maximum values for all cutoff values and weights.

G. Source of Data

The Proposed Rule should set forth the source of all of the data that will be the input for the calculation of premium rates for large and highly complex institutions. While basic data clearly will come from Call Reports, it is clear from the Proposed Rule that the FDIC will have to collect numerous other data elements in order to calculate the premium rate for large and highly complex institutions.

The substantial scope of that data collection is readily evident from Appendix E to Subpart A, Additional Risk Considerations for Large Institutions, as set forth on FR page 23548. It is interesting to note that the column titled "Information Source" contains no source information. Some examples of "Associated Risk Indicators or Information" from the table on that page illustrate the complexity and human judgment that creating and utilizing this data in premium rate-setting formulae will entail:

- Robustness of internal stress testing models and reserve methodology.
- Portfolio characteristics such as internal loan rating and credit score distributions, internal estimates of default, internal estimates of loss given default, and internal estimates of exposures in the event of default.
- Portfolio underwriting characteristics and trends (including portfolio growth).

- Robustness of credit administration and credit risk monitoring (e.g., internal loan classification).
- Robustness of contingency or emergency funding strategies and analyses.
- Assessment of VaR framework, stress testing framework and results.
- Margining policies, netting enforceability and hedging capabilities.

These examples illustrate the following problems with attempting to use these "risk indicators" in any premium rate-setting formula:

- Many of these indicators reflect qualitative judgments and hence are open to dispute.
- These qualitative judgments will vary across institutions and, for any one institution, across time.
- It will be expensive, for both the institution and the FDIC, to develop sufficient and consistently reliable risk indicators. The FDIC implicitly acknowledged this consistency challenge when stating, on FR page 23526, that it "would use the senior bond spread [as a market indicator in the scorecard for highly complex institutions] because this measure can be compared consistently across institutions."
- The Proposed Rule provides no guidance as to how FDIC staff would utilize these risk indicators to "adjust the performance score and/or the loss severity score for all large institutions and complex institutions, up or down, by a maximum of 15 points each, based upon significant risk factors that are not adequately captured in the scorecard."

The Proposed Rule clearly goes to excess in trying to utilize a wide variety of highly judgmental factors developed for highly complex financial institutions in establishing risk-sensitive DIF premium rates for those institutions. For this reason alone, the FDIC should withdraw the Proposed Rule and develop a much simpler rule which relies to the greatest extent possible on quantifiable data already collected by regulators on Call Reports and Thrift Financial Reports, and minimizes reliance on data collected on and judgments made on an ad hoc, institution-by-institution basis.

H. Large and Highly Complex Institutions

We note that the FDIC faces a fundamental problem in calculating risk-sensitive premium rates for large institutions and highly complex institutions in contrast to small institutions, as well as contrasting highly complex institutions with large institutions. Specifically, there is little recent failure data on large institutions, and arguably only one institution with more than $25 billion in total assets. Developing risk-sensitive premium rates for large and highly complex institutions with little data for large institutions (as little as a sample of one for institutions larger than $25 billion in total assets) is empirically unsound and potentially inequitable to all three categories of institutions: small, large and highly complex.

In closing, the Roundtable urges the FDIC to withdraw the Proposed Rule and to not reissue it until FDIC staff have fully evaluated the impact of DFA on the Proposed Rule and more specifically on the premium rates and rate ranges specified in the rule. However, even if DFA had not been enacted, the Proposed Rule should still have been withdrawn for consideration of the above comments not related to DFA.

Thank you again for the opportunity to share our views with you on this subject. If you have any questions, please feel free to contact me or Brad Ipema at 202-289-4322.

Sincerely,

Steve Bartlett

Steve Bartlett