American Bankers Association

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

Re: RIN 3064–AD57; Notice of Proposed Rulemaking to Amend the Large Bank Risk-Based Assessments Scheme; 12 CFR Part 327; 75 *Federal Register* 23516, May 3, 2010[1]

Dear Mr. Feldman:

The American Bankers Association (ABA) welcomes the opportunity to comment on the proposal from the Federal Deposit Insurance Corporation (FDIC) to amend the large bank premium pricing scheme. The ABA represents banks of all sizes and charters and is the voice for the nation's $13.4 trillion banking industry and its two million employees.

The ABA appreciates the considerable work done by FDIC staff in investigating the current risk-based pricing system, and we share the view that a risk-based system should fairly differentiate risk among banks. We do not believe the proposed scheme meets this standard, however, at least not yet. More work remains to be done. The proposed scheme gives ***unique*** scores and, therefore, the ***appearance*** that there are finely measureable differences in the risk of failure and loss to the FDIC. We believe that such a finely gradated system cannot possibly reasonably reflect the risk of failure (which is unlikely to be so finely calibrated) and, therefore, puts an additional cost on some institutions that are no more likely to fail than others. A more complex system should not be confused with a better or more accurate system.

Bankers believe that the methodology relies too heavily on the very recent past, which may not be indicative of future problems that will lead to failure. We believe that before any change is adopted there should be an ***independent validation*** of the proposal and its ability to differentiate over a wider variety of possibilities the risk of loss for the FDIC. We note that banks are asked to have independent validations of key operating models that they use or intend to implement, and we believe the same standard should apply in this case to the FDIC.

The FDIC Should Provide Banks with Premiums Rates that Would Have Applied Under this Formula.

Evaluating this proposal by the affected banks has not been easy. Before any new pricing scheme is put in place, we recommend that the FDIC should provide each bank, on a confidential basis, an estimate of the premium rate it would have paid in the past under the scheme were it in effect then. This would allow banks to verify the calculations across periods where the information is well

[1] FDIC, 75 *Federal Register* 23516, May 3, 2010, *http://edocket.access.gpo.gov/2010/pdf/2010-10161.pdf.*

understood and would demonstrate more clearly the expected impact on premiums going forward. By comparing the assessment rates actually paid with what would have been applied under the proposal, banks could better understand the actions they could take to lower their assessment rates (and presumably improve their risk profiles). Given that less than 100 institutions are affected by this rule, providing such estimates should not be a difficult undertaking. We believe that feedback from this will be important and supports a more measured approach to implementation.

Implementation of Any Change Should Not be Undertaken Until the Implications of the New Regulatory Reform Law is Fully Understood.

The ABA believes that it is unrealistic to implement such a significant change in the methodology of calculating risk-based assessments by the end of this year, particularly when an independent analysis is needed to verify the effectiveness of the proposed system.

Moreover, implementation is confounded by the dramatic changes in law Congress is finalizing that will impact the funding and business strategies of the banks subject to this proposal. How these changes alter the risk profile (or relative risk) of banks is unknown and will not be known for some time. Should these changes indeed alter risk profiles, then the calibration of the proposed scheme and the premium rates applied would be incorrect.

In addition, the broadening of the assessment base upon which assessment rates will be applied will obviously affect the range of premium rates needed to generate the revenues expected under the current system. One of the fundamental principles of the proposal – which we support – is that the revised system should be revenue neutral, *i.e.*, raise an equivalent amount of money from the industry as would have been raised under the current system. Without knowing how the broadened assessment base changes the size and composition of the liabilities (and, of course, the assets funded), it would be very difficult to know with any degree of certainty what range would generate the same amount of revenues for the FDIC. Moreover, we should understand better to what extent the revenue implications for the changes in the assessment base might operate to mute the effects of the FDIC's risk-based premium formula. At its core, a risk-based system should assure that riskier institutions pay relatively more in premiums than do less risky institutions, and the FDIC should use the flexibility given to it in the law to ensure that its premiums do in fact give life to that principle.

Therefore, we strongly recommend that adoption of any new large bank premium pricing scheme be delayed until the various provisions of the legislation that affect FDIC premiums are implemented, adjustments to these changes have largely taken place, and revenue neutrality is assured. Because the FDIC has collected three years of prepaid assessments, there is no urgency to implement the proposal from the point of view of bringing cash resources into the hands of the FDIC.

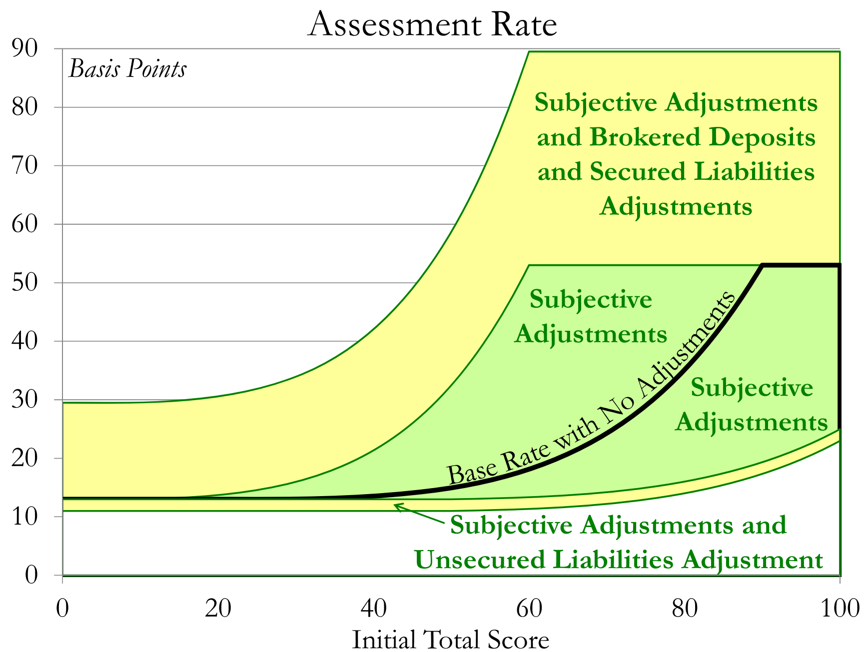
Subjective Downgrades Should be Removed.

One of the most troubling aspects of the proposal is the degree of subjectivity that could be used in determining the point score and, therefore, the premium assessed. As we have repeatedly argued in the past, it is inappropriate to expand the FDIC's authority to make arbitrary adjustments in the assessment rate. Unfortunately, this proposal further expands the potential ***magnitude*** of subjective adjustment in premium rates – ***out of proportion and completely out of sync with the***

extraordinary detail and complexity of the objective part of the scoring. If the FDIC does not have confidence that the new objective formula adequately reflects the relative risk absent subjective adjustments, the answer is not to have authority to override the objective decision – particularly where it raises the assessment rate – but to improve the objective formula.

The Potential Impact of Subjective Decisions on Premiums is Excessive.

The proposal gives the FDIC considerable discretion to adjust rates up or down. Under current procedures, the FDIC has authority to adjust an assessment rate up or down by up to one basis point, and, in the case of a higher adjustment, allow the affected bank to correct the cited reason for the downgrade before the financial penalty is applied. Of course, it is the downgrades that are of particular concern (both with the current system and the proposal).



As proposed, the FDIC would have discretion to adjust both the Performance and Loss Severity Scores up or down by as much 15 points. How a subjective change in the score affects the assessment depends on the initial score, as the premium rate increases exponentially as the score rises. Only if the initial score is below 20 points would the upward adjustments be limited to one basis point. Thus, initial scores above that level would have a potential subjective adjustment greater than the existing authority. ***In fact, a subjective adjustment could raise the final premium rate by over 52 basis points, to 2½ times the initial rate.***[2]

Many bankers that have attempted to estimate their own premiums (typically using the FDIC's calculator) feel that a potential subjective downgrade makes it virtually impossible to estimate with any degree of confidence the ultimate assessment rate and cost. Many expressed frustration that

[2] If the initial total score is 60 then the assessment rate would be 18.1 basis points (assuming the assessment scale is raised three basis points from the proposal, as proposed). If the assessment rate is raised 50 percent for the secured liabilities adjustment and 10 basis points for the brokered deposits adjustment, then the final assessment rate would be **37.2** basis points. But suppose that subjective adjustments are then applied to raise the assessment rate to the maximum extent. If both the Performance and Loss Severity Scores are adjusted up to the maximum then the total score would rise to 90, corresponding to an assessment rate of 53 basis points. And if the assessment rate is raised 50 percent for the secured liabilities adjustment and 10 basis points for the brokered deposits adjustment, then the final assessment rate would be **89.5** basis points.

access to information that might be used in a subjective determination is not available to any bank. Furthermore, this problem is compounded by the lack of clarity regarding the magnitude of any added subjective penalty and how it would be calculated. For example, what factors would lead to a 4 point versus an 8 point versus a 15 point increase? More to the point, however, is whether there is a meaningful distinction between a bank with six added points and a bank with seven added points. There is a related concern for banks that have acquired failed banks; they wonder what additional penalties might retroactively be applied as a result of the assets acquired or managed and whether FDIC guarantees would be considered as offsets.[3] Variations of this potential magnitude are in danger of straying from "fine tuning" into arbitrariness contrary to the principles of due process.

The concerns raised are not just theoretical. Several banks report being hit with, in their views, unreasonable adjustments under the current system for which they were not provided sufficient justification. Further, the bankers felt that they were not allowed to challenge effectively the adjustments through the FDIC's appeals process. As we have repeatedly recommended in the past, the FDIC should publish aggregate statistics on adjustments, challenges, and final results.

The current system does allow banks to make adjustments to avoid the financial penalty associated with a subjective penalty adjustment – a feature that ABA supports. However, without adequate information regarding the reasons for a penalty rate adjustment, we are not convinced that in practice this will be effective. This is a critical component that must be strengthened before any new rule is put in place.

In fairness, subjective changes should ***only*** be made to lower the point score (and premium rate) of a bank and never should be used to punish banks. For example, risk mitigation strategies and insurance can lower the risk and/or cost of failure and should reduce the premium assessment, just as having a smoke detector or fire extinguisher are factors that can lower fire insurance premiums. As a monopoly provider of deposit insurance coverage, there must be strict limitations on discretionary changes that impose costly penalties. To do otherwise opens the door to the appearance of arbitrary and capricious regulatory action. The ABA believes that rather than expand the authority to use discretion, it should be strictly limited to lowering premium rates.

The Add-On Adjustments for Brokered Deposits and Secured Liabilities Should be Calibrated into the Scorecard, Subject to Independent Validation.

ABA believes that the add-on adjustments for brokered deposits and secured and unsecured liabilities are inappropriate as structured. They are not supported by the analysis presented in the proposal and should be calibrated within the Scorecard.

We expressed concerns above that the proposed pricing model was developed using data from an abnormally extreme period and that the pricing model should be subject to independent validation. These concerns are especially true for the add-on adjustments based on bank financing, as evaluated

[3] Several bankers have expressed concerns to ABA that the items in the current and proposed premium pricing formula can lead to significantly higher premiums for well-managed banks that acquire failed banks. They suggest that premium pricing should make allowances for failed bank acquisitions, and warn that if this is not done then the FDIC may have a much harder time – and suffer larger losses – in the future handling failed banks.

during the recent severe liquidity turmoil.[4] The important point is that the much bigger concern is the riskiness of the assets that are funded, regardless of the funding source. Perhaps this is why the FDIC analysis of the add-on factors does not provide clear support. We note that in Appendix 1, Tables 1.2 and 1.3, the brokered deposits variable does not show up as statistically significant in most of the years of analysis, 2005-2009, and the secured liabilities variable is significant in some of the years. In Table 1.4, which specifically tests the variables in the proposed Scorecard, the brokered deposits variable does not come in at all, and the secured liabilities variable is statistically significant in only one of the five years.

We note that, despite the extensive analysis to calibrate the proposed Scorecard, as outlined in Appendix 1, the proposed pricing scheme would simply retain the add-on adjustments exactly as currently applied. This is particularly surprising since factors for brokered deposits and secured liabilities are also included in the Scorecard.[5] The fact that these are add-on penalties gives these funding sources far more significance in determining FDIC premiums than is supported by the statistical analysis. ABA feels that the add-on adjustments should be calibrated directly into the Scorecard. If, subject to independent validation, these variables cannot be consistently related to risk exposure for the insurance fund, they should be dropped from the large bank pricing scheme.

Brokered Deposits

ABA continues to object to the brokered deposits adjustment in its current form. As we stated in our letter of December 17, 2008, we "are troubled by the fact that some recently failed banks used brokered deposits to grow rapidly and fund risky assets. It is important to understand, however, that not all brokered deposits share the attributes that are of particular concern to the FDIC. Treating all types of brokered deposits the same is unfair and inaccurate. Several types of brokered deposits – such as reciprocal deposit programs and sweeps from broker-dealers – have characteristics much more like core deposits and should not be considered in the same category as more volatile forms of brokered deposits. The FDIC should entirely exclude reciprocal deposit programs and broker-dealer sweep deposits from the premium calculations."[6]

ABA is particularly troubled that the proposal would no longer exclude from the brokered deposits adjustment banks that are well capitalized and of no supervisory concern (Risk Category I), as under the current system – although the exemption would continue to apply for banks under $10 billion. Thus, there is no recognition for larger banks that longstanding established use of brokered deposits, even as a significant funding source, can be done in a safe and sound manner. Bankers feel that the Scorecard would be better served by dropping the brokered deposit adjustment and raising the weight on Liquidity Management in the CAMELS score, considering the increased attention

[4] Relative to bank liquidity, as a specific suggestion for the proposed Scorecard, in the liquid assets/short-term liabilities variable, government-backed mortgage securities should be included in the list of liquid securities. Bankers note that these assets have the same weighting in risk-based capital as Treasury securities and proved to be equally as liquid in during the recent liquidity turmoil.

[5] The Performance Score in the Scorecard includes a positive factor for core deposits / total liabilities, but brokered deposits under $100,000 are not considered as core deposits. And the Scorecard's Loss Severity Score is based half on secured liabilities / total domestic deposits.

[6] ABA letter of December 17, 2008, *www.fdic.gov/regulations/laws/federal/2008/08c410ad35.pdf*, page 6.

supervisors are paying it.[7] If a brokered deposits adjustment is to be retained, bankers feel that the measure used should be enhanced to consider long-term use and whether an above-market rate is paid on this funding.

Secured Liabilities

ABA continues to be concerned about the excessive penalty in the secured liabilities adjustment for developing alternative funding sources, such as Federal Home Loan Bank advances. Advances provide stable and reliable funding that helps banks manage interest rate risk. We note that the "Interagency Policy Statement on Funding and Liquidity Risk Management" recently issued by the FDIC and its fellow banking agencies strongly encourages banks to avoid funding concentrations.[8] In contrast, the add-on for secured liabilities imposes a potentially severe penalty on banks for diversifying their funding.

Further, recent changes in accounting rules for SFAS 166 and SFAS 167 brought onto some banks' balance sheets large amounts of liabilities resulting from asset securitizations and loan participations. These entries are secured by the securitizations and participations, not by the banks themselves, but nonetheless are recorded on the banks' books as secured liabilities. Since such entries were not recorded before this year, there is no realistic way to quantify any risk they might pose. Thus, either the securitization and participation secured liabilities should be excluded from any risk pricing scheme until they can be reasonably quantified, or at the very least the secured liabilities adjustment should be recalibrated to account for the accounting change.

ABA further objects to retention of the unbalanced treatment of secured and unsecured liabilities in the current pricing scheme. The current scheme caps any downward adjustment in the assessment for unsecured liabilities at two basis points. There is no basis for such a cap, since the more unsecured liabilities that are subordinated to insured deposits, the lower the risk of loss to the FDIC in case the bank fails. In fact, a bank with sufficient claims subordinate to the FDIC would involve no insurance losses, should it fail. In contrast, the upward adjustment for secured liabilities could exceed 25 basis points. The consequence is a bias toward higher assessments, even for banks where there may be more unsecured debt than secured debt to offset it. We recommend that, instead, unsecured liabilities should be weighed against secured liabilities.

Conclusion

ABA appreciates this opportunity to comment on the proposed amendment to the large bank risk-based assessments scheme. Given that under the proposal there would be radically different premium pricing schemes for different classes of banks, the FDIC must carefully assure that all banks are treated consistently in pricing premium assessments.

In brief, affected institutions are seriously concerned that the proposed methodology is opaque, based on outdated data, and overly subjective. Further, there is a need to better understand the implications of the pending regulatory reform legislation, since without this insight it will be virtually

[7] The bank regulators recently issued an "Interagency Policy Statement on Funding and Liquidity Risk Management," March 17, 2010, *www.federalreserve.gov/boarddocs/srletters/2010/sr1006.pdf.*
[8] *Ibid.*

impossible to develop credible premium pricing. As a result, there is little confidence that the proposed system accurately captures and differentiates risk, and hence the importance of independent validation.

The proposal says that the new premium system would be recalibrated as often as annually (page 23527). Bankers are concerned that in this case the pricing formula would always be "fighting the last battle." As noted above, we believe that the parameters in the proposed model suffer from this weakness. Moreover, annual recalibration would make it hard for banks to plan and budget for FDIC assessments. Instead, ABA recommends that the FDIC take time to develop a stable model based on through-the-cycle parameters. We do not seek to delay implementation of improvements in pricing for premiums; however, we note that the prepayment of premiums gives the FDIC and insured banks time to evaluate, validate, adjust and budget for the change. We are prepared to work with the FDIC staff in resolving remaining issues in the proposal to arrive at a premium program that is more accurately sensitive to genuine risk and thereby a useful tool in encouraging better risk management.

Sincerely,

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