DISCOVER
FINANCIAL SERVICES

July 2, 2010

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

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

Discover Bank appreciates this opportunity to comment on the proposal by the Federal Deposit Insurance Corporation ("FDIC") to revise the FDIC's assessment system for large institutions ("Proposal"). Discover Bank is one of the largest issuers of general purpose credit cards in the United States. Discover Bank, a subsidiary of Discover Financial Services, is chartered by the State of Delaware. As one of the nation's largest insured depository institutions, with deposits of $35 billion as of May 31, 2010, Discover Bank is vitally interested in the FDIC's Proposal to change the way the FDIC differentiates for risk in the deposit assessment system.

I. FDIC Should Withdraw Proposal Based on Reform Act

Discover Bank supports the FDIC's efforts to make the deposit assessment system more sensitive to risks assumed by individual insured depository institutions. As of the date of this comment letter, it appears that the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Reform Act") may become law. Two provisions of the Reform Act suggest that the FDIC withdraw the Proposal and start anew in developing an assessment system for large insured institutions.

First, Section 331 of the Reform Act 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. The change of assessment base under the Reform Act would substantially increase the assessment base. Therefore, everything else being equal, to achieve the same targets for the Deposit Insurance Fund, the premium assessment rates would decline significantly due to the Reform Act's substantial increase in the Deposit Insurance Fund assessment base. The FDIC noted in the Proposal 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 the Reform Act ensures there will have to be another round of rulemaking as the Reform Act would invalidate many of the assumptions and analyses underlying the Proposal. As such, the FDIC should withdraw the Proposal if the Reform Act becomes law.

Second, Section 1506 of the Reform Act 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. As set forth below, Discover Bank believes that brokered deposits can be an important source of funding and liquidity if prudently managed. Discover Bank would welcome the opportunity to provide information on the use of brokered deposits in connection with the FDIC study.

II. APPLICATION OF BROKERED DEPOSIT ADJUSTMENT TO LARGE RISK CATEGORY I BANKS

A. Background

The Proposal includes a provision that would extend the existing brokered deposit adjustment that applies to Risk Category II, III and IV banks that have brokered deposits in excess of 10% of total deposits to all large banks, including Risk Category I banks. For the following reasons, which are discussed below, Discover Bank disagrees with the proposed extension of the brokered deposit adjustment to large Risk Category I banks:

1. Application of the brokered deposit adjustment to large Risk Category I banks lacks empirical support.

2. Application of the brokered deposit adjustment to large Risk Category I banks is inconsistent with the reasoning in the 2009 amendment to the deposit assessment system.

3. The Proposal already contains adjustments for use of brokered deposits, including possible discretionary adjustments.

In addition, if the brokered deposit adjustment provision is not removed, Discover believes that a transition period should be provided.

Since the launch of the Discover Card, Discover Bank has been an innovator in providing lending products to consumers. Discover Bank was the first credit card lender to offer a no-fee card, and has been a leader in rewards cards, particularly through its Cashback Bonus program. Discover Bank does not have a branch network and has obtained funding through the brokered deposit channel for 20 years. The stability, pricing and flexibility provided by this funding channel has supported Discover Bank's ability to provide attractive, competitive lending products to consumers.

As discussed below, the Proposal inappropriately increases the costs of using the brokered deposit channel without regard to the actual risk to the insurance fund presented by a specific insured institution. In addition, by imposing additional assessments on brokered deposits as proposed, insured institutions may be influenced to choose other funding sources even though brokered deposits could provide prudent, cost-effective liquidity and funding diversification for banks that have the risk management infrastructure and controls to use brokered deposits appropriately.

Further, there is already a legislative framework that addresses risks associated with use of brokered deposits. The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") adopted the current restrictions on the acceptance of brokered deposits by insured institutions. "Well capitalized" insured institutions can accept brokered deposits without restriction. "Adequately capitalized" insured institutions can accept brokered deposits only with a waiver from the FDIC. Discover Bank believes that this framework, the supervisory and examination framework used by the banking agencies, and certain provisions in the Proposal, give the FDIC sufficient tools to control the use of brokered deposits by riskier insured institutions and to increase assessments for such institutions.

B. Application of Brokered Deposit Adjustment to Large Risk Category I Banks Lacks Empirical Support

Financial institutions that are considered low risk banks under the existing deposit assessment system (Risk Category I banks) are currently not subject to the brokered deposit adjustment to which Risk Category II, III and IV banks are subject. The Proposal extends the brokered deposit adjustment to Risk Category I institutions, which can subject such institutions to up to a 10 basis point increase in their deposit assessment rate.

The Proposal does not provide any empirical support or analysis for the extension of the brokered deposit adjustment to include Risk Category I financial institutions when the brokered deposits of such institutions exceed 10% of total deposits. In fact, the Proposal suggests that there is not a statistically significant relationship between a large bank having greater than 10% brokered deposits and exposure of the insurance fund. In this regard, the FDIC's own data provided in the Proposal under Tables 1.2 and 1.3 suggest that the risk measure identified as "brokered deposits/total domestic deposits" does not meet the test of being statistically significant. As such, the Proposal does not clearly achieve the FDIC's objective of drawing "finer distinctions among large institutions based upon the risk that they pose." Further, it strongly argues against imposing the brokered deposit adjustment to large Risk Category I banks.

The lack of empirical support for extending the brokered deposit adjustment to large Risk Category I banks is not surprising as it underscores that banks can and do make prudent use of brokered deposits. One form of brokered deposit, certificates of deposit ("CDs") obtained through relationships with retail securities firms, have certain characteristics that give them a stability not found in other deposit channels. First, brokered CDs are sold through the wealth management systems of retail securities firms that have brick-and-mortar characteristics similar to bank branch networks with the added benefit of providing access to higher net worth individuals. Second, as a result of the limited early withdrawal features and the existence of a secondary market, retail brokered CDs provide a stable, reliable source of funding. In this regard, CDs issued in the retail brokered CD market permit early withdrawal only upon the death or adjudication of incompetence of the depositor. As an alternative to early withdrawal, CD holders can liquidate their CDs in a secondary market offered by most brokers to their customers. Because CD holders have a means to liquidate their CDs as an alternative to early withdrawal, an insured institution can issue CDs with longer maturities without the potential of facing early withdrawal demands. So, funds obtained in this market can be expected to remain with the issuing bank until maturity.

This inherent stability in brokered CD funding creates a platform for this funding channel to be a strong funding and liquidity risk management tool. Although certain banks may have used brokered deposits to build assets in a manner that represented an unsafe and unsound practice, there are appropriate uses of the brokered deposit channel, particularly where used to fund prudently managed asset strategies. For banks like Discover Bank, the ability to issue stable, longer term CDs with appropriate maturity profiles for the institution's asset classes permits the bank to match liabilities to assets and to stagger maturities to manage liquidity and funding risks. The weekly rate posting process used in the brokered CD market facilitates the sale of CDs with maturity profiles consistent with a bank's maturity targets. As of May 31, 2010, the weighted average maturity of Discover Bank's brokered CDs was approximately 24 months in sharp contrast to potentially riskier institutions that have used this market to grow rapidly through short term deposit funding.

This underscores that there is a broad spectrum of potential uses of the brokered deposit market, including uses that promote the stability and safety and soundness of the insured institution. In the Proposal, the FDIC takes a one size fits all approach by penalizing use of brokered deposits without properly considering the form of such deposits or how such deposits are used. The inherent characteristics of the market are consistent with the view that the market itself is a stable, efficient source of funding that, when prudently used, can be an important component in a financial institution's overall funding program. As the FDIC has previously stated, brokered deposits are not the problem, it is how brokered deposits are used by the financial institution:

> In point of fact, the problem is not brokered deposits per se, but how these funds, like any other funds, are used. A dollar deposited in an insured institution is the same whether obtained directly from a local depositor or through the intermediation of a deposit broker. There may be differences in the cost and stability of that dollar deposit depending on its source. However, losses in

> banks do not occur, generally speaking, by virtue of the source of their deposit liabilities. Instead, the losses arise from the quality of and return on loans and investments made with those funds. Consequently, the focus of attention should be on the employment of brokered deposits rather than their source.[1]

And also:

> The prudent use of brokered deposits within legal requirements is entirely acceptable. Brokered deposits should be treated and assessed as any other funding alternative having its own special advantages and disadvantages. Furthermore, the acceptance of brokered deposits should not be grounds for criticism per se by virtue of the nature or origin of such deposits without considering the manner in which they are used and the impact of such use on the institution's overall condition and operations.[2]

C. Application of Brokered Deposit Adjustment to Large Risk Category I Banks Is Inconsistent with Reasoning in 2009 Amendment

The application of the brokered deposit adjustment to large Risk Category I banks is not supported by the reasoning set forth in the 2009 amendment to the deposit insurance assessment system (the "2009 Amendment") when the adjustment was applied to Risk Category II, III and IV financial institutions. In the 2009 Amendment, the FDIC stated that the brokered deposit adjustment was being applied to weaker institutions because the statutory and market limitations on brokered deposits become much more relevant for financial institutions as they become weaker (i.e., move below Risk Category I) and the risk that the institution will become less than well capitalized has increased. This rationale does not apply to a financial institution that remains a Risk Category I bank and underscores that the application of the brokered deposit adjustment to all Risk Category I banks does not properly differentiate the risks posed by financial institutions. In this regard, under the Proposal, the brokered deposit adjustment is the same for all financial institutions, regardless of their Risk Category or how they use brokered deposits, <u>i.e.</u>, the brokered deposit adjustment is the same for both a well-capitalized and well-managed institution and an institution that is undercapitalized and poorly managed. This is

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1 *Insured Brokered Deposits and Federal Depository Institutions: Hearing before the Subcommittee on General Oversight and Investigations of the House Committee on Banking, Finance and Urban Affair*s, 101st Cong., 1st Sess. (1989), at 98 (statement of L. William Seidman, Chairman of the FDIC).
2 FDIC Interpretive Letter 95-24 (April 26, 1995).

inconsistent with the stated purpose of the Proposal to appropriately differentiate financial institutions based on risk under the assessment system.

D. The Proposal Already Contains Adjustments for Use of Brokered Deposits by Risk Category I Banks, Including Possible Discretionary Adjustments.

The Proposal contains sufficient adjustments and tools to take into account any risk to the insurance fund from the use of brokered deposits by large Risk Category I banks. In this regard, the Proposal includes an increase in the assessment rate for use of brokered deposits since brokered deposits are excluded from the definition of Core Deposits, which results in a decline in the Core Deposit/Total Liabilities ratio and related increase in assessment rate. In addition, imprudent use of brokered deposits could be reflected in lower CAMELS ratings, which would also increase the assessment rate.

Further, under the Proposal, the FDIC has the discretion to adjust the performance score and loss severity score applicable to an insured depository institution upwards or downwards by up to 15 points each. This discretion could be used to tailor the assessment rate of a large Risk Category I bank to the extent the bank were using brokered deposits imprudently.

These provisions of the Proposal permit the FDIC to tailor the assessment rate applicable to a large Risk Category I bank to the extent that the FDIC believed that the assessment rate otherwise did not account for the risk of brokered deposit use. Further, this approach, in contrast to the undifferentiated application of the brokered deposit adjustment, is more consistent with the stated purpose of the Proposal to differentiate assessments by risk.

E. At a Minimum, a Transition Period Should be Provided.

If the brokered deposit adjustment is not removed from the final rule, the FDIC should include a transition period to permit insured depository institutions to adjust their balance sheets to reflect the added costs of brokered deposit funding. Because brokered deposits are often in the form of certificates of deposit, this transition period should be long enough to allow for such deposits to mature and be replaced with other funding. For example, at Discover, the weighted average maturity of brokered CDs as of May 31, 2010 was approximately 24 months**.** Financial institutions will also need time to expand other funding channels to replace maturing brokered deposits. For these reasons, a transition period of 2-3 years would be appropriate.

Respectfully submitted,

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