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January 3, 2011

Via Electronic Delivery

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

Attention: Comments

Re: RIN 3064-AD66: Notices of Proposed Rulemaking — Deposit Insurance Assessment Base and Rates and Large Bank Pricing

Dear Mr. Feldman:

The Clearing House Association L.L.C. ("*The Clearing House*"),[1] an association of major commercial banks, appreciates the opportunity to comment on the Notices of Proposed Rulemaking issued by the Federal Deposit Insurance Corporation ("*FDIC*") to revise the pricing system applicable to large insured depository institutions ("*LDIs*") (the "*Large Bank NPR*")[2] and to revise the deposit insurance assessment base

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1 Established in 1853, The Clearing House is the nation's oldest banking association and payments company. It is owned by the world's largest commercial banks, which collectively employ 1.4 million people in the United States and hold more than half of all U.S. deposits. The Clearing House Association is a nonpartisan advocacy organization representing – through regulatory comment letters, amicus briefs and white papers – the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer and check-image payments made in the U.S. See The Clearing House's web page at www.theclearinghouse.org for additional information.

2 75 Fed. Reg. 72612 (Nov. 24, 2010). For the purposes of this comment letter, unless otherwise indicated, LDIs include both large Insured Depository Institutions ("*Large IDIs*") and Highly

and rates (the "*Assessment Base NPR*"[3] and, collectively with the Large Bank NPR, the "*NPRs*").[4]

Although we appreciate that the FDIC has made some improvements in the Large Bank NPR's approach to assessing LDIs, the Large Bank NPR remains deeply flawed and requires fundamental change to comport with the FDIC's obligation to carry out its statutory mandate to base assessments on risk to the Deposit Insurance Fund (the "*DIF*"). In part, this is a function of the Large Bank NPR's failure to correlate accurately the pricing system with actual risk. In part, this also is a function of the Large Bank NPR's failure to take into account the distortive impact of the radical change in the assessment base in Section 331 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "*Dodd-Frank Act*"). Considered individually, each of these two fundamental flaws in the Large Bank NPR violates the statutory mandate, in Section 7(b)(1) of the Federal Deposit Insurance Act ("*FDIA*")[5] that the assessment system be risk based. When these flaws are aggregated, the departure from the statutory mandate is so pronounced as to place the Large Bank NPR outside the scope of judicial deference. Accordingly, we respectfully submit that the Large Bank NPR requires basic changes to comport with the FDIC's obligation to carry out the statutory standard, and, because these necessary changes are so significant, the FDIC should publish a new notice of proposed rulemaking for public comment. We also believe that certain aspects of the Assessment Base NPR could have negative unintended effects if the FDIC fails to take into account certain crucial considerations, such as the potential for double-counting and for discouraging acquisitions of distressed IDIs by assessing goodwill.

Complex IDIs, as defined in the Large Bank NPR. A Large IDI is defined as an IDI that has had $10 billion or more in total assets for at least four consecutive quarters (other than an insured branch of a foreign bank or a Highly Complex IDI). *Id*. at 72614. A Highly Complex IDI is defined as: (i) an IDI (excluding a credit card bank) that has had $50 billion or more in total assets for at least four consecutive quarters that either (x) is controlled by a parent company that has had $500 billion or more in total assets for four consecutive quarters or (y) is controlled by one or more intermediate parent companies that are controlled by a holding company that has had $500 billion or more in assets for four consecutive quarters, or (ii) a processing bank or trust company that has had $10 billion or more in total assets for at least four consecutive quarters. *Id*. at 72620.

[3] 75 Fed. Reg. 72582 (Nov. 24, 2010).

[4] The Clearing House previously submitted a comment letter on July 16, 2010 (the "*July Comment Letter*") in response to the FDIC's prior notice of proposed rulemaking regarding large bank pricing issued in April 2010 (the "*Original Proposal*"). 75 Fed. Reg. 23516 (May 3, 2010).

[5] 12 U.S.C. § 1817(b)(1).

I. Executive Summary

Collectively, the NPRs represent a fundamental change from past practice, and will result in an estimated additional annual insurance assessment cost of approximately *$3 billion* for our member banks.[6] This represents an approximately 50% increase over current costs. On average, we expect the proposals under the NPRs to increase assessment costs for Highly Complex IDIs and Large IDIs by approximately 50% and 25%, respectively. This results in LDIs bearing approximately 80% of the burden for deposit insurance, up from approximately 70% under the current methodology, with the majority of the incremental assessment costs falling on Highly Complex IDIs. Such a significant shift of the overall burden of assessments to LDIs in the short time frame proposed by the FDIC will destabilize a still-fragile banking system, possibly leading to sudden inflows of insured deposits into the DIF in a manner that increases risk to the DIF, and will destabilize global funding markets.

As a matter of process, both the 45-day comment period for the Large Bank NPR and the implementation period, which would begin on the April 1, 2011 effective date, are too short to provide for the careful and deliberate process necessary to analyze the Large Bank NPR's impact. The NPRs not only represent a change in the assessment system of unprecedented magnitude, but the Large Bank NPR also is exceedingly complex and detailed, posing both significant analytical and implementation issues for both LDIs and the FDIC. The Clearing House is disappointed that the FDIC chose not to extend the comment period for a rulemaking with consequences of such magnitude.[7] At the very least, the FDIC should provide a longer time period for implementation to afford LDIs a chance to ensure prudential implementation of this entirely new assessment system.

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[6] The Clearing House retained McKinsey & Co ("*McKinsey*") to assist in our analysis of the impact of the NPRs on our member banks and the U.S. banking industry. McKinsey had access to the FDIC assessment calculations under the current and proposed assessment methodology, as well as other confidential data, provided by 18 participating IDIs who agreed to participate in our analysis, accounting for approximately 45% of U.S. banking assets at June 30, 2010. The analysis calculated the change in Q2 2010 assessment costs under the current and proposed assessment methodology using actual assessment data from participating IDIs and estimated assessments for other non-participating IDIs. We estimated assessments for non-participating IDIs using the FDIC assessment calculators, leveraging publically available data, Veribanc CAMELS estimates, and peer comparison/expert opinions for other non-public assessment calculator inputs. References to the potential impact of the FDIC's proposals throughout this comment letter refer to this analysis.

[7] The Clearing House requested an extension of the comment period in a letter dated December 10, 2010. This request was denied by the FDIC on December 15, 2010.

Substantively, the FDIC's approach to changing the assessment system remains deeply flawed in the following significant aspects:

- The Large Bank NPR ignores the impact of Section 331 of the Dodd-Frank Act (the so-called Tester Amendment) on the FDIC's statutory mandate to base assessment on risk. The FDIC is not legally authorized to consider risk to the DIF separate and apart from the distortion of risk created by Section 331. Accordingly, the calculation of risk must be adjusted to take into account that distortive impact.

- The Large Bank NPR continues to fall short of satisfying the FDIC's statutory mandate – to base assessments on *actual risk* to the DIF. This failure has a number of manifestations.

- The Large Bank NPR remains based on the inaccurate, unjustified and unjustifiable assumption that large banks inherently pose more risk to the DIF than do small- and medium-sized banks.

- Although the FDIC has provided some additional weight to the loss severity measure, its methodology remains insufficient in acknowledging this important component of risk to the DIF. The arbitrary scaling of the loss severity score and inclusion of the ratio of noncore funding to total liabilities dilute the influence of the loss on failure variable and result in an unrealistically high level of assumed losses for LDIs given failure.

- In addition, the Large Bank NPR's calculation of the loss severity score continues to fail to take into account the loss absorption function of statutorily subordinated liabilities, inappropriately addresses foreign deposits and suffers from a lack of transparency regarding the loss severity measure.

- Certain components of the performance score, such as the growth-adjusted portfolio concentration score, credit quality measure and the balance sheet liquidity ratio, need improvement to ensure that they adequately reflect risk of failure.

- Although the FDIC has made certain improvements in calculating the initial base assessment rate (the "*IBAR*"), some aspects of the calculation are still flawed, including adjustments for unsecured debt, brokered deposits and the FDIC's broad discretionary authority to adjust a large bank's total score.

- Aspects of the Assessment Base NPR could have negative unintended impact on IDIs, such as potential double-counting and discouraging acquisitions of failed and distressed IDIs by assessing goodwill.

- By departing from a true risk-based approach, the deeply discounted assessment rates on small banks could create the very moral hazard for small banks to take too much risk that Section 7(b)(1) of the FDIA was designed to prevent. This outcome is caused by the FDIC's failure to revise the risk-based assessment system for small IDIs to take into account the risk factors demonstrated to cause the failure of such institutions during the recent financial crisis (*e.g.*, heavy concentration in real estate loans and substantial reliance on brokered deposits).

The Clearing House is concerned that the NPRs' results are so disconnected from the empirical record that they reflect an unstated view, totally unsupported, that a small number of large banks were responsible for the collapse of hundreds of smaller banks and the resultant unprecedented losses for the DIF. As the FDIC appreciates, its statutory mandate with regard to assessments has nothing to do with assessing blame but is statutorily limited to actual risk to the DIF. Accordingly, we strongly recommend that the FDIC revise the NPRs to reflect accurately actual risk in the assessment system and publish a new notice of proposed rulemaking for public comment. Absent these revisions, The Clearing House is concerned that the FDIC will inadvertently promulgate a new system of assessing premiums on LDIs that produces perverse consequences for the safety-and-soundness of the U.S. banking system and the DIF.

II. Discussion

A. The comment period for the Large Bank NPR and effective date for its proposals are too short given the Large Bank NPR's complexity and the FDIC's overall significant change to the assessment system for LDIs

As required by Section 331 of the Dodd-Frank Act, the FDIC, through the Assessment Base NPR, changed the assessment base from average domestic deposits to average consolidated total assets minus average tangible equity. This change, combined with the Large Bank NPR, represents a fundamental departure from the FDIC's long-standing practice for deposit insurance assessment and will result in an estimated additional annual insurance assessment cost of approximately *$3 billion* for our member banks. As explained by one of the FDIC's own Board members, the associated changes proposed in the Large Bank NPR to the assessment methodology applicable to LDIs — the scorecard method — are "exceedingly complex."[8] The Clearing House

[8] John Walsh, the Acting Comptroller of the Office of Comptroller of the Currency and a member of the FDIC's Board, acknowledged that the NPRs propose "a sea change" and are "exceedingly complex." *See* FDIC board meeting of November 9, 2010, *available at*

acknowledges the FDIC's attempt to streamline the Large Bank NPR (*e.g.*, by removing the outlier add-ons, simplifying the discretionary adjustment, etc.). Nonetheless, market participants need more time to implement the Large Bank NPR because it poses both significant analytical and implementation issues that need to be carefully and properly analyzed.

Although there was no specific deadline for this rulemaking in the Dodd-Frank Act, the FDIC provided for only a 45-day comment period for the Large Bank NPR. Because of the Large Bank NPR's complexity and the substantial impact of the change in the assessment methodology on the safety and soundness of LDIs, such a short time frame is both arbitrary and capricious and does not provide for the careful and deliberate process necessary to analyze the impact of the Large Bank NPR. The Clearing House submitted a comment letter on December 10, 2010 requesting an extension of the comment period to February 22, 2011, and we were disappointed that our request was denied. Our member banks will continue to analyze the significant effects of the Large Bank NPR and hope that the FDIC will remain flexible in hearing the concerns of the LDIs most impacted by these proposed changes.

At the very least, The Clearing House recommends that the FDIC extend the effective date of the proposals contained in the Large Bank NPR from April 1, 2011 to a date that is one year from the date that the FDIC adopts a final rule. An extension will afford the FDIC, other primary regulators and LDIs an appropriate opportunity to analyze the Large Bank NPR's impact on business activities and to implement the necessary operational systems and analytical methodologies to ensure prudent implementation of the Large Bank NPR. Doing so would allow the FDIC to coordinate with other federal agencies, including the Financial Stability Oversight Council and the Board of Governors of the Federal Reserve System ("*Federal Reserve*"), in the context of implementing various mandates of the Dodd-Frank Act regarding heightened supervision of LDIs.[9] An extension of the implementation date also would permit the FDIC to incorporate changes in certain components of the assessment system (*e.g.*, tangible equity, counterparty exposure) that are based on definitions that were very recently revised by the Basel Committee. In addition, an extension will ensure a full analysis of the interaction of the various rules proposed under the Dodd-Frank Act to avoid adverse effects as banks manage the revised assessment system.

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http://www.vodium.com/MediapodLibrary/index.asp?library=pn100472_fdic_boardmeetings&SessionArgs=0A1U0100000100000101.

[9] These include, among others, Title I of the Dodd-Frank Act and the heightened prudential regulation, capital and liquidity requirements for systemically important financial institutions; requirements for large institutions to adopt recovery and resolution plans that will help prevent a failure and make any failure more orderly; and Title II of the Dodd-Frank Act and the establishment of the new Orderly Liquidation Authority.

B. The FDIC continues to fail the statutory mandate to base assessments on the actual risk to the DIF

1. Introduction

As the Large Bank NPR acknowledges, Section 7(b)(1) of the FDIA requires that the assessment system be risk-based and that the risk have two essential components: (i) the potential of failure of a bank as reflected in the probability of loss due to the composition and concentration of the institution's assets and liabilities and (ii) the likely amount of any loss on failure.[10] This mandate is absolute, and was designed to "significantly moderate the risk taking of insured financial institutions."[11] Although the FDIC has discretion in developing the system, it must be risk-based.

The Clearing House respectfully submits that, for two basic reasons, the assessment methodology proposed in the Large Bank NPR does not satisfy the FDIC's statutory mandate – to base assessments on actual risk to the DIF. The first reason is that the Large Bank NPR fails to make any adjustment for the risk-distortive impact of Section 331 of the Dodd-Frank Act. The second reason is that the calculations in the Large Bank NPR are demonstrably flawed.

2. Failure to Adjust for Section 331

As discussed in the July Comment Letter, the empirical record of actual bank failures demonstrates that the Original Proposal substantially overstated the relative risk that Highly Complex IDIs posed to the DIF in comparison to small- and medium-sized banks.[12] Our view has been further substantiated in recent months, as scores of additional smaller banks have failed.[13] As discussed below, the Large Bank NPR has failed to remedy this fundamental flaw.

Even assuming, however, that the Original Proposal accurately evaluated relative risk, we submit that it is incontrovertible that the Large Bank NPR has failed to account for the subsequent risk-distortive impact of Section 331 of the Dodd-Frank Act. The modest changes in the Large Bank NPR from the Original Proposal do not explicitly

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[10] *See* 75 Fed. Reg. at 72612.

[11] H.R. Rep. 504-54(I), 1989 (U.S.C.C.A.N. 86).

[12] Even if it was just happenstance that Highly Complex IDIs did not fail in the recent financial crisis, for the reasons discussed below in Parts II.B.3.c and II.B.4.a, if a Highly Complex IDI had failed, losses to the DIF, if any, would have been minimal.

[13] From June 1, 2010 to the date of this letter, 79 small IDIs have failed. According to our estimates, those failures resulted in approximately $5.4 billion in losses to the DIF. *See* the FDIC's Failed Bank List, *available at* http://fdic.gov/bank/individual/failed/banklist.html.

or in fact take into account the effect of Section 331 or that the Large Bank NPR is otherwise adjusted for this impact.

It is presumably beyond question that Section 331 has nothing to do with risk. Its sponsor, Senator Tester, made no pretense that the purpose of Section 331 was anything beyond shifting a substantial part of the FDIC assessment burden from small banks to large banks. Not only is there an absence of any legislative history suggesting a correlation between the Tester Amendment and the FDIA's risk-based assessment system, but there is no reliable evidence that size equates to greater risk.[14]

Indeed, both the Large Bank NPR and the Original Proposal repudiate such a concept. They presume that a different evaluative system is required for large banks, not that large size automatically equates to greater risk. Moreover, that evaluation system is highly complex, which repudiates any suggestion of a simplistic correlation of size and risk.

There is no legitimate statutory argument that the Tester Amendment can exist separate and apart from the risk-based requirement, as some sort of independent provision. The risk-based assessment requirement is contained in Section 7(b)(1) of the FDIA. The Tester Amendment amends Section 7(b)(2), which is not an exception to Section 7(b)(1) but contains a number of calculation methodologies. The aggregate of those methodologies must carry out the statutory mandate in Section 7(b)(1).

The impact of the Tester Amendment, which, as discussed above, is not related to risk, is nonetheless substantial with respect to the risk analysis. Assessment costs for Highly Complex IDIs under the Original Proposal issued in April 2010 are generally aligned with assessment costs calculated under the current methodology (*i.e.*, an approximately 30 basis points annual premium on insured deposit balances on average). In stark contrast, the amount of annual FDIC assessments expected to be paid by Highly Complex IDIs under the Large Bank NRP equates to an approximately 45 basis points annual premium on insured deposit balances on average — an approximately 50% increase in assessment costs compared to the Original Proposal or the current methodology. Consequently, for the assessment system as a whole to be risk-based, the FDIC must adjust the Large Bank NPR to shift this excessive additional burden from the Highly Complex IDIs to other banks and appropriately adjust for the impact of the Tester Amendment change in the assessment base. Failure to do so would arbitrarily penalize Highly Complex IDIs with assessments of this magnitude that bear no correlation to Highly Complex IDIs risk to the DIF.

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[14] As discussed below in Part V.B.3.a, empirical analysis suggests a negative correlation between size and risk.

3. Calculation Methodology Flaws

a. The arbitrary bias in the calculation methodology against large banks produces an assessment structure that deviates markedly from the statutory risk-based mandate

As will be discussed in the following subsections, there are numerous flaws in the calculation methodology, and almost all result in an increase in the assessment of large banks, and even more so for the very largest banks, in relation to smaller banks. In the aggregate, the differential is extraordinary. We estimate that under the NPRs, Highly Complex IDIs will be assessed approximately 45 basis points annually on their insured deposits, Large IDIs will be assessed approximately 30 basis points annually on their insured deposits and small IDIs with assets below $10 billion will be assessed approximately 15 basis points annually on their insured deposits.[15]

This produces a distortion of actual risk to the DIF and thereby violates Section 7(b)(1) of the FDIA. In the years of 2006 to 2009, failures of IDIs resulted in $57 billion of losses to the DIF. Among those failures, however, losses caused by Highly Complex IDIs were zero, losses caused by Large IDIs accounted for about 1.5% of Large IDIs insured deposits,[16] while losses caused by small IDIs accounted for about 1.5% of small IDIs' insured deposits.[17] The only reasonable conclusion that can be derived from this analysis is that the assessment differential should be reversed, with smaller banks being assessed at a higher rate than LDIs.

Accordingly, we submit that the flaws in the calculation methodology should be corrected so that the methodology correlates to the actual, demonstrated risk to the DIF rather than be structured to support an inaccurate and unsupported assumption that large banks inherently pose more risk than do small- and medium-sized banks.

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15 *See* footnote 6 for estimation of assessment costs. Q2 2010 insured deposit balances sourced from CALL and TFR reports. Highly Complex IDIs and some LDIs are also subject to assessment under Title II of the Dodd-Frank Act in the event of a liquidation of a covered financial institution.

16 Remarkably, all of the losses to the DIF since 2007 arose from the failure of IDIs with under $50 billion in assets.

17 Based on FDIC reported losses to the DIF for the period 2006 to 2009; insured deposit balances as of Q2 2010. The fact that the losses caused by the failures of Large IDIs and small IDIs are the same further underscores the point that LDIs do not pose more risk than small IDIs to the DIF on failure.

b. Loss on failure continues to be inappropriately calculated

The Large Bank NPR continues to be predominantly focused on the first component of risk to the DIF (risk of failure) without appropriately incorporating the second component (loss on failure). The resultant distorted evaluation of risk to the DIF was the main criticism in The Clearing House's July Comment Letter. As we pointed out there, the risk of failure is basically irrelevant if the loss on failure is non-existent or minimal. Although we acknowledge the FDIC's attempt to increase the significance of loss on failure by increasing the weight assigned to the loss severity measure, the Large Bank NPR continues to fall far short of appropriately accounting for this component of risk in the assessment methodology.

The loss on failure variable, the "loss severity ratio," is still relegated to merely a component of the total loss severity score — the "loss severity measure." In calculating an LDI's total score for determining its IBAR, the loss severity score (0–100 scale) is converted into a loss severity factor that ranges from 0.8 to 1.2, although the performance score (which measures the probability of failure) stays on a 0–100 scale. The total score is the product of the performance score (0–100 scale) *times* the loss severity factor (0.8–1.2 scale). Accordingly, the loss severity score accounts for only a 20% upward or downward variance in the total score. Furthermore, the true loss on failure variable (the loss severity ratio) is afforded at most a 15% influence on the total score due to the weight of the non-core funding ratio discussed below.

The arbitrary scaling of the loss severity score dilutes the influence of the calculated loss on failure variable (the loss severity ratio). This results in an unrealistically high level of assumed losses for LDIs given failure and, thereby, vastly overstates the potential risk to the DIF. For example, several of our members have a calculated loss severity ratio of zero, yet will face over $2.5 billion in annual assessment costs.[18] In the absence of empirical evidence supporting the disparate treatment of these two scores, the Large Bank NPR's discounting of the loss severity score is arbitrary and without foundation. This approach not only prevents an accurate evaluation of risk of loss to the DIF, but also distorts the assessment process among insured banks.

The Clearing House strongly suggests that the FDIC use a much broader range of probability and fully and appropriately weigh the components for the loss severity score to better align this measure with the FDIC's statutory mandate — to assess IDIs based on actual risk to the DIF. The FDIC fails to provide sufficient substantive evidence to adequately support the current methodology in calculating and scaling the loss severity score under the Large Bank NPR. Although this calculation has a significant element of subjectivity and uncertainty, so, too, does the performance score.

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[18] Represents annualized Q2 2010 assessment costs calculated by our members under the methodology proposed by the NPRs.

This distortion is exacerbated by the proposed methodology's incorporation of a second variable — the "ratio of non-core funding to total liabilities" — in the calculation of loss severity with a 25% weighting. This factor is inversely related to loss severity to the extent that certain of the non-core deposits are statutorily subordinated, and, thus, it further mutes the influence of the loss on failure variable on the total loss severity score.

c. The method for calculating loss on failure remains deeply flawed

Even if the Large Bank NPR's loss severity measure were adequately weighted, the calculation methodology for this measure would be deeply flawed because it continues to fail to take into account the level of statutorily subordinated liabilities in calculating the loss severity score and inappropriately deals with the presence of foreign deposits. The DIF's exposure in the event of a bank's failure is measured by the potential that (i) the excess of (x) the proceeds received by the FDIC from the sale or liquidation of the assets and franchise of the failed bank over (y) secured and other claims senior to the FDIC claims as subrogee of insured depositors is less than (ii) the sum of such FDIC claims and the other liabilities that rank *pari passu* with such FDIC claims. Accordingly, if a failed bank has substantial liabilities that are statutorily subordinate to the FDIC's claims, the DIF's exposure is eliminated or substantially reduced.

Because almost all Highly Complex IDIs and a number of other LDI's have very substantial liabilities that are statutorily subordinate to the FDIC's claims — in contrast to the low amounts of such liabilities at small- and medium-sized banks — the DIF's exposure of loss is far lower in the case of these LDIs relative to small- and medium-sized banks because of the differences in their liability structures. Accordingly, the absolute risk of loss to the DIF is also very low and is not proportionate to, and, indeed, is totally disconnected from total assets.[19] The Large Bank NPR fails to account for the loss absorption benefits of these liabilities for insured depositors in the event of failure, and we do not understand how this issue can be ignored under a mandated risk-based system.

We estimate that approximately 38% of Highly Complex IDIs liabilities are statutorily subordinated to the FDIC claims, and that these institutions have equity of approximately 10% of assets. This means that the losses on assets must exceed about 45% for the FDIC to suffer a loss from the failure of a Highly Complex IDI. In comparison, of the 19 LDIs that failed or needed substantial government assistance from 2006 to

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[19] Although this issue was raised in the July Comment Letter, the Large Bank NPR provides no discussion whatsoever of the issue. With all due respect, this crucial issue cannot be ignored, and, if this issue were taken into account in developing the Large Bank NPR, basic principles of administrative law and jurisprudence seemingly mandate that the FDIC present its analysis.

2009, in no instance did the FDIC experience DIF losses as a percentage of IDI assets above 45% — in fact, only two LDI failures resulted in DIF losses greater than 25% of assets.[20] In this light, it is simply not credible for insurance assessment calculations to ignore the loss absorption benefits of Highly Complex IDI balance sheets structures for insured depositors in the event of failure.

The Clearing House also continues to be concerned about the assumptions used in, and the lack of transparency regarding, the Large Bank NPR's calculation of the loss severity measure. This critical measure is based on a standardized set of assumptions regarding liability runoffs and the recovery value of asset categories. These assumptions are applied to the institution's balance sheet for a given quarter to measure possible losses to the FDIC in the event of the institution's failure. However, the assumptions used by the FDIC are based predominantly on failures of small banks in the past several years whose balance sheets have vastly different characteristics than those of large banks, thereby posing very different risks to the DIF.[21] Those failed banks generally had a heavy concentration in real estate loans and substantial reliance on brokered deposits. The Clearing House notes that, during the financial crisis, the only truly large depository institution to fail, Washington Mutual, resulted in *no* net loss to the FDIC.

The Clearing House is particularly troubled by the Large Bank NPR's unsupported and overly conservative assumption that LDIs with foreign deposits would lose 80% of such deposits upon failure. There is no empirical data of large banks' failure presented to support this and the other assumptions. In addition, the assumptions are derived using the FDIC's own internal, undisclosed metrics. The Clearing House continues to believe that the assumptions underlying this important measure should be transparent and the FDIC should provide sufficient statistical supporting analysis to validate its assumptions.[22]

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20 Based on the FDIC reported losses to the DIF for the period 2006 to 2009; balance sheet data for Highly Complex IDIs sourced from the FDIC Statistics on Depository Institutions ("*SDI*") as of June 30, 2010; calculation of statutorily subordinated liabilities does not treat unsecured foreign deposits as secured liabilities — contrary to the FDIC's treatment of these liabilities as secured at the time of failure in its calculation of the loss severity ratio.

21 *See* Rosalind L. Bennett, *Evaluating the Adequacy of the Deposit Insurance Fund: A Credit-Risk Modeling Approach*, the FDIC working paper 2001-02, *available at* http://www.fdic.gov/bank/analytical/working/wp2001_02/workingpaper2001-02.pdf, page 35.

22 Such transparency would be consistent with the FDIC's stated policy regarding the rulemaking process under the Dodd-Frank Act. *See* FDIC press release of August 12, 2010, *FDIC Announces Open Door Policy for Regulatory Reform Rulemaking*, *available at* http://www.fdic.gov/news/news/press/2010/pr10187.html.

Moreover, the second component of the loss severity score — the ratio of noncore funding to total liabilities — suffers from two critical defects. As an initial matter, we question the FDIC's basis for including this measure at all. The only support noted in the Large Bank NPR is the FDIC's *belief* that "heavy reliance on secured liabilities or other types of noncore funding reduces an IDI's potential franchise value, thereby increasing the FDIC's potential loss in the event of failure."[23] The Large Bank NPR contains no reasoning or supporting evidence regarding the impact of these noncore funding sources or any basis for the underlying assumption that all types of "noncore" funding create an equal loss of franchise value. In addition, The Clearing House strongly believes that foreign deposits should not be included as a noncore deposit because the FDIC has not demonstrated that foreign deposits are more volatile than domestic deposits. Accordingly, The Clearing House recommends that the FDIC should revise this component to exclude foreign deposits and reduce the weight of this component to 10% or less in factoring the loss severity score.

d. Certain components of the performance score fail to adequately reflect risk of failure

The Large Bank NPR employs various measures, including CAMELS ratings and numerous financial ratios, to determine the risk of failure of LDIs in calculating the performance score. Certain of these measures, such as the growth-adjusted portfolio concentration score, credit quality measure and the balance sheet liquidity ratio, need improvement to ensure that they adequately reflect risk of failure.

To measure an LDI's ability to withstand asset-related stress, the Large Bank NPR uses, among others, two measures: concentration measure and credit quality measure. Both measures are designed to take the higher score of two sub-components. For the concentration measure, the concentration score will be the higher score of (i) the ratio of higher-risk assets to Tier 1 capital and reserves and (ii) the growth-adjusted portfolio concentrations measure score.[24] For the credit quality measure, the asset credit quality score will be the higher of (x) the ratio of criticized and classified items to Tier 1 capital and reserves and (y) the ratio of underperforming assets to Tier 1 capital and reserves.[25]

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23 75 Fed. Reg. at 72618 (emphasis added). Once again, this belief may be derived from the FDIC's experience with small banks, which have very different characteristics than LDIs.

24 For Highly Complex IDIs, the concentration score will be the higher score of (i) the ratio of higher-risk assets to Tier 1 capital and reserves, (ii) the ratio of top 20 counterparty exposure to Tier 1 capital and reserves and (iii) the ratio of largest counterparty exposure to Tier 1 capital and reserves. 75 Fed. Reg. at 72647.

25 *Id*.

The Large Bank NPR proposes to use the three-year, merger-adjusted portfolio growth rates in the calculation of the growth-adjusted portfolio concentrations measure score.[26] The FDIC should exclude the impact of Financial Accounting Standards Nos. 166 and 167, which inflates the real growth rate by applying a change in accounting convention to consolidate certain securitizations and special-purpose entities, from the three-year, merger-adjusted portfolio growth rates. This impact is simply the result of a one-time accounting rule change, and it does not represent real business growth or increase in risk.

The Clearing House also submits that an average of the two sub-components in each of the concentration measure and credit quality measure should be used, instead of taking the higher of the two sub-components for each measure. An average score will better reflect the actual risk posed by an LDI. An LDI with high scores for both sub-components clearly poses more risks than an LDI with one high score and one low score. However, under the Large Bank NPR, those two banks would be treated as presenting the same risk and face the same impact to their assessment rate.

With regard to the balance sheet liquidity ratio included in the ability to withstand funding-related stress measure, The Clearing House suggests that agency backed available-for-sale residential mortgage securities should also be included in the composition of the balance sheet liquidity ratio (in addition to the assets listed in the Large Bank NPR). Markets for these assets are highly liquid. In this regard, we note that the Basel Committee has included such securities for the purposes of calculating the liquidity ratio.[27]

4. The Proposed Adjustments to the IBAR Are Still Flawed

In addition to changes in the assessment base, rates and the large bank scorecard system discussed above in this Part II.B, the FDIC also revisited and revised certain adjustments to the IBAR. These adjustments are discussed and proposed in the Assessment Rate NPR and the adjustments apply in the same manner to LDIs under the Large Bank NPR. The Large Bank NPR contains some improvements to the adjustments, such as abandoning the adjustment for secured liabilities and increasing the weight and cap for the adjustment on unsecured debt. The Clearing House appreciates the FDIC's efforts in this regard, but respectfully submits that the adjustments still contain certain flaws as discussed below.

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[26] *Id*.

[27] *See* Basel Committee on Banking Supervision, *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring*, *available at* http://www.bis.org/publ/bcbs188.pdf, page 9.

a. Unsecured debt

As described above in Part II.B.3.c of this letter, the liabilities that are statutorily subordinate to the FDIC's claims provide a cushion that reduces the FDIC's loss in the event of a failure. The FDIC recognizes this principle and proposes a reduction in assessment rate for long-term unsecured debt. By raising the multiplier and cap for unsecured debt adjustment (which we appreciate), the FDIC recognizes that the greater the amount of unsecured debt, the lower is the FDIC's risk of loss. However, the NPRs' proposal is far from implementing this principle in full.

The Clearing House strongly recommends that the FDIC provide complete recognition and use all unsecured debt of an institution as a measure of risk in calculating assessment and not, as currently contemplated, only long-term unsecured debt instruments. In the event of a failure, short-term debt absorbs loss upon failure, and thereby affords the FDIC protection, just as well as long-term debt.[28]

In addition, we recommend a downward adjustment for the presence of foreign deposits. Under the Assessment Base NPR, such deposits will be charged assessments because they support the total assets of a bank. However, under the Depositor Preference Act, 12 U.S.C. § 1813, foreign deposits are subordinate to the FDIC's claims and would absorb loss in the event of failure. The NPRs fail to take into account the loss absorption benefits of these liabilities. Assessing these non-U.S. deposits will make it difficult for U.S. banks to compete with local banks for these foreign deposits because of the incremental FDIC tax (particularly at the proposed much higher level). As a result, the presence of non-U.S. deposits at U.S. banks will decline. Such a result is harmful because it discourages an important source of liquidity for banks, it harms the ability of U.S. banks to serve global customers, and it may increase risks to the DIF by reducing the loss absorbency benefits of non-U.S. deposits.

Consequently, we recommend that the FDIC take into account all liabilities that are statutorily subordinate to the FDIC's claims in the event of a failure in determining a downward assessment rate adjustment. At the very least, we suggest that the FDIC provide a downward adjustment for the presence of foreign deposits, which have now effectively become assessed as a result of the Tester Amendment.

b. Brokered deposits

The Clearing House agrees with the FDIC that a bank poses more risk to the DIF when it relies heavily on brokered deposits that do not constitute a stable source of funding, thereby justifying an upward adjustment. We respectfully submit,

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[28] If only the adjustment for long-term unsecured debt remains, we suggest that the FDIC define the long-term unsecured debt by looking at a debt's original maturity rather than the remaining maturity.

however, that the FDIC's definition of "brokered deposits" is overbroad and discourages banks from accepting deposits that are a stable source of funding. It is our understanding that our member banks did not experience any runoff of such deposits during the recent financial crisis.

Assessment rates should take into account "classic" brokered deposits, and that the FDIC should continue to attack the "hot money" problem by restraining a weak bank's ability to attract additional deposits by raising rates. The Clearing House submits, however, that the adjustment should not discourage healthy banks from participating in programs that deliver stable deposits. Examples of such programs include arrangements pursuant to which balances are swept into an insured depository institution from brokerage accounts (i) at an affiliated broker-dealer or (ii) by an independent administrator subject to examination by the insured institution's primary federal regulator, where the administrator selects the insured institutions that receive the deposits based on objective criteria designed to ensure that the insured institutions are well capitalized and well managed. Another example of stable brokered deposits is brokered time deposits with longer term contractual maturities, such as long-term certificates of deposits. Accordingly, we respectfully submit that such swept deposits and long-term brokered time deposits should be excluded from the FDIC's definition of "brokered deposits." These deposits behave less like brokered deposits and more like core deposits.

5. Other

a. The Assessment Base NPR overlooks double-counting and discourages acquisitions of distressed IDIs by assessing goodwill

In the Assessment Base NPR, the FDIC implemented the statutory mandate to change the assessment base to average consolidated total assets minus average tangible equity. The Clearing House appreciates the FDIC's difficult task in defining the components of this new assessment base, and we applaud the FDIC for taking a logical and realistic approach in defining the assets of custodial banks excluded from such bank's assessment base. We submit, however, that the Assessment Base NPR needs to address the potential for double-counting of inter-company loans between sister IDIs and discouraging bank acquisitions by assessing goodwill.

In the Assessment Base NPR, the FDIC explicitly acknowledges the potential for double-counting when determining the consolidated assets of parent IDIs with consolidated IDI subsidiaries.[29] However, the FDIC overlooks a potential double charge for inter-company loans between sister IDIs. The following hypothetical example

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[29] 75 Fed. Reg. at 72584.

illustrates the point. Bank X lends $1 million in cash to Bank Y. For Bank X, its total assets do not change and the only change on its balance sheet is the form of the assets from cash to a receivable. For Bank Y, it adds $1 million cash to its assets. Under the Assessment Base NPR, the same $1 million will be included in both Bank X's and Bank Y's assets at the same time, and will be assessed twice by the FDIC. The Clearing House recommends that such transactions be excluded from the average consolidated assets of one of these two institutions to avoid double-counting.

We are also concerned about possible unintended consequences of assessing goodwill. Because average consolidated total assets, for purposes of the assessment base, is defined in the Assessment Base NPR as total assets minus tangible equity,[30] both tangible and intangible assets (*e.g.*, goodwill) are included as part of the assessment base. We note that banks' regulatory capital ratios, in the interest of symmetry, exclude goodwill from *both* the capital base and total assets, and that approach seems equally appropriate here. Moreover, goodwill does not represent a true risk to the DIF and including goodwill in the assessment base may discourage IDIs from acquiring failed or less-healthy IDIs, and therefore increases the risk of loss to the DIF. Accordingly, The Clearing House recommends that goodwill be excluded from the definition of average consolidated assets.

b. FDIC discretionary authority

The Clearing House commends the FDIC's efforts to streamline the adjustment process by adjusting only the total score instead of both performance score and loss severity score in the Large Bank NPR. The Clearing House also supports the Large Bank NPR's proposal that the FDIC will not adjust assessment rates until the associated guidelines are approved by the FDIC's Board after public comment, and we look forward to commenting on these guidelines.

We are still concerned, however, that the FDIC's broad discretionary adjustment authority creates too much uncertainty and could be used to penalize a specific institution. The potential impact of adjustment up or down by 15 points is substantial. A decrease in total score by 15 points would reduce LDIs assessment rates by 6 basis points on average. Conversely, an increase in total score by 15 points would increase LDI assessment rates by 9 basis points on average. Because of the non-linear relationship between the score and the assessment rate, an adjustment to total score has significantly more ability to raise an IDI's overall assessment than the ability to decrease an IDI's overall assessment. The Clearing House is particularly concerned about the ability of the 15 points score adjustment to be used to penalize or tax LDIs. For LDIs, an increase in total score by 15 points would translate into an approximately 60% increase in the assessment fee for such institutions on average.

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[30] 75 Fed. Reg. at 72591.

Accordingly, The Clearing House believes that the FDIC should give serious consideration to eliminating in the final rule the FDIC's discretionary authority. We strongly recommend that, if discretion is retained, the FDIC's proposed guidelines on the adjustment authority (for a downward adjustment or, if rejected, any adjustment) require concurrence by the institution's primary banking regulator (as opposed to just consultation). At the very least, if only consultation with the institution's primary regulator remains, the FDIC should stipulate deference to the primary regulator as a principle in the associated guidelines.

c. The NPRs could create a moral hazard for small banks to take too much risk

The risk-based assessment was introduced in Section 302 of the Federal Deposit Insurance Corporation Improvement Act ("*FDICIA*") in 1991. It was designed to remedy the moral hazard problem in the deposit insurance system and to "significantly moderate the risk taking of insured financial institutions."[31] Prior to the FDICIA, all insured institutions paid the same flat premium regardless of the riskiness of their operations and therefore, riskier banks would receive a subsidy for using more "insurance services" than less risky banks.[32] This may have resulted in imprudent risk-taking and contributed to the numerous depository institution failures in the 1980s.[33]

In the proposed assessment system under the NPRs, Highly Complex IDIs and Large IDIs will face a significant increase in their assessment burdens (from 30 and 25 basis points to 45 and 30 basis points, respectively) while small IDIs will receive a deep discount (from 20 basis points to 15 basis points), notwithstanding the hundreds of recent small bank failures. Therefore, the subsidy to small IDIs created by the NPRs could create a moral hazard for these small banks to take too much risk, which contravenes a basic objective of the risk-based assessment system.

III. Conclusion

The Clearing House acknowledges the difficulty of the task facing the FDIC to implement the Dodd-Frank Act's mandate and appreciates that the FDIC has

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31 H.R. Rep. 504-54(I), 1989 (U.S.C.C.A.N. 86). *See also* Antoine Martin, *A Guide to Deposit Insurance Reform*, the Kansas City Federal Reserve Research Publication-Economic Review (1st Quarter 2003), *available at* http://www.kansascityfed.org/publicat/Econrev/PDF/1q03mart.pdf, page 29.

32 *See* Marcia Millon Cornett et al., *The Impact of Risk-Based Premium on FDIC-Insured Institutions*, Journal of Financial Services Research 13:2 153-169 (1998), page 155.

33 *See* Antoine Martin, *A Guide to Deposit Insurance Reform*, the Kansas City Federal Reserve Research Publication-Economic Review (1st Quarter 2003), *available at* http://www.kansascityfed.org/publicat/Econrev/PDF/1q03mart.pdf, pages 32-35.

made some improvements regarding large bank pricing since the Original Proposal. Nonetheless, the dramatic departure from the long-standing assessment base, the complexity of the scorecard system and the substantial adverse impact of the NPRs on the profitability of LDIs require a thorough and deliberate analytical process to ensure that the final rules meet statutory requirements, meet the FDIC's goals and minimize safety and soundness risk. We respectfully submit that the FDIC delay the effective dates for one year from the date of the final rule to allow affected LDIs to work out various implementation issues.

Substantively, we submit that the FDIC should take into account the distortive impact of the radical change in the assessment base in Section 331 of the Dodd-Frank Act, and correlate accurately the pricing system with actual risk to the DIF. Without robust statistical support, the NPRs' extraordinary shift in the assessment burden from small banks to large banks is inconsistent with the FDIA's mandate that the assessment be risk-based. We respectfully recommend that the FDIC revise the NPRs to remedy the flaws discussed in this letter, including, among others, the arbitrary scaling of the loss severity score, failure to consider the loss absorption function of statutorily subordinated liabilities in the loss severity score's calculation, failure to appropriately deal with foreign deposits and brokered deposits, potential double-counting between sister IDIs and the FDIC's broad discretionary adjustment authority, and focus on the real risk posed by IDIs, both large and small, to the DIF.

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Thank you for considering the views expressed in this letter. We appreciate the opportunity to share our views and would be pleased to discuss any of them further at your convenience. If you have any questions, please contact Joseph Alexander at (212) 612-9234 (email: joe.alexander@TheClearingHouse.org) or Eli Peterson at (202) 649-4602 (email: eli.Peterson@theclearinghouse.org).

Sincerely,

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