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September 11, 2015

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

Re: Proposed Rule on Assessments (12 CFR §327); RIN 3064–AE37

Dear Mr. Feldman:

The California Bankers Association is a non-profit organization that represents most of the FDIC-insured financial institutions doing business in California, and is submitting these comments on our member banks' behalf. CBA appreciates the work that the FDIC has put into developing a more risk-based deposit insurance system. Its efforts have resulted in a new proposal ("Proposal") aimed at revising the way that small banks are assessed. This effort is made possible by the availability of data collected from the over 500 banks that have failed since the end of 2007 and the hundreds more during the banking crisis of the late 1980s and early 1990s.

Introduction

The FDIC explains its justification for the Proposal in this way: "While the current deposit insurance assessment system effectively reflects the risk posed by small banks, it can be improved by incorporating newer data from the recent financial crisis and revising the methodology to directly estimate the probability of failure three years ahead." A key goal of the Proposal is to reduce "cross-subsidization" of higher risk banks by lower-risk banks.

CBA concurs that the core aims of FDIC deposit insurance must include the effective and efficient assessment of risk-based premiums. A system is effective if the incentives it creates align with the goals of maintaining depositor confidence. A system is efficient if in doing so it minimizes over-taxation of activities that do not pose risks to the fund (or, worse, activities that are in fact beneficial), and if it minimizes moral hazard—that is, it reduces incentives by banks to accept more risk because the costs are borne by others.[1] Thus, the FDIC's changes should neither assess too broadly so as to suppress productive activities nor assess insufficiently so as to allow risky behavior to be subsidized by less risky banks.

The FDIC has helpfully released an assessment calculator to let banks determine how the Proposal will affect their premiums. Preliminarily, the feedback we received from CBA member banks that we know to be healthy suggests that their premiums would be lowered under the Proposal. To the extent that this is a result of more proper alignment between assessments and risk, the Proposal moves in a direction that we support. Nevertheless, the most salient data available to the FDIC about the risk profile of banks is not from CALL Reports or even, derivatively, from its resolution activities. Rather, the most comprehensive and relevant information available regarding individual banks by a long shot is obtained from examinations.

The FDIC and other prudential regulators and the banks dedicate a great deal of resources to the examination process wherein each and every bank is assessed on several sets of criteria on an individual basis. Much of the FDIC's analysis about industry-level risks to the insurance fund is captured at the bank level in the CAMELS ratings. It is axiomatic that the strength of prudential regulation and supervision complements the effectiveness of deposit insurance. Strong prudential supervision ensures that an institution's weaknesses are promptly identified and corrected, thus helping to lower the costs associated with bank failures. Therefore, as we will discuss in greater detail below, the effectiveness of the insurance system would be improved to the extent that it relies more on reliable and salient CAMELS ratings data. With these principles in mind, we now address the three new measures in the Proposal.

Loan Mix

The FDIC proposes to incorporate an institution's "loan mix" by applying risk weightings to separate categories of loans held by banks as a percentage of total assets. These risk weightings are derived from industry-wide historical data on the types of loans that had high charge-off rates during downturns. In this analysis, construction and development loans are identified in the Proposal as having the highest weighted charge-off rate followed by commercial and industrial loans and then leases. CBA believes that the FDIC's strong reliance on such data is flawed in key respects.

While the FDIC's data is gleaned from relatively long periods of time, the FDIC acknowledges it relies heavily on charge-off data from 2009 through 2014 because of the high number of bank failures occurring during this period compared to prior years. The experience of banks in the aggregate with these loans and across all geographies during a particular downturn is not the kind of data that supports setting in stone by regulation what loan categories will be favored and which will not. How much is the default rate

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[1] IADI Core Principles for Effective Deposit Insurance Systems. IADI is the International Association of Deposit Insurers.

data a reflection of the period leading up to the last crisis—chronically low interest rates, speculative economic environment—and will the same risk weightings still reflect insurance fund risks, say, during a high interest rate recessionary economic cycle? How did the charge-off data of failed banks during the downturn compare with banks that did not fail but shared a similar loan mix? CBA is aware of member banks that held high concentrations of residential mortgage loans during the economic crisis but experienced well below industry average default rates. What likely made the difference were the quality of their loan underwriting, how effective they managed their portfolios, and whether they adequately hedged risks. Industry-average charge-off data does not capture these distinctions among individual banks.

The consequence is that, under the Proposal, some banks will be incentivized to avoid making loans even though doing so would have little effect on risk to the insurance fund and even if making the loans would be beneficial to a bank and its customers. Other banks might be under-assessed to the extent that the risk weighting masks deficient risk management that affects all their loans. This is precisely the kind of cross-subsidization that the FDIC said it wishes to avoid. Banks need the flexibility to operate within their own markets and respond to the loan demand of their customers based on their available expertise, local economic conditions, and so on. Today, for example, many of our member banks believe that with capital ratios at relatively high levels, banking examiners' strong focus on certain loan concentrations unnecessarily restrains lending that can be beneficial both to borrowers and banks and, derivatively, to the economy.

The FDIC can avoid inefficiencies in the assessment system, avoid moral hazards, and avoid stifling business decisions by relying more on individual bank information already available in the CAMELS rating system. What the FDIC is striving to capture through the loan mix measure is, in essence, the quality of a bank's loans. No aggregate data can reveal as much about a bank's loan default risk as examiners can through successive, arduous, and expensive bank examinations that generate the CAMELS ratings (in this case asset quality or "A" and sensitivity to market risks or "S"). We recommend that the FDIC revise the loan mix measure to incorporate more individualized CAMELS data or otherwise reduce the impact of this measure in the assessment system.

One Year Asset Growth

The FDIC also proposes to raise assessment rates for small banks that grow significantly over a year other than through merger or by acquiring failed banks. We have the same general concern here as with the loan mix factor—it is too general to be used for assessment purposes. The underlying reasons for a bank's growth may or may not be associated with increased risks to the insurance fund. Growth may be indicative of improved management, local loan demand, faltering competition, or a host of reasons other than imprudent risk-taking. Here again, the FDIC's rule of thumb approach could in individual circumstances stifle business decisions that have no impact on the insurance fund or fail to capture experiences that are indicative of risk, such as below-average growth during an expansionary cycle. Prudential regulators can ascertain the characteristics of a bank's excessive growth through the examination process. On balance, we believe that the disadvantages of applying the one year asset growth measure may be too great.

Core Deposits/Total Assets

The FDIC's core concern underlying the core deposits/total assets ratio is liquidity, once again, a criterion that is represented in the CAMELS system (as "L"). The Proposal defines core deposits as balances up to the $250,000 insurance limit excluding brokered deposits. The concept of core deposits is well known—they are valuable for their stability and relatively low sensitivity to rate. However, not all deposits that are stable and less sensitive to rate are core deposits, as narrowly defined. Availability of deposit insurance is one factor contributing to stability—probably a major factor—but not the only one. A bank's reputation in the community, duration of customer relationships, breadth of services provided to the same customer, types of businesses in the bank's geography, the size of the bank, all these factors affect a bank's ability to attract over-limit deposits.

The ratio also fails to recognize the beneficial aspects of maintaining a diversified deposit base beyond accumulating small dollar core deposits locally. In its guidance in FIL 2-2015, referring to brokered deposits, the FDIC noted "brokered deposits can be a suitable funding source when properly managed as part of an overall, prudent funding strategy." The same can be said of other deposits not defined as "core."

The Proposal now treats deposits taken under a reciprocal deposit arrangement as brokered deposits. Brokered deposits in excess of a specified level, combined with high asset growth, can affect assessment rates. Reciprocal deposits differ from brokered deposits in key ways that are relevant to insurance risk. Reciprocal deposit arrangements allow smaller banks to accept higher dollar deposits from customers with whom they have established relationships. This means that a bank is able to maintain and deepen relationships with customers in their local geographies, the benefits of which are not limited to holding stable deposits. In contrast, customers gained through deposit brokers on average focus less on the banking relationship and more on yield.

For good reasons, use of reciprocal deposits is widespread in California. Well over half of California banks offer it. Recently, California enacted laws specifically allowing local agencies to place deposits in banks that use reciprocal deposit arrangements. As a result smaller banks are able to take public deposits that exceed the FDIC insurance threshold without having to pledge collateral. This has helped local agencies keep their deposits working in local communities.

The FDIC has not articulated sound reasons for treating reciprocal deposits as brokered deposits. Where the FDIC cites to robust data in support of other aspects of the Proposal, it offers no evidence of a relationship between holding reciprocal deposits and risks to the insurance fund. And because, once again, the ratio is such a rough measure of liquidity and ignores the many other ways that banks manage liquidity, this ratio is ineffective and inefficient for assessment purposes. The Proposal should not put incentives in place for banks to focus on one type of deposit while disincentivizing efforts to build a diversified deposit base that includes non-core deposits, as narrowly defined.

Conclusion

We appreciate the FDIC's efforts to ensure that the deposit insurance system reflects actual risks and allocate premiums accordingly. It is important to wring inefficiencies out of the system where they are known or can be easily foreseen. Thank you for considering our comments.

Sincerely,

Leland Chan
General Counsel