September 11, 2015

comments@fdic.gov

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

Re: <u>RIN 3064-AE37</u>

Ladies and Gentlemen:

I am writing on behalf of Promontory Interfinancial Network, LLC ("*Promontory*")[1] to comment on the Notice of Proposed Rulemaking on Assessments (the "*NPR*") issued by the Federal Deposit Insurance Corporation (the "*FDIC*") on July 13, 2015.[2] In the NPR, the FDIC requests comment on a proposed rule that would amend 12 C.F.R. Part 327 to modify the deposit insurance assessment system for established small banks (the "*Proposed Rule*"). The Proposed Rule would set assessment rates for small banks using a financial ratios method based on a new statistical model that estimates the probability of failure over three years.

INTRODUCTION AND SUMMARY

The NPR acknowledges that "the current deposit insurance assessment system effectively reflects the risk posed by small banks," but states that the system can be improved.[3] In the current system, reciprocal deposits are subtracted from a healthy small bank's brokered deposits in determining an adjusted brokered deposit ratio. The FDIC adopted this approach in 2009 after recognizing that reciprocal deposits "may be a more stable source of funding for healthy banks" and concluding that the assessment system should treat reciprocal deposits at such banks less unfavorably than it treats other brokered deposits.[4]

---

[1]   Founded in 2002, Promontory provides services to the bank and brokerage industries. Promontory's deposit allocation services include CDARS®, the Certificate of Deposit Account Registry Service® (CDARS®), for time deposits, ICS®, the Insured Cash Sweep® service, for non-time deposits, and IND®, the Insured Network Deposits® service, for automated sweeping of funds to non-time deposit accounts.

[2]   FDIC, *Notice of Proposed Rulemaking on Assessments*, 80 Fed. Reg. 40,838 (July 13, 2015) ("*2015 NPR*").

[3]   *Id.* at 40,842.

[4]   FDIC, *Final Rule on Assessments*, 74 Fed. Reg. 9,525, 9,532 (March 4, 2009) ("*2009 Final Rule*"). Pursuant to 12 C.F.R. § 327.9(a)(4), a small bank in Risk Category I has its initial base assessment rate determined using the financial ratios method. Pursuant to 12 C.F.R. § 327.9(a)(4)(i), one of the financial ratios used in that method is the adjusted brokered deposit ratio, which is defined in Table A.1 of Appendix A to Subpart 1 of 12 C.F.R. Part 327 as

Nothing that has happened since 2009, and nothing in the NPR, suggests that the FDIC's 2009 judgment about reciprocal deposits was anything but correct. Nevertheless, the proposed new model, which eliminates the adjusted brokered deposit ratio, adds a new ratio of core deposits to total assets that treats reciprocal deposits as _non_-core.[5] The effect of this treatment would be to reverse the treatment of reciprocal deposits for small bank assessment purposes and impose on small banks that hold reciprocal deposits the equivalent of a punitive new reciprocal deposits tax, which for many banks will be as high as 11 to 13 basis points.[6]

The NPR also proposes to remove from the assessment model the threshold requirements – non-reciprocal brokered deposits above 10% of domestic deposits and four-year asset growth above 40% – that, in the current adjusted brokered deposit ratio, protect against the inappropriate imposition of higher assessments on banks that do not use brokered deposits to fund excessive growth.[7] The NPR provides no evidence that removing the thresholds improves the model.

Promontory respectfully submits that, consistent with the treatment of reciprocal deposits in the current assessment system and the positive characteristics of reciprocal deposits that the FDIC has recognized, the ratio of core deposits to total assets in the new model should be adjusted by including in the numerator, along with core deposits, reciprocal deposits as defined at 12 C.F.R. § 327.8(q). Such an adjustment would preserve all the benefits that the FDIC attributes to the new model, but would do so without producing the profoundly negative effects that heavily taxing reciprocal deposits would inflict on community banks. Promontory also respectfully submits that the 10% and 40% threshold requirements should be retained, so that brokered deposits incur the elevated assessment rate only to the extent they exceed 10% and growth exceeds 40%.

Adjusting the Core Deposits Ratio

The core deposits ratio proffered in the NPR (the "_Proffered Core Deposits Ratio_") should be replaced by a core deposits ratio that includes reciprocal deposits in the numerator (the

---

"Brokered deposits divided by domestic deposits less 0.10 multiplied by the asset growth rate factor . . . ." Pursuant to 12 C.F.R. Part 327, Appendix A to Subpart A, the financial ratios, including the adjusted brokered deposit ratio, are as defined in Table A.1, "except that . . . reciprocal deposits are deducted from brokered deposits in determining the adjusted brokered deposit ratio."

5   _See_ 2015 NPR, _supra_ note 2, 80 Fed. Reg. at 40,892.

6   _See id._ at 40,846. Using the FDIC's "Assessment Rate Calculator for Small Institutions under the Proposed Rule," available at https://www.fdic.gov/deposit/insurance/calculator.html, and other data, including commercial CAMELS ratings estimates, Promontory estimates that more than 550 small banks will be assessed this new reciprocal deposits tax and that the vast majority of them (nearly 500, or approximately 90%) will be assessed between 11 and 13 basis points on their reciprocal deposit holdings.

7   The current adjusted brokered deposit ratio, which "measure[s] the extent to which brokered deposits are funding rapid asset growth," applies when a bank's "brokered deposits (less reciprocal deposits) make up more than 10 percent of _domestic deposits_" and its four-year asset growth exceeds 40%. 2009 Final Rule, _supra_ note 4, 74 Fed. Reg. at 9,530 (footnotes omitted) (emphasis added).

"*Adjusted Core Deposits Ratio*"). This change is warranted by four key principles, applied in the NPR, that guide the FDIC's efforts to improve the assessment system:

- The system should "predict the likelihood of bank failure with statistical significance . . . ."[8]

- The system should achieve a proper balance between achieving overall accuracy and "reducing the risk that a particular bank's assessment rate might be inappropriate . . . ."[9]

- The system should provide "incentives to banks to . . . reduce risks"[10] and should not have "perverse incentive effects."[11]

- The system should not discriminate against community banks or "impair their ability to compete with large banks."[12]

1. Overall Accuracy. There is no evidence, and no reason to believe, that the new statistical model predicts failures using the Proffered Core Deposits Ratio any more accurately than it would predict them using the Adjusted Core Deposits Ratio. On the contrary, the record shows that the FDIC did not test the new statistical model, or the 2011 model cited in the NPR as a basis for using the core deposits ratio, with any variable that takes reciprocal deposits into account. Had the FDIC done so, it would have obtained results consistent with its own past findings and with the multiple independent data analyses showing that reciprocal deposits are not positively associated with failures, but rather, if anything, reduce failure risk.

2. Bank Level Accuracy. Because the total amount of reciprocal deposits at established small banks is a relatively small fraction of total deposits, no overall model will fully reflect the positive effect that reciprocal deposits have at the level of the hundreds of small banks that use them. This effect is evident, however, from bank level data and experience. The required balance between overall accuracy and bank level accuracy necessarily tips toward the bank level because lumping reciprocal deposits together with non-reciprocal brokered deposits (and other non-core deposits) adds nothing to overall predictive accuracy, but imposes inappropriately high assessment rates on community banks for which reciprocal deposits are a vital source of funding.

3. Positive Incentives. Whereas the Proffered Core Deposits Ratio would have perverse incentive effects, the Adjusted Core Deposits Ratio would incentivize banks to reduce risks. An assessment system using the Proffered Core Deposits Ratio would tax reciprocal deposits as if – contrary to the evidence – they were no different from non-reciprocal brokered deposits. By doing

---

[8]   2015 NPR, *supra* note 2, 80 Fed. Reg. at 40,854.

[9]   *Id.* at 40,852.

[10] *Id.* at 40,842.

[11] *Id.* at 40,854.

[12] *Id.* at 40,860.

so, it would, perversely, encourage small banks that rely on brokered deposits to treat stable reciprocal deposits as interchangeable with non-reciprocal deposits, which the FDIC deems volatile and risky. A system using the Adjusted Core Deposits Ratio, in contrast, would provide an incentive for small banks that rely on brokered deposits to continue using reciprocal deposits, a practice that not only reduces the bank's reliance on non-reciprocal deposits that the FDIC has identified as risky, but also contributes to the bank's customer relationships and franchise value.

    4. Ability to Compete. The Proffered Core Deposits Ratio, by severely taxing reciprocal deposits, would discriminate against the community banks that use them and impair the ability of community banks to compete with large banks. Especially hard hit by the Proffered Core Deposits Ratio would be community development financial institutions and minority-owned banks, which are major users of reciprocal deposits. The NPR indicates that the FDIC excluded another variable, bank size, apparently without testing its predictive accuracy, because the FDIC was "disinclined to discriminate" on the basis of size against established small banks, many of which "are the only bank in their community."[13] The same disinclination to discriminate should lead the FDIC to replace the Proffered Core Deposits Ratio, as the comments on the NPR that have already been submitted to the FDIC by many community banks vividly demonstrate. The Adjusted Core Deposits Ratio would eliminate this discrimination and its harmful effects.

Retaining the Thresholds

    For many of the same reasons, the 10% and 40% threshold requirements should be retained in the assessment model. The NPR's statement that removing the threshold requirements will result in a larger number of small banks being affected is not an argument for or against doing so. In 2009, the FDIC saw the clear value in the thresholds, which is that they take into account the hypothesized process by which brokered deposits are thought actually to cause or contribute to bank failure, namely by enabling or encouraging a bank to engage in excessively rapid asset growth. In the absence of any evidence that the thresholds impair the predictive accuracy of the model, there is no basis for discarding them.

DISCUSSION

A. Adjusting the Core Deposits Ratio

    1. Overall Accuracy

    The assessment system, using empirical data, should "predict the likelihood of bank failure with statistical significance . . . ."[14] The NPR sets forth a new statistical model based on small bank failures from 1986 to 2014.[15] According to the NPR, the new model predicts bank failure

---

[13]   *Id.*

[14]   *See id.* at 40,854.

[15]   *Id.* at 40,843. The NPR indicates that the new statistical model was developed using, among other things, Call Report data from 1985 forward. *See id.* at 40,843, 40,861, 40,862. The FDIC website provides Call Report data only

with statistical significance and does so with greater predictive accuracy than the model used in the current system. The NPR makes clear, however, that the FDIC did not test the treatment of reciprocal deposits in the new model by comparing the version of the model that uses the Proffered Core Deposits Ratio with a version of the ratio that, like the Adjusted Core Deposits Ratio proposed by Promontory, includes reciprocal deposits in the numerator. As a result, the NPR shows that the FDIC had no basis to conclude that the overall accuracy of a model that uses the Proffered Core Deposits Ratio is any better than, or even as good as, the overall accuracy of a model that uses the Adjusted Core Deposits Ratio.

That reciprocal deposits were not given a fair chance in the model development process is evident from the NPR's extensive description and discussion of the different variables that the FDIC did consider for possible inclusion in the new model. Appendix 1 to the NPR describes not only the variables that the FDIC uses in the new model, but also "Considered Variables" and "Excluded Variables."[16] None of the variables used in the new model, and none of the variables identified as having been considered or excluded, contains any reference to reciprocal deposits or any indication that anything like the Adjusted Core Deposits Ratio was ever tested. Accordingly, the proposal to reverse the treatment of reciprocal deposits in small bank assessments cannot have been based, and cannot be justified, on the ground of superior predictive accuracy.

Moreover, the NPR makes clear that the models on which the FDIC relied in developing the new model also do not contain any reference to reciprocal deposits. Appendix 1 to the NPR states that, in addition to the existing model, "the FDIC relied on other existing models of bank risk, both regulatory and academic, to select candidate variables for inclusion in the new model."[17] With the exception of citations to papers from the 1990's or earlier, before reciprocal deposits were invented, Appendix 1 identifies only one such other model – the FDIC's Growth Monitoring System ("GMS") described in an unpublished 2011 paper – as having included any measure involving core or brokered deposits.[18] The 2011 paper states: "As a first step in developing the new [Growth Monitoring ("GM")] model, we tested a large number of financial and institution ratios (the full list is provided in Appendix Table 1) . . . ."[19] None of the ratios described in the 2011 paper as having been used in the GM model, and none of the ratios identified in the Appendix to the 2011 paper as having been tested for inclusion in the GM model, contains any reference to reciprocal deposits or any indication that reciprocal deposits were tested apart from non-core deposits. As a result, the GM model also cannot provide any support for reversing the treatment

---

from 1992 forward, however, and Promontory therefore has not had access to, and is unable to comment on, the effect of the 1985-1992 data on the model's output.

[16]   *Id.* at 40,860.

[17]   *Id.* at 40,857.

[18]   The NPR states: "Detailed description of the GMS model can be found in 'Bank Growth and Long Term Risk,' Hwa, Jacewitz, and Yom (May 2011)." *Id.* at 40,859 n.66. In response to Promontory's request for a copy of this unpublished paper, the FDIC provided a paper by the same authors with the same title dated July 8, 2011. Promontory assumes that the paper dated July 8, 2011, is the paper to which the NPR meant to refer.

[19]   Hwa, Jacewitz, and Yom, *supra* note 18, at 8.

of reciprocal deposits so that they are taxed as if they were non-reciprocal deposits to which the FDIC attributes greater risk.

The empirical evidence on reciprocal deposits that is available to the FDIC, rather than providing support for reversing the treatment of reciprocal deposits, shows that the such deposits are not positively associated with bank failure and are negatively associated with loss given default. The evidence includes the following two studies.

Study by Professor Blinder and Dr. Shastri

On January 3, 2011, Promontory submitted a letter to the FDIC commenting on two Notices of Proposed Rulemaking[20] with an attached study by Professor Alan Blinder and Dr. Arun Shastri, *Estimated Effects of CDARS Reciprocal Deposits on the Likelihood of Bank Failure*.[21] The study's findings, reflecting data through the third quarter of 2010, include the following:

- Although banks that use CDARS reciprocal deposits may look "weaker" on some characteristics, "CDARS banks fail slightly *less* often than non-CDARS banks. . . ."[22]

- "When we analyze the relationship between CDARS usage and bank failure *quantitatively* – as opposed to just qualitatively . . . – we find that heavier use of CDARS Reciprocal Deposits (as a share of deposits) is associated with a *lower* probability of failure. The effect is both statistically significant and economically meaningful."[23]

- "The negative relationship between CDARS usage and failure is reasonably robust." Although the relationship does not hold in every single quarter, "[i]t continues to hold, though often not statistically significantly, in more complicated multivariate models that include a large number of other bank characteristics as statistical controls (examples: bank size, capital, charge-offs, non-current loans, etc.). . . ."[24]

The study concludes: "Overall, a very conservative summary of these conclusions might be that the use of CDARS Reciprocal Deposits has either no effect or a salutary effect on the probability of bank failure."[25]

---

[20] FDIC, Notice of Proposed Rulemaking, RIN 3064-AD66, Assessments, Large Bank Pricing, 75 Fed. Reg. 72,612 (Nov. 24, 2010), as corrected 75 Fed. Reg. 73,983 (Nov. 30, 2010).

[21] Alan Blinder and Arun Shastri, Promontory Interfinancial Network, *Estimated Effects of CDARS Reciprocal Deposits on the Likelihood of Bank Failure* (January 3, 2011).

[22] *Id.* at 8 (emphasis in original).

[23] *Id.* (emphasis in original).

[24] *Id.*

[25] *Id.* at 9.

The FDIC's congressionally-mandated *Study on Core Deposits and Brokered Deposits* from 2011 cites the Blinder and Shastri study in support of findings on brokered deposits.[26] The NPR cites no study or other empirical evidence that contradicts or calls into question any aspect of the findings of Blinder and Shastri on reciprocal deposits.

Study by Professor Flannery

On May 1, 2011, Promontory submitted comments to the FDIC for the 2011 brokered deposits study with an attached study by Professor Mark J. Flannery, *Data-Driven Deposit Insurance Assessments*.[27] The study, reflecting data through the end of 2010, concludes that reciprocal deposits placed through the CDARS service have "*no significant effect*" on an insured depository institution's probability of default.[28] Moreover, the study finds: "CDARS balances are also associated with substantially and significantly *lower* resolution costs . . . ."[29]

Flannery tested the effect of CDARS reciprocal deposits on failure risk and loss given default over a three-year time horizon, as does the FDIC model, as well as over one-year and two-year horizons. Summarizing the findings in all time horizons, the Flannery study concludes: "CDARS funding has no significant effect on default probabilities and seems to reduce FDIC losses at failed [insured depository institutions]."[30]

The FDIC's 2011 core deposits study cites the Flannery study in support of findings on brokered deposits.[31] The NPR cites no study or other empirical evidence that contradicts or calls into question any aspect of Flannery's findings on reciprocal deposits.

More Recent Data

From 2011 through 2014, most small bank failures have continued to be failures of banks that did not hold reciprocal deposits during the preceding three years.[32] Failures of banks that did hold reciprocal deposits during the preceding three years have decreased at an even higher rate than have failures of non-reciprocal banks.[33]

---

[26] FDIC, *Study on Core Deposits and Brokered Deposits* 40 n.90 (July 8, 2011).

[27] Mark J. Flannery, *Data-Driven Deposit Insurance Assessments* (May 1, 2011).

[28] *Id.* at second page of Executive Summary (emphasis in original).

[29] *Id.* (emphasis in original).

[30] *Id.* at 24.

[31] FDIC, *Study on Core Deposits and Brokered Deposits*, *supra* note 26, at 40 n.91.

[32] From 2011 through 2014, 114 (62%) of the 184 small banks that failed had not held any reciprocal deposits in the preceding three years. Source: Promontory Interfinancial Network, LLC, and Call Report data.

[33] The number of failures of small banks that held reciprocal deposits in the preceding three years dropped from 49 in 2010 to 2 in 2014, a cumulative four-year decrease of 96%. The number of failures of small banks that did not hold

In short, experience validates the FDIC's 2009 determination that the assessment system should treat reciprocal deposits at healthy small banks less unfavorably than it treats other brokered deposits. Reversing that treatment would be denying, not applying, the empirical evidence.

2. Bank Level Accuracy

The NPR recognizes that "[t]he statistical model does not take into account idiosyncratic or unquantifiable risk or risk mitigators . . . except through weighted average CAMELS component ratings."[34] The NPR acknowledges that, "for banks that have significant idiosyncratic or unquantifiable risk or risk mitigators, the model may not assign an assessment rate that reflects their actual risk."[35] In this context, the NPR explains steps that the FDIC has taken in "seeking the proper balance between maintaining the accuracy of the assessment system overall and reducing the risk that a particular bank's assessment rate might be inappropriate" and invites "comment on whether the proposal achieves the proper balance . . . ."[36]

The absence of elevated bank failure risk from using reciprocal deposits *is* evident from quantitative analysis, as the studies cited above make clear, but the dollar amount of reciprocal deposits – approximately $40 billion[37] – is small in relation to total core or non-core deposits. Reciprocal deposits, by their nature, are used selectively to foster and strengthen relationships. About 21% of small banks use them, and they represent about 1.2% of total small bank deposits.[38] As a result, the overall model, focused as it is on much larger and far broader categories such as core deposits, has limited power to identify the positive effects of reciprocal deposits.[39] But given the demonstrated lack of association between reciprocal deposits and bank failure, adopting the Adjusted Core Deposits Ratio would not *reduce* the model's predictive accuracy.[40]

---

reciprocal deposits in the preceding three years declined less, from 107 in 2010 to 16 in 2014, a cumulative four-year decrease of 85%. Source: Promontory Interfinancial Network, LLC, and Call Report data.

[34]   2015 NPR, *supra* note 2, 80 Fed. Reg. at 40,852.

[35]   *Id.*

[36]   *Id.*

[37]   Source: Promontory Interfinancial Network, LLC.

[38]   Source: Promontory Interfinancial Network, LLC, and Call Report data.

[39]   A further reason that the overall model is not equipped to capture the risk-mitigating effect of reciprocal deposits is that most of the bank failures on which the model relies occurred before reciprocal deposits existed. The model uses data for failures from 1986 through 2014. *See* 2015 NPR, *supra* note 2, 80 Fed. Reg. at 40,843. Of the 2,585 small bank failures in that period, 80% occurred before 2002, when reciprocal deposits were introduced. Moreover, of the 519 small bank failures that occurred from 2002 through 2014, only 30% involved banks that had held reciprocal deposits in the preceding three calendar years. Accordingly, only 6% of all the bank failures included in the model involved reciprocal banks. Source: Promontory Interfinancial Network, LLC, Call Report data, and FDIC Failures and Assistance Transactions, available at https://www5.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30&Header=1.

[40]   If a variable (such as non-core deposits) in a model contains a large component (non-reciprocal non-core deposits) that is associated with an outcome (bank failure) and a small component (reciprocal deposits) that is not associated

When the focus shifts to the level of the small banks that actually use reciprocal deposits, however, the relative advantages of reciprocal deposits become quite clear. Although reciprocal deposits represent a small fraction of total small bank deposits, they represent more than 44% of all brokered deposits at the small banks that use them.[41] In other words, small banks that use reciprocal deposits meet nearly half of their brokered deposit needs with reciprocal deposits rather than non-reciprocal brokered deposits. In doing so, they reduce what the FDIC identifies as elevated risk from its use of brokered deposits by nearly half.

If a measure will not diminish overall accuracy, but will make assessments materially more appropriate at the bank level, the "balance between maintaining the accuracy of the assessment system overall and reducing the risk that a particular bank's assessment rate might be inappropriate"[42] tips entirely in favor of adopting the measure. As discussed above, the overall model provides no basis to believe that the Adjusted Core Deposits Ratio, by adding reciprocal deposits to the numerator, would diminish overall accuracy. At the level of banks that use reciprocal deposits, the evidence shows that Proffered Core Deposits Ratio, by treating reciprocal deposits as no different from non-reciprocal brokered deposits, significantly overstates risk, generating assessment rates that are inappropriately high. The straightforward solution is to add reciprocal deposits to the numerator of the core deposits ratio.

3. Positive Incentives

The system should provide "incentives to banks to . . . reduce risks"[43] and should not have "perverse incentive effects."[44] For small banks that use brokered deposits, the clear way to reduce risks – given the evidence cited above – is to use reciprocal deposits. Setting an assessment rate for reciprocal deposits that is the same as the rate for core deposits would provide an incentive for small banks to act in this risk-reducing manner.

Setting an assessment rate for reciprocal deposits that is the same as the rate for non-core deposits, on the other hand, would have the perverse incentive effect of encouraging small banks that use brokered deposits to treat reciprocal deposits and non-reciprocal brokered deposits as interchangeable sources of funding. Banks could be expected to act on this incentive, because the pricing of reciprocal deposits, unlike that of non-reciprocal brokered deposits, is based on local

---

with the outcome, removing the small component that is not associated with the outcome might not dramatically improve the model's power to predict the outcome, depending on how small the small component is in relation to the large one. But removing the small component that is not associated with the outcome will not reduce the predictive power of the model in such a case. Likewise, given that reciprocal deposits share the risk characteristics of core deposits rather than those of non-reciprocal non-core deposits, adding reciprocal deposits to core deposits for purposes of the model will not reduce the predictive power of the core deposits ratio.

[41]   Source: Promontory Interfinancial Network, LLC, and Call Report data.

[42]   2015 NPR, *supra* note 2, 80 Fed. Reg. at 40,852.

[43]   *Id.* at 40,842.

[44]   *Id.* at 40,854.

market conditions and cannot be arbitrarily adjusted to accommodate a punitive new tax. The incentive's effect – replacing less risky reciprocal deposits with the non-reciprocal brokered deposits that the FDIC considers problematic – would be perverse.

Indeed, in the 2011 *Study on Core Deposits and Brokered Deposits*, the FDIC points out the explicit statement in its own examiner guidance that "the proper use of [reciprocal] deposits should <u>not</u> be discouraged."[45] If the FDIC were now to reverse course and adopt an assessment rate that discourages such use, the FDIC would be devaluing the very characteristics of reciprocal deposits that make them a risk mitigator for banks that rely on brokered deposits:

- The relationship bank – not some third-party broker – places deposits for its customer at other banks in the reciprocal network.

- The relationship bank owns the key customer relationship, which is typically long-term and includes multiple services, and more than 80% of customers are local in origin.[46]

- The relationship bank sets the interest rate, based on local market conditions, for its customer's deposits placed at other banks.[47]

- Unlike wholesale funding, reciprocal deposits – and the relationships they represent – add to bank franchise value.

- Reciprocal deposits do not run. For 2007-2014, CDARS reciprocal reinvestments averaged 81% and early withdrawals were less than 1% of overall balances.[48] Similarly, the average monthly account closure rate for ICS reciprocal in 2014 was less than 1.8%. There have been fewer account closures than openings in ICS every month since its 2010 inception.[49]

4. <u>Ability to Compete</u>

Strong and profitable customer relationships are a bank's crown jewels, and large banks have tremendous inherent advantages in attracting the safe, stable, large-dollar deposits on which such relationships are built. Large banks can attract such deposits without providing deposit insurance and in most cases without posting collateral. When large banks dominate such relationships, the prospects for a community bank are limited to the residuum.

The introduction of reciprocal deposits has changed this dynamic. Reciprocal deposit networks, by providing access to deposit insurance at multiple banks, enable community banks to

---

[45] FDIC, *Study on Core Deposits and Brokered Deposits*, *supra* note 26, at 3 (emphasis added).

[46] Source: Promontory Interfinancial Network, LLC.

[47] *See* 12 U.S.C. § 327.8(q).

[48] Source: Promontory Interfinancial Network, LLC.

[49] *Id.*

compete for the customers and deposits that were once beyond their reach. Major local customers with large deposit needs now see community banks as viable alternatives to large banks, which is the key to the community banking renaissance that policy makers should be actively advancing.

That reciprocal deposits are a tool for small banks to compete with large banks is evident from the rates at which small and large banks use them. At small banks, reciprocal deposits represent more than 15 times the share of deposits that they represent at large banks.[50]

The Proposed Rule, by onerously taxing reciprocal deposits, would threaten community bank competitiveness with large banks and roll back the hard-won progress community banks have achieved by using reciprocal deposit networks. The effect would be hardest on the community banks that depend most on reciprocal deposits to compete, which include community development financial institutions ("*CDFIs*") and minority-owned banks.

CDFIs use reciprocal deposits at a rate that is *four times* the national average.[51] The Proposed Rule would result in an annual assessment increase of more than $600,000 on such institutions alone,[52] and in doing so it would seriously undermine their ability to compete with large banks for the deposits that the CDFIs so vitally need.

Similarly, minority-owned banks use reciprocal deposits at a rate that is *six times* the national average.[53] Many minority-owned banks have successfully used reciprocal deposits to attract and retain socially-motivated depositors. With the proposed new tax on reciprocal deposits, such banks may no longer be able to offer interest rates sufficient to compete against large banks for these deposits. This result is the opposite of what the FDIC's own stated principles require.

B. Retaining the Thresholds

The FDIC adopted the adjusted brokered deposit ratio in 2009 as a measurement of "the extent to which brokered deposits are funding rapid asset growth,"[54] which is the problem that brokered deposits are said to cause. As the FDIC recognized, if a bank's brokered deposits represent less than 10% of its domestic deposits, or its four-year asset growth is less than 40%, brokered deposits are not funding rapid asset growth.

---

[50] Source: Promontory Interfinancial Network, LLC, and Call Report data.

[51] Source: www.cdfifund.gov, and Call Report data.

[52] Using the FDIC's "Assessment Rate Calculator for Small Institutions under the Proposed Rule," available at https://www.fdic.gov/deposit/insurance/calculator.html, and other data, including commercial CAMELS ratings estimates, Promontory has calculated the aggregate proposed assessment for all CDFIs with and without reciprocal deposits included in the numerator of the core deposits ratio. All other inputs have been held constant. The assessment that includes reciprocal deposits in the numerator of the core deposits ratio results in an estimated assessment that is approximately $619,000 less than when reciprocal deposits are excluded from the numerator.

[53] Source: Promontory Interfinancial Network, LLC, and Call Report data.

[54] 2009 Final Rule, *supra* note 4, at 9,530.

The NPR, in proposing to abandon the thresholds, states as follows: "The adjusted brokered deposit ratio increases a Risk Category I small bank's assessment rate only if the bank has both large amounts of brokered deposits and high asset growth. <u>Few banks have both</u>, so the ratio affects few banks."[55] What the NPR does <u>not</u> do is demonstrate that the thresholds are faulty by saying that they cause the ratio to affect fewer banks. There is nothing inherently better about imposing what amounts to a penalty on more banks.

In 2009, the FDIC saw the value in the thresholds. Rather than applying data in a shotgun approach hoping to find correlations that are not spurious, a model that uses the thresholds builds on a substantive understanding of the hypothesized process by which brokered deposits are thought actually to cause or contribute to bank failure. Indeed, the FDIC increased the asset growth threshold to 40% in the 2009 final rule from 20% in the notice of proposed rulemaking after finding that a 20% four-year growth rate would not be excessive.[56]

The NPR provides no evidence that using the 10% and 40% thresholds would lead to predictions any less accurate than predictions obtained without using them. In the absence of such evidence, the FDIC should retain these thresholds for the same good reason it adopted them a few short years ago.

* * *

Thank you for consideration of our comments. Should you wish to discuss them further, please contact the undersigned at (703) 292-3333 (mjacobsen@promnetwork.com).

Sincerely,

Mark P. Jacobsen
President and Chief Executive Officer

---

[55] 2015 NPR, *supra* note 2, 80 Fed. Reg. at 40,843 (footnotes omitted) (emphasis added). The NPR does not attempt to reconcile its finding that "few banks have both" large amounts of brokered deposits and high asset growth with the FDIC's frequently stated concern that banks use brokered deposits to fund high asset growth. If the thresholds have created a disincentive to using brokered deposits for high growth, that is a reason to keep them, not to toss them out.

[56] 2009 Final Rule, *supra* note 4, at 9,532.