From: Bert Ely
To: Comments
Cc: Bert Ely
Subject: July 13, 2015 - Assessments - RIN 3064-AE37
Date: Friday, September 11, 2015 11:57:45 PM
Attachments: Failed banks -- 2007 to 2015.xls

Dear Mr. Feldman:

I am writing on my own behalf, and not on behalf of any other party, to comment on the Notice of Proposed Rulemaking (NPR) pertaining to revisions in how small banks are assessed for deposit insurance; RIN 3064-AE37, published in the Federal Register on July 13, 2015, with comments due to today. I am submitting this comment in accordance with the requirements specified in the Federal Register notice.

I strongly recommend that this NPR be withdrawn and this assessment proposal be substantially reworked to address very serious and fundamental flaws in the methodology for determining the supposedly risk-sensitive premiums small banks (i.e. those with total assets of less than $10 billion) are to be charged once the Deposit Insurance Fund (DIF) reaches a 1.15% reserve ratio.

This comment letter will address the following key fundamental flaws in the manner in which the deposit insurance premium rate is proposed to be determined for small banks: (1) geographical risk exposures; (2) asset growth rates; (3) nonperforming loans; (4) net loan charge-offs; (5) other real estate owned; and (6) brokered deposits. Time does not permit addressing lesser flaws in the proposed revisions.

The fundamental rationale for risk-sensitive premiums for any type of insurance is to deter, in advance, unwise, reckless, or undercompensated risk-taking that will lead, in a later period of time, to higher losses for the insurer. An important corollary: risk-sensitive premiums should not incentivize unwise or insufficiently compensated risk-taking by the insured. Not only will the revised premium structure for small banks proposed in this NPR not deter unwise, reckless, or undercompensated risk-taking but perhaps inadvertently it will incentivize activities that will magnify losses to the DIF.

Perhaps most importantly, the past is not prologue. More specifically, basing future premium rates largely, if not completely, on recent past experience, especially over the last decade, most certainly does not provide an analytically sound basis for constructing a premium-calculation mechanism intended to deter future unsound banking. Put another way, it should not be assumed that bankers, or the economy, will replicate past errors to the extent reflected in the revisions to the FDIC's formulae for pricing risk-sensitive premiums for small banks.

The following addresses specific failings in the NPR at issue:

Geographical risk exposures: Perhaps the greatest flaw in the proposed revision is the lack of any sensitivity to geography -- where potentially risky loans and investments are geographically located. This is especially important with regard to real estate loans as well as for businesses tied to

geographical areas, such as construction-related activities in South Florida or fracking-related activities in North Dakota. This criticism is especially relevant to the FDIC's apparent bias against ADC lending.

Given that almost all banks which failed during last banking cycle (2008 to 2015) were small (i.e. less than $10 billion in assets at the time of failure) -- 507 of 515 -- the role that geography plays in bank failures is crucial and must be factored into the calculation of risk-sensitive premiums. To get more specific, failures in four states (California, Florida, Georgia, and Illinois) accounted for 57% of the initial estimated insolvency loss the DIF experienced over the 2008-2015 period. Failures in five other states (Alabama, Nevada, Ohio, Texas, and Washington) plus Puerto Rico accounted for 11% of the bank failures in the 2008-2015 period and 26% of the total initial estimated loss the DIF experience during that period. At the other end of the loss distribution, there were no failed banks in nine states plus the District of Columbia. Clearly, geography plays a very significant role in the FDIC's loss experience yet the revisions to the risk-based premium-setting formulae completely ignore the importance that geography plays, as was the case in earlier banking crises.

Asset growth rates: Rapid asset growth does increase the risk of failure, especially if it occurs over several years, in any type of business. The FDIC's premium variable based on a one-year growth rate is far too short-term in its impact on failure rates, especially given that a growth rate can change significantly from one year to the next for quite legitimate reasons and even reverse itself. It is sustained rapid growth that is the real bank killer.

Nonperforming loans: Nonperforming loans are very much a lagging measure of banking risk, for by the time a loan is not performing, the damage has long since been done, back at the time the loan was approved. Worse, an important element of nonperforming loans -- putting loans on a non-accrual status -- is highly judgmental. The FDIC's loss experience in failed banks, and specifically the difference between a bank's book net worth at the time of failure, as reported in the bank's call report, and the FDIC's loss in the failed bank, is a powerful indicator of the extent to which, one, nonperforming loans were under-reported prior to failure, and two, there was insufficient reserving for prospective losses on nonperforming loans.

Net loan charge-offs: Net loan charge-offs are even more of a lagging indicator of banking risk than nonperforming loans. By then, not only have the horses left the barn, but they have long since been far out of sight.

Other real estate owned (OREO): Like data on nonperforming loans and net loan charge-offs, data on OREO is a very serious lagging indicator -- perhaps by two, three, or more years -- of the risks the bank took. Focusing premium rates on such a lagging measure of the product of unproductive credit risk-taking is hardly a deterrent to unwise credit risk-taking in the future.

Brokered deposits: The FDIC has yet to demonstrate, in a convincing cause-and-effect manner, that brokered deposits directly contribute to bank failures. Brokered deposits have been characterized as the sole funding source of rapid asset growth that often does, as noted above, lead to banking problems and bank failures. However, the problem attributed to brokered deposits in fact is rapid asset growth, per se, not how that growth is funded, whether through brokered

deposits, retail deposits solicited directly by the bank, FHLB advances, or borrowings from other sources.

I appreciated the opportunity to submit these comments to the FDIC and I would welcome the opportunity to discuss them with FDIC staff. I have attached to this email a spreadsheet of all bank failures since 2007 in support of the data I have cited in this comment letter.

Respectfully submitted.

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