AMERICAN BANKERS ASSOCIATION

1120 Connecticut Avenue, NW
Washington, DC 20036

1-800-BANKERS
www.aba.com

World-Class Solutions, Leadership & Advocacy Since 1875

Robert W. Strand
Senior Economist
202-663-5350
rstrand@aba.com

September 21, 2006 Via E-mail

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

Re: RIN 3064-AD02; Proposal to set the Designated Reserve Ratio;
71 Federal Register 41973; July 24, 2006

Dear Mr. Feldman:

The Federal Deposit Insurance Reform Act of 2005 (the Act) requires the Federal Deposit Insurance Corporation (FDIC) to set by regulation and annually publish a Designated Reserve Ratio (DRR) for the Deposit Insurance Fund (DIF).[1] The Act eliminated the fixed DRR of 1.25 percent of insured deposits and allows FDIC to set the DRR within a range between 1.15 percent and 1.50 percent. FDIC issued a Notice of Proposed Rulemaking (NPR) to set the DRR initially at 1.25 percent.

The American Bankers Association (ABA) appreciates the opportunity to comment on this proposal. ABA, on behalf of the 2.2 million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

In summary, ABA makes the following points:

- The DRR should be viewed only as a very rough guide to a long-run equilibrium for the DIF reserve ratio, and should ***not*** be used as a primary driver of premiums in the short-run. Rather, the most important decision for FDIC is to set the lowest premium schedule that will maintain the reserve ratio over time within the new statutory range without significant changes in assessment rates.

- Even as a long-term equilibrium, 1.25 percent is too high a DRR.

[1] Sections 2104, 2105 and 2109(a)(1) of the Federal Deposit Insurance Reform Act of 2005 (Title II of the Deficit Reduction Act of 2005, P.L. 109-171) amended Section 7(b)(3) of the Federal Deposit Insurance Act, 12 U.S.C. 1817(b)(3)(B),(D).

- If FDIC goes forward with setting the DRR at 1.25 percent, it should not aggressively set premium rates to attain this level in a short period of time, but rather should use the new statutory reforms to maintain a system of steady, low premiums without premium spikes.

- If the DRR is set at 1.25 percent at this time, particularly if it is used to drive short-term assessment rates (both of which we disagree with), then FDIC should analyze carefully each year whether the DRR is reasonable given the actual risk of loss to the DIF.

I. FDIC should set the lowest premium schedule that will maintain the DIF reserve ratio within the normal range without significant changes.

Congress set a single, fixed "designated reserve ratio" in 1991 following a period of unusual losses in the banking and savings association industries. The ratio represented a fixed, unvarying obligation that had to be funded rapidly. Such a requirement had the potential for dramatic short-term spikes in assessment rates. Congress became appropriately concerned that sudden large increases in assessment rates could negatively affect bank operations, and in turn, the cost and availability of the services that banks provide.

In the new reform legislation, Congress retained the term "designated reserve ratio" but its meaning is radically different. Congress provided a more flexible approach by creating a normal range within which the DIF reserve ratio could move up or down while keeping premiums at low and steady rates. While the new law does require FDIC to set a DRR, unlike the old system, ***there is no requirement in the law that the reserve ratio reach that level within any set period of time.*** Thus, rather than a fixed mandate, the DRR under the new law is simply a reference point within a normal range of acceptable levels. The more important issue for FDIC is to find the lowest steady and sustainable premium schedule that will keep the reserve ratio within the required range without significant changes.

ABA is very concerned that in setting a DRR, the focus could shift to charging whatever premiums are needed to reach that level in the short run, rather than charging low and steady rates that will keep the fund in the normal range throughout the business cycle. Setting the DRR at the old level only reinforces this notion that it is an invariable level that must be maintained at all times. From the point of view of the economy and the banking system that supports it, steady premium levels are far more important than maintaining an arbitrary DIF reserve ratio.

As we have stated in other letters related to implementation of the Act, ABA believes that low, steady premiums in both the short- and long-run will offer the best strategy for maintaining an adequate reserve for the FDIC while minimizing the potential for negative consequences for banks and their customers.

II. The DRR target for the DIF over the long run should be lower than 1.25 percent.

Even as a long-term equilibrium, 1.25 percent is too high a DRR. The FDIC has proposed that the DRR remain at the same level set in 1991 by Congress: 1.25 percent. It is natural to ask whether the risk has remained the same as it was in 1991. The answer is clearly no. First, Congress enacted significant regulatory powers in the early 1990s – including prompt corrective action, depositor preference and cross guarantee measures – that make it less likely that a bank will fail and less costly to resolve those that do.[2] Enhancements under development in risk-based premiums and risk-based capital, if done correctly, should further encourage sound banking and reduce the risk of loss to the DIF.

Supervisory practices have also improved substantially since 1991. According to former Comptroller of the Currency Eugene Ludwig:

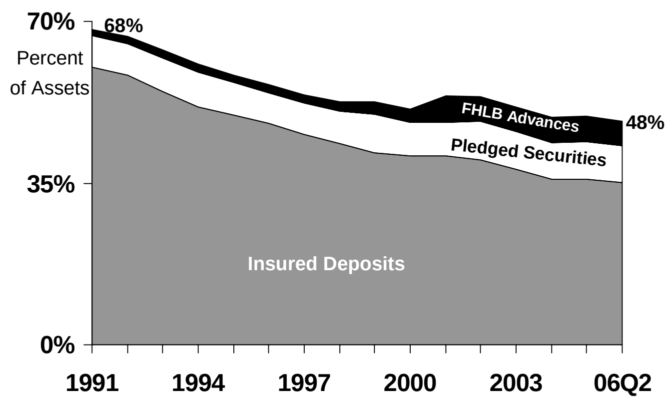
> In the 1990s, U.S. regulators adopted a supervision-by-risk approach to get bankers and examiners to focus on the quality of banks' risk management systems. Since then, through supervisory pronouncements and on-site examination work, regulators have continued to advance their expectations for risk management. Other standard setters, such as accounting bodies, auditors, and the Congress, have added to the picture."[3]

Similarly, the banking industry has significantly improved risk management over the last fifteen years. Banks have increasingly put enterprise risk management systems and processes in place, increased the use of sophisticated risk-management models, and implemented strong systems of checks and balances. Advances in managing operational risks, in collecting data and benchmarking performance, and in identifying key risk indicators all contribute to safe and sound banking.

Moreover, FDIC's exposure today – measured by the ratio of insured deposits to assets – is far less than it was fifteen years ago when the 1.25 percent target level was established. As the charts on this page and the next show, the portion of bank funding with priority over FDIC in bank failures fell from 68 percent in 1991 to 48 percent today. Similarly, bank capital and subordinated debt, which backstop FDIC's potential claims, rose from 7½ percent to 11½ percent over the same period.

Declining FDIC Exposure

Banking Industry Funding Superior in Position to the FDIC



Source: ABA analysis of data from the FDIC

---

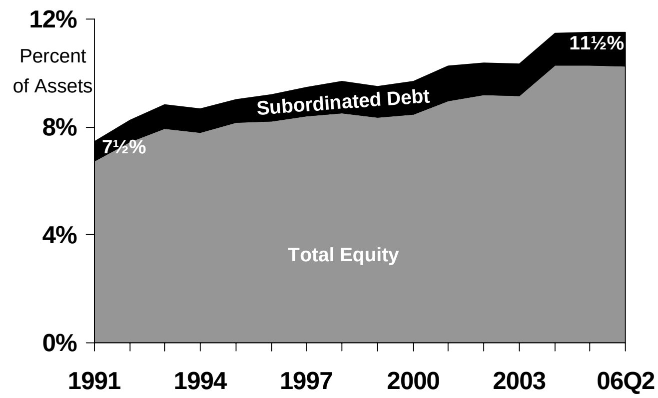
[2] It is worth noting that the analysis related to CAMELS downgrades and failure rates includes the period before enactment and implementation of these important regulatory authorities. Thus, the predictive power of the model is limited and would, in fact, overstate the risk to FDIC.

[3] Eugene Ludwig, "Viewpoint: Elements of Basel II that Debate Won't Alter" *American Banker*, August 18, 2006.

Simply put, the proposed DRR target of 1.25 percent is high relative to FDIC's risk going forward. Considering all these factors – major enhancements in regulation and supervision, significant improvements in bank risk management, increased geographic and business diversification by banks, and the continuing decline of FDIC exposure – the target DRR should be lower in the permissible range than the outdated 1.25 percent.

Declining FDIC Exposure

Banking Industry Funding Subordinate in Position to the FDIC



Source: ABA analysis of data from the FDIC

III. FDIC should assess low and stable premiums to bring the DIF to the DRR gradually.

Whatever level is determined for the DRR – but especially if FDIC sets it at 1.25 percent – it is very important that premium rates not be set aggressively to attain this level within a year or two. As mentioned above, there is no statutory requirement for an aggressive adherence to this level and undue focus on doing so is directly counter to Congressional intent to allow the DIF reserve ratio to float within a normal range. To set an aggressive timetable for returning to the DRR only continues the old paradigm that Congress rejected.

Rather, the short- and long-term goals should be low and stable premiums that avoid disruptive effects on the industry and the customers it serves. FDIC has supported this approach throughout the debate in Congress. There is no reason to deviate from this approach, including during the transition period where credits are being used to offset premium assessments for some banks. Setting high premiums would, in fact, frustrate the achievement of important goals of the reform law and would disrupt a smooth and steady transition to the system where all banks will pay cash premiums. We would note that under a sustainable, low-premium rate program, most credits would be used within three or four years – a short time period for any transition.

As ABA discussed in detail in our comment letter on the proposed rule for assessment credits, there are several reasons supporting this approach:[4]

- The banking industry is healthy, with strong earnings, rising capital, and problem loans near historic lows.

- The DIF balance will exceed $50 billion by the end of 2006, having grown by more than $400 million each quarter on average for the last three years – even with most banks paying

[4] See www.fdic.gov/regulations/laws/federal/2006/06c15onetime.pdf.

no premiums at all. Under a program of low, steady premiums, continuation of steady growth in DIF balances can be expected.

- High premiums would reduce the resources available for banks to serve their customers. In view of the big impact that high premium rates can have on the resources – and services – of banks, Congress specifically required FDIC to consider such factors in setting rates.

- Congress anticipated that the DIF reserve ratio would fluctuate and abandoned a fixed statutory reserve ratio in favor of a range. This gives FDIC flexibility in setting rates, and more importantly, allows the FDIC to pursue a smooth, low premium policy that avoids spikes in premium levels.

- Congress allowed a full five years to return to 1.15 percent should the DIF reserve ratio fall below it. With such a sensible timeframe for returning to the normal range, it seems more than reasonable to have an appropriate transition timeframe for achieving any specific DRR. Given that the system will be in transition as the credit pool is exhausted, a deliberate, smooth and steady approach is justified.

IV. If the DRR is set at 1.25 percent at this time, particularly if it is used to drive short-term assessment rates (which we do not agree with), then FDIC should analyze carefully each year whether the DRR is reasonable given actual risk of loss to the DIF.

If the DRR is used only as a rough long-term guide, as ABA suggests, the simple process of reconfirming the level each year (or proposing a new ratio for comment) may be reasonable.[5] However, if the DRR is used as a driver of short-term premium rate spikes then its importance is elevated and the FDIC should, as a matter of course, provide an opportunity for public comment each year even if the level proposed is the same as the existing level.

The effects of incentives created under the new risk-based assessment system are also hard to judge. This will affect both the setting of assessment rates and the pace of change of the DIF reserve ratio. For example, as the experience of the early 1990s demonstrated rather dramatically, at high assessment rates, the growth of insured deposits is likely to be very low. In fact, insured deposit growth was ***negative*** for four straight years in the early 1990s. Thus, the actual insurance fund reserve ratio changed much more rapidly than anticipated. Experience with the new system is important to setting a long-term equilibrium DRR even if used as a rough guide.

The NPR does confirm this need: it states that "FDIC believes that more experience with managing the fund under the new framework established by the Reform Act will be of benefit in determining

---

[5] The Act requires FDIC to announce the DRR target every year. Originally, FDIC is required to set the DRR through the public notice and comment process. Thereafter, FDIC is not required to use the notice-and-comment process if it is not considering changing this target. Federal Deposit Insurance Reform Act of 2005 §2105(a) (Title II of the Deficit Reduction Act of 2005, P.L. 109-171)

whether the DRR should be raised or lowered from 1.25 percent" (page 41975). Because the new risk-based system is untested, and if FDIC uses the DRR to drive short-term premium rates, ABA recommends that FDIC thoroughly review the DRR decision ***each*** year and seek comment, even if the same level is proposed.

V. Conclusion

The new law has significantly changed the approach to managing the insurance fund reserve ratio. Rather than having a fixed designated reserve ratio with highly variable premiums, Congress shifted the focus to having low and steady premiums allowing the reserve ratio to vary within a normal range. This is a much better approach from the point of view of the economy and the banking industry, and is fully consistent with sound management of the Deposit Insurance Fund. Thus, FDIC's focus should be on low and steady premiums, not an arbitrary designated reserve ratio. Too much focus on and too much importance attributed to the DRR only keeps the system stuck in an antiquated system that Congress firmly rejected.

ABA appreciates this opportunity to comment on the NPR. The public, deliberative, and active approach of FDIC in implementing this landmark legislation is to be commended. We are prepared to work with FDIC staff throughout this process. If you have any questions, please contact me at (202) 663-5350.

Sincerely,

Robert W Strand

Robert W. Strand