America's Community Bankers Shaping Our Future

September 19, 2006

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

Re: Deposit Insurance Assessments
RIN 3064-AD09
71 FR 41910 (July 24, 2006)

Dear Mr. Feldman:

America's Community Bankers (ACB)[1] is pleased to comment on the Federal Deposit Insurance Corporation's (FDIC) proposal concerning deposit insurance assessments for all insured depository institutions.[2] This is one of several proposals recently issued by the FDIC to implement the Deposit Insurance Reform Act of 2005 (Reform Act).[3] This proposal is intended to make the assessment system more sensitive to risk as well as make the system fairer by limiting the subsidization of riskier institutions by more highly rated institutions. The FDIC's proposal does the following: 1) consolidates the existing nine categories for risk differentiation into four; 2) establishes one method of risk differentiation for small institutions, and another for large institutions within Risk Category I; 3) treats all new institutions, regardless of size, established within the last 7 years, the same in Risk Category I and assesses all at the maximum rate for Risk Category I; and 4) establishes a base-rate schedule which could be adjusted uniformly up or down a maximum of 5 basis points at the discretion of the FDIC, without further notice and comment periods.

ACB Position

ACB appreciates the swift, thoughtful and transparent process the FDIC has used to implement the changes mandated by the Reform Act. However, we have significant reservations about certain portions of the proposal and urge the FDIC to approach the development of the new premium assessment methodology in a manner that will not cause unintended consequences once implemented. Specifically, our concerns are: 1) the bifurcated assessment system for large and small institutions within Risk Category I; 2) the assessment methodology for new institutions

[1] America's Community Bankers is the national trade association committed to shaping the future of banking by being the innovative industry leader strengthening the competitive position of community banks. To learn more about ACB, visit *www.AmericasCommunityBankers.com*.
[2] 71 Fed. Reg. 41910 (July 24, 2006).
[3] The Reform Act was included as Title II, Subtitle B of the Deficit Reduction Act of 2005, Public Law 109-171, 120 Stat. 9 (February 8, 2006).

established within the last 7 years; 3) the base rate schedule's floor and spread for premium assessments within Risk Category I; 4), the potential inclusion of Federal Home Loan Bank (FHLBank) advances in the calculation of volatile liabilities; and 5) the risk of rapid deposit insurance fund dilution by institutions that hold very large and rapidly growing deposit amounts.

The following is a summary of ACB's position:

- ACB believes that the proposed bifurcation between large and small institutions is not fair as proposed and that the FDIC should work to develop a more comparable assessment system between small and large institutions. This will eliminate the potential for discrimination due to size or availability of market data.
- ACB disagrees with the proposed definition of a new institution and suggests that newer institutions be assessed in the same way as all other depository institutions, and that all premiums assessed be done so as a result of an institution's risk profile, not their age.
- ACB opposes the current Risk Category I base rate proposal and instead requests that the FDIC lower the floor assessment rate to 1 basis point. ACB strongly urges the FDIC to widen the spread for Risk Category I assessments to 3 basis points while maintaining the proposed premium ceiling at 4 basis points.
- ACB opposes any change to the assessment without notice and comment and requests that the FDIC establish a notice and comment period for all assessment modifications, even changes as small as 1 basis point.
- ACB strongly opposes the inclusion of FHLBank advances as a factor in determining premium assessment calculations, as such advances have pre-defined, predictable terms and are continuously available in all market conditions.
- ACB suggests assessing a growth premium on institutions that have shown rapid deposit growth, established by way of a predetermined "qualified dilution factor." These institutions should be assessed such a fee to offset material dilution of the deposit insurance fund.

Background

Deposit Insurance Reform Act. The Reform Act mandates the following key changes:

- Merges the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) into a new fund, the Deposit Insurance Fund (DIF).
- Indexes the coverage for standard accounts beginning in 2010 and increases the coverage for retirement accounts to $250,000, also indexing the coverage limits for these accounts to inflation.
- Grants an assessment credit to each eligible depository institution based on the institution's assessment base as of December 31, 1996.
- Allows the FDIC to price deposit insurance according to risk for all insured institutions at all times.
- Enables the FDIC Board of Directors to establish a Designated Reserve Ratio (DRR) between 1.15 percent and 1.50 percent and allows the FDIC to manage the pace at which the reserve ratio varies within this range.

- Allows the FDIC to update other operational policies concerning deposit insurance for assessment collections, dividend payments and advertising for insured accounts.

President Bush signed the Reform Act into law on February 8, 2006. The Act mandates a 270 day implementation deadline, giving the FDIC until November 5, 2006 to put the principles of the Reform Act into practice for all insured depository institutions.

Deposit Insurance Assessments Proposal. The Reform Act gives the FDIC the opportunity to better price deposit insurance for risk. It continues to require the assessment system to be risk-based and allows the FDIC to define risk more broadly than permitted under the existing system. It grants the FDIC the discretion to price each institution's deposit insurance according to its individual risk, regardless of the level of the aggregate reserve ratio. The Reform Act leaves in place the opportunity to establish separate systems for small and large institutions, under the stipulation that no institution could be barred from the lowest risk category solely due to size.

Currently, the FDIC operates an assessment system that places institutions into nine risk categories based on two criteria: capital levels and supervisory ratings. The three capital groups are well capitalized, adequately capitalized and undercapitalized, which are numbered 1, 2 and 3 respectively. Three supervisory subgroups, termed A, B and C, are generally based upon the FDIC's consideration of evaluations provided by the institution's primary regulatory supervisory, or composite CAMELS rating. Institutions rated CAMELS 1 or 2 are generally placed in subgroup A, CAMELS 3 are placed in subgroup B, and CAMELS 4 and 5 are placed in subgroup C. The three capital groups and three supervisory groups form a nine-cell matrix for risk-based assessments.

As of December 31, 2005, five of the nine categories contained only a total of 10 institutions with almost 94 percent of all institutions falling into the 1A Category. In addition, failure rates among several of the groups were very similar, blurring the distinctions between the categories.

Bifurcated Assessment System for Risk Category I

The FDIC's proposal consolidates the existing nine categories into Risk Categories I, II, III and IV. All institutions in any one risk category, other than Risk Category I, are charged the same assessment rate with no further differentiation. Within Risk Category I, the FDIC proposes one assessment method for small institutions and another for large institutions.[4] Both methods, as proposed, make use of CAMELS component ratings, but the small institution methodology combines these ratings with current financial ratios. Large institutions are treated in a different manner depending on their asset size. For larger institutions with assets between $10 and $30 billion, assessment rates are determined using financial ratios (although different than those used for smaller institutions) in addition to CAMELS component ratings and long-term debt issuer ratings. For larger institutions with assets greater than $30 billion, assessment rates are determined by combining CAMELS component rates with long-term debt issuer ratings only.

[4] Large institutions are defined in the proposal as those with assets greater than or equal to $10 billion. Smaller institutions, therefore, are defined as those with assets less than $10 billion.

ACB does not believe that there is a need for two such widely differing systems between large and small institutions. We recognize the variations that exist among institutions of differing asset sizes and agree that two systems for large and small institutions may be workable, but this proposal does not accomplish fairness between the two systems. We do not believe that a risk-based premium assessment system should have any room for potential inequity among institutions due solely to size. ACB has concerns that there may be a substantial risk for potential discrimination within the proposed bifurcated Risk Category I methodology.

Inequity Potential Within Supervisory and Market Data. ACB is concerned that, in the aggregate, both supervisory ratings and market data are perceived as favoring certain types of institutions. It is assumed by many in the banking industry, and elsewhere, that larger institutions have a tendency to score higher than small institutions in both supervisory examinations and investor analysis. This circumstance seems to repeat itself in a related context as diversified institutions appear to generally score higher with examiners and investors over those with a more focused or limited business strategy. ACB cautions against placing too much reliance on information from ratings agencies. For example, even rating agencies themselves have historically evaluated the same institution differently.

Market data and supervisory ratings provide valid information. However, we are concerned that too much focus on one variable could bring about the unintended consequence of favoritism towards certain types of depository institutions. Therefore, ACB opposes establishing any premium assessment methodology that has the potential to produce different results for institutions of varying size that present the same level of risk to the deposit insurance fund.

Differing Methodologies in Determining the Financial Ratio Factor. For smaller institutions, the FDIC is proposing to include, in addition to CAMELS ratings, the following financial ratios for determining premium assessments: Tier 1 Leverage Ratio, Loans past due 30-89 days/gross assets, Nonperforming loans/gross assets, Net loan charge-offs/gross assets, Net income before taxes/risk-weighted assets, and Volatile liabilities/gross assets. However, for large institutions, the financial ratio factor is calculated using the institution's estimated probability of a downgrade and the FDIC's predetermined minimum and maximum assessment rate cutoff values. These two methodologies may have starkly different results.

ACB questions the need for two such dissimilar methods for determining an institution's financial ratio factor in premium assessment calculations. The financial data used to calculate a smaller institution's financial ratio factor can also be applied to a large institution. ACB believes that the large institution methodology is overly subjective because part of the formula to calculate an institution's financial ratio factor - the minimum and maximum assessment rate cutoff values within Risk Category I - are set quarterly by the FDIC. We believe that this also opens the door for potential inequity among institutions of varying size that present the same level of risk to the deposit insurance fund.

Exclusion of Financial Data in Favor of Market Data. Regarding the use of market data in the large bank methodology, ACB agrees that where information regarding an institution is available, such as long-term debt issuer ratings, it should be used to help determine a more complete premium assessment. However, we do not support the use of market data to the exclusion of other data, such as financial ratios, as is proposed in the large bank methodology. Once an institution crosses the $30 billion threshold, the FDIC's proposal fails to consider the information available in those institutions financial statements, which can be highly indicative of risk.

ACB understands that the information available in financial statements should, in theory, already be incorporated into an institution's supervisory and market data. However, as noted above, such data has the perception of being biased due to size, diversification and bank type. Market data cannot fully replace financial data, but should serve to supplement both financial and supervisory data. It does not seem well founded to completely phase out financial data for any bank based on its size. Therefore, ACB does not support the FDIC's proposal to eliminate completely the consideration of financial data for institutions based on size.

Large Bank Sub-Category Pricing Approach. In the FDIC's proposal, large institutions within Risk Category I are assigned to one of six premium assessment rate subcategories, which are determined in two steps. First, an insurance score is determined by a weighted average of three elements: 1) the weighted average CAMELS component rating, 2) long-term debt issuer ratings, and 3) for institutions with between $10 billion and $30 billion in assets, the financial ratio factor, which varies based on asset levels. Second, the FDIC then determines whether to adjust the initial assessment rating subcategory assignment based on considerations of "additional information" including other market information, financial performance and condition measures, and internal stress testing.

ACB has concerns about the "subcategory pricing approach" within the premium assessment methodology for large banks in Risk Category I, especially as compared to the small bank methodology, which is on a continuous scale, where small changes in an institution's risk profile produce small changes in premium assessments. Any approach that incorporates cutoffs has the potential for a cliff effect as an institution nears the edge of a subcategory. ACB recognizes that the FDIC's proposal assures institutions that should they fall near the edge of a subcategory, "additional information" will be considered to determine whether or not the FDIC should adjust the initial assessment rating. However, this seems to be an additional, unnecessary complication within an already highly detailed framework.

ACB questions the need for such an approach for large banks within the Risk Category I methodology. The continuous scale methodology for small institutions, where small changes in an institution's risk profile result in small changes in their overall premium assessment, should be applicable to large institutions as well. A continuous scale approach eliminates the extra step of considering "additional information" for large institutions and provides for more comparable premium assessment methodologies between large and small institutions.

Suggested Alternatives. ACB appreciates the substantial effort involved in developing the proposed assessment systems for large and small institutions. However, as discussed above, we have significant concerns in relation to some of the key features of these methodologies. We are specifically concerned about both the potential for discrimination and the perception of inequity within supervisory and market data, the differing calculations of the financial ratio factor, the exclusion of financial data for banks greater than $30 billion, and the stair step approach for large institutions over $10 billion. Therefore we request that the FDIC revisit the assessment methodologies for both large and small institutions. We make the following suggestions for improvement.

First, ACB believes that the large and small bank methodologies should be more closely aligned. The large bank approach should not follow a stair step approach, but rather the same continuous scale approach as is proposed for small banks. This would eliminate the potential for any cliff effect and would limit the need for consideration of "additional information" related to every institution that falls near the edge of the proposed subcategories. We believe the format of the small bank methodology is simpler in construction and is completely applicable to larger institutions and would allow for greater transparency.

Second, ACB urges the FDIC to revise the approach for calculating the financial ratio factor in order to make it more comparable between large and small institutions and less likely to be varied based on FDIC determined maximum and minimum assessment cutoff scores. The small bank methodology is more objective and depends only on financial statement data and CAMELS ratings.

Third, ACB supports the use of market data when available for all institutions from current rating agencies and other companies that will likely become NRSROs.[5] We do not support the use of such data to the complete exclusion of other available data elements, such as financial or supervisory data. We therefore suggest, when market data is available for any institution, that it be incorporated into the premium assessment calculations for that institution. ACB supports phasing in the weighting of market data in the calculation of premium assessments as an institution grows, but does not agree that financial data should be completely phased out once a bank crosses $30 billion in assets.

Where supervisory and market data exist and are used to determine premium assessments, ACB believes that there should be additional determining factors (e.g. financial statement data) for calculating an institution's assessment rate. This will address concerns regarding perceived potential inequities resulting from the exclusive use of supervisory and market data. We suggest revising the FDIC proposed weighting scale to incorporate financial data for all banks.

Regardless of the outcome of the final regulation issued by the FDIC on its deposit insurance premium methodology, if two separate systems are indeed adopted, they should be frequently and consistently monitored and tested for inconsistencies and inequities between banks of varying size.

New Institutions

Under the proposal, institutions in Risk Category I that are less than seven years old are assessed the highest premium available (i.e., the Risk Category I ceiling) for any other institution in this category. If an established institution (older than 7 years) merges into or consolidates with a new institution, the resulting institution would be considered a new institution but would have the ability to request an FDIC review to determine whether it should be treated as an established

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[5] Nationally Recognized Statistical Rating Organizations

institution. If a merger or consolidation agreement was entered into prior to the date of the proposal (July 24, 2006), the FDIC proposes a grandfather rule under which the resulting or acquiring institution would be deemed to be an established institution.

ACB has significant reservations regarding this particular issue and we believe that the proposed definition of a new institution as less than seven years old is arbitrary. This timeframe is harsher than the current three-year estimates for business maturity that are used by both the majority of the banking industry and the banking agencies when assessing a de novo application. Additionally, the reversion of a mature institution to a new institution by virtue of a merger is unreasonable and prejudices the shareholder value of any acquired new institution.

ACB does not support establishing a global assessment rate for all new institutions as it is inconsistent with the FDIC's mandate to create a risk-based assessment system for all insured institutions. It is unclear why all new institutions are being lumped together in one category simply based on a bank's age. It is also unclear why these institutions need to be assessed differently from other banks with similar objective risk levels. The FDIC should draw upon the strength of the proposed system in order to adequately assess premiums for all institutions, including new institutions. Therefore, ACB urges the FDIC to revise its proposal in order that new banks be assessed in a manner substantially similar to all other depository institutions.

Finally, we believe the FDIC has overlooked the timely industry issue of converted credit unions. As defined in the proposal, an established institution would be one that has been chartered only as either a bank or thrift for at least seven years. This would automatically label a newly converted credit union as a new institution, which would then be assessed at the ceiling of Risk Category I, even if such an institution had been in existence for more than seven years as a credit union. ACB believes that credit unions operate in virtually the same business lines as banks and thrifts, and banks that have converted from credit union charters should therefore be assessed the same as all other institutions.

Base Rate Schedule

The FDIC proposes to adopt a base-rate schedule where all institutions in any one risk category (other than Risk Category I) would be charged the same assessment rate. For institutions within Risk Category I, the FDIC has proposed establishing a continuous scale with a 2 basis point spread between a set floor and ceiling within which institutions fall. The base rate is proposed as follows: For all institutions in Risk Category I (other than new institutions), the FDIC proposes base annual assessment rates between two and four basis points; Risk Category II is charged seven basis points; Risk Category III is charged 25 basis points; and Risk Category IV is charged 40 basis points.

The FDIC also proposes to continue to adjust rates uniformly up to a maximum of five basis points higher or lower than the base rates without a notice and comment period, provided that any single adjustment from one quarter to the next cannot move rates more than five basis points.

Base Rate Floor and Spread. ACB does not support the current proposal to set the base rate floor at two basis points because the data used to determine the continuous scale for premium assessments indicates a continuous decline in risk that falls well below the 2 basis points floor. Therefore, a lower floor is more appropriate and is supported by the data.

In addition, the narrow two basis point spread between the floor and ceiling assessment rates within Risk Category I as proposed by the FDIC seems arbitrary. The FDIC has proposed to set the assessment floor and spread where approximately 45 percent of all Risk Category I institutions actually fall below the floor based on their risk profile, five percent above the ceiling, and the remaining within the spread. ACB questions why the percentage of institutions falling below the floor is so high. We would argue for both a lower floor and a wider spread to allow more institutions to fall within the continuous scale for premium assessments, rather than allowing 45 percent to fall below the floor.

Therefore, ACB strongly urges the FDIC to lower the floor assessment rate to one basis point for the base rate schedule in Risk Category I and retain the proposed ceiling of four basis points. This would widen the spread for Risk Category I assessments to three basis points and allow for greater differentiation among institutions within Risk Category I.

Mobility Without Notice and Comment Period. While ACB agrees that the FDIC should have the ability to adjust the premiums as necessary, we strongly believe that the banking industry should be able to comment on such a matter that impacts all depository institutions. ACB believes that allowing for such a large alteration from quarter to quarter without input was not originally intended by the Reform Act.

Although the FDIC's current regulation contains a similar provision, 12 CFR 327(c), the changes made by the Reform Act give the FDIC more flexibility in changing the DRR. If the DRR slips below the targeted level, the FDIC is no longer required to replenish the DIF to a specific level. Therefore, it is unlikely that the FDIC would need to move assessment rates as drastically as 5 basis points in a short period of time. Under the changes in statute, and given that depository institutions will be paying premiums for the first time in many years, a notice and comment period is appropriate for changes in the assessment schedule.

Therefore, ACB urges the FDIC to revise its proposal to include a mandatory notice and comment period for all assessment changes - even changes as small as one basis point. We also believe that a notice and comment process can be designed to occur on an expedited basis when necessary and the FDIC could make a "good cause" determination under the Administrative Procedure Act at the time it is necessary, not as a blanket determination by regulation covering all circumstances.

Federal Home Loan Bank Advances

The FDIC proposal seeks comment on numerous specific issues that could effect the final direction of the rulemaking. One such question relates to the appropriateness of including Federal Home Loan Bank (FHLBank) advances in the definition of volatile liabilities when calculating the financial ratio factor for small institutions in Risk Category I. Advances are an especially stable and reliable form of liability that reduces funding risk. ACB strongly opposes the inclusion of FHLBank advances as a factor in assessing FDIC premiums.

FHLBank advances are not volatile liabilities as they have pre-defined, disclosed terms which are under the control of the institution rather than outside market forces, such as with foreign deposits. It would be illogical to include these advances within the definition of volatile liabilities given the reliable availability of advances as a source of wholesale funding in all market conditions and the predictable effect of such funding on an institution's business plans.

If the FDIC were to include FHLBank advances in the calculation of an institution's premium assessments, thereby discouraging borrowing from FHLBanks, it would be counterproductive to reducing the risk of failure of insured depository institutions and would actually increase risk. Borrowers frequently use FHLBank advances for liquidity purposes and to manage interest-rate risk, as well as to fund loan growth. Curtailing the use of FHLBank advances would force institutions to look to alternative, often more costly wholesale funding sources that are considerably more volatile, therefore reducing profitability and increasing liquidity risk. Penalizing FHLBank members for using advances would not only limit their use of a valuable liquidity source, but also make them less competitive and limit the availability of credit in the communities they serve. Therefore, ACB believes that the inclusion of advances in the definition of volatile liabilities would not be justified.

Free Riders

ACB continues to be concerned about "free riders" that are a source of deposit insurance fund dilution. The definition of "free riders," for purposes of this comment letter, includes large institutions that bring in substantial amounts of deposits that deviate from normal deposit trends and materially dilute the DIF. In the past 10 years, the excessive deposit growth fueled by free riders has managed to undermine the federal deposit insurance system as such institutions had the ability to add an unlimited amount of insured deposits to the system at any time by shifting funds from uninsured accounts into banks that they control without paying anything into the insurance funds. In the past, this activity substantially lowered the reserve ratio notwithstanding modest growth in deposit insurance funds through earnings.

Free riders remain a source of instability to the deposit insurance system as large institutions that rapidly grow deposits over a short period of time will materially dilute the deposit insurance reserves going forward. These institutions should be assessed for this risk. Although nothing can be done to repair the damage done to the deposit insurance fund by free riders up until now, ACB believes such a future occurrence can be avoided. In light of several ILC applications currently being considered by the FDIC, this issue could potentially become one of grave concern to all members of the DIF.

Therefore, ACB believes that, going forward, the FDIC should levy a "growth premium" on top of the regular premium assessments for large institutions that are growing deposits rapidly and materially diluting the reserve ratio. These premiums would address dilution of the fund and prevent the imposition of unfair and unnecessary premiums on other institutions.

In order to determine whether or not an institution has materially diluted the deposit insurance reserves, ACB recommends establishing formal guidelines to determine a "qualified dilution factor" against which institutions must be judged in order to be subject to the growth premium. Such guidelines will help define what constitutes material dilution and will prevent unnecessary penalties on other institutions that have grown at a more even pace or have not contributed to any significant fund dilution.

Conclusion

In summary, ACB urges the FDIC to reconsider several aspects of its proposal on deposit insurance assessments. Specifically, we suggest that the FDIC develop a more comparable assessment system for small and large institutions in order to eliminate the potential for discrimination due to size or availability of market data; assess newer institutions in the same way as all other depository institutions; rework the base rate schedule for Risk Category I to lower the floor assessment rate to one basis point and widen the spread to three basis points; establish a notice and comment period for assessment modifications exceeding one basis point; avoid including FHLBank advances as a factor in determining premium assessment calculations; and assess a "growth fee" on institutions that have rapid deposit growth, determined by way of a predetermined "qualified dilution factor."

ACB appreciates the opportunity to comment on this important issue. We have long supported the concept of deposit insurance reform and applaud the FDIC for its efforts towards creating a more equitable system under such an ambitious time frame. If you have any questions about our comments, please do not hesitate to contact the undersigned at (202) 857-3121 or via email at pmilon@acbankers.org or Jodie Goff at (202) 857-3158 or via email at jgoff@acbankers.org.

Sincerely,

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