From: Bert Ely [mailto:bert@ely-co.com]
Sent: Thursday, September 21, 2006 5:09 AM
To: Comments
Subject: RIN 3064-AD09 Assessments

To all concerned:

I am submitting as a comment letter on this proposed rule an article of mine (copied below the horizontal line into the body of this email) which appeared in the September 15, 2006, issue of the American Banker newspaper. As the biographical information at the end of the article indicates, my comments on the proposed rule do not represent any client views. Instead, they reflect my personal views, which are based on over 30 years of predicting bank and thrift failures and analyzing numerous deposit-insurance issues, including the setting of deposit-insurance premium rates.

Thank your for your consideration of my comments on this most important proposed rule. Please email or call (703-836-4101) if you have any questions regarding this article.

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Viewpoint: FDIC Needs a Simpler System for Assessments

From: American Banker
Friday, September 15, 2006
By Bert Ely

The risk-based deposit insurance assessment system the FDIC has proposed to implement in January is way too complex and will be far too expensive to the banking industry.

The FDIC should therefore retain the present risk-based premium system until it designs a simpler system. It can do this by adopting an “interim rule” which keeps the present system in place until it develops a much simpler risk-based premium structure.

Bankers have until Sept. 22 to raise their specific objections to the proposed assessment system, as well as to recommend retaining the present premium rates for the time being.

The complex assessment process the FDIC has proposed seeks a pricing precision that is neither feasible nor necessary. Worse, it is duplicative of Basel II. By setting the appropriate, risk-adjusted capital level for each bank and thrift, Basel II theoretically will eliminate much of the variation in insolvency risk that the FDIC is trying to capture with risk-sensitive premiums.

That is, if Basel II succeeds in forcing riskier banks to hold more capital, then those banks will pose much less of a failure risk to the FDIC. Healthy banks should either be subject to Basel II or to risk-sensitive premiums, but not both.

Worse, the FDIC is trying to make its premium rates most risk-sensitive where that is least important with those banks least likely to fail.

Specifically, for Category I banks (well-capitalized ones with a Camels rating of 1 or 2), the FDIC seeks to set premium rates precisely, bank by bank, at between 2 and 4 basis points annually. These 8,345 institutions accounted for 98.4% of the industry's deposit insurance assessment base on June 30.

Quite crudely, though, the FDIC proposes a rate of 7 basis points for every one of the 397 banks in Category II (1.5% of the assessment base), 25 basis points for the 45 Category III banks, and 40 basis points for the three Category IV banks. Except where fraud is the primary cause of failure, the banks most likely to fail over the next two or three years already should be in those three categories.

This pricing approach is upside down. Every Category I bank should pay the same premium rate, since it is extremely difficult to predict which banks within this large group are most likely to fail within the next two or three years.

Trying to look farther into the future is unnecessary, since a Category I bank today which fails five years from now should have been placed in a higher-risk category long before then, and then charged a higher premium.

The FDIC should focus its resources on setting premium rates bank by bank only for the Category II, III, and IV banks. Each bank's rate should be sufficiently high to incent the bank to turn itself around, raise capital, or sell itself to a stronger bank, before it goes bust. Perhaps, for example, premium rates should range from 5 to 20 basis points for the Category II banks, and from 20 to 40 basis points for Category III banks.

Of course, since there has not been a single bank failure in almost 27 months, and only 41 over the last decade, the FDIC faces the difficult task of actuarially determining premium rates which reflect the failure probabilities of even weak banks. Yet that would be worthwhile compared to trying to predict the failure of well-capitalized, well-managed banks. Bankers should urge the FDIC to concentrate on fine-tuning the premium rates for weak banks while charging the same rate to all Category I banks.

One of the most egregious flaws in the proposal is its treatment of bank insolvency losses due to fraud. According to the FDIC, from 1989 to 2004, fraud was the primary factor in 12% of the failures of banks it insured and was present in another 26% of the failures. However, while fraud can sink a small bank quickly, or seriously harm it, the impact declines as a bank's size increases, and bad banking becomes the more significant factor in a failure.

Even though fraud causes many small-bank failures, the FDIC plans to assign "fraud-related failure-resolution costs to all insured institutions on a pro-rata basis (based on their share of the total assessment base).”

Consequently, over 60% of the agency’s fraud-related loss exposure has been attributed to the 75 banks with more than $10 billion of deposits, even though almost all the fraud-related cost lies in banks with less than $1 billion. These small banks account for only 20% of the assessment base. This aspect of the proposed risk-based assessments is patently absurd!

The fundamental flaws in the proposed risk-based assessment system discussed above, as well as more specific problems in the proposal, cannot be fixed by early November, when the FDIC must set premium rates for the first half of next year. Therefore, it should retain the present system until it develops a simpler assessment system focused on weak banks.

Because of strong industry deposit growth, and certainly not bank failures, the FDIC has no choice but to levy an across-the-board premium next year to begin rebuilding the Deposit Insurance Fund’s reserve ratio to 1.25%.

This premium should not incorporate any risk sensitivity. To minimize the impact of the rebuilding charge, the FDIC should take three to five years to get back to 1.25%, instead of trying to get there next year.

The request for comments on the risk-based system posed 32 questions. Those questions divert attention from the irreparable flaws in what has been proposed they focus on knotholes in individual trees.

Instead, bankers should advocate clear-cutting the entire forest by urging the FDIC to start over and design a much simpler risk-based premium system.

Mr. Ely, the principal at Ely & Co. Inc., is a financial institutions and monetary policy consultant in Alexandria, Va. He has consulted on deposit-insurance related issues for trade associations and individual companies, but the views expressed above are his own.