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THE CLEARING HOUSE
Advancing Payment Solutions Worldwide

September 22, 2006

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

Attn: Comments

Re: RIN 3064-AD09: Deposit Insurance Assessments

Dear Mr. Feldman:

The Clearing House Association L.L.C. ("The Clearing House"), an association of major commercial banks,[1] appreciates the opportunity to comment on the Federal Deposit Insurance Corporation (the "FDIC") notice of proposed rulemaking on risk-based deposit insurance assessments (the "Proposal"). 71 Fed. Reg. 41910 (July 24, 2006). The Proposal was issued by the FDIC pursuant to the provisions of the Federal Deposit Insurance Reform Act of 2005 (the "Reform Act").

The Clearing House appreciates the substantial effort that the FDIC has undertaken to improve the deposit insurance system, and we agree with the basic objectives identified by the FDIC as guiding this effort (sensitivity to risk, fairness, avoidance of subsidization, consistency and reasonableness). We also believe that the basic approach for assessing the risk profile of banks with assets of $30 billion or more (50% CAMELS ratings,

[1] The members of The Clearing House are: Bank of America, National Association; The Bank of New York; Citibank, N.A.; Deutsche Bank Trust Company Americas; HSBC Bank USA, National Association; JPMorgan Chase Bank, National Association; LaSalle Bank National Association; UBS AG; U.S. Bank National Association; Wachovia Bank, National Association; and Wells Fargo Bank, National Association.

50% debt ratings) represents a fair and balanced approach. We are concerned, however, that the Proposal will not fully achieve its objectives, and will have offsetting negative effects, unless it more fully takes into account six crucial considerations: (i) the actual relationship between risk of loss and level of assessment; (ii) loss given default; (iii) the substantial improvement in the overall condition of the banking industry; (iv) the views of the primary regulator; (v) the adverse impact of unnecessary complexity; and (vi) the potential impact of disclosure of the level of assessment. We urge the FDIC to provide more weight to these considerations in its final rule so that the guiding principles will be more effectively realized and adverse effects avoided.

I. Key Considerations Not Adequately Recognized in the Proposal

A. Relationship of Premium to Risk

The Clearing House fully agrees with the FDIC's key objective of making "the risk-based assessment system fairer, by limiting the subsidization of riskier institutions by safer ones". 71 Fed. Reg. at 41911. We believe, however, and the FDIC's own statistics confirm, that the Proposal falls well short of achieving this objective. The following table illustrates the substantial differential between risk of failure and the Proposal's proposed assessment rates.

	Relative Risk of Failure in Relation to Category I[2]	Multiple of Assessment Rate in Relation to Category I[3]
Category II	4.6x	2.6x
Category III	14.4x	9.3x
Category IV	37.5x	14.8x

In summary, the risk of failure of institutions in Categories II, III and IV in relation to institutions in Category I is between 1.5 and 2.5 times greater than the differential in

2 Based on Table 5, 71 Fed. Reg. at 41912.

3 Utilizes a 2.7 basis point assessment rate for Category I, which is based on the weighted average of the FDIC-assumed 45% at the minimum Category I assessment level, 5% at the maximum assessment level, and the remaining 50% at the four subcategory levels described in Table 16 of the Proposal.

the respective assessment rates. Consequently, under the Proposal, a substantial subsidization will remain of the riskier institutions by the safer ones.

B. Loss Given Default

As the FDIC explicitly recognizes, loss given default ("LGD") is a cornerstone of a risk-based assessment program. 71 Fed. Reg. at 41910. Indeed, it is arguably even more important than the risk of default itself.

Yet, virtually every metric used in the Proposal relates to the risk of default, with little or no recognition of LGD. The Clearing House believes that this approach undermines the fundamental principle of a risk-based assessment system, particularly when there are easily determinable standards for evaluating LGD.

The FDIC's risk of loss in the event of the failure of a depository institution is a function of two principal factors. The first is the amount of recoveries on the assets (including the value of goodwill if there is a sale of the failed institution). The second is the aggregate amount of (i) equity and (ii) liabilities that are subordinate to the claims of depositors (discussed below). Insofar as the potential of loss to the FDIC fund is concerned, liabilities subordinated to the FDIC's claims serve the same function as equity. The FDIC has no risk of loss unless recoveries are less than equity plus subordinated liabilities.

The following examples, using truncated balance sheets, illustrate the importance of subordinated liabilities in determining LGD. In each case, the bank fails and the FDIC is assumed to recover 85% of the value of the bank's assets.

Bank A

Assets	100	Domestic Deposits	90
		Other Liabilities	4
		Equity	6
	100		100

Bank B

Assets	100	Domestic Deposits	60
		Other Liabilities	34
		Equity	6
	100		100

In the first example (Bank A), the FDIC's loss would be 5 (domestic deposit payout of 90 less asset recoveries of 85). In the second example (Bank B), the FDIC would not suffer any loss because the domestic deposit payout of 60 would be more than covered by the asset recoveries. Indeed, in the second example, the FDIC would need to recover only 60% of the value of the assets to avoid any loss.

We note that the Proposal does refer, at one point, to subordinated liabilities as a potential "stress" test factor (71 Fed. Reg. at 41924), but we believe that this factor requires direct, specific recognition -- similar to equity -- in developing the base assessment rates. At many institutions, including our member banks, there are substantial subordinated liabilities that afford the same protection to the FDIC as equity. These subordinated liabilities are principally created by the Depositor Preference Act, 12 U.S.C. § 1813, which, irrespective of contractual terms, grants preference in a liquidation to "deposit liabilities" over other general creditors and requires domestic depositors, insured and uninsured, to be paid in full before remaining creditors can collect their claims. Because the FDIC pays the insured depositors in full and then stands in their place to seek recovery, this depositor preference arrangement provides protection to the full extent of an institution's foreign deposits and other liabilities.

We recognize that the FDIC is under a statutory mandate not to treat small banks less favorably because they are small. This does not, however, preclude the FDIC from taking into account the protection against loss afforded by subordinated liabilities even if they are more likely to be prevalent at large banks rather than small banks. We urge the FDIC to provide actual weight to LGD by explicitly providing for these subordinated liabilities to be taken into account.

C. The Condition of the Banking Industry

As the FDIC recognizes in the Proposal, the condition of the banking industry has sharply improved during the past 15 years. Capital ratios and earnings are significantly higher and levels of non-performing loans and loan charge-offs are significantly lower. As one example, the industry's noncurrent loan rate of 0.70% at June 30, 2006 was the lowest level in the 23 years such data has been reported.[4]

Indeed, the U.S. banking industry has never been stronger. The health of the banking industry was further validated this past June when, for the first time in the FDIC's history, not a single insured depository institution failed during a two-year period. The number of "problem" institutions continues to decline to an historic low -- at the end of June 2006 there were only 50 problem insured institutions, down from 136 at the end of 2002.[5] Three factors responsible for this sharp improvement are improved risk management policies and procedures in the banking industry, legislation that has equipped the federal bank regulatory agencies with additional supervisory and enforcement tools and the increased sophistication of the supervisory process.

We believe that the target level of the FDIC fund, the Designated Reserve Ratio ("DRR"), should be consistent with the level of risk reflected by these changed financial metrics. Starting with the base 1.25% DRR established in 1991, the improvement in the financial condition of the banking industry in the ensuing 15 years suggests a DRR today that is well below the statutory minimum of 1.15%. We urge that the DRR, assessment rates and other aspects of the Proposal reflect this reality.

D. Views of the Primary Regulator; Override

The Clearing House strongly supports the Proposal's recognition of the primacy of a depository institution's primary regulator by basing 50% of the risk assessment on that institution's CAMELS rating. We are concerned, however, that the FDIC has relegated to itself an almost unbounded authority to utilize "stress" and other factors to override the primary regulator's assessment. The Proposal reserves for the FDIC the right to supersede the primary

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4 *See* FDIC Quarterly Banking Profile Second Quarter 2006.

5 *See* FDIC Quarterly Banking Profile Second Quarter 2006.

regulator's CAMELS ratings by applying the FDIC's own self-selected "relevant information". The FDIC suggests that the financial factors contained in this relevant information provide a finer differentiation of risk than CAMELS ratings. 71 Fed. Reg. at 41920.

We recommend that the FDIC should either delete this override feature entirely from the final rule or limit it to special situations. Those situations would exist where the FDIC, with the concurrence of the primary regulator, determines that the CAMELS ratings of a depository institution clearly fail to capture the institution's current condition. We respectfully submit that any more frequent use of the override feature, particularly if applied to a particular class of depository institutions, would violate the letter and spirit of the Reform Act.

The appropriateness of deference to an institution's primary regulator absent such a special situation is a function of the examination and rating process. The CAMELS ratings are determined on the basis of a wide variety of objective and subjective factors that the primary regulator considers during an institution's supervisory examination and over many years. In the case of larger banks, this reliance is particularly appropriate because the primary regulator maintains a permanent on-site examination staff.[6] The examination process provides the primary regulator with the interpersonal interaction with a bank's management over a period of time that cannot be replicated by numerical tests and mechanistic formulae. Moreover, the "additional information" described in the Proposal is already largely incorporated into the CAMELS ratings.

The FDIC notes the possibility that an institution's condition could deteriorate between formal examinations. 71 Fed. Reg. at 41925. Once again, the permanent on-site examination process at larger banks should minimize the impact. Perhaps even more importantly, an additional assessment of a fraction of a basis point for a period of a few months does very little to protect the insurance fund. If the FDIC becomes alarmed by what it believes

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6 The Proposal notes, in a different context, that "[a]s a result of . . . frequent, on-site examinations, supervisory evaluations (primarily CAMELS ratings) and capital levels provide a good measure of failure risk". 71 Fed. Reg. at 41912.

to be a significant deterioration at an insured institution, it could best protect the fund by immediately alerting the primary regulator and working together with the primary regulator to arrest that decline.

E. Complexity; Multiple Assessment Levels

The Clearing House fully agrees with the FDIC's objective to "strive to make the pricing mechanism simple and straightforward".[7] Unfortunately, however, the Proposal is highly complex in its differentiation among Category I institutions. The principal source of this complexity is the development of six different assessment levels for large Category I institutions (in contrast to only three for small Category I institutions). The need to produce such fine distinctions leads to the introduction of complexity in the Proposal -- numerous factors that are presumably intended to help produce these demarcations. The FDIC reserves the right to alter the weighting of the factors in the basic formula by assigning different CAMELS weightings based upon various categories of institutions that the FDIC would define. The Proposal even suggests the possibility of a unique CAMELS weighting for each large institution. Further complexity is introduced by the proposed authority of the FDIC, described above, to introduce totally new factors into the formula.

Our member banks strongly believe that complexity in regulatory standards is not a virtue. It creates uncertainty and confusion, not only for depository institutions, but for their stockholders, funders and customers. In the final analysis, if regulatory standards are so complex that they cannot be readily understood, the public's perception of the regulatory system itself is undermined.

The dangers of an overly complex regulatory scheme are illustrated by the proposed Basle II capital adequacy rules. Although the Basle II rules were proposed with worthy

7 Statement of Donald E. Powell, Chairman, Federal Deposit Insurance Corporation, on Deposit Insurance Reform before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services, U.S. House of Representatives (Mar. 17, 2005).

intentions, they have become so complex as to be "virtually impenetrable".[8] The consequence has been not merely delay in implementation, but the emergence of serious debate as to their fairness. This debate does not exist so much because of demonstrated unfairness, but because the complexity makes it so difficult to determine if there is unfairness. We recognize that the complexity in the Proposal differs from Basle II in that it is the regulator, and not the institution, that has the responsibility for implementing the complex regulatory scheme. Although that difference may reduce burden, it does not affect the principal defect of complexity -- uncertainty and confusion.

Accordingly, as recommended below, we strongly urge that the Proposal be made less complex.

F. <u>Disclosure</u>

A problem inherent in a risk-based assessment system is the potential that disclosure of a higher assessment rate at a particular institution could create funding problems for that institution. If funders believe that the regulators regard one institution as involving higher risk than another, the funders will, in turn, demand higher returns from the higher risk institution to account for the greater risk. Indeed, at some point, funders may even decide not to place funds with an institution designated as higher risk. Although there are theoretical benefits of market discipline, we believe that the very fine and subjective distinctions proposed for Category I create a significant risk of uninformed and even irrational "market" discipline.

There is uncertainty whether an institution can disclose its assessment rate because an element of that rate is examination ratings. In any event, however, it is possible for analysts to determine the rate, particularly if the institution discloses the amount of the assessment.

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8 Statement of Honorable John D. Hawke, Jr., Comptroller, Office of the Comptroller of the Currency, before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology of the Committee on Financial Services, U.S. House of Representatives (Feb. 27, 2003).

We realize that this issue is inherent in the congressionally mandated risk-based assessment scheme. Nonetheless, under the current assessment system, the disclosure risk is minimized, because, as the Proposal notes, the vast majority of institutions are in Category I-A.

The Proposal will significantly change that dynamic, and thereby exacerbate the disclosure issue. Over one-half of the former Category I-A banks will now be ranked as riskier than the remainder, and those banks will be further subdivided into five categories of risk. The impact on funders, and perhaps even the debt rating agencies, if this information is disclosed or derived is, at a minimum, unpredictable.

As discussed below, we believe that the FDIC can take certain actions that both reduce the impact of the disclosure problem and accommodate other key considerations.

II. Principal Recommendations

We respectfully submit, for the FDIC's consideration, the following basic recommendations relating to the Proposal. These recommendations are designed to address the considerations discussed in the prior section of this comment letter and thereby advance the Proposal's objectives.

A. DRR

Reflecting the condition of the banking industry, the DRR should be set at 1.15%, the low end of the statutory mandated reserve range. As discussed below, assessment rates should reflect such a DRR.[9]

B. Allocation Among Category I Institutions

The Clearing House strongly recommends that the FDIC eliminate the subcategories in Category I. All institutions in that Category represent a very low level of risk to

[9] If the FDIC establishes a DRR above 1.15%, the current condition of the industry suggests that it be given substantial time, if needed, to reach the DRR. Whatever the DRR level, the final rule should explain how the assessment rates relate to the DRR.

the insurance fund, and the making of extraordinarily fine distinctions among such low risk institutions is both unnecessary and counterproductive. It significantly increases the complexity of the Proposal and compounds the disclosure risk discussed above. In view of the subjectivity and multiplicity of factors involved, it also creates the potential for unintentional inequitable treatment.[10] Moreover, unless the assessment levels are altered, it results in a continued substantial subsidization of the higher risk institutions by lower risk institutions.

We note that one of the benefits suggested by the Proposal is the reduction in the number of categories from nine to four. Yet, when the subcategories are considered, the actual number of "cells" remains at nine.

If the FDIC decides to maintain some subcategory approach, we strongly recommend the number of subcategories be reduced to three and that the allocation be more heavily weighted to the minimum subcategory. For example, 75% of the Category I institutions could be assigned to the minimum assessment rate, 5% to the maximum and remaining 20% to a middle subcategory (with an assessment rate equal to the average of the minimum and maximum).

The elimination of the Category I subcategories would reduce the complexity and disclosure risk and, combined with a downward revision of the assessment rates, would also reduce the subsidization. Any change in the number of subcategories should in no event increase the average weighted assessment rate for Category I.

C. Assessment Rates in Category I

If the DRR is set at our recommended 1.15% level, then there would be no need for any assessment of institutions in Category I. If a higher DRR is established, we strongly recommend that the proposed assessment rates in Category I be reduced both to minimize the

10 The Proposal notes that a reduction in subcategories would lead to a sharper difference in rates if an institution changes its subcategory. We believe that this disadvantage is more than offset by the far higher likelihood of a change.

subsidization factor and recognize the very low risk created by institutions in this category. If only one rate is used, we recommend that it be 1.5 basis points. If three subcategories are used, we recommend that the rates be 1.25, 2 and 2.75 basis points and the subcategory allocations be 75%, 20% and 5%. Both approaches would eliminate the subsidization element by making the relative assessment rates and relative risk of failure more consistent between Category I and the other categories.

D. Loss Given Default

As discussed above, LGD is a crucial (arguably, the most crucial) element in determining risk to the insurance fund. In turn a fundamental aspect of LGD is the amount of equity and subordinated liabilities that stand behind the FDIC's claims. Unless the final rule recognizes the LGD benefit of significant subordinated liabilities, the assessment system will fall far short of its stated goal of a greater correlation to risk.

We recommend that an institution in Category I that has equity and subordinated liabilities equal to at least 25% of assets be assessed at the minimum rate in Category I. It is our understanding that this level of subordinated liabilities and equity would be substantially in excess of the FDIC's average loss rate in bank failures (which includes a substantial element of fraud).[11]

This approach recognizes the very low LGD risk in such an institution. Unless the recovery rate were far below the average, the FDIC would be exposed to no risk of loss even in the event of the institution's failure. Indeed, the recovery rate is likely to be well above the average in a large institution with subordinated liabilities because of the institution's franchise value.

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11 We have proposed a figure substantially in excess of the FDIC's average loss rate to take account of the possible loss of some of these subordinated liabilities before the institution is closed.

E. Reduced Complexity

We strongly recommend that the Proposal be made less complex by eliminating the possibility of alternative CAMELS weightings and limiting the introduction of additional factors to the special circumstances described below in the next recommendation.

F. Primary Regulator; "Additional Relevant Information"

As described above, we strongly believe that the views of an institution's primary regulator should rarely be overridden. Only the primary regulator has the breadth and depth of experience and knowledge to provide the most accurate evaluation of a bank's risk profile.

The Clearing House recognizes, however, that the FDIC has an important role to play in preserving the integrity of the insurance fund. We believe that this role can best be reconciled with the role of the primary regulator through a collaborative process. More specifically, if the FDIC believes, based on its analysis of the "additional relevant information" listed in the Proposal (market information, financial tests and stress considerations), that an institution's CAMELS ratings clearly fail to reflect the risk posed to the insurance fund, the FDIC should contact the primary regulatory agency, and, if the two agencies agree, a change in the assessment rate would be made.

Under no circumstances should the additional relevant information be used to place larger banks in general, or any other class of institution, in a higher assessment category. Indeed, as discussed above, because most larger banks have substantial subordinated liabilities, they represent far less risk to the insurance fund.

G. Disclosure

We believe that the recommendations above relating to Category I allocations and the primary regulator would reduce the disclosure risk. We also recommend that the FDIC provide guidance in the final rule on the disclosure issue.

III. Additional Comments

A. Change in Category I Assessments

The Proposal would authorize the FDIC to adjust the assessment rate for Category I institutions by as much as 5 basis points per year without opportunity for notice and comment. We believe that a change of this magnitude — an increase of 250% for the lowest risk institutions — should be the subject of a notice and comment process. In the event of an emergency, the FDIC could take this action immediately, subject to a subsequent notice and comment process.

B. Large Institutions

In testimony before Congress, the former Chairman of the FDIC appeared to suggest that the "complexity" of larger institutions may create risk to the insurance fund.[12] We respectfully disagree. In fact, the diversity of larger institutions reduces risk to the fund. Moreover, the primary regulators are aware of the issues arising from size and multiplicity of products and geographies and they exercise their supervision with those considerations in mind.

C. Tier I Leverage Ratio

To the extent that the FDIC uses financial ratios beyond those incorporated in the CAMELS ratings (whether as a financial factor for banks with assets of $10-$30 billion or as "additional information" for larger banks), the Clearing House strongly believes that the Tier I leverage ratio should not be included. We regard this ratio as an anachronism that is more misleading than helpful in assessing an institution's actual financial position. At the time risk-based capital ratios were originally adopted, it was stated by the regulators that this would lead to the phasing-out of the less precise leverage ratio. The failure of the regulators to achieve this objective increasingly places U.S. banks at a competitive disadvantage in relation to banks

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[12] See n.7 on page 7.

elsewhere in the world that are able to invest in high quality short term assets without artificial capital constraints.

D. Retroactive Increases

As we understand the Proposal, if an insured institution's assessment rate changes as a result of a CAMELS rating change, the rate change would be effective as of the start date of the examination that resulted in the rating change. As a financial matter, this is not a concern because the detriment from downgrades would be substantially offset by the benefits of upgrades.

Our concern is, instead, the accounting impact. A CAMELS rating change would often occur in the quarter following the start date of the related examination and, depending on the timing of the start date within the quarter, will not infrequently occur two quarters after the start date. As a consequence, it is conceivable that in one quarter an assessment of over four times the prior assessment would be imposed.[13] Accordingly, we recommend that either there should not be a retroactive assessment or that it should be spread out over a period of time.

E. "Watch List"

Although the "watch list" approach suggested by the Proposal could be helpful in some cases, it is not sufficient to overcome the disadvantages of six subcategories of low risk. In many cases, it will not be possible to make the necessary adjustments to reduce risk.

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13 An even worse result would occur if, rather than accounting for the entire amount in a single quarter, a restatement of prior quarters were required.

Thank you for considering the views expressed in this letter. If you would like additional information regarding this letter, or if it would be helpful to meet with representatives of our member banks, please contact Norman R. Nelson, General Counsel of The Clearing House, at (212) 612-9205.

Sincerely,