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September 22, 2006

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 Seventeenth Street, N.W.
Washington, D.C. 29429

Re: RIN 3064-AD09; Proposal to Amend the Risk-Based Assessment System and to Establish a Base Assessment Rate Schedule; 71 Federal Register 41910; July 24, 2006

Dear Mr. Feldman,

The American Bankers Association (ABA) appreciates the opportunity to comment on this proposal. The Federal Deposit Insurance Reform Act of 2005 requires the Federal Deposit Insurance Corporation (FDIC) to prescribe regulations, following public notice and opportunity for comment, to make changes in the assessment system.[1] The FDIC has proposed to amend its regulations to create different risk differentiation frameworks for smaller and larger banks that are well capitalized and well managed, establish a common risk differentiation framework of all other banks, and establish a base assessment rate schedule.

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.

We appreciate the considerable staff work that supports the proposal presented by the FDIC. We particularly want to acknowledge the openness of staff to consider ideas by the banking industry in all the stages of development of this and other proposals implementing the new law. We share the view that it is critically important to get this system right. While seemingly small, ***each*** basis point assessment on the industry is ***$640 million*** today. This is a huge sum of money, and, if the system is not structured appropriately, it may result in very negative consequences not only for resources and earnings of individual banks, but for consumer savings and access to credit.

[1] Sections 2105, 2106, 2108, and 2109 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) of the Federal Deposit Insurance Act, 12 U.S.C. 1817(b).

Any new system will need to be tested. However logical the approach, there inevitably will be unintended consequences. Therefore, a conservative approach is required, particularly in the range of premiums charged to different institutions. If the variation is too large relative to the actual risk, then some institutions will bear a disproportionate cost and will be unfairly competitively disadvantaged. Moreover, with an untested system, incentives may be created that could result in changes in corporate structures, in funding mixes, and in other business practices – which are very likely to be unrelated to risk of bank failures or loss to FDIC. A conservative approach will help to minimize adverse impacts. As experience is gained, adjustments can be made.

As ABA has stated in other recent comment letters to FDIC,[2] it would be a mistake for the FDIC to charge high premiums for next year. In fact, the FDIC proposal acknowledges that high rates may impact "customers in the form of higher borrowing rates, increased service fees and lower deposit interest rates." Not only is the revenue not needed to protect the insurance fund and insured depositors, but ***with an untested system, high rates will compound the financial consequences of a mis-specification of the risk-based system***. To minimize negative consequences, the most appropriate strategy is for low, smooth premiums both in the near-term and long-term. We recommend that premium rates begin at a base of no more than 1 basis point, and that total assessments not exceed 2 or 3 basis points (b.p.) on average each year, which can and should be lowered once credits have been largely used up.

While the old system certainly had its shortcomings, it had a very important attribute: it created incentives to be in the best risk category. It made no distinctions between a CAMELS rated 1 or 2 bank – as in practice, the difference between the two is very small. It should be no surprise nor cause for concern that 95 percent of the industry is in the lowest risk category, as the high level of capital and lack of supervisory concern warranted this treatment – emphasized by the very low loss experience of the FDIC in recent years. With the industry in a strong condition, a well-designed risk-based system would have – and should have – a high percentage of the industry paying the lowest premium rate.

Moreover, ABA has stated consistently that the chief focus of the FDIC risk-based system should be on CAMELS 3, 4 and 5 rated institutions, not on banks that pose far less supervisory concern. The level of extensive effort and detail in the proposed rules aimed at differentiating very minor differences in risk among healthy banks seems out of balance when compared to the simple formula for banks that ***do*** pose a heightened supervisory concern. While there is no doubt that some distinctions in risk do exist among the healthiest banks, the fine line between institutions is magnified many times in the premiums they will be assessed under the proposal.

In summary, the ABA makes the following specific recommendations:

- The initial percentage of banks paying the lowest rate is too small given the health of the industry.
- The base premium rate schedule should be lower for healthy banks.

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[2] See ABA's comment letter on the FDIC's proposed distribution of assessment credits at www.aba.com/NR/rdonlyres/A8F1C91D-7B23-4FD1-B6D9-9D885CB2433D/44447/ABAFDIRAAssessmentCredits060816.pdf.

- The spread between the base and ceiling premium rates in Category I should be one basis point, not two.
- *De novo* institutions should not be automatically assessed the highest Category I rate.
- Increases to the premium schedule should be limited to 2 basis points annually, not 5 basis points.
- Complexity in the system should be avoided.
- CAMELS components should have equal weight.
- CAMELS ratings should not exceed 50 percent of the overall risk score.
- Examiner ratings should not be overridden by FDIC.
- Risk based capital ratios and subordinate debt should be considered.
- Use of debt issuer ratings is an important aspect of any risk-based assessment system.
- The additional information, or "stress" consideration, should not be included.
- Federal Home Loan Bank advances and deposits greater than $100,000 should ***not*** be included in the volatile liabilities variable.
- Warning institutions of a downgrade before a financial penalty is appropriate.
- Higher risk categories should provide incentives for improvement.
- The review and appeals process must be improved.

## 1. The Initial Percentage of Banks Paying the Lowest Rate is Too Small

Within Category I, under the terms of the proposal, 45 percent of banks would pay the base rate, 5 percent would pay the highest rate, and 50 percent would pay between these two levels. Since the percentage of institutions in the base rate will change with the ebb and flow of the business cycle, setting this initial distribution appropriately is critical. There is no question that the banking industry today is in exceptional financial health. In fact, 99½ percent of banks are well-capitalized and the number of problem banks is at an historic low. Thus, it would be very unlikely at any time in the future that more than 45 percent of institutions would be in this base-rate assessment group. ***Given the very low risk profile of the banking industry today, ABA strongly recommends that the percentage of institutions initially paying the lowest rate be considerably higher***.

In fact, the proposed share of banks paying the floor rate would be too low for most periods, not just the current one. We are concerned that the proposed system is not well calibrated to economic cycles. Applying the proposed new system to experience for the last decade and a half, using the financial ratios and CAMELS ratings, we find that the percentage of institutions that would qualify for the floor rate is greater than the 45 percent for every year since 1992, except one.[3] Given the current exceptional health of the industry, this clearly shows some mis-specification of the model.

***The greater the difference between the floor and ceiling rate, the more important the distribution becomes.*** For a small change in any financial ratio or CAMELS ratings, the wider spread would make the financial consequences more severe than is the case with a smaller spread.

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[3] The exception was 2001, which was marked by a recession.

We would note that with this new, untested premium system, a more conservative approach is warranted until more experience is gained.

## 2. Base Rate Should Be Lower for Healthy Banks

The ABA strongly believes that the proposed base rate is higher than is appropriate. FDIC also asks whether a "permanent" base rate schedule should be adopted. ABA is concerned that permanent implies that the minimum rate would effectively be a floor rate. While the FDIC does propose authority to lower the schedule, the tendency may be to focus on recent events (e.g., the past year's growth in insured deposits) and increase the base rate well beyond what is required in the long-run. This could create more volatility in the assessment rates and is counter to the goal of low, steady premiums. Moreover, the terms "permanent" and "base" themselves imply a floor from which only increases would be considered.

More critical is the likelihood that a range of between 2 and 4 basis points for the healthiest banks would produce a revenue stream in excess of what would be required to maintain the reserve ratio under normal conditions. For example, an average assessment of 1.9 basis points would have kept the reserve ratio steady over the last five years (taking into account FDIC operating and insurance expenses, income from securities, and unusually high insured deposit growth). Moreover, ***over the last decade, an average premium of only 0.9 basis points would have sufficed***.

In addition, according to FDIC research, a fair assessment rate for banks with S&P ratings between AAA and A would be one-third of one basis point. ***The ABA believes that initially the best risk-rated banks should pay no more than one basis point and certainly less under most normal economic conditions.***

## 3. The Spread Between the Base and Ceiling Rates is Too High

Given the very small differences in risk among banks in the healthy bank category, the proposed 2 basis point spread is too large for Category I banks. By definition, these institutions have capital at least 25 percent greater than minimum requirements and do not pose supervisory concerns. With negligible differences in relative risk to the Deposit Insurance Fund (DIF), it makes no sense to charge one bank twice as much as the other bank (i.e., the proposed 2 basis point floor rate versus the 4 basis point ceiling rate). Further, given the strong improvements in risk-management systems of banks, improvements in supervisory evaluations and off-site monitoring, and enhanced supervisory powers enjoyed by the regulators, the spread should not be greater than 1 basis point for these healthy banks.

Once again, the caution called for by the untested nature of this new risk-based premium system argues for a much narrower premium range in the healthy bank category. As experience is gained, the FDIC can, and should, review the system and propose adjustments that can be justified by experience with the new system.

The relatively wide spread between the floor and ceiling rates in Category I, while troubling for all institutions, is particularly a concern for large banks. This is due to the proposed six premium bucket approach for banks with over $10 billion in assets. The wider the spread of rates, the greater the change in premiums from one premium bucket to the next. Given very small relative differences in the risk among these banks, such a premium differential is excessive. A smaller range would reduce these large jumps and lower the penalty for a small change in performance.

The spread is also particularly troubling for those categorized as new banks under the proposal (less than seven years old), as they are automatically placed in the highest rate in Category I. We object to this treatment of automatically placing new banks at the highest rate, as will be discussed below, but a narrower spread would lessen the impact on these banks should the FDIC adopt such treatment.

**4. One-Size-Fits-All Treatment of New Institutions is Not Appropriate**

The ABA believes that the blanket premium assessment proposed for banks that are less than seven years old (so-called "new" banks) is an inappropriate and arbitrary assessment of risk. First, *de novo* banks are scrutinized more often and more intensively by examiners than most other banks. Examinations every six months for the first three years is not uncommon. Moreover, there is already an inherent bias in the CAMELS ratings of new banks. Examiners are extremely reluctant to give a CAMELS 1 rating to a new bank, regardless of whether the institution has strong financial ratios and experienced management. The examiner prejudice inherent in CAMELS ratings is already one source of arbitrary risk assessment that penalizes these banks. There is no justification for an additional penalty. The capital of these institutions is typically well above that for established banks of similar size (as generally required by the chartering authority) to accommodate expected growth and the characteristic experiences in the early years of existence. It is this capital that helps protect the FDIC, yet there is no recognition of this when the highest rate is charged automatically. Instead, the FDIC should encourage safe and sound bank operations by rewarding good management practices with lower premiums, regardless of the age of the bank.

The proposal defends disparate treatment for *de novo* banks by citing past data that "new institutions have a higher failure rate than established institutions".[4] This evidence is out of date and does not relate to today's *de novo* banks. Many *de novo* banks are chartered by experienced bankers in markets where these bankers have lived and done business for years. Often these bankers began the bank following acquisitions of their former institutions. Such bankers typically bring a book of business from borrowers that they have known and lent to for many years. Frequently these credits were established 5 or 10 years before. The lending relationships are with the same banker, but at a different – new – institution. Thus, these loans are, in practice, much like seasoned loans of an established bank. With the considerable experience of such bankers that in many cases run these start up banks, it is not surprising that today's *de novo* banks achieve profitability and mature performance faster than start ups had in the past.

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Other new institutions were created by buying a branch of a larger bank – including many of the loans originated from that branch. These institutions normally capitalize the new bank well in excess of the capitalization from the selling bank. This serves to lower the FDIC's risk.

The one-size-fits-all approach also ignores other characteristics of new banks, including the holding companies under which they operate. For example, it is not unusual for an established institution to add another charter under their holding company. Imposing now a deposit insurance penalty for that structure choice will raise an incentive to merge the new charter with the established charters, or to expand by branching rather than by new bank charter, to avoid this extra penalty. This would introduce a new regulatory influence into banker considerations of the optimal business structure for serving customers. A rule that forces such a change and which does nothing to alter the underlying risk to the FDIC is fundamentally wrong.

Other institutions have considerable financial support from the parent holding company, with significant financial resources and long experience in the banking business. This source of strength, which can downstream capital if necessary, should be an important consideration in determining the likelihood of loss to the DIF and assessing a risk-based premium.

Such a one-size-fits all rule has other consequences as well related to the conversions of credit unions to bank charters. Several dozen credit unions in recent years have determined that they could best serve their customers by converting to mutual savings associations. These institutions have a seasoned loan portfolio, experienced leaders, and an established business history. They have been carefully screened by their new banking regulator. Imposing a financial penalty will erect an unnecessary disincentive to these conversions. Converted credit unions will be under bank supervision, and the CAMELS ratings and financial variables should capture the actual risk to the FDIC as it would for other established institutions. The actual experience with converted credit unions does not justify a deposit insurance premium penalty. Should the FDIC – despite the strong arguments otherwise – proceed with a premium differential for new banks, the date used for converted credit unions should be the establishment date of federal deposit insurance, which would include both the FDIC and the National Credit Union Share Insurance Fund.

*De novo* banks should be evaluated based on examination ratings and financial ratios, just like any other institution. If there are questions about the health of a *de novo* bank, the regulators have the ability to discuss it with the primary regulator. As experience is gained under the new system, the FDIC can make adjustments as appropriate.

Finally, there are important public policy reasons <u>not</u> to apply separate treatment to *de novo* banks. If the public is told that the FDIC believes that all banks chartered within the last seven years are less safe, confidence in all *de novo* banks will be undermined. Moreover, requiring existing *de novo* banks, regardless of condition, to pay higher premiums would put them at a competitive disadvantage relative to established banks, a disadvantage imposed by regulatory action rather than market conditions.

Under the current proposal, no new bank had expected such a penalty rate. Moreover, the system is untested. If the FDIC goes forward with this provision, at a minimum, the FDIC needs to have flexibility to grant exceptions to this hard and fast rule. For example, a bank chartered under established bank or financial services holding companies should be excluded and converted credit unions (where the credit union has existed for more than seven years) should be excluded. There may be other exceptions that would be appropriate.

### 5. Increases to the Premium Schedule Should Be Limited to 2 Basis Points Annually, Not 5 Basis Points

The proposed authority to increase the base schedule up or down by as much as 5 basis points, without opportunity for public notice and comment, is excessive and unnecessary. The hypothetical assessment rate schedule (Table 17 in the NPR) shows the danger in the FDIC's approach. This table uses high growth rates to suggest that such authority would be needed. The table demonstrates that at high annual growth rates of ***7 or 8 percent for a full 5-year period***, an upward adjustment would be needed to keep the reserve ratio roughly steady.

At lower – ***and more realistic*** – growth rates, the additional revenue from the increase in premiums sends the reserve ratio rapidly upward. At a 4 percent growth rate in deposits, the reserve ratio rockets to 1.35 percent within four years. Under the new law, dividends would be authorized at this level – a pointed commentary on what the excess premium adjustment can do. At a 5 percent annual deposit growth rate, the reserve ratio increases to 1.31 in four years. Clearly, extra premiums are not needed at these more realistic growth rates.

***Importantly, in the last 15 years there has never been a five-year period where insured deposit growth has exceeded 5.1 percent annually.*** The last five year period saw the highest growth rate, but this period included a significant accounting change that artificially boosted the recorded insured deposits for the first quarter of 2002. Typically, the five year annual growth rates are much lower, and the 10-year growth rate is 3.8 percent. This strongly suggests that the authority to increase assessment rates by five basis points without public notice and comment is excessive under reasonable assumptions based upon historic experience, including our most recent experience with very high deposit growth rates.

Moreover, an increase of 5 basis points has a significant impact on bank resources available for providing services to customers, as the FDIC acknowledged in the proposal. Funds unnecessarily placed into the FDIC reserves are removed from optimal use within the economy. In addition, there is also an impact on bank earnings. The FDIC analysis points out that the 5 basis point increase would cause ***a reduction of income up to 5 percent for nearly two-thirds of all institutions and a 5 to 10 percent reduction in income for nearly one-quarter of all institutions.*** The remaining 9 percent of institutions would experience an even greater reduction. Such an impact is unjustified, particularly given the fact that the DIF has $50 billion in resources.

The ABA recommends that the ***increase*** above the base without public comment be limited to two basis points. Even this increase would mean under the proposal a doubling of premium costs for the best-rated banks (paying 2 basis points). The FDIC's analysis in Table 17 shows that the 2 basis point adjustment is more than sufficient to build the reserve ratio steadily under normal deposit growth rates.[5] Should a higher increase be necessary, the FDIC would be able to approve the change. Such unusual circumstances requiring such a steep increase would surely justify a procedure for public notice and comment.

Importantly, such an approach will keep premium levels from dramatically increasing from quarter to quarter or year to year and would reinforce the important public policy of steady, low premium rates. Sudden increases in premiums impose expenses that can be difficult to absorb and may be interpreted by markets very negatively. Because of the importance to avoid taking unnecessary resources out of the banking industry, ***the ABA also recommends that there be no limit to reducing the rate schedule***. Should the FDIC find that there is no longer a need to raise revenue, the rate schedule should promptly be cut back accordingly. Such an approach, which limits increases but provides flexibility to reduce costs, is the best way to protect institutions and their customers from much higher costs and yet provide immediate relief when appropriate. If more funding is necessary, the FDIC always has the option to provide notice and seek comment on the appropriateness of higher rates.

## 6. Complexity in the System Should be Avoided

The proposed system can become increasingly complex, with the possibility of many different approaches to different types of institutions or the treatment of institutions within a holding company. For example, there are many reasons why a holding company may establish a subsidiary bank, some related to lines of business, others related to past acquisitions, and some related to efficient management and allocation of resources. Consider a bank holding company with three banks: $1 billion, $20 billion, and $50 billion in assets. Each of these banks would be treated differently under the proposal, yet the same holding company is standing behind all three. It becomes difficult to understand who is paying what in relation to what risk. Moreover, the program as proposed can encourage changes in the structure of an organization, not to improve efficiency, but to minimize premium costs. An established bank holding company may not be willing to charter a new bank because of the hard and fast rule that the new bank would pay the highest premium rate in Category I. ***A more cohesive approach for institutions within holding companies is needed.*** Other steps to reduce the tendency toward complexity should be adopted in the development, implementation, and operation of the new program. Again, the potential for paralyzing complexity speaks to the need for a conservative approach in implementing this new, untested system.

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[5] Table 17 uses a 2 b.p. adjustment for two years (following one 5 b.p. adjustment in the first year). The reserve ratio at a 4 or 5 percent growth rate rises rapidly.

## 7. CAMELS Components Should Have Equal Weight

The FDIC proposes that some components of the CAMELS ratings have more weight assigned to them when calculating the total risk-based assessment score. That is, Capital and Management would be weighted at 25 percent, Asset Quality at 20 percent and the remaining three components at 10 percent each.

We strongly recommend that there be no over-weighting of individual CAMELS components. We appreciate that examiners may believe that certain components are more important than others in the evaluation of a bank. Taken as whole, however – considering both the CAMELS and financial ratios (and debt ratings for large banks) – the proposed model provides the right balance without overweighting individual components of examination ratings.

For example, capital enters the risk-based premium evaluation in several ways: first, the institution must be well-capitalized even to be in Category I. Second, the tier one capital leverage ratio adds a further distinction – going even further beyond "well-capitalized."[6] Third, capital is the first component in the CAMELS ratings. While we understand that capital absorbs losses before the FDIC and therefore more might seem better, such an overemphasis is out of line with the real risk of loss to the FDIC. Moreover, such overweighting is inconsistent with efforts to tie risk more accurately to capital under the Basel II and 1A capital standards reform projects. On this note, the FDIC and other federal banking agencies need to consider the interaction between risk-based premium and risk-based capital rules.

Asset quality also is given significant emphasis, as is reflected in at least three financial variables in the risk-scoring model – past due loans, non-performing loans, and net charge offs. Thus, there is no reason to give it added weight in the examination rating component.

Management – the most subjective of all the CAMELS components – must by necessity be involved in all the financial ratios and other examination components. In practice, therefore, it is unlikely that examiners would rate management higher than the other components. Thus, there is always a bias against a high management rating. Furthermore, management can be downgraded for technical compliance issues that have nothing to do with the possibility of the bank failing. For example, one banker commented that his bank was downgraded for management for one technical violation related to the Bank Secrecy Act (BSA) – which has small bearing on the risk of his bank failing. His story is echoed in reports from many other banks. Under the proposed system, not only would such a technical violation result in a financial penalty in the form of higher insurance premiums, but the proposed super-weight would magnify it.

[6] Prompt Corrective Action rules implemented in the early 1990s effectively require banks to hold at least 25 percent more capital than what is required to meet minimum standards. Almost all banks – 99½ percent – have found it necessary to meet all the requirements of being "well capitalized" in order to avoid punitive limits on their activities.

Given the considerable subjectivity of examiner ratings and the emphasis already captured in the financial ratios, we would strongly recommend that each CAMELS component be weighted the same.

### 8. CAMELS Ratings Should Not Exceed 50 Percent of the Overall Risk Score

The large bank risk-scoring model assigns a 50 percent weight to CAMELS, whereas the small bank model includes CAMELS as one of seven variables (the other six being financial ratios). Given the subjective nature of ratings and the importance of the financial and market information, CAMELS ratings should not be greater than 50 percent of the overall risk score for either the large or small bank model and a significantly lower weighting than that may be more appropriate.

Subjectivity is inescapable in the examination process. However, many bankers believe this subjectivity has resulted in examination ratings remaining higher (i.e., rated weaker) than the data would suggest are appropriate. We have heard from several of our members that their component ratings have remained the same notwithstanding their banks' steadily improving performance. This difference in perspective between banks and their examiners underscores the problems with using CAMELS ratings to determine insurance premiums. To avoid having a bank charged a premium that is inappropriately high because of subjective factors, we strongly urge the FDIC not to overemphasize the role of CAMELS ratings in the premium assessment model.

Moreover, the proposal asks whether there is merit to applying a 50 percent weight on CAMELS for both large and small banks. While there is certainly some merit in having continuity between the small and large bank systems, continuity does not require having a 50 percent CAMELS weighting in each system. Regulators have dedicated case managers assigned for most large banks, often with a continual on-site presence at the bank; examination ratings are practically under constant review. For smaller banks, these ratings are reviewed with examinations occurring every 12 to 18 months. Thus, the CAMELS ratings for small banks are not typically as current as they are for larger banks, neither are they as current as the bank's financial ratios. Thus, for the small bank model, it is more appropriate to include CAMELS as one of the variables, rather than automatically giving it a 50 percent weight. This helps to mitigate the double counting of the elements that would be included in both the financial ratios and the CAMELS ratings.

### 9. Examiner Ratings Should Not Be Overridden By FDIC

ABA recommends that there be no FDIC override of examiner ratings of a bank's primary regulator. There are two instances under the proposal where the override might occur. The first is in the CAMELS rating, and the second is in the "additional information and analyses" factors that might be considered in assessing the rating of banks over $10 billion in assets. Regardless of the size of institution, we believe that the primary regulator is in the best position to determine the condition of the bank and any second-guessing may lead to inconsistent treatment across the industry.

Overriding the primary regulator can also occur in the large bank model through the proposed application of "stress considerations." We believe that the primary regulator is in the best position to judge the ability of the bank to handle stressful situations and would most likely include such an evaluation in its CAMELS ratings. In fact, it is already included as part of the evaluation of the sensitive to risk component of the examination ratings. Moreover, as risk-based capital models and risk-management models are developed, it is the primary supervisor that will be assessing the effectiveness of these systems and thereby be in the best position to render a ratings judgment. Should the FDIC choose to use additional information – which, as is noted below, is neither well documented nor clearly articulated in the proposal – it should be the decision of the primary regulator as to how it would be included in the risk-based formula.

**10. Risk-Based Capital Ratios and Subordinate Debt Should Be Considered**

The proposal uses the tier one leverage ratio as one of the financial ratios in risk-scoring banks with less than $30 billion in assets. In a ***risk-based*** premium system, the use of a ***risk-adjusted*** capital ratio may be more appropriate. Moreover, just as capital is an important financial variable protecting the bank and FDIC, so is subordinated debt. We suggest the FDIC include this as a financial ratio, perhaps in concert with the capital variable. It may be particularly important for the financial ratios used in the large bank model.

**11. Debt Ratings for Large Institutions**

The ABA believes that including debt issuer ratings is appropriate as market evaluations and market discipline are important factors in measuring and managing risk. Many banks believe that this is the most important component of the new system. Debt issuer ratings are certainly not perfect, however, as they tend to be more subjective than is generally assumed, and many banks with less than $100 billion in assets believe that they can never get ratings as favorable as those for larger banks. The FDIC must be sure that there is fair treatment for all banks when using these ratings. We understand that the phase-in of debt issuer ratings for banks between $10 billion and $30 billion in assets is an attempt to address this disparity to some degree. It is also true that the financial variables – particularly the tier 1 capital and volatile liabilities – tend to be less favorable and thus may act to raise the premium assessments for banks with assets in the $10 billion to $30 billion range. We suggest that if the premium assessment calculated using just the debt ratings is ***lower*** than the assessment calculated using the financial ratios, then the FDIC should assess the lower premium.

Furthermore, while the proposal places its focus on the bank, and therefore on the bank rating, the holding company rating should also be considered. Often the bank rating is built upon the rating of the holding company, as downstream capital from the holding company and upstream dividend payments are important considerations. Some institutions issue debt only from the holding company. In this case, the bank should have the option of whether to use the holding company rating, rather than simply relying on financial ratios. A bank should not be penalized for choosing one way to issue debt versus another.

## 12. The Additional Information, or "Stress Considerations," Should Not Be Included

The proposal would give the FDIC authority to adjust the risk-category of large banks up or down based on additional information. This would include the ability of the bank to deal with stress, the extent of risk-management systems, and the liability structure. While these may be very important variables, their specification, how they would be used, what role would be played by the primary regulator versus the FDIC, and how disputes would be addressed, is not well developed in the proposal. Given the untested nature of the proposal and the significant uncertainty surrounding the use of this information, ABA recommends that this added element not be included. Rather, further study and evaluation should be conducted in close consultation with the affected banks. Once this approach can be more fully articulated, notice and opportunity for public comment should be provided.

## 13. Federal Home Loan Bank Advances and Deposits Greater than $100,000 Should Not Be Included in the Volatile Liabilities Variable

We applaud the FDIC for not including Federal Home Loan Bank (FHLB) advances in the definition of volatile liabilities. This has been an important issue for the banking industry and the FDIC has been very receptive to the concerns voiced by the ABA throughout the debate on the legislation and in the development of this proposal.

The FHLBs are a stable and reliable source of funds for banks. Advances are readily accessible for member banks with available collateral, and the advances have pre-defined and predictable terms. They are as stable as core deposits and are not vulnerable to short-term promotions in the local market or surging returns on alternative assets. Even in the case where a bank is experiencing financial difficulties, the FHLB is required by regulation to coordinate with the FDIC to ensure that the bank has adequate liquidity while minimizing other risks, including losses to the FDIC. The FHLBs have legal authority to access confidential examination reports to assist with this analysis. Therefore, it would be illogical to include advances in the definition of volatile liabilities.

Moreover, the use of FHLB advances does not increase the risk of a bank failing, and therefore does not warrant higher FDIC assessments. The availability of such funding has a predictable, beneficial effect on a bank's business plans. Advances are designed to be matched to the maturities of home loans and other term credits, helping a bank manage its interest rate risk exposure. Banks also use advances for liquidity purposes to fund loan growth. In markets where the supply of deposit funds is insufficient to meet loan demand, a FHLB member bank can rely on advances to meet customer needs. Without this funding, the bank would be forced to turn to alternative, more costly wholesale funding sources that are demonstrably more volatile. This, in turn, will reduce profitability, increase liquidity risk, and provide less stability for the bank. Therefore, the use of FHLB advances more likely lowers the risk to the FDIC, and banks should not be penalized through higher FDIC assessments for using them.

The cooperative relationship between the FHLBs and their member banks has worked remarkably well for 75 years, and in so doing has helped protect the FDIC deposit insurance funds. FHLB advances serve as a critical source of funding for housing and community development purposes, support sound financial management practices, and allow more than 8,200 institutions throughout the nation to have guaranteed access to liquidity. There is no justification for treating advances as volatile liabilities or as a determinant of higher FDIC assessments. We urge the FDIC not to consider advances in this way.

Neither should the definition of volatile liabilities include large deposits in excess of $100,000. Bankers report that these deposits are very stable and are typically less expensive than alternative funding sources. Many community banks consider these to be core deposits, even in times of stress.

**14. Warning Institutions of a Downgrade Before a Financial Penalty is Appropriate**

The ABA believes that instituting a system that would notify a bank of a pending increase in premiums, and giving the bank an opportunity to make corrective action before the increase becomes effective, is a very good idea. The large premium increases between risk buckets in the large bank model makes having such an early warning system particularly important. Such a warning system creates positive incentives to improve.

**15. Higher Risk Categories Should Provide Incentives for Improvement**

We appreciate the desire to simplify the current system's 9-box assessment rate system. However, several concerns still exist. First, the system does not recognize differences that could exist among institutions in the higher risk categories. For example, an institution that has an approved recovery plan and is meeting the intermediate goals of it should be given credit in the premium system.

This is particularly the case as institutions raise new capital. Every new dollar raised lowers the risk of the FDIC. For example, consider a bank that is adequately capitalized and CAMELS 3 rated. Under the proposed system, it would have a base assessment of 7 basis points. Should this bank raise additional capital to become well-capitalized (thereby reducing FDIC's risk), one would naturally expect the premium rate to decline. Under the proposed system, however, the premium assessment remains 7 basis points. If the goal is to provide positive incentives to raise capital and otherwise reduce risk of loss to the DIF, some reduction in premiums is advisable. Given all the attention to differentiating the risk among banks representing little supervisory concern, it seems that more differentiation among the higher risk banks is even more appropriate.

**16. Review and Appeals Process Must be Improved**

In the proposed systems, the emphasis on examination findings, as summarized in the CAMELS ratings, is much greater—and their consequences much more tangible—than in the current risk-based system. Under the old system, there was little direct *financial* consequence from a 2-rating rather than a 1-rating overall. The same held true for a CAMELS component. The examiner could use the ratings to acknowledge a strength in the organization or send a signal for some improvement before the next examination. However, under the proposed system, there now is a direct financial consequence associated with any rating. Not only do we expect this to make examinations more contentious, but also there will be an institutional bias against giving a rating of one in any category. For the first time in FDIC's history, an examination rating of 1 would result in less revenue for the FDIC.

***It is critical therefore that the review procedure and the appeals process be significantly improved.*** Given the potential increase in contentiousness in examinations and the substantial negative financial impact of downgrades, it is likely that there will be many more appeals of material supervisory determinations and of resulting deposit insurance assessment determinations. The quality of the appeals process was reduced in 2004, over the strenuous objections of the American Bankers Association.[7] Those amendments removed the FDIC's Ombudsman from the Supervisory Appeals Review Committee and the Assessment Appeals Committee and reduced overall the voting members of these committees. As we said in our comment to the 2004 changes, we believe such steps were inconsistent with the intent of Congress when it required the banking agencies to have ombudsmen. Moreover, these changes weakened the credibility of the FDIC's appeals process with bankers.

Given that the FDIC's current rulemaking will result in the bank bearing the financial consequences of the regulatory decision, every effort should be made to make the appeals process as open and fair as possible. This will not be easy and will likely require further work beyond the compass of this proposed rule. ***As a first step, however, the ABA recommends that as part of this rule the FDIC Board – which includes the heads of three regulatory agencies – commit to a comprehensive revision of the supervisory and assessment review and appeals process to ensure that it is open, fair, and independent***. We would be eager to participate with the regulators in the development and implementation of such a revision.

Inasmuch as the proposed rule places significant reliance upon CAMELS assessments made by examiners from a variety of regulatory agencies, we also recommend that steps be taken to improve the consistency of examination assessments within and among the different regulators. There are considerable differences among the examinations by the federal regulators, as there is between the state and federal regulators. It is very important to avoid having dissimilar examination ratings – and therefore different premiums – for institutions with very similar profiles. Under the old system, there was little financial consequence to such variations; under the new one, the financial consequences can be significant and the competitive consequences unfair. Therefore, ABA affirms that the reforms in this proposed rule give added urgency to the efforts by the Federal Financial Institutions Examination Council (FFIEC) and the individual agencies to improving the consistency of examination findings.

[7] See ABA's comment letter on the FDIC's proposed revisions to the supervisory appeals process at www.fdic.gov/regulations/laws/federal/04cABAappeal428.html.

**Conclusion**

In this and other recent proposals, the FDIC has proposed significant changes to the system of assessing premiums. With so many changes, there is significant risk of unintended consequences. To minimize this risk, ABA strongly recommends that the FDIC take a cautious approach. A key element is low and steady premiums with the base assessment rate no higher than one basis point, considering the current health of the banking industry.

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) 663-5130 or Robert Strand at (202) 663-5350.

Sincerely,

James Chessen