From: Wallach, Drew [mailto:dwallach@northshorebank.com]
Sent: Friday, September 22, 2006 6:43 PM
To: Comments
Subject: RIN 3064-AD09 Assessments

September 22, 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:

As a bank officer and a Chartered Financial Analyst with 25+years experience, I appreciate the opportunity to comment on the proposed improvements to the FDIC's risk-based assessment system. I would like to preface my comments by recognizing the high quality of the proposal as presented. My comments here focus on my concerns, rather than the many things that I think are well designed.

The challenge, of course, is in creating rules to be applied across all institutions, or even across large subgroups such as all institutions under $10 billion. It requires describing and differentiating the myriad complexities of each unique institution with simple rules. The wisdom of establishing categories on the basis of CAMELS rating lies in the fact that the ratings are simple and yet encompass the specifics of each institution. At the time of the examination, the whole institution is evaluated and offsetting characteristics melded into the rating.

However, the proposed process for risk differentiation within Category I is fundamentally backward in going from CAMELS ratings to financial ratios in calculating the FDIC assessment in Category I,

The proposal correctly points out that for years the FDIC and other financial regulators have used financial ratios in offsite monitoring systems to aid in analyzing the financial condition of financial institutions. Financial ratios have the advantage of timely availability and simplicity. They cut through the complexities. However, the best use of financial ratios is to uncover anomalies for further investigation through examination. Through examination, regulators confront institution management and through that process the anomalies are further defined or explained.

If one believes in the validity of the examination process and its product, then the proposed process of combining CAMELS rating 1 and 2 into one category, and then differentiating by financial ratios to calculate the assessment level is fundamentally flawed. It discounts the product of the examination process. It will result in the replacement of reasoned judgment with mechanical observations. It will result in a less than optimal allocation of insurance cost among insured institutions.

Other methods of risk differentiation would better build on the examination product and CAMELS rating.

Risk differentiation within Category I could be based on the CAMELS component scores without losing the superior insights of the examination.

Alternatively, if lack of timeliness is a concern as regards relying on the most recent examination, ***change*** in financial ratios since the last examination date could be used, rather than overriding the examination product completely.

Beyond the complexities of specific institutions, certain aspects of the "Volatile Liabilities to Total Assets" ratio raise concerns.

One should have serious reservations about the use of this ratio in assessing insurance costs. It is stated in the proposal that "…removing time deposits greater than $100,000 would make volatile liabilities insignificant in explaining potential downgrades." Elsewhere the proposal states that the FDIC used data from the period 1984 to 2004 to determine the pricing multipliers. Having worked in the industry throughout this period, I know that the usage of $100,000 time deposits has changed dramatically during this time. At the start, failing institutions carried significant books of funding that relied on deposit insurance rather than the quality of the institution for repayment. Subsequent prohibitions of use of brokered deposits by weak institutions have dramatically altered the usage of this liability. The choice of the data set period may cause the emergence of this as a significant factor ratio in predicting potential downgrades. I believe that it is not a valid predictor today.

Further, on a fundamental basis, presence of what is called volatile liabilities without regard to asset composition is not a logical predictor of risk to the insurance fund. For example, high quality liquid assets must back all repurchase agreements. It does not make sense that the presence of the liability alone, without consideration of the asset position is a symptom of impending downgrade.

Finally, as defined, volatile liabilities are a diverse mix of funding that seem to be artificially grouped together. High levels of fed funds vs. repurchase agreements vs. local deposits vs. brokered deposits all look the same through the lens of this distorting ratio, but each represents a very different liability to the institution and risk level to the insurance fund.

Potential for a liquidity problem at a financial institution is an important but complex financial characteristic that would not be easy to diagnose with a simple rule. The "L" component in the CAMELS rating would be a much better guide.

Rapid growth in insured deposits represents a significant risk to the insurance fund that is not considered directly in the current proposal.

It is recognized in the proposal that a new institution undergoes rapid change in scale and scope of operations, leading ultimately to a higher risk of failure. Rather than a blanket rule increasing the cost of insurance to all new institutions, a rule imposing a special charge for rapid insured deposit growth would have advantages for protecting the insurance fund from risk in the future.

Even older institutions can be taken over and their operating characteristics radically changed in a way that adds risk to the system. Given the control of both insured and uninsured investment vehicles within one entity, it is easy to imagine the possibility of future "just in time" use of insurance that could inappropriately spread the cost of insurance. The imposition of additional assessments associated with rapid growth would cover all these possibilities.

Thank you for your consideration of these comments.

Sincerely,

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