August 16, 2006

Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Re: RIN 3064-AD02:
Proposed Rule Setting the Designated Reserve Ratio for 2007

RIN 3064-AD08:
Proposed Rule Implementing the One-Time Assessment Credit

RIN 3064-AD07:
Proposed Interim Rule Specifying Dividend Requirements

Dear Mr. Feldman:

The FDIC-insured institutions submitting this letter (Charles Schwab Bank, N.A., Countrywide Bank, E*TRADE, ING DIRECT, Morgan Stanley Bank and Discover Bank, and Nationwide Bank) were all either chartered or experienced significant growth in deposits after December 31, 1996. The signatory banks together held approximately $140 billion of FDIC-insured deposits as of June 30, 2006. The proposed rules currently under consideration by the FDIC implementing the deposit insurance reforms called for by Congress with passage of the *Federal Deposit Insurance Reform Act of 2005* (Public Law 109-171, Title II) will no doubt have a significant impact on all FDIC-insured institutions; however, the potential for unintended adverse consequences that could flow from this rulemaking proceeding are of particular concern to the signatory institutions and others that were chartered or experienced significant deposit growth since December 31, 1996.

In an effort to avoid any unnecessary or unintended negative consequences on the financial services industry as a whole or on any individual FDIC-insured institution, we offer the following comments and recommendations to assist the members of the FDIC Board in crafting final implementing regulations.

Summary of Recommendations

Each of the FDIC-insured institutions that are signatories to this letter has devoted extensive time and resources analyzing the proposed rules and their potential impact on our organizations. We have studied the law as passed by Congress and spent many hours reviewing the proposed regulations. What follows in this letter reflects our collective best faith effort to arrive at legitimate policy recommendations that we believe are consistent with both the letter and the spirit of the enabling statute passed by Congress.

Against that backdrop, it is our collective recommendation that the FDIC Board, in promulgating either final or interim regulations, should:

- set the designated reserve ratio ("DRR") at the lower end of the permissible range;
- to the extent that the current Deposit Insurance Fund ("DIF") reserve ratio is lower than the DRR, provide for a multi-year period for the DIF to achieve the DRR;
- phase-in use of assessment credits; and,
- use the multi-factor criteria required by the Federal Deposit Insurance Reform Act of 2005 ("FDIRA") in establishing both an interim and final dividend formula.

We believe that each of these recommendations is clearly within the scope of authority that Congress conferred upon the FDIC when it enacted FDIRA. The rationale and justification for each of these recommendations is set forth below.

Designated Reserve Ratio

The FDIC should set the DRR at the lower end of the range authorized by FDIRA. With the enactment of FDIRA, Congress provided the FDIC with significantly greater flexibility and important new tools to manage the newly-constituted DIF than was the case prior to the merger of the Bank Insurance Fund ("BIF") and the Savings Association Insurance Fund ("SAIF") on March 31 of this year. One of the many significant changes contained in FDIRA was the provision that jettisoned the old fixed DRR of 1.25 percent and in its place gave the FDIC Board the authority to set the DRR where the FDIC Board members thought it most appropriate, provided it was within the statutorily-prescribed range of 1.15 percent to 1.5 percent.[1]

The signatories of this letter believe that when Congress eliminated the statutory mandate that the FDIC have a reserve ratio of 1.25 percent, Congress did so recognizing that those with day-to-day responsibility for the administration of the FDIC were in a far better position than Congress to judge where on the continuum of possible reserve ratios the target reserve ratio should be placed. By taking the inflexible 1.25 percent ratio out of the law, Congress sent a clear signal that there is nothing "sacrosanct" about a 1.25

[1] *Federal Deposit Insurance Reform Act of 2005* (Public Law 109-171, Title II, Sec. 2105(a)).

percent reserve level. The clear and unmistakable message sent by Congress was not only that they were giving the FDIC Board discretionary authority to exercise its best judgment in setting the DRR, but that they *expected* the FDIC Board to exercise that judgment on an annual basis as part of its responsible management of the DIF.

We believe it is imperative that the FDIC Board exercise its discretion in a way that encourages the growth of savings and avoids unnecessary anti-competitive effects. Given that newer institutions will not receive any meaningful credit against insurance premiums, they should not be assessed premiums that are so high as to prevent them from fairly competing in the financial services marketplace. Nor should barriers to entry be set so high as to prevent new banks from being formed and entering that marketplace. Under FDIRA, the FDIC clearly has broad discretion to take considerations such as these and other "fairness" factors into account in setting both the DRR and the period of time by which the DIF should achieve the reserve ratio.

Today the FDIC has statutory tools that enable it to ensure the safety of depositors' funds and minimize the likelihood of claims against the insurance fund that were not available to it when Congress first prescribed the 1.25 percent reserve ratio. Some of these tools that Congress has given the FDIC and other banking regulators, such as Prompt Corrective Action ("PCA"), cross-guarantees, depositor preference, and the "source of strength" doctrine, have proven highly effective in guarding against losses. As a result, the risk of loss to the DIF is proportionally smaller today than in prior years.

In its proposed rule establishing the DRR, the FDIC recognized the statutory requirement "[t]hat sharp swings in assessment rates for insured depository institutions should be prevented."[2] It was clearly the intent of Congress that the FDIC should take whatever prudent steps it could to eliminate the so-called "cliff" in premiums, a view supported by the banking trade associations who acknowledged that "[e]liminating the so-called 'cliff' was a very good idea, because assessing insurance premiums in a more stable way is likely to avoid the negative impact on the economy and the activities of banks that could result from sizeable spikes in deposit insurance premiums."[3]

The Committee Report issued by the House Financial Services Committee, following the Committee's vote to approve FDIRA and send it to the full House for consideration, contains the following highly relevant observation by the Congressional Budget Office ("CBO"):

> … CBO expects that the FDIC would attempt to limit volatility in premiums and avoid increases in premiums for temporary reductions in the fund. As a result, CBO assumes that the FDIC would *try to set*

[2] *Federal Deposit Insurance Reform Act of 2005* (Public Law 109-171, Title II, Sec. 2105(a)).

[3] Letter dated June 12, 2006 from the American Bankers Association, America's Community Bankers, the Consumer Bankers Association and The Financial Services Roundtable to then Acting Chairman Martin J. Gruenberg.

> *premiums at levels considered likely to achieve the desired reserve ratio over several years*. By expanding insurance coverage, H.R. 1185 also would affect the FDIC's decision about the reserve target, because increasing insured deposits would reduce the DIF's reserve ratio from 1.3 percent to less than 1.2 percent. For this estimate, *CBO assumes that the FDIC would opt to rebuild the reserve gradually following enactment of the bill,* ***resulting in a reserve ratio of close to 1.20 percent*** *over the 10-year period. Setting a higher target would require correspondingly higher assessments and would yield higher receipts to the DIF*.[4] (Emphasis added).

Since Congress granted the FDIC clear discretion to set the DRR anywhere within the authorized range of 1.15 to 1.5 percent, we urge the FDIC to establish a DRR that will allow assessments to be made in an even and balanced way across an appropriate period of time, rather than endeavor to build up the DIF rapidly with substantial short-term premium increases. Such an approach would be consistent with the statutory mandate contained in FDIRA that the FDIC consider "[t]he projected effects of the payment of assessments on the capital and earnings of insured institutions."[5]

For the foregoing reasons, the signatory institutions urge the FDIC to exercise its statutory discretion and set the DRR at the lower end of the range (i.e., in the vicinity of 1.15 to 1.20 percent). In addition, should the target DRR selected by the FDIC be higher than the DIF's current reserve ratio, we would strongly recommend that initial insurance premium rates be set at levels that would provide for a gradual increase in the reserve ratio over a multi-year period consistent with the intent of Congress as discussed above.

One-Time Assessment Credits

At the time Congress was considering FDIRA and for the ten-year period preceding President Bush signing FDIRA into law on February 8, 2006, the 10-year average annual growth rate in FDIC-insured deposits was 3.9 percent. It was with that relatively modest growth rate in insured deposits in mind that Congress crafted the legislative provisions permitting the use of assessment credits by some institutions to off-set the actual payment of premium assessments with hard dollars. While the disparate impact on institutions with available credits and those with no credits or no substantial credits would be significant at a projected 3.9 percent rate of growth in insured deposits, the disparity of treatment becomes all the greater as the growth in insured deposits increases and the ratio of funds in DIF to insured deposits declines. At the time hearings were held on FDIRA and Congress gave the legislation its imprimatur, the assumption was that the deposit growth rate would continue close to its historical pace. It has only been within the last 24 months that deposit growth has far exceeded these historical

[4] U.S. House of Representatives. Committee on Financial Services. *Federal Deposit Insurance Reform Act of 2005*. 109th Congress, 1st Session, 2005. House Report 109-67 at 28.

[5] *Federal Deposit Insurance Reform Act of 2005* (Public Law 109-171, Title II, Sec. 2104).

limits. According to the FDIC staff, while their "best estimate" for insured deposit growth over the four quarters ending December 2006 is 6.8 percent, they nevertheless concede that growth in insured deposits this year *could be* as high as 9.8 percent.[6]

To the extent that institutions have available assessment credits, the proposed rule would put in place a procedure which would automatically draw upon an institution's available assessment credits to offset 100 percent of the premium due in 2007 and 90 percent of the premium due in 2008, 2009 and 2010. Absent other considerations the black-letter law of FDIRA appears to allow such an approach. However, we point out that if the FDIC Board were to implement this provision as proposed it clearly would be taking what was intended by Congress to be a ***ceiling*** and make it a ***floor***. The law is explicit:

> The amount of a credit to any eligible insured depository institution under this paragraph *may not be applied to* ***more than*** *90 percent* of the assessments imposed on such institution … that become due for assessment periods beginning in fiscal years 2008, 2009, and 2010.[7] (Emphasis added).

Rather than opting for simplicity of administration and making what was meant to be a ***ceiling*** into a ***floor***, and in the absence of any compelling policy justification for allowing insured institutions to exhaust their assessment credits as rapidly as possible, we urge the FDIC Board members to exercise their regulatory discretion and provide for a more phased-in utilization of assessment credits.

There are several ways that assessment credits could be phased-in. Among them:

Option 1: FDIC-insured institutions with available assessment credits could use assessment credits to off-set up to 50 percent of their premium assessment in any one year.

Option 2: FDIC-insured institutions with available assessment credits could use up to a specified amount of their available credits -- "x" basis points -- to off-set premium assessments in any one year; however, assessment credits could not be used to pay premium assessments above "x" basis points. Insured institutions would be required to pay any amount in excess of "x" basis points with actual hard dollars.

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[6] Federal Deposit Insurance Corporation. Memorandum to the Board: *DIF Assessment Rates for the Second Semiannual Assessment Period of 2006.* Arthur J. Murton, Director, Division of Insurance and Research. May 5, 2006 at 14.

[7] *Federal Deposit Insurance Reform Act of 2005* (Public Law 109-171, Title II, Sec. 2107(a)).

Option 3: FDIC-insured institutions with available assessment credits could off-set premium assessments according to a graduated schedule which could be structured in a variety of ways.

The phased use of credits under any of these three options: is clearly within the FDIC's discretionary authority under FDIRA;[8] will be consistent with the FDIC's statutory mandate to consider "[t]he projected effects of the payment of assessments on the capital and earnings of insured depository institutions;"[9] and, will demonstrate that the FDIC is giving appropriate deference to the Congressional directive that the FDIC "seek to prevent sharp swings in the assessment rates for insured depository institutions."[10] We believe that if any of these options is implemented, the end result will be a fairer and more equitable system of assessing insurance premiums.

Impact of Waiving Premium Assessments for the Second Semiannual Assessment Period of 2006

Our recommendations -- that the DRR be set at the lower end of the permissible range, that any increases in the DIF necessitated by whatever DRR is set should be achieved gradually over a period of years, and that the use of assessment credits be phased-in are made all the more compelling by the fact that the FDIC decided to forego a premium -- assessment for the second half of 2006. While the FDIC may not have had an *affirmative obligation* to assess a premium for the second half of 2006, it is clear that the FDIC had the *authority* to do so.

FDIRA contains transition provisions *specifically preserving* the FDIC's authority to set and collect deposit insurance assessments under the regulations in effect before the effective date of the revised assessment rules.[11] These provisions specify that during the interim period between the funds merger and the effective date of new assessment regulations, the existing assessment regulations shall apply to all DIF members, even though the regulations still refer to BIF members and SAIF members. Thus, the law related to assessments in effect prior to enactment of FDIRA remained "the law of the land" on May 9th, when the FDIC decided to forego the assessment of insurance premiums for the second half of 2006. The law then (and still today) in effect stated that:

> Except as provided in paragraph (2)(F), if the reserve ratio of any deposit insurance fund is less than the designated reserve ratio under paragraph (2)(A)(iv), the Board of Directors shall set semiannual assessment rates for members of that fund –

[8] *Federal Deposit Insurance Reform Act of 2005* (Public Law 109-171, Title II, Sec. 2107(a)).
[9] *Federal Deposit Insurance Reform Act of 2005* (Public Law 109-171, Title II, Sec. 2104).
[10] *Federal Deposit Insurance Reform Act of 2005* (Public Law 109-171, Title II, Sec. 2105(a)).
[11] *Federal Deposit Insurance Reform Act of 2005* (Public Law 109-171, Title II, Sec. 2109(b)).

> (i) that are sufficient to increase the reserve ratio for that fund to the designated reserve ratio not later than 1 year after such rates are set …

Paragraph (2)(A)(iv) of the "old" law (which is also still in effect today) sets a bright-line threshold for the DRR at "1.25 percent of estimated insured deposits … or … a higher percentage …" under certain circumstances as determined by the FDIC Board.

Against this statutory backdrop, a compelling case can be made that since on May 9 the FDIC staff forecast a "single point estimate for the reserve ratio as of December 31, 2006 … of 1.20 percent" the FDIC Board clearly had the statutory authority to set a semiannual assessment rate "sufficient to increase the reserve ratio for that fund to the designated reserve ratio not later than 1 year after such rates are set …." Instead, the FDIC Board "in keeping with the spirit of the new law" decided to forgo the imposition of a premium assessment for the second half of 2006. The consequences of this decision were clearly stated in the memorandum presented to the Board by the FDIC staff at that time. It recognized that as a consequence of that decision "premium rates in 2007 and possibly 2008 would likely have to be higher than they otherwise would need to be … if the Board raised rates for the second half of this year."[12]

Had the FDIC assessed premiums for the second semiannual assessment period of 2006 in order to bring the ratio of DIF to the 1.25 percent level, all Category AI institutions would have paid the same assessment rates, since the law then in effect did not provide for assessment credits. As a result of the FDIC decision not to exercise its discretionary authority to raise premiums in the second half of 2006, under the proposed rules one quarter of the banking industry (essentially institutions like our own that were either chartered or experienced significant growth in insured deposits after December 31, 1996) will now be required to pay greater premiums than would otherwise have been the case.

Thus, as a direct result of the FDIC's decision to forego the exercise of its discretionary authority in "the spirit of the new law," institutions like ours will bear a far more significant cost of replenishing the FDIC's coffers than would have been the case if on May 9 the FDIC Board had acted to bring the fund ratio back to its statutorily-mandated ratio of 1.25 percent. That reality was tacitly acknowledged by then-Acting FDIC Chairman Martin Gruenberg when following the FDIC Board's decision to forego the assessment of a premium for the second semiannual assessment period of 2006 he noted that:

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[12] Federal Deposit Insurance Corporation. Memorandum to the Board: *DIF Assessment Rates for the Second Semiannual Assessment Period of 2006*. Arthur J. Murton, Director, Division of Insurance and Research. May 5, 2006 at 20.

> … it seems prudent to expect that a substantial premium charge may have to be imposed in November. How large that premium charge will be will depend on the circumstances at that time – the level of the reserve ratio, the projections for insured deposit growth, and how quickly the Board wants to raise the level of the deposit insurance fund.[13]

Against that backdrop we believe that our recommendation that the use of assessment credits be phased-in over time is all the more compelling.

Deposit Insurance Fund Dividends

Despite the multi-factor criteria prescribed by Congress,[14] the proposed interim rule would for a two-year period allocate any dividends paid by the DIF when the ratio exceeds 1.35 percent based exclusively upon each insured institutions' 1996 assessment base ratio. We urge the FDIC to adhere to the multi-factor criteria set forth in the statute for calculating dividend payments, since to omit from the dividend calculation "the total amount of assessments paid on or after January 1, 1997" is simply unfair to those institutions that were chartered or experienced significant growth in insured deposits since December 31, 1996. While we do not dispute the assertion made by the FDIC in promulgating the proposed rule that "it appears quite unlikely that the reserve ratio of the DIF will equal or exceed 1.35 percent in the near future" and there is only "a small likelihood of a dividend,"[15] we nevertheless believe that the statutory criteria should be adhered to even if the likelihood of a dividend is extremely remote, and a framework should be put in place from the outset ensuring that all institutions paying assessments into DIF will receive their pro rata share of any dividends paid by DIF. Basing possible future dividends solely on institutions' 1996 assessment base ratio, even though that determination will have no practical impact in the near-term and the FDIC will have ample opportunity to revise dividend eligibility criteria at a later date, sets a bad precedent that will potentially make it all the more difficult for the FDIC to establish a more equitable dividend framework in the future.

Conclusion

The signatory institutions appreciate this opportunity to comment on the many rules proposed by the FDIC to implement the *Federal Deposit Insurance Reform Act of 2005*. In summary, we recommend that the FDIC Board, in promulgating either final or interim regulations, should:

- set the designated reserve ratio ("DRR") at the lower end of the permissible range;

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[13] FDIC press release PR-45-2006. *FDIC Board Votes to Maintain Premium Rates for Banks and Thrifts*. May 9, 2006.
[14] *Federal Deposit Insurance Reform Act of 2005* (Public Law 109-171, Title II, Sec. 2107(a)).
[15] *Federal Register*. (Volume 71, Number 96). May 18, 2006 at 28806.

- provide that any required increases in the current DIF reserve ratio be achieved gradually over a multi-year period of time;
- phase-in use of assessment credits; and,
- use the multi-factor criteria required by FDIRA in establishing both an interim and final dividend formula.

In closing we would like to commend the members of the FDIC Board as well as the members of the FDIC staff for their efforts and would like to convey our appreciation for the time and effort they have devoted to carefully crafting rules and regulations intended to faithfully reflect the intent of Congress and treat all insured institutions in a fair and even-handed manner.

If you would like any additional information or if you would like to discuss our recommendations further, please do not hesitate to contact us.

The following institutions have each authorized the submission of this letter:

Charles Schwab Bank, N.A.	Countrywide Bank
E*TRADE	ING DIRECT
Morgan Stanley Bank and Discover Bank	Nationwide Bank