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November 19, 2007 Via E-mail

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

Re: RIN 3064–AD19; Advance Notice of Proposed Rulemaking on Assessment Dividends; 12 CFR Part 327; 72 Federal Register 53181; September 18, 2007

Dear Mr. Feldman:

The Federal Deposit Insurance Reform Act of 2005 (Reform Act) requires the Federal Deposit Insurance Corporation (FDIC) to distribute dividends whenever the Deposit Insurance Fund exceeds 1.35 percent of insured deposits (except under special circumstances).[1] On October 18, 2006, FDIC issued an interim rule for this purpose.[2] However, that temporary rule will terminate at the end of 2008 and a more comprehensive rule is to be developed and adopted before that time. This Advance Notice of Proposed Rulemaking (ANPR) is, therefore, the next step in setting the permanent rule governing the allocation, annual determination, and notification and payment of assessment dividends, as well as administrative appeals for individual dividend amounts.

The American Bankers Association (ABA) appreciates the opportunity to comment on this proposal. ABA membership – which includes community, regional and money center banks and holding companies, as well as savings associations, savings banks and trust companies – makes it the largest banking trade association in the country. Upon completion of its merger with America's Community Bankers at the end of November, ABA's members – the majority of which are banks with less than $500 million in assets – will represent 95 percent of the industry's $12.3 trillion in assets and employ 2.2 million men and women.

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[1]The Federal Deposit Insurance Reform Act of 2005 (Sections 2107(a) and 2109(a)(3) of Title II of the Deficit Reduction Act of 2005, P.L. 109-171) amended Section 7(e)(2) of the Federal Deposit Insurance Act, 12 U.S.C. 1817(e) to require the FDIC to pay assessment dividends if, at the end of any year, the insurance fund exceeds 1.35 percent of insured deposits. Above 1.35 percent, FDIC must dividend half of the excess; above 1.50 percent, it must dividend the entire excess. The agency is allowed to temporarily limit the dividend relative to these parameters only if it can document significant insurance expenses.

[2] FDIC, "Assessment Dividends," 71 *Federal Register* 201, October 18, 2006, pages 61385–91.

Management of the Premium Rates to Maintain the Designated Reserve Ratio is Critical

For a dividend distribution to be triggered, the reserve ratio would have to exceed the upper limit of the normal operating range – 1.35 percent of insured deposits. Thus, an obvious, but critical point, is that the FDIC should manage the assessment income to keep the reserve ratio ***below*** 1.35 percent so that no dividend payout would be triggered. The FDIC should set premiums rates just sufficient to maintain the insurance fund near the Designated Reserve Ratio. It should only be in rare circumstances that the reserve ratio would be in the upper portion of the normal operating range. Thus, by appropriate fund management, the question of how dividends should be distributed – as Director Curry stated in the FDIC Board meeting approving the ANPR – is largely academic.

Nonetheless, conditions can be imagined under which the ratio may grow to excessive amounts. For example, there may be times when deposit growth is so slow that the reserve ratio will rise due to interest income alone and trigger a dividend distribution. Therefore, it is appropriate to devise a fair distribution policy.[3] The ANPR poses two basic options for how dividends would be distributed – a fund balance method and a payments method approach.

- ***Fund Balance Method:*** The insurance fund balance would be allocated among insured institutions for the purpose of determining shares of any future dividend. A bank's allocated share of the fund would define its share of any aggregate dividend paid. That allocation would be increased by (1) the "eligible premium" paid by the bank and (2) the bank's allocated share of net fund earnings from interest and "ineligible premiums" less fund expenses.

- ***Payments Method:*** A bank's share of assessment dividends would be determined by the premiums it paid over some past "look-back" period – regardless of fund performance. Its share of the 1996 assessment base would proxy premiums paid prior to 1996, and 1997-through-2006 would not count in the period, since lowest-risk banks paid no premiums then. The ANPR offers variants on this method to: (1) change the look-back period, (2) discount past premiums for every year until dividends are paid, (3) alter the weight of premiums paid before 1997 (proxied by shares of the 1996 fund balance), and (4) net dividends received against premiums paid.

As the ANPR notes, the former tends to favor "older" banks (those that were chartered before 1996), while the latter tends to favor "newer" banks depending on the parameters that are set, such as the length of the look-back period and the weight assigned to more recent payment versus those made in the past. In the end, of course, the Board must decide which approach it considers most

[3] It is interesting to note that the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) combined reached a reserve ratio of 1.41 in 1999 due to interest income alone (as the vast majority of institutions were paying no premiums at all for many years before that). Under the new system, all institutions will pay a premium – even a very small one – each quarter. Thus, the likelihood that the reserve ratio will exceed 1.35 percent is greater than under the old system.

appropriate and keeping with the statute. We are pleased to assist the Board in that effort by presenting in a careful and unbiased way the arguments made by those that favor the fund balance method and those that favor the payments method. We expect that banks supporting their preferred solution will present even greater detail supporting that method and we urge the FDIC to consider carefully all such approaches.

It is worth reiterating that appropriate fund management to maintain the fund ***below*** the triggering 1.35 percent level has an important implication, especially during the early years following adoption of the assessment dividend formula. This is because, as the ANPR notes, the relative shares of dividends will converge for older and newer banks over time no matter which allocation method is selected.[4] Thus, low and steady premiums over a long period of time would limit the impact of either dividend distribution option on any one segment of the industry.

Arguments Supporting the Fund Balance Approach

This year, 2007, is the first year for premium assessments under the new system. It marks the first time since 1996 that any healthy, well-capitalized bank has paid premiums. At the start of this year, the fund balance was $50 billion dollars. This balance represented all the historical contributions paid by the banking industry and the interest earned on the accumulated assessment revenue (net of expenses, which include all operating expenses and expenses related to resolving failed banks).

Banks supporting the fund balance approach believe that the FDIC operates in a manner that closely resembles a mutual insurance company, that is, the banks are entirely responsible for financial health of the FDIC, including the capitalization of the fund and all the expenses of managing the corporation (including losses resulting from bank failures).[5] Therefore, should the fund exceed 1.35 percent, distribution should be based upon each bank's share of the total capital of the fund. This concept was called the "historical basis" approach during the debate leading to the Reform Act and was a concept embraced for distribution of the assessment credits.

To illustrate the impact of the historical basis approach, consider the experience in the early 1990s as banks were rebuilding the insurance funds following the banking difficulties of the late 1980s. From 1990 through 1996, banks paid an average of over 20 basis points in premiums to recapitalize the insurance funds to the 1.25 percent level mandated by Congress.[6] The expectation was that it would take ten years of such payments to rebuild the funds, an estimate that turned out to underestimate

[4] Page 53183.
[5] The responsibility to cover all losses is written explicitly into the law. FDIC-insured institutions are required to pay premiums to cover any losses to the insurance fund, even if the losses were so significant as to require FDIC borrowing from the Treasury (12 U.S.C. 1824).
[6] The BIF assessment rate was raised in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA, P.L. 101-73) from the longstanding flat premium of 8.3 basis points. BIF members paid a flat 12 basis points in 1990, 21 basis points for the first half of 1991, and 23 basis points through 1992. A risk-based premium schedule was adopted in 1993 and banks paid a minimum 23 basis points from 1993 through May 1995. The BIF was fully capitalized in May 1995; in November 1996, SAIF members paid a one-time 65.7 basis points – a $4.5 billion premium – to fully capitalize the SAIF.

significantly how quickly the fund would be built up. Payments made at this time were substantial, constituting 8.3 percent of industry pre-tax earnings and lowering industry average return on equity by more than 100 basis points. All told, Bank Insurance Fund (BIF) members and Saving Association Insurance Fund (SAIF) members paid $36½ billion in premiums between 1990 and 1996. In fact, SAIF members paid a one-time assessment of nearly 66 basis points – $4½ billion – to fully recapitalize their fund fully in 1996.

The premium rates were set so high that after full recapitalization in 1996, the interest income on the fund – totaling $23 billion from 1997 through 2006 – was more than enough to pay all operating expenses and all bank failure expenses for 10 years without the need for further premiums to be assessed to top-rated banks.[7] Even in the first half of 2007, interest income accounted for nearly 81 percent of total revenue (i.e., assessment plus interest income and recaptured reserves).[8] In 2008, when most of the assessment credits will be exhausted, the share of interest income to total revenue will be 39 percent (assuming premium and interest rates remain at the 2007 rates). Of course, the premium rates assessed today are higher in order to rebuild the reserve ratio to 1.25 percent more quickly and to compensate for credits offsetting a sizable portion of the industry's assessments. As premiums are lowered – which we believe would be a wise and prudent course of action next year – the contribution of interest income to the total revenue will increase (see the table).

Interest Income
as a Share of FDIC Revenues in 2008

Base Assessment Rate	Interest Income Share
5-7 b.p.	39%
4-6 b.p.	53%
3-5 b.p.	66%
2-4 b.p.	79%

Assumes no change in interest rates or risk-classification

Simply put, proponents of the fund balance approach argue that interest income derived from their historical premium payments will continue to constitute the majority of the FDIC's income and offset the majority of its expenses. Thus, these banks believe that it is important to consider both payments made and interest earned over time on those payments in order to determine each bank's contribution to the capitalization of the insurance fund. Put another way, without the contribution of the interest income on past premium payments, the reserve ratio would not likely exceeded the 1.35 percent level and no distribution would be forthcoming to any institution. Thus, proponents argue that ignoring the contribution of interest and from where it is derived ignores the most significant contribution to the funding of FDIC.

Proponents of this approach also argue that as newer banks pay premiums they will receive a pro-rata dividend distribution commensurate with that historical contribution to the fund (and any interest earned on those payments. Thus, supporters argue that the treatment of old and new is consistent and fair.

[7] Well-capitalized banks of no supervisory concern paid no premiums over 1997-2006; banks of higher risk paid risk-based premiums.
[8] The premium income in 2007 has largely been paid by institutions that were chartered after 1996 and which had no or small amounts of credits to offset the assessments.

Finally, these banks argue that the calculation of shares of the fund based on payments and interest earned is analogous to a how a mutual fund that would pay dividends. Therefore, the underlying principle of the fund balance approach is a much broader concept that captures banks' full commitment to the financial health of the FDIC. Moreover, proponents of this mutual-based approach argue that it is not subject to an arbitrary look-back period or weightings on payment years (such as giving more weight to current-period payments over prior-year payments) and would not need any alteration in future periods. Generally, proponents of either approach believe that the FDIC should not be changing the distribution unless there is a such compelling reasons for this and full support of the industry to do so.

Arguments Supporting the Payments Approach

Those banks favoring the Payments Approach argue that the reserve ratio level is completely under the control of the FDIC. Should the reserve ratio rise above 1.35 percent, it is because the FDIC has failed to manage the premium assessment to keep the reserve ratio in line with the Designated Reserve Ratio. Had rates been lower over the preceding years, the fund would have grown more slowly and not triggered the dividend distribution. Thus, banks favoring the payments method argue that since the FDIC mis-priced the premium rates, the dividend payment acts like a refund for overpayment. Thus, they argue, a pro rata distribution based on total payments made over a relevant period would be the most appropriate.

Institutions favoring this approach also argue that should a dividend be triggered, the fund balance approach would constitute a transfer from newer banks to older banks. This results because older institutions' share includes past payments and interest income that has accumulated for many years. To illustrate, consider a new and old institution with identical assessment bases and risk profiles. In this case, both pay the same premium. If a dividend is announced, the older bank would receive a greater share of the distribution and that bank's "effective premium" would be smaller. Moreover, once the reserve ratio exceeds 1.35 percent, it is possible that it will continue to exceed this level for some period of time. This is because only half of the excess above the 1.35 percent level is required to be returned as dividends; quarterly premiums continue to be assessed; and interest income continues to accumulate. Thus, it could well be that there would be more than one year when a dividend payout was made, prolonging this transfer from newer to older banks.

Proponents of the payments method acknowledge that the old law (that prevented the FDIC from charging premiums on healthy banks) benefited the newer institutions chartered after 1996. However, they argue that Congress dealt with this issue of fairness by providing older institutions with $4.7 billion in credits to offset premium assessments. Therefore, the dividend provision was not intended to compensate older institutions further (as the fund balance method would do). Thus, proponents argue that the payments approach provides fair treatment for all banks.

Assumptions Under the Payments Approach
Should this second method be adopted, a critical consideration is the length of the look-back period. The longer the period, the greater the total payments are from older institutions and the greater their share of any dividend. The shorter the period, the share balance shifts in favor of new institutions.

One question is whether the period between 1996 and 2006 should be included, as no premium payments (other than those paid by higher-risk banks) were made. It would not be appropriate to include this period. The reason is that ***no*** payments by ***any*** institution were needed because expenses were covered by interest income (derived from the payments of older banks). Thus, to include these years – which would have zero eligible premium payments for all banks – would penalize the very banks that supported the fund during this time. A pure "payments" model should give credit to those institutions only in the years where the well-capitalized institutions with no supervisory concerns were assessed and paid premiums.

There are many variations of the payments approach that change the relative balance between older and newer banks. Obviously, it is difficult to comment on these without knowing the specifics of any proposal. We encourage FDIC to consider carefully the comments submitted by bankers on these variants.

"Eligible premiums" Should Include Any Payments Made by Banks in Risk Category I

The Reform Act §2107(a) specifies that, when allocating dividends, FDIC is to "take into account … that portion of assessments paid by an insured depository institution (including any predecessor) that reflects higher levels of risk assumed by such institution."[9] Thus, no matter whether the fund balance method, the payments method, or some variant thereof is used, FDIC must define what portion of assessments paid count as eligible premiums for building claims on potential future dividends.

ABA recommends that the eligible premium be defined as any premium paid by institutions in Risk Category I.[10] All the institutions in Risk Category I are well capitalized – with at least 25 percent more capital than the minimum requirement – and pose no supervisory concerns. While there are very small differences in risk to the insurance fund among banks in this category, bankers generally agree that the difference between this category and the higher risk ones are significant. Banks paying premiums in Risk Category II, III, or IV should be given eligible-premium credit equal to the highest premium for banks in Risk Category I.

The ANPR notes the importance of defining eligible premiums so as to reinforce the risk incentives of the risk-based premium system. Including all Risk Category I premiums accomplishes this goal. The incentive to a bank to be in Risk Category I is already very strong, due to the large jump in assessments for failing to do so. The fact that 95.3 percent of banks with 98.2 percent of the

[9] 12 U.S.C. 1817(e)(2)(C)(ii)(III).
[10] Under the current assessment schedule, this would mean any assessment made from the base rate of 5 basis points to the ceiling rate of 7 basis points.

aggregate assessment base qualified for Risk Category I in second quarter 2007 testifies to the strength of the motivation already in place. Moreover, the two basis point difference in assessment rates within that category (under the current assessment schedule) represents a meaningful spread in premiums – amounting to millions of dollars to the largest institutions. The possibility of some assessment dividend at some point in the future will never provide an incentive comparable to that of the current risk-based premium incentive (and the need to remain well-capitalized with no supervisory concerns).

Furthermore, if the fund balance method is used, it would not be appropriate to include premiums offset by assessment credits.

Shares for Dividend Distributions Should Be Posted to FDIC Connect

The ANPR acknowledges the importance of transparency, to help bankers understand their claims on potential future dividends, due to the complexity of any allocation method.[11] To promote transparency, ABA recommends that FDIC should post to FDIC Connect each bank's current allocated share of the fund (under the fund balance method) and percentage of any future dividend. This year, FDIC posted every bank's allocation of assessment credits to FDIC Connect, and bankers found these listings very useful.

FDIC should follow the same procedure to challenge the calculation made by the FDIC as it did with assigning credits to institutions. For example, questions may arise in a branch sale or merger. We recommend that FDIC provide a dispute resolution process for dividend share claims comparable to that for other disputes under the new risk-based assessments system.

Rules Regarding Transferability of Claims on Future Dividends Should Be Established

FDIC should establish rules for the transferability of claims on dividends in cases where banks sell branches or deposits. The assessment credit rule weighed the alternatives of "stay-with-the-charter" versus "follow-the-deposits"[12] FDIC adopted the "stay-with-the-charter" approach with allowance for *de facto* mergers.[13] For consistency, ABA recommends that FDIC adopt the same rule for transfers of claims on assessment dividends. Whichever approach FDIC selects, what is most important is that FDIC establish rules in advance so that transactions can be priced based on a clear understanding about whether rights to dividends are being transferred or not.

It is conceivable that banks may want to sell their claims on potential future dividends to other banks. This would be comparable to selling out-of-the-money options. ABA recommends that FDIC should permit such sales, and should promulgate rules to clarify the procedures for doing so.

[11] See the sections under "Simplicity" on pages 53187 and 53194 of the ANPR.
[12] FDIC, "One-Time Assessment Credit," 71 *Federal Register* 201, October 18, 2006, page 61376.
[13] FDIC, "One-Time Assessment Credit," 71 *Federal Register* 201, October 18, 2006, page 61378–9.

However, if FDIC determines not to permit the sale of claims on potential future dividends, we recommend that this be clarified in rule.

Conclusion

ABA appreciates this opportunity to comment on the ANPR. The public, deliberative, and active approach of FDIC in establishing a rule for the allocation of any future dividends is to be commended. We are prepared to work with the FDIC staff as they complete their analysis and develop a full, final rule before the end of next year.

Sincerely,

James H. Chessen