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January 3, 2011

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

Re: RIN 3064–AD66; Notice of Proposed Rulemaking Regarding the Pricing of Large Bank Assessments; 12 CFR Part 327; 75 Federal Register 72612, November 24, 2010

Dear Mr. Feldman:

The American Bankers Association (ABA) welcomes the opportunity to comment on the proposal from the Federal Deposit Insurance Corporation (FDIC) for a new assessment pricing scheme for banks over $10 billion in assets (large banks). ABA represents banks of all sizes and charters and is the voice for the nation's $13.4 trillion banking industry and its 2 million employees. ABA's extensive resources enhance the success of the nation's banks and strengthen America's economy and communities. While the majority of ABA's members are banks with less than $165 million in assets, banks directly affected by the proposal are strongly represented in ABA's membership and actively participated in the development of this comment letter.

The proposed scheme would abandon the current matrix for determining premiums (which relies on CAMELS ratings, debt issuer ratings and financial ratios) and create a "Scorecard" system that does not use debt issuer ratings. The four-bucket system, where assessment rates are set by formula for Risk Category I ("well capitalized," CAMELS 1&2) and fixed for Categories II-IV would no longer apply. The premium assessment rate determined in this system would rise by formula exponentially with the total score determined by the Scorecard. In a separate proposal, which ABA will comment on separately, the FDIC proposes to change its assessment base (per the Dodd-Frank Wall Street Reform and Consumer Protection Act §331(b)) (DFA) and to make corresponding changes in the assessment rate schedule for banks under $10 billion in assets and changes in the assessment rate "adjustments" for all banks.

This proposal is a revision from one published on May 3, 2010.[1] ABA appreciates that the current version reflects several changes we recommended.[2] In particular, the implementation schedule of the new scheme has been extended in recognition of the change anticipated with expanding the assessment base under the DFA. The proposed system was simplified somewhat (for example, the outlier add-ons were removed from the Performance Score) and the definition of "core deposits"

[1] FDIC, 75 Federal Register 23516, May 3, 2010, http://edocket.access.gpo.gov/2010/pdf/2010-10161.pdf.
[2] See ABA letter of July 2, 2010, www.fdic.gov/regulations/laws/federal/2010/10c17ad57.pdf.

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was revised to include balances up to the $250,000 insurance limit. Moreover, the excessive amount of subjectivity in the rate-setting scheme has been limited in the re-proposal, and no adjustment will be made for any bank until the objective criteria are proposed for public comment. Bankers have also expressed to us appreciation that the FDIC staff has made special efforts to answer banker questions and has supplied a calculator for the proposed system and a mapping of Call Report and Thrift Financial Report (TFR) line items to the Scorecard variables. This interaction and dialog is much appreciated, encouraging banks to bring to the rule-making process their extensive depth and breadth of understanding of the banking industry and of how FDIC proposals would affect their ability to serve customers.

In that spirit, we offer our comments on elements of the Scorecard approach, which we believe still remains extremely complex and detailed, posing significant analytical and implementation issues. As we noted in our previous comment letter, the change in the premium pricing formula on top of the assessment base change makes the impact of each extremely difficult to disentangle. It has added to the confusion and uncertainty surrounding the change. With many millions of dollars at stake with these changes, it is critical that there be clarity of the impact of each and assurance that the risk-based system that is ultimately adopted fairly distinguishes the risk among large banks and small banks. Simply put, there should be no biases in the risk-based formulation that would impose greater costs on any bank based on size alone.

It is not clear that the proposed scheme would achieve its goal of reducing the pro-cyclical nature of the current system, since many of the Scorecard variables are highly pro-cyclical.[3] ABA believes that the complexity of the Scorecard – and particularly the subjective authority to alter the premium assessed – has made it very difficult for banks to forecast their premium obligations under different scenarios and to assess the sensitivity of the model to changes in its various components. This complexity has made it difficult to provide meaningful suggestions for improving the model, and unless adequately addressed, this complexity will limit the ability of the risk-based system to encourage better risk management by the banks and by the FDIC.

It was for these reasons that ABA (on December 13, 2010) requested extension of the comment period on this proposal in order to provide more time for affected institutions to understand what is proposed and evaluate the impact.[4] We are disappointed that the FDIC denied that request. We do appreciate the resources that FDIC has made available to answer questions of bankers. However, the complexity of the system and its financial implications make a 45-day comment period unreasonable.

We share the view that a risk-based pricing system should fairly differentiate risk among large banks – indeed, all banks. We do not believe that the large bank proposal does this. Complexity is not a guarantee of accuracy. Given the magnitude of change and the financial consequences, we believe the FDIC must convincingly demonstrate that the system does, in fact, fairly differentiate risk among large banks and is consistent and unbiased with respect to the risk-based model for smaller banks.

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[3] 75 Federal Register 72613, November 24, 2010, http://edocket.access.gpo.gov/2010/pdf/2010-29138.pdf.
[4] ABA letter of December 13, 2010, www.aba.com/aba/documents/FDIC/LBRBP101213.pdf.

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In our letter, we focus on several important themes:

- The FDIC must assure that the assessment system is focused on risk and contains no biases based on bank size or any other factor unrelated to risk.
- The assessment scheme should be calibrated against actual risk exposure for the insurance fund.
- Subjective adjustments that raise the Scorecard score (and premium paid) should be eliminated in the final rule.
- The adjustments for unsecured debt, depository institution debt, and brokered deposits should align with risk exposure to the FDIC and provide incentives for sound banking.

In addition, ABA offers several more technical points on specific elements of the Performance Score in the proposed Scorecard.

I. The FDIC must assure that the assessment system is focused on risk and contains no biases based on bank size or any other factor unrelated to risk.

Monumental changes in process for FDIC assessments have led banks to examine the impact on their premiums. The altered assessment base will, at least from a static analysis, significantly shift the burden of financing the FDIC to large banks (that typically have greater non-deposit liabilities than smaller banks). Moreover, the proposed large bank assessments scheme would create completely separate systems for banks under and over $10 billion in assets, and, according to FDIC staff, the proposed Scorecard approach would increase further the share of FDIC funding that is shifted to the largest banks.

While we understand the desire to improve the risk-based assessment methodology for large banks, it is incumbent upon the FDIC to demonstrate convincingly that there are no biases that favor banks of any size. As the goal is to assess fairly the risk of loss to the FDIC of any sized institution, such testing to assure equitable treatment is critical. This involves fully understanding the differences and true risks of a bank's asset mix, liability funding mix, and risk mitigation practices. While the proposed system attempts to reflect asset risk and funding liquidity (with, in our opinion, an unfair penalty for using brokered deposits), it does not consider fully differences in loss expectations in a failure from different liability mixes; nor does it consider the effect of risk mitigation (including hedging, collateralization, insurance, and conservative underwriting practices). Thus, as complicated as the proposed system is, we are not convinced it truly reflects differences in relative risk among large banks or relative risk among banks with less than $10 billion in assets.

For example, several banks have reported to us that the large bank model yields a much higher assessments charge than the small bank model for their risk profiles. This suggests that there is a "cliff effect" as a bank grows above $10 billion in size. There should be no difference in the premium assessment rate of a bank with $9.5 billion in assets and the same bank with $10.5 billion in assets. If the large bank model ***systematically*** results in larger banks paying more, then the result is a system penalizing banks for size, not true risk to the FDIC. Nowhere has the FDIC

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demonstrated that size alone is a factor that raises the risk of loss to the FDIC. ***ABA believes that the FDIC must rigorously demonstrate that the risk-based assessments system applied to large or small banks accurately reflects the risk posed to the insurance fund and is not biased based on the size of the bank. Failure to do so will result in a risk-based system that is less sensitive to risk rather than more sensitive, eroding progress made in recent years on improving risk management.***

Banks have also questioned whether the Scorecard was calibrated based on robust statistical analysis. Because there have been few failures of banks with assets greater than $10 billion, the FDIC was required to set parameters based on smaller bank failures and CAMELS downgrades. Yet nowhere is there evidence that the asset mix, liability mix and risk-mitigants in large banks are similar to those found in those small bank failures or in banks with CAMELS downgrades. Moreover, the analysis covers only the most recent bank failure cycle, which, while instructive, may not adequately capture the variables that would trigger failures of large banks in the future. Banks have noted that provisions in the DFA related to oversight and management of systemic risks change this calculation considerably, yet there is no evidence that this was considered by the FDIC.

In addition, the proposed scheme has not been calibrated on the four data elements not reported in the Call Report. As a result, the quantitative analysis presented in the proposal is not conclusively definitive, and the relevance of this analysis to future large bank failures is questionable.

II. The assessment scheme should be calibrated against actual risk exposure for the insurance fund.

Under 12 U.S.C. §1817(b)(1)(C), the FDIC's risk-based assessment system must calculate "a depository institution's assessment based on – (i) the probability that the Deposit Insurance Fund will incur a loss with respect to the institution, … (ii) the likely amount of any such loss; and (iii) the revenue needs of the Deposit Insurance Fund." Accordingly, ***the proposed assessment pricing model needs to be calibrated to the actual risk to the insurance fund posed by large banks.***

Some large banks have calculated that the effective assessment rate relative to their insured deposits would be very high. Since the FDIC's only exposure is to the banks' insured deposits, this cannot correlate with risk to the insurance fund.

ABA sees the Loss Severity Score as a critical element of the Scorecard. ***A major failure of the Scorecard, which undermines its objective to quantify risk to the insurance fund, is its focus on asset and liquidity risks, while it under-weights and mis-measures the potential loss to the fund should a large bank fail.*** We note that the effect of the Loss Severity Score is limited to 20 percent of the Performance Score, whereas no analytical support is provided for this arbitrary weighting. This weighting appears unreasonable for some large banks funded with relatively small amounts of insured deposits, which therefore pose minimal risk exposure to the insurance fund.

Moreover, ABA questions the variables used as proxies for loss severity. ***The most significant issue is omission of a variable for the portion of an institution's assessment base that is***

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subordinate to the FDIC's claim in a receivership. Clearly, if a bank is heavily funded with capital and liabilities that stand behind the FDIC (as surrogate for the insured deposits) then the FDIC should expect to recoup more from liquidation of the institution – and suffer lower losses – if the bank fails. Goodwill and other intangible assets should also be counted as claims subordinate to the FDIC; although they are included in the new assessment base, they do not result in losses for the FDIC in a bank failure.

As to the "loss severity measure" that represents 75 percent of the proposed Loss Severity Score, ABA questions the derivation of the parameters. The asset haircuts and deposit run-off rates were derived using data predominantly from recent failures of small banks, since there have been very few large bank failures from which they could be estimated. These calculations fail to account for the significant difference in characteristics of small and large banks.

We offer the following specific suggestions with respect to the proposed parameters:

- The 80 percent run-off rate on foreign deposits is excessive and unsubstantiated in the proposal.

- Deposits from a bank's parent holding company typically reflect cash raised in the form of long-term unsecured debt, so should be accorded a lower run-off rate than other deposits.

- Due to implementation of Statement of Financial Accounting Standards 141(R) in 2009, the carrying value of acquired loans has in many cases been marked down. As a result, loss rates on these assets will likely be lower than historical levels. On a December 20, 2010, conference call, FDIC staff suggested that allowance could be made for this effect through subjective adjustments. However, carrying the logic forward, since all banks are now subject to this accounting rule, subjective adjustments would be required for every large bank. This is not a practical approach. A more reasonable one would be for the haircut parameters to be adjusted downward.

As to the 25 percent weighting for "noncore funds-to-total liabilities," it is not clear that this measure has any appreciable relevance to large bank failures. The only support for this variable is a statement in the proposal that the FDIC believes that "heavy reliance on secured liabilities other than other types of noncore funding reduces an IDI's potential franchise value, thereby increasing the FDIC's potential loss in the event of failure."[5] The FDIC provides no evidence that this observation holds true as bank size increases. If the concern is about franchise value, then a more careful look is needed at differences in franchise value stemming from diversification of businesses, geography, or other factors. Furthermore, the FDIC has not demonstrated that foreign deposits are more volatile than domestic deposits. If this cannot be quantitatively determined, the inclusion of these deposits as noncore funding sources is questionable. Bankers report that these function in similar ways to domestic deposits.

[5] 75 Federal Register 72618, November 24, 2010, http://edocket.access.gpo.gov/2010/pdf/2010-29138.pdf.

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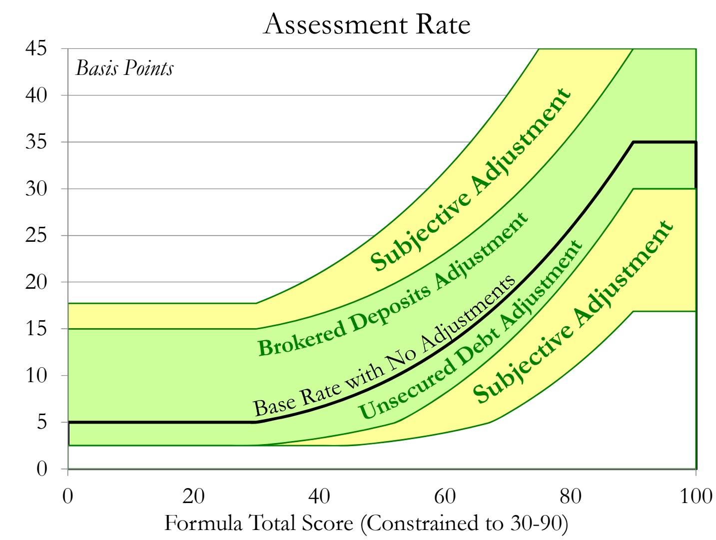
III. Subjective adjustments that raise the Scorecard score (and premium paid) should be eliminated in the final rule.

ABA appreciates the sensitivity shown by the FDIC on the issue of subjective adjustments, including reducing the potential magnitude of the adjustment and deciding not to impose any adjustment until the process and factors used for any adjustment can be fully exposed for public comment.

The subjectivity of the large bank risk-based proposal continues to be of significant concern to bankers. As we have argued in the past, it is inappropriate to expand the FDIC's authority to make arbitrary adjustments in the assessment rate.[6] We believe that even with the smaller potential adjustment in the current proposal, ***it is still out of proportion and completely out of sync with the extraordinary detail and complexity of the objective Scorecard.***[7]



As proposed, the FDIC would have discretion to adjust the Scorecard score up or down by as much 15 points (but constrained such that the final score must be between 30 and 90). How a subjective change in the score affects the assessment rate depends on the initial score, as the rate increases by formula exponentially as the score rises. The chart shows that, even for the lowest-risk banks – those with the lowest initial scores – the formula would allow a subjective increase in the assessment rate of up to 2¾ basis points. The subjective adjustment could even exceed 13 basis points for higher initial scores.

Such adjustments are many multiples greater than the FDIC's current authority to adjust an assessment rate up or down by up to one basis point. Not only do the potential adjustments under the proposed rule stand in stark contrast to the magnitude of current authority, they are completely at odds with the notion that the new system improves the accuracy of the risk based assessment. ***If the new system is an improvement, then the subjective component should be smaller, not larger.*** If there is little confidence that the formula does accurately reflect relative risk, then the answer is not to provide greater subjective authority, but rather the answer is to abandon the proposed formula until one can be developed that does reflect the true risk much more accurately.

The proposal states that the FDIC plans later this year to propose for public comment updated guidelines for evaluating whether assessment rate adjustments are warranted and whether the size of

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[6] See ABA letter of July 2, 2010, pages 2-4, www.fdic.gov/regulations/laws/federal/2010/10c17ad57.pdf.

[7] We would note that there already is ample supervisory discretion in the CAMELS ratings, as assigned by the primary federal supervisor.

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the adjustments are appropriate, and will abstain from making any subjective adjustments until the updated guidelines are finalized.[8] We agree that no subjective adjustment should be applied until and unless the guidelines satisfy all material concerns, and we appreciate the FDIC's sensitivity to such an important concern of the industry.[9]

The concerns over subjective adjustments are not just theoretical. Bankers report being hit with unreasonable adjustments under the current system for which they were not provided sufficient justification. Further, the bankers felt that they were not allowed to challenge effectively the adjustments through the FDIC's appeals process. ***ABA appreciates that the proposal acknowledges that aggregate statistics on adjustments will be made public quarterly, but we further request publication of statistics on challenges and rulings.***

The current system does allow a bank to make adjustments to avoid the financial penalty associated with a subjective adjustment – a feature that ABA supports. However, without adequate information regarding the reasons for a penalty rate adjustment, we are not convinced that in practice this will be effective. This is a critical component that must be strengthened before any new rule is put in place.

In consideration of the concerns expressed above, ABA believes that subjective adjustments that <u>raise</u> the Scorecard score – and that would result in higher premium payments – should be <u>eliminated</u> in the final rule. In fairness, subjective changes should ***only*** be made to lower the point score (and premium rate) of a bank and never should be used to punish banks. For example, risk mitigation strategies and insurance can lower the risk and/or cost of failure and should reduce the premium assessment, just as having a smoke detector or fire extinguisher are factors that can lower fire insurance premiums. As the only provider of federal deposit insurance coverage, there must be strict limitations on discretionary changes that impose costly penalties. To do otherwise opens the door to the appearance of arbitrary and capricious regulatory action. ABA believes that rather than expand the authority to use discretion, it should be strictly limited to lowering premium rates. Factors that increase risk can and should be objectively identified and incorporated into the basic formulas.

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8 75 <u>Federal Register</u> 72623, November 24, 2010, http://edocket.access.gpo.gov/2010/pdf/2010-29138.pdf.

9 Bankers have raised several questions in our discussions about the impact of any subjective adjustment, and we wish to alert the FDIC to these in order that they be considered as part of the forthcoming proposal. For example, what factors would lead to a 4 point *versus* an 8 point *versus* a 15 point increase? More to the point, however, is whether there is a meaningful distinction between a bank with six added points and a bank with seven added points. There is a related concern for banks that have acquired failed banks: they wonder what additional penalties might retroactively be applied as a result of the assets acquired or managed and whether FDIC guarantees would be considered as offsets.

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IV. The adjustments for unsecured debt, depository institution debt and brokered deposits should align with risk exposure to the FDIC and provide incentives for sound banking.

In ABA's comment letter on the proposal expanding the assessment base mandated under the DFA, we commented on several adjustments. These same concerns are valid in this proposal as well. Here are our concerns:

Unsecured Debt Adjustment

ABA supports increasing the Unsecured Debt Adjustment to 40 basis points plus the Initial Base Assessment Rate per dollar of long-term unsecured debt, as per the proposal. The intent is to recognize that claims subordinate to the FDIC reduce insurance fund losses in bank failures.[10]

ABA recommends that the Unsecured Debt Adjustment in the final rule recognize the broader spectrum of funding subordinate to the FDIC's claims. In the event of failure, short-term unsecured debt absorbs losses before the FDIC as well as long-term unsecured debt. For liquidity purposes, a bank may use short-term debt on a continuing basis to diversify its sources of liquidity. Therefore, denying short-term unsecured debt in the Unsecured Liability Adjustment neither lowers the risk to the FDIC nor encourages better bank liquidity management. ABA similarly recommends that foreign office deposits should be included in the Unsecured Liability Adjustment, as the Depositor Preference Act (12 U.S.C. §1813) subordinated foreign deposits to the FDIC's claim.

Goodwill and other intangible assets could also be included in the Unsecured Debt Adjustment. Bankers feel that intangible assets should be deducted from the assessment base as they cannot pose any risk exposure to the insurance fund. To be consistent with the DFA, ABA recommends that goodwill be included in the Unsecured Liability Adjustment and treated like unsecured debt.

Considering the broader scope of elements in the new assessment base that pose no risk to the FDIC or that reduce the FDIC's exposure, ***ABA recommends that the Unsecured Debt Adjustment have a higher cap than that proposed*** (*i.e.*, higher than the lesser of 5 basis points or half of the Initial Base Assessment Rate). If claims subordinate to the FDIC reduce its risk exposure, then truly risk-based assessments must fully recognize their effect − unless the FDIC can empirically defend the proposed narrow limit to this adjustment. Moreover, it is inequitable that banks with lower Initial Base Assessment Rates – and therefore preliminarily judged to be among the healthiest – would be the most constrained by this overly narrow limit.

Depository Institution Debt Adjustment

The proposal would impose a new assessment rate adjustment in the form of a premium of 50 basis points on the balance of long-term debt issued by other banks. ***ABA objects to the premise, level, and lack of substantiation for this adjustment.***

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[10] 75 Federal Register 72586, November 24, 2010, http://edocket.access.gpo.gov/2010/pdf/2010-29138.pdf.

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The proposal claims that unsecured debt reduces the risk to the FDIC on the issuing bank but increases systemic risk for the FDIC.[11] It is curious that the proposal singles out bank-issued debt for systemic risk over debt issued by any other industry or firm. If a major commercial or industrial operation defaults, or several firms in a commercial or industrial business default, and banks hold an excessive share of the debt, does this not represent systemic risk to the FDIC? Supervisors have long recognized that concentration in any single type of exposure represents a risk to a bank, and if that concentration is found in many banks then there is the potential for (although no guarantee of) systemic risk. In contrast, if banks hold diversified portfolios of debt issued by a range of other banks, then this diversification reduces the risk to each bank and, therefore, to the FDIC. In this case, failure of any single bank, or even multiple banks, will not by itself seriously threaten any institution. In other words, it is the *concentration* that creates the potential for risk.

Moreover, there is no *de minimis* cutoff under the proposal. This means that even a small holding of another bank's debt would cost extra premiums. This makes no sense from an individual bank risk point of view and certainly from a broader perspective, as a minimal holding would not create meaningful systemic risk. Nor is there any cap proposed, similar to the treatment afforded to the Unsecured Debt Adjustment, Brokered Deposits Adjustment, and (eliminated) Secured Debt Adjustment. At the very least, there should be lower and upper limits for the Depository Institution Debt Adjustment.

Besides these clear flaws, a 50 basis points premium on holding other banks' debt would undermine bank soundness and also increase the FDIC's risk exposure. Every bank could face reduced access to liquidity because other banks would eschew its debt in favor of non-bank debt on which they would not pay the added premium, or else require an interest rate perhaps as much as 50 basis points higher in compensation. Moreover, the discouragement of bank unsecured debt would work in opposition to the aim of the Unsecured Debt Adjustment which is to encourage such debt to reduce the FDIC's exposure.

There is little justification for the 50 basis point assessment. No quantitative analysis is presented to support the premise or the level of the premium proposed. We note that anecdotal evidence from a handful of bank failures does not constitute solid statistical support, particularly for so high a penalty rate.

The proposed adjustment would also require changes in the Call Report and TFR. Banks do currently report bank deposits and loans – but not by maturity – and do not segregate out bank-issued debt. We note that securities' CUSIP numbers do not identify the industry of the issuer, so manual review would be required to identify whether the issuer is a bank. Collecting and reporting long-term exposures in these categories would represent a new and unreasonable reporting burden.

Therefore, ***ABA recommends that the proposed Depository Institution Debt Adjustment not be included in the final rule.*** Risk concentrations should continue to be addressed by bank supervisors, and, in fact, concentrations are already reflected in factors built into the risk-based assessments system.

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[11] 75 Federal Register 72586, November 24, 2010, http://edocket.access.gpo.gov/2010/pdf/2010-29138.pdf.

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Certainly, the final rule should clarify that it does not apply to exposures between affiliated banks in a banking organization, as this would represent double-counting of the risk. Similarly, secured debt arrangements where unsecured debt of banks is pledged to banks (*e.g.*, securities purchased under agreements to resell) should not be assessed this premium. ABA requests that the final rule clarify whether the premium would apply to term certificates of deposit and federal funds sold.

Brokered Deposit Adjustment

ABA understands the FDIC's concerns regarding volatile sources of funding. However, we continue to take issue with the FDIC lumping all brokered deposits together. Not all types of brokered deposits are volatile, out of market, or held by individuals that had no prior relationships with the bank.[12] "Brokered" is not synonymous with "volatile." Treating the two as equivalent will inevitably lead to mispriced risk and create unintended consequences that favor more volatile, non-brokered sources of funds. Therefore, ***ABA recommends that reciprocal deposit programs, sweeps from affiliated broker-dealers, and deposits placed by affiliated banks should <u>not</u> be included in the Brokered Deposit Adjustment; they have characteristics like core deposits and should not be considered in the same category as more volatile forms of brokered deposits.***

Deposits raised in reciprocal deposit programs should be viewed as core deposits. The point of reciprocal deposit programs is to enable customers to maintain relationships with their banks. Thus, unlike volatile brokered deposits, reciprocal deposits increase a bank's franchise value and allow a bank to attract and retain more core deposits from loyal customers. These deposits are typically based on established relationships with the bank and the rate paid is typically on par with other core deposits, so these are not unstable funds chasing rates. In fact, the reinvestment rate, for example, for the Certificate of Deposit Account Registry Service (CDARS) is around 81 percent.

Programs that allow banks to sell certificates of deposit of affiliated banks should also be excluded from the calculation of brokered deposits. While not reciprocal deposit programs, these deposits are similar in that the deposits are priced like core deposits and are relationship-based as the customer has a pre-existing business relationship with an affiliated insured depository institution. In addition, the deposits stay within the banking organization's footprint and have a high reinvestment rate.

Deposits raised from sweep accounts at affiliated broker-dealers similarly function as core deposits. Many banks offer such accounts, where excess cash in the customer brokerage accounts are swept daily into interest-bearing or transaction accounts at the broker-dealer's affiliated bank. Characteristics of these accounts resemble core deposits. For example:

- Even though the account relationship is technically with the broker-dealer, the deposit account is functionally the same as if it were the bank's account. In fact, customers may choose the broker-dealer account because of the relationship with the affiliated bank, as the

[12] See ABA letters of July 2, 2010, pages 5-6 www.fdic.gov/regulations/laws/federal/2010/10c17ad57.pdf and of December 17, 2008, pages 6-12, www.fdic.gov/regulations/laws/federal/2008/08c410ad35.pdf.

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broker-dealer may market this relationship. Thus, these are essentially established accounts among a family of companies. Establishment of the brokerage account reinforces the customer's relationship with the financial institution.

- Broker-dealer-affiliated sweeps are not rate sensitive nor carry high interest rates. These arrangements are designed to manage excess cash and are not established to compete for rates. The interest rates paid are typically below yields on money market mutual funds.

- These are relationship-based deposits that provide stable funding. In the aggregate across all accounts (which total tens, and even hundreds, of thousands of accounts at a given institution), there are daily flows into the deposit account and daily withdrawals made by the customers. Over time these aggregate flows in and out tend to offset. Therefore, these deposits are predictable, stable and behave like term funding.

Furthermore, consideration should be given to sweep deposits collected from unaffiliated brokers where the funds are subject to strict contractual commitments (e.g., a 2-year restriction on withdrawing funds, other than as a result of customer withdrawals). Institutions that have taken such funds have found them to be very stable. Also, bankers have suggested that the seasoning of brokered deposits be considered to evaluate the volatility of brokered deposits.

Simply put, where deposits from brokers can be shown to be more stable, the Brokered Deposit Adjustment penalty should not apply.

ABA feels strongly that well-capitalized, CAMELS 1&2 banks with over $10 billion in assets should not be subject to the brokered deposit penalty rate. Under the current rules, no penalty rate is applied to Risk Category I institutions (*i.e.*, well-capitalized banks that pose no supervisory concerns) except in the case where the institution has brokered deposits in excess of 10 percent ***and*** has experienced rapid growth (defined as 40 percent over the prior four years). The proposal for large bank assessment pricing makes no distinction based on whether the institution is well-capitalized, rated CAMELS 1 or 2, or has recently grown rapidly. Such disparate treatment unfairly penalizes large banks without any justification by the FDIC.

We acknowledge that while there is an "adjusted brokered deposit ratio" in the assessment calculation for banks under $10 billion, there is not an explicit variable for brokered deposits in the proposed assessments scheme for large banks. However, funding with brokered deposits would factor into a large banks' CAMELS Liquidity rating, its "core deposits-to-total liabilities" ratio, and its "noncore funding-to-total liabilities" measure in the proposed Scorecard. Therefore, applying the full Brokered Deposit Adjustment to the soundest large banks seems inequitable.

Moreover, maintaining the same penalty rate applied to a much larger assessment base only magnifies the financial burden with no justification. The premiums paid for many large banks are already considerably higher due to the broadened assessment base; this higher penalty rate on the larger base would impose an even greater disproportionate cost on these large banks. There is already triple-counting of funding with brokered deposits in the pricing system. The proposal provides no demonstration that the brokered deposits penalty should be increased.

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ABA recommends that – for banks <u>not</u> considered equivalent to Risk Category I institutions under small bank model – the Brokered Deposit Adjustment penalty should be capped at 6½ basis points on the new assessment base. This is equivalent to the 10 basis point cap on the current base.

Finally, the DFA (§1506) mandates that, by July 2011, the FDIC review the definitions of brokered and core deposits and the impact of these definitions on assessments and the insurance fund. We believe the clear intent of Congress was for the FDIC to carefully consider the many different types of brokered deposits and the nature and variety of risk that they may pose to the FDIC in order to guide the policy on how each type might be treated for deposit insurance pricing. To fundamentally change the current practice for large banks before this assessment is completed is counter to the intent of Congress to fully understand the risk and fairly price it. Just as the FDIC has deferred consideration of the subjective adjustments until these issues can be fully aired, we strongly suggest the same approach be taken with respect to brokered deposits. Moreover, ABA suggests that the study explicitly consider the role and relative risk of reciprocal deposit programs, sweep programs from affiliated broker-dealers, deposits placed by affiliated banks, and sweep deposits place by non-affiliated parties with strict contractual requirements versus other forms of brokered deposits. We believe that these programs provide demonstrably low cost, stable funding.

V. Suggestions on specific elements of the Scorecard.

We have heard specific ideas relative to different elements of the Performance Score in the proposed Scorecard from several bankers, which we are forwarding as suggestions.

- ***The Performance Score should take account of risk mitigation.*** A glaring omission from the "ability to withstand asset-related stress" measures is that there is no recognition of risk mitigants, including collateralization, insurance, hedging, underwriting standards, and other risk mitigants aside from capital. Assessment pricing that does not consider risk mitigation cannot truly correlate with risk and does not encourage better risk management.

- The proposed criterion for "leveraged lending" and "subprime loans" requires granular detail at the customer level. ABA is concerned about the burden and cost that could be imposed on banks if the FDIC were to expect regular updating of FICO scores and property valuations for loans in these categories. We suggest that scores and valuations at loan origination be used for these variables. However, should a bank choose for its own purposes to obtain updated values, then it should be allowed to use the updated scores and valuations.

- ABA believes that "subprime loans" in the "concentration measure" should be defined as in the 2001 interagency Expanded Guidance for Subprime Lending Programs.[13] The proposal would

[13] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Office of Thrift Supervision, "Expanded Guidance for Subprime Lending Programs," January 31, 2001, www.federalreserve.gov/boarddocs/srletters/2001/sr0104a1.pdf.

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define "subprime loans" to "include loans that were not considered subprime at origination, but meet the characteristics of subprime subsequent to origination."[14] This would be a significant shift from the 2001 interagency guidance, which states:

> … subprime lending does not refer to individual subprime loans originated and managed, in the ordinary course of business, as exceptions to prime risk selection standards. The Agencies recognize that many prime loan portfolios will contain such accounts. Additionally, this guidance will generally not apply to prime loans that develop credit problems after acquisition...[15]

The proposed Scorecard already takes loan quality migration into account directly through the Asset quality measure in CAMELS, as well as indirectly in the "core earnings" measure. From a practical standpoint, the proposed re-definition would be difficult to implement consistently across all banks and would necessitate an extended implementation time frame to accommodate the more complex reporting required. We note further that including loans that become subprime after origination is inconsistent with the proposal's aim to "mitigate the pro-cyclicality of the current system."[16]

Simply put, deviation from the 2001 interagency guidance would create confusion and a needless burden for banks. ***This large bank proposal should not be used to modify guidance already established and agreed to by all the banking agencies.***

- In the concentration measure, using an average of the "higher risk assets-to-Tier 1 capital and reserves" and "growth-adjusted portfolio concentrations" measures would provide a better measure of the risk exposure, as compared to using the higher of the two (as proposed). The same applies to the "credit quality measure" that would, as proposed, use the higher of "criticized and classified items-to-Tier 1 capital and reserves" and "underperforming assets-to-Tier 1 capital and reserves."

- Where loans are sold yet the transaction fails to satisfy true sale from an accounting standpoint, these loans should be excluded in the "concentration measure."

- The "growth-adjusted portfolio concentrations" measure should exclude the impact of Statements of Financial Accounting Standards 166 and 167. This one-time accounting rule change created assets that do not actually exist, and therefore artificially inflated asset growth rates.

- The "growth-adjusted portfolio concentrations" measure would penalize banks for specializing in one or a few business lines. Banks that specialize in business lines they know well can achieve higher profitability, closer risk management, and overall greater soundness by doing so. Particularly troubling is the failure to recognize the fact that thrift institutions are legally

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[14] 75 Federal Register 72649, November 24, 2010, http://edocket.access.gpo.gov/2010/pdf/2010-29138.pdf.
[15] Agencies, "Expanded Guidance for Subprime Lending Programs," January 31, 2001, page 2.
[16] 75 Federal Register 72613, November 24, 2010, http://edocket.access.gpo.gov/2010/pdf/2010-29138.pdf.

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obligated by their charters to hold a high concentration of mortgage loans. It would be unfair for FDIC premiums to penalize thrift institutions for abiding by their charter mandate.

- The final rule should clarify that real estate loans are not included in the definition of "leveraged loans" in the "higher risk assets-to-Tier 1 capital and reserves" measure. When this issue came up during a December 20, 2010, conference call for bankers subject to the proposal, FDIC staff said that this clarification would be made.

- Level 3 trading assets in the proposed "market risk measure" for the Highly Complex Institutions Scorecard are reported as ***gross*** levels in Schedule RC-Q of the Call Report and therefore are not a good representation of risk. ***Netting*** as per FASB Status of Interpretation #39 should be reported separately in the Call Report and used in the market risk measure. Moreover, Schedule RC-Q includes non-traded securities that are reported at fair value following Statement of Financial Accounting Standards 115 (per the Call Report instructions). These should be reported separately in the Call Report and TFR and excluded from the "trading assets ratio."

- In the "balance sheet liquidity ratio," the list of items in the definition of "liquid assets" should include available-for-sale residential mortgage-backed securities from federally-sponsored or backed agencies. Such securities are highly liquid and not subject to default risk. Some haircut may be appropriate in recognition of rate risk. We note that these securities qualify as "high quality liquid assets" in the "Liquidity Coverage Ratio" recently finalized by the Basel Committee.[17]

Conclusion

ABA appreciates this opportunity to comment on the proposed rule. We are prepared to work with the FDIC in resolving remaining issues in the proposal to arrive at a premium program that is more accurately sensitive to genuine risk and, thereby, a useful tool in encouraging better risk management by banks and by the FDIC. We also look forward to working with the FDIC on the forthcoming proposal for subjective adjustments in large bank assessment pricing and study on brokered deposits.

Sincerely,

Chief Economist

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[17]Basel Committee on Banking Supervision, "Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring," December 2010, www.bis.org/publ/bcbs188.pdf.