FDIC comment letter on NPR pertaining to deposit-account aggregation filed June 27, 2016

Dear Mr. Feldman:

I am writing to comment on the notice of proposed rulemaking (NPR) on Recordkeeping for Timely Deposit Insurance Determination published in the Federal Register on February 26, 2016, pages 10026 to 10056. The RIN is 3064-AE33.

In brief, the proposed rule should be withdrawn and any attempts to revise it should not be undertaken. Further, the FDIC should repeal the existing regulation pertaining to recordkeeping for timely deposit insurance determination codified as 12 C.F.R. 360.9. I will explain below why the FDIC should take these two steps.

Discussion of the two recommendations

The notion that the FDIC will, over the course of a weekend, liquidate a large bank with more than two million deposit accounts, whether through an actual payoff of insured deposits, a transfer of just the insured portion of deposit accounts to another bank, or transfer of just the insured portion of deposit accounts to a bridge bank is a fundamentally absurd, preposterous proposition. Therefore, mandating that all banks with more than two million deposit accounts be capable of aggregating, overnight, every night, all deposit accounts subject to a single deposit insurance limit is equally absurd and preposterous given the substantial cost to the affected banks, as well as to the FDIC, of being prepared to undertake such an aggregation. Further, as will be discussed below, the likelihood that any large bank will need to undertake such an account aggregation because it will be liquidated the next day is essentially zero.

As many commentators have pointed out, even if such an aggregation capability would be desirable, the inability of large banks to obtain ownership data on accounts which must be aggregated is not possible where the ownership information for those accounts is held by third parties, such as deposit brokers, escrow agents, attorneys, retirement account administrators, and the like.[1] Put another way, it simply will not be possible for

[1] For example, see the comment letters on this NPR filed by the American Bar Association (https://www.fdic.gov/regulations/laws/federal/2016/2016_recordkeeping_3064%E2%80%93AE33_c-09.pdf), The Spark Institute (https://www.fdic.gov/regulations/laws/federal/2016/2016_recordkeeping_3064%E2%80%93AE33_c-08.pdf), the Mortgage Bankers Association (https://www.fdic.gov/regulations/laws/federal/2016/2016_recordkeeping_3064%E2%80%93AE33_c-05.pdf) and Prudential Asset Resources, Inc. (https://www.fdic.gov/regulations/laws/federal/2016/2016_recordkeeping_3064%E2%80%93AE33_c-03.pdf)

the banks to which this proposed rule would apply to comply fully with the rule because of legal and operational bars to obtaining the necessary account ownership information.

<u>The FDIC is highly unlikely to liquidate a large, troubled bank through a deposit payoff</u>.

As history readily shows, the FDIC is highly unlikely to resolve a large failed bank, specifically a failed bank with more than two million deposit accounts, through an outright payment to depositors of the insured portion of their deposit account or accounts at the failed bank. This type of transaction is what the FDIC describes in its Resolutions Handbook as a "straight deposit payoff.[2]" The actual payoff process would require the FDIC to write several million checks totaling many billions of dollars which would severely tax the FDIC's liquidity, substantial though it is at this time.[3]

For example, if the FDIC paid off a bank with three million deposit accounts that, on average, had an insured balance $10,000, the FDIC would have to write several million checks, totaling $30 billion, equal to almost half of its liquid assets at the end of 2015. Such a payoff would be substantially larger than the FDIC's largest insured-deposit payoff in recent years, when it closed the Advanta Bank Corp. on March 19, 2010; Advanta had approximately $1.5 billion in deposits and 125,000 deposit accounts.

Further, it would take at least a few days to prepare and mail the checks in a large-bank liquidation. In the meantime, a million or more depositors would be scrambling to open new bank accounts and then arrange for direct deposits into the new accounts as well as to establish automatic bill-payment arrangements. In the meantime, customers of the failed bank would be faced with dealing with bounced checks, late payment fees, and dings on their credit records. These disruptions, and cost, to the affected households and businesses would be enormous. The liquidation process also would destroy whatever franchise value the bank had at the time it failed. That loss in franchise value could range from several hundred million dollars to several billion dollars!

Worse, the liquidation of the bank also would terminate tens of thousands, if not several hundred thousand, lending and other credit relationships, such as home-equity lines of credit and lines of credit for businesses that borrowers would have to replace, a process that could take weeks, if not several months. Those borrowers, suddenly adrift without a credit facility they had been relying upon, could quickly face severe financial distress

[2] Federal Deposit Insurance Corporation, Resolutions Handbook, December 23, 2014, revision, pg. 19.
[3] According to the FDIC's annual report for 2015, at December 31, 2015, the FDIC's Deposit Insurance Fund (DIF) held cash and cash equivalents of $876 million plus U.S. Treasury obligations with a "fair value" of $62.5 billion. However, only $21.8 billion of those obligations mature within one year; the balance mature within 1 to 5 years or were Treasury Inflation-Protected Securities, or TIPS. Despite these substantial investments, the FDIC would not be able to come up with $30 billion on a few days' notice without substantial liquidity assistance from the U.S. Treasury and/or the Federal Reserve.

or even bankruptcy. This replacement process also would strain the ability of banks serving the same market to accommodate all the new borrowing requests. The macroeconomic affects in the affected banking markets could be enormous if a very large bank serving that market was suddenly liquidated. An outright bank liquidation of such a magnitude would be tantamount to economic arson!

In a May 19, 2016, interview in the American Banker, Neel Kashkari, president of the Federal Reserve Bank of Minneapolis, referencing a discussion at a recent conference about "living wills" that large banks must develop and periodically update, noted this comment by private equity investor Christopher Flowers: "I thought he [Flowers] brought the most grounded perspective. He said, in a crisis, you're kidding yourself if you think you're going to wind down one of these [large] institutions." I fully agree with that sentiment!

Since the IndyMac failure in July 2008 the FDIC has almost always protected uninsured deposits in failed banks against any loss.

Since the IndyMac failure in July 2008, which featured widely televised scenes of panicked depositors lined up outside IndyMac branches, the FDIC has bent over backward to protect uninsured deposits by determining whenever possible that it would cost less to have another bank acquire all of the deposits of the failed bank than to liquidate the bank, imposing losses on uninsured deposits.

Of the 512 failures since IndyMac was closed, uninsured depositors were protected against any loss in all but 30 situations. The deposits in the 30 failed banks where uninsured depositors were not protected against loss account for just 5.9% of the deposits in all the banks that have failed since IndyMac. The largest failure since IndyMac was closed where uninsured deposits bore some of the bank's insolvency loss was Nevada's Silver State Bank, which was closed in September 2008; it had $1.7 billion in deposits when it was closed and approximately 20,000 deposit accounts.

Protecting uninsured depositors in failed banks definitely has not been limited to larger banks. Since July 2008, uninsured depositors have been protected against any loss in all but five of the 122 failed banks with less than $100 million of assets.

An insured-deposit-transfer to resolve a large, troubled bank is highly unlikely, too.

Two alternatives to a straight deposit payoff discussed in the FDIC's Resolutions Handbook – Insured Deposit Transfer (IDT) and Deposit Insurance National Bank (DINB) – would be only slightly less disruptive to the customers of the failed bank, but the depositors and borrowers of a failed bank resolved in this manner still have to establish new deposit and borrowing relationships within a fairly short period of time.

The FDIC, in its Resolutions Handbook, obliquely acknowledges this disruption potential by noting on page 20 that "by using a DINB rather than a payoff, the transferring of accounts to account holders <u>occurs in a less disruptive and more orderly manner for the local community</u>." [emphasis supplied] Ironically, the FDIC's sole use of a DINB in recent years – upon the failure of New Frontier Bank of Greeley, Colorado, on April 10, 2009 – proved to be highly disruptive to borrowers. According to news reports, numerous customers of that bank, which had deposits of $1.5 billion, experienced great difficulty establishing new banking relationships and suffered financial harm while doing so. <u>Imagine the harm to customers and the economy if a bank 10 times or 100 times the size of New Frontier was liquidated or its insured deposits were transferred to a DINB!</u>

<u>Reliance on market forces, reinforced by FDIC enforcement orders, to restore the health of a large, troubled bank is far superior to an FDIC takeover and liquidation of the bank</u>.

Market forces – through recapitalization, restructuring, downsizing, divestiture of certain lines of business, or some combination of these actions – represents a far superior way to deal with a large, troubled bank. Further, troubled banks send lots of signals over time as they are becoming increasingly troubled and possibly approaching insolvency. Additionally, banking supervisors, with their access to extensive <u>inside</u> information about a bank and their broad enforcement powers (Prompt Corrective Action), should be able to deal in a timely manner with a large, troubled bank in a manner that does not cause the marketplace disruptions that liquidating that bank would cause. There is absolutely no reason why banking supervisors should be so caught by surprise by a large, failing bank that they have no choice but to liquidate it quickly in a manner that imposes loses on uninsured deposits.

JPMorgan's acquisition of Washington Mutual and Wells Fargo's acquisition of Wachovia are excellent examples of the resolution of large, troubled banking companies that did not require any financial assistance from the FDIC or taxpayers and therefore did not cause any loss to the FDIC or to taxpayers. Instead, the operations of Washington Mutual and Wachovia, including loans and deposit relationships, were melded into the acquiring banking companies over a period of months with minimum disruption to those relationships or in the markets where the acquired banks operated.

As politically unpalatable as it was, the government assistance Citigroup received when it got into financial trouble following the 2008 financial crisis saved that company, and its banking subsidiaries, from failure. The alternative – liquidating Citigroup's bank subsidiaries and all of their banking and credit relationships – would have been far more destructive to the economy. As a plus, the government earned a substantial profit on its investment in Citigroup.

While small banks can fail suddenly, often due to fraud,[4] contrary to the FDIC's apparent belief, large banks do not "fail with little prior warning.[5]" The FDIC has provided absolutely no evidence that a large bank, of at least the size to which the proposed rule would apply, has ever failed with little prior warning. Instead, a large, troubled bank will slide, slowly and very publicly, towards insolvency, with the likelihood of insolvency increasingly evident as the market value of its parent holding company's common stock, relative to the holding company's book value, steadily declines. Supervisory actions, backed up by enforcement orders, at both the bank and the holding company level, should trigger a multitude of corrective actions, including downsizing, recapitalization, or even an outright sale, before losses in the bank have wiped out its book capital and franchise value.

<u>A purchase-and-assumption (P&A) transaction or a bridge bank is the most likely resolution vehicle for a large, troubled bank not otherwise resolved through market forces and/or supervisory actions</u>.

If a large bank which was subject to the proposed rule were to become so troubled that it could not be resolved through market forces and/or supervisory actions, then it should be resolved through a purchase-and-assumption transaction with a sound bank, as has been the case with most smaller banks that have failed in recent years. If a Whole Bank P&A is not feasible, then the FDIC should execute a Bridge Bank P&A[6] to transfer the failed bank to a new, temporary national bank chartered by the OCC and controlled by the FDIC, as discussed on page 20 of the FDIC's Resolutions Handbook. A bridge bank can be established only if it is projected to be the least costly resolution alternative for the DIF.

As noted above, liquidating a large bank (i.e., a bank with more two million deposit accounts) will likely have serious negative macroeconomic consequences, at least in the region it has served, if not nationally, as its depositors and borrowers desperately search for new banking relationships. Those negative macroeconomic consequences

[4] An excellent example of a small bank suddenly failing due to fraud was the closure on February 1, 2002, of the Oakwood Deposit Bank of Oakwood, Ohio. Just the day before it was closed, the bank's president, Mark Miller, was arrested when a bank examination uncovered serious irregularities, specifically that Miller had stolen $49 million from the bank by selling bank CDs on the Internet and then diverting the money to his own uses, mostly to invest in a casino boat operation in South Carolina. At the end of 2001, Oakwood had total assets of $72 million and capital of $6.4 million.

[5] On Federal Register page 10027, middle column, the following statement appears: "the FDIC believes that if a large institution were to <u>fail with little prior warning</u> additional measures would be needed to ensure the prompt and accurate payment of deposit insurance to all depositors." [emphasis supplied]

[6] Both Whole Bank P&As and Bridge Bank P&As are discussed in the FDIC's Resolutions Handbook.

consequently will adversely impact federal tax revenues. Although not widely known, that potential loss in federal tax revenues must be taken into account by the FDIC in making a least-cost resolution determination. Specifically, 12 U.S.C. §1823(c)(4)(B)(ii) provides:

> FOREGONE TAX REVENUES.—Federal tax revenues that the Government would forego as the result of a proposed transaction, to the extent reasonably ascertainable, shall be treated as if they were revenues foregone by the deposit insurance fund.

From the perspective of federal government accounting, a foregone revenue has the same impact on the budget deficit or surplus as a government outlay, such as the expense the FDIC would incur in financing a P&A transaction, keeping in mind that, for federal budget accounting purposes, the FDIC is an "on-budget" federal agency.

<u>The FDIC almost certainly has grossly underestimated the cost to the affected banks of implementing and maintaining deposit-account aggregation as specified in the NPR</u>.

When the FDIC extended the closing date for comments on this NPR, it posted on its website its Cost Estimation Methodology for this proposed regulation (https://www.fdic.gov/regulations/laws/federal/2016/2016_recordkeeping_3064-AE33_report.pdf), presumably to justify its assertion that it will only cost the banks to which the proposed rule would apply $328 million to implement the rule and $2.88 million annually to maintain the aggregation linkages mandated by the proposed rule.

My review of this cost estimation methodology suggests that the calculations in it substantially underestimate both the initial cost the affected banks would bear in implementing the proposed regulation as well as the annual costs they would incur in maintaining the linkage of all of a depositor's accounts at the bank. Understandably, data for individual banks was redacted so it was not possible to assess the reasonableness of the cost estimate of any one bank. However, based on the FDIC's estimate that the banks which would be subject to the aggregation requirement had 397 million deposit accounts at the end of 2014, <u>that estimated cost equals just 83 cents per account to be aggregated</u>.

For the following reasons, my sense is that that the FDIC's cost estimate errs on the low side, perhaps significantly. <u>First</u>, the FDIC's cost estimate is based on out-of-date December 31, 2014, call report data that does not reflect an increase since then in the number of banks that would be subject to the aggregation regulation, the number of deposit accounts to be aggregated, and cost inflation. Based on March 31, 2016, FDIC call report data, I estimate two or possibly three additional banks would be subject to the regulation while the number of accounts to be aggregated on a daily basis would be at least 5% higher than the FDIC estimate, based on data set out in the FDIC cost estimation model.

<u>Second</u>, I question the accuracy of data inputs in the cost estimation model. For example, American Express Centurion Bank is shown as having 6,424,893 deposit accounts on December 31, 2014, but that bank's call report states that it had 1,209,225 deposit accounts on that date. Also, the cost estimation model includes three banks with far fewer than two million deposit accounts -- Bank of New York Mellon, State Street Bank & Trust Company, and Northern Trust Company. These are large banking companies but presumably they would be exempt from the aggregation requirement by virtue of having relatively few deposit accounts.

<u>Third</u>, the FDIC cost estimate is far below the estimated cost of a similar undertaking in the United Kingdom in 2008, as reported on page 7 of the FDIC report on its cost estimation methodology. According to that report, "the estimated cost of this regulation to the entire UK banking industry was between £400 million and £1.0 billion." In U.S. dollars, that would be a range of $600 million to $1.5 billion, far higher than the FDIC's $325 million cost estimate. Further, UK banks would have up to seven days after failure to provide payments to depositors, which gives UK banks much more slack in the operational accuracy of their account aggregation processes. Although the UK proposal applied to all UK deposit-taking institutions, those institutions collectively almost certainly have far fewer deposit accounts to aggregate given that the UK has just one-fifth the population (64 million) of the United States' population (323 million). <u>On a per-capita basis, the UK cost estimate for account aggregation is as much as 23 times as great as the FDIC 's cost estimate when expressed in per-capita terms</u>!

<u>Fourth</u>, it is not clear that the FDIC included the expense of obtaining account ownership information from third parties for brokered deposits, escrow deposits, and other forms of deposit. For example, in the report's list of "cost estimation complexity factors" on page 12, there is no mention of obtaining account-ownership data from third parties, such as deposit brokers, if the bank can even obtain that data. Since the UK does not have pass-through deposit insurance, UK banks do not face the challenge, and expense, American banks would face in identifying the owners of deposit accounts placed in the bank by third parties, such as deposit brokers.

<u>Fifth</u>, given the magnitude of normal deposit account turnover that banks continually experience, the FDIC's total annual cost of "ongoing operations" of $2.88 million for the 36 banks that the FDIC believes would initially be subject to the regulation seems absurdly low – less than one cent per account that would be subject to the aggregation requirement. <u>The $2.88 million cost estimate for the 36 banks equates to an average</u>

annual ongoing cost of just $80,000 per bank, approximately the cost of devoting just one employee at each bank to meeting all of its ongoing aggregation requirements.

The FDIC should repeal 12 C.F.R. § 360.9, large-bank deposit insurance determination modernization.

The arguments presented above for not adopting the proposed regulation apply with equal validity to the current large-bank deposit insurance determination modernization regulation, codified as 12 C.F.R. § 360.9. Therefore, in addition to not adopting the proposed revisions to deposit-account aggregation regulation, the FDIC should repeal the current regulation, thereby removing all regulatory authority to impose deposit-account aggregation requirements on large banks.

FDIC staff should feel free to contact me should they have any questions about this comment. I can be reached by email at bert@ely-co.com or by phone at 703-836-4101.

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