

September 11, 2015

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429
Attention: Comments

RE: Notice of Proposed Rulemaking on Assessments (12 CFR §327), RIN 3064–AE37¹

Dear Mr. Feldman:

The American Bankers Association (ABA) appreciates the opportunity to respond to the notice of proposed rulemaking on “small bank assessments” from the Federal Deposit Insurance Corporation (FDIC).² ABA supports the proposal’s stated primary purpose, to improve the risk-based deposit insurance assessment system for “established small banks” (FDIC-insured institutions with less than \$10 billion in assets and that have been insured for at least five years) to more accurately reflect their risk to the FDIC’s insurance fund.³ As discussed below, we feel that some aspects of the proposal support this purpose and recommend that some be reconsidered.

Certainly, much has been learned from over 500 bank failures since the current system was developed in 2006, and it is reasonable for the FDIC to incorporate those lessons into its assessments system. ABA sees several positive aspects to the proposal, including:

- Elimination of the risk categories and application of a uniform assessments formula across “established small banks,” which would avoid a jump in assessments under the current system when there is a decline in capital or composite CAMELS rating for a bank that is not “well capitalized” and composite CAMELS I or II;

¹ 80 *Federal Register* (133) 40838, July 13, 2015, available at www.gpo.gov/fdsys/pkg/FR-2015-07-13/pdf/2015-16514.pdf (Proposal).

² The American Bankers Association is the voice of the nation’s \$16 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard \$12 trillion in deposits and extend \$8½ trillion in loans.

³ Proposal, page 40838.

- Incorporation of a change in a bank’s CAMELS component ratings into its assessments calculation at the point during a quarter when it occurs, which would smooth quarter-to-quarter changes in assessments;⁴
- Calibration of any change in assessments pricing such that it would not result in any change in total assessments collected by the FDIC;
- Implementation of any change in the assessments system in the quarter after the insurance fund reaches 1.15 percent of insured deposits when the assessments rate schedule is set to decline, which would lessen the increase in assessments for banks whose assessments rise as a result of the change; and
- A stated intent to incorporate loss-given-default into assessments pricing once reliable data is available, so that assessments can be tied more truly to the risk to the insurance fund.⁵

ABA further appreciates the intent to make the “small bank assessments” system more forward looking. However, we question whether some of the proposed changes would reliably differentiate the risk of failure among banks through future economic cycles. Specifically, we recommend that:

- The extreme increase in weighting for the tier 1 leverage ratio in the proposed assessments formula would unfairly penalize banks that meet the “well capitalized” standard but do not hold excess capital, and should therefore be revised to align with the weighting in the current formula.
- The proposed new factors for loan mix index, core-deposits-to-total-assets, and one-year-asset-growth are of uncertain value in forecasting bank failures, and should therefore be reconsidered.
- CAMELS component ratings are the truest measure of the potential for an individual bank to fail, and should therefore be given the highest weighting in the small bank assessments formula – higher than as proposed.

Discussion of these recommendations follows.

⁴ “[I]f a bank’s CAMELS composite or component ratings change during a quarter ... then its assessment rate would be determined separately for each portion of the quarter in which it had different ... ratings.” (Proposal, page 40846)

⁵ Proposal, page 40853.

Weighting for Tier 1 Leverage

The tier 1 leverage ratio has a weighting of -0.056 in the current assessment formula, but the weighting would jump to -1.337 in the proposed formula – an increase of nearly 2,300 percent.⁶ In consequence, this factor would become dominant in the revised formula.

Some “well capitalized” banks, especially some larger “small banks,” have calculated that this change would significantly raise their assessments. They feel that they would be unfairly penalized for not holding leverage capital well above the “well capitalized” standard of five percent.⁷ A “well capitalized” bank should not be punished for putting its excess capital to work in making loans. The FDIC participated in the interagency collaboration in setting the Prompt Corrective Action standards, including “well capitalized,” and should respect this level in its own rules.

We note that, in addition to tier 1 leverage, “adequacy of capital” already carries additional weight in the assessments formula (current and proposed) as the “C” component of CAMELS. In fact, capital adequacy is one of the two higher-weighted CAMELS components (along with “management capability”).

ABA understands that somewhat higher weighting for tier 1 leverage may be fitting for banks that are not “well capitalized.” Considering that 99.9 percent of banks currently meet the “well capitalized” standard, this is the industry norm.⁸ However, ***for banks that are “well capitalized,” the weighting for the tier 1 leverage ratio should be much lower than as proposed, in line with the current formula.***

⁶ These values were observed in the calculators posted under “current assessment rate calculator for small institutions” and “assessment rate calculator for small institutions under the proposed rule,” respectively, on www.fdic.gov/deposit/insurance/calculator.html. ABA recognizes that the assessments formula may be recalibrated prior to implementation. (Proposal, page 40842)

⁷ The leverage ratio would have little or no effect on a bank’s assessments if, due to other factors in the assessments formula, it’s calculated assessment rate would be at the minimum or maximum level.

⁸ FDIC, “Capital Category Distribution,” June 30, 2015, posted to www5.fdic.gov/qbp/grgraph.asp.

New Factors in the Assessments Formula

Loan mix index

ABA believes that the proposed loan mix index is of questionable value in forecasting bank failures. The weighting of this factor would be based only on banks that failed.⁹ We recognize that a number of banks with certain loan concentrations failed during the last bank failure cycle. However, the index does not consider the quality of credit underwriting, portfolio management and risk hedging, or that many banks with similar loan portfolios survived due to better asset quality management. Many banks that have experimented with the proposed assessment rate calculator feel that they would be punished for their business strategies even though they have experienced few loan problems over the years.

Moreover, this is a backward-looking factor based primarily on the most recent spate of bank failures.¹⁰ Yet history has seen significant variance in economic and bank failure cycles. In the early 1980s, many agricultural banks failed. Similarly for many residential mortgage lenders in the late 1980s and early 1990s. Future bank failures may well be characterized by different loan portfolios than in the recent failure cycle. The FDIC apparently recognizes this fact, given that the proposal would provide specific authority to alter the loan mix index in the future.¹¹

The effect of the loan mix index on assessments could lead some “small banks” to consider modifying their loan portfolios. ***ABA recommends that the FDIC should avoid policies that encourage banks to concentrate in certain loan categories and move out of others, even if unintentionally, as doing so could unnecessarily tighten certain types of credit.*** Moreover, we recommend that the risks that the index is trying to gauge are best measured by supervisors and included in the “A” (for “asset quality”) and “S” (for “sensitivity to market risks”) components of CAMELS ratings.

⁹ “For each loan category, the weighted average charge-off rate weights each industry-wide charge-off rate for each year by the number of bank failures in that year.” (Proposal, page 40843)

¹⁰ “[C]harge-off rates from 2009 through 2014, during the recent banking crisis, have a much greater influence on the weighted average charge-off rate than the charge-off rate from the years before the crisis, when few failures occurred.” (Proposal, page 40843)

¹¹ “The FDIC proposes to retain the flexibility to update the statistical model from time to time ... and publish a new loan mix index ...” (Proposal, page 40846)

Core-deposits-to-total-assets

Core deposits represent stable, relatively rate-insensitive funding that can help sustain a bank and create franchise value. Thus, a measure of core deposits can be a useful predictor of bank failures. However, ***the proposed measure of core deposits is a crude one. Accordingly, ABA recommends that the proposed core-deposits-to-total-assets measure should be weighted lower in the assessments formula than as proposed.***

In the proposal, core deposits would include all domestic office deposits less time deposits over the \$250,000 insurance limit and those under \$250,000 that classify as brokered deposits. However, community bankers report that many of their time deposits with balances above \$250,000 are from long-standing depositors who are not rate sensitive; thus these deposits should be considered “core.” Moreover, much of the deposits the FDIC considers to be brokered should not be. This issue was exacerbated by the FDIC’s recent FIL-2-2015, under which even stable deposits resulting from bank-affiliate relationships or obtained by contract employees would count as brokered.¹²

We note that “reciprocal deposits” count as brokered deposits under the proposal.¹³ This is in contrast to the treatment in the current assessment formula, yet the proposal provides no justification for the change.¹⁴ ***ABA recommends that reciprocal deposits should be considered as core deposits and, therefore, deducted from brokered deposits.*** In justification, reciprocal deposits are like core deposits and unlike brokered deposits in that (1) the depositor is normally from the bank’s local market, (2) the deposit interest rate is set based on local market conditions, (3) the bank owns the relationship with the depositor, and (4) the customer relationship is typically long-term and includes multiple services. In fact, an FDIC study recognized “that reciprocal deposits may be more stable than other brokered deposits if the originating institution has developed a relationship with the depositor and the interest rate is not above market.”¹⁵

¹² FDIC, *Guidance on Identifying, Accepting, and Reporting Brokered Deposits*, Financial Institutions Letter FIL-2-2015, January 5 2015, posted to www.fdic.gov/news/news/financial/2015/fil15002.html. A letter dated August 11, 2015 addressed to FDIC General Counsel Charles Yi from ABA, The Clearing House Association and the Institute of International Bankers details issues with FIL-2-2015.

¹³ Reciprocal deposits are defined in 12 CFR 327.8 as “deposits that an insured depository institution receives through a deposit placement network on a reciprocal basis, such that: (1) for any deposit received, the institution (as agent for depositors) places the same amount with other insured depository institutions through the network; and (2) each member of the network sets the interest rate to be paid on the entire amount of funds it places with other network members.”

¹⁴ Proposal, footnote 29 on page 40843.

¹⁵ FDIC, “Study on Core Deposits and Brokered Deposits,” July 8, 2011, page 54 (available at www.fdic.gov/regulations/reform/coredeposit-study.pdf).

Another reason to reduce the proposed core deposits factor weighting is that diversifying funding into other than core deposits can help control illiquidity risk, a principle that has been recognized by the federal banking agencies, including the FDIC.¹⁶ In addition, many banks use Federal Home Loan Bank advances and term brokered CDs, in place of deposits, to manage interest rate risk. Banks should not be punished with higher assessments for sound liquidity and rate risk management.

Bank examiners gauge the effects of core deposits, diversification of funding sources, and rate risk management in the L (for “liquidity management”) and S (for “sensitivity to market risk”) CAMELS component ratings. ABA suggests that the weighting for the proposed core deposits measure be shifted to these measures. We further recommend separate consideration in the assessments formula for reciprocal deposits, as well as for Federal Home Loan Bank advances and term brokered deposits as paired with loan maturities.

One-year asset growth

The proposed one-year-asset-growth factor (adjusted for acquisitions and mergers), when related to assessments in fixed, linear form, would also be problematic for several reasons.

First, relatively rapid but sound growth can result when a local competitor fails or sells out to another bank that is not appreciated locally, the bank hires a strong loan officer, or there is an influx of deposits and the funds are placed in high-quality securities. On the other hand, slow asset growth can result from write-offs of bad loans, which likely does not imply lower risk.

Second, a fixed coefficient on asset growth would mean that any growth raises assessments. This does not square with a sound bank’s role to fund growth in and grow with its local economy.

And third, a fixed coefficient that ties risk to asset growth cannot be appropriate over time. Robust growth in a strong business environment does not signal weakness any more than tepid growth in a weak marketplace signals strength.

At issue, then, is whether asset growth over a short, one-year period can reasonably proxy risk-taking in fixed, linear fashion. ***ABA believes that a nationwide standard for a fixed asset growth rate over time is unreasonable.*** A sound bank grows with its local market, faster in a strong economy and *vice versa*, so a reasonable standard would have to vary across geography and time. Any measure to gauge this would be unreasonably complex.

¹⁶ “The agencies believe that a diversification of funding sources strengthens an institution’s ability to withstand idiosyncratic and market wide liquidity shocks.” (*Interagency Policy Statement on Funding and Liquidity Risk Management*, 75 *Federal Register* (54), March 22, 2010 13656 at page 13657)

Instead, ABA recommends that asset quality is best measured in the A (for “asset quality”) component of CAMELS. On this point, we note that faster growth naturally triggers sooner and/or closer supervisory scrutiny. Thus, if a bank has not handled growth well, this will be reflected in the CAMELS “A” rating and, thus, in its FDIC assessments.¹⁷

The core-deposits-to-total assets and one-year-asset-growth factors in the proposed assessments formula would replace the adjusted brokered deposits ratio in the current formula. Bankers advise that rapid growth is least sound when financed by “hot money.” This concept underpins the adjusted brokered deposits ratio factor in the current assessments formula. ABA recommends that the current measure is, therefore, superior to the two that would replace it.

Weighting of the CAMELS Component Ratings

As noted above, ABA recommends that several of the factors in the proposed assessments formula would be measured better through the component CAMELS ratings. In support, the proposal observes that “[t]he statistical model does not take into account idiosyncratic or unquantifiable risk or risk mitigators (*e.g.*, entering or exiting a risky line of lending; having inexperienced or experienced management, reducing or tightening underwriting requirements), again except through weighted average CAMELS component ratings.”¹⁸ The fact that the vast majority of banks in existence in 2006, when the current assessments formula was derived, did not fail during the ensuing bank failure cycle suggests that idiosyncratic and unquantifiable factors are key to the soundness of bank performance and likelihood that any bank will fail.

Moreover, ABA believes that *no mathematical formula based on a few items from the Call Report can gauge the performance and condition of an individual bank, and the potential for it to fail in the future, as well as supervisors do during regular on-site examinations.* Supervisors thoroughly consider the business model and idiosyncrasies of each bank individually, and assign CAMELS ratings corresponding to the degree of risk taken.

Accordingly, *ABA recommends that CAMELS component ratings should be given the highest weighting in the FDIC’s small bank assessments formula – much higher than as proposed.*¹⁹

¹⁷ If a growth factor is to be used in the assessments formula – if the problem of a linear relationship between growth and assessments can be resolved – loan growth could be a better measure of risk for “small banks” than asset growth. In addition, the growth factor could be designed to have no effect unless growth exceeds some industry norm, following the example of the current brokered deposit adjustment (which applies only if four-year asset growth exceeds 40 percent).

¹⁸ Proposal, page 40852.

¹⁹ The coefficient on the weighted average CAMELS component ratings is actually higher in the draft assessments formula than in the current formula, 1.731 *vs.* 1.095. However, the “uniform amount” in the proposed draft assessment formula is 19.376 b.p., a four-fold increase from 4.861 b.p. in the current formula. The former, unlike the latter, is far from the median assessment rate. Thus, higher factor

Conclusion

The proposal notes that the current assessments formula “did relatively well at capturing risk and predicting failures in more recent years.”²⁰ At issue then, is whether the proposed changes would yield assessments that are more closely aligned with risk to the FDIC insurance fund going forward. The proposal defends that the proposed assessments formula, with some new factors replacing others, performed satisfactorily in back-tests over the recent bank failure cycle. However, that cycle differed in many respects from those before it, and we question whether bank failures in the future will follow an identical pattern. Therefore, we question the robustness into the future of the replacement factors and weightings in the proposed assessments formula.

The danger is that adoption of a revised assessments formula with identifiable weaknesses may have undesirable consequences if, in response to assessments mispricing, some banks curtail lending (to raise leverage capital and restrain one-year growth), concentrate funding (to increase core deposits), or alter their loan portfolios (to portfolios favored by the loan mix index).

We therefore recommend reconsideration of the new factors as proposed and suggest that the CAMELS components be more heavily weighted in any revision to the assessments formula (with a lower “uniform amount”). Supervisory evaluations adjust as fitting the times and, thus, are the most reliable measure of the risk posed by any bank.

ABA appreciates that the FDIC has posted assessments calculators for the current and proposed small bank assessments systems, which have allowed affected banks to evaluate the impact of the proposed changes and provide feedback. We look forward to working with FDIC staff to achieve the ends that the proposal seeks: assessments that more closely align with risk to the FDIC insurance fund. Please contact the undersigned if you have any questions regarding ABA’s response to the proposal.

Sincerely,

Robert W Strand

Robert W. Strand

weightings are needed in the draft, as compared to current, formula, in order to bring the median assessment rate down to the desired level. In the process, the weightings of the CAMELS components are muted relative to the influence of some of the troubling factors. Retention of a lower “uniform amount” in the assessment formula could permit a more appropriate weighting for the CAMELS components.

²⁰ Proposal, page 40851.