DECISION
OF THE
ASSESSMENT APPEALS COMMITTEE

CASE NO. 2018-01

*** (the “Bank”) filed an appeal with the Assessment Appeals Committee (“AAC” or “Committee”) of the Federal Deposit Insurance Corporation (“FDIC”) by letter dated March 23, 2018. The Bank is appealing a determination issued by the FDIC’s Division of Insurance and Research (“DIR”) dated February 27, 2018. In that determination, DIR denied the Bank’s request to use an “individualized assessment” or otherwise adjust the Bank’s assessment rate for the third quarter 2017 assessment period (i.e., July 1-September 30).

The Committee met to consider the Bank’s appeal on April 17, 2018. After carefully considering the Bank’s submission and the facts of this case, the Committee has denied the appeal.

BACKGROUND

*** Bank is a ***-chartered state nonmember bank and ***. ***. Based on the Bank’s Call Report data as of ***, it had approximately $*** in total assets. The Bank’s assessment rate is calculated under the small bank pricing methodology in the FDIC’s assessment regulations.[1]

In a letter to the Director of DIR, dated January 9, 2018, the Bank requested review of its assessment rate for the third quarter of 2017 under procedures set forth in section 327.4(c) of the FDIC’s regulations.[2] The Bank contended that due to the Bank’s “unique product offerings”, its

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[1] *See* 12 CFR § 327.16(a). In this decision, the term “bank” is synonymous with the term “insured depository institution” as it is used in section 3(c)(2) of the Federal Deposit Insurance Act (“FDI Act”), 12 U.S.C. 1813(c)(2), and the term “small bank” is synonymous with the term “small institution” as it is used in 12 CFR § 327.8. For the purposes of 12 CFR Part 327, a “small bank” is generally one with less than $10 billion in total assets.
[2] 12 CFR § 327.4(c). The Bank timely filed and met other requirements set forth in the regulations, including timely payment, to obtain review of its assessment for the third quarter of 2017.

assessment rate increased under the small bank pricing methodology that went into effect on July 1, 2016.[3] The Bank pointed to several measures in the small bank pricing methodology that it argues contributed to the increase in its assessment rate, including loan mix index, brokered deposit ratio, one-year asset growth rate, and net income before taxes ratio. The Bank asserted that these measures do not indicate increased risk due to the Bank's unique characteristics, and therefore requested that the FDIC formulate an individualized assessment for the Bank. The Bank, however, did not assert that the FDIC applied the assessment regulations incorrectly. On February 27, 2018, DIR denied the Bank's request for review. DIR's response stated that it cannot use a methodology not approved by the FDIC Board to determine a bank's assessment rate. DIR also stated that the Bank's assessment rate calculated according to the current pricing method was appropriate. In addition, DIR's response stated that the measures that contributed to the Bank's increased assessment rate are statistically significant predictors of bank failures.

The Bank timely appealed DIR's denial by letter dated March 23, 2018. In its appeal, the Bank reiterates the arguments set forth in its request for review. In addition, the Bank requests that the FDIC treat its *** loan portfolio the same as a *** portfolio for purposes of the loan mix index, which would result in a decrease in the Bank's assessment rate.

ANALYSIS

The Bank requests application of an individualized assessment for the Bank. The Bank argues that there are several factors in the FDIC's current assessment system that result in an inappropriate premium for the Bank, given its unique product line and history. The Committee notes that the Bank does not assert that the FDIC applied the assessment regulations incorrectly,

[3] *See* the Bank's January 9, 2018 letter, page 1.

and as discussed below, the Committee finds that the assessment regulations were applied correctly.

While the regulations do not provide for an individualized methodology for calculating a bank's assessment rate, the Committee at times has considered whether unique circumstances–generally circumstances beyond a bank's control–prevented a bank from complying with the relevant regulations.[4] The Committee also has considered whether application of the regulations in a particular case would be inequitable.[5] For the reasons set forth below, the Committee concludes that the circumstances of this case do not warrant the relief requested.

Small Bank Pricing Methodology

Under the FDI Act, the FDIC is required, by regulation, to establish a risk-based assessment system for insured depository institutions.[6] As authorized under the FDI Act, the FDIC established separate risk-based systems for large and small banks through notice and

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[4] *See e.g.*, Case Nos. 2002-02 (granting relief where the terrorist attacks on September 11, 2001, prevented the bank from consummating a previously arranged transaction that would have made the bank well capitalized on the cutoff date); and 2004-02 (granting relief where the primary federal regulator's delay in granting a needed approval prevented the bank from consummating a previously arranged transaction that would have made the bank well capitalized on the cutoff date). *But see e.g*., Case Nos. 2004-06 (denying bank's appeal to upgrade its capital evaluation, in part, because the bank was correctly assigned to a lower capital group based on its Call Report data); 2008-02 (denying bank's appeal to upgrade its capital evaluation because the timing circumstances related to the bank's public stock offering process, which the bank argued caused its capital ratio to fall, was in the full discretion of the bank and not based on any regulatory constraint); 2009-01 (denying bank's appeal to upgrade its capital evaluation because there was no unusual delay in approval of the bank's capital plan by its primary federal regulator and that the decision to hold certain securities that were declining in value was in the bank's control).

[5] Under the AAC guidelines adopted by the FDIC Board, the burden of proof as to all matters at issue rests with the institution. *See* Guidelines for Appeals of Deposit Insurance Assessment Determinations, Paragraph H, 77 FR 17055, 17060 (Mar. 23, 2012).

[6] *See* 12 U.S.C. 1817(b)(1)(A). A "risk-based assessment system" means a system for calculating an insured depository institution's deposit insurance assessment based on the probability that the Deposit Insurance Fund ("DIF") will incur a loss with respect to the institution, taking into consideration the composition and concentration of the institution's assets and liabilities, the likely amount of any such loss, and the revenue needs of the DIF. *See* 12 U.S.C. 1817(b)(1)(C).

comment rulemaking.[7] The current small bank pricing methodology took effect on July 1, 2016, following two notices of proposed rulemaking ("NPR").[8, 9] The primary purpose of the revisions to the methodology was to improve the risk-based assessment system applicable to established small banks[10] to more accurately reflect risk.[11] The FDIC went on to explain that the improvements would allow the FDIC to more effectively price risk, and would further the goals of reducing cross-subsidization of high-risk institutions by low-risk institutions and helping to ensure that banks that take on greater risks will pay more for deposit insurance.[12]

The measures in the small bank pricing methodology are derived from a statistical model that estimates a bank's probability of failure within three years.[13] Each of the measures is statistically significant in predicting a bank's probability of failure over that period.[14] The estimation of the statistical model uses bank financial data and CAMELS ratings[15] from 1985 through 2011, failure data from 1986 through 2014, and loan charge-off data from 2001 through 2014.[16] In addition, the current methodology was subject to validation and back testing to ensure that it performed better than the previous methodology. The superior performance of the current

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[7] *See* 12 U.S.C. 1817(b)(1)(D). *See also* 81 FR 32180 (May 20, 2016) (final rule implementing the current small bank pricing methodology); 76 FR 10672 (Feb. 25, 2011) and 77 FR 66000 (Oct. 31, 2012) (final rules implementing the current pricing methodologies for large and highly complex banks).

[8] *See* 81 FR 32180 (May 20, 2016) (final rule); 81 FR 6108 (Feb. 4, 2016) (second notice); 80 FR 40838 (July 13, 2015) (first notice). In the same assessment period that the final rule went into effect, and as required by regulation, an assessment rate schedule with lower initial and total base assessment rates went into effect for all banks because the reserve ratio of the DIF exceeded 1.15 percent. *See* 12 CFR § 327.10(b).

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[10] Subject to exceptions, an established insured depository institution is one that has been federally insured for at least five years as of the last day of any quarter for which it is being assessed. 12 CFR § 327.8(k).

[11] *See* 81 FR at 32180.

[12] *See id*.

[13] *See* 81 FR at 32183.

[14] *Id*.

[15] A financial institution is assigned a CAMELS composite rating based on an evaluation and rating of six essential components of an institution's financial condition and operations. These component factors address the adequacy of capital (C), the quality of assets (A), the capability of management (M), the quality and level of earnings (E), the adequacy of liquidity (L), and sensitivity to market risk (S).

[16] *Id*. Appendix 1 to the Supplementary Information section of the first NPR (80 FR at 40857-872) and the second NPR (81 FR at 6124-35), as well as appendix E to the second NPR (81 FR at 6153-55), describe the statistical model and the derivation of these measures in detail.

small banking pricing methodology, as compared to the previous methodology during the back testing process, was particularly evident when it was applied to the period immediately before the recent banking crisis.[17]

Under the current small bank pricing methodology, a small bank's assessment rate is calculated using seven financial measures and the bank's weighted average CAMELS ratings.[18] Four of the seven financial measures are at issue in this appeal: the loan mix index; the brokered deposit ratio; the one-year asset growth rate; and the net income before taxes ratio. The FDIC uses data reported on a bank's quarterly Call Reports to calculate all of the financial measures, which are then combined with the weighted average CAMELS components to calculate an initial assessment rate.[19]

The loan mix index measures the relative riskiness of a bank's loan portfolio, as well as the extent to which a bank's assets are loans (rather than liquid assets or other assets). Commercial and industrial (C&I) loans are included in the index ***.[20] The brokered deposit ratio increases an established small bank's assessment rate only when brokered deposits exceed 10 percent of assets.[21] The one-year asset growth measure increases a bank's assessment rate when annual asset growth (other than through merger or failed bank acquisition) exceeds 10 percent. It does not penalize banks for normal asset growth. Finally, the net income before taxes ratio is measured by dividing the bank's income (before applicable income taxes and discontinued operations) for the most recent twelve months by the bank's total assets. The small

[17] *See* 81 FR at 32185.
[18] *See* 12 CFR § 327.16(a).
[19] *See id.*; *see also* 12 CFR § 327.2(f).
[20] ***
[21] For a bank that is well capitalized and has a CAMELS composite rating of 1 or 2, reciprocal deposits will be deducted from brokered deposits. For a bank that is less than well capitalized or has a CAMELS composite rating of 3, 4, or 5, however, reciprocal deposits will be included with other brokered deposits. *See* 12 CFR § 327.16(a)(1)(ii)(A).

bank pricing methodology sets a cap of three percent of total assets for the income ratio. This cap resulted from model estimates of failure probabilities that were most closely correlated with actual failures.

Bank's Argument

The Bank argues that the 2016 changes in the small bank pricing methodology led to "excessive insurance premium fees" in the case of the Bank's own assessment, and that "the FDIC has not achieved its stated objective of matching risk of institutions with corresponding insurance premiums."[22] Specifically, the Bank argues that four financial measures in the small bank pricing system contributed to an inappropriate premium for the Bank and that these measures do not adequately reflect the Bank's unique characteristics. As a result, the Bank believes that the FDIC should use an individualized assessment for the Bank.

Loan Mix Index

The Bank argues that its C&I loans, which it refers to as "*** loans," should be treated as loans similar to *** for assessment purposes. The Bank acknowledges that its *** loans to commercial customers meet the definition of C&I loans in the Call Report instructions,[23] but argues that its C&I loans are unlike commercial loans that have commitments or *** payment terms. According to the Bank, its C&I loans "have a much better performance record than do ***. Additionally these loans are underwritten with much more scrutiny than a *** portfolio."[24] The Bank argues that it is paying a higher assessment because of the Call Report instructions,

[22] *See* the Bank's March 23, 2018 appeal letter, page 3.
[23] *See* App. C. to Subpart A to Part 327, footnote 4 ("Commercial and industrial loans are as defined as commercial and industrial loans in the instructions to Call Report Schedule RC-C Part I—Loans and Leases, as they may be amended from time to time. This definition includes purchased credit impaired loans and overdrafts.").
[24] *See* the Bank's March 23, 2018 appeal letter, page 2.

rather than the underlying risk of its portfolio. The Bank suggests that "treating these loans similar to a *** portfolio would be more appropriate and in line with the true nature of these loans."[25]

Brokered Deposit Ratio

The Bank argues that the brokered deposit ratio results in an inappropriate assessment for the Bank. The Bank asserts that it has always used brokered deposits to fund its loan portfolio, and these deposits are efficient and stable in the Bank's circumstances. The Bank also points out that it has not received criticism for its use of such deposits during safety and soundness exams.

One-Year Asset Growth Rate

The Bank contends that the FDIC has failed to acknowledge the unique nature of the Bank's portfolio. In particular, the Bank asserts that it can grow or shrink its portfolio size due to ***. Also, the Bank asserts that its growth is due to the acquisition of new portfolios of commercial customers, but this growth does not pose additional risk because the Bank is not entering into new lines of business and this lending is not risky.

Net Income before Taxes Ratio

The Bank argues that the FDIC did not acknowledge that the Bank's income has been stable since its inception, and is not an anomaly due to risky practices. In the Bank's view, this record proves that it can remain highly profitable while operating in a safe and sound manner and should qualify the Bank "as having unique characteristics that warrant and individualized assessment."[26]

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[25] *Id*.
[26] *Id*. at pages 2-3.

The Committee's Findings

The small bank assessment system utilizes a combination of supervisory ratings, regulatory capital measures, and financial measures to determine a small bank's assessment rate. The assessment rate is a reflection of risk to the DIF.[27] It is the Committee's view that consistent application of the assessment regulations is important for transparency, predictability, and fairness.[28] The Committee has determined that the assessment regulations were properly applied, and again notes that the Bank does not assert that the FDIC applied the assessment regulations incorrectly.

As the Committee has stated before, "while exceptions to the rule may, under compelling circumstances, be considered, such must be both rare and well supported if the system is to maintain credibility."[29] Here, the Bank has not established unique or compelling circumstances that would justify an exception to the rule. The Bank is treated similarly to other banks in the small bank pricing system with similar Call Report data.[30] For example, the Bank's loan mix index is calculated the same as any other established small bank that reports C&I loans. Thus, to allow the Bank to classify its C&I loans as something else for assessment purposes would provide an adjustment that is not provided to other banks in the same or similar circumstances, and would result in inequitable treatment of small banks.

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[27] *See e.g.*, AAC Case No. 2015-01 (denying bank's appeal to change its assessment rate by excluding goodwill impairment loss from the calculation of one of the financial ratios; the Committee reasoned that, among other things, that under both the FDIC regulations and GAAP, goodwill impairment losses are not considered extraordinary items and thus, was accurately included in the calculation of the bank's assessment rate).

[28] *See e.g.*, AAC Case No. 2000-01.

[29] *Id*.

[30] The Committee has previously denied requests in which the institution contests an assessment premium based on accurate Call Report data. *See* AAC Case Nos. No. 2009-01 (denying bank's appeal to upgrade its capital evaluation, which was based on data reported on its Call Report); and 2010-01 (rejecting bank's argument that its capital evaluation for assessment purposes should be based on Call Report data that initially contained goodwill reporting errors, rather than the amended Call Reports in which the bank reported goodwill correctly; the Committee reasoned that the bank is responsible for accurate reporting).

Further, the Committee is not persuaded by the Bank's argument that the assessment system does not match the risk of the Bank with its corresponding assessment premiums. In making this assertion, the Bank argues that its historical performance is sufficiently strong and that application of the risk factors built into the small bank assessment system produces an inappropriate assessment for the Bank. As explained above, the small bank pricing model is a *predictive* model and captures more than a bank's historical performance. In particular, with respect to the Bank's brokered deposit ratio and its one-year asset growth rate, the FDIC's statistical analyses and other studies have found that brokered deposits in general are correlated with a higher probability of failure and higher losses upon failure[31]; moreover, "[n]umerous academic papers discussing models that predict bank failures include explanatory variables that include…rapid asset growth."[32] Based on available data, rapid asset growth, reliance on brokered deposits, and significant concentrations in riskier assets have all been found to contribute to bank failure, which is why they are important factors in calculating a small bank's assessment rate under the regulations.[33] Similarly, regarding the Bank's net income before taxes ratio, as the Bank acknowledges, and as DIR points out in its determination letter, a high income ratio could be evidence of a risky lending strategy. The current small bank pricing methodology was adopted after thoughtful deliberation and extensive analyses, including validation and back testing, and was subject to two notice-and-comment periods. The assessment regulations were properly applied to the Bank, and it is the Committee's view that application of the assessment regulations in this case accurately reflects the Bank's risk to the DIF.

[31] *See* 81 FR at 32185.
[32] 81 FR at 32188.
[33] *Id.*

CONCLUSION

After considering the facts and arguments the Bank presented in its appeal, the Committee finds that the circumstances in this case are neither unique nor inequitable so as to warrant an exception to the assessment regulations or a corresponding adjustment to the Bank's assessment rate for the third quarter of 2017. The Bank's assessment rate was correctly calculated under the FDIC assessment regulations using data reported in its Call Report and appropriately reflects the underlying risks that the Bank poses to the DIF. Accordingly, for the reasons set forth in this decision, the Bank's appeal is denied.

By direction of the Assessment Appeals Committee, dated April 30, 2018.

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