To: Federal Deposit Insurance Corporation (FDIC)

From: Katherine Starkey

Re: Unsafe and Unsound Banking Practices: Brokered Deposits Restrictions

Date: October 15, 2024

Disclaimer: This comment is submitted as part of a classroom assignment in my Administrative Law Course at Cumberland School of Law. The arguments presented are not necessarily my own views, but instead a comprehensive assessment based on research conducted.

I. Introduction and Summary of Argument

This Proposed Regulation ("PR") reverses important progress made in the modernized treatment of brokered deposits from the Federal Deposit Insurance Corporation's ("FDIC") 2020 Final Rule ("2020 Rule").[1] The FDIC must properly balance the competing needs of prioritizing the safety of the banking system with encouraging innovation in the fintech and banking industry.[2] To help achieve this, the FDIC should conduct an updated study that reflects the specific costs of the PR, apply different standards of exceptions for deposits placed at affiliate and non-

[1] Wang, *FDIC's brokered deposit proposal expected to face industry pushback* (August 21, 2024) https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/fdic-s-brokered-deposit-proposal-expected-to-face-industry-pushback-82943391.
[2] Treves, Gannon, et al., *Is the FDIC's Proposed Rulemaking on Brokered Deposit Restrictions a Solution in Search of a Problem?* (August 15, 2024) https://www.dwt.com/blogs/financial-services-law-advisor/2024/08/fdic-brokered-deposit-proposal-faces-challenges.

affiliate IDIs, and amend the "Enabling Transaction" exception to include non-reloadable prepaid card programs.[3]

II. Legislative and Regulatory History

On June 16, 1933, President Franklin D. Roosevelt signed the Banking Act of 1933 into law in response to thousands of bank failures in the 1920s and early 1930s.[4] Through an amendment to the Federal Reserve Act, Section 8 of the Banking Act created the FDIC as an independent agency of the federal government to "maintain stability and public confidence in the nation's financial system."[5] The FDIC carries out this power through "insuring deposits, examining and supervising commercial and savings banks, working to make large and complex financial institutions resolvable, and managing receiverships."[6] In 1989, Congress amended the Act to include Section 29 to correct troubled institutions from using brokered deposits to rapidly fund growth.[7] Section 29 prohibits the acceptance of brokered deposits by banks that fail to maintain a minimum level of capital.[8]

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[3] *See* FDIC Proposed Rule: *Unsafe and Unsound Banking Practices: Brokered Deposit Restrictions*: 89 Fed. Reg. 68244 (proposed August 23, 2024) (to be codified at 12 C.F.R. pt. 303 and 337) https://www.govinfo.gov/content/pkg/FR-2024-08-23/pdf/2024-18214.pdf.

[4] Weinstein, *Federal Deposit Insurance (FDIC) Established* (August 22, 2023) https://guides.loc.gov/this-month-in-business-history/june/fdic-established.

[5] FDIC, *A Brief History* (Accessed October 13, 2023) https://www.fdic.gov/system/files/2024-06/brief-history-deposit-insurance-3.pdf.

[6] FDIC, *What We Do* (Updated May 15, 2020) https://www.fdic.gov/about/what-we-do#:~:text=The%20mission%20of%20the%20Federal,in%20the%20nation's%20financial%20system.

[7] FDIC, *Keynote Remarks by FDIC Chairman Jelena McWilliams on "Brokered Deposits in the Fintech Age" at the Brookings Institute, Washington, D.C.* (December 11, 2019) https://www.fdic.gov/news/speeches/2019/spdec1119.html.

[8] FDIC, *Statement of Martin J. Gruenberg, Chairman Federal Deposit Insurance Corporation on the Notice of Proposed Rulemaking on Brokered Deposits* (July 30, 2024) https://www.fdic.gov/news/speeches/2024/statement-martin-j-gruenberg-chairman-federal-deposit-insurance-corpoation.

Since the 1980s, "the deposit landscape now encompasses a broad range of deposit arrangements" due to the emergence of internet, smartphones, and other innovations in the financial industry.[9] The FDIC has responded to difficult questions regarding what type of deposit arrangements should be reported as brokered through advisory opinions and FAQs resulting in a fragmented structure understood by few.[10] After years of inconsistency, the 2020 Rule brought structure that the banking industry needed for far too long.[11] The 2020 Rule predominantly narrowed the types of deposit-related activities that are considered brokered by expanding the scope of the primary purpose exception.[12] The 2020 Rule went into effect in April 2021 as reported brokered deposits notably declined by 31.8% between the first and second quarter of 2021.[13] However, the PR fails to address that the number of brokered deposits returned to "normal" levels by 2023.[14]

III. Analysis of Proposed Regulation

This PR is facing harsh pushback from the banking industry as the regulation reverses major changes made in the 2020 Rule.[15] FDIC Vice Chairman, Travis Hill

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[9] FDIC, *Remarks by Vice Chairman Travis Hill at the American Enterprise Institute "Reflections on Bank Regulatory and Resolution Issues"* (July 24, 2024) https://www.fdic.gov/news/speeches/2024/remarks-vice-chairman-travis-hill-american-enterprise-institute-reflections-bank.
[10] *Id.*
[11] *Id.*
[12] FDIC, *supra* note 3.
[13] Polk, *FDIC changes tack and proposes significant expansion of brokered deposit rule* (August 12, 2024) https://www.davispolk.com/insights/client-update/fdic-changes-tack-and-proposes-significant-expansion-brokered-deposit-rule.
[14] Treves, *supra* note 2.
[15] Wang, *supra* note 1.

stated that it would be a mistake to reopen the brokered deposits rule as "[d]oubling down on the pre-2020 brokered deposits regime in 2024 is like doubling down on stone castles after the invention of cannons."[16] Similarly, CEO of Ampersand Kelly Brown said "[t]he world is changing. Complete reliance on local bank and local deposits, those days are gone. Liquidity is elsewhere and fintech is one type."[17] There seems to be a gap between a significant threat to the safety and reliability of the banking system and the regulatory need for this PR.[18] Fintech and other non-banks want to participate in a financial system that operates with an antiquated regulatory framework.[19] Implementing this PR would be a significant step backward for encouraging innovation in how products and services are offered to customers.[20]

a. Consequences of More Brokered Deposits

Under this PR, many deposits currently viewed as core will be reclassified to brokered. The consequences of more brokered deposits are significant, not only for insured deposit institutions (IDIs) but also for customers and fintech partnerships.[21] For instance, large banks will have to find other sources of funding to maintain a stable liquidity coverage ratio as brokered deposits hold higher flight risks.[22]

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[16] Remarks, *supra* note 9.
[17] Beals, *Banks adapted and now what? FDIC's brokered deposit proposal rattles industry* (August 14, 2024) https://www.bai.org/banking-strategies/banks-adapted-and-now-what-fdics-brokered-deposit-proposal-rattles-industry/.
[18] Treves, *supra* note 2.
[19] Bigart and Bonici, *FDIC Rethinks Brokered Deposits, Again*, (August 9, 2024) https://www.venable.com/insights/publications/2024/08/fdic-rethinks-brokered-deposits-again
[20] Remarks, *supra* note 9.
[21] Wang, *supra* note 1.
[22] *Id.*

Additionally, if more deposits were categorized as brokered, smaller banks would be unable to rely on them because of costs associated with higher assessment fees, changing organizational structures, restructuring liabilities, complying with regulatory ratios, and reforming internal systems.[23] Furthermore, allowing only IDIs to submit applications for the primary purpose exception will shift the financial and reporting burden back to IDIs.[24] Finally, the 2020 Rule was implemented with the intent to help low-income communities.[25] Many banks in these low-income areas rely on deposits sourced from outside their local areas for funding.[26] Agreeing with FDIC Chairman McWilliams, the president of the American Bankers Association Rob Nichols said the new proposal would restrict access to sources of liquidity while penalizing banks for pursuing funding sources "that enable them to meet the needs of their communities."[27]

b. Timing Issues

The timing of the PR and the uncertainty of its adoption causes concern among the banking industry.[28] The Final Rule will likely not take effect before the outcome of the presidential election.[29] Considering the two Republican FDIC board members were opposed to the rule, the PR will likely not be adopted if a Republican chairs

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[23] Treves, *supra* note 2.
[24] Beals, *supra* note 17.
[25] Keynote, supra note 7.
[26] *Id.*
[27] Treves, *supra* note 2.
[28] *See* id.
[29] Wang, *supra* note 1.

the FDIC.[30] Additionally, Ampersand CEO Kelly Brown stated due to the impacts of COVID-19, "there hasn't been a sufficient amount of time to test those 2020 rules."[31] Also, Brown highlighted the unusually short comment period and the subsequent effect on the number of submissions.[32] Finally, FDIC Chairman Martin Gruenberg announced his intention to resign in May 2024.[33] American Bankers Association President and CEO Rob Nichols questioned the need to make significant regulatory changes during a time of both changing leadership and the clear lack of consensus on the issue within the agency, as the PR was voted through 3-2.[34]

IV. Recommendations

1. Conduct an updated study that reflects the specific costs of the PR and a modernized view of brokered deposits.

Members of the banking community have criticized the PR for using outdated data that does not reflect the current landscape of brokered deposits.[35] At the July 30, 2024 FDIC board meeting, member Jonathan McKernan noted that the PR does not offer sufficient data to justify why the PR was necessary and how exactly the regulation will tackle these concerns.[36] Additionally, the FDIC has indicated that

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[30] Wang, *supra* note 1.
[31] Beals, *supra* note 17.
[32] *Id.*
[33] American Bankers Association, *ABA disappointed with FDIC brokered deposit changes, lengthy list of policy proposals* (July 30, 2024) https://bankingjournal.aba.com/2024/07/aba-disappointed-with-fdic-brokered-deposits-changes-lengthy-list-of-policy-proposals/.
[34] *Id.*
[35] Wang, *supra* note 1.
[36] *Id.*

IDIs, especially small institutions, will suffer costs resulting from this PR.[37] However, the FDIC states that because it does not have the data to conduct these estimates, the agency is unable to quantify the costs to IDIs.[38] Furthermore, the PR references several FDIC studies indicating a correlation between more brokered deposits with higher bank failure rates and losses to the Deposit Insurance Fund (DIF).[39] However, the PR "does not cite any data indicating that brokered deposits had any connection to bank failures causing losses to the DIF."[40] Because of this, the FDIC might have trouble justifying the need for this PR based on bank failures.[41]

This substantial lack of information will potentially subject the FDIC to challenge under the Administrative Procedure Act (APA) "for having flawed economic and related analyses and lacking a reasoned explanation."[42] In analyzing the arbitrary and capricious standard stated under APA 706(2)(A), "[t]he agency must examine the relevant data and articulate a satisfactory explanation for its action, including a rational connection between the facts found and the choice made."[43] Many stakeholders in the banking industry believe the FDIC has not considered all relevant data nor articulated a proper explanation for the need for regulatory

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[37] FDIC, *supra* note 3.
[38] *Id.*
[39] Polk, *supra* note 13.
[40] Treves, *supra* note 2.
[41] *Id.*
[42] *Id.*
[43] *Motor Vehicle Mfrs. Ass'n v. State Farm Mutual Automobile Ins. Co*., 463 U.S. 29 (1983).

change.[44] After industry outcry, the FDIC has recognized the need for updated data.[45] However, the request for data should have occurred before acting on this PR.[46] While it is possible the FDIC has more data to support the proposed rulemaking, this data is not in the record of the rulemaking as of now.[47]

2. Apply "25 Percent Test" to deposits at affiliate IDIs and "Broker Dealer Sweep Exception" (BDSE) to deposits at non-affiliate IDIs.

The PR suggests revising the "25 Percent Test" exception to limit total assets to less than 10 percent and renaming it as "BDSE."[48] However, the "25 Percent Test" should be amended to apply to deposits placed at affiliate IDIs only. Furthermore, "BDSE" should only apply if the broker-dealer places swept funds into accounts at a non-affiliate IDI and the amount of funds are less than 10 percent of assets.[49] Affiliated sweep programs are designed to ensure the customer is the beneficial owner of the account as opposed to the broker-dealer.[50] Affiliated sweep deposits are considered more stable in both stressed and unstressed economic markets.[51] Also, these types of deposits tend to grow during times of change and instability.[52]

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44 *See* Treves, *supra* note 2.
45 Wang, *supra* note 1.
46 *Id.*
47 Bigart, *supra* note 19.
48 FDIC, *supra* note 3.
49 *See* id.
50 Morgan (Charles Schwab Corporation), *Re: Brokered Deposits and Interest Rate Restrictions (RIN 3064-AE94)* (May 7, 2019) https://www.fdic.gov/system/files/2024-06/2019-unsafe-and-unsound-banking-practices-3064-ae94-c-074.pdf.
51 *Id.*
52 *Id.*

The FDIC makes several references to the failure of First Republic Bank stating the bank "experienced a significant run on affiliated sweep deposits."[53] The FDIC suggested that because of this failure, affiliated sweep deposits are no more "sticky" than unaffiliated sweeps.[54] However, the FDIC's own report does not cite concerns about brokered deposits.[55] Rather, the report focuses on the significant number of uninsured deposits instead of addressing any issues of affiliation.[56] Because affiliated sweep deposits pose less risk than unaffiliated sweep deposits, sweep deposits should not be treated equally by the FDIC.[57]

3. Amend the primary purpose exception for "Enabling Transaction" to include non-reloadable prepaid card programs only.

Instead of eliminating the "Enabling Transactions" exception, this recommendation suggests amending the expectation for "Enabling Transaction" to include non-reloadable prepaid card programs only.[58] Non-reloadable prepaid cards can be used to make purchases in store, over the phone or online, until the balance reaches zero.[59] Once the funds are used, the owner of the prepaid card will not be able to make any further purchases with that card.[60]

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[53] FDIC, *supra* note 3.
[54] *Id.*
[55] Treves, *supra* note 2.
[56] *Id.*
[57] *See* Morgan, *supra* note 50.
[58] FDIC, *supra* note 3.
[59] ExactBins, *Prepaid and Reloadable/Non-Reloadable Detection* (February 11, 2021) https://exactbins.com/2021/02/11/prepaid-and-reloadable-non-reloadable-detection/.
[60] *Id.*

In evaluating the primary purpose exception regarding debit cards that serve multiple purposes, the FDIC considers the (1) primary purpose of the cards; (2) the features of the card, (such as whether the card is reloadable and whether the card will provide access to a permanent account); and (3) if any compensation is received by the third party.[61] The FDIC states the importance of reloadability in the analysis of the primary purpose exception.[62] Prepaid cards should not be covered by the primary purpose exception if the card is reloadable and serves as a device that provides access to the funds in the underlying deposit account.[63] On the other hand, non-reloadable prepaid cards should be included in the "Enabling Transactions" exception as there would not be access to a deposit account.[64]

V. Conclusion

This PR is arbitrary and capricious as the FDIC has not considered all relevant data nor articulated a proper explanation for the need for regulatory change in brokered deposits.[65] The FDIC should safely prioritize innovation of the banking system through implementing these recommendations before approving this PR.[66]

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[61] FDIC, *Identifying, Accepting and Reporting Brokered Deposits Frequently Asked Questions*, (Revised July 14, 2016) https://www.fdic.gov/sites/default/files/2024-03/fil16042b.pdf.
[62] *Id.*
[63] *Id.*
[64] *See* id.
[65] *See* Treves, *supra* note 2.
[66] *See* id.