Statement by Martin J. Gruenberg

Member, FDIC Board of Directors

Notice of Proposed Rulemaking on Brokered Deposits

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Introduction

The Notice of Proposed Rulemaking (NPR) before the FDIC Board today would amend the FDIC's regulation implementing the statutory prohibition against the acceptance of brokered deposits by insured depository institutions that are less than well capitalized.

Despite the experience in two banking crises with the liquidity risks posed by brokered deposits, the proposed rule would significantly weaken this important prudential rule by narrowing the types of deposit-related activities covered by the prohibition.

For this reason I will vote against this NPR.

Statutory Requirement

The Federal Deposit Insurance Act provides that "[a]n insured depository institution that is not well capitalized may not accept funds obtained, directly or indirectly, by or through any deposit broker for deposit into 1 or more deposit accounts."[1] The FDIC has authority under the statute to waive the prohibition for an adequately capitalized institution based on a finding that acceptance of brokered deposits does not constitute an unsafe or unsound practice for that institution.[2]

The statute does not define what constitutes a brokered deposit. The determination of whether an activity results in a brokered deposit turns on the definition of "deposit broker."

Section 29 of the Federal Deposit Insurance Act defines "deposit broker" as "any person engaged in the business of placing deposits, or facilitating the

[1] 12 U.S.C. 1831f.
[2] 12 U.S.C. 1831f(c).

placement of deposits, of third parties with insured depository institutions or the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties …”.[3]

The proposed rule would interpret “facilitating the placement of deposits”, so as to narrow the scope of the brokered deposit prohibition. With the same intention, it would also interpret the statutory exclusion from the definition of deposit broker that exempts “an agent or nominee whose primary purpose is not the placement of funds with depository institutions”.

I will focus my comments on these provisions of the NPR which I believe are the most consequential.

The Risks of Brokered Deposits

Before discussing the proposal, I want to comment on the FDIC’s extensive experience with brokered deposits.

The brokered deposit provision of the Federal Deposit Insurance Act was adopted in 1989 in the aftermath of the thrift crisis in which brokered deposits played a significant role. Although there have been dramatic changes in the banking system since then, experience does not suggest that brokered deposits pose less of a risk to safety and soundness today than in 1989.

Following the financial crisis in 2008-2009, the Dodd-Frank Act directed the FDIC to conduct a study of core and brokered deposits, which the FDIC completed in July 2011. In the study,

“the FDIC … concluded that the brokered deposit statute continues to serve an essential function and recommends that Congress not amend or repeal it. During the most recent crisis, the statute has, in large measure, prevented failing banks from increasing their brokered deposits, and, therefore, from taking on greater risk in an effort to grow out of trouble and prevented greater FDIC losses when banks fail.”[4]

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[3] 12 U.S.C. 1831f(g).

[4] Study on Core Deposits and Brokered Deposits, Submitted to Congress pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, FDIC, July 8, 2011, at 3, found at https://www.fdic.gov/regulations/reform/coredeposit-study.pdf.

The Advance Notice of Proposed Rulemaking on brokered deposits (ANPR), adopted by the FDIC in December of last year, updated the 2011 analysis with data through the end of 2017.[5] The ANPR stated:

"The results of that analysis confirm the previous findings of the 2011 study.…The research provided in the study shows that higher brokered deposit use is associated with higher probability of bank failure and higher insurance fund loss rates. Banks with higher levels of brokered deposits are also, in general, more costly to the Deposit Insurance Fund (DIF) when they fail. The study also found that, on average, brokered deposits are correlated with higher levels of asset growth, higher levels of nonperforming loans, and a lower proportion of core deposit funding."[6]

The ANPR points out that, in the recent crisis, 47 banks failed that relied heavily on brokered deposits and caused losses to the DIF. Those 47 banks -- which included IndyMac Bank -- represented only 13 percent of the aggregate total assets of the 530 banks that failed during and after the crisis, but 38 percent of losses to the DIF.[7]

Whatever the changes that have taken place in the banking industry since 1989, recent experience, supported by multiple studies,[8] demonstrates that brokered deposits remain a significant safety and soundness risk.

[5] Advance Notice of Proposed Rulemaking: Unsafe and Unsound Banking Practices: Brokered Deposits and Interest Rate Restrictions, 84 Fed. Reg. 2366 (Feb. 6, 2019).
[6] Id. at 2369.
[7] Id. at 2370.
[8] Follow-Up Audit of FDIC Supervision Program Enhancements, FDIC Office of Inspector General, Office of Material Loss Reviews Report No. MLR-11-010 (December 2010) (stating that Material Loss Reviews undertaken for individual banks after their failure as required by law "indicated that failed financial institutions were prone to relying heavily on non-core funding sources, especially brokered deposits, [footnote omitted] to achieve rapid asset growth, and the extent of that funding and/or other non-core funding often significantly and consistently exceeded the bank's peer group."); SAFETY AND SOUNDNESS: Analysis of Bank Failures Reviewed by the Department of the Treasury Office of Inspector General, August 15, 2016 (finding that 20 percent of 119 banks failed, in part, because of an overreliance on wholesale funding, most commonly brokered deposits which "are highly interest-rate-sensitive and, therefore, an unstable deposit source); Summary Analysis of Failed Bank Reviews, Office of Inspector General, Board of Governors of the Federal Reserve System, September 2011 (finding that ten of 20 banks failed, in part of an over-reliance on non-core funding, which includes brokered deposits). See also Advance Notice of Proposed Rulemaking on Unsafe and Unsound Banking Practices: Brokered Deposits and Interest Rate Restrictions, 84 Fed. Reg. 2366, 2369-70 (Feb. 6, 2019) for a discussion of these studies and brokered deposits in bank failures.

The Proposed Rule

The preamble to the proposed rule states the overall context that led to this NPR:

"On December 18, 2018, the FDIC Board adopted an advance notice of proposed rulemaking (ANPR) to obtain input from the public on its brokered deposit and interest rate regulations in light of significant changes in technology, business models, the economic environment, and products since the regulations were adopted. After reviewing comments received, the FDIC is proposing changes to its regulations relating to brokered deposits."[9]

The premise for this NPR appears to be adjustment to technological change in the banking industry. However, an examination of the proposed changes indicates they relate less to technological change than to narrowing of the interpretation of "facilitating the placement of deposits" and expanding the "primary purpose" exclusion so as to reduce the universe of deposits that would be considered brokered under the rule.

Facilitating the Placement of Deposits

The proposed rule would define "*engaged in the business of facilitating the placement of deposits*" as those instances where a person's connection to a third party potential depositor, deposit account, or insured depository institution include a specified set of activities. These activities include: sharing third party information with the bank; legal authority to close or move an account; setting rates, fees, terms and conditions for a deposit account; and acting as an intermediary between a third party placing deposits on behalf of a depositor and a bank.[10]

The preamble to the NPR states that the FDIC believes that, if the person is not engaged in any of these activities, "then the needs of the depositor are the primary drivers of the selection of a bank, and therefore the person is not facilitating the placement of deposits."[11]

[9] Preamble to the NPR at 2-3 (footnotes omitted).
[10] Proposed Section 337.6(a)(5)(ii) in the NPR.
[11] Preamble to the NPR at 19.

Under the current regulation, whether a person is engaged in “facilitating the placement of deposits” has typically been a highly fact specific case-by-case evaluation of the arrangement based on a number of factors including whether the bank pays a fee and what service the fee compensates.[12]

The proposed definition of facilitating the placement of deposits appears to be preemptive. It precludes consideration of other factors. For example, it would eliminate any reference to the fees paid by the bank in exchange for the service provided by the person involved in the placement of a third party’s funds at the bank. Often these fees are based on the number of potential depositors referred to the bank. Thus, they play a key role in incentivizing referral volume, and are a hallmark of a brokered deposit. Removing them from consideration significantly weakens the standard.

Primary Purpose Exception

The proposed rule would also significantly expand the primary purpose exception in the definition of deposit broker.

Currently, as noted in the preambles to the NPR and ANPR, in evaluating whether a person meets the primary purpose exception, FDIC staff analyzes the relationship between the depositor and the person acting as agent or nominee for the depositor.[13] The question has been whether there’s a substantial purpose for the placement of those deposits other than simply placing them or obtaining deposit insurance. Put another way, “staff has considered whether the deposit-placement activity is incidental to some other purpose.”[14]

The proposal would establish an application process for an agent or nominee of a bank to request application of the primary purpose exception to the deposits resulting from their relationship. The analysis would focus on the larger business relationship between the agent or nominee and its customers. It sets forth criteria

[12] ANPR, 84 Fed. Reg. at 2370-71.
[13] Preamble to the NPR at 24, citing 84 Fed. Reg. at 2372.
[14] Preamble to the NPR at 25.

that appear, from the preamble, to be expected to lead to a finding that the agent or nominee is not a deposit broker and the resulting deposits are not brokered.[15]

Most significantly, the proposed rule would provide that the primary purpose of an agent or nominee's business relationship with its customers would not be the placement of funds, subject to the application process, if less than 25 percent of the total funds the agent or nominee has under control for its customers, in a particular business line, is placed at depository institutions.

As a practical matter, this would set a 25 percent threshold per business line for what constitutes acceptable levels of deposit placement as part of an agent or nominee's activities.

In the past, in the context of sweep arrangements between a broker-dealer and an affiliated depository institution, the FDIC has, through interpretation of the current regulations, established 10 percent as representative of an incidental part of the brokerage business.[16] On its face, the proposal initially more than doubles the amounts that may be swept between affiliates without being characterized as brokered. Significantly, it also expands the interpretation to third parties not affiliated with the bank.

While we cannot with confidence estimate the amount of deposits that could qualify for this exception, it seems likely to be large given the current reporting of $1.1 trillion in brokered deposits, which already excludes certain sweeps between brokerage firms and affiliated banks that fall below the current 10 percent threshold.

Furthermore, it is not clear how the 25 percent threshold was reached. There is no analysis provided to explain the basis for this change, or the potential risks to bank safety and soundness and the DIF. Despite the business relationship between the bank and the person placing those deposits, the latter may well have a fiduciary duty and other incentives to transfer those deposits if the bank is perceived to be in trouble.

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[15] See Preamble to the NPR at 25-28.

[16] FDIC Advisory Opinion 05-02 (Feb. 3, 2005), entitled "Are funds held in 'Cash Management Accounts' viewed as brokered deposits by the FDIC? " found at https://www.fdic.gov/regulations/laws/rules/4000-10350.html#fdic400005-02.

Deposit Placements That Enable Transactions

Under this NPR, subject to the application process, a primary purpose exception would also be available for an agent or nominee whose business relationship with its customers is solely the placement of depositors' funds into transactional accounts for the purpose of enabling payments, if no fees, interest, or other remuneration is provided to the depositor. If fees are provided, the FDIC would more closely scrutinize whether the primary purpose is truly to enable payments. No explanation is provided as to why the placement of deposits into transactional accounts without a fee should, *per se*, qualify for the exception.

Catch-All Option for Primary Exclusion

Both of the foregoing exceptions may be expanded under a catch-all option for applying for a primary purpose exception. Under the proposed rule, a transactional account exception might also be available in broader circumstances based on consideration of a number of factors, such as the volume of transactions in customer accounts and the interest, fees, or other remuneration provided. Similarly, an applicant where the placement of funds exceeds the 25 percent threshold could qualify for the primary purpose exception.

Liquidity Coverage Ratio

For the largest banks, the proposed changes to the brokered deposit regulation raise serious additional concerns with regard to the impact on the liquidity coverage ratio (LCR).

The LCR rule requires the largest banks to hold defined buffers of high-quality liquid assets in amounts at least sufficient to cover a 30-day period of severe cash-flow stress. The preamble to the final LCR rule highlighted in detail the risks posed by brokered deposits.[17] Under the liquidity coverage ratio requirements, deposits that are currently treated as brokered -- for example, sweeps between nonaffiliated broker-dealers and banks -- are subject to higher liquidity requirements because of the faster outflow rate attributed to such deposits.

[17] See Final Rule: Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. 61440 (Oct. 10, 2014) for a discussion of the LCR regulations and the bases for their adoption.

Under the proposed rule, subject to an application process and certain limitations, those same sweep deposit arrangements between non-affiliates would not be treated as brokered. This could significantly lower the liquidity requirements for some of the largest, most systemically important banks.

The preamble to the proposed rule makes only a brief reference to the LCR indicating that available data do not allow for a reliable estimate of deposits that would no longer be designated as brokered under the proposed rule. The impact of the proposed rule on the liquidity requirements of our largest banks may well be one of its most significant consequences. It should receive much more careful consideration.

Conclusion

In conclusion, the proposed rule signals that, except for the placement of brokered certificates of deposit, a wide range of activities may no longer be treated as brokered deposits. Based on limitations with current deposit reporting, the potential impact on how much of the $1.1 trillion of brokered deposits currently reported would no longer be considered brokered is difficult to assess but may be quite large. The exclusion of sweep deposits from unaffiliated third parties could have a particularly large impact. These activities also would seem likely to grow in response to this rulemaking.

Experience in two financial crises demonstrates that brokered deposits pose a very serious safety and soundness risk to insured depository institutions and the Deposit Insurance Fund. The changes to the brokered deposit rule proposed in this NPR seem less related to a careful evaluation of whether a deposit is brokered and the risks attendant to that designation than to a general objective to narrow the scope of the rule. While technology may have a role to play, it is not clear how it changes the fundamental considerations of the relationship between a bank, a depositor, and a third party intermediary, and the risks the relationship may pose.

This proposed rule will likely reduce dramatically the scope of deposits that are currently considered brokered without adequate justification and expose the banking system to significantly increased risk. For that reason, I will vote against this notice of proposed rulemaking.