SEWARD & KISSEL LLP

901 K STREET, NW
WASHINGTON, DC 20001

PAUL T. CLARK
PARTNER
clark@sewkis.com

TELEPHONE: (202) 737-8833
FACSIMILE: (202) 737-5184
WWW.SEWKIS.COM

ONE BATTERY PARK PLAZA
NEW YORK, NEW YORK 10004
TELEPHONE: (212) 574-1200
FACSIMILE: (212) 480-8421

September 11, 2015

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 – 17th Street, N.W.
Washington, D.C. 20429

Attention: Comments

RE: RIN 3064-AE37

Dear Mr. Feldman:

I am writing in response to a request for comments by the Federal Deposit Insurance Corporation ("FDIC") on a proposal (the "Proposed Rule") to revise the deposit insurance premium assessment formula for small insured depository institutions, *i.e.*, depository institutions with assets of $10 billion or less ("Covered Banks").[1] I appreciate the opportunity to provide these comments on behalf of our clients.

Seward & Kissel represents a wide range of participants in the deposit markets, including broker-dealers, banks and service providers. Our clients underwrite and issue certificates of deposit ("CDs") and offer, support and participate in so-called deposit account "sweep" programs. Collectively, such deposit arrangements total in excess of $1.1 trillion, or approximately 11% of all domestic deposits.[2]

The stated purpose of the proposed changes to the premium assessment methodology is "to improve the risk-based deposit insurance assessment system applicable to small banks to more accurately reflect risk."[3] Among the changes proposed by the FDIC is the introduction of a "core deposits/total assets" ratio as a factor in determining the premiums for all

---

1 Assessments, Notice of Proposed Rulemaking and Request for Comment, 80 Fed.Reg. 40,838 (July 13, 2015) ("NPR").

2 Data are derived from brokered deposits reported on Call Reports ($856 billion as of March 31, 2015) and an estimate of broker-dealer "sweep" program deposits not reported by the banks as brokered pursuant to the "primary purpose" exception from the definition of "deposit broker" in FDIC regulations.

3 NPR, *supra* note 1 at 40,838.

Covered Banks. Since the apparent definition of "core deposit" used in the Proposed Rule excludes all fully-insured brokered deposits, this change would effectively subject every dollar of retail brokered deposits to a premium surcharge, regardless of whether the Covered Bank was engaged in rapid asset growth or exhibited other hallmarks of risk. The new factor would be applied in addition to the existing Brokered Deposit Adjustment in the premium assessment formula that is applicable to weaker Covered Banks. This approach is in conflict with the FDIC's stated policy that brokered deposit use by healthy banks does not *per se* raise regulatory issues.[4]

As explained in detail below, we oppose the introduction of this factor because the definition of "core deposit" is not clearly presented or explained in the context of the Proposed Rule and has been a matter of substantial controversy within the banking industry, a controversy that was not resolved by the FDIC's 2011 study of core and brokered deposits[5]. Furthermore, the FDIC needs to address a number of significant issues relating to the analysis it uses to support the introduction of the core deposit factor. Among the issues are (i) the FDIC's reliance on bank failure data from periods of time with significantly different regulatory schemes, (ii) the FDIC's use of two alternative definitions, "core deposits" and "non-core liabilities," in conducting the analysis, (iii) the failure of the analysis to explain the failure of banks with minimal brokered deposits and (iv) the failure of the analysis to address the limited failure rate of banks that rely substantially on brokered deposit funding, such as industrial loan banks.

Definition of Core Deposit

Section 327.8 of the Proposed Rule, which sets forth the defined terms for the Proposed Rule, does not define the term "core deposit". A definition of "core deposit" is set forth in Table 1.1 in the Notice of Proposed Rulemaking ("NPR") – "domestic office deposits (excluding time deposits over the deposit insurance limit and the amount of brokered deposits below the standard maximum deposit insurance amount)" – though it is unclear whether this definition was used in the FDIC's analysis or is being proposed for use if the Proposed Rule is adopted. The NPR does not explain the rationale for the definition in Table 1.1 or request comments on what deposits should be included in the definition.

The federal banking statutes, including the Federal Deposit Insurance Act ("FDIA"), neither include a definition of the term "core deposit" nor require the federal banking regulators to establish a concept of core deposits. None of the federal banking regulators have promulgated regulations concerning core deposits. Instead, the definition of "core deposit" is found in a report titled Uniform Bank Performance Report ("UBPR") utilized by the federal banking regulators. The definitions in the UBPR were not adopted after solicitation of public comment and they can be, and have been, changed without solicitation of public comment.

---

4 *See, e.g.*, FDIC, Guidance on Identifying, Accepting and Reporting Brokered Deposits, Frequently Asked Questions (January 5, 2015).

5 FDIC, Study on Core Deposits and Brokered Deposits (July 8, 2011) ("FDIC Study").

Until 2011, the definition of "core deposit" in the UBPR was "the sum of demand deposits, all NOW and automatic transfer service (ATS) accounts, money market deposit accounts (MMDAs), other savings deposits, and time deposits under $100,000". On March 31, 2011, three months prior to the release of the FDIC Study, the Financial Institutions Examination Council amended the UBPR definition of "core deposit" to exclude fully insured brokered deposits, so that the UBPR now defines core deposits to mean "the sum of demand deposits, all NOW and ATS accounts, MMDAs, other savings and time deposits under $250,000, minus all brokered deposits under $250,000". No explanation of this change was provided. This definition is essentially the same as the definition in Table 1.1 in the NPR, though it is not clear why the two utilize a different formula.

The UBPR also defines the term "non-core liabilities". This term is defined as "the sum of total time deposits of more than $250,000 + other borrowed money + foreign office deposits + securities sold under agreements to repurchase + federal funds purchased + insured brokered deposits less than $100,000 + insured brokered deposits of $100,000 through $250,000". Like the term "core deposits", this definition was adopted without public comment.

While the concept of core deposits is simple, the federal banking regulators have repeatedly noted that the concept is not as simple in practice as in theory. According to the FDIC Examination Guidelines, core deposits are ". . . generally stable, lower cost funding sources that typically lag behind other funding sources in repricing during a period of rising interest rates. The deposits are typically funds of local customers that also have a borrowing or other relationship with the institution. Convenient branch locations, superior customer service, extensive ATM networks and low or no fee accounts are significant factors that contribute to the stability of the deposits."[6] However, the FDIC and the other federal banking regulators note that there are numerous exceptions with respect to the stability of core deposits,[7] exceptions also noted by the Basel Committee on Banking Supervision.[8] In addition, the federal banking regulators have not articulated a methodology for re-classifying core deposits as "non-core" when repricing of deposits ceases to lag or if a bank ceases to offer convenient locations, ATMs and superior service.

The exclusion of fully insured brokered deposits from the definition of "core deposits" finds no justification in the legislative history of the definition of "deposit broker" in

---

6 DSC Risk Management Manual of Examination Policies at p. 6.1-8 ("Examination Manual").

7 *See, e.g.*, the Examination Manual, *supra* note 6, which states that "[i]n some instances, core deposits included in the UBPR's core deposit definition might exhibit characteristics associated with more volatile funding sources…. Management and examiners should not automatically view these deposits as a stable funding source without additional analysis. Alternatively, some deposit accounts generally viewed as volatile, non-core funds by UBPR definitions … might be considered relatively stable after a closer analysis." (Examination Manual at 6.1-9.)

8 *See* Liquidity Stress Testing: A Survey of Theory, Empirics and Current Industry and Supervisory Practices, BCBS Working Paper No. 24 at 17 (October 2013).

the FDIA.[9] Congressional concern over brokered deposits was never focused on deposit stability or volatility.[10] Some members of Congress expressed concern about the expansion of the federal safety net and the interest rates that some thrifts paid for deposits, but, as the FDIC has itself noted, there was no true Congressional consensus on whether concerns about brokered deposits were justified.[11]

During consideration of the Financial Institutions Reform, Recovery and Enforcement Act in 1989 ("FIRREA"), the federal banking regulators testified that no restrictions on brokered deposits were necessary.[12] Likely as a result of this testimony, the Senate Banking Committee did not address brokered deposits in the version of FIRREA it adopted on April 13, 1989. However, during full Senate consideration of the bill reported by the Senate Banking Committee, Senator Frank Murkowski (R-AK) offered an amendment to the bill that would require "troubled institutions"[13] to obtain a waiver from the FDIC in order to accept deposits from a "deposit broker". The definition of "deposit broker" in Senator Murkowski's amendment was taken in its entirety from the definition of "deposit broker" in an FDIC regulation limiting "pass-through" deposit insurance for brokered deposits that was struck down by the U.S. Court of Appeals for the District of Columbia Circuit in 1985.[14] There was no discussion of the scope of the definition during Senate debate on the bill. The amendment was accepted by the Senate managers of the bill after the FDIC indicated that it did not object. As with the Senate, the Murkowski amendment was included in the version of FIRREA adopted by the House Banking Committee without debate over the scope of the definition of "deposit broker".

The current restrictions on brokered deposits were adopted as part of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") in response to a study of deposit insurance by the U.S. Treasury Department mandated by FIRREA (the "Treasury Study").[15] The Treasury Study recommended limiting deposit insurance coverage in a number of areas, including eliminating coverage of multiple insurable capacities (*e.g.*, individual, joint,

---

9 *See* Paul T. Clark, *Just Passing Through: A History and Critical Analysis of Insurance of Deposits Held by Brokers and Other Custodians*, 32 REV. BANKING & FIN. LAW (2012-2013) ("Clark Article") for a thorough discussion of the legislative history of the definition of "deposit broker".

10 Rapid asset growth using brokered deposits was addressed by the FDIC in regulations proposed in April 1989 and adopted in May 1990 and, therefore, was never a matter of Congressional debate. These regulations were repealed in 1994.

11 *See* FDIC Study at 17.

12 *See Regulators Oppose Further Restrictions on Brokered Deposits*, Wall Street Journal (May 18, 1989).

13 "Troubled institutions" were those that did not meet the applicable minimum capital requirements. *See* P.L. 101-73, § 224.

14 *See FAIC Securities, Inc. v United States*, 595 F.Supp. 73 (D.D.C. 1984), *aff'd*, 768 F.2d 352 (D.C. Cir. 1985).

15 *See* U.S. DEP'T OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS (1991).

IRA, *etc.*) and "pass-through" coverage of brokered deposits. The Treasury Study did not address the stability, volatility or other potential characteristics of brokered deposits.

Congress rejected the recommendations of the Treasury Study on a number of issues, including brokered deposits. While there were numerous hearings in both the House and Senate preceding adoption of FDICIA, there was no discussion of the definition of "deposit broker" included in FIRREA during the hearings nor during debate over the restrictions on brokered deposits that were ultimately adopted. Congress merely utilized the definition in FIRREA without review or comment.

Given this legislative history, there is no basis for concluding that the definition of "deposit broker" in the FDIA should be used as a surrogate for deposit volatility or instability, or that brokered deposits cannot be core deposits. Changes in the brokered deposit market since 1991 also argue against the blanket exclusion of brokered deposits from the definition of "core deposit".

These changes include the following:

- An increase in the number of deposit brokers and brokered deposit products in the marketplace, which has led to greater choices by banks of deposit account terms, including rates;
- The development of reciprocal deposit products that permit banks to place deposits for their customers with other banks and receive a like amount of deposits in return;
- The substantial growth of so-called "sweep deposits" from registered broker-dealers; and
- The affiliation of broker-dealers and banks after adoption of the Gramm-Leach Bliley Act of 1999 and the growth of referred deposits that are deemed "brokered".[16]

The apparent definition of "core deposit" in the NPR would permit deposits obtained through internet advertising and so-called listing services to be characterized as core. The FDIC has acknowledged the rate sensitive nature of these deposits[17] and, in the case of listing service deposits, acquirers of failed banks during the recent financial crisis frequently

---

16 *See* Clark Article, *supra* note 9, for a more detailed discussion of the changes in the brokered deposit market.

17 *See* Joint Agency Advisory on Brokered and Rate-Sensitive Deposits (May 11, 2001), which states that "[a]lthough these deposits may not fall within the technical definition of "brokered" . . ., their inherent risk characteristics are similar to brokered deposits . . . . such deposits are typically attractive to rate-sensitive customers who may not have significant loyalty to the bank."

declined to include such deposits in the calculation of the deposit franchise bid premium.[18] The definition of "core deposit" used in the NPR is, therefore, both over-inclusive and under-inclusive.

FDIC Risk Factor Analysis

The FDIC states that the proposed measures, including the new core deposits/total assets ratio, "were statistically significant in predicting a bank's probability of failure within a three-year period."[19] This conclusion merits additional examination given the data base that the FDIC used, the conflicting definitions utilized by the FDIC and the absence of other studies corroborating the FDIC's conclusions.

Data Base

The FDIC utilized Call Report data from 1985 through 2011 and data on failures through 2014 in order to determine the predictive value of the proposed measures three years prior to failure. While this is a significant data base, the data are not consistent due to the varying regulatory schemes and regulatory practices that were in place during the time periods covered by the data. There were 2,192 bank and thrift failures from 1984 to 1992 and 636 failures between 1993 and 2015.[20] Prior to 1990, there were no restrictions on the acceptance of brokered deposits. Between the end of 1989 and June 1992, only "troubled" institutions were required to obtain a waiver from the FDIC to accept brokered deposits. More importantly, between 1985 and 1992, the FDIC and the Federal Savings and Loan Insurance Corporation ("FSLIC") arranged for weak banks and thrifts to utilize brokered deposits to delay closure of these institutions until they could be resolved. Indeed, the FSLIC entered into guarantee arrangements with some registered broker-dealers to broker deposits for weak institutions.[21]

Since nearly 78% of the failures occurred under different regulatory schemes than the scheme that was implemented in 1992, failure to control for these factors would clearly distort the relationship between brokered deposits and failed institutions in the FDIC's analysis.

In addition to controlling for differing regulatory schemes and practices, the FDIC needs to address the following:

- How does its analysis account for failed banks with zero to minimal brokered deposits?

---

[18] *See, e.g.*, the Purchase and Assumption Agreement between the FDIC, as receiver of Sterling Bank, Lantana, Florida, and Iberia Bank, dated July 23, 2010 (available on the FDIC website).

[19] NPR, *supra* note 1 at 40,842.

[20] These data were obtained on the FDIC website (Historical Statistics on Banking – Failures and Assistance Transactions).

[21] These guarantees were assumed by the Resolution Trust Corporation pursuant to FIRREA. *See* P.L. 101-73, § 501(h).

- How does its analysis account for banks that rely substantially on brokered deposit funding, such as industrial loan banks, that have demonstrated very limited failure rates?

- Do the results of the analysis differ when taking into account different brokered deposit products: CDs, "sweep deposits", reciprocal deposits, deposits referred by affiliates, *etc.*, which are each accorded different treatment in the Liquidity Coverage Ratio regulation[22]?

- Do the results of the analysis change for different rates of asset growth?

- Finally, did the FDIC control for the failure of the federal banking agencies prior to the recent financial crisis to take timely action with respect to banks exhibiting classic signs of weakness (*e.g.*, weak management, rapid asset growth, over-concentration in a single asset class) while using brokered deposits or, as in the case of the failure of IndyMac, for the role of the federal banking agencies in encouraging the bank to grow out of its problems while enabling it to accept brokered deposits by allowing the bank to retroactively increase its capital? Virtually every Inspector General's review of a failed bank notes the failure of its primary regulator to intervene earlier and to address obvious problems more decisively.[23]

Definitional Issues

The FDIC notes that it initially used "non-core liabilities" in its model and found its predictive value statistically significant. The FDIC later substituted core deposits for non-core liabilities, and concluded that core deposits provided a "similar predictive power" to non-core liabilities.[24]

The substitution of core deposits for non-core liabilities raises a question of the degree of similarity between the two results. Non-core liabilities include "other borrowings", such as Federal Home Loan Bank advances, which were significant at many failed banks. It would be useful to understand the differences in the results produced by using the alternative definitions.

---

22 *See* 12 C.F.R. Part 249 (Federal Reserve Board), Part 50 (Comptroller of the Currency) and Part 329 (FDIC).

23 *See, e.g.*, Office of Inspector General, Department of the Treasury, Material Loss Review of United Western Bank (OIG-11-096, September 2, 2011); FDIC, Material Loss Review of ShoreBank, Chicago, Illinois (MLR-11-012, February 2011); Board of Governors of the Federal Reserve System, Material Loss Review of San Joaquin Bank (May 2010); and Office of Inspector General, Department of the Treasury, Material Loss Review of TeamBank, National Association (OIG-10-001, October 7, 2009).

24 NPR, *supra* note 1 at 40,860.

Absence of Supporting Studies

The role of brokered deposits in bank failures has been the subject of study since the 1980s. As noted earlier, the Congressional Committees never determined that brokered deposits caused banks to fail or even played a significant role in bank failures. One Congressional Committee, the House Government Operations Committee, issued a report in 1984 and a follow-up report in 1986 concluding that brokered deposits had not played a significant role in thrift failures during the time period examined.[25] Other non-government studies reached similar conclusions.[26] So, it is surprising that the FDIC has concluded that the use of brokered deposits, absent other risk factors, such as rapid asset growth, provides predictive value in determining whether a bank will fail.

It is also significant that the FDIC cites to no independent studies to support its analysis. No prior studies have concluded that the mere use of brokered deposits can be used to predict bank failures and the FDIC has never before suggested this correlation. Given the policy significance of this conclusion, the FDIC should make its data base, assumptions and analytic methodology available to the public for independent review.

I appreciate the opportunity to submit these comments and would be pleased to discuss them with the FDIC staff.

Very truly yours,

Paul T. Clark

SK 21613 0007 6810802

25 H.R. REP. NO. 98-1112 (1984) and H.R. REP. NO. 99-676 (1986).

26 *See*, *e.g.*, David C. Cates, The Retail Insured Brokered Deposit: Risks and Benefits (May 1, 1991).