Promontory Interfinancial Network

Promontory Interfinancial Network, LLC
1300 North 17th Street
Suite 1800
Arlington, VA 22209-3810

T 703-292-3400
F 703-528-5700

www.promnetwork.com

October 24, 2018

comments@fdic.gov

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

Re: RIN 3064-AE89

Ladies and Gentlemen:

On behalf of Promontory Interfinancial Network, LLC ("*Promontory Network*"),[1] I write to comment on the Notice of Proposed Rulemaking on the Limited Exception for a Capped Amount of Reciprocal Deposits from Treatment as Brokered Deposits issued by the Federal Deposit Insurance Corporation (the "*FDIC*") and published in the Federal Register on September 26, 2018 (the "*NPR*").[2] We appreciate having this opportunity to present our views.

INTRODUCTION AND SUMMARY

The NPR's stated objective is to implement section 202 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (the "*Regulatory Relief Act*"), which adds to the Federal Deposit Insurance Act (the "*FDI Act*") a new section 29(i).[3] The NPR proposes new text for 12 C.F.R. § 337.6 that tracks the language of section 29(i). We applaud the FDIC's decision to adhere closely to the statutory language in its regulations. Contrary to the NPR's stated objective, however, the NPR outlines a prospective framework for determining whether an insured depository institution is an "agent institution" that conflicts with the statute's terms. Specifically, although the statutory language limits only the amount of reciprocal deposits that certain institutions can "receive" to be considered agent institutions, the NPR mistakenly refers to this so-called "special cap" as a limitation on the amount of reciprocal deposits that such institutions can "maintain," "retain," or "hold." Accordingly, the outlined framework requires modification.

---

[1] Founded in 2002, Promontory Network provides services to the banking and brokerage industries. Promontory Network's deposit allocation and sweep services include CDARS®, the Certificate of Deposit Account Registry Service®, for time deposits, ICS®, the Insured Cash Sweep® service, for non-time deposits, and IND®, the Insured Network Deposits® service, for non-time deposits swept to banks primarily by broker-dealers.

[2] Fed. Deposit Ins. Corp., *Notice of Proposed Rulemaking on Limited Exception for a Capped Amount of Reciprocal Deposits from Treatment as Brokered Deposits*, 83 Fed. Reg. 48,562 (Sept. 26, 2018).

[3] Codified at 12 U.S.C. § 1831f(i).

In response to the FDIC's request for comment on whether non-brokered reciprocal deposits would be considered more favorably than brokered deposits in the failing bank context, we answer yes and describe why they would be. In response to the FDIC's request for comment on how the regulations on reciprocal deposits should apply to de novo institutions, we outline why, under section 29(i), a de novo institution is subject to the special cap only if it has been found not to have a composite condition of outstanding or good or determined to be not well capitalized.

DISCUSSION

1. The so-called "special cap" limits the amount of reciprocal deposits that an institution to which it applies can "receive" to be considered an agent institution, not the amount that such an institution can "maintain," "retain," or "hold."

a. Definition of Agent Institution

The new section 29(i) of the FDI Act, added by section 202 of the Regulatory Relief Act, provides an exception from brokered deposit treatment for reciprocal deposits of an agent institution to the extent that the total amount of the institution's reciprocal deposits does not exceed the lesser of (i) $5 billion or (ii) 20 percent of the institution's total liabilities.[4] The NPR refers to this limit as the "general cap." The general cap applies to all agent institutions.

Section 29(i) defines "agent institution" as "an insured depository institution that places a covered deposit through a deposit placement network at other insured depository institutions in amounts that are less than or equal to the standard maximum deposit insurance amount, specifying the interest rate to be paid for such amounts," if the institution:

> (i) (I) when most recently examined . . . was found to have a composite condition of outstanding or good; and (II) is well capitalized,
>
> (ii) has obtained a waiver pursuant to [12 U.S.C. § 1831(c)], or
>
> (iii) does not receive an amount of reciprocal deposits that causes the total amount of reciprocal deposits held by the agent institution to be greater than the average of the total amount of reciprocal deposits held by the agent institution on the last day of each of the 4 calendar quarters preceding the calendar quarter in which the agent institution was found not to have a composite condition of outstanding or good or was determined to be not well capitalized.[5]

To be an agent institution, an insured depository institution can satisfy the condition in the definition above through any of alternatives (i), (ii), and (iii). An institution that has been the subject of a finding that it does not have a composite condition of outstanding or good (an "adverse

---

[4] 12 U.S.C. § 1831f(i)(1).

[5] 12 U.S.C. § 1831f(i)(2)(A) (emphasis added).

rating") or of a determination that it is not well capitalized (an "adverse capital determination") satisfies the condition through alternative (iii) only if it does not receive an amount of reciprocal deposits that causes its total amount to exceed the preceding four-quarter average. The NPR refers to alternative (iii) as the "special cap."

b. Application of the "Special Cap"

Although the NPR proposes new text for 12 C.F.R. § 337.6 that tracks section 29(i), the NPR characterizes what it calls the "special cap" as a limitation on the amount of reciprocal deposits that an institution can "maintain," "retain," or "hold." As section 29(i) explicitly provides, however, alternative (iii) limits only the amount of reciprocal deposits that an institution can "receive" to qualify as an agent institution under that alternative.

The NPR's characterization is reflected in the following statements, among others:

- An institution to which the special cap applies "may meet the definition of 'agent institution' by maintaining its reciprocal deposits at or below the special cap . . . ."[6]

- "[A]n institution [that "is well capitalized but not well rated"] would need to decide whether to (1) retain all of its reciprocal deposits and report them as brokered deposits (assuming the institution was well capitalized), or (2) lower the amounts of its reciprocal deposits to within the *special cap* by the end of the quarter that it is notified that it is no longer well rated . . . ."[7]

- "An institution that is less than adequately capitalized or adequately capitalized without a waiver would have the option to lower its reciprocal deposits to within the special cap by the end of the quarter for which, in the ordinary course, the change in capital status is reported, or work with its primary federal regulator to establish a supervisory plan for addressing reciprocal deposits."[8]

- "The FDIC requests comment on other ways an institution that is not well rated or not well capitalized could manage its holdings of reciprocal deposits in excess of the special cap, consistent with the applicable provisions of section 202 so that its reciprocal deposits would be treated as non-brokered."[9]

Contrary to these statements, nowhere does section 29(i) limit the amount of reciprocal deposits that an institution can "maintain," "retain," or "hold." Merely retaining reciprocal deposits that an institution accepted before becoming subject to the special cap is not "receiv[ing]"

---

[6] Fed. Deposit Ins. Corp., *supra* note 2, 83 Fed. Reg. at 48,564 (emphasis added).

[7] *Id.* (italics in original; underlining added).

[8] *Id.* (emphasis added).

[9] *Id.* (emphasis added).

anything. There is, accordingly, no basis to say that the institution must "lower its reciprocal deposits to within the special cap."

The NPR correctly notes that "section 202 does not provide a date by which an institution must demonstrate that its amount of reciprocal deposits are within the special cap."[10] The statute provides no such date because, under the statute's plain language, there is no such date. The statute does not require that the institution at any time demonstrate that the amount of reciprocal deposits it holds is within the special cap. Rather, to satisfy the special cap, it need only refrain from receiving an amount that causes its total balance to exceed the specified average.

If an institution holds $100 million in reciprocal deposits and then becomes the subject of an adverse rating, or becomes the subject of an adverse capital determination and does not obtain a waiver pursuant to 12 U.S.C. § 1831(c), nothing in section 29(i) prohibits the institution from retaining the $100 million in reciprocal deposits after its rating or capital status drops. As a result, the institution is free to retain the reciprocal deposits until (i) they mature, if they are time deposits, or (ii) the depositor chooses to withdraw them in the ordinary course, if they are not time deposits. This is true whether the institution's preceding four-quarter average is $75 million or $125 million, because in neither case does merely retaining the existing deposits constitute a "receiv[ing]" of deposits that causes the average to be exceeded.

Moreover, the institution not only is free to retain its existing $100 million in reciprocal deposits until they are withdrawn in the ordinary course, but can accept new reciprocal deposits as non-brokered (up to the general cap) as long as it does not receive an amount of reciprocal deposits that causes the total amount it holds to exceed the preceding four-quarter average. For example, if the institution's preceding four-quarter average is $125 million, it can accept new reciprocal deposits as non-brokered (up to the general cap) as long as it does not receive an amount that causes the total amount to exceed $125 million. If depositors withdraw $25 million of the $100 million that the institution held when its rating or capital status dropped, the institution can receive up to $50 million in new reciprocal deposits without causing its total reciprocal deposit amount to exceed the preceding four-quarter average.

If the preceding four-quarter average is $75 million, the institution is still free under section 29(i) to retain its existing $100 million in reciprocal deposits. The only restriction under section 29(i) is that the institution will not be an agent institution under alternative (iii) if it receives an amount of reciprocal deposits that causes its total balance to exceed $75 million. The institution can fully comply with this limitation by, for example, retaining existing reciprocal deposits until, through ordinary withdrawals, the balance drops below $75 million, after which the institution can accept new reciprocal deposits that bring its total balance up to $75 million.

The operation of section 29(i) of the FDI Act is consistent with the mechanism by which all of section 29 works. Section 29(a) provides that, if an institution becomes less than well

---

[10] *Id.*

capitalized, it may not "accept" brokered deposits.[11] As the FDIC has stated, "[a] deposit is 'accepted' when the insured depository institution receives the funds."[12] Therefore, if the institution was well capitalized when it received brokered deposits, section 29(a) – which restricts only the acceptance of brokered deposits – does not affect the institution's ability to retain the deposits or require the institution to "lower" the amount of such deposits. Multiple authorities recognize this point, including a June 2009 report by the FDIC's Office of Inspector General that reproduces excerpts from the FDIC's standard form of notification letter to institutions that have dropped to adequately capitalized. The letter definitively states: "Brokered deposits that were previously accepted while the institution was well capitalized . . . do <u>not</u> require a waiver."[13]

Through section 29(i), Congress acted to permit an institution that becomes troubled not only to <u>keep</u> its existing reciprocal deposits, as it could already do under prior law, but also to a specified extent to <u>replace</u> them with new reciprocal deposits, even without a waiver. The special cap is a prudential limit on the amount that such an institution can receive to replace existing reciprocal deposits. The statutory text does not permit construing this provision as a curtailment of an institution's pre-existing ability to retain reciprocal deposits that it already holds.

The NPR's treatment of the so-called special cap as a limitation on the amount of reciprocal deposits that an agent institution can "maintain," "retain," or "hold" is, for these reasons, unfounded. Congress has directly spoken to the issue in section 29(i), which unambiguously limits only the amount of reciprocal deposits that an institution subject to the special cap can "receive" to be an agent institution. When the statutory language is clear, "that is the end of the matter."[14]

2. Other Issues

a. <u>Value of Reciprocal Deposits</u>

The NPR states as follows:

> Historically, when resolving failed institutions, the FDIC has found that potential acquiring institutions have generally been unwilling to pay a premium for reciprocal deposits, typically treating them consistent with other brokered deposits.

---

[11] 12 U.S.C. § 1831f(a). Under section 29(b), for purposes of section 29(a), renewal or rollover of a time deposit is treated as an acceptance of funds. *Id.* § 1831f(b).

[12] Fed. Deposit Ins. Corp., *Frequently Asked Questions on Identifying, Accepting and Reporting Brokered Deposits* F1 at page 12.

[13] Fed. Deposit Ins. Corp., Office of Inspector General, *FDIC's Brokered Deposit Waiver Application Process*, Report No. AUD-09-015, at 15 (June 2009) (emphasis added). Similar language appears in a typical OIG Material Loss Review, which states: "Brokered deposits that were previously accepted while the institution was *Well Capitalized* do <u>not</u> require a waiver . . . ." Fed. Deposit Ins. Corp., Office of Inspector General, *Material Loss Review of Main Street Bank, Northville, Michigan*, Report No. EVAL-09-005, at 21 (Apr. 2009) (italics in original; underlining added).

[14] *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842 (1984). *See Board of Governors of Federal Reserve System v. Dimension Financial Corp.*, 474 U.S. 361, 368 (1986) (the statutory language controls).

> It is not clear whether reciprocal deposits that are no longer considered brokered as a result of section 202 would be viewed by potential acquiring institutions as more akin to traditional retail deposits for purposes of warranting a premium. As a result, the FDIC requests comment on whether these non-brokered reciprocal deposits would be considered differently in the failing bank context.[15]

If there has been a historical unwillingness of acquiring institutions to pay more for reciprocal deposits than for other brokered deposits, an obvious reason is that reciprocal deposits have received the same regulatory treatment as traditional brokered deposits. The restrictions that have applied under section 29 of the FDI Act and the potentially higher assessment costs for some institutions have themselves made the deposits less valuable, quite apart from the actual characteristics of the deposits. Now that most reciprocal deposits are considered non-brokered, consistent with their actual characteristics, there is every reason to believe that the recognized value of such deposits to an acquiring institution will increase.

Indeed, there is considerable evidence that, even before enactment of the Regulatory Relief Act, reciprocal deposits were regarded as highly valuable in a failed bank scenario. For example, at the FDIC Core and Brokered Deposits Roundtable on March 18, 2011, Randy Dennis from Media Net Consulting Group in Little Rock, Arkansas, a bank consultant, stated that "two-way [reciprocal] CDARS [deposits] are viewed very positively" by potential bank acquirers.[16] He added that most of his firm's clients "want to maintain [a CDARS] customer relationship and it is usually a high dollar customer." Now that most reciprocal deposits are non-brokered, they can only be viewed even more positively than before.

b. <u>De Novo Institutions</u>

The NPR states as follows:

> The FDIC seeks comments on how the regulations should apply to de novo institutions that lack four preceding quarters of reciprocal deposits to calculate the special cap.[17]

As noted above, section 29(i) provides three alternatives through which an insured depository institution can satisfy a condition in the definition of "agent institution." An institution can satisfy the condition (i) by being rated outstanding or good and being well capitalized, (ii) by obtaining a waiver, or (iii) by not receiving an amount of reciprocal deposits that causes total reciprocal balance to be greater than an average balance for four quarters preceding an adverse rating or an adverse capital determination. Alternative (iii) is what the NPR calls the "special cap."

---

[15] Fed. Deposit Ins. Corp., *supra* note 2, 83 Fed. Reg. at 48,566.

[16] Fed. Deposit Ins. Corp., *Core and Brokered Deposits Roundtable* at 29 (March 18, 2011), https://www.fdic.gov/regulations/reform/3-18-11transcript.pdf.

[17] Fed. Deposit Ins. Corp., *supra* note 2, 83 Fed. Reg. at 48,567.

An institution satisfies the condition through alternative (iii), and is an agent institution, if there has been no adverse rating and no adverse capital determination. The reason is that, if there has been no such rating and no such determination, there are no four quarters preceding such a rating or determination, and if there are no such quarters, there is no such average for such quarters. The average is not zero; it is undefined. No amount that the institution accepts causes its balance to be greater than (or less than or equal to) an average that does not exist.

As a result, whether or not a de novo institution "lack[s] four preceding quarters of reciprocal deposits," it is an agent institution, subject only to the general cap, as long as there has been no adverse rating and no adverse capital determination. A de novo institution in its first four quarters of operation presumably does not undergo an annual review at which it could receive an adverse rating, and given the requirements and scrutiny applied to de novo institutions, it appears unlikely that a de novo institution in its first four quarters of operation would be determined to be not well capitalized. If no adverse rating or adverse capital determination has occurred, there are no calendar quarters preceding such a rating or determination, there is no average for such quarters, and no amount that the institution accepts causes it to exceed the nonexistent average.

In the unlikely event that a de novo institution in its first four quarters of operation is the subject of an adverse rating or an adverse capital determination, the average of amounts for the four calendar quarters preceding such a rating or determination can be understood to be the average for the calendar quarters in which the institution was actually in operation. For example, if the institution was in operation for two quarters and then in its third quarter is determined to be not well capitalized, the relevant average would be the average for the first two quarters. Without a waiver, the institution could not receive an amount of reciprocal deposits that would cause its total reciprocal deposits to exceed the average for the first two quarters.

A de novo institution in its fifth or later calendar quarter of operation can be treated like any other institution if it is the subject of an adverse rating or an adverse capital determination, based on the average for the four quarters preceding the rating or determination.

* * *

Thank you for consideration of our comments. Should you wish to discuss them further, please contact the undersigned at (703) 292-3338 (dphillips@promnetwork.com).

Sincerely,

[redacted]

Douglas E. Phillips
Senior Vice President and General Counsel