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October 26, 2018

Via E-Mail to *comments@FDIC.gov*

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20249

Re: Comments on the Federal Deposit Insurance Corporation ("FDIC") Proposed Rule Regarding Limited Exception for a Capped Amount of Reciprocal Deposits from Treatment as Brokered Deposits (RIN 3064-AE89)

To Whom It May Concern:

On behalf of our clients, we appreciate the opportunity to comment on the FDIC's proposed rule to implement Section 202 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (the "Proposed Rule"). Section 202, which took effect on May 24, 2018, amended Section 29 of the Federal Deposit Insurance Act ("FDI Act"), codified in 12 U.S.C. § 1831f, to except a capped amount of reciprocal deposits from treatment as brokered deposits for certain insured depository institutions (referred to herein as the "reciprocal deposit carve-out"). Reciprocal deposits that do not meet the Section 202 exception remain brokered deposits under Section 29.

I. Background

Section 202 provides that an agent institution may except reciprocal deposits up to the lesser of the following amounts (the "General Cap") from being classified as brokered deposits: (i) $5 billion or (ii) an amount equal to 20% of the agent institution's total liabilities. "Reciprocal deposits" are defined as deposits received by an agent institution through a deposit placement network (i.e., a network in which an insured depository institution participates, together with other insured depository institutions, for the processing and receipt of reciprocal deposits) with the same maturity (if any) and in the same aggregate amount as covered deposits placed by the agent institution in other network member banks (i.e., institutions that are members of the deposit placement network). "Covered deposits" are deposits that (i) are submitted for placement through a deposit placement network by an agent institution and (ii) do not consist of funds that were obtained for the agent institution, directly or indirectly, by or through a deposit broker (i.e., that are not brokered deposits) before submission for placement through a deposit placement network.

Our comments focus on the definition of "agent institution" under Section 202 and the Proposed Rule, which dictates which financial institutions can use the reciprocal deposit carve-out. As calibrated, the definition leads to more regulatory relief as a bank's condition worsens. This cannot have been the FDIC's or Congress's intention.

An "agent institution" is defined 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, and specifies the interest rate to be paid for such amounts, if the insured depository institution:

- is well capitalized *and* has a composite condition of "outstanding" (CAMELS 1) or "good" (CAMELS 2) when most recently examined under Section 10(d) of the FDI Act (described herein as "well rated");
- has obtained a waiver pursuant to Section 29(c) of the FDI Act;[1] or
- 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" (collectively, the prerequisites in this bullet referred to as the "Special Cap").

To illustrate the problems implicated by the "agent institution" definition, we invite the FDIC to consider the applicability of Section 202 to the following four banks:

Bank A (Well Capitalized; Well Rated)

- Subject only to the General Cap.

Bank B (Well Capitalized; Not Well Rated)

- Subject to the lesser of the General Cap or the Special Cap.
- If Special Cap equals zero, cannot benefit from reciprocal deposit carve-out. No waiver is available.

Bank C (Adequately Capitalized; Not Well Rated)

- Subject to the lesser of the General Cap or the Special Cap; *but, if Section 29(c) waiver is obtained, subject only to the General Cap*
- If Special Cap equals zero, cannot benefit from reciprocal deposit carve-out; *but, if Section 29(c) waiver is obtained, can benefit from reciprocal deposit carve-out (up to the General Cap)*

Bank D (Undercapitalized; Not Well Rated)

- Subject to the lesser of the General Cap or the Special Cap

[1] Under Section 29 of the FDI Act, an insured depository institution is restricted from accepting deposits by or through a deposit broker (i.e., brokered deposits) unless the institution is well capitalized for Prompt Corrective Action (PCA) purposes. 12 U.S.C. 1831f(a). The FDIC may waive this restriction if the insured depository institution is adequately capitalized. 12 U.S.C. 1831f(c).

- If Special Cap equals zero, cannot benefit from reciprocal deposit carve-out. No waiver is available.

As described in the FDIC's notice of the Proposed Rule, an institution that is not well capitalized or not well rated (i.e., each of Banks B, C and D) is subject to the lesser of either the Special Cap or the General Cap.[2] What the FDIC fails to note is that this is only true if the institution has not received a waiver pursuant to Section 29(c) of the FDI Act. Of the four banks, Bank C (and *only* Bank C) could apply for a waiver pursuant to Section 29(c) of the FDI Act. If such waiver were granted, Bank C would qualify as an "agent institution" and be limited only by the General Cap. Strangely, Bank B is lumped in the same category, and treated in the same way, as Bank D—that is, neither Bank B nor D can request a waiver under Section 29(c) of the FDI Act and both are limited to receiving reciprocal deposits up to the lesser of the General Cap or the Special Cap.

Just as it is unclear why a well capitalized institution should be treated on par with an undercapitalized institution, it is also unclear why an adequately capitalized institution with a waiver should get the benefit of reciprocal deposits being considered non-brokered when a well capitalized institution cannot. As indicated in the last bullet points above, these perverse effects become even more exaggerated when there are no historic reciprocal deposit holdings—i.e., if we assume that the Special Cap for each bank equals $0. In its notice of the Proposed Rule, the FDIC states the following:

> With respect to an institution that is well capitalized but not well rated, if it received reciprocal deposits above the special cap, it would no longer meet the definition of "agent institution." In this situation, an institution 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, in which case all of the institution's reciprocal deposits could be excepted from its brokered deposits.

But what if the institution's Special Cap is $0? In that situation, because of the way "agent institution" is defined, Bank C may apply for a waiver under Section 29(c) of the FDI Act and, if such waiver is granted, be on equal footing with Bank A, benefitting from the reciprocal deposit carve-out up to the General Cap. However, Bank B, which is in an objectively better position than Bank C from a safety and soundness perspective, would have no way to benefit from the reciprocal deposit carve-out and, again, would be on equal footing with Bank D, the undercapitalized bank. In fact, if Bank D's Special Cap were greater than $0, Bank D would be able to use the reciprocal deposit carve-out, whereas Bank B would still be unable to do so. In essence, Bank B would be punished for not having historic reciprocal deposit holdings.

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[2] The FDIC specifically requested comment on 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.

Alternatively, imagine that Bank C (adequately capitalized and not well rated) has obtained a waiver under Section 29(c) and is excepting reciprocal deposits up to the General Cap. If the bank then improves its capital position and becomes well capitalized (but still not well rated), must it then reduce its reciprocal deposits to below the Special Cap? According to the FDIC's excerpt above, the answer appears to be yes. But why should a bank be punished for improving its capital position? Inversely, why should a bank (like Bank B) be rewarded for falling from well capitalized to adequately capitalized, at which point it could obtain a Section 29(c) waiver and use the reciprocal deposit carve-out?

These perverse effects are especially curious given that an earlier version of Section 202 (specifically, Section 14 of HR 2133) did not yield the same results. Under HR 2133, the four banks would have been treated as follows:

Bank A (Well Capitalized; Well Rated)

- No cap on reciprocal deposits

Bank B (Well Capitalized; Not Well Rated)

- Subject only to the General Cap

Bank C (Adequately Capitalized; Not Well Rated)

- Subject to the lesser of the General Cap or the Special Cap; *but, if Section 29(c) waiver is obtained, subject only to the General Cap*
- If Special Cap equals zero, cannot benefit from reciprocal deposit carve-out; *but, if Section 29(c) waiver is obtained, can benefit from reciprocal deposit carve-out (up to the General Cap)*

Bank D (Undercapitalized; Not Well Rated)

- Subject to the lesser of the General Cap or the Special Cap
- If Special Cap equals zero, cannot benefit from reciprocal deposit carve-out

In other words, under this previous version of Section 202 (as set forth in Section 14 of HR 2133), Bank C and Bank D would be treated the same as they are treated under the final version of Section 202; however, Bank A could except unlimited reciprocal deposits, and Bank B could except reciprocal deposits up to the General Cap. This tiered treatment in HR 2133 is much more intuitive than the disparate treatment in the Proposed Rule. It is unclear why the language of HR 2133 was eventually changed. We suspect that a decision was made to make well capitalized and well rated banks subject to the General Cap, at which point the well rated requirement was moved from the language of the exception to the definition of "agent institution." Even then, it is unclear why the waiver requirement stands alone rather than being grouped together with the well capitalized requirement to which it relates.

II. Proposals

Admittedly, it may appear at first glance that the inability of a well capitalized but not well rated bank (such as Bank B) to except reciprocal deposits would not have much effect, from a legal standpoint. After all, well capitalized institutions are not restricted from accepting or soliciting brokered deposits and have no restrictions on the rates they pay on deposits. However, from a supervisory standpoint, there are significant consequences. Regardless of whether a bank is well capitalized or not, examiners and regulators look to a bank's brokered deposit levels when evaluating the bank's liquidity risk and funds management during examinations and in other supervisory contexts.[3] But Section 202 reflects Congress's risk assessment that reciprocal deposits are generally less problematic than traditional brokered deposits, and we agree. In fact, the FDIC has made the same assessment in the past—even in 2011, long before much of current reciprocal deposit technology existed, the FDIC acknowledged that "reciprocal deposits based upon real customer relationships . . . appeared likely to pose fewer problems than other brokered deposits . . . ."[4]

A. Definition of Agent Institution

Operating under the assumption that Congress would not consciously enact a definition that leads to *more* regulatory relief as a bank's condition worsens, there are at least two ways of adjusting the regulatory definition of "agent institution" to address the paradoxes described above and to better capture Congress's original intent for the reciprocal deposit exemption:

<u>Option 1</u>:

(i) *Agent institution* means 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 insured depository institution:
(A)(1) When most recently examined under Section 10(d) of the Federal Deposit Insurance Act (12 U.S.C. 1820(d)) was found to have a composite condition of outstanding or good; ~~and~~ or (2) Is well capitalized;
(B) Has obtained a waiver pursuant to paragraph (c) of this §337.6; or
(C) 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

[3] While the FDIC states in its notice of the Proposed Rule that "[w]ell capitalized institutions can accept all brokered deposits, including reciprocal deposits that are brokered deposits, *without any restrictions*" (emphasis added), because of the regulatory stigma on brokered deposits, that statement is not consistent with the practical reality of the examination process.

[4] *Study on Core Deposits and Brokered Deposits*, FDIC, July 8, 2011 (*available at* https://www.fdic.gov/regulations/reform/coredeposit-study.pdf).

each of the four 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.

Option 2:

(i) *Agent institution* means 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 insured depository institution:
(A)(1) When most recently examined under Section 10(d) of the Federal Deposit Insurance Act (12 U.S.C. 1820(d)) was found to have a composite condition of outstanding or good; ~~and (2) Is well capitalized;~~
(B) Is well capitalized or has obtained a waiver pursuant to paragraph (c) of this §337.6; or
(C) 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 four 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.

We are interested to know if the FDIC agrees. While we recognize that the FDIC's ability to depart from the statutory definition may be constrained, to the extent the FDIC declines to adjust the formulation for the regulatory definition of "agency institution" as described above, we urge the FDIC to consider the consequences when promulgating its final rule.

B. Reclassification of Capital Category

Section 202 defines the term "well capitalized" by cross referencing to the definition in Section 38(b)(1) of the FDI Act (i.e., well capitalized for PCA purposes). 12 C.F.R. § 324.403 sets forth the criteria for each of the capital categories under Section 38 and provides that, notwithstanding an institution's satisfaction of the objective criteria, the FDIC has authority to reclassify a well capitalized institution as adequately capitalized if the FDIC has determined after notice and opportunity for hearing that (1) the institution is in unsafe or unsound condition or (2) in the institution's most recent examination, the institution received and has not corrected a less-than-satisfactory rating for any of the categories of asset quality, management, earnings, or liquidity.[5] This provision does not specify that the reclassification must be for all purposes or that the reclassification cannot be for one specific purpose. Therefore, the FDIC appears to have the authority to reclassify a well capitalized bank as adequately capitalized *solely for purposes of Section 29 of the FDI Act and 12*

[5] 12 C.F.R. § 324.403(d).

C.F.R. § 337.6, thereby allowing that bank to request a Section 29(c) waiver and avail itself of the reciprocal deposit carve-out. We propose this authority as one avenue for the FDIC to address the negative consequences of the statutory definition of "agent institution."

C. Retroactive Application of "Reciprocal Deposits" Definition

In its notice of the Proposed Rule, the FDIC acknowledges that Section 202 does not provide a date by which an institution must demonstrate that its amount of reciprocal deposits is within the Special Cap, and states that it is considering evaluating whether an institution's reciprocal deposits meet the Special Cap based on information reported in its Call Reports.[6] Additionally, the FDIC has requested comments on how the regulations should apply to de novo institutions that lack four prior quarters of reciprocal deposits to calculate the Special Cap. This is an issue not only for de novo institutions but for any institutions that did not previously hold reciprocal deposits. Before the enactment of Section 202, all reciprocal deposits were classified as brokered deposits.[7] Therefore, even a bank that was proactively managing its brokered deposit levels did not distinguish between reciprocal deposits and brokered deposits.

The Special Cap is particularly problematic because it envisions four calendar quarters of "reciprocal deposit" data. However, reciprocal deposits did not exist before May 24, 2018, when Section 202 was enacted. Thus, the FDIC cannot retroactively apply that term to periods before May 24, 2018 when calculating an institution's Special Cap. In other words, it is unclear how to calculate the Special Cap for a bank that (i) became less than well capitalized or less than well rated before May 24, 2018 or (ii) becomes less than well capitalized or less than well rated within the four calendar quarter after May 24, 2018. To the extent that quarterly data from pre-May 24, 2018 is used, what should that data reflect? Note, this problem ceases to exist after March 31, 2019. Until that time, we propose that the FDIC make the following adjustment to the Special Cap to address this ambiguity:

> (i) Agent institution means an insured depository institution that [. . .] if the insured depository institution:
> (A)(1) When most recently examined under Section 10(d) of the Federal Deposit Insurance Act (12 U.S.C. 1820(d)) was found to have a composite condition of outstanding or good; and (2) Is well capitalized;[8]
> (B) Has obtained a waiver pursuant to paragraph (c) of this §337.6; or
> (C) (1) Before March 31, 2019 (inclusive thereof), 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 lesser of (x) \$5,000,000,000 or (y) an amount

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[6] For an institution that is determined to fall below well rated, the FDIC would evaluate its compliance with the Special Cap based on Call Report data submitted for the reporting date immediately following when the determination is made.

[7] *See* 12 C.F.R. § 327.16(a)(1)(ii).

[8] We request that the FDIC clarify in its final rule that this subsection focuses solely on the results of safety and soundness examinations and not on the results of compliance examinations.

> equal to 20 percent of the total liabilities of the agent institution, and (2) After March 31, 2019, 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 four 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.

By using the language from the General Cap, this proposed solution is designed to leverage Section 202's existing language to the greatest extent possible, while also addressing the statutory ambiguity.

D. Treatment of Reciprocal Deposits in Other Contexts

In addition to the above, we propose that the FDIC amend its brokered deposit regulations to specify that, in supervisory contexts beyond 12 C.F.R. § 337.6 and Section 29 of the FDI Act, both brokered and non-brokered reciprocal deposits will generally be considered less volatile than traditional brokered deposits and may be considered core deposits. The FDIC has the authority to make such a proclamation, either in its final rule on reciprocal deposits, in another regulation or in guidance—we urge the FDIC to do it here. We believe that such a proclamation would (1) align with technological developments that have occurred with respect to reciprocal deposits in the last decade and (2) work to address the perverse (and likely unintended) consequences of the "agent institution" definition. Specifically, we propose that the FDIC add the following language as a new paragraph (g) in 12 C.F.R § 337.6, in addition to the FDIC's proposed amendments to 12 C.F.R. § 337.6 and the proposed amendment to the Special Cap discussed above:

> 337.6 Brokered deposits.
>
> *   *   *   *   *
>
> (g) *Perception of Risk and Volatility.* In contexts outside of this §337.6, including in the examination context and general supervisory context, the FDIC will view, consider and treat non-brokered reciprocal deposits and brokered reciprocal deposits as core deposits, notwithstanding the definition of core deposits in the Uniform Bank Performance Report or in any other non-authoritative source. For purposes of this §337.6(g), *non-brokered reciprocal deposits* means reciprocal deposits as defined in section 337.6(e)(2)(v), and *brokered reciprocal deposits* means reciprocal deposits as defined in section 337.6(e)(2)(v) that are not excepted from the institution's brokered deposits pursuant to section 337.6(e).

E. Assessment Regulations

A bank's ability to use the reciprocal deposit carve-out may also affect a bank's assessments. The FDIC has proposed to make conforming amendments to its assessments regulations to be consistent with Section 202's definition of reciprocal deposits. This is not mandated by Section 202, which, as the FDIC notes, did not address the assessment rules in 12 C.F.R. Part 327 with respect to reciprocal deposits. However, the FDIC was "concerned that having two different definitions of 'reciprocal deposits' could cause confusion as well as undue burden in the industry, particularly for reporting purposes." Thus, the FDIC has proposed to replace the current definition of "reciprocal deposits" in 12 C.F.R. § 327.8(q) with a new term, "brokered reciprocal deposit," which is a reciprocal deposit as defined under Section 202 that does not meet the statute's limited exception (e.g., deposits over the applicable caps or deposits that are not "covered deposits"). We appreciate the FDIC's desire to promote consistency. However, we also believe that there are strong policy reasons to allow well capitalized institutions to benefit from the reciprocal deposit schema. Accordingly, we suggest the following amendments to the assessment rules, in place of those set forth in the Proposed Rule:

- Revise 12 C.F.R. § 327.8(q) to read as follows:

  (q)(i) *Brokered reciprocal deposits*—reciprocal deposits as defined in section 337.6(e)(2)(v) that are not excepted from the institution's brokered deposits pursuant to section 337.6(e).

  (q)(ii) *Non-brokered reciprocal deposits*—reciprocal deposits as defined in section 337.6(e)(2)(v).

- Amend 12 C.F.R. §§ 327.9(d)(3) and 327.16(e)(3) by replacing "The brokered deposit adjustment includes all brokered deposits as defined in Section 29 of the Federal Deposit Insurance Act (12 U.S.C. 1831f), and 12 CFR 337.6, including reciprocal deposits as defined in §327.8(p), and brokered deposits that consist of balances swept into an insured institution from another institution" with "The brokered deposit adjustment includes all brokered deposits as defined in Section 29 of the Federal Deposit Insurance Act (12 U.S.C. 1831f), and 12 CFR 337.6, except brokered reciprocal deposits as defined in §327.8(q)(i), and brokered deposits that consist of balances swept into an insured institution from another institution."[9]

- Amend 12 C.F. R. §§ 327.16 (the definition of Brokered Deposit Ratio) by replacing "For institutions that are well capitalized and have a CAMELS composite rating of 1 or 2, reciprocal deposits are deducted from brokered deposits" in 327.16(a)(1)(ii) with

[9] While we also advocate deleting the language in the last clause of the sentence ("and brokered deposits that consist of balances swept into an insured institution from another institution"), we recognize that the subject of the Proposed Rule is limited to reciprocal deposits and, therefore, we do not address that concern here (but reserve the right to do so in the future).

> "For institutions that are well capitalized, brokered reciprocal deposits and non-brokered reciprocal deposits are deducted from brokered deposits."[10]

Once again, we appreciate the opportunity to submit these comments and assist the FDIC in developing the Proposed Rule. We also look forward to providing comments on the second part of the FDIC's effort to revisit the brokered deposit rules, which we understand is planned for later this year. Should you wish to discuss any of the above or desire any clarification, please contact me or Marysia Laskowski at mlaskowski@huntonak.com or (214) 468-3502.

Sincerely,

[redacted]

Heather Archer Eastep

cc: Peter Weinstock, Hunton Andrews Kurth LLP (*via email*)
Carleton Goss, Hunton Andrews Kurth LLP (*via email*)
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[10] We note that this approach avoids having a conflicting definition of "reciprocal deposits" in the assessment rules.