May 7, 2019

Robert E. Feldman
Executive Secretary
ATTN: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Unsafe and Unsound Banking Practices: Brokered Deposits and Interest Rate Restrictions, RIN 3064–AE94

Dear Mr. Feldman:

Better Markets[1] appreciates the opportunity to comment on the advance notice of proposed rulemaking captioned above ("ANPR" or "Release"),[2] issued by the Federal Deposit Insurance Corporation ("FDIC"), regarding brokered deposits and interest rate restrictions.

The Release explains that the FDIC is undertaking a comprehensive review of the regulatory approach to brokered deposits and interest rate caps applicable to banks that are less than well-capitalized—even though that class of banks includes less than 1% of all banking organizations. Brokered deposits and interest rate caps have been sources of regulatory concern since at least the 1970's.[3] The Release further notes that the FDIC is inviting comment on all aspects of these two issues, in light of changes in technology, business models, the economic environment, and product evolution since the regulations governing brokered deposits and interest rate caps were first issued.[4]

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1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

2 84 Fed. Reg. 2367 (Feb. 6, 2019).

3 Release at 2366.

4 *Id.*

Better Markets submits this letter to sound early and important cautionary notes. First, the undeniable fact is that brokered deposits pose enhanced risks to banks and to the wider financial system, as demonstrated by their history. They contributed to the savings and loan crisis of the 1980's that cost taxpayers hundreds of millions of dollars. Second, brokered deposits have already received permissive regulatory treatment. Over 99% of banks are considered "well-capitalized," and therefore can accept brokered deposits without restriction. Depositors therefore already have ample access to these banking products. Moreover, recent amendments exempt certain amounts of reciprocal deposits from treatment as brokered deposits.[5] Under these circumstances, it is unclear why the FDIC is even undertaking this review with respect to the less than well-capitalized banks. At a minimum, any changes to the current regulatory regime—such as narrowing the scope of what is considered a brokered deposit or specifically excluding certain products from the definition of what is considered a brokered deposit—should only be undertaken upon a strong showing that such changes are consistent with the public interest, and in particular that these changes will not materially increase risk to the financial system nor pose a threat to the DIF.

Finally, in the process of this regulatory review, the FDIC can expect to receive a plethora of comments from the regulated industry urging the FDIC to weaken its regulations—calls which are often couched in euphemistic terms such as "tailoring regulations," "increasing flexibility," "modernizing," "increasing consumer choice," and the like. Banks may have information relating to brokered deposits and interest rate caps that the FDIC should weigh as it reviews these issues, including data regarding technological and other changes that may impact the appropriate scope of the FDIC's regulatory treatment of brokered deposits and interest rates. However, the banks also have a profit motive that may, and often does, conflict with the FDIC's mission to promote the safety and soundness of the banking system and protect the deposit insurance fund ("DIF"). Accordingly, Better Markets also urges the FDIC to thoroughly scrutinize any such comments from the industry and to discount any arguments that are not supported by credible, empirical, and independent data and analysis.

<u>BACKGROUND</u>

As noted in the ANPR, the FDIC's concerns about brokered deposits date back to at least the 1970's, when it observed in its Division of Bank Supervision Manual that use of brokered deposits had led to abuses in banking and contributed to bank failures.[6] The FDIC's concerns about brokered deposits were realized with the high-profile failure of Penn Square Bank. Penn Square's dramatic growth from $30 million in assets in 1977 to $436 million in assets in 1982, when it failed, was fueled by brokered deposits.[7] The FDIC and other banking agencies recognized that brokered deposits allowed banks such as Penn Square to grow rapidly and invest in riskier assets, and that brokered deposits allowed weak banks to attempt to grow their way out of

5 Release at 2366.
6 Release at 2367.
7 *Id.*

instability.[8] Accordingly, in 1984 the regulators issued a final rule that restricted the ability of brokers to obtain full deposit insurance coverage for the deposits they placed.[9] However, that rule was challenged and the D.C. Circuit Court of Appeals struck it down.[10]

The D.C. Circuit's decision to strike down the rule was consequential. Without any restrictions on their use, brokered deposits were a significant contributor to the savings and loan crisis in the 1980's, a crisis that would eventually cost taxpayers $150 billion.[11] As a result of the role brokered deposits played in the savings and loan crisis, Congress acted to restrict certain banks' use of brokered deposits, first with the Financial Institutions Reform, Recovery, and Enforcement Act of 1989,[12] and again with the Federal Deposit Insurance Corporation Act of 1991.[13] The statute and FDIC regulations define a "deposit broker" as:

> Any person engaged in the business of placing deposits, or facilitating the 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; and…An agent or trustee who establishes a deposit account to facilitate a business arrangement with an insured depository institution to use the proceeds of the account to fund a prearranged loan.[14]

Under the current regulatory regime, there are no restrictions on the ability of "well" capitalized banks to accept brokered deposits. Even those banks that are only "adequately" capitalized can accept brokered deposits if they receive a waiver from the FDIC. "Undercapitalized" banks are prohibited from accepting brokered deposits in all circumstances.[15] As of December 31, 2018, only 0.6% of banks are less than well-capitalized and thus subject to any legal restriction

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8 *Id.*

9 Generally speaking, brokers solicited deposits from investors, the total of which exceeded the then-applicable deposit insurance limit of $100,000 per account, placed the aggregate deposit in an account at a bank, and notified the bank that the deposits were being held on behalf of the individual investors. The 1984 rule provided that the insurance limit applied *per broker*, rather than per investor.

10 *FAIC Sec., Inc. v. United States*, 768 F.2d 352 (D.C. Cir. 1985).

11 William M. Isaac, *BankThink: A Cautionary Tale on Brokered Deposits*, AMERICAN BANKER (Nov. 9, 2018), https://www.americanbanker.com/opinion/a-cautionary-tale-on-brokered-deposits.

12 Pub. L. 101-73, Aug. 9, 1989, 103 Stat. 183.

13 Pub. L. 102-242, Dec. 19, 1991, 105 Stat. 2236.

14 12 U.S.C. § 1831f; 12 C.F.R. § 337.6. A brokered deposit is a deposit from a deposit broker.

15 Congress also imposed interest rate restrictions to prevent banks from offering significantly above market interest rates as a means to avoid restrictions on brokered deposits. There is no restriction on the interest rate well-capitalized banks can offer. An adequately capitalized bank with a waiver to accept brokered deposits cannot pay a rate of interest that "significantly exceeds" the rate paid for deposits of similar maturity in the bank's market area, or the national rate paid for deposits of similar maturity outside of the bank's normal market area. Adequately capitalized banks without waivers to accept brokered deposits cannot offer interest rates "significantly higher" than prevail interest rates on deposits offered in the bank's normal market area. Undercapitalized banks cannot offer interest rates "significantly higher" than prevailing rates in the bank's normal market area, or in the market area where such deposits would otherwise be accepted. *See* Release at 2374.

whatsoever on accepting brokered deposits.[16] The expenditure of agency resources to re-examine regulatory limitations that affect such a small segment of the banking community is unwise, especially since further relaxation in the already scant regulation of brokered deposits will only increase systemic risk without any demonstrable benefits.

Section 1506 of the Dodd-Frank Act required the FDIC to conduct a study on core deposits and brokered deposits, and to include in that study any legislative recommendations to address concerns relating to the definitions of core and brokered deposits. The FDIC released that study in July 2011 ("Dodd-Frank Study").[17] That study, based on the FDIC's own experience and an exhaustive review of the literature, confirmed the inherent riskiness of brokered deposits as a funding source—the use of brokered deposits was associated with rapid growth, investment in riskier assets, increased risk of bank failure, and increased loss in the event of bank failure.

Notably, the study assessed the riskiness of certain new types of products that had developed as a result of technological change, such as broker-dealer sweep accounts and reciprocal deposits, and which fit the decades-old definition of brokered deposits. It concluded that, to varying degrees, these products posed risks similar to more traditional brokered deposit products. Accordingly, despite technological changes and the emergence of new products that did not exist when the definition of "deposit broker" was originally drafted, the FDIC recommended that no changes be made to the statutory definition of deposit broker, because that definition remained "sufficiently flexible" to address differences in various brokered deposit products, including products that did not exist when the definition was originally drafted. The FDIC noted that the statute "served a useful purpose" during the recent financial crisis by preventing "failing banks from trying to grow out of trouble by taking on greater risk and limiting FDIC losses at failure."[18]

COMMENTS

As it moves forward with this rulemaking process, including considering whether to make significant changes to the rules regarding brokered deposits, the FDIC must keep the following considerations in mind: (1) As Congress recognized, brokered deposits present unique risks, and the FDIC's primary concern must be with mitigating the risks brokered deposits pose to the financial system and the DIF; and (2) the current regime governing brokered deposits is already permissive, allowing over 99% of all banks the unfettered right to receive brokered deposits.[19]

The FDIC's Mission Is to Mitigate the Unique Risks Posed by Brokered Deposits

[16] FDIC Quarterly Banking Profile: Fourth Quarter 2018, https://www.fdic.gov/bank/analytical/qbp/2018dec/qbp.pdf.

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

[18] Dodd-Frank Study at 59.

[19] With respect to interest rate caps, it would be inconsistent with congressional intent for the FDIC to take action to deregulate interest rate restrictions in a manner that would allow less than well-capitalized banks to circumvent the restrictions on accepting brokered deposits.

It is clear that the use of brokered deposits increases risk. The FDIC first recognized decades ago that brokered deposits are less stable funding sources that allow banks to grow rapidly and invest in riskier assets—and that are too often used by struggling banks to attempt to grow out of stressed financial conditions.[20] The FDIC's own experience with failed banks, as well as both government and independent academic studies, have all confirmed that the use of brokered deposits is generally associated with increased risk. Specifically, the following risky characteristics associated with banks that rely on brokered deposits have been repeatedly and empirically confirmed:

- Greater use of brokered deposits is associated with rapid growth.[21]
- Banks with greater use of brokered deposits invest in riskier assets, which results in higher nonperforming loan ratios.[22]
- Banks with greater use of brokered deposits are more likely to fail.[23]
- Banks with greater use of brokered deposits that fail are more likely to result in loss to the DIF.[24]

In short, the greater a bank's reliance on brokered deposits as a funding source, the riskier that bank is likely to be, and the greater threat it poses to the public interest and the DIF. Moreover, as the FDIC has recognized, while technological innovation has led to the creation of products that did not exist when the definition of "deposit broker" was drafted—including broker-dealer sweep accounts and reciprocal deposits—those products contain some, if not all, of the core characteristics that motivated Congress to regulate brokered deposits in the first place. That is why the FDIC did not recommend Congress make any changes to the statutory definition of "deposit broker."[25] As the FDIC recognized, the mere fact that new products have come into existence which Congress and the FDIC may not have specifically foreseen when drafting the definition of "deposit broker" does not, in and of itself, justify narrowing the definition or specifically excluding those new products from the definition.

Thus, the statutory and regulatory scheme established by Congress and the FDIC, respectively, are not necessarily outdated just because new products are covered by those schemes

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[20] Brokered Deposits, 48 Fed. Reg. 50,339, 50,340 (Nov. 1, 1983).

[21] Dodd-Frank Study at 40-41; *see also* Déjà vu All Over Again: The Causes of U.S. Commercial Bank Failures *This* Time Around, 42 J. Fin. Serv.s 5 (2012) ("brokered deposits have traditionally been seen as a way for a bank to gather funds and grow quickly; and rapid growth has often been synonymous with risky growth.").

[22] Dodd-Frank Study at 39. The relationship between increased use of brokered deposits and investment in riskier assets is indirect, but still straightforward. Unlike core deposits, which are "typically funds of local customers that also have a borrowing or other relationship with the bank," brokered deposits typically are more interest rate sensitive and thus a more volatile funding source: Lacking a meaningful relationship with the bank, customers holding brokered deposits are more likely to seek better interest rates and withdraw money. *Id.* In order to maintain liquidity, a bank that relies on brokered deposits, therefore, is likely to need to offer higher interest rates. And to do that, the bank must invest in riskier assets offering higher interest rates so as to maintain a spread between what it pays in interest on deposits and what it receives in interest from loans.

[23] *Id.* at 38.

[24] *Id.* at 42.

[25] Dodd-Frank Study at 53-56.

that were not envisioned by lawmakers or regulators at the time. Rather, if the new products present the same risks that motivated Congress and regulators to address brokered deposits, then it is entirely appropriate for these new products to be treated as brokered deposits. Put differently, different treatment for new products cannot be justified simply because the products are new – different treatment is only justified upon an affirmative, evidence-based showing that new products do not represent the same risks as traditional brokered deposits.

The Brokered Deposits Regulatory Regime Is Already Permissive

Given the known risks associated with brokered deposits and given that brokered deposits played a high profile role in the savings and loan crisis of the 1980's, the current regime governing brokered deposits is amply permissive, and any further weakening in that regime threatens to increase risks without any demonstrable benefits. By statute, any bank that is considered "well-capitalized" can accept brokered deposits without any legal restriction.[26] As of September 30, 2018, **99.6%** of all U.S. banks are considered well-capitalized.[27] In other words, virtually every U.S. bank can accept brokered deposits, however defined, without legal restriction. Moreover, even banks that are only "adequately" capitalized may accept brokered deposits, subject to a waiver requirement. Thus, the FDIC should view with extreme skepticism unsubstantiated industry assertions that "the FDIC's treatment of brokered deposits" has frustrated "the ability of banks to innovate and to be competitive in serving financial customers."[28] On its face, such claims strain credulity. How could a regime that allows over 99% of banks to accept brokered deposits be considered "overly restrictive" in any sense?

It is true that banks with a relatively greater reliance on brokered deposits are subject to correspondingly higher deposit insurance assessments.[29] This is of course appropriate, as higher insurance assessments are meant to account for the higher risk an institution's risk profile represents to the DIF. As noted above, increased reliance on brokered deposits as a funding source increases risk of failure and risk of loss to the DIF, making increased assessments for banks that rely on brokered deposits a minimally necessary regulatory measure. Moreover, given that statutorily, the FDIC cannot legally restrict over 99% of U.S. banks from accepting brokered deposits, marginal disincentives to overreliance on brokered deposits, such as increased assessments, take on even greater importance. But the fact that higher insurance assessments are *necessary and appropriate* hardly means that those assessments provide *sufficient* protections against the risks that come with brokered deposits. In short, under no circumstances can the current approach to increased assessments for banks accepting brokered deposits be considered as an adequate regulatory protection against the risks posed by use of brokered deposits.

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[26] Release at 2366.

[27] FDIC Quarterly Banking Profile: Fourth Quarter 2018, https://www.fdic.gov/bank/analytical/qbp/2018dec/qbp.pdf.

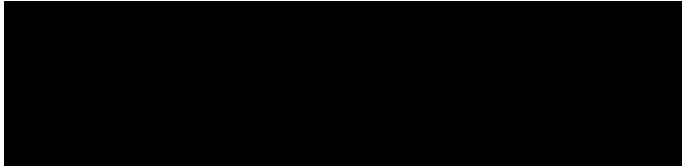
[28] Letter to from Rob Nichols, President & CEO of American Bankers Association to the Honorable Jelena McWilliams (Feb. 28, 2019), https://www.aba.com/Advocacy/LetterstoCongress/Documents/fdic-mcwilliams-brokered-deposit-policies-022819.pdf.

[29] Smaller banks with a ratio of brokered deposits to total assets over 10%, and larger banks with a ratio of brokered deposits to total domestic deposits of over 10%, may face higher assessments. Release at 2370.

CONCLUSION

We hope you find these comments helpful.

Sincerely,



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