COVINGTON

BEIJING BRUSSELS DUBAI FRANKFURT JOHANNESBURG
LONDON LOS ANGELES NEW YORK PALO ALTO
SAN FRANCISCO SEOUL SHANGHAI WASHINGTON

Michael Nonaka

Covington & Burling LLP
One CityCenter
850 Tenth Street, NW
Washington, DC 20001-4956
T +1 202 662 5727
mnonaka@cov.com

May 7, 2019

VIA ELECTRONIC MAIL (comments@fdic.gov)

Robert E. Feldman, Executive Secretary
Attention: Comments
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:

On behalf of our client, which is a depository institution that offers deposit products insured by the Federal Deposit Insurance Corporation ("FDIC"), we write in response to FIL-87-2018, "Reciprocal Deposit Rulemaking and Request for Comments on Brokered Deposit and Interest Rate Restriction Issues" (December 18, 2018) ("ANPR"). We appreciate the FDIC's efforts to reform this critical component of the supervisory framework for depository institutions.

We urge the FDIC to promulgate regulations that will both clarify and narrow the scope of brokered deposit regulation to avoid adversely classifying deposits when they are associated with cash management or other banking services that deepen customer relationships and thus do not present the risks associated with brokered deposits. By narrowing the focus to "hot money" and avoiding more "sticky" deposits, the FDIC will better align the brokered deposit regulatory framework with the risks it was intended to address.

The ANPR cites the FDIC's 2011 study of core and brokered deposits and subsequent update with data through the end of 2017 and identifies the risks of brokered deposits as follows:

1. Rapid growth—the extent to which deposits can be gathered quickly and used imprudently to expand risky assets or investments.

2. Volatility—the extent to which deposits might flee if the institution becomes troubled or the customer finds a more appealing interest rate or terms elsewhere. Volatility tends to be also

mitigated somewhat by deposit insurance, as insured depositors have less incentive to flee a problem situation.

3. Franchise Value—the extent to which deposits will be attractive to the purchasers of failed banks, and therefore not contribute to losses to the DIF.[1]

Currently, these three risk factors are not well correlated to the definitions and criteria applied in determining whether a deposit is a brokered deposit. In particular and as noted in the ANPR, the analysis under the primary purpose exception largely revolves around the formality of the arrangement and the fee structure between the insured depository institution and any potential broker. That cursory analysis could – and sometimes does – lead to stable, "sticky" deposits, which do not present any of the identified risks, being classified as brokered because the exception applies in only very limited circumstances. For example and of importance to our client, corporate non-maturity accounts with substantial cash management, lockbox, billing, remittance processing, or other banking relationships associated with them are generally "sticky" deposits because of the practical challenges associated with finding another bank provider and moving the relationship. As a result, the risk of flight to "chase rates" is low, and these deposits pose lower risk of volatility. Similarly, the sale cycle for such deposits may be long, and thus they are unlikely to fuel imprudent growth. These risk characteristics are entirely independent of whether or not there is a third party assisting the bank in sourcing such deposits or whether that third party has continuing involvement in the accounts over time. And the fee structure paid to that third party – whether volume based or otherwise – would have very little to no bearing on the magnitude of the three risks cited in the ANPR that give rise to the brokered deposit regulation. A volume based fee, for example, does not incentivize the third party to move the funds, as there is no fee based incentive to do so. And this is true whether the third party is an accounting software company offering integration tools for banks and clients, a lawyer or accountant managing accounts for an entity, or, as with the deposits discussed here, a property management company seeking a single banking relationship to assist it in efficiently managing a portfolio of multifamily properties.[2]

The FDIC should ensure that the primary purpose exception serves its important role in enabling institutions to classify a deposit sourced with some third-party involvement as a non-brokered deposit when such deposit poses none of the risks of traditional brokered deposits and the third party's primary business is not to place or facilitate the placement of deposits. To determine the primary purpose of the third party, the FDIC should assess the customer's relationship with the third party – does the customer seek out the third party because that third party is in the business of placing deposits or does the customer seek out the third party for some other purpose? If the customer seeks out the third party to obtain accounting software or to help manage the customer's business, and the third party has a preferred banking partner ancillary to its primary service offering, the existence of the banking partner does not change the fact that the primary purpose of the third party is to provide the underlying service to the customer and is not the placement of deposits with financial institutions.

In considering a revision of the brokered deposit regulations, the FDIC also should ensure that it remains focused on the practical effect of classifying deposits as brokered. While brokered deposits are subject to

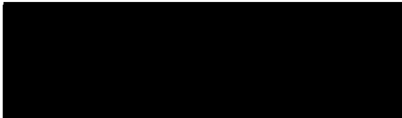
[1] 84 Fed. Reg. 2366, 2369 (Feb. 6, 2019).

[2] These deposits may present other risks such as concentration risk. However, this risk can be addressed by regulators through the examination process. Classifying such deposits as brokered even though they do not present the three risk factors associated with brokered deposits creates regulatory inefficiencies.

regulatory skepticism generally, the regulation does not actually limit brokered deposits unless and until the institution is troubled. At that point, there is an outright ban on accepting brokered deposits. The regulation thus creates a cliff instead of a ramp. Rolling off "traditional" brokered deposits in the form of CDs as they mature over time is straightforward and presents low liquidity risks and risks of business disruption, thereby providing more time for coordination with regulators. Non-maturity accounts with complex cash management, lockbox, remittance processing or other cash management features, on the other hand, require a different regulatory approach, as the regulation could be read to prohibit a bank from accepting any deposits into such accounts on the day after the institution is classified as troubled. This jeopardizes the institution and its customers unnecessarily.[3]

We welcome the FDIC's efforts to address the brokered deposit regulation and recommend that it limit the regulation to "traditional" brokered deposits and avoid encompassing stable, "sticky" deposits such as those discussed above in the brokered deposit framework. Please let us know if there is any other information that would be helpful for us to provide as the FDIC evaluates next steps in the rulemaking process.

Sincerely,



Michael Nonaka
Covington & Burling LLP

CC: Thomas Hearn, Federal Deposit Insurance Corporation
Vivek V. Khare, Federal Deposit Insurance Corporation
Thomas F. Lyons, Federal Deposit Insurance Corporation
Judy Gross, Federal Deposit Insurance Corporation
Ashley Mihalik, Federal Deposit Insurance Corporation

[3] Question F6 in the FDIC brokered deposit FAQs highlights this issue generally. *See* FDIC, Frequently Asked Questions on Identifying, Accepting, and Reporting Brokered Deposits, FIL-43-2016 (June 30, 2016). While the regulation establishes an absolute ban on the acceptance of brokered deposits upon an institution becoming troubled, the FAQ suggests that this ban would be informed for non-maturity accounts through three-way discussions with the primary regulator, FDIC, and institution. During such discussions, the institution will be forced to make real time decisions about its customers that may well violate the regulation as written and interpreted by the FDIC. This is an untenable position for the institution.