Morgan Stanley

May 7, 2019

BY ELECTRONIC SUBMISSION

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 NW 17th Street NW
Washington, DC 20429

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

Ladies and Gentlemen:

We appreciate the opportunity to provide comments to the Federal Deposit Insurance Corporation (the "**FDIC**") in connection with the Advanced Notice of Proposed Rulemaking (the "**ANPR**") seeking views on all aspects of the FDIC's brokered deposit and interest rate regulations.[1]

Morgan Stanley is a global financial services firm and is registered as a financial holding company with the Board of Governors of the Federal Reserve System. We control two U.S. insured depository institutions, Morgan Stanley Bank, N.A. and Morgan Stanley Private Bank, National Association (collectively, the "**Morgan Stanley Banks**").

We believe the ANPR is a key step toward updating the FDIC's brokered deposit and interest rate regulations to reflect significant changes over the decades in technology, business models, and products, as well as in the regulatory and supervisory landscape. We support comments on the ANPR that have been submitted by the American Bankers Association (the "**ABA**"). Morgan Stanley submits these further comments to provide the FDIC with additional information to assist in its review of the brokered deposit and interest rate regulations.

I. The brokered deposit regulations should be updated to recognize the supervisory and regulatory environment in which banks operate today.

In response to the banking crises of the 1980s and early 1990s, Congress and the FDIC passed restrictions defining "brokered" deposits and limiting troubled institutions' use of these deposit sources. Congress and the FDIC sought to balance "safety-and-soundness considerations . . . against the objective of permitting evolution to proceed in the financial markets."[2] Yet, the focus on the source of the deposits has resulted in knock-on effects, described in Section II, which we do not believe were intended by the brokered deposit laws and regulations. We believe

[1] 84 Fed. Reg. 2366 (Feb. 6, 2019).
[2] 1 FDIC, History of the Eighties: Lessons for the Future 13 (Dec. 1997).

the brokered deposit regulations should be updated to reflect the supervisory and regulatory environment banks operate in today.

The brokered deposit restrictions seek to reduce the ability for less than well-capitalized banks to use brokered deposits to facilitate "rapid growth in risky assets without adequate controls," address concerns that banks in trouble would use such deposits to fund additional risky assets, and mitigate against liquidity risk presented by deposits of customers motivated principally by interest rates (so-called "hot money").[3] To prevent weak institutions from skirting the brokered deposit restrictions "by merely advertising or otherwise offering very high rates,"[4] Congress and the FDIC also imposed interest rate restrictions. These policy concerns were highlighted in the wake of the Penn Square Bank failure in 1982, whose growth was fueled by brokered deposits that supported high risk loans to small oil and gas producers.[5]

Compared to the 1980s and 1990s, depository institutions today are subject to comprehensive regulation and supervision of liquidity risk in a way that did not exist when the FDIC's brokered deposit regulations first emerged. The risk governance guidelines issued by the Office of the Comptroller of the Currency establish heightened standards for a large national bank's risk governance framework (including liquidity risk) and the oversight of that framework by the bank's board of directors. Further, banks and their holding companies are subject to a variety of reviews and tests that require them to maintain certain levels of capital and liquidity; these include the Dodd-Frank Act Annual Stress Tests, Comprehensive Capital Analysis and Review, Comprehensive Liquidity Analysis and Review and internal liquidity stress testing. Thus, institutions are subject to both qualitative and quantitative requirements that mitigate concerns of rapid growth, inadequate controls and liquidity risk.

Further, managing the risks of duration and interest rate mismatches between assets and liabilities is an inherent part of the business of banking. As a matter of safe and sound operation, banks should manage risks on the liability side regardless of the source of a deposit (and whether it is deemed brokered or non-brokered). Moreover, interagency supervisory guidance requires institutions to implement "effective corporate governance, policies and procedures, risk measuring and monitoring systems, stress testing, and internal controls" to manage interest rate risk exposure across the institution's strategies, products, and businesses.[6] To meet these requirements, the Morgan Stanley Banks, for example, have policies which outline the processes for ensuring that the banks maintain liquidity sufficient to fund the banks in a variety of adverse stress environments, do not assume excessive risk, monitor and report compliance with risk limits, and escalate exceptions or issues. Robust liability management and prudent risk management across a bank's operations should be more important measures than the particular distribution channels for deposits in the FDIC's evaluation of whether a bank's growth is stable.

Given the expansion of supervisory and regulatory requirements over the last three decades, even if the brokered deposit rules did not exist, most banks today would be restrained as

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[3] 84 Fed. Reg. at 2366.
[4] *Id.* at 2368.
[5] *Id.* at 2367.
[6] "Interagency Advisory on Interest Rate Risk Management," at 1, 3(Jan. 6, 2010); see also "Interagency Advisory on Interest Rate Risk Management: Frequently Asked Questions" (Jan. 12, 2012).

a supervisory and regulatory matter from relying on high-risk funding sources to fuel rapid growth. Therefore, the brokered deposit regulations should be updated to reflect advances in supervision and regulation. Doing so would remediate several knock-on effects that banks face today from the brokered deposit regulations. We highlight one such area requiring revision below.

II. The brokered deposit regulations should carve out deposits sourced from affiliates.

Deposits sourced from affiliates generally are similar to traditional core deposits because, like core deposits, affiliate deposits frequently are funds of customers with long-term relationships with the firm. The FDIC has described core deposits as "generally stable and lower cost" and "typically funds of local customers that also have a borrowing or other relationship with the bank."[7] Indeed, the FDIC observes that "[m]any core depositors have long-term financial relationships with a bank that involve deposits, lending, and other financial services that generate bank profits."[8] The overall stability of core deposits derives in part from "convenient branch locations" and "superior customer service" available to clients and which reinforce the client-bank relationship.[9] Generally, the banking agencies find that "local retail deposit relationships" provide more stable funding sources than customers who focus exclusively on rates.[10] In contrast, deposits received through a "deposit broker" are "third-party arrangements"[11] and generally are from clients who have no prior relationship with the bank but instead are seeking the highest returns currently offered.[12] Deposit brokers and other automated services "enable investors who focus on yield to easily identify high-yield deposits" such that "[i]f more attractive returns become available, these customers may rapidly transfer funds to new institutions or investments in a manner similar to that of wholesale investors."[13]

Clients with long-term relationships with bank affiliates, and who place deposits with the affiliated bank through those relationships, are akin to local, retail deposit clients. Affiliate-sourced deposits derive their stability from many of the same factors (*e.g.*, convenience, customer service, relationships) as do core deposits. Thus, relationships with affiliate clients generally are more stable than those with banking customers who focus exclusively on interest-bearing products with the highest yields. An affiliate customer's relationship with the Morgan Stanley Banks, for example, is one element of a broader relationship with Morgan Stanley, and

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[7] FDIC, Study on Core Deposits and Brokered Deposits Submitted to Congress Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act 5 (July 8, 2011); *see also* FDIC, "Liquidity and Funds Management," Risk Management Manual of Examination Policies 6.1-8 (updated Mar. 2015) ("**Risk Management Manual**"). As the FDIC notes, "core deposits" is not defined by statute. For analytical and examination purposes, the Uniform Bank Performance Report defines "core deposit" to mean the sum of demand deposits, all negotiable order of withdrawal and automatic transfer service accounts, money market deposit accounts, other savings deposits and time deposits under $250,000, minus all brokered deposits under $250,000. 84 Fed. Reg. at 2377.
[8] 84 Fed. Reg. at 2385.
[9] Risk Management Manual, at 6.1-8.
[10] "Joint Agency Advisory on Brokered and Rate-Sensitive Deposits" (May 11, 2001) ("**Joint Agency Advisory**").
[11] 84 Fed. Reg. at 2370.
[12] *See, e.g.*, Risk Management Manual, at 6.1-9 (describing customers that provide wholesale funding, such as brokered deposits).
[13] *Id.*

the Morgan Stanley Banks are not competing for deposits solely on interest rates. The Morgan Stanley Banks are able to leverage these client relationships with affiliates and receive deposits from clients with significant loyalty to the firm brand. Affiliate-sourced deposits therefore do not necessarily present the risks of rapid, unstable growth and volatility that the brokered deposit regulations aim to curb.

Broker-dealer clients, for example, often work closely with representatives and financial advisors at their broker-dealers and build long-term relationships with the advisors. We have seen this at Morgan Stanley, where 69% of our wealth management clients have been with Morgan Stanley for at least seven years. Relationship business models used by Morgan Stanley and other firms seek to create a single point of contact for a variety of financial product and service offerings. A client's primary contact may be a representative at a broker-dealer who can offer securities and investment products and financial advice; this representative also may discuss bank products directly with clients or refer these clients to representatives of an affiliate bank, depending on the clients' banking needs. Ideally, clients would benefit from the convenience of having one firm manage their cash and other assets and can work with a financial advisor who understands the totality of the client's financial needs. For example, at Morgan Stanley, wealth management clients benefit from a broad roster of approximately 16,000 representatives in approximately 600 offices throughout the United States.[14] Morgan Stanley clients can choose a representative and an office based on where they live and work. Further, 69% of our wealth management clients' assets are distributed across three or more financial products at Morgan Stanley (which may include products at the Morgan Stanley Banks), a statistic which suggests strong client loyalty to, and trust in, Morgan Stanley. An integrated service model and dedicated advisors solidify affiliate clients' relationships with the firm and therefore with the banks.

Morgan Stanley believes that the brokered deposit regulations should be agnostic about firms' business models as long as their risk profiles are similar. The current treatment of affiliate-sourced deposits, however, fails to fully acknowledge the retention benefits of affiliate client-bank relationships described above and results in operating and regulatory effects that are inconsistent with the stability of such deposits.

For example, affiliate-sourced deposits are treated as brokered under the current interagency liquidity regulations, whereas deposits received directly by the bank from a customer are not, regardless of the channel. This disparate treatment results in substantially higher outflow rates under the liquidity coverage ratio ("**LCR**") rule for affiliate-sourced deposits. Specifically, under the LCR rule's provisions on retail funding, banks can apply as little as a 3% outflow rate even if customers have only a tenuous relationship to the bank – for example, when their only interaction with the bank is to place deposits via a website or mobile application.[15] In contrast, because affiliate-sourced funding is treated as brokered under the LCR rule, an affiliate-sourced sweep deposit is subject to a 10%, 25% or 40% outflow rate,[16] transactional accounts from

[14] *See* Morgan Stanley, First Quarter 2019 Earnings Release, at 7 (April 17, 2019).
[15] *See, e.g.*, 12 C.F.R. § 50.32(a)(1) (providing a 3% outflow rate for "stable retail deposits").
[16] 12 C.F.R. §§ 50.32(g)(7)-(9).

affiliates other than sweeps are subject to a 20% or 40% outflow rate,[17] and non-transactional accounts from affiliates are subject to up to a 100% outflow rate.[18]

Affiliate-sourced deposits should receive the same LCR treatment as non-brokered deposits. The LCR rule's definition of "stable retail deposits" recognizes that relationship-based funding is generally more stable than funding that lacks a relationship. A "stable retail deposit" is a retail deposit that is not only covered by deposit insurance, but must also be (1) held by the depositor in a transactional account or (2) the depositor "has another established relationship" with the institution that would make deposit withdrawal highly unlikely during a liquidity stress event.[19] Affiliate-sourced deposits are one piece of a broader "established relationship" a client has with an institution and, as described above, are akin to local, retail deposits received by a bank. Therefore, affiliate-sourced deposits should benefit from the stability that results from the existence of an established relationship with the depositor by receiving the same treatment as non-brokered deposits.[20]

In particular, the LCR treatment of affiliate-sourced funding compared to internet deposits is illogical in light of the banking agencies' acknowledgement that relationship-based funding generally is stable. Internet deposits "offering premium rates to customers without another banking relationship [with that bank] . . . are typically attractive to rate-sensitive customers who may not have significant loyalty to the bank,"[21] but nonetheless benefit from treatment as stable retail deposits whether or not any relationship exists, simply because they generally are non-brokered retail funds held by a depositor in a transactional account.

III. The primary purpose exception's 10% ratio does not reflect client or market behavior.

Many banks rely on the "primary purpose exception" for sweep deposit programs between the banks and broker-dealer affiliates.[22] The exception and its conditions, however, fail to fully recognize the relationship between a bank affiliate and its clients that makes these sweep deposits inherently more stable than third-party brokered offerings. A bank relying on the primary purpose exception must ensure that the swept funds do not exceed 10% of the total assets in those customers' broker-dealer accounts.[23] The 10% ratio is arbitrary; even at greater than 10%, the broker-dealer cannot be said to be "primarily" engaged in sourcing deposits for its affiliate bank. A broker-dealer affiliate is not primarily engaged in sending deposits to the

[17] 12 C.F.R. §§ 50.32(g)(3), (4).
[18] 12 C.F.R. § 50.32(g)(1).
[19] 12 C.F.R. § 50.3 (emphasis added).
[20] The LCR rules separately define "brokered sweep deposit." *See* 12 C.F.R. § 50.3. Therefore, a carve out for all affiliate-sourced deposits from the brokered deposit regulations may result in ambiguity as to whether it is meant to flow through to the LCR for affiliate-sourced sweep deposits. Thus, if the FDIC removes affiliate-sourced sweep deposits from the definition of brokered deposits, we would support an interagency rulemaking to remove affiliate-sourced sweep deposits from the LCR and proposed net stable funding ratio rules to provide interpretive clarity that brokered deposits do not include affiliate-sourced deposits under those rules.
[21] Joint Agency Advisory.
[22] *See* FDIC Advisory Opinion 05–02, "Are funds held in 'Cash Management Accounts' viewed as brokered deposits by the FDIC?"(Feb. 3, 2005).
[23] *See id.*

affiliate bank; instead, the affiliate's clients take advantage of the convenient opportunity to have an affiliate bank hold their free cash in an insured account as part of a suite of products and services designed to meet the clients' financial needs. As described above, affiliate-sourced deposits are just one element of a client's entire relationship with a firm. If the brokered deposit regulations do not carve out all affiliate-sourced deposits, we believe that banks that rely on the primary purpose exception should not be subject to a ratio requirement.

In practice, banks have little control over the ratio of deposits eligible for sweeps to total customer assets: the amount of client cash swept into a bank depends almost exclusively on the investment activities of the clients and trends in the securities markets more generally. In times of market stress, broker-dealer clients may decide to sell securities and hold the resulting cash, which will be swept to the affiliated bank, at the same time as client assets are decreasing in value. Both events will serve to drive up the percentage of client assets in the sweep program, but neither is within the control of the bank or the broker-dealer. A bank may feel pressured to divert free credit balances out of the sweep deposit program in order to remain within the 10% ratio requirement, and avoid having its affiliate sweep deposits become brokered as a result of a breach of the 10% limit.

A proper liability management program can assess funding needs during times of market stress. Adjusting liabilities as described above merely to remain within an arbitrary 10% ratio runs counter to the policy goal of the brokered deposit regulations to reduce deposit volatility.[24] Instead, banks should have flexibility to adjust liabilities to meet current market conditions and liquidity risks. More broadly, the primary purpose exception represents a policy determination that the sweep deposits are not "hot money." We agree, and our experience has been that these are stable funds from a loyal base of affiliate customers, and the 10% ratio has no bearing on that fact.

IV. Conclusion

We support the FDIC's efforts in the ANPR to gather industry views of the brokered deposit regulations in light of today's regulatory, supervisory, and economic environment. Banks today are subject to comprehensive supervisory and regulatory requirements, including with respect to capital and liquidity, that did not exist at the time the brokered deposit laws and regulations were initially developed. Further, robust liability management and prudent risk management are essential to stable growth at a firm, regardless of the source of a bank's deposits. We believe affiliate-sourced deposits have been and are a stable source of deposits, akin to core deposits banks receive from local, retail clients. Therefore, the brokered deposit regulations should reflect the FDIC's preference for stable, relationship-based funding sources and carve out affiliate-sourced deposits. Additionally, the FDIC should drop the 10% ratio as a condition to the availability of the primary purpose exception because the ratio has no relation to the exception's policy view that affiliate-sourced sweep deposits are stable and lower-risk.

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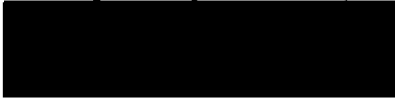
[24] For example, the FDIC states that the brokered deposit regulations address concerns regarding volatility, or the extent to which deposits might flee if the institution becomes troubled or the customer finds a more appealing interest rate or terms elsewhere. 84 Fed. Reg. at 2366, 2369.

We appreciate the opportunity to provide comments on this ANPR. Please feel free to contact us if further discussion would be helpful.

Respectfully submitted,



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