May 7, 2019

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

RE: RIN 3064-AE94 – Unsafe and Unsound Banking Practices: Broker Deposits and Interest Rate Restrictions

Dear Mr. Feldman:

We appreciate the opportunity to comment on the advanced notice of proposed rulemaking (ANPR) on Brokered Deposits and Interest Rate Restriction issues.

Darling Consulting Group is an asset / liability and model risk management advisory firm that works with over 600 banking institutions ranging in size from *de novo* to many of the largest 100 U. S. banks. For over 30 years DCG has helped community banks, in particular, successfully plan for and manage operating and contingency liquidity through a myriad of economic, credit and interest rate environments. We believe our breadth and depth of experiences working in the trenches with community banks during prosperous, challenging and transitional times alike, enables us to provide tangible and hopefully valuable perspective on this important banking industry business issue.

Our response letter consists of two components, with the first being the remainder of this cover letter which reflects an executive summary of our comments. The second element is an attachment which includes some more detailed comments on selected questions/issues raised in the ANPR. In preparing our comments, we found the extensive background data and FDIC perspectives incorporated into the ANPR to be helpful. Thank you.

Summary Comments

We have always and continue to believe that prudent liquidity risk management necessitates that all banks, regardless of size, ensure that they have appropriate access to a broad array of funding alternatives. What matters most regarding the prudent use of alternative sources is management/board understanding of their important comparative differences, and how this knowledge is incorporated into operating and contingency liquidity management, including the establishment of appropriate polices and risk monitoring activities/processes.

Regardless of nomenclature (deposit, borrowing, core/non-core, reciprocal, brokered, listing, local, internet, etc.), the reality is that every source of funding shares at least one critically important trait: the provider of the funds wants their money back (presumably). In reality every source of funding, including deposits of all types, is a borrowing. The business issues thus become less about what a particular source is "labeled", and all about the important differences associated with them, such as their availability, reliability, cost/advantage, flexibility/structures, ease of use, collateral requirements, etc., and how these variables can change as financial institution specific and/or market conditions change.

Thus we have always been adamant that a bank owns this prudence/responsibility regardless of whether any relevant issue is addressed by regulation/statute or not. This includes "brokered deposits", a name that conjures up fear in some and a yawn in others; and an unfortunate and challenging environment whereby irreconcilable biases can exist, and tendencies to define a very gray area with black and white definitions prevail.

Comment: "Principles-Based" Regulation
Importantly, *our first comment* is to strongly suggest that the FDIC adopt an approach regarding its concerns surrounding brokered deposits and interest rate restrictions that is founded more deeply in a "principles-based" methodology vs. one that is unnecessarily skewed towards a "rules-based" approach. We recognize that this results in more subjectivity for bankers and examiners. We also believe that this will place the burden where it belongs: with the bank and their ability to explain, document and defend their operating and contingency liquidity management policies and practices.

In this regard, the ANPR states that perceived biases against prudent use of brokered deposits should not exist and acknowledges that problems emanating from banks using brokered deposits are concentrated with outlier situations. We support this view as we feel strongly that funding strategies prudently utilized by very many community banks should not be looked upon unfavorably because of the failed lending and growth strategies of outlier institutions.

Comment: Deposit Broker Definition
In the last comprehensive review done by the FDIC on this subject, it noted that technology was making the definition of a deposit broker (and thus brokered deposit) increasingly difficult. Since then, the steepness of the technology curve and its impact on attracting and maintaining deposits has only intensified, thus further accentuating the challenges surrounding an appropriate definition of a brokered deposit.

As community banks seek opportunities to share development resources and partner with Fintech companies rather than bear the R&D cost themselves, some are finding that appropriate and potentially transformative tech strategies will run afoul of deposit broker definitions. This can exponentially increase the risk of community banks becoming significantly less competitive relative to larger banks who can afford to develop captive technology solutions that attract these same deposits, but with the "technical advantage" of deeming them non-brokered.

We ask that the FDIC consider this technology reality more deeply, and in conjunction with variables such as changing demographics, expanding role of the internet, and the declining number of deposit transactions occurring in brick and mortar settings as it conducts its review of the definition of a deposit broker.

We also continue to hear confusion amongst bankers regarding the logic and applicability regarding a number of niche deposit types such as HSA, pre-paid cards, crypto related, and others. Updated guidance that includes clear examples of the many types of niche deposit strategies would be helpful.

Comment: High Rate Deposit Definition (Interest Rate Restrictions)
We question the appropriateness of an average "national rate", or alternative local market prevailing rate for a number of reasons. First of all, it is a metric that bears little resemblance to how banks think about, let alone price deposits. Notwithstanding the "noise"/deficiencies associated with promotional pricing (specials), internet deposits, off-cycle deposit terms, "large vs. small" bank pricing, etc., its greatest deficiency is that it does not

capture very real bank deposit substitutes such as brokerage accounts, money market funds, and others. Perhaps more importantly, it excludes credit unions who have demonstrated a very real tendency to pay premium rates.

We are concerned that a manufactured "average deposit rate" metric will evolve that necessitates significant and unnecessary additional reporting and, while better than the existing approach, will amount to a "national rate" that merely becomes a more "precisely incorrect" metric. A national average rate also has the inherent flaw in that it is a lagging rate not a marginal rate, and is thus ripe for unintended consequences. We have seen this as rates have been rising and the vast majority of negotiated deposit rates and/or special offerings have been exceeding the "high rate restriction", despite typically being meaningfully below wholesale market rates such as the FHLB. In a declining rate environment, the restriction would enable banks to pay rates meaningfully above wholesale, while potentially penalizing banks when paying below wholesale merely because interest rates are rising.

There needs to be a more frequent review of this determination methodology, or an accommodation that can appropriately transition through various economic cycles. We believe that pegging the high rate definition to a readily verifiable market index such as Treasury would be preferable (FHLB an alternative but pricing varies by district). A 50-75bp spread over the Treasury would certainly constitute a reasonable restrictive rate. While this would work in a rising rate environment, it could still be problematic if market rates declined precipitously. Alternatively, an approach that enabled the bank to utilize the "greater of" the suggested Treasury driven index or the bank's defensible local market average would seem to work well.

Comment: Unintended Consequence – Restricted Funding Impact on Asset Disposition
While limiting a troubled bank's access to funding may reduce its ability to double down on bad asset decisions, overly zealous restrictions may impede such a bank's ability to buy critical time to prudently and productively work through issues for the benefit of the FDIC, let alone its depositors, community and/or owners. Requiring a bank to quickly divest of certain funding sources that "fit" the brokered deposit definition may result in a bank selling off its best assets at inappropriate discounts, further impairing earnings/capital, reducing the institution's marketability, and increasing its potential risk to the deposit insurance fund.

We ask the FDIC to consider these concerns, especially as it relates to those less-traditional deposit sources that may fall under current deposit broker guidelines.

Comment: Call Reports
We encourage the FDIC to expand the granularity of brokered deposit related data captured on Call Reports. Given the array of deposit types currently classified as brokered, there is limited value in an aggregated brokered deposit data point. For example, delineating "brokered balances" that are high rate designated vs. broker-sourced would be informative. Brokered deposits by type would also be informative, including DTC vs. individual CDs, and HSA vs. other niche sources. We also advocate for additional granularity for relevant non-brokered deposit data. This includes items such as reciprocal deposits, internet deposits, listing services, and even off balance sheet deposits such as CDARS One-Way-Sell.

The remainder of this document provides some additional color for the above comments and recommendations. We appreciate your consideration of our input, and would be delighted to take part in any additional discussions that would be of assistance as the FDIC continues with this important process.

Sincerely,

Darling Consulting Group, Inc.

Attachment

Darling Consulting Group, Inc.
RIN 3064-AE94, Attachment

Understanding the Regulatory Perspective on Brokered Deposit Funding

Fundamentally, it is understood that a bank that is "core funded" is preferable to one that relies on a high degree of wholesale funding. We also feel that it is entirely reasonable that a bank that utilizes brokered (or other "non-traditional") funding sources *can* present added risks that need to be actively monitored and managed. We have witnessed this in the past and have worked diligently with many to mitigate these risks.

Notwithstanding, and importantly, we concur with and acknowledge the ANPR comment that *"historically, most institutions that use brokered and higher-rate deposits have done so in a prudent manner"*.

Based on the distribution of brokered and total deposits included in the ANPR, it is clear that the vast majority of brokered deposits reside at banks larger than $50 billion, which hold approximately 70% of all domestic and brokered deposits. These 41 referenced banks should clearly be examined/managed differently than the less complex community banks that collectively account for slightly more than 12% of total brokered deposits.

FDIC Insurance Fund Losses Attributed to Community Banks: Bad Asset Strategy Driven

Examples have been provided that show that outliers such as IndyMac Bank, FSB ($30 billion) and ANB Financial National Association ($2 billion) can result in heavy losses to the FDIC insurance fund. Notwithstanding, we strongly suggest that the funding mechanism did not cause the 40% of assets loss noted for the resolution of IndyMac. The excessive risk taking with poorly structured residential ARMs (and other lending activities) did. Likewise, ANB's 54% of assets loss was largely a result of poorly underwritten and excessive amounts of out of market land and construction loans.

The ANPR seems to suggest that a big part of the problems was the use of brokered deposits (IndyMac's 30%+ and ANB's 50%+). Perhaps brokered deposit funding was an enabler of these bad asset strategies. To many, this is like blaming the availability of gasoline for a terrible car accident.

We believe that bank failures occurred primarily because of where banks put their money, not where they sourced it. The blame squarely rests on the decisions to make those loans. As noted in the ANPR, these banks and many others were outliers that were likely not appropriately challenged during exams (based on CAMELS ratings leading up to their failures, as often noted in Office of the Inspector General's Material Loss Reviews).

The financial crisis and history provide valuable lessons related to balance sheet risk management. However, given the true root cause of the losses (the assets) and the fact that the majority of the concerns noted in the ANPR seem to be from a concentrated pool of outliers, we hope that all parties involved in this review process take care in not letting legitimate concerns (excessive growth and weak underwriting decisions) paint a perspective that brokered deposit funding (and wholesale / non-traditional funding in general) indicate unsafe and unsound banking practices.

Traditional Deposit Broker Definitions Failing to Keep Up with a Steep Technology Curve

FDIC definitions of "deposit brokers" (discussed by the FDIC in its 2011 "Study on Core Deposits and Brokered Deposits") can quickly become dated because of the steepness of the technology curve, and the corresponding pace with which technology changes drive changes in the realities of the banking landscape.

The ANPR notes that these cases can be petitioned for specific review by the FDIC, which relies on a process that is guided by precedents in past cases. While this can be helpful, history (even a decade old) is by definition dated because of the steepness of the rapid advancement of technology and the undeniable fact that fewer deposit transactions are being conducted in brick and mortar settings with each passing year. Customer preferences for all things technology will continue to impact sourcing, delivery and service channels related to deposit acquisition and retention. We question whether capturing deposits through captive channels where incentives are paid to employees (e.g. larger banks) are materially different from legitimate 3rd party channels that are utilized by community banks as a matter of convenience/cost.

We urge the FDIC to take this into consideration when considering the deposit broker definition that, in turn, drives classification as a brokered deposit.

High Rate Designation / National Average Rate Calculation

There are clear challenges in defining exactly what constitutes a "high rate deposit". It changes as an economic cycle is born, matures, dies, and transitions to another cycle. As those changes happen, market rates will move and liquidity needs among banks will change. Financial institutions, while inherently incentivized to maintain liquidity at the lowest optimal cost, will employ different strategies that are anything but "one size fits all".

The current 2015-present rate cycle has rendered the utility of the current "simple average survey", administered weekly by the FDIC to determine national average deposit rates, to be as inadequate as the former methodology (pegged as a percentage of US Treasury rates) was in 2009.

When treasury rates cratered in 2009 as a result of the FOMC response to the financial crisis, deposit rates lagged notably behind the declining cost of the wholesale funding markets. As more banks found themselves with regulatory orders to address capital levels due to loan problems, more banks were unable to comply with the rate cap of 120% of comparable term UST rates. Figuratively speaking, 120% of 0.00% is still 0.00%.

This prompted the shift to the current methodology, the foundation of which is a weekly rate listing service survey conducted by the FDIC through a third party. It captures the posted rate for each bank branch in the US, and forms a simple average of those rates. Anything 75bp over that rate was deemed to be a "high rate" deposit, creating a cap on what problem banks could pay on a given product before triggering a "brokered" designation.

While this move appeared to solve the issue at the time and did not present many challenges over the following 6 to 7 years, the utility of posted deposit rates for the national rate cap calculation is now very questionable. As market rates have increased, explicit strategies to lag deposit rate increases as much as possible have been employed by the vast majority of the industry. This behavior is not only expected, it is prudent and reflective of previous cycle behavior patterns. Banks readily employ both defensive and offensive strategies which result in

very divergent pricing points, with the resulting "average" bearing no resemblance of reality to either strategy. It is merely a mathematical calculation without relevance. For example, this has been readily seen in CD pricing and product strategy throughout this rising rate cycle as banks have attempted to leverage depositor inertia in their existing base while segmenting more rate sensitive depositors whose value propositions are more heavily skewed to rate.

Under the simple average methodology, a "priced for inertia" deposit product (e.g. 1 year CD at 0.30%) carries equal weighting as a "featured rate" product (e.g. 11 month CD at 1.75%) that is competitively priced. Even though 75% of the CD rollover may be moving to the "featured rate" for term deposits, it is equally weighted in the simple average methodology with the "priced for inertia" product.

Further clouding the picture of reasonably determining a "market rate" are factors such as unadvertised specials, target marketing, different pricing for different depositor segments (e.g. retail versus commercial versus municipal), negotiated rates, and relationship pricing strategies, which have all contributed to making rate board listings less reflective of a true market rate.

While better than the more transparent and less manipulated treasury peg at one point in time, the changed economic environment has caused a shift back to the treasury peg as being more reliable now. There is no way that publicly available information can reliably compute the "actual" current national deposit market rate.

The FDIC does allow a bank to prove it operates in a high rate market and operate above the national rate cap levels. While the intent is appreciated, a bank falls victim to the same issues cited in making the national rate survey irrelevant. Even within many local markets, many posted rates remain intentionally low while much higher rate "specials" are driving market volume. Further, increased use of digital strategies make defining a particular market highly problematic (an online strategy from a bank with no brick and mortar presence may be highly disruptive in a given MSA). This amplifies the need to modify the approach used to calculate the deposit rate cap.

We strongly urge the FDIC to consider an alternative approach that is more adaptable to changing economic and interest rate cycles. We recommend a method that incorporates a spread above (as opposed to the previous percentage above) a reliable market rate benchmark (e.g. UST, average of FHLB, "Libor"/SOFR curve) that is more transparent than "posted branch deposit rates" when calculating deposit rate caps for the purpose of brokered deposit restrictions and funding concentration purposes. It has been our experience that the first thing a bank looks at when determining an offensive deposit strategy is comparable wholesale "market rates" such as FHLB and brokered. Competitor rates/strategies serve as an additional data point that guides where exactly the bank sets "the rate" at which it believes it can attract deposits at the lowest possible cost; recognizing that it may have to adjust it upward to be successful.

Alternatively, a hybrid approach that uses both methods could be considered. We feel that this could be easily and reasonably accomplished by adopting a "greater of" the UST market yield peg (say T + 50/75bp) or the current simple average of posted deposit rates + 75bp.

Unintended Consequences of Restricted Funding in a Time of Need

One challenge a funding manager faces when weighing the risk/rewards of different alternatives is determining the potential change in regulatory attitudes regarding a funding source that is acceptable "today", but under a more challenging operating environment with stressed conditions may be a funding source that is criticized in the future. In the case of brokered deposits, the biggest question pertains to the likelihood that a waiver would be granted to roll brokered or other non-traditional funding sources in the face of a PCA "Adequately Capitalized" designation.

To the best of our understanding, the regulatory directive to banks conducting stress testing exercises is that while perhaps a waiver may be granted, it is prudent to not count on it. We concur. In practical terms, during the most recent crisis, waivers were rarely granted. Complications also resulted, for example, in the case of DTC funding, whereby early withdrawals are precluded with the exception of death covenants.

We have observed many cases where waivers were not granted and when combined with directives to divest or wind down certain funding classes, banks were commonly faced with a single plausible option to sell their best assets in order to unwind funding positions that may have otherwise remained relatively stable except for the MRA directive. Directives that in effect force a bank to liquidate quality earning assets in a time of stress can unnecessarily accelerate losses (compromising much needed capital) that could have otherwise been minimized with a corrective action emphasis placed on restricting capital utilization and/or underwriting standards rather than contracting funding by virtue of precluding the replacement of brokered deposit maturities. It should be noted that there are specific credit scoring systems in the marketplace that help a bank forecast the probability of increased risk of non-renewals by third party deposit channels.

Limiting a troubled bank's access to funding is often cited in the ANPR as a way to limit a bank from doubling down on poor asset decisions. If, in fact, controlling poor asset strategies is the objective, there are many tactics that may be employed by a troubled institution. Restricting access to funding is only one option, and is ironically typically the most risky option, especially if it also involves the speedy pay down of existing balances. We would think that it would be in the best interest of a bank's insurer to limit the need for asset liquidation whenever possible given the consequences of doing so at prices likely well below intrinsic value. Our close observations of these situations in the past reveal that restricting growth, mandating higher capital ratios, and even directives to outright cease certain lending activities, have consistently proven to be more successful in reducing risk to the insurance fund.

Risk Management Has Come a Long Way Since 2008

As noted earlier, it is acknowledged by the FDIC that it is entirely reasonable to expect that a bank which utilizes a non-traditional funding approach can appropriately articulate its understanding of the associated potential risks of that strategy.

Changes in risk management practices and regulatory expectations for developing that understanding and managing liquidity risk have grown by leaps and bounds since the 2008 financial crisis.

Expectations for managing concentration risks via routine risk monitoring and stress testing afford regulators a far better sightline into liquidity risk that has moved the industry further from ratio management to a more holistic process. Accordingly, these advances should afford banks and the regulatory community alike a better

position for monitoring potential risks of certain deposit/funding sources that find themselves in the gray area of "deposit broker" definitions.

We hope that those advances in liquidity management practices afford a reasonable counter balance to the potential discomfort associated with breaking away from some of the more dated historical perspectives around deposit and overall funding management.

- END -