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January 3, 2011

Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 – 17th Street, N.W.
Washington, D.C. 20429

Re: RIN: 3064-AD66

Dear Mr. Feldman:

We are submitting this letter in response to a request by the Federal Deposit Insurance Corporation ("FDIC") for comments on a proposal to revise the assessment system applicable to "large" insured depository institutions (the "Proposal").[1] We appreciate the opportunity to submit these comments.

The FDIC published a similar proposal for comment on May 3, 2010 (the "Prior Proposal")[2], which was superseded by the Proposal. Included in both the Prior Proposal and the Proposal is an amendment to the existing Brokered Deposit Adjustment to FDIC insurance premiums for large Risk Category I depository institutions that, if adopted, would impose a 25 basis point premium on all brokered deposits,[3] including reciprocal deposits, over 10% of a large depository institution's domestic deposits. The FDIC did not offer in the Prior Proposal, and has

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1 Seward & Kissel represents broker-dealers, depository institutions and other entities sponsoring deposit placement arrangements for retail and institutional depositors, as well as depository institutions seeking deposits, and regularly submits comments to the federal banking regulators on issues affecting this market. We are submitting these comments at the request of various clients.

2 75 Fed.Reg. 23,516 (May 3, 2010).

3 FDIC staff has confirmed that the term "brokered deposits" for purposes of the Adjustment does not include deposits placed by an intermediary that qualifies for an exemption from the definition of "deposit broker."

not offered in the Proposal, a justification or an explanation for this change to the current Adjustment.

We oppose this proposed change to the Brokered Deposit Adjustment and respectfully request that the FDIC withdraw it.

As discussed more fully below, the FDIC has not fulfilled its legal obligation under the Administrative Procedure Act to provide a rationale for revising the Adjustment. The current Adjustment for Risk Category I depository institutions is imposed only if a depository institution has brokered deposits in excess of 10% of domestic deposits and has experienced 40% asset growth over the prior four years. Reciprocal deposits are not treated as brokered deposits under the current Adjustment. The FDIC's justification for the current Adjustment when it was adopted in 2009 was the assertion of a linkage between brokered deposits, rapid asset growth and weak or failing depository institutions, which we challenged at the time. By eliminating the asset growth requirement, the FDIC has abandoned any attempt at a justification for its policy.

In addition, in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), Congress directed the FDIC to study its definitions of "core deposit" and "brokered deposit" for, *inter alia*, calculating insurance premiums on depository institutions and to submit a report to Congress recommending any necessary legislative changes resulting from its study.[4] Amending the Brokered Deposit Adjustment prior to the completion of the study contravenes the clear intention of Congress to defer any significant changes in FDIC policy on brokered deposits until the FDIC has completed its study and has submitted its findings and recommendations to Congress.

As with the FDIC's current premium policies, the FDIC appears to continue to use the term "brokered deposits" as a surrogate for "high rate" and/or "volatile" deposit funding, despite the fact that brokered deposits are not inherently either. Characterizing a deposit as "brokered" merely indicates the presence of an intermediary, not the nature of the deposit. Deposit account "sweep" arrangements from a broker-dealer to a depository institution, for example, are a demonstrably low cost, stable source of deposit funding. The cost of one-year CDs with limited early withdrawal penalties in the CD market maintained by registered broker-dealers[5] is currently 60 to 70 basis points, including fees to the broker,[6] which is substantially

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4 P.L. 111-203 (July 21, 2010), § 1506.

5 Early withdrawal of CDs in this market is permitted only upon death or adjudication of incompetence of the depositor.

6 The cost of deposit funding to a depository institution cannot be determined solely by the interest rate. Depository institutions incur other costs in attracting and maintaining deposits, including marketing, office overhead, customer statements and tax reporting. These costs have been estimated at up to 90 basis points. In contrast, a depository institution offering deposits through a broker-dealer does not incur these costs.

less than the 1.02% national average rate on Bankrate.com as of December 27, 2010.[7] In contrast, the FDIC's definition of brokered deposits does not include listing services or internet deposits, which the federal banking regulators have characterized as both high rate and volatile.[8]

Definition of "Brokered Deposit"

The FDIC's definition of brokered deposits was not developed for purposes of imposing insurance premiums or for distinguishing between deposits with different characteristics. It was developed solely to implement restrictions on the acceptance of brokered deposits by "adequately capitalized" depository institutions[9] and a since-repealed requirement that entities notify the FDIC before acting as a deposit broker.[10] The definition was developed prior to the use of the internet by depository institutions to solicit deposits.

FDIC regulations define "brokered deposits" as deposits "obtained, directly or indirectly, from or through the mediation or assistance of a 'deposit broker'."[11] A "deposit broker" is a person "engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions . . ."[12] FDIC regulations include an exemption for, *inter alia*, "an agent or nominee whose primary purpose is not the placement of funds with depository institutions."[13]

A "brokered deposit" can be a time deposit, savings deposit, NOW account or demand deposit account. It can be high rate or low rate, short term or long term. The deposits can be held through an agent, or held directly in the name of the depositor.[14] The only unifying feature is the presence of an intermediary to facilitate the placement of the deposit.

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7 The current broker-dealer rate is near the so-called "national rate" of 52 basis points posted by the FDIC on its website on December 27, 2010, and substantially lower than the 1.27% rate the FDIC would permit an "adequately capitalized" depository institution to pay without a waiver. Weekly national rates and rate caps are posted by the FDIC at www.fdic.gov/regulations/resources/rates/.

8 *See, e.g., Proposed Agency Information Collection Activities; Comment Request*, 75 Fed.Reg. 60,497 at 60,501 (September 30, 2010) ("Listing Services Comment Request").

9 12 C.F.R. § 337.6(b)(2).

10 12 C.F.R. § 337.6(e) (rescinded at 66 Fed.Reg. 17,621 (April 3, 2001).

11 12 C.F.R. § 337.6(a)(2).

12 12 C.F.R. § 337.6(a)(5)(i)(A).

13 12 C.F.R. § 337.6(a)(5)(ii)(I).

14 *See* description of a brokered deposit set forth in *FAIC Securities, Inc. v. United States*, 768 F.2d 352 (D.C. Cir. 1985), a case holding that the FDIC cannot deny deposit insurance for deposits held through an agent or nominee.

For example, in various interpretive letters, the FDIC staff has determined that a bank referring a depositor to an affiliated depository institution to make a deposit is a "deposit broker."[15] Registered investment advisers assisting clients in purchasing CDs can be "deposit brokers."[16] The receipt by the intermediary of a fee from the depository institution accepting the deposit is not a requirement.[17]

Through interpretive guidance, the FDIC has approved two exemptions from the definition of "deposit broker": the so-called "primary purpose" exemption and an exemption for deposit listing services. Neither of these exemptions is based upon the status of the depository institution, or the characteristics of the deposits or the depositors.

The primary purpose exemption is most frequently applied to certain deposit "sweep" arrangements offered by registered broker-dealers to their customers in which the broker automatically deposits customer funds into deposit accounts at an affiliated depository institution. Under criteria established by the FDIC in a 2005 interpretive letter,[18] the "primary purpose" of the broker in offering the sweep arrangement is not the placement of funds with an affiliated depository institution if (i) the funds swept to the depository institution are primarily awaiting investment by the broker's customers in securities or other financial products, (ii) the broker performs a *bona fide* service for the depository institution (*e.g.*, recordkeeping), (iii) the broker receives a "flat" fee (as opposed to a fee based on a percentage of deposits) from the depository institution as compensation for the services provided to the depository institution and (iv) the deposits placed with the depository institution do not exceed 10% of the total customer assets, including the deposits, held by the broker for its customers.

While this is an appropriate legal interpretation of the "primary purpose" language in the FDIC's regulations, it is worth observing that the criteria to qualify for the exemption are wholly unrelated to the economic characteristics of the deposits. One depository institution could substantially fund itself through an affiliated broker's sweep arrangement that meets the criteria of the exemption and not treat the deposits as "brokered," while another depository institution could fund itself at a lower total cost than the first depository institution and be required to treat the deposits as brokered because the broker does not qualify for the primary purpose exemption. Under the proposed Brokered Deposit Adjustment, one depository

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15 *See, e.g.*, FDIC Interpretive Letter 92-68 (October 21, 1992).

16 *See, e.g.*, FDIC Interpretive Letters 94-15 (March 16, 1994) and 92-66 (October 11, 1992).

17 *See* FDIC Interpretive Letter 92-73 (October 27, 1992).

18 FDIC Interpretive Letter 05-02 (February 3, 2005).

institution would pay no Adjustment, while another depository institution could pay a substantial Adjustment.[19]

Similarly, a broker-dealer's sweep arrangement that deposits funds in a depository institution that is not affiliated with the broker would not meet the terms of the exemption, even if all other criteria are met. Again, neither the rate nor the stability of the funding is a factor in the determination that the deposits are "brokered."

The listing service exemption created by the FDIC[20] is intended to exempt entities that merely compile rate information on deposits offered by depository institutions. Depositors must establish a deposit account directly with a depository institution and not through an intermediary. The service may receive a flat fee from the depository institutions, the potential depositors, or both.[21]

The federal banking regulators have acknowledged that deposits obtained through listing services "enable investors who focus on yield to easily identify high-yielding deposit sources" and have noted that these depositors may "rapidly transfer funds to other institutions if more attractive returns become available."[22] As a result, an amendment to the Call Reports/Thrift Financial Reports was recently proposed that would require depository institutions to include on their Call Reports/Thrift Financial Reports an estimate of deposits obtained through listing services. The regulators have not proposed re-characterizing listing service deposits as brokered deposits and do not rigorously police compliance with the terms of the interpretive letters granting the listing service exemption.

A final category of deposits that are widely acknowledged to be potentially high rate and volatile are deposits obtained by a depository institution through the internet.[23] These deposits are not "brokered" because they are obtained by a depository institution without the assistance of an intermediary.

<u>The Current Brokered Deposit Adjustment</u>

Prior to 2009, the FDIC did not impose a specific premium or premium adjustment on the use of brokered deposits. In 2009, the FDIC adopted the current Brokered

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19 *See* discussion on pages 9-10 concerning affiliated broker sweep arrangements as "core" deposits.

20 Congress expressly rejected an exemption for listing services. *See* 135 CONG.REC. S4266, *et seq.* (daily ed. April 19, 1989). However, the FDIC, by interpretation, has created an exemption. *See* FDIC Interpretive Letter 90-24 (June 12, 1990).

21 *See, e.g.*, FDIC Interpretive Letter 02-04 (November 13, 2002).

22 Listing Services Comment Request, *supra* note 8.

23 *Id.*

Deposit Adjustment, citing a connection between rapid asset growth funded by brokered deposits and weak or failing depository institutions.[24] The Adjustment for Risk Category I depository institutions applies if more than 10% of a depository institution's total domestic deposits are brokered and the depository institution has experienced more than 40% asset growth during the prior four years.

Unlike the proposed revisions to the Brokered Deposit Adjustment, the current Adjustment does not impose a pre-determined premium on brokered deposit use. Instead, the depository institution's brokered deposit use and growth in excess of the threshold amounts are included in a formula that weighs this data along with other factors, such as loan quality, management, etc. If the overall health of the depository institution is strong, the effect of the Adjustment may be *de minimis*.

In connection with the proposal of the current Brokered Deposit Adjustment in 2008, we filed a comment letter opposing the proposed Adjustment for many of the same reasons we oppose the proposed revised Adjustment: (i) utilization of the legal term "brokered deposit" to characterize the underlying nature of the deposits cannot be supported; (ii) the FDIC's statements about the role of brokered deposits in failed depository institutions were in conflict with long-standing FDIC positions on brokered deposits[25] and a number of studies on the connection between brokered deposits and depository institution failures; and (iii) the Adjustment, and the stigma on brokered deposits resulting from the Adjustment, would cause distortions in the deposit funding markets by placing a stigma on brokered funding in favor of non-brokered funding, irrespective of rate or stability.[26] We renew these objections and incorporate our 2008 Comment Letter, and its attachments, by reference in this letter.

With respect to the latter point, the distortions in the deposit funding market are already evident. Depository institutions needing funding are willing to pay substantially more for "non-brokered" deposit funding through listing services and the internet to avoid reporting the deposits as "brokered" on their Call Reports/Thrift Financial Reports.[27] The current

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24 74 Fed. Reg. 9525, 9531 (March 4, 2009).

25 *See, e.g.*, FDIC Interpretive Letter 95-24 (April 26, 1995), in which FDIC staff stated that the "prudent use" of brokered deposits is "entirely acceptable." Furthermore, the current edition of the FDIC's Risk Management Manual of Examination Policies states:

> The acceptance of brokered deposits by well-capitalized institutions is subject to the same considerations and concerns applicable to any other type of special funding. These concerns relate to volume, availability, cost, volatility, and maturities and how the use of such special funding fits into the institution's overall liability and liquidity management plans. There should be no particular stigma attached to the acceptance of brokered deposits per se and the proper use of such deposits should not be discouraged. (p. 6.1-10)

26 December 17, 2008 comment letter of Seward & Kissel LLP in connection with *Assessments, 12 CFR 327-RIN 3064-AD35* (the "2008 Comment Letter").

27 *See* discussion on pages 12-13 about the economic impact of the proposed Brokered Deposit Adjustment.

differential between CDs offered through a broker-dealer and CDs obtained through a listing service is 35 to 50 basis points, including fees to the broker, but not including fees to the listing service. Although there are no official data, one major listing service has stated that between May 2009 and May 2010 the number of transactions through the service increased by 66%.[28]

Another result of the stigma on brokered deposits is the pre-payment of brokered CDs, including all interest owed through maturity, by depository institutions that do not want to report brokered deposits on their Call Reports/Thrift Financial Reports. Pre-payments of interest have ranged from a few months to up to 21 months.[29] In other words, the current regulatory policies are prompting irrational behavior predicated on a deposit's label, not its characteristics.

The FDIC's proposed revisions to the Brokered Deposit Adjustment would exacerbate the current market distortion by taxing brokered deposit use by large depository institutions irrespective of the strength of the depository institutions or their use of the deposits.

In 2008, we also filed a comment letter concerning sweep arrangements between a broker-dealer and one or more affiliated depository institutions, describing the relationships between the broker's customers, the broker and the depository institution and how these relationships cause the deposits to be a uniquely stable and cost effective source of funding.[30] Others, including the American Bankers Association, agreed.[31]

The FDIC declined to respond to the comments that we and others filed, other than to state that it was "not persuaded" by comments concerning sweep arrangements. Instead, it cited to a "study" that made a connection between brokered deposits and weak or failed depository institutions. Requests for the results of the study submitted during the comment period pursuant to the Freedom of Information Act were denied[32] and an economic model attached to the proposal was identified as the study the FDIC referred to. Upon examination, the model proved to be inappropriate for its intended use, as set forth in the letter (attached hereto as Attachment B) from Professor Joseph Mason that was sent to the FDIC, but never included in the public record.

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28 *See* May 12, 2010 press release of QwickRate (attached hereto as Attachment A).

29 Source: The Depository Trust Company.

30 *See* December 17, 2008 comment letter of Seward & Kissel LLP, on behalf of Charles Schwab & Co., Citigroup Inc., Morgan Stanley & Co., Raymond James Financial Inc., UBS Bank USA and UBS Financial Services Inc., in connection with *Assessments, 12 CFR 327-RIN 3064-AD35*. That letter is incorporated herein by reference.

31 *See* December 17, 2008 comment letter of the American Bankers Association in connection with *Assessments, 12 CFR 327-RIN 3064-AD35*.

32 *See* FDIC FOIA Log 08-0974.

Because the FDIC has not offered an explanation for its proposed modification to the Brokered Deposit Adjustment, we are forced to assume that the FDIC has no rationale that it is prepared to articulate. We note also that FDIC's rationale for the current Brokered Deposit Adjustment, which we believe was flawed for the reasons given above, provides no support for the proposed modification since that rationale is inconsistent with the proposed modification.

The FDIC's Rulemaking Obligations

Pursuant to the Administrative Procedure Act, which governs rulemakings by federal agencies, including the FDIC, an agency must state the basis for any rule.[33] Agency rulemaking actions that are "arbitrary and capricious" may be set aside by a court.[34] The U.S. Supreme Court has held that although its scope of review under the "arbitrary and capricious" standard is narrow, an agency, nonetheless, "must examine relevant data and articulate a satisfactory explanation for its actions including a 'rational connection between the facts found and the choice made'."[35] An agency must respond in a "reasonable manner" to comments that raise significant problems and its failure to respond may demonstrate that the agency's decision was not based on a consideration of the relevant factors.[36]

The FDIC is required by statute to establish a risk-based deposit premium system.[37] In doing so, it is required to consider the following factors:

(i) the probability that the Deposit Insurance Fund will incur a loss with respect to the institution, taking into consideration the risks attributable to –

(I) different categories and concentrations of assets;

(II) different categories and concentrations of liabilities, both insured and uninsured, contingent and noncontingent; and

(III) any other factors the Corporation determines are relevant to assessing such probability;

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33 5 U.S.C. § 553(c).

34 5 U.S.C. § 706(2)(A).

35 *Motor Vehicle Manufacturers Association of the United States, Inc., et al. v. State Farm Mutual Automobile Insurance Co., et al.*, 463 U.S. 29 (1983) (*quoting Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168 (1962)).

36 *See Dr. Zinovy V. Reytblatt, et al. v. United States Nuclear Regulatory Commission, et al.*, 105 F.3d 715, 722 (D.C. Cir. 1997).

37 12 U.S.C. § 1817(b)(1)(A).

(ii) the likely amount of any such loss; and

(iii) the revenue needs of the Deposit Insurance Fund.[38]

The FDIC is permitted to treat large and small banks differently.[39]

Nothing in the FDIC's statutory mandate to establish a risk-based deposit premium system permits it to act without stating a rationale and supporting that rationale with at least a rudimentary analysis.

The FDIC has sought in both the Prior Proposal and the Proposal to impose a premium on large depository institutions that is materially different from the current premium imposed on them and on all other Risk Category I depository institutions. Commenters on the Prior Proposal raised concerns about the FDIC's failure to state a basis for modifying the Brokered Deposit Adjustment.[40] Despite these objections, the FDIC did not state a rationale when it published the Proposal for comment.

Based on publicly available information, of the 297 depository institutions that failed between January 1, 2009 and December 17, 2010, only six met the definition of "large" in the Proposal. Of these six depository institutions, four had brokered deposits of 10% or less. In addition, we have identified 27 depository institutions that would be affected by the proposed Brokered Deposit Adjustment. We estimate that the proposal would change the Adjustment for these depository institutions by over $464 million in the aggregate, a substantial cost to impose in the absence of a stated justification or evidence of abuse of brokered deposits by the large depository institutions that have failed since the adoption of the current Adjustment.

The FDIC has stated no rationale for the proposed change to the Brokered Deposit Adjustment; the rationale for the current Brokered Deposit Adjustment is inapplicable to the proposed change; and there is no pattern of large bank failures with excessive brokered deposits. Lastly, as discussed below, rather than providing the rationale for the proposed change, recent FDIC statements concerning brokered deposits demonstrate the absence of such a rationale.

The FDIC has characterized brokered deposits as "volatile,"[41] but it has never produced any support for this statement. In common usage, the term volatile means "characterized by or subject to rapid or unexpected change."[42] Depository institutions receiving

38 12 U.S.C. § 1817(b)(1)(C).

39 12 U.S.C. § 1817(b)(1)(D).

40 *See, e.g.*, the July 2, 2010 comment letters of The Financial Services Roundtable, the American Bankers Association, and Discover Financial Services in connection with *Assessments, 12 CFR 327-RIN 3064-AD57*.

41 *See, e.g.*, FDIC FIL 32-2009 (June 19, 2009).

42 *See* www.merriam-webster.com.

deposits through sweep arrangements offered by an affiliated broker-dealer can demonstrate, and have offered to demonstrate, to the FDIC the stability of their deposit base. The FDIC declined to accept the data during the rulemaking on the current premium.[43] We renew our offer to provide this data to the FDIC on a confidential basis, either in connection with the proposed change to the Brokered Deposit Adjustment or, more appropriately, in connection with the Dodd-Frank Act study. Further, the FDIC has never addressed how long-term CDs with limited early withdrawal provisions (*i.e.*, only upon death or adjudication of incompetence) are volatile. At the same time, the FDIC has twice adopted versions of the Transaction Account Guarantee Program, which provides unlimited deposit insurance for certain transaction accounts because of concerns that depositors will rapidly withdraw their funds if they believe a depository institution is weak. Yet transaction accounts are considered so-called "core deposits" that are treated as stable deposit funding.

The FDIC has characterized brokered deposits as "high rate."[44] In 2009, the federal banking regulators proposed an amendment to the Call Reports that would have required reporting by banks of the total interest expense associated with their brokered deposits.[45] This is a clear concession that the FDIC does not in fact know the rates associated with brokered deposits. In our 2008 Comment Letter we provided historic cost information concerning CDs offered through registered broker-dealers, comparable CDs offered through listing services and FHLB advances. The FDIC has provided no indication that these data were considered in the rulemaking.

The FDIC has not referenced a study that identifies and analyzes the various components and attributes of the brokered deposit market.[46] The Inspector General of the FDIC[47] has examined a number of failed depository institutions in order to determine the cause

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43 FDIC staff cited the inability to accept proprietary information on a confidential basis in connection with a rulemaking. There is nothing in the FDIC's regulations or governing statutes that would prohibit the acceptance of proprietary information during a rulemaking. The User Notice on Regulations.gov, a web-based federal rulemaking application that facilitates the submission of public comments in federal rulemaking proceedings, clearly contemplates the submission of confidential business information by instructing users on how to do so.

44 *See, e.g.*, Listing Services Comment Request, *supra* note 8.

45 *See Proposed Agency Information Collection Activities; Comment Request*, 74 Fed.Reg. 41,973 (August 19, 2009). The regulators subsequently determined not to implement that amendment and instead decided to "reconsider their data needs" in connection with deposit funding costs. *See* 74 Fed. Reg. 68,314 (December 23, 2009).

46 "It is not consonant with the purpose of a rule-making proceeding to promulgate rules on the basis of inadequate data, or on data that, [to a] critical degree, is known only to the agency." *Portland Cement Association v. Ruckelshaus*, 486 F.2d 375, 393 (D.C. Cir. 1973).

47 The Inspector General of each appropriate federal banking agency is required to conduct a "material loss review" with respect to every failed depository institution under its regulatory jurisdiction that has caused a loss to

of the failures and has noted the reliance of some depository institutions on "volatile funding" sources, which it defines to include brokered deposits and internet deposits. These reports are periodically cited as evidence that brokered deposits were a cause of a depository institution's failure.[48] The FDIC's references fail to note the following findings by the Inspector General:

- In all cases weak management and poorly managed asset strategies were the primary cause of the failures.

- The depository institution's regulator had identified the asset problems early, but failed to follow up to ensure that the depository institution's management was addressing the problems.

- In some cases, the regulators were aware of rapid asset growth strategies involving brokered deposits and either failed to exercise its authority to prevent the depository institutions from pursuing the strategy, or enabled the strategy.[49]

In addition, the Inspector General has not examined the following:

- Whether the amount of brokered deposits at a failed depository institution at time of failure was relatively high because other depositors had withdrawn their funds as the depository institution weakened.

- The actual cost of the brokered deposits to the failed depository institution.

The Inspector General of the FDIC also does not attempt to identify the types of brokered deposits in the failed depository institutions. In addition, the FDIC has never noted the fact that no depository institution that received deposits from an affiliated broker through a sweep arrangement has failed.

The Dodd-Frank Act Study

Although there is no legislative history concerning the study of core deposits and brokered deposits that the FDIC is required to conduct pursuant to the Dodd-Frank Act, it is reasonable to assume that Congress has concerns about the current definitions of these terms and the treatment accorded to deposits that fall into these definitional categories. As a result, we

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the Deposit Insurance Fund in excess of $25 million, or two percent of the institution's assets at the time the FDIC is appointed receiver, whichever is greater. (12 U.S.C. § 1831o(k).)

[48] *See, e.g.*, Listing Services Comment Request, *supra* note 8.

[49] *See, e.g.*, Office of Inspector General, Department of the Treasury, Material Loss Review of IndyMac Bank, FSB (OIG-09-032, February 26, 2009).

believe that the intention of Congress is to have the FDIC defer any changes in policy until the study has been completed and recommendations sent to Congress.

Congressional concerns are legitimate, as neither the term "core" deposit nor the term "brokered" deposit is based upon the underlying characteristics of the deposit. While it is widely assumed that a core deposit is a relationship-based deposit and, therefore, is more stable than other deposit funding sources,[50] no operative definition in fact exists. The sole definition of a core deposit for reporting and insurance premium purposes is what deposits are NOT core: the total of all time deposits of $100,000 or more; foreign office deposits; and insured brokered deposits issued in denominations of less than $100,000.[51]

The most obvious example of the flaws in the current policy is the inclusion of listing services and internet deposits as "core" deposits despite the fact that the federal banking regulators have characterized these deposits as potentially high rate and volatile. These deposits are "core" solely because they are not brokered.

An example at the other end of the spectrum are deposits swept to a depository institution from its affiliated broker-dealer. The depositors have a significant relationship with the broker and typically have a high degree of loyalty to the broker's brand. Furthermore, in addition to sweeping customer funds to the depository institution, in many instances the broker also cross-markets various bank credit products to its customers: credit cards, home mortgages, lines of credit, etc. As a result, many of the broker's customers also have business relationships with the affiliated depository institution. These factors cause the deposits swept to the depository institution to be as stable as any in the banking industry.

We believe that these examples are sufficient to demonstrate that making changes to the Brokered Deposit Adjustment prior to conducting a *bona fide* study of these definitions is precipitous.

Economic Impact

Another significant reason to delay modification of the Brokered Deposit Adjustment pending further study is that, as described above, the current Brokered Deposit Adjustment appears to have impelled banks toward increased use of non-brokered deposits

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50 This assumption is curious, as it is based on a belief that customer loyalty to a depository institution's brand is very high, or that there is no competition between depository institutions for customers. According to the 2010 Retail Banking Satisfaction Survey (J.D. Power and Associates), a survey of approximately 48,000 retail bank customers, 37% of bank customers who changed their primary banking relationship in 2010 did so because of dissatisfaction with the services provided. The FDIC's Risk Management Manual of Examination Policies notes that deposits made by depositors that have credit relationships with a depository institution tend to be more stable. However, no methodology is employed to identify these deposits.

51 Uniform Bank Performance Report, p. 10. We assume that the $100,000 figure has been, or will be, adjusted to reflect the increase of FDIC coverage to $250,000.

available through listing services and the internet. Those deposits have been identified by the federal bank regulators as high cost and volatile and must necessarily result in a higher cost of credit to borrowers.[52] These trends would be exacerbated by the proposed change.

Both CDs and sweep arrangements offered by broker-dealers permit depository institutions to access funds that are not otherwise available to them. Brokers offer CDs and sweep arrangements to customers as merely two of hundreds of investment options. If depository institutions are discouraged by regulatory policies from accessing these investors through a broker, the investors will simply be offered other investment options. These funds will not be re-directed to the banking industry.

As a result, the proposed change would reduce the potential depositor universe that could be accessed by banks. The effect of reducing this universe will be to increase the pressure on banks to pay whatever higher interest rates are necessary to attract the deposit funding the banks need. This would further drive up the cost of deposit funding and the cost of credit to borrowers.

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For the reasons set forth above, we respectfully request that the proposed change to the Brokered Deposit Adjustment be withdrawn. We look forward to having an opportunity to assist the FDIC in connection with the Dodd-Frank Act study and are prepared to work with our clients to provide information for the study to the FDIC.

Paul T. Clark

Anthony C.J. Nuland

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52 *See* Listing Services Comment Request, *supra* note 8.

ATTACHMENT A

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QwickRate Grows Subscriber Base by 24% in the Past 12 Months

Financial Institutions In Search of Best Rates for CD Funding and Investing Drive 68% Surge in Transaction Activity

ATLANTA, Ga., May 12, 2010 – QwickRate® announced today that more than 3,000 financial institutions are now utilizing its premier, online marketplace as a trusted, nationwide source for non-brokered funding and investing. The Company reported that it has grown its subscriber base by 24% in the past 12 months and has witnessed a 68% increase in transaction activity for the same period.

QwickRate's strong, continued growth is attributed to the fact that an abundance of new investors are turning to its marketplace as a reliable avenue to get better returns on their investments. At the same time, other financial institutions are relying upon QwickRate more and more as a prudent source for generating lower cost funding outside of their local markets, and diversifying their funding mix.

The QwickRate marketplace is a direct forum for hundreds of credit unions to quickly connect with pre-screened banks from all over the country and identify investment opportunities—without incurring third party, rate stripping or broker fees. Through the marketplace, these investors are securing the best nationwide rates for certificate of deposits (CDs), increasing their returns on each CD investment by as much as 30 to 90 basis points.

"Hands down, we are getting the best yields on our CD investments from the QwickRate marketplace," said Linda Williams, CEO at Akron Firefighter's Credit Union. "We made more interest in the first quarter of 2010 on just one third of our investment dollars than we made for all of 2009."

Fully compliant with the FDIC as a non-brokered Direct Deposit CD listing service, the QwickRate marketplace offers banks the ability to generate deposits at the best rates for their institution—even at an interest rate that is lower than the national rate. Since January 1, 2010, the average of the top 10 rates listed in QwickRate has been consistently below the national rate. In addition, rates for over 50% of the deposits generated through QwickRate were posted at least 25 positions below the top rate listed—and those positions are well below the national rate.

"QwickRate has been and will continue to be a valuable source for diversifying our funding," said Brant Ward, Funding Officer at Signature Bank of Arkansas. "The deposits we've raised have helped us reconfigure our balance sheet and better manage assets and liabilities in this lower rate environment. At the same time, we're in a stronger liquidity position for when rates rise."

Financial institutions utilize the Company's QwickTools™ to eliminate paperwork and streamline the direct funding and investing process. QwickRate is constantly advancing the capabilities and automated features of its marketplace to make it even more advantageous for subscribers. The latest development is its new, expanded View Rates capability which provides more flexibility and time-savings for investors purchasing multiple CDs with varied durations at one time.

"The continual growth we're experiencing year over year is a real testament to the incredible value the marketplace is providing institutions seeking to diversify their funding and investing, especially in the wake of the financial crisis," said Shawn O'Brien, president, QwickRate. "We've built a unique marketplace where banks and credit unions across the country are connecting and finding opportunities time and time again that are helping them maximize their net interest margins."

About QwickRate
QwickRate is the premier marketplace for non-brokered funding and investing. With more than 3,000 members, QwickRate offers community financial institutions a cost-effective way to gain access to a nationwide CD market. The marketplace includes QwickTools™, a comprehensive set of online tools that speed the funding and investing process and help banks and credit unions get the best rates for their institutions, while more efficiently managing their portfolios. QwickRate is known for its exceptional customer service which includes unlimited support and valuable regulatory guidance. QwickRate is a Preferred Service Provider of The Independent Community Bankers of America (ICBA). For more information, visit www.qwickrate.com.

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ATTACHMENT B

LOUISIANA STATE UNIVERSITY

E. J. Ourso School of Business

Louisiana State University
2164-A Patrick F. Taylor Hall
Baton Rouge, LA 70803

February 12, 2009

Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20420

RIN: 3064-AD35

Dear Mr. Feldman:

I have been asked to review the FDIC's econometric model of CAMEL downgrades in Appendix A of the Notice of Proposed Rulemaking to increase the deposit insurance premium assessment rates for certain Insured Institutions (the "Proposed Rule").

The FDIC's Proposed Rule contains a "Brokered Deposit Adjustment" to the premium assessment that is intended to recognize potential additional risk to an Insured Institution posed by the use of brokered deposits in certain circumstances. The Proposed Rule uses the definition of "brokered deposit" in FDIC regulations and applicable interpretations of that term.[1] The adjustment for Risk Category I institutions would apply if an Insured Institution's brokered deposits exceed 10% of its domestic deposits and its assets have increased by more than 20% during the prior four years. For Risk Category II, III and IV institutions, the adjustment would apply if brokered deposits exceed 10% of domestic deposits, irrespective of asset growth.

The FDIC's rationale for imposing a "Brokered Deposit Adjustment" to the premium assessments appears to rest on two assumptions: (1) some recently failed institutions experienced rapid asset growth before failure and may have funded that growth with brokered deposits; and (2) a "significant correlation" between rapid asset growth funded by brokered deposits and the probability of an institution's CAMELS rating being downgraded. A stylized model of CAMEL downgrade is advanced in Appendix A of the Notice of Proposed Rulemaking to justify the specification of the combination of growth and brokered deposits that the FDIC proposes to regulate.

Implicitly, though it is not stated in the Notice of Proposed Rulemaking, the FDIC claims that a certain combination of asset growth and brokered deposit funding raises the costs of resolving

[1]. 12 C.F.R. §337.6(a)(2).

failed institutions. But not all institutions that have their CAMEL rating downgraded ultimately fail and not all failures impose substantial costs on the FDIC. Indeed, some institutions may use brokered deposits as part of a strategy leading to a subsequent upgrade of their CAMEL rating. In other words, Assumption (1) is assumed to follow directly from Assumption (2) above, but in fact the correlation between the two may be statistically significantly less than one, especially for higher-level single-notch CAMEL downgrades. Indeed, that is why the methodology left out CAMEL downgrades from 1 to 2, but other important downgrade relationships are left unreported. This concern, along with others, render the single non-replicable model used to justify the rule highly suspect, and in my opinion not an adequate justification for the proposed policy.

Overall, the model seems to be questionably statistically specified, and the results are therefore of dubious value. In lay terms, there is so much manipulation of the dependent and independent variables within the chosen statistical model, that the genuine statistical relationships remain unclear. I enumerate my concerns below:

First among my concerns, the dependant variable in the specification in Appendix A is only a downgrade from CAMEL 1 and 2 to 3, 4, and 5, but only FDIC Risk Category I institutions are included in the estimation sample. Because the classification of a Risk Category I institution is made using the same model that is to be tested, the restriction to Risk Category I institutions induces significant correlation into the modeling framework. Furthermore, because all the institutions are of the highest grade, the framework allows additional influences to have a unidirectional (deleterious) effect: by sample choice, institutions cannot use brokered deposits to improve their classification the way the dependant variable is currently specified.

Additionally, downgrades from CAMEL 1 and 2 to below 3 implicitly include both single-notch downgrades—from 2 to 3—and multiple-notch downgrades. Multiple-notch downgrades are very severe occurrences and can be argued to be more the result of either fraud or lack of diligent supervision, like that which resulted recently at IndyMac. Multiple-notch downgrades seem to be dramatic cases that are unrepresentative in the real world, similar to a significant multi-notch downgrade in bond ratings where a dramatic change in the firm occurs unexpectedly overnight. Although there may not be many multi-notch downgrades in the data set, we are not told the distribution nor the importance of small changes to the specification. Indeed, there should not be many multi-notch downgrades for CAMEL 1 institutions, where even downgrades from 1 to 3 would represent significant problems that slip by examiners unexpectedly. More dramatic downgrades, from 1 to 4 or 1 to 5, especially those associated with brokered deposits and growth, would skew the specification even further.

Second, the risk weighting of assets and the CAMELS on the right-hand side of the specification are endogenous—that is, the regulator sets those variables AND determines the CAMELS downgrade on the left-hand side. The same process probably governs each, so they are statistically inseparable. Such highly correlated series are statistically problematic, and are generally avoided if at all possible. Where such specifications are impossible to avoid, they need to be handled with extreme care. No such care is demonstrated in the description in Appendix A.

Third, the study only considers the *combination* of growth and brokered deposits, and even then that variable is massaged through ad hoc weights and limits. It could be that the 10% brokered deposit and 20% growth cutoffs do not matter much, or that other cutoffs matter even more. Because we are not given the actual statistical results we cannot say.

Furthermore, a proper statistical specification would include both the individual variables, as well as the interaction of growth and brokered deposits. Without including the direct effects of each, there is no way to disentangle the individual effects of growth and brokered deposits.

Additionally, even if those variables and the interaction are statistically significant (which is not shown in Appendix A), since the dependant variable is CAMELS downgrade all the specification is saying is that those effects may be part of a typical strategy to mask true goals or condition from examiners, which can be remedied through stricter examination procedures rather than merely accepting the conditions and addressing the costs via other means. There is an implicit assumption operating throughout the analysis that CAMEL downgrades result in failure, which is costly to the deposit insurance fund. That assumption, however, has not been proven nor parameterized. We need to know much more about the roll rates—that is, the propensity of a downgraded institution to be upgraded or downgraded again in subsequent periods—before we can parameterize that cost. Moreover, the on-balance sheet growth that is the focus of the proposed rule is less reflective of risk in a banking system that can freely choose securitization as a means of off-balance sheet growth. The type of rapid growth that has led to failures since the late 1990s is more attributable to off-balance sheet growth funded via securitization than the traditional on-balance sheet growth of the Thrift Crisis.

Fourth, OLS is the wrong statistical method for the analysis of the discrete dependent variable because the dependent variable, the existence of a CAMEL downgrade, is discrete rather than continuous – that is, the variable is either zero or one. Hence, the downgrade probability cutoffs produced by the statistical model are not bounded between zero and one. The authors respond to that shortcoming by chopping off the ends of the probabilities, but that method is not suitable or sufficient. Moreover, the vast majority of banks will have no downgrade in any chosen period, so the dependant variable is skewed as mostly zeros. Even worse, some of those zeros mask upgrades, and excluding those upgrades may obscure an important role for brokered deposits. Statistical models like Logit and Probit are much more amenable to measuring the types of dependant variables examined here, and such models can differentiate between single- and multiple-notch downgrades as well as upgrades in the data set. Such models relieve the need to chop off the probabilities so that they lie between zero and one and more accurately and appropriately measure the dynamics attempting to be summarized here.

Although there are many more concerns to be voiced about the statistical specification, the point is that the present non-replicable and unproven statistical model is a poor choice upon which to base important rulemaking. The brokered deposit/growth variable that is the subject of the proposed rule is introduced into the statistical model in the final form of the policy variable and variations from that form are not tested. Such justification is particularly problematic because the confidentiality of the CAMELS component and aggregate ratings prevents variations of the proposed brokered deposit/growth variable from being tested or verified by outside economists.

In my view, the data and modeling procedure appear designed to deliver the desired policy recommendations, rather than having the policy recommendations properly derived from appropriately specified statistical models. Hence, the statistical model is not appropriate justification for the proposed rule.

Respectfully Yours,

Dr. Joseph R. Mason
Hermann Moyse, Jr./Louisiana Bankers Association Endowed Professor of Banking, Louisiana State University and Senior Fellow, The Wharton School