



April 30, 2019

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

Via E-Mail: [comments@fdic.gov](mailto:comments@fdic.gov)

Re: Brokered Deposits RIN 3064-AE94

Dear Mr. Feldman:

First Financial Northwest Bank (“FFNW”) sincerely appreciates the opportunity to comment on the Federal Deposit Insurance Corporation’s (“FDIC”) advanced notice of proposed rulemaking (“ANPR”) on brokered deposits. FFNW is supportive of this comprehensive review and strongly agrees with the FDIC that significant changes in technology, business models and products warrant a review of the regulations, interpretations and guidance that make up the FDIC’s approach to brokered deposits. The regulatory stigma inappropriately attached to the use of brokered deposits and the national rate cap calculation is inhibiting the abilities of community banks to compete with national branch and branchless banks and credit unions.

Enacted in 1989, as part of the Financial Institutions Reform, Recovery and Enforcement Act (“FIRREA”), Section 29 of the Federal Deposit Insurance Act (“FDIA”) sets restrictions on the acceptance of brokered deposits by institutions with weakened capital positions. The statute intends to prevent troubled institutions from holding funds placed by third-parties whose primary business is “placing deposits or facilitating the placement of deposits of third parties” to insured depository institutions. In addition, recent safety and soundness examinations have inappropriately applied the rate cap limitations to well capitalized institutions in the liquidity portion of the examination, whereas the regulations were specifically intended to apply to institutions that were less than well capitalized.

We respectfully request that the FDIC remind its field examiners that well-capitalized banks are not subject to supervisory limitations regarding the amount of brokered deposits the institution can accept or the deposit rates it may offer. FFNW and other community institutions have had a substantial portion of stable branch deposit accounts labeled as “potentially volatile” simply because the rates paid on certain deposits exceeded the national rate cap in effect at the time the deposit was received. This element, inappropriately applied to well-capitalized institutions, has significantly impacted the liquidity component of safety and soundness examinations under a false narrative. More information on the extremely flawed national rate cap is presented below. In addition, the definition of “brokered deposits” should not be so broad that the industry is required to perform costly stress tests to manage a potential funding cliff that the FDIC itself has created.

While current regulations track the statute, FDIC interpretations (in the form of advisory opinions and FAQs) over the last 30 years have gone well beyond the original statutory intent by exponentially expanding who qualifies as a deposit broker but narrowly interpreting the exceptions. Compounding the



broad legal interpretation of “deposit broker” is the supervisory use of brokered deposits as a gauge of volatile or enhanced risk funding pertaining to deposits generated at our branches. Therefore, there currently is a significant overlap between the deposits classified as “brokered” by the legal interpretations and what, for liquidity and interest rate risk management purposes, is stable funding. In fact, as a practical matter, the two classifications are no longer mutually exclusive. Together, the result is a broad, outdated concept of brokered deposits that has led to increased insurance assessments and supervisory bias against what, by any definition, is stable funding. This in turn, discourages banks from seeking funding from sources at terms that are both more favorable to the bank and its customers.

In order to ensure that neither banks nor their customers are disadvantaged by an overly broad definition of brokered deposits, we urge that the label of “deposit broker” be applied only in the limited situation of intermediaries that contract to place deposits of unaffiliated third parties with insured depository institutions or with insured depository institutions for the purpose of selling interests in those deposits to third parties.

Additionally, deposits involving a direct, continuing relationship between a customer and an insured depository institution should not be considered “brokered” deposits, even if an unaffiliated third-party is involved in the origination of the deposit. Inclusion of these types of deposits seems to go beyond Congressional intent of Section 29 of the FDIA.

### **Interest rates and the national rate cap**

The rates banks offer on deposits are determined by a variety of factors, including competition and various benchmarks including treasury rates, Federal Home Loan Bank (“FHLB”) advances, brokered deposits, LIBOR swap rates and money market rates, among others, and the wide variety of business models and cost structures in the overall banking industry. However, the FDIC’s methodology does not currently employ or consider these common benchmarks, indices, nor the bank’s specific operating structure to determine if a bank is paying rates that constitute an unsafe or unsound practice. In order to identify outlier interest rates, as directed by the statute, we recommend that the FDIC investigate the use of robust, transparent, and widely used benchmarks to determine a market interest rate, with an appropriate add-on to establish a threshold for rates that are significantly above market. A specific recommendation in this regard is presented later in this document.

An artificially low rate is problematic for well-capitalized and weaker banks alike. Because examiners use the national rate cap as a proxy for higher risk deposits, banks are often discouraged from raising or holding deposits with a rate higher than the national rate cap. Additionally, a non-competitive rate means that weaker institutions have a reduced ability to improve their condition as they are hobbled in their ability to raise deposits. Moreover, as with other factors and items within the FDIC’s framework, it is unclear how the 75 basis point add-on was derived or if it allows for a sufficiently high level output during all phases of the interest rate and business cycles, or if it should be dynamic through the cycles. Establishing a more robust rate will go a long way to ensuring that healthy, well capitalized banks are not inappropriately discouraged from holding stable funding gathered at true market rates not those imposed by the flawed national rate cap.

### **The national rate cap should be above the market rate for deposits**

In addition to setting restrictions on brokered deposits, Section 29 of the FDIA, directs the FDIC to calculate a national rate cap and imposes those limits on the interest rates weaker institutions may offer to its customers. The cap is calculated by adding 75 basis point to the national rate. The national rate is currently established by taking a “simple average of “posted” rates [which is an incomplete population of actual rates] paid by all insured depository institutions and branches for which data are available,”

and are weighted by the number of the institution’s branch offices. Because banks with the most branches drive the output, the current rate does not accurately reflect the cost of deposits for community banks that have significantly fewer branches than the “SIFI” banks. As a result the FDIC’s rate is significantly below market in a rising rate environment. In addition, understanding the mechanics of how the national rate cap is derived, the intentional practices of large national banks keep this national rate cap artificially low, thereby forcing community banks to pay their customers lower than market rates.

During the period when Section 29 of the FDIA was enacted, the assets of the banking industry were divided equally among banks: i) under \$1 billion in assets; ii) \$1 to \$10 billion in assets; iii) \$10 to \$50 billion in assets; and, iv) above \$50 billion in assets. Today, banks above \$50 billion hold over 75% of total bank assets. Furthermore, during that same timeframe, total federally-insured credit unions saw their deposits grow six-fold from less than \$200 billion to over \$1.2 trillion today. In fact, the largest financial institution in Washington is a credit union. Make no mistake, credit unions are very formidable and aggressive competitors for deposits. Since credit unions enjoy a federal and state subsidized cost of structure by not being subject to income taxes, CRA, etc., they parlay this crushing advantage into paying significantly higher rates on deposits that are not factored into the national rate cap.

On February 20, 2019, FFNW management obtained rate information from the brokered deposit market and compared them to rates being paid in our local market (brokered CD rates were obtained from an active brokered deposit broker, D.A. Davidson, while competitor’s rates were obtained from their websites and/or obtaining rate sheets directly from their local branch offices).

The following grid highlights the issue at hand and is helpful to illustrate how large national banks are keeping the national rate cap low while simultaneously raising funds in the brokered market at significantly higher rates:

**Table #1**

Brokered CD Rates offered 2-20-20			2-20-19		2-20-19	2-20-19	2-20-19
			Jumbo Deposits > \$100,000 - Retail rates	Brokered vs retail rate differential	Alaska Federal Credit Union (direct, local competitor)	National Rate Cap >\$100,000	U.S. Treasury Rates
Term	Bank	Coupon					
1 year	JP Morgan Chase Bank, NA	2.50	0.05	2.45	2.20	1.47	2.54
2 year	JP Morgan Chase Bank, NA	2.65	1.01	1.64	2.90	1.67	2.50
3 year	JP Morgan Chase Bank, NA	2.80	1.21	1.59	3.20	1.81	2.47
3 year	Wells Fargo Bank, NA	2.80	1.55	1.25	3.20	1.81	2.47
4 year	Wells Fargo Bank, NA	2.90	1.60	1.30	3.40	1.90	2.47
4 year	JP Morgan Chase Bank, NA	2.90	1.31	1.59	3.40	1.90	2.47
4 year	Citibank, NA	2.85	1.15	1.70	3.40	1.90	2.47
5 year	Citibank, NA	3.00	1.50	1.50		2.04	2.47
5 year	Wells Fargo Bank, NA	3.00	1.65	1.35		2.04	2.47

As shown in the table above, JP Morgan Chase (“Chase”) was paying its retail customers a rate of 0.05% for a one-year Certificate of Deposit (“CD”), while simultaneously raising funds in the brokered deposit market at 2.50%. Additionally, Alaska Credit Union was paying its retail customers 2.20%; however, only the 0.05% rate posted by Chase was what was used in the national rate cap calculation making it a flawed indication of the “market.” Similarly, for a two-year CD, Chase’s posted rate (and therefore the rate that would be used in the national rate cap calculation) was 1.01% while it was raising brokered funds at a rate of 2.65% (a full 164 basis points higher than its retail rate) and Alaska Credit Union that was paying 2.90%. Further, Citibank was paying its retail customers a rate of 1.15% for a four-year CD while raising brokered deposits at a rate of 2.85% (a differential of 170 basis points) and Alaska Credit Union that was paying 3.40%. Slightly smaller, yet still significant differentials were prevalent at Wells Fargo Bank, as illustrated in the table above.

This makes the whole discussion around ‘rate caps’ incredibly frustrating. Chase’s 0.05% rate for one-year CDs contributes to a ‘rate cap’ calculation input of 0.80%, and if we are paying above the national rate cap, while competing with credit unions that do not get factored into the calculation, our deposits get labeled ‘potentially volatile’. We recognize that the rate cap is based on averages, however these large banks are over-weighted in the calculation due to their large number of branch offices and their intentional and strategic practice of paying low rates for on-the-run retail deposits (while raising needed funds in the brokered market) thereby undermining the rate cap calculation, to the detriment of community bank customers.

In addition, we found that rates offered for “off term” specials were often higher (e.g. a 13-month rate was significantly higher than a 12-month rate), but the on-the-run rates are what we are held to in terms of comparisons to national or local rate caps.

And consider this in terms of potential disparate impact: the large national banks are paying very low rates to their less sophisticated, retail customers, hoping they will be “asleep at the switch” at time of rollover, while paying the high rates to their wealthier, more sophisticated, brokered and institutional clients. Many community banks are willing to offer these higher rates to customers in their communities where we compete with credit unions, however, because of this whole ‘rate cap’ issue, these deposits are labeled as ‘highly volatile’, discouraging community banks from doing so.

Also worth noting in Table #1, above: the national rate cap is SIGNIFICANTLY below U.S. Treasury rates at every term. The notion that community banks should be able to raise term funds at a rate significantly below that being offered with the full faith and credit backing of the U.S. Government is entirely inappropriate and should be an obvious telltale that the national rate cap calculation is flawed.

After careful consideration of a number of alternatives, we highly recommend that instead of the current flawed national rate cap formula, that a superior alternative be considered, one that would be consistent over time and varied interest rate and business cycles. The best alternative would be to use the FHLB fixed rate advance curve for each maturity, plus 120%. Thus a 1.00% FHLB advance rate would imply a deposit cap rate of 1.20%, while a 3.00% advance rate would equate to a deposit cap rate of 3.60%. All banks have access to the FHLB and this would help level the playing field. Using a percentage of the rate in this regard is much more appropriate than using a fixed number like the 75 basis points used in the current calculation. In a low rate environment and short-end of the curve, 75 basis points may be excessive, while providing a much smaller benefit in a higher interest rate environment and long-end of the curve. Using a percentage in this equation alleviates this issue. We believe that this alternative is superior to others (i.e. swap curve listing service averages, etc.) due to its representation as a long-standing, alternative source of funding. Further, in order to respect the confidentiality of some FHLB

Districts, each financial institution could easily calculate the rate caps, once they fall below well capitalized, thus eliminating this burden from the FDIC.

To continue with the comparisons as of 2-20-2019 shown in the table above, the following rate caps would have applied using the formula of the FHLB fixed rate advance curve, plus 120% (using rates from the FHLB of Des Moines for this illustration):

**Table #2**

<b>FHLB (Des Moines) Fixed Advance Rates 2-20-19</b>		
<b>Term</b>	<b>Rate</b>	<b>Rate Cap using FHLB * 120%</b>
1 year	2.79%	3.35%
2 year	2.79%	3.35%
3 year	2.80%	3.36%
4 year	2.82%	3.38%
5 year	2.87%	3.44%

This FHLB wholesale alternative provides appropriate, easily obtainable data for rate cap calculations that are not able to be manipulated by large financial institutions, unlike the current national rate cap calculations as illustrated in Table #1, above.

Of course, the ideal solution is the full repeal of Section 29 of the FDIA, as it is now only results in unintended consequences detrimental to community banks, but that is a subject for a different audience.

**Well capitalized banks and unnecessary stigmatization of brokered deposits.**

Brokered deposits have evolved from a "hot" money product when they first emerged in the 1980s into the most cost effective and stable source of funding available to a bank. The use of deposits that traditionally fit the definition of brokered deposits is discouraged as they are viewed by supervisors as volatile or risky deposits. There is no empirical evidence that supports this view and, in fact, many banks use brokered deposits as a low cost source of funding and a vehicle for managing interest rate risk, such as match funding or as rate hedges.

Today, our institution is very balanced in terms of interest rate risk, due in large part to efforts undertaken in recent years by issuing long term callable brokered CDs (we hold the call option; one of the very few balance sheet items where such an option is truly in our favor). Loan customers can refinance loans and deposit customers can withdraw funds prior to maturity, at times when it benefits them, to our detriment. The callable brokered CD contracts, however, cannot be broken by the customer and can only be redeemed early in the rare event of death or the adjudication of incompetency of the deposit holder. Yet, we are able to exercise these call options when it makes sense for us to essentially "refinance" our borrowing with the customer. These callable brokered deposits are incredibly valuable tools to assist with interest rate risk and funding management.

On a separate but related note, part of our balance sheet at FFNW includes an overnight FHLB advance position of \$67.5 million. We keep a fair amount of our FHLB advances short so we are able to pay them down quickly as our deposit strategies succeed or other opportunities present themselves. In mid-

February 2019, when we were drafting a message relating to brokered deposits to the Washington State Department of Financial Institutions, the rate paid on these overnight advances was approximately 2.60%. In the brokered CD market, we could raise three month funds at a guaranteed all-in rate of 2.34%. If we were to utilize the brokered market instead of the FHLB for these funds, we would save \$175,500 on an annualized basis. We did execute such a transaction, raising \$35 million in the brokered deposit market and used the funds to pay down our FHLB advances, as the savings were far too great to ignore. However, doing so will likely cause some criticism and increased scrutiny at our next exam due to this increase in brokered funding. From our perspective, this is precisely what we *should* do and we hope you agree. We are certainly not “relying” on these brokered funds to fund a rapidly growing balance sheet, however we are instead actively managing our liability costs by taking advantage of material cost savings being provided to us by the markets. When such opportunities exist, we owe it to all of our stakeholders to take advantage of such money saving opportunities. In doing so, not only does it improve earnings, it improves our liquidity position as our available borrowing capacity at the FHLB will increase when this overnight advance is paid down.

We recognize that some regulatory studies cited a correlation between the presence of brokered CDs on a bank’s balance sheet and bank failures in the recent crisis, and as such, brokered CDs are labeled as “risky” or “volatile”. While correlations may exist for a number of variables during the crisis, this existence of a specific item on a bank’s balance sheet does not necessarily translate to causation of its failure. We, and others who have opined on the subject, disagree that brokered deposits caused the loan losses in the crisis. Instead, it was aggressive lending and poor underwriting that caused the overwhelming majority of the losses and banking failures. The existence of brokered deposits on a failed institution’s balance sheet does not necessarily imply causation of the failure. Restrictions on certain types of lending (especially construction and land development), including limitations on growth rates make sense. Tying the lending underwriting mistakes to the funds used to make the loans is not necessarily appropriate. For those banks that tried to “grow their way” out of the crisis, a limitation on growth rates of high risk lending may have accomplished what the current brokered regulations are attempting to limit. Therefore, limiting our ability to utilize the national brokered funds market under these false correlations puts us at a distinct disadvantage to the largest institutions who control the vast majority of the nation’s assets. Further, in this regard, associating concentrations of stabilized CRE (exclusive of construction and land development) to failures is equally a false correlation as the FDIC’s own statistics show, for the past 25 years, loss rates on C&I loans are greater than loss rates of stabilized CRE (including multifamily). Again this is a topic for another time.

As stated above, changes to Section 29 of the FDIA itself may be in order to address the problematic aspects of regulating brokered deposits. As originally intended, Section 29 of the FDIA is a regulatory tool to reduce FDIC losses springing from rapid growth of high risk loans at less than well capitalized banks that emerged from the S&L crisis. Limiting deposit growth is an indirect solution to the primary problem targeted by Section 29 of the FDIA, (i.e. growth in risky credits.) Using improved capabilities, there may be more effective means of limiting the proliferation of risky assets in outlier banks in a more targeted and direct fashion. We believe alternative risk management solutions should be considered, including those targeting the origination of risky assets.

## **Conclusion**

We appreciate the FDIC’s efforts towards modernization of the brokered deposits rules. We hope the proposal begins a thorough review of what is considered a brokered deposit, the process through which a third party is evaluated as being a “broker”, and the policy goals of Section 29 of the FDIA, modernization of the national rate cap calculation, and whether or not the FDIC’s approach to brokered

deposits is aligned with both the intent of Section 29 of the FDIA and modern banking practices.

We see this is as a critical issue to ensure the viability of a large segment of community banks in the country. If the goal is instead to significantly reduce the number of community banks, then the existing brokered deposit policies and the renewed focus on labeling any deposits raised at a rate above the inappropriate and flawed national rate cap as 'potentially volatile,' will likely achieve that result and no changes would be needed. We sincerely hope this is not on your agenda.

Thank you very much for your time and consideration.

Sincerely,

[REDACTED]  
Joseph W. Kiley III  
President and CEO

[REDACTED]  
Richard P. Jacobson  
EVP/CFO/COO

Cc: The Honorable Jelena McWilliams, Chairman, FDIC