SEWARD & KISSEL LLP

901 K STREET, N.W.
WASHINGTON, DC 20001

TELEPHONE: (202) 737-8833
FACSIMILE: (202) 737-5184
WWW.SEWKIS.COM

PAUL T. CLARK
PARTNER
clark@sewkis.com

ONE BATTERY PARK PLAZA
NEW YORK, NEW YORK 10004
TELEPHONE: (212) 574-1200
FACSIMILE: (212) 480-8421

June 9, 2020

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

Re: Brokered Deposits Restrictions (RIN 3064-AE94)

Ladies and Gentlemen:

In response to the Notice of Proposed Rulemaking (the "Proposal") published by the Federal Deposit Insurance Corporation ("FDIC") seeking comment on proposed changes to its brokered deposit regulations,[1] we are submitting this letter on behalf of our clients who participate in the national brokered deposits market. We appreciate the opportunity to provide these comments and applaud the FDIC's efforts to revise its regulations to reflect the changes in the banking industry since 1992.

Since the 1980s, Seward & Kissel has been a leader in representing clients in the brokered deposit market, including representing our securities industry clients in connection with the 1989 and 1991 legislation that created the statutory framework that exists today. During the course of those legislative initiatives, we met with regulators, members of Congress and Congressional staff to discuss the brokered deposit market. We attended every relevant Congressional hearing and Committee mark-up, including sessions of the Conference Committee that crafted the current restrictions on brokered deposits. We have remained engaged in the regulatory process on behalf of our clients and ourselves ever since, providing comments to the FDIC on various FDIC policies and proposals related to brokered deposits.[2]

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[1] FDIC, Notice of Proposed Rulemaking, Unsafe and Unsound Banking Practices: Brokered Deposits and Interest Rate Restrictions, 85 Fed. Reg. 7453 (Feb. 10, 2020).

[2] *See, e.g.*, Ltr. from Seward & Kissel to FDIC, Regulatory Publication and Review Under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (Mar. 22, 2016) (attached as Appendix B); Ltr. from Seward & Kissel to FDIC, Proposal to Amend Brokered Deposit Adjustment (Jan. 3, 2011); Ltr. from Seward & Kissel to FDIC, Deposit Premium Assessment Rate (Dec. 17, 2008); Ltr. from Seward & Kissel to FDIC, Legislative History of the Brokered Deposit Provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (Feb. 18, 1992).

Seward & Kissel represents a wide range of participants in the deposit markets, including insured depository institutions ("IDI's"), broker-dealers registered with the Securities and Exchange Commission ("SEC") and service providers to IDI's and broker-dealers. We have developed the documentation that is used throughout the industry to establish brokered CD arrangements between registered broker-dealers and IDI's. We have advised on the structuring of the first and largest broker-dealer bank "sweep" programs and have advised numerous programs on obtaining primary purpose treatment for the deposits in those programs. We advised on the first "reciprocal" deposit program and have advised firms on compliance with the FDIC's regulations implementing the recently-adopted reciprocal deposit exception. We also regularly advise banks on whether third-party deposit arrangements are brokered deposits under existing FDIC regulations and interpretations.

Summary

This letter will discuss the history of brokered deposit regulation, including the premises behind such regulation, and how the deposit markets have changed since 1991. We will also provide a critique of the Proposal and a recommendation on policies that the FDIC should pursue in implementing its various regulations that affect the deposit markets.

Set forth below is a summary of our conclusions concerning the Proposal. Based upon our extensive experience with sweep programs, we support the provisions of the Proposal that expand the existing primary purpose exception ("PPE") for broker-dealer sweep programs to affiliated banks ("Affiliated Bank Sweep Programs") and urge the FDIC not to require firms that have already received confirmation of the applicability of the PPE to their affiliated sweep program to re-apply for the PPE. As has been consistently demonstrated to the FDIC, deposits placed through these programs demonstrate a high degree of stability.

We also believe that deposits placed through broker-dealer sweep programs to unaffiliated banks ("Unaffiliated Bank Sweep Programs") can exhibit similar stability to those placed through affiliated programs, but that the FDIC should subject those broker-dealer programs to greater scrutiny before granting the PPE.

Moreover, numerous other types of third-party deposit arrangements exhibit similar stability, and we request that the FDIC provide greater clarity on these arrangements in any final rulemaking rather than require firms to submit to a burdensome application procedure to ascertain PPE eligibility.

While we applaud the efforts of the FDIC to revise its regulations, and believe there are a number of positive elements to the Proposal, we believe that more work is necessary to address the issues confronting the market in a manner that provides clarity without adding to regulatory burden.

The Proposal does not explain how the FDIC intends to meet its stated goal of modernization, or why it broadly characterizes the brokered deposit market as high-rate and volatile.

- The FDIC's stated goal in the Proposal is to "modernize…the regulations to reflect recent technological changes and innovations." But it does not describe those changes, how the proposal reflects those changes, or how the changes have informed its policies.
- In the Proposal the FDIC repeats its long-standing characterization of certain brokered deposits, particularly brokered CDs, as high rate, volatile deposits, and mischaracterizes how brokered CDs are originated and evidenced.
- The FDIC has not substantiated its characterization with data in the Proposal, and, further, has denied requests under the Freedom of Information Act for any data supporting its characterization. The FDIC should be aware that information has been provided to it by the industry over the years that contradicts this characterization.

In addition to the issues set forth above, the FDIC needs to address several other important issues in order to implement a consistent policy with respect to deposit funding and to avoid confusion and significant administrative difficulties for the FDIC and the industry.

- Should state licensed "money transmitters" that offer payment services to consumers and hold substantial customer fund that can be moved from IDI to IDI seeking the highest available rates or fees be exempt from the brokered deposit regulations?
- Why must all deposit arrangements seeking a PPE be required to seek relief through a burdensome application process?
- Will PPE applications that are approved by the FDIC be published and can they be relied upon by others?
- There is no reference to nearly 30 years of staff guidance or the 2016 staff "Frequently Asked Questions." What is the status of this guidance? Does the Proposal supersede this guidance?
- Will the FDIC address other exceptions in its regulations to provide greater clarity?

Table of Contents

I. Foundation of Brokered Deposit Regulation

a. Legislative History of FDICIA

A popular narrative about the legislative history of FIRREA and FDICIA is that in the early- to mid-1980s, IDIs, particularly small IDIs in certain localities, began funding themselves with high levels of brokered deposits relative to deposits solicited through branches or other conventional means. This in turn caused the deposit bases of these IDIs to be unstable, leading to a higher rate of bank failures during the Savings and Loan Crisis and an increase in the number of deposit insurance payouts. Congress, concerned about IDIs' use of "hot money" to fuel unstable rapid asset growth, enacted, through FIRREA and FDICIA, certain restrictions on brokered deposits specifically to address that particular problem.

However, the true legislative history does not support this reading. While the FDIC is required to enforce the plain language of the statute, it is not bound by any purported "legislative intent" of Congress that is not embodied in the statute itself. The FDIC is thus permitted to use its judgment and discretion to craft appropriate regulations to the extent permitted by the statutory text.

In fact, the brokered deposits provisions in FDICIA were adopted as a series of compromises to address myriad policy positions espoused by individual legislators, with no common thread and no overriding policy concern. Seward & Kissel represented a number of large broker-dealers during congressional consideration of FDICIA. As a result, we were present at the significant congressional debates on brokered deposits and had firsthand dealings with members of Congress on the issue.

The advocates for eliminating, or severely restricting, brokered deposits were divided on their rationale. The Department of Treasury, which issued a study on deposit insurance in 1990, sought to lower taxpayer exposure to the insurance fund by limiting coverage of various types of accounts, including, but not limited to, brokered deposits. Some members of Congress linked brokered deposits to thrift failures. Still others asserted that brokered deposits were a product for the wealthy, and that the wealthy did not need FDIC coverage.

As observers of this process we saw one common thread among the critics of brokered deposits: they could not envision a banking system that was not premised on bricks and mortar branches and face-to-face banking. In 1991, few in Congress or elsewhere envisioned a banking system that was both national in its competition for deposit funding and impersonal in its ability to attract such funding. Yet that is our banking system today.

In contrast to the critics, members who supported no restrictions, or limited restrictions, on brokered deposits cited studies, including findings of a congressional committee, refuting any connection between brokered deposits and thrift failures, as well as studies citing the benefits of banks having access to a national market for deposits. Perhaps the most telling statement during the debates came from Rep. Frank Annunzio, a senior member on what was then called the House Banking Committee. Rep. Annunzio announced that he would not support the Treasury Department's position because he had asked both the Treasury Department and the FDIC for data supporting that position — and had received no response.

The attempt to ascribe a single purpose to the brokered deposit statute frustrates a productive dialogue between industry and the FDIC on what policy concerns should motivate restrictions on brokered deposits. The Proposal, with its emphasis on "modernization," offers an ideal opportunity for the FDIC to question its assumptions that have long informed its regulatory posture toward brokered deposits.

b. Incorrect Assumptions Underlying the FDIC's Approach

i. Brokered Deposits "Stigma"

The Proposal recognizes that the FDIC's approach to brokered deposits has created a "stigma" against the use of brokered deposits by IDIs. The Proposal does not seek to refute this stigma, and in fact justifies it by stating that, "Historical experience has been that higher use of deposits currently reported to the FDIC as brokered has been associated with higher probability of bank failure and higher deposit insurance fund loss rates."[3] The Proposal repeats this assertion twice verbatim. The assertion is factually incorrect.

ii. Empirical Studies

The possible correlation between the acceptance of brokered deposits and the weakness or failure of IDIs has been examined several times over the last 35 years, and each study has concluded that there is no correlation. Before FIRREA and FDICIA, both the House Committee on Government Operations and the FDIC determined that brokered deposit restrictions were unnecessary.[4] Private analysts in the 1990s and 2000s repeatedly concluded that brokered deposits were unrelated to bank or thrift failures, or even to "high-risk" activities by banks and thrifts.[5]

There is also no shortage of more recent scholarship examining the effect of brokered deposits on IDI failures. James Barth and Yanfei Sun of Auburn University recently compiled a survey ("Barth Survey") of some 19 empirical studies of IDI failures analyzing the relationship between brokered deposits and the likelihood of bank failures.[6] The findings of the Barth Survey are striking: of the 19 empirical studies reviewed, *none* provided direct evidence that brokered deposits are a causal factor in bank failures, failure costs, or banking instability."[7] Further, the

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[3] Proposal at 7464.

[4] *See Federal Regulation of Brokered Deposits in Problem Banks and Savings Institutions*, House Committee on Government Operations, 98th Cong., 2nd Sess., H. Rept. 98-1112, 9-10 (Sept. 28, 1984); *Federal Regulation of Brokered Deposits: A Followup Report*, House Committee on Government Operations, 99th Cong., 2nd Sess., H. Rept. 99-676, 13 (July 16, 1986). The FDIC testified during consideration of FIRREA that no restrictions on brokered deposits were necessary; indeed, each of the federal banking regulators testified that restrictions were unnecessary because the regulators could respond to abuses on a case-by-case basis. *Insured Brokered Deposits and Federal Depository Institutions*, Hearing before the Subcommittee on General Oversight and Investigations of the Committee on Banking, Finance and Urban Affairs, House of Representatives, 101st Congress, 1st Sess., 98 (May 17, 1989) (hereinafter ("FIRREA Hearing").

[5] *See* David C. Cates and Stanley C. Silverberg, The Retail Insured Brokered Deposit: Risks and Benefits (May 1, 1991); Memorandum to FDIC from Joseph Mason, Hal Singer and Jeffrey West, The Effect of Brokered Deposits and Asset Growth on the Likelihood of Failure (Dec. 17, 2008).

[6] James R. Barth and Yanfei Sun, Bank Funding Sources: A New Look at Brokered Deposits (Jan. 2018).

[7] Barth Survey at 6.

evidence presented by these studies "shows that brokered accounts in better capitalized institutions operate like any other deposits."[8]

The clearest explanation for why institutions largely or entirely funded by brokered deposits appear so healthy is that failed IDIs using brokered deposits failed *in spite of* the brokered deposits, not *because* of the brokered deposits.[9]

iii. IDI Failure Mechanism

Researchers consistently find that IDIs do not fail because of weaknesses on the liability side of the balance sheet; IDIs fail because of weakness on the asset side.[10] IDI failures from the savings and loan crisis in the 1980s through the financial crisis in 2008-09 follow the same path: IDIs encounter problems with their assets, leading to a weakened capital position, which leads them "to take in more funds and invest them in risky assets, whether sources of those funds were brokered deposits or some other sources, including high-rate non-brokered deposits."[11] In these cases, the cause of the IDIs weakness and eventual failure were not the use of brokered deposits, "but from the opposite direction – in that troubled institutions can turn to [brokered and high-cost] deposits late in the game and as a last-ditch effort to grow out of their problems by investing the funds in risky assets."[12] In fact, it is reasonable to assume that some troubled IDIs might turn to brokered deposit funding precisely *because* they are less likely to run.

The FDIC itself also took the position that bank losses arise from problems on the asset side during Congressional hearings on the legislation that became FIRREA, in testimony from then-Chairman William Seidman:

> A dollar deposited in an insured institution is the same whether obtained directly from a local depositor or through the intermediation of a deposit broker. There may be differences in the cost and stability of that dollar deposit depending on its source. However, losses in banks do not occur, generally speaking, by virtue of the source of their deposit liabilities. Instead, the losses arise from the quality of and return on loans and investments made with those funds. Consequently, the focus of attention should be on the employment of brokered deposits rather than their source.[13]

The problem, then, is not that otherwise healthy IDIs somehow use brokered deposits as a "gateway drug" to investing in risky assets, as the FDIC has posited on numerous occasions; rather, the issue is that unhealthy IDIs are permitted to invest in the risky assets.

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[8] *Id.*
[9] Ltr. from Bert Ely to Robert Feldman (May 7, 2019), commenting on FDIC, Advance Notice of Proposed Rulemaking – Unsafe and Unsound Banking Practices: Brokered Deposits and Interest Rate Restrictions, 84 Fed. Reg. 2366 (Feb. 6, 2019) (hereinafter "ANPR").
[10] *See* Barth Survey at 34.
[11] Barth Survey at 34.
[12] *Id.*
[13] FIRREA Hearing at 98 (Statement of L. William Seidman).

This is precisely what happened during the failure of IndyMac in 2008, and the issues were compounded because of supervisory failures.[14] IndyMac was permitted by the Office of Thrift Supervision to backdate a $18 million contribution from its parent company in order to preserve the bank's appearance as a "well-capitalized" institution, allowing IndyMac to continue to receive brokered deposits in spite of its truly weakened capital position.

Therefore, the most appropriate position for the FDIC is not to hamper the responsible use of brokered deposits, which its current policies do, but to focus on curtailing the rapid growth of risky assets through appropriate supervision.

III. Description of the Modern Deposit Market

a. Overview

Over the past 30 years, numerous changes have marked the national market for deposits. These changes accelerated following the 1999 repeal of the Glass-Steagall "firewall" between banking and brokerage activities and by firms' adoption of new technology to provide a wider variety of financial services to a broader base of customers.

The advent of technology has changed, likely on a permanent basis, the deposit taking activities of IDIs. The pervasiveness of the internet now permits banks to compete for deposit funding in a nationwide market. Digital or online banking, and mobile banking in particular, are dramatically increasing in prevalence.[15] In recent years, certain banks have begun to operate online only. The rates offered by those banks are affecting the market generally, a fact the FDIC acknowledged in its recent national interest rate notice of proposed rulemaking.[16] Community and regional banks even have access to non-local sources of deposits due to technological access including mobile banking.

Since the 1990s, the number of broker-dealers participating in the market has increased substantially, providing greater resources for deposits and driving down fees paid by the IDIs to the brokers through competition. In the 1980s, a 60-basis-point fee was standard; today, fees are generally within the range of 9-15 basis points. The marketplace is competitive. Changes have taken place not only in consumer behavior, but also in the market itself.

Perhaps the most significant change in the deposit market since the early 1990s is that community and regional banks must now compete with larger banks in the national deposit market owing to the impact of technology and the increasing consolidation of the banking industry.

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[14] U.S. Dep't of Treas. Office of Inspector General, Safety & Soundness: OTS Involvement With Backdated Capital Contributions by Thrifts (May 21, 2009).

[15] *See* Ellen A. Merry, Mobile Banking: A Closer Look at Survey Measures, Federal Reserve FEDS Notes (Mar.27, 2018), *available at* https://www.federalreserve.gov/econres/notes/feds-notes/mobile-banking-a-closer-look-at-survey-measures-20180327.htm; Federal Reserve Bank of Boston, Financial Institutions across the U.S. Participate in the Mobile Landscape Transformation (Dec. 23, 2019), *available at* https://www.bostonfed.org/publications/mobile-banking-and-payment-surveys/financial-institutions-across-the-us-participate-in-the-mobile-landscape-transformation.aspx; *see also* Jim Dobbs, Coronavirus throws digital banking into the crucible, AMERICAN BANKER (Mar. 19, 2020).

[16] FDIC, Interest Rate Restrictions on Institutions That Are Less Than Well Capitalized, 84 Fed. Reg. 46470 (Sept. 9, 2019), *available at* https://www.govinfo.gov/content/pkg/FR-2019-09-04/pdf/2019-18360.pdf.

More depositors than ever are depositing funds with IDIs without physically travelling to a branch location, and increased use of technology has led to a substantial decrease in the number of bank branches operating in the United States. As described by Bank of America CEO and Chairman Brian Moynihan, "When you look at deposit transactions you can see that 21% of all deposits are made through mobile devices today. That's the equivalent of what 1,000 [branches] do."[17]

Accepting deposits utilizing "remote deposit capture" is far more cost effective for IDIs. For example, JPMorgan Chase has said it costs $0.65 to handle a deposit transaction in a branch, $0.08 per ATM transaction, and just $0.03 per mobile deposit.[18]

The consolidation of deposits in larger banks is striking. For example, at Bank of America, deposits rose 6.0% to $1.4 trillion in the first quarter of 2020 from the same period a year earlier. Citi's deposits rose 15% year over year to $1.2 trillion as it accelerated deposit gathering by marketing checking and savings deposits to its existing credit card customers.[19]

Online banking, peer-to-peer payments, and mobile check deposits have re-shaped the business of banking over the last decade. In 2017, the Bureau of Labor Statistics (BLS) forecast that teller jobs would decline about 8% through 2026.[20] However, by 2018 tellers had already decreased more than 8% from 502,700 to 481,490. BLS now projects employment of tellers will decline another 12% by 2028.[21] More than half of the top 100 U.S. banks reduced their branch count by more than 50% from 2014-2019. The biggest 12-month decline occurred between June 2016 and June 2017, when more than 1,700 U.S. bank branches closed.

As community and regional banks face stiff headwinds in competition for deposits as a result of technology and consolidation, so too do they face competition for assets. In 2010, lending by FinTech firms was less than 1% of all U.S. personal loans. As of March 2019, lending by FinTech firms was 49.4% of all U.S. personal loans.[22]

Because banking is no longer a community-based, bricks-and-mortar business, intermediaries play a crucial role in the modern deposit market, assisting both IDIs and depositors in establishing relationships. These intermediaries, whether they are broker-dealers, third-party sponsored websites or service providers, foster a better flow of information in the market and increase competition among IDIs, thereby improving terms for depositors. This increased information flow also permits IDIs to access a broader and more diverse deposit base that permits IDIs to better withstand countervailing regional market conditions.

In sum, the deposit market in 2020 is far different from the deposit market in 1989 or 1991. In 1991, few in Congress, or elsewhere, envisioned a banking system that did not involve brick-

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[17] https://www.fool.com/investing/2017/07/19/5-things-brian-moynihan-wants-bank-of-america-shar.aspx

[18] http://www.businessinsider.com/wells-fargo-is-closing-450-branches-2017-7 .

[19] *See* Why big banks keep raking in deposits, *American Banker* (Oct. 16, 2019).

[20] U.S. Bureau of Labor Statistics, Employment Projections program.

[21] https://www.bankrate.com/banking/bank-tellers-disappearing.

[22] American Banker, *Fintech lenders taking more market share from banks, survey finds* (Sept. 25, 2019).

and-mortar branches and face-to-face interactions with customers. Yet that is our banking system today. Because banks now compete for deposits in a nationwide market, a market that is increasingly characterized by the flow of information online, the FDIC has become, as a practical matter, a capital markets regulator.[23] The FDIC is free to identify reasonable policy goals in interpreting the brokered deposit statute, especially in light of the way the deposit market has modernized, and how much technological change has occurred in the banking industry since 1991. A better tailoring of the brokered deposit regulations to the actual risks posed by such deposit-taking would benefit all banks, including community and regional banks, and the banking industry generally.

a. Brokered Certificates of Deposit

The market for Brokered Certificated of Deposit ("Brokered CDs"), with current Brokered CDs outstanding totaling nearly $500 billion,[24] is deep, liquid, and has been a continuous and stable source of liquidity for IDIs since the mid-1980s, including through the financial crisis of 2008-09 and the current COVID-19 crisis.

Since the early 1990s, numerous changes have affected the Brokered CD market. The number of brokers and IDIs participating in Brokered CD offerings has markedly increased. This increased competition has, in turn, reduced fees and improved consumer choice. Technology has augmented this increased participation in the Brokered CD market and has improved logistical and marketing efficiency.

Each CD is an individual deposit obligation of the IDI.[25] A customer can move his or her CDs from an account at one broker to an account at another broker and trade them individually in a secondary market maintained by the broker. Unlike a participation interest (as the Proposal incorrectly labels brokered CDs), each $1,000 CD can be directly enforced by the holder directly against the issuing IDI.

Seward & Kissel's comments on the ANPR ("ANPR Comments") included a 4.5-year study finding that the "all-in cost" (interest rate plus fees to brokers) of Brokered CDs from April 2014 through January 2019 was virtually always lower for every CD maturity than the interest rates, without fees, posted on the listing service for the same CD maturity,[26] and was often only marginally higher than Treasury security yields. With respect to one-year brokered CDs, the same is true through April 2020, the latest data available.

Moreover, approximately 34% of CDs in the retail Brokered CD Market have maturities of one year and longer, empirically demonstrating the stability of these deposits. Indeed, Brokered CDs with call provisions can be issued in maturities of up to 20 years.

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[23] *See* Paul T. Clark, *Just Passing Through: A History and Critical Analysis of FDIC Insurance of Deposits Held by Brokers and Other Custodians*, 32 Rev. Banking & Fin. L. 99, 172-178 (2012-2013) (hereinafter "Clark Article").
[24] Data from the Depository Trust Company.
[25] For a detailed description of the Brokered CD market, *see* Clark Article, *supra* note 23, at 160-63.
[26] 3-month rates are unavailable.

Data from the 2008 financial crisis further demonstrates the stability of Brokered CDs. During the crisis, deposits at the two banks owned by Lehman Brothers Holdings – each of which had brokered deposits that were over 98% of their total deposits – were stable despite the failure of the top tier holding company. Despite the banks being precluded from accepting new brokered deposits after the bankruptcy filing of the parent company, during the subsequent three-month period only 4.7% of the brokered deposits at each bank ran off – run-off attributable to maturing time deposits.[27]

b. Affiliated Bank Sweep Programs

After the Gramm-Leach-Bliley Act of 1999 vitiated certain relevant portions of the Glass-Steagall Act, many broker-dealers came under common control with IDIs, allowing financial institutions to offer a broad suite of services under a single brand. Every full service broker-dealer affiliated with a bank now offers to its customers an Affiliated Bank Sweep Program; that is, a program to sweep uninvested funds into deposit accounts at the affiliated bank.[28] The aggregate amount of deposits in these programs is estimated to be near one trillion dollars.

Based on our experience, Affiliated Bank Sweep Programs exhibit the following characteristics:

- The majority of brokered sweep deposits are "entirely insured" as defined under the Liquidity Coverage Ratio ("LCR") regulation;[29]
- "[T]he sweep feature is merely a service offered by a broker to support the other financial products offered by the broker to its customers. These customers, therefore, are not going to engage in the expense and effort to terminate their relationship with their broker and move their assets to another broker merely because of the sweep feature."
- Where "the broker and the bank share a common name, or the affiliation is otherwise clear, this may instill a brand loyalty among the broker's customers that enhances deposit stability."
- Many customers prefer to combine their banking and investing into a single relationship, whether for convenience or to obtain pricing advantages.
- It is highly unlikely that a broker would terminate a sweep feature to an affiliated bank, which results in very stable, long-term arrangements.

Affiliated Bank Sweep Programs are structured to ensure that each customer, not the broker-dealer, is clearly the beneficial owner of the deposit account and possesses all material indicia of ownership, including the ability to pledge the deposit account as security for a loan, enforce his or her rights in the deposit account directly against the bank, and where operationally feasible, transfer his or her deposit account to another custodian.

[27] Data are derived from Call Reports.
[28] *See* Clark Article, *supra* note 23, at 153.
[29] *See* 12 CFR Part 329.

Based on our experience, affiliated sweep deposits demonstrate highly stable behaviors in both stressed and un-stressed economic markets.[30] The FDIC itself agreed with this characterization in adopting the regulations governing the LCR with the other Federal banking agencies, stating that:

> "The agencies believe that affiliated brokered sweep deposits are more reflective of an overall relationship with the underlying retail customer. . . . Affiliated brokered sweep deposits generally exhibit a stability profile associated with retail customers, because the affiliated sweep providers generally have established relationships with the retail customer that in many circumstances include multiple products with both the covered company and the affiliated broker-dealer. Affiliated sweep deposit relationships are usually developed over time. Additionally, the agencies believe that because such deposits are swept by an affiliated company, the affiliated company would be incented to minimize harm to any affiliated depository institution."[31]

As a result, the LCR regulation applies lower outflow assumptions to affiliated sweep deposits than to unaffiliated sweep deposits.

In fact, affiliated sweep deposits exhibit countercyclical behavior, meaning that such deposit balances typically and predictably grow during times of volatility. This is a result of customers "de-risking" by holding deposits until the securities market improves, at which time they can use their funds to purchase securities.

Because affiliated sweep deposits exhibit such stability, we support the FDIC's expansion of the PPE which will grant these programs additional flexibility. We urge the FDIC not to require firms that have already received confirmation of their eligibility for the PPE to re-apply through the formal application process described in the Proposal.

c. Unaffiliated Bank Sweep Programs

A number of broker-dealers offer Unaffiliated Bank Sweep Programs; that is, programs that sweep customer funds to deposit accounts at unaffiliated IDIs. These programs are structured similarly to Affiliated Bank Sweep Programs. Many of these broker-dealers are not full-service broker-dealers, and many have emerged following the 2008-09 financial crisis. It is unclear what behavior these deposits would exhibit in highly stressed conditions.

Based on our experience, there are a number of factors that signal stability for affiliated sweeps that may not be present to an equal degree with some unaffiliated sweeps. For example:

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[30] Ltr. from Peter Morgan to Mr. Robert deV. Frierson et al. commenting on the Federal banking agencies' proposed liquidity coverage ratio rule (Jan. 31, 2014).

[31] 79 Fed. Reg. 61440, 61493 (Oct. 10, 2014).

- The broker and the IDI do not share a common name, there are no other indications of affiliation, and thus no brand loyalty is instilled among the broker's customers that enhances deposit stability.
- It may be more likely that a broker would terminate an unaffiliated bank from its sweep program if the bank showed signs of financial weakness.

Notwithstanding these differences, we believe that Unaffiliated Bank Sweep Programs can exhibit deposit stability similar to Affiliated Bank Sweep Programs, and that many, in fact, do. Nonetheless, we believe that it is appropriate for Unaffiliated Bank Sweep Programs to be subject to additional FDIC scrutiny, such as through a formal application process like the one described in the Proposal, before they may rely on the PPE. Specifically, we believe that the Unaffiliated Bank Sweep Programs should be required to respond to the following questions:

1. Are banks in the program clearly identified to the depositors?
2. Can the banks be changed without prior notice to the depositors?
3. Can a depositor's funds be moved between banks in the program and, if so, under what circumstances?
4. What are the fees paid to the broker by the banks?
5. How does the broker market the program?

d. Other Deposit Arrangements

New technology has broadened the options that consumers have to transfer funds and make payments. The Federal Reserve found, in a 2019 study, that the number of payments by check in the United States declined by 7.2% per year from 2015 through 2018, and that the value of such transactions declined by 4.0% per year over the same period.[32] The decline of check transactions reflects the rise of alternative payment mechanisms such as prepaid cards and peer-to-peer payments. Prepaid cards and peer-to-peer payment systems reduce the friction previously endemic to fund transfers and have thus improved efficiency. At the same time, these services have altered the traditional deposit market.

Prepaid cards and some peer-to-peer systems permit a user to establish an account with the vendor and have funds held by the vendor for a specified or potentially undetermined period of time. These vendors typically hold customer funds – in many cases, very large amounts of customer funds – in deposit accounts at IDIs. According to the Government Accounting Office, between January and June 2017, $189 billion in payments were made through FinTech providers.[33]

[32] The 2019 Federal Reserve Payments Study, available at https://www.federalreserve.gov/newsevents/pressreleases/files/2019-payments-study-20191219.pdf. The 14.5 billion check transactions observed in 2018 have declined from 18.1 billion in 2015. For comparison, the same study reports that there were more than 40 billion check transactions in 2000.

[33] GAO Report to Congress on Financial Technology (Mar. 2018).

As of March 31, 2020, PayPal (including Venmo) customers held approximately $22.8 billion in their accounts, some of which PayPal places into deposit accounts.[34]

As licensed money transmitters, PayPal and other similar peer-to-peer payment providers are required to hold customer funds in liquid assets including deposit accounts, but they have no constraints on moving funds from bank to bank in search of higher rates or higher fees, for their own profit.

IV. A Better Regulatory Approach to the Modern Deposit Market

a. Summary of Suggested Approach

The FDIC's historic approach, and the approach taken by the Proposal, toward brokered deposits has been piecemeal, without a common thread or theme connecting the diffuse parts of the regulatory approach. In that vein, the Proposal does not proclaim any clear policy goal beyond "modernization": Is the goal to promote stability? Reduce potential claims on the deposit insurance fund? Encourage IDIs to return to a more brick-and-mortar focus?

We believe that a better approach to brokered deposit regulation would focus on deposit stability. Currently, there is no relationship between stability and brokered versus non-brokered status under the current regulatory framework; many brokered deposits are stable and many non-brokered deposits are not.

A truly modern and comprehensively reconsidered approach to brokered deposits focusing on stability has support in legislative precedent and FDIC actions and interpretations over the previous 30 years. Moreover, we note that the FDIC has many tools available to further its goals, not just rulemakings, among them supervisory guidance and supervisory priorities. The FDIC could reduce emphasis on brokered deposits that are stable in its supervisory process, and issue guidance saying so, particularly with respect to Call Reports, as described below.

b. Focus on Stability

The FDIC has long stated, including in the recent ANPR on brokered deposits, that brokered deposits can be a volatile and unstable source of funding for banks, are correlated with a higher risk of bank failure, and increase the cost to the FDIC of resolving failed banks. But the FDIC has never produced data supporting these positions. If deposit stability is the goal – and we agree that it should be – the status of a deposit as brokered versus non-brokered is a poor proxy for volatility. Some brokered deposits are more stable than so-called "core" deposits. Some brokered deposits may not be. Rather than focus on the brokered/non-brokered distinction, the FDIC's efforts should focus on favoring stable deposits and disfavoring volatile ones, regardless of whether such deposits are brokered or non-brokered.

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[34] PayPal Holdings, Inc. 10-Q filed with the SEC for the first quarter of 2020. Of the total, approximately $8.9 billion was held as cash or cash equivalents and $0.6 billion was held as time deposits. The remainder was either held as available for sale debt securities or constituted funds receivable for PayPal.

When a third party is involved in the placement of deposits, the stability of those deposits derives from (1) the incentives to the third party and (2) any contractual limitations on the ability of the deposits to be withdrawn by either the depositor or the third party.

The Proposal would permit deposits placed through Unaffiliated Bank Sweep Programs to be eligible for the PPE through the same process as Affiliated Bank Sweep Programs. In Affiliated Bank Sweep Programs, there are strong incentives for deposits to be maintained within the group of affiliated entities that make up the financial organization. If the program is not properly structured, a broker-dealer not affiliated with a bank could have an incentive to pull deposits and seek higher fees.

The same is not true with Brokered CDs because of the early withdrawal provisions. There is ample empirical evidence of their stability in stressed conditions, as described in more detail in our ANPR Comments. Therefore, under the rubric of deposit stability, there is no justification for differential treatment of Brokered CDs.

The Proposal provides a new exception for "placements that enable transactions." However, these placements do not bear the hallmarks of stability. Payment processors often have the incentive to shop for the highest return. Their profits are based in large part on what they can earn on the deposits. As with Unaffiliated Bank Sweep Programs, there are no contractual measures to ensure stability.

As an alternative to the Proposal's approach, we suggest that the FDIC categorize deposit arrangements based on their demonstrated, empirical stability and whether there are contractual features that ensure stability. Once appropriately categorized as stable or not-stable, the FDIC should provide regulatory relief for stable deposit arrangements in line with the relief described in the Proposal (i.e., expedited processing of PPE applications, increasing the limitation on the percentage of assets placed from 10% to 25%, and exempting stable deposits from categorization as brokered on an IDI's Call Report).

Such an approach would better align with the modern deposit market and ensure that IDIs have access to stable, diverse, and cost-effective sources of funding that increase the safety and soundness of IDIs that appropriately utilize brokered deposits.

c. Call Report Distinction Between "Core" and "Brokered" Deposits

The term "core deposit" is not defined by statute or regulation and has defied definition without significant qualification. The designation of a liability as "core" or "non-core" is accomplished through definitions in the Uniform Bank Performance Report ("UBPR"), a financial reporting tool on which public comment has never been solicited.[35] The UBPR deems all fully-insured brokered deposits "non-core" liabilities, and the FDIC does not treat them as core deposits regardless of their terms or characteristics.

[35] *See* the UBPR definition of "core deposit," *supra* note 19.

The FDIC's Risk Management Manual of Examination Policies (the "FDIC Examination Manual") provides the following description of a core deposit:

> Core deposits are generally stable, lower cost funding sources that typically lag behind other funding sources in the need for repricing during a period of rising interest rates. The deposits are typically funds of local customers that also have borrowing or other relationships with the institution. *Convenient branch locations, superior customer service, extensive ATM networks and low or no fee accounts are factors that contribute to the stability of the deposits.*[36]

The FDIC Examination Manual cautions that:

> In some instances, deposits included in the UBPR's core deposit definition might exhibit characteristics associated with more volatile funding sources. For example, out-of-area certificates of deposit (CDs) of $250,000 or less that are obtained from a listing service may have a higher volatility level, but be included in core deposits under the UBPR definition. Management and examiners should not automatically view these deposits as a stable funding source without additional analysis. Alternatively, some deposit accounts generally viewed as volatile, non-core funds by UBPR definitions (for example, CDs larger than $250,000) might be considered relatively stable after a closer analysis. [37]

The Federal Reserve Board's Commercial Bank Examination Manual (the "Board Examination Manual") contains an important additional caveat. In discussing the use of financial ratios to measure the stability of funds, the Board Examination Manual notes that the ratios "necessarily employ assumptions about the stability of an institution's deposit base" and cautions liquidity managers and examiners to "take care in constructing the estimates of stable or core liabilities. . . . This caution has become especially important as changes in customer sophistication and interest-rate sensitivity have altered behavioral patterns and, therefore, the stability characteristics traditionally assumed for retail and other types of deposits traditionally termed 'core.'"[38]

Similarly, the FDIC notes in its guidelines for deposit management programs the "[s]trong competition for depositors' funds and customers' preference to receive market deposit rates . . ." in emphasizing the need for careful deposit management.[39]

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[36] FDIC Examination Manual at 6.1-8 (emphasis added).
[37] *Id*. at 6.1-9.
[38] Board Examination Manual, Section 4020.1 at 43-44.
[39] FDIC Examination Manual at 6.1-9.

The FDIC has asserted that a 2011 study of brokered deposits that it conducted as a requirement of the Dodd-Frank Act[40] supports the existing definition of "deposit broker," including the FDIC's interpretations, and the exclusion of brokered deposits from the definition of "core deposit" used in the UBPR. But the analysis and conclusions in that study merely confirm the fact that there is no consensus on the definition of the term "core deposit" and the FDIC's statements about the behavior of brokered deposits, particularly their volatility, are not based in fact.

The FDIC Study made no attempt to arrive at a consistent or meaningful definition of a "core deposit." Indeed, the FDIC Study conceded that many of the independent studies reviewed by the FDIC define "core deposits" based on the insured status of deposits irrespective of the whether the deposits were "brokered."[41]

Notwithstanding Congress' direction of the FDIC Study, the FDIC amended its definition of "core deposit" to exclude fully insured brokered deposits (which previously were categorized as core) before the FDIC Study was complete, contravening the clear intention of Congress to defer any significant changes in FDIC policy on brokered deposits until the FDIC completed its study and submitted its findings and recommendations to Congress.

In 2013, the Basel Committee on Banking Supervision ("BCBS") produced a working paper on liquidity stress testing ("BCBS Working Paper").[42] The BCBS Working Paper noted that core deposits are associated with greater funding stability, but goes on to state:

> [T]he definition of "core" varies across studies and one paper shows that deposits commonly labeled as core do not exhibit these tendencies uniformly. This suggests that liquidity stress tests should avoid coarse definitions when possible.[43]

The BCBS Working Paper highlights studies of two U.S. banks during the recent financial crisis: Wachovia Bank and Washington Mutual Bank.[44] Those studies indicate that the "definition of 'core' deposits proved to have little bearing on actual deposit run-off."[45] Insured deposit run-off at one of the institutions "remained consistent with historical trends during non-stress periods." Together, the two banks averaged 9% one-month deposit run-off during their peak stress periods, which is substantially less than the 24% run-off assumed by the BCBS.[46]

The BCBS Working Paper and the FDIC's own statements make clear that the concept of a core deposit is illusory. The FDIC has no reliable method to delineate stable deposits from non-

[40] FDIC, Study on Brokered Deposits and Core Deposits (July 8, 2011), available at https://www.fdic.gov/regulations/reform/coredeposit-study.pdf (hereinafter, "FDIC Study").
[41] *Id.* at 36.
[42] Liquidity Stress Testing: A Survey of Theory, Empirics and Current Industry and Supervisory Practices, BCBS Working Paper No. 24 (Oct. 13, 2013).
[43] *Id.* at 18.
[44] *Id.* at 8.
[45] *Id.*
[46] *Id.*

stable deposits, and has provided no guidance with respect to when deposits characterized as core should be re-characterized as non-core and vice versa.

We ask the FDIC to re-assess the concept of "core" versus "non-core" deposits in the context of the stability of brokered deposits. The current concept of core deposits is an arbitrary and ineffective regulatory tool that sows unnecessary confusion and frustration among IDIs and their examiners.

V. Recommended Changes to the Proposal

In this section, we first provide three "big picture" observations and suggestions on critical uncertainties for the industry that are left unaddressed by the Proposal as written. Second, we provide comments on areas of the Proposal that would benefit from additional clarification.

a. Critical Uncertainties

i. Policy Goals

The Proposal leaves unclear the FDIC's policy goals. Its only stated policy goal is to "modernize its brokered deposit regulations to reflect recent technological changes and innovations that have occurred."[47] Yet nothing in the Proposal describes the specific technological changes that the FDIC had in mind when crafting the Proposal. Competition between brick-and-mortar banks, including community banks, on the one hand, and online banking platforms on the other, is a major technological change since the brokered deposit laws took their current shape in 1991. So is the advent of FinTech lenders in recent years. We recommend the FDIC go into more detail about the exact technological changes to which it is adapting its regulations.

There is also nothing in the Proposal to tell the industry how the various changes in it would succeed in modernizing the brokered deposit regulations, or how they would address issues that have arisen because of technological changes. The Proposal would make three significant changes to the current brokered deposit regulatory regime:

- It would add a new exception from the deposit broker definition for employees of wholly-owned subsidiaries of banks.
- It would expand on and modify the definition of "facilitation" in determining whether a person meets the definition of a deposit broker by "facilitating" the placement of deposits for others.
- It would amend the criteria for the PPE to the deposit broker definition, and adopts a more detailed and concrete administrative process for any person seeking to rely on the PPE to get the FDIC's approval.

None of the discussion around any of these three changes connects any of them to the FDIC's stated goal of modernization. We agree with the goal. Any final rule should spell out how the FDIC intends to achieve it.

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[47] Proposal at 7453. *See supra* Section III of this letter for a discussion of our recommended policy approaches, in addition to the stated goal of modernizing the brokered deposit regulations.

ii. Status of Current Guidance

A critical issue for the banking industry, which generates substantial funding from third-party deposit arrangements, is how much it will be able to rely on current guidance from the FDIC regarding brokered CD programs, deposit sweep programs, and other deposit products that are or may be classified as brokered.

In the Proposal, the FDIC indicates that prior staff advisory opinion letters are being evaluated "[a]s part of this rulemaking process" and seeks comment on which staff opinions should be codified.[48] But the Proposal does not explain what the status of any other advisory letters will be after the final rule, and it appears to ignore the fact that many relevant letters, some of which are very important, are unpublished and thus cannot receive public comments.

The FDIC should clarify whether a final rule will be intended to supersede all prior staff opinions, or all published staff opinions, or only a certain subset of staff opinions that will presumably be discussed in a final rule.

iii. Administrability of the PPE Application Process

The Proposal's discussion of the application process[49] is ambiguous on several key issues. For example, the Proposal does not address the application process, if any, applicable to financial institutions that have already obtained FDIC confirmation of the primary purpose exception's applicability to their deposit placements. If every financial institution already operating under the PPE must re-apply through the new process, will the FDIC make a determination on the "expedited" timeframe provided for certain applicants?[50] On a faster timeline? Even if so, what should such a financial institution do during the time between application and approval? Will it be permitted to continue to operate under its previously-received exception until the FDIC acts on its new application?

In general, how should financial institutions operate between application and approval? May a program go ahead on a provisional basis? Must a financial institution that has been approved re-submit a new application for a new or modified sweep arrangement for the same line of business?

Questions arise for new applicants as well. In particular, could a nonfinancial company apply to the FDIC to rely on the PPE? For example, could a large auto manufacturer develop a program through which it places a portion of employees' wages into deposit accounts at depository institutions and be eligible for the PPE?

[48] Proposal at 7460.
[49] *Id*. at 7461-62.
[50] *Id*. at 7461.

Separately, must brokers relying on the PPE for deposits in special reserve accounts, as required by the SEC,[51] apply for the PPE through the new process? The FDIC should clarify the answers to these questions.

Additionally, while the Proposal discusses sweep programs, there are a number of other third-party deposit arrangements that are established to accomplish a bona fide business, legal or regulatory purpose that are not addressed. These arrangements include, but are not limited to, the following:

- *Property Management Firms.* A bank receives deposits from property management firms that assist in the maintenance, upkeep, collection of rent, management of facilitates, payment of expenses, and allocation of profits, at the direction of underlying property owners.
- *Mortgage Servicers.* A bank receives deposits by mortgage servicers who are collecting funds from borrowers to fulfill certain lender requirements.
- *Residential/Commercial Escrow Services.* A bank receives deposits from title insurance companies that offer various services to facilitate real estate transactions, including providing escrow services.[52]
- *Qualified Settlement Funds.* A bank receives deposits from a court-appointed custodian of funds used to settle class-action lawsuits.
- *Broker-Dealer Special Reserve Accounts.* A bank receives deposits from a broker-dealer to satisfy the regulatory requirements of a broker-dealer registered with the SEC.

FDIC Advisory Opinion 17-02 addresses some of the above arrangements and specifies that such arrangements "would not be viewed as 'brokered deposits.'"[53] However, the Proposal leaves unclear whether these arrangements would require firms to apply for the PPE using the proposed application procedure. We urge the FDIC to clarify the status of these types of arrangements as well as address the status of Advisory Opinion 17-02, particularly with respect to whether the presence of third-party fees may affect whether the arrangement is eligible for the PPE.

b. Items for Clarification

i. Facilitation Prong of the Deposit Broker Definition

The Proposal introduces a number of ambiguities in the language used to describe the facilitation of placing deposits. Among other ambiguities, the Proposal indicates that a putative deposit broker might "provide assistance" or be "involved in" setting rates, fees, or terms for a deposit account, or "take an active role" in opening an account.[54] While the Proposal does say that engaging in this level of involvement would make the relevant deposits brokered, it does not specify the circumstances or provide sufficient examples for the industry to know when a financial

[51] *See* Rule 15c3-3 under the Securities Exchange Act of 1934, as amended.
[52] For a description of escrow deposit arrangements, *see* Clark Article, *supra* note 23, at 142.
[53] FDIC, Advisory Opinion 17-02 (June 19, 2017), https://www.fdic.gov/regulations/laws/rules/4000-10357.html.
[54] Proposal at 7457.

institution is "providing assistance," "involved in setting terms," or "taking an active role" in opening an account.

The Proposal contains an exception from the facilitation prong for purely "administrative" functions.[55] But this exception is also ambiguous. The Proposal provides that reporting and bookkeeping would constitute purely administrative functions, but only that "assisting in decision-making" or "steering persons" to a particular financial institution would not.[56] The FDIC should provide more examples and more clarity.

The Proposal also would define "facilitation" to include "directly or indirectly shar[ing] any third-party information with the insured depository institution."[57] Many "listing services," pursuant to FDIC staff opinions, are permitted to share customer information with IDIs to permit depositors to open accounts using rates listed on the listing service.[58] In this context, we believe it is appropriate to effectively repeal that guidance and cause deposits originating through such listing services to be brokered deposits.

However, we note that the proposed facilitation definition poses one problem. The FDIC should clarify that this definition is only applicable to non-affiliated third parties of insured depository institutions. Under federal privacy law, affiliates are permitted to share information under certain constraints,[59] and such permissible activity should not, on its own, result in an affiliate being classified as a deposit broker.

ii. 25% Test Ambiguities

The Proposal would allow agents and nominees to be eligible for the PPE if the party places less than 25 percent of the customer "assets under management" in a particular "line of business" at depository institutions (the "25 Percent Test").[60] However, the Proposal does not define the terms "line of business" or "assets under management" (or, for that matter, "agent" or "nominee"). The imprecise use of these terms may result in an ambiguous application of the 25 Percent Test, contrary to the FDIC's stated goal of a clear, bright line test.[61] "Assets under management," in particular, has a specific regulatory meaning for registered investment advisers that would not apply to broker-dealers that are not registered investment advisers, or to unregistered entities.

While using "assets under custody" would be appropriate for a broker-dealer that is not a registered investment adviser, it does not clarify the application of the 25 Percent Test to nonfinancial firms. What if a nonfinancial firm, such as the hypothetical auto manufacturer we refer to in Section V.a.iii. above seeks to rely on the exception? Such a company would, presumably, have zero assets under management and zero assets under custody. How would it

[55] *Id*.
[56] *Id*.
[57] *Id*.
[58] *See, e,g.,* FDIC Advisory Op. No. 04-04.
[59] Gramm-Leach-Bliley Act, Title V, Subtitle A, *codified at* 15 U.S.C. § 6801-6809 and relevant regulations promulgated thereunder.
[60] Proposal at 7459.
[61] *Id*.

qualify under the 25 Percent Test? Should it report its "assets under management" (if such term is retained) as zero? The FDIC should clarify.

iii. Third-Party Fees

In addition to the 25 Percent Test, the Proposal would allow third party agents or nominees to meet the PPE if they "[place] depositors' funds into transactional accounts for the purpose of enabling payments" (the "Transactions Test").[62]

The Proposal indicates that eligibility for the primary purpose exception under the Transactions Test is conditioned on whether the third party pays "any sort of interest, fee, or provides any remuneration" to the depositor.[63] If any such fee is paid, the FDIC would "more closely scrutinize the agent's or nominee's business to determine whether the primary purpose is truly to enable payments."[64]

This limitation of the fees paid to depositors is curious in light of the FDIC's previously voiced concerns. In past releases and discussions, the FDIC has indicated its concern that fees paid by depository institutions to third parties increases the likelihood that the third party may withdraw the deposits in search of higher fees elsewhere – an outcome that the FDIC has previously believed to be less likely if more of the fee were paid to the depositor.

iv. Savings and FDIC Insurance Limitation Issues

Placements of deposits for the primary purposes of encouraging savings, maximizing yield, or providing deposit insurance would not be eligible for the PPE.[65]

While it seems clear that the FDIC does not intend for the primary purpose exception to be available for brokers whose primary business is moving customer funds from a securities account into deposit accounts, it is unclear why the FDIC believes that these accounts are not effectively screened by either the 25 Percent Test or the Transactions Test. Perhaps another goal of the FDIC is to exclude certain sweep programs offered by "FinTech" broker-dealers advertising high rates.

In either case, the Proposal does not address the ramifications of this limitation on multi-bank sweep programs that place funds at multiple banks to maximize deposit insurance. All of these programs are designed to provide additional deposit insurance. Even a single-bank sweep program in which depositors receive pass-through deposit insurance coverage in an amount no greater than the standard maximum deposit insurance amount "encourages" savings in an economic sense if the depositor receives any interest at all on their deposits. This provision of the Proposal may have been drafted more broadly than the FDIC may have intended.

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[62] *Id*.
[63] *Id*. at 7459-60.
[64] *Id*. at 7460.
[65] *Id*.

Thank you for the opportunity to submit these comments. We would be happy to meet with you to discuss the information in this letter.

Sincerely,

[redacted]

Paul T. Clark

[redacted]

Casey J. Jennings

[redacted]

Nathan S. Brownback