

FEDERAL DEPOSIT INSURANCE CORPORATION

12 C.F.R. PART 330

Recordkeeping Requirements For Deposits
Placed by Deposit Brokers

AGENCY: Federal Deposit Insurance Corporation ("FDIC").

ACTION: Notice of proposed rulemaking.

SUMMARY: The FDIC is proposing to amend certain recordkeeping requirements affecting the manner in which insurance coverage on brokered deposits is determined. The amendments would require disclosure in the account records of the bank of the identity of each person having a beneficial ownership interest in such accounts in order for those persons to obtain insurance coverage. The information provided will enable the FDIC to: (1) more accurately assess its insurance exposure in insured banks utilizing brokered deposits, (2) shorten the delay in determining the validity of insurance claims on such accounts and thus speed the entire insurance settlement process as required by law, (3) assess more accurately and quickly the viable alternatives in a failing bank situation under the section 1823(c)(4) cost test, and (4) prevent fraud and abuse designed to increase insurance coverage.

DATE: Comments must be received by [30 days from publication in the Federal Register.]

ADDRESS: Comments should be sent to Hoyle L. Robinson, Executive Secretary, Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, D.C. 20429. Comments may be hand delivered to Room 6108 on weekdays between 8:30 a.m. and 5:00 p.m. and should reference the date and page number of this issue of the Federal Register. All written comments will be made available for public inspection during normal business hours at the Office of the Executive Secretary.

FOR FURTHER INFORMATION CONTACT: Joseph A. DiNuzzo, Senior Attorney, or Patti C. Fox, Attorney, Legal Division, (202) 389-4171, or William G. Hrindac, Examination Specialist, Division of Bank Supervision, (202) 389-4761, Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, D.C. 20429.

SUPPLEMENTARY INFORMATION:

As announced in the Federal Register on April 11, 1985, the FDIC intends to review and revise its current regulations on deposit insurance coverage found at 12 C.F.R. Part 330. See 50 Fed. Reg. 14247, 14248 (1985). The proposed recordkeeping regulations constitute the first of several changes contemplated for Part 330. Additional changes to Part 330 will be made pending further study.

The banking system has changed considerably in the recent past. Deregulation of interest rates on deposits has substantially increased the funding costs of banks and created pressures to invest in riskier loans and other investments in order to obtain higher yields necessary to cover the increased costs with a margin of profitability. Vigorous competition for quality loans and investments has added to this tendency to assume greater risk in order to obtain higher yields. Many state legislatures have liberalized the investment powers of state-chartered depository institutions by authorizing them to invest in a variety of new, higher-risk undertakings such as real estate development. Banks are also taking advantage of sophisticated new investment and fee-generating mechanisms such as futures contracts and interest rate swaps. As a result, the banking system today is considerably more diverse and complicated, thereby posing potentially greater risks to the banks and to the FDIC insurance fund.

With regard to bank funding in particular, deregulation of interest rates on deposits now permits banks to compete for deposits on the basis of price, i.e., by offering higher interest rates. Technical improvements in data processing and telecommunications have expanded deposit markets geographically while the existence of the \$100,000 FDIC insurance coverage has effectively created a risk-free investment unit for potential depositors everywhere. As a result, depositors may now pursue the highest risk-free yields available from insured banks throughout the United States. Insured banks in turn are now able to attract virtually unlimited funding simply by offering marginally higher rates of interest. Moreover, this insured funding can be obtained very rapidly regardless of a bank's financial condition. In many instances, the banks most willing to pay marginally higher rates are those preparing to embark on high-risk investment strategies. Others in this category are already in a weakened or failing condition and seeking to prolong their life, while hoping to recoup their losses through high-risk lending and investment practices. A significant number of companies whose business it is to identify insured banks paying high rates of interest on deposits and to place customers' deposits with those banks have provided funding to banks based solely on the interest rates offered. The activities of these deposit brokers have resulted in increased losses to the FDIC when the depository banks eventually failed.

Bank failures have increased dramatically in recent years. For the three year period of 1979 through 1981, 30 banks failed. From January 1982 through December 1984, there were 169 bank failures. As of the end of June, 52 banks had failed in 1985. There are approximately 1000 banks on the problem bank list. Given the pace of failures to date, the number of banks which will fail this year will likely exceed the post-Depression record of 79 failures in 1984.

Data collected by the FDIC has established a clear correlation between brokered deposits and problem banks. Between 1982 and 1984, 69 of the FDIC-insured banks that failed held over \$1 billion in fully insured brokered deposits; and, in two cases, brokered funds represented more than 75 percent of the closed banks' deposits. A recently completed survey of FDIC-insured banks and thrifts holding fully insured brokered deposits in excess of five percent of their deposits revealed \$2.3 billion of such funds in more than 70 institutions. These figures illustrate that an insured bank can obtain a substantial amount of brokered deposits, thereby acquiring the ability to alter radically the character of the bank's investments and the risk the bank poses to the FDIC insurance fund.

Unfortunately, the precise amount of the risk to the insurance fund is not always apparent because of the varying nature of the brokerage arrangements. In many instances, brokers obtain large denomination certificates of deposit in bearer form or as agents or nominees for their client investors. In these cases, it is impossible to determine the extent of deposit insurance coverage, and hence the risk to the insurance fund, from the records of the bank because the beneficial ownership of these deposits is revealed only in the records of the broker. Based on a recent survey, it is estimated that up to two-thirds of all fully insured brokered deposits may be held in this manner, i.e., as certificates of deposit in bearer form or by brokers as agents or nominees for investors.

In view of the increased rate of bank failures and the frequent use of brokered deposits by failing banks, the FDIC has an increasing need to know the extent of insurance coverage of deposits in problem and failing banks. This information is important to the FDIC in meeting its statutory obligation under the assistance provisions of the Garn-St Germain Depository Institutions Act of 1982. See 12 U.S.C. 1823(c). Generally, section 1823(c) authorizes the FDIC to provide assistance, directly or through a merger, to a failing insured bank to prevent its closing or to facilitate the assumption of its liabilities after the bank closes. In making a determination under section 1823(c), the FDIC generally is bound by a "cost test": the amount of assistance is limited to that "reasonably necessary to save the cost of liquidating, including paying the insured accounts." 12 U.S.C. 1823(c)(4)(A). A proper evaluation of the risk of exposure to the FDIC insurance fund under the cost test requires as accurate an assessment as possible of the amount and number of potentially insured accounts. The proposed regulations will provide the information necessary to facilitate an assessment of the amount of insurance to be afforded to potentially insured brokered deposits promptly at the time of a bank's closing.

The FDIC's current rules on recordkeeping provide that the deposit account records of an insured bank are conclusive as to the existence of any relationship pursuant to which funds in the account are deposited and on which a claim for insurance coverage is founded. 12 C.F.R. 330.1(b)(1). If the account records reveal a

relationship between the depositor and other persons which may provide a basis for additional insurance, the details of the relationship, including the interests of other persons, must be disclosed either in the bank's records or the depositor's records maintained in good faith and in the regular course of business. 12 C.F.R. 330.1(b)(2). When an agent holds an account for a principal, for example, the insurance coverage "flows through" the agent to the principal so long as the bank's records indicate that the account is held in an agency capacity and either the bank's or the agent's records show the ownership interest of the principal in the account. 12 C.F.R. 330.2. In addition, section 330.11 provides that an owner of a negotiable deposit instrument will be recognized for insurance purposes as if his or her name and interest were disclosed on the bank's records, provided the instrument was negotiated to that owner prior to the bank's closing. 12 C.F.R. 330.11.

Given the frequency and volume of brokered deposits held by failing banks and the complex account ownership devices commonly used, the current recordkeeping rules do not provide the FDIC with sufficient information to assess its insurance exposure. In addition, the current rules do not sufficiently enable the FDIC to determine accurately the potential costs of viable alternatives in assisting, merging, or liquidating a failing bank as required under section 1823(c). The inability to obtain ownership information on brokered funds from a bank's records may impede the decisional process and expose the insurance fund to additional costs. In view of the volume of brokered deposits being placed in problem banks, the FDIC must have a means of identifying the beneficial ownership interests in these funds. The FDIC is required by law to settle insured accounts as expeditiously as possible. 12 U.S.C. 1821(f).

In January 1985 the FDIC issued a regulation imposing monthly reporting requirements on all FDIC-insured banks maintaining a certain level of brokered deposits. 12 C.F.R. 304.4. The rule is designed to enable the FDIC to monitor the receipt of insured brokered funds and take appropriate supervisory action to curb improper activities. The proposed recordkeeping requirements thus parallel the supervisory efforts of the FDIC as regulator by also addressing concerns raised in the FDIC's capacity as receiver and insurer. In that regard, the proposed recordkeeping regulations do not cover the issues raised in the FDIC's rule on brokered deposits now in litigation. See 49 Fed. Reg. 13,003 (1984). There is no limitation on insurance coverage for brokered deposits under the proposed rules nor do they operate in any manner as a replacement for the prior rule.

The proposed regulations would create an exception from existing recordkeeping requirements for deposits placed by deposit brokers. In situations where deposit brokers place customers' funds with insured banks, the banks' records would have to indicate the existence of the agency relationship and the names of the owners of the deposits. If not, the recordkeeping requirements for "flow

through" insurance coverage to the agent's principals would not be met, and the deposits would be deemed held by the deposit broker in his or her individual ownership capacity for insurance purposes. The proposal defines a "deposit broker" as any person engaged in the business of placing or facilitating the placement of funds of third parties with insured banks. It also encompasses businesses that place funds with insured banks for the purpose of selling interests in the deposits to third parties. The use of the phrase "engaged in the business of" deposit brokering is intended to exclude implicitly from the definition of deposit broker persons and entities such as insured banks which solicit funds for themselves, trust departments of depository institutions, trustees of employee benefit plans, trustees of trusts established for a purpose other than that of placing funds with insured banks, agents or nominees whose primary purpose is not the placement of funds with banks, and deposit-listing services. In addition, the current regulation covering negotiable instruments, 12 C.F.R. 330.11, has been amended to prevent easy circumvention of the proposed rule.

The possibility of fraud and abuse is of particular concern to the FDIC in view of the potential losses to the insurance fund. Limiting potential fraud and evasion of insurance limits is one purpose of the recordkeeping rules. As the Federal Home Loan Bank Board recently observed in the proposed revision of its insurance regulations, the \$100,000 insurance coverage has encouraged the development of complex ownership devices. 50 Fed. Reg. 19,185 (1985). Such devices increase the possibility of the invention of fraudulent relationships designed to increase insurance coverage. FDIC investigations in several recent bank failures have uncovered facts indicating possible fraud and misuse in connection with brokered funds. In some instances, a linked financing arrangement between the deposit broker and the bank results in questionable, abusive loan practices, such as ill-advised loans to out-of-territory customers or illegal loans to insiders. The FDIC believes the proposed recordkeeping regulations will help to deter the possibility of fraud and abuse in connection with brokered deposits.

The proposed amendments to the current recordkeeping rules would be authorized by section 12(c) of the Federal Deposit Insurance Act (12 U.S.C. 1822(c)) (the "Act"), which gives the FDIC discretionary authority in the non-recognition of certain claims:

(c) Except as otherwise prescribed by the Board of Directors, neither the Corporation nor such new bank or other insured bank shall be required to recognize as the owner of any portion of a deposit appearing on the records of the closed bank under a name other than that of the claimant, any person whose name or interest as such owner is not disclosed on the records of such closed bank as part owner of said deposit, if such recognition would increase the aggregate amount of the insured deposits in such closed bank.

The FDIC's authority to implement appropriate regulations to determine insurance coverage is well within the express statutory language of section 1822(c). Further, section 1819 "Tenth" of the Act authorizes the FDIC to prescribe the rules and regulations necessary to carry out the provisions of the Act. 12 U.S.C. 1819 Tenth. The FDIC can thus exclude from deposit insurance coverage those categories of persons not listed on bank records as owners of deposits, if recognition would increase the aggregate amount of insured deposits in a closed bank.

The FDIC believes that brokered deposits represent a unique situation very different from other custodial accounts, thereby warranting disclosure of the beneficial owners on the bank's records. The other major category of custodial accounts is employee benefit plans, in which a high percentage of all such deposits are insured. See 12 C.F.R. 330.1(c) and 330.10. As a matter of public policy, employee benefit plans have been accorded special treatment under the law to support and encourage their retirement and pension functions. See 29 U.S.C. 1001. The extensive regulation to which employee benefit plans are subject provides safeguards against fraud and abuse. Although employee benefit plans are investment vehicles, the custodian of such a plan is subject to legal and fiduciary duties not present in the typical money brokerage relationship. In contrast, the use of brokered deposits has contributed to the number and complexity of bank failures and has caused sizeable losses to the FDIC insurance fund.

Other types of custodial accounts do not present the same prospect for dramatic growth as do brokered deposits; thus, there is no need to except them from current recordkeeping rules. Nor do other custodial accounts appear with as much frequency in failed banks compared to brokered deposits. The FDIC, however, may determine the necessity for stricter recordkeeping rules for other custodial accounts in the future. Comments are invited on the prospect of expanding the scope of this proposed amendment to other custodial accounts, as well as on all aspects of the proposed regulation.

Procedural Requirements

In accordance with the Regulatory Flexibility Act (5 U.S.C. 601-612), the Board of Directors hereby certifies that the rule would not have a significant economic impact on a substantial number of small entities. The rule would require that the records of an insured bank pertaining to deposit accounts placed by deposit brokers disclose the identity of each person having a beneficial ownership interest in such accounts and the amount of that interest. The banks that are most likely to be affected by the rule are those issuing large (\$1 million and over) certificates of deposit in bearer form or in the names of nominees for subsequent participation by individual depositors up to \$100,000 each. Such banks tend to be the larger institutions. The recordkeeping requirement contained in

this rule has been submitted to the Office of Management and Budget for review pursuant to section 3504(h) of the Paperwork Reduction Act (44 U.S.C. 3504(h)).

Although the FDIC usually provides a sixty-day comment period for proposed regulations, the Board of Directors has determined that a thirty-day comment period is necessary in this situation because of the increasing number of bank failures and the serious risk posed to the insurance fund by brokered deposits. The Board believes that the proposed amendments will aid the FDIC in carrying out its duties as regulator and insurer, and believes these rules will provide an additional tool for monitoring brokered deposits and their impact on banks.

List of Subjects

Administrative practice and procedure; Bank deposit insurance; Banks, banking; Federal Deposit Insurance Corporation; Foreign banks, banking; Reporting and recordkeeping.

For the reasons set out above, it is proposed that Part 330 of Title 12 of the Code of Federal Regulations be amended as set forth below.

Part 330 - Clarification and Definition of Deposit Insurance Coverage

1. The authority citation for Part 330 is amended to read as follows:

Authority: 12 U.S.C. 1813, 1817, 1821, 1822, 1823.

2. It is proposed that paragraph (b) of section 330.1 be amended by revising subparagraph (2) to read as follows:

§ 330.1 General principles applicable in determining insurance of deposit accounts.

* * * *

(b) * * *

(2) If the deposit account records of an insured bank disclose the existence of a relationship which may provide a basis for additional insurance, the details of the relationship and the interests of other parties in the account must be ascertainable either from the records of the bank or the records of the depositor maintained in good faith and in the regular course of business. Notwithstanding this general rule, no claim for insurance coverage based on an ownership interest in deposit accounts maintained by a "deposit broker" will be recognized unless the identities of the owners of such interests and the amount of those interests are disclosed on the records of the bank. For purposes of this section, "deposit broker" means any person engaged in the business of: (i) placing or facilitating the placement of funds of third parties with

insured banks, or (ii) placing funds with insured banks for the purpose of selling interests in the deposits to third parties. All funds placed or renewed by a deposit broker on or after [the effective date of this amendment] will be subject to this provision.

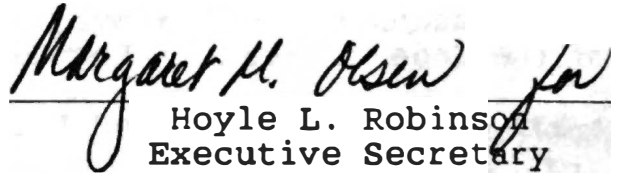
3. It is proposed that section 330.11 be amended by adding a new sentence at the conclusion thereof as follows:

§ 330.11 Deposits evidenced by negotiable instruments.

* * *

Notwithstanding the provisions of this section, an owner with an interest in a deposit placed by a "deposit broker," as defined in section 330.1(b)(2), and which is evidenced by a negotiable instrument shall be subject to the recordkeeping requirements of section 330.1(b)(2) for all purposes of claim for insured deposits.

By order of the Board of Directors this 29th day of July, 1985.



Hoyle L. Robinson
Executive Secretary

(SEAL)