Speeches, Statements & Testimonies

Statement by FDIC Board Member Martin J. Gruenberg on the Final Rule: Brokered Deposits and Interest Rate Restrictions at the FDIC Board Meeting

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Introduction

Last year, the FDIC Board acted on a Notice of Proposed Rulemaking (NPR) to amend the FDIC's regulation implementing the statutory prohibition against the acceptance of brokered deposits by insured depository institutions that are less than well capitalized.[1]

Despite the experience in two banking crises with the substantial liquidity risks posed by brokered deposits, the NPR would significantly weaken this important prudential rule by narrowing the types of deposit-related activities covered by the statutory prohibition.[2]

Today, the FDIC Board is considering a Final Rule that would make significant changes to the NPR that would dramatically further weaken the prudential protections of the current rule.

In addition, as a procedural issue, a draft of this complex and significant rulemaking was not available to members of the Board until last Wednesday, and a complete draft was not available until Saturday. The Board did not receive the actual Final Rule until shortly before midnight last night. In fact, an amendment to the regulatory text was just incorporated yesterday introducing a major new weakening change to the brokered deposit standard.

The changes in the Final Rule, combined with changes proposed in the original NPR, raise important and complex safety and soundness concerns that could have serious consequences for banks and the Deposit Insurance Fund. Further, the FDIC Board was not provided an adequate opportunity to review and evaluate these changes and their impact before being asked to vote.

For these reasons, I will vote against the Final Rule.

Changes Made by the Final Rule

The preamble to the Final Rule begins with the following statement,

"Significant technological changes have affected many aspects of the banking industry, including the manner in which banks source deposits. For many banks, brokered deposits are an important source of funds, and the marketplace for brokered deposits has evolved in response to technological developments and new business relationships."[3]

The premise for this Final Rule, as for the NPR, appears to be adjustment to technological change in the banking industry. However, an examination of the proposed changes indicates they

relate less to technological change than to interpreting the Federal Deposit Insurance Act to dramatically narrow the universe of deposits that are considered brokered. This has safety and soundness consequences because, under the Federal Deposit Insurance Act, a bank that is not well capitalized may not accept brokered deposits.[4]

The Act does not define what constitutes a brokered deposit. The determination of whether an activity results in a brokered deposit turns on the definition of "deposit broker."

The Act defines "deposit broker" as "any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions…."[5] The Act also provides an exclusion from the definition of deposit broker for "an agent or nominee whose primary purpose is not the placement of funds with depository institutions."[6]

The NPR would reduce the universe of deposits that are considered brokered by narrowing the interpretation of "facilitating the placement of deposits" and expanding the "primary purpose" exclusion. This Final Rule goes even further.

I would ask that the remainder of my statement, which describes how the Final Rule further narrows the interpretation of "facilitating the placement of deposits" and further expands the "primary purpose" exclusion to reduce the universe of deposits that are considered brokered, be included in the record of this Board meeting.

Before I conclude, I would like to describe the change that was added to the Final Rule just yesterday that would exclude from the definition of "deposit broker" exclusive deposit placement arrangements.

Exclusive Deposit Placement Arrangements

A new section was added to the preamble to the Final Rule yesterday, the day before this Board meeting, entitled "Exclusive Deposit Placement Arrangements." That section states,

"Section 29 (of the Federal Deposit Insurance Act) provides that a person meets the "deposit broker" definition (as described above) when it is "engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions or the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties" (emphasis added). The FDIC recognizes that a number of entities, including some financial technology companies, partner with one insured depository institution to establish exclusive deposit placement arrangements. Under these arrangements, the third party has developed an exclusive business relationship with the IDI and, as a result, is less likely to move its customer funds to other IDIs in a way that makes the deposits less stable.

As such, in an effort to clarify the types of persons that meet the "deposit broker" definition, and consistent with the statute, under this final rule, any person that has an exclusive deposit placement arrangement with one IDI, and is not placing or facilitating the placement of deposits at any other IDI, will not be "engaged in the business" of placing, or facilitating the placement of, deposits and therefore will not meet the "deposit broker" definition.

This change is also intended to address comments, further described below, that the FDIC would be inundated with applications from banks and third parties seeking the primary purpose exception under the proposed application process."[7]

The logic of this change to the regulatory definition of "Engaged in the Business of Placing Deposits" seems to be that the reliance of a sophisticated unaffiliated third party on only one bank for the placement of customer deposits will reduce the run risk of those deposits if the bank gets into trouble. It also appears that concern about operational burden to the FDIC from the change made by this Final Rule to the "primary purpose" exclusion prompts this additional change.

The preamble offers no evidence to support the assertion of reduced run risk. No specific comment on the NPR was cited requesting this regulatory change. It is a complete departure from the FDIC's historical interpretation of the statute. It appears some reliance may be placed on the statutory reference to "insured depository institutions" rather than to a single institution.

This regulatory change opens up great risk to the banking system. Under this change, a bank could rely for one hundred percent of its deposits on a sophisticated, unaffiliated third party without any of those deposits considered brokered. The bank could fall below well capitalized and still rely on those third party placed deposits for one hundred percent of its funding without any of those deposits considered brokered, effectively an end-run around the statutory prohibition on less than well capitalized banks receiving brokered deposits. A bank could form multiple "exclusive" third party relationships to fund itself without any of those deposits considered brokered.

There would be no limit to the reliance on these unaffiliated third party placed deposits, no application required, not even a notice.

And just to be clear, there is no regulatory requirement for the third party to stay with the bank. The third party could discontinue its "exclusive" relationship with a given bank and transfer its business to another bank with a new "exclusive" relationship.

This may be the most extreme change yet made to the brokered deposit rule, disregarding the FDIC's history of bank risk related to brokered deposits.

Conclusion

In conclusion, this Final Rule goes well beyond the NPR in weakening the important prudential protections of the current brokered deposit rule. In addition, for a rule of this consequence and complexity, the FDIC Board was given inadequate opportunity to review and evaluate the rule and its impact.

For these reasons, I will vote against this Final Rule.

Additional Issues with the Final Rule

Facilitating the Placement of Deposits

The NPR would define "engaged in the business of facilitating the placement of deposits" as those instances where a person's connection to a potential third party depositor, deposit account, or insured depository institution includes the following specified set of activities:

- sharing third party information with the bank;
- legal authority to close or move an account;
- setting rates, fees, terms and conditions for a deposit account; and
- acting as an intermediary between a third party placing deposits on behalf of a depositor and a bank.[8]

The preamble to the NPR states that the FDIC believes if the person is not engaged in any of these activities, "then the needs of the depositor are the primary drivers of the selection of a bank, and therefore the person is not facilitating the placement of deposits."[9]

The Final Rule would replace the first and the last of the four prongs with a new prong that would capture persons engaged in "matchmaking." Under the Final Rule,

"A person is engaged in matchmaking if the person proposes deposit allocations at, or between, more than one bank based upon both (a) the particular deposit objectives of a specific depositor or depositor's agent, and (b) the particular deposit objectives of specific banks…."[10]

The purpose of this change would appear to be to narrow further the scope of the statutory standard "*engaged in the business of facilitating the placement of deposits*".

Under the current regulation, whether a person is engaged in "facilitating the placement of deposits" has typically been a fact specific case-by-case evaluation of the arrangement based on a number of factors including whether the bank pays a fee and what service the fee compensates.[11]

The proposed definition of "facilitating the placement of deposits" in today's Final Rule appears to be preemptive, largely precluding consideration of other factors. For example, the definition would eliminate any reference to the fees paid by the bank in exchange for the service provided by the person involved in the placement of a third party's funds at the bank.

However, the amount, nature, and purpose of these fees is relevant to the relationship. Often these fees are based on the number of potential depositors referred to the bank. Thus, they play a key role in incentivizing referral volume, and are a hallmark of a brokered deposit. Removing fees from consideration significantly weakens the standard.

Primary Purpose Exception

The Final Rule, like the NPR, would also significantly expand the primary purpose exception to the definition of deposit broker.

Currently, as noted in the preamble to the NPR, in evaluating whether a person meets the primary purpose exception, FDIC staff analyzes the relationship between the depositor and the person acting as agent or nominee for the depositor.[12] The threshold question has been whether there is a substantial purpose for the deposit placement other than simply placing the funds or obtaining deposit insurance. Put another way, "staff has considered whether the deposit-placement activity is incidental to some other purpose."[13]

The NPR would have established an application process for an agent or nominee of a bank to request application of the primary purpose exception to the deposits resulting from their relationship. That analysis would have focused on the larger business relationship between the agent or nominee and its customers. It sets forth criteria that would appear, from the preamble to the NPR, to lead to a finding that the agent or nominee is not a deposit broker and the resulting deposits were not brokered.[14]

In addition, the NPR would provide that the primary purpose of an agent or nominee's business relationship with its customers would not be the placement of funds, subject to the application process, if less than 25 percent of the total funds the agent or nominee has under control for its customers, in a particular business line, is placed at depository institutions.[15]

This exception would set a 25 percent threshold per business line for what constitutes acceptable levels of deposit placement as part of an agent or nominee's activities. In the past, the FDIC has established 10 percent as representative of an incidental activity of the brokerage business in the context of sweep arrangements between a broker-dealer and affiliated depository institutions.[16]

The NPR, and now the Final Rule, more than double the amount of funds that may be swept between affiliates without being characterized as brokered.[17]

Perhaps most significantly, it also expands the interpretation to third parties not affiliated with the bank. Bank affiliates, since they are part of the same organization as the bank, may be more cautious withdrawing deposits because of the corporate relationship. No such consideration would apply to unaffiliated third parties.

Based on current reporting requirements, we cannot with confidence estimate the amount of deposits that could qualify for this exception. However, it is likely large given the current reporting of $1.2 trillion in brokered deposits,[18] which already excludes certain sweeps between brokerage firms and affiliated banks that fall below the current 10 percent threshold.

Furthermore, it is not clear how the 25 percent threshold was reached. There is no analysis provided to explain the basis for this change, or the potential risks to bank safety and soundness and the Deposit Insurance Fund. Despite the business relationship between the bank and the person placing those deposits, the latter may well have a fiduciary duty and other incentives to transfer those deposits if the bank is perceived to be in trouble.

Finally, under the NPR, subject to the application process, a primary purpose exception would also be available for an agent or nominee whose business relationship with its customers is solely the placement of depositors' funds into transactional accounts for the purpose of enabling

payments, if no fees, interest, or other remuneration is provided to the depositor. If fees are provided, the FDIC would more closely scrutinize whether the primary purpose is truly to enable payments.[19] Importantly, no explanation is provided as to why the placement of deposits into transactional accounts without a fee should, per se, qualify for the exception.

The Final Rule would retain these exceptions but eliminate the application requirement and just require written notice. In addition, the Final Rule would add ten additional designated primary purpose exceptions that have been the subject of prior staff interpretations and relationships raised by commenters on the NPR. For these additional designated relationships, no notice to the FDIC would be required.[20]

The Final Rule would establish an application process for entities that do not meet one of the designated business relationships to seek a primary purpose exception.[21]

The Final Rule thus dramatically expands the scope of the primary purpose exception, and the risk, while significantly reducing FDIC oversight of the process.

Conclusion

In conclusion, this Final Rule goes well beyond the NPR in weakening the important prudential protections of the current brokered deposit rule. Other than the placement of brokered certificates of deposit, it is not clear what activities would continue to be treated as brokered deposits.

Based on limitations with current deposit reporting, the potential impact on how much of the $1.2 trillion of brokered deposits currently reported would no longer be considered brokered is difficult to assess but may be quite large. The expanded exclusion of sweep deposits from unaffiliated third parties could have a particularly large impact. The funds associated with these activities also could be expected to grow in response to this rulemaking.

Experience in two financial crises demonstrates that brokered deposits pose a very serious safety and soundness risk to insured depository institutions and the Deposit Insurance Fund. The changes to the brokered deposit rule contained in this Final Rule seem less related to a careful evaluation of whether a deposit is brokered and the risks attendant to that designation than to a general objective to narrow the scope of the rule. While technology may have a role to play, the Final Rule has not addressed how technology changes the fundamental considerations of the relationship between a bank, a depositor, and a third party intermediary, and the risks the relationship may pose.

This Final Rule will likely dramatically reduce the scope of deposits that are considered brokered and expose the banking system to significantly increased risk. In addition, for a rule of this consequence and complexity, the FDIC Board was given inadequate opportunity to review and evaluate the rule and its impact.

For these reasons, I will vote against this Final Rule.

[1]85 FR 7453 (February 10, 2020).

[2]*See* Statement by Martin J. Gruenberg, Member, FDIC Board of Directors; Notice of Proposed Rulemaking on Brokered Deposits (Dec. 12, 2019), available at https://www.fdic.gov/news/speeches/spdec1219c.html.

[3]Preamble to the Final Rule at 3.

[4]Under 12 U.S.C. 1831f(c), the FDIC may, on a case-by-case basis and upon application by an insured depository institution which is adequately capitalized (but not well capitalized), waive the applicability of prohibition against the acceptance of brokered deposits upon a finding that their acceptance does not constitute an unsafe or unsound practice with respect to such institution.

[5]12 U.S.C. 1831f(g).

[6]12 U.S.C. 1831f(g)(2)(I).

[7]Preamble to the Final Rule at 14.

[8]Proposed Section 337.6(a)(5)(ii) in the NPR.

[9]Preamble to the NPR, 85 FR at 7457.

[10]Preamble to the Final Rule at 22.

[11]Advance Notice of Proposed Rulemaking: Unsafe and Unsound Banking Practices; Brokered Deposits and Interest Rate Restrictions, 84 FR 2366, 2370-71 (February 6, 2019). See also Identifying, Accepting, and Reporting Brokered Deposits Frequently Asked Questions, available at https://www.fdic.gov/news/financial-institution-letters/2016/fil16042.html.

[12]Preamble to the NPR, 85 FR at 7459, citing 84 Fed. Reg. at 2372.

[13]Id.

[14]*See* discussion at 85 FR 7459-60.

[15]85 FR at 7459.

[16]FDIC Advisory Opinion 05-02 (Feb. 3, 2005), entitled "Are funds held in 'Cash Management Accounts' viewed as brokered deposits by the FDIC? " found at https://www.fdic.gov/regulations/laws/rules/4000-10350.html#fdic400005-02.

[17]Proposed Final rule section 337.6(a)(5)(v)(I)(1).

[18]Preamble to the Final Rule at 77.

[19]85 FR 7459-60.

[20]Preamble to the Final Rule at 57-58.

[21]Preamble to the Final Rule at 61-62.