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May 7, 2019

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

Re: Brokered Deposits and Interest Rate Restrictions
Comments on Advance Notice of Proposed Rulemaking
RIN 3064-AE94

Ladies and Gentlemen:

In response to the Advance Notice of Proposed Rulemaking ("ANPR") issued by the Federal Deposit Insurance Corporation ("FDIC") seeking comment on the comprehensive review of its regulatory approach to brokered deposits,[1] we are submitting this letter on behalf of our clients who participate in the national brokered certificate of deposit ("CD") market. Our clients include broker-dealers registered with the Securities and Exchange Commission ("SEC") that engage in offering CDs issued by depository institutions at which deposits are insured by the FDIC ("IDIs").

The national brokered CD market has current outstandings of nearly $500 billion,[2] constituting over 50% of the total reported brokered deposits.[3] This market is mature, deep and liquid, permitting eligible IDIs access to term deposit funding in various maturities at market rates. CDs issued in this market have limited early withdrawal provisions, providing IDIs with extremely stable funding. The market has been in continuous operation for over 30 years without disruption, including during the recent financial crisis.

Seward & Kissel represents a wide range of participants in the deposit markets, including broker-dealers, IDIs, and service providers. Our clients underwrite and issue CDs and offer, support, and participate in so-called deposit account "sweep" programs. Collectively, such

[1] 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").
[2] Data from the Depository Trust Company.
[3] Data are derived from the amount of brokered deposits reported on banks' Consolidated Reports of Condition and Income ("Call Reports").

deposit arrangements total in excess of an estimated $1.4 trillion, or approximately 11% of all domestic deposits.[4] For over 30 years Seward & Kissel has provided comments to the FDIC on various FDIC policies and proposals related to brokered deposits.[5]

We appreciate this opportunity to address the regulatory and policy issues presented by the access of IDIs to the national market in CDs supported by broker-dealers. However, we note that we have provided comments to the FDIC on brokered deposits on numerous occasions since the recent financial crisis, including data and expert analysis, that contradict the premises underlying the FDIC's policies with respect to brokered deposits. Our comments have rarely, if ever, been acknowledged, and when they have been addressed the response has been dismissive.[6]

We submit these comments in the sincere hope that the FDIC will consider our comments in good faith and, when it has a substantive basis for disagreement, will provide data and expert analysis to support its position.

In this letter, we will describe the national brokered CD market and address the FDIC's stated assumptions about brokered CDs. We will demonstrate that (i) brokered CDs are not high-cost, (ii) brokered CDs provide stable funding for IDIs, and (iii) IDIs that use brokered deposits are not more likely to fail than IDIs that do not. We ask that the FDIC revisit its supervisory approach to brokered deposits generally, and to brokered CDs specifically, and that the FDIC give serious consideration to needed revisions of its regulations and policies relating to brokered deposits, including:

- The definition of "core deposit" used in the Uniform Bank Performance Report ("UBPR")[7];
- Improving bank examiner education to ensure that brokered deposit use is treated in accordance with the FDIC's Examination Manual;
- The treatment of brokered CDs in the FDIC's regulations implementing the Liquidity Coverage Ratio (the "LCR Rule")[8]; and
- The assessment of deposit insurance premiums on brokered CDs.

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[4] Data are derived from Call Reports and an estimate of broker-dealer "sweep" program deposits not reported by the banks as brokered pursuant to the "primary purpose" exception from the definition of "deposit broker" in FDIC regulations.

[5] *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).

[6] Under the Administrative Procedure Act, a federal agency may not "consider an important aspect of the problem" or make a decision that "runs counter to the evidence before [it]." *Motor Vehicle Manufacturers Association v. State Farm Auto Mutual Insurance Co.*, 463 U.S. 29, 42-44 (1983).

[7] "Core deposits . . . equal the sum of all transaction accounts + nontransaction money market deposit accounts + nontransaction other savings deposits (excludes MMDAs) + nontransaction time deposits of $250,000 and less - fully insured brokered deposits $250,000 and less." UBPR Users Guide at 5 (Feb. 2016).

[8] *See, e.g.*, 12 CFR 329.3.

Although we do not address the FDIC's interpretation of the definition of "deposit broker" or the various exceptions from that definition, we believe the FDIC has taken an overly broad view of the definition and an overly narrow view of the exceptions. We support those commenters who are urging the FDIC to revise its approach to interpreting the regulations.

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I. Mischaracterizations of Brokered Deposits

A. In General

For years, the FDIC has characterized deposits meeting the definition of "brokered deposits" as "volatile" and "high rate."[9] According to the FDIC, brokered deposits are "interest rate sensitive deposits for customers in search of yields."[10] Furthermore, brokered deposits, the FDIC has asserted, are held under a third-party structure which increases instability.[11]

The FDIC has also asserted that the features of brokered CDs creating deposit stability are irrelevant. For example, the FDIC has stated, without support, that brokered time deposits with limited early withdrawal provisions (*i.e.*, only upon death or adjudication of incompetence of the owner) are no more stable than deposits without such limitations because during a liquidity crisis banks would waive the provision and permit the funds to be withdrawn.[12]

Despite the widespread use of brokered deposits as a source of funding for IDIs since the early 1980s, the FDIC lacks data to arrive at any meaningful conclusions concerning the characteristics of brokered deposits, including rates, deposit account types (*e.g.*, time deposits, savings deposits, etc.), original maturity of time deposits or how the deposits were originated (*e.g.*, placed by a broker-dealer, referred by a third party, etc.). While IDIs are required to report their total brokered deposits in their Call Reports,[13] they are not required to report many important details about the deposits. The FDIC's claims about interest rates, account types, and characteristics are, therefore, based on assumptions and not facts.

Policymakers have consistently refused to respond to, or even acknowledge, data and other evidence from the industry that contradicts speculative assumptions about brokered deposit products.[14] This has impeded constructive debate about brokered deposits. Broker-dealers participating in the national brokered CD market are willing to work with the FDIC on an ongoing basis to ensure that the FDIC has an informed understanding of the market.

Set forth below is a discussion of the brokered CD market, including responses to the features and attributes of brokered CDs that have been mischaracterized by the FDIC.

B. Brokered CD Market

1. FDIC's Characterization

The ANPR discusses the brokered CD market, but does not accurately describe its mechanics. The FDIC has long misunderstood how brokered CDs are structured, offered, and

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[9] *See, e.g.*, FDIC, FIL-18-2010; Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, Final Rule, 79 Fed. Reg. 61,440, 61,491 (Oct. 10, 2014) (hereinafter "LCR Final Rule"); Study on Core Deposits and Brokered Deposits, Submitted to Congress Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act at 32 (Jul. 8, 2011) (hereinafter "FDIC Study").

[10] FDIC Study at 32.

[11] *See id.*

[12] *See* LCR Final Rule at 61,492.

[13] *See* Call Reports, Schedule RC-E, Memoranda Item 1.b.

[14] *See generally* LCR Final Rule.

sold, and the ANPR perpetuates that misunderstanding, describing a process through which a broker-dealer places deposits at an IDI and then "issues" fractional interests in a Master Certificate of Deposit ("Master Certificate") to its retail customers.[15] This implies that a broker-dealer places funds with an IDI that issues a CD to the broker and then the broker sells a participation interest in the CD to its retail customers. However, this is not how the brokered CD market operates or the correct characterization of a Master Certificate.

2. Brokered CD Offering Process

The brokered CD market is an organized, mature market that operates in many respects like the market for publicly issued securities. The market is deep and liquid with hundreds of broker-dealers and thousands of IDIs participating. Currently nearly $500 billion of CDs issued in the market are outstanding.[16] The brokered CD market has operated continuously since the early 1980s without disruption, even during the recent financial crisis.

More than 15 broker-dealers act as lead underwriters for brokered CDs. Many of these broker-dealers have organized selling groups with other broker-dealers. Some selling groups have more than 250 brokers that offer CDs for IDIs, permitting an IDI access to hundreds of thousands of investors. In any given week, hundreds of IDIs may access this market.

The brokered CD market is not, as commonly portrayed, a market in which brokers contact IDIs offering to deposit large sums of money in return for high interest rates. In the CD programs offered by registered broker-dealers, the broker-dealer acts as an underwriter for the IDI pursuant to a CD Brokerage Agreement entered into between the parties. An IDI must agree to certain conditions, including its eligibility to accept brokered deposits. An IDI is contractually obligated to inform a broker if its capital category changes and must re-confirm its capital category at every settlement.

An IDI wishing to obtain funding in the national brokered CD market contacts one or more brokers with which it has entered into a CD Brokerage Agreement to determine the best current market pricing. After agreeing on acceptable pricing and other terms with one or more brokers, the IDI and each broker enter into a "Terms Agreement" for the offering of CDs of a specific maturity. The Terms Agreement establishes the offering period and the number of CDs that may be sold.

IDIs issuing CDs in the national brokered CD market do so after comparing the price of CDs in the market to alternatives such as Federal Home Loan Bank advances, listing service deposits, and internet offerings. An IDI that chooses to use the brokered CD market does so after determining that brokered CDs are the most cost-effective funds available.

Each broker offering an IDI's CDs lists the offering on its Bloomberg page, which can be accessed by members of the broker's selling group. This information is available to the FDIC via a Bloomberg terminal.

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[15] ANPR at 2368.

[16] Data from the Depository Trust Company.

Brokers do not "fractionalize" or "participate out" CDs. Each customer purchases one or more CDs in denominations of $1,000 and each CD is an individual deposit obligation of the IDI. 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.

Broker-dealers do not "issue" CDs. Upon completion of the offering, the IDI issues a Master Certificate, a negotiable instrument representing a specified number of individual CDs, in denominations of $1,000. The Master Certificates are held (with few exceptions) by the Depository Trust Corporation ("DTC") as subcustodian for the broker-dealers. The CDs are recorded on the books of the IDI in the name of DTC, in a manner designed to permit the "pass-through" of deposit insurance to the broker's customers. The broker-dealer maintains records of the CDs held by its customers and these records are submitted to the FDIC in the event of the failure of the IDI.[17]

Retail brokered CD programs provide certain efficiencies not available to IDIs through direct deposit relationships. IDIs do not need to send customer statements or tax reporting forms and do not need to maintain customer service personnel to answer customer questions. Estimates of the cost of raising deposits through a branch network ranges between 90 to 150 basis points for overhead.[18] Retail brokered CDs can save IDIs some or all of these costs.

C. Cost of Brokered CDs

1. FDIC's Characterization

The FDIC has long asserted, without a basis in fact, that brokered deposits are a high-cost source of funding for IDIs. For example, the FDIC Core and Brokered Deposit Study (the "FDIC Study") simply assumed without question that brokered deposits are high-rate deposits even though no interest rate data were cited and no benchmark was established to determine what constitutes high rates. Neither the relationship between brokers and IDIs, nor the relationship between brokers and their customers, was examined. And while there were brief overviews of certain brokered deposit arrangements – reciprocal deposits and sweep deposits – there was no examination of the oldest segment of the market, CDs. This is significant, as data on this market, including maturities and rates, were provided to the FDIC by the industry and ignored.[19]

The ANPR repeats this error, contrasting brokered deposits with core deposits, which the FDIC asserts are "relatively cost effective source[s] of funds."[20] The assumption that brokered deposits are "high rate" is simply unwarranted.

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[17] *See generally* Paul T. Clark, Just Passing Through: A History and Critical Analysis of FDIC Insurance of Deposits Held by Brokers and Other Custodians, 32 Boston Univ. Rev. Bank. & Fin. Law 99 (2013), for a more complete description of the book entry recordkeeping system used for brokered CDs.

[18] *See* Bert Ely & Vicki Vanderhoff, *Retail Brokered Deposits: A Post-FIRREA Analysis* 2 (June 1991).

[19] *See, e.g.,* Seward & Kissel 2008 Comment Letter, *supra* note 5; materials submitted to the FDIC by Jeff Zage, Chief Executive Officer, Financial Northeastern Securities, Inc. in connection with the FDIC's March 18, 2011 public roundtable on brokered deposits (the "Roundtable"); and data submitted confidentially to the FDIC by industry participants in connection with FDIC rulemakings.

[20] ANPR at 2384-85.

2. Brokered CDs Are Not High Cost

i. Data Analyzed

Appendix A provides data on the "All-In Cost" of brokered CDs of different maturities relative to the other selected benchmarks: the interest rates advertised by listing services and the yields on U.S. Treasury securities. All-In Cost includes interest on the CDs plus fees to the broker. In contrast, the rates paid by IDIs for deposits solicited through listing services[21] do not include fees to the listing service, which are not publicly disclosed.

IDIs may also raise funds in a national market from deposits obtained through listing services. Listing service rates are thus a proxy for rates that IDIs must pay in order to attract deposits nationally.

U.S. Treasury securities are backed by the full faith and credit of the U.S. government and are the safest investment available. While the FDIC insurance fund may be backed by the full faith and credit of the U.S. government, individual IDIs and CDs are not. Thus, one would assume, all things being equal, that the yield on U.S. Treasury securities would approximate the lower bound for rates that IDIs can pay in order to attract deposits in a national market.

We did not include the FDIC's "national rate" as a benchmark because most IDIs simply cannot attract deposits by paying the national rate. As recognized by the ANPR, the national rate oversamples large, national IDIs which have "a disproportional effect on average interest rates. Even as other interest rates have begun to rise, the average has stayed low as the largest banks have been slow to increase interest rates on deposits."[22] Moreover, the fact that IDIs are offering certain rates through their branches does not necessarily mean that they are actually attracting deposits at those rates.

The flaws in the national rate methodology are illustrated by comparing the national rate for a CD to the yield on a comparable U.S. Treasury security. As of April 22, 2019, the national rate for 3-month CDs was 0.97%,[23] while the yield on 3-month U.S. Treasury securities was 2.43%. Simple economics would dictate that an FDIC insured deposit should not pay 140 basis points less than a U.S. Treasury security of the same maturity.

ii. Results

The All-In Cost of brokered CDs during the 4.5-year period examined was virtually always lower for every CD maturity than the interest rates, without fees, posted on the listing service for the same CD maturity,[24] and were often only marginally higher than Treasury security yields. For example, in March 2019 for six-month maturities, the All-In Cost for brokered CDs was 2.4%, the yield on U.S. Treasury securities was 2.5%, and the listing service

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[21] The listing service rate reflects the average of the ten highest rates available. Listing service data for 3-month maturities are not available.

[22] *Id.*

[23] *See* https://fred.stlouisfed.org/release/tables?rid=317&eid=20544.

[24] 3-month rates are unavailable.

rate was just under 2.75%. For one-year maturities, the All-In Cost for brokered CDs was 2.6%, the Treasury yield was approximately 2.54%, and the listing service rate was 2.85%.

Several conclusions can be drawn from this data. First, the brokered CD All-In Cost is virtually always lower than the listing service rate before fees because an IDI can always obtain term funding at a lower cost through the brokered CD market than by advertising nationally through a service. We should also note that it is not clear that IDIs can successfully issue longer term CDs using a listing service. While IDIs can advertise the availability of such CDs, there is no data to indicate that IDIs are successful in attracting these deposits. Certainly, unlike brokered CDs, the IDIs would need to offer early withdrawal options on such CDs that would reduce their stability.

Second, brokered CD rates can, during certain periods, be marginally *lower* than rates on U.S. Treasury securities of similar maturity. Given that U.S Treasury securities are liquid instruments backed by the full faith and credit of the U.S. government, this demonstrates that brokered CD rates are reasonable relative to an equivalent benchmark.

Finally, fully insured brokered deposits are "non-core liabilities" for purposes of the UBPR. Deposits solicited by IDIs locally using teaser rates, nationally over the internet, through nationwide advertisements, or through deposit listing services are not "brokered" and therefore are treated as "core deposits." These deposits are consistently more expensive to an IDI than deposits obtained through the national brokered CD market. As a result of the FDIC's definition of "core deposits" and its insurance premium policies,[25] IDIs have an incentive to pay more for these non-brokered deposits than deposits that would be reported as "brokered."

Inevitably, such disparate regulatory treatment will drive IDIs to sources of deposit funding based on legal characterizations, not cost. Indeed, our clients report to us that IDIs that have traditionally accessed the retail brokered CD market are currently willing to pay substantially more for deposits that do not need to be reported as "brokered."

D. Stability of Brokered Deposits

1. FDIC's Characterization

The FDIC has stated for years that brokered deposits are inherently unstable and "volatile." For example, without any support or examination, the FDIC Study stated that "brokered deposits are considered volatile, interest rate sensitive deposits for customers in search of yields."[26] The FDIC Study, however, did not empirically examine the stability of brokered deposits.

Without evidentiary support, the FDIC asserted in the preamble to the LCR Rule that brokered deposits are held under a structure involving a third party, which inherently increases instability.[27] The FDIC further stated that the features of some types of brokered deposits that

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[25] See 12 CFR Part 327. Effective 1Q 2009, the FDIC implemented a Brokered Deposit Adjustment to assessment of deposit insurance premiums.
[26] FDIC Study at 32.
[27] *See id.*

increase deposit stability are irrelevant, and that brokered time deposits with limited early withdrawal provisions (*i.e.*, only upon death or adjudication of incompetence of the owner) are no more stable than deposits without such limitations.[28] The FDIC's overreach on the issue is illustrated by its statement in the LCR Rule preamble that:

> Although many agreements for brokered deposits with contractual maturity provide for limited contractual withdrawal rights, as with non-brokered term retail deposits, the agencies believe that [IDIs] may agree to waive such contractual maturity dates for retail deposits.[29]

First, "many agreements" is, in fact, all agreements. Limited early withdrawal is a long-standing, uniform feature of brokered CDs. Second, and more importantly, there is not a single known instance of an IDI waiving the early withdrawal provisions, even during a time of stress such as the financial crisis.

The ANPR repeats similar assertions about the stability of brokered deposits – assertions that have never been grounded in data. The ANPR repeats the claim made in the FDIC Study that brokered deposits "might flee if the institution becomes troubled or if the customer finds a more appealing interest rate or terms elsewhere,"[30] or that, if the IDI becomes stressed, "wholesale counterparties may be more apt to withdraw funding or demand additional collateral."[31] The ANPR also states that, in contrast to brokered deposits, "[c]ore deposits provide a bank with a stable . . . source of funds."[32]

There is simply no evidence to support the supposition that brokered deposits are unstable; in fact, brokered CDs have mechanisms to ensure stability and proved to be stable through the financial crisis.

2. Brokered CDs Are Stable

The national brokered CD market permits IDIs to access longer-term deposit funding that can be withdrawn by depositors only at maturity or upon the death or adjudication of incompetence of the depositor. This limitation on early withdrawal is standard in the CD product and not a feature that changes from issuance to issuance.

IDIs offering CDs to depositors directly through their branch networks must include early withdrawal provisions, either with or without a penalty, in order to satisfy depositor needs for liquidity in the event the depositor needs the funds. IDIs typically have difficulty directly issuing longer-term CDs because of the depositors' demand for liquidity, and early withdrawal provisions contribute to the potential instability of the deposits.

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[28] *See* LCR Final Rule at 61,492.
[29] *Id.*
[30] ANPR at 2369.
[31] *Id.*
[32] ANPR at 2384.

IDIs are able to issue longer-term CDs with limited early withdrawal provisions utilizing brokers because brokers maintain a secondary market in CDs that permit CD holders to sell their CDs prior to maturity at market prices without funds being withdrawn from the IDI. CDs are established and issued under the U.C.C. Article 8 regime that permits the "indirect holding of financial assets." CDs are issued in $1,000 denominations and evidenced by a book-entry in the name of the fiduciary and negotiable Master Certificates held by the DTC.[33] This system permits individual CDs to move between customers of the broker by being transferred on the books of the broker and between brokers by being transferred on the books of DTC without the funds being withdrawn from the IDI.

Most full-service brokers make a market for their customers and, in some cases, make a market for other brokers. In addition, four electronic trading platforms are dedicated to the offer and sale of CDs.[34] The liquidity provided by the secondary markets permits banks to issue CDs with longer maturities than is possible through a branch network. While maturities will vary depending on the yield curve, CDs with maturities greater than one year constitute one-third of brokered CD issuances. Because CDs can be issued with a "call" provision that permits a bank to redeem the CDs in its discretion, CDs can be issued with maturities of 20 years and longer.

The ability to issue CDs of varying maturities permits banks to match the maturity of liabilities with assets. Matching assets and liabilities contributes to an IDIs stability.

As a result of the limited early withdrawal features and the secondary market, retail brokered CDs provide a stable, reliable source of funding. Funds obtained in the market will remain with the IDI until maturity.

Only 13.5% of all deposits are time deposits, which are structurally more stable than accounts with transaction features.[35] In contrast to the short-term funding IDIs rely on through their branch networks, retail brokered CDs routinely have longer maturities and include provisions restricting early withdrawal. Approximately 34% of CDs in the retail brokered CD market have maturities of one year and longer. Indeed, brokered CDs with call provisions can be issued in maturities of up to 20 years. This permits IDIs to lock in funding at a specific rate for a period of time, enhancing the IDIs ability to match the maturity of its liabilities to it assets.

Because the brokered CD market is large, deep, and continuously operating, an IDI can readily replace CDs as they mature. This ability to easily access the market at any time permits IDIs to readily replace brokered CDs as they mature.

The stability of brokered CDs is demonstrated by a survey of major brokerage firms finding that the run-off from withdrawal due to death or adjudication of incompetence is substantially less than 1%. With respect to banks waiving limitations on early withdrawal of brokered CDs during a liquidity crisis, no such waiver of the provision has ever occurred during the more than 35-year existence of the product. As set forth in a letter from Seward & Kissel to

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[33] *See* Clark, *supra* note 17, at 152.

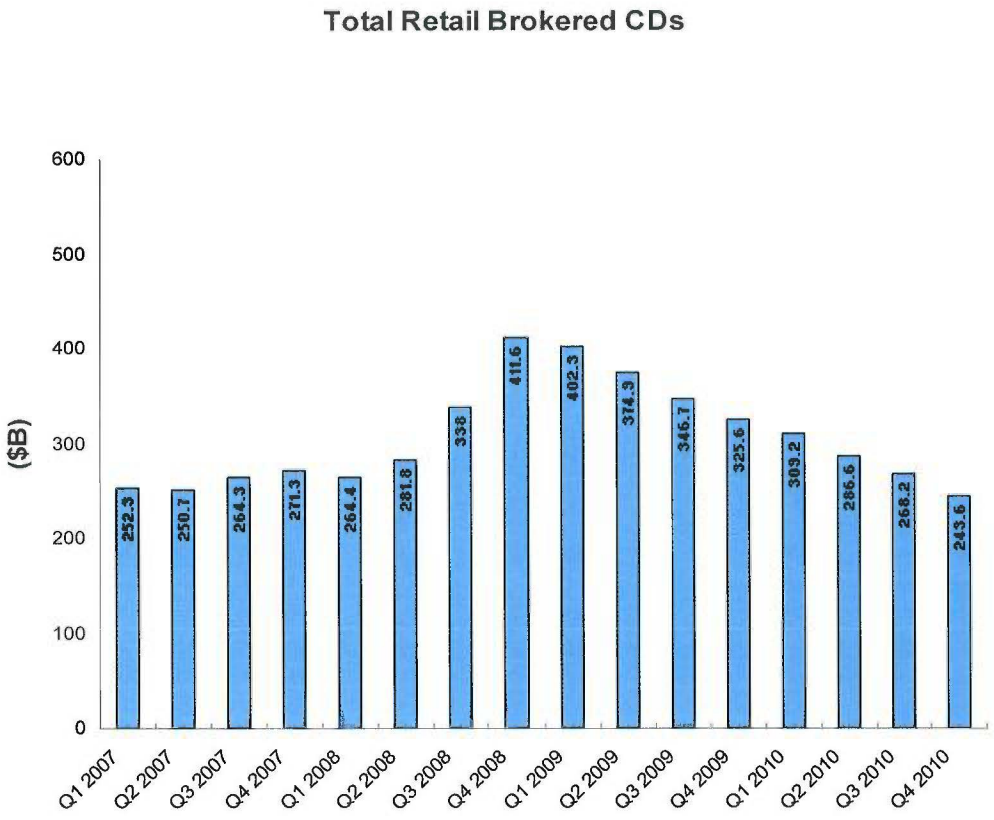
[34] These include Knight BondPoint, Tradeweb, TheMuniCenter, and the Bloomberg Trade Order Management System.

[35] Data as of December 2017.

FDIC Vice Chairman Thomas Hoenig in June 2014, the very structure through which brokered CDs are typically held would make waiving early withdrawal restrictions nearly impossible.[36]

The chart below (Total Retail Brokered CDs) demonstrates the significant increase in bank issuances in the retail brokered CD market during the financial crisis, illustrating that even in times of great stress, this market never ceased functioning and provided a reliable source of liquidity to IDIs.

The data were obtained from DTC and other sources.



Moreover, deposits at the two banks owned by Lehman Brothers Holdings, Lehman Brothers Bank FSB and Lehman Brothers Commercial Bank, were stable despite the failure of the top tier holding company. Lehman Brothers Holdings filed for bankruptcy on September 15, 2008. As of September 30, 2008, each of the two Lehman banks had brokered deposits that were over 98% of their total deposits. Despite the fact that the banks were 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 that was

[36] *See* unpublished letter dated July 15, 2014 from Paul T. Clark to Thomas M. Hoenig, Vice Chairman, FDIC.

attributable to time deposits maturing since the deposits were eligible only for highly restricted early withdrawal.[37]

At the opposite end of the spectrum, there was a $1.3 billion retail deposit outflow at IndyMac Bank from June 27, 2008 through July 10, 2008. This deposit run, which is well documented,[38] was initiated by direct depositors, not brokers or their customers.

Additionally, the FDIC has not examined in any of its brokered deposit studies the history of brokered deposit use by Utah industrial loan banks. These banks are in many cases entirely funded by brokered deposits, yet have not experienced deposit outflows even during periods of great stress. In 2012, an economist at the Federal Reserve Bank of San Francisco, having examined the use of brokered deposits at Utah industrial loan banks where brokered deposits comprise nearly 40% of total deposits, concluded that brokered deposits provide a stable source of funds for IDIs in good financial condition and found that brokered deposits do not appear to have contributed to the recent financial crisis.[39]

In the past, the FDIC has ignored data contravening its prior assumptions about the stability of brokered deposits. For example, the FDIC Study did not incorporate valuable information about deposit stability provided to the FDIC in connection with its March 18, 2011 public roundtable on brokered deposits (the "Roundtable").[40] During the Roundtable, bankers discussed the factors that contribute to the stability of deposits. The bankers repeatedly mentioned rates as a factor in deposit retention and specifically the impact that the internet and technology have had on customer expectations concerning interest rates. One banker referred to the "Wal-Martization" of rates on CDs offered directly by IDIs to their depositors due to the impact of the internet. Even with a relationship with the depositors, the deposit "is good as long as your rate is competitive."[41]

The systemic impact of the internet on deposit account stability is further evidenced by a letter from the American Bankers Association ("ABA") to FDIC Chairman Sheila Bair on May 27, 2009. In that letter, the ABA requested the FDIC to take action with respect to an IDI advertising high deposit account rates over the internet. Citing historic experience with national advertising of high deposit account rates, the ABA stated that such high rates force "other banks in their markets to raise interest rates above market rates in order to retain their own deposit customers."[42]

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[37] Data are derived from Call Reports.

[38] *See, e.g.,* Joe Adler, FDIC Defends Handling of IndyMac Run, Am. Banker, July 18, 2008.

[39] *See* Gary Palmer, Manager, Risk Analytics & Monitoring, Division of Banking Supervision and Regulation, Federal Reserve Bank of San Francisco, Economic & Industrial Banking Trends and Conditions, a presentation before the National Association of Industrial Bankers' Annual Convention (August 17, 2012), at 37. Mr. Palmer's views do not necessarily reflect the official positions of the Federal Reserve System or the Federal Reserve Bank of San Francisco.

[40] *See, e.g.,* the materials submitted by Jeff Zage, Chief Executive Officer, Financial Northeastern Securities, Inc.

[41] *See* transcript of the Roundtable, *supra* note 19 at unnumbered p. 9 (remarks of David Hayes, Security Bank, Dyersburg, Tennessee), https://www.fdic.gov/regulations/reform/3-18-11transcript.pdf.

[42] Ltr. from ABA to Sheila Bair, Chair, FDIC (May 27, 2009), https://www.aba.com/archive/Letters_Congress_Archive/Letters%20to%20Congress%20Archive/FDIC-AllyBank-090527.pdf.

The FDIC Study did not consider the possibility that interest rates on deposit accounts are established by reference to a national market in which all IDIs in all regions must compete, or that depositors using a broker may have their funds placed in IDIs out of convenience and not in pursuit of the highest available rate.

E. Brokered Deposits and IDI Failures

1. FDIC's Characterization

The FDIC has asserted that brokered deposit use is correlated with a higher probability of IDI failure.[43] As discussed below, the FDIC's data does not support this conclusion. Further, the FDIC posits that, but for brokered deposit use, failed IDIs would not have engaged in the risky asset strategies that, in fact, cause IDIs to fail.[44] In other words, the FDIC takes the novel and unsupported position that an IDI's funding source drives its asset strategy.

Rather than directly assert that brokered deposits cause IDIs to fail, an assertion that is at odds with all expert analysis, the ANPR asserts that brokered deposits are correlated with IDI failures. When selectively controlling for certain single variables, the FDIC finds a weak correlation. However, when controlling for additional variables, there is *no* statistically significant correlation between brokered deposits and IDI failures.

As explained below, the data demonstrate that IDIs do not fail as a result of using brokered deposits, and that the FDIC's restrictions on brokered deposit use are not the most direct method of ensuring appropriate asset management to prevent failures.

2. Brokered Deposits Do Not Predict IDI Failures

i. Studies During the Thrift Crisis

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. In two reports issued by the House Committee on Government Operations in 1984 and 1986, the Committee concluded that brokered deposits were not a significant source of fully insured deposits for most rapidly growing problem institutions and that any abuses involving brokered deposits could be controlled by the regulators on a case-by-case basis.[45]

During consideration of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"), the FDIC testified that no restrictions on brokered deposits were necessary. At a hearing on May 17, 1989, each of the federal banking regulators testified that restrictions were unnecessary because the regulators could respond to abuses on a case-by-case basis. William Seidman, who had been appointed Chairman of the FDIC in 1985, framed the

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[43] *See* ANPR at 2369, 2370, 2381, 2385-88.

[44] *See* ANPR at 2387.

[45] *Federal Regulation of Brokered Deposits in Problem Banks and Savings Institutions*, H.R.Rep. No. 1112, 98th Cong., 2d Sess. (1984); *Federal Regulation of Brokered Deposits: A Followup Report*, H.R.Rep. No. 676, 99th Cong., 2d Sess. (1986).

issue in a manner that remains one of the clearest statements about the role of deposit funding in IDI failures:

> 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.[46]

In 1991, David Cates of Ferguson & Company and Stanley Silverberg, the former Director of Research and Strategic Planning of the FDIC, studied the role of fully-insured brokered deposits in 1,518 failures of banks and thrifts from 1987 to 1990.[47] They concluded that 1,003, or 66%, had no brokered deposits at the time of closing and that 270, or 18%, had brokered deposits of 5% or less at the time of closing. In other words, 84% had zero to 5% brokered deposits at the time of closing.

Cates and Silverberg further examined "high risk"[48] banks and thrifts that were still open. While insured brokered deposits were present at 50% of the 44 worst-rated thrifts and at 36% of the 132 worst-rated banks, only 16% of the riskiest thrifts and 15% of the riskiest banks had more than 5% of their deposits in insured brokered deposits.

Cates and Silverberg also concluded that

> The FDIC and the OCC have long maintained, together with most private sector bank/thrift analysts, that asset strategies drive funding strategies, not the other way around. In other words, brokered deposits, FHLB advances, other secured borrowings, and Jumbo CDs don't just happen, followed by reckless investment. The causal chain of risk begins with the asset strategies.

A study (commissioned by Seward & Kissel) by Professor Joseph Mason and Empiris Consulting (the "Mason Study")[49] examined the role of brokered deposits in the failure of ANB

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[46] *Insured Brokered Deposits and Fed. Depository Insts: Hearing Before the Subcomm. on General Oversight and Investigations of the H. Comm. on Banking, Fin. And Urban Affairs,* 101st Cong. 98 (1989) (Statement of L. William Seidman). Chairman Seidman's views on the relative insignificance of the source of funding were echoed by at least one of the banking industry representatives participating in the FDIC's March 18, 2011 Roundtable. *See* transcript of the Roundtable, *supra* note 19, at 42 (remarks of David Hayes).

[47] *See* Cates and Silverberg, The Retail Insured Brokered Deposit: Risks and Benefits (May 1, 1991).

[48] "High-risk" still-open institutions were defined in the study as those with a Cates Bank Rating Service risk rating of "5" (highest risk). The Cates Bank Rating Service was a quantified evaluation of asset quality, capital, earnings, liquidity and holding company financial risk. The ratings were assigned prior to the time the study was commissioned.

[49] 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).

Bank and IndyMac Bank, which are cited by the ANPR to illustrate the potential dangers of brokered deposits. In both cases, the Mason Study concluded that other indices of ill health were present well before failure and that existing prompt corrective action authority could have been used to mitigate or prevent the FDIC's losses in connection with the failures.

ii. Recent Studies

There is no shortage of 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.[50] We discuss the findings of the Barth Survey below, and the results 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."[51] Further, the evidence presented by these studies "shows that brokered accounts in better capitalized institutions operate like any other deposits."[52]

IDIs with High Brokered-to-Total Deposit Ratios

To best illustrate the safety and soundness of brokered deposits, it is useful to look at the performance of institutions that use brokered deposits most heavily. If brokered deposits were a key driver of failures, one would expect to see that the IDIs relying the most on brokered deposits would have lower capital ratios, higher asset losses, and/or a higher rate of failure. This is simply not the case though.

The Barth Survey analyzed 15 Utah-chartered industrial loan companies ("ILCs") with an average ratio of brokered-to-total deposits of 75.3%. On average, these ILCs "have fewer branches, lower efficiency ratios (indicating greater efficiency), and higher capital ratios" than banks surveyed with markedly lower ratios of brokered-to-total deposits.[53] These results extend when one includes the 100 banks with the highest ratio of brokered-to-total deposits, suggesting that, on average, "greater use of brokered deposits is associated with higher capital ratios and better efficiency ratios."[54]

These ILCs are then useful controls for the FDIC's working assumption that brokered deposits lead to IDI failures. Any theory advanced by the FDIC that brokered deposits lead to IDI failures must account for these ILCs and explain why the heaviest users of brokered deposits are empirically healthy institutions, and if no such explanation is possible, the FDIC should revise its assumption.

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. In fact, as discussed more fully in the

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[50] James R. Barth and Yanfei Sun, Bank Funding Sources: A New Look at Brokered Deposits (Jan. 2018) (hereinafter "Barth Survey").
[51] Barth Survey at 6.
[52] *Id.*
[53] *Id.* at 26.
[54] *Id.* at 28.

comment submitted by Ely & Company, most failed IDIs have relatively low ratios of brokered to total deposits.[55]

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.[56] 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."[57] 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."[58] 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 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.

This is precisely what happened during the failure of IndyMac in 2008, and the issues were compounded because of supervisory failures by the IDIs primary federal regulator.[59] 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. FDIC's Analysis Does Not Support its Conclusions

The ANPR endeavors to demonstrate that the use of brokered deposits correlates to IDI failures, and purports to do so using a regression analysis of data collected over the previous three decades. Nonetheless, the ANPR concedes the weakness of this evidence in several key respects:

- Of the 530 IDIs that failed from 2007-2017, only 47, or 8.8%, relied "heavily" on brokered deposits.[60]

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[55] Ltr. from Bert Ely to Robert Feldman, ANPR (May 7, 2019).
[56] *See* Barth Survey at 34;Ely, *supra* note 55.
[57] Barth Survey at 34.
[58] *Id.*
[59] U.S. Dep't of Treas. Office of Inspector General, Safety & Soundness: OTS Involvement With Backdated Capital Contributions by Thrifts (May 21, 2009).
[60] ANPR at 2370.

- Of the 530 failed IDIs, only 12, or 2.3%, held a majority of deposits that were brokered.[61]
- Of the 530 failed IDIs, 280, or 52.8%, held less than 1% of their deposits as brokered deposits.[62]
- The FDIC's regression analysis, when controlling for brokered deposits, equity, and core deposits, found that "brokered deposits can be substituted for other bank liabilities without any statistically measurable effect on a bank's failure probability, provided that a bank's share of equity and core deposit funding and its asset risk characteristics remain unchanged."[63]

The FDIC's analysis does not differentiate between brokered CDs and other types of brokered deposits.

Other commenters have noted the same concessions.[64] These findings by the FDIC are consistent with the studies discussed above which generally found that IDIs do not fail on the liability side of the balance sheet; they fail on the asset side.

iv. Conclusions

The Barth Survey, and the underlying studies it reviewed, analyzed a number of banks with high levels of brokered deposits that were uniformly well capitalized, efficient, and healthy. The FDIC analyzed a large number of IDIs that failed, and found that the majority of them held very low levels of brokered deposits, and only one in 50 held a majority of their deposits as brokered. These statistics are simply inconsistent with the FDIC's long-repeated narrative that IDIs are more likely to fail if they use brokered deposits. The data plainly show that IDIs are *not* more likely to fail if they use brokered deposits.

II. Review of Regulations Relating to Brokered Deposits

A. In General

The FDIC has ascribed characteristics to brokered deposits that have no foundation in the plain language of the statutory definition of "deposit broker," and cannot be supported by data, industry practice, or experience. Section 29 of the Federal Deposit Insurance Act defines brokered deposits solely by reference to a third-party intermediary, and not by reference to any specific attribute or characteristic of brokered deposits. However, the FDIC has relied on the characteristics it has ascribed to brokered deposits in developing its policies and regulations, such as the definition of "core deposit" and the LCR Rule. Using the attributes of brokered deposits to make broad policy judgments is unsupported by the text of the statute.

We ask that the FDIC re-visit its supervisory approach to brokered deposits, the definition of "core" deposits used in the UBPR, the LCR regulations, and other policies that rely

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[61] ANPR at 2381.
[62] *Id.*
[63] ANPR at 2386.
[64] *See* Ely, *supra* note 55.

on the concept of brokered deposits. We urge the FDIC to base its determinations on the facts and data presented in this letter and received from other commenters.

B. Definition of "Core" Deposit for the Purposes of Call Reports and Liquidity Management Ratings

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 UBPR, a financial reporting tool on which public comment has never been solicited. [65] 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.

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.*[66]

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. [67]

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

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[65] *See* the UBPR definition of "core deposit," *supra* note 19.
[66] FDIC Examination Manual at 6.1-8 (emphasis added).
[67] *Id.* at 6.1-9.

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.'"[68]

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.[69]

The FDIC has asserted that the FDIC Study[70] 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. 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."[71]

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").[72] 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.[73]

The BCBS Working Paper highlights studies of two U.S. banks during the recent financial crisis: Wachovia Bank and Washington Mutual Bank.[74] Those studies indicate that the "definition of 'core' deposits proved to have little bearing on actual deposit run-off."[75] Insured

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[68] Board Examination Manual, Section 4020.1 at 43-44.
[69] FDIC Examination Manual at 6.1-9.
[70] *See* FDIC Study.
[71] *Id.* at 36.
[72] Liquidity Stress Testing: A Survey of Theory, Empirics and Current Industry and Supervisory Practices, BCBS Working Paper No. 24 (Oct. 13, 2013).
[73] *Id.* at 18.
[74] *Id.* at 8.
[75] *Id.*

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.[76]

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-stable deposits, and have provided no guidance with respect to when deposits characterized as core should be re-characterized as non-core and vice versa. For example, if an IDI reduces its staff and eliminates branches, thereby decreasing service to its depositors, should deposits be recharacterized as non-core? If a time deposit, regardless of its origin, cannot be withdrawn, or withdrawn only under very limited circumstances, why should it not be treated as a core deposit? If a broker-dealer sweeps idle customer funds into a fully-insured bank deposit account as part of the comprehensive financial services it offers to customers, is there a basis for not treating these deposits as core?

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

C. Liquidity Coverage Ratio Run-Off Rates

The purpose of the LCR Rule is to ensure that IDIs hold a sufficient quantity of "high quality liquid assets" to maintain short-term balance sheet liquidity assuming a given rate of balance sheet inflows and outflows in a stressed situation.[77] Deposits are assigned an outflow rate based on the anticipated "run-off rate," *i.e.*, the anticipated rate at which the funds dissipate.

Despite being empirically stable during the stress of the financial crisis, brokered CDs are assigned an outflow rate commensurate with less stable types of deposits. For example, brokered CDs with remaining maturities of more than 30 days are assigned a 10% run-off rate, even though there are significant contractual and structural impediments to the early withdrawal of such deposits. In fact, as noted above, there was an *increase* in bank issuances in the retail brokered CD market during the recent financial crisis, not a run-off. Meanwhile, retail "transactional deposits" are assigned a 3% run-off rate, even though these deposits have no similar contractual or structural limitations on early withdrawal in stressed scenarios.

The FDIC and the other federal banking agencies adopted the LCR Rule without sufficient evidence to justify the requirements. In order to determine the basis for the run-off rates initially proposed by the agencies, we filed a Freedom of Information Act request with each of the Agencies and the Office of Financial Research ("OFR") (Treasury Department) requesting copies of any reports, studies and analyses supporting the deposit run-off rates in the proposed LCR rule. We received the following responses:

1. The FDIC referenced information publicly available on its website that was not responsive to the request, including the FDIC's 2011 core/brokered study, which

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[76] *Id.*

[77] LCR Final Rule at 61,444.

did not purport to study deposit run-off and did not provide support for the run-off rates in the proposed LCR.
2. The OFR stated that it had no information.
3. The Board provided a 2011 study prepared by The Clearing House ("Assessing the Liquidity Coverage Ratio"), which concluded that the calibrations of the proposed LCR were not supported by the evidence.
4. The OCC provided the same Clearing House study provided by the Board.

No additional evidence was cited in the final LCR Rule.

Given the data described above that empirically establish the stability of brokered CDs, and the paucity of evidence grounding the assigned LCR run-off rate, we urge the FDIC to revisit its assumptions on this issue and evaluate whether to revise the rate assigned to brokered CDs with remaining maturities longer than 30 days.[78]

D. The Brokered Deposit Insurance Adjustment is Unsupported

Other FDIC regulations improperly rely on the concept of brokered deposits. For example, the FDIC prescribes an additional deposit insurance assessment for certain IDIs with a ratio of brokered deposits to domestic deposits over 10%.[79] In adopting this requirement, the FDIC again cited the connection between brokered deposit use and IDI failures.[80] As described above, the data do not support such a connection.

Moreover, the 10% threshold itself is unsupported by evidence. The FDIC has never established an empirical connection between the use of brokered deposits in excess of 10% and failed or weak institutions, and in support of that figure has simply stated that "in the FDIC's view, a ratio of brokered deposits to domestic deposits greater than 10 percent is a significant amount of brokered deposits."[81]

We urge the FDIC to revisit this regulation in light of the data presented in this and other comments.

* * *

[78] Though beyond the intended scope of this comment, we question the wisdom of enacting the BCBS's LCR recommendations in the United States, a nation with a very well established and effective deposit insurance structure. As the ANPR notes, "Volatility tends to be [] mitigated somewhat by deposit insurance, as insured depositors have less incentive to flee a problem situation." ANPR at 2369.
[79] 12 CFR 327.16(e)(3).
[80] *See* FDIC, Final Rule, Assessments, 74 Fed. Reg. 9525, 9531 (Mar. 4, 2009).
[81] *Id.* at 9532.

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

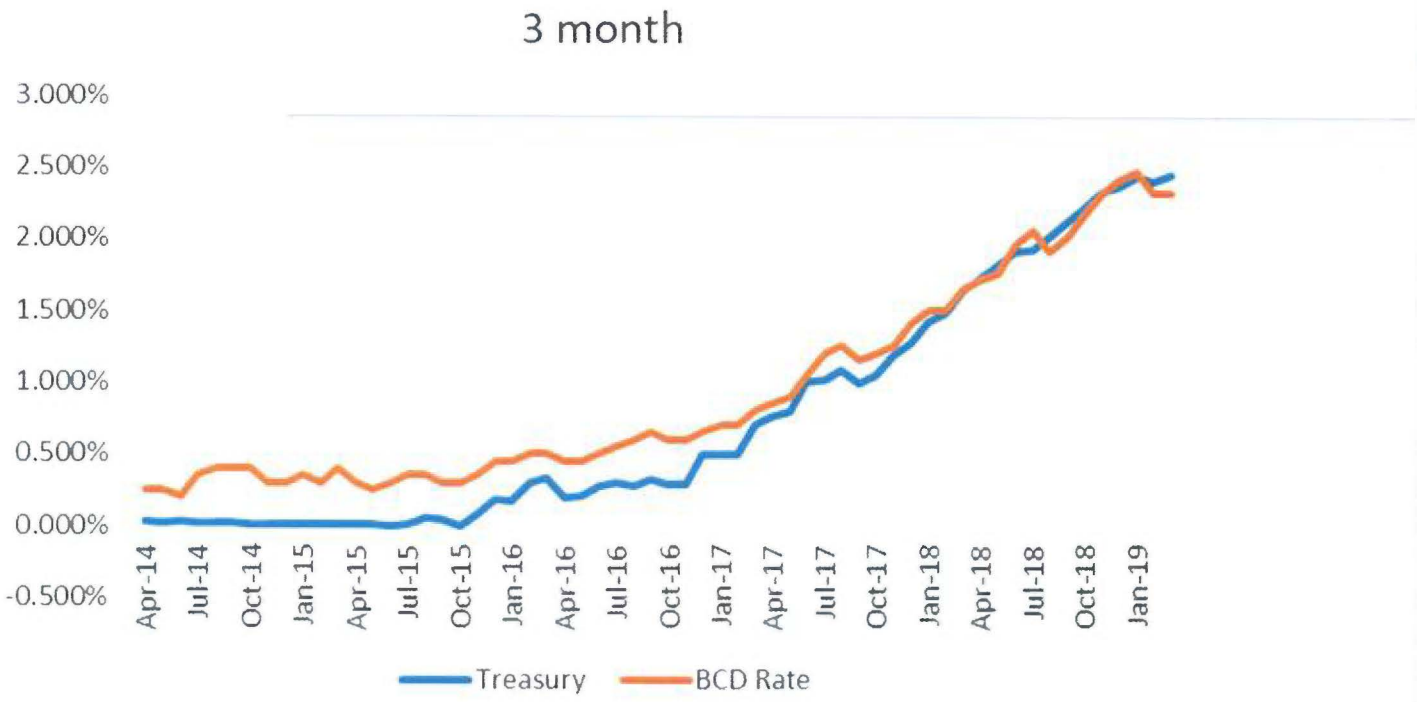
[redacted]

Casey J. Jennings

Appendix A

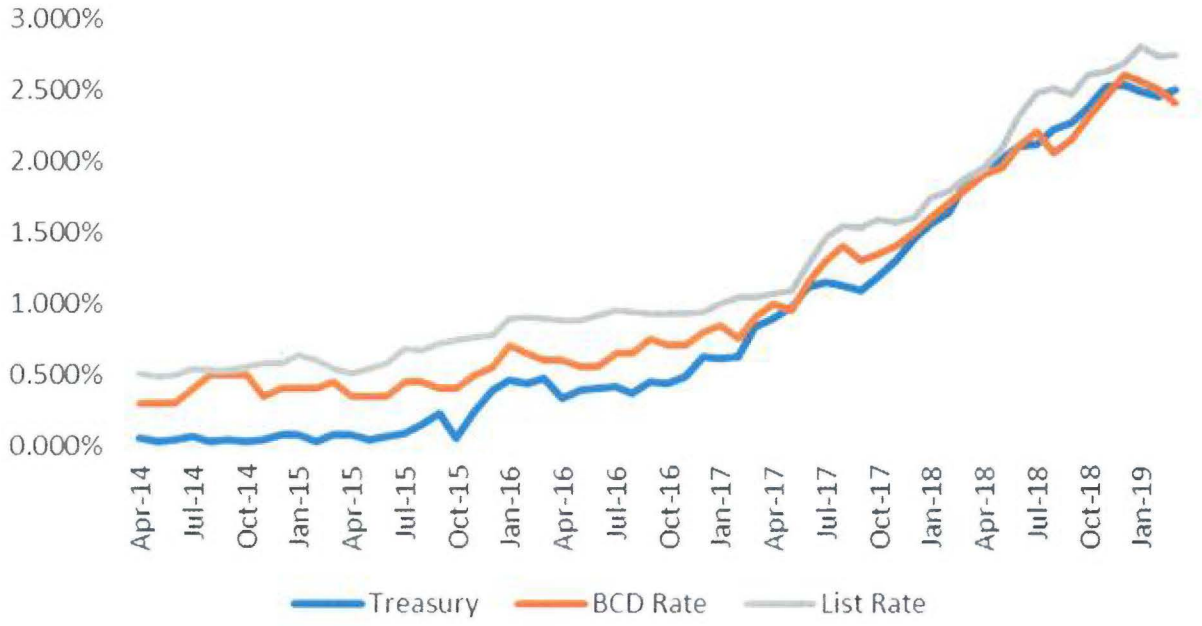
Comparison of Rates Compiled by Leading National Financial Institutions

Key:
"Treasury" = Yield on U.S. Treasuries
"BCD Rate" = All-in rates on brokered CDs (including fees to the broker)
"List Rate" = Listing Service rates (average of 10 highest rates)

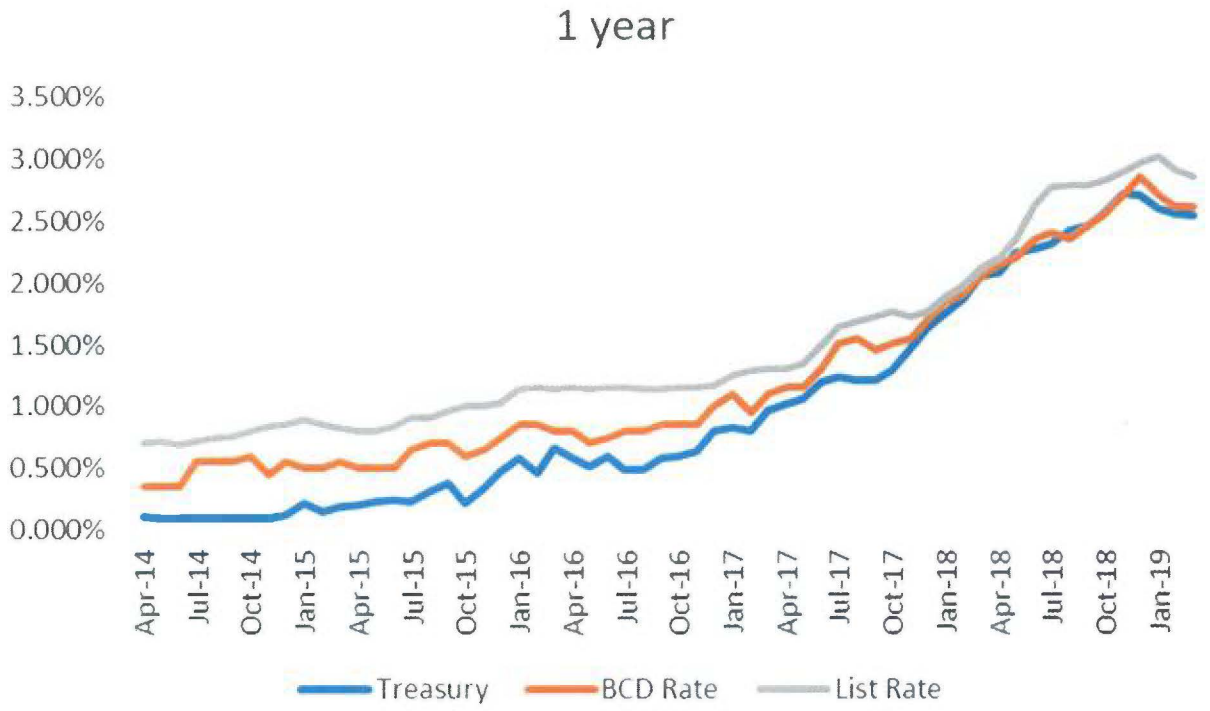


***Note: 3-month listing service rates are unavailable.**

6 month



9 month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Jul-18
Oct-18
Jan-19
Treasury
BCD Rate
List Rate


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3.000%
2.500%
2.000%
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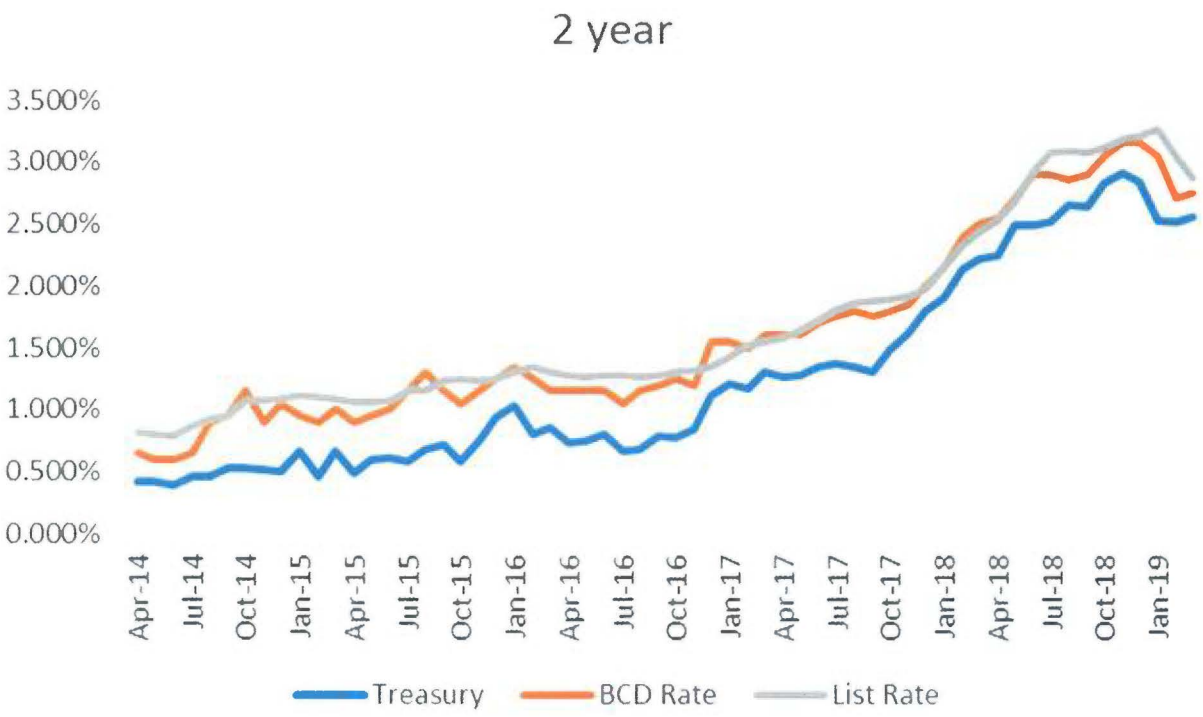
Treasury
BCD Rate
List Rate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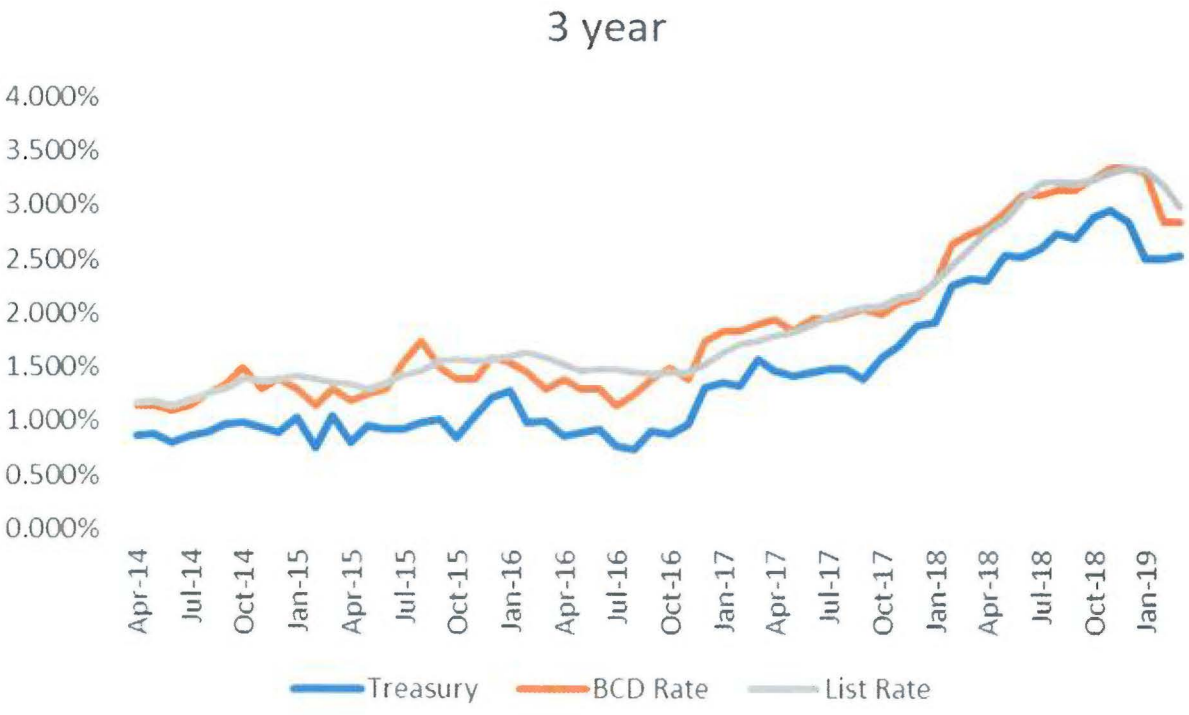
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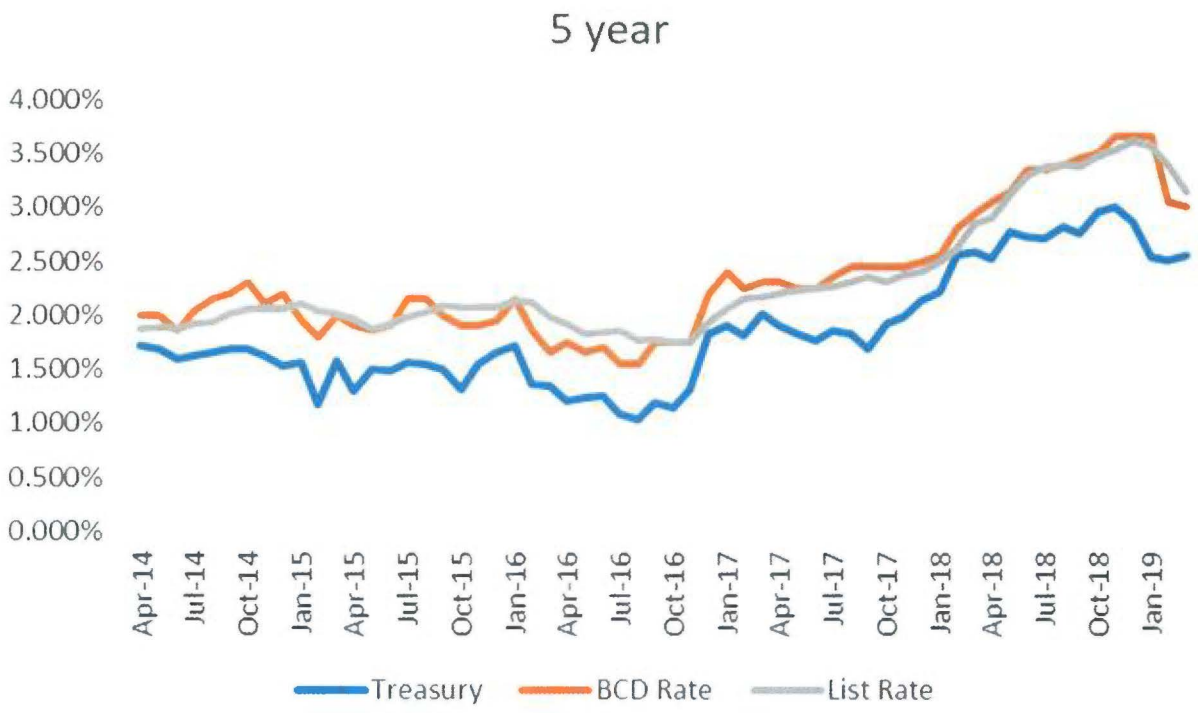
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Treasury
BCD Rate
List Rate

Appendix B

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March 22, 2016

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street SW, Mail Stop 9W-11
Washington, D.C. 20219
OCC Docket ID FFIEC-2014-0001

Robert deV. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551
EGRPRA - Docket No. R-1510

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
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Attn: Comments

Re: Regulatory Publication and Review Under the Economic Growth and Regulatory Paperwork Reduction Act of 1996: 12 U.S.C. § 1831f and 12 C.F.R. § 337.6 (Brokered Deposits)

Ladies and Gentlemen:

We are pleased to submit this letter to the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System (the "Board") and the Federal Deposit Insurance Corporation ("FDIC") (collectively, the "Agencies") in response to the Agencies' request for comments on their existing regulations pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996 ("EGRPRA"). The EGRPRA requires the Agencies to review their regulations every ten years to identify outdated or otherwise unnecessary requirements imposed on insured depository institutions. Commenters have been asked to identify regulations or statutes that impose an undue burden on insured depository institutions or that are no longer consistent with the way that business is conducted.

Seward & Kissel represents a wide range of participants in the deposit markets, including broker-dealers, insured depository institutions and service providers. Our clients underwrite and issue certificates of deposit ("CDs") and offer, support and participate in so-called deposit account "sweep" programs. Collectively, such deposit arrangements total in excess of an estimated $1.4 trillion, or approximately 11% of all domestic deposits.[1]

The purpose of this letter is to demonstrate that the provisions of the Federal Deposit Insurance Act ("FDIA") concerning brokered deposits, and the FDIC's implementing regulations, do not reflect significant changes in the industry, including changes in technology and market structure, since the adoption of the definition of "deposit broker" as part of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"). The statute and FDIC regulations utilize an over-broad and antiquated definition of the term "deposit broker" to determine whether an insured depository institution is accepting "brokered deposits." The definition does not incorporate or reflect the underlying characteristics of the deposit accounts; it simply turns on the presence of an intermediary who has "facilitated" the placement of deposits with an insured depository institution.

This letter will also demonstrate that the Agencies have ascribed characteristics to brokered deposits that have no foundation in either the plain language of the statutory definition of "deposit broker" or its legislative history, and cannot be supported by data, industry practice or experience. Relying on the characteristics they have ascribed to brokered deposits, the Agencies have imported the statutory definition, as broadly interpreted by the FDIC, into other policy realms, such as the definition of "core deposit," the Liquidity Coverage Ratio ("LCR") and deposit insurance premiums. As a result, undue and unnecessary burdens are imposed on insured depository institutions accessing a national funding market that exceeds $1.4 trillion.

Request

Nothing in the legislative history or purpose of the definition of "deposit broker" in the FDIA would support the use of the definition to implement policies beyond the narrow statutory limitations on weak institutions accepting brokered deposits. We respectfully request that the Agencies review their use of the term "brokered deposit" in implementing various policies and determine whether use of the definition is appropriate. Specifically, we request that the exclusion of all fully-insured brokered deposits from the definition of the term "core deposit" used in the Uniform Bank Performance Report ("UBPR") be reviewed by the Agencies and that the definition of "core deposit" be revised to reflect the actual characteristics of the underlying deposits.

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[1] Data are derived from the amount of brokered deposits reported on banks' Consolidated Reports of Condition and Income ("Call Reports") ($935 billion as of December 31, 2015) and an estimate of broker-dealer "sweep" program deposits not reported by the banks as brokered pursuant to the "primary purpose" exception from the definition of "deposit broker" in FDIC regulations.

We further request that the FDIC review its implementation of the statutory definition of "deposit broker" and determine whether its interpretation of the term "facilitate" is broader than necessary to achieve the purposes of the statute. In addition, the implementation of the so-called "primary purpose" exemption should be reviewed to determine whether it is being consistently applied and can be given broader application to exclude deposit arrangements that do not achieve the purposes of the statute.

We also request Congressional review of the provisions of the FDIA relating to brokered deposits in light of the numerous changes in the industry since 1989. Congress should consider replacing the definition of "deposit broker" with a functional definition and reconsider the limitation on the acceptance of brokered deposits by "adequately capitalized" institutions.

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I. Overview of the Definition of "Deposit Broker"

The FDIA contains restrictions on the acceptance of deposits by insured depository institutions[2] from a "deposit broker." The statute permits "well capitalized" depository institutions to accept such deposits without restriction.[3] An "adequately capitalized" depository institution may accept deposits from a deposit broker only if it has received a waiver from the FDIC. A waiver may be granted by the FDIC "upon a finding that the acceptance of such deposits does not constitute an unsafe or unsound practice" with respect to that institution.[4] An "undercapitalized" depository institution is prohibited from accepting deposits from a deposit broker.[5]

The FDIA also characterizes deposits solicited by an insured institution that is not a "well capitalized" institution as having been placed by a deposit broker if the institution, or an employee of the institution, solicits deposits at an interest rate that is significantly higher than the interest rates offered on deposits by other insured depository institutions in the institution's "normal market area."[6]

A "brokered deposit" is a deposit placed or facilitated by a deposit broker.[7] The definition of the term "deposit broker" was incorporated into the FDIA in 1989 and is included in FDIC regulations with only minor changes. Congress has never amended the definition since its adoption in 1989. The definition is subject to over 40 published interpretive letters from the FDIC staff, many of which were incorporated into a "Frequently Asked Questions" release published by the FDIC in 2015.[8] The full text of the definition is set forth in Exhibit A.

The definition of the term "deposit broker" does not turn on the type, term, characteristics or behavior of the deposits, or upon whether the deposit account is established by the broker or the depositor. It depends merely upon the presence of a third party that has either placed, or facilitated the placement of,[9] deposits for someone else. The FDIC staff has interpreted the term "facilitate" quite broadly to mean activities that make the establishment of a deposit easier.[10] As a result, a third party does not need to handle depositor funds to be a deposit broker. For example, a person

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2 For purposes of this letter, the terms "bank," "institution," "insured institution," and "depository institution" all refer to insured depository institutions.

3 12 U.S.C. § 1831f(a).

4 12 U.S.C. § 1831f(c).

5 12 U.S.C. § 1831f(a).

6 12 U.S.C. § 1831f(e).

7 12 C.F.R. § 337.6(a)(2).

8 *See* Financial Institution Letter 2-2015 (FDIC, Jan. 5, 2015) ("FAQs").

9 12 C.F.R. § 337.6(a)(5).

10 *See, e.g.,* Advisory Opinion 92-77 (Nov. 9, 1992).

that makes the availability of deposit accounts at banks known to prospective depositors and receives a commission is a deposit broker.[11]

The statute contains several exemptions from the definition of "deposit broker," such as exemptions for employees of a bank with respect to deposits at that bank, trust departments of banks when acting in a trust capacity and certain persons acting for employee benefit plans. The broadest exemption is for an agent or nominee whose "primary purpose" is not the placement of funds. The FDIC has applied the primary purpose exemption narrowly, opining that it does not exclude persons merely because deposit placement or facilitation is incidental to its business.[12] In some cases the FDIC has required a bank to seek confirmation that the primary purpose exemption is available.[13]

The FDIC has recognized an exception from the definition of deposit broker for so-called deposit "listing services" that permits banks to list available interest rates on deposits. The promoter of the service is permitted to charge a subscription fee to either the banks or prospective depositors so long as the fee is not based on the volume of deposits received by the banks. The promoter of the service can also facilitate the opening of a deposit account by a depositor by transmitting information between the depositor and the bank.[14]

For purposes of this letter, unless otherwise indicated, the terms "brokered deposit" and "deposit broker" have the meanings given to those terms in FDIC regulations and published interpretations of those regulations.

II. Characterizations of Brokered Deposits by the Agencies

The Agencies, without reservation or qualification, have characterized deposits meeting the definition of "brokered deposits" for purposes of FDIC regulations and interpretations as "volatile" and "high rate."[15] These two characteristics are, in the view of the Agencies, linked. According to the Agencies, brokered deposits are volatile because they are "more easily moved from one institution to another, as customers seek

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11 *See, e.g.*, Advisory Opinion 92-56 (Aug. 6, 1992).

12 *See, e.g.*, Advisory Opinion 90-21 (May 29, 1990).

13 *See, e.g.*, the FDIC's RMS Manual of Examination Policies at 6.1-10; *see also* FAQs, *supra* note 8.

14 *See, e.g.*, Advisory Opinion 04-04 (Jul. 28, 2004).

15 *See, e.g.*, FDIC's Financial Institution Letter 18-2010; Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, Final Rule, 79 Fed. Reg. 61,440, 61,491 (Oct. 10, 2014) ("LCR Adopting Release"); Study on Core Deposits and Brokered Deposits, Submitted to Congress Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act at 32 (Jul. 8, 2011) ("FDIC Study").

higher interest rates."[16] Furthermore, brokered deposits, the Agencies assert, are held under a structure with a third party, which increases instability.[17]

The Agencies also believe that the features of some types of brokered deposits that increase deposit stability are irrelevant. For example, the Agencies have stated that brokered time deposits with limited early withdrawal provisions (*i.e.*, only upon death or adjudication of incompetence of the owner) are no more stable than deposits without such limitations because during a liquidity crisis banks would waive the provision and permit the funds to be withdrawn.[18]

The Agencies have also expressed concerns that the statute itself contributes to the potential instability of brokered deposits. Under the FDIA, a "well capitalized" bank that has been utilizing brokered deposits will have to stop accepting such deposits if it becomes "adequately capitalized" and the FDIC denies it a waiver to continue accepting brokered deposits.

Apparently for these reasons, the Agencies have excluded all fully-insured brokered deposits from the definition of "core deposit" used in the UBPR.[19] The UBPR is used by the Agencies for bank supervisory, examination and management purposes. The concept of a core deposit is used to identify stable deposit funding. It should be noted that deposits solicited through so-called deposit "listing services" or over the internet based solely on interest rates are core deposits because they are not facilitated by a deposit broker. It should also be noted that there is no consensus among regulators, including the international banking regulators, on deposits that can reliably be deemed stable.[20]

Because of the attributes that the Agencies ascribe to all deposits meeting the definition of "brokered deposit," the Agencies have used the brokered deposit definition to implement other policies. The definition is utilized in the Agencies' regulations implementing the LCR[21] to assign run-off rates for deposits during a hypothetical liquidity crisis. The FDIC uses the definition in its insurance premium calculations.[22]

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16 LCR Adopting Release, *supra* note 15 at 61,491.

17 *See Id.*

18 *See* LCR Adopting Release, *supra* note 15 at 61,492.

19 "Core deposits . . . equal the sum of all transaction accounts + nontransaction money market deposit accounts + nontransaction other savings deposits (excludes MMDAs) + nontransaction time deposits of $250,000 and less - fully insured brokered deposits $250,000 and less." UBPR Users Guide at 5 (Feb. 2016).

20 FDIC Study, *supra* note 15 at 36.

21 *See, e.g.,* 12 C.F.R. § 329.3 (FDIC).

22 *See* 12 C.F.R. § 327.9.

III. Response to Agency Characterizations

Despite the fact that broker-dealers have been offering bank deposit products to their clients since the early 1980's and that this market is now in excess of $1.4 trillion, the Agencies lack the data to arrive at any meaningful conclusions concerning the characteristics of brokered deposits, including rates, deposit account types (*e.g.*, time deposits, savings deposits, etc.), maturity of time deposits or how the deposits were originated (*e.g.*, placed by a broker-dealer, referred by a third party, etc.). While banks are required to report their total brokered deposits in their Call Reports,[23] they are not required to report details about the deposits. It is, therefore, impossible for the Agencies to make any claims about interest rates or account structure.

The Agencies have consistently refused to respond to, or even acknowledge, data and other evidence from the industry that contradicts assumptions the Agencies have made about brokered deposit products. This has made constructive debate about brokered deposits difficult and, in most cases, one-sided.

A. High Rates

In 2009, the Agencies requested comment on a proposed amendment to the Call Reports to require reporting of interest expenses on brokered time deposits, acknowledging that they do not possess this information.[24] After receiving public comments on the proposal, the Agencies withdrew it in order to "reconsider their data needs with respect to deposit funding and related costs."[25] To date, the Agencies have not published a new proposal to collect this information.

In 2008, Seward & Kissel submitted a letter to the FDIC commenting on a proposal to include a "Brokered Deposit Adjustment" in the deposit insurance assessment.[26] Included with that letter were data on brokered CD "all-in cost" – *i.e.*, interest rate plus commission to the broker – covering August 2005 to November 2008 and data on interest rates on CDs listed on a national listing service for the same period. The listing service rates did not include fees to the listing service promoter. Interest rates posted by banks on a listing service are a good surrogate for the rates a bank would need to offer to attract depositors. The all-in cost of brokered CDs was virtually always lower for every CD maturity than the interest rates posted on the listing service for the same CD maturity.

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23 *See* Call Reports, Schedule RC-E, Memoranda Item 1.b.

24 *See* Proposed Agency Information Collection Activities; Comment Request, 74 Fed. Reg. 41,973 (Aug. 19, 2009).

25 Agency Information Collection Activities: Submission for OMB Review; Joint Comment Request, 74 Fed. Reg. 68,314, 68,316 (Dec. 23, 2009).

26 *See* letter dated December 17, 2008 from Paul T. Clark to Robert E. Feldman, Executive Secretary, FDIC (RIN: 3064-AD35).

The FDIC has never acknowledged or responded to the data provided by Seward & Kissel.

As of the date of this letter, a one-year CD in the brokered deposit market has an all-in cost of .80%. The average interest rate for a one-year CD on one national listing service is 1.20%.[27]

B. Brokered Deposit Structure

Brokered deposits are not structured in a uniform manner and it is not clear why the Agencies believe that certain structures affect volatility and, if so, which structures promote the most volatility. A deposit can be "brokered" for purposes of the deposit broker definition under a variety of different structures:

- A deposit account held in the name of the depositor is brokered if the depositor is referred by a third party who receives a commission.
- A deposit account held in the name of a broker-dealer or a bank acting as agent for its customers can be brokered.
- A deposit account held in the name of a sub-custodian, such as The Depository Trust Company ("DTC") or a bank, acting for other financial institutions that are acting for their customers, can be brokered.

There is nothing inherent in any of these diverse structures that causes deposit volatility and, in fact, when deposit accounts are held through a broker or a bank acting for its customers, the relationship between the broker or the bank and its customers can enhance deposit stability. See the discussion in Section V of this letter.

C. Waiver of Early Withdrawal Restrictions

With respect to banks waiving limitations on early withdrawal of brokered CDs during a liquidity crisis, no such waiver of the provision has ever occurred during the more than 30-year existence of the product. As set forth in a letter from Seward & Kissel to FDIC Vice Chairman Thomas Hoenig in June 2014, the very structure through which brokered CDs are typically held would make waiving early withdrawal restrictions nearly impossible.[28]

Seward & Kissel received a *pro forma* response from the FDIC that neither acknowledged, nor responded to, the issue raised in the letter.

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[27] Source: Bankrate, Inc. (www.bankrate.com) (March 21, 2016).

[28] *See* unpublished letter dated July 15, 2014 from Paul T. Clark to Thomas M. Hoenig, Vice Chairman, FDIC.

D. LCR Run-Off Rates for Brokered Deposits

In 2013, the Agencies proposed regulations to implement the LCR run-off rates that the U.S. agreed to implement under the Basel III accords.[29] The proposed regulations contained run-off rates for different brokered deposit products, including CDs and sweep arrangements, and treated certain sweep arrangements that are exempt from the definition of "brokered deposit" as brokered deposits.

In order to determine the basis for the proposed run-off rates, Seward & Kissel filed a Freedom of Information Act request with each of the Agencies and the Office of Financial Research ("OFR") (Treasury Department) requesting copies of any reports, studies and analyses supporting the deposit run-off rates in the proposed LCR rule. Seward & Kissel received the following responses:

- The FDIC referenced information publicly available on its website that was not responsive to the request, including the FDIC's 2011 core/brokered study, which did not purport to study deposit run-off and did not provide support for the run-off rates in the proposed LCR.
- The OFR stated that it had no information.
- The Board provided a 2011 study prepared by The Clearing House ("Assessing the Liquidity Coverage Ratio"), which concluded that the calibrations of the proposed LCR were not supported by the evidence.
- The OCC provided the same Clearing House study provided by the Board.

E. Core 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 UBPR, a financial reporting tool on which public comment has never been solicited.[30] The UBPR deems all fully-insured brokered deposits "non-core" liabilities, and the Agencies do not treat them as core deposits regardless of their terms or characteristics.

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

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[29] *See* Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, and Monitoring: Proposed Rule, 78 Fed. Reg. 71, 818 (Nov. 29, 2013).

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

> 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.*[31]

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. [32]

An important additional caveat is contained in the Board's Commercial Bank Examination Manual (the "Board Examination Manual"). In discussing the use of financial ratios to measure the stability of funds, the Board's 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'."[33]

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.[34]

In 2013, the Basel Committee on Banking Supervision ("BCBS") produced a working paper on liquidity stress testing ("BCBS Working Paper").[35] The BCBS Working Paper notes 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

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31 FDIC Examination Manual at 6.1-8 (emphasis supplied).

32 *Id.* at 6.1-9 (emphasis supplied).

33 Board Examination Manual, Section 4020.1 at 43-44.

34 FDIC Examination Manual, at 6.1-9.

35 Liquidity Stress Testing: A Survey of Theory, Empirics and Current Industry and Supervisory Practices, BCBS Working Paper No. 24 (Oct. 13, 2013).

> uniformly. This suggests that liquidity stress tests should avoid coarse definitions when possible.[36]

The BCBS Working Paper highlights studies of two U.S. banks during the recent financial crisis: Wachovia Bank, National Association, and Washington Mutual Bank.[37] Those studies indicate that the "definition of 'core' deposits proved to have little bearing on actual deposit run-off."[38] 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.[39]

The BCBS Working Paper and the Agencies' own statements make clear that the concept of a core deposit is illusory. The Agencies have no reliable method to delineate stable deposits from non-stable deposits, and have provided no guidance with respect to when deposits characterized as core should be re-characterized as non-core and vice versa. For example, if a bank reduces its staff and eliminates branches, thereby decreasing service to its depositors, should deposits be recharacterized as non-core? If a time deposit, regardless of its origin, cannot be withdrawn, or withdrawn only under very limited circumstances, why should it not be treated as a core deposit? If a broker-dealer sweeps idle customer funds into a fully-insured bank deposit account as part of the comprehensive financial services it offers to customers, is there a basis for not treating these deposits as core?

F. FDIC Core/Brokered Study

The Agencies have asserted that a 2011 study of core and brokered deposits by the FDIC that was mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "FDIC Study")[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. 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 Agencies' statements about the behavior of brokered deposits, particularly their volatility, are not based in fact.

The FDIC Study makes no attempt to arrive at a consistent or meaningful definition of a "core deposit." Indeed, the FDIC Study concedes 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]

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36 *Id.*, at 18.

37 *Id.*, at 8.

38 *Id.*

39 *Id.*

40 See FDIC Study, *supra* note 15.

41 *Id.* at 36.

The FDIC Study never examines the brokered deposit market, including the number and types of participants, how banks access the market and how interest rates are established. The FDIC Study simply assumes without question that brokered deposits are high-rate deposits even though no interest rate data are cited and no benchmark to determine high rates is established. Neither the relationship between brokers and banks, nor the relationship between brokers and their customers, is examined. And while there are brief overviews of certain brokered deposit arrangements — reciprocal deposits and sweep deposits — there is no examination of the oldest segment of the market — CDs. This is significant, as data on this market, including maturities and rates, were provided to the FDIC by the industry and ignored.[42]

More importantly, the FDIC Study does not examine the stability of brokered deposits. Without any support or examination, the FDIC Study states that "brokered deposits are considered volatile, interest rate sensitive deposits for customers in search of yields."[43] There is, for example, no examination of the fact that brokered deposits (including deposits placed by broker-dealers through sweep programs that are exempt from the definition of "brokered deposits") increased by 33.4% during the peak of the recent financial crisis from December 31, 2007 through December 31, 2008 (see chart below), or that brokered deposits decreased only after the imposition of a deposit insurance premium on brokered deposits by the FDIC.[44] In other words, rather than facilitating a run on banks during the crisis, brokers were a source of liquidity during a period when other sources of liquidity were not available.

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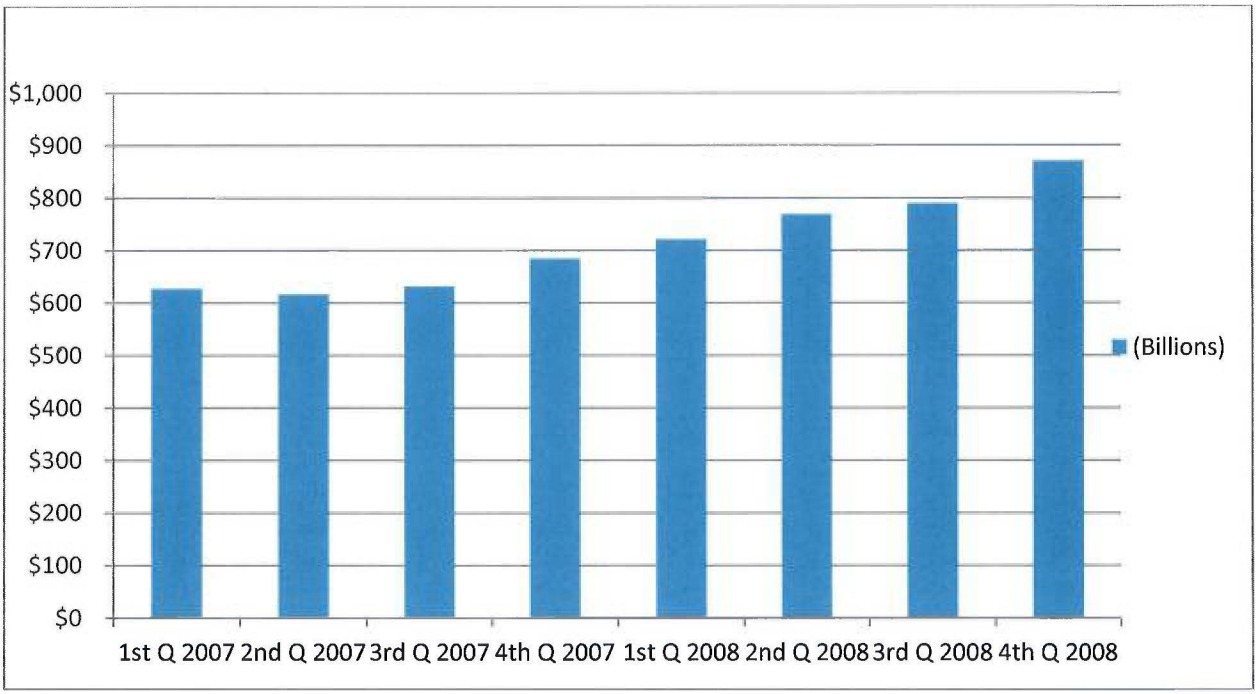
42 *See, e.g.,* Seward & Kissel 2008 Comment Letter, *supra* note 26; materials submitted to the FDIC by Jeff Zage, Chief Executive Officer, Financial Northeastern Securities, Inc. in connection with the FDIC's March 18, 2011 public roundtable on brokered deposits (the "Roundtable"); and data submitted confidentially to the FDIC by industry participants in connection with FDIC rulemakings.

43 FDIC Study, *supra* note 15 at 32.

44 The "Brokered Deposit Adjustment" was implemented beginning with the second quarter of 2009. Data are derived from Call Reports and estimates of deposits placed by broker-dealers through sweep programs that are exempt from the definition of "brokered deposits."

Increase in Brokered Deposits during the Financial Crisis



Source: Call Report data and an estimate of broker-dealer sweep program deposits exempt from the definition of "brokered deposits."

Tellingly, there is no discussion of deposit stability at the two banks owned by Lehman Brothers Holdings: Lehman Brothers Bank FSB and Lehman Brothers Commercial Bank. Lehman Brothers Holdings filed for bankruptcy on September 15, 2008. As of September 30, 2008, each of the two Lehman banks had brokered deposits that were over 98% of their total deposits. Despite the fact that the banks were 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 that was attributable to time deposits maturing since the deposits were eligible only for highly restricted early withdrawal.[45]

At the opposite end of the spectrum, there is no discussion of the $1.3 billion retail deposit outflow at IndyMac Bank from June 27, 2008 through July 10, 2008. This deposit run, which is well documented,[46] was initiated by direct depositors, not brokers or their customers.

The FDIC Study does not consider the history of brokered deposit use by Utah industrial loan banks. A year after the FDIC Study was published, an economist at the Federal Reserve Bank of San Francisco, having examined the use of brokered deposits at Utah industrial loan banks where brokered deposits comprise nearly 40% of total

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45 Data are derived from Call Reports.

46 *See, e.g.,* Joe Adler, FDIC Defends Handling of IndyMac Run, AM. BANKER, July 18, 2008.

deposits, concluded that brokered deposits provide a stable source of funds for banks in good financial condition and found that brokered deposits do not appear to have contributed to the recent financial crisis.[47]

The FDIC Study fails to incorporate valuable information about deposit stability provided to the FDIC in connection with its March 18, 2011 public roundtable on brokered deposits (the "Roundtable").[48] During the Roundtable, bankers discussed the factors that contribute to the stability of deposits. The bankers repeatedly mentioned rates as a factor in deposit retention and specifically the impact that the internet and technology have had on customer expectations concerning interest rates. One banker referred to the "Wal-Martization" of rates on CDs offered directly by banks to their depositors due to the impact of the internet. Even with a relationship with the depositors, the deposit "is good as long as your rate is competitive."[49]

The systemic impact of the internet on deposit account interest rates is further evidenced by a letter from the American Bankers Association ("ABA") to FDIC Chairman Sheila Bair on May 27, 2009. In that letter, the ABA requested the FDIC to take action with respect to a bank advertising high deposit account rates over the internet. Citing historic experience with national advertising of high deposit account rates, the ABA stated that such high rates force "other banks in their markets to raise interest rates above market rates in order to retain their own deposit customers."[50]

The FDIC Study never examines the possibility that interest rates on deposit accounts are established by reference to a national market in which all banks in all regions must compete, or that depositors using a broker may have their funds placed in banks out of convenience and not in pursuit of the highest available rate.

IV. History of the Brokered Deposit Provisions in the FDIA

The use of the definition of "deposit broker" in the FDIA as a surrogate for volatile deposits can find no support in the legislative history of the statute. During Congressional debates at the height of the savings and loan crisis in 1989 and 1991, over whether and, if so, how, to limit brokered deposits, Congressional concern over

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47 *See* Gary Palmer, Manager, Risk Analytics & Monitoring, Division of Banking Supervision and Regulation, Federal Reserve Bank of San Francisco, Economic & Industrial Banking Trends and Conditions, a presentation before the National Association of Industrial Bankers' Annual Convention (August 17, 2012), at 37. Mr. Palmer's views do not necessarily reflect the official positions of the Federal Reserve System or the Federal Reserve Bank of San Francisco.

48 *See, e.g.,* the materials submitted by Jeff Zage, Chief Executive Officer, Financial Northeastern Securities, Inc., *supra* note 42.

49 *See* transcript of the Roundtable, *supra* note 42 at unnumbered p. 9 (remarks of David Hayes, Security Bank, Dyersburg, Tennessee), available on the FDIC's website.

50 The letter is available on the ABA's website.

brokered deposits was never focused on deposit stability or volatility.[51] Some Members of Congress expressed concern about the expansion of the federal safety net and the interest rates that some thrifts paid for deposits, but, as the FDIC has itself noted, there was no true Congressional consensus on whether concerns about brokered deposits were justified.[52]

Brokered deposits became the focus of attention from both the FDIC and Congress in the mid-1980's. In 1984, the FDIC and the Federal Home Loan Bank Board ("FHLBB") jointly adopted a rule to deny "pass-through" deposit insurance to deposits placed by deposit brokers in order to address their concerns about rapid growth of weak institutions and the potential costs to the insurance funds.[53] Although the regulations were overturned by the U.S. Court of Appeals for the District of Columbia Circuit as being beyond the statutory authority of the FDIC and FHLBB,[54] the controversy surrounding the regulations prompted three Congressional hearings on brokered deposits in 1984 and 1985.[55]

The Congressional hearings exposed a difference of opinion on brokered deposits among the federal banking regulators. While the FDIC and FHLBB defended the need for their rule, representatives of the Board, OCC and Treasury Department took an opposing view. The Comptroller of the Currency testified that brokered deposit abuses by national banks were being controlled through existing supervisory measures and that "there was no need to remove the deposit insurance coverage on brokered deposit funds in order to control the abuses."[56]

In two reports, the House Committee on Government Operations (the "Committee") called the rationale behind the regulations and the concerns of the FDIC and the FHLBB into question. In its 1984 report, the Committee found that brokered deposits were not "a significant source of deposit growth for the great majority of rapidly growing problem institutions during the period from December 31, 1983 through March 31, 1984" and concluded that brokered deposits have a "legitimate and

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51 Rapid asset growth using brokered deposits was addressed by the FDIC in regulations proposed in April 1989 and adopted in May 1990 and, therefore, was never a matter of Congressional debate. These regulations were repealed in 1994.

52 *See* FDIC Study, *supra* note 15 at 17.

53 Brokered Deposits; Limitations on Deposit Insurance, 49 Fed. Reg. 13,003 (Apr. 2, 1984).

54 *See FAIC Securities, Inc. v United States*, 595 F.Supp. 73 (D.D.C. 1984), *aff'd*, 768 F.2d 352 (D.C. Cir. 1985) ("*FAIC Securities*").

55 *Proposed Restrictions on Money Brokers: Hearing before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations*, 98th Cong.,. 2nd Sess. (1984); *Brokered Deposits: Hearing before the Subcommittee on Financial Institutions and Consumer Affairs of the Senate Committee on Banking, Housing and Urban Affairs*, 99th Cong., 1st Sess. (1985); *Impact of Brokered Deposits on Banks and Thrifts: Risks Versus Benefits: Hearing before the Subcommittee on General Oversight and Investigations of the House Committee on Banking, Finance and Urban Affairs*, 99th Cong., 1st Sess. (1985).

56 *Id.* at 7.

useful function in financial markets and should not be needlessly restricted."[57] The Committee reiterated its conclusions in a subsequent report in 1986.[58]

During consideration of FIRREA, the Agencies, including the FDIC, testified that no restrictions on broker deposits were necessary.

At a hearing on May 17, 1989, each of the federal banking regulators testified that restrictions were unnecessary because the regulators could respond to abuses on a case-by-case basis. William Seidman, who had been appointed Chairman of the FDIC in 1985, framed the issue in a manner that remains one of the clearest statements about the role of deposit funding in bank failures:

> 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.[59]

Likely as a result of the testimony of the banking regulators, the Senate Banking Committee did not address brokered deposits in the version of FIRREA it adopted on April 13, 1989. However, during full Senate consideration of the bill reported by the Senate Banking Committee, Senator Frank Murkowski (R-AK) offered an amendment to the bill that would require "troubled institutions"[60] to obtain a waiver from the FDIC in order to accept deposits from a "deposit broker." The definition of "deposit broker" in Senator Murkowski's amendment was taken in its entirety from the definition of "deposit broker" in the FDIC/FHLBB regulations struck down by the U.S. Court of Appeals for the District of Columbia Circuit in 1985.[61] There was no discussion of the scope of the definition during Senate debate on the bill. The amendment was accepted

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57 *Id.* at 9.

58 H.R. Rep. No. 99-676, at 13 (1986).

59 *Insured Brokered Deposits and Fed. Depository Insts: Hearing Before the Subcomm. on General Oversight and Investigations of the H. Comm. on Banking, Fin. And Urban Affairs,* 101st Cong. 98 (1989) (Statement of L. William Seidman). Chairman Seidman's views on the relative insignificance of the source of funding were echoed by at least one of the banking industry representatives participating in the FDIC's March 18, 2011 Roundtable. *See* transcript of the Roundtable, *supra* note 42 (remarks of David Hayes).

60 "Troubled institutions" were those that did not meet the applicable minimum capital requirements. *See* P.L. 101-73, § 224.

61 *FAIC Securities*, *supra* note 54.

by the Senate managers of the bill after the FDIC indicated that it did not object. As with the Senate, the Murkowski amendment was included in the version of FIRREA adopted by the House Banking Committee without debate over the scope of the definition of "deposit broker."

The current restrictions on brokered deposits were adopted as part of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") in response to a study of deposit insurance by the Treasury Department mandated by FIRREA (the "Treasury Study").[62] The Treasury Study recommended limiting deposit insurance coverage in a number of areas, including eliminating coverage of multiple insurable capacities (*e.g.*, individual, joint, IRA, etc.) and "pass-through" coverage of brokered deposits. The Treasury Study did not address the stability, volatility or other potential characteristics of brokered deposits.

Congress rejected the recommendations of the Treasury Study on a number of issues, including brokered deposits. While there were numerous hearings in both the House and Senate preceding adoption of FDICIA, there was no discussion of the definition of "deposit broker" included in FIRREA during the hearings nor during debate over the restrictions on brokered deposits that were ultimately adopted. Congress merely utilized the definition in FIRREA without review or comment.

V. Overview of the Brokered Deposit Funding Market

The deposit funding market is not well understood. This is due both to the lack of data possessed by the Agencies, as discussed above, and to the terminology the Agencies use to determine the regulatory reporting of deposits by banks. The terminology is imprecise and based, in many cases, on technical legal interpretations rather than the economic realities of the deposit funding market.

As discussed above, fully-insured brokered deposits are "non-core liabilities" for purposes of the UBPR, and are used in determining "net non-core funding dependence," a classification of bank funding sources. Deposits solicited by banks locally using teaser rates, nationally over the internet or through nationwide advertisements, and through a deposit listing service are not "brokered" and, therefore, are treated as "core deposits." These deposits are consistently more expensive to a bank, and less stable, than deposits obtained through the organized market maintained by registered broker-dealers and other regulated financial institutions. Indeed, as a result of the Agencies' definition of "core deposits" and the FDIC's insurance premium policies,[63] banks have an incentive to pay more for these non-brokered deposits than deposits that would be reported as "brokered."

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62 *See* U.S. DEP'T OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS (1991).

63 See 12 C.F.R. Part 327. Effective 1Q 2009, the FDIC implemented a Brokered Deposit Adjustment to assessment of deposit insurance premiums.

Deposit funding needs to be discussed in an objective fashion without the use of imprecise and, in some cases, inaccurate terminology. It is simply not accurate to conclude that deposits carrying a particular, sometimes arbitrary, label are more or less stable or expensive than other deposits.

A. Development of the Brokered Deposit Market

The origins of the brokered deposit market can be traced to the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980 (the "Monetary Control Act"). Prior to the Monetary Control Act, interest rates on deposit accounts were subject to a ceiling established by regulation. The Monetary Control Act de-regulated interest rates on deposit accounts[64] and raised the deposit insurance limit from $40,000 to $100,000.[65] These changes occurred at a time when banks and savings associations were losing deposits to money market mutual funds, which were not subject to interest rate ceilings.[66] Taking advantage of these changes in the law and the demand by banks for "re-intermediation" of deposits into the banking system, a few brokerage firms began entering into arrangements with banks and savings associations seeking deposits to offer their CDs. By 1990, outstanding brokered deposits were $90 billion. Although a few brokers offered savings deposits, the market was predominantly CDs.

The adoption of FDICIA in 1991 provided stability to the regulatory environment for brokered deposits. The stable regulatory environment and healthy economy resulted in significant growth in the brokered CD market. During the 1990s, the number of brokers participating in the market significantly increased. Many brokers formed syndicates comprised of other brokers in order to expand the distribution of CDs. Some brokers specialized in offering CDs of community banks, a sector of the banking industry that had not previously had access to a national market for deposits. This increase in the number of brokers expanded the options available to banks and increased competition, which lowered the fees to the brokers and the cost of the deposits to the banks. As a result, by the end of 1999, there were $120 billion of brokered deposits.

In 2000, Merrill Lynch announced that it was eliminating taxable money market funds as an automatic investment, or "sweep", option for the uninvested cash of many of its customers and was replacing it with a bank sweep feature, which offered a money market deposit account ("MMDA") linked to a negotiable order of withdrawal ("NOW") account at its two affiliated banks. Many brokerage firms with affiliated banks launched similar programs shortly thereafter. By 2005, total brokered deposits had reached $482 billion, with over half that amount represented by deposits from

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64 Depository Institutions Deregulation and Monetary Control Act of 1980, P.L. 96-221, § 202.

65 *Id.*, at § 308(a)(1)(C).

66 *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 (2012) ("Clark Article") at 102.

sweep programs. Beginning in the early 2000's, brokers that were not affiliated with banks increasingly began offering bank deposit sweep programs as a sweep investment as an alternative to, or instead of, money market funds. Many of these programs offered customers the opportunity to have funds swept to a number of unaffiliated banks in a "waterfall," *i.e.*, with funds being deposited up to the FDIC insurance limit in each bank in a pre-determined order. This expansion of the sweep product created deposit funding opportunities for banks not affiliated with a broker.

Since the issuance of an opinion of the FDIC's General Counsel on broker-dealer deposit sweep programs in 2005,[67] a number of banks have availed themselves of the exemption and no longer report sweep deposits as brokered on their Call Reports. As of the date of this letter, we estimate those deposits to be approximately $450 billion.[68]

The final significant development in the brokered deposit market was the introduction of so-called "reciprocal" deposits by Promontory Interfinancial Network in 2003. Using its CDARS service, banks can place customer funds in time deposits at other banks on a fully-insured basis and issue time deposits for a like amount of funds in return. Similar services are now offered for MMDAs.

Banks seeking deposit funding can now select from a number of options. They can access term funding with various payment and interest rate features, including fixed rate, floating rate and zero coupon CDs. "Callable" CDs permit banks to issue CDs with maturities of twenty years and beyond while retaining the ability to call the CD if interest rates decline. Sweep programs offer banks the ability to attract stable deposit funding that is priced to an overnight funding index. Reciprocal deposit programs allow banks to retain existing customer relationships while obtaining deposits from the depositors of other participating banks.

B. Common Features of Brokered Deposit Programs

Although there are differences in the various brokered deposit products described above, the products share certain structural similarities, some of which have not been examined by the Agencies or have been mischaracterized.

- Relationship between Broker and Bank. Banks are not forced or obligated to accept deposits from a broker, and the acceptance of brokered deposits by a bank is typically not a one-time occurrence. Rather, it is part of a funding arrangement between the bank and the broker or other intermediary that is negotiated at arm's length in the context of a competitive market among brokers and other intermediaries to assist banks with deposit funding. In the case of banks affiliated with

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67 *See* Advisory Opinion No. 05-02 (Feb. 3, 2005).

68 Data are derived from a survey of broker-dealer sweep programs.

a broker, the arrangement is subject to the Board's Regulation W (Transactions Between Member Banks and Their Affiliates).[69]

All of the brokered deposit products utilize sophisticated agreements that establish the basic terms of the deposit accounts to be offered, the obligations of each of the parties and also address regulatory compliance issues. The agreement is frequently the subject of extensive negotiation, even between affiliates, and is available for review by a bank's examiner. In the case of sweep programs, the interest rate is typically established in reference to a common short-term rate index, such as LIBOR or Fed Funds. In the case of CDs, a procedure for establishing the terms of the CDs to be offered is set forth in the agreement. The agreements may be for a term of years with limited termination provisions, or may be terminable by either party upon notice.

- Pass-Through Deposit Insurance. Each of the brokered deposit products offered through intermediaries relies on the availability of pass-through deposit insurance for deposit accounts held through an agent/custodian. In the case of CDs, the deposit accounts are typically established at a bank by the DTC, a regulated securities depository, or another regulated entity that acts as sub-custodian for the brokers holding CDs for their customers. The sub-custodian maintains records of the CDs held by the brokers and the brokers maintain records of their customers' CD ownership. In the event of the failure of a bank, the FDIC notifies the sub-custodian and the sub-custodian notifies the brokers. Each broker then submits information concerning its customers' CD holdings at the failed bank to the FDIC for payment of insurance.[70]

In sweep programs, the broker typically establishes an MMDA, and in most cases a linked demand deposit account or a NOW account, with the bank as agent and custodian for its customers – a so-called "omnibus" account. As with CDs, each customer's ownership of his deposit accounts, including principal balances and accrued interest, is evidenced by books and records maintained by the broker. In the event of the failure of the bank, the broker would submit its records to the FDIC for payment of insured amounts.

- Legal Structure. Deposit account ownership in brokered deposit arrangements is frequently mischaracterized, with the deposit accounts being viewed as having been "fractionalized" or "participated out."[71] In general, a financial asset is fractionalized when the asset is issued in one denomination and broken into smaller pieces by a third party who sells the smaller pieces. The smaller pieces cannot be enforced against the issuer because the holder's recourse is against the third party. Brokered

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69 12 C.F.R. Part 223.

70 *See* Deposit Broker's Processing Guide, available on the FDIC's website.

71 *See, e.g.*, Instructions for Preparation of Consolidated Reports of Condition and Income (FFIEC 031 and FFIEC 041) (FFIEC) at A-9.

deposits, in contrast, are maintained on the books of a bank by a book entry in the name of the fiduciary. By the terms of the agreement with the bank, the book entry deposit account evidences an aggregation of individual ownership rights each of which is separately enforceable by the holder against the bank. In the case of most brokered CDs, a "Master Certificate of Deposit" is issued by the bank that further evidences the issuance of multiple CDs, each in a $1,000 denomination.

In addition to complying with the requirements for FDIC pass-through insurance, CD and sweep programs are structured to avoid characterization of the deposit account or the program as a "security" for purposes of the Securities Act of 1933 and the Securities Exchange Act of 1934,[72] and as an investment company for purposes of the Investment Company Act of 1940.[73] In order to accomplish this, the programs are structured to ensure that each customer, not the broker, 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.

Article 8 of the Uniform Commercial Code ("U.C.C."), which has been adopted by every state, provides a legal framework for the book-entry ownership structure described above. Under Article 8, a deposit account is a "financial asset" that can be held by a custodian (typically a bank or broker) referred to as a "securities intermediary." The owner of the financial asset, referred to as a "securities entitlement holder", can exercise the indicia of ownership over the financial asset.[74]

In addition to the rights provided under Article 8, it is the accepted practice to permit the beneficial owner to terminate the relationship with the broker/custodian and establish the deposit account directly on the books of the bank. This permits the owner to enforce rights in the deposit account directly against the bank.

- Relationship between Broker and Customer. A broker or other regulated financial institution acts as an agent for its customers in offering the customers various deposit accounts, whether a CD or an MMDA linked to transaction account through a sweep program. Unless specifically authorized by a customer, a broker does not have investment discretion over a customer's financial assets. Indeed, the exercise of such discretion, even over deposit accounts, would require registration with

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72 *See Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985).

73 *See* SEC No-Action Letter, Kemper Financial Services, Inc. (available November 29, 1985).

74 *See* Clark Article, *supra* note 66 at 149, *et seq.*

the Securities and Exchange Commission ("SEC") under the Investment Advisers Act of 1940.[75]

As an agent, a broker must receive direction from its customers to place a customer's funds in a deposit account and such direction must be based on adequate disclosure concerning the identity of the bank and the terms of the deposit account.[76] With respect to CDs, customers select a CD based on the terms, including interest rate and maturity, being offered and the fully disclosed identity of the bank. In a sweep arrangement, the customer authorizes the broker to sweep funds into specifically identified banks pursuant to the terms and conditions of the sweep program.[77] In both CD and sweep programs, customers receive a comprehensive disclosure document that describes the product. In addition, brokers send their customers periodic statements setting forth the balance in the deposit accounts at each bank.

- Efficiencies. Brokered deposits provide numerous efficiencies to banks that lower their cost of deposit funding. Because the deposit accounts are held by the broker or its subcustodian, the bank does not need to maintain records of individual customer deposit accounts, send customer statements or provide information on interest income for tax purposes (IRS Form 1099). These are significant cost savings compared to soliciting and maintaining deposits through a branch network.

In addition to these efficiencies, brokered deposits permit banks to more closely control their deposit liabilities. Whether through a sweep program or CDs, a bank can control the amount of deposits in order to better match funds to its loan portfolio. In a sweep program, the broker and bank agree on the amount of deposits to be placed through the program. In a CD program, the bank controls when it wishes to access the market and the amount of CDs it is willing to offer.

C. Sweep Programs

Broker-dealers offer various liquid investments as a sweep option for their customers' uninvested cash, including money market mutual funds and bank deposit accounts. Sweep options are offered as a service to customers to allow them to earn some interest on their funds pending a decision by the customer concerning possible longer term investments. In addition, many brokerage firms offer cash management features, such as check writing and debit cards, that are satisfied by withdrawing funds from the customer's sweep investment. With regard to sweep investments, liquidity and safety are of greater concern to customers than yield on the investment.

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75 *See* SEC No-Action Letter, First United Management Corporation (available Feb. 28, 1974).

76 *See* Sweep Guidelines Draft (2006), developed by the staff of the SEC and the Financial Industry Regulatory Authority ("FINRA"), and provided in draft form to selected FINRA members, but never published.

77 *See* SEC regulations governing a broker's treatment of a customer's free credit balances at 17 C.F.R. § 240.15c3-3(j)(2).

Even though sweep investments are offered as a short-term investment option, the total balances in such investments are stable due to the constant flow of cash into customer brokerage accounts from dividend and interest payments on securities held in the accounts, and proceeds from the sale of securities. On any day, customer withdrawals from the sweep investment will be offset by customer deposits.

As discussed above, beginning in 2000, broker-dealers began offering a sweep to bank deposit accounts to customers either as a replacement for a sweep to a money market fund or as an additional option. At many firms, the bank sweep is the only option offered to customers or to certain classes of customers. This development has resulted in the transfer of approximately $750 billion of brokerage customer funds from money market funds to the banking industry. While much of this funding has been deposited in banks affiliated with a broker, an increasing amount is deposited in banks not affiliated with the broker. This has opened up new funding opportunities for the banking industry.

Whether the banks in a broker's sweep feature are affiliated with the broker or not, certain dynamics common to all sweep programs affect the amount of funds on deposit at the bank and the stability of those funds.

- A very small percentage of customers maintain funds above the FDIC insurance limit through the sweep feature, even in one-bank programs. Across the industry, approximately 92% to 95% of all customers have less than $100,000 on deposit at one time and most customers maintain deposits substantially less than that amount.

- The broker has a relationship with its customers that is broader than just offering the sweep feature. As described above, the sweep feature is merely a service offered by a broker to support the other financial products offered by the broker to its customers. The 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.

- A broker can generally control the amount of funds that flow to a bank by the eligibility criteria it establishes for the sweep feature and the number of other sweep options it offers. The greater the number of customers who are eligible for the bank sweep feature and the fewer the alternatives, the greater the amount of customer funds that will be deposited through the feature.

Affiliated Bank Sweep Programs. In addition to the general sweep feature characteristics described above, programs that sweep customer funds to an affiliated bank or banks can have additional elements that promote deposit stability.

- If 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 brokers cross-sell products of their affiliated banks, such as margin credit, credit cards and home loans. In addition, some banks establish direct relationships with the broker's customers and facilitate transfers of funds between a deposit account at the bank and the customer's brokerage account. These cross-selling activities further blur the distinction between the customer's relationship with the broker and the bank.

- It is highly unlikely that a broker would terminate a sweep feature to an affiliated bank.

- Many, though not all, banks accepting sweep deposits from an affiliated broker have qualified for the "primary purpose" exemption in the FDIC's brokered deposit regulations and are not subject to the restrictions on acceptance of brokered deposits.

Non-Affiliated Bank Sweep Programs. The stability of deposits in a sweep program with non-affiliated banks can be controlled by a number of factors, including the agreement between the broker and the banks in the program and the management of the banks in the program. Increasingly, the agreements are for a term of several years, require the broker to maintain a minimum level of deposits and can only be terminated by the broker in the event of a material breach of the agreement by the bank. Through such an agreement, the bank can assure itself of a certain level of deposit funding at an agreed-upon rate, which is typically tied to a short-term funding rate such as LIBOR.

Brokers or their service providers are able to manage the flow of funds to the banks in the program through the eligibility criteria described above and managing the banks made available to each of the broker's customers and the order in which funds will be deposited into the banks in the program.

D. Stability of Sweep Deposits

The chart set forth below (Total Sweep Deposits) shows the growth and stability of sweep deposits during the height of the recent financial crisis.[78] The data were derived by subtracting CD outstandings from reported Total Brokered Deposits on Call Reports, using data obtained from the DTC and other sources, and then adding deposit balances from sweep programs that are exempt from classification as "brokered deposits," using data obtained from Call Reports of banks participating in exempted programs and data provided by some banks. Because the number of banks qualifying for the brokered deposit exemption, and the timing of such qualification, is not publicly available, the chart likely understates total sweep deposits.

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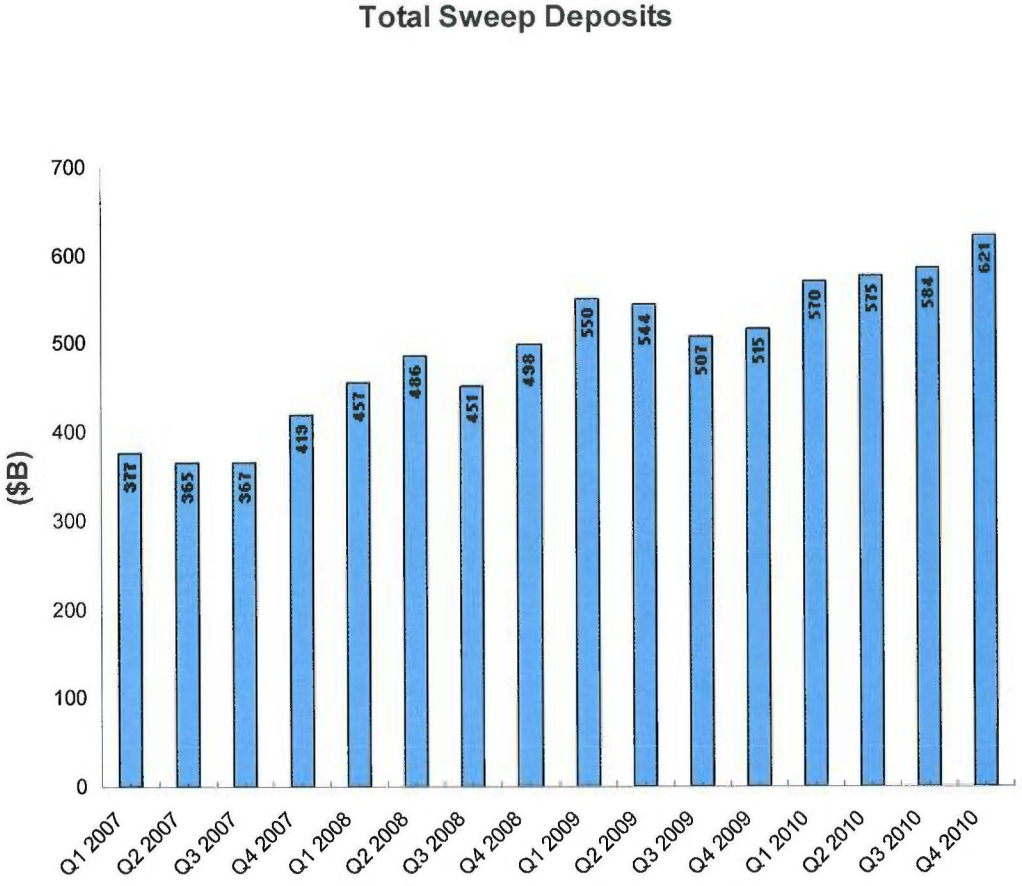
[78] Sweep deposits have continued to grow and are currently estimated to be approximately $1 trillion.

The chart shows a significant upward trend in total sweep deposits from 2007 into 2009, and increasing again through 2010. We believe that small declines in total sweep deposits are attributable to deposit re-allocation resulting from mergers, particularly Bank of America/Merrill Lynch and Wells Fargo/Wachovia, as well as to the variations caused by brokers qualifying for the brokered deposit exemption.



Data included in the comment letter submitted by Charles Schwab & Co. to the Agencies (in connection with the proposed LCR regulations)[79] show a steady increase in sweep deposits at its affiliated bank and supports the position that such deposits are stable. Data included in the comment letter submitted by Promontory Interfinancial

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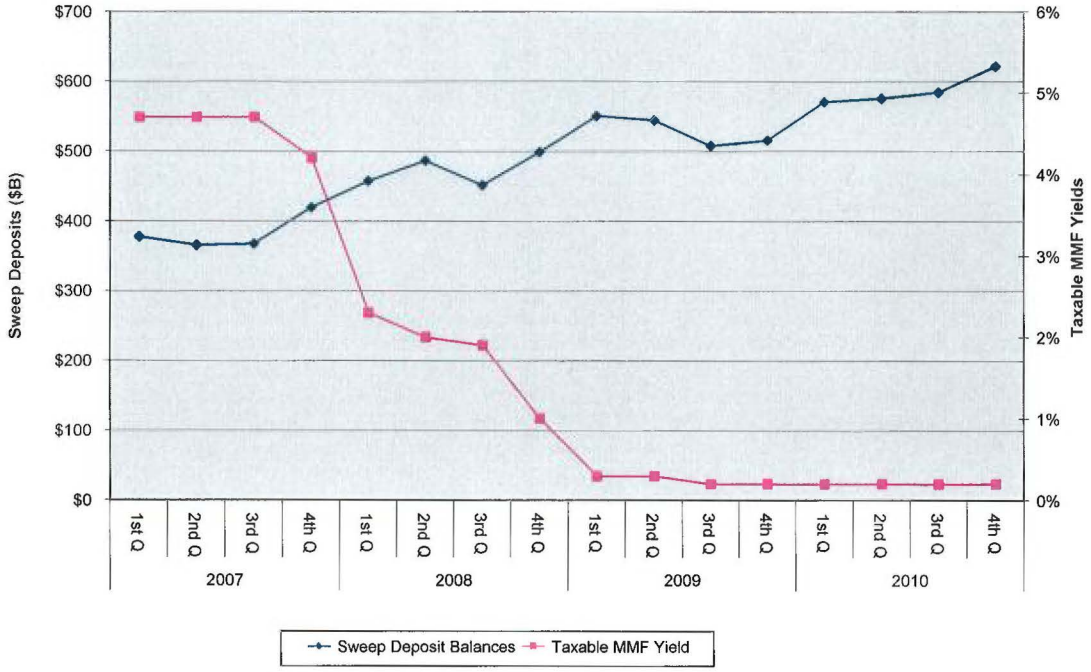
[79] *See* letter dated January 31, 2014 from Peter Morgan, Senior Vice President & Deputy General Counsel, The Charles Schwab Corporation, to Robert E. Feldman, Executive Secretary, FDIC (RIN 3064-AE04), available on the FDIC's website.

Network, LLC,[80] to the Agencies demonstrate similar stability for deposits from broker-dealer sweep programs to non-affiliated banks.

The chart set forth below (Sweep Deposit Balances and Taxable MMF Yields) demonstrates that sweep deposit balances are not sensitive to decreases in interest rates; as interest rates fell during the financial crisis, sweep deposit balances rose. Virtually all broker-dealer sweep programs establish interest rates by tiers based either on the value of customer assets or the amount of customer deposits: the greater the value of assets or the amount of deposits, the higher the interest rate. Because the interest rates offered by various brokers are not publicly available, we have used the yield on taxable money market funds published by the Investment Company Institute[81] as a surrogate for sweep program interest rates. Since the highest interest rate available in most sweep programs is typically equal to the current yield on taxable money market mutual funds, the index may overstate the actual blended rates of the interest rate tiers.

Sweep Deposit Balances and Taxable MMP Yields 2007-2010



80 *See* letter dated January 31, 2014 from Mark P. Jacobsen, President and Chief Executive Officer, Promontory Interfinancial Network, LLC, to Robert E. Feldman, Executive Secretary, FDIC (RIN 3064-AE04), available on the FDIC's website.

81 *See* Money Market Funds in 2013, available on the Investment Company Institute's website.

E. CD Programs: Limited Early Withdrawal

Brokered CD programs permit banks to access longer-term deposit funding that can be withdrawn by depositors only upon the death or adjudication of incompetence of the depositor. This limitation on early withdrawal is standard in the CD product and not a feature that changes from issuance to issuance.

Banks offering CDs to depositors directly through their branch networks must include early withdrawal provisions, either with or without a penalty, in order to satisfy depositor needs for liquidity in the event the depositor needs the funds. Banks typically have difficulty issuing longer-term CDs because of the depositors' demand for liquidity, and early withdrawal provisions contribute to the potential instability of the deposits.

Banks are able to issue longer-term CDs with limited early withdrawal provisions utilizing brokers because brokers maintain a secondary market in CDs that permits CD holders to liquidate their CDs at market prices without withdrawing their funds from the bank. As discussed above, CDs are established and issued under the U.C.C. Article 8 regime that permits the "indirect holding of financial assets." CDs are issued in $1,000 denominations and evidenced by a book-entry in the name of the fiduciary and negotiable "Master Certificates of Deposit" held by the DTC.[82] This system permits individual CDs to move between brokers by being transferred on the books of DTC and between a broker's customers by being transferred on the books of the broker.

The secondary market is deep and liquid. Most full-service brokers make a market for their customers and, in some cases, make a market for other brokers. In addition, four electronic trading platforms are dedicated to the offer and sale of CDs.[83] The liquidity provided by the secondary markets permits banks to issue CDs with longer maturities than is possible through a branch network. While maturities will vary depending on the yield curve, CDs with maturities greater than one year constitute between 35% and 45% of all brokered CD issuances. Because CDs can be issued with a "call" provision that permits a bank to redeem the CDs in its discretion, CDs can be issued with maturities of 20 years and longer.

The ability to issue CDs of varying maturities permits banks to reduce the mismatch of assets and liabilities on their books. Matching assets and liabilities contributes to a bank's stability.

The limited early withdrawal provisions in brokered CDs make a run on these deposits impossible. Based on a survey of major brokerage firms, the run-off from withdrawal due to death or adjudication of incompetence is substantially less than 1%. Furthermore, the withdrawal provisions are only available to natural persons. Business

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82 *See* Clark Article, *supra* note 66 at 152.

83 These include Knight BondPoint, Tradeweb, TheMuniCenter, and the Bloomberg Trade Order Management System.

entities cannot die or be adjudicated incompetent. Business entities, therefore, cannot withdraw funds from the bank until maturity of the CD. The stability of brokered CDs was demonstrated by the small run-off rates of the deposits at the Lehman Brothers banks after Lehman Brothers Holdings filed for bankruptcy.[84]

The total cost (fees and interest) to the banks issuing CDs in this market closely tracks rates on Treasury securities of like maturity. In addition, the total cost of brokered CDs is typically less than the average listing service rates for CDs of like maturity. The current APY on a one-year retail brokered CD is .80%, while the average APY offered by the ten highest paying banks on one internet listing service is currently 1.20%.[85] Because there are fifteen to twenty active CD underwriters, banks can seek pricing on CDs of varying maturities from multiple sources and choose the most cost-effective option.

The chart set forth below (Total Retail Brokered CDs) demonstrates the significant increase in bank issuances in the retail brokered CD market during the recent financial crisis. This market never ceased functioning and provided a reliable source of liquidity during the crisis.

The data were obtained from DTC and other sources.

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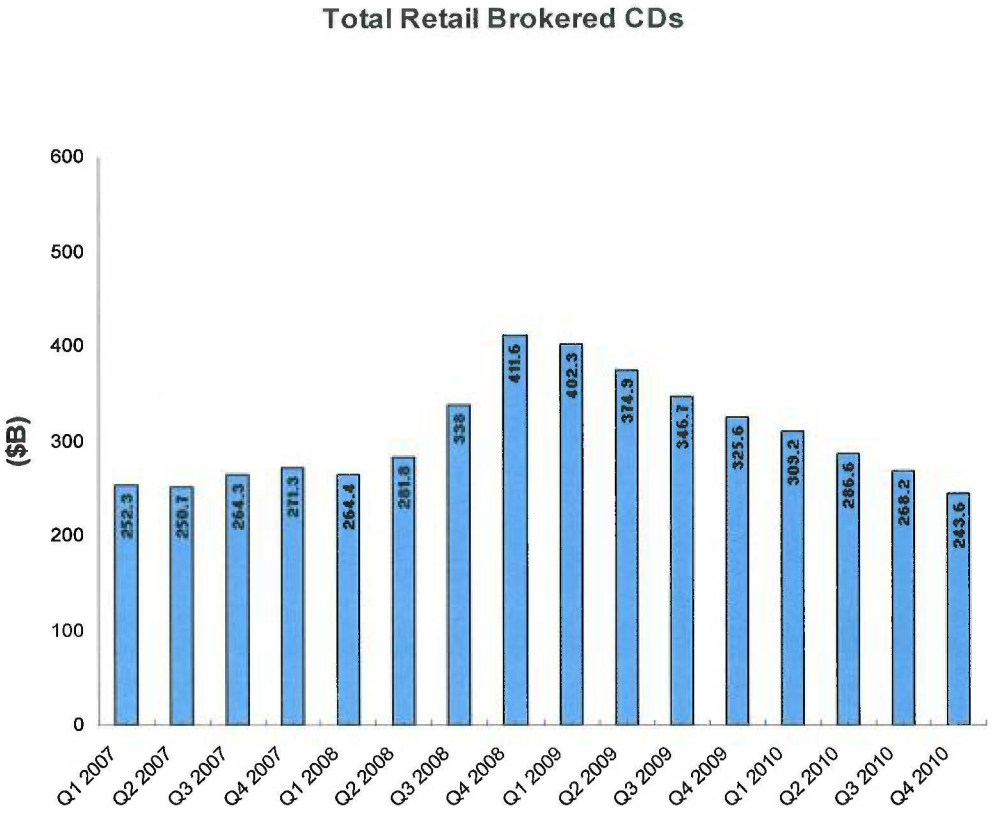
84 *See supra* p. 10.

85 Source: Bankrate, Inc. (www.bankrate.com) (Mar. 21, 2016).



Retail brokered CD issuances began declining beginning in the middle of 2009 as a result of an overall decline in bank lending, as well as the FDIC's "Brokered Deposit Adjustment" to deposit insurance premiums. Based upon data from DTC, brokered CD outstandings declined to a low of approximately $200 billion at the end of 2013 and has increased to nearly $240 billion as of February 2016.

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We appreciate the opportunity to provide these comments on behalf of our clients and would be pleased to discuss them with staff of the Agencies.

Very truly yours,

Paul T. Clark

SK 99031 0032 7064812

EXHIBIT A

Definition of "Deposit Broker"

(12 U.S.C. § 1831f(g)

The term "deposit broker" is defined to mean the following:

(1) Deposit broker

The term "deposit broker" means-
(A) any person 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; and
(B) an agent or trustee who establishes a deposit account to facilitate a business arrangement with an insured depository institution to use the proceeds of the account to fund a prearranged loan.

(2) Exclusions

The term "deposit broker" does not include-
(A) an insured depository institution, with respect to funds placed with that depository institution;
(B) an employee of an insured depository institution, with respect to funds placed with the employing depository institution;
(C) a trust department of an insured depository institution, if the trust in question has not been established for the primary purpose of placing funds with insured depository institutions;
(D) the trustee of a pension or other employee benefit plan, with respect to funds of the plan;
(E) a person acting as a plan administrator or an investment adviser in connection with a pension plan or other employee benefit plan provided that that person is performing managerial functions with respect to the plan;
(F) the trustee of a testamentary account;
(G) the trustee of an irrevocable trust (other than one described in paragraph (1)(B)), as long as the trust in question has not been established for the primary purpose of placing funds with insured depository institutions;
(H) a trustee or custodian of a pension or profitsharing plan qualified under section 401(d) or 403(a) of title 26; or

(I) an agent or nominee whose primary purpose is not the placement of funds with depository institutions.

(3) Inclusion of depository institutions engaging in certain activities

Notwithstanding paragraph (2), the term "deposit broker" includes any insured depository institution that is not well capitalized (as defined in section 1831o of this title), and any employee of such institution, which engages, directly or indirectly, in the solicitation of deposits by offering rates of interest which are significantly higher than the prevailing rates of interest on deposits offered by other insured depository institutions in such depository institution's normal market area.

(4) Employee

For purposes of this subsection, the term "employee" means any employee-
(A) who is employed exclusively by the insured depository institution;
(B) whose compensation is primarily in the form of a salary;
(C) who does not share such employee's compensation with a deposit broker; and
(D) whose office space or place of business is used exclusively for the benefit of the insured depository.