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February 3, 2014

Department of the Treasury
Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E-218, Mail Stop 9W-11
Washington, D.C. 20219
Attn: Legislative and Regulatory Activities Division
Docket ID OCC-2013-0016

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, D.C. 20551
Attn: Robert deV. Frierson, Secretary
Docket No. R-1466

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429
Attn: Comments / Legal ESS
Robert E. Feldman, Executive Secretary
RIN No. 3064-AE04

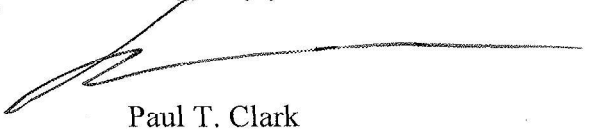
Re: Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring; Proposed Rule

Ladies and Gentlemen:

We hereby request permission to file the attached amended comment letter in connection with the above-referenced rulemaking. The amended letter corrects a minor error with respect to data presented on page 4 of the letter and does not change the substance of the letter.

Please contact the undersigned if you have any questions concerning the amended comment letter.

Very truly yours,



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Attachment

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January 31, 2014

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Robert E. Feldman, Executive Secretary
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Re: Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring; Proposed Rule

Ladies and Gentlemen:

Thank you for the opportunity to provide comments on the proposal by the Board of Governors of the Federal Reserve System ("Board"), the Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of the Currency ("OCC") (collectively the "Agencies") to implement the Liquidity Coverage Ratio ("LCR") established by the Basel Committee on Banking Supervision ("BCBS") (the "Proposed Rule").[1] Seward & Kissel LLP represents a wide range of participants in the brokered

[1] The Proposed Rule is published at 78 Fed. Reg. 71,818 (November 29, 2013). The LCR is part of a comprehensive set of BCBS regulatory proposals referred to as "Basel III."

deposit market, including broker-dealers, 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 currently total approximately $1 trillion of deposits, or more than 10% of all domestic deposits.[2]

As detailed in this letter, we believe that the Proposed Rule is deeply flawed and that the Agencies have failed to meet their statutory obligation to set forth the basis for, and to justify, proposed deposit run-off rates. We respectfully request that the Proposed Rule be withdrawn, revised and re-proposed with adequate explanation and support to permit the public to provide meaningful comment.

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[2] Data are derived from a survey of broker-dealer sweep program deposits not reported by the banks as brokered pursuant to an exemption, and call reports.

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I. Executive Summary

Under the Proposed Rule, a bank[3] must maintain an amount of high quality liquid assets ("HQLA") not less than 100% of its projected net cash outflows, including deposit outflows, over a hypothetical 30-day liquidity stress event, as determined by deposit run-off rates set forth in the Proposed Rule. The Proposed Rule assigns run-off rates ranging from 3% to 100% to various types of deposit funding for purposes of calculating net cash outflows. Run-off rates are determined first by whether the holder of the deposit account is a "retail" depositor or a "wholesale" depositor. Retail deposits, defined to include deposits of individuals and certain small businesses, are assigned lower run-off rates than wholesale deposits, with "stable retail deposits" – "transactional deposits" – assigned the lowest run-off rate. While all deposit accounts held by wholesale depositors are subject to higher run-off rates relative to deposit accounts held by retail depositors, certain types of wholesale depositors (*e.g.*, regulated financial institutions and pension funds) are assigned higher run-off rates relative to deposit accounts held by non-financial institutions and pension funds.

The deposit run-off rates assigned to brokered deposits, including sweep programs that meet the terms of an exemption from having the deposits characterized as "brokered,"[4] are higher than the deposit run-off rates assigned to similar deposits held directly at a bank by a depositor. The Agencies' stated rationale for this discrepancy is the assumption that brokered deposits are "a more volatile form of funding than stable retail deposits, even if deposit insurance coverage is present, because of the structure of the attendant third-party relationship and the potential instability of such deposits during a liquidity stress event."[5] No examples of the structural issues or other factors that would create "potential instability" are cited.

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[3] A bank is subject to the Proposed Rule's minimum liquidity standards if (i) it has consolidated total assets equal to $250 billion on more; (ii) it has consolidated total on-balance sheet foreign exposure of $10 billion or more; (iii) it is a depository institution that is a consolidated subsidiary of a company described in (i) or (ii) and has consolidated total assets equal to $10 billion or more; or (iv) the applicable federal banking agency determines that application of the standards is appropriate in light of the bank's asset size, level of complexity, risk profile, scope of operations, affiliation with foreign or domestic covered entities, or risk to the financial system. 78 Fed. Reg. 71,856. The Proposed Rule would also impose a modified liquidity coverage ratio standard based on a 21-calendar day rather than a 30 calendar-day stress scenario for bank holding companies and savings and loan holding companies without significant insurance or commercial operations that, in each case, have $50 billion or more in total consolidated assets. *Id.*, at 71,846.

References in this letter to the generic term "bank" are references to those banks that are subject to the Proposed Rule.

[4] *See* FDIC Advisory Opinion 05-02 (February 3, 2005) ("2005 Advisory Opinion"). The Proposed Rule defines "Brokered Sweep Deposits" includes deposits exempted for purposes of FDIC regulations.

[5] 78 Fed. Reg. 71,840.

The need for the Proposed Rule was prompted by the weakness of the liquidity position of many banking organizations during the recent financial crisis, "many of which experienced difficulty meeting their obligations due to a breakdown of the funding markets".[6] Although certain funding markets did break down,[7] the deposit funding market is not identified by the Agencies as being a contributor to bank liquidity problems during the crisis and, in fact, remained fully accessible to banks during the financial crisis: both total deposits and total brokered deposits in the banking system increased during the crisis and runs on fully-insured deposits, regardless of origination, were virtually non-existent.

We believe the Agencies have failed to meet their statutory obligation to establish the basis for the deposit run-off rates set forth in the Proposed Rule. Despite cautions by the BCBS and the Agencies themselves against simplistic approaches to determining deposit stability,[8] the Agencies have attempted to codify a highly simplistic approach to characterizing deposit stability. Among the deficiencies of the Proposed Rule are the following:

- The Agencies have cited no data or studies to support the deposit run-off rates, which appear to be based solely on "observations" and undisclosed "supervisory data."[9] In response to Freedom of Information Act ("FOIA") requests we filed with each of the Agencies and the Office of Financial Research ("OFR") requesting copies of any reports, studies and analysis supporting the deposit run-off rates in the Proposed Rule, we received the following responses:
    - The FDIC referenced information publicly available on its website that was not responsive to the request, including the FDIC's Study on Core Deposits and Brokered Deposits (FDIC, July 8, 2011) (the "FDIC Study"), which did not purport to study deposit run-off and does not provide support for the run-off rates in the Proposed Rule.
    - The OFR stated that it has no information.
    - As of the date of this letter, neither the Board nor the OCC has responded to our November 13, 2013 request.

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6 *Id.*

7 *See, e.g.,* Chairman Ben S. Bernanke, Speech at the Fourteenth Jacques Polak Annual Research Conference (November 8, 2013) ("Bernanke Speech"); and THE FINANCIAL CRISIS INQUIRY REPORT (U.S. Financial Crisis Inquiry Commission, January 2011) ("FCIC Report"), at 353, *et seq.*

8 *See, e.g.,* Liquidity Stress Testing: A Survey of Theory, Empirics and Current Industry and Supervisory Practices, BCBS Working Paper No. 24 (October 2013)("BCBS Working Paper"), at 18; the FDIC's Risk Management Manual of Examination Policies (the "FDIC Examination Manual"), at 6.1-7; and the Board's Commercial Bank Examination Manual (the "Board Examination Manual"), at 43-44.

9 *See,* 78 Fed. Reg., 71,835, *et seq.*

See Section III.

- Statistics cited in BCBS Working Paper No. 24 ("BCBS Working Paper"), the findings of the Financial Crisis Inquiry Commission ("FCIC") and publicly available data contradict the run-off rates set forth in the Proposed Rule. As Board Chairman Bernanke has stated, insured deposits did not run during the recent financial crisis.[10] *See* Section III.B.

- The Agencies have ignored over 80 years of experience in the United States with deposit insurance during financial crises, as well as the unique features of the U.S. deposit insurance system, including, *inter alia*, (i) high coverage limits, (ii) coverage of multiple insurable capacities, (iii) pass-through deposit insurance, (iv) expeditious resolution of failed banks, and (v) mandating the advertising by banks that insured deposits are backed by the full faith and credit of the U.S. Government. These features are never noted or discussed by the Agencies. In effect, the Agencies have approached the Proposed Rule as though the U.S. deposit insurance system were the equivalent of the demonstrably less robust deposit insurance systems in Indonesia, Korea, Russia, Turkey and other BCBS members. *See* Section II.A.

- The Proposed Rule utilizes the definition of "brokered deposits" in FDIC regulations, though it ignores certain exceptions from the definition in its definition of "Brokered Sweep Deposits". The characterization of a deposit account as "brokered" for purposes of both the Federal Deposit Insurance Act ("FDIA") and FDIC regulations is based merely upon the presence of an intermediary, not upon the characteristics of a deposit account, including its volatility. For example, rate-driven internet and listing service deposits[11] are not "brokered" and are, therefore, assigned lower run-off rates in the Proposed Rule than deposits that are characterized as "brokered." The proposed use of the definition of brokered deposit as a proxy for deposit volatility is, therefore, arbitrary. *See* Section V.

- Publicly available data, private data previously provided to the FDIC[12] and data included in this letter demonstrate that brokered deposits are a stable

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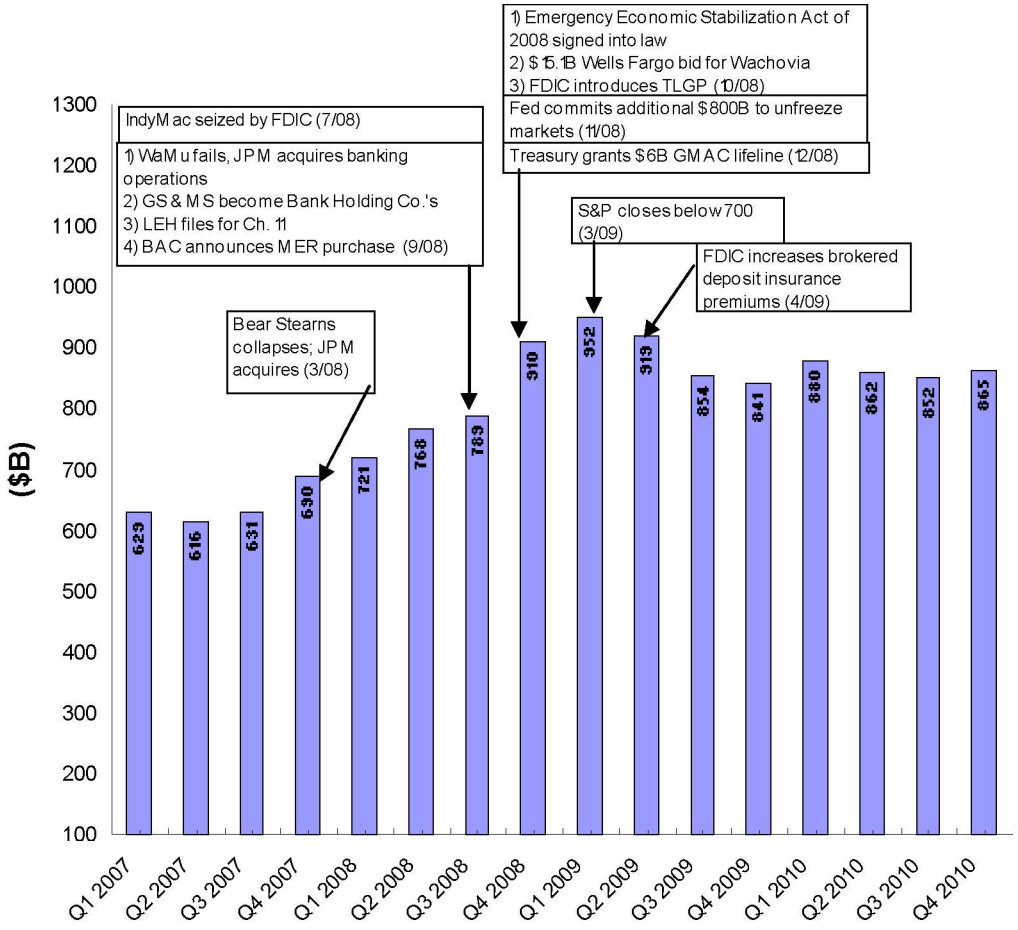
10 Bernanke Speech, *supra* note 7.

11 The current APY on a one-year CD in the retail brokered CD market is .25%. One listing service currently lists 21 banks offering one year CDs with APYs from .55% to 1.05%. The average APY of the 10 highest paying banks listed is 1.00%. Source of data: Bankrate, Inc. website (www.bankrate.com).

12 *See, e.g.*, Seward & Kissel comment letter to the FDIC dated December 17, 2008, in connection with the FDIC's proposal to establish a "Brokered Deposit Adjustment" to the insurance premium assessment; and 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 (hereinafter, the "Roundtable"); and data submitted confidentially to the FDIC by industry participants in connection with FDIC rulemakings.

source of deposit funding and, in fact, were a highly reliable source of funding during the recent financial crisis. From January 1, 2008 through December 31, 2008 total domestic deposits increased by 8.7%, while reported brokered deposits and sweep deposits exempt from being classified as brokered deposits increased by 31.9%.[13] *See* Section V.I.



- The Proposed Rule does not define various types of deposit accounts and the Agencies do not examine the specific features of various types of deposit accounts and assign run-off rates that reflect these features. For example, time deposits with very restrictive early withdrawal provisions

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[13] Data are derived from call reports and a survey of broker-dealer sweep programs.

are assigned the same run-off rates as time deposits with liberal early withdrawal provisions. This treatment of time deposits conflicts with the BCBS LCR proposal, which states that "the maturity of fixed time deposits with a residual maturity or withdrawal notice period of greater than 30 days will be recognized (*i.e.*, excluded from the LCR) if the depositor has no legal right to withdraw deposits within the 30-day horizon of the LCR, or if early withdrawal results in a significant penalty that is materially greater than the loss of interest."[14] Brokered CDs can only be withdrawn upon the death or adjudication of incompetence of the depositor, which results in a withdrawal rate of less than 1%. Yet brokered CDs are assigned a run-off rate of between 10% and 100% depending on the depositor. *See* Section IV.B.2.

- The Agencies have not examined the relationship between a broker-dealer or other regulated financial institution and the customers for whom they place deposits, or attempted to understand how such relationship affects deposit stability. Broker-dealers offer numerous financial products as well as financial advice to their clients, of which sweep arrangements and CDs are a small part. This broad, robust relationship promotes deposit stability, particularly with respect to sweep deposits. *See* Section VII.B.

- The FDIA mandates, and FDIC regulations implement, "pass-through" deposit insurance,[15] which permits the ownership of deposit accounts established at a bank by a "fiduciary", a term broadly defined to include trustees, agents, custodians and nominees, to be reflected on the books of the fiduciary for insurance purposes.[16] Under FDIC regulations, a bank is not required to know the identity of the beneficial owner of a deposit account held by a fiduciary. The Proposed Rule does not reference pass-through deposit insurance or address various types of fiduciary relationships, including relationships with fiduciaries who are not deposit brokers. The Proposed Rule does not attempt to address how banks will obtain information from such fiduciaries, including broker-dealers and other regulated financial institutions, on the nature of the underlying depositors or their insured status, and a depositor's insured status cannot be ascertained without the bank having the identity of the depositor in order to aggregate all deposits held by the depositor in the same insurable capacity. The Agencies have not attempted to estimate the cost of

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[14] Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring (BCBS, December 2010), at p 13. (The BCBS issued its LCR proposal in 2010 and made certain refinements to it in 2013. *See* note 65, *infra*.)

[15] 12 U.S.C. § 1821(a)(1)(C); 12 C.F.R. § 330.7.

[16] 12 C.F.R. § 330.5(b). For a complete discussion of pass-through insurance, *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 116, *et seq*.

implementing a practical system to obtain such information, if such system can in fact be implemented, or conducted a cost-benefit analysis of implementing such system. *See* Section VI.

- In support of their treatment of brokered deposits, the Agencies cite to statutory restrictions on the acceptance of brokered deposits by a bank whose capital category has changed from "well capitalized" to "adequately capitalized." The definition of "Brokered Sweep Deposit" in the Proposed Rule includes deposits accepted by banks through sweep programs that are not "brokered deposits" for purposes of FDIC regulations and are not subject to the restrictions on brokered deposits. The Agencies cannot, therefore, cite these restrictions as a basis for deposit run-off in these sweep programs. Furthermore, the Agencies do not acknowledge that the FDIC can grant waivers to "adequately capitalized" banks and that under the statutory standard the FDIC can only deny a waiver if acceptance of the deposits by a bank would be "unsafe and unsound," a finding that would be unusual in the context of a bank seeking funding during a systemic liquidity crisis. *See* Section V.C.

We believe the Agencies should withdraw the Proposed Rule and revise the deposit run-off rates to reflect the documented experience with deposit run-off during a financial crisis in the United States. The Agencies should specifically address (i) why any fully-insured deposit, no matter the nature of the depositor or how the deposit was originated, should receive a run-off rate higher than 3% (the run-off rate assigned to "stable" retail deposits), (ii) why a sweep deposit that is not entirely insured should be treated as if it is wholly uninsured, and (iii) why a time deposit with a limited early withdrawal option, no matter the nature of the depositor, the insured status of the depositor, or how the deposit was originated, should receive a run-off rate greater than the depositor's actual ability to withdraw the deposit. The revised rule should clearly set forth the rationale and supporting data for each proposed deposit run-off rate. The Agencies should publish the revised rule for public comment on the deposit run-off rates and their specified rationale.

II. Agency Rulemaking Standards

Pursuant to the Administrative Procedure Act,[17] which governs rulemaking by federal agencies, including the Board, FDIC and OCC, an agency must state the basis for any rule.[18] Agency rulemaking actions that are "arbitrary and capricious" may be set aside by a court.[19] The U.S. Supreme Court has held that an agency "must examine

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17 5 U.S.C. § 551, *et seq.*

18 5 U.S.C. § 553(c).

19 5 U.S.C. § 706(2)(A).

relevant data and articulate a satisfactory explanation for its actions including a 'rational connection between the facts found and the choice made'."[20] As stated by the Court:

> [A]n agency rule is arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.[21]

In adopting a regulation after receiving public comment, an agency must respond in a "reasonable manner" to comments that raise significant problems and its failure to respond may demonstrate that the agency's decision was not based on a consideration of the relevant factors.[22]

Because the Agencies cite no studies and provide no data to support their proposed run-off rates, the public cannot examine the basis for the run-off rates and comment on the validity of the assumptions underlying the run-off rates. As will be demonstrated in this letter, brokered deposits, no matter the identity of the holder of the deposit account, have no demonstrated run-off during a systemic stress period. Due to highly restrictive withdrawal provisions, brokered CDs cannot run. As previously stated, the amount of reported brokered deposits increased during the recent financial crisis.[23] A similar increase was reflected in sweep programs that are exempt from having the deposits characterized as "brokered".[24]

The LCR was not mandated by Congress and the Agencies have not been directed by Congress to use Basel III to effect significant changes to the U.S. banking system. The LCR has a narrow purpose and should not be used as a vehicle for working out differing visions of the U.S. banking industry. As stated by Board Governor Daniel Tarullo in Congressional testimony:

> Although adopting a robust, common set of capital and liquidity rules for internationally active banks is critical, it is neither practical nor desirable to negotiate all details of financial regulation internationally. It is important that the United States preserves the flexibility to adopt prudential

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20 *Motor Vehicle Manufacturers Association of the United States, Inc., et al. v. State Farm Mutual Automobile Insurance Co., et al.*, 463 U.S. 29 (1983) (*quoting Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168 (1962)).

21 *Id.*, at 43.

22 *See Dr. Zinovy V. Reytblatt, et al. v United States Nuclear Regulatory Commission, et al.*, 105 F.3d 715, 722 (D.C. Cir. 1997).

23 *See supra* p. 4.

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

regulations that work best within the U.S. financial and legal systems.[25]

Unfortunately, the Proposed Rule fails to reflect the history of the U.S. deposit insurance scheme and its unique legal structure. The U.S. deposit insurance system, including both the FDIC and the former Federal Savings and Loan Insurance Corporation ("FSLIC"), which was merged into the FDIC in 1990, is the oldest deposit insurance system in the world.[26] As a result, the U.S. has more experience with depositor behavior in an insured environment during a financial crisis than any other country in the world. Surprisingly, none of this experience is noted in the Proposed Rule.

A properly formulated rule proposal should address the various features of the U.S. deposit insurance system, including both its legal structure and its operational features, and reconcile these features with the goals of the LCR. The Agencies should, at a minimum, address the following factors that affect deposit stability:

- The FDIC has historically covered all insured deposits, and nearly all uninsured deposits, in failed banks.[27]
- The FDIC has instituted policies and procedures to quickly resolve failed institutions and to make depositors' funds available within two business days following a bank closure.[28]
- Pursuant to the FDIA, banks are required to advertise that insured deposits are backed by the "full faith and credit" of the U.S. Government[29]
- The FDIC engages in substantial consumer education efforts concerning deposit insurance coverage, including the maintenance of a website and a consumer hotline.[30]

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[25] Statement by Board Member Daniel K. Tarullo before the Subcommittee on Security and International Trade and Finance, Committee on Banking, Housing and Urban Affairs, United States Senate, at 4 (July 20, 2010).

[26] *See* 2011 International Association of Deposit Insurers Annual Survey Results.

[27] *See* 1980 Annual Report of the Federal Deposit Insurance Corporation, at 18-21 (1981) (noting that through 1980 the FDIC had paid nearly all depositors in failed banks, whether insured or uninsured). A similar approach was taken by the FDIC in the savings and loan crisis of the late 1980s and the recent financial crisis. *See generally* FDIC, MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE, 1980-1994 (1998) (stating that, between 1986 and 1991, 83% of all bank failures were resolved in a manner that protected uninsured deposits). According to data derived from data made publicly available by the FDIC, between July 2008 and December 2013, 93.8% of all bank failures were resolved in a manner that fully protected uninsured deposits. Bert Ely, Failed Banks and Thrifts—2007 to 2012 (Dec. 26, 2012) (unpublished spreadsheet, subsequently updated by email to Mr. Clark).

[28] The FDIC has stated publicly that its goal is to make deposit insurance payments within two business days of an insolvency. *See* When A Bank Fails – Facts for Depositors, Creditors and Borrowers (FDIC, last updated July 27, 2010) (available on the FDIC's website).

[29] 12 U.S.C. § 1828(a)(1); 12 C.F.R. § 328.1.

- The U.S. deposit insurance scheme insures depositors in multiple insurable capacities (*e.g.*, individual, joint, IRA, etc.) and the insurance coverage of $250,000 per insurable capacity is the second highest in the world.[31]

- The United States is the only country to provide "pass-through" insurance for deposit accounts held through a wide range of "fiduciaries", including trustees, agents, custodians and nominees. Under FDIC regulations, the identity of the beneficial owner of the deposit account is maintained on the books of the fiduciary, not the books of the bank. As a result, hundreds of billions of dollars of deposits are fully or substantially insured without the bank knowing the number or nature of the owners.

The Agencies' explanation of the Proposed Rule fails to discuss any of these features. For example, the Agencies fail to explain why any fully-insured deposit in a banking system with the above-referenced features would be vulnerable to substantial run-off. Furthermore, the Agencies have failed to address the fact that during times of stress, including the recent financial crisis, funds flow into banks because an insured deposit under a comprehensive taxpayer-backed deposit insurance scheme is the best investment alternative during a financial crisis.

The Agencies have not examined the likely consequences of assigning extraordinarily high run-off rates to certain deposits, particularly brokered deposits. The proposed run-off rates appear to reflect the type of deposit disintermediation the banking industry suffered in the 1970's and 1980's when depositors withdrew deposits and invested in money market mutual funds and other investments for reasons having nothing to do with a financial crisis. The Agencies should give due consideration to the fact that if the deposit run-off rates discourage certain types of deposits or depositors, or substantially increase the cost to banks to offer them, the depositors will seek investments outside the banking industry where there can be greater financial instability.

The Agencies should also closely examine the impact of the proposed run-off rates on the institutional CD market, in which banks issue CDs to institutional depositors in amounts substantially in excess of the FDIC limit. This market has long been viewed as important because it imposes market discipline on banks. Even though CDs issued in this market contractually do not permit early withdrawal, they would be assigned run-off rates between 40% and 100%, thereby discouraging banks from issuing CDs in this market.

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30 *See* www.fdic.gov/consumers/.

31 *See* Thematic Review on Deposit Insurance Systems, Peer Review Report (Financial Stability Board, February 8, 2012), at 48.

III. Absence of Support for the Deposit Run-off Rates

The Agencies are required to provide a "rational connection between the facts formed and the choice made" when proposing regulations.[32] The Agencies have set forth no factual basis for the proposed deposit run-off rates and, as noted above, were unable to provide any data or studies to support such rates in response to our FOIA requests. In fact, it appears that the Agencies engaged in no specific fact finding in connection with its formulation of the deposit run-off rates in the Proposed Rule.

In formulating the deposit run-off rates, the Agencies have generally ignored the stabilizing role played by deposit insurance. Instead, the Agencies appear to have based the run-off rates on the concept of a "core deposit", a concept that the BCBS and the Agencies themselves have cautioned is based on factors that may vary among banks and is virtually impossible to reliably define.

In its response to our FOIA request, the FDIC provided no studies or memoranda specifically prepared for the Proposed Rule, but did cite its 2011 Study. However, the FDIC Study merely repeats various conclusions about brokered deposit volatility without providing any support for the conclusions. The primary purpose of the FDIC Study appears to have been to attempt to link brokered deposits to bank failures, a linkage that has been previously examined and rejected.[33] Regardless of the Agencies' views on that issue, the purpose of the Proposed Rule is to accurately address the stability of various deposit relationships, not unrelated policy issues.

A. Role of Deposit Insurance

During the recent financial crisis, U.S. banks confronted a liquidity crisis resulting from a rapid deterioration of asset quality that required the Agencies to provide temporary liquidity facilities.[34] The liquidity crisis was not prompted by a run on fully-insured deposits, and neither the Agencies nor the BCBS cite any data or studies to

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32 *See supra* p. 7.

33 *See infra* p. 22. William Seidman, former FDIC Chairman, described the role of deposit funding in bank failures as follows:

> 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.

Insured Brokered Deposits and Federal Depository Institutions: Hearing before the Subcommittee on General Oversight and Investigations of the House Committee on Banking, Finance and Urban Affairs, 101st Cong., 1st Sess. (1989), at 98 (statement of L. William Seidman).

34 *See* Bernanke Speech, *supra* note 7; Philip A . Strahan, Liquidity, Risk and Credit in the Financial Crisis (FRBSF Economic Letter, May 14, 2012); and the FCIC Report, *supra* note 7.

support the proposition that U.S. banks confronted a run on fully-insured deposits, however originated, during the financial crisis.

Board Chairman Ben Bernanke recently acknowledged the role of deposit insurance in preventing deposit run-offs during the recent financial crisis: "[I]n 1907, in the absence of deposit insurance, retail deposits were much more prone to run, whereas in 2008, most withdrawals were of uninsured wholesale funding, in the form of commercial paper, repurchase agreements, and securities lending."[35]

The BCBS Working Paper reviewed case studies and literature concerning liquidity stress testing and, not surprisingly, concluded that "a deposit's insurance status is the most important characteristic in determining the sensitivity of deposits to risk or stress".[36] The Proposed Rule fails to acknowledge the stabilizing role of deposit insurance and, without explanation, creates different classes of insured deposits on what appears to be an arbitrary basis.

B. Core Deposits

The BCBS Working Paper notes that so-called "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.[37]

The BCBS Working Paper highlights studies of two U.S. banks during the financial crisis: Wachovia Bank, National Association, and Washington Mutual Bank.[38] Those studies indicate that the "definition of 'core' deposits proved to have little bearing on actual deposit run-off".[39] 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.[40]

The FCIC, which was established by Congress in 2009 to examine the causes of the recent financial crisis, noted in its report that "[t]he run on Wachovia Bank, the country's fourth-largest commercial bank, was a 'silent run' by uninsured depositors and

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35 Bernanke speech, *supra* note 7.

36 BCBS Working Paper, at 17.

37 *Id.*, at 18.

38 *Id.*, at 8.

39 *Id.*

40 *Id.*

unsecured creditors sitting in front of their computers, rather than by depositors standing in lines outside bank doors. By noon on Friday, September 26, 2008, creditors were refusing to roll over the bank's short-term funding, including commercial paper and brokered certificates of deposit."[41] The brokered certificates of deposit that were not being rolled over (they could not be withdrawn) were institutional CDs that were held by institutional depositors in amounts substantially above the FDIC insurance limit. Wachovia continued to have unrestricted access to the retail brokered CD market and its fully insured brokered deposits increased by $1.245 billion from June 30, 2008 through September 30, 2008.

The findings set forth in the BCBS Working Paper are consistent with the Agencies' own cautions concerning deposit funding stability and the concept of a "core" deposit. The term "core deposit" is not defined in the United States by statute or regulation and has defied definition without significant qualification. The designation of a liability as "core" or "non-core" is accomplished through definitions in the Uniform Bank Performance Report ("UBPR"), a financial reporting tool on which public comment has never been solicited. The UBPR deems all brokered deposits "non-core" liabilities, and the Agencies do not treat them as core deposits regardless of their terms.

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. These deposits are typically funds of local customers that also have borrowing or other relationships with the institution. *Convenient branch locations, superior customer service, dense ATM network and/or no fee accounts are significant factors associated with inertia of these deposits.*[42]

The FDIC Examination Manual cautions that

> . . . in some instances, core deposit accounts (e.g. time deposits) might exhibit characteristics associated with more volatile funding sources. *Conversely, deposit accounts generally viewed as volatile funding (e.g., CDs larger than $[250,000]) might be relatively stable funding sources.*[43]

The FDIC Examination Manual further cautions that

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41 FCIC Report, *supra* note 7 at 367.

42 FDIC Examination Manual, at 6.1-7 (emphasis supplied).

43 *Id.* (emphasis supplied).

> . . . at a particular institution, core deposit account balances might fluctuate significantly or might be more prone to run-off. For example, out of area CDs less than $[250,000] obtained from an Internet listing service are included in core deposits under the UBPR definition, but it is nevertheless likely that such deposits should not be viewed as a stable funding source.[44]

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 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 construing 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'."[45]

Similarly, the FDIC notes in its guidelines for deposit retention programs that "[i]ncreased competition for funds and the desire of most depositors to not only minimize idle, non-earning balances but also to receive market rates of interest on invested balances, have given further impetus to deposit retention efforts".[46]

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?

C. The FDIC Study

Although brokered deposits are excluded from core deposit characterization, the Agencies have not conducted, or commissioned a third party to conduct, a meaningful examination of the brokered deposit market and its component parts. In part, the absence of such an examination can be explained by the lack of data on call reports. While banks

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44 *Id.*, at 6.1-17.

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

46 FDIC Examination Manual, at 6.1-7.

are required to report their total brokered deposits, there is no breakdown by type of deposit account, specific maturity of CDs[47] or interest rates. The Agencies, therefore, cannot reach conclusions about the brokered deposit market solely based on reported data.

The Dodd-Frank Act required the FDIC to conduct a study to evaluate, *inter alia,* "an assessment of the differences between core deposits and brokered deposits and their role in the economy and banking sector of the United States".[48] The FDIC published its findings in the FDIC Study on July 8, 2011. The analysis and conclusions merely confirm the fact that there is no consensus on the definition of core deposit and that statements about the behavior of brokered deposits, particularly their volatility, are not based in fact. Consequently, the FDIC Study should not be relied upon to support the Proposed Rule.

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".[49]

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 is 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.[50]

More relevant to the Proposed Rule, 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".[51] There is, for example, no examination of the fact that brokered deposits increased by 33.4% during the peak of the recent financial crisis from December 31, 2007 through December 31, 2008, or that reported brokered deposits

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47 Banks report brokered deposits with a "remaining maturity of one year or less" in addition to total brokered deposits.

48 Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203 (July 21, 1010), § 1506.

49 *Id.*, at 36.

50 *See* note 12, *supra.*

51 FDIC Study, at 32.

decreased only after the imposition of a deposit insurance premium on brokered deposits by the FDIC.[52]

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.[53] Without any justification, under the Proposed Rule those deposits would have been assigned a run-off rate of between 10% and 100%, depending on the maturity of the deposit account and the nature of the deposit account holder.

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,[54] 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 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.[55]

The FDIC Study fails to incorporate valuable information about deposit stability from the FDIC's March 18, 2011 public roundtable on brokered deposits (the "Roundtable").[56] During the Roundtable, bankers discussed the factors that contribute to 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

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52 The "Brokered Deposit Adjustment" was implemented beginning with the second quarter of 2009.

53 Data are derived from call reports.

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

55 *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.

56 *See, e.g.,* the materials submitted by Jeff Zage, Chief Executive Officer, Financial Northeastern Securities, Inc., *supra* note 12.

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".[57] This raises significant questions as to why retail time deposits have a run-off rate of 10% to maturity under the Proposed Rule while brokered retail time deposits have a 100% run-off rate during the 30 days prior to maturity under the Proposed Rule, even though the brokered CDs have highly restrictive early withdrawal provisions.

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".[58]

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 do so out of convenience and not in pursuit of the highest available rate.

IV. Description of the Factors Determining the Deposit Run-Off Rates in the Proposed Rule

A. Overview of the Run-Off Rates

As set forth in the chart below the deposit run-off rates in the Proposed Rule are determined by:

- The nature of the deposit account holder (retail vs. wholesale);
- If retail, whether the deposit account is a "transactional deposit";
- Whether the deposit account is brokered or non-brokered; and
- In some, though not all, cases, whether the deposit is "entirely insured."

Wholesale deposits are further divided into two groups of depositors: (i) depositors that are regulated financial companies, investment companies, pension funds, investment advisers, public sector entities and other institutions ("Category 1 Deposits") and (ii) depositors that are not included in the above ("Category 2 Deposits").

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[57] *See* transcript of the Roundtable, at unnumbered p. 9 (remarks of David Hayes, Security Bank, Dyersburg, Tennessee).

[58] The letter is available on the ABA's website.

Category[59]	Agencies' LCR Outflow Amount	Modified LCR Outflow Amount
Unsecured Retail Funding		
Stable retail deposits **(Entirely insured "transactional deposits" and entirely insured other deposits of depositors that have a relationship with the bank)**	3%	2.1%
Other retail deposits **(Do not need to be entirely insured)**	10%	7%
Retail Brokered Deposits		
Brokered deposits with remaining maturities over 30 days	10%	7%
Reciprocal brokered deposits, **entirely covered by deposit insurance**	10%	7%
Reciprocal brokered deposits, **not entirely covered by deposit insurance**	25%	17.5%
Brokered sweep deposits, issued by a consolidated subsidiary, **entirely covered by deposit insurance**	10%	7%
Brokered sweep deposits, not issued by a consolidated subsidiary, **entirely covered by deposit insurance**	25%	17.5%
Brokered sweep deposits, **not entirely covered by deposit insurance**	40%	28%
All other retail brokered deposits, including time deposits with remaining maturities 30 days or under	100%	70%
Unsecured Wholesale Funding		
Category 2: Non-operational deposits not provided by a regulated financial company, investment company, non-regulated fund, pension fund, investment adviser, identified company, sovereign entity, U.S. government-sponsored enterprise, public sector entity, or multilateral development bank, or any consolidated subsidiary of the foregoing, **entirely covered by deposit insurance and not a brokered deposit**	20%	14%
Category 2: Non-operational deposits, not provided by a regulated financial company, investment company, non-regulated fund, pension fund, investment adviser, identified company, sovereign entity, U.S. government-sponsored enterprise, public sector entity, or multilateral development bank, or any consolidated subsidiary of the foregoing, **not entirely covered by deposit insurance or the funding is a brokered deposit**	40%	28%
Category 1: All other wholesale funding, including funding provided by a regulated financial company, investment company, non-regulated fund, pension fund, investment adviser, identified company, sovereign entity, U.S. government-sponsored enterprise, public sector entity, or multilateral development bank, or any consolidated subsidiary of the foregoing.	100%	70%

Under the Proposed Rule, retail deposits are assigned lower run-off rates than wholesale deposits, brokered deposits are assigned higher run-off rates than non-brokered deposits and Category 1 Deposits are assigned higher run-off rates than Category 2

[59] This chart excludes the proposed run-off rates for "operational wholesale deposits."

Deposits. Deposits entirely covered by deposit insurance are not always assigned a lower run-off rate than other deposits. Consider the following three examples:

1. A not entirely insured transaction account falling into the category of "other retail deposits" has a 10% run-off rate. However, an entirely insured retail sweep deposit to an unaffiliated bank has a 25% run-off rate, regardless of the depositor's relationship with the broker.

2. A not entirely insured time deposit falling into the category of "other retail deposits," regardless of withdrawal provisions, has a 10% run-off rate to maturity, while an entirely insured brokered Category 1 Deposit has a 100% run-off rate during the last 30 days to maturity, even though the brokered time deposit has highly restrictive withdrawal rights.

3. A not entirely insured Category 2 Deposit has a run-off rate of 40% while an entirely insured Category 1 Deposit has a 100% run-off rate regardless of the terms of the deposit or whether the depositor's relationship with a broker would deter withdrawal of the deposit.

The Agencies offer no explanation for this incongruent treatment of entirely insured and not entirely insured deposits. Furthermore, without explanation, internet and listing service deposits, which are not brokered, receive lower run-off rates than brokered deposits. Internet and listing service deposits are rate-driven deposits that have none of the characteristics that contribute to the stability of brokered deposits (*e.g.*, relationship with the broker-dealer, limited early withdrawal of time deposits, *etc.*).

B. Lack of Meaningful Definitions

1. Stress Event

The Proposed Rule assigns deposit run-off rates based upon a hypothetical 30-day liquidity stress event, but does not define the term "stress event" or attempt to describe with any precision the type of stress that would result in deposit run-off. The Agencies state that the proposed run-off rates "are meant to reflect aspects of the stress events experienced during the recent financial crisis. Consistent with the Basel III LCR, these components of the proposed rule would take into account the potential impact of idiosyncratic and market-wide shocks. . ."[60] While the Agencies mention the possibility of stress suffered by an individual bank, instances of idiosyncratic stress are not described. The BCBS Working Paper notes that there is "difficulty in identifying banks which experienced idiosyncratic liquidity stress" during the recent financial crisis.[61]

In order to provide clarity to the industry and permit an accurate analysis of the proposed run-off rates, the Agencies should adopt a definition of the term "stress event"

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60 78 Fed. Reg. 71,822.

61 BCBS Working Paper, at 5.

that makes clear that the term refers to a systemic liquidity crisis and outline the characteristics of such crisis. This will narrow the scope of the regulation and avoid application of the regulation to circumstances for which it was not intended. It should also result in a substantial reduction in the deposit run-off rates based on the experience of banks in the United States during the recent financial crisis.

In clarifying that the intended focus is systemic stress, the Agencies should specifically address whether systemic liquidity stress is likely to cause a bank's capital category to decline from "well capitalized" to "adequately capitalized" and, if so, why. In addition, the Agencies should address the fact that a bank maintains its capital category for the three-month period from the filing of its call report to the filing of its next call report and how this relates to a 30-day stress period. Finally, the FDIC should publish its brokered deposit waiver policies and specifically address under what circumstances it would find the acceptance of brokered deposits by an "adequately capitalized" bank during a systemic liquidity crisis "unsafe and unsound".

2. Types of Deposit Accounts

The Proposed Rule fails to provide definitions of the various types of deposit accounts offered by banks or to recognize that the terms of deposit accounts can vary widely. The only references to types of deposit accounts are contained in the definition of "retail deposit", which means a "demand or term deposit" placed by a retail customer, and in the definition of "stable retail deposit" which refers to, though does not define, "transactional accounts".

Banks in the United States are not obligated to offer specific types of deposit accounts or deposit accounts with specific terms. Pursuant to the Board's Regulation D (Reserves),[62] a deposit account may be subject to reserves if it has certain terms specified in Regulation D.

For example, time deposits are currently reserve-free under Regulation D as long as they have a maturity of seven days or more and any early withdrawal permitted during the first seven days must have a minimum penalty of all interest accrued to date of withdrawal.[63] Other than that requirement, a bank is free to negotiate the terms of the time deposit with its depositors, including maturity, interest rate and whether, and under what conditions, early withdrawal is permitted.

Although Regulation D does not mandate the offering of specific types of deposit accounts, it does provide definitions of deposit accounts for reserve purposes that are widely used throughout the industry, including for regulatory reporting purposes.[64]

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62 12 C.F.R. Part 204.

63 12 C.F.R. § 204.4.

64 12 C.F.R. § 204.2.

- *Time deposits*, deposits with a stated maturity of more than seven days;

- *Transaction accounts*, including accounts payable on demand ("demand deposit accounts" or "DDAs") and "NOW" accounts, accounts that have no limitations on the number of withdrawals, but permit the bank to require seven days' advance written notice of a withdrawal; and

- *Savings deposits*, including money market deposit accounts ("MMDAs"), deposits that have limitations on the number of withdrawals per month and permit the bank to require seven days' advance written notice of a withdrawal.

In order to accurately reflect the features of deposit accounts offered by U.S. banks, we believe the Agencies should incorporate Regulation D's deposit account definitions into the rule implementing the LCR. Furthermore, in order to accurately assess the run-off rates of various types of deposit accounts, the Agencies need to analyze the effects of the terms of these accounts on possible run-off.

- *Savings Deposits and NOW Accounts*. Banks may require seven days' prior written notice of a withdrawal from a depositor for either of these accounts. The process of requesting such a notice from a depositor and the actual submission of the notice to the bank could likely take a few more days. The Agencies should address whether their pre-notification right serves as a deterrent to outflows during a 30-day stress period.

- *Transaction Accounts Linked to Savings Deposits*. Banks frequently link transaction accounts to savings deposits and maintain substantial balances in the savings deposits in order to manage their reserves. The Agencies should address the effect of the seven-day prior written notice of withdrawal on the savings deposits on outflows from these linked accounts.

- *Time Deposits*. Banks are not required to offer early withdrawal to a depositor. If early withdrawal is permitted, it may be limited to certain circumstances (*e.g.*, death of the depositor) and the withdrawal may be subject to a substantial penalty or may be subject to no penalty. Therefore, as stated by the BCBS,[65] the Agencies need to assign run-off rates that reflect the actual early withdrawal provisions of the time deposits. Where a time deposit can be withdrawn without penalty, it should be treated as a demand deposit. Where it cannot be withdrawn at all, or only upon payment of a substantial penalty, it should be assigned a 0% run-off rate, or an appropriately low run-off rate.

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[65] *See* Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools (BCBS, January 2013), at 22.

3. Retail vs. Wholesale Deposits

The Proposed Rule attempts to accomplish something that has historically eluded all U.S. financial regulators: provide meaningful definitions for the terms "retail" and "wholesale."[66] While these terms are used in the marketplace, they are not used with the degree of precision necessary for a federal banking regulation. And in the context of deposits, the terms typically distinguish a fully-insured deposit from a deposit that is substantially uninsured, not a natural person from an institution.

By way of example, the International Banking Act of 1978 precludes U.S. branches of foreign banks from engaging in "retail deposit taking" without FDIC insurance. The OCC and FDIC determined that the most meaningful way to implement the restriction was to limit the ability of U.S. branches to accept an initial deposit from a depositor, regardless of the nature of the depositor, in an amount below the current FDIC insurance limit.[67]

The Agencies have provided no rationale for the distinction they have drawn, other than the implied rationale that a "wholesale" depositor is more likely to withdraw funds than a "retail" depositor, even when the funds are fully insured or cannot be withdrawn. As stated earlier, the Agencies have not established a basis for the view that any fully-insured deposit, whether retail or wholesale, is prone to run-off during a systemic liquidity crisis.

While the proposed distinction between "wholesale deposit" and "retail deposit" is flawed from many perspectives, one issue may serve to illustrate the problem. The Proposed Rule includes "pension funds" in the definition of wholesale deposit and defines the term in the broadest possible manner to include defined contribution, defined benefit and Keogh plans, as well as other types of employee benefit plans ("Plans").[68] Under FDIC regulations, the deposit accounts held by employee benefit plans are insured on a "pass-through" basis to the Plan beneficiaries.[69] In many of these Plans the beneficiary, a retail depositor for purposes of the Proposed Rule, can direct the investment of the funds. In fact, a condition of pass-through insurance imposed by the FDIC is that the beneficiary in a self-directed Plan must know the identity of the bank in which funds are being deposited.[70] The Agencies provide no basis for including such

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66 While the term "retail" is used in several places in the body of federal regulations governing depository institutions (*e.g.*, the term "retail banking services" in regulations implementing the Community Reinvestment Act), the term is not defined or explained. Similarly, the Securities and Exchange Commission ("SEC") has wrestled with the definition of "accredited investor."

67 *See* 12 C.F.R. § 28.6; and 12 C.F.R. § 347.213.

68 *See* § __.3 of the Proposed Rule, which defines "pension fund" by cross-reference to the Employee Retirement Income Security Act of 1974.

69 *See* 12 C.F.R. § 330.14.

70 *See* Deposit Insurance Regulations; Inflation Index; Certain Retirement Accounts and Employee Benefit Plan Accounts, Final Rule, 71 Fed. Reg. 53, 547, 53, 549 (September 12, 2006).

Plans in the definition of wholesale deposit and have provided no basis for concluding that the beneficiary of a self-directed Plan that has fully-insured funds on deposit at a bank would direct these deposits to be withdrawn during a stress period, or that such withdrawal would even be an option.

V. Characterization of Deposits as "Brokered"

A. Legislative History

The history of the FDIA provisions on brokered deposits provide no basis for the Proposed Rule's use of the definition of "brokered deposit" in FDIC regulations as a proxy for deposit volatility or for assuming a higher run-off rate relative to other deposit accounts. Furthermore, without explanation, the Proposed Rule defines the term "Brokered Sweep Deposit" to include deposits placed through sweep arrangements that are not "brokered deposits" for purposes of FDIC regulations. The Agencies' use of these definitions permit, *inter alia*, rate-driven internet and listing services deposits to have a lower run-off rate than more stable brokered deposits.

There is ample history to demonstrate that volatility was not even a consideration by Congress in adopting the brokered deposit provisions of the FDIA.[71] The FDIA does not reference the term "brokered deposits". Instead the statute limits the acceptance of deposits from a "deposit broker" and defines that term. The definition is derived from a regulation adopted by the FDIC and the Federal Home Loan Bank Board in 1984 to limit "pass-through" deposit insurance on deposits placed by certain intermediaries.[72] The regulation was overturned by the U.S. Court of Appeals for the District of Columbia Circuit on the basis that the FDIA provides a "clear and unequivocal mandate" to insure a depositor's deposit account held in the name of another person.[73]

From 1984 through 1990, Congressional committees held hearings and conducted studies on brokered deposits. The focus of the Congressional inquiry was the role of brokered deposits in bank failures and specifically whether brokered deposits permitted weak institutions to grow rapidly. Despite findings that brokered deposits were not a significant source of deposit growth for weak institutions,[74] and over the objections of the federal banking regulators,[75] Congress included an amendment to the FDIA in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA") that required undercapitalized depository institutions to obtain a waiver before receiving

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71 *See* 12 U.S.C. § 1831f.

72 *See* Brokered Deposits; Limitations on Deposit Insurance, 49 Fed. Reg. 13, 003 (April 2, 1984).

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

74 *See* Federal Regulation of Brokered Deposits in Problem Banks and Savings Institutions, H.R.Rep. No. 1112, 98th Cong., 2d Sess., at 6.

75 *Id.*, at 7.

deposits from a "deposit broker". The definition of deposit broker was taken from the overturned regulation without any change or debate.[76]

In 1991, the U.S. Department of the Treasury recommended that pass-through insurance be denied to brokered deposits.[77] Again, the concern was about the ease with which fully-insured deposits could be raised by weak institutions, not the volatility of the deposit accounts. Congress rejected the recommendation and adopted the current limitations, leaving in place the definition of deposit broker adopted as part of FIRREA.

B. The FDIA

The FDIA contains restrictions on the acceptance of deposits by insured depository institutions from a "deposit broker." The statute permits "well capitalized" depository institutions to accept such deposits without restriction.[78] An "adequately capitalized" depository institution may accept deposits from a deposit broker only if it has received a waiver from the FDIC.[79] An "undercapitalized" depository institution is prohibited from accepting deposits from a deposit broker.[80]

The FDIA also characterizes deposits solicited by an insured institution that is not a "well capitalized" depository 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."[81]

On a case-by-case basis, the FDIC may give an "adequately capitalized" bank a waiver from the brokered deposit restrictions upon a finding that the acceptance of deposits from a deposit broker does not constitute an "unsafe or unsound" practice by the bank.

The definition of deposit broker does not turn on the type of deposit account (*i.e.*, transaction account, savings deposit or time deposit) or the interest rate, term or other feature of the deposit account. Instead, it turns on the presence of an entity that is "engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions or the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties". The definition also includes "an agent or trustee who establishes a deposit

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76 *See* 12 U.S.C. § 1831f(g)(1); 12 C.F.R. § 337.6(a)(5).

77 *See* U.S. DEP'T OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS iv-5 (1991).

78 12 U.S.C. § 1831f(a).

79 12 U.S.C. § 1831f(c).

80 12 U.S.C. § 1831f(a).

81 12 U.S.C. § 1831f(e).

account to facilitate a business arrangement with an insured depository institution to use the proceeds of the account to fund a prearranged loan".[82]

The statute contains a number of exclusions from the definition of deposit broker, including the following:[83]

- An insured depository institution or an employee of an insured depository institution with respect to funds placed with that institution.

- A trust department of an insured depository institution if the trust placing deposits has not been established for the "primary purpose" of placing funds with insured depository institutions.

- A trustee of a pension or employee benefit plan with respect to funds of the plan; a plan administrator or investment adviser in connection with a pension plan or other employee benefit plan if the person is performing management functions; and a trustee or custodian of a pension or profit sharing plan qualified under section 401(d) or 403(a) of Title 26 of the United States Code.

- An agent or nominee whose "primary purpose" is not the placement of funds with depository institutions.

C. FDIC Regulations

Unlike the FDIA, FDIC regulations contain a definition of "brokered deposit." The term brokered deposit means "any deposit that is obtained, directly or indirectly, from or through the mediation or assistance of a deposit broker."[84] Again, the type, terms and characteristics of the deposit account are not a factor in the definition.

The definition of deposit broker in the FDIC regulations[85] mirrors the definition in the statute, with one exception. FDIC regulations exempt the following arrangements from the definition of deposit broker:

> An insured depository institution acting as an intermediary or agent of a U.S. government department or agency for a government sponsored minority or women-owned depository institution deposit program.[86]

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82 12 U.S.C. § 1831f(g)(1).

83 12 U.S.C. § 1831f(g)(2).

84 12 C.F.R. § 337.6(a)(2).

85 12 C.F.R. § 337.6(a)(5).

86 12 C.F.R. § 337.6(a)(5)(ii)(J).

Under the FDIC regulations, a bank's capital category is determined pursuant to regulations adopted by the bank's primary federal banking regulator. Pursuant to each Agency's regulations, a bank's capital category is fixed from the date its call report is filed until the date of the filing of its next call report three months later, unless the regulator re-classifies the bank's capital category.[87]

As with the FDIA, the FDIC regulations provide that the FDIC may grant a waiver if the acceptance of brokered deposits does not constitute an "unsafe or unsound" practice. The regulations slightly amplify this standard by adding that the FDIC may conclude that acceptance of brokered deposits is not "unsafe or unsound" if it poses "no undue risk to the institution".[88]

The FDIC has not published its waiver policies, which, under the statute and its own regulations, should be limited to denying a request for a waiver based solely on the effect of accepting the deposits on the safety and soundness of the bank. The waiver process is not intended to be a vehicle for enforcing policy considerations outside the scope of the FDIA. The failure of the FDIC to publish waiver guidelines, and the possibility that it would inappropriately deny a waiver application from an "adequately capitalized" bank during a liquidity crisis, contribute to the perception that the requirement to obtain a waiver should be viewed as a factor in determining the stability of brokered deposits.

D. FDIC Interpretations

FDIC interpretations further support the conclusion that a deposit's categorization as "brokered" is an inappropriate proxy for that deposit's stability. The FDIC staff has stated that the definition of deposit broker is "quite broad and unless the activity in question comes within any of the statutory or regulatory exclusions, the FDIC must and will consider the activity deposit brokering."[89] In other words, the mere proximity of an intermediary, regardless of the nature of the relationship between the depositor and the bank or the terms of the deposit account, can cause the deposit account to be a brokered deposit.

Although the common view of a "brokered deposit" is a deposit placed by, and held in the name of, a financial intermediary, the FDIC's expansive interpretation of the definition of deposit broker encompasses many activities where the role of the deposit broker is merely tangential. For example, the FDIC staff has advised that a bank that assists a customer in placing uninsured funds in a deposit account in the depositor's name at an affiliated bank is a deposit broker.[90] Neither the terms of the deposit account nor the receipt of a fee were cited as factors relevant to this determination. The FDIC staff

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87 *See, e.g.*, 12 C.F.R. § 325.102.

88 12 C.F.R. § 337.6(c).

89 FDIC Advisory Opinion 93-14 (February 24, 1993).

90 FDIC Advisory Opinion 92-68 (October 21, 1992).

has also advised that certain "finder" and "match-making" services offered by an intermediary causes the intermediary to be a deposit broker even though the depositor establishes the account directly with the bank and may have other relationships with the bank.[91]

E. Primary Purpose Exception

In 2005, the FDIC's General Counsel provided an interpretation with respect to the availability of the "primary purpose" exception from the definition of deposit broker in connection with certain broker-dealer sweep programs.[92] The guidance, which by its terms applies only to a sweep program from a broker to an affiliated bank, provides that the broker is not a "deposit broker" if, *inter alia*, the deposits do not exceed 10% of total customer assets with the broker and the bank pays the broker a flat per account fee, rather than a fee based on a percentage of deposits. As a result, the deposit accepted by the bank through such program is not a "brokered deposit" and is not subject to the brokered deposit restrictions.

F. Internet and Listing Service Deposits

A further illustration of the inappropriateness of using brokered deposits as a proxy for deposit volatility is the fact that deposit accounts solicited via the internet, or utilizing a so-called listing service that operates pursuant to an FDIC staff exclusion from the definition of deposit broker,[93] are not brokered and, therefore, are eligible for lower run-off rates under the Proposed Rule. Yet these deposits have been repeatedly characterized as volatile by the Agencies.[94] In fact, in 2011, the Agencies began requiring banks to report their listing service deposits on their call reports.[95]

VI. Pass-Through Deposit Insurance

A. Background

Commencing with the adoption of the Banking Act of 1933, the FDIC has been required to insure all net amounts due to an owner of a deposit insurance claim "whether such deposits be maintained in his name or in the name of others for his benefit".[96] Since 1946, FDIC regulations have specifically recognized insurance of deposit accounts held through a custodial relationship and since 1967 the regulations have referenced deposit

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91 FDIC Advisory Opinions 92-86 (December 7, 1992) and 92-53 (August 3, 1992).

92 *See* 2005 Advisory Opinion, *supra* note 4.

93 *See* FDIC Advisory Opinions 92-50 (July 24, 1992) and 04-04 (July 28, 2004).

94 *See, e.g.*, FDIC FIL-13-2009 (FDIC, March 3, 2009); Board Examination Manual, § 3000.1.

95 *See* FDIC FIL 9-2011 (February 14, 2011).

96 *See* 12 U.S.C. § 1821(a)(1)(C). For a complete discussion of the history of pass-through deposit insurance, *see* Clark Article, *supra* note 16.

accounts held by a trustee, agent, custodian or executor.[97] In 1990, the FDIC adopted regulations that included a section titled "Recognition of Deposit Ownership and Recordkeeping Requirements" that sets forth specific requirements for pass-through deposit insurance, including a definition of "fiduciary" that includes, but is not limited to, trustees, agents, nominees, guardians, executors and custodians.[98]

The 1990 regulations also set forth the manner in which deposit accounts held through "multi-tiered fiduciary relationships" — relationships in which a fiduciary acting on behalf of other persons itself uses a fiduciary to establish the deposit account — would be insured. This could occur, for example, when an employee benefit plan holds deposit accounts through a broker-dealer or other regulated financial institution acting as a fiduciary under FDIC regulations. Deposit insurance "passes through" the financial institution to the trustee of the plan and ultimately to the beneficiaries of the plan based upon the records maintained by the financial institution and the trustee of the plan.

As discussed above, the courts have denied attempts to selectively limit pass-through deposit insurance, holding that the FDIA unambiguously requires the FDIC to insure deposits held through others.[99] Based on this statutory mandate and the expansive application of pass-through insurance by the FDIC, the Agencies must address the LCR treatment of deposit accounts held through various fiduciary arrangements that are accorded pass-through insurance, whether deemed "brokered" or not.

B. Criteria

In general, pass-through deposit insurance is available if (i) the deposit account records of a bank indicate that the account has been established by a fiduciary acting for other, frequently unnamed, persons and (ii) the records of the fiduciary "maintained in good faith and in the regular course of business" provide the identities of the parties with an ownership interest in the deposit account and the amount of such ownership interest. If a bank fails, the fiduciary's records would form the basis of the insurance claim by the person with an interest in the deposit account and such persons would be eligible for FDIC insurance as if the person held the deposit account directly with the bank, including aggregation of the deposit account with other deposit accounts at the bank held by the person in the same insurable capacity.

C. Fiduciary Relationships

The FDIC has taken an expansive view of the types of fiduciary relationships that are eligible for pass-through deposit insurance, including irrevocable and revocable trust arrangements, employee benefit plans, various types of custodians (including broker-dealers and banks) and escrow agents (including banks, title companies and attorneys). Furthermore, in 1998, the FDIC amended its regulations to permit greater flexibility in

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97 12 C.F.R. §§ 330.6 and 330.7.

98 12 C.F.R. § 330.5(b)(1).

99 12 U.S.C. § 1821(a)(1)(C).

granting pass-through insurance where there is no express indication of the existence of a fiduciary relationship on the deposit account records if the titling of the account indicates the possible existence of a fiduciary relationship. The regulations state that "this exemption may apply, for example, where the deposit account title or records indicate that the account is held by an escrow agent, title company or a company whose business is to hold deposits and securities for others".[100]

There is no publicly available data on the balances in deposit accounts held through fiduciaries where the deposit accounts are not treated as brokered. However, since these non-brokered deposit accounts would include deposit accounts held through a sweep program that are exempt from being classified as brokered, deposit accounts at a bank held through its own trust department, deposit accounts at one bank held by another bank either as a trustee or custodian, deposit accounts held through title companies and other third-party escrow agents and deposit accounts held through all types of employee benefit plans, the deposit balances are likely in the many hundreds of billions of dollars.

D. Application of the Proposed Rule to Fiduciaries

With the exception of certain brokered deposit arrangements where pass-through insurance is acknowledged by implication,[101] the Agencies do not reference pass-through insurance or provide a rationale for the run-off rates assigned to deposit accounts held through various types of fiduciaries. With respect to brokered deposits, including sweep programs where the deposits are exempt from the definition of brokered deposits, the Proposed Rule provides lower run-off rates for deposit accounts held by retail depositors than for deposit accounts held by wholesale depositors. For sweep programs, retail "entirely insured" deposits receive more favorable treatment than retail deposits that are not entirely insured.

Despite the distinctions that the Proposed Rule draws between retail *versus* wholesale and entirely insured *versus* not entirely insured deposits, no mechanism is contemplated for banks to determine the nature of the depositors and the insured status of their deposit as reflected on the books of the fiduciary, whether the fiduciary is a broker or other agent. For example, in order to determine whether a deposit is entirely insured, a bank would need to know the identity of the depositor for whom the fiduciary is acting in order to determine whether the depositor has other deposits at the bank in the same insurable capacity.

The Agencies have not included the cost to the financial services industry of developing mechanisms for providing information concerning tens of millions of beneficial owners and beneficiaries and hundreds of billions of dollars of deposit balances in its cost estimate to the Office of Management and Budget.[102] Furthermore,

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100 12 C.F.R. § 330.5(b).

101 *See* 78 Fed. Reg. 71,835, *et seq.*, where the Agencies refer to entirely insured deposits and not entirely insured deposits without any explanation as to how insurance coverage is to be determined.

102 *See Estimated Costs and Benefits of the Proposed Rule,* 78 Fed. Reg. 71,853, *et seq.*

the Agencies have not attempted to determine whether there is a mechanism that is practical and feasible or whether the benefits merit the cost of implementing such a mechanism.

With respect to deposit accounts held through fiduciaries that are not deposit brokers, the Proposed Rule looks only to the identity of the fiduciary in assigning run-off rates, ignoring the pass-through insurance treatment of the deposit accounts. In addition, the Proposed Rule assumes that all such fiduciaries have the authority and the motivation to withdraw deposits during a stress period. As a result, deposit relationships with little chance of run-off, such as deposit accounts held by a bank trust department acting as trustee or custodian at its own bank, which are fully insured on a pass-through basis, are assigned a 100% run-off rate. How likely is it that the bank will withdraw fully-insured funds from itself during a hypothetical 30-day stress period?

Many third-party escrow arrangements present similar issues. Under the laws of a number of states, title companies acting as escrow agents in real estate transactions must disclose to the parties the identity of the bank at which funds are held in escrow.[103] Is it likely and feasible that a title company holding fully-insured funds from numerous parties to various real estate transactions is going to incur the cost of notifying parties to the escrow arrangement that it is moving funds to another bank because of systemic stress in the economy?

VII. Overview of the Brokered Deposit Funding Market

The deposit funding market is not well understood. In part, this is because the terminology used to discuss deposit funding, and to determine the regulatory reporting of deposits by banks, is imprecise and based in many cases on technical legal interpretations rather than the economic realities of the deposit funding market. For example, fully-insured brokered deposits are "non-core liabilities" for purposes of the UBPR, and are used in determining "net non-core funding dependence," an indicator of bank funding. Deposits solicited locally using teaser rates, over the internet, through national advertisements or through a deposit listing service are not "brokered" and, therefore, are treated as "core" deposits. These deposits are frequently 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 FDIC's insurance premium policies[104] a bank's ability to report these deposits as "core" provides an incentive for banks to pay more for these deposits than deposits that would be reported as "brokered".

Deposit funding needs to be discussed in an objective fashion without the use of imprecise 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

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103 *See, e.g.*, N.Y. GEN. BUS. LAW § 778-a.

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

deposits. As discussed earlier, the concept of a core deposit is more illusory than real. In the United States, the existence of a comprehensive deposit insurance scheme is itself a guarantor of deposit stability.

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[105] and raised the deposit insurance limit from $40,000 to $100,000.[106] 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.[107] 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 an MMDA linked to a 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 sweep programs. Between 2005 and 2013, 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

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

106 *Id.*, at § 308(a)(1)(C).

107 *See* Clark Article, *supra* note 16 at 102.

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 the 2005 General Counsel's opinion on sweep programs[108], 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 non-brokered deposits to be in excess of $400 billion.[109]

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 CDs 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 that is negotiated at arm's length in the context of a competitive market for deposit funding and, in the case of banks affiliated with a broker, subject to the Board's Regulation W (Transactions with Affiliates).

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

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108 *See* 2005 Advisory Opinion, *supra* note 4.

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

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 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 Depository Trust Company ("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.[110]

In sweep programs, the broker typically establishes an MMDA, and in most cases a linked DDA 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."[111] 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 smaller pieces. The smaller pieces cannot be enforced against the issuer. Brokered 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[112] and as an investment company for purposes of the Investment Company Act of 1940.[113] In order to accomplish this, the programs are structured to

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

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

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

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

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, 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.[114]

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 the Securities and Exchange Commission ("SEC") under the Investment Advisers Act of 1940.[115]

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.[116] 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.[117] 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.

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114 *See* Clark Article, *supra* note 16 at 149, *et seq.*

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

116 *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.

117 *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)(effective on March 3, 2014).

- 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.

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 Sweep Programs. In addition to the general sweep feature characteristics described above, programs that sweep customers 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 management of 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

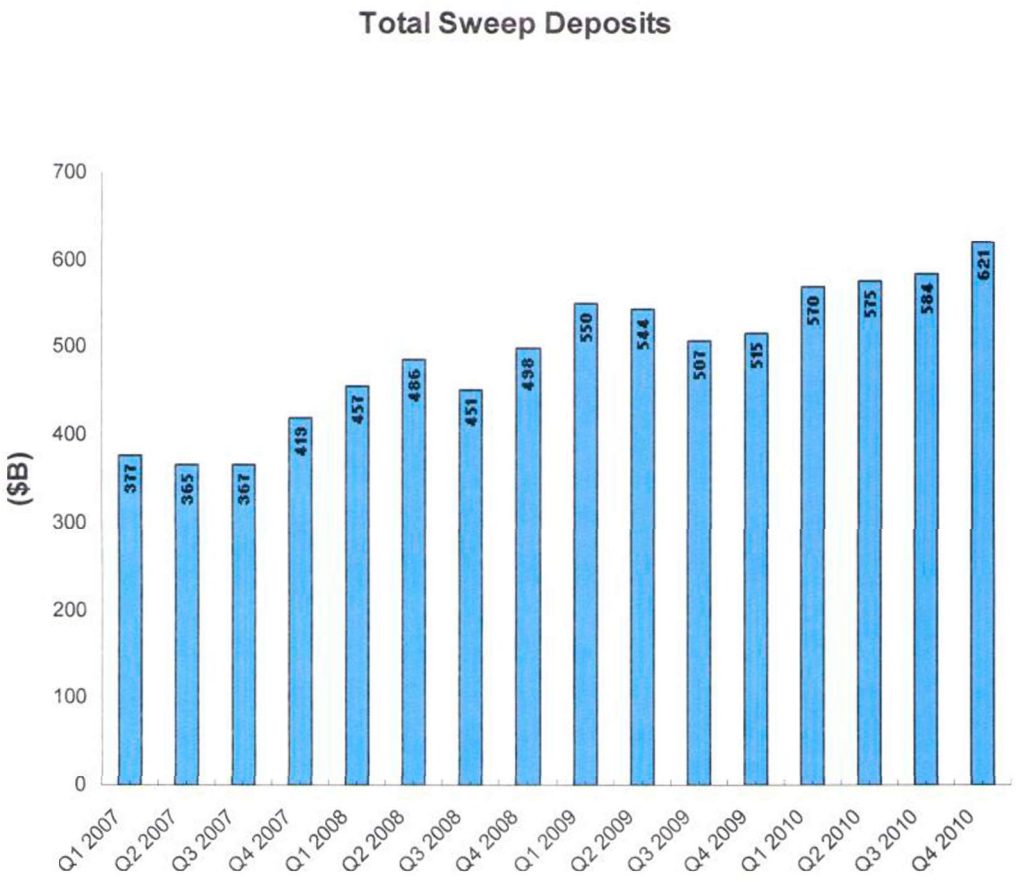
agreement, the bank can assure itself of a certain level of deposit funding at an agreed-upon rate, which is typically tied to a short-term funding index such as LIBOR.

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 from the beginning of 2007 through the end of 2010. The data was derived by subtracting CD outstandings from reported Total Brokered Deposits on call reports, using data obtained from 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.

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. shows 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 Network, LLC, demonstrates similar stability with deposits from sweep programs to non-affiliated banks.

The chart set forth below, Sweep Deposits and Taxable MMF Yields, demonstrates that sweep deposits are not sensitive to decreases in interest rates. 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[118] as a surrogate for sweep

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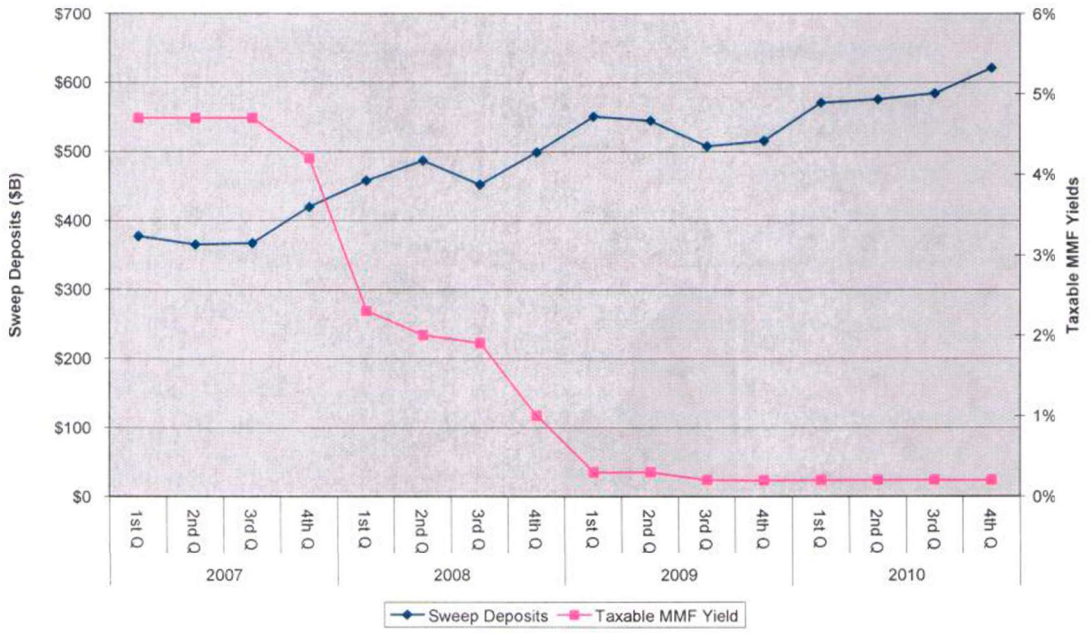
[118] See Money Market Funds in 2013, available on the Investment Company Institute's website.

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 Deposits and Taxable MMF Yields 2007-2010



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.[119] 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.[120] 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 permit a bank to redeem the CDs in its discretion, CDs can be issued with maturities 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 entities – "wholesale" depositors for most purposes of the Proposed Rule – cannot die or be adjudicated incompetent. Wholesale depositors, 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 Holdings filed for bankruptcy.[121]

The total cost (fees and interest) to the banks issuing CDs in this market closely tracks rates on Treasury security of like maturity. See Appendix A. In addition, the total cost of brokered CDs is typically less than the average listing service rates for CDs of like maturity. As noted earlier, the current APY on a one year retail brokered CD is .25%, while the average APY offered by the ten highest paying banks on one internet listing service is currently 1.00%. 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 demonstrates the significant increase in bank issuance 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. As

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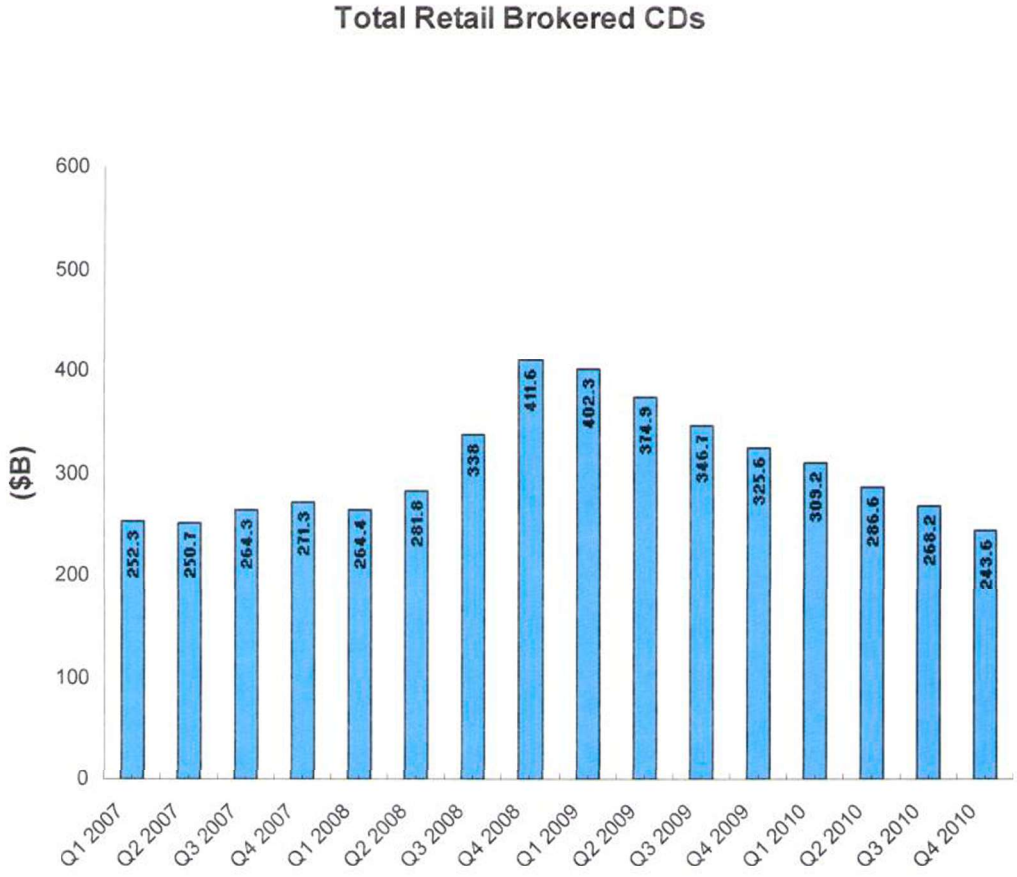
119 *See* Clark Article, *supra* note 16 at 152.

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

121 *See supra* p. 15.

previously noted, Wachovia raised over $1 billion in deposits in this market during the silent run on its uninsured deposits and unsecured liabilities.

The data was obtained from DTC and other sources.



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. Depositor demand for retail brokered CDs remains strong, accounting for the current .25% APY on one year CDs.

VIII. Conclusion

As detailed above, the deposit run-off rates set forth in the Proposed Rule are not supported by studies conducted in the wake of the recent financial crisis or by data that is readily accessible by the Agencies. Furthermore, based upon responses to our FOIA requests, the Agencies do not appear to have conducted any studies specifically for the

purpose of developing the deposit run-off rates. While the deposit run-off rates generally are consistent with depositor behavior under the robust, comprehensive deposit insurance scheme we have in the U.S., the deposit run-off rates assigned to brokered deposits, whether sweep deposits or CDs, are particularly unsupportable.

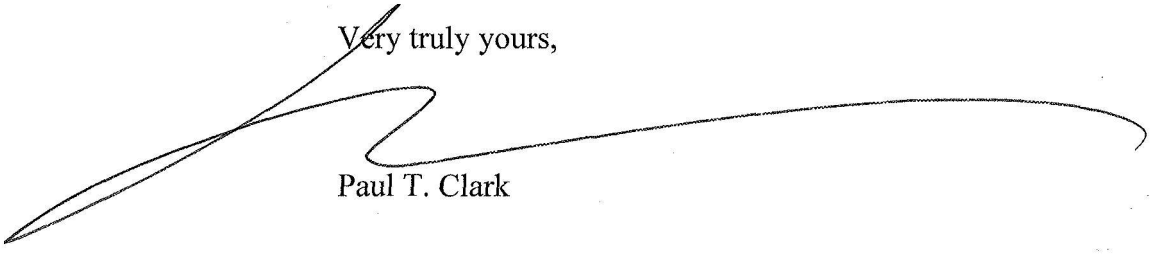
Brokered deposits do not run. In the case of sweep deposits, run-off is discouraged by the availability of deposit insurance, the relationship between a broker and its customers and the nature of a sweep product within the broker-dealer environment. In the case of brokered CDs, run-off is curtailed by highly restrictive early withdrawal provisions.

In this letter we have identified a number of factors that the Agencies should address in reconsidering the Proposed Rule including, but not limited to, the following:

- The numerous features of the U.S. deposit insurance system that assure the stability of deposits;
- Data and studies supporting the fact that fully-insured deposits at U.S. banks remained stable during the recent financial crisis;
- Data specifically demonstrating the stability of brokered deposits at U.S. banks during the recent financial crisis; and
- The FDIC's obligation to insure deposits on a "pass-through" basis and the costs and benefits of implementing procedures to determine the insured status of deposit accounts held by depositors through various types of fiduciaries.

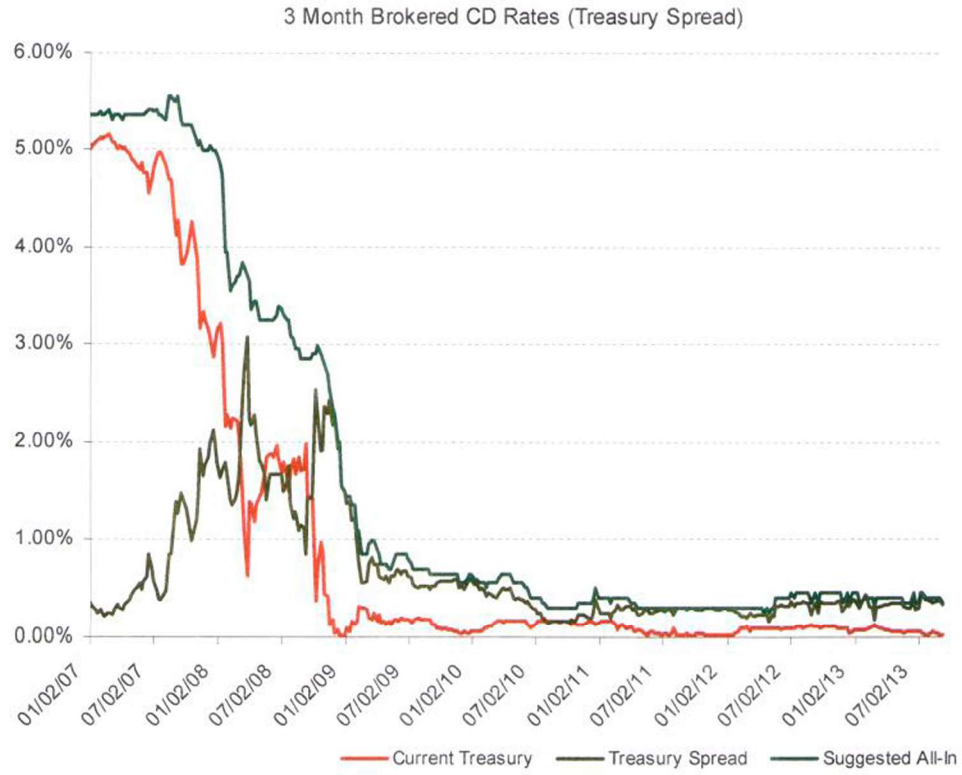
We would be pleased to work with the Agencies as they review these issues and determine the most appropriate manner in which to address them.

Very truly yours,



Paul T. Clark

APPENDIX A


3 Month Brokered CD Rates (Treasury Spread)
6.00%
5.00%
4.00%
3.00%
2.00%
1.00%
0.00%
01/02/07
07/02/07
01/02/08
07/02/08
01/02/09
07/02/09
01/02/10
07/02/10
01/02/11
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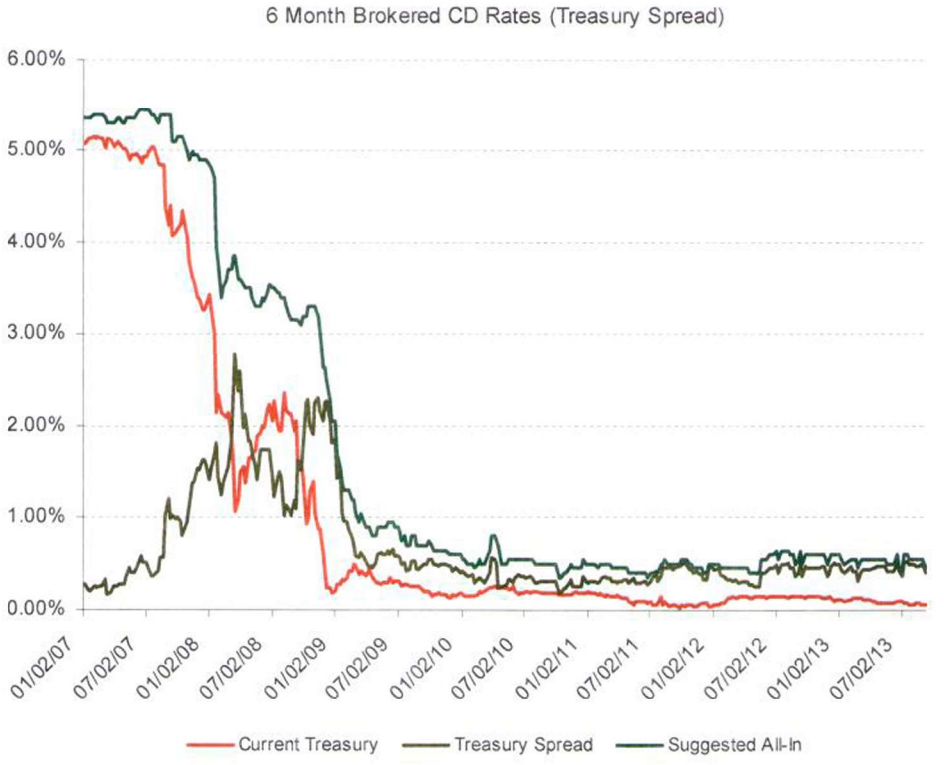
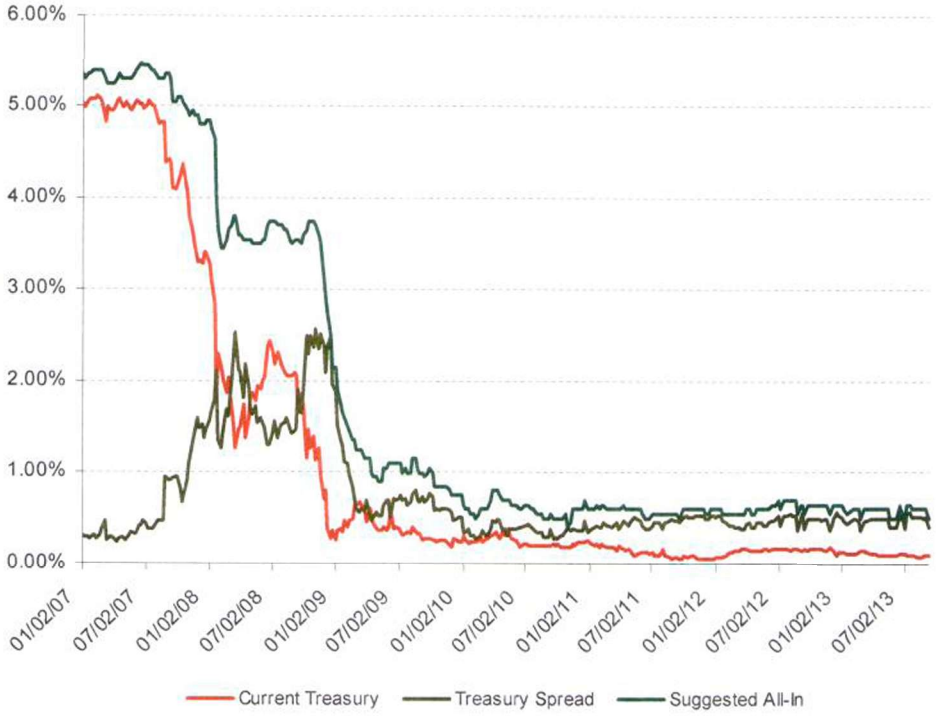
07/02/13
Current Treasury
Treasury Spread
Suggested All-In


6 Month Brokered CD Rates (Treasury Spread)
6.00%
5.00%
4.00%
3.00%
2.00%
1.00%
0.00%
01/02/07
07/02/07
01/02/08
07/02/08
01/02/09
07/02/09
01/02/10
07/02/10
01/02/11
07/02/11
01/02/12
07/02/12
01/02/13
07/02/13
Current Treasury
Treasury Spread
Suggested All-In

9 Month Brokered CD Rates (Treasury Spread)



1 Year Brokered CD Rates (Treasury Spread)

2 Year Brokered CD Rates (Treasury Spread)

3 Year Brokered CD Rates (Treasury Spread)

5 Year Brokered CD Rates (Treasury Spread)

10 Year Brokered CD Rates (Treasury Spread)