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INSIGHT

FDIC Proposes Changes to Brokered Deposit Regulation

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On December 12, 2019, the Federal Deposit Insurance Corporation (FDIC) proposed changes to current rules that restrict banks that are not well capitalized from accepting brokered deposits, a perennial point of contention between banks and regulators. Recently, banks and financial technology companies have developed or begun using new arrangements that may qualify as brokered deposits. This development has refocused attention on the issue.

Background

Core deposits are the funds individuals or companies directly place in checking and savings accounts, primarily to utilize the safekeeping, check-writing, and money-transfer services banks provide. *Brokered deposits*, in contrast, are funds that a third-party broker places in a bank on behalf of a client, typically to maximize interest earned and possibly also to ensure the client does not have any one bank account that exceeds the FDIC's $250,000 insurance limit.

Core deposits are sticky—depositors are unlikely to switch banks due to differences in interest rates, because they face costs and inconvenience when doing so (e.g., filling out new direct deposit forms, getting new checks, and changing automatic bill payment information). In contrast, brokers typically monitor interest rates offered at numerous banks and move funds from one bank to another with higher interest rates, even if the difference is small.

Regulators traditionally have been wary of brokered deposits due to their potential lack of stability as a funding source, and banks that overly rely on them or use them to lend imprudently could face an increased risk of failure. Banks face *liquidity risk*—their assets cannot be converted into cash as easily as depositors can withdraw funds. A bank run is a classic illustration of this: depositors demand their deposits back en masse, but the bank does not have the cash to meet its obligations. Similarly, if deposit

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brokers withdraw funding en masse, a bank could become distressed. The risk of failure increases further if a bank seeks brokered deposits to expand in a relatively risky manner, such as by making loans in volatile or unfamiliar markets. Bank runs on core deposits have been rare since the creation of federal deposit insurance because core depositors have less incentive to run when they are confident they will not suffer losses in the event of a bank failure. In contrast, if a bank does not offer high-enough interest rates, brokers would still have an incentive to withdraw large amounts of deposits quickly in order to move them to a bank offering higher rates.

Despite their relative lack of stickiness, brokered deposits—when prudently accepted and used for carefully underwritten lending—can be a useful and beneficial source of funding for a bank. Brokered deposits, though sensitive to interest rates, can be less costly than issuing debt and capital instruments to raise funds. Meanwhile, population and economic growth rates limit how strongly wholly new bank account demand grows. Thus, attracting core deposits may require offering high-enough interest to entice existing core account holders to switch banks. In addition, banks and certain third-party service providers, including financial technology companies, have argued that brokered deposit restrictions are outdated and should not apply to certain technology-enabled arrangements. For example, deposits gained by certain internet advertising arrangements involving targeted advertising and bank referrals can qualify as brokered deposits.

Current Regulation and the FDIC's Proposal

The FDIC's *Study On Core Deposits and Brokered Deposits*, done pursuant to Section 1506 of the Dodd-Frank Act (P.L. 111-203), describes how regulators became concerned about brokered deposits during the savings-and-loan (S&L) crisis of the 1980s, a systemic event in which more than 1,000 depositories failed, costing taxpayers $124 billion according to one estimate. Regulators noticed a pattern at certain depositories wherein the institution would increase reliance on brokered deposits, grow quickly (often by making loans in new or risky market segments), and become distressed. Analyses presented in the FDIC study and academic papers it cites indicate that a higher proportion of broker deposits relative to core deposits at a bank is correlated to—though not necessarily the cause of—greater probability and cost of failure.

To address the problems revealed by the S&L crisis, Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA; P.L. 101-73). Among other things, FIRREA added Section 29 to the Federal Deposit Insurance Act (P.L. 81-797). Section 29 generally prohibits banks that are not well capitalized from accepting deposits from a "deposit broker." It also provides a definition of that term and enumerates nine exclusions not included in that definition. However, the definition and the exclusions require a degree of interpretation by the FDIC to implement their regulations.

Banks have argued that the FDIC has been too broad in its interpretation of what a deposit broker is, and as a result certain banks have been precluded from accessing useful funding sources that are dissimilar (e.g., more stable, not interest rate maximizing) from the deposit broker businesses FIRREA intended to address in the now 30-year-old law. In the case of a type of arrangement called *reciprocal deposits*, Congress agreed that brokered deposits restrictions should be relaxed and amended Section 29 in the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (P.L. 115-174). However, certain industry observers argue further loosening restrictions will unnecessarily expose banks to the risks associated with brokered deposits and the FDIC's Deposit Insurance Fund to losses.

In December 2018, the FDIC issued a request for comment that indicated it sought to modernize the brokered deposit regulations given recent technological developments. On December 12, 2019, it issued a notice of proposed rulemaking that included proposed changes and asked for further comments. The proposal seeks to address issues raised by third-party arrangements, which are often technology-based or -enabled. Broadly, under the proposal the FDIC would do the following, among other things:

1. change the definition of "deposit broker" such that the degree of control the third party has over the movement of funds has greater importance; and
2. create criteria and an application process for third parties to qualify for a certain exception from the deposit broker definition.

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