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Key Concerns To Confront In FDIC Brokered Deposit Proposal

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On July 30, the Federal Deposit Insurance Corp. issued a notice of rulemaking proposing significant changes to the FDIC's brokered deposits rules.[1]

A number of the proposed rule changes, highlighted below, could materially affect banks, neobanks, fintech companies and other third parties in the industry, many of whom have crafted business models, started new businesses or even undertaken transformative acquisitions in reliance on the brokered deposits rules the FDIC finalized in December 2020.

The proposal could also materially affect consumers, particularly those who are underbanked or unbanked, and who rely on neobank and fintech apps for access via bank-fintech partnerships to traditional financial products and services.

Comments on the proposal are due no later than Oct. 22, 60 days after the rule was published in the Federal Register.

Background

On Dec. 15, 2020, the FDIC finalized its brokered deposits rules to modernize those regulations and establish a new framework for analyzing whether certain deposit arrangements qualify as brokered deposits.[2] The 2020 rule promoted innovation between commercial banks and fintech companies by providing clearer guidance on what constituted a deposit broker and, by extension, a brokered deposit.[3]

Fast-forward to 2024, and the intersection of banks and nonbank financial services providers is at the regulatory and supervisory forefront. The environment for banks and bank-fintech partnerships has changed dramatically following events including the spring 2023 bank failures, current enforcement trends in the bank-fintech partnership space and the bankruptcy of Synapse Financial Technologies Inc.

The proposal suggests an intent to address this current reality and pulls back on many of the changes to the brokered deposits framework implemented by the 2020 rule.

Notably, at the time the 2020 rule was finalized, FDIC Chair Martin Gruenberg, acting then in his capacity as a member of the board, sharply dissented.[4] The preamble to the proposal references many of those

same concerns as a basis for the changes under the proposal.[5]

Key Aspects of the Proposal

The proposal includes several notable changes that would materially affect the brokered deposits analysis for insured depository institutions, or IDIs, and their third parties.

It eliminates the exclusive deposit arrangement carveout.

The 2020 rule provides that any entity that contracts or partners exclusively with one IDI, and is not placing or facilitating the placement of deposits at any other IDI, is not considered a deposit broker and, therefore, any deposits placed by the entity with the IDI are not brokered deposits.

The proposal would eliminate the exclusive deposit arrangement carveout by revising the FDIC's brokered deposits regulations to restore their applicability to any third party that meets the definition of deposit broker, including those involved in placing deposits at only one IDI.[6]

It revises the definition of "deposit broker," including adding a new prong to the definition related to fees paid to a third party.

The proposal would affect commonly used bank marketing practices by adding a new prong to the definition of "deposit broker" related to fees paid to a third party. The proposed rule specifically provides that a person is engaged in the business of placing or facilitating the placement of deposits of third parties if that person "has a relationship or arrangement with an IDI or customer where the IDI, or the customer, pays the person a fee or provides other remuneration in exchange for or related to the placement of deposits."[7]

Fees that would be covered under the proposal would include fees for administrative services provided in connection with a deposit placement arrangement.[8]

It revises the analysis for determining when an agent or nominee meets the primary purpose exception.

The proposal would provide that the primary purpose exception to the "deposit broker" definition would apply "when an agent or nominee whose primary purpose in placing customer deposits at IDIs is for a substantial purpose other than to provide a deposit-placement service or FDIC deposit insurance with respect to particular business lines."[9]

This interpretation would align with how the FDIC historically interpreted the primary purpose exception before the 2020 rule.[10] As part of this analysis and any corresponding application process for a primary purpose exception, or PPE, the FDIC would analyze the intent of the third party and consider the relationship between the third party and the IDI, including whether fees were paid to the third party.[11]

It eliminates the enabling transactions PPE.

The 2020 final rule created a PPE for third parties that place deposits to allow their customers to enable transactions. Without any substantive discussion, the proposal quickly eliminates this enabling transactions test and corresponding notice process, stating:

> The current enabling transactions test would not satisfy the proposed primary purpose exception, because placing deposits into accounts with transactional features would not, by itself, prove that the substantial purpose of the deposit placement arrangement is for a purpose other than providing deposit insurance or a deposit-placement service. The FDIC believes that there is no relevant difference between an agent or nominee's purpose in placing deposits to enable transactions and placing deposits to access a deposit account and deposit insurance.[12]

Under the proposal, IDIs that currently rely on the enabling transactions test under the notice or application process could file an application under the general PPE application process.[13]

It eliminates existing exceptions for PPE notices or applications.

The proposal provides that IDIs relying on an existing approved PPE application, a 25% test designated-exception notice, or an enabling-transactions exception notice or application, would no longer be able to rely on such exceptions. As a result, IDIs would need to submit a new PPE application, rely on the new 10% broker-dealer sweep exception, described below, or rely on one of the preserved designated business exceptions from the 2020 rule.[14]

It changes the PPE application process.

The proposal would update the PPE application process and would add additional factors to the FDIC's review of those applications, including any fees paid to the third party and whether the third party has discretion to choose the IDIs where it will place customer funds.

The proposal also would provide that only IDIs, not third parties, must submit PPE applications.[15]

It proposes a broker-dealer sweep exception.

The proposal would amend the 25% test to a 10% of assets-under-management test and rename it the "broker-dealer sweep exception." Under the proposal, the proposed broker-dealer sweep exception would be available only to a broker-dealer or registered investment adviser, and only if less than 10% of its total assets under management in a particular business line, is placed into nonmaturity accounts at one or more IDIs.

Prior notice would be required where no additional third party is involved in the sweep program. An application would be required for sweep programs that use one or more third parties.[16]

It removes the "matchmaking activities" prong and replaces it with a "deposit allocation" prong.

The proposal would eliminate the "matchmaking activities" prong to the deposit broker definition and replace it with the new "deposit allocation" standard.[17] As a result, deposit brokers would include a person who proposes or determines deposit allocations, including through the use of algorithmic or similar technologies.[18]

Unlike the current matchmaking activities prong, which excludes the provision of services to affiliated entities, the deposit allocation standard could be met in connection with the provision of services to affiliates.[19]

It retains the remaining designated business exceptions.

As noted, the proposal would amend the 25% test and eliminate the enabling transactions test. The proposal would retain the remaining designated business exceptions listed in the 2020 rule, as well as the additional designated exception for nondiscretionary custodians engaged in the placement of deposits.[20]

Key Concerns and Takeaways

While much more will be written on these topics, the fundamental changes to the 2020 final rule, coupled with the FDIC's request for information on deposits, reflect concerns within the FDIC on how it currently oversees the risks associated with different types of deposits.[21]

Thematically, we believe there are several key issues to confront, in addition to the responses needed to the alternatives in the proposal and technical clarifications.

1. Risks Defined Widely

First, the restrictions on brokered deposits are derived from Section 29 of the Federal Deposit Insurance Act, which relates to banks that are not well capitalized. There is little disagreement within the industry that banks that fail to remain well capitalized should not be relying on brokered deposits for growth.

However, the FDIC and other agencies have leveraged the definition of brokered deposits for other purposes — essentially defining a very diverse set of deposits to be inherently risky and penalizing banks that accept such deposits — be it in the form of assessments or, for the larger banks, the calculation of the liquidity coverage ratio and the net stable funding ratio.

2. Risk Assessment Without Good Data

Second, the conflation of the risks related to certain types of uninsured deposits and the risks of brokered deposits is not supported by data.

The proposal cites the FDIC's 2011 "Study on Core Deposits and Brokered Deposits," but even that study indicates that a higher proportion of brokered deposits relative to core deposits at a bank is correlated to — though not necessarily the cause of — greater probability and cost of failure. In addition, the data for that study is not reflective of today's banking system.

Instead of overhauling such a recent regulation, it would be prudent for the FDIC to receive and release information relating to the deposits RFI so both the FDIC and the industry can consider the actual risks associated with brokered deposits.

Once such data is analyzed, it would be worth considering whether the definition of a brokered deposit for purposes of institutions that are not well capitalized should be broadly defined. And, if so, should there be different categories of such brokered deposits for other regulatory purposes to more accurately reflect the inherent risks?

3. Unintended Consequences for Bank Operations

Third, there are practical implications of these changes that could pose unintended consequences. For instance, the removal of affiliate considerations for exclusivity and deposit allocations does not reflect

the reality of how banks and bank holding companies organize themselves — frequently in consideration of resolution planning.

In addition, the burden of new notices for the PPE and ongoing reporting fail to address situations where there is a spot increase in cash held that is wholly unrelated to the business of the broker-dealer or the IDI that receives the swept funds.

4. Access for Underbanked Consumers

Fourth, the proposal could materially affect consumers, particularly those who are underbanked or unbanked, and who rely on neobank and fintech apps for access, through bank partnerships, to traditional financial products and services. The proposal acknowledges only that consumers "might experience changes in interest rates on those funds, or costs associated with placing those funds with different entities."[22]

The proposal does not, however, take into account that the 2020 rule was aimed, in part, at enabling banks to reach new customers through bank-fintech partnerships and extend their services to underbanked and unbanked populations. The proposal would roll this back and could create harmful unintended consequences for those segments of the population through increased costs or decreased availability or access, pushing underbanked or unbanked consumers to less reliable and less safe financial services providers.

5. Vulnerability to Election-Year Reversals

Fifth, rulemaking this late in an election year could be vulnerable to reversal depending on the outcome of the election. The process of reviewing and responding to comments submitted in the 60-day public comment period and then finalizing the proposal will take substantial time and may not be completed before the end of the current administration. If the proposal is not finalized by then, a new administration with a different policy perspective could stop the process.

In addition, if adopted in a final rule, the proposal would qualify as a rule under the Congressional Review Act and therefore could be reviewed and disapproved by Congress in the event of a change in the administration and control of Congress. Under the Congressional Review Act, disapproval would require each chamber to pass a resolution of disapproval by a bare majority and would also require approval by the new president. This is a streamlined legislative process that can be used in a new Congress to undo rules adopted shortly before an election.

Conclusion

As with any proposal, it is imperative that all stakeholders actively engage in the rulemaking process with the FDIC and other policymakers to facilitate a thoughtful approach to the final rule. Recent U.S. Supreme Court decisions have increased a trend of judicial skepticism towards agency rulemakings, which could potentially make the proposal vulnerable to legal challenge under the Administrative Procedure Act.

The comment process will play a critical role in highlighting the myriad issues raised by the proposal and its potentially broader unintended consequences, including impacts on consumers, namely the underbanked and unbanked. The comment process may also form the basis for any future legal challenges to the FDIC's final rule.

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[1] FDIC, Unsafe and Unsound Banking Practices; Brokered Deposits Restrictions (July 30, 2024), available at: https://www.fdic.gov/system/files/2024-07/fr-npr-on-brokered-deposit-restrictions.pdf.

[2] FDIC, Press Release: FDIC Board Approves Final rule on Brokered Deposit and Interest Rate Restrictions (Dec. 15, 2020), available at: https://www.fdic.gov/news/press-releases/2020/pr20136.html. The 2020 final rule was published in the Federal Register on Jan. 22, 2021. See Unsafe and Unsound Banking Practices: Brokered Deposits and Interest Rate Restrictions, 86 FR 6742 (Jan. 22, 2021).

[3] Section 29 of the Federal Deposit Insurance Act does not define the term "brokered deposit." The determination of whether an activity results in a brokered deposit turns on the definition of "deposit broker."

[4] The 2020 final rule was approved by a vote of three to one, with Gruenberg dissenting. Gruenberg's dissenting statement is available at: https://www.fdic.gov/news/speeches/2020/spdec1520f.html.

[5] Compare Gruenberg's dissent:

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

with Proposal, p. 36:

Under this change, an IDI can rely for one hundred percent of its deposits on an unaffiliated third party without any of those deposits considered brokered. The IDI can fall below well capitalized and still rely on those third party placed deposits for one hundred percent of its funding without any of those deposits being considered brokered, which provides an avenue for less than well-capitalized IDIs to obtain and retain brokered deposits that appears to conflict with intent of the statutory prohibition. An IDI can form multiple "exclusive" third party relationships to fund itself without any of those deposits considered brokered. Thus, the current regulation exposes the banking system to the kind of risk the brokered deposit restrictions were intended to address.

[6] See Proposal, pp. 35-36.

[7] Proposal, p. 29.

[8] See Proposal, p. 33.

[9] Proposal, p. 38.

[10] Id.

[11] See Proposal, pp. 38-39.

[12] Proposal, p. 54.

[13] See id.

[14] See Proposal, p. 28.

[15] See Proposal, pp. 41-44.

[16] See Proposal, pp. 47-53.

[17] See Proposal, p. 29.

[18] See Proposal, pp. 31-32.

[19] See Proposal, p. 32.

[20] See Proposal, p. 55.

[21] On July 30, 2024, the FDIC issued a request for information soliciting the public's comments on deposit data that is not currently reported in the call report or other regulatory reports, including for uninsured deposits. See FDIC Request for Information on Deposits (July 30, 2024), available at: https://www.fdic.gov/system/files/2024-07/fr-request-for-information-on-deposits.pdf. Comments are due on the deposits RFI within 60 days of publication in the Federal Register.

[22] Proposal, p. 69.