November 13, 2024

James P. Sheesley
Assistant Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Re.: *Unsafe and Unsound Banking Practices: Brokered Deposits Restrictions/RIN 3064–AF99*

Dear Mr. Sheesley:

The Committee on Capital Markets Regulation (the "Committee") offers these comments to the Federal Deposit Insurance Corporation ("FDIC") on its proposed rule "Unsafe and Unsound Banking Practices: Brokered Deposits Restrictions" (the "Proposal").[1]

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-seven leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Emeritus Dean, Columbia Business School) and John L. Thornton (Former Chairman, The Brookings Institution) and is led by Hal S. Scott (Emeritus Nomura Professor of International Financial Systems at Harvard Law School and President of the Program on International Financial Systems). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

Our letter proceeds in two parts.

Part I summarizes how the Proposal would expand the scope of deposit arrangements classified as brokered deposits, thereby increasing banks' capital and liquidity requirements and deposit insurance premiums for many types of deposit arrangements.

Part II assesses the Proposal and finds that it is fundamentally flawed. These flaws invalidate the Proposal as an "arbitrary" and "capricious" agency action under the Administrative Procedure Act. In particular, the Proposal fails to consider relevant evidence, reverses a prior agency action without a rational basis, and fails to acknowledge the costs it would impose on the banking system, other financial intermediaries, and their customers. For these reasons, we recommend that the FDIC withdraw the Proposal and maintain the FDIC's current brokered deposits regulations.

[1] FEDERAL DEPOSIT INSURANCE CORPORATION ["FDIC"], *Unsafe and Unsound Banking Practices: Brokered Deposits Restrictions*, FED. REG. Vol. 89, No. 164, 68,244 (Aug. 23, 2024), https://www.federalregister.gov/documents/2024/08/23/2024-18214/unsafe-and-unsound-banking-practices-brokered-deposits-restrictions [the "Proposal"].

I. Summary

The Federal Deposit Insurance Act (the "FDIA") defines a deposit broker as a person engaged in the business of placing or facilitating the placement of customer deposits with insured depository institutions.[2] Brokered deposits are deposits that insured depository institutions obtain with the assistance of a deposit broker.[3] Typical examples of brokered deposits are certificates of deposits ("CDs") that banks sell to brokers, which brokers then resell to customers.[4]

Congress enacted a specialized regime for brokered deposits under the FDIA in the 1980s in response to the perception that undercapitalized banks were using brokers to grow their deposits rapidly and using the funds to make risky loans and investments. Brokered deposits were also thought to be a less stable source of funding because they can be quickly transferred among banks in large quantities by the broker and because they are often purchased for the purpose of obtaining a higher interest rate.[5] As a result, they may be withdrawn faster than deposits obtained directly from customers if the bank shows signs of distress or competing banks offer higher interest rates.

As a result of these concerns, banks are required to pay higher deposit insurance premiums with respect to brokered deposits relative to non-brokered (i.e., "core") deposits.[6] Brokered deposits also have a greater impact on a bank's liquidity coverage ratios,[7] net stable funding ratios,[8] and, for Global Systematically Important Banks ("G-SIBs"), capital surcharges.[9] Banks are thus required to hold more liquid assets and capital with respect to brokered deposits relative to core deposits. Moreover, because brokered deposits are classified as "short-term wholesale funding" ("STWF") a bank's level of brokered deposits is relevant to determining which tier of overall capital and liquidity requirements and which supervisory framework the bank must comply with. Specifically, banks with $75 billion or more in brokered deposits or other STWF, non-bank assets, and off-balance sheet exposures are classified as "Category III" banks and are thus subject to more stringent capital, liquidity, and supervisory requirements relative to smaller banks.[10] Expanding the scope of the definition of brokered deposits will therefore potentially increase the overall capital and liquidity requirements for some banks and subject them to more stringent supervisory frameworks.

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[2] 12 USC § 1831f(g)(1).
[3] 12 CFR § 337.6(a)(2).
[4] In this letter we hereafter refer to insured depository institutions covered by the Proposal as "banks."
[5] FDIC, *Study on Core Deposits and Brokered Deposits* 50-51, Appendix A, 66 (July 8, 2011), https://www.fdic.gov/sites/default/files/2024-03/coredeposit-study.pdf; FDIC, *Unsafe and Unsound Banking Practices; Brokered Deposits Restrictions* 85(27) FED. REG. 7453, 7464 (Feb. 10, 2020), https://www.govinfo.gov/content/pkg/FR-2020-02-10/pdf/2019-28275.pdf.
[6] 12 CFR § 327.16(e)(3)
[7] *Id*. §§ 329.32(a), (g).
[8] *Id*. §§ 329.104(b), (c).
[9] *Id*. § 217.406(b)(2)(v).
[10] FEDERAL RESERVE, *Requirements for Domestic and Foreign Banking Organizations* (Oct. 10, 2019), https://www.federalreserve.gov/aboutthefed/boardmeetings/files/tailoring-rule-visual-20191010.pdf.

Although the restrictions of the brokered deposits regime apply directly to banks, the classification of an intermediary as a deposit broker also has consequences for the intermediary. In particular, if an intermediary is classified as a deposit broker, it may be more difficult or costly for the intermediary to place customer funds with banks, because the regulatory cost to the bank of accepting deposits from the intermediary increases.[11] An intermediary may also need to file a notice or application with the FDIC in order to avoid classification as a deposit broker. Examples of intermediaries that could be classified as deposit brokers include broker-dealers that place their clients' uninvested cash in bank accounts, as well as fintech firms and other "banking-as-a-service" providers that pair a financial service such as accounting software or payment services with access to a deposit account at one or more partner banks within a single interface. Whether such an intermediary is classified as a deposit broker depends on the specifics of the depository arrangement.

Until 2020, the FDIC analyzed whether arrangements involving banks, third-party service providers, and customer deposits were classified as brokered deposits on a case-by-case basis though staff guidance and piecemeal rulemakings that did not establish a clear or comprehensive framework. In 2020, the FDIC proposed a rule, which it finalized in January 2021, and which established a comprehensive framework with "bright-line standards" for analyzing whether a deposit arrangement is a brokered deposit (the "2020 Regulations").[12] The Proposal would reverse substantially all the provisions of the 2020 Regulations and make other changes that would significantly expand the scope of deposit arrangements that are classified as brokered deposits.[13] The FDIC does not directly estimate how many deposits the Proposal would reclassify as brokered deposits, but the Proposal suggests that by reversing the 2020 Regulations, the Proposal could increase the total value of deposits classified as brokered by more than 30%.[14]

We summarize here the most important changes that the Proposal would make to the current regulations.

1. Eliminating the "matchmaking" exception

The 2020 Regulations provide that service providers that use the financial information of customers and banks to propose allocations of customer deposits ("matchmaking") are deposit brokers unless the service provider is affiliated with the bank.[15] In the 2020 Regulations, the FDIC explained that the intermediary's access to the financial information of customers and banks is an

[11] COOLEY, *FDIC's Proposed Brokered Deposit Rule Could Adversely Impact Fintech-Bank Partnerships* (Sept. 4, 2024), https://www.cooley.com/news/insight/2024/2024-09-04-fdics-proposed-brokered-deposit-rule-could-adversely-impact-fintech-bank-partnerships.

[12] FDIC, *Unsafe and Unsound Banking Practices: Brokered Deposits and Interest Rate Restrictions* 86(13) FED. REG. 6, 742 (Jan. 22, 2021), https://www.govinfo.gov/content/pkg/FR-2021-01-22/pdf/2020-28196.pdf ["2020 Regulations"]; FDIC, Banker Resource Center, Brokered Deposits https://www.fdic.gov/banker-resource-center/brokered-deposits (last visited Sept. 25, 2024).

[13] 12 CFR § 337.6 (a)(5).

[14] Proposal at 68,259-60.

[15] 12 CFR § 337.6(a)(5)(iii)(C).

indicator that the intermediary is intended to have the ability to influence the movement of deposits among different banks and that the intermediary is acting as a broker. It also explained that the exception for affiliate relationships recognizes that when there is an affiliate relationship between a deposit matchmaker and the bank, the likelihood that customer deposits will be withdrawn and placed in another bank is lessened (i.e., the deposits are "sticky").

The Proposal would eliminate the matchmaking exception and replace it with a narrower exception that (1) omits the requirement that the intermediary must have access to the financial information of the customer and bank, and (2) removes the exception for bank affiliates.[16] The Proposal explains that the narrower exception, which omits the requirement of access to financial information, is intended to cover arrangements that use algorithms rather than specific financial information of the customers and banks involved to suggest allocations of customer deposits. However, the new exception is not specific to the use of algorithms and is so broad that it could encompass other arrangements. It also explains that, contrary to the FDIC's conclusion in the 2020 Regulations, the FDIC now believes that deposits allocated by bank affiliates "do not seem to act in a more 'sticky' manner."[17] However, as discussed in Part II, the event that the Proposal cites to support this conclusion – the spring 2023 banking crisis – in fact relates to uninsured deposits and does not provide any evidence about brokered deposits.[18]

2. <u>Removing the "exclusive relationship" exception</u>

The 2020 Regulations exclude service providers that place customer deposits exclusively with a single bank from the definition of deposit broker.[19] The 2020 Regulations introduced this exception to harmonize the FDIC's regulatory approach with the statutory language. In particular, the FDIA defines deposit brokers as persons who place deposits with "insured depository *institutions*," in the plural. In the 2020 Regulations, the FDIC explained that it is inconsistent with this language to classify a service provider that uses a singular insured depository institution to hold customer funds as a deposit broker. The 2020 Regulations also explained that when a service provider has "developed an exclusive business relationship" with a single bank the FDIC has found that "it is less likely to move its customer funds to other banks in a way that makes the deposits less stable."[20]

The Proposal would remove this exception and reclassify these arrangements as brokered deposits.[21] The Proposal explains that the FDIC has now reinterpreted the same statutory language to reach the opposite of its conclusion in the 2020 Regulations – that is, the FDIC now believes the FDIA's use of the plural includes the singular. The Proposal also claims that the current

[16] Proposal at 68,252.
[17] *Id.*
[18] *Id*. at 68,245.
[19] 12 CFR § 337.6(a)(5)(ii), (iii).
[20] 2020 Regulations at 6,745.
[21] Proposal at 68,251.

exception "exposes the banking system to the kind of risk the brokered deposit restrictions were intended to address."[22]

3. Narrowing the "primary purpose" exception

The FDIA excludes from the definition of deposit broker "an agent or nominee whose primary purpose is not the placement of funds with depository institutions."[23] The 2020 Regulations look solely to the purpose of the service provider's relationship with its customers to determine if this exception applies. To rely on this exception, either the bank or the service provider must file an application and receive approval from the FDIC.

The Proposal would narrow this exception by adding a requirement that is not present in the statute to the effect that the service provider's business relationship *with the bank* must also be for a substantial purpose other than to provide a deposit placement service or to obtain deposit insurance protection for its customer deposits.[24] As a result, the FDIC would also consider the nature of the relationship between the service provider and bank, and not just the service provider and the customer, which is contrary to the statute. For example, if the service provider receives fees from the bank related to the placement of customer deposits, this would be relevant to determining if the exception applies because the payment of the fee could indicate that the purpose of the arrangement is the placement of customer deposits, whereas it is not relevant under the current rules.

The Proposal explains that this change is necessary to "fully consider the intent driving the placement of third-party deposits at an insured depository institution."[25] However, the Proposal does not cite any facts or circumstances that have changed since 2020 that warrant this change. In addition, the Proposal would limit the ability to file the application for this exception to the bank. The Proposal claims that this limitation is necessary because some non-bank applicants "have provided insufficient information" in their applications and "misunderstand" the application process.[26] But the Proposal does not explain why more targeted changes, such as issuing additional guidance on information to be included in applications, would be insufficient to address this issue.

4. Removing the "enabling transactions" exception

The 2020 Regulations exclude from the definition of deposit broker service providers that place customer deposits in non-interest-bearing transaction accounts in order to facilitate customer transactions.[27] The 2020 Regulations explained that these features are an indicator that the deposit is not for the purpose of earning a return on deposited funds, but is instead ancillary to a separate payment-related service being provided to the customer, and that the arrangement thus presents a

[22] *Id*. at 68,253.
[23] 12 USC §1831f(g)(2)(I).
[24] Proposal at 68,271.
[25] *Id*. at 68,253.
[26] *Id*. at 68,254.
[27] 12 CFR § 337.6(a)(5)(v)(I)(1)(ii).

smaller risk of rapid withdrawal. The Proposal would remove this exception.[28] The Proposal explains that the FDIC now believes that this exception is "overly broad" and that many of the notices being filed to claim this exception have been "incomplete, inaccurate, or vague."[29] The FDIC now believes that these arrangements should be assessed under the revised "primary purpose" exception discussed above.

5. Narrowing the "sweep account" exception

The 2020 Regulations exclude from the definition of deposit broker, with respect to a particular business line, an agent or nominee that places less than 25% of their total "assets under administration" for customers at depository institutions.[30] For example, a broker-dealer that has $100 billion in customer assets under administration for a specific deposit sweep program is not a deposit broker if it maintains less than $25 billion of those assets in bank accounts. Either the bank or the third party must file a notice with the FDIC in order to rely on this exception.

The Proposal would narrow this exception. First it would limit its availability to SEC-registered broker-dealers and investment advisers. Second, it would reduce the maximum percentage of assets that the intermediary is permitted to hold in bank deposits from 25% to 10%. Third, it would change the denominator used to calculate this percentage to "assets under management," which is a narrower category than the current "assets under administration." As explained in Part II, these conditions or qualifications would cause third parties whose "primary purpose is not the placement of funds with depository institutions" to be encompassed within the definition of deposit broker, contrary to the statute.[31] The Proposal would similarly limit the ability to file the notice necessary to rely on this exception to the bank but does not clarify the rationale for this limitation.

[28] Proposal at 68,255.
[29] *Id*.
[30] 12 CFR § 337.6(a)(5)(v)(I)(1)(i).
[31] 12 USC §1831f(g)(2)(I).

II. Analysis

Part II analyzes the Proposal and finds that it is flawed in several respects. These flaws are sufficiently fundamental to legally invalidate the Proposal as an "arbitrary" or "capricious" agency action under the Administrative Procedure Act ("APA").[32]

More specifically, under the APA, a reviewing court must invalidate a final agency action found to be arbitrary or capricious.[33] The Supreme Court has held that an agency action is arbitrary or capricious if the action is not "reasonable and reasonably explained."[34] In particular, the agency "must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'"[35] Further, if the agency is "departing from a prior interpretation" it must "display[] an 'awareness' of that change" and "articulate[] 'good reasons for the new policy.'"[36] In addition, an agency cannot "entirely fail[] to consider an important aspect of the problem" that is being addressed and must "look at the costs as well as the benefits" of the proposed action.[37]

The Proposal would be arbitrary and capricious because it fails to meet these requirements. First, the evidence the FDIC presents with respect to the purported risks of brokered deposits to the safety and soundness of the banking system does not support the new rules proposed, and the FDIC fails to examine countervailing evidence indicating that brokered deposits do not present these risks. Second, the FDIC does not provide sufficient reasons for reversing its 2020 Regulations and replacing it with the Proposal, which also departs from the statute in several respects. Third, the FDIC fails to consider the principal costs of the Proposal for banks, intermediaries, and customers.

We therefore recommend that the FDIC withdraw the Proposal and maintain the 2020 Regulations.

A. *The evidence the FDIC presents does not support the proposed rule changes, and the FDIC fails to examine countervailing evidence.*

The FDIC fails to substantiate its rationale for the Proposal in four critical respects.

First, the Proposal cites two FDIC studies to claim that brokered deposits are riskier than core deposits. However, these studies analyze all brokered deposits generally.[38] Moreover, the studies rely on analysis and data from 2011 and 2017 – before the 2020 Regulations were implemented. As Director McKernan observed, neither these studies nor any other evidence the Proposal cites

[32] 5 U.S.C. § 706(2)(A).
[33] *Id.*
[34] *Ohio v. EPA*, 144 S. Ct. 2040, 2053 (2024) (quoting FCC v. Prometheus Radio Project, 592 U.S. 414, 423 (2021).
[35] *Motor Vehicle Mfrs. Assn. of United States, Inc. v. State Farm Mut. Automobile Ins. Co*., 463 U.S. 29, 43 (1983) (citation omitted).
[36] Thomas E. Nielsen & Krista A. Stapleford, *What Loper Bright Might Portend for Auer Deference*, HARVARD LAW REVIEW BLOG (July 5, 2024), https://harvardlawreview.org/blog/2024/07/what-loper-bright-might-portend-for-auer-deference/ (quoting *FCC v. Fox Television Stations, Inc*., 556 U.S. 502, 515 (2009)).
[37] *Motor Vehicle Mfrs.*, 463 U.S. at 43, 54.
[38] FDIC, *supra* note 5; FEDERAL DEPOSIT INSURANCE CORPORATION, *Crisis and Response: An FDIC History, 2008–2013* (2017), https://www.fdic.gov/publications/crisis-and-response-fdic-history-2008-2013.

"offer any evidence" that the specific types of deposit arrangement that the Proposal would reclassify as brokered deposits present risks to the safety and soundness of the banking system.[39] Indeed, no historical studies have provided evidence that the specific types of deposit arrangements that the Proposal would reclassify as brokered deposits, such as deposits placed through certain sweep account arrangements, differ from core deposits in terms of the risk they pose to the stability of the banking system.[40]

Second, there is countervailing evidence suggesting that brokered deposits as a broad category are not in fact riskier than core deposits. Empirical studies that the Proposal does not consider have shown that brokered deposits do not increase the likelihood of bank failures or the costs of resolving failed banks.[41] In fact, a recent empirical study found that deposits placed through sweep account arrangements and other deposits the Proposal would treat as brokered deposits stabilize rather than destabilize banks.[42] The Department of the Treasury has also concluded that there is no statistically significant relationship between brokered deposits and either the probability or cost of bank failures.[43] The Proposal ignores this evidence, which clearly indicates that the Proposal's new requirements are unnecessary from a safety and soundness perspective.

Third, the FDIC also attempts to support its Proposal with anecdotal evidence, citing (1) the failures of First Republic Bank ("FRP") and Silicon Valley Bank ("SVB") in 2023, and (2) Metropolitan Commercial Bank, which held the deposits of the customers of the cryptoasset company Voyager Digital, which failed in 2022.[44] However, the Proposal does not demonstrate any connection between these incidents and brokered deposits generally or the specific types of deposits the Proposal would reclassify as brokered, particularly deposits that a service provider holds as part of an exclusive relationship with a single bank. With respect to FRP and SVB, the Proposal does not provide any data on brokered deposit outflows preceding their failures. Further, the Proposal ignores the substantial evidence demonstrating that these bank failures were due to their high percentage of uninsured deposits, not brokered deposits. Neither the FDIC's report on the failure of FRB nor the Material Loss Review of the FDIC's Office of Inspector General cites brokered deposits as a factor contributing to FRB's failure.[45] As former FDIC Chairman William

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[39] FDIC, *Statement by Jonathan McKernan, Director, FDIC, Board of Directors, on the Proposed Brokered Deposit Restrictions* (Jul. 30, 2024), https://www.fdic.gov/news/speeches/2024/statement-jonathan-mckernan-director-fdic-board-directors-proposed-brokered ["McKernan Statement"].
[40] *Id*.
[41] James R. Barth et al., *Regulatory Restrictions on US Bank Funding Sources: A Review of the Treatment of Brokered Deposits* 13(6) J. RISK & FIN. MGMT. 130 (2020). https://doi.org/10.3390/jrfm13060130.
[42] James R. Barth, et al., *Runs to Banks: The Role of Sweep Banking Deposits During Market Downturns* (2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3809322.
[43] U.S. DEPARTMENT OF THE TREASURY, *Modernizing the Financial System: Recommendations for Safer, More Competitive Banks* at IV-4 (2020), https://www.google.com/books/edition/Modernizing_the_Financial_System/IQlT_VzlUZ0C?hl=en&gbpv=1&pg=PR13&printsec=frontcover.
[44] Proposal at 68,245.
[45] FDIC, FDIC'S SUPERVISION OF FIRST REPUBLIC BANK (Sept. 8, 2023), https://www.fdic.gov/sites/default/files/2024-03/pr23073a.pdf; FDIC, Office of Inspector General, Material Loss

Isaac explained, "[t]he failures of these regional banks were clearly due to their excessive concentrations of volatile, short-term uninsured deposits, which were primarily invested by the banks in illiquid long-term fixed-rate assets" and "not from brokered deposits."[46] The Proposal is thus not a rational response to the runs on uninsured deposits that occurred in spring 2023. The 2023 crisis suggests that the FDIC's focus should instead be on other factors, particularly deposit concentration and a bank's mix of insured and uninsured deposits.[47]

Nor is the Proposal a rational response to the growth of the increasing role of financial technology and "banking as a service" arrangements in placing customer deposits with banks.[48] Most fintech deposits are not interest-rate sensitive, since consumers are typically attracted to fintech platforms for the types of services they provide rather than the interest rate offered.[49] Furthermore, the providers of these arrangements typically seek to build long-term relationships with partner banks rather than shifting deposits among multiple banks, making their deposits less subject to flight risk.[50]

With regard to Voyager, it was not considered a deposit broker at the time of its bankruptcy because it benefited from the exclusive placement exemption by placing all of its customer deposits with a single bank: Metropolitan Commercial Bank. The Proposal suggests that Metropolitan Commercial Bank was put at risk because it held deposits of Voyager customers and that this is an example of how these arrangements create legal, operational, and liquidity risks for the bank if the broker fails.[51] However, the bankruptcy of Voyager does not support the conclusion that these depository arrangements create these risks. In fact, Metropolitan Commercial Bank did not experience distress as a result of Voyager's failure. Instead, it has enjoyed increased profitability and improved capital ratios since Voyager's failure in 2021.[52]

Review of First Republic Bank (Nov. 29, 2023), https://www.fdicoig.gov/news/summary-announcements/material-loss-review-first-republic-bank.

[46] William M. Isaac, *Uninsured Deposits, Not Brokered Deposits, Led to 2023 Bank Failures* AMERICAN BANKER (Aug. 8, 2024), https://www.americanbanker.com/opinion/uninsured-deposits-not-brokered-deposits-led-to-2023-bank-failures.

[47] *See, e.g.*, Acting Comptroller of the Currency Michael J. Hsu, *Statement at the FDIC Board Meeting, July 30, 2024, NPR on Brokered Deposits Restrictions and RFI on Deposits*, https://www.occ.gov/news-issuances/news-releases/2024/nr-occ-2024-86a.pdf ("Not all deposits are created equal. From a bank liquidity risk perspective, some are riskier than others. Our regulations need to better differentiate between them. The proposed RFI on deposits will help us achieve that.").

[48] FDIC, *Statement by Martin J. Gruenberg, Chairman, FDIC on the Notice of Proposed Rulemaking on Brokered Deposits* (Jul. 30, 2024), https://www.fdic.gov/news/speeches/2024/statement-martin-j-gruenberg-chairman-federal-deposit-insurance-corpoation.

[49] Yizhu Wang, *FDIC Proposal Would Classify More BaaS Deposits as Brokered, Not Core*, S&P GLOBAL (Aug. 5, 2024), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/fdic-proposal-would-classify-more-baas-deposits-as-brokered-not-core-82667379.

[50] *Id.*

[51] *Id.*

[52] *See* METROPOLITAN COMMERCIAL BANK, *As Reported Financial Statements* https://investors.mcbankny.com/financial-information/as-reported-financial-statements/default.aspx (last visited Sept. 27, 2024).

Fourth, the FDIC claims that the Proposal is partially justified by the significant decline in the extent of brokered deposits after the promulgation of the 2020 Regulations, which clarified and narrowed the definition of brokered deposits.[53] However, the FDIC enacted the 2020 Regulations precisely in order to classify deposit arrangements that are not risky as non-brokered, and thereby to reduce the number of deposits that are considered brokered. No reason is given for reversing this approach, and as noted above, the Proposal offers no evidence of the purported risks of these types of deposits.

The Proposal thus offers no evidence that the Proposal would reduce risks to the banking system by reclassifying certain deposit arrangements as brokered deposits.[54] As the Supreme Court has stated, a "regulation perfectly reasonable and appropriate in the face of a given problem may be highly capricious if that problem does not exist."[55]

B. The FDIC does not provide sufficient reasons for its policy reversals.

The Supreme Court has held that when an agency reverses a prior policy "a reasoned explanation is needed for disregarding facts and circumstances that underlay or were engendered by the prior policy" and that failure to provide such an explanation is "arbitrary or capricious" under the APA.[56] The Proposal would reverse substantially all of the FDIC's 2020 Regulations on brokered deposits but does not provide the required reasoned explanation.

As noted above, the Proposal cites two FDIC studies on the risks of brokered deposits in support of expanding the scope of the brokered deposits regime. However, both FDIC studies predate the promulgation of the 2020 Regulations and were taken into account in the FDIC's design of those regulations. The Proposal does not acknowledge this and does not explain why or how the studies could now support the opposite regulatory outcome. Moreover, the Proposal does not explain how the 2020 Regulations might have engendered an environment that requires further regulatory refinement, as it does not present any evidence that the 2020 Regulations have been detrimental to the safety and soundness of the banking system.

The FDIC also argues that the Proposal's reversal of the 2020 Regulations is justified because it would improve the safety and soundness of the banking system by limiting the ability of less than well-capitalized institutions to rely on risky funding sources.[57] But the number of less than well capitalized institutions has *declined* since the 2020 Regulations were proposed from 16 out of 5,303[58] to only seven out of the total 4,577 insured depository institutions in the United States (0.15%).[59] The Proposal also cites no evidence that these few less than well capitalized institutions increased their reliance on deposits that the 2020 Regulations exempted from the brokered deposits

[53] Proposal at 68,244.
[54] McKernan Statement.
[55] *City of Chicago, Ill. v. Fed. Power Comm'n*, 458 F.2d 731, 742 (D.C. Cir. 1971)
[56] *FCC v. Fox Television Stations, Inc*. 556 U.S. at 515.
[57] Proposal at 68,260.
[58] FDIC, *Unsafe and Unsound Banking Practices; Brokered Deposits Restrictions*, *supra* note 5 at 7,464.
[59] Proposal at 68,259.

regime. Thus, even assuming that the deposits that would be reclassified as brokered present these risks, the evidence indicates that these risks have declined since the 2020 Regulations were promulgated and thus cannot justify reversing those regulations.

In addition, the FDIC fails to provide a reasoned explanation for reversing course on the enabling transactions exception and the sweep account exceptions. As Director McKernan noted, in eliminating the enabling transactions test, the Proposal "offers no discussion of the risks of these deposits."[60] Instead, the Proposal asserts without substantiation that the FDIC "believes that there is *no relevant difference*" between enabling transactions and placing deposits.[61] And in lowering the 25% threshold for the sweep account exception, the Proposal asserts without substantiation that "lowering the threshold to 10 percent *may* reduce potential risks to safety and soundness."[62] The Proposal's unsubstantiated assertions do not amount to reasoned explanations. Moreover, the Proposal's revised threshold also conflicts with the statute's reference to "primary purpose." As FDIC Vice Chairman Hill observed, it is not accurate that a company's "primary purpose" is the placement of deposits at banks if, for example, it places 12 percent of customer funds at banks "given that 88 percent of those funds are placed elsewhere."[63]

The potential alternative revisions that the Proposal contemplates – namely eliminating the 25 percent test altogether or re-imposing the conditions to its availability that the 2020 Regulations eliminated (e.g., that the bank and broker-dealer must be affiliated) – are similarly unsupported by any reasoned explanation.[64]

A court should therefore find that these reversals in policy are arbitrary and capricious.

C. The FDIC fails to consider the costs of the Proposal.

The Supreme Court has held that an agency must engage in a reasoned explanation of its action including by examining evidence bearings on the "costs as well as the benefits" of the action.[65] The Proposal would thus also be arbitrary and capricious under the APA because it fails to consider or estimate the principal costs that it would impose.

Most fundamentally, the FDIC acknowledges that it cannot assess the impact of the Proposal because it "does not have the data to estimate the amount of deposits that would be reclassified as brokered by the proposed rule at particular [banks], nor how many [banks], if any, might make changes to the structure of their liabilities."[66] The Proposal thus cannot quantify any of its potential

[60] McKernan Statement, *supra* note 60.
[61] *Id*.
[62] *Id.*
[63] FDIC, *Statement by Vice Chairman Travis Hill on the Notice of Proposed Rulemaking on Brokered Deposit Restrictions* (Jul. 30, 2024), https://www.fdic.gov/news/speeches/2024/statement-vice-chairman-travis-hill-notice-proposed-rulemaking-brokered-deposit ["Travis Hill Statement"].
[64] Proposal at 68,258.
[65] *Motor Vehicle Mfrs. Ass'n*, *supra* note 35 at 462.
[66] Proposal at 68,260.

effects. In addition, the Proposal fails even to identify its potential negative effects in general terms, of which there are several:

First, the Proposal does not estimate the extent of the increases to banks' capital and liquidity requirements or their deposit insurance premiums that would result from the Proposal's reclassification of a broad range of deposits as brokered deposits and the additional costs that would result. In particular, a substantial body of empirical evidence indicates that increasing capital and liquidity requirements causes banks to reduce their lending activities, which in turn reduces economic growth.[67] The Proposal does not address this evidence.

Second, the Proposal would make it more costly for banks to obtain the types of deposits that the Proposal would reclassify as brokered deposits and would thereby deprive banks of beneficial sources of funding.[68] Indeed, in his statement on the Proposal, Vice Chairman Hill criticized the fact that the Proposal would "cut banks off from certain types of funding as their condition deteriorates."[69] This could be even costlier for community banks.[70] As noted in several comments to the 2020 Regulations, most bank customers in rural areas are relatively low-income and net-borrowers – i.e., they tend to borrow more than they deposit.[71] Small banks therefore rely extensively on third party wholesale funding to serve the needs of these communities, much of which they obtain through arrangements the Proposal would reclassify as brokered. Though these smaller banks are not subject to the same increased capital and liquidity requirements as larger banks, smaller banks report that their acceptance of deposits classified as brokered results in increased scrutiny from supervisors and market stigma.[72] And if such a bank were to experience distress such that it is considered less than well capitalized, it could no longer rely on brokered deposits for funding.[73] As a result, the costs to banks of serving these communities would increase, and banks would likely curtail their services to these communities or pass on these additional costs to customers.

Third, the Proposal fails to acknowledge the increased costs it would impose on the intermediaries that the Proposal would reclassify as deposit brokers and their customers. Intermediaries that the

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[67] *See, e.g.*, COMMITTEE ON CAPITAL MARKETS REGULATION, *The 2018 & 2020 Capital and Liquidity Reforms and Bank Lending* (2024), https://capmktsreg.org/wp-content/uploads/2024/01/CCMR-Supplemental-Comments-Regulatory-Capital-Rule-Study-of-Capital-and-Liquidity-Reforms-and-Bank-Lending.pdf.

[68] HUNTON ANDREWS KURTH, *The Brokered Deposits Boomerang: Takeaways from the FDIC's Proposed Rule* (Aug. 20, 2024), https://www.huntonak.com/insights/legal/the-brokered-deposits-boomerang-takeaways-from-the-fdics-proposed-rule.

[69] Travis Hill Statement, *supra* note 63.

[70] SIDLEY, *FDIC Proposes Significant Expansion of Brokered Deposit Coverage* (Aug. 13, 2024) https://www.sidley.com/en/insights/newsupdates/2024/08/fdic-proposes-significant-expansion-of-brokered-deposit-coverage.

[71] *See e.g.,* People Bank (Feb. 17, 2020), https://www.fdic.gov/system/files/2024-06/2020-unsafe-unsound-banking-practices-brokered-deposits-3064-ae94-c-001.pdf.

[72] *Id*.

[73] Yizhu Wang, *FDIC's Brokered Deposit Proposal Expected to Face Industry Pushback* S&P GLOBAL (Aug. 21, 2024), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/fdic-s-brokered-deposit-proposal-expected-to-face-industry-pushback-82943391.

Proposal would reclassify as deposit brokers, including many fintech firms and banking-as-a-service providers, will likely find it more difficult or costly to partner with banks because banks would be required to treat deposits received from that service provider as brokered and thereby incur the higher regulatory costs associated with those deposits.[74] The Proposal also fails to consider whether these additional costs could be disproportionately borne by smaller banks and intermediaries. And by removing the provisions allowing intermediaries to apply for the limited and narrowed exceptions to the deposit broker definition that the Proposal would retain, the intermediary would need to convince each of its potential partner banks to file for the exception, thus further increasing the cost to the bank of partnering with the intermediary. As a result of the narrowed sweep account exception, broker-dealers would also be potentially required to curtail deposit sweep arrangements that provide investors with the safety of a bank-insured deposit account and potentially increased returns.

Fourth, the Proposal does not consider how it would impede fintech innovation that lowers the cost and increases the availability of banking services, particular to low-income persons. According to FDIC data, between 2011 and 2021, the percentage of unbanked and underbanked US households fell from 28.3% to 18.6% overall and from 49.8% to 39% in the lowest income bracket.[75] The FDIC's own analysis attributes these trends to enhancements in "digital account opening technologies" and increases in "consumer comfort and familiarity with financial technology."[76] Many such technologies are excluded from the brokered deposits regime under exceptions that that the Proposal would remove or narrow. But the Proposal does not consider how subjecting these arrangements to the brokered deposits regime could cause banks to limit or cease their participation in these arrangements as a result of the higher costs of accepting brokered deposits, and the resulting consequences for the availability of banking services, particularly to low-income persons and the un- or underbanked. Furthermore, empirical evidence indicates that financial inclusion drives economic growth.[77] The Proposal's potential limiting effect on the availability of banking services could thus also impose costs on the broader economy. But the Proposal does not consider these potential effects.

Fifth, the Proposal fails to acknowledge the extent to which it would significantly increase the number and complexity of the regulatory notices and applications that market participants would be required to file with the FDIC. Furthermore, by abrogating the bright line exceptions to the brokered deposits regime that the 2020 Regulations introduced in favor of vaguer standards, the

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[74] COOLEY, *FDIC's Proposed Brokered Deposit Rule Could Adversely Impact Fintech-Bank Partnerships* (Sept. 4, 2024), https://www.cooley.com/news/insight/2024/2024-09-04-fdics-proposed-brokered-deposit-rule-could-adversely-impact-fintech-bank-partnerships.

[75] FDIC, 2011 FDIC NATIONAL SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS 4 (2012) https://www.fdic.gov/analysis/household-survey/2011/2011-unbankedreport.pdf; FDIC, 2021 FDIC NATIONAL SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS 1,7 (2022), https://www.fdic.gov/sites/default/files/2024-03/2021report.pdf.

[76] FDIC 2021 Survey, *supra* note 75 at 82.

[77] Dinabandhu Sethi & Debashis Acharya, *Financial Inclusion and Economic Growth Linkage: Some Cross-Country Evidence*, 10 J. FIN. ECON. POLICY 369 (2018).

Proposal would increase regulatory uncertainty for banks and intermediaries. The increased volume and complexity of filings would strain the FDIC's resources. Indeed, Vice Chairman Hill noted how the Proposal has the potential to precipitate an "enormous avalanche" of applications that the FDIC is "completely unequipped to process . . . in any sort of timely or efficient manner."[78]

By failing to consider these costs, the Proposal fails to consider an important aspect of the problem and to offer a reasoned explanation of the proposed regulatory action. We believe a court would therefore find the Proposal to be arbitrary and capricious. We therefore recommend that the FDIC withdraw the Proposal and maintain the 2020 Regulations.

[78] Travis Hill Statement, *supra* note 69.

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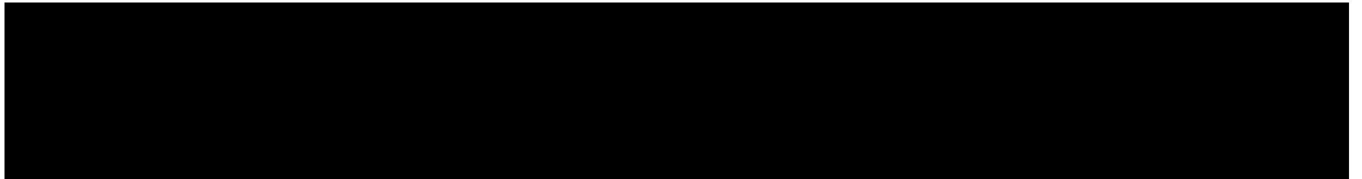
Thank you for your consideration of the Committee's position. Should you have any questions or concerns, please do not hesitate to contact the Committee's President, Professor Hal S. Scott (hscott@law.harvard.edu), or its Executive Director, John Gulliver (jgulliver@capmktsreg.org), at your convenience.

Respectfully submitted,



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