American Bankers Association
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Diane Ellis
Deputy Director
Division of Insurance and Research
Federal Deposit Insurance Corporation
1776 F Street, NW
Washington, DC 20006

Re: Core and Brokered Deposit Study Mandated by the Dodd-Frank Act

Dear Ms. Ellis:

The American Bankers Association[1] appreciates the opportunity to share our views on the definition of "core" and "brokered" deposits with the FDIC as the FDIC prepares the report required by section 1506 of the Dodd-Frank Wall Street and Reform Consumer Protection Act. That section directs the FDIC to evaluate –

- The definition of core deposits for the purpose of calculating insurance premiums;
- The potential impact on the Deposit Insurance Fund of revising the definitions of brokered deposits and core deposits to better distinguish between them;
- Differences between core deposits and brokered deposits and their role in the economy and U.S. banking sector;
- The potential stimulative effect on local economies of redefining core deposits; and
- The competitive parity between large institutions and community banks resulting from redefining core deposits and brokered deposits.

This study is an important step in the process of modernizing the rules to reflect industry innovations, and we commend the FDIC for its efforts.

We respectfully submit that the current rules apply outdated labels in an inflexible manner. This has the unintended adverse effect of placing stable sources of funding off-limits for many banks, often at precisely the time when the banks most need this funding. To address this problem, we urge that the rules be amended in a way that balances the simplicity of bright lines with the flexibility to demonstrate stability of a deposit when those bright lines are inappropriate.

The ABA has long advocated for changes to the rules governing brokered deposits. The current law was enacted in response to the use of volatile deposits that increased the severity of the thrift

[1] The American Bankers Association brings together banks of all sizes and charters into one association. The ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.3 trillion in assets and employ over 2 million men and women.

crisis of the 1980s. These deposits typically were generated from out-of-market customers and generally paid interest rates considerably higher than those paid on "core" deposits. Given that these customers typically were chasing rates offered by banks[2] with whom the customer had no other relationship, funds generated by a bank through brokered deposits tended to disappear when another bank offered a higher rate.

To address this situation, Congress limited the use of brokered deposits only to "well capitalized" banks as that term is defined in the Prompt Corrective Action (PCA) rules[3] and, with the FDIC's permission, to "adequately capitalized" banks as defined in the PCA rules.[4] As defined by the FDIC, a deposit is deemed brokered if, in essence, a third party has either placed, or facilitated the placement of, deposits for someone else or if the rates paid for a deposit by a bank that is less than well capitalized "significantly exceed" the prevailing rates paid by other insured depository institutions in the bank's normal market area.

Advances in financial products since the statute was enacted and implemented have rendered this definition of brokered deposit obsolete. Many innovations, including those that facilitate the swapping of deposits by banks that are members of a reciprocal network and those that allow a bank to obtain funds through various sweep programs, have provided banks of all sizes with the ability to attract new, and larger, deposits that are as stable as any deposit that would be considered "core." However, deposits obtained through many of these innovations are considered by the FDIC to be "brokered" given that there is an intermediary between the customer and the bank.

Banks often will avoid using a deposit simply because of the "brokered" or "noncore" labels. The analysis of a bank's noncore funding dependence ratio under the Uniform Bank Performance Report can be skewed by inclusion of stable, albeit "noncore," funding, causing many banks to rely more heavily on more restricted "core" funding as currently defined despite the operational disadvantages of doing so. Many banks are concerned about the potential sudden disruption in funding sources that can occur when the bank's PCA capital category declines. Indeed, banks often are criticized by their examiners for using "brokered deposits" in part because of the risk that a PCA downgrade could render those deposits unavailable.

Ironically, then, the statute creates volatility where none may exist. Many of the deposits considered "brokered" have all the characteristics of a stable deposit but become unstable solely

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[2] As used herein, the term "bank" refers to all insured depository institutions.

[3] To be deemed "well capitalized," a bank must have total risk-based capital of at least 10%; tier 1 risk-based capital of at least 6%; a leverage ratio of at least 5%; and not be subject to a written requirement to meet a specific capital level. 12 CFR 325.103(b)(1).

[4] A bank will be deemed "adequately capitalized" under the PCA rules if it is not well capitalized but has total risk-based capital of at least 8%; tier 1 risk-based capital of at least 4%; and a leverage ratio of at least 4% (or 3% if the bank is a CAMELS 1 and not experiencing or anticipating "significant" growth). *Id.* at 325.103(b)(2).

by application of the law. A bank that is experiencing capital-related problems will have to contend with a pro-cyclical rule that adds artificial funding problems to the more real problems that led to the PCA downgrade.

By compounding a bank's problems in this fashion, the rule can have the effect of making it more difficult for a bank to meet the credit needs of its community, as fewer deposits taken in translates into fewer loans going out. Forcing banks that are less than well capitalized to rely more on narrowly-defined "core" funding can force the cost of funds to increase dramatically for all banks in the market as competition for finite core deposits increases. In extreme cases, the rule can create reputational risk for a bank, as large customers whose deposits are fully insured through a reciprocal deposit-swapping network are effectively forced by the rule to withdraw deposits and place them elsewhere to remain insured. Moreover, the current policy may increase volatility in the banking system as a whole, as depositors, no longer able to obtain the desired insurance protection through one bank, spread deposits around several banks by using a deposit broker who seeks to maximize the yield for the customer. A bank can avoid these outcomes by avoiding deposits obtained through new delivery means, but in so doing it either may chase off good customers or increase exposure to truly volatile funding.

We submit that a better approach is one that focuses on the stability of a deposit.[5] The label attached to a given deposit is growing progressively less relevant as new technologies permit banks to attract stable sources of deposits through sweep programs, deposit-swapping networks, and other sources. The rules should avoid classifying deposits based on the channel through which the deposit was obtained and rely instead on the characteristics of the deposits. This will become an increasingly important issue as customers become more familiar and comfortable with alternative distribution channels and transacting business outside of a traditional brick-and-mortar branch.

When reviewing the stability of a given source of deposits, we believe it is appropriate as a threshold matter to distinguish transaction accounts from time deposits. Transaction accounts traditionally are viewed as among the most stable forms of deposits and are obtained from customers that are not looking primarily to maximize the rate of return on the transaction account balances. This is reflected in the inclusion in the Federal Financial Institutions Examination Council's Uniform Bank Performance Report (UBPR) of all transaction accounts (as well as money market deposit accounts and other savings deposits) within the definition of "core" deposits. Customers typically are reluctant to disrupt an established transaction account in the absence of dissatisfaction with the service associated with the account. Thus, we suggest that the

[5] While we recognize that Congress has directed the FDIC to focus in the Section 1506 study on core and brokered deposits, we urge the FDIC to focus its supervisory efforts apart from the study on the broader issue of core funding and not just deposits. Brokered deposits can play an important role in ensuring that a bank has appropriately diversified funding, but, as FDIC staff has recognized, the supervisory issue clearly is broader than the narrow issue of what should be considered "core" or "brokered" deposits.

FDIC adopt an approach that is consistent with the UBPR treatment of transaction accounts and view them as stable.[6]

As a starting point, all fully insured transaction accounts should be viewed as stable. In the event that a determination of stability hinges as a general rule on whether the account is insured, we suggest that banks have the flexibility to demonstrate that uninsured amounts are stable as well. Customers that maintain large balances often will have other accounts with, or obtain other services from, a bank that contribute to the stability of the relationship and the customer's willingness to keep uninsured balances in the bank. When reviewing uninsured transaction account balances, we suggest that a bank have the flexibility to demonstrate the stability of such balances by showing these other relationships with the bank and related information, such as the length of the relationship, the number of renewals of time deposit products, and use of ancillary services.

The stability of time deposits also will depend in large part on whether they are fully insured and whether there are other relationships with the depositor. Thus, when assessing whether a time deposit is stable, we would urge the FDIC to consider those factors. In addition, we suggest that the FDIC take into consideration the following:

- Duration. Certificates of deposit (CDs) with long durations and restrictions on early withdrawals typically are very stable. Indeed, some CDs may be terminated early only upon the death of the customer. When assessing duration the focus should be on the remaining duration and not the duration at origination.

  It is difficult to establish a bright line for how long a CD's term should be in order for the deposit to be deemed stable. While further analysis of this question may be productive, we suggest that the issue of duration should be analyzed in the context of other characteristics of the deposit, with duration being one factor that may indicate a source of funds that is likely to remain with the bank for an extended period of time.

  The relevance of deposit duration also should be viewed in part as a function of the duration of the bank's assets. Diversification of terms and a bank's overall interest rate risk management and liquidity management are important factors when assessing stability of funding. Poorly matched assets and liabilities can lead to increased interest rate risk, liquidity problems, and a resulting decrease in the franchise value of a bank.

- Interest rate paid. Deposits that are priced significantly above the prevailing market rates may be more volatile and can reduce franchise value. However, there may be exceptions to this general rule. For instance, banks that have demonstrably lower operating costs may be able to offer more attractive rates. Thus, pricing consistency also is an important factor to consider. If a bank suddenly increases its rates to attract deposits, deposits attracted by the "rate special" may prove to be volatile.

[6] We also urge continuation of the consideration of MMDAs and other savings deposits as stable.

The principles outlined above would enable banks to demonstrate the stability of their deposits while leading to a supervisory response that is appropriate to a particular bank's risk profile. While bright-line rules of what will be treated as stable would provide certainty and ease of implementation, banks should have the flexibility to demonstrate that other sources of deposits – including those obtained from reciprocal deposit networks, sweep programs, and other delivery channels – are stable and should be treated as such. This would allow room for the industry to innovate and better serve their customers while providing a supervisory framework to guard against the abuse of "hot money."

Rules that incent banks to rely more on stable deposits regardless of the delivery channel will increase the banks' franchise values. A stable base of deposits provides many advantages to a prospective buyer, including more reliable pricing of deposits, greater control over interest rate risk, and a better understanding of funding needs going forward. Buyers thus are willing to bid up the price of an institution that affords these benefits. Conversely, rules that discourage several stable sources of funding will diminish franchise value.

When evaluating franchise value, the FDIC needs to consider both sides of the balance sheet. As noted above, maturity mismatches between assets and liabilities can lead to heightened interest rate risk and liquidity problems. A bank needs the flexibility to manage these risks through funding that is appropriate for that bank's business. Many banks use diversified funding sources, including deposits, Federal Home Loan Bank advances, and other funding vehicles. While issues may arise in connection with some of these funding sources once a bank has failed, these issues should not drive the policy regarding what types of deposits banks should be incented to use. The focus should be on whether the funding *reduces the likelihood of failure* on the front end and not on whether the funding complicates the *resolution* of a failed bank on the back end.

We also urge the FDIC to avoid setting the policy regarding liabilities based on concerns about the inappropriate growth of assets. Clearly, rapid growth can lead to problems and should be addressed by the bank regulators. However, attacking the problem of inappropriate asset growth by limiting funding sources penalizes the entire industry in order to address the problems of a few. There is nothing inherently unsafe or unsound about any deposit-generating channel, regardless of whether it is obtained from a "core" customer, a deposit broker, the Internet, or some other source. Rather, it is the bank's use of the deposit that can create safety and soundness problems. Accordingly, we believe it is more appropriate and effective to respond to asset growth-related issues directly through measures aimed at curtailing unsafe and unsound growth in assets at a specific bank rather than through a one-size-fits-all deposit rule that focuses on the wrong issue.

In addition to changing the rules to focus on whether a deposit is stable instead of whether it is brokered, we urge the FDIC to change its rules regarding the ability of a bank to rely on a particular funding source once the bank's PCA capital category declines. As noted above, currently there is a "cliff effect" built into the rule: once a bank's capital category declines, the bank no longer may accept, renew, or roll over certain deposits except in limited circumstances.

This procyclical implementation of the PCA and brokered deposit rules can exacerbate problems in a bank that already is struggling. The rules should permit a bank at least to renew or roll over existing CDs that mature. Alternatively (or perhaps in addition), the rules could allow a bank a certain period of time -- perhaps 12 months -- within which to achieve certain deposit-related benchmarks.

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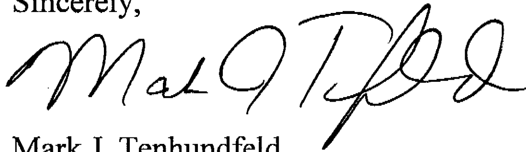
By moving away from artificial and increasingly meaningless labels of "brokered" and "core," the FDIC can preserve the industry's access to stable funding sources, decrease volatility in the system as a whole, and minimize procyclical disruptions. We urge the FDIC to support changes to the law that are easy to implement while sufficiently flexible to permit banks to rely on sources of demonstrably stable deposits. We appreciate the FDIC's consideration of these comments and would be happy to discuss these issues further with you if you would find that helpful.

Sincerely,



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