

Encouraging Innovation: Brokered Deposits—What Fintechs Need to Know to Partner with Banks under the FDIC’s Proposed Regulations

VISUAL MEMORANDUM

January 16, 2020



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Introduction

- The Federal Deposit Insurance Corporation (**FDIC**) proposed changes to its brokered deposits regulations that are designed to update the regulatory framework as much as possible within the constraints of the existing statute, Section 29 of the Federal Deposit Insurance Act (the **FDIA**)
- This memo is focused on those parts of the proposal that would widen opportunities for banks, fintechs and others in the digital transformation.
- Changes to the regulations are needed in a number of areas but for fintech partnerships one of the key drivers is that as online banking activities evolve, more institutions are forced to rely upon funding channels that involve third parties, which triggers the definition of a deposit broker, and thus the regulations.

The Chairman Speaks and the Former Chairman Dissents



The Chairman Speaks and the Former Chairman Dissents

- When announcing the December 12, 2019 notice of proposed rulemaking, FDIC Chairman Jelena McWilliams explained that the proposal is focused on four main goals:
 - Creating a more **transparent and consistent process**.
 - Minimizing the risk to the Deposit Insurance Fund.
 - Ensuring consistency with the statute.
 - **Encouraging Innovation** in how banks offer services and products to customers.
- She further explained that the proposal is aimed at accounting for changes in technology and to encourage partnerships between banks and non-banks to bring more products to more people.
- Martin J. Gruenberg, a member of the FDIC Board of Directors, and the former Chairman, voted against the notice of proposed rulemaking and released a dissenting statement on why he opposed the rulemaking.

The Chairman Speaks and the Former Chairman Dissents



Jelena McWilliams

Chairman, FDIC Board of Directors

“Today, the term “brokered deposits” encompasses a diverse range of deposit placement arrangements, including traditional brokered CDs, various types of brokerage sweep accounts, certain prepaid card programs and health savings accounts, and a range of other types of deposit products that involve online or mobile third parties. When Congress enacted brokered deposits restrictions thirty years ago, most of these types of deposit placement arrangements did not exist, and today they exhibit meaningfully different characteristics from the traditional brokered deposits Congress sought to address.

This is not just an esoteric rule about back-office operations. It has a real impact on how banks deliver products and services to consumers, including the more than 20 million unbanked Americans who could have greater access to banking services. The proposal before the Board today does not ignore the potential risks associated with different forms of funding. For example, brokered CDs, the specific products Congress targeted when it enacted brokered deposits restrictions in 1989, will remain brokered deposits under the proposal. The FDIC also plans to revisit its deposit insurance assessment regulation in light of any changes made to the brokered deposits rule to ensure banks’ assessments properly reflect the risks posed to the Deposit Insurance Fund. Our supervisors will also continue to examine institutions for rapid and risky growth.”



Martin J. Gruenberg

Member (former Chairman),
FDIC Board of Directors

“Despite the experience in two banking crises with the liquidity risks posed by brokered deposits, the proposed rule would significantly weaken this important prudential rule by narrowing the types of deposit-related activities covered by the prohibition.”

Brokered Deposit History



Brokered Deposit History

- To address a series of bank failures in the 1980s, Congress passed Section 29 of the Federal Deposit Insurance Act, which generally prohibits the acceptance of brokered deposits by insured depository institutions that are not well capitalized.
 - The FDIA was originally designed to prevent troubled and failing banks from taking hot money deposits at higher than market interest rates.
 - The FDIA was later amended in 1991 to change the threshold for brokered deposit restrictions from troubled institutions to those that were not well capitalized.
 - It was passed not only before the development of the internet and digital banking but at a time when email was in its infancy, fax machines were not ubiquitous and mobile phones did not exist.
- The statutory language is still binding, however, and constrains what the FDIC can do.

Brokered Deposit History

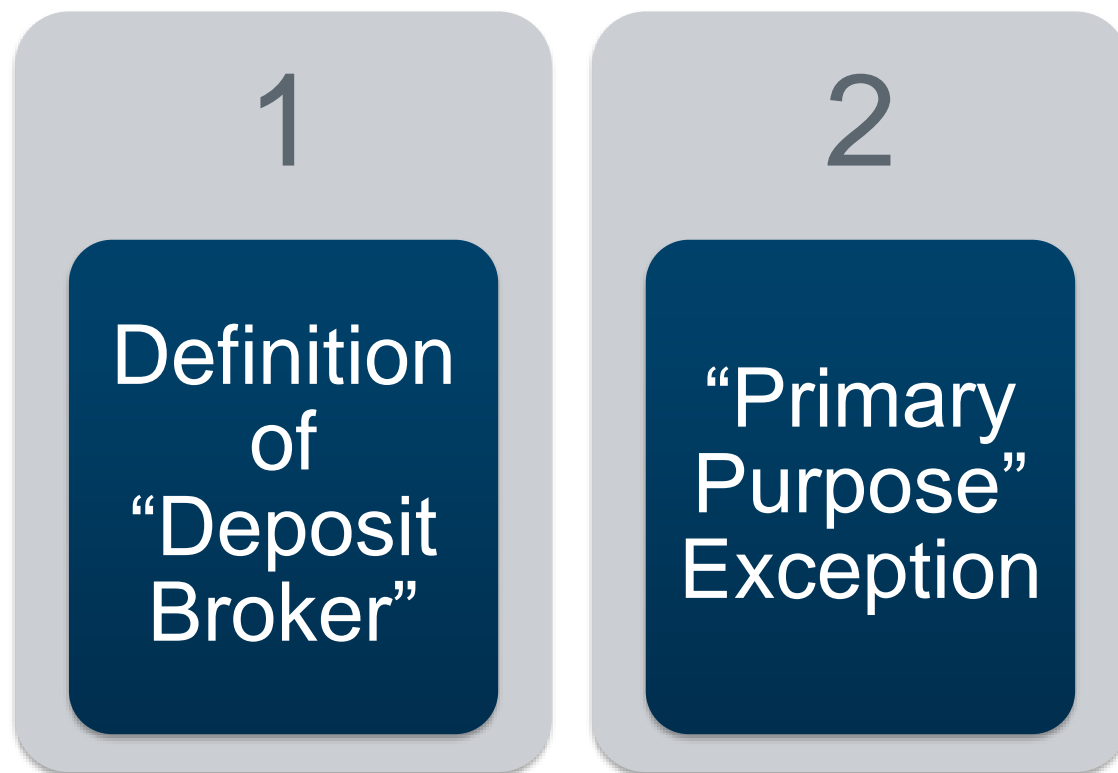
- Even though the statute applies only to IDIs that are less than “well capitalized” at a time when 99% of IDIs meet that requirement, the broad regulatory interpretations of a “deposit broker,” the statutory term, cast a wide shadow over the banking sector.
 - Classifying a deposit as brokered can affect even a well capitalized bank’s core deposit ratios (i.e. the rate at which it pays assessments to the deposit insurance fund), liquidity ratios, contingency planning and capital planning.
 - Moreover, bank management may hesitate to enter into a partnership that creates brokered deposits if, at the next downturn, that line of business needed to be suddenly shut down. In essence, there is a chilling effect.
 - As a result, the Chairman of the FDIC has suggested that Congress should act by updating Section 29 of the FDIA. See the “Congressional Action?” section of this memo.
 - The proposal represents what the FDIC believes it can do to encourage innovation without statutory change.
- The FDIC and OCC’s proposal to revise the CRA regulations excludes brokered deposits from the overall CRA metric calculation in order to focus on deposits that come from those in the assessment areas.

The Constraints of the Statutory Definitions



The Constraints of the Statutory definitions

- For fintechs and others who might want to partner with IDIs, the key changes to the legal framework around brokered deposits revolve around two interrelated elements of Section 29 of the FDIA.



The Constraints of the Statutory Definitions

- The FDIA does not define “brokered deposit” but defines “deposit broker.” The FDIC has interpreted the meaning of brokered deposits to depend on the definition of “deposit broker.”
 - FDIC regulations define brokered deposit as “**any deposit that is obtained**, directly or indirectly, **from** or through the mediation or assistance of **a deposit broker**.”
 - As a result, the FDIC has faced questions from the financial sector about what types of deposit arrangements are considered brokered. The FDIC has issued staff opinions responding to questions about deposit arrangements on an *ad hoc* basis creating, as described by FDIC Chairman Jelena McWilliams in her speech on the proposal, a “fragmented, opaque legal regime that exists outside of the FDIC’s public-facing regulations, understood by only a select few.”
 - In 2015 and 2016, the FDIC issued a set of FAQs in an attempt to clarify the FDIC’s interpretation of Section 29 of the FDIA, and the meaning of brokered deposits, but did not address many of the underlying issues and there continues to be uncertainty on what is a brokered deposit.

The Constraints of the Statutory Definitions

- Under Section 29 of the FDIA a **person** meets the “deposit broker” definition if “it is engaged in the **business of placing deposits**, or **facilitating the placement of deposits**, of third parties with insured depository institutions or for the purpose of **selling interests in those deposits to third parties**.”
 - Traditionally the FDIC has broadly interpreted who is a deposit broker casting a wide net over what is a brokered deposit.
- The FDIA includes 9 exceptions to the definition of deposit brokers, only one of which we believe is relevant here: the **primary purpose exception**.
 - The “primary purpose exception” is an exception to the definition of a “deposit broker” for “an agent or nominee whose primary purpose is **not** the placement of funds with depository institutions.”
- A person in the business of placing or facilitating the placement of deposits may still fall out of the definition if its “primary purpose” is not being a deposit broker. As a result, any deposits would not be treated as brokered deposits.
 - The primary purpose exception has traditionally been narrowly interpreted by the FDIC.

Congressional Action?



Congressional Action?

- In a speech at the Brookings Institute on December 11, 2019, FDIC Chairman Jelena McWilliams said that despite the FDIC's effort to update the brokered deposits rule, the new framework is still complicated, which is the result of an “ambiguous statute that was written in a very different era.”
- FDIC Chairman Jelena McWilliams called on Congress to update Section 29 of the FDIA, specifying two options that Congress could take to update the brokered deposit statute:
 - Replace Section 29 of the FDIA with a restriction on asset growth for banks that are in trouble.
 - Repeal the primary purpose exception and replace it with a more flexible exception based on actual risk to the deposit insurance fund.



Ranking Member of the House Financial Services Committee, Rep. Patrick McHenry (NC-10) issued a statement in support of the FDIC NPR and congressional review of the statute: **“Our regulatory framework should be working to encourage financial innovation, not hinder it...The Chair has also made it clear that congress must work alongside the FDIC to meaningfully review the brokered deposits statute. I look forward to continuing to identify updates that help foster innovation in financial services.”**

Regulatory Interpretation of the Definition of “Deposit Broker”



Regulatory Interpretation of the Definition of “Deposit Broker”

- As mentioned above, a **person** meets the “deposit broker” definition if “it is engaged in the **business of placing deposits**, or **facilitating the placement of deposits**, of third parties with insured depository institutions or for the purpose of **selling interests in those deposits to third parties**.”
- The proposal recommends a revised definition of all three prongs of the deposit broker definition:
 - Engaged in the business of placing deposits
 - Engaged in the business of facilitating the placement of deposits
 - Selling interests in deposits to third parties

Definition of a “Deposit Broker”

ENGAGED IN THE BUSINESS OF **PLACING** DEPOSITS

- “The FDIC would view a person to be in the business of placing deposits if that person **has a business relationship with its customers, and as part of that relationship,** places deposits on behalf of the customer.
 - Examples would be acting as a custodian or agent for the underlying depositor.
- As a result, any person that places deposits on behalf of a depositor at an IDI as part of a business relationship with the depositor is a “deposit broker.”

Definition of “Deposit Broker”

ENGAGED IN THE BUSINESS OF FACILITATING THE PLACEMENT OF DEPOSITS

- FDIC staff have traditionally interpreted the term “facilitating the placement of deposits” to include “actions taken by third parties to connect insured depository institutions with potential depositors.”
 - This broad interpretation of “facilitating” includes “**any** actions taken by third parties to connect insured depository institutions with potential depositors.”
- Under the proposal’s new interpretation the term “facilitating” would be significantly narrower, and a person would meet the facilitation prong if engaged in any **one or more** of the following activities:

The person, directly or indirectly, shares any third party information with the IDI;

The person has legal authority to close the account or move the third party’s funds;

The person provides assistance or is involved in settling rates, fees, terms or conditions for the deposit accounts, or

Other than in an administrative capacity, the person is acting, with respect to the placement of deposits, directly or indirectly, as an intermediary between a third party that is placing deposits on behalf of a depositor and an IDI.

- The purpose of this definition is to capture activities indicating when a person takes an active role in the opening of an account or maintains a level of influence or control over the deposit account after it is open.
 - A level of control or influence indicates the deposit relationship is between the person and the depositor not the IDI and the depositor.
 - “Administrative capacity” is narrowly defined in the proposal. Only “reporting or bookkeeping assistance provided to the person placing its customers’ deposits” is considered a purely administrative function and not considered “facilitating the placement of deposits.” Assisting in “decision-making or **steering** persons, including the underlying depositors, to particular insured depository institutions” would not be a purely administrative function.

Definition of a “Deposit Broker”

THE FACILITATION PRONG AND FINTECH/BANK PARTNERSHIPS

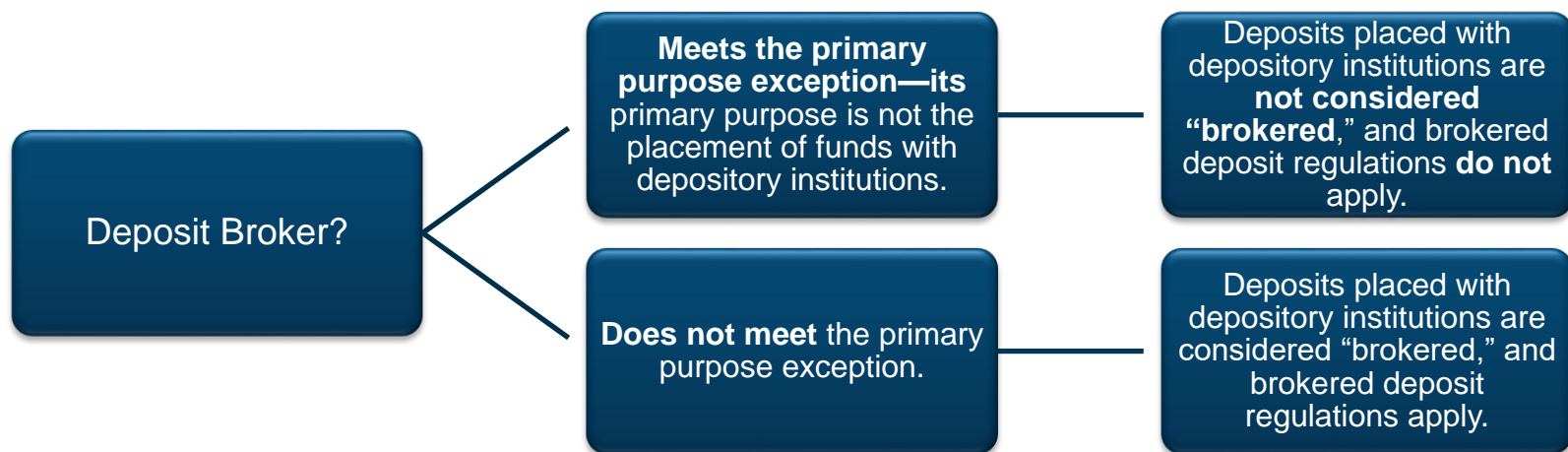
- The regulatory definition of “facilitation” remains broad and it is clear that the FDIC feels constrained by the statutory language.
- In our view, the number of fintech/bank partnerships that would be able to rely upon avoiding falling into “facilitation” and the therefore into the general definition of “deposit broker” could be limited.
- Business models may change in the future and comments to the proposal may lead to more flexibility, but the key difficulties we see are:
 - the limits on data sharing, and
 - the narrow scope of the administrative activities permitted.
- As a result, we expect that reliance on the primary purpose exception, which requires application to the FDIC and which we discuss below, would be used more often.

Primary Purpose Exception



Primary Purpose Exception

The primary purpose exception, which would require an application process, is likely to be the most important route for fintech partnerships. Under the statute and the regulation, even if an agent or nominee is in the business of placing or facilitating the placement of deposits, if its primary purpose is not being a deposit broker, deposits would not be treated as brokered.




Primary Purpose Exception

- The proposal states that the application of the primary purpose exception is “**based on the business relationship** between the agent or nominee and its customers.”
- The FDIC will analyze specific **business lines** of agents or nominees in determining whether the primary purpose exception would apply.
 - The focus on business lines is to prevent an agent or nominee from evading the statutory restrictions by combining its brokering business with another business so that the deposit broker business is no longer its primary purpose.
 - The term “business line” means “the business relationships an agent or nominee has with a group of customers for whom the business places or facilitates the placement of deposits.”
 - The proposal specifies that “ultimately, the determination of what constitutes a business line will depend on the facts and circumstances of a particular case, and the FDIC retains discretion to determine the appropriate business line to which the primary purpose exception would apply.”
- In addition to changing the definition and circumstances in which the primary purpose exception will apply, in the proposal the FDIC proposes to establish an **application and reporting process** to “ensure that the FDIC’s role in protecting the Deposit Insurance Fund and ensuring safety and soundness is preserved.”

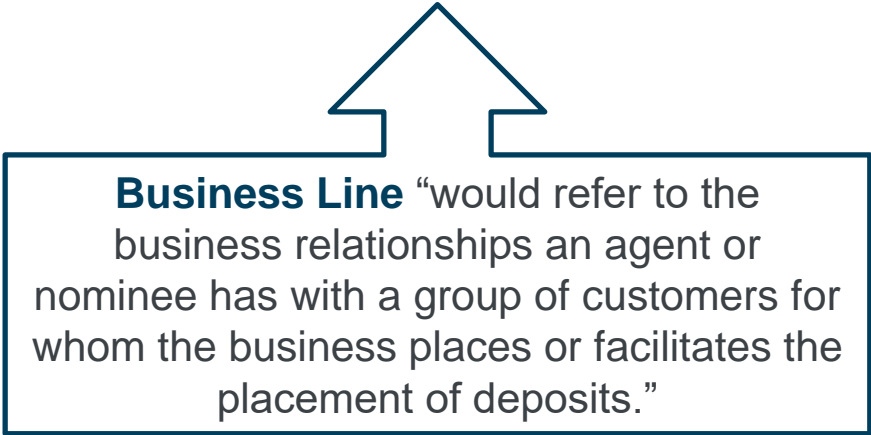
Primary Purpose Exception

LESS THAN 25% OF TOTAL ASSETS UNDER MANAGEMENT

- If **less than 25% of the total assets** that the agent or nominee has **under management for its customer**, in **a particular business line**, is placed at depository institutions, the primary purpose exception would apply and the deposit would not be considered brokered.
 - It is a bright-line test.
 - The FDIC stated that it “believes that establishing a transparent, bright line test is beneficial for all parties.”



Assets under management would be measured by market value.



Business Line “would refer to the business relationships an agent or nominee has with a group of customers for whom the business places or facilitates the placement of deposits.”

Primary Purpose Exception

TRANSACTIONAL ACCOUNTS FOR THE PURPOSE OF ENABLING TRANSACTIONS OR MAKING PAYMENTS

- If the agent or nominee places depositors' funds into **transactional accounts** for the purpose of **enabling transactions** or **making payments**, the primary purpose exception would apply and the deposit would not be considered brokered.
 - Checking accounts, as opposed to savings accounts, are transactional accounts.

If the agent or nominee or depository institution pays any sort of interest, fee or provides any remuneration then the FDIC will **more closely scrutinize** to determine whether the primary purpose was truly to enable payments.

- “If an agent or nominee places 100% of its customer funds into transaction accounts at depository institutions and no fees, interest or other remuneration is provided to the depositor, then it would meet the primary purpose of enabling payments.”

In a case where interest, fees or other types of remuneration is paid the FDIC **would consider a number of factors** in determining if the exception applies, including, the volume of transactions in the customer accounts and the interest, fees or other remuneration provided.

- The agent or nominee seeking to use the primary purpose exception based on the “transactional accounts” standard would be required to submit an application.

Primary Purpose Exception

OTHER DEPOSIT PLACEMENTS THAT MAY MEET THE PRIMARY PURPOSE EXCEPTION

- Agents or nominees that do not fit within the other two business relationships **may demonstrate through an application** that the primary purpose of the business relationship is not the placement of funds at depository institutions.
 - This standard will likely permit the primary purpose exception to take into account market developments and permit innovation.
- An agent or nominee may apply for the primary purpose exception under this category even if it is placing more than 25% of its customer assets under management for a particular business line into deposit accounts at depository institutions.
- The proposal notes that “the FDIC’s review of whether an agent or nominee meets the primary purpose exception would be a case-by-case review and depend upon a consideration of factors . . . as well as the information presented by the applicant as to why it should meet the primary purpose exception.”

Factors that the FDIC would review when determining whether the primary purpose of the agent or nominee is something other than the placement of funds in deposit accounts:

- Does the agent or nominee receive a **majority of its revenue** from this deposit placement activity (i.e. revenue structure of the agent or nominee)?
- Are the agent’s or nominee’s **marketing** activities aimed at **opening a deposit** account or other services?
- The **fees, and type of fees**, the agent or nominee receives for any deposit placement services.
- If the third party’s deposits are **brokered CDs**, they will **not** meet the primary purpose exception.
- If the primary purpose of the deposit is to place, or assist in placing, funds into deposit accounts to “**encourage savings**” or similar purposes, the FDIC would **not grant the exception**.

Application Process



Application Process

- In order to avail itself of the primary purpose exception, an agent or nominee, or an IDI acting on behalf of an agent or nominee, must request the exception from the FDIC through an application process.
 - Under the proposal, an IDI can apply to the FDIC on behalf of a third party seeking a determination that the third party meets the primary purpose exception.
 - If an IDI applies on behalf of an IDI, that determination “could be applicable to all deposit placements by that third party at other IDI(s) to the extent that the deposit placement arrangements with the other IDI(s) are the same as the arrangement between the applicant and the third party.”
 - The FDIC anticipates that an agent or nominee is likely to apply on its own behalf because it will have the information necessary to complete the application.

Application Process

TIMING

- Applicants for the primary purpose exception “would receive a written determination from the FDIC within 120 days of a **complete application**.”
 - The FDIC intends to provide an expedited processing applications that are “simple and straightforward and [meet] the relevant standards.”
- Traditionally, an application is “complete” only when the FDIC staff decides that all questions have been answered.
- As a result, the 120 days is not from the date of application, but from the date it is considered “complete,” a milestone that is entirely within the discretion of the FDIC staff.

Application Process

APPLICATION CONTENTS

- The proposal sets forth what an application would be required to contain in order for the FDIC staff to consider whether it meets the primary purpose exception:

Less than 25 Percent of Customer Assets under Management at IDIs

- A description of the business line.
- The total number of customer assets under management for that particular business line.
- The total amount of deposits placed by the third party on behalf of its customers for that particular business line, at **all** depository institutions.
- A description of the deposit placement arrangement(s) with the IDI(s) and the services provided by other third parties involved.

For Third Parties that Seek the Primary Purpose Exception based on Enabling Transactions

- Information, including contracts with customers and with the depository institutions in which the third party is placing deposits, showing that all of its customer deposits are in transaction (i.e. checking) accounts.
- A description of the deposit placement arrangement(s) with the IDI(s) and the services provided by any other third parties involved.
- Information on the amount of interest, fees, or remuneration being provided or paid for the transaction accounts.
- Information regarding the volume of transaction in customer accounts, and an explanation of how its customers use its services **for the purpose** of making payments and not for the receipt of a deposit placement service or deposit insurance (for third parties that pay interest, fees or provide other remuneration).

For Other Business Relationships That May Meet the Primary Purpose Exception

- A description of the deposit placement arrangements.
- A description of the business line.
- A description of the primary purpose of the business line.
- The total amount of assets under management.
- The total amount of deposits placed by the third party at all insured depository institutions, including the amounts placed with the applicant, if the applicant is an insured depository institution.
- Revenue generated from the placement or the facilitating of the placement, of deposits.
- Revenue generated from activities not related to the placement, or the facilitating of the placement, of deposits.
- The reasons the third party meets the exception.
- Any other information the applicant deems relevant.
- Supporting documentation and contracts related to the above statements.

Any additional information requested by the FDIC staff during the application of the process and review.

Application Process

ONGOING REPORTING REQUIREMENTS

- There would also be an ongoing reporting requirement for any primary purpose application that was granted.
 - “The FDIC will describe the reporting requirements, including the frequency and any calculation methodology, as part of its written approval for a primary purpose exception.”
 - The ongoing reporting requirement will likely be a condition of the continued approval of application of the primary purpose exception.

Other Key Parts of the Proposal



Other Key Parts of the Proposal

- There are other elements of the proposal which provide relief to the banking sector or which are designed to carry out the core policy purposes of the state. We list them here in a very summary form only to illustrate the overall context which may impact the timing and content of any final regulation.

Brokered CDs

- Brokered CDs would still be treated as brokered deposits, preserving one of the core policy goals of the statute.
- Brokered CDs would not meet the primary purpose exception.

Deposit Sweeps Between Affiliated Banks and Broker-Dealers

- The 25% bright line test in the primary purpose exception is meant to be the fix for affiliated broker-dealer sweeps. In the proposal the FDIC specifically mentions that if “a broker dealer that sweeps un-invested cash balances into deposit accounts at depository institutions [they] would meet the primary purpose exception if the amount of customer funds it places at deposit accounts represents less than a quarter of the total amount of customer assets it manages for its broker dealer business.”

Encouraging Savings

- The proposal notes that deposit placements for the purpose of “encouraging savings,” “maximizing yield,” “provide deposit insurance,” or any similar purpose would not be granted a primary purpose exception.

Prepaid Cards

- The proposal does not directly address many of the industry comments about prepaid cards.
- Affiliates of IDIs involved in card program management services (other than wholly-owned subsidiaries of IDIs) could still be viewed as deposit brokers.
- Primary purpose exception for agents/nominees enabling transactions or payments could be a path forward, depending on fee arrangements.

HSAs

- FDIC Chairman Jelena McWilliam’s [statement](#) on the proposal mentions HSAs as being covered by the term brokered deposits. We believe that HSAs will continue to be treated as core deposits, not brokered deposits, as suggested by the FDIC’s [definition of core deposits](#) and [guidance from 2013](#).

Conclusion



Conclusion

- The proposal marks a step forward for the digital transformation of banking and partnerships between banks and fintechs.
- Given its history and wider purpose, there are likely to be extensive comments and differing points of view among different stakeholders.
- But, in light of the fact that the proposal follows the earlier advanced notice of proposed rule making, and solves a number of problems for different stakeholders, it is to be hoped that the FDIC will not long delay finalizing this step forward.
- For more information see: [FDIC NPR on Brokered Deposits](#) and [FDIC Chairman Jelena McWilliams' statements on the NPR](#)

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