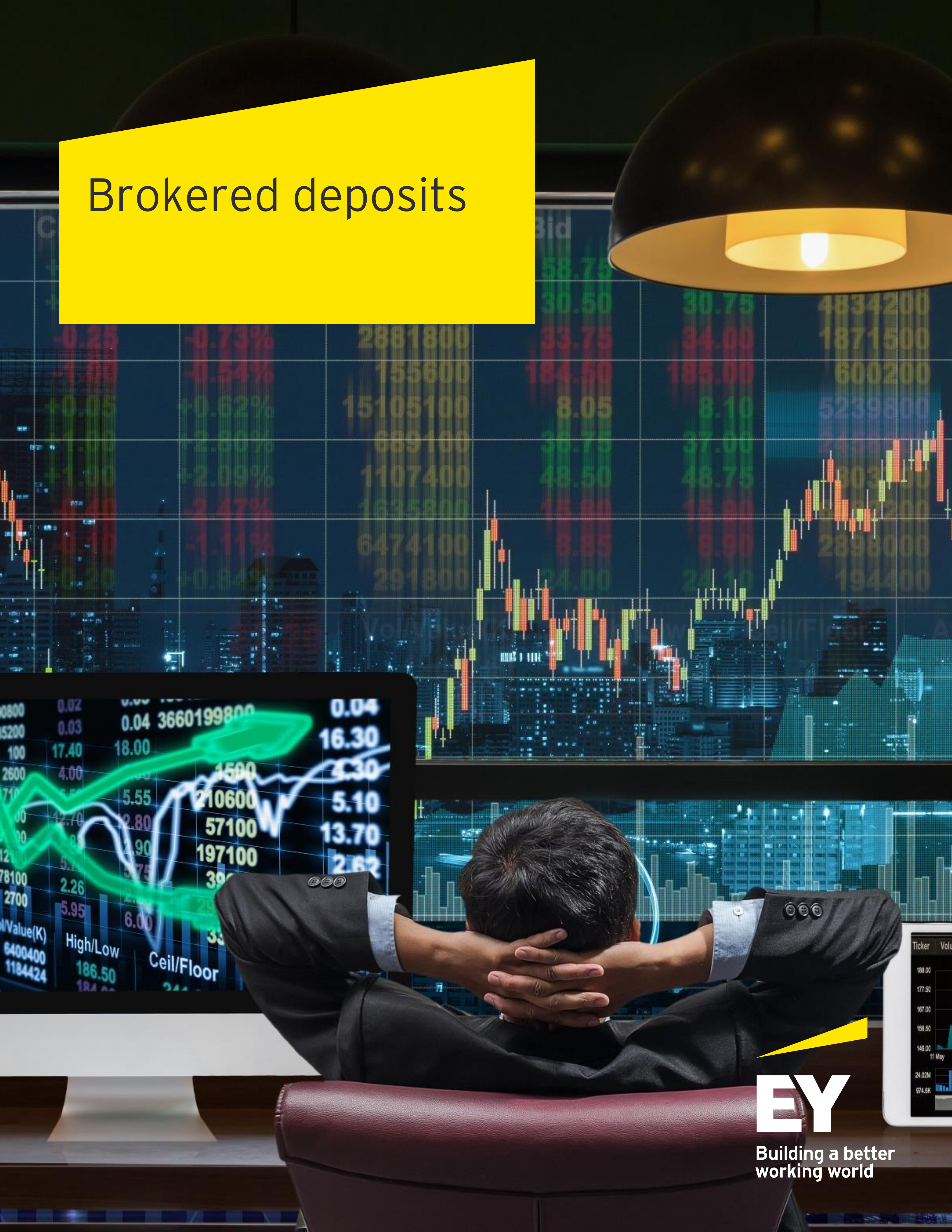
Brokered deposits



Building a better working world

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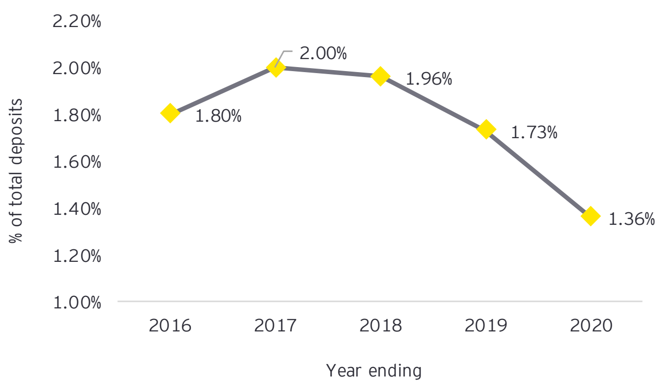
Introduction

For years, banking institutions have utilized brokered deposits as a tool to establish and maintain healthy funding channels, diversify wholesale funding portfolios, and fund asset growth. While brokered funds can serve as an important funding tool for adequately capitalized institutions (and their customers), regulators have identified the historical mismanagement of unstable brokered funding sources — and the rapid asset growth these funds can finance — as a driver of bank failures dating back to the 1980s. The FDIC was mandated to conduct a study on core and brokered deposits by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010; a key finding was that an excessive reliance on brokered funding was a statistically significant data point contributing to historical bank failures.

Total industry brokered deposits[1]



[1]Uniform Bank Performance Report data as of December 31, 2020

EY takeaways

- The FDIC is redefining who qualifies as a deposit broker, potentially shrinking the industry brokered deposit population.
- A new framework views deposits through the lens of the evolving technological landscape, with a goal of encouraging innovation and expanding consumer access to traditional banking, while still ensuring the safety and soundness of financial institutions.
- Banks should re-evaluate existing deposit portfolios holistically, considering broad deposit reporting implications.

The use and reporting of brokered deposits has been an area of consistent regulatory focus for over 30 years. While the Federal Deposit Insurance Act (12 U.S.C. § 1831f) defines by statute which third-party relationships constitute a "deposit broker," and by extension, which deposits should be considered brokered, the FDIC serves as the primary regulatory body governing the interpretation and reporting of brokered deposits according to the Federal Deposit Insurance Act.

In mid-December, the FDIC finalized changes to its interpretation of the statutory definition, prompting banks to revisit the reporting of complex deposit relationships. Additionally, the final rule amended the FDIC's methodology for calculating interest rate caps for less-than-well-capitalized banks, impacting the maximum rate on deposit arrangements solicited by these institutions.

With the regulatory changes, banks will need to evaluate their deposit portfolios holistically — viewing deposit sources through a new lens, considering avenues for relief and assessing reporting — while recognizing the wide-spread implications of balances reported as "brokered."

Why now?

Technological advances in the deposit-gathering marketplace and multifaceted third-party relationships have changed the way banks source deposits, interact with customers and expand their footprints. The rapid pace of technological change and digital customer interaction growth has rendered prior rulemaking less effective in capturing deposits intended by statute to be considered brokered, from the viewpoint of the FDIC. At the time of the original rulemaking, it would have been difficult to conceptualize the way FinTechs and other firms have innovated over the past few decades to create unique avenues to reach customers when it is easier than ever to bank online — a digital banking shift further expedited by impacts of the COVID-19 pandemic. In many ways, technological developments over the past 30 years have fundamentally changed the deposit relationships between banks, customers and other third-party participants. With this new guidance, the FDIC intends to clarify which relationships must be reported as brokered deposits while promoting innovation between banks and the FinTech industry.

Institutions will need to evaluate existing and future relationships in light of the new rule, which is effective April 1, 2021. This regulatory brief will focus on how banks should evaluate deposits sourced from third parties, the costs of carrying brokered funding and how banks can take advantage of avenues for relief.

Key considerations

With the final rule, the FDIC has implemented a revised framework for evaluating any deposit relationship a bank sources from third parties. This includes ongoing consideration of parties engaged in placing deposits, facilitating the placement of deposits and placing deposits to sell those interests to third parties. Some existing deposit portfolios will continue to be recognized as brokered under the new framework. Notably, the FDIC expects brokered CDs and similar arrangements to continue to carry the brokered designation, citing their historical contributions to losses to the FDIC's Deposit Insurance Fund. The rule's most significant changes include the interpretation of parties who "facilitate" deposit placement at FDIC-insured banks and what types of relationships qualify for the primary purpose exception (PPE).

The final rule narrows the definition of deposit broker: the statute defines third parties who "facilitate" deposit placement at banks to be engaged in deposit brokerage activities. With the final rule, the FDIC has attempted to bright-line which activities constitute "facilitation," including retaining legal control over deposit accounts, negotiating terms and "matchmaking" depositors with financial institutions. These "prongs" of the facilitation interpretation are intended to capture business activities that suggest deposit placement via facilitation. The FDIC also added anti-evasion clauses to further strengthen the rule. While the final rule attempts to provide clarity with this revised interpretation, the onus will continue to be on banks to determine which third-party relationships constitute facilitation of placement of deposits.

The FDIC has implemented a new framework for assessing the PPE: Historically, entities whose primary purpose is not placing deposits at banks have been excluded from the deposit broker definition, subject to specific statutory exceptions and a general exception determined by the FDIC. The FDIC has analyzed applicability of the "primary purpose exception" on a case-by-case basis with arguments crafted and supported by each requesting institution. While the final rule retains this procedure broadly, it also implements an updated process for which banks or third parties may request the primary purpose exception for individual portfolios. This new application process requires quantitative and qualitative analysis and support based on the relationship between the third party and its customers, including 11 required data and analytical fields within the application. While this process is anticipated to reduce burden on the agency itself, it will require banks to potentially re-evaluate and resubmit primary purpose arguments that may not be grandfathered by the new rule.

The primary purpose exception

- **14** designated exceptions
- **11** required criteria rationalization in primary purpose request applications
- **245** firms anticipated to submit primary purpose applications within the first year of implementation
- **5,800** hours of industry reporting burden expected in the first year of implementation
- Exceptions accepted beginning **April 1, 2021**

Designated exceptions: As part of the primary purpose exception, the final rule identifies 14 business relationships known as "designated exceptions" for which no application process is required (notification is necessary for two of the relationships). Agents or nominees not qualifying for designated exceptions must apply for the PPE. In most cases, the burden continues to be placed on banks to identify applicable deposit portfolios. As part of this effort, banks should document evidence within the structure of such relationships to justify qualitative arguments that an individual portfolio meets one of the designated exceptions.

Key designated exceptions

- Deposit placement represents less than **25% of customer assets under administration** of the third party
- Placements for the purpose of **enabling transactions**
- Other specific relationships, including those enabling certain real estate transactions or tax advantage programs

IDI exception: The statute also excludes the insured depository institution (IDI) itself and its employees from the deposit broker definition. While divisions of an IDI that place bank deposits are included under this exception, wholly owned bank subsidiaries were carved out of the final rule's interpretation of the IDI exception regarding funds placed at the parent bank. However, because the final rule excludes parties that have exclusive deposit placement arrangements at a single IDI from the deposit broker definition, banks must evaluate whether their subsidiaries that engage in deposit placement activities do so exclusively with the bank itself — considering sweep arrangements and other relationships with unaffiliated institutions — to support accurate reporting.

Implications

In addition to the effort for financial institutions to analyze deposit portfolios through the lens of a new framework, brokered funding carries a number of implications for banks, both explicit and implicit. Regulatory reporting of brokered deposits results in downstream impacts, including potential increases to FDIC assessment expense, core deposits and non-core funding reliance; liquidity risk management, including funding risk appetite and concentration limits; liquidity stress testing; and deposit decay assumptions. Brokered portfolios can carry an even larger FDIC insurance premium for institutions with greater than 10% of domestic deposit portfolios representing brokered funding, subject to certain capital adequacy and associated risk categorizations. Additionally, greater levels of brokered funding have a direct impact on Basel III liquidity reporting, potentially affecting levels of high-quality liquid assets subject institutions are required to hold and are measured uniquely for purposes of the Liquidity Coverage Ratio and the Net Stable Funding Ratio.

- What key risks can be mitigated proactively by ***recasting the viewpoint of the funding portfolio*** in light of the changes?
- What opportunities to receive positive determinations can be pursued ***swiftly*** to maximize the impact?
- How will requests that are not designated exceptions be analyzed and ***tailored*** exception requests be crafted?

Brokered deposits can also send signals to the market, potentially impacting the perceived stability of funding profile of a given bank. While brokered funds can be an excellent tool for banks when used prudently in the context of a broad, diversified funding strategy, overreliance on brokered balances compared to peers (as observed via investor reporting or peer comparison reports, such as the Uniform Bank Performance Report) can be an indicator of funding instability or weaknesses in core funding or deposit-gathering channels.

The final rule's changes potentially add increased flexibility for banks to engage in relationships beneficial to their customers. The FDIC expects the rule's changes to lift the burden associated with brokered deposits from many innovative FinTech relationships — enabling banks to pursue avenues for innovation and serve potentially underbanked consumers. Additionally, to the extent that some historically brokered portfolios no longer meet the definition under the new rule, the FDIC cites the possibility for increased funds available for lending — resulting in the potential for broad downstream economic benefits.

What's next?

The FDIC's final rule on the interpretation of brokered deposits presents an opportunity for banks to evaluate their holistic deposit portfolios — re-evaluating brokered through the lens of the new framework as well as assessing deposit reporting on a larger scale. While some existing relationships will continue to be classified as brokered under the new framework, banks should evaluate the structures of such relationships, specifically regarding the FDIC's bright-lined primary purpose interpretation. Accurate reporting under the new framework supplemented by applying the potential avenues for relief under the rule (i.e., PPE) can provide direct and indirect financial benefits for banks.

As banks look to address complex deposit reporting initiatives, including evaluation of brokered deposit reporting populations and tailored primary purpose exception request letters, they should be mindful in navigating the evolving regulatory framework related to brokered deposit identification and the potential impact on regulatory expense.

Conclusion

The FDIC's final rule on brokered deposits attempts to ease burden on both the industry and the agency itself by providing clarity regarding regulatory interpretation on deposit brokerage relationships. Evaluating existing deposit portfolios holistically — re-evaluating brokered populations and considering implications for deposit reporting more broadly — is essential to support accurate reporting and utilization of all avenues of relief available in the final rule. As banking continues to evolve and institutions implement rich and complex new avenues to interact with depositors while serving, collaborating and, at times, competing with new FinTech entrants, banks must evaluate these relationships in the context of the new regulatory framework and appropriate regulatory reporting. The time is now to recast the net in line with new expectations and work to reduce exposure through exemptions.

Key contacts

To learn more about how the changing regulatory reporting environment might affect your organization and how Ernst & Young LLP can help, please contact one of our professionals:

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