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Alert | Financial Regulatory & Compliance

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Reminder: Comments to FDIC's Proposed Brokered Deposit Rule Due Nov. 21

Go-To Guide:

- The Federal Deposit Insurance Corporation (FDIC) issued a notice of proposed rulemaking that significantly revises FDIC regulations concerning brokered deposits.
- If adopted, the proposed rule would either eliminate or considerably narrow several exceptions that allow fintechs to place deposits at insured depository institutions without being considered brokered, including (1) the exclusive deposit placement exception, (2) the 25% test designated exception, and (3) the enabling transactions test exception.
- The proposed rule would revoke all previous primary purpose exceptions approved by the FDIC and revoke the capability of third parties, such as fintech partners, to submit exception applications.
- Comments to the proposed rule must be submitted no later than Nov. 21, 2024.

On Aug. 23, 2024, the FDIC Board of Directors published a notice of proposed rulemaking (Proposed Rule) that would amend the agency's existing brokered deposits rules (BD Rule).[1] The Proposed Rule would likely have a substantial impact on the deposit-taking activities of many insured depository institutions (IDIs) and their relationships with financial technology companies (Fintechs).

Background of the Brokered Deposit Rule

Section 29 of the Federal Deposit Insurance Act (FDI Act) governs and places restrictions on the ability of less-than-well-capitalized IDIs to accept "brokered deposits," generally defined as deposits obtained through the assistance of a third-party "deposit broker."[2] The BD Rule seeks to mitigate the risks that can accompany volatile funding sources, e.g., rapid growth, higher FDIC deposit insurance assessments, and liquidity issues stemming from a less stable deposit base. While well-capitalized IDIs may accept brokered deposits without restrictions, adequately capitalized IDIs must apply for an FDIC waiver to accept brokered deposits, and undercapitalized IDIs are prohibited from accepting, renewing, and/or rolling over brokered deposits.[3]

In December 2020, the FDIC updated the BD Rule to establish a new framework for analyzing whether certain deposit arrangements qualify as brokered deposits, paving the way for new Fintech-IDI partnership structures. The Proposed Rule would make several changes to the existing BD Rule as it stands today, likely impacting existing business relationships between IDIs and Fintechs by: (1) broadening the "deposit broker" definition to include certain business relationships that are currently exempt; (2) eliminating the "exclusive placement arrangement" exception; (3) narrowing the "primary purpose" exception to the "deposit broker" definition, including eliminating the 25% test designated exception for IDIs; (4) eliminating the "enabling transactions" designated exception; and (5) updating the primary purpose exception application and notice processes by limiting exception applicants to IDIs.

Expansion of 'Deposit Broker' Definition

Under the BD Rule, a "deposit broker" is any person, including "(A) any person engaged in the business of placing deposits of third parties with insured depository institutions; and (B) any person engaged in the business of facilitating the placement of deposits of third parties with insured depository institutions."[4] The current BD Rule provides that a person is engaged in the business of "placing deposits" or "facilitating the placement of deposits" if such person places third party deposits at ***more than one*** IDI, thus creating a *de facto* exemption for exclusive deposit placement relationships.

The Proposed Rule would expand the definition of a "deposit broker" by:

1. Consolidating the "placement" **<u>and</u>** "facilitation"[5] prongs of the "deposit broker" definition into a single test for "[a]ny person **engaged in the business** of ***placing <u>or</u> facilitating*** the placement of deposits of third parties with insured depository institutions."

2. Eliminating the exclusive deposit placement relationship exemption since, under the Proposed Rule, a person would be deemed as engaging "in the business of placing or facilitating the

[1] 12 C.F.R. §§ 337.6 and 303.243.
[2] 12 C.F.R. § 337.6(a)(2).
[3] 12 C.F.R. § 337.6(b)(1)-(3).
[4] 12 C.F.R. § 337.6(a)(5)(i).
[5] Currently codified at 12 C.F.R. § 337.6(a)(5)(i)(A) and (B), respectively.

placement of deposits" when the person receives third-party funds and deposits those funds at ***one or more*** IDIs.

3. Classifying deposit brokers based on the receipt of fees by including a new provision that classifies a person as a deposit broker if such person has a relationship or arrangement with an IDI or customer where the IDI or the customer ***pays such person a fee or provides other remuneration*** for placing deposits at one or more IDIs.[6]

These proposed changes to the definition of "deposit broker" alone would apply to numerous Fintechs and could materially impact Fintech relationships with IDIs. Fintechs typically partner with only one IDI that pays a fee in exchange for deposits, with the IDI relying on the exclusive deposit placement exemption to classify Fintech-placed deposits as non-brokered.

Narrowing the 25% Test Designation Exemption

Currently, deposit arrangements can meet the primary purpose exception when less than 25% of the total assets that a person (i.e., an agent or nominee) has under administration for its customers is placed at IDIs.[7] The Proposed Rule would significantly narrow the existing 25% primary purpose exception in three important ways:

1. By making this exception available only to registered broker-dealers and investment advisers, as opposed to any relevant line of business;

2. reducing the less than 25% asset threshold by making the exemption available "only if less than 10 percent of the total assets that the broker-dealer or investment adviser… has under management for its customers, in a particular business line, is placed into non-maturity accounts at one or more IDIs [;]" and

3. amending one of the key measures of this designated exception from "customer assets under administration" to "customer assets under management[,]" a change that could potentially reduce the denominator used by firms to calculate the funds placed in sweep programs.[8]

Therefore, while the current BD Rule permits a third-party entity like a Fintech partner to avail itself of a primary purpose exception when less than 25% of its customers' assets under administration are deposited with an IDI, the Proposed Rule would ***considerably narrow*** this exemption to apply exclusively to broker-dealers or investment advisers, and only if they placed or facilitated the placement of less than 10% percent of the total assets under management (versus under administration) for customers at IDIs.

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[6] The FDIC notes in the Proposed Rule that fees "passive listing services" receive would not be captured under this new provision because these fees are not in exchange for or related to the placement of deposits, but are rather subscription fees subscribers pay for information on the rates listing services gather and listing fees IDIs pay for the opportunity to list or post the IDIs' rates.
[7] 12 C.F.R. § 337.6(a)(5)(v)(I)(1)(i).
[8] It is generally understood that "assets under administration" include all assets a broker-dealer, advisor, or custodian holds or directs on behalf of its clients, including assets for which the firm may not exercise deposit placement or investment discretion, while the Proposed Rule defines "assets under management" as securities portfolios and cash balances in which an investment adviser or broker-dealer provides continuous and regular supervisory or management services.

Revisions to Primary Purpose Exception Application and Notice Processes

Under the BD Rule, third-party agents or nominees may submit their own application to the FDIC seeking a primary purpose exception for business relationships that do not meet one of the "designated exceptions." The Proposed Rule would ***eliminate*** that process for third parties, restricting such applicants to IDIs. Importantly, the Proposed Rule would ***revoke all existing primary purpose exception applications*** approved pursuant to the existing BD Rule.

FDIC Vice Chairman Travis Hill, who voted against the Proposed Rule, noted in his statement the potential challenges the FDIC will face in applying these proposed changes to the application and notice process: "[I]f an entity works with 10 banks, every single bank would need to apply individually and receive approval from the FDIC to treat the arrangement as non-brokered under the primary purpose exception. Given (1) the number of deposit arrangements that may be newly scoped in by the rule, (2) the more subjective standard by which the FDIC will judge applications, and (3) the lack of grandfathering of existing arrangements, I suspect an enormous avalanche of applications may hit the FDIC on day 1, which the agency is completely unequipped to process in any sort of timely or efficient manner."

Eliminating the Enabling Transactions Designated Exception

The BD Rule includes a primary purpose exception for third parties that place 100% of customers' funds into transactional accounts that do not pay any fees, interest, or other remuneration, the so-called "enabling transactions test."[9] The Proposed Rule would eliminate the enabling transactions test exception.

In the Proposed Rule, the FDIC indicates that persons who rely on the enabling transactions test exception would be required to satisfy the heightened standard of applying and receiving approval from the FDIC under the proposed primary purpose exception. The FDIC explains that placing deposits into transactional accounts "would not, by itself, prove that the substantial purpose of the deposit placement arrangement is for a purpose other than providing deposit insurance or a deposit placement service."

Potential Impact on Fintech Partnerships

If approved without changes, the Proposed Rule would eliminate several exceptions IDIs and their Fintech partners currently rely upon. As a result, IDIs that partner with Fintechs would likely be required to reclassify a greater amount of their deposits as brokered deposits, potentially increasing deposit insurance assessments and harming their supervisory liquidity ratings.

FDIC Chairman Martin Gruenberg issued a statement in support of his vote to issue the Proposed Rule in which he underscored the uncertain nature of third-party funding arrangements, including IDI-Fintech partnerships. According to Chairman Gruenberg, these arrangements can be highly unstable, with either the third-party Fintech or the underlying customers moving funds based on market conditions or other factors and can also be prone to other forms of disruption such as the potential or actual insolvency of the third-party Fintech, citing the recent bankruptcy of Synapse Financial Technologies, Inc.

[9] 12 C.F.R. § 337.6(a)(5)(v)(I)(1)(ii).

Looking Ahead

Federal regulators continue to prioritize scrutiny of IDI and Fintech partnerships, particularly those partnerships involving deposit accounts. IDIs and Fintech companies should prepare for potential changes by reviewing their business models in light of the Proposed Rule and assessing what steps they may need to take to comply. All impacted institutions should consider submitting comments by the Nov. 21, 2024, deadline.

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