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Application of the Final Liquidity Coverage Ratio Rule to Brokered Deposits

Introduction

On September 3, 2014, the Board of Governors of the Federal Reserve System (the “Board”), the Office of the Comptroller of the Currency (the “OCC”) and the Federal Deposit Insurance Corporation (the “FDIC” and together with the Board and the OCC, “the Agencies”) each adopted a final rule (collectively, the “Final Rule”) to establish a liquidity coverage ratio (the “LCR”) to implement the liquidity risk standards proposed by the Basel Committee on Banking Supervision (the “Basel Committee”). The liquidity risk standards are a part of what is commonly referred to as “Basel III.”¹ The LCR’s stated purpose is to ensure that banking organizations have an adequate amount of unencumbered high-quality liquid assets (“HQLA”) to survive a hypothetical 30-day stress period.

The Final Rule was adopted less than a year after the Agencies published a proposed rule for comment on November 29, 2013 (the “Proposed Rule”). Each of the Agencies received over 100 comments on the Proposed Rule. We have identified at least 15 comment letters that addressed the impact of the LCR on various aspects of the brokered deposit market. While the Agencies made several minor revisions to the Proposed Rule, as noted below, the Final Rule is substantially unchanged from the Proposed Rule.

Summary of the Final Rule

Under the Final Rule, a bank must maintain an amount of HQLA not less than 100% of its projected net cash outflows, including deposit outflows, over a hypothetical 30-day liquidity stress event. The Final Rule assigns deposit run-off rates ranging from 3% to 100% to various types of deposit funding for purposes of calculating net cash outflows.

Run-off rates are determined first by whether the holder of the deposit account is a “retail” depositor or a “wholesale” depositor. Retail depositors, defined to include individuals and certain small businesses, are assigned lower run-off rates than wholesale depositors, with “stable retail deposits” – “transactional deposits” – assigned the lowest run-off rate of 3%.

¹ The Basel Committee is a group of banking supervisory authorities that sets global standards for the prudential regulation of banks. Basel III, issued in the wake of the recent financial crisis, represents a comprehensive set of reform measures that target capital and liquidity.

While all deposit accounts held by wholesale depositors are subject to higher run-off rates relative to retail depositors, deposit accounts held by wholesale depositors that are “financial sector entities” are assigned higher run-off rates than to deposit accounts held by other types of wholesale depositors. The Final Rule defines “financial sector entities” to include investment advisers, investment companies, pension funds and regulated financial companies.

The run-off rates assigned to brokered deposits, including sweep programs that meet the terms of an exemption from having the deposits characterized as “brokered,” are higher than the run-off rates assigned to similar deposits held directly at a bank by a depositor. The Agencies’ rejected arguments that brokered deposits are as stable as, and in some cases more stable than, many direct deposits with no explanation other than their assumption that brokered deposits are “a more volatile form of funding.”² In addition, the Agencies rejected arguments that the limited withdrawal rights of brokered CDs and contractual commitments for minimum deposit balances in sweep arrangements provide stability.

Although many agreements for brokered deposits with contractual maturity provide for limited contractual withdrawal rights, as with non-brokered term retail deposits, the agencies believe that covered companies may agree to waive such contractual maturity dates for retail deposits. The agencies believe a brokered deposit should not obtain more favorable treatment than a non-brokered deposit because the relationship between the brokered deposit customer and the covered company is not as strong as the relationship between a direct retail customer and the covered company, as a brokered deposit interposes a third party.³

Set forth below are

- A description of the institutions covered by the Final Rule and the timing of its implementation.
- The relevant definitions and run-off rates provided by the Final Rule with respect to brokered deposits.⁴
- The questions raised by the Agencies’ lack of guidance with respect to the depositor information banks will need in order to determine the run-off rates applicable to all of their deposits, including brokered deposits, in accordance with the LCR.

² Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, Final Rule (the “Adopting Release”), at p. 195. The Adopting Release has not yet been published in the Federal Register.

³ Adopting Release, at p. 199.

⁴ This memo does not address the LCR’s application to reciprocal brokered deposits.

Institutions Covered by the Final Rule

The following banking organizations are subject to the LCR:

1. Banking organizations with \$250 billion or more in total consolidated assets;
2. Banking organizations with \$10 billion or more in on-balance sheet foreign exposure (regardless of asset size);
3. Bank and savings association subsidiaries thereof that have total consolidated assets of \$10 billion or more; and
4. Any other banking organization whose primary federal regulator has determined that it should be made subject to the LCR.

Bank holding companies and savings and loan holding companies with at least \$50 billion in total consolidated assets that are not internationally active and do not have significant insurance or commercial operations are subject to a modified LCR.

The Final Rule applies to insured state branches of foreign banking organizations, but does not apply to federal branches (insured or uninsured) or to uninsured state branches of foreign banking organizations. The Adopting Release states that the Board plans to implement an LCR-based standard through a future rulemaking for the U.S. operations of some or all foreign banking organizations with \$50 billion or more in combined U.S. assets.⁵

Implementation Schedule for the Final Rule

The Final Rule will become effective on January 1, 2015, although mandatory compliance will be phased in between then and January 1, 2017. Both the frequency of the LCR calculation (from once a month to once every business day) and the percentage of the LCR (80% to 100%) will be transitioned over that time period according to an institution's size. The largest institutions (those with assets of \$700 billion or more, or \$10 trillion or more in assets under custody) will be subject to an accelerated transition schedule, as set forth in Appendix A to this memorandum.

Relevant Definitions

The Agencies made minor revisions to the definitions contained in the Final Rule, including (i) clarification of the term "operational deposit;" (ii) addition of the term "financial sector entity" with respect to "wholesale" deposits; and (iii) inclusion of living trusts in the definition of "retail customer or counterparty." The chart below sets forth the pertinent definitions contained in the Final Rule.

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Adopting Release, at p. 32.

Definitions	
Brokered deposit	"any deposit held at the bank that is obtained, directly or indirectly, from or through the mediation or assistance of a deposit broker as that term is defined in section 29 of the Federal Deposit Insurance Act (12 U.S.C. 1831f(g)), and includes a reciprocal brokered deposit and a brokered sweep deposit."
Brokered sweep deposit [applies to any sweep program regardless of the existence of a brokered deposit exemption]	"deposit held at the bank by a customer or counterparty through a contractual feature that automatically transfers to the bank from another regulated financial company at the close of each business day amounts identified under the agreement governing the account from which the amount is being transferred."
Deposit	" 'deposit' as defined in section 3(l) of the Federal Deposit Insurance Act (12 U.S.C. 1831(l)) or an equivalent liability of the bank in a jurisdiction outside of the U.S."
Financial sector entity	"an investment adviser, investment company, pension fund, non-regulated fund, regulated financial company, or identified company."
Operational deposit	"unsecured wholesale funding or a collateralized deposit that is necessary for the bank to provide operational services as an independent third-party intermediary, agent, or administrator to the wholesale customer or counterparty providing the unsecured wholesale funding or collateralized deposit. In order to recognize a deposit as an operational deposit for purposes of this part, a bank must comply with the requirements of § 4(b) with respect to that deposit."
Operational services	"Operational services means the following services, provided they are performed as part of management, clearing, or custody services: (1) Payment remittance; (2) Administration of payments and cash flows related to the safekeeping of investment assets, not including the purchase or sale of assets; (3) Payroll administration and control over the disbursement of funds; (4) Transmission, reconciliation, and confirmation of payment orders;

	<p>(5) Daylight overdraft;</p> <p>(6) Determination of intra-day and final settlement positions;</p> <p>(7) Settlement of securities transactions;</p> <p>(8) Transfer of capital distributions and recurring contractual payments;</p> <p>(9) Customer subscriptions and redemptions;</p> <p>(10) Scheduled distribution of customer funds;</p> <p>(11) Escrow, funds transfer, stock transfer, and agency services, including payment and settlement services, payment of fees, taxes, and other expenses; and</p> <p>(12) Collection and aggregation of funds.</p>
Pension fund	"means an employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974 (29 U.S.C. 1001 et seq.), a "governmental plan" (as defined in 29 U.S.C. 1002(32)) that complies with the tax deferral qualification requirements provided in the Internal Revenue Code, or any similar employee benefit plan established under the laws of a foreign jurisdiction."
Reciprocal brokered deposit	"brokered deposit that a bank receives through a deposit placement network on a reciprocal basis, such that (1) for any deposit received, the bank (as agent for the depositors) places the same amount with other depository institutions through the network and (2) each member of the network sets the interest rate to be paid on the entire amount of funds it places with other network members."
Retail customer or counterparty	"a customer or counterparty that is (1) An individual; (2) A business customer, but solely if and to the extent that (i) the bank manages its transactions with the business customer, including deposits, unsecured funding, and credit facility and liquidity facility transactions, in the same way it manages its transactions with individuals; (ii) transactions with the business customer have liquidity risk characteristics that are similar to comparable

	transactions with individuals; and (iii) the total aggregate funding raised from the business customer is less than \$1.5 million; or (3) A living or testamentary trust that: (i) Is solely for the benefit of natural persons; (ii) Does not have a corporate trustee; and (iii) Terminates within 21 years and 10 months after the death of grantors or beneficiaries of the trust living on the effective date of the trust or within 25 years, if applicable under state law.”
Retail deposit	"a demand or term deposit that is placed with the bank by a retail customer or counterparty, other than a brokered deposit."
Stable retail deposit	"a retail deposit that is entirely covered by deposit insurance and (1) is held by the depositor in a transactional account or (2) the depositor that holds the account has another established relationship with the bank such as another deposit account, a loan, bill payment services, or any similar service or product provided to the depositor that the bank demonstrates to the satisfaction of the applicable regulatory agency would make deposit withdrawal highly unlikely during a liquidity stress event."
Wholesale customer or counterparty	"a customer or counterparty that is not a retail customer or counterparty."
Wholesale deposit	"a demand or term deposit that is provided by a wholesale customer or counterparty."

Deposit Run-Off Rates

The Agencies made minor revisions to the deposit run-off rates in the Proposed Rule, including (i) adding a category for non-brokered deposits held by a fiduciary, such as employee benefit plan deposits, (ii) adding a category for brokered deposits in transaction accounts with no contractual maturity date that do not meet the definition of brokered sweep deposits, (iii) changing the level of affiliation, from “consolidated subsidiary” to “controlled subsidiary,” required for the 10 % affiliated brokered sweep deposit outflow rate to apply, and (iv) employing the new term “financial sector entity” to replace the litany of institutions captured in the unsecured wholesale funding category in the Proposed Rule. The chart below sets forth the deposit run-off rates contained in the Final Rule.

The new run-off rate category for retail non-maturity transaction accounts that are brokered deposits but are not “sweep” deposits (*i.e.*, are not held through a contractual feature that automatically transfers funds from a broker to the bank at the close of each business day)

would include deposits made at a brokerage customer's direction into a transaction account at a bank. While these deposits would have been subject to a 100% run-off rate under the Proposed Rule, the Final Rule applies a 20% run-off rate if the deposit is entirely covered by insurance and otherwise applies a 40% run-off rate. These rates mirror the run-off rates applicable to unaffiliated brokered sweep deposits.

Category	Agencies' LCR Outflow Amount	Modified LCR Outflow Amount ⁶
Unsecured RETAIL Funding		
Stable retail deposits	3%	2.1%
Other retail deposits	10%	7%
Deposits placed by a third party on behalf of a retail customer or counterparty that are not brokered deposits, where retail customer or counterparty owns the account and entire amount is covered by deposit insurance	20%	14%
Deposits placed by a third party on behalf of a retail customer or counterparty that are not brokered deposits, where retail customer or counterparty owns the account and less than entire amount is covered by deposit insurance	40%	28%
RETAIL Brokered Deposits		
Brokered deposits with remaining maturities over 30 days	10%	7%
Brokered deposits held in a transactional account with no contractual maturity date, entirely covered by deposit insurance	20%	14%
Brokered deposits held in a transactional account with no contractual maturity date, not entirely covered by deposit insurance	40%	28%
Reciprocal brokered deposits, entirely covered by deposit insurance	10%	7%
Reciprocal brokered deposits, not entirely covered by deposit insurance	25%	17.5%
Brokered sweep deposits, issued by a controlled subsidiary, entirely covered by deposit insurance	10%	7%

⁶ Under the Proposed Rule, organizations subject to the modified LCR would have been required to use a 21-day stress period rather than 30-day period. In response to commenters' concerns about the operational and technological challenges of using a 21-calendar-day period that does not correspond to existing systems and processes, the Final Rule eliminates the 21-calendar-day period and applies a full 30-calendar-day stress period to the modified LCR. To adjust for the full 30-calendar-day stress period, outflow rates will be capped at 70% of the outflow rate that applies to the full LCR.

Brokered sweep deposits, not issued by a controlled subsidiary, entirely covered by deposit insurance	25%	17.5%
Brokered sweep deposits, not entirely covered by deposit insurance	40%	28%
All other retail brokered deposits, including time deposits with remaining maturities 30 days or under	100%	70%
Unsecured WHOLESALE Funding (for transactions that mature within 30 calendar days or less)		
Non-operational deposits not provided by a financial sector entity, or any consolidated subsidiary of a financial sector entity, entirely covered by deposit insurance and not a brokered deposit	20%	14%
Non-operational deposits, not provided by a financial sector entity, or any consolidated subsidiary of a financial sector entity, not entirely covered by deposit insurance or the funding is a brokered deposit	40%	28%
Operational deposits, entirely covered by deposit insurance	5%	3.5%
Operational deposits, not entirely covered by deposit insurance	25%	17.5%
All other wholesale funding, including funding provided by a financial sector entity, or any consolidated subsidiary of a financial sector entity.	100%	70%

Interpretive Guidance in the Adopting Release

Fully Insured vs. Not Entirely Insured Deposits

As evidenced by the run-off rate chart above, the insured status of a brokered deposit is relevant only for determining run-off rates for brokered sweep deposits and retail brokered deposits held in non-maturity transaction accounts that are not sweep deposits. Insured status is not relevant to the determination of run-off rates for brokered time deposits. The Adopting Release clarifies that the entire balance of the brokered sweep deposit or non-maturity retail brokered deposit must be insured for the deposit to be eligible for the lower run-off rate assigned to “fully insured” deposits and that the entire deposit will be assigned the higher run-off rate if it is over the insurance limit.⁷

Employee Benefit Plan Deposits

With respect to deposits placed by employee benefit plans, referred to as “pension funds” in the Final Rule, the Adopting Release acknowledges commenters’ concerns that the characterization of all employee benefit plan deposits as “wholesale deposits” is inconsistent with the fact that, under FDIC regulations, deposit accounts held by employee benefit plans are insured on a pass-through basis to plan beneficiaries and ignores the fact that, in many employee benefit plans, a plan beneficiary can direct the investment of the funds.

⁷ Adopting Release, at p. 159.

The Adopting Release rejects the insurance of deposits placed by employee benefit plans as a rationale for applying retail, rather than wholesale, run-off rates to “defined benefit” plan deposits. The Final Rule therefore applies the 100% run-off rate applicable to wholesale deposits provided by a financial sector entity to these deposits. Deposits placed through “defined contribution” plan that provides plan beneficiaries with the right to direct investments will be treated as retail deposits, and the run-off rates will depend on whether the deposits are brokered or non-brokered. Deposits placed at a bank by a broker for self-directed “defined contribution” plans will be treated as retail brokered deposits, with run-off rates based on whether the deposit is a sweep deposit or a time deposit. Deposits placed at a bank directly by the employee benefit plan (*i.e.*, non-brokered deposits) will be assigned the run-off rates applicable to deposits placed by a third party on behalf of a retail customer that are not brokered deposits.⁸

Lack of Guidance Regarding Depositor Information Needed by Banks

In order to calculate total net cash outflows in compliance with the LCR, banks must determine the run-off rates applicable to all of their deposits as set forth in the Final Rule. With respect to brokered deposits, proper application of the run-off rates will necessarily require banks to characterize the deposits as retail *vs.* wholesale, to distinguish between the wholesale deposits of financial sector entities and the wholesale deposits of non-financial sector entities, and to classify brokered sweep deposits as fully insured *vs.* not entirely insured. However, neither the Final Rule nor the Adopting Release specifies the degree of certainty or manner of verification expected in connection with making these determinations. Until the Agencies provide more specific guidance to the banks, which are subject to the LCR and therefore responsible for correctly categorizing deposits, it is not clear what procedures, if any, brokers should adopt in anticipation of implementation of the LCR.

The Agencies’ lack of specificity with respect to characterizing deposits was also evident in the Proposed Rule. Commenters expressed concern regarding the difficulty and costs of distinguishing between fully and partially insured brokered sweep deposits, since banks are not required to know the identities of the depositors for purposes of FDIC pass-through deposit insurance.⁹ In response to commenters’ requests for clarification regarding determination of the insured status of a deposit, the Adopting Release states:

The agencies believe that a covered company should be able to identify the applicable treatment for all of its deposits under the proposed rule by obtaining the applicable information through the deposit provider, irrespective of a bank failure. The agencies note that banking organizations are expected to have adequate policies

⁸ Adopting Release, at p. 218. The run-off rates applicable to *non-brokered* self-directed “defined contribution” plan deposits will either be 20%, for “deposits placed at the bank by a third party on behalf of a retail customer or counterparty that are not brokered deposits, where the retail customer or counterparty owns the account and the entire amount is covered by deposit insurance,” or 40%, for “deposits placed at the bank by a third party on behalf of a retail customer or counterparty that are not brokered deposits, where the retail customer or counterparty owns the account and the entire amount is not covered by deposit insurance.” 12 C.F.R. § __.32(a)(3), (4).

⁹ See 12 C.F.R. § 330.5.

and procedures in place for determining whether deposits are above the applicable FDIC-insurance limits.¹⁰

Like the Final Rule itself, this response, including the vague reference to “policies and procedures,” lacks clarity and is inconsistent with existing regulatory policies and industry practices.¹¹ Furthermore, when a bank receives sweep deposits from more than one broker and/or accepts direct deposits from the public, determination of insurance coverage becomes difficult, if not impossible, because of the need to compare customer records of the broker or brokers with the depositor records of the bank. Such sharing of customer information raises significant operational challenges as well as issues under federal laws protecting customer privacy.

The need for banks to make the distinctions required by the Final Rule raises a number of questions.

- Will banks be permitted to rely on the historic breakdown between a broker’s retail and wholesale depositors (*e.g.*, annual average), or must the information regarding the number of retail *vs.* wholesale depositors be real-time and precise?
- Will banks be allowed to rely on contracts in which brokers agree to restrict the offer of brokered deposit accounts at the bank to retail customers, or to place a percentage cap on the offer of brokered deposit accounts to wholesale depositors (*e.g.*, no more than 20%), or must the bank verify the nature of each depositor?
- Similarly, with respect to brokered sweep deposits and non-maturity brokered deposits in transaction accounts, will banks be entitled to rely on a broker’s contractual representations that customer funds will be deposited in the bank only up to the FDIC limit, thus allowing the bank to assume that each deposit is fully insured, or must the bank attempt to verify the insurance status of every deposit based on detailed customer records obtained from multiple sources?
- Must banks account for CDs that have been syndicated among multiple brokers or are held by depositors that have moved their accounts from one brokerage firm to another?

In considering the Agencies’ possible response to these questions, we note the Final Rule’s lack of prescribed sanctions for failure to comply with the LCR. During the Board’s open meeting, Staff member Michael Gibson noted the important distinction between the LCR and existing bank capital requirements:

¹⁰ Adopting Release, at p. 210.

¹¹ See, *e.g.*, Instructions for Preparation of Consolidated Reports of Condition and Income, at p. RC-E-10 (instructions for the reporting of fully insured brokered deposits).

. . . there's an important difference as [Governor Tarullo] alluded to between the capital regulation and liquidity regulation in terms of the consequences of a breach. For capital, there starts to be restrictions on dividends, restrictions on compensation, *and with the liquidity regulation, the only consequence is you have to have a conversation with your supervisor about how you're going to deal with the liquidity stress that's pushed your LCR below 100 percent, and that's it.* So, that's a recognition that once a firm is under liquidity stress, it's really becomes a supervisory matter rather than something of regulation is intended to deal with, the regulation as really intended to deal with ex ante make sure firms have strong liquidity buffers before the crisis.¹²

While bank capital requirements require a high degree of specificity with respect to the information collected and analyzed to determine compliance, these regulations also impose a hierarchy of specific statutory consequences on banks that fail to comply. By contrast, the Final Rule lacks explicit punitive provisions for non-compliance. One interpretation of this difference is that the Final Rule also requires a lower level of certainty and specificity with respect to the information banks must collect to properly calculate their LCR, thus allowing banks to rely on agreements with brokers, and reasonable assumptions based on these agreements, in collecting the relevant information.

If the Agencies insist that the Final Rule requires a high degree of precision and certainty with respect to depositor information, precluding banks' reliance on agreements and assumptions, it is unclear how banks, other than the banks that accept deposits solely from their affiliated brokers, will comply with the requirements of the LCR.

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Daphne A. L. Trainor

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Transcript of September 3, 2014 Open Board Meeting, at p. 13 (emphasis added).

LCR Transition Schedule	
Covered depository institution holding companies that have total consolidated assets equal to \$700 billion or more, or \$10 trillion or more in assets under custody, and any depository institution that is a consolidated subsidiary of such holding company that has total consolidated assets equal to \$10 billion or more	<p><u>January 1, 2015 through June 30, 2015:</u> The company must calculate and maintain an LCR monthly, on each calculation date that is the last business day of the applicable calendar month, that is equal to or greater than 0.80.</p> <p><u>July 1, 2015 through December 31, 2015:</u> The company must calculate and maintain an LCR on each business day that is equal to or greater than 0.80.</p> <p><u>January 1, 2016 through December 31, 2016:</u> The LCR must be equal to or greater than 0.90.</p> <p><u>January 1, 2017 and thereafter:</u> The LCR must be equal to or greater than 1.0.</p>
Every other covered company	<p><u>January 1, 2015 through December 31, 2015:</u> The company must calculate and maintain an LCR, on each calculation date that is the last business day of the applicable calendar month, that is equal to or greater than 0.80.</p> <p><u>January 1, 2016 through June 30, 2016:</u> The company must calculate and maintain an LCR, on the last business day of the applicable calendar month, that is equal to or greater than 0.90.</p> <p><u>July 1, 2016 through December 31, 2016:</u> The company must calculate and maintain an LCR, on each business day that is equal to or greater than 0.90.</p> <p><u>January 1, 2017 and thereafter:</u> The LCR must be equal to or greater than 1.0.</p>
Bank holding companies and savings and loan holding companies subject to the modified LCR	<p><u>January 1, 2016</u> The company must calculate its LCR on a monthly basis.</p>