

LESS THAN TWO MONTHS LEFT: The FDIC's Proposed Brokered Deposit Rule Will Negatively Impact Fintechs and Their Bank Partners. WHAT YOU NEED TO KNOW

August 29, 2024
John ReVeal
Judie Rinearson

INTRODUCTION

- Fintechs need to partner with banks to hold their customer funds – especially for prepaid programs.
- Many bank regulators disapprove of bank-fintech partnerships, considering them “high risk.”
- Banks are already under significant pressure to monitor their fintech partners’ compliance. This increases the cost of a fintech-bank partnership.
- The FDIC also categorizes the kind of deposits that a bank holds. “Brokered deposits” are considered high-risk by the FDIC and so having deposits deemed to be “brokered” adds even more cost to a fintech-bank partnership.
- Therefore, the goal of many fintech friendly banks is to **AVOID** having their fintech deposits deemed “brokered.”

HISTORICAL BACKGROUND

- The concept of “brokered deposits” started in the 1980s when the FDIC issued a regulation that limited the total FDIC insurance placed in any single depository institution by the same deposit broker to an aggregate of \$100,000: not \$100,000 per depositor.
- This regulation was struck down in a 1984 court decision: *FAIC Securities, Inc. v. U.S.*, 595 F.Supp. 73 (U.S. Dist. Ct., District of Columbia).
- The thrift crisis in the late 1980s allowed the FDIC to get at least some of what it wanted: a new Section 29 to the Federal Deposit Insurance Act to prevent “troubled institutions” from accepting or renewing brokered deposits.

HISTORICAL BACKGROUND (continued)

- The FDIC's regulation under Section 29 has been amended several times since their first interim regulation issued on December 12, 1989.
- The basic concept has always been, and still is, that a brokered deposit is a deposit obtained from or through the mediation of a "deposit broker."
- For many years, the definition of deposit broker was written and interpreted very broadly.

HISTORICAL BACKGROUND (continued)

- Until January 2021, a “deposit broker” was:
 - “Any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions, or the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties.”

The January 2021 rules retained the placing and facilitating prongs of this definition, but added important qualifications.

HISTORICAL BACKGROUND (continued)

- Until January 2021:
 - “Facilitate” was sometimes broadly interpreted by the FDIC as “to free from difficulty” or “to make easy.”
 - Per FDIC opinions, the fact that the third party received no compensation didn’t mean it was not a deposit broker, but compensation based on the number or dollar amount of deposits was usually conclusive that a deposits were brokered.

HISTORICAL BACKGROUND (continued)

- There was a “primary purpose” exception to the deposit broker definition, but it rarely applied:

“An agent or nominee whose primary purpose is not the placement of funds with depository institutions” was NOT a deposit broker. The FDIC often would consider:

- “But for” the availability of deposit insurance, would the program have been created?
- Was there any “substantial purpose” for the arrangement other than the placement of deposits?
- Was there any “substantial purpose” for the arrangement other than to obtain deposit insurance for third parties?

HISTORICAL BACKGROUND (continued)

- Brokered deposit “volatility” was a stated FDIC concern but the relative stability or “stickiness” of the accounts rarely persuaded the FDIC that a deposit was not brokered.
- Prior FDIC staff informed this Firm that the requirement for Bank Merger Act approval to transfer prepaid accounts or other deposits to another bank did not alter their conclusion that the accounts were brokered deposits.

HISTORICAL BACKGROUND (continued)

- The emerging payments/prepaid industry pushed back, and finally, on January 22, 2021, the FDIC amended the regulation to provide hard fought for regulatory relief:
 - The primary purpose exception would apply where, with respect to a particular business line:
 - 100% of the depositors' funds that the agent or nominee places, or assists in placing, are placed into transaction accounts that do not pay any fees, interest, or other remuneration; or
 - Less than 25% of the total assets that the agent or nominee has under administration of its customers is placed at depository institutions.
 - A person would be “engaged in the business of placing deposits” only if placing deposits of third parties with more than one insured institution.

HISTORICAL BACKGROUND (continued)

- Under the current rule as amended January 2021, a person would be treated as facilitating the placement of deposits under a “matchmaking” rule if it proposed deposit allocations based upon both the particular deposit objectives of a specific depositor or depositor’s agent, and the particular deposit objectives of specific banks.
- However, the current rule excludes from the definition of deposit broker third parties that engage in these activities as a depositor’s agent with the third party’s affiliated bank.

THE PROPOSAL

- On July 30, 2024, the FDIC issued a proposal that would significantly roll back the gains made in 2021 and cause far more deposits to be treated as brokered deposits.
- Published in the Federal Register on August 23, 2024, the comment period now ends October 22, 2024.
- <https://www.govinfo.gov/content/pkg/FR-2024-08-23/pdf/2024-18214.pdf>

THE PROPOSAL (continued)

- **Why does this matter?**
 - Increased deposit insurance assessments for brokered deposits, depending on numerous factors, but including the institution's ratio of brokered deposits to assets.
 - An institution that is only adequately capitalized and not well capitalized may not “accept, renew or roll over” any brokered deposit without a waiver from the FDIC.
 - An institution that is undercapitalized may not ever accept, renew or roll over any brokered deposit – no FDIC waiver is available.
 - Since early 2021, banks, fintechs and other third parties have innovated and built their business models in reliance on the modern brokered deposit rules.

THE PROPOSAL (continued)

- The transactional account / enabling transactions exception would be entirely removed.
- The 25% exception would be narrowed:
 - A broker-dealer or investment adviser that places or facilitates the placement of less than 10 percent of the total assets that it has under management for its customers is placed at depository institutions, and no additional third parties are involved in the deposit placement arrangement.

THE PROPOSAL (continued)

- But the 25% rule is then used to narrow the standard for the FDIC specifically identifying a relationship that meets the primary purpose exception:
 - The agent or nominee places, or assists in placing, customer funds into deposit accounts pursuant to such other relationships as the FDIC specifically identifies as a designated business relationship that meets the primary purpose exception. Less than 25 percent of the total assets that the agent or nominee has under administration for its customers is placed at depository institutions.
- The definition of “engaged in the business of placing deposits” would no longer depend on whether the person places deposits of third parties with more than one insured institution.

THE PROPOSAL (continued)

- The primary purpose exception would be amended to “codify” the substantial purpose test:
 - An agent or nominee whose primary purpose in placing customer deposits at insured depository institutions “is for a substantial purpose other than to provide a deposit-placement service or to obtain FDIC deposit insurance with respect to particular business lines between the individual insured depository institution and the agent or nominee.”

THE PROPOSAL (continued)

- The definition of deposit broker is amended by the addition of a new standard relating to fees:
 - A person is engaged in the business of placing or facilitating the placement of deposits if the “person has a relating or arrangement with an insured depository institution or customer where the ... institution or customer pays the person a fee or provides other remuneration in exchange for deposits being placed at one or more insured depository institutions.”

THE PROPOSAL (continued)

- The matchmaking rule would be replaced with a rule under which any person would be a deposit broker if it proposes or determines deposit allocations. A person would be a deposit broker if it “proposes or determines deposit allocations at one or more insured depository institutions (including through operating or using an algorithm, or any other program or technology that is functionally similar).”
 - Unlike the current matchmaking rule, the proposed rule would not exclude deposits placed by a depositor’s agent with a bank affiliated with the depositor’s agent. In other words, the proposed rule would not exclude third parties that provide the deposit allocation services between affiliated parties.

WHAT TO DO

- Comments on the Proposal may be submitted to the FDIC until October 22, 2024. Possible arguments to make include:
 - Not all fintech and banking partnerships are the same. One size fits all is not fair and discourages innovation.
 - The new rule may often result in higher costs for consumers.
 - In certain arrangements between banks and third parties, the bank fundamentally controls the program. In these “bank centered” programs, the bank might have significant control over account terms, how customers are solicited, how deposit funds arrive at the bank, and even the third party’s relationship with the depositor after the account is established. (This distinction has been recognized by FinCEN for Bank Secrecy Act purposes.)
 - At a minimum, any changes as significant as the FDIC is proposing should either exempt existing arrangements that were based on the current rules or provide an extended timeline for banks and their partners to restructure their programs.

TO DO

- Review your operations, funds flow and determine the likely impact.
- If you are a fintech, you may wish to discuss the impact with your bank.
- If seriously impacted, contact your local member of Congress, Senate or lobbyist.

TO DO

- Note: This proposed rule was released at the same time as a Request For Information (RFI) issued by the OCC, Treasury, Fed and FDIC, seeking information about Bank-Fintech relationships
- <https://www.govinfo.gov/content/pkg/FR-2024-08-23/pdf/2024-18214.pdf>
- Consider reviewing and responding to the RFI as well.

Questions? For more information

John ReVeal

- John.reveal@klgates.com
- 202-778-9055

Judie Rinearson

- Judith.rinearson@klgates.com
- 212-536-3928