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January 14, 2015

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Federal Deposit Insurance Corporation
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Re: FIL-2-2015, FAQ B6 – referrals by professionals resulting in brokered deposits

Dear Messrs. Thompson and Hencke,

Thank you for your telephone call on January 9 and, at the end of our conversation, your invitation for me to put my concerns in writing to you. That is the purpose of this letter.

As we discussed, I am troubled by the answer to FAQ B6 contained in the just-published FIL-2-2015:

> **B6. Are insurance agents, lawyers, or accountants that refer clients to a bank considered to be deposit brokers?**
>
> Yes. By referring clients to a bank, these persons are facilitating the placement of deposits. Therefore, they are deposit brokers, and the deposits would be brokered.

I believe that such a treatment of referred deposits is patently wrong, because (i) the answer to FAQ B6 is inconsistent with the statutory definition of deposit broker; (ii) the answer to FAQ B6 ignores the realities of the way banks, and community banks in particular, gather new customers; (iii) there is no reason to believe that the types of referred deposits covered by FAQ B6 are more likely to have undesirable characteristics than deposits gathered by other conventional means; (iv) the FDIC's rationale for *not* categorizing listing service deposits as brokered deposits argues against the answer given for FAQ B6; and (v) the required data collection and reporting implied by the answer to FAQ B6 would be needless, burdensome, and counterproductive.

I will elaborate on each of these points below.

<u>(i) The answer to FAQ B6 is inconsistent with the statutory definition of deposit broker.</u> As noted in the FDIC's 2011 Study on Core Deposits and Brokered Deposits:

> Brokered deposits are defined by statute. Section 29 of the Federal Deposit Insurance Act (the FDI Act) in essence defines a "brokered deposit" as simply a deposit accepted through a "deposit

broker." Thus, the meaning of the term "brokered deposits" turns upon the definition of "deposit broker." In section 29 of the FDI Act, the term "deposit broker" is defined as follows:

> The term "deposit broker" means (A) 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; and (B) an agent or trustee who establishes a deposit account to facilitate a business arrangement with an insured depository institution to use the proceeds of the account to fund a prearranged loan.[1]

As observed by Director Eberley in her cover letter to FIL-2-2015, that definition is broad.[2] Yet despite its breadth, each aspect of the (Congressionally-given) definition nonetheless explicitly hinges on the person deemed to be a "deposit broker" being one who is engaged in the business of placing, or in the business of facilitating the placement of, deposits with an insured depository institution.

(The "primary purpose" exception addressed in FAQ E6 echoes this same theme[3], as does the FDIC's Risk Management Manual of Examination Policies in which it is stated that bank management should "perform adequate due diligence procedures before entering any business relationship with a deposit broker."[4])

Facilitating the placement of deposits is not the "business" activity of insurance agents – they sell insurance and offer insurance advice. It is not the "business" of lawyers – they provide legal services and offer legal advice. And it is not the "business" activity of accountants – they provide accounting services and offer financial and tax planning advice.

However, members of the insurance, accounting and legal professions will, outside the scope of their own business services, sometimes refer their clients with a particular need to another professional or business owner.

For example, if they have a client who is having unresolved stomach pain, they may refer the client to a trusted, local gastroenterologist. But that referral does not suddenly mean the referring professional is in the business of brokering medical patients. Rather, the professional simply wants the best for the client's health.

Similarly, if the client owns an automobile with ongoing electrical issues, the professional may refer the client to a reputable auto mechanic who specializes in such repairs. But that act does not somehow put the referring professional into the business of brokering auto repairs. Instead, it only means the professional wishes to help the client solve his/her car trouble.

And if the client has unmet financial needs, or mentions that he/she is unsatisfied with his/her current bank, the professional may refer the client to a local, trusted, reputable banker. And that does not put the referring professional into the business of placing deposits. Nor should it make that professional a "deposit broker."

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[1] FDIC, Study on Core Deposits and Brokered Deposits, July 8, 2011, emphasis added.
[2] FDIC, Financial Institution Letter FIL-2-2015, January 5, 2015.
[3] Ibid.
[4] FDIC, Risk Management Manual of Examination Policies, Section 6.1 – Liquidity and Funds Management, emphasis added.

(ii) The answer to FAQ B6 ignores the realities of the way banks, and community banks in particular, gather new customers. The FDIC's December 2012 Community Banking Study rightly characterizes a key attribute of community banking as being relationship-based. In fact, throughout the Study appear phrases such as "relationship banking", "relationship lending", "long-term business relationships", "managing relationships at a personal level", etc.[5] It is therefore very surprising to me that FDIC's answer to FAQ B6 ignores the way in which most of those deep customer relationship begin. They do not materialize out of thin air, and the highest quality customers rarely just stroll through the front door of the bank. They most often begin with the *referral* of that new, prospective customer by another person who trusts the bank or banker. Most often the referring party is himself/herself a customer of the bank who has experienced, firsthand, the quality of service the bank delivers to its customers. *And, not infrequently, the referring party is an insurance agent, lawyer, accountant or some other trusted financial professional.*

In my 25+ years of banking in Southern New Jersey I am proud of the numerous customer relationships I have developed, and many of those relationships go back 10, 15 and 20 years. They have been cultivated through long-term quality service, integrity and mutual respect. Those banking relationships are the very essence of core customers – they are loyal, local and they are not changing banks because someone offers them a quarter-percent improvement in their interest rate. But every one of those relationships had a point in time at which it began, when that customer was new to me and my bank. And as I think about those customers, name by name, I realize that *virtually every one* of those relationships began with the referral from someone else - often a mutually-known financial professional. Therefore the FDIC should not equate referrals from insurance agents, accountants and lawyers as brokered deposits; if anything, it should be the exact opposite! Generally speaking, their referrals are among the highest quality, and most core, that bankers receive.

(iii) There is no reason to believe that the types of referred deposits covered by FAQ B6 are more likely to have undesirable characteristics than deposits gathered by other conventional means. The FDIC's Risk Management Manual of Examination Policies provides the following instructions to its examiners with regard to brokered deposits:

> Deposit brokers have traditionally provided intermediary services for financial institutions and investors. However, the Internet, certificate of deposit listing services, and other automated services enable investors who focus on yield to easily identify high-yielding deposit sources. Customers who focus exclusively on yield are highly rate sensitive and can be a less stable source of funding than typical relationship deposit customers. These customers may have no other relationship with the bank and have no loyalty with their deposit funds. If more attractive returns become available, these customers may rapidly transfer funds to new institutions or investments in a manner similar to that of wholesale investors. Management should be aware of the number and magnitude of such deposits.
>
> Management should perform adequate due diligence procedures before entering any business relationship with a deposit broker. Deposit brokers are not regulated by bank regulatory

[5] FDIC Community Banking Study, December 2012.

> agencies. Also, management should assess potential risk to earnings and capital associated with brokered or other (such) rate sensitive deposits.[6]

Those cautionary statements are prudent and well-founded. But the types of deposits they describe bear no correlation to the types of customers generally referred by insurance agents, accountants and lawyers.

Those professionals' referrals are typically *not* primarily focused on interest rates, they tend to develop *deep relationships* with the bank, they tend to be *local*, and they are *less prone to leave* than other customers. Indeed, if most interested in rate, those clients had no need to seek the advice of their trusted financial professional – rather, with a few keystrokes they could go to bankrate.com. Instead, the referred client sought the advice of his/her professional because of some more complex or subjective reason.

It could be due to a unique banking need for their business. It may be because they have been declined by another bank for a mortgage or other financing request. It could be out of frustration with their big, high-fee, impersonal bank and a desire to do business with a friendlier, lower-fee, more flexible institution. In any of those cases (and others), the reasons the customer was referred are the same reasons that they are likely to wind up as long-term, loyal, "sticky" customers of the bank. If they receive the (non-rate sensitive) services they sought, then they will tend to develop a deeper and multi-faceted relationship with the bank which their trusted professional recommended. In fact, they typically match the definition of core deposits as given in the same section of the FDIC's Risk Management Manual of Examination Policies:

> Core deposits are generally stable, lower cost funding sources that typically lag behind other funding sources in the need for repricing during a period of rising interest rates. These deposits are typically funds of local customers that also have a borrowing or other relationship with the institution. Convenient branch locations, superior customer service, dense ATM networks, and low or no fee accounts are significant factors associated with the inertia of these deposits.[7]

The FDIC has also noted that a chief concern about brokered deposits is their ability to enable banks to depart from a traditional model and grow faster with risky assets, "often funded by volatile brokered deposits. And they are the ones that ended up on (the FDIC's) failing bank list."[8] This is another aspect of true brokered deposits which differs from that of deposits referred to a bank by insurance agents, accountants and lawyers - i.e. the speed with which they are gathered. A bank can add brokered deposits with one telephone call or a few clicks of a mouse. In contrast, the deposits garnered from professional referrals are the result of a slow, deliberate process, and one which – just like other conventionally-gathered deposits – depends in the end on the customer's decision to do business with the bank, not the bank's unilateral action to, overnight, increase its liabilities. The attraction cycle for accounts referred by professionals is just like that of other local, core deposits it gathers. They result from a bank's long-term development of its local reputation, image and word-of-mouth goodwill.

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[6] FDIC, Risk Management Manual of Examination Policies, Section 6.1 – Liquidity and Funds Management, emphasis added.

[7] Ibid.

[8] Remarks by FDIC Chairman Martin J. Gruenberg, ICBA 2014 National Convention and Techworld, March 4, 2014.

(iv) The FDIC's rationale for *not* categorizing listing service deposits as brokered deposits argues against the answer given for FAQ B6. The FDIC has determined that listing service deposits shall not be considered brokered deposits, despite the ease with which a bank can obtain listing service deposits, the lack of meaningful relationship between the bank and the depositor, and those deposits' rate sensitivity.

The FDIC has based its reasoning, at least in part, on the fact that the listing service merely "facilitates... the decision of the would-be buyer whether (and from whom) to buy a CD, or the decision of the depository institution as to what rate to set; it is not facilitating the *placement* of deposits *per se*.[9]"

Further, FDIC takes "the position that a listing service is not a deposit broker if the service 'is compensated only by means of subscription fees... and such fees are not calculated on the basis of the number or dollar amount of deposits placed as the result of information provided by the listing service.'[10]"

Similar to a listing service, insurance agents, accountants and lawyers who refer clients to banks are merely facilitating their clients' evaluation of their banking options. They are not making the decision for the client. The client will meet with the banker himself and make his/her own decision. His/her professional is not *placing* the deposits *per se*.

And, also similar to a listing service, a referring professional is not compensated for the referred deposit on the basis of the number or dollar amount placed. Indeed, that professional is not directly compensated for those referred deposits *at all*.

(And really, which type of deposit do you think is more likely to exhibit the unfavorable characteristics of a brokered deposit – a CD customer from out of the area who came to the bank via a listing service, or a local individual or business owner referred by a local, mutually-known financial professional?)

(v) The required data collection and reporting implied by the answer to FAQ B6 would be needless, burdensome and counterproductive.

The promulgation of this answer to FAQ B6 logically implies that bankers should have systems in place to comprehensively track, collect and report professionals' referrals as brokered deposits. For all the reasons cited above, the collection of that data would result in banks reporting as brokered deposits vast amounts of deposits that really have none of those deposits' characteristics. And therefore the FDIC would be receiving large amount of "false positive" brokered deposit data, obscuring the *true* quantity of volatile, "hot" deposits that the FDIC (rightly) wants to stay apprised of, in both the industry and bank-by-bank. This would result in the brokered deposit data being far less, not more, useful to regulators.

In addition to resulting in bad data, it would create a misguided and needless collection burden on banks. Bankers would need systems to track referrals enterprise-wide, which would be extremely difficult given the idiosyncratic way referrals are made; it would likely result in examiners challenging

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[9] FDIC, Study on Core Deposits and Brokered Deposits, Submitted to Congress pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, July 8, 2011.
[10] Ibid.

bankers to see what systems and risk management processes we have in place to comprehensively collect and report referred deposits as brokered; it would necessarily result in added personnel, systems and audit costs to manage the process; and all for the result of muddled and less meaningful brokered deposit data.

(And, truly, the last thing we bankers need is one more set of data to track!)

I am glad to have the opportunity to comment to you on this topic. I am also grateful to the FDIC for its extensive research on community banks over the last several years. I agree with, and am encouraged by, Chairman Gruenberg's repeated comments such as "the community banking sector in the United States is going to be here for the long term, and continue to play a vitally important role in the banking system and economy of the United States."[11]

To do so, we need rules that make sense and which do not create illogical and pointless burden.

You got the answer to FAQ B6 wrong. It should be "No." And I implore you to change it.

Thank you.

Sincerely,
CAPITAL BANK OF NEW JERSEY

David J. Hanrahan
President and CEO

cc: Martin J. Gruenberg, Chairman, FDIC
Doreen R. Eberley, Director, Division of Risk Management Supervision, FDIC
John F. Vogel, Regional Director, New York Regional Office, FDIC
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[11] Remarks by FDIC Chairman Martin J. Gruenberg, ICBA 2014 National Convention and Techworld, March 4, 2014

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February 4, 2015

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Re: FIL-2-2015, FAQ B6 – Referrals by Professionals Resulting in Brokered Deposits

Dear Mr. Hanrahan:

Thank you for your letter dated January 14, 2015, which followed-up on our conversation held earlier this month. We welcome your comments regarding the referenced Financial Institution Letter, specifically as it relates to our guidance on how the FDIC categorizes deposits related to referrals to a bank by business professionals. As cited in the FIL:

"[Question] B6. Are insurance agents, lawyers, or accountants that refer clients to a bank considered to be deposit brokers?

Yes. By referring clients to a bank, these persons are facilitating the placement of deposits. Therefore, they are deposit brokers, and the deposits would be brokered."

We would like to elaborate on our response to the answer to Question B6. We recognize that within a community, there are many business professionals that conduct banking business with a particular insured financial institution (IDI), and, due to that banking allegiance, often refer their customers to a particular financial institution on an informal basis for deposit products. Those types of informal deposit referrals that are not related to a programmatic arrangement, such as a written agreement or referral fee between the IDI and the business professional, would not be considered brokered. Rather, Question B6 relates to more formal, programmatic arrangements, such as where (1) the professional has entered into a written agreement with the bank for the referral of depositors; or (2) the professional receives fees from the bank. In either of these two cases, the FDIC would consider the professional to have facilitated the placement of deposits in the bank and therefore, the deposits received by the IDI to be brokered.

Again, we appreciated you taking the time to write to us, and hope that this letter clarifies our position regarding referrals to a bank by business professionals. If you have questions, please feel free to contact us.

Sincerely,

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