



FUNDING

Dodd Frank Relevance is Re-Evaluated — FDIC Study and Report on “Brokered” and “Core” Deposits

On July 8th 2011, the FDIC released copies of a report they had submitted to Congress on core deposits and brokered deposits. The report outlines the history of brokered deposits starting in the 1980's, and reviews different benchmark rulings by Congress on this subject. The report discusses several different kinds of brokered deposits, and provides a list of related services and servicing agents, including: listing services, marketers, investment companies (which facilitate “sweep” accounts), pass-through arrangements, bank networks (which facilitate “Reciprocal arrangements”), and prepaid products. The following are some highlights which pertain to DTC Brokered CD products.

Acceptance and Use of Brokered Deposits as Funding

In discussing how bank examiners conduct supervision over insured institutions, it was found that:

*“Examiners do not necessarily view the presence of any certain source of funding as inherently bad. The FDIC’s Risk Management Manual of Examination Policies states that the acceptance of brokered deposits by well-capitalized institutions is subject to the same considerations and concerns applicable to any other type of funding. These concerns relate to volume, availability, cost, volatility, maturities, and how the use of such funding fits into the bank’s overall liability and liquidity management plans. **Furthermore, there should be no particular stigma attached to the acceptance of brokered deposits per se and the proper use of such deposits should not be discouraged**”.*

During the previously conducted FDIC Roundtable, several members of the panel discussed adopting a more formal “spectrum” approach based upon deposit characteristics, to replace the brokered deposit statute and the core deposit concept. However the FDIC clearly states that this will not happen:

“Through the supervisory process, examiners already consider deposit characteristics when assessing an institution’s liquidity position. To develop a formal approach—to replace the statute, or change the supervisory approach or assessment system—would require that banks undertake considerably more tracking and reporting of deposits. The costs of doing so would appear to outweigh the potential benefits.”

Therefore, it appears for the time being that the current definitions for “Core” and “Brokered” deposits will stay as they are.

The section of the Report that covers “Studies and Analyses” stated this:

“Brokered deposits can be a valuable funding source when banks manage them well and use them to grow prudently. However, the

use of brokered deposits by problem banks has often been associated with abuses and contributed to failures with consequent losses to the deposit insurance funds. They can represent a consistent and heavy funding source to support unsound or rapid expansion of loan and investment portfolios.”

Did Brokered Deposits Fuel Higher-Risk Investing and Lending?



The FDIC seems to see value in having certain types of brokered deposits on the books, or at least available in case of emergency liquidity needs. However the report reiterates time and again the FDIC’s concern for the DIF fund, and rightly so, since this fund was established to protect consumers and give the public the insurance coverage that was demanded in the early

1900’s. When reviewing the report it is easy to see that protecting the DIF fund is definitely a driving force in their decision making.

The study gives a pretty fair assessment for the cause of the recent bank failures when it states:

“Many failed banks operated with an aggressive growth strategy, typically by increasing higher risk assets that were extremely vulnerable to market or economic downturns. In most cases, the higher risk asset concentrations were CRE (Commercial Real Estate) loans, predominantly acquisition development and construction (ADC) and land loans. Examples of other higher risk assets included: private label mortgage-backed securities, non-traditional mortgages (including option adjustable rate mortgages), high loan to value home equity loans, and sub-prime auto loans.”

But the report also makes several references citing brokered deposits as being indirectly responsible -- although only in part -- for some of the bank failures.

“In most instances, the MLRs (Material Loss Reviews) that the FDIC reviewed identified concentrations in high-risk assets and losses on those assets as the major factor that led to failures. Although many of the MLRs mentioned reliance on noncore funding, particularly brokered deposits and FHLB borrowings, as a cause of failure, the MLRs rarely stated that failure was the direct result of this reliance (on brokered deposits). However, without brokered deposits and FHLB borrowings, many of the banks that grew rapidly could probably not have done so.”

The implication being made is that low cost funding sources (i.e., brokered deposits) led some banks to invest in higher risk loans, which in turn led to higher non-performing loan ratios. Two assumptions are being made by the FDIC here: That the management teams of failed banks were all doing higher-risk investing and lending; and brokered deposits were the source for fueling their investing and lending. The bigger and unaddressed issue, however is, "Are these true and accurate assumptions?"

The paper goes on to reference many independent studies, some as recent as 2011, some going all the way back to the 1980's. There are several favorable references to brokered deposits, as well as a variety that are not.

A large part of the study took five different products and analyzed them in three different ways, addressing rapid growth, volatility and franchise value. In this very important section of the report, traditional DTC brokered CDs are hardly commented on at all. The stability and cost-effectiveness of long-term brokered CDs, in particular those with limited early withdrawal provisions, is really never examined in detail despite discussion at the Roundtable.

When discussing brokered deposit Assessments, and adjustments to a bank's brokered deposit ratio, the FDIC reiterates its current policy:

"The Assessment Rate of a small bank that is well capitalized and has a composite CAMELS rating of 1 or 2 depends, in part, on an adjusted brokered deposit ratio. A bank's assessment rate will increase if its total gross assets were more than 40 percent greater than they were four years previously, after adjusting for mergers and acquisitions, and its brokered deposits make up more than 10 percent of its domestic deposits. As discussed in the previous section, the FDIC may consider possibly making a bank's assessment rate increase for greater levels of high rate deposits and may consider possibly excluding some or all sweeps and referrals from affiliates from the adjusted brokered deposit ratio, but doing so would, again, require additional reporting."

So at present, there are no significant changes to this issue. A very small percentage of banks that hit the thresholds mentioned would incur an extra brokered deposit assessment. Most banks do not meet these requirements largely because they just have not grown that much over the previous four years.

Balancing Growth and Brokered Deposits In Well Capitalized Institutions

When discussing the reason for the high rate of bank failures over the last 2-3 years, the report states this:

"Most banks failed because their boards of directors and management did not implement effective risk management practices with respect to rapid growth and significant concentrations in riskier assets, such as CRE and ADC."

"Failed banks often exhibited a growing dependence on volatile, noncore funding sources, particularly brokered deposits and, in some cases, FHLB advances and Internet CDs."

"While none of these MLRs and Reports determined that brokered deposits directly caused failure, aggressive growth could not have been pursued without volatile funding sources such as brokered deposits."

Failed banks may have inappropriately or excessively used brokered deposits for funding loan growth, but the report also frequently emphasizes that brokered deposits can be a valuable funding source when used prudently by "well capitalized" institutions. The abusive use of brokered deposits may have helped lead to increased failures and losses in the



FDIC fund, but brokered deposits in and of themselves are simply one of several valuable funding 'tools' available to prudent bank management teams. This theme has been stated for many years now, and is supported by the brokered CD community and well-managed banks: Brokered deposits, or any deposit for that matter, do not make a bank fail. Rather, it is the assets purchased by a bank that potentially put it in an insolvent position, irrespective of the type of deposit or funding source utilized.

So what is the lesson to be learned from this report? In a nutshell, if any kind of deposit (brokered, core, FHLB loans and so forth) is used to purchase "risky loans" or "high risk assets", or is employed to facilitate "rapid growth", coupled with unsound underwriting practices, inadequate risk management systems, or unhealthy business practices, then that deposit is not being used in a manner consistent with promoting the health and welfare of that bank.

The report points toward the conclusion that;

- (a) Current FDIC policies are now sufficient to prevent insured institutions from operating in the same fashion as they did during the recent real estate and financial crisis, and;
- (b) Current definitions of Brokered and Core deposits are adequate as now stated.

FDIC examiner guidance states that there should be **no particular stigma attached to the acceptance by well-capitalized banks of brokered deposits per se, and that the proper use of such deposits should not be discouraged.**

The FDIC has also concluded that the brokered deposit statute continues to serve an essential function and recommends that Congress not amend or repeal it.

- Well-capitalized banks may accept brokered deposits at any time.
- Adequately capitalized banks may accept new brokered deposits and renew or roll over existing brokered deposits if they have obtained a waiver from the FDIC.
- Undercapitalized banks may never accept, renew, or roll over brokered deposits.

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