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Brokered Deposits and Community Banks; A Strategic Perspective

Brokered Deposits ("BDs") have long been available to community banks as both an alternative funding source and an interest rate risk diversification solution. Viewed as non-core deposits, BDs have often been a practical solution for banks with a loan portfolio growth rate that exceeds their core deposit growth rate.

But, then came the great recession. During this period the use of BDs began to appear to be a tool to shore up banks with operating weaknesses. This led to bank regulators discouraging or in some cases forbidding the use of BDs. Most Consent Orders (or Formal Agreements/Cease & Desist Orders, MOUs, etc.) included restrictive or prohibiting language regarding BDs. Some now believe that this led to the perception that underperforming banks are more likely to use BDs compared to average and higher performing banks. It also led to the belief (real or perceived) by many that the regulators wanted to further restrict the use of BDs.

With that in mind, we decided to take a current look at banks that appear to strategically include BDs as a part of their funding strategy vs. those that do not (banks with no BDs). As a baseline, we chose banks which had 7% or more of their deposit portfolios classified as BDs at the end of 2015 and 2014. (NOTE: Banks with at least 7% in BDs in their portfolios at the end of each fiscal year are assumed to have maintained that level throughout our 2015 test year. We also acknowledge that BDs as reported in the Call Report may consist of broker-dealer provided CDs, various CDARS products, and sweep accounts.) Our analysis included 5,898 community banks with assets from <$100M to $3B. For purposes of our research we broke them out into 5 groups, based upon asset size.

Our objective was to compare the performance of banks with BDs to those without BDs during 2015. We focused on the following key performance indicators: ***Asset Growth, ROAA, ROAE, Net Interest Margin, Bank Efficiency, and Asset Quality***. *Finally, for those banks with BDs we also compared their* ***Average BD Balances Maintained*** *and their* ***Percentage of BDs to Total Deposits.***

SUMMARY OF FINDINGS

Based upon our analysis comparing banks with BDs to those without BDs in their portfolios, we noted the following:

- 2,305 banks of 5,898 (39%) had some balance of BDs during 2015
- 776 (13%) had 7% or more in BDs in their deposit portfolio
- The number of banks using BDs increased with the asset size of the bank

From a performance standpoint banks with 7% or more in brokered deposits vs. banks with no brokered deposits:

- Grew at a greater rate
- Generated higher ROAA
- Generated higher ROAE
- Net Interest Margin was higher
- Operating efficiency was better
- Asset quality was mixed
- Average BD portfolio size was between 14% - 19%

The analysis indicates that during 2015, banks with 7% or more in BDs grew at a higher rate, earned more, created a higher shareholder return, had stronger margins and operated more efficiently than banks that did not utilize BDs as a business funding strategy.

This would tend to dispel the perception that banks with BDs have an operating weakness, or that they underperform peer banks with no BDs.

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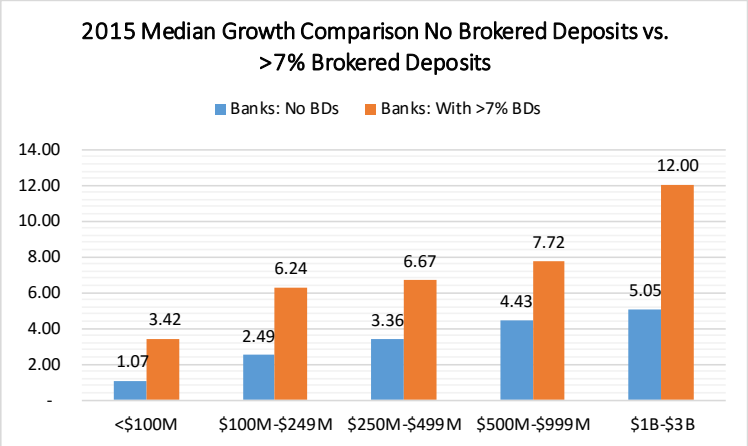
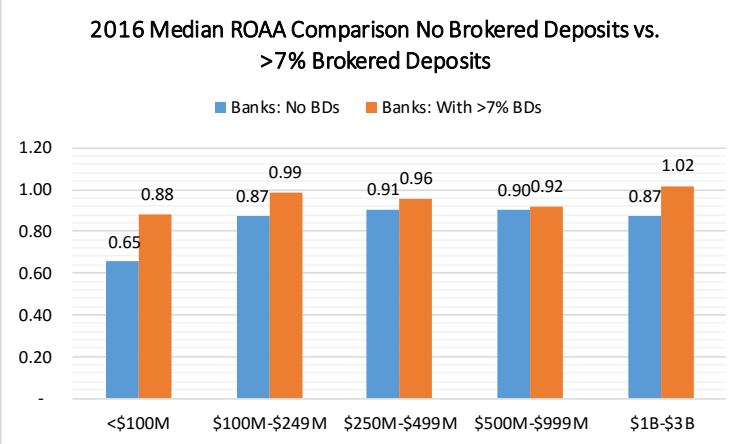
2015 GROWTH RATE



Asset Growth	No BDs	>7% BDs	Variance
<$100M	1.07	3.42	219%
$100M-$249M	2.49	6.24	151%
$250M-$499M	3.36	6.67	98%
$500M-$999M	4.43	7.72	74%
$1B-$3B	5.05	12.00	138%

When analyzing the growth impact, it was not surprising to see the BD banks with a higher rate of growth. It is not uncommon for banks with a greater growth rate to utilize brokered deposits as a funding source. What is interesting is to see the magnitude of difference between the two groups. The difference in growth rates spanned between 74% to 219% greater.

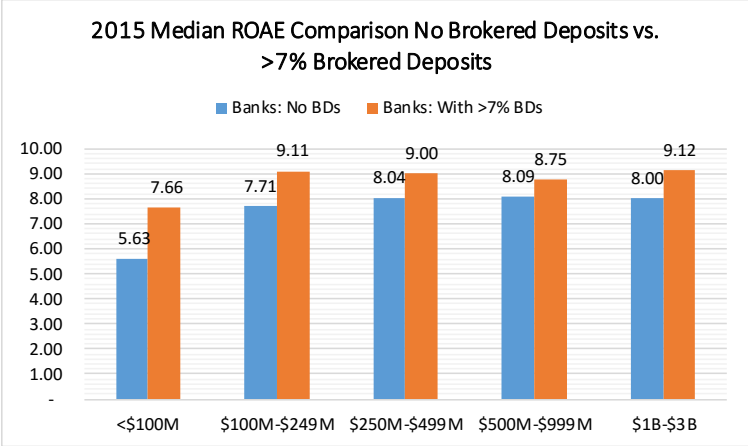
2015 RETURN ON AVG ASSETS (ROAA)



ROAA	No BDs	>7% BDs	Variance
<$100M	0.65	0.88	34%
$100M-$249M	0.87	0.99	13%
$250M-$499M	0.91	0.96	6%
$500M-$999M	0.90	0.92	2%
$1B-$3B	0.87	1.02	17%

When reviewing 2015 annual earnings comparison, the difference between the groups does narrow. The findings tend to more dramatic for the smallest and largest banks in our test group, tightening within the two middle groups. Based on asset size the range of difference was from 2 basis points to 23 basis points.

2015 RETURN ON AVG EQUITY (ROAE)



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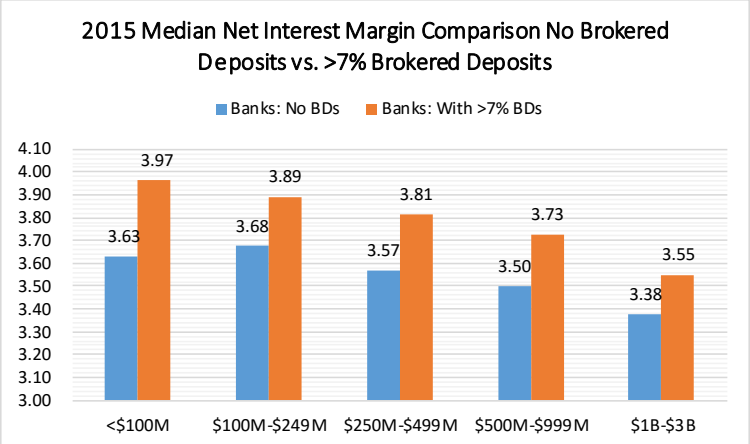
ROAE	No BDs	>7% BDs	Variance
<$100M	5.63	7.66	36%
$100M-$249M	7.71	9.11	18%
$250M-$499M	8.04	9.00	12%
$500M-$999M	8.09	8.75	8%
$1B-$3B	8.00	9.12	14%

Board members will likely be surprised to discover that banks using BDs are providing greater returns than those without. Over the last several years most directors have been discouraged from approving BDs as a part of their banks funding strategy. In this study, banks with BDs provided an 8% to 36% greater return to their shareholders.

NET INTEREST MARGIN COMPARISON

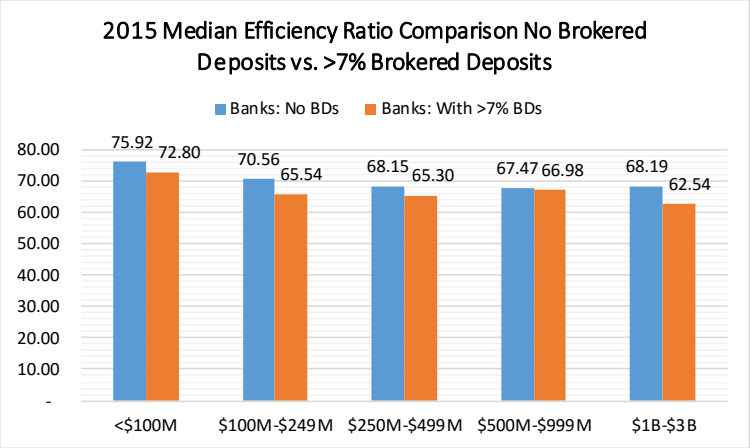


NIM	No BDs	>7% BDs	Variance
<$100M	3.63	3.97	9%
$100M-$249M	3.68	3.89	6%
$250M-$499M	3.57	3.81	7%
$500M-$999M	3.50	3.73	7%
$1B-$3B	3.38	3.55	5%

The Net Interest Margin ("NIM") comparison, though perhaps a smaller percentage difference between the two groups, was the most consistent in terms of asset level performance. The range of improvement among the group ranged from 17 to 33 basis points better for the banks with BDs.

EFFICIENCY RATIO COMPARISON

Efficiency	No BDs	>7% BDs	Variance
<$100M	75.92	72.80	-4%
$100M-$249M	70.56	65.54	-7%
$250M-$499M	68.15	65.30	-4%
$500M-$999M	67.47	66.98	-1%
$1B-$3B	68.19	62.54	-8%



Similar to NIM the difference between groups was a little less dramatic, but within each asset group, banks with BDs in their portfolios generated slightly better efficiency ratios among all asset size groups. BD banks Efficiency ratios were better between 0.50 to 5.65 basis points.

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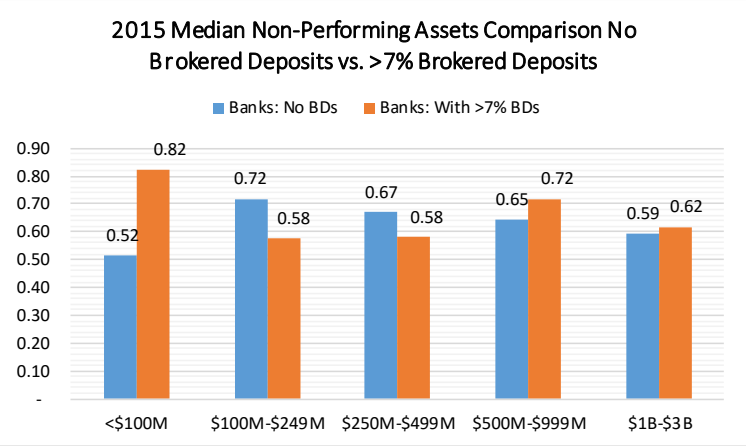
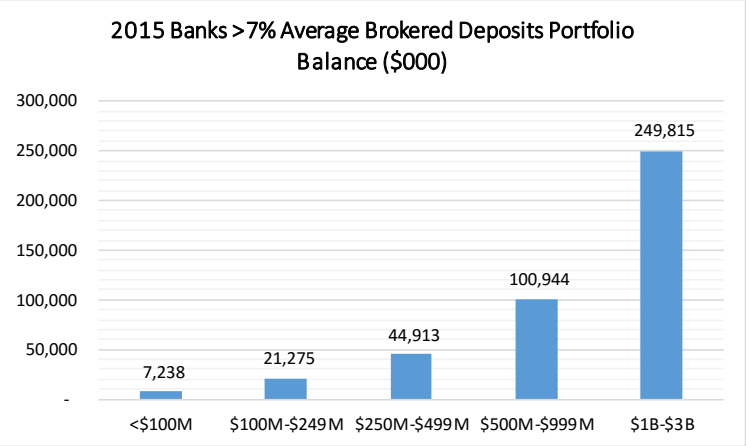
NON PERFORMING ASSETS



NPAs	No BDs	>7% BDs	Variance
<$100M	0.52	0.82	59%
$100M-$249M	0.72	0.58	-20%
$250M-$499M	0.67	0.58	-13%
$500M-$999M	0.65	0.72	11%
$1B-$3B	0.59	0.62	4%

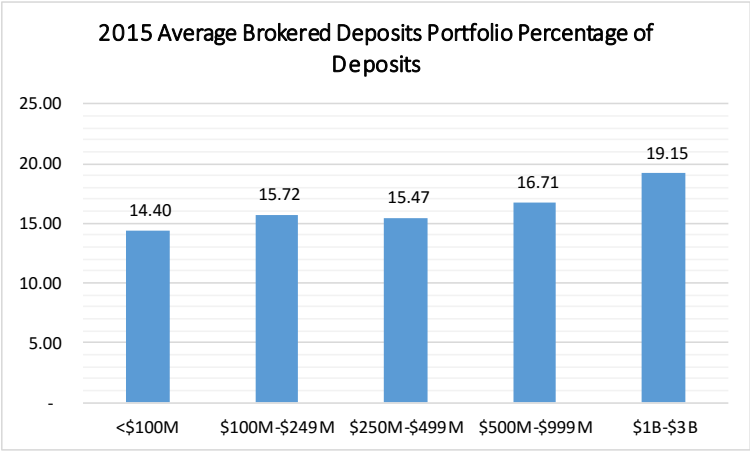
The analysis around asset quality was less conclusive. There are cases, as with banks under $100M where asset quality for non-BSs banks was materially better than their counterparts with BDs. However, it is also worth noting that all asset level medians are well within a range of sound performance, especially when considering recent past credit quality issues, within community banks.

AVERAGE BROKERED CD PORTFOLIO SIZE



As mentioned at the outset of the study, we reviewed banks with 7% or more in BDs for comparison purposes. When reviewing each of the asset groups within the category, we found that the average BD deposits for each group ranged from $7M to just under $250M.

AVERAGE PERCENTAGE OF BDs to DEPOSITS



The actual average BD percentage for each asset group ranged from 14.40% to 19.15%.

CLOSING THOUGHTS

When we initiated this study, it was primarily driven by a curiosity about the performance levels of banks utilizing brokered deposits in their funding strategies. Over the last decade it is fair to say that many bankers, boards, and regulators assigned a certain stigma to the use of these instruments.

These findings, based on 2015 financial performance indicates that banks with brokered deposits as a group tended to have better overall performance than those who choose not to use brokered deposits in their funding strategies. Over time this could have a significant impact on a bank's overall franchise value. Finally, as another view of the results of our study, we lowered the level banks with BDs from 7% to all banks above 0% in BDs, the results, though not quite as dramatic, reflected equal to or better than performance for those banks maintaining some level of brokered deposits.