

THE FDIC CORE AND BROKERED DEPOSITS STUDY: A SYNOPSIS OF THE CONGRESSIONAL REPORT

Over the years, the FDIC and others have studied the specific role of core and brokered deposits in the performance of banks and the loss they impose on the Deposit Insurance Fund (DIF) when a bank fails. Section 1506 of the Dodd Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) directed the FDIC to conduct a study to evaluate how core deposits are defined; determine how redefining core and brokered deposits might impact the fund; assess the differences between core and brokered deposits and the roles they play; assess how changing the definitions might stimulate local economies; and determine how redefining core deposits might affect competition between large institutions and community banks.

Essentially, Dodd-Frank called on the FDIC to study whether the core and brokered deposit classifications, which the agency uses for regulatory supervision and bank assessments, can and should be improved. This mandate generated a lot of speculation in our marketplace and throughout the financial industry. Some suggested that the FDIC might recommend changing the definition of a deposit broker. Others were convinced that the FDIC would recommend reversing the classification of reciprocal and sweep deposits, allowing them to be defined as “core” deposits.

The FDIC submitted its highly anticipated study results to Congress on July 8, 2011. Now that this report has been published, we want to give you a synopsis of key points it contains. In the paragraphs below, we summarize the conclusions, FDIC recommendations, and Dodd-Frank directives that are addressed in the study report, starting with a brief background of the methodology used by the FDIC to research the issues involved.

Overview of the Study Findings and Facts

To comply with the Dodd-Frank mandate, the FDIC solicited written comments from the banking industry and the public; organized roundtable discussions and held individual meetings with industry participants; undertook a detailed statistical analysis; and conducted a review of numerous academic studies, Material Loss Reviews and congressional reports. QwickRate was directly engaged in the FDIC’s fact finding process. We met personally with FDIC staff and presented QwickRate marketplace research. We also participated in the FDIC roundtable discussion held in Washington, D.C., and submitted written comments to the FDIC regarding this topic.

The FDIC study drew several conclusions:

1. Conclusions regarding Core Deposits (Pages 46-47)

In the FDIC’s view, the definition of core deposits should not be changed based on the continuing usefulness of core deposits as they are currently defined. Historical analyses, including those conducted by the FDIC and others, have confirmed that increased levels of core deposits are associated with a lower probability of bank failure and lower losses to the FDIC in the event of an institution failure. These conclusions are made with a high degree of statistical confidence.

Some commenters urged the FDIC to abandon the concept of a core deposit or to treat certain types of brokered deposits as core (for example, reciprocal deposits, sweeps and referrals from affiliates). Although some types of brokered deposits have some of the characteristics of core deposits, as commenters have argued, the FDIC determined there is no conclusive statistical evidence indicating that any type of brokered deposit should be treated as core.

2. Conclusions regarding Brokered Deposits (Pages 47-48)

The FDIC concludes that the definition of brokered deposits should not be changed. The statute remains useful in evaluating and predicting bank performance. It also continues to be relevant for determining the FDIC's losses in the event that a bank fails.

Some commenters urged the FDIC to abandon the concept of a brokered deposit. While banks can certainly benefit from the prudent use of brokered deposits, the FDIC's statistical analyses show that they are one indicator of a bank's higher risk appetite. The study indicates that their use often leads to higher growth, as well as higher subsequent nonperforming loan ratios. Both of these factors are associated with a higher probability of bank failure. In addition, brokered deposits tend to increase the FDIC's losses when a bank fails.

3. Conclusions Regarding Particular Kinds of Deposits (Pages 53-59)

The report reviews different types of deposits and how they are viewed by the industry as well as the FDIC. The discussion for some of these are included here:

Reciprocal Deposits: Several commenters argued that reciprocal deposits should be considered core deposits, and should not be considered brokered deposits. These arguments were based on the following opinions held by the commenters: 1) reciprocal deposits are insured, low-cost, stable deposits based on relationships with local customers; 2) they have high retention rates. However, there is no extensive historical data sufficient to support these statements.

The FDIC agrees that reciprocal deposits do not necessarily present all of the problems inherent in traditional brokered deposits. However, the study asserts that reciprocal deposits do pose significant potential problems. In particular, they depend on a network and the network's continued willingness to allow a bank to participate in it. For this and other reasons, the FDIC concludes that reciprocal deposits should not be considered core, and that their classification should remain as it is currently defined in the FDIC's brokered deposit statute. The study says that a few commenters also supported this view on the grounds that classifying reciprocals as core would only benefit a few individual companies and not the banking industry in general.

Sweep Deposits: In reviewing sweep deposits, the FDIC again found a very small amount of data available from which to draw its conclusions. Among the banks providing information, deposit sweeps from an affiliated broker dealer do appear to pose fewer problems compared to brokered deposits in general. However, the FDIC expresses concern that the marketing strategies of the affiliates, and also general market conditions, could exacerbate the impact that these deposits make on a financial institution. Having said that, the FDIC recognizes that sweep deposits from affiliated broker dealers can be a stable source of funding for financially sound institutions. These deposits are already being evaluated during the examination process in the context of total dollar volume and the financial condition of the bank receiving the funds. The FDIC's "deposit broker" definition contains a "primary purpose" exception under which a limited percentage of sweep deposits from affiliated broker dealers can be considered non-brokered. Aside from this exception, the FDIC still maintains that factors including volume, dependence on the business success of the affiliate, and the affiliate's control over whether the deposits will leave the bank for other investment opportunities, require these deposits to remain under the brokered deposit regulation in general.

The FDIC separately addresses non-affiliated sweep deposits, ones that a bank might acquire from more than one broker dealer by contractual arrangement. In its analysis, the FDIC found that sweep deposits from non-affiliates do pose potential problems in volatility and rapid growth, and provide no franchise value. Consequently, the agency maintains that these deposits should not be considered core and should continue to come under the purview of the brokered regulation.

Referrals from Affiliates: Some deposits are referred by affiliates that are engaged in other lines of business, where the referrals are ancillary to the affiliate's legitimate business. These deposits appear to pose fewer of the problems compared to brokered deposits, do not appear to foster bank growth, and appear to be relatively stable. Whether they have franchise value depends on particular circumstances. While these deposits do not present all of the problems that traditional brokered deposits do, they still pose greater potential problems than many other non-brokered deposits. In particular, these deposits depend on the success and strategies of an affiliate, and the bank's continued relationship with the affiliate. The FDIC concludes that they should not be considered core, and should continue as currently classified in the brokered deposit statute.

Passive (Non-brokered) Listing Service Deposits: The FDIC clearly defines listing service deposits as non-brokered. Banks began reporting listing service deposits on their call reports as "Estimated amount of deposits obtained through the use of deposit listing services that are not brokered deposits" on March 31, 2011. At this time, the FDIC maintains that there is insufficient data to facilitate a valid and complete determination regarding the potential risks associated with listing service deposits. The FDIC does point out that listing service deposits have proven to be a source of liquidity for banks when other sources are no longer available to them, allowing the institutions to fund liquidity shortfalls and avoid a potential liquidity event.

High Rate Deposits: The study acknowledges that high rate deposits can be obtained locally and from alternative sources beyond the bank's local market area. Obviously high rates are attractive to a depositor. All else being equal, particularly when a deposit is insured, a depositor should choose a higher rate over a lower rate. Even when a deposit is uninsured, a sufficiently high rate should allow a bank to attract large volumes of deposits. Moreover, all else being equal, a bank must earn more on its assets for a high rate deposit than for a low rate deposit in order to net the same amount. Thus, by its nature, a high rate deposit would appear more likely to lead a bank to take greater risk. During bank exams, the FDIC already considers interest rates (including a comparison with competitors' rates) and an institution's deposit pricing strategies. In assigning the Liquidity ("L") portion of a CAMELS rating, examiners evaluate a bank's overall exposure to high rate deposits. Significant exposure, particularly if the institution's financial condition is deteriorating, may adversely affect the examiner's overall assessment.

Final Recommendations

The FDIC recommends that Congress should not amend or repeal the brokered deposit statute. In the FDIC's view, the brokered deposit statute has served a useful purpose during the most recent crisis. In large measure, the statute has prevented failing banks from increasing their brokered deposits, thus preventing them from trying to grow out of

trouble by taking on greater risk. For example, prior studies of banks that failed between 1984 and 2003 found that bank failures occurring after the enactment of statutory restrictions were more likely to have lower resolution costs than failures that occurred before the brokered deposit statute was established. Therefore, the statute as currently defined has limited FDIC losses at failure. Further, the FDIC believes that the flexibility of the current statute allows it to be used without causing liquidity failures.

Dodd-Frank Issues

As stated earlier, Dodd-Frank directed the FDIC to consider five specific points in its evaluation. These points are listed below, along with the study results and recommendations.

A. Evaluate the Definition of Core Deposits for the Purpose of Calculating the Deposit Insurance Premiums of Banks

The FDIC has found that core deposits, defined to exclude insured brokered deposits, are significantly correlated with lower probability of failure and lower loss when failure occurs for all banks. The FDIC includes the core deposit ratio because it is one of the most relevant measures used to assess a large bank's ability to withstand funding related stress. This has been found to be statistically significant in predicting a large bank's long-term performance.

B. Evaluate the Potential Impact on the DIF of Revising the Definitions of Brokered Deposits and Core Deposits to Better Distinguish Between Them.

Changing the statutory definition of brokered deposits or the UBPR definition of core deposits would have no effect on the DIF, in part because the FDIC has complete flexibility to define these concepts for purposes of deposit insurance assessments and already uses slightly different definitions from either the statute or the UBPR. At present, the deposit insurance assessment system uses the concept of core deposits in only one way.

C. Evaluate an Assessment of the Differences between Core Deposits and Brokered Deposits and Their Role in the Economy and Banking Sector of the United States

Under their current definitions, brokered deposits and core deposits have had measurably diverse effects on the banking sector. While brokered deposits can be a valuable funding source when used prudently, numerous studies have found that a bank's use of brokered deposits contributes significantly to its likelihood of failure and increases the FDIC's losses upon failure.

By contrast, core deposits are intended to encompass stable, lower-cost deposits that enhance a bank's franchise value. The FDIC's statistical analysis also shows that core deposits are significantly correlated with a lower probability of failure. The different effects that brokered and core deposits have on banks carry over to the broader economy. Brokered deposits can affect a local economy differently depending on their prudent or imprudent use.

D, E. Evaluate the Potential Stimulative Effect on Local Economies of Redefining Core Deposits and Evaluate the Competitive Parity between Large Banks and Community Banks that Could Result from Redefining Core Deposits

The use of brokered deposits would probably increase if core deposits were redefined to include brokered deposits in the FDIC's supervisory and assessment systems. The same would be true if the brokered deposit statute were eliminated or weakened. On average, statistical research reveals that increased use of brokered deposits would raise the number of bank failures and the FDIC's losses upon failure. Because of these increased losses, the FDIC would have to collect more in deposit insurance assessments to maintain the DIF, reducing the amount of funds that banks have available to lend in the local economy and across the nation.

These increased losses and higher assessments would frustrate goals that the FDIC has set for the DIF in light of the increased flexibility to manage the fund that Dodd-Frank granted the FDIC. Under Dodd-Frank, the FDIC gained the ability to achieve goals for fund management that it has sought to achieve for decades, but lacked the tools to accomplish. These goals include maintaining a positive fund balance even during a banking crisis and maintaining moderate, steady assessment rates throughout economic and credit cycles. Greater fund losses due to increased use of brokered deposits could frustrate these goals, requiring higher and less constant assessment rates and a larger fund size.

Looking Forward

Congress will now review the findings, opinions and FDIC conclusions expressed in this study. In the future, these factors would be considered should there be any efforts to make legislative changes regarding brokered and core deposit definitions.

In Conclusion

QwickRate has always worked with the Federal agencies on behalf of our subscribers. We will continue to do so, and will provide updates and new information as they become available.

Concurrently, we will maintain our emphasis on regulatory research, taking the time and effort to notify subscribers of pertinent changes, rulings, and new regulations.

In the study, the FDIC notes five characteristics that are most useful in evaluating deposits from any source in order to determine how stable the sources are. Therefore, it will be very important for banks to keep good records moving forward to help examiners and agencies to develop a better understanding of your deposit sources and their characteristics, including QwickRate, so that you can demonstrate the stability of the deposits.

We are currently in the process of preparing additional insights regarding these five characteristics and other points gleaned from the FDIC's study. We will be following this synopsis with those insights to help your bank continue to improve liquidity management practices in the future.

About QwickRate:

QwickRate is the premier online marketplace for non-brokered funding and investing. We provide banks with a cost effective approach to gain direct access to a nationwide CD market. Our automated tools put banks in control to get the best rates for their institutions and more efficiently manage their portfolio. QwickRate is one funding source that is always available to FDIC-insured bank subscribers, which makes it an important component of your diversified funding strategy. With no transaction fees and unlimited support and regulatory guidance, our clients rely on QwickRate as a stable and efficient source of liquidity. For more information, contact us at 800.285.8626 or www.qwickrate.com.



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