AN IN DEPTH LOOK AT BROKERED DEPOSITS

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THE UNIVERSITY OF UTAH

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OVERVIEW

Banks have long relied on a number of funding sources, including equity capital, non-brokered and brokered deposits, and other liabilities, to make various types of loans and investments. And for almost as long, bank regulatory authorities have imposed various restrictions and costs on those funding sources that are perceived to be excessively risky.

Brokered deposits have been incorrectly identified as a cause of bank failure when in fact they have proven to be a safe and valuable source of funding for banks.

KEY POINTS

1. **Brokered deposits are an important, useful and safe funding source.**
2. **Brokered deposits have been unfairly linked with bank failures and higher resolution costs.**
3. **It is the leniency extended to troubled banks, not the type of funding that should be the focus of regulators.**
4. **The regulations on brokered deposits should be no different from those imposed on other deposits and purchased funds.**
5. **The FDIC should re-examine and re-define the rules of brokered deposit use.**

THE BARTH REPORT

The information in this guide is taken from Bank Funding Sources: A New Look at Brokered Deposits ("The Barth Report") by Dr. James Barth and his colleague, Yanfei Sun. In it they examine brokered deposits in the context of their origin, regulatory history, use, and performance. They also reviewed fifty-nine studies on the causes of bank failure/instability to understand how brokered deposits affect bank failures. The report concludes with a discussion of the role of brokered deposits in a technologically-oriented financial marketplace.

ABOUT DR. JAMES BARTH

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ORIGINS OF BROKERED DEPOSITS

Brokered deposits came into existence in the early 1960s, when electronic technologies made it possible for banks to transfer funds between different geographic areas easily and at almost no cost. Prior to this banks relied on "core deposits" which generally originate from a banks natural demographic market. A savings account deposit is a good example of a core deposit.

Brokered deposits make it possible for banks to raise large sums from savers and investors well beyond their local service markets. The use of brokered deposits has grown exponentially due to the development of branchless banking, which is one of the strongest trends in banking today.

BROKERED DEPOSITS & CORE DEPOSITS COMPARED

CORE DEPOSITS	BROKERED DEPOSITS
Unmatched funds - They flow in and out of the bank for reasons unrelated to the bank's loans.	**Matched funds** - Loans are funded with deposits that match the term and rate.
Prone to bank runs - They have few or no restrictions on early withdrawals and are therefore more vulnerable during periods of uncertainty.	**Bank run resistant** - Contracts enforce early withdrawal penalties and most are held to their full term.
Expensive overhead costs - They rely on a branch driven model that carries costly marketing and operational costs.	**Inexpensive and easy** - Deposits can be received in bulk outside of the geographic area and are available almost immediately.
Idle cash - Money has to be kept on hand to fund withdrawals and loans.	**Cash when needed** - They enable lower expenses because they can draw cash on demand.
FDIC insured	**FDIC insured**

OUTDATED REGULATIONS

In the 1980's brokered deposits were labeled by some as dangerous because of their use by troubled institutions for irresponsible asset growth.

The FDIC in reaction to the situation placed misguided regulatory constraints on brokered deposits instead of dealing with the source of the problem, the inadequate management of the banks in question.

However, the FDIC itself said:

> ***"...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."***

Brokered deposits are a proven safe reliable source of deposits for modern banking institutions.

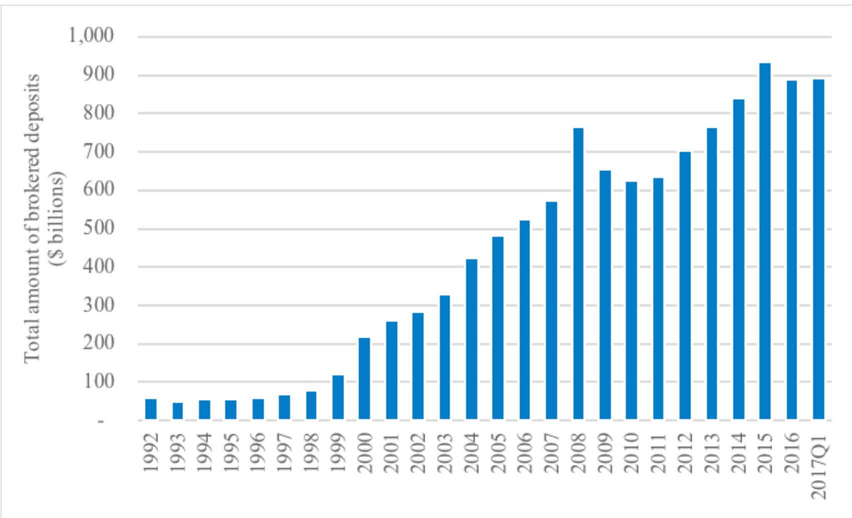
Today the FDIC says it disfavors a high reliance on brokered deposits because they sometimes cost more when liquidating a failed bank. However, this disregards the fact that banks that use brokered deposits the most have proven to be the least likely to fail. It is now generally assumed that the current administrators of the FDIC try to restrain the use of brokered deposits in order to limit the growth of branchless banks despite their highly successful record of safe and sound operations.

A MODEL OF PERFORMANCE

An examination of performance indicators show that brokered deposits have fared as well as, and in many cases better, than core deposits.

WIDESPREAD USE

It is important to look at how frequently brokered deposits are used and who uses them. As of 2017, **2,530** banks representing **43%** of the industry use some form of brokered deposits equaling **$891 billion**. From 1992-2008 the number of institutions using brokered deposits rose from **1,185** to **3,788**.



Total amount of brokered deposits, 1992–Q1 2017

BROKERED DEPOSIT TOTALS

43%

OF BANKS USE BROKERED DEPOSITS

$891BN

IN BROKERED DEPOSITS

BROKERED DEPOSITS & EFFICIENCY RATIOS

One measure of a bank's financial condition is its efficiency ratio which is the percentage of non-interest expense to income, the lower the number the better.

Community banks which generally operate via the branch model operate at an efficiency ratio of around **80%** on average.

A bank working mainly with brokered deposits and no branches has an efficiency ratio ranging from **30% - 60%.**

EFFICIENCY RATIOS COMPARED

CORE DEPOSIT BANKS W/ BRANCHES

80%

VS

BROKERED DEPOSIT BANK NO BRANCHES

30-60%

SAFETY

Brokered deposits have proven to be the most stable and reliable deposits a bank can hold.

Investors generally don't know where their funds geographically are and so the panic of a bank run is basically non-existent. Once the deposit is made it generally stays for the full term and is therefore far more predictable and stable.

An interesting example can be found in the failure of Barnes Bank in Utah. When a story ran in a local paper about mismanagement and heavy loan losses a bank run ensued and 15% of its deposits were lost in 10 days. During the run all the withdrawals were core deposits of local customers. Brokered deposits represented one third of deposits but none were withdrawn during the run.

The irony is that the regulators' stigmatization of brokered deposits may also mean higher costs and lower franchise value when a bank fails since the reputation attached to those deposits could prompt potential acquirers to demand that a discount be applied to the brokered deposits instead of seeing them as more stable.

But the proof is in the studies. The Barth Report examined fifty-nine studies about the causes of bank failures and found **NO** direct causal relationship between brokered deposits and bank failures.

BROKERED DEPOSITS IN THE 21ST CENTURY

The strength of brokered deposits is not just in their performance and safety but in their ability to meet the needs of modern banking.

- They enable banks to operate under a variety of business models.
- They make it possible for smaller banks to compete with larger banks.
- They facilitate the transfer of funds from savings-rich areas to areas with unmet credit needs for individuals and businesses.
- They narrow the opportunity gap between institutional and individual investors.

CONCLUSION

The overwhelming information indicates that brokered deposits are not the problem. On the contrary, the FDIC should treat brokered deposits as a superior form of bank funding because of their relatively low cost and accessibility.

The problem is how funds obtained by troubled banks are used. Banks that acquire any available assets in an attempt to “grow” their way out of their troubles are not demonstrating fund stability. In other words, the regulatory focus is misplaced.

There is likewise no convincing empirical evidence to show that brokered deposits increase the cost to the FDIC when resolving bank failures. In fact, the stigma now associated with these deposits, rather than the deposits themselves, may increase resolution costs. Because bank regulatory authorities want to treat these deposits differently, they impose additional costs and scrutiny on the banks that use them, and on the agencies themselves.

The problem is not in the funding source itself but a troubled bank using its funding sources irresponsibly.

WHAT WE WOULD LIKE TO SEE

1. **We believe regulatory authorities should treat brokered deposits no differently than other deposits.**

2. **The FDIC needs to re-examine its regulatory approach to brokered deposits. Because they have been incorrectly linked to troubled institutions, they have been unfairly stigmatized.**

3. **The FDIC need to develop an approach to determine a bank’s funding stability.**

4. **New rules for brokered deposits would allow the banking system to make full use of an important, safe, and effective funding source for individuals and businesses.**

GLOSSARY

Brokered deposit: Brokered deposits are funds accepted by a third-party deposit broker. A deposit broker places investors' funds with a bank that is FDIC insured. The deposit broker has a relationship with the bank, not the investors.

Core deposit: A deposit from a customer/investor made in a bank's natural demographic market. The customer/investor has a direct relationship to the bank. A savings account is an example of a core deposit.

Matched funds: Deposits that fund loans that are the same term and rate. Brokered deposits can fill this function.

Unmatched funds: Deposits that have no direct relation to the bank's loans. Core deposits are an example.

Efficiency ratio: The percentage of non-interest expense to income. The lower the number the more efficient a bank's performance.

MORE INFORMATION

The Utah Center for Financial Services (UCFS) is an independent research center funded by grants and focused on understanding the dual banking system and the role of state-chartered banks in the United States.

The **UCFS** research mission includes better understanding the plight of state-chartered banking, exploring the role innovation can play in providing financial services to unserved and under served communities, and developing policy recommendations to improve the use of technology in the delivery of financial services.

UCFS supports research conducted by faculty at universities nationwide, research in partnership with industry associations, and research done in conjunction with state regulatory bodies and state banking supervisors. The **UCFS** research agenda is developed in consultation with its stakeholder partners, which includes the **Council of State Banking Supervisors (CSBS)** and various banking associations. **UCFS** is connected to the **David Eccles School of Business** and the **Lassonde Entrepreneur Institute at the University of Utah**.

This information in this document is based on The Barth Report published by **UCFS**. For more information and to read the whole report please visit: **utahcenter.org**
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