



# NEWS RELEASE

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A STATEMENT ON

BROKERED DEPOSITS

PRESENTED TO THE

SUBCOMMITTEE ON GENERAL OVERSIGHT  
AND INVESTIGATIONS

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS  
U.S. HOUSE OF REPRESENTATIVES

BY

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FEDERAL DEPOSIT INSURANCE  
CORPORATION

Mr. Chairman, members of the subcommittee, let me commend you for conducting this hearing on deposit brokerage activities, a subject of vital concern to the FDIC. The indiscriminate placement of fully insured brokered funds into troubled banks and thrifts is without question a threat to the viability of the deposit insurance system.

#### An Overview of the Problem

Just over 50 years ago, the financial system lay in ruin. Nearly 10,000 banks had failed during the first four years of the Great Depression, President Roosevelt had declared a bank holiday and the public clamored for reform. Over a hundred proposals for a federal deposit insurance system had been introduced in Congress during the late 1800s and early 1900s, but none had become law.

The political climate changed dramatically in the midst of the chaos, though there was still powerful opposition to federal deposit insurance, most notably from President Roosevelt and the American Bankers Association. They believed the system would be too expensive and would subsidize marginal, high-risk institutions at the expense of well-managed firms. But millions of individuals had lost or faced the prospect of losing some or all of their life savings. They wanted action, not excuses. They wanted protection, not philosophy. Their voices were heard; the FDIC was created to restore confidence and stability in the banking system by safeguarding the savings of depositors, up to \$2,500 per customer.

The system worked remarkably well. The holiday was ended and the failure rate plummeted. The fears expressed by opponents of deposit insurance did not come to pass. Bankers and their regulators, freshly scarred by the financial collapse, were extremely conservative. Competition, innovation and service were eschewed out of an over-zealous concern for safety.

Driven by advances in technology, a volatile and changing economic environment, a growing sophistication on the part of investors and heightened competition, the financial world has undergone a virtual revolution during the past two decades. The signal event with respect to the problem at hand -- deposit brokerage -- was the passage of the Deregulation and Monetary Control Act of 1980, mandating the phaseout of deposit interest rate ceilings.

Prior to decontrol of interest rates, banks and thrifts were pretty much prohibited from bidding for deposits. Funds generally flowed to institutions that were perceived to be strong and could offer the best and most convenient services.

Overall, deregulation of interest rates has been an enormous success. Banks and thrifts have stopped the erosion of their market share dead in its tracks, and consumers and smaller businesses have reaped tens of billions of dollars in additional interest income. The fears expressed by some that rate wars and cutthroat competition would ensue have proved to be largely unfounded.

A major exception to this generally positive record involves the activities of money brokers and their investor clients. In a few short years money brokering has become a very big and enormously lucrative business. It requires no particular skill apart from salesmanship. Money brokers scour the country in search of hot money seeking the highest available risk-free return. The funds are packaged in fully insured blocks and then sold to the highest bidder, which all too often is a marginal, high-risk institution. A survey conducted by the FDIC last year revealed that of the \$24 billion in brokered funds in FDIC-insured institutions, over \$9 billion was held by troubled institutions.

Let me explain how the system works. Suppose a credit union has \$10 million it wishes to invest in the money markets rather than lend to its members. If there were no deposit insurance system, the credit union would likely invest in Treasury obligations, high-grade state or municipal bonds or high-quality bank or thrift CDs. Yield would be balanced against risk.

No such deep thought is required in the era of deregulation and the money broker. The credit union simply wires the \$10 million to a broker and the broker in turn wires it in fully insured \$100,000 blocks to the 100 banks and thrifts offering the highest rates. The entire transaction is completed nearly instantaneously -- no muss, no fuss and, most importantly, no risk to anyone but the FDIC or the FSLIC.

The worst fears of the early opponents of deposit insurance are coming to pass. Marginal, high-risk banks and thrifts are being subsidized by well-run institutions, and the costs are staggering. Attached to our statement as Schedule A is a list of all FDIC-insured institutions that failed from January 1, 1982, to July 12, 1985, showing, where available, the amount and percentage of brokered funds, the names of the brokers and the sources of the funds placed by the brokers. The brokered funds ranged as high as 76 percent of deposits. In all, they totalled nearly \$1.1 billion in 80 banks. There is no question that use of brokered funds in these banks has cost the FDIC hundreds of millions of dollars. Schedule B attached to our statement gives a brief case history of several of these banks. While they represent some of the more egregious examples of abuse, they are but a handful of the many examples we and the FSLIC could provide.

We should point out that some brokers are also involved in supplying funds to banks in amounts over the \$100,000 insurance limit. If the CD is not subsequently subdivided among various investors so as to obtain full insurance coverage, we have no objection to this practice. In this situation the broker and/or the broker's customers must perform a credit analysis, measuring the risk versus the yield, instead of blindly relying on our insurance guarantee.

The FDIC recently completed a survey (data as of February 28) of all FDIC-insured banks and thrifts rated 3, 4 and 5 -- the lowest categories on our CAMEL rating system -- which had fully insured brokered deposits in excess of five percent of their deposits. We were interested in looking at a number of aspects and specifically sought to determine who supplied these funds and how each of the troubled institutions was utilizing the FDIC-insured brokered deposits.

We were able to identify more than \$2.3 billion in fully insured brokered deposits placed in more than 70 troubled institutions. The brokered funds ranged from just over five percent to almost 50 percent of the sampled institutions' deposits. In one instance a major brokerage firm, in less than a week, placed \$60 million in new funds in a clearly troubled FDIC-insured savings bank, which used the funds to speculate in high-yield corporate (so-called "junk") bonds.

Schedule C appended to our statement identifies the 25 largest suppliers of fully insured brokered deposits to these weak and risky banks and thrifts. You will note that some of the nation's largest financial services organizations are heavily involved in funneling fully insured investment monies to these institutions.

Keep in mind that this survey occurred after nearly two years of intense efforts by the FDIC to control this clear abuse of the deposit insurance system. It is frightening to contemplate how much more massive the problem might have become in the absence of these efforts.

It is a simple fact that troubled banks and thrifts use brokered funds more frequently and more extensively than well-rated institutions. These institutions tend to pay the highest rates, and brokered funds flow to the highest bidders. Our studies have revealed that troubled banks are twice as likely as all banks as a group to hold significant amounts of insured brokered funds.

Who are the principal investors in brokered funds? Credit unions were identified as the largest single aggregate dollar holders, followed by S&Ls and commercial banks. Frankly,

we find it appalling that the biggest abusers of the deposit insurance system are the very institutions the system was designed to assist.

#### The Response to the Problem

The FDIC has addressed the problem of brokered deposits by regulation and, in individual cases, by use of our supervisory and enforcement powers. We issued a regulation limiting federal deposit insurance coverage for all deposits placed by or through brokers to \$100,000 per broker, per insured institution. As you are aware, however, our 1984 joint effort with the Federal Home Loan Bank Board to accomplish this is being challenged in the courts.

We have also dealt with the problems resulting from brokered deposit use on a case-by-case basis. When abuses are found, we use our enforcement powers to guard against further deterioration. For nearly two years now, as a matter of routine, we have inserted a provision in all enforcement actions taken against 3, 4 and 5 rated institutions prohibiting further usage of brokered funds. While our vigorous enforcement activities have had a limiting effect on brokered deposit use, I would stress that these actions are not preventive measures. They are, of necessity, initiated after the fact when problems and clear abuse have been identified.

In January of this year, the FDIC instituted a monthly reporting requirement for all FDIC-insured banks and thrifts holding fully insured brokered and financial institution deposits in excess of either the institution's capital or five percent of deposits. This reporting requirement provides more frequent and meaningful information than had been available, and increases our effectiveness in dealing with the problems. Institutions reporting heavy usage of brokered funds are targeted for much more frequent inspections, as are those that show up on deposit listing services as paying above normal interest rates.

We recently began publicly disclosing the names of financial institutions placing funds in failed banks and thrifts. Our aim is to focus attention on the fact that brokered and financial institution deposits are all too often placed in institutions offering the highest rates, without regard for the soundness of the issuing institution. The point must be driven home that when these institutions fail, the cost to the deposit insurance fund is greatly increased.

All these measures have helped, but they cannot be expected to solve the problems. In an environment in which a bank or thrift may purchase a massive volume of funding overnight, an institution can radically and precipitously alter its character and its risk to the insurance fund.

Legislative Alternatives

We have received virtually no help from the Congress during the past two years as we have struggled to contain this serious threat to the insurance system. A subcommittee in the House issued two "studies" contending there is no problem despite overwhelming facts to the contrary. Last year the Senate passed a bill that would have literally tied both hands behind our back by establishing an exceedingly high cap on shorter term brokered funds, exempting longer term funds altogether and restricting our current enforcement powers over troubled institutions.

The FDIC's joint regulation with the Bank Board to limit deposit insurance coverage of brokered funds is, in our view, the simplest and by far the most preferable alternative for dealing with the brokered deposit problem. It does not prohibit any bank or thrift from using brokered funds or any broker from placing funds; there is absolutely no interference with the functioning of the marketplace. Funds will flow only to those institutions with a balance sheet strong enough to inspire investor confidence. The validity of this regulation should be affirmed by the Congress and coupled with a law denying deposit insurance coverage for funds placed in other insured institutions by credit unions, banks and S&Ls.

Though the brokerage houses like to portray themselves as champions of the free-enterprise system, they are opposed to this market-oriented approach. They would prefer that we regulate the flow of funds through a law placing a cap on the amount of brokered deposits any institution may receive. While we do not like it, we can accept such a bill so long as the cap is reasonable and so long as the law does not in any way impinge on our current authority to prohibit the use of any brokered funds by any troubled institution.

No bank or thrift should be able to leverage upon the federal guarantee with insured brokered deposits in a volume greater than that which its owners have at risk. The cap for insured brokered deposits should thus be limited to 100 percent of an institution's capital. When you consider that FDIC-insured institutions currently hold \$24 billion in both insured and uninsured brokered funds and that a limit of 100 percent of capital would allow nearly \$190 billion in fully insured brokered funds alone, this limit is more than generous and ought to satisfy the fee-generating appetite of the brokerage industry for years to come.

The limit must apply to any deposits placed by or through brokers regardless of the term or maturity. Some suggest that longer-term brokered funds -- those with maturities

of one year or more -- ought to be of less concern to the FDIC because they represent a more stable funding source to a depository institution than do short-term funds. There is absolutely no justification for a distinction between long-term and short-term brokered deposits. Maturity is not the relevant problem. Fully insured brokered deposits of any maturity provide almost limitless funds to a bank or thrift which can be misused without risk to the broker or investor. I would point out that the bulk of the funds supplied to troubled banks by the major investment firms have a maturity in excess of one year. How much more do these brokers need than a ceiling of \$190 billion for FDIC-insured banks and thrifts, not to mention FSLIC-insured institutions? A ceiling that will likely grow by 8-to-10 percent per year as capital increases. A ceiling that is nearly eight times greater than the amount of all brokered funds, insured and uninsured, in these institutions today. A ceiling that is over 10 times the size of the FDIC's insurance fund!

Thank you once again Chairman Hubbard and members of this subcommittee for giving us this opportunity to express our views on an issue of great importance to the nation's financial system. I will be pleased to respond to any questions you may have.

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