# STATEMENT ON

# BROKERED DEPOSITS AND FEDERAL DEPOSIT INSURANCE

PRESENTED TO

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER AFFAIRS
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

BY

WILLIAM M. ISAAC
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

JUNE 5, 1985
DIRKSEN SENATE OFFICE BUILDING
ROOM 538
9:30 a.m.

Mr. Chairman, we appreciate this opportunity to address the issue of brokered deposits and to emphasize its importance to the FDIC. As you know, for some time now the FDIC has been quite concerned about brokered deposits. I cannot overstate the case. Fully insured brokered deposits represent a clear and present threat to the federal deposit insurance system.

Let me first make it clear that the FDIC is not against the use of brokered deposits or the practice of deposit brokerage, *per se*. We do not seek to deny brokered funds to any sound institution that uses them prudently in the normal course of business. What we object to are money market investment decisions predicated exclusively on the existence of a full federal deposit insurance guarantee rather than on a proper credit analysis of the bank or thrift borrowing the funds.

## The Changing Role of Deposit Brokerage

Money brokering is not a new phenomenon. Brokers have performed an intermediation function for a number of years, matching investors with financial institutions seeking funds. Over the last decade, however, the nature of the money brokers' role has changed dramatically. This transformation resulted from the convergence of a number of economic factors and trends -- most notably a growing sophistication on the part of investors, advances in technology, a volatile and changing economic environment and the impact of the deregulation movement.

In the mid-1970s, when interest rates first reached a double digit level, increased numbers of investors actively began searching for the highest return and altered many of their historical patterns. Money brokers became a more common medium to all investors. By the 1980s, many brokerage firms had essentially become mass marketers stressing the advantages they could offer investors who were intent solely upon maximizing their return at a time of economic volatility. Deregulation of interest rates accelerated this trend as banks and thrifts were permitted to bid freely for funds.

The highly publicized failure of the Penn Square Bank, N.A. in July 1982 -- the largest insured depositor payoff in the FDIC's history -- also had a major effect on deposit brokering practices. Its collapse and the FDIC's handling of it through a payoff rather than a supervisory merger resulted in large depositors with uninsured balances not receiving immediate settlement.

This event could have restored an element of market discipline to our financial system, and to some extent it did, by reminding large investors of the need to look beyond

the promises of a high yield to the underlying strength of the financial institution in which they invest. Unfortunately, many deposit brokers and their investor clients responded by splitting funds in order to obtain full federal deposit insurance protection.

We are now faced with a situation where deposit brokerage is being utilized for the purpose of obtaining the highest available risk-free return on investment funds. The cost of that federal guarantee of risk-free return is not borne by the deposit brokers or their investor clients, but is shared by every well-run insured bank and thrift through the increased cost of deposit insurance, higher deposit interest rates and/or lost business opportunities.

## The Consequences of Excessive Use of Brokered Funds

Since Penn Square, fully insured brokered deposits have been utilized as a major funding source and have been found in an alarming number of failed banks. During the 1982-84 period, for example, 69 of the FDIC-insured banks that failed held over $1 billion in fully insured brokered deposits; in two instances, the brokered funds represented more than 75 percent of the closed bank's deposits. The use of brokered funds by these institutions cost the FDIC hundreds of millions of dollars in additional losses.

Our Division of Bank Supervision 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 an FDIC-insured savings bank, which used the funds to speculate in high yield, corporate (so-called "junk") bonds.

The attached exhibit 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 such institutions. The Merrill Lynch and Dean Witter organizations were responsible for placing several hundred million dollars each, substantially increasing the FDIC's exposure to loss.

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.

Who are the investors? Credit unions were identified as the largest single aggregate dollar holders, followed by commercial banks and savings and loan associations.

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. Another earlier survey conducted by the FDIC showed that out of a total of $24 billion in both insured and uninsured brokered funds held by all FDIC-insured institutions, more than $9 billion was held by those rated 3, 4 and 5. 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.

Banks and thrifts can now market fully insured CDs through brokerage houses to reach a nationwide pool of potential customers. An institution's strengths or weaknesses are of little concern -- with deposit brokerage, bank risk does not translate into investor risk. The investor merely has to look to the FDIC for repayment if something goes wrong. How many other business enterprises in the United States have their money market borrowings backed by the federal government in this fashion? Clearly, this is not what Congress intended when it crafted the deposit insurance system more than 50 years ago to protect the life savings of working men and women.

## The Response to the Problem

The FDIC has addressed these issues 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 was challenged in the courts. The ensuing uncertainty about insurance protection has had some effect in limiting the use of brokered funds -- for now.

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, after an interim testing period, 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 safety and 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.

Mr. Chairman, members of the subcommittee, we would prefer a good, strong bill to help us in our efforts to preserve our insurance fund. If you can deliver it, we will be extremely grateful. If you cannot, we urge you to do nothing. Please do not add to our burdens by giving us another bill like last year's Senate bill.

The FDIC's joint regulation with the FHLBB 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 to credit unions, banks and S&Ls placing their excess funds directly in other insured institutions.

Though the brokerage houses like to portray themselves as champions of the free-enterprise system, they are steadfastly 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 Merrill Lynch and Dean Witter organizations 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 Gorton 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.

* * * * *

# NEWS RELEASE

JUN 5 1985
FEDERAL DEPOSIT INSURANCE CORPORATION

FOR RELEASE UPON DELIVERY
June 5, 1985 - 9:30 a.m.

PR-77-85 (6-5-85)

## FDIC CHAIRMAN OUTLINES THREAT TO INSURANCE FUND POSED BY BROKERED DEPOSITS

The Federal Deposit Insurance Corporation testified today that the indiscriminate placement of fully insured brokered funds in troubled banks and thrifts continues to pose "a clear and present threat to the deposit insurance system."

FDIC Chairman William M. Isaac, in testimony before a subcommittee of the Senate Banking Committee, noted that 69 of the FDIC-insured banks that failed during 1982-84 held over $1 billion in fully insured brokered deposits, increasing the FDIC's losses by hundreds of millions of dollars.

Mr. Isaac also cited an earlier survey that showed that of $24 billion in both insured and uninsured brokered funds in all FDIC-insured institutions, more than $9 billion was held by those rated as problem or marginal institutions. He said that troubled banks are twice as likely as all banks as a group to hold significant amounts of brokered deposits.

"It is a simple fact that troubled banks and thrifts use brokered funds more frequently and more extensively than well-rated institutions," Mr. Isaac noted. "These institutions tend to pay the highest rates, and brokered funds flow to the highest bidders."

The FDIC Chairman pointed out that a bank or thrift's strength or weakness is of only secondary concern to a broker, because there is no risk to the broker or its customers. "The investor merely has to look to the FDIC for repayment if something goes wrong," he said. "How many other business enterprises in the United States have their money market borrowings backed by the federal government in this fashion? Clearly,

- more -

this is not what Congress intended when it crafted the deposit insurance system more than 50 years ago to protect the life savings of working men and women."

Mr. Isaac identified the 25 largest suppliers of brokered deposits to weak and risky banks, noting that Merrill Lynch and Dean Witter were at the top of the list, placing hundreds of millions of dollars in such institutions and substantially increasing the FDIC's exposure to loss. He said credit unions represented the largest single aggregate suppliers of insured brokered deposits, followed by commercial banks and savings and loan associations.

Mr. Isaac charged that the deposit insurance agencies "have received virtually no help from the Congress" in attempting to contain this serious threat to the insurance system. He noted that a House subcommittee has issued two "studies" contending there is no problem despite overwhelming facts to the contrary. He also noted that the Senate last year passed a bill that "would have literally tied both hands behind our back as we attempt to deal with misuse of brokered funds."

Mr. Isaac said regulatory initiatives to control the problem have helped, but additional measures are needed because a bank or thrift can purchase a massive volume of funding overnight, radically and precipitously altering its character and its risk to the insurance fund. He expressed continued support for a regulation, now being challenged in the courts, to limit insurance coverage of brokered deposits to $100,000 per broker per bank. He also called for enactment of legislation denying deposit insurance coverage to credit unions, banks and savings and loans placing their funds directly in other insured institutions.

# # #