STATEMENT ON

PROPOSED REGULATION OF BROKERED DEPOSITS IN FINANCIAL DEPOSITORY INSTITUTIONS

PRESENTED TO the

SUBCOMMITTEE ON COMMERCE, CONSUMER, AND MONETARY AFFAIRS of the House
COMMITTEE ON GOVERNMENT OPERATIONS
HOUSE OF REPRESENTATIVES

BY

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Mr. Chairman, we appreciate this opportunity to address the issue of brokered deposits and the insurance proposal made jointly by the FDIC and the Federal Home Loan Bank Board. We commend you and your colleagues on the Subcommittee for holding hearings on this important subject.

I am mystified by the reaction to the proposal in some quarters. The proposed rule has been attacked, by people who profess allegiance to the free enterprise system, as being a "giant step backward" and a "sledgehammer." We have been told that instead of permitting the marketplace to operate by limiting the federal guaranty on brokered funds, we should attempt to solve the admittedly serious problems we face through the regulation of brokers and of banks who utilize their services. Mr. Chairman, that may be the way the special interest groups and others force the issue to be resolved, but the FDIC believes it would be a mistake.

Federal deposit insurance was born out of the banking collapse of the 1930s. During the first four years of the Great Depression, nearly 10,000 banks -- one-third of all banks -- failed as anxious depositors panicked and withdrew their funds. A banking holiday was declared and the financial system lay in ruins.

Despite the chaotic conditions, deposit insurance was opposed by the banking industry, the President and key members of Congress. It was felt the system would be too expensive and would undermine market discipline by forcing well-managed banks to subsidize the marginal, high-risk operators. Despite these concerns, a compromise measure was agreed upon which would reassure smaller depositors while maintaining the essential ingredients of a free enterprise banking system. Deposit insurance was initially set at $2,500 per depositor.

Over the years, the scope of insurance has been expanded many fold, reaching $100,000 coverage in 1980. Moreover, in practice the system has moved toward 100 percent coverage as deposit payoffs have been eschewed in favor of mergers of failed banks that bailed out all depositors. When coupled with deposit interest rate decontrol, the worst fears of the opponents of deposit insurance have been reinforced.

It is against this backdrop that deposit brokerage must be viewed. At issue are the type of financial system we desire -- free enterprise or government controlled -- and the viability of the deposit insurance funds.

We are not against brokered deposits or deposit brokers. We would not deny brokered deposits to any individual or institution. Our rule would, however, require banks and thrifts to compete for funds on some basis other than simply interest rate. Capital adequacy, asset quality, the competence of management, the degree of insider lending and the convenience of branch locations would be among the factors considered in placing funds.

The brokering of deposits has been an important issue since the 1960s. However, the problems attendant to brokered deposits at that time were isolated and could be handled on a supervisory level.

During the past several years, the problem has become more acute and widespread. The increase in the insurance limit to $100,000 in 1980, deposit interest rate decontrol (coupled with action by the DIDC to permit the payment of fees on brokered funds), new computer technology and the manner in which the Penn Square Bank failure was handled have contributed to the substantial increase in deposit brokering.

The Penn Square situation involved massive abuses and imprudent banking practices on the part of a number of financial organizations around the country. It was determined, due to our statutory cost test, that insured deposits should be paid off rather than a merger arranged. This action was also intended to restore an element of discipline to the financial system. Unfortunately, many deposit brokers and their investor clients responded to that failure not by taking care to place their funds in sound institutions but by exploiting the federal guaranty. The cost of that guaranty is not shared by deposit brokers, but is purchased and paid for by every well-run insured bank and thrift in terms of both increased premiums and lost business opportunities.

Since the failure of Penn Square Bank, brokered deposits have been found in a high and growing proportion of failed banks. In 1982, 32 commercial banks failed; 9 held brokered deposits. Of the 45 commercial banks that failed in 1983, 29 -- or nearly two-thirds -- held brokered deposits ranging as high as 76 percent of total deposits. So far in 1984, 11 commercial banks have failed; 6 of those held brokered deposits ranging as high as 53 percent of total deposits.

Poorly-rated banks tend to use brokered funds more frequently and more extensively than well-rated banks. Whether the use of brokered funds contributes to a less than satisfactory condition or whether this condition provides the occasion and need for brokered deposits is not the question. It is some of both. Unchecked, the abuses will lead to increased failures and impose massive costs on the insurance funds.

Recently a small nonproblem bank in South Dakota and another related bank in Wyoming borrowed extensively, virtually overnight, from deposit brokers and invested the proceeds in insurance annuities. The banks subsequently failed, costing the FDIC millions. Is this what Congress intended when it adopted the deposit insurance scheme?

A large thrift sells its long-term CDs throughout the nation through underwritten offerings by a major brokerage house. The CDs are sold in denominations of $5,000 and are fully insured. What other business in the nation has its borrowings backed by the federal government in this fashion?

Opponents of the proposed rule contend that brokers facilitate the flow of funds from credit-surplus to credit-deficient areas. The fact is that this funds flow has occurred quite efficiently for decades through the interbank market and will continue with or without brokers. But the funds in the interbank market are at risk and are placed based on considerations of soundness, not simply the rate paid.

Others argue that the proposed rule penalizes small savers who prefer the convenience of dealing through a broker. We do not believe deposit insurance was ever intended to cover investors seeking the highest yields in national money markets. If Congress wishes to make this service available, the answer is to dismantle the Glass-Steagall Act.

These are the issues that face us. We have raised them in every possible forum for the past couple of years, including our deposit insurance study, testimony, speeches, our advance notice of rulemaking and the proposed rule.