FDIC Speeches

TESTIMONY OF

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ON

BROKERED DEPOSITS

BEFORE THE

House SUBCOMMITTEE ON GENERAL OVERSIGHT AND INVESTIGATIONS
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

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Good morning, Mr. Chairman and members of the Subcommittee. It is a pleasure to testify this morning on the use of brokered deposits by insured banks and thrifts. We appreciate the opportunity to discuss the provisions in the House and Senate savings and loan rescue bills that would restrict the use of brokered deposits by undercapitalized insured financial institutions.

BACKGROUND

Brokered deposits have had a controversial history over the past decade. You may recall that a few years ago the FDIC opposed the use of insured brokered deposits to fund rapid and imprudent growth that was increasing our costs in resolving bank failures. The 1982 failure of the Penn Square Bank in Oklahoma City was an example of the abuse that can occur through the use of fully insured brokered deposits.

The FDIC attempted to address these abuses in March of 1984 by issuing a regulation to limit insurance coverage on brokered deposits to $100,000 per deposit broker per insured bank. After legal challenge, the courts ruled that the FDIC lacked the authority to limit insurance coverage in that manner.

About the same time, we enhanced our ability to control possible abuses of insured brokered deposits by issuing a regulation (described more fully below) that required monthly (now quarterly) reporting when the use of insured brokered deposits exceeded a threshold amount. This regulation is still being used to monitor growth through brokered deposits. (See Attachment A for reporting summaries under the regulation.)

In our view, brokered deposits have both negative and positive aspects. On the negative side, they have been used to fund excessive growth and imprudent, even fraudulent, loans or other investments. This has led to the failure of a number of banks and has increased our costs in those cases. From a failure resolution standpoint, the presence of long-term, high-cost brokered deposits in a failing bank tends to reduce its franchise value. This makes it more difficult to satisfy our cost test for arranging a purchase and assumption transaction -- our preferred method of resolving failed banks.

On the positive side, brokered deposits can represent a valuable liquidity management tool for all financial institutions, including undercapitalized ones, and in some markets may even represent a low-cost funding option. In the current savings and loan situation, the controlled use of brokered deposits has been an important tool in handling some of the liquidity pressures that have arisen. Without the use of brokered deposits to allow continued funding for liquidity purposes, the thrift crisis would be much worse. Consequently, we must not foreclose the use of brokered deposits to undercapitalized institutions in all circumstances. Brokered deposits should be denied to undercapitalized institutions only when used as a means to grow and not when needed as a continued source of liquidity.

In point of fact, the problem is not brokered deposits per se, but how these funds, like any other funds, are used. A dollar deposited in an insured institution is the same whether obtained directly from a local depositor or through the intermediation of a deposit broker. There may be differences in the cost and stability of that dollar deposit depending on its source. However, losses in banks do not occur, generally speaking, by virtue of the source of their deposit liabilities. Instead, the losses arise from the quality of and return on loans and investments made with those funds. Consequently, the focus of attention should be on the employment of brokered deposits rather than their source.

In general, we do not find the use of brokered deposits to be a major problem in the banking industry at this time. This is in spite of the fact that brokered deposits usage has increased over the past several years. At the end of March of this year 804 banks held approximately $51.4 billion in brokered deposits, up from $29.4 billion at the end of 1986 (See Attachment B). Of the $51.4 billion, $29.6 billion, or about 58 percent, represent wholesale deposits issued in amounts greater than $100,000, the bulk of which are uninsured. They are heavily concentrated in the larger banks that would likely receive FDIC assistance in the event of financial difficulties (See Attachment C). The remainder, $21.8 billion, or 42 percent, represent retail brokered deposits that are fully covered by deposit insurance. These deposits include those under $100,000, and large deposits arranged by brokers and then participated out in fully-insured amounts of $100,000 or less.

In the past, brokered deposits may have contributed to problems in the thrift industry. Today, however, continued access to brokered deposits by insolvent and unhealthy thrifts is vitally important to keep the problem from getting worse.

Brokered deposits provide troubled thrifts with an important source of liquidity to fund their operations until a more permanent solution to the S&L problem can be implemented. Of the 390 FSLIC-insured institutions with GAAP capital of between zero and three percent at year-end 1988, nearly one-third relied on some level of brokered deposits. Out of another 364 thrifts with negative GAAP capital ratios, 44 percent relied on brokered funds for necessary liquidity. Thus, of the $71.6 billion of brokered deposits used industry-wide, 40 percent or $28.5 billion provided liquidity to marginally solvent institutions or to institutions with negative GAAP net worth.

The FDIC is currently acting as conservator to 220 of the most troubled thrifts with total liabilities of about $100 billion. As of the beginning of May, 12 percent of these liabilities were in the form of brokered deposits. These funds are used as a liquidity management tool, not as a means of funding reckless growth. Prohibitions on the use of brokered funds by undercapitalized thrifts could pose a serious problem to the FDIC or to the Resolution Trust Corporation and hamper the orderly sale or liquidation of these thrifts. This type of liquidity constraint could potentially add to the RTC's overall cost of resolving these cases.

FDIC REGULATORY APPROACH

Appropriate supervision is the key to a deposit insurance system like ours in which an insured institution's management can obligate the credit of the government through the solicitation and receipt of insured deposits. The ability to tap a national funding market through brokered deposits makes virtually unlimited funds available at any time without regard to a financial institution's condition or the uses contemplated for the funds. Thus, it is the integrity and competence of bank management, the bank's own capital and, most importantly, timely and effective supervision by the regulatory authorities that protect the deposit insurance fund.

The FDIC presently controls the receipt and use of brokered deposits through reporting requirements and the supervisory process. Data on the total amount of brokered deposits in all insured banks are obtained from quarterly call reports. Section 304.6 of the FDIC's regulations requires each insured bank to file with the FDIC a special quarterly report whenever the total of the bank's fully-insured brokered deposits and fully-insured direct deposits of other depository institutions exceeds either its capital and reserves or five percent of its total deposits. These reports are considered in the context of other file information in devising an appropriate supervisory response. We also are in the process of developing an off-site computerized system for monitoring rapid growth, including growth that results from the receipt of brokered deposits.

As stated above, the best way to control our exposure as a result of brokered deposits and other types of funding -- such as borrowings -- is through timely and effective supervision. That is, by making sure those funds are not used or invested imprudently. Thus, the FDIC recently proposed for public comment a rule requiring advance notice by any bank planning to grow rapidly through the use of brokered deposits, borrowings or other extraordinary funding means. A copy of our proposed rule is attached (Attachment D).

Upon receipt of such a notice, we intend to work closely with the appropriate supervisory authorities to carefully examine any reporting institution's planned use of such funds. Such a pre-notification will alert us to institutions that need special supervisory attention and enable us to work with bank management to prevent risky, unwise and imprudent loans and investments. By eliminating substantial losses that deplete a bank's capital we hope to prevent the transfer of a disproportionate share of the risk of the enterprise from the bank's investors to the FDIC as deposit insurer. By the adoption of this rule, we seek to prevent the types of losses that eventually could lead to failures and losses to the FDIC insurance fund.

PROPOSED LEGISLATION

We support the idea of giving the regulators the authority to regulate brokered deposits. However, we do not believe legislating specific prohibitions against or restrictions on brokered deposits is the best approach. Instead, to further assure that there will be appropriate monitoring and supervision of the uses of brokered deposits the Congress should provide the FDIC with the specific authority to regulate their use. Such legislation, however, should be applicable to all institutions, not just troubled ones, whenever brokered deposits are being used in an unsafe or unsound manner.

The brokered deposit provisions in the House and Senate bills (H.R. 1278 and S. 774) have a couple of other weaknesses. They do not cover possible risks associated with excessive growth by healthy or "nontroubled" institutions. And, most importantly, they could result in reducing liquidity to the thrift industry just when that liquidity is most urgently needed.

We also are concerned with the burden both proposed bills, if enacted, would place on the FDIC by requiring a case-by-case applications process for exemptions from the limitations on brokered deposits. We would prefer explicit authority to provide general guidance through regulations, as well as to process requests for exceptions in individual cases.

In comparing the bills that are before the Senate and House, the House version is the more acceptable of the two. The Senate bill would prohibit any additions to <u>or renewals of</u> existing brokered deposits. On the other hand, the House bill would prohibit <u>only increases</u> in the amount of brokered deposits. The House version is preferable because it would at least permit institutions to maintain brokered deposits at current levels. However, even this may be overly restrictive, particularly with respect to the liquidity needs of the thrift industry.

Finally, if enacted, we believe there should be a delayed effective date for these provisions, somewhere in the range of three to six months. This would allow affected institutions to adjust their operations to the new requirements and, under our approach, would allow time to promulgate any required regulations.

Thank you for inviting me to testify on this important and timely topic. I would be pleased to respond to any questions.

Attachments