

Joint Agency Advisory on Brokered and Rate-Sensitive Deposits

Purpose

The Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (the Agencies) are reminding bankers and examiners of the potential risks associated with excessive reliance on brokered and other highly rate-sensitive deposits, such as those obtained through the Internet, certificate of deposit listing services, and similar advertising programs. When prudently managed, these deposits can be and often are beneficial to banks. However, without proper monitoring and management, they may be an unstable source of funding for an institution. This issuance outlines prudent risk identification and management for rate-sensitive deposits. It applies to all FDIC insured commercial and savings institutions ("banks")¹.

Background

Deposit brokers have traditionally provided intermediary services for banks and investors. Recent developments in technology provide bankers increased access to a broad range of potential investors who have no relationship with the bank and who actively seek the highest returns offered within the financial industry. In particular, the Internet and other automated service providers are effectively and efficiently matching yield-focused investors with potentially high-yielding deposits. Typically, banks offer certificates of deposit (CDs) tailored to the \$100,000 FDIC deposit insurance limit to eliminate credit risk to the investor, but amounts may exceed insurance coverage. Rates paid on these deposits are often higher than those paid for local market area retail CDs, but due to the FDIC insurance coverage, these rates may be lower than for unsecured wholesale market funding.

Customers who focus exclusively on rates are highly rate-sensitive and provide less stable funding than do those with local retail deposit relationships. These rate-sensitive customers have easy access to, and are frequently well informed about, alternative markets and investments, and may have no other relationship with or loyalty to the bank. If market conditions change or more attractive returns become available, these customers may rapidly transfer their funds to new institutions or investments. Rate-sensitive customers with deposits in excess of the insurance limits also may be alert to and sensitive to changes in a bank's financial condition. Accordingly, these rate-sensitive depositors, both under and over the \$100,000 FDIC insurance limit, may exhibit characteristics more typical of wholesale investors.

Under 12 USC 1831f and 12CFR 337.6, determination of "brokered" status is based initially on whether a bank actually obtains a deposit directly or indirectly through a deposit broker. Banks that are considered only "adequately capitalized" under the "Prompt Corrective Action" (PCA) standard² must receive a waiver from the FDIC before they can accept, renew, or roll over any brokered deposit. They also are restricted in the rates they may offer on such deposits. Banks falling below the adequately capitalized range may not accept, renew, or roll over any brokered deposit nor solicit deposits with an effective yield more than 75 basis points above the prevailing market rate. These restrictions will reduce the availability of funding alternatives as a bank's condition deteriorates. Bank managers who use brokered deposits should be familiar with the regulation governing brokered deposits and understand the requirements for requesting a waiver.

Deposits attracted over the Internet, through CD listing services, or through special advertising programs offering premium rates to customers without another banking relationship, also require special monitoring. Although these deposits may not fall within the technical definition of "brokered" in 12 USC 1831f and 12 CFR 337.6, their inherent risk characteristics are similar to brokered deposits³. That is, such deposits are typically attractive to rate-sensitive customers who may not have significant loyalty to the bank. Extensive reliance on funding products of this type, especially those obtained from outside a bank's geographic market area, has the potential to weaken a bank's funding position.

Some banks have used brokered and Internet-based funding to support rapid growth in loans and other assets. Bankers are reminded that under the Agencies' safety and soundness standards⁴, a bank's asset growth should be prudent and its management must consider the source, volatility, and use of the funds generated to support asset growth.

Risk Management Guidelines

The Agencies expect bank management to implement risk management systems commensurate in complexity with the liquidity and funding risks undertaken. Such systems should incorporate the following principles:

- **Proper funds management policies.** A good policy should generally provide for forward planning, establish an appropriate cost structure, and set realistic limitations and business strategies. It should clearly convey the board's risk tolerance and should not be ambiguous about who holds responsibility for funds management decisions.
- **Adequate due diligence when assessing deposit brokers.** Bank management should implement adequate due diligence procedures before entering any business relationship with a deposit broker. Deposit brokers are not regulated by the Agencies.

- **Due diligence in assessing the potential risk to earnings and capital associated with brokered or other rate-sensitive deposits, and prudent strategies for their use.** Bankers should manage highly sensitive funding sources carefully, avoiding excessive reliance on funds that may be only temporarily available or which may require premium rates to retain.
- **Reasonable control structures to limit funding concentrations.** Limit structures should consider typical behavioral patterns for depositors or investors and be designed to control excessive reliance on any significant source(s) or type of funding. This includes brokered funds, and other rate-sensitive or credit-sensitive deposits obtained through Internet or other types of advertising.
- **Management information systems (MIS) that clearly identify non-relationship or higher-cost funding programs and allow management to track performance, manage funding gaps, and monitor compliance with concentration and other risk limits.** At a minimum, MIS should include a listing of funds obtained through each significant program, rates paid on each instrument and an average per program, information on maturity of the instruments, and concentration or other limit monitoring and reporting. Management should also ensure that brokered deposits are properly reported in Consolidated Reports of Condition and Income⁵.
- **Contingency funding plans that address the risk that these deposits may not "roll over" and provide a reasonable alternative funding strategy.** Contingency funding plans should factor in the potential for changes in market acceptance if reduced rates are offered on rate-sensitive deposits. The potential for triggering legal limitations that restrict the bank's access to brokered deposits under Prompt Corrective Action standards, and the effect that this would have on the bank's liability structure, should also be factored into the plan.

Examination Guidelines

Examiners should carefully assess the liquidity risk management framework at all banks. Banks with meaningful reliance on brokered or other rate-sensitive deposits should receive the appropriate level of supervisory attention. Examiners should not wait for PCA provisions to be triggered, or the viability of the institution to be in question, before raising relevant safety and soundness issues with regard to the use of these funding sources. If a determination is made that a bank's use of these funding sources is not safe and sound, or that these risks are excessive or that they adversely affect the condition of the institution, then appropriate supervisory action should be immediately taken. The following represent potential red flags that may indicate the need to take action to ensure the risks associated with brokered or other rate-sensitive funding sources are managed appropriately:

- Ineffective management or the absence of appropriate expertise,
- Newly chartered institution with few relationship deposits and an aggressive growth

strategy,

- Inadequate internal audit coverage,
- Inadequate information systems or controls,
- Identified or suspected fraud,
- High on- or off-balance-sheet growth rates,
- Use of rate-sensitive funds not in keeping with the bank's strategy,
- Inadequate consideration of risk, with management focus exclusively on rates,
- Significant funding shifts from traditional funding sources,
- The absence of adequate policy limitations on these kinds of funding sources,
- High loan delinquency rate or deterioration in other asset quality indicators,
- Deterioration in the general financial condition of the institution, and
- Other conditions or circumstances warranting the need for administrative action.

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¹ This guidance supplements each agency's existing supervisory and examination guidance on funding and liquidity issues.

²See 12 CFR Part 325, Subpart B for FDIC insured institutions, 12 CFR 6.4 for national banks, 12 CFR 208.40 for state member banks, or 12 CFR Part 565 for thrift institutions.

³ Moreover, under 12 CFR 337.6(a)(5)(iii), the restrictions on brokered deposits do apply to solicitations by a depository institution that is less than well-capitalized where the solicitation offers rates of interest "significantly higher" than the prevailing rates of interest in the institution's "normal market area." This can be particularly problematic for Internet solicitations since determination of the bank's "normal market area" for such deposits is difficult.

⁴See 12 CFR 364 for FDIC insured institutions, 12 CFR 30 Appendix A for national banks, 12 CFR 208 Appendix D-1 for state member banks, or 12 CFR Part 570 for thrift institutions.

⁵See Instructions for Consolidated Reports of Condition and Income, schedule RC-E - Deposits.