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CONGRESSIONAL TESTIMONY

FDIC Insurance and the Brokered Deposit Market: Not a Recipe for Market Discipline

Testimony before
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Financial Institutions and Consumer Credit Subcommittee
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Chairman Neugebauer, Ranking Member Clay, and Members of the Committee, thank you for the opportunity to testify at today's hearing. My name is Norbert Michel and I am a Research Fellow in Financial Regulations at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation. In my testimony I will argue that, at the very least, Congress should ensure brokered deposits cannot be used to provide more than the FDIC coverage limit to any individual, and that agencies should not be allowed to write rules that allow market participants to circumvent the coverage limit in any way. Ultimately, Congress should completely eliminate federal deposit insurance for brokered deposits.

Basics of Brokered Vs. Core Deposits

Banks acquire deposits to fund their operations from a variety of sources, and these sources can have key policy implications. Core deposits, though not statutorily defined, are defined in the Uniform Bank Performance Report (UBPR) because regulators have long been concerned with identifying a bank's most stable sources of funding.[1] The UBPR User Guide defines core deposits to include demand deposits, all Negotiable Order of Withdrawal (NOW) accounts, automatic transfer service (ATS) accounts, money market deposit accounts (MMDAs), other savings deposits, and time deposits under $250,000.[2] Core deposits are also defined so that they explicitly exclude brokered deposits. Thus, a bank's core deposits typically consist of those funds that local customers have at their bank.

Brokered deposits, on the other hand, are more similar to an investment-product: deposit brokers can pool individual investments to sell to banks that need funds. There are a variety of sources and structures for these types of arrangements,[3] but brokered deposits are statutorily defined in Section 29 of the Federal Deposit Insurance Act as any deposit "obtained, directly or indirectly, from or through the mediation or assistance of a deposit broker."[4] A deposit broker, in turn, is defined as:

> (A) Any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions, or the

[1] The UBPR is "an analytical tool created for bank supervisory, examination, and management purposes." The UBPR contains performance data as well as balance-sheet composition data, both of which are regularly used to evaluate "the adequacy of earnings, liquidity, capital, asset and liability management, and growth management" in commercial banks. See Federal Financial Institutions Examination Council, Uniform Bank Performance Report, https://www.ffiec.gov/ubpr.htm (accessed September 25, 2016).

[2] See Financial Institutions Examination Council, "Uniform Bank Performance Report User's Guide: Balance Sheet $--Page 4," September 15, 2016, Pg. 24, https://cdr.ffiec.gov/Public/DownloadUBPRUserGuide.aspx (accessed September 25, 2016).

[3] See, for example, Federal Deposit Insurance Corporation, "Deposit Broker's Processing Guide," March 9, 2016, https://www.fdic.gov/deposit/deposits/brokers/4documentationreq.html (accessed September 25, 2016); Paul Clark, "Just Passing Through: A History And Critical Analysis Of Fdic Insurance Of Deposits Held By Brokers And Other Custodians," Review Of Banking & Financial Law, 2012-2013, Vol. 32, https://www.bu.edu/rbfl/files/2013/09/Just-Passing-Through.pdf (accessed September 25, 2016); and Paul Clark and David Freeman, "Bank Brokered Deposits: New FDIC Guidance on Identifying, Accepting and Reporting Deposits," Strafford, May 19, 2015, http://media.straffordpub.com/products/bank-brokered-deposits-new-fdic-guidance-on-identifying-accepting-and-reporting-deposits-2015-05-19/presentation.pdf (accessed September 25, 2016).

[4] 12 C.F.R. § 337.6(a)(2).

> business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties; and (B) An agent or trustee who establishes a deposit account to facilitate a business arrangement with an insured depository institution to use the proceeds of the account to fund a prearranged loan.[5]

Section 29 of the Federal Deposit Insurance Act also lists ten specific exceptions to the definition of deposit broker, such as another depository institution or a trustee of a pension or other employee benefit plan (with respect to funds placed with the depository institution or the funds of the plan, respectively).[6]

Section 29 of the Federal Deposit Insurance Act also places several restrictions on the use and acceptance of brokered deposits. Essentially, a well-capitalized[7] insured depository institution (IDI)[8] can accept and renew brokered deposits without special brokered-deposit restrictions.[9] However, adequately capitalized[10] banks can only accept new brokered deposits (or roll over existing brokered deposits) if they receive a waiver from the Federal Deposit Insurance Corporation (FDIC). Additionally, undercapitalized[11] banks may not accept or renew brokered deposits. Furthermore, adequately and undercapitalized banks face various interest rate restrictions on brokered deposits.[12]

Key Policy Questions

One main reason for the distinction between core and brokered deposits relates to the safety and soundness of banks. In particular, to whatever extent the risk characteristics of brokered deposits differ from those of core deposits, banking regulators should treat the two funding sources differently. A recent FDIC report cites several peer-reviewed studies that provide evidence that a higher reliance on brokered (rather than core) deposits is associated with a higher likelihood of bank default.[13] The report also provides original empirical evidence that shows "that the use of brokered deposits is associated with a higher probability of bank default."[14] Naturally, the higher risk of this funding source justifies more stringent regulation and/or closer supervision compared to core deposits.

The above-mentioned FDIC report also points out that the higher default risk is not simply a recent phenomenon. It notes "Core deposits have historically been categorized as stable, less costly deposits obtained from local customers that maintain a relationship with the institution, while brokered deposits are considered volatile, interest

[5] 12 C.F.R. § 337.6(a)(5)(i).
[6] 12 C.F.R. § 337.6(a)(5)(ii).
[7] 12 U.S. Code § 1831o(b)(1)(A).
[8] An insured depository institution is defined as "any bank, savings association, or branch of a foreign bank insured under the provisions of the Federal Deposit Insurance Act (12 U.S.C. 1811 et seq.)." 12 C.F.R. § 337.6(a)(8).
[9] 12 C.F.R. § 337.6(b) and 12 U.S. Code § 1831f.
[10] 12 U.S. Code § 1831o(b)(1)(B).
[11] 12 U.S. Code § 1831o(b)(1)(C).
[12] 12 C.F.R. § 337.6(b) and 12 U.S. Code § 1831f.
[13] FDIC, "Study On Core Deposits And Brokered Deposits," July 8, 2011, https://www.fdic.gov/regulations/reform/coredeposit-study.pdf (accessed September 25, 2016).
[14] Ibid.

rate sensitive deposits from customers in search of yield."[15] Not surprisingly, the FDIC considers relative levels of core and brokered deposits when estimating the liquidity portion of banks' CAMELS ratings.[16] The FDIC also adjusts its risk-based deposit insurance premiums to account for larger reliance on brokered deposits,[17] and the Basel III liquidity coverage ratio assigns a higher cash outflow rate based on larger amounts brokered deposits.[18] In general, regulators have always operated as if brokered deposits present a higher risk to bank safety and soundness because they are more likely to "run" from a bank than core deposits.

More broadly, policymakers should question whether federally insuring brokered deposits violates the spirit of FDIC deposit insurance. That is, aside from any unique risks that brokered deposits may possess relative to core deposits, it is clear that providing FDIC deposit insurance on such funds goes well beyond the original intent of FDIC insurance. Federal deposit insurance was established after the banking panics of the early 1930s in an attempt to prevent individual depositors from withdrawing their deposits in a panic (running), thereby crippling the banking system (even healthy banks) in the process.[19]

From the beginning, Congress accounted for the possibility that an individual may have a claim on an FDIC insured deposit through a custodial arrangement, whereby a third party had opened an account on behalf of such an individual.[20] It flies in the face of all available evidence, however, that Congress allowed for such a possibility so that individual investors could obtain deposit insurance in excess of the coverage limit. There is no doubt, however, that the brokered deposit market now provides precisely such opportunities.

Though it has proven difficult to obtain comprehensive data on this sector market, it appears that the bulk of the brokered deposit market (as of 2015) is split between the brokered certificate of deposit (CD) market ($350 billion) and broker-dealers' sweep accounts ($875 billion).[21] The brokered CD market includes reciprocal deposits,[22] a type

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[15] Ibid, Pg. 32.

[16] Ibid, Pg. 63 and Pg. 67.

[17] FDIC, "Risk Categories & Risk-Based Assessment Rates Key Provisions Pertaining to Risk-Based Assessments," May 9, 2016, https://www.fdic.gov/deposit/insurance/assessments/risk.html (accessed September 25, 2016).

[18] See Department of the Treasury, Office of the Comptroller of the Currency, "Liquidity Coverage Ratio: Liquidity Risk Measurement Standards," Final Rule, 12 CFR Part 50, January 1, 2015, https://www.occ.gov/news-issuances/news-releases/2014/nr-ia-2014-120a.pdf (accessed September 25, 2016).

[19] Of course, providing taxpayer deposit insurance comes at a price, namely that it creates moral hazard and adverse selection problems that increase the incentives for risk taking in the banking industry. See Frederic Mishkin, "An Evaluation of the Treasury Plan for Banking Reform," Journal of Economic Perspectives, 1992, Vol. 6, No. 1, Pgs. 133–153, https://www.aeaweb.org/articles?id=10.1257/jep.6.1.133 (accessed September 25, 2016).

[20] Statutory language was included in the Banking Act of 1933 (the law that created the FDIC), and also in FDIC regulations issued in 1946. See Clark, "Just Passing Through," Pg. 101.

[21] Clark and Freeman, Pgs. 11 and 12. Broker-dealer sweep accounts refer to a practice whereby broker-dealers automatically transfer (sweep) cash in their brokerage accounts into a deposit account at a bank or money market mutual funds. The banks and funds, of course, pay the broker-dealers for access to these funds. See Securities and Exchange Commission, "Investor Bulletin: Bank Sweep Programs," June 5, 2014, https://www.sec.gov/oiea/investor-alerts-bulletins/ib_banksweep.html (accessed September 25, 2016). The

of brokered deposit arrangement where a "participating bank places funds at other participating banks through the network in order for its customer to receive full insurance coverage."[23] Promontory Interfinancial Network, for example, provides customers with a reciprocal deposit service known as Certificate of Deposit Account Registry Service (CDARS). Promontory advertises this service as follows:

> CDARS Reciprocal provides banks with one of several ways to use CDARS to obtain cost-effective funding. By keeping the full amount of funding on balance sheet, CDARS Reciprocal enables banks to easily replace more cumbersome and expensive funding options so your existing relationships are more profitable. And CDARS offers a cost-effective way to attract new, multi-million-dollar customers for those banks looking to grow more profitable relationships."[24]

Thus, the network facilitates a type of wholesale funding for banks where large investors – those investing sums that exceed the per-account FDIC insurance cap – are able to easily obtain full FDIC deposit insurance on incremental accounts that aggregate to more than the FDIC insurance cap.

In one sense, these types of networks are merely facilitating what an individual could do on his own by opening several accounts at several banks.[25] However, these networks are providing wholesale funding to banks through capital markets by providing access to federally insured deposit coverage, an innovation which is clearly beyond the original intent of FDIC deposit insurance. This expansive use of federally backed deposit insurance is the main reason that, in 1984, the FDIC proposed regulations that would have severely limited the ability of investors to obtain federal deposit insurance on brokered deposits.[26]

In 1991, several years after the U.S. District Court for the District of Columbia ruled that the FDIC had exceeded its authority in writing these regulations,[27] the U.S. Treasury Department recommended completely eliminating FDIC insurance for brokered

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author was unable to locate a comprehensive data source to include *replicable* statistics in this written testimony.

[22] 12 CFR 327.8 defines reciprocal deposits as "Deposits that an insured depository institution receives through a deposit placement network on a reciprocal basis, such that: (1) for any deposit received, the institution (as agent for depositors) places the same amount with other insured depository institutions through the network; and (2) each member of the network sets the interest rate to be paid on the entire amount of funds it places with other network members."

[23] FDIC, "Guidance On Identifying, Accepting, And Reporting Brokered Deposits Frequently Asked Questions," December 24, 2014, Pg. 4, https://www.fdic.gov/news/news/financial/2015/fil15002a.pdf (accessed September 25, 2016).

[24] See Promontory Interfinancial Network, CDARS® Reciprocal, http://promnetwork.com/home/services/certificate-of-deposit-account-registry-service/cdars-reciprocal/ (accessed September 25, 2016).

[25] FDIC deposit insurance covers accounts (up to $250,000) per depositor, per ownership category, per bank. 12 CFR 330.3(b) states that "Any deposit accounts maintained by a depositor at one insured depository institution are insured separately from, and without regard to, any deposit accounts that the same depositor maintains at any other separately chartered and insured depository institution, even if two or more separately chartered and insured depository institutions are affiliated through common ownership."

[26] The regulations were issued jointly by the FDIC and the Federal Home Loan Bank Board. Clark, Pg. 134.

[27] In 1985 the U.S. Court of Appeals for the District of Columbia affirmed the lower court's decision.

deposits.[28] Treasury justified its policy proposal for essentially the same reasons the FDIC originally sought to limit the use of the FDIC insurance. By aggregating deposits for *individuals* and subjecting those amounts to the FDIC insurance coverage limits, Treasury sought to limit the scope of FDIC insurance and its consequent increase in moral hazard and adverse selection.

Policy Recommendations

For decades, regulators have increasingly taken on a more active role in managing financial firms' risk despite the fact that this approach has repeatedly failed. Protecting the FDIC insurance fund is a main justification for the increasingly burdensome safety and soundness regulations imposed on U.S. banks, but there is no doubt that the taxpayer-backed deposit insurance provided by the FDIC insulates banks from market discipline.[29] Both theory and evidence suggest that the banking system will perform better when banks' capital suppliers face more market discipline, so policymakers should take all steps possible to reduce the scope of FDIC deposit insurance.

An obvious first step that would impose more market discipline on banks' capital suppliers is to reduce FDIC deposit insurance to (at least) the pre-Dodd–Frank limit of $100,000 per account. Even lowering the value to the pre-1980 limit of $40,000 per account would insure a level (based on 2014 data) nearly 10 times the average transaction account balance of approximately $4,000.[30] Naturally, such changes would be wholly ineffective if individuals can use brokered deposits to insure more than the FDIC coverage limit.

At the very least, Congress should ensure that brokered deposits cannot be used to insure deposits exceeding the coverage limit to any individual, and that agencies cannot write rules allowing market participants to circumvent the coverage limit in any way. Ultimately, Congress should eliminate FDIC deposit insurance for brokered deposits and move the U.S. banking system to one covered by private deposit insurance. In the interim, reducing the scope of FDIC insurance would help to bring private capital into such a market.

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[28] United States Treasury, "Modernizing the Financial System: Recommendations for Safer, More Competitive Banks," February, 1991, Washington, D.C.: United States Government Printing Office.

[29] See David Burton and Norbert Michel, "Financial Institutions: Necessary for Prosperity," Heritage Foundation Backgrounder No. 3108, April 14, 2016, Pgs. 11-13, file:///Users/norbertmichel/Downloads/BG3108.pdf (accessed September 25, 2016).

[30] Burton and Michel, Pg. 12.

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