



**UTAH CENTER
FOR FINANCIAL SERVICES**

THE UNIVERSITY OF UTAH
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June 8, 2020

Via Electronic Mail to:

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

Attention: Comments

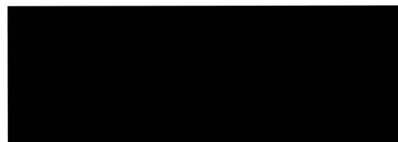
Re: RIN 3064-AE94 – Brokered Deposits Restrictions

Dear Mr. Feldman:

The Utah Center for Financial Services is pleased to submit the appended report as a comment on the Notice of Proposed Rulemaking (NPR) entitled: Unsafe and Unsound Banking Practices: Brokered Deposits Restrictions. The report is titled: Why banks fail, and why brokered deposits do not cause those failures.

Thank you for the opportunity to submit this report as a comment on the pending NPR. Please contact me by phone at 435-901-1040 or by email at Al.Landon@eccles.Utah.edu should you have any questions about the contents of the report.

Very truly yours,



Al Landon, Director

Why banks fail, and why brokered deposits do not cause those failures

A report prepared by

Bert Ely

for the

**Utah Center for Financial Services
Salt Lake City, Utah**

June 5, 2020

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Why banks fail, and why brokered deposits do not cause those failures

by Bert Ely

Executive Summary

The FDIC and other critics of brokered deposits (BDs) have long asserted, at least since the savings-and-loan (S&L) crisis of the 1980s, that BDs have been a major cause of bank and S&L failures. They argue that BDs represent “hot money” that fuels the rapid asset growth of banks and S&Ls that later fail, usually because of substantial loan losses. Rapid growth, however funded, can kill a bank – the faster the bank grows the greater the likelihood that eventually it will fail.

Despite the criticism of BDs and the regulatory bias against them, BDs have become an important source of funding for banks of all sizes. The growing digitization of banking, and specifically the deposit-gathering process, has further enhanced BDs as a source of funds to lend and invest.

Regardless of how banks fund themselves, regulators must be ever diligent in monitoring banking risk, especially in curbing excessively rapid loan growth, as history has repeatedly shown how destructive rapid growth can be, especially during a subsequent economic downturn. This paper draws upon the extensive research about bank failures that the author has conducted since the 1980s.

However the business of banking evolves, BDs must always be viewed as a legitimate funding source for well-managed and properly regulated banks. Technology-driven innovations in recent years, which have led to a substantial reduction in activity inside bank branches, have heightened the importance of BDs as a funding source for bank loans and investments. Bank regulators must accept that reality and step up their game in limiting excessively risky banking activities, especially rapid loan growth, however funded.

Introduction

Brokered deposits have long been alleged to be an underlying cause of many bank¹ failures, both during the S&L crisis of the 1980s and the subsequent spate of failed commercial banks in the 1980s and 1990s as well as a wave of bank failures, from 2007 to 2017. BDs were not a significant source of funding for the six banks that failed in 2019 and so far in 2020; there were no failures in 2018.

Far from contributing to bank failures, history has clearly shown that BDs have provided an important and relatively stable source of funding for banks to complement deposits raised through branches or over the Internet as well as funding from other sources, such as Federal Home Loan Bank advances. Most importantly, no linkage between BD funding and bank failures has been demonstrated – instead unproven assertions are frequently made that such a linkage exists.

This paper will first discuss the principal causes of bank failures and summarize the bank-failure history of recent years and then explain how poor government supervision of FDIC-insured institutions contributed substantially to those failures. The paper will conclude with key policy recommendations. Appendix I summarizes the results of regulatory analyses of the causes of certain bank failures. Appendix II discusses the potential impact the Covid-19 pandemic might have on the brokered-deposits debate.

Principal causes of bank failures

In order to understand why BDs do not cause bank failures, it is important to understand the principal causes of bank failures. Quite simply, a bank fails, and should be promptly closed, when it becomes insolvent; that is, its liabilities to its depositors and other creditors exceed the realistic value of its assets. Almost without exception, bank failures stem from losses on the asset side of a bank's balance sheet, not from its liability side – the bank's deposits and other sources of funding. Put another way, deposits and other funding sources do not cause a bank's assets to lose value.

The uncollectable portion of loans that go into default is the principal cause of asset losses leading to bank insolvency and then closure (i.e., failure), regardless of how those loans are funded. Key reasons why loans go bad, generating a loss for the bank, include:

- Substantial losses in the market value of the types of assets financed by the bank, a weak economy in the geographic area where the borrower or loan collateral is

¹ Unless otherwise indicated, the term “bank” encompasses commercial banks, savings banks and S&Ls but not credit unions.

located, and/or a broader economic slide into a recession. This is especially true for loans financing or secured by real estate.

- ◆ Out-of-market lending by a bank is especially risky, particularly for loans collateralized by real estate, since banks lending where they have little knowledge of local market conditions are more likely to make loans or buy loan participations that local banks avoid.
- An excessive concentration of loans in specific asset classes, such as construction or automobile loans, resulting in the bank lacking a sufficient dispersion of its lending risks by type of loan and/or where the credit risk is located.
- Inept evaluations by bank officers of the creditworthiness of its borrowers and the projects or activities the bank has financed, leading to the underpricing of specific loans and the extension of credit when credit should have been denied.
- Fraud committed by the borrower and/or bank officials in obtaining a loan or in the use of loan proceeds.
- Excessively rapid loan growth, notably in loan categories or geographic areas where the bank has little or no lending expertise. Rapid growth of any type usually increases the risk of failure in any type of business because that rate of growth stresses existing management structures and financial controls. Banking is no exception.
- Delayed recognition of loan losses and the restructuring of loans with the intent of delaying the recognition of an inevitable loss.

Other factors causing losses leading to bank failure include:

- Operational inefficiencies, such as poorly located branches and a high ratio of expenses to revenues, leading to a low return on the bank's assets.
- Defalcations and outright theft of bank assets by bank insiders, an especially serious risk in small banks.
- Maturity mismatching, specifically using deposits and other funding sources with relatively short-term maturities or repricing intervals to fund assets with longer-term maturities or repricing intervals. Maturity mismatching was the principal cause of S&L and savings bank failures in the early 1980s but it can still occur today.
- Investment losses arising from defaults or a loss in market value due to rising interest rates.

Common to all causes of losses leading to bank failure is bad management compounded by weak or insufficient board oversight, for well-managed banks do not fail, even during times of great financial distress, such as in the aftermath of the 2008 financial crisis.

While 530 banks failed in the 2007-2017 period,² the other 8,151 banks in operation at the end of 2006 did not fail – they either are in operation today or were merged into or acquired by other banks without any government assistance. Many of the banks which did not fail over the last decade have held brokered deposits.

While bank directors, and stockholders in the case of investor-owned banks, should ensure the competent management of a bank, government supervision of FDIC-insured banks is a crucial backstop to ensuring sound management. That backstop failed in many regards before and during the crisis, as will be discussed below.

Appendix I to this report, which reflects a review of numerous inspectors general (IG) reports analyzing the causes of bank failures in recent years as well as the bank regulators' analysis of the IG reports, reinforces the conclusions set out in this report – BDs do not cause bank failures; rather the failures were due primarily to rapid asset growth, poor management, and deficient regulatory supervision.

Bank failures in recent decades

Two factors greatly influence when and where bank failures occur – they most definitely are not uniform across time nor evenly distributed across the length and breadth of the United States. As **Figure 1** clearly illustrates, bank failures have been highly cyclical in recent decades, with two waves of failures (2,799 failures in the 1980-1994 period and 506 failures in 2008-2014 period) interspersed by relative banking calm (just 58 failures in the 1995-2007 period) and an apparent calm since then, with just 27 mostly small-bank failures from 2015 to the present, including two failures so far in 2020.³

A multiplicity of factors contributed to the failures of the 1980s and early 1990s, including a sharp rise in interest rates in the early 1980s that led to the insolvency of hundreds of S&Ls and savings banks, rapid asset growth among S&Ls trying to grow their way out of trouble, the collapse of oil prices in the mid-1980s, and structural weaknesses in the banking industry, notably interstate and intrastate branching restrictions. Most importantly, brokered deposits did not contribute to those failures, as I explained in a 1991 report.⁴

² All data in this paper pertaining to bank failures excludes the resolution of Washington Mutual (WaMu) because, one, its acquisition by JPMorgan Chase did not impose any loss on the Deposit Insurance Fund and two, due to WaMu's very large size, its inclusion would severely distort the analysis of and conclusions drawn from post-crisis bank-failure data.

³ Of these 27 failures, 15 had fewer than \$100 million in total assets while only three exceeded \$1 billion in total assets. Only four of the 27 failures had BDs greater than 10% of their total deposits three years prior to their closure while 11 of the failed banks had no brokered deposits at the quarter-end prior to closure or at the quarter-ends one, two, three, and four years prior to the quarter-end preceding the date of closure.

⁴ Ely, Bert, and Vicki Vanderhoff, "Retail Brokered Deposits: A Post-FIRREA Analysis," Ely & Company, Inc., June 1991.

Most interestingly, the number of bank failures has declined in recent years despite a substantial portion of the banking industry continuing to utilize BD funding and BDs continuing to account for a substantial portion of total domestic bank deposits, based on bank call report data, as shown in the following table.

Year ending December 31	Percent of banks with BDs outstanding	BDs as a percent of total domestic bank deposits	Number of bank failures
2013	32.6%	7.71%	24
2014	36.3%	8.10%	18
2015	41.1%	8.58%	8
2016	42.4%	7.59%	5
2017	44.2%	7.95%	8
2018	40.9%	8.49%	0
2019	38.9%	8.35%	4

One of the most interesting aspects of the post-2006 failures is how many failed banks did not report any BD funding during the five years preceding their failure. Specifically, of the 63 failures in the 2013-2017 period, 21 reported no BDs outstanding at their quarter-ends one, two, three, four, and five years prior to failure; many of these failed banks were small institutions, some with total assets of less than \$100 million. A few of these banks may have had relatively small amounts of BD funding between the quarter-end dates, but that occasional BD funding cannot have caused any bank to fail!

Several of the larger failed banks also never reported any BDs outstanding on the quarter-end dates referenced above. For example, Guaranty Bank of Milwaukee, which had \$1 billion of deposits when it was closed on May 5, 2017, reported no BDs on any of the quarter-end dates within five years of its failure. Clearly, BDs did not contribute to Guaranty's failure.

Most of the remaining failed banks relied upon a relatively minor amount of BD funding within one, two, three, four, and five years preceding closure. It is unsupported for anyone to assert that a modest level of BD funding during the five years preceding a bank's failure would have caused it to fail. This observation certainly holds true for the most recent wave of failures (closures in the 2014-17 period). The data also show that high[er] levels of BD funding do not correlate with rapid asset growth, asset weakness, and the probability of bank failure.

The FDIC has long held a negative view on BDs and in doing so has failed to recognize important nuances. Rather than holistically analyzing the role of BDs in asset growth rates and bank failures, the FDIC has adopted a blanket, one-size-fits-all regulatory approach that has no analytical basis and therefore is highly inappropriate. The better solution would be for the FDIC to use its supervisory processes to develop an

institution-specific, fact-based approach to BDs that clearly acknowledges the role that rapid asset growth, however funded, plays in bank failures.

Figure 2 illustrates another widely ignored aspect of bank failures and the losses they trigger for the FDIC's Deposit Insurance Fund (DIF) – the geographical maldistribution of losses borne by the DIF, based on where a failed bank was headquartered. Because larger banks, and some smaller banks, too, often lend outside the state where they are chartered, the bad loans that contributed to a bank's insolvency often were not located in the state where the bank was chartered or where it gathered its deposits.⁵ Nonetheless, Figure 2 provides a reasonable approximation of where the asset losses occurred that caused many banks to fail.

Generally speaking, the states with the highest per-capita losses are the states which suffered substantial declines in real estate values. In particular, acquisition, development, and construction (ADC) loans can generate substantial losses when the realized value of the real estate development funded by an ADC loan fails to reach the market value projected at the time the loan was made. Losses on ADC lending often were the underlying cause of the failure of numerous banks operating in relatively mature banking markets which purchased participations in ADC loans secured by real estate in "hot" markets that cooled after the 2008 recession hit.

It is not possible to quantify all the causes of the losses that led to the 530 bank failures due to limited publicly available data about most failed banks as well as comparable data about banks that did not fail. For most banks, call reports provide the only publicly available data about a bank. Even with that limited data, it is reasonable to conclude that the underlying cause of almost all bank failures was poor regulatory supervision, which itself falls into the four categories discussed below. Based on this analysis, it is reasonable to conclude that brokered deposits, per se, were not an underlying cause of any bank failure.

Failure to constrain rapid growth. As noted above, rapid loan growth, especially lending in markets when management has little experience or expertise, greatly increases the likelihood of subsequent loan losses which, if sufficiently severe, could cause the bank to become insolvent, leading to its closure. Most importantly, rapid loan growth can be funded in numerous ways and not solely by BDs.

With some exceptions, such as when an enforcement order has been issued against a bank, regulators seem unwilling to constrain a bank's rate of growth, and specifically loan growth, until too many risky loans are on the bank's books. The riskiness of those loans often does not become evident until the economy turns down, which reinforces the

⁵ A bank is not required to include in the call reports it files with regulators any data pertaining to the geographic location, or geodata, of its borrowers and loan collateral. The absence of such data is significant with regard to real estate loans.

old banking adage, “bad loans are made during good times.”⁶ Unfortunately, history sadly teaches that it is difficult during good times for banking supervisors to constrain imprudent lending.

The FDIC’s perhaps unintended bias against penalizing excessively rapid growth has been demonstrated most explicitly by the following premium-pricing limitation stated in a footnote to the current rule for deposit-insurance pricing for small banks. That footnote reads: “asset growth (merger adjusted) over the previous year in excess of 240 percent . . . will not further increase a bank’s assessment rate.”⁷ [Emphasis supplied]

That statement reflects the FDIC’s misguided philosophy about the pricing of deposit insurance, which was most recently expressed in a footnote to a recently issued FDIC staff study on the history of the FDIC’s risk-based deposit-insurance premiums:

A deposit insurer may limit the premium imposed on riskier banks because premiums that are too high could have the unintended consequence of contributing to a weak bank’s failure.⁸ [emphasis supplied]

This pricing philosophy totally ignores the risk-curbing intent of high premiums for any kind of insurance; i.e., discouraging unwise risk-taking by financially incentivizing the insured, through the prospect of lower premiums, to take actions that reduce the probability of a loss and/or the cost to the insurer should a loss event occur. Capping premium rates also introduces an unwarranted cross-subsidy – from well-run banks to the poorly managed – into deposit-insurance pricing.

In fact, there should be no upper limit on a bank’s deposit-insurance premium rate, provided there is an actuarial justification for whatever rate is charged. Imposing the premium cap noted above effectively removed a disincentive against an asset growth-rate in excess of the cap, however that growth was funded.

Most interestingly, in a speech last December about the brokered-deposit issue, FDIC Chairman Jelena McWilliams acknowledged the problem caused by rapid asset growth when she stated “[o]ne option to consider is replacing Section 29 of the [Federal Deposit Insurance] Act altogether with a simple restriction on asset growth for banks that are in trouble.”⁹ Section 29 is the statutory provision empowering the FDIC to regulate brokered deposits. Subsection (f) of that section states that the FDIC “may impose, by

⁶ “Underwriting standards – Lesson From the Past,” Banking in the Ninth, Federal Reserve Bank of Minneapolis, June 18, 2014.

⁷ Federal Register, Vol. 81, No. 98, May 20, 2016, pg. 32208, footnote 4 to the table at the top of the page, Definition of Measures Used in the Financial Ratios Method. Codified in 12 CFR Sec. 327.16(a)(1)(ii)(A).

⁸ “A History of Risk-Based Premiums at the FDIC,” Federal Deposit Insurance Corporation, Report No. 2020-01, January 2020, footnote 5, pg. 3

⁹ Keynote remarks by Jelena McWilliams, Chairman, Federal Deposit Insurance Corporation, “Brokered Deposits in the Fintech Age,” at the Brookings Institution, Washington, D.C., December 11, 2019, pg. 5.

regulation or order, such additional restrictions on the acceptance of brokered deposits by any institution as the [FDIC] may determine to be appropriate.” Presumably a regulation limiting the rate of asset growth by a trouble bank that had accepted brokered deposits would therefore be permissible.

Delayed recognition of losses, credit or otherwise. While bank management is responsible for the timely financial-statement recognition of lending, investment, and other types of losses, bank supervisors have to be diligent in ensuring timely recognition of losses so that they can properly assess the bank’s soundness and survivability. Timely recognition can and should lead to prompt corrective actions, including changes in business strategy and management, recapitalization of the bank, sale to a stronger bank, or even liquidation before the bank becomes insolvent.

Delayed loss recognition is harmful in several ways. First, ignoring losses enables the bank’s management to hide problems from its owners, directors, and regulators, and even from some in management, which postpones the initiation of corrective action to strengthen the bank. Second, the continuation of loss-making activities, such as continuing to fund a loss-making project or property development, is harmful to the relevant marketplace as well as to other lenders. Third, delayed loss recognition often delays the closure of a failing bank and its resolution, either through a sale to a stronger bank or its liquidation.

Delayed loss recognition, usually on loans, accounts for much of the difference between the last reported net worth of a failed bank within a few months of its closure and the cost of that failure to the DIF. Most failed banks in the 2007-2017 period actually reported a positive net worth at the quarter-end before they were closed; only 95 of the 530 failures reported a negative net worth in their final quarter-end call report. For the other 435 failures, the failed bank reported a positive net worth even as the FDIC was on the verge of suffering a sometimes substantial loss upon the imminent closing of the bank. That many clearly failing banks reported a positive net worth just before a costly closing is powerful evidence of poor regulatory supervision of weak and badly run banks and certainly not an indictment of BDs.

The most recent bank failure, just two months ago, illustrates some of the common causes of bank failures as well as the failed supervision of a long-troubled bank. On April 3, 2020, the West Virginia Division of Financial Institutions closed The First State Bank in Barboursville, West Virginia. Since this state-chartered bank was not a member of the Federal Reserve System, the FDIC was its principal federal regulator. Rather than being liquidated, the FDIC entered into a purchase-and-assumption agreement with another bank which assumed all of the failed bank’s deposits, thereby protecting

uninsured depositors from any loss.¹⁰ The FDIC estimated its loss at \$46.8 million, equal to 33.5% of its deposits and 30.7% of its assets as of the end of 2019.

The FDIC stated in its news release that the bank had “experienced longstanding capital and asset quality issues, operating with financial difficulties since 2015. The bank’s December 31, 2019 financial reports indicated capital levels were too low to allow continued operations under federal and state law.” In fact, the bank reported an equity-capital-to-total-assets ratio at the end of 2019 of 1.43% – far below regulatory minimums. Given the magnitude of the FDIC’s loss, the bank clearly had not been recognizing in the call reports it filed with the FDIC the asset-quality losses it had been experiencing for at least several years. Without a doubt, the bank’s failure to report those losses was a material supervisory failure by the FDIC.

Interestingly, The First State Bank of Barboursville had partially funded itself with BDs, but not excessively so. Five years prior to its failure, BDs accounted for 24.2% of its total deposits. Over time, its BDs shrank as the bank reduced its total deposits, declining to 5.3% of its total deposits one year before it was closed.

Poorly supervised geographical expansion of credit risks. While rapid growth is especially fatal to banks, excessive lending in fast-growing geographic markets or specific asset classes can harm all banks lending in that market or asset class. Even prudent lenders can fail or be severely weakened by loan losses if they happen to be an established lender in a market that has attracted more aggressive lenders. This phenomenon is often evident in areas with rapid population growth or an economic boom is underway, as occurred in oil-producing areas of the country during the late 1970s and early 1980s. By constraining the growth of reckless lending, banking supervisors indirectly help more prudent lenders to survive a boom’s subsequent bust.

While bank examiners know where a bank is lending, by reviewing a bank’s outstanding loans, they do not know how that lending, or loan growth, compares with other banks lending in the same markets. That is the case because, as noted above, bank call reports do not require banks to report the geographic location of their outstanding loans. Consequently, bank supervisors, as well as the public at large, do not know where excessive loan concentrations are quietly building.

The absence of this data was not a serious problem when branching restrictions resulted in relatively small banks lending in relatively limited geographic areas. Working with call-report data, supervisors could usually determine where there was excessive lending, especially on real estate. Bank consolidation, the elimination of branching restrictions, more extensive buying and selling of loan participations, and the securitization of collateralized loan obligations have made it much more difficult, if not

¹⁰ FDIC news release, April 3, 2020; <https://www.fdic.gov/news/news/press/2020/pr20046.html>

impossible, for supervisors and policymakers to properly assess where excessive lending is occurring.

To some extent, risky loan concentrations can be assessed from other publicly available data, such as building-permit issuance and auto-sales data, but that data does not give banking supervisors a sufficiently analytical basis for identifying a particular bank's credit exposure to a hot loan market.

Mispriced deposit insurance. Insurances of all types should be priced to deter excessively risky activity that generates losses for the insurer while producing sufficient premium income to at least cover the insurer's losses and operating expenses. That is not true for the supposedly risk-sensitive premiums the FDIC has charged for several decades. The key failing of the FDIC's premium-rate formula is that it is based on lagging measures of banking risk, such as non-performing loans and loan charge-offs.

The FDIC's premium rates should instead reflect leading measures of banking risk, such as rapid asset growth and high-risk lending concentrations in geographical areas where there is overbuilding that will likely lead to declines in property values and loan losses when an economic downturn hits, reflecting the adage cited above: bad loans are made in good times.

To that end, the FDIC should consider requiring banks to geocode individual real estate loans, based on the location of the property being financed, and to report that data electronically as a call-report supplement. Well-managed banks already should be managing the geographical dispersion of their lending risks. The FDIC should then aggregate that data across the entire banking industry to identify specific areas where overinvestment in real estate may be occurring that will eventually lead to declining property values and consequent loan losses.

Banks should then pay a higher deposit-insurance premium rate for credit exposures in those high-risk areas. That higher rate not only should have a deterrent effect on lending in such areas but it also would compensate the DIF for higher future losses arising from failed banks that lent too heavily in overbuilt areas. Deterring overinvestment in real estate in high-risk areas also will protect the value of the collateral securing existing loans, which in turn should reduce bank failures and consequent losses to the DIF.

Policy recommendations

The following policy recommendations can reasonably be drawn from the above analysis:

- Banking supervisors should adopt regulations that do not discriminate against BDs and recognize that bank deposits increasingly are not linked to a specific bank branch in any meaningful sense.
- Supervisors should be more diligent in constraining rapid loan growth, specifically by limiting the rate of growth of troubled banks, regardless of how they are funded.
- Supervisors should be especially diligent in monitoring out-of-market lending by banks, either through direct loan origination or by purchasing loan participations in markets where the bank does not have a physical presence or prior lending experience.
- Supervisors need to be more aggressive in insisting that banks identify non-performing loans in a timely manner, record realistic loss provisions on those loans, and deal aggressively with repossessed loan collateral. The eventual implementation a new accounting rule, CECL or current expected credit losses, which will require banks to forecast their future credit losses, could help in this regard. Forecasting is a highly subjective undertaking, but CECL will force bank managements to more closely examine the assumptions on which they based prior lending decisions.
- Implementing risk-based deposit insurance premiums based on leading indicators of banking risk, as discussed above.

Conclusion

Brokered deposits have long been tagged as a cause of bank failures, in part because some failed banks, but far from all, have had substantial BD funding at some point prior to their closure. To the extent that there is any correlation between a bank's reliance on BD funding and its eventual failure, that correlation does not prove, or even imply, causation. Assertions that BDs cause bank failures, or are even a significant contributing cause, clearly has not been proven. The causes discussed above – rapid growth, poor supervision of credit risk, delayed recognition of losses, and mispriced deposit insurance – have been the principal causes of bank failures, especially during and after major economic downturns. Those are the causes on which policymakers should focus.

Appendix I

A review of Inspector General reports analyzing the causes of bank failures since the onset of the last financial crisis

Section 38(k) of the Federal Deposit Insurance Act requires the inspector general (IG) of the appropriate federal banking agency to prepare a written report “which shall ascertain why the [failed] institution’s problems resulted in a material loss to the Deposit Insurance Fund.” The definition of a material loss, as of January 1, 2014, was an amount exceeding \$50 million.

During the course of preparing this paper, a sample of 21 material loss reports (MLR) and failed bank reviews (FBR) prepared by the various IGs was reviewed to assess the reasons why those banks failed. These failures occurred from 2010 to 2019 and were spread across 15 states. Attached is a table summarizing the review of those reports. Columns A to I in the table identify the primary cause or causes of failure, as determined by the IG, while columns J to O indicate contributing causes of failure the IG identified. Not surprisingly, management and board oversight, or more specifically poor management and weak board oversight, were cited as the primary causes of failure.

Brokered deposits were not cited as the primary cause of failure in any of these cases and as a contributing factor in only nine cases. Importantly, as the boxes in the table indicate, in eight of the nine failures where brokered deposits were cited as a contributing cause, the primary cause of failure was identified as rapid growth and/or high cost deposits. High-cost deposits, of course, can be deposits raised in branches or over the Internet. The FDIC should conduct and publish a table of all bank failures dating back to 2008 in which the primary and contributing causes of failure were identified in a banking agency’s IG report, regardless of which banking agency was the bank’s primary regulator.

Three summaries of the IG reports prepared by the bank regulatory agencies also were reviewed, as follows:

FDIC – Follow-up Audit of FDIC Supervision Enhancements¹¹

This 45-page report was prepared in 2010 by the FDIC’s Office of Inspector General. While there are numerous references in this report to BDs, these references deal primarily with the FDIC’s regulation of BDs rather than alleging that BDs caused or

¹¹ Follow-up Audit of FDIC Supervision Program Enhancements, Office of Material Loss Reviews, Report No. MLR-11-010, December 2010.

contributed to any bank failure. It is most interesting that in a 2018 FDIC report, titled Forward-Looking Supervision,¹² there is not one mention of brokered deposits.

Department of the Treasury Audit Report – August 2016¹³

This report addressed the causes of the failure of national banks chartered by the Treasury’s Office of the Comptroller of the Currency (OCC) and federal and state-chartered thrift institutions formerly supervised by the Office of Thrift Supervision after it was merged into the OCC. The 119 failures covered by this audit report occurred between September 28, 2007, and July 20, 2012.

This report listed the following common causes of bank failures: Ineffective management and inadequate board oversight, aggressive growth strategy, economic downturn, insufficient capital, asset concentrations, inadequate credit administration and risk management, reliance of wholesale funding, and a miscellanea of other causes, including losses from investments in Fannie Mae and Freddie Mac stock; failed mergers, sales, or acquisitions; high management and staff turnover; improper accounting transactions; inadequate internal controls; and a lack of core deposits or funding. Most interestingly, this IG “identified certain matters in 29 failed banks relating to potential fraud.”

In discussing the failed banks’ reliance of wholesale funding, the reported stated on page 11 that 24 of the 119 banks “failed, in part, because of an overreliance on wholesale funding, often used to finance growth.” [emphasis supplied] The report then erroneously asserted that “brokered deposits, the most common type of wholesale funding that banks in our review used, are highly interest-rate sensitive; and therefore an unstable funding source.” That assertion is simply not true for a brokered CD, for its interest rate is locked in when the CD is issued by the bank and it cannot be redeemed before maturity, except with the consent of the bank. In fact, BDs in the form of CDs are a far more stable source of bank funding than so-called core deposits – demand deposits, savings accounts, and readily redeemable CDs issued directly by a bank to the owner of a CD.

¹² Forward-Looking Supervision, FDIC Office of Inspector General, Eval-18-004, August 2018.

¹³ Audit Report, Department of the Treasury Office of Inspector General, OIG-16-052, August 15, 2016.

One especially valuable portion of the Treasury report was Table 2 (starting on page 32) which listed for each of the 119 failed banks the causes the IG identified for each failure. These causes and the number of failed banks identified with each cause are as follows:

High loan concentration in commercial real estate	89
Inadequate credit administration and risk management	86
Reliance on wholesale funding	24
Concentration in nontraditional mortgage loans	20
Other concentration	18
GSE	6
Various other factors	51

Unfortunately this report only analyzes failures through July 20, 2012. It does not appear that the Treasury IG has produced a subsequent report analyzing the 17 failures of OCC-regulated banks since then.

Federal Reserve Summary Analysis of Failed Bank Reviews – September 2011¹⁴

As best can be determined from a Google search, the last failed-bank summary the Federal Reserve System’s IG has produced analyzed the failure of 35 state-chartered banks that were members of the Federal Reserve System; these failures occurred between December 5, 2008, and February 4, 2011. There have been 16 failures since then of state-chartered, Fed-member banks for which the Fed has not produced a comparable analysis of its failed-bank reviews.

The 2011 analysis did include in Appendix 3 a Table 1, which summarized the contributing causes of 20 of the 35 failures for which the Fed’s IG prepared a material loss review or in-depth review. For all 20 banks, the IG identified two contributing causes of failure – concentration risk and strategic planning, decision-making, or execution. It is reasonable to summarize these issues as bad management. Risk management was identified as a causal factor in 16 of the failures and reliance on certain specific funding sources in ten of the failures.

Most interesting is the fact that brokered deposits were cited as a contributing cause of the failure of just one bank, SolutionsBank, which failed on December 11, 2009. According to this report, “Solutions failed because its Board of Directors and management did not control the risks associated with an aggressive growth strategy funded by non-core deposit sources . . . primarily with high-rate CDs over \$100,000,

¹⁴ Summary Analysis of Failed Bank Reviews, Office of Inspector General, Board of Governors of the Federal Reserve System, September 2011.

supplemented by Federal Home Loan Bank advances, and brokered deposits. . . . The bank's growth strategy resulted in a significant loan concentration in [commercial real estate], including [construction and land development loans] that made the bank particularly vulnerable to real estate market deterioration." Although this report does not state as such, Solutions failed because of aggressive, risky loan growth regardless of how that growth was funded.

BDs got a bum rap in the case of Solutions' failure for they were never a significant source of funding for the bank. At the quarter-end prior to its failure, BDs accounted for just 2.5% of its total deposits. At one year prior to failure, BDs accounted for 8.0% of the bank's total deposits; for 11.4% of its total deposits two years prior to failure; for 9.1% of its total deposits three years prior to failure; and 6.5% of total deposits four years prior to failure. By one year prior to failure the total amount of the bank's BDs had begun to decline. Clearly one must look elsewhere for the causes of Solutions' failure.

Appendix II

The Potential Impact of the Covid-19 Pandemic on the brokered deposits

Since the FDIC proposed new rules governing BDs on December 12, 2019, just six months ago, the outbreak of the Covid-19 pandemic has dramatically impacted the U.S. economy, the banking industry, and more specifically, the manner in which individuals and businesses interact with their banks. Social distancing and concerns about the physical transmission of the coronavirus have rapidly eroded the utilization of bank branches for the purpose of gathering and dispersing bank deposits.

Instead, the Internet and electronic banking have become central to deposit-account management for individuals and businesses, and almost certainly will become more so. The geographical link between where a depositor lives or does business and where her bank is located has lost some of its relevance. That trend will continue, vitiating any notion of what a “core” deposit is. No longer can “brokered” deposits be differentiated in a meaningful or relevant manner from non-brokered deposits.

The pandemic has dramatically altered the debate over brokered deposits

The ongoing coronavirus pandemic is a tragic event of enormous proportions that will have numerous long-term consequences for the United States, the economy, and the banking industry. Without question, the pandemic had dramatically altered the terms of the debate over brokered deposits.

More specifically, we are seeing the emergence of “bank distancing” that is a consequence of the accelerating growth of “virtual banking” or branchless banking via the Internet. That is, bank customers – individuals and businesses of all sizes – are increasingly dealing with their bank remotely, through the Internet and mobile devices, because the closure of bank branches is steadily reducing physical access to banking offices.

From June 2014 to June 2019, the number of banking offices in the United States declined by 8.8%,¹⁵ and more closures are on the way. For example, U.S. Bancorp stated that it “has anticipated it will close 10% to 15% of its branches in legacy markets while

¹⁵ FDIC Quarterly, Volume 14, Number 1, pg. 36.

opening branches is select new markets.¹⁶ Most likely fewer branches will be opened in new markets than are being closed in legacy markets.

Branch closures are being driven in part because the pandemic has greatly accelerated the digitization and automation of a wide range of banking services, including the opening of bank accounts. U.S. Bancorp found that its customers “have become more comfortable using its digital channels during the coronavirus pandemic. . . . that between 17% and 35% of digital transactions are those that typically took place inside branches before the pandemic struck.”¹⁷

Because of the growing digitization of banking, more and more depositors will be receptive to placing deposits in, and specifically purchasing certificates of deposit from, banks they cannot easily visit. The already ill-defined notion of what are a bank’s “core” deposits will become even more meaningless as deposit relationships become increasingly digitized and therefore disconnected from actual bank branches. As this trend grows, BDs will likely become an increasingly important source of bank funding. Already, small banks especially are utilizing BDs and deposit placement firms to obtain the funds they need to meet a surge in loan requests triggered by the pandemic.¹⁸

Further, given that a brokered CD cannot be redeemed by a depositor except with the bank’s consent, brokered CDs represent a far more stable source of bank funding than CDs sold directly by a bank or checkable deposits which can be withdrawn on a moment’s notice. Consequently, from a safety-and-soundness and financial stability perspective, brokered CDs should become a much important source of bank funding as a result of the coronavirus pandemic. Due to the varied times to maturity of brokered CDs, they are a very effective tool in holding maturity mismatches between a bank’s assets and its liabilities to a comfortable level.

FDIC Chairman Jelena McWilliams noted in recent congressional testimony that technology has dramatically altered the deposit-taking aspects of the banking business: “Over the past 30 years, the financial services industry has seen significant changes in technology, business models, and practices. [The pending BD] rulemaking is designed to develop a framework that encourages and provides greater clarity and consistency regarding the classification of a deposit as brokered or not.¹⁹” Those technological innovations will not be reversed after the pandemic has ended.

¹⁶ U.S. Bancorp could step up branch closings post-Covid,” American Banker, May 28, 2020.

¹⁷ Ibid.

¹⁸ Prior, Jon; “Out-of-market deposits helping small banks meet surge in loan requests,” American Banker, April 7, 2020.

¹⁹ Statement by Jelena McWilliams, Chairman, Federal Deposit Insurance Corporation on Oversight of Financial Regulators before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, May 12, 2020.

A temporary 100 percent guarantee of deposits in non-interest-bearing transaction accounts would further heighten the importance of brokered CDs

Section 4008 of the recently enacted CARES Act²⁰ authorized the FDIC to provide an unlimited guarantee of balances in non-interest-bearing transaction accounts at FDIC-insured banks until the end of 2020, as the FDIC was empowered to do following the 2008 financial crisis. Given that banks today are awash in liquidity, very much unlike the case during the financial crisis, the FDIC may not exercise that authority.²¹ If it does, though, the banking industry might experience an increase in the balances in non-interest-bearing transaction accounts, only to see that increase melt away early in 2021.

Given the statutorily mandated expiration of the full guarantee of non-interest-bearing transaction accounts, banks would have a powerful incentive before the end of 2020 to utilize deposit brokers to convert large balances in transaction accounts at other banks into fully-insured, interest-bearing CDs in their own bank. This strategy would enable banks to lock in low-cost funding that would be especially beneficial if interest rates begin to rise after the pandemic has subsided and the economy has begun to grow again.

The impact of the coronavirus pandemic on bank failures

The likely, and possibly long and deep, recession following the coronavirus pandemic the world is now experiencing will be an especially challenging time for bank managements as well as bank supervisors. It is far too soon to state definitively what impact the coronavirus pandemic will have on bank failures, but given the sharp and possibly deep and prolonged recession the U.S. economy will likely experience, there almost certainly will be an uptick, and possibly a substantial increase, in bank failures over the next few years.

There will be absolutely no justification to blame BDs for those failures. Rather, the failures will come from the asset side of bank balance sheets and the mismanagement of suddenly troubled banks prior to their failure. Regulators may fail, too, in not promptly identify those banks seriously harmed by recession and quickly resolve those problems through mandated capital raises, acquisition by a stronger bank, or prompt closure. By no stretch of the imagination should BDs be blamed for the forthcoming failures.

²⁰ The Coronavirus Aid, Relief, and Economic Security Act.

²¹ Pederson, Brenda, "FDIC tool to prevent bank runs goes unused vs. coronavirus," American Banker, May 14, 2020.

Number of bank, thrift failures

1980 to May 2020 – Recessions indicated by vertical bars

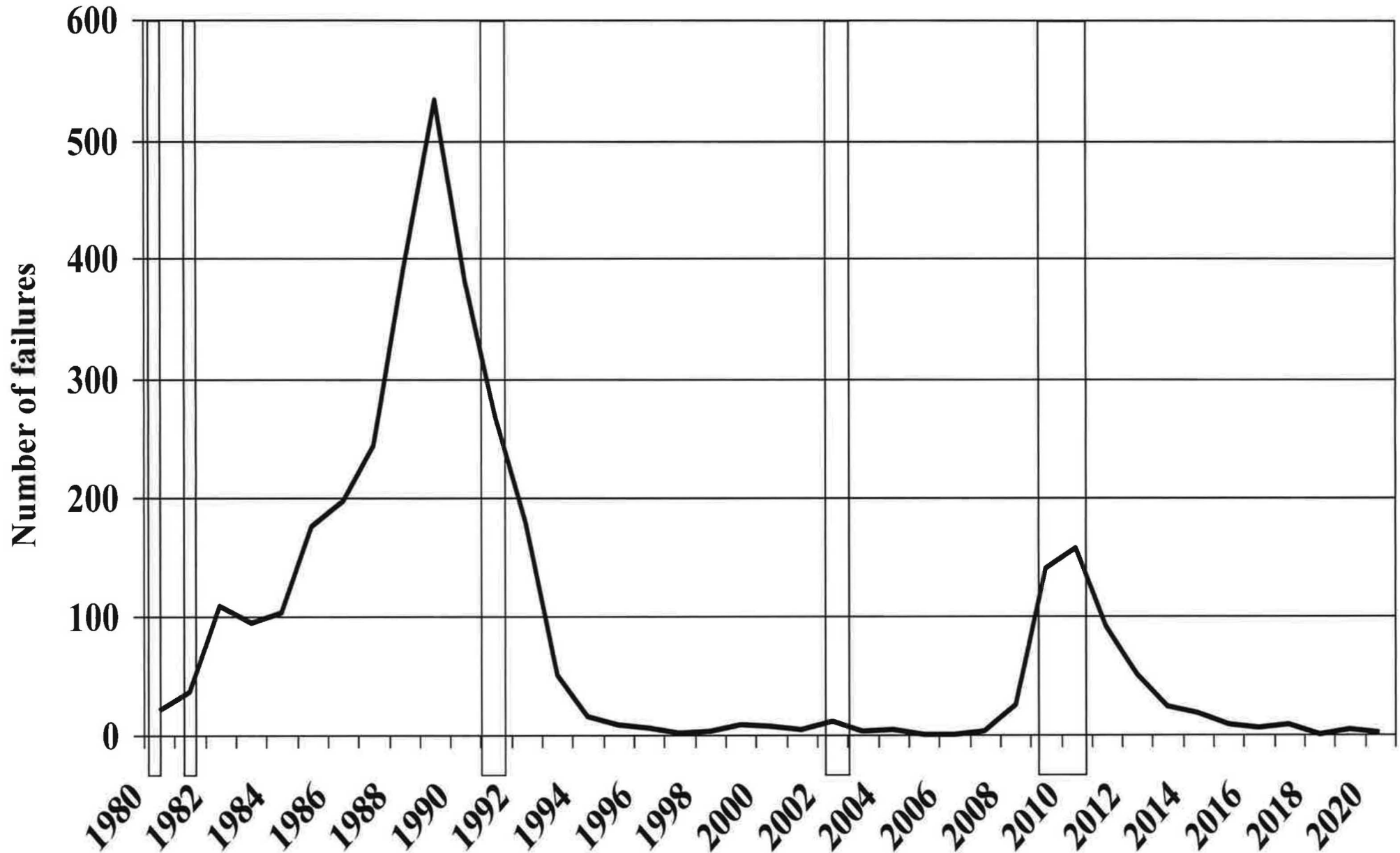
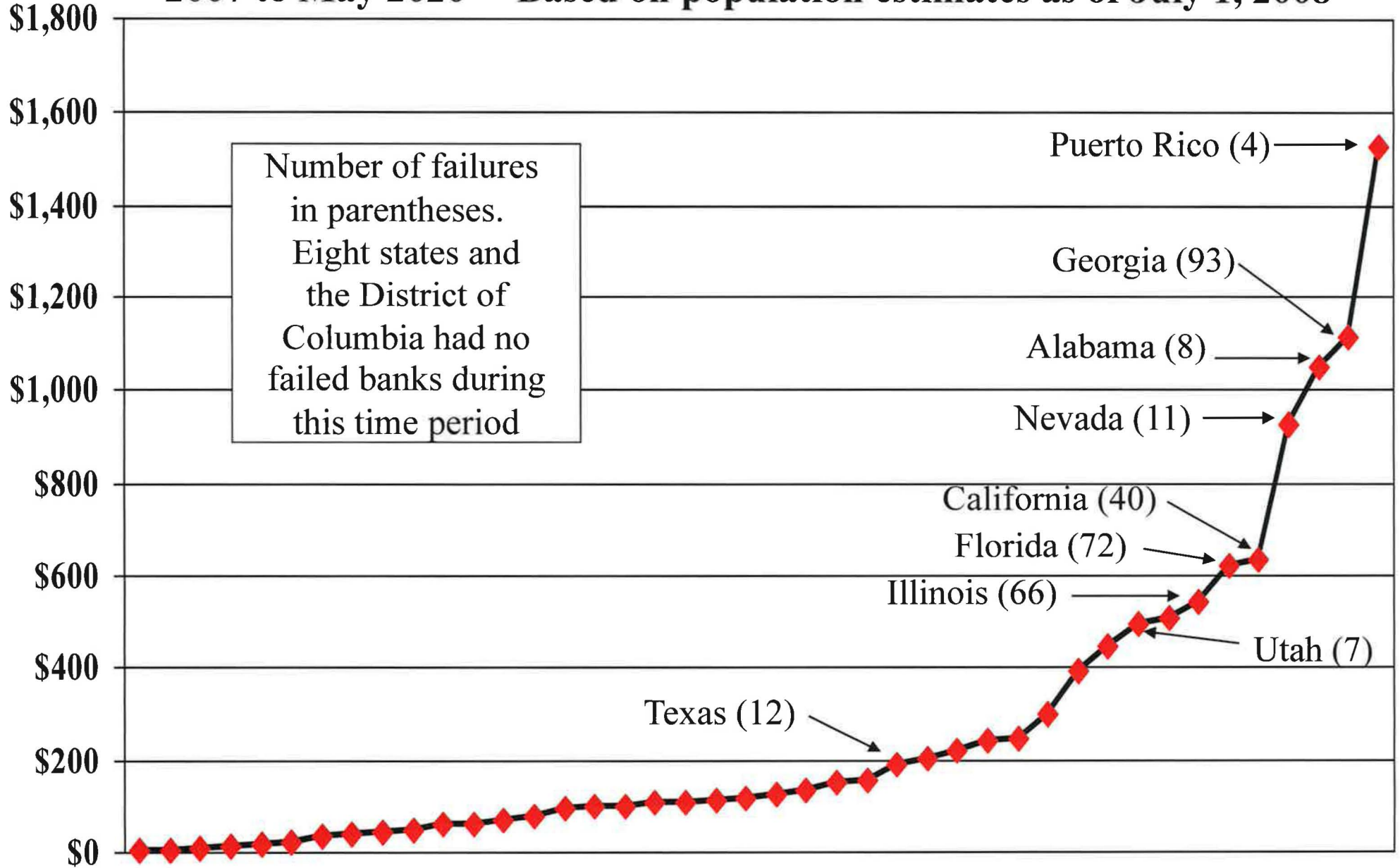


Fig. 2

Per-capita deposit-insurance losses by state

2007 to May 2020 Based on population estimates as of July 1, 2008



Summary of Failed Bank Analyses

Bank	State	Date Failed	Type of Review	Asset Size (dollars in millions)	FDIC Loss	Primary cause of Failure											Contributing causes of Failure					
						A	B	C	D	E	F	G	H	I	J	K	L	M	N	O		
Enloe State Bank	TX	5/31/19	Focused	37	27.6	X	X						X									
Proficio Bank	UT	3/3/17	Focused	62	11	X	X							X		X						
F&M of Argonia Bank	KS	10/13/17	Focused	35	2.6	X	X	X														
First NBC	LA	4/28/17	Material	4,000	997	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Seaway Bank & Trust	IL	1/27/17	Material	280	57	X		X	X								X	X	X			
Capitol City Bank & Trust	GA	2/13/15	Material	272	89	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Doral Bank	PR	2/27/15	Material	5,600	749	X		X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Valley Bank	IL	6/20/14	Material	493	51	X	X	X									X					
Vantage Bank	PA	2/28/14	Focused	63	11	X				X		X							X			
Bank of Union	OK	1/14/14	Material	244	70	X	X		X	X												X
Tennessee Commerce Bank	TN	1/27/12	Material	1,000	417	X		X	X					X	X							X
First State Bank, Stockbridge	GA	1/20/12	Material	529	216	X		X	X		X											X
Colorado Capital Bank	CO	7/8/11	Material	682	284	X		X	X				X						X			X
Bank of Choice	CO	7/22/11	Material	979	214	X		X	X				X						X			
Atlantic Southern Bank	GA	5/20/11	Material	726	274	X		X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
FirsTier Bank	CO	1/28/11	Material	808	243	X		X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Peninsula Bank	FL	6/25/10	Material	655	193	X		X	X					X	X							X
USA Bank	NY	7/9/10	?ID	196	61	X	X	X	X					X	X							
Washington First Int'l Bank	WA	6/11/10	?ID	500	154	X		X	X				X		X			X				
Premier Bank	MO	10/15/10	Material	1,000	405	X		X		X			X		X			X				X
Hillcrest Bank	KS	10/22/10	Material	1,600	312	X		X	X	X									X			X
Number of citations						21	8	17	15	9	1	2	1	11	9	5	3	10	2	9		

Column Heading Meanings

A = Management and Board Direction and Oversight	I = High Cost/Internet Deposits
B = Domineering CEO or Executive	J = Brokered Deposits
C = Concentration in Risk Assets, CRE, ADC, Indirect Loans	K = Accounting Irregularity
D = Deficient Asset Policy, controls or Administration	L = Acquisitions
E = Rapid Growth	M = Supervision Issues
F = High Operating Costs	N = TARP Funded Growth
G = Fraud	O = Weak Economy
H = Liquidity	