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December 17, 2008

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Attention: Comments

Re: Federal Deposit Insurance Corporation (FDIC) Notice of Proposed Rulemaking and Request for Comment, RIN 3064-AD35

Dear Mr. Feldman:

We are writing on behalf of the Promontory Interfinancial Network, LLC, ("Promontory"), which provides a deposit service known as the Certificate of Deposit Account Registry Service, ("CDARS"), to comment on the Notice of Proposed Rulemaking ("Notice") suggesting changes to the FDIC's deposit insurance assessment regulation. One of the Notice's specific requests for comments relates directly to the type of service that CDARS provides:

> *Should deposits received through a network on a reciprocal basis that meet the statutory definition of brokered deposits be excluded from the definition of brokered deposits for purposes of the adjusted brokered deposit ratio or the brokered deposit adjustment?*

Although covered by the definition of brokered deposits as it stands today, CDARS Reciprocal deposits are very different in practice. Indeed, they share all the key characteristics of *core deposits*. The funds are less expensive and less volatile. They originate from local sources and do not involve a third-party broker. They enhance rather than subtract from a bank's franchise value. Finally, and most germane to the Notice, CDARS Reciprocal deposits, in contrast to other popular funding alternatives, help to *minimize* the FDIC's liability in the event of a bank's failure. CDARS Reciprocal deposits, which are deposits placed through a network on a reciprocal basis, should therefore indeed be excluded from the definition of brokered deposits for purposes of the adjusted brokered deposit ratio and the brokered deposit adjustment.

The Certificate of Deposit Account Registry Service (CDARS)

The CDARS Reciprocal program[1] is a deposit swapping service that enables banks to provide their customers with access to millions of dollars of FDIC-insured certificates of deposit. More than 2,700 mostly-smaller banks and thrifts are members of the CDARS network. The median asset size of a Network member is just under $250 million. The CDARS service allows member banks, especially smaller ones, to build valuable face-to-face banking relationships with traditional banking customers – businesses, charities, trusts, higher net worth individuals, public entities – that want to have stable banking relationships and the security of FDIC insurance. Absent CDARS, many such customers gravitate to much larger institutions that are, rightly or wrongly, perceived to be "too big to fail."

With CDARS, a Network member bank places its clients' excess funds into certificates of deposit issued by other banks in the Network in increments less than the FDIC's deposit insurance limit. These deposits are then mutually exchanged on a dollar-for-dollar basis among the Network members. This is why the transaction is described as "reciprocal." The end result is that the original bank retains on its balance sheet deposits equal to the full amount its customers placed into CDARS.

One key feature of CDARS is that every member bank sets its own interest rates, in stark contrast to all other forms of brokered deposits. Even though deposits are swapped among banks, each bank's cost of funds is determined solely by the bank itself. The CDARS Network facilitates bank-to-bank payments so that lower rate paying banks are compensated for issuing CDs to customers of higher rate paying banks, and vice-versa. Interest rates on CDARS CDs, therefore, reflect local markets. There is no bidding, no national rate and no averaging of rates.

Most important, CDARS deposits do not require or involve a third-party "broker" or other form of intermediary. Customers that use the CDARS service have a relationship only with their local bank. Participating banks do indeed "know their customers."

CDARS Deposits Behave Like Core Deposits

CDARS deposits behave like stable core deposits and not like traditional, rate-sensitive deposits in three critical respects: They are reinvested like core CD deposits and are therefore "sticky;" they originate with local customers like all other core deposits; and they are priced at a significant discount to the bank from traditional brokered deposits. These characteristics have led one noted academic economist to conclude that "Reciprocal deposit placements through a network do not pose the same threat to FDIC as traditional brokered deposits and should not be treated the same."[2]

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[1] Henceforth, this letter will use the term "CDARS" only to refer to the CDARS Reciprocal service, as distinguished from Promontory's CDARS One Way program, a non-reciprocal deposit service that is akin to traditional brokered deposits.

[2] "*Brokered" Deposits Received Through a Network of Depository Institutions on a Reciprocal Basis*; Flannery, Mark J., Dec. 10, 2008, page 2. Hereinafter cited as "Flannery." Appended hereto as an Attachment.

CDARS Deposits Are Stable

Though CDARS deposits are arguably defined as "brokered" under current law, they do not present the risks associated with traditional rate-sensitive deposits. Those risks were outlined in the operative regulatory guidance issued May 11, 2001, entitled "Joint Agency Advisory on Brokered and Rate-Sensitive Deposits." The risks center on the lack of any substantive relationship between the bank and the depositor. In the case of traditional brokered funds, the bank does not even know the name of its customers. With rate-sensitive funds, customers exhibit little, if any, loyalty to the bank, having been attracted only by the high rate. For both types of funds, the end result is that the deposits are potentially unstable. Thus, banks were warned of the dangers of depending on such 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.*[3]

While the owner of a traditional brokered deposit only has a customer relationship with a brokerage firm, the owner of a CDARS deposit has an account and perhaps other relationships directly with the bank itself. The fact is that banks have established relationships with their CDARS customers, often multiple relationships (e.g., other accounts, lending relationships).

As a result, CDARS deposits have high reinvestment rates, a key defining characteristic of core deposits. In fact, the average reinvestment rate for 2008 exceeds 83%.[4] In contrast, because there is no depositor-bank relationship, traditional brokered deposits have what amounts to a *zero* reinvestment rate as that term is generally understood. Indeed, since the accounts are at brokerage firms, these deposits are more likely to leave when CD rates become less attractive compared to other investment alternatives or when fear and market volatility decline. The situation with CDARS is quite the opposite – the customers are at a bank (as opposed to a brokerage firm) because they want a deposit product and their bank has little incentive to try to move them to non-deposit products. CDARS deposits "stick" in the bank.

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[3] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision; *Joint Agency Advisory on Brokered and Rate Sensitive Deposits*; May 11, 2001, page 1

[4] This is despite the fact that CDARS deposits do *not* automatically reinvest. Because of this unique operational characteristic, Promontory calculates the reinvestment rate by determining whether a particular customer's funds were reinvested within 28 days of maturity instead of only those that reinvest immediately.

CDARS Deposits Originate with Local Customers

The CDARS network was designed to help banks strengthen their relationships with large-dollar depositors. By their very nature, CDARS deposits require a tangible relationship at the bank level. For these reasons, CDARS deposits are overwhelmingly gathered within a bank's geographic footprint. The Network's geographic analysis indicates that 80 percent of CDARS placements are made by customers within 25 miles of a branch location of the relationship institution.[5]

Given the community bank makeup of the Network, that finding is unsurprising. As mentioned above, the median asset size of CDARS institutions is less than $250 million. Our members, therefore, are typically locally-based, community institutions. They do not compete in a national marketplace. The Network was designed to address the needs of such local banks by allowing them to attract and retain large-dollar *local* depositors.

CDARS Deposit Rates Reflect Local Conditions

With CDARS, banks have complete control over the interest rates they offer to their customers. This enables each participating bank to manage its cost of funds within the context of its local market. On average, even in today's razor-thin rate environment, CDARS funds are gathered at costs roughly 20 to 40 basis points less (depending on maturity) than the all-in costs for traditional brokered deposits.[6] This difference in relative pricing is indicative of how CDARS transactions, with their tangible customer relationships and bank-level rate control, help insulate banks from changes in national liquidity demand.

In short, CDARS deposits are the antithesis of "hot money" chasing the highest interest rates around the country. Bank customers who use CDARS are, instead, primarily interested in safety and convenience.

CDARS Can Reduce Potential FDIC Liability

Not only do CDARS deposits behave like standard core deposits, CDARS deposits help strengthen banks' liquidity positions and thus benefit the FDIC's insurance fund. By strengthening margins, CDARS funding lowers the risk that any particular bank will fall into troubled status. Once troubled, a bank with CDARS funding will have more time to right itself. And if a bank fails, its past use of CDARS can lower the cost of its failure to the Deposit Insurance Fund.

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[5] Promontory is willing and prepared to share with the FDIC its data and analysis pertaining to customer/bank proximity or any other data referenced in this letter.

[6] Flannery, page 20

CDARS Strengthens Banks, Reducing Likelihood They Will Become Troubled

By using CDARS, smaller institutions are able to compete for accounts that previously would have only gone to the nation's largest institutions. Having such accounts strengthens community banks by giving them access to valuable, large-dollar relationships that might otherwise be beyond their reach. It also helps level the playing field to the extent government policy is perceived to benefit the largest financial institutions. Also, by using CDARS, banks are able to replace wholesale funding with deposits from their own customers. Banks generally are able to obtain CDARS deposits at meaningfully lower rates than wholesale funds, allowing for greater margins and thus greater profitability.

CDARS Deposits Can Give Troubled Banks More Time to Recover

Even banks with the best liquidity positions occasionally become troubled, but institutions that use CDARS Reciprocal deposits should have more time to correct their position (e.g., to raise capital, arrange a sale) than otherwise. A major reason is that, unlike secured liabilities, CDARS does not require any collateral, leaving the bank far better positioned to handle liquidity emergencies.

Also, once a bank is known to be troubled, large uninsured depositors often flee. By providing access to insurance, CDARS makes that much less likely. Moreover, even if one or more customers did withdraw their CDARS funds through their bank, it would have no serious impact on this bank since the relationship bank in fact holds only a portion of the customer's deposited funds and most of the customers' funds are placed with *other* institutions. The very act of deposit swapping sharply reduces the impact of early withdrawal risk. With CDARS, an institution is no longer subject to losing a multi-million dollar deposit as remains the case with uninsured deposits or even deposits secured by excess deposit insurance or collateral. At most, a bank utilizing CDARS might lose $100,000 or $250,000 (the amount of funds not swapped with other banks as part of the CDARS transaction) instead of the full value of a customer's account.[7] The stability that CDARS provides is increasingly important today, as the increased flow of information about bank conditions – whether accurate or not – has heightened large depositor fears and increased deposit volatility.

[7] While the customer's relationship bank would not be affected if the customer withdraws all CDARS funds early, other participating banks that issued CDARS CDs to that customer would be affected. However, their exposure would be limited to an amount less than FDIC's deposit insurance limit ($100,000 or $250,000) and they would receive as compensation for their loss a very sizable early withdrawal penalty. CDARS early withdrawal penalties are standardized and equal to 100% of the interest scheduled to be paid on CDs with a maturity up to 90 days. For CDs longer than 90 days, the penalty is equal to one half of the total interest scheduled to be paid.

CDARS Can Lower Cost of Bank Failure to Insurance Fund

In the event a bank is closed, CDARS funding can reduce the cost to the Deposit Insurance Fund. Compared to secured liabilities, a popular wholesale funding option, CDARS has multiple advantages.

First, CDARS deposits are not collateralized so no collateral is outside the reach of the FDIC receivership at closure.

Second, in the event the FDIC would ever need to terminate CDARS CDs, it can do so without being subject to any form of prepayment penalty. The depositor bears the risk of pre-payment in the event of a liquidation.[8]

Third, and perhaps most important, CDARS deposits have genuine franchise value. Unlike traditional brokered deposits, they come with a solid depositor relationship, so they can be sold by the FDIC to another institution at a premium. Indeed, CDARS relationships may be the most valuable customers within any banking institution due to their high dollar banking requirements. The potential for cross-selling other banking services is manifest.

Penalizing CDARS Deposits Would Negatively Impact Banks

Failure to exclude CDARS deposits from the definition of brokered deposits for purposes of the proposed rule would have several unfortunate effects.

Assessing Additional Premium Will Unfairly Stigmatize CDARS

Historically, the federal bank regulators have maintained that brokered deposits are a useful funding option. As stated in the FDIC examination manual, "There should be no particular stigma attached to the acceptance of brokered deposits per se and the proper use of such deposits should not be discouraged."[9] Unfortunately, the proposed rule, as drafted, will cause the media and financial analyst community to focus much more intently on the brokered line of the Call Report. Unless CDARS deposits are differentiated from the more volatile and costly non-reciprocal brokered deposits, CDARS will be tarred with a broad brush, unfairly stigmatizing and punishing a service that not only provides significant and important benefits to banks and practical benefits to bank customers, but also enhances bank safety and soundness.

The CDARS service is certainly not a means to increase deposits rapidly to support unsound asset expansion. CDARS deposits are difficult to gather, just like core deposits. They

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[8] Another benefit of CDARS is that this prepayment risk born by depositors is disbursed across many institutions, unlike the case of a single, large uninsured or secured deposit.

[9] *FDIC Risk Management Manual of Examination Policies; Sec. 6.1 - Liquidity and Funds Management; Brokered and Rate Sensitive Deposits.*

require the establishment of a genuine depositor relationship.[10] Banks should not be penalized in the marketplace for holding CDARS deposits on their books.

Assessing Additional Premiums on CDARS Deposits Will Weaken Bank Liquidity

If banks are discouraged from offering CDARS deposits because of an increased assessment fee and an accompanying stigma, both depositor and bank behavior will be affected. In each case, the behavioral changes will impact a bank's liquidity profile negatively.

Current depositors could elect to invest funds in non-bank products. If so, fewer deposits will enter the banking system and depository institutions will have fewer (or more expensive) funds with which to lend. Alternatively, depositors could continue to make large dollar deposits but, without the protection of deposit insurance, become more likely to withdraw their funds when rumors circulate about the bank's condition or about the health of the banking system generally. If so, stable funds would be replaced by less stable funds. Or, depositors may demand collateral, which presents the FDIC with all of the downsides associated with secured liabilities in the event of a bank failure. Alternatively depositors may simply move funds to the largest banks that hold what they might perceive to be implicit government backing, thereby further concentrating the FDIC's risk. None of these alternatives will improve the health of the banking system or of any individual bank.

Many banks will turn to other, less attractive funding alternatives in lieu of CDARS. A number of our member institutions have told us that if CDARS remains in the definition of brokered deposits and such deposits are assessed additional premiums, they will turn to secured liabilities or ironically, to Internet rate boards in order to reduce their overall brokered deposit ratio as reported on their Call Reports. Such actions would result in more expensive and otherwise less attractive funding without a meaningful depositor relationship. Yet our members have said that such adjustments may be necessary to avoid alienating potential investors, as well as their bank examiners, with an otherwise higher than average brokered deposit ratio. Encouraging such behavior would defeat the purpose of the Notice.

CDARS Particularly Benefits Community Development Banks and Local Governments

Community Development Banks and Minority-Owned banks often make the difference in the lives of people in the communities they serve. Frequently they are the only source of credit and other financial services in their communities. It has been said that they lift up entire neighborhoods by empowering people, individually and collectively, with the resources they need to effect positive change where they live. The Network is proud that 86 Community Development Banks and Minority-Owned banks are members of the Network – more than 82 percent of all the Community Development Banks and Minority-Owned banks that are eligible.

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[10] Promontory also provides funding that is akin to traditional brokered deposits through its CDARS One Way Buy service. Through that program, banks can acquire anywhere from $50,000 to $100 million or more in deposit funding at a time. These One Way funds are very similar to traditional brokered deposits. The pricing is based on a national rate, they do not roll over and they do not come with a depositor relationship.

They use CDARS Reciprocal to fund loans that quite likely would not be made otherwise. They operate in places where local people have only modest discretionary income, and by necessity must raise deposits from civic-minded and socially-responsive individuals and institutions within their market area. They have found that people and institutions are willing to place much larger deposit volumes in a community development bank if they are assured that those deposits are secure. CDARS provides that assurance.

Here is one real-world example: The Community's Bank is the only Minority-Owned bank in Connecticut. It has been awarded a U.S. Treasury Department Bank Enterprise Award in recognition of its success in lending in distressed areas of Bridgeport, Hartford and New Haven. Last year, because The Community's Bank is a member of the Network and offers CDARS, an affiliate of Fairfield-based General Electric, deposited $3 million in the $50 million-asset bank to support increased lending in Connecticut's urban centers. Such a deposit would not have been made but for the CDARS service.[11]

As other sources of credit decline in response to current economic conditions, credit demands on Community Development Banks and Minority-Owned banks are likely to grow significantly. To meet the credit needs of the communities they serve, these banks may have to grow significantly. Such growth makes the FDIC's proposed premium plan, with its inclusion of CDARS in the definition of a brokered deposit, problematic for these banks because one of the proposed rule's key measures for higher premiums for brokered deposits is rapid growth.[12]

Another example of the public benefits flowing from CDARS is the reliance on the service by local governments. Over the past five-and-a-half years, 22 states have enacted legislation to enable local governments to invest through CDARS. Public officials in six other states have issued legal or administrative interpretations to permit such investment. As a result, today, local government units in 40 states and the District of Columbia can invest through CDARS.

For local governments, CDARS has multiple benefits. CDARS eliminates the need to post and laboriously track collateral, thereby allowing banks to put the deposits to full use and to pay a more competitive interest rate. CDARS also allows public entities to make a substantial deposit through just one local institution, reducing the costs associated with managing funds across multiple institutions. Most important, CDARS enables local money to remain local, so

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[11] In the Winter 2004/2005 issue of its publication *Community Developments*, the Office of the Comptroller of the Currency reported that banks that are Community Development Financial Institution (CDFI)-certified by the Treasury Department's CDFI Fund "may earn Community Reinvestment Act credit for the investing bank."

[12] Dr. Flannery has pointed out the FDIC's definition of "rapid" asset growth in the proposal "would have included the average U.S. banking institution nearly every year since 1970." (Flannery, page 2.) He also noted that, "A 20% growth rate over four years corresponds to a compounded annual rate of 4.66%" and stated, "Indeed, the banking system's annual asset growth rate lay below 4.66% in only six individual years between 1970 and 2007." (Flannery, page 10.)

that a local government's money can go to work in its community as loans to individuals and institutions.

CDARS and Call Reports

Last, the Notice notes that Call Reports do not distinguish between CDARS deposits and traditional brokered deposits. To that point we quote from a letter dated September 17, 2008, to Chairman Sheila Bair from Edward L. Yingling, President and CEO of the American Bankers Association:

> *While the Call Report currently lacks a line item for CDARS reciprocal deposits, banks would likely support adding this item in order to provide the information needed to distinguish between these deposits and other liquidity sources that may raise higher risk concerns.*[13]

We can confirm that our CDARS members strongly support the addition of such a line item to the Call Report. So do we. Having a separate line for reciprocal deposits would recognize their very different role in a bank's funding picture. Alternatively, or in the interim before such modifications can be implemented, the CDARS Network is able to secure the authority from its members to assist in this process by giving the FDIC reports listing each bank's CDARS holdings and to have that data made public.

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In conclusion, for many reasons we urge the FDIC to exclude CDARS deposits from the Notice's definition of brokered deposits.

Thank you for your consideration of these comments.

Sincerely,

Eugene A. Ludwig
Chairman & CEO

Alan Blinder
Vice Chairman

Mark Jacobsen
President & COO

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[13] Letter from Edward L. Yingling, President and CEO, American Bankers Association to Sheila Bair, Chairman, Federal Deposit Insurance Corporation, September 17, 2008.

"Brokered" Deposits Received Through a Network of Depository Institutions on a Reciprocal Basis

Two comments on the FDIC's Notice of Proposed Rulemaking: Assessments; Proposed Rule; Establishment of FDIC Restoration Plan; Notice, *Federal Register*, October 16, 2008, pp. 61560 – 61597.

December 10, 2008

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Executive Summary

Brokered deposits can serve useful and prudent purposes at insured financial institutions. However, regulators also believe that brokered deposits raise potential problems. First, brokered deposits permit even a weak bank to expand rapidly and thereby (perhaps) to increase its risk exposure. Given the normal lags between on-site examinations, a rapidly-growing bank's risk profile could shift radically before supervisors become aware of the changes. The FDIC has identified banks whose failure was preceded by rapid asset growth funded with brokered deposits, and claims that such banks are more costly to resolve. Second, traditional brokered deposits are highly interest-sensitive and exhibit no tendency to remain with any particular institution. Unlike "core" deposits, therefore, a failed bank's brokered deposits cannot be sold to offset FDIC's cost of compensating depositors for their losses.

In order to refine its system of risk-based deposit insurance premia, FDIC proposes to introduce a new formula by which banks whose brokered deposits exceed 10% of their domestic deposit balances may confront higher insurance premia. Specifically, banks in the safest risk category (Risk Category I) would pay insurance premia in a range of 10 – 14 basis points per year. Within that range, institutions whose brokered deposit balances exceed 10% of their domestic deposits and whose 4-year asset growth exceeds 20% will pay higher insurance premia. FDIC further proposes that institutions in the three riskier categories (Risk Categories II, III, and IV) would pay a larger increment than the Risk Category I banks for brokered deposits in excess of 10% of domestic deposits, regardless of their recent asset growth rate.

A financial institution's brokered deposit balances are presently reported quarterly on the Call Reports, which rely upon a very broad definition of brokered deposits. This definition excludes some sorts of "hot money" (e.g. funds gathered over the Internet), and fails to differentiate between categories of brokered deposits whose economic properties make them substantially different sorts of funding.

Part I: Problems with the Definition of "Rapid Growth Funded by Brokered Deposits"

FDIC proposes to impose higher insurance premia on banking firms whose rapid asset expansions have been financed with brokered deposits. Toward this end, the Corporation specifies a numerical standard which, if exceeded, will have the effect of raising an institution's insurance premium. This numerical formula suffers from two conceptual problems: it does not explicitly link asset growth with increased brokered deposits, and its definition of "rapid" asset growth would have included the average U.S. banking institution nearly every year since 1970. The FDIC's goals would be better served by specifying a formula that explicitly links brokered deposit and asset expansions.

Part II: Reciprocal Deposit Placements Through a Network Do Not Pose the Same Threat to FDIC as Traditional Brokered Deposits and Should Not Be Treated the Same

The majority of brokered deposits arise when a financial institution sells a high-yielding CD to a distant customer through a third party. However, the Promontory Interfinancial Network has innovated a class of CDs that are exchanged on a <u>reciprocal</u> basis among Network member institutions. These reciprocal "Certificate of Deposit

Account Registry Service" (CDARS) deposits differ from traditional brokered deposits in two important dimensions. First, CDARS deposits cost less than traditional brokered deposits, suggesting that a banking relationship provides part of the compensation for those funds. Second, maturing CDARS deposits are very likely (> 75% of balances) to roll over into new CDs within the Promontory Network, much as core deposits are expected to remain with a bank even if its pricing falls somewhat behind that of its local competitors.

Current regulatory reports do not separate CDARS from a bank's other brokered deposits. Yet CDARS' economic characteristics indicate that they *should be* distinguished in any effort to price deposit insurance according to the FDIC's true risk exposure.

Introduction and Background

Prior to 1980, deposit rate ceilings effectively prevented smaller U.S. banking institutions from seeking deposits from customers outside a relatively confined market area. Rapid growth was difficult in most markets. Some areas suffered from credit shortages because the local economy could not provide enough deposit balances to meet the local credit demand.[1] In 1980, however, Congress passed the Depository Institutions Deregulation and Monetary Control Act (DIDMCA), which removed the rate ceilings on all time deposits. The freedom to pay high interest rates facilitated a bank's ability to attract deposits from outside its local market area. Deposit brokers had previously been relatively unimportant, but they expanded rapidly in the early 1980s to help satisfy some institutions' demands for loanable funds. Brokered deposits have been a source of regulatory concern ever since.

Brokered deposits can serve useful and prudent pourposes at an insured institution. Banks with a plethora of good lending opportunities can obtain loanable funds via brokered deposits, which presumably permits more efficient investments in the real economy. Depositors also benefit from brokered deposits by earning higher yields on their savings. However, regulators have also identified some threats to bank soundness. Brokered deposits permit even a weak bank to expand rapidly and thereby (perhaps) to increase the FDIC's risk exposure. Given the normal lags between on-site examinations, a bank's risk profile could shift radically before supervisors become aware of the changes. The FDIC has identified banks whose failure was preceded by rapid

[1] For example, California and other western states suffered from a shortage of mortgage funds in the 1960s. These institutions enjoyed deposit rate ceilings 25 bp higher than those applied in areas with more abundant loanable funds.

asset growth funded with brokered deposits, and claims that such banks are more costly to resolve. These higher insurance losses apparently derive from two main sources (FDIC (2008), page 61571).

1) An insured institution can expand very quickly by offering a higher deposit rate to brokered depositors, and rapid expansion is often linked with poor (or risky) asset choices that increase the probability of failure.[2] This connection between brokered deposits and asset growth clearly caused numerous problems during the 1980s' thrift crisis.

2) When an insured institution fails, a larger proportion of brokered deposits reduces the amount for which FDIC can sell the failed entity's branches and account relationships. Many depositors who deal with a bank through a deposit broker have no other relationship with the bank. Absent a strong customer relationship, such deposit balances are weakly tied to the bank and will remain only if they receive high rates of interest. These weaker customer relationships reduce the amount for which FDIC can sell a failed bank's branches or branch network. Given two banks of equal deposit size, it will therefore cost FDIC more to pay off the one with a higher proportion of traditional brokered deposit balances.

FDIC further suggests that brokered deposits are inferior to local, "core" deposit balances in providing liquidity:

> When an institution becomes noticeably weaker or its capital declines, the market or statutory restrictions may limit its ability to attract, renew or roll

[2] Language in the FDIC's recent NPR clearly reflects the Corporation's concern:

> A number of costly institution failures, including some recent failures, have experienced rapid asset growth before failure and have funded this growth through brokered deposits. (FDIC (2008), page 61656, emphasis added)

> over these deposits, which can create significant liquidity challenges. (FDIC (2008), page 61571)

In other words, FDIC fears that "hot money" will flee at the first hint of trouble, compounding an institution's difficulties.

Early regulatory concerns about undue reliance on brokered deposits were addressed in the Federal Deposit Insurance Corporation Improvement Act (FDICIA, *12 U.S.C. 1831f*). Section 29 states that

> An insured depository institution that is not well capitalized may not accept funds obtained, directly or indirectly, by or through any deposit broker for deposit into 1 or more deposit accounts. (section (a)). [3]

Strong banks are thus permitted to use brokered deposits, while weaker institutions – for whom rapid growth might be particularly risky – may not.[4] (FDICIA's Section 29(c) permits the FDIC to waive this restriction on a case-by-case basis.)

Although FDICIA may have mitigated regulatory concerns about brokered deposits, a recent Notice of Proposed Rulemaking from FDIC ((*Federal Register* Vol. 72, No. 201, page 61560) indicates that such concerns have not been eliminated. In addition to raising the level of risk-based insurance premia, this proposal introduces a new formula by which banks whose brokered deposits exceed 10% of their domestic deposit balances may confront higher insurance premia. Specifically, banks in the safest risk category (Risk Category I) would pay insurance premia in a range of 10 – 14 basis points per year. Within that range, institutions whose brokered deposit balances exceed 10% of their domestic deposits and whose 4-year asset growth exceeds 20% will pay higher

[3] Section (a) also provides the Call Reports' flawed definition of "brokered deposits." See also 12 CFR §337.6(a)(2).

[4] As a component of prompt corrective action (PCA), Section 38 of FDICIA prohibits adequately capitalized banks from paying deposit rates substantially exceeding those on regional or national market areas. Undercapitalized banks may not issue or renew brokered deposits.

insurance premia. FDIC proposes that the relatively few institutions in the three lowest Risk Categories (Risk Categories II, III, and IV) would pay a larger increment than the Risk Category I banks for brokered deposits in excess of 10% of domestic deposits, regardless of their recent asset growth rate (FDIC (2008), page 61570).[5]

This Comment evaluates two dimensions of the FDIC's recent NPR.

1) Does the proposal properly account for asset growth funded by brokered deposits? In other words, will FDIC's proposed formula accurately "capture brokered deposits (in excess of 10 percent of domestic deposits) that are used to fund rapid asset growth."? (FDIC (2008), page 61563, emphasis added)

2) Does the proposal rely on an accurate definition of "brokered deposits"? Does the current definition of brokered deposits inappropriately combine deposit types with very different economic characteristics?

I argue here that the answer to both of these questions is in the negative.

[5] This additional indicator of risk would become part of the "financial ratios method" of computing risk-based insurance premia.

Part I: Problems with the Definition of "Rapid Growth" Funded by Brokered Deposits

Abstract

FDIC proposes to impose higher insurance premia on banking firms whose rapid asset expansions have been financed with brokered deposits. Toward this end, the Corporation specifies a numerical standard which, if exceeded, will have the effect of raising an institution's insurance premium. This numerical formula suffers from two conceptual problems: it does not explicitly link asset growth with increased brokered deposits, and it uses an historically restrictive measure of "rapid" asset growth. The FDIC's goals would be better served by specifying a formula that explicitly links brokered deposit and asset expansions.

The FDIC's NPR (FDIC (2008)) proposes to charge a higher insurance premium for certain banks that use brokered deposits. Although the evidence indicates that some banks have failed after a period of rapid asset growth financed with brokered deposits, the proposed rule does not effectively identify these risks. Rather, the proposed rule suffers from two conceptual problems. First, the proposal does not explicitly require that rapid asset growth be funded with brokered deposits. Second, it utilizes an overly restrictive measure of "rapid asset growth."

As a result, the FDIC's proposed rule classifies as risky many banks that use brokered deposits for legitimate purposes, while missing some banks that may be growing rapidly in a risky manner.

I-1. Linking Brokered Deposits to Asset Growth

The proposed rule for identifying banks at which brokered deposits pose additional risk to the FDIC insurance fund does not identify institutions that have grown

rapidly through brokered deposits. Rather, it singles out firms with "rapid" asset growth whose current level of domestic deposits includes more than 10% brokered balances. Several specific examples of asset and deposit growth illustrate the vagaries of the proposed criteria. (Note that the equity account is not explicitly discussed in the following examples, in order to focus on the proposed insurance premium implications.)

	Four Years Ago			***Currently***		
	Assets	**Local deposits**	**Brokered deposits**	**Assets**	**Local deposits**	**Brokered deposits**
Case 1	100	65	25	200	165	25
Case 2	100	65	25	200	130	50
Case 3	100	80	10	200	80	110

Case 1: Rapid asset growth is funded exclusively by additions to the bank's stock of local deposits balances. The asset growth (100% over 4 years) and ending level of brokered deposits (25/190 = 13.2%) would raise this institution's deposit insurance premium. However, the funding changes in ***Case 1*** probably leave the bank safer than it was four years ago.

Case 2: Rapid asset growth is funded proportionally by local and brokered deposits. The proportion of brokered deposits remains unchanged at 38.5%. Although this proportion is high, the risk associated with recent growth is not obviously greater than the risk in place four years ago.

Case 3: Rapid asset growth (100% over four years) is funded entirely by additional brokered deposits. This is clearly the sort of growth FDIC proposal seeks to identify. The brokered deposit rate rises from 11.1% to 57.9%. The FDIC's

> statistical analysis cites this pattern as dangerous, and its logic justifies a higher insurance premium for this sort of institution.[6]

In summary, the proposed rule for identifying banks that pose additional risk to the FDIC is too coarse. In addition to identifying legitimate causes for concern, the proposed rule will capture (many) firms with healthy growth patterns and charge them inappropriately higher insurance premia.

A better rule would identify depository institutions that had rapid asset growth funded by an increase in brokered deposit balances.

I.2. Definition of "Rapid" Asset Growth

The Proposal defines "rapid" asset growth as "total assets … more than 20 percent greater than they had been four years previously, after adjusting for mergers and acquisitions." (FDIC (2008), page 61565) A 20% growth rate over 4 years corresponds to a compounded annual rate of 4.66%. How unusual is this rate of growth? Figure 1 plots the average annual growth rates of total U.S. bank assets for each (overlapping) 4-year period from 1970 to 2007. The banking system's 4-year average asset growth rate fell below 4.66% for only 5 of these 38 intervals. Indeed, the banking system's annual asset growth rate lay below 4.66% in only six individual years between 1970 and 2007.

[6] It is important to note, however, that this bank could easily have sound reasons – serving local credit needs -- for expanding local loans via brokered deposits.

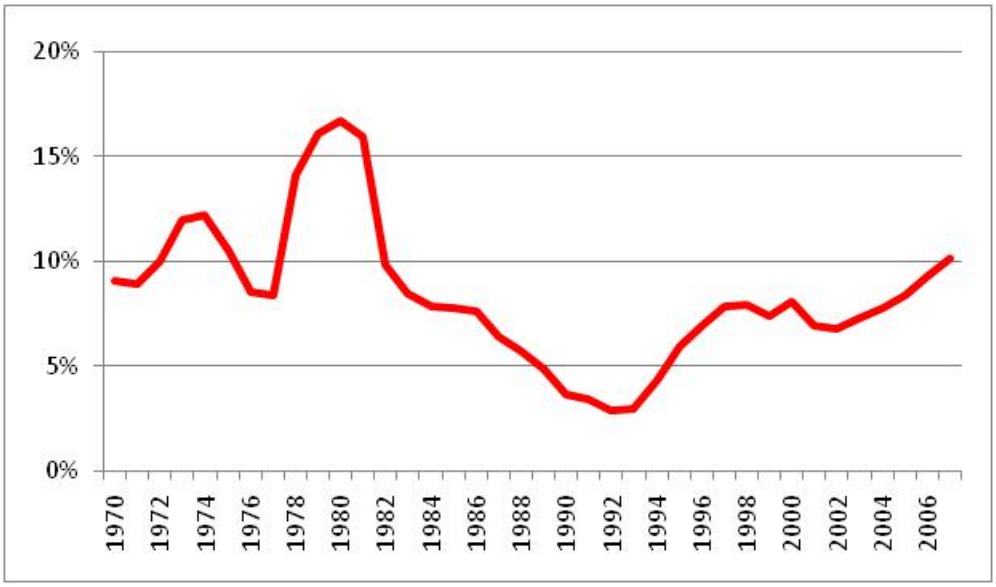

Figure 1: 4-year Average Annual Deposit Growth Rate

Source: Federal Deposit Insurance Corporation, Table CB09

It thus appears that "20% over four years" is much too low a criterion for "rapid" asset growth if the FDIC seeks to identify banks that have grown so quickly that their asset quality is suspect.

I.3. Conclusions Regarding the Definition of Rapid Growth using Brokered Deposits

The FDIC's proposed rule for incorporating brokered deposits into insurance premia does not reflect the Corporation's main concerns about rapid expansion funded with brokered deposits. The Proposal should be revised to identify institutions at which brokered deposit balances were actually used to finance rapid asset growth. Furthermore, the definition of "rapid" asset growth should be higher than the proposed 20% over the most recent 4 years. Finally, the proposal uses a questionable definition of "brokered

deposits (based on the Call Report), which excludes high-rate, interest-sensitive balances collected directly by an institution, for example via the Internet.

Part II: Reciprocal Deposits Received Through a Network Differ from Traditional Brokered Deposits and Pose Less Risk

Abstract

Although the majority of brokered deposits are arranged as one-sided transactions, the Promontory Interfinancial Network has a class of CDs that are exchanged on a reciprocal basis among Network member institution. These reciprocal "Certificate of Deposit Account Registry Service" (CDARS) deposits differ from traditional brokered deposits in two related dimensions. First CDARS deposits earn substantially lower interest rates, suggesting that a banking relationship provides part of the compensation for those funds. Second, maturing CDARS deposits are very likely (> 75% of balances) to roll over into new CDs within the Promontory Network. CDARS' economic characteristics indicate that they should be distinguished in any effort to price deposit insurance according to the FDIC's true risk exposure.

II.1. Not All "Brokered Deposits" are the Same

The FDIC wishes to charge higher premia to banks that gather substantial deposits from outside their normal market area by paying relatively high interest rates to attract interest-sensitive depositors. Weak or rapidly-growing banks constitute particular threats to FDIC reserves if they circumvent the usual forms of market discipline by bidding for fully-insured deposits. Yet the current definition of "brokered deposits" suffers from two conceptual flaws. The Call Report's definition is *incomplete* because it omits deposits gathered by advertising directly for out-of-market balances, e.g. via the Internet. The definition of brokered deposits is *over-inclusive* because it lumps together two quite distinct sorts of brokerage arrangements:

a) deposits secured from non-customers through a broker

versus

b) "deposits received through a network on a reciprocal basis" (FDIC (2008), p. 61579).

This second category includes the CDARS program operated by Promontory Interfinancial Network, LLC (the "Promontory Network"). The FDIC's recent NPR specifically asks:

> Should deposits received through a network on a reciprocal basis that meet the statutory definition of brokered deposits be excluded from the definition of brokered deposits for purposes of the adjusted brokered deposit rate or the brokered deposit adjustment? (FDIC (2008), page 61579),

Yes, they should.

II.2. What is CDARS Reciprocal?

The Promontory Network operates a weekly matching process, in which its client institutions exchange CD funds in increments below the FDIC insurance limit. For example, suppose that "Bank 1" has a customer wishing to deposit $900,000 into ten CD accounts of $90,000 each, so that her entire investment is FDIC insured.[7] The banker and his customer negotiate an acceptable maturity and interest rate for the entire balance. "Bank 1" probably issues one of the CDs on its own, and then contacts Promontory to request that nine other member banks each accept a $90,000 deposit from its customer at the agreed interest rate. In turn, "Bank 1" will receive $810,000 in deposits (of the same maturity) from the customers of other Network banks – in addition to the $90,000 CD it sells to its own customer. If the rate negotiated by "Bank 1" for its customer's nine exported CDs differs from the average rate it is required to pay on the imported funds, the

[7] Because the insured deposit is set to $250,000 only temporarily, I have constructed this example as if the limit is $100,000.

present value of the difference in interest payments will be exchanged when the transaction is booked.

Several features distinguish CDARS Reciprocal deposits from other types of brokered deposit solicitations. First, "Bank 1" negotiates a deposit rate that becomes its own effective cost of $900,000 in new deposit balances. The banker therefore pays a rate that reflects local market competition, not necessarily the nationwide competition that is accessible through traditional deposit brokers or over the Internet.[8] Second, "Bank 1" receives a deposit inflow equal to the initial customer's full $900,000. Loanable funds can thus remain in the community from which they originate, provided there is demand for them. Finally, the initial customer interacts only with "Bank 1" and receives the convenience of a single statement (and tax reporting) for multiple accounts. The depositing customer might be entirely new to "Bank 1", which therefore has an opportunity to cross-sell other services. In addition, a bank can use CDARS transactions to strengthen its relationship with pre-existing customers.

II.3. The Economics of CDARS Reciprocal Balances

Brokered deposits permit a bank to attract funds quickly from rate-sensitive investors who have no other relationship with the bank. In the absence of a valuable relationship, brokered deposits will tend to be expensive and the investors will quickly move to another institution if offered a higher rate. CDARS Reciprocal balances differ from typical brokered deposits in both these dimensions.

[8] Promontory data indicate that more than half of the member institutions obtain effectively all their CDARS deposits from customers who live within 25 miles of a branch office.

The Cost of CDARS Funds

The economic differences between CDARS Reciprocal and traditional brokered deposits are clearly reflected in the cost of funds. Figures 2 – 4 plot weekly CD rates and the yield on the matching constant maturity Treasury.[9] The Treasury maturities (3-month, 6-month and 1-year) differ only trivially from the CDARS CD maturities. All three graphs tell the same story: at all maturities, the median brokered CD rate almost always exceeded the weighted CDARS average rate between mid-2006 and November 2008. The weighted CDARS rate approximately coincided with the Treasury rate through mid-2007. As the subprime crisis began to unfold in August of 2007, however, investors' fled to the certainty offered by treasury securities. Treasury rates therefore dropped substantially, while private-sector borrowing rates fell less dramatically. In Figures 2 - 4, this development manifests itself in the CDARS and brokered deposit rates substantially exceeding treasury rates at all three maturities after the middle of 2007.

[9] Data provided by the Promontory Interfinancial Network, LLC. Brokered CD rates are the median "all-in" cost of funds available during the week. The all-in cost reflects both the coupon paid to the customer and the broker dealer mark-up to the bank. These data were gathered over several years from publicly available sources. CDARS rates reflect the initiating banker's cost of CD funds acquired, including the CDARS Reciprocal transaction fee, and are directly comparable to the brokered CD rates.

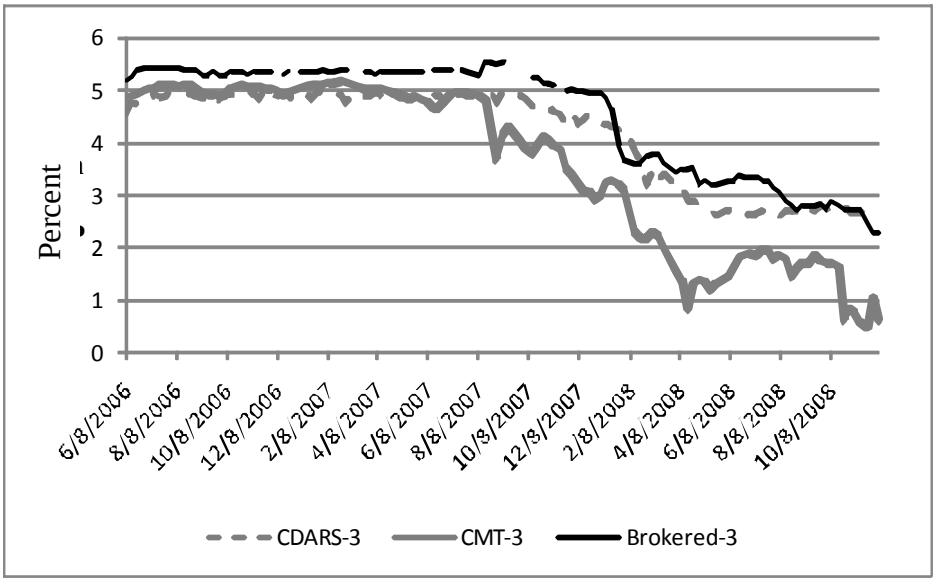

Figure 2: CD and Treasury Rates, 3-month Maturity

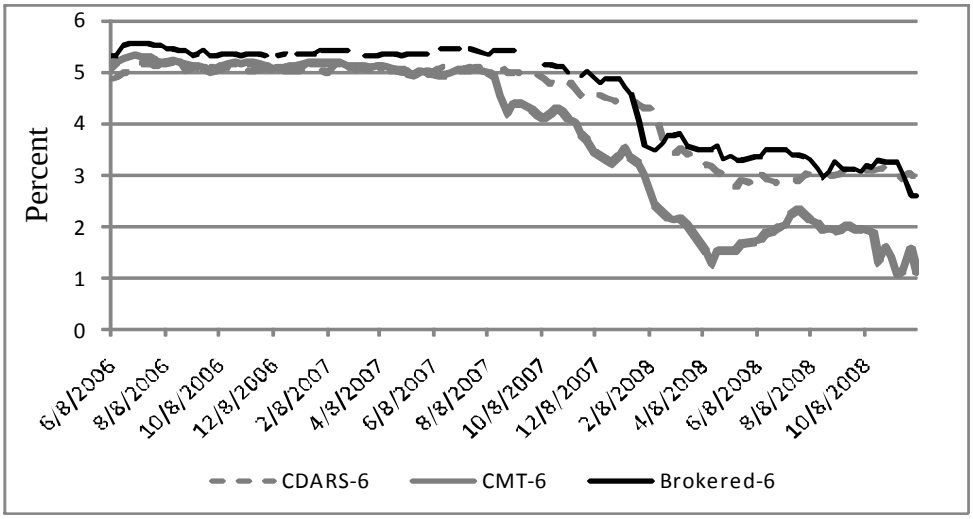

Figure 3: CD and Treasury Rates, 6-month Maturity

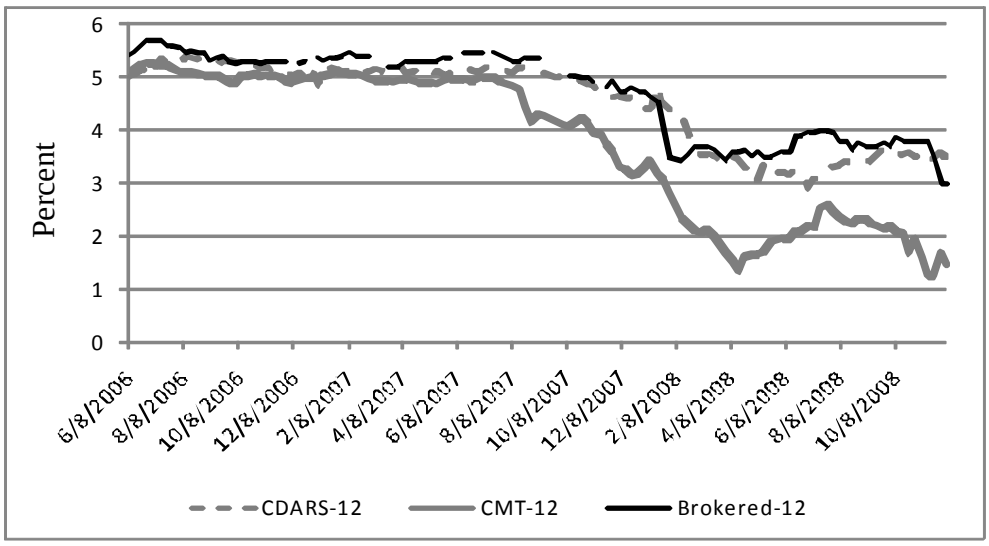

Figure 4: CD and Treasury Rates, 12-month Maturity

Figures 5 - 7 plot the *differential* between CDARS rates and the corresponding-maturity treasury rate or the corresponding-maturity brokered CD rate. The differences between CDARS Reciprocal and brokered deposit rates are mostly negative, indicating (again) that brokered deposit rates nearly always exceeded CDARS rates.

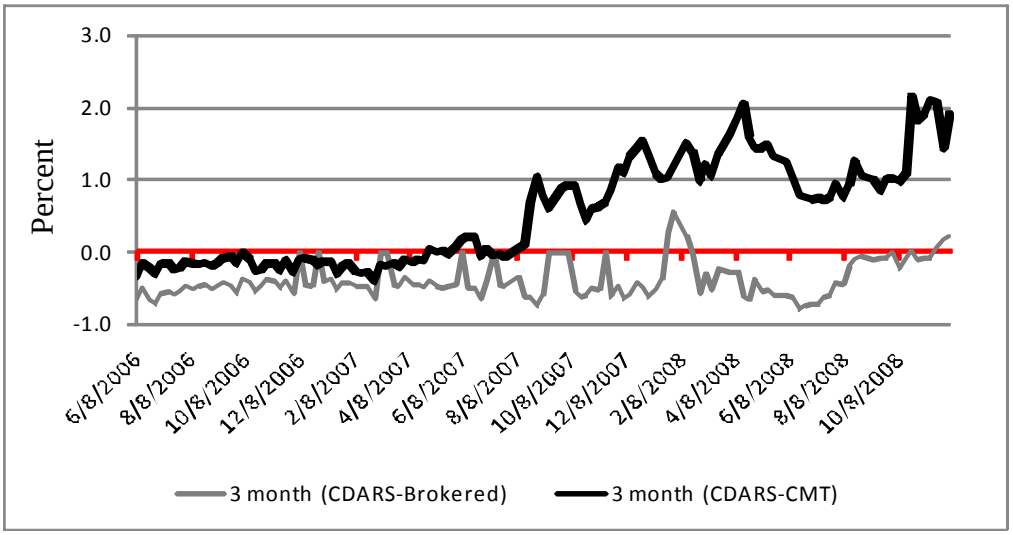

Figure 5: CDARS Rate Differentials, 3-month Maturity

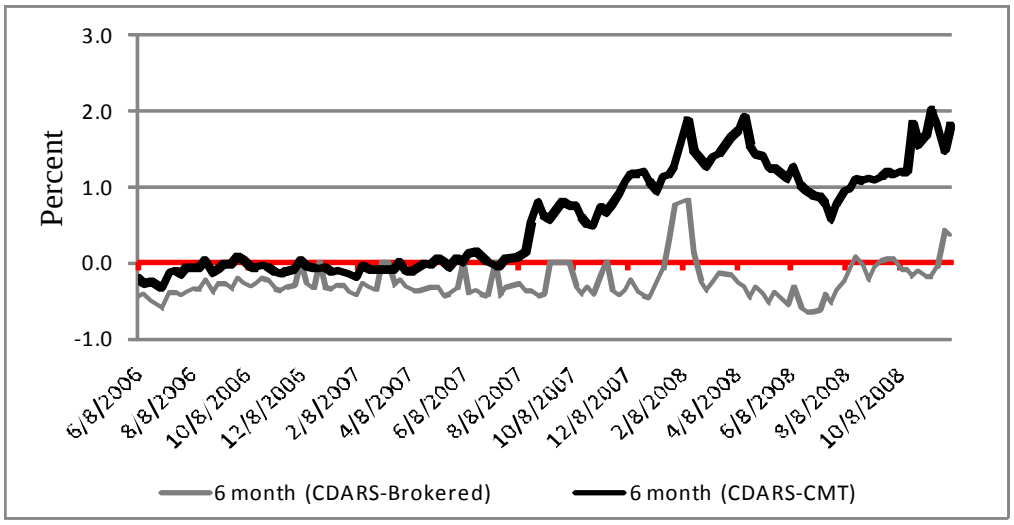

Figure 6: CDARS Rate Differentials, 6-month Maturity

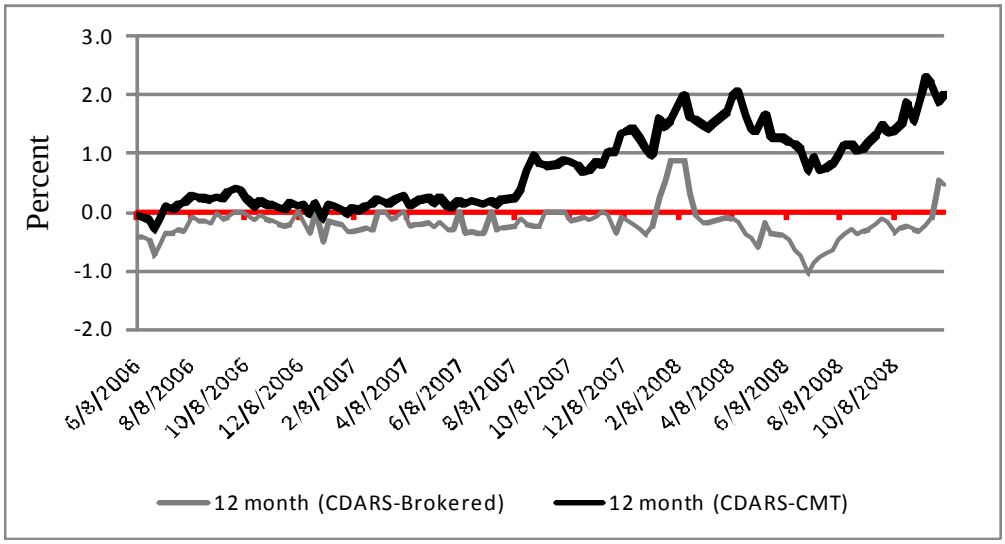

Figure 7: CDARS Rate Differentials, 12-month Maturity

Further information is provided in Table 1, which reports differences between brokered CD rates and the all-in CDARS Reciprocal rates for various calendar periods. For 3-month CDs, the typical brokered deposit rate exceeded the CDARS rate by an average of about 42 bp over the period June 2006 – October 2008. In 2007, the mean difference was

51.4 bp. In 2008, it was 27.7 bp. The parenthesized numbers in each cell indicate the proportion of

Table 1: Mean Excess of Brokered CD Rates Over CDARS Rates, measured in basis points			
	3-month CD Maturity	6-month CD Maturity	12-month CD Maturity
June 2006 – October 2008	42.4 (94.0%)	28.0 (91.4%)	23.2 (92.2%)
Calendar 2007	51.4 (100%)	35.3 (100%)	23.3 (97.7%)
Calendar 2008	27.7 (84.1%)	16.4 (77.3%)	23.1 (84.1%)

weeks for which the brokered CD rate exceeded the CDARS rate: 94% in the overall period, 100% during 2007, and 84.1% during 2008 (through October). Similar patterns occur for the 6-month and 12-month maturities.

These pricing results are consistent with bankers negotiating CD rates that reflect local competition and customer relationships, rather than trying to match the highest rates available in a national market. Recall that most CDARS depositors live within 25 miles of the bank handling their CDARS deposits. Without valuable customer relationships, investors providing CDARS funds could earn the higher rates associated with national deposit brokers or the Internet.

Supply Reliability: CDARS Re-Investment Rates

"Core deposits" are valued because a bank can expect to retain loanable funds without being forced to meet market rate fluctuations on a continuous basis. The

propensity for CD customers to roll over their certificates thus provides some information about the deposits' relationship value.

Promontory computes a reinvestment rate for all maturing CDARS deposits. Using each customer's tax ID number, Promontory determines whether the owner of a maturing CD re-deposits less than or equal to the matured amount at the same match or any of the subsequent four weekly matches. (Any CD maturity purchased by a maturing investor counts as "re-invested".) Figure 8 plots this re-investment rate for the sum of 3, 6, and 12-month maturing CDs. The reinvestment proportion varies between 62.4% and 85.1%, averaging 76.4% over the full sample period. Clearly, CDARS investors are very likely to purchase another CD within four weeks of having one mature, manifesting a "stickiness" commonly associated with core deposits.[10]

[10] CDARS Reciprocal transactions constituted 81 percent of the Network's dollar volume during October 2008. Further confirmation that CDARS balances reflect customer relationship effects comes from analyzing the other Promontory Network insured CD product, called One-Way Buys (Sells). These transactions resemble more traditional brokered deposits. Unreported calculations indicate that these balances are more expensive than CDARS balances, and that they are less likely to be reinvested within the Promontory Network upon maturity.

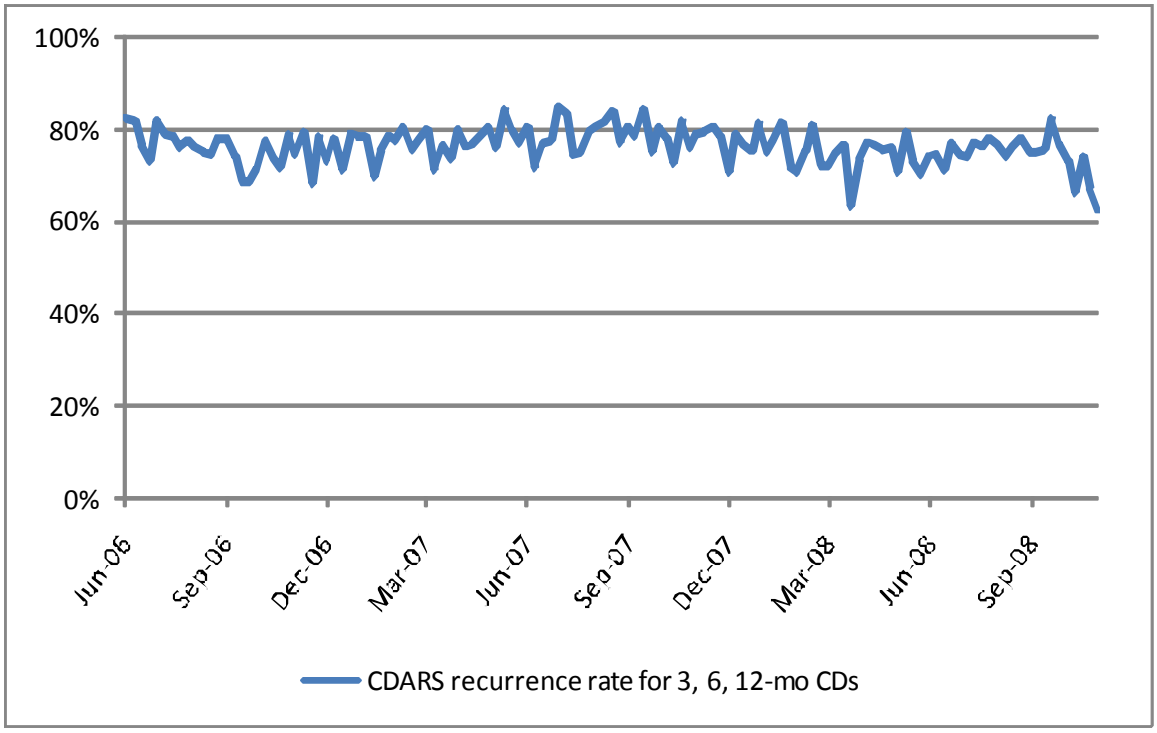

Figure 8: CDARS Reinvestment Rates, Aggregate of 3, 6, and 12-month Maturities

II.4. Conclusions Regarding the Differences between CDARS Reciprocal and Traditional Brokered Deposits

Traditional brokered deposits pose potential risks to the FDIC because banks can grow quickly by paying high, nationally-competitive rates to attract new CD balances. These CDs are relatively expensive and provide no customer relationship value to the issuing banks. Accordingly, failed institutions with a large proportion of brokered deposits cost FDIC more to resolve.

CDARS Reciprocal deposits contrast with traditional brokered deposits in all these dimensions. They are cheaper than brokered deposits because a local banker negotiates rate and maturity with his customer on the basis of local market conditions. Indeed, until the onset of the subprime financial crisis, the average CDARS balance paid no more than the rate on similar-maturity Treasury bills. These balances are obtained primarily from savers who live within 25 miles of the bank they use to access the

Promontory Network. Consistent with the nature of core deposits (as opposed to "hot money"), the retention rate for CDARS deposits is also very high: more than three-quarters of maturing CDs have been re-invested within the Promontory Network, presumably through the same local institution. Current regulatory reporting standards do not differentiate between traditional brokered CDs and CDARS Reciprocal balances. However, since CDARS Reciprocal deposits behave more like core deposits than like nationally-brokered deposits, they should be distinguished from standard brokered deposits when computing risk-based insurance premia.

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