E. J. Ourso School of Business

Louisiana State University
2164-A Patrick F. Taylor Hall
Baton Rouge, LA 70803

January 3, 2011

Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20420
RIN 3064–AD66

Comment on Proposed Changes to 12 CFR Part 327 - RIN 3064-AD66, Assessments, Large Bank Pricing NPR

Dear Mr. Feldman:

The FDIC is proposing to substantially increase the incremental cost of brokered funding by 25% or more in today's rate environment. Unfortunately, that increase is occurring at a crucial time in the economic recovery when banks are in dire need of funding to make investments in firms and industries that can create the economic value that is the basis for growth. Moreover, the effects hit squarely upon the sector of the deposit funding industry that can most effectively distinguish those banks in today's marketplace that can efficiently intermediate lending in recovering markets from those that continue to lag. Hence, the FDIC's brokered deposit assessment will place unnecessary constraints on U.S. economic growth at a crucial juncture in the recovery with potentially debilitating effects.

Modern macroeconomics and monetary theory ascribes particular importance to the role of financial intermediation in economic recoveries. The idea of the "credit channel problem" impeding recovery is that banks, uncertain of borrower conditions, are reluctant to lend. Of course, the problem is endemic in the entire financial system, not just banks. Depositors, too, – uncertain of bank conditions – are unwilling to put funds into the banking system and without funding, banks – even sound banks – cannot hope to supply credit.

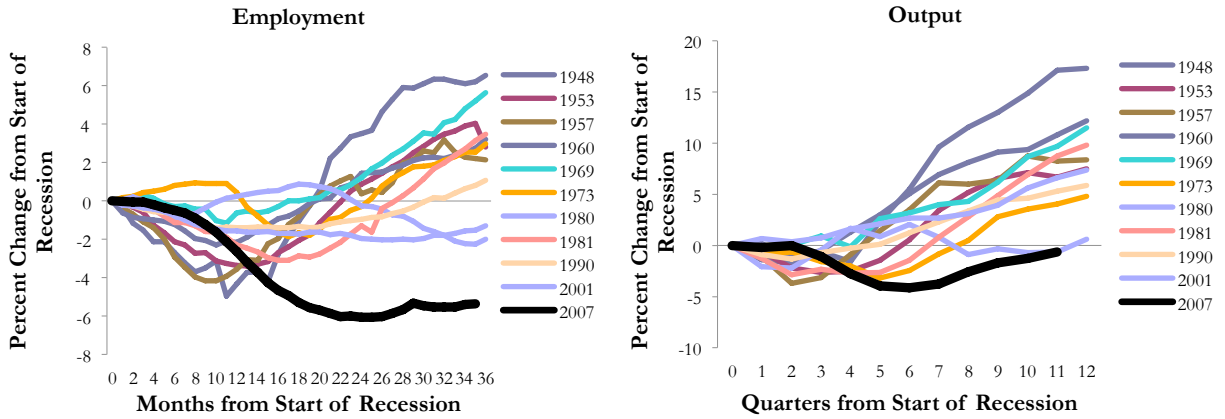
Today, therefore, we find ourselves confronted with classic issues of credit channel disruptions that may prolong recovery from the recent recession and financial crisis. In such an environment, it is important to stimulate deposit funding to help banks create credit. Brokered deposits work at this

stage of the recovery to allocate funds to banks that can best fund credit creation and economic growth.

The distinction between recession and recovery is an important one. While the recession may be over, recovery is not yet at hand. To illustrate the distinction, while the recession phase of the Great Depression ended in March 1933 recovery to pre-recession GDP levels cannot be said to have occurred until roughly 1940.

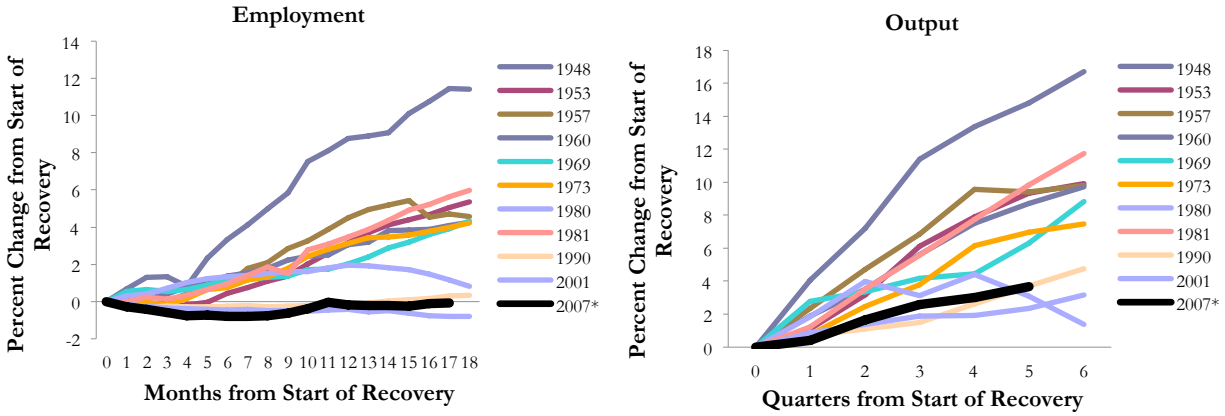
Moreover, recovery from the most recent recession is taking longer than those of other post-WWII recessions. Figure 1 illustrates just how employment and output growth remain suppressed three years after the onset of the recession.

Figure 1a: Post-WWII U.S. Recessions, Three-year horizon



http://www.minneapolisfed.org/publications_papers/studies/recession_perspective/

Figure 1b: Post-WWII U.S. Recoveries, Three-year horizon



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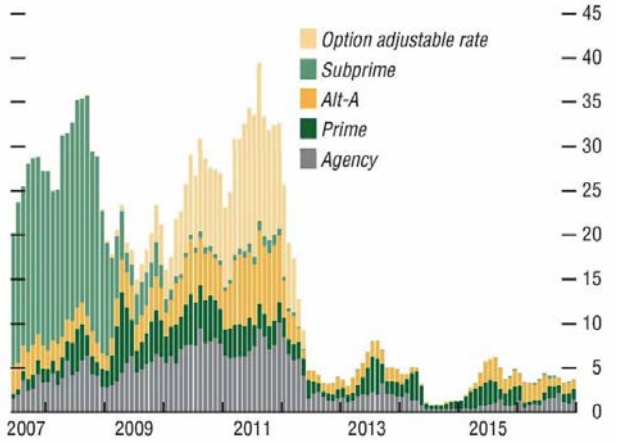
A variety of different measures suggest recovery from the present crisis and recession may take considerable time. According to S&P, "All of the recent recoveries from U.S. recessions have been

"jobless recoveries," and this is no exception."[1] Even without employment pressures, employment recovery would still take a long time. Extrapolating peak job growth rates from the bubble era results in a return to pre-crisis employment levels only in 2017.[2] In summary, S&P maintains, "The incoming data have shown that the economy is growing, but at a sluggish pace, supporting our early views that this is likely to be a half-speed recovery."[3]

While some may be tempted to downplay those extrapolations, it is important to remember that mortgage foreclosures are expected to remain elevated for some time, even if they have recently peaked. According to Credit Suisse, while subprime loan problems are largely behind us Option Adjustable ARM mortgages – a particularly toxic mortgage product – and Alt-A and Agency mortgage rate resets (the time at which payment stress is the greatest) are expected to peak in 2011-2012.

Figure 2: Monthly Mortgage Rate Resets (First Reset in Billions of U.S. Dollars)

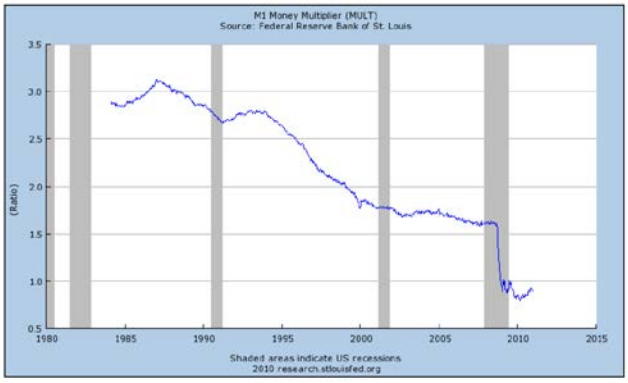


Credit Suisse, 2008

As a result of such pressures, money multipliers remain at historic lows. The M1 money multiplier recently fell as low as 0.90, suggesting that each dollar of deposits presently creates *less* than a dollar of loans.

[1] Standard & Poor's U.S. Structured Finance 2010 Midyear Outlook, June 29, 2010, at http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245215139472.
[2] James W. Hughes and Joseph J. Seneca, "America's New Post-Recession Employment Arithmetic," Advance & Rutgers Report, Issue Paper Number 1, September 2009.
[3] Standard & Poor's U.S. Structured Finance 2010 Midyear Outlook, June 29, 2010, at http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245215139472.

Figure 3: M1 Money Multiplier, 1980-2010



http://research.stlouisfed.org/fred2/series/MULT

So while the recession may have technically ended in June 2009, recovery may still be a long way off. Moreover, restoring the multiplier to values even simply above one will take improvements to aggregate financial intermediation efficiency that can be augmented through bank regulatory policy. While brokered deposit policy can be part of that policy a blanket assessment surcharge will almost certainly cut the wrong way, impeding recovery and growth at precisely the time when we need funds most efficiently motivated in the U.S. economy.

I. Macroeconomic Theories of the Role of Banks in Business Cycle Persistence

Macroeconomic and monetary theory supports this view. The majority of macroeconomic and monetary theory focuses on business cycle turning points, particularly recessionary turning points. NBER phases are referred to as recession and growth. But recovery – and therefore persistence – remains elusive, defying an NBER definition. Far less literature, therefore, has focused on recovery from recessions, also referred to as business cycle persistence.

The primary reasons are twofold. First, rather than a single turning point persistence requires measuring the duration of recovery. But recovery, *per se*, is not the entire NBER growth phase. Some mark recovery as a return to trend economic growth. Some as a return to a *moving average* economic growth measure. Others, to resumption of nominal or real GDP or employment. Hence, recovery is a hard concept to pin down and therefore remains at the edge of macroeconomic theory.

Moreover, economic growth – in both recovery and beyond – is generally viewed by policymakers as a good thing. Of course, such a perspective ignores the *rate* of growth (as well as its base). Prolonged periods of low growth are not good, nor are prolonged periods of overly high growth. Hence, even growth-based economic policy targets are problematic, although somewhat less so than targets toward persistence.

As a result, business cycle persistence is the subject of some of the most important macroeconomic research. Much of that literature builds upon lessons from the US Great Depression, one of the most persistent recessions in modern history.

Bernanke (1983), for instance, proposed that the bank credit channel was an important factor in prolonging recovery from the Great Depression.[4] Of course, measuring the credit channel was problematic. Bernanke tried several different proxies, including the growth rate on bank loans, the difference between Baa rated corporate bond yield and US Treasury Bonds, and the number of bank failures and amount of deposits in failed banks.

Since Bernanke (1983), the credit channel has received a great deal of attention and been the focus of strong debate. Some like Glenn Hubbard (1995) and Valerie Ramey (1993) find weak empirical support for the construct using proxies like total bank loans, bank holdings of securities relative to loans, and the difference in the growth rate of short-term debt of small and large firms for the availability of bank credit or Bernanke's "Cost of Credit Intermediation."[5]

Still Bernanke and Gertler (1995) and others maintain that testing the empirical relevance of the credit channel requires more than just credit aggregates.[6] That point was made in Bernanke's (1983) paper, where he maintained that "As a matter of theory, the duration of the credit channel effects… depends on the amount of time it takes to 1) Establish new or revive old channels of credit flow after a major disruption, or 2) rehabilitate insolvent debtors. Since these processes may be slow, the persistence of nonmonetary effects of financial crisis has a plausible basis. (In contrast, the persistence of purely monetary effects relies on the slow diffusion of information or unexplained stickiness of wages or prices.)"

In reality, the debate has lingered since during and after the Great Depression, when several historically important surveys were conducted in attempts to establish whether the credit channel problem arose from a reluctance of banks to lend or a reluctance of firms to borrow. Among those, Kimmel (1939)[7] and Hardy and Viner (1935)[8] found mixed evidence. While some banks were certainly reluctant to lend, significant numbers of businesses had no desire to borrow. Moreover, those businesses that expressed a desire to borrow and were rejected often sought funds to stave off bankruptcy rather than expand business activity, which is rarely a worthwhile credit proposition for a bank nor, many times, long-term economic growth.

My own research supports a credit channel theory based on the scarcity of bank capital. As long as significant bank assets remain unresolved recovery remains slow. Mason (2005) shows the theoretical effect and empirically tests the dynamic using data from bank resolutions following the

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[4] Bernanke, Ben S., "Non-Monetary Effects of the Financial Crisis in the Propagation of the Great Depression," *The American Economic Review*, Vol. 73, No. 3, June 1983, pp. 257-276.
[5] Hubbard, R. Glenn, "Is There a 'Credit Channel' for Monetary Policy?" *Federal Reserve Bank of St. Louis Review*, Vol. 77, No. 3, May/June 1995, pp. 63-77; Ramey, Valerie, "How Important is the Credit Channel in the Transmission of Monetary Policy?" *Carnegie-Rochester Conference Series on Public Policy*, December 1993, pp. 1-45.
[6] Bernanke, Ben S., and Mark Gertler, "Inside the Black Box: The Credit Channel of Monetary Policy Transmission," *Journal of Economic Perspectives*, Vol. 9, No. 4, Fall 1995, pp. 27-48.
[7] Kimmel, Louis H, "The Availability of Bank Credit 1933-1938," New York: *The Conference Board*, 1939.
[8] Hardy, Charles Oscar, and Jacob Viner, "Report on the Availability of Bank Credit in the Seventh Federal Reserve District," *Federal Reserve Bank of Chicago*, 1935.

1991 recession.[9] Anari, Kolari, and Mason (2005) show the aggregate effect in a Bernanke (1983)-type specification in the Great Depression. Both show that failed bank asset resolutions are an important element of the credit channel.[10]

The results of Mason (2005) and Ali, Kolari, and Mason (2005) can be reflected back to the original Bernanke (1983) as well as work in asymmetric information by Akerlof (1973).[11] Bernanke (1983) originally described his theoretical approach in terms of a classic bank intermediation mechanism, which is well-accepted in today's economic literature. Suppose that banks "…specialize in making loans to small idiosyncratic borrowers whose liabilities are too few in number to be publicly traded." The small borrowers can be of two types, "good" and "bad." "Good borrowers desire loans in order to undertake individual-specific investment projects. These projects generate a random return from a distribution whose mean will be assumed always to exceed the social opportunity cost of investment. If this risk is nonsystematic, lending to good borrowers is socially desirable. Bad borrowers try to look like good borrowers, but they have no "project." Bad borrowers are assumed to squander any loan received in profligate consumption, then to default. Loans to bad borrowers are socially undesirable." (at 263)

In short, credit intermediation is costly. Bernanke's work characterized credit channel interruptions as an increase in the "Cost of Credit Intermediation," or the cost of separating the good and bad borrowers in his model. Mason (2005) and Ali, Kolari, and Mason (2005) further point out that when bank assets are available for purchase from assets in resolution, going concern banks often find it cheaper to purchase old loans – whose costs of intermediation are at least partially borne, already – rather than originate new loans.

Hence, there is a two-pronged problem in recovering from financial crises that hampers the credit channel's ability to generate economic growth. First, banks need sufficient funds to intermediate credit at higher post-crisis costs. Second, banks need funds to absorb existing good loans from failed banks that can be intermediated at lower cost than new loans.

So the idea of the credit channel is that banks, uncertain of borrower conditions and unable to pay higher costs to separate good from bad borrowers, are reluctant to lend. Of course, the problem is endemic in the entire financial system, not just banks. Depositors – uncertain of bank conditions – are unwilling to lend funds into the banking system. Without funding, banks cannot hope to supply credit to fuel economic recovery.

When funds injected into the banking system are held back from investment by either depositors or banks, the money multiplier falls. Hence, we have seen the money multiplier in Figure 3 above fall from over 3.0x to about 0.75x over recent decades, and from about 1.6x to 0.75x in the recent crisis alone.

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[9] Mason, J., "A Real Options Approach to Bankruptcy Costs: Evidence from Failed Commercial Banks during the1990s," *Journal of Business*, Vol. 79, No. 3, July 2005, pp. 1523-1553.
[10] Anari, A., J. Kolari, and J. Mason, "Bank Asset Liquidation and the Propagation of the Great Depression," *Journal of Money, Credit, and Banking*, Vol. 37, No. 4, August 2005, pp. 753-773.
[11] Akerlof, George A, "The Demand for Money: A General-Equilibrium Inventory-Theoretic Approach," *Review of Economic Studies*, Blackwell Publishing, Vol. 40, No. 1, 1973, pp. 115-130.

The main problem in the post-crisis economy is therefore bank and borrower heterogeneity. Systemic crises – by definition – are driven by asymmetric information. Where the incidence of a common shock to asset values is indistinguishable to investors, investors – banks and depositors alike – rationally retreat from the sector indiscriminately. Attention is therefore needed to restore information about the incidence of the shock to asset values as well as intermediation capabilities, i.e., whether the shock was due to banks' own intermediation failures or those of others.

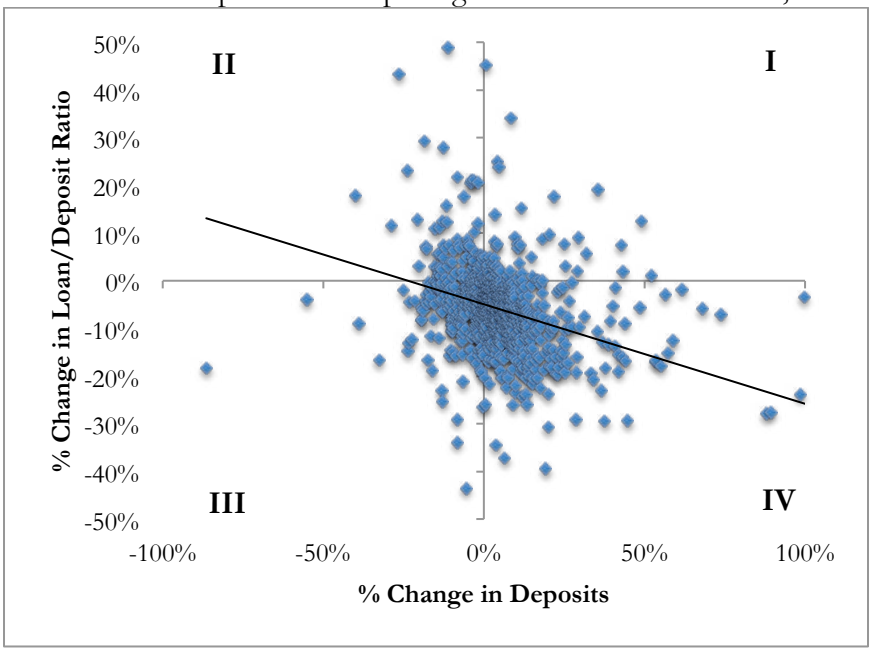
Historically, retail bank customers have looked to knowledgeable bank clients to help them understand which banks are sound.[12] I argue here that an FDIC policy supporting credible deposit brokers can play a similar role in today's market, if allowed to do so.

II. Practical Evidence of Reduced Efficiency and Increased Heterogeneity in Deposit Growth and Bank Lending

Already there are ample reports of bank behavior similar to that described above exacerbating credit channel effects and restraining U.S. economic growth. But as savings rates increase following the new onset of austerity, banks are not motivating deposits into loans. Directing deposits to those who can best use them is therefore the key challenge for recovery.

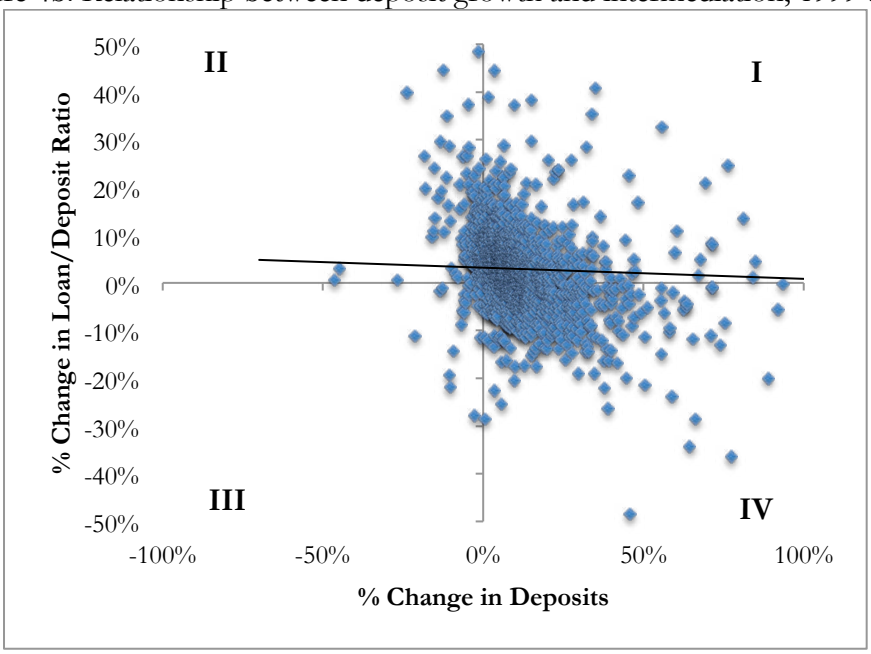
The credit channel is the mechanism that links deposits and loans. At its heart is the money multiplier, which reflects the degree to which banks turn deposits into new loans that, in turn, create additional deposits. As reported above, the aggregate money multiplier has declined considerably since the credit crisis.

Figure 4a: Relationship between deposit growth and intermediation, 2009-2010



[12] Calomiris, Charles W. and Kahn, Charles M, "The Role of Demandable Debt in Structuring Optimal Banking Arrangements," American Economic Review, vol. 81(3), pages 497-513, June 1991.

Figure 4b: Relationship between deposit growth and intermediation, 1999-2000



Source: BHC Y-9 Consolidated Reports of Condition
http://www.chicagofed.org/webpages/banking/financial_institution_reports/data_extraction_for_bank_holding_company_data1.cfm

The relevant question for deposit policy, however, is whether the money multiplier is declining for all banks or just a few. Recall, borrower (including bank) heterogeneity is the key problem of the credit channel disruption that continues to drag out the economic recovery. If some banks can intermediate credit more efficiently than others, directing funding to those banks would help drive the economic recovery more strongly than would otherwise be the case.

Figures 4a and 4b show that banks typically provide a wide variety of intermediation capabilities. The vertical axis in the Figures is a money multiplier-like measure for individual bank holding companies – the growth level of the ratio of loans to deposits – which is indicative of changes in bank levels of intermediation. A growing loan to deposit ratio suggests the bank is increasing the efficiency with which it intermediates deposits and therefore effectively stimulating economic growth.

The horizontal axis of Figures 4a and 4b reflects bank deposit growth. Figure 4a shows the relationship between deposit growth and loan to deposit ratio growth from 3q2009 to 3q2010, while Figure 4 shows the relationship between 4q1999 and 4q2000.

We would hope that banks that have higher deposit growth have higher loan to deposit ratio growth. In terms of Figure 4a and 4b, this means banks will be distributed in Cartesian quadrants I and III, resulting in a positive relationship between deposit growth and loan to deposit ratio growth.

Figure 4b shows that, ordinarily, banks in the industry exhibit such a positive relationship. In Figure 4b, 53.37% of banks in 1999-2000 show up in Cartesian quadrant I, where positive deposit growth rates are associated with positive changes in loan to deposit ratios. Figure 4a, however, shows the credit crisis disruption, when in 2009-2010 only 7.61% of banks show up in quadrant I.

While some banks shrink in terms of deposit growth and intermediation efficiency – that is, show up in quadrant III – in both periods, only 1.57% of banks are in quadrant III in 1999-2000, while 22.84% of banks are in quadrant III in 2009-2010. We see the effect when, comparing Figures 4a and 4b, the mass of points in the graph moves from the upper right in 1999-2000 to the lower left in 2009-2010. Such broad industry movement is indicative of the credit crisis and the general slowdown in lending, overall.

But as I argue in my academic work, a credit crisis is about more than merely some additional difficulty in intermediating credit. It is about the *efficiency* with which different banks do so as they struggle with the financial constraints of loan loss reserves and additional workout costs. Those costs are a drag on growth, sapping resources that can be diverted to economic growth rather than just status quo. Banks in quadrants II and IV therefore represent the "problem children" for the recovery.

Banks in quadrant IV are experiencing deposit growth but declining intermediation efficiency. Banks in quadrant IV therefore impede recovery, since they are taking in deposits but cannot intermediate them as efficiently into loans as banks in quadrant I, who are experiencing rising loan to deposit ratios. In 2009-2010, 59.96% of banks are in quadrant IV, whereas in 1999-2000 only 35.53% of banks were in quadrant IV.

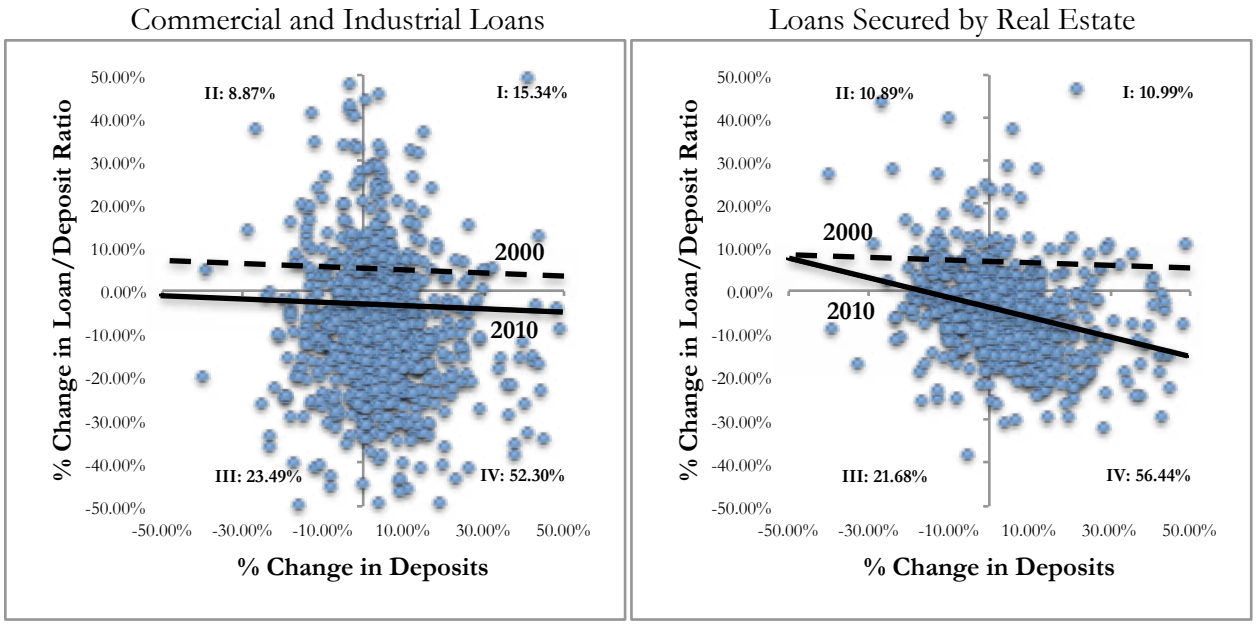
Banks in quadrant II are experiencing shrinking deposits but increasing intermediation efficiency (growing loan to deposit ratios). Those banks are likely the key to recovery, possessing the skills to intermediate loans but lacking the deposits with which to do so. In 1999-2000, 9.34% of banks were in quadrant II, compared to 9.59% of banks in 2009-2010.

Off-diagonal relationships – banks in quadrants II and IV – illustrate the problems of the credit crisis. In 1999-2000 only 44.86% of banks were off the diagonal, either growing deposits without the intermediation efficiency to use them effectively or possessing the intermediation efficiency but lacking deposits. In 2009-2010, however, a whopping 69.55% of banks are off the diagonal (and recall that only 7.61% of banks in 2009-2010 are in quadrant I, attracting deposits and intermediating those funds with greater efficiency, compared with 58.37% in 1999-2000).

The greater dispersion of bank performance in the off-diagonal regions – both in terms of attracting deposits and increasing the efficiency of their intermediation – is exactly the type of wider performance dispersion that is making it difficult to interpret aggregate market dynamics and perpetuating asymmetric information conditions that restrain investment behavior.

Figure 5 shows that the shift is particularly important for certain categories of lending. For instance, commercial and industrial lending as a percent of deposits is declining on average throughout the industry in 2009-2010, instead of rising on average throughout the industry as it did in 1999-2000. In 2009-2010, some 60.90% of banks were in the off-diagonal regions for commercial and industrial lending in Figure 5 compared to only 47.03% in 1999-2000 (details for 1999-2000 are available upon request but are not presented here to save space).

Figure 5: Relationship between deposit growth and intermediation for different types of loans, 3Q2009-3Q2010, with linear comparisons for 4Q1999-4Q2000



Similarly, loans secured by real estate are declining more for banks with positive deposit growth in 2009-2010, instead of growing across the industry, on average, in 1999-2000. In 2009-2010, *67.33%* of banks are in the off diagonal regions for lending secured by real estate in Figure 5 compared to only 40.59% in 1999-2000. Even more importantly, banks with positive deposit growth appear to have pulled back *more* from the toxic real estate sector than those still facing deposit declines. Such a negative relationship between deposit funding growth and loan intermediation is exactly the *opposite* of that which one would assume to be associated with bank safety and soundness. Economic recovery will therefore remain elusive until we can once again associate deposit growth with sound intermediation.

The 69.55% of banks that are off-diagonal in 2009-2010 in Figure 4a are, therefore, the key target for recovery policy. Recognizing their existence, the policy target becomes directing deposits to quadrant II banks (those that are intermediating loans with greater efficiency but lack the deposits with which to do so) by pulling them away from banks in quadrant IV (banks that are increasingly attracting deposits but whose intermediation efficiency is declining). Such a transformation will restore again the upward slope of the relationship between deposit growth and intermediation efficiency and therefore drive increased economic growth as the increased prevalence of positive individual bank multipliers aggregate into a higher aggregate money multiplier in Figure 3.

III. The Role of Deposit Intermediation in the Recovery: Matching Deposits with Banks that Can Best Use Them

Deposit insurance is great for preventing deposits from fleeing the banking system in the aggregate but it does nothing to increase the allocational efficiency of deposit distribution. In fact, it can be argued that deposit insurance not only reduced depositors' concern with being exposed to the

banking system, but it also reduced their concern with being exposed to any *particular* bank in the system, including those the FDIC is worried about with respect to brokered deposit policy.

While some are concerned that price competition over deposits may be perverse, those arguments are being made on the wrong side of the economic cycle. It is true that price competition *preceding* a financial crisis and recession is one culprit that potentially misallocates assets to less economically valuable projects. But it is also true that price competition-based misallocation *after* crises has only been a problem in the face of institutional governance problems, i.e., unclosed and unmonitored zombie bank tendencies to gamble on resurrection (which were addressed directly by FDICIA after the Thrift Crisis).[13]

With retail deposit rates hovering near one percent and chaste consumers valuing savings thrift over yield, price competition is hard pressed to be of much concern among retail depositors. Some banks relatively unaffected by the crisis are reported to be running off old high-rate deposits and foregoing loan growth, despite demonstrated efficiencies in intermediation.[14] Price competition by those banks – many of whom would be expected to lie in quadrants II and possibly III – would benefit economic recovery despite the regulatory concerns giving rise to the proposed assessments on brokered deposits.

On the other hand, curtailing deposit growth at banks that are not efficiently intermediating funds – those in quadrant IV – would not significantly harm economic growth. Moreover, moving deposits in quadrant IV institutions to quadrant II (and potentially some quadrant III) institutions would, again, help recovery by helping those banks aggregate sufficient deposit growth to move to quadrant I. In the aggregate, such reallocation would shift the distribution of intermediation efficiency upward and to the right, similar to where it was in 1999-2000.

The policy question is, therefore, how do we get deposits from banks in quadrants III and IV – those that are lagging in efficiently intermediating funds – to banks in quadrants I and II that can best drive economic recovery?

The answer is to let intermediation markets work. Deposit markets – even retail deposit markets – are now national and global affairs. Brokered deposit markets now offer a vast array of services, from mere information on rates and placement services (aggregator services, the internet, and rate boards) to screening and intermediation. Differentiating among those services can help allocate deposits to banks that can use them most efficiently and fuel economic recovery.

While there are many brokered deposit products in the market today, it is easy to identify at least three that increase market efficiency and help drive economic growth and can therefore help the economic recovery. Reciprocal brokered deposits actively seek to avoid the types of risks that brokered deposits posed to the industry after the Thrift Crisis. Similarly, sweep deposits add low-risk overnight reserves to the Fed funds market and help reduce the price and demand for liquidity at the Federal Reserve. Even contemporary retail brokered deposits now include certificates of deposit,

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[13] Calomiris , C. W., and G. Gorton, "The Origins of Banking Panics: Models, Facts, and Bank Regulation," *Financial Markets and Financial Crises,* R. G. Hubbard, ed., University of Chicago Press, 1991, pp. 109-173.

[14] Landy, Heather, "Trend of Plentiful, Cheap Deposits Still Has Legs," *American Banker*, January 26, 2010.

therefore eliminating the "hot money" feature that posed costs to the FDIC following the Thrift Crisis.

Most importantly of all, those services provided by credible deposit brokers emphasize the brokers' intermediation services, which screen arrangements for counterparty risk. Intermediation is especially crucial to the recovery since intermediated brokered deposit services bring depositors together with banks that can best use the funds, socially, systemically, and economically. Intermediated programs screen potential banks for appropriate risk-return tradeoffs and – by helping banks that can efficiently intermediate funds obtain deposits – help recovery.

Reciprocal Deposits

Reciprocal brokered deposits involve two or more banks that swap their customers' deposits. The end result is that their customers have placements at multiple banks and thus have access to multiples of the normal $250k in deposit insurance coverage. Each bank retains their customer relationships as well as the full value of the deposits the customer has placed – since they have only been swapped with another bank.

Like Treasury Tax and Loan accounts, reciprocal deposits allow large deposit balances to be spread throughout the financial system, geographically diversifying deposit funding and therefore economic growth. Without reciprocal deposits, large corporate accounts would reside only at the largest banks. Smaller deposit accounts (including those of local businesses and municipalities) would reside at small banks in geographically remote areas. In such an arrangement, small banks would not receive the benefit of large corporate accounts should depositors in their markets suddenly desire liquidity and large banks would not receive the benefit of geographically remote smaller deposit accounts should large corporate accounts suddenly desire liquidity.

Reciprocal deposits do not originate from third-party brokers representing customers that place deposits on the basis of high interest rates. Rather, reciprocal deposits are typically derived from existing bank deposit relationships and enjoy a high reinvestment rate, helping institutions to retain valuable customer relationships and enhance their liquidity and franchise value. Local banking customers are less likely to move deposits – including reciprocal deposits – to other institutions simply because of changes in rates.

The FDIC has acknowledged such characteristics in earlier rulemaking. The FDIC already excluded reciprocal deposits from the calculation of the adjusted brokered deposit financial measure for Risk Category I institutions under the 2009 assessment rule, noting that:

> *The FDIC is persuaded that reciprocal deposits… should not be included in the adjusted brokered deposit ratio applicable to institutions in Risk Category I.… The FDIC recognizes that reciprocal deposits may be a more stable source of funding for health banks than other types of brokered deposits and that they may not be as readily used to fund rapid asset growth.*[15]

[15] 74 FR 9532 (March 4, 2009).

Now, however, for large institutions, the FDIC proposes to reverse course with its previous treatment of reciprocal deposits without offering any supporting analysis or reasoning.

One key economic reason for maintaining consistent treatment of reciprocal deposits is in consideration of alternative economic arrangements. Banks could always post collateral against brokered deposits in order to geographically diversify their funding and, indeed, that used to be the norm. Today, however, with Treasuries and other risk-free collateral so dear such collateralized – indeed, two-way collateralized – treatment is economically inefficient and unnecessary. Moreover, such treatment could open the door for collateral rehypothecation or tri-party repo activity, which, was shown by the crisis to be a much more risky shadow banking activity than intermediated reciprocal deposits. By using a reciprocal placement service, collateral is unnecessary and the funds can be lent back to their communities while maintaining safe and sound bank funding.

Sweep Accounts

Broker-dealers typically offer arrangements to automatically move or "sweep" excess cash in customers' brokerage accounts to and from savings or NOW accounts at insured institutions. Banks may make similar arrangements to sweep cash from bank transaction accounts to savings accounts. Whether the primary customer relationship is with the brokerage or the bank, however, the placement agent again has a strong incentive to intermediate risk, constraining them to maintain safe bank placements on behalf of the customer.

It is important to note that with broker-dealer sweeps, the only real investment choice is whether excess funds will go into the Fed Funds market or the money market. Cash balances in brokerage accounts can just as easily be invested in money market funds as deposit accounts, and punitive assessments on sweep deposits can be expected to result in a large movement of sweep funds from deposit accounts to money market funds. With the dearth of activity in repo and tri-party repo finance today, however, money is better off being offered in Fed Funds markets where it can be motivated to economic advantage in the banking system.

Although precise data are unavailable to show how large broker-dealer sweep programs that could be considered brokered deposits really are, industry estimates indicate that broker-dealer customer funds in deposit accounts at banks through sweep services represent hundreds of billions of dollars of important bank funding.

If sweeps receive adverse assessments as brokered deposits, large amounts of money that are currently in the banking system as a result of deposit sweep services will be removed from the banking system and swept to money market accounts instead. Outside the banking system, those funds will not be available to be lent in the Fed Funds market, but would instead fuel traditional and tri-party repo markets in the shadow banking sector.

In an efficient market, we can fully expect overnight lending (including Fed Funds, repo, and tri-party repo) rates to increase by the cost of the assessment in order to eliminate any arbitrage between swept cash in the Fed Funds market and on-balance sheet funding.

Retail Brokered CDs

Retail brokered deposit services also necessitate intermediation. In many retail placement services the deposit relationship remains with the originating bank and the deposits are sold temporarily to other institutions that can more efficiently motivate the funds. Hence, sound intermediation is necessary because the originating bank is loath to damage the deposit relationship due a "misplacement" of the funds. If a customer comes to find that the originating bank had placed their funds at risk, the originating bank would lose the valuable "stickiness" that makes deposit funding so desirable.

Moreover, retail brokered deposit market participants tend to align along familiar industry boundaries so that altering the economics of market participation would have dire effect for mid-sized community banks. In retail brokered deposit markets, mid-sized and small banks typically benefit from large banks who raise funds at low cost through their national networks and sell excess deposits to smaller institutions for a slightly higher rate. Deposits sourced through large bank retail networks therefore help small and medium-sized institutions save money on retail operations and advertising and provide geographic diversification that benefits small and medium-sized banks.

Restricting retail brokered market dynamics in the manner suggested by the proposed rule would therefore force medium-sized banks to compete in national funding markets directly with large firms. Exempting small banks (under $10 billion) from the brokered deposit rule would leave only the middle market constrained, perpetuating the "barbell" in bank size distribution and performance.

The Brokered Deposit Market Targeted by the Proposed Assessment is Large and the Cost of the Assessment will therefore be a considerable Weight on Economic Recovery

The overall size of the market is important because that determines the probable impact of the proposed assessment on the industry. Lower ranges of estimates of the impact begin with the FDIC's proposed 25bp surcharge. Some, however, maintain that double counting can result in a surcharge as high as 50bp or more. Using the roughly $575 billion market for brokered deposits taken from the most recent call reports, the range of estimates for the new brokered deposit assessment sums to somewhere between $450 million and $1 billion in additional costs to the industry annually, as well as another $50 million to $100 million from banks approaching the threshold cutoffs for the assessment. Such additional costs along with the need to raise additional capital pursuant to Basel III as well as other costly initiatives imposed in recent financial regulation, however, can reasonably be expected to impede economic recovery.

V. Summary and Conclusion

In summary, the key economic dynamic that needs to play out in the recovery is that of restoring investment funding to economically value-creating projects. In the bubble that preceded the crisis, too much investment was allocated to value destroying investments with prices inflated by a combination of cheap money and sales hype. With dear money and discriminating investors, banks and other financial market participants that help efficiently intermediate investment funding – that is, expertly investigate new investments and sometimes direct investor funds – become crucial to economic growth.

Investors and regulators, alike, are aware that not all banks are equally capable of intermediating funds efficiently in today's financial marketplace. (Indeed, even the FDIC has their hands full dealing with the fallout from banks that made of business of allocating easy money in the economic bubble but could not withstand the pressures of the economic crisis that ensued.) Hence, brokered deposit placement agents add value to the economy by allocating deposits to banks that can economically best use the funds.

As I am not of the opinion that all banks are equally capable of intermediating funds efficiently in today's economic environment, however, I would also not opine that all brokered deposit placement agents are equally good at placing funds at banks that can meaningfully drive economic growth. The counterparty credit risk evaluations implemented at credible deposit brokers, however, discriminate against banks that use brokered deposits to raise funds for different purposes. For banks that efficiently intermediate credit, the pooled funding offered by credible deposit brokers creates allocational efficiencies that enable banks to raise funds quickly so that they can fund economically value-creating investment projects. At the same time, such pooled funding can be used by less-capable deposit brokers to fuel bids for resurrection, as after the Thrift Crisis. The problem, therefore, is not how to restrict brokered deposits but to restrict the deposit brokers.

Credible brokers can be differentiated from others by their involvement with brokered deposit products that maintain valuable customer relationships rather than just allocate hot money. In fact, a far more powerful brokered deposit policy could be fashioned by differentiating across the individual broker patterns of placements than by focusing on the mere bank use of a broad category of "brokered deposits." Nonetheless, that is not the approach offered in the current proposal.

Brokered deposit policy is an important one not only because of the heterogeneity of bank intermediation capabilities in today's markets but also because the heterogeneity of bank funding models in normal markets. A considerable number of special-purpose banks fund themselves almost exclusively with brokered deposits, yet pose little risk of failure to the DIF. Special purposed banks like Ally Financial, American Express, and Discover rely crucially on brokered deposits, including broker-dealer sweep deposits, and are well-situated in today's financial marketplace to provide a basis for economic recovery.

For banks paying even the highest rates today, a 25bp surcharge amounts to an increase of 25% or more in their interest expense, enough to kill off brokered deposit funding, altogether. It is interesting to ask, what will affected banks' market response to such a policy be? In my opinion, the increased competition for deposits to make up the shortfall of brokered funding will increase interest rates, moving them in a manner that will make it even harder than today to differentiate banks that can efficiently intermediate credit from those that are still bidding for resurrection at the margin. The additional asymmetric information from such a market shift will again mask the relationship between risk and return among banks, hampering recovery as investors struggle again to establish which banks are bidding for deposits because they have few credit crisis losses and good investment prospects and which are merely arbitraging the deposit insurance premium, borrowing with insured deposits to cover losses.

The time for propping up weak banks by masking differences between them and the strong institutions that can fund recovery is over. Indeed, *emphasizing* the differences among institutions in non-crisis states of the world well before failure is the first step toward ending too-big-to-fail. The FDIC therefore has before it an opportunity to harness market participants like deposit brokerage

services to help differentiate banks and therefore allocate deposits in an incentive-compatible manner that will reduce systemic risk.

Moving forward, nobody – including credible deposit brokers – wants to continue to prop up weak banks. It is time to allocate capital and liabilities to banks with sound intermediation potential – the quadrant I banks in Figure 4a – that can drive economic recovery. In this stage of the cycle we need to motivate all the capabilities of the U.S. financial markets to get capital and investment into economically value-creating investments that can drive the recovery.

Respectfully Yours,

Dr. Joseph R. Mason
Hermann Moyse, Jr./ Louisiana Bankers Association Professor of Finance, Louisiana State University, and Senior Fellow, the Wharton School