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September 10, 2015

Mr. Robert E. Feldman  
Executive Secretary  
Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street N.W.  
Washington, D.C. 20429

VIA E-MAIL TO [comments@FDIC.gov](mailto:comments@FDIC.gov)

Re: RIN 3064-AE37 Written comments on the FDIC proposal to amend 12 CFR Part 327 to refine the deposit insurance assessment system for small insured depository institutions

Dear Mr. Feldman,

The National Association of Industrial Bankers (“NAIB”)<sup>1</sup> appreciates the opportunity to comment on the proposed amendment to refine the deposit insurance assessment system (hereinafter “the Proposal”).

Statement of Interest:

NAIB is the national association representing industrial banks. While our comments focus on the current and proposed deposit insurance premium rule’s impact on industrial banks, we share the interests of financial institutions of all types in ensuring that premiums are calculated in a fair and well-reasoned manner.

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<sup>1</sup> First chartered in 1910, industrial banks operate under a number of titles; industrial loan banks, industrial loan corporations, or thrift and loan companies. These banks engage in consumer and commercial lending on both a secured and unsecured basis. They do not offer demand checking accounts but do accept time deposits, savings deposit money market accounts and NOW accounts. Industrial banks provide a broad array of products and services to customers and small businesses nationwide, including some of the most underserved segments of the US economy. Our members are chartered in California, Nevada and Utah.

There are currently 29 industrial banks holding over \$148 billion in total assets. Due in part to ready access to capital through diversified parent companies and efficient funding strategies, this group of banks is among the best-capitalized and most profitable banks operating in the nation today and have been so for many years.

*I. Banks should not be subject to higher insurance premiums for holding brokered deposits.*

The FDIC can fairly assign higher risk premiums to particular deposits and loans only if there are actually higher risks. Developing a risk based premium formula obligates the FDIC to evaluate and identify the risks forming the basis for its formula. The narrative relating to the new proposed formula fails to consider the different risk profiles of various bank models utilizing brokered deposits. It focuses only on the higher risk model and ignores the fundamentally different low risk model utilized by many banks, including industrial banks. In these instances, the proposal fails to satisfy the requirements of the Administrative Rulemaking Act and should be withdrawn and revised to comply with the reasoned evaluation of relevant factors required by the law.

This is particularly true with respect to the treatment of brokered deposits in the current and the proposed rule. The underlying logic reflects regulatory bias, not facts or any reasoned justification for applying higher premiums to every bank holding significant amounts of brokered deposits without any regard for differences in how those deposits are used. The mere presence of brokered deposits is not inherently risky, and in many cases it is less risky than relying on core deposits for all funding. While some banks that held high proportions of brokered deposits failed, many other banks that failed held no brokered deposits. On the other end of the spectrum, industrial banks are among the strongest and safest banks ever insured by the FDIC and many of them primarily rely on brokered deposits for funding. Any reasonably adequate risk based formula must take these differences into account but both the current and the proposed formula completely fail to do so.

Most industrial banks operate differently than a typical community bank. Most industrial banks have no retail branches. The markets they serve have nationwide geographical characteristics consisting of customer or product niches as opposed to a particular community. Because they lack branches and retail offices, many industrial banks rely more on brokered deposits for funding than a community bank. It is entirely logical for banks that are lending to a national market to fund those loans with brokered deposits that also come from a national market.

There is no evidence that holding brokered deposits presents higher risks of failure in all instances. In fact, the opposite is clearly true, at least for industrial banks. For more than 20 years industrial banks have consistently been among the best-capitalized and most profitable banks in the nation and most of those are primarily funded with brokered deposits. In many respects brokered deposits are

less risky than other deposits. Brokered deposits are more stable than other deposits and they facilitate match funding with assets. The FDIC's current deposit premium formula ignores this record and in so doing imposes a special tax on banks that are actually less risky than other banks. The proposed changes in the premium factors would increase that unjustified treatment of banks posing the lowest risks to the FDIC. The narrative relating to the proposed rule and past studies of brokered deposits do not provide any credible justification for this special tax.

Brokered deposits have played a role in funding poorly managed rapid growth in some troubled banks. This began when many failing savings and loans made a "hail Mary" effort to change from mortgage originations to other kinds of lending during the inflationary economy in the 1980s. Rapid diversification was their only hope of survival and most did not make it. The ease of acquiring brokered funds often facilitated these desperate strategies. This same pattern appeared again in the period prior to the Great Recession when a number of community banks grew rapidly originating imprudent real estate loans and funded that growth with brokered deposits.

In this context, the value in "core" deposits, however those are defined, is their inefficiency relative to brokered funds. Core deposits are harder to attract and typically flow into the bank in smaller amounts than brokered deposits. This inefficiency moderates growth, which can be good in some instances, but no argument can be made that it is good in all instances or even in most instances. There are many cases where a bank can safely grow a new loan program faster than it can raise core deposits at market rates to fund those loans. Brokered deposits provide a sound alternative to increasing core deposit inflows by offering above market rates and incurring the marketing costs to make local depositors aware of the bonus interest they can earn.

The most that can be said is that brokered deposits can be used to fund bad loans, but so can core deposits. Brokered deposits can also be used to fund sound loans. Ignoring the good loans and fashioning policy solely on the basis of the bad loans is arbitrary and capricious.

The real issue is how deposits are used, not their origin. Every deposit is cash to be used at the bank's discretion. The bank's challenge is to put the money to work earning more interest than the bank pays to the depositor.

Brokered deposits often pay higher interest rates than other deposits of comparable terms but the differences are normally marginal. All in, brokered deposits are actually significantly less costly when the expense of branches, marketing and system costs are included in the "core" deposits. Brokered deposits are also more stable, and thus far the supply of brokered deposits have proven highly and increasingly reliable. There have been no instances when the supply of brokered deposits was inadequate to successfully fund banks reliant on brokered funds for liquidity in any economic conditions. In fact, the supply of brokered

deposits typically increases during periods of economic stress. Most depositors seek safety.

Brokered deposits are the most stable deposits. They are not "sticky" in the sense that a particular depositor will usually deposit all of his/her money in a particular bank, but that is insignificant because a brokered deposit will almost always remain on deposit until maturity and a replacement deposit will almost always be available. Unlike "core" deposits, brokered deposits cannot be withdrawn prior to maturity, unless the death of the depositor or if the depositor is deemed incompetent by a court of law. Thus, they are more stable.

More importantly, there is no better way to fund loans. In a bank primarily funded with core deposits, funds flow in and out for reasons largely unrelated to loan demand. This increases the need for liquidity and makes it more difficult to manage net interest margins. In a bank funded primarily by brokered deposits, deposits are coordinated with loan demand and loan terms largely dictate deposit rates and terms. That produces safer and easier to manage banks. Since banks take deposits to fund loans, it works best to have loan demand determine deposit inflows. This also permits "match funding" of asset and liability interest rate and duration, which contributes to a safe and sound institution.

The most important distinction ignored by the FDIC is the different risk profile between two kinds of bank. One kind relies mostly on core deposits but uses brokered deposits to fund rapid loan growth when it is lending into a bubble or is troubled and is attempting to grow out of a failing business plan. This is the only kind of bank the FDIC expressly associates with brokered deposits.

The other kind of bank uses brokered deposits as its primary funding source for all of the beneficial reasons outlined above. That kind of bank avoids the noninterest expense of maintaining retail offices, higher marketing costs, investments in operating systems needed to service transactional accounts, and the need to offer a wide array of products and services regardless of profitability to attract local customers. The advantages to the branchless business model can readily be seen in comparing efficiency ratios, meaning the ratio of non-interest expense to income. Most community banks currently report efficiency ratios around 80%. Larger banks report about 60%. Most industrial banks report efficiency ratios between 20% and 40%. Those far lower expense structures translate into higher profitability and contribute significantly to the industrial banks' long standing record as among the most profitable banks operating in the nation today.

To fairly evaluate risks, the FDIC must take these differences into account. No evidence exists, and no credible argument can be made, that it is reasonable to ignore the safest and least risky banks insured by the FDIC because they utilize sources of deposits that are occasionally misused by banks with entirely different risk profiles. The whole issue is how the deposits are used, not how they are sourced.

The other common criticism of brokered deposits is that they are "hot" money requiring premium interest rates and will likely be withdrawn as soon as another bank offers a higher rate. This has proven entirely false. In reality, brokered deposits are the most stable deposits a bank can hold. During the recent financial crisis depositors were more concerned with safety of their money rather than the yield. In fact, at times the rates of brokered CDs have actually been lower than the US Treasury rates of the corresponding terms. Most brokered deposits are held in the form of Certificates of Deposits (CDs) and again, the current CD contracts prohibit early withdrawal except in the case of the death of the depositor or if the depositor is determined to be incompetent. For the reasons articulated above the rate of early withdrawals among brokered CDS is virtually zero.

The risk of a run on a bank utilizing brokered deposits is also virtually zero for the same reason. Depositors utilizing brokers often don't know which bank holds their money; only that it is federally insured. The bank holding the funds is usually in another place and depositors usually don't follow the local news where the bank is based. In Utah during the Great Recession, one community bank failed due to a run provoked by local news stories about a bank director claiming the bank was mismanaged and likely to fail. The bank lost about 15% of its deposits in 10 days and failed when it ran out of liquidity. About a third of its deposits were brokered. None of the brokered deposits were withdrawn during the run. All of the deposits withdrawn were "core" deposits frequently described as the most "sticky." This highlights the difference between "sticky" and "stable." Core deposits will be sticky only as long as the bank is perceived as sound, but they are not stable if depositors sense trouble. Brokered deposits are truly stable.

NAIB considers this record compelling proof that brokered deposits do not present increased risks of bank failure and higher deposit insurance premiums are unjustified. The FDIC has many other effective tools to address situations where access to brokered deposits could present a risk. Existing federal law prohibits banks with low capital from accepting brokered deposits. Cease and desist orders can be utilized to stop or moderate a bank from imprudently growing higher risk loan programs using brokered deposits.

*II. The proposed rule unfairly imposes increased premiums when a bank holds types of loans that experienced higher than normal charge off rates at some banks without regard for the risk of loan losses at individual banks as reflected in CAMELS ratings and examination reports.*

NAIB is concerned that the proposal to use industry wide averages to calculate deposit insurance premiums underweights the expertise of examiners and their examinations in setting CAMELS ratings and will diminish the use of those supervisory evaluations. The primary purpose of a bank examination is to examine the safety and soundness of a bank, and hence its risk to the deposit insurance fund.

NAIB is concerned that the proposed loan mix index is a move away from

the use of individual institution, supervisory-based assessments toward industry-wide evaluations that do not reflect an institution's actual risk to the deposit insurance fund. Furthermore, the de-emphasis of individual factors in deposit insurance assessments may result in an unintended and perverse effect on institutions' behavior, increasing, rather than decreasing, the risk to the fund.

For example, the proposed loan mix index, measuring the categories of loan in a bank's loan portfolio, uses industry wide charge-off rates. The distribution of types of loans in a bank's portfolio could have a significant impact on assessments. Banks that concentrate on construction and development lending, in particular, as well as commercial and industrial loans and leases and consumer loans, could pay higher assessments even if that bank's loans are above average quality. Agricultural banks, especially, and mortgage lenders would pay lower assessments. This industry-wide approach to risk ignores important factors such as the quality of loan underwriting, risk mitigation, and portfolio management. Banks with solid underwriting and risk management practices should not be unduly penalized for mistakes made by some institutions in the past.

The proposed changes could also lead to a situation where banks are penalized for loans that are not yet delinquent and may have a very low risk of default.

Simply stated, this proposal, rather than providing an incentive for strong underwriting standards and rigorous loan management, provides no incentive in the assessment for behaviors that reduce risk to the fund. It is the equivalent of an automobile insurer ignoring whether a driver has installed safety features on an individual car and considering only the prevalence of those features in the automobile population as a whole.

We appreciate the opportunity to submit these comments and hope you find them helpful. Respectfully, we request consideration of the items we have detailed in the deliberations regarding the proposed amendment.

Sincerely,

A handwritten signature in black ink, appearing to read "Frank R. Pignanelli", written in a cursive style.

Frank R. Pignanelli  
NAIB Executive Director