AMERICAN BANKER
On Focus and In Depth

Agencies Zero In on Brokered Deposits

American Banker | Thursday, May 22, 2008

By Joe Adler

WASHINGTON — Regulators are increasing their scrutiny of institutions that rely heavily on brokered deposits as those liabilities featured prominently in some recent bank failures.

Four of the last five banks to fail had relied heavily on brokered funds, and Federal Deposit Insurance Corp. Chairman Sheila Bair warned last week that new banks with such a reliance will get more scrutiny of their applications. Bankers and industry observers have also noticed heightened attention to those liabilities during exams.

Only a few years ago, brokered deposits were seen as a boon for small banks struggling to attract core funds. But regulators say they have fueled excessive growth at many institutions now reeling from the credit crisis.

"One of the worst things that has happened to the industry is the incredible increase in liquidity needs being met by sources other than those customers that you can see, feel, and touch," said Patrick F. Patrick, the president and chief executive of Towne Bank of Arizona.

The Mesa banking unit of Towne Bancorp Inc., with about $200 million of assets, hired Mr. Patrick in February to address a slew of concerns identified in an FDIC order, including the bank's out-of-market lending and heavy reliance on brokered funds.

Brokered deposits may give a bank early liquidity, he said, but they are hard to give up. They also present an inherent problem, he said. The need to pay competitive rates to get brokered deposits makes institutions more likely to go after riskier assets in order to turn a profit.

If you over-rely on brokered funds, "you're not a bank," said Mr. Patrick, who specializes in leading troubled institutions. "You're really a mortgage banker. Banking requires the hard work of establishing relationships."

Regulators say brokered deposits, though not risky in themselves, can indicate problems if an institution is growing quickly, relies heavily on them for funding, and has an exposure to construction lending and other sectors hurt by the real estate downturn.

Serena Owens, an associate director of supervision at the FDIC, said a high level of brokered deposits will probably provoke a closer look by the agency.

Brokered deposits "are definitely less stable than core deposits, and we have observed that in some of the institutions that have had problems," Ms. Owens said.

"If an institution's call report suddenly shows a large proportion of brokered deposits where they had none before," she said, "that is certainly something that would show up in our off-site monitoring process, and we would probably make a couple of calls to determine what's going on there."

Ms. Bair was even stronger last week. She told reporters Friday that brokered deposits "can be used to fuel rapid growth with institutions that maybe shouldn't be growing that fast."

Other regulators agree.

"We're very concerned with rapid asset growth, and to the extent that brokered deposits are used to fund growth that the bank is incapable of managing, that would be something we would watch very closely," said Robert Garsson, the Office of the Comptroller of the Currency's deputy comptroller for public affairs.

These were hardly the first concerns raised by regulators about brokered deposits. The banking agencies have long viewed such liabilities as an unstable source of funding, which helped aggravate the savings and loan crisis.

In recent years, however, regulators have appeared to mellow somewhat. In a 2005 report the FDIC said brokered deposits could work to a bank's advantage.

"Many institutions have found that brokered deposits can be a more cost-effective deposit-gathering mechanism than building a new branch," the report said.

To be sure, the industry includes many players that focus their funding on brokered deposits without problems. Under prompt corrective action provisions, a bank gets less scrutiny for its brokered deposits if it is well-capitalized. (If a bank is considered only adequately capitalized, however, it must seek the FDIC's permission to keep accepting brokered funds.)

Some bankers defended their use of brokered deposits, saying the funding source is needed as larger banks such as ING dominate the retail market.

Bryan Kennedy 3rd, the president of the $246 million-asset Park Sterling Bank in Charlotte, said his bank — less than two years old — needs alternative funding to support the lending efforts of the established loan officers it hired. The bank raised $45 million in initial capital, and brokered funds are 43% of its deposit base. (The industrywide proportion is 6.8%.)

"If you have great local loan demand with good-quality customers, and a good stable of lenders like we have, you can't grow your core deposits quickly enough to keep up with that," he said, adding that the bank plans to replace brokered funds with core deposits over time.

But a review of recent insolvencies indicates that significant brokered deposits can correspond with serious problems. The poster child was ANB Financial, the $1.9 billion-asset Arkansas bank that failed May 9 amid bad out-of-state construction loans funded by an 86% concentration of brokered deposits.

ANB was not alone. NetBank, a $2.5 billion-asset thrift in Alpharetta, Ga., which failed in September from a glut of bad mortgage assets, held $744 million in brokered deposits, 32% of its base. A week later, regulators closed the $86.7 million-asset Miami Valley Bank in Ohio; its brokered funds were 53% of its deposits.

(Douglass National Bank in Kansas City, Mo., which was closed in January, had few brokered deposits at the time of failure, but they had made up 26% of its base at yearend 2005.)

Nicholas Ketcha, a former FDIC supervision director who is now a bank consultant, said examiners are zeroing in on a bank's brokered deposits to determine their exact use.

"They don't outlaw brokered deposits because they're valid, but what they're going to say is: 'We want to see how you're going to use them … and that you're not just using quick money to make some bad bets,' " said Mr. Ketcha, the managing director of FinPro Inc. in Liberty Corner, N.J.

Other observers said a reliance on brokered deposits may diminish a bank's franchise value, turning off shareholders and reducing the likelihood that the institution's retail operation will earn an adequate premium in a sale or resolution.

"The market recognizes and rewards those who are building a franchise based on relationships," said Ralph F. MacDonald 3rd, a partner in the Atlanta office of the Jones Day law firm.

Speaking with reporters last week, Ms. Bair noted the same issue. Brokered deposits tend "to increase our resolutions cost too because a bank that relies on brokered deposits will have much less franchise value than when it's got core deposits," she said.

At the end of last year, Towne Bank's brokered deposits were 64% of its total deposits, and 72% of its $158 million real estate lending portfolio was in construction and development loans.

Other institutions showed similar patterns.

Brokered deposits at the $900 million-asset Omni National Bank in Atlanta, which has yet to post fourth-quarter results and this year disclosed violations of its own lending policy, made up more than 60% of its $726 million deposit base at yearend.

Franklin Bank, a $5.7 billion-asset state thrift in Houston, which on Monday announced the firing of its chief executive over accounting deficiencies tied to bad real estate loans, had nearly $1 billion in brokered deposits at yearend, or 32% of its deposits.

Connie Perrine, Omni's chief financial officer, said the bank was less concerned about the funding source than obtaining funding. The difficulty of obtaining core deposits — which involves building and operating branches — cannot be ignored.

"Brokered deposits are far cheaper and far more efficient," she said. "I don't really worry about that being a source that's cut off to anybody. We've had discussions with our regulators in the current environment, and it's not a concern of ours.

"I find the examiners to be a lot more savvy about the fact that bricks-and-mortar deposits are very, very expensive to obtain with an ING out there and everybody else competing for them. It's not the future of banking," she said.

But Mr. Patrick said he immediately worked to reduce Towne's reliance on brokered deposits but met resistance early on.

"When I came here, what I heard was the new core deposit was the brokered deposit," he said. "But how do you get the brokered deposit customer to open any other type of account with you?"