Redefining Brokered Funds, and What It Means for Community Banks

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By Joe Adler

WASHINGTON — Left unchanged for two decades, the definition of brokered deposits is about to receive an update — one that could significantly alter the regulatory landscape for many community banks.

Brokered funds, dubbed "hot money" during the savings and loan crisis, have long been a concern among regulators because they can exacerbate a liquidity problem and raise costs to the Federal Deposit Insurance Corp. in the event of a failure.

Despite efforts to restrict the use of such deposits after the thrift crisis, many believe the current definition of brokered deposits is outdated. The FDIC is working on a study, required by the Dodd-Frank Act, on how to bring the definition more in line with today's deposit products. Though the regulatory reform law is crammed with studies that likely will not produce policy changes, observers said a lot is riding on the brokered deposit study, including the ability of troubled banks to take brokered deposits as well as how deposit insurance premiums are assessed.

"At some point, we have to realize that all the changes that have taken place since" the 1980s "have really changed this marketplace, and it's going to change a lot more," said Chris Whalen, managing director at Lord, Whalen LLC's Institutional Risk Analytics.

In the past, it was relatively easy to tell the difference between a brokered and nonbrokered deposit. When volatile funding spurred overheated growth — and hundreds of failures — in the crises of the '80s and '90s, Congress placed new restrictions on deposits facilitated through a third-party "broker," including banning undercapitalized banks from accepting them. Such funds similarly sparked concerns in the recent financial crisis, yet to a smaller degree.

But since the legal definitions were set, the line between which funds were considered brokered has blurred, and many argue it is a mistake to focus solely on a third-party relationship.

For example, certain deposit-swapping products, such as the Certificate of Deposit Account Registry Service, meet the "brokered" definition. Under that program, CDARS acts as an intermediary, and a deposit placed in the network is technically held at a third-party bank. But such deposits are relatively stable, and are not designed to pursue high interest rate products, but instead offer a deposit insurance protection service to bank customers.

On the other side, an array of funding options, including Internet-based banks and high-rate CDs advertised on listing services like Qwickrate or Bankrate.com, technically do not meet the definition of a brokered deposit, since banks in effect raise those deposits themselves. But many believe they can be just as volatile, if not more, than funds that do meet the definition.

"The rate of the deposit, the duration of the deposit — none of those are incorporated into the definition at all," said Paul Clark, a partner at Seward & Kissel LLP. "The only thing that makes something 'brokered' is because there happens be a third party that's somewhere in there doing something.

"What we should be doing is getting away from the labeling of 'Should this be brokered?' or 'Should this be core?' and look at the underlying characteristics of the deposits."

But Shawn O'Brien, the president of Qwickrate, defended the listing-service model. He said Qwickrate advertises rates in a "controlled" environment, and is only used by banks and institutional investors. "It's a very stable source of funding and it's a very definable source of funding," he said. "The bottom line is a diversified funding source and one that is managed consistently with the business plan is what is most important. It's not the definitions that are causing the problems."

The Dodd-Frank Act requires the FDIC to complete a study on core and brokered deposits, evaluating the definitions and looking at issues from how they affect deposit insurance premiums to the potential impact of reforms.

Under Dodd-Frank, the FDIC study, the subject of an agency roundtable in March, must evaluate the current definitions of core and brokered funds, how those labels affect regulatory treatment such as a bank's deposit insurance premium and what the impact would be of changing the definitions. The agency must report back to Congress by July.

"It is a different type of study," said Edward Yingling, a partner at Covington & Burling LLP and the former chief executive of the American Bankers Association. Lawmakers "knew there was a problem, but they didn't really have time given all the other hot issues to delve into. They wanted to get some suggestions as to how it might be addressed going forward."

Concern persists that brokered funds played a role in scores of recent failures. While brokered deposits are not viewed as inherently flawed, regulators are concerned that banks that rely heavily on such deposits can grow too quickly, do not properly account for their heightened interest rate risks and hurt an institution's retail franchise in the event of a failure. "Use of brokered deposits rather than core deposits reduces the value of the financial institution, thus FDIC should take measures to discourage the use of brokered deposits and provide every incentive to build core deposits," Haluk Unal, a University of Maryland business professor, said at the FDIC roundtable.

Still, despite the concerns, observers said the outdated definitions have meant banks using funds considered safe are being regulated as if they were not, and deposits that avoid the technical "broker" label are escaping scrutiny. Meanwhile, brokered deposits can be a lifeline to a bank in dire need of liquidity.

Observers said a more precise method for assessing a bank's funding base, rather than just checking a box if a third party is involved, is needed.

"The tough part is to come up with a mechanism of essentially scoring the volatility of deposits, so that from a public perspective — in terms of disclosure — and from a supervisory perspective, which is at least equally important, you have a broad view of how the bank funds and what the changes are in funding," Whalen said.

The implications of getting the "brokered" label are huge. Institutions can either receive surcharges on FDIC premiums for heavy use of brokered funds, or alternatively a discount for high use of nonbrokered funds. Meanwhile, an "adequately capitalized" bank must get an FDIC waiver to allow it to take new brokered deposits, and undercapitalized banks are completely cut off.

"If I had my dream, I would completely blow up the broker terminology and instead focus on the characteristics of the deposit," Mark Jacobsen, president and chief executive of Promontory Interfinancial Network, which runs CDARS, said at the FDIC roundtable. "It clearly has to reflect relationship as being valuable, but that's just one aspect."

But despite consensus over the need for changes, it is unclear how far the FDIC will go in changing the definitions, or even if the agency can go without further legislative changes.

"I don't think we have it right. I think there are some things probably that we treat now as brokered that should be core, and I think there are some things that perhaps are treated as core that perhaps should be viewed more as volatile," FDIC Chairman Sheila Bair said at the roundtable.

"There really is a completely open playing field to reconsidering how we approach this. On the other hand … the liability structure definitely impacts our costs."

Bair said the agency has some flexibility to make changes on its own, such as through its premium-pricing and how its examiners view liquidity sources when conducting regular exams. But altering how capital levels can affect a bank's ability to raise brokered funds, she said, would require congressional action.

"I do think we need to have more discussion on it, because the road forward is still not clear to me," she said.

At the roundtable, participants said some banks decline products such as CDARS because they fear the "brokered" stigma. Some observers note that CDARS, which allows community banks to offer large-account customers maximum deposit insurance by spreading CDs around to multiple banks in the network, caters to depositors who reside in an institution's immediate geographic area.

"It's not like the bank went out looking for the deposit; they just swapped it for protection for their customer," said Nicholas Ketcha Jr., a former FDIC supervision director and now a managing director at the bank consulting firm FinPro, who did not attend the meeting.

The roundtable also featured comments from institutions that collect or support collection of deposits that, while not traditional, are not considered brokered.

Todd Sandler, an executive of the Internet bank ING Direct, called the current definitions "appropriate."

"If the consumer is the one making their own deposits, then we feel that the definition is appropriate at the core deposit level," he said at the meeting.

While Clark agreed a model like ING's is stable, he said designating as core certain deposits raised through other avenues, such as a high-rate CD advertised on a Web-based listing service, is flawed.

"If what we're trying to get to is more granular decision-making on stable funding, I think that that would have to be looked at, and in many cases could be wrong," he said. "If the bank has got to survive by issuing substantial amounts of CDs at very high rates, I think there's something very wrong with that bank."

He added that regulators have also never really established formal definitions for what qualifies as core funds.

"They appear to just exclude brokered, period," he said. "Getting into what really is core becomes a highly subjective judgment. Clearly, under their current guidelines and regulatory reporting, brokered simply can't be core."

But other observers note that vehicles like Qwickrate, which provides a neutral marketplace for connecting banks with institutional depositors looking for high rates, can be the most useful means for an institution to quickly access liquidity.

"If it weren't for Qwickrate, we would have more liquidity failures," said Randy Dennis, the president of DD&F Consulting in Little Rock, Ark. "The Federal Home Loan banks will restrict any new funding … once a bank is in trouble. Promontory will also restrict any new activity by a troubled bank. Qwickrate is there. In the past, it's been a relief valve to fund liquidity needs."

O'Brien said changing how brokered funds are classified could backfire if the regulatory update ends up favoring a particular type of deposit product. "Our concern with changing the definition is you're going to indirectly perhaps anoint one particular deposit over another," he said.

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