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Statement by

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Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Commerce, Consumer and Monetary Affairs

of the

Government Operations Committee

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Mr. Chairman and members of the Committee, I am happy to have the opportunity to present the views of the Board of Governors of the Federal Reserve System on proposals to limit the use of fully insured brokered deposits. Briefly, the Board's position is that brokered deposits serve a useful function. Excessive reliance on insured brokered deposits, however, poses serious risks to individual depository institutions, to the financial system, and to the Federal deposit insurance funds. The Board believes that legislation to limit the use of such deposits is needed. Until the necessary legislation is passed, the Board would not object to the proposal published for comment by the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC) to limit insurance coverage to $100,000 per brokerage firm.

Insured brokered deposits are a relatively new source of funds to the nation's depository institutions. Reliable data on how large the activity presently is, and how fast it is growing, are sparse. We know, however, that total brokered deposits at federally insured savings and loan associations (S&L's) rose from less that $2 billion at the end of 1979 to something like $25 to $30 billion at the end of last year. At commercial banks, brokered deposits at the end of 1983 amounted to about $22 billion.

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It appears from available data that S&L's rely more heavily on brokered deposits than do commercial banks. Not surprisingly, smaller institutions rely more heavily on such deposits than do larger institutions that have ready access to the market for large-denomination negotiable certificates of deposit. We know, also, that a few individual S&L's obtain half or more of their total deposits through brokers. Moreover, among those institutions relying heavily on brokered deposits are a number with relatively low ratios of net worth to total liabilities -- that is, ratios of less than three percent. Such deposits constituted approximately one-sixth of total deposits held by banks that failed in the past two years and, in a few of those cases, they amounted to more than one-half of total deposits of the failing institution. This suggests that there is a tendency for the marketing process to direct brokered deposits toward financially weaker institutions -- and, in extreme cases, to failing institutions.

The volume of fully insured brokered deposits is still very small in relation to total deposits. Apparently, however, the proportion is rising rapidly, and no one can be sure what the limits of this market may be. The effects of some of the factors giving rise to the recent growth of the industry -- such as regulatory actions permitting payment of finders' fees

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to brokers and the effective deregulation by the Depository Institutions Deregulation Committee (DIDC) of interest rate ceilings on most time deposits -- may be less of a catalyst to growth in the future. Nationwide marketing of brokered deposits, however, stems more generally from a process of financial innovation -- driven by both deregulation and rapid technological advances -- that is changing financial practices dramatically, and the impact of those forces on financial markets and institutions is far from over. Moreover, the element of subsidy contained in Federal deposit insurance will provide a continuing incentive to growth of insured deposits channeled through brokerage arrangements.

Brokered deposits would be less of a problem from the standpoint of public policy if they were not fully insured. Uncertainties prevailing in financial markets in recent years, however, have caused depositors to place a high value on safety of principal. For example, the failure and liquidation of Penn Square National Bank in July 1982, in which many depositors incurred losses, served as an important catalyst to the practice of breaking up large brokered deposits into amounts of $100,000 or less to achieve fully insured status. Federal insurance, in such cases, removes the incentive for depositors to seek strong, well-managed depository institutions in which to place their funds. This lack of market discipline can have unfortunate consequences.

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Brokered deposits, the Board believes, provide economic benefits to individual depository institutions and to the nation as a whole -- benefits that should be preserved. They serve as a conduit -- although by no means the only one -- for transferring funds from capital-rich to capital-short areas. They permit smaller depository institutions to compete on more equal grounds with larger ones in the attraction of funds. They provide an additional source of liquidity to the individual depository institutions in time of need. And they increase the options open to depositors -- institutions as well as individuals -- in the placement of funds, and often increase the yields available to them.

There are no empirical studies that I know of that seek to put quantitative dimensions on such benefits. But we must recognize that brokered deposits give rise to costs as well as benefits, particularly when they are fully insured. For example, facilitating easy movement of funds from one market to another through full insurance for brokered deposits loosens the links between depositors and consumers and their local institutions. The competitive position of some smaller depository institutions improves, but that of other small institutions may deteriorate, reducing their ability to meet local needs for credit. Heavy reliance on brokered deposits as a source of funds may encourage some institutions to move away

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from their traditional community orientation, with effects that are hard to predict on the economic welfare of those communities. Indeed, it is not entirely clear that economic efficiency is increased when funds are transferred from one use to another solely because brokered deposits are fully insured. The element of subsidy contained in Federal deposit insurance may, in fact, lead to the opposite result because it erodes market discipline as regards risk taking.

While the economic and social benefits of brokered deposits are mixed, the Board believes that, on balance, continued use of this financial instrument is desirable. The Board also believes, however, that excessive reliance on fully insured brokered funds results in risks that are sufficiently serious to warrant prudential measures by the Congress and the Federal regulatory authorities.

First, there are risks created for individual financial institutions that may not be capable of safely employing brokered funds on a large scale, especially when the attraction of brokered funds permits an institution to grow at a spectacular pace, as sometimes happens. To attract brokered deposits, an institution often pays above-market rates to depositors and a fee to the broker. In order to employ the funds profitably, the institution must invest them in assets

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that earn a relatively high rate of return. Methods by which such higher rates of return are earned may include taking greater than normal credit risks and mismatching of maturities.

Over time, an institution may become overly dependent on brokered deposits as a source of funding. Despite efforts to diversify sources of deposits, this dependency may make the institution susceptible to pressures from the principal funding source, including suggestions that it make credit available to particular borrowers. Failure to make good credit judgments is particularly likely when an institution obtains funds on a scale that exceeds its capacity to document properly and control its credit decisions. Experience has indicated that this can prove to be troublesome.

Brokered deposits, it is sometimes argued, provide individual depository institutions with the opportunity to restructure their assets and liabilities in ways that lead to a better match of maturities. That is true. But unfortunately, it is also true that the opportunity is provided to create a serious mismatch by borrowing short and lending long.

When an activity such as brokered deposits grows as rapidly as it has in recent years, there is a danger that the problems of individual financial institutions may become so

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widespread as to warrant concern for the stability of financial markets more generally. That is probably not a concern at the moment, but the prospect that even larger numbers of small depository institutions might become heavily dependent on a relatively higher cost, and potentially highly volatile, source of deposits to finance their lending activities is clearly worrisome.

Troubled institutions may end up with relatively large volumes of insured brokered deposits because once an institution is facing difficulties, this may be one of the few sources of funds it can still attract. Brokered deposits can be used to replace uninsured funds that are being withdrawn by wary depositors, or to finance additional asset growth in the hope that the earnings generated will offset losses in existing operations. Unfortunately, all too often the effort is futile, and the end result is to prolong the life of a failing institution, increase its overall size and in particular the volume of insured deposits, and add to the liabilities faced by the Federal insurance funds.

The danger to the Federal deposit insurance system is a clear and present one. The potential liability to the Federal insurance funds is growing at a disturbing rate as the reliance on fully insured brokered funds increases, particularly

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when such deposits are concentrated among financially weak institutions.

The proposal published for comment by the FDIC and FSLIC, limiting Federal insurance to $100,000 per broker, would severely limit the use of brokered deposits. A less disruptive means of addressing this problem would be to impose a limit on the total amount of insured brokered deposits that may be accepted by a depository institution. This limitation could take the form of a "cap," calculated as a percentage of insured brokered deposits to total deposits, of, say, five percent. Alternatively, the proportion of such deposits to the total could be made to depend, to some degree, on the ratio of an institution's capital to its assets. Although the limit should be clearly set, it would be desirable for the regulatory authorities to have the flexibility to grant exceptions in special situations.

Effective implementation of a "cap" on insured brokered deposits on a system-wide basis could best be done with new legislation. The regulatory agencies do have the authority, through cease and desist powers, to proceed on an institution-by-institution basis. However, using this authority requires proving for each situation a direct relationship between safety and soundness and a specific level

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of fully insured brokered deposits, a process that could bog down in litigation and delay.

The Congress faced a similar problem in the field of capital adequacy, and it provided the regulators with new authority to require specific levels of capital in connection with the recent IMF legislation. Similar action is needed in the case of fully insured brokered deposits. Because of the inevitable pressures that would be brought to bear on agencies to broaden and make more flexible any administratively established levels pursuant to a general grant of authority provided by Congress, we believe that in this instance it would be desirable for Congress to set a specific legislative cap.

Legislative caps have the advantage of allowing reasonable use of insured brokered deposits, while maintaining such use within limits that institutions should be able to manage. In view of the inherent incentive for fully insured brokered funds to gravitate to those institutions that are prepared to take the greatest risks and to pay the highest rates, the "cap" approach takes the prudent course of limiting access and thus avoiding the necessity of attempting to correct, with cease and desist action, a dangerous situation after it has occurred.

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In the design of enabling legislation, thought must be given as to how such a cap should be phased in to avoid disruptive effects on individual institutions whose ratio of fully insured brokered deposits to the total exceeds the cap. (The Board does not believe that grandfathering existing ratios would be appropriate.) It would also be desirable to discourage increases in reliance on such deposits prior to the effective date of the cap. The Board would be happy to work with the Congress in developing legislative language that would achieve such results.

The Board recognizes that Congressional authorization may take some time to enact and implement. In view of the need to take action now to prevent problems from developing later, the Board would not object to implementation of the proposal made by the FDIC and FSLIC in its current rule-making process pending the enactment of legislation. As with implementation of a legislated cap, it would be desirable if their proposal included arrangements for an orderly phase-down of insured brokered deposits for those institutions already significantly dependent on this source of funding.

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If the Congress is disposed to enact new legislation imposing a cap on fully insured brokered deposits, it would be desirable for such legislation to be enacted promptly and to take effect prior to October 1, 1984, when the FDIC/FSLIC proposal is scheduled to take effect. Depository institutions dependent on such funds, and brokerage firms engaged in this activity, would then be disrupted less by regulatory change.

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