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Statement by

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before the

Subcommittee on General Oversight and Investigations

of the

Committee on Banking, Finance and Urban Affairs

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I am pleased to appear before this Subcommittee to present the views of the Board of Governors on the legislative proposals to limit the use of brokered deposits by troubled federally insured financial institutions. The Board recognizes that the use of brokered deposits by troubled institutions can have a potentially adverse impact on the deposit insurance system. For this reason, the Board supports reasonable efforts to limit the use of brokered deposits by such institutions. However, brokered funds can also improve the efficiency of capital markets by channelling investment funds to their optimal use and by helping institutions address short-term liquidity and funding needs. In attempting to control the potential abuses of brokered deposits, we must be careful to preserve their benefits.

The Administration's legislative proposal to address the thrift industry's problems calls for a study that would, among other things, review the role of brokered deposits and the need for any limitations on the use of these funds. Thus, while the Board shares the concern of Congress over the use of brokered deposits by troubled institutions, we believe that it would be more appropriate at this time to defer legislative action on brokered deposits pending the findings of the anticipated study. After a full review of the relevant issues and problems, the merits of the proposed legislation can be better determined.

In my remarks today, I will briefly discuss the extent to which financial institutions have used brokered deposits, the potential benefits and problems the deposits may present, and the supervisory approach the Federal Reserve has taken toward these accounts. I will also offer some suggestions for strengthening the legislative proposals, should you decide to pursue this approach. In general, my comments will focus on fully insured (retail) brokered deposits that are either initially obtained in amounts of less than \$100,000 or that are subsequently divided into deposits of that size. These deposits represent a potential for abuse and the main risk to the federal deposit insurance system.

#### Role of brokered deposits

Depository institutions have used brokered deposits for a number of years in order to attract funds from outside their traditional geographic markets. In recent years, the use of these deposits has increased substantially. At the end of 1984, the first year we collected data on retail brokered deposits, insured commercial banks held \$25 billion in total brokered deposits, of which \$7 billion were insured retail deposits. By the end of 1988, total brokered deposits had increased to more than \$53 billion, of which \$19 billion were retail. State member banks, which are subject to supervision by the Federal Reserve, held \$7 billion in brokered deposits at the end of 1988, of which \$3 billion were in the form of insured retail deposits.

Savings and loans associations currently hold about \$72 billion in brokered deposits, of which \$59 billion are insured.

Overall, brokered deposits represent about 2.5 percent of all domestic deposits at commercial banks and about 7.4 percent of the deposits at savings and loans. Fully insured retail brokered deposits represent less than 1 percent of the domestic deposits at banks and around 6 percent of the domestic deposits at thrifts. The vast majority of depository institutions, about 90 percent, do not make use of brokered deposits at all.

Much of the overall growth in these deposits occurred because they increased the efficiency of financial markets. Indeed, a significant portion of these funds are held by large banks that currently meet or exceed the minimum primary capital standard and that are otherwise in satisfactory condition. Banks that specialize in credit card activities, those that have little or no local deposit-taking powers, and those that are affiliates of much larger institutions are often active users of brokered deposits. Brokered deposits contribute to more open competition for depositor funds and increase sources of liquidity to financial institutions. This is particularly true for organizations that do not otherwise have access to national money markets.

Most brokered deposits in commercial banks are not federally insured and do not inherently raise the issue of "moral hazard," whereby investors gain increased income while the government absorbs any increased risk. Providers of large amounts of uninsured funds normally have both the incentive and the capacity to evaluate the creditworthiness of the banks in which they are investing. Nonetheless, even uninsured brokered deposits can increase the risk to the insurance system if they are used to fund poor investments by the purchasing bank.

However, the unintended expansion of insurance coverage by troubled institutions through the use of retail brokered deposits significantly increases the risks to the deposit insurance system. Institutions that seek rapid asset and earnings growth can often raise substantial funds nationwide by offering higher-than-market rates for insured brokered funds. In order to reach their growth targets and to cover their high funding costs, these institutions may then invest in increasingly risky ventures. This could lead to increased losses, and possibly failures, rather than to higher profits. As their condition declines, these institutions may seek to raise additional brokered funds and acquire additional high-risk, high-yielding assets. This may further contribute to their deterioration and raise the ultimate cost to the federal deposit insurance fund.

The evidence also shows that the use of brokered deposits appears to increase the costs of resolving failures that do occur. An examination of the use of brokered deposits by banks that eventually failed indicated that failed banks with large ratios of brokered deposits to total deposits imposed greater resolution costs per dollar of deposits on the FDIC than did failed banks with smaller ratios of brokered deposits. In statistical tests, this relationship was highly significant. The analysis also indicates that banks that failed in 1988 had higher ratios of brokered deposits in the previous two years than banks in the same size classes that did not fail. However, in the vast majority of cases failed banks did not make excessive use of brokered deposits.

Clearly, bank managers can make poor investments with funds from any source. They can also raise insured deposits directly through telephone solicitations or by advertising for the deposits nationwide--thereby avoiding brokers altogether, as some institutions have done. The critical factor is to maintain an adequate level of supervision over insured institutions in order to detect and prevent undue exposure of the insurance system.

#### Federal Reserve supervisory approach

In recognition of the potential for abuse, the bank regulatory agencies began in 1983 to collect information from banks about their use of brokered funds. At that time, the

Federal Reserve also developed and implemented specific procedures for monitoring the use of brokered deposits by state member banks and for taking actions to detect and deter abusive actions involving such funds. These procedures involve the monitoring of changes in the level of an institution's brokered funds and an identification of the use of these funds. Where appropriate, excessive use can trigger an on-site credit evaluation or a full-scope examination.

An evaluation of the use of brokered deposits is also part of all on-site examinations. In light of the potential risks that these deposits present, examiners focus on various aspects of asset quality and growth rates in banks with substantial use of brokered funds. Specifically, when brokered deposits exceed five percent of total deposits, or are otherwise of concern, examiners are required to evaluate the bank's use of such deposits, the role they have in the bank's overall funding strategy, their effect on the condition of the bank, the quality of the loans funded by them, and other relevant factors.

Examiners also review the activities of banks that place deposits with money brokers to ensure that they have exercised appropriate credit judgment. Deficiencies in this area can constitute an unsafe or unsound banking practice.

Virtually all formal enforcement actions undertaken by the Federal Reserve against state member banks that involve safety and soundness issues include provisions relating to the use of brokered deposits. These provisions typically require the banks to give prior notice to the Federal Reserve before acquiring further brokered deposits and to provide periodic information about the intended and actual use of the funds. The Federal Reserve may halt those plans when considered appropriate.

Active enforcement of these procedures has enabled the Federal Reserve to minimize the use of brokered deposits among problem state member banks.<sup>1</sup> At the end of 1988, problem banks held only \$25 million of brokered deposits--less than one half of one percent of the total brokered deposits held by all state member banks. Thus, regulatory action by the Federal Reserve has significantly curtailed the use of brokered deposits in troubled state member banks.

#### Proposed legislation

As we understand it, the proposed House bill would prohibit a bank or thrift that does not meet minimum capital standards from increasing its use of brokered deposits.

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<sup>1</sup>Problem banks are institutions that have been rated 4 or 5 under the rating system used by federal bank regulatory agencies.

However, the legislation appears to permit institutions to maintain existing levels of brokered deposits through the "rollover" or renewal of such accounts. The Senate version would likewise grandfather existing brokered deposits in troubled institutions, but would otherwise prohibit the use of brokered deposits, including existing deposits if they are subsequently increased or renewed.

Both versions of the legislation define troubled institutions as federally insured financial institutions that do not meet minimum capital requirements according to the FDIC. Both versions would also allow the FDIC to waive these restrictions after finding that accepting such deposits does not constitute an unsafe or unsound banking practice.

The Senate approach would appear to reduce or eliminate the use of brokered deposits by troubled institutions more quickly than the House bill. It would do so by, in effect, prohibiting the renewal of brokered accounts. At the same time, this approach could create significant liquidity pressures for troubled institutions that rely heavily on brokered funds, unless they receive supervisory waivers. Without such waivers, these institutions would need to find alternative sources of funds or could be forced to the discount window. In either event, their liquidity problems would surface earlier and could be resolved more quickly, either by forcing them to reduce their size or to cease operations.

As I have already stated, the Board believes that the Congress should defer any legislative action on brokered deposits pending the results of the proposed study of the deposit insurance system. However, if the Congress chooses to proceed with these legislative proposals at this time, the Board would recommend four changes to render the legislation more effective.

One, as currently drafted, the legislation gives to the FDIC the authority to determine if an institution does not meet minimum capital standards, as well as the authority to grant any waivers on the legislation's brokered funds restrictions. We strongly believe that in the case of commercial banks it would be more appropriate and consistent with the current supervisory structure to assign these responsibilities to the bank's primary federal regulator, rather than to the insuring agency. The primary supervisor sets the capital standards for commercial banks under its jurisdiction and is the appropriate agency for determining whether a bank meets the minimum capital standard. The primary supervisor should also have the authority to grant waivers, since it is the agency whose longstanding supervision of the bank best enables it to assess the potential risks stemming from the institution's use of brokered deposits.

Two, Congress may also wish to consider whether the definition of "troubled institution" should be expanded to

include factors other than the capital ratio. The relative level of problem loans and other measures of overall financial strength may be important factors to be considered.

Three, the Board notes that the proposed legislation is directed at all brokered funds. Since insured brokered deposits have been the principal source of concern, the Congress might consider focusing any legislation only on those deposits.

Four, we believe that any legislation that is adopted should cover all insured financial institutions. However, as currently drafted the proposed restriction would apply only to banks because of the manner in which "deposit broker" is defined.

#### Conclusion

In summary, the Board supports vigorous efforts to restrict the use of brokered deposits in troubled depository institutions. Indeed, while the Federal Reserve has been generally successful in limiting the misuse of brokered deposits in state member banks, we recognize the potential for abuse of the insurance system that they may present. In this regard, we believe the legislative proposals contained in the House and Senate bills properly focus on restricting the use of brokered deposits by troubled institutions, while avoiding unnecessary limitations on the prudent use of such funds by sound banks and thrifts.

We also believe, however, that the use of brokered funds by depository institutions raises a number of complex issues and questions. For this reason, we believe it would be more appropriate to defer legislative action at this time, and to await the outcome of the anticipated deposit insurance system study, which will include a detailed review of the advantages and disadvantages of brokered deposits.

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