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BROKERED DEPOSITS PROVIDE RISKY, SHORT-TERM FIX

A financial instrument popular with not only wealthy bank depositors, but community banks seeking to prop up their liquidity, is playing a conspicuous role in the problems of several failed and troubled institutions. That has regulators and others in the industry concerned.

The $765 billion brokered deposit market has mushroomed in this decade, up from only $120 billion in 1999. Financial institutions have used these instruments for years as a wholesale funding source to support asset growth and the **Federal Deposit Insurance Corp.** itself notes that when properly managed, they offer institutions a number of important benefits such as ready access to funding.

They're also a boon to wealthy investors who can use the brokered instruments to spread millions of dollars in federally insured $250,000 increments across several banks who compete for them by bidding the highest interest rate, keeping a depositor's money not only safe but churning out lucrative returns. For example, an investor with $5 million would divide the money among 20 different banks while his or her broker moves the money from bank to bank in search of the highest interest rate.

Brokered deposits give banks easy access to money. So much so that they are often referred to as "hot money," because the deposits move around quickly, always gravitating to the highest bidder. That makes the money not only flighty, but expensive, because the banks need to offer high interest rates to stay competitive.

RICHARD M. BROOKS

Financial services consultant Dennis Nason says interest expense can skyrocket as a bank seeks to stay competitive in the brokered deposit market.

"It's remarkable if you look through the call reports of Florida banks the number of banks that are heavily dependent on brokered deposits," said **Bowman Brown**, partner and international banking attorney with Shutts & Bowen in Miami. "There are a lot of banks that are pressing the limit and that's a huge volume of expensive and hot money to be dependent upon."

Brown

This is also where the FDIC begins to urge caution.

"Brokered deposits can be a higher-cost and more volatile funding source and, as such, present potential liquidity, earnings and other risks that must be properly managed," the agency said in an inspector general's report, which also notes recent bank failures involving "excessive reliance" on such deposits to support rapid loan growth.

The FDIC monitors the amount of brokered deposits a bank has on hand. However, a bank that has brokered deposits (often in the form of CDs) coming due risks quickly losing them to banks bidding higher interest rates.

As South Florida financial services consultant **Dennis Nason** says, "It makes the bank that buys the deposits more vulnerable because they don't have their own deposits to fall back upon if there is a crisis. If you get banks that have to depend on this because either

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they can't get the interest on the part of the depositors or the system set up to get their own core deposits, it's not a good thing to have to depend on these."

Brokered deposits can allow a small bank to come from nowhere. If they bid lucrative rates, they have an enormous amount of money pouring in to them from brokerage firms. But in three months or six months when that CD comes due, if those same depositors are nervous about the bank or they find a higher rate, there goes the deposit base — it can get diminished dramatically. This is not the first time that we've seen this as a problem, by the way. They also played a role in the savings and loan crisis during the 1980s.

"Brokered CDs are almost a wholesale approach to bringing in deposits, but a very risky one," said **Orlando Roche**, Miami-Dade regional president at **Lydian Bank & Trust** in Coral Gables. "It does two things: it implies risk, because typically it goes to the highest bidder in terms of interest rate — and that means the weakest bank is charging the highest rate because that's the only way to raise it."

The volatility creates problems for the smaller banks that are relying on brokered

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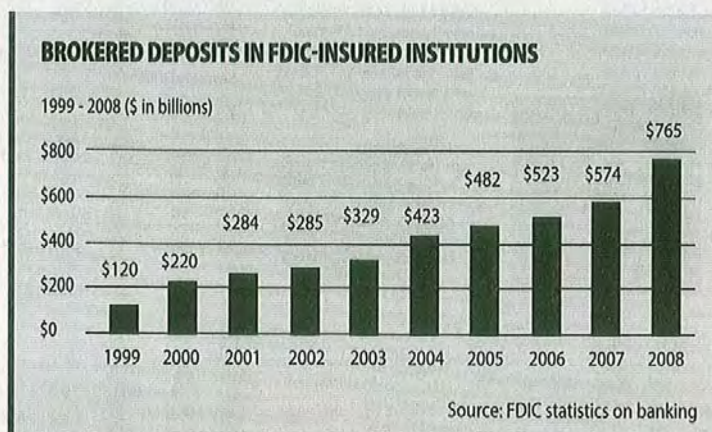

CDs and affects its profitability.

"Brokered deposits can move in an instant," Roche said. "If you have issues on the lending side and the deposit side gets hurt, then you have a capital issue because you don't have enough to keep the loans. When things get bad, this money flies, and when it flies it's not like you're losing one or two accounts. It's almost wholesale-like."

Interest expense can skyrocket as a bank seeks to stay competitive in the brokered deposit market.

"If you pay more, you have to charge more for your loans, which means you're probably involved in riskier loans," Nason said, noting the deposits are mostly favored by community banks. "The large commercial banks don't use them. They don't need them."

Raul Fernandez, a Nason executive and longtime international banker, said brokered deposits can be useful to banks in a crisis, when properly managed.

"In some cases, they may have saved some banks," he said. "Having access to this kind of deposit may have helped them maintain their liquidity ratio."

High-interest consumer loans funded with brokered deposits can still be profitable, Fernandez added. And because even short-term deposits mature at different times, a bank has time to recover from that loss by bringing in new brokered depositors.

Only institutions that regulators consider "well-capitalized" can use brokered deposits, although "adequately capitalized" banks can use them with an FDIC waiver. Undercapitalized institutions are not permitted to accept them.

"If the institution, because of continuing nonperforming loans, winds up in a less than well-capitalized position, it cannot take brokered deposits and therefore its source of funding has dried up," said Brown, the Shutts & Bowen attorney. "If the bank has issues and falls out of the well-capitalized area, most depositors aren't going to rush in to fill the void left when the brokered deposits leave. That can lead to a liquidity crisis for a bank which, of course, is a very serious thing."

IndyMac Bank, the Pasadena, Calif.-based bank whose 2008 failure heralded the onset of the banking crisis, is often cited as a case study of how over-reliance on brokered deposits can contribute to a bank's failure.

A Treasury Department auditors' report published several months after the bank's collapse noted that with only 33 retail branches IndyMac had limited access to retail deposits, causing it to depend more closely on brokered deposits beginning in August 2007, when the market for the thrift's loans collapsed.

Within six months, brokered deposits increased from about $1.5 billion to $6.9 billion. An April 2008 FDIC analysis noted that the bank had $12 billion in certificates of deposits that would mature with six months and be subject to withdrawal — especially as word of the bank's condition spread.

"At this point, the thrift's capital position was put in jeopardy and, combined with its lack of retail deposits and reliance on brokered deposits" caused a liquidity crisis.

Brown said brokered deposits give a bank temporary liquidity — and a bank that has a significant loan portfolio, troubled or not, with a declining deposit base needs to replace those deposits.

"That's usually the last resort for a bank that gets in trouble, so it's logical that every bank which has an issue is going to wind up with a slug of brokered deposits to fill the liquidity hole," he said. "It's the most expensive, it's the least dependable in terms of a relationship. The depositor doesn't have any other business relationship with the bank, so no ancillary business comes off of it."

Closer to home, Treasury's after action report on **Ocala National Bank**'s failure in late January noted that in September of 2006 and 2007, brokered deposits represented approximately 22 percent and 16 percent, respectively, of its total deposits.

"The bank's heavy reliance on brokered deposits increased its vulnerability to an economic downturn," auditors wrote. "In 2008, the bank could no longer readily rely on wholesale funding, including brokered deposits, because of its asset deterioration and restrictions on the use of brokered deposits."

As a result, liquidity became stressed.

"You can't borrow short and lend long. Sooner or later, that's going to get you in trouble," said **Wayne Rogers**, the Destin-based actor-turned-entrepreneur and financial advisor.

"You've got to have a fairly solid deposit base," but banks that got dependent on brokered deposits were doomed to fail in a contraction, he said. "Desperation was the mother of a lot of those things. They got themselves in trouble, and they had to do it."

Even so, he says brokered deposits really are a small part of a bigger question. After all, he said, the brokered deposits community banks have gravitated toward are backed by insurance premiums paid by banks.

"What's going on with these big money center banks that have been bailed out with taxpayer money? That's much more money than anything that's in these brokered deposits."

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