McHenry Kane
Vice President
Attorney

SunTrust Banks, Inc.
303 Peachtree Street, N.E.
Suite 3600
Atlanta, Ga. 30308
Tel 404.588.8627
Fax 404.230.5387
[redacted] (b)(6)

May 27, 2011

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429-9990
Attn: Comments
coredepositstudy@fdic.gov

Re: Adjustment Guidelines

Ladies and Gentlemen,

On behalf of SunTrust Bank, I would like to take this opportunity to provide certain comments to the Federal Deposit Insurance Corporation's ("FDIC") notice of proposed rulemaking that would determine how discretionary adjustments would be made to the total scores used in calculating the deposit insurance assessment rates of large and highly complex insured institutions (the "NPR").

First, SunTrust would like to applaud the FDIC for proposing a process that is designed to ensure that the adjustment process is fair and transparent and results only in adjustments that are well-supported. We genuinely appreciate the efforts and procedures set forth in the guidelines to meet these goals. In particular, permitting requests from the industry for adjustments reflects your willingness to work with financial institutions and desire to reach fair and just results. Also, only permitting adjustments that are material goes a long way towards allaying fears of capricious or arbitrary application of these rules. SunTrust acknowledges your responsiveness to those concerns that were raised by the industry in earlier comment letters and thanks you for addressing these concerns in this NPR.

Second, we find it difficult to reconcile the FDIC's public remarks similar to those made in "Supervisory Insights: Regulatory Actions Related to Foreclosure Activities by Large Servicers and Practical Implications for Community Banks,"[1] in which the FDIC describes how it encourages institutions to avoid unnecessary foreclosures and consider loan modifications, with the FDIC's rules that classify performing restructured loans as both underperforming assets for the life of the loan and as criticized and classified items for the life of the loan to the extent the restructured loan meets other criticized or classified criteria, resulting in higher deposit insurance premiums to institutions that enter into loan modifications with borrowers. The final rule on the new assessment scheme (the "Final

1 http://www.fdic.gov/news/news/press/2011/pr11082.html. See also FIL-35-2007, Working With Residential Borrowers: FDIC Encourages Institutions to Consider Workout Arrangements for Borrowers Unable to Make Mortgage Payments, http://www.fdic.gov/news/news/financial/2007/fil07035.html; FIL-76-2007, Servicing for Mortgage Loans: Loss Mitigation Strategies http://www.fdic.gov/news/news/financial/2007/fil07076.html.

Rule")[2] suggested that the FDIC may address the issue by its discretionary adjustments; however, this issue is not addressed in the NPR. While it may be supported by evidence and perfectly reasonable for the FDIC to allocate greater risk to restructured loans for purposes of risk assessing financial institutions, such allocation undermines the FDIC's public position that it encourages financial institutions to work to keep borrowers in their homes. If the FDIC is committed to encouraging financial institutions to work with defaulting borrowers to restructure loans, then the FDIC should not actively penalize financial institutions for doing so, particularly if such restructured loans are performing. In light of public statements made by the FDIC that it encourages financial institutions to work with borrowers who have defaulted to restructure loans, we would like the FDIC to specifically show how it will encourage financial institutions to restructure such loans through the discretionary adjustment in light of how the Final Rule, at present, penalizes financial institutions for restructuring loans with borrowers.

Third, SunTrust requests that the FDIC clarify certain terms used in the NPR in order that compliance with any final rule would be straightforward. With respect to the definitions for the proposed peer groups, it is not clear whether mortgage loans plus mortgage backed securities are intended to be limited to residential mortgage loans plus residential mortgage backed securities or whether the intention is also to include commercial real estate loans and commercial real estate backed securities. Furthermore, it is unclear whether "mortgage loans" is meant to encompass home equity lines of credit also or only first lien mortgage loans.

Fourth, it is not clear whether the regional offices of the FDIC will suggest discretionary adjustments or whether the national office of the FDIC will make such suggestions based upon a review of data received. SunTrust would advocate that such decisions be left to the national office of the FDIC because that would enhance the impression that the FDIC is taking into consideration the whole banking industry in determining outliers in light of how hard the FDIC has worked in this NPR to lend credibility and fairness to the entire process.

Finally, we note, however, that because of the short-time from when a financial institution receives notice of a potential discretionary adjustment to the end of the relevant quarter (approximately fifteen (15) days), financial institutions will not have much time, if any, to make meaningful changes to reduce risk. It has been understood by SunTrust that the FDIC evaluates the risk of an institution in assessing deposit insurance in part to discourage risky banking practices and encourage safe banking practices; however, this goal will not be fully realized if financial institutions do not have a meaningful opportunity to make adjustments to minimize its risk. Therefore, we would ask that the FDIC consider more forewarning of a potential discretionary adjustment that increases an institution's deposit insurance assessment.

---

2 76 FR 10672, 10692; 2011 WL 663989 (F.R.).

LA11-374

BRAD MILLER
13TH DISTRICT, NORTH CAROLINA

WASHINGTON, DC
1127 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, DC 20515
(202) 225-3032

www.bradmiller.house.gov

Congress of the United States
House of Representatives

COMMITTEE ON FINANCIAL SERVICES
CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
OVERSIGHT AND INVESTIGATIONS

COMMITTEE ON SCIENCE, SPACE, AND TECHNOLOGY
RANKING MEMBER, ENERGY AND ENVIRONMENT
INVESTIGATIONS AND OVERSIGHT

FDIC

April 29, 2011

MAY 4 2011

OFFICE OF LEGISLATIVE AFFAIRS

The Honorable Sheila C. Bair
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

RE: Study and Report on Core Deposits and Brokered Deposits

I am writing as part of the comment period under section 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which instructs the FDIC to assess the differences between core and brokered deposits.

Brokered deposits are frequently "hot money" chasing the highest interest rates, and those deposits are obviously less stable and contribute less to the bank's franchise value. It certainly makes sense for banks to pay higher insurance premiums on those deposits. Some deposits obtained through brokers and agents of third parties perform more like core deposits, however. Some "affinity" banking models receive most of their deposits through referrals from third parties. Those deposits have a retention rate similar to core deposits, as opposed to "hot money" deposits, and otherwise are stable, low-cost funding sources from customers that have a relationship with the institution.

I urge you to develop definitions that take into account the stability of the deposits, and not just how those deposits are obtained. An unnecessarily restrictive definition of core deposits could well reduce lending opportunities to small businesses and farmers without increasing the safety and soundness of banks with an affinity banking model.

Sincerely,

(b)(6)

Brad Miller
Member of Congress

RALEIGH, NC
1300 ST. MARY'S STREET, SUITE 504
RALEIGH, NC 27605
(919) 836-1313

GREENSBORO, NC
125 SOUTH ELM STREET, SUITE 504
GREENSBORO, NC 27401
(336) 574-2909

LA11-385

U.S. House of Representatives
Committee on Agriculture
Washington, DC 20515

April 29, 2011

The Honorable Sheila C. Bair
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

RE: Study and Report on Core Deposits and Brokered Deposits

Dear Chairman Bair:

Section 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) requires the Federal Deposit Insurance Corporation ("FDIC") to study the differences between *core deposits* and *brokered deposits* and develop recommendations for better distinguishing between them. We commend your efforts thus far, and we write to reiterate our interest in a Section 1506 study and report addressing, in detail, the plight of smaller banks, especially banks chartered to serve a particular affinity group.

The fundamental premise behind Section 1506 is that the existing statutory and regulatory framework does not adequately take into account how deposit gathering has changed and how the legal framework affects affinity-based banks. We are concerned that the Section 1506 study and report will not address the unfair impact on these institutions and will instead focus only on the concerns of larger industry participants.

As you know, the term *core deposits* is used within the banking industry to refer to the deposits placed by a bank's reliable customer base. These deposits are made by customers who usually have a borrowing or other relationship with the bank, which makes these deposits a stable source of funding and growth.

The term *brokered deposits* generally refers to deposits that are pooled together and placed by brokers at whichever bank offers the highest interest rate. The insured depositor has no relationship with the bank, and brokers are prone to transferring these deposits opportunistically, whenever rates change. This instability, coupled with the higher interest rates banks pay to attract deposits through brokers, makes these deposits potentially dangerous, especially for weaker banks that rely on such deposits to fuel rapid growth.

We understand that the current statutory and regulatory framework requires affinity-based banks to report many of their core deposits as brokered deposits. It appears as though the current framework over-emphasizes the means of obtaining a deposit and fails to adequately consider the nature of the deposit itself.

The roundtable you recently held to discuss brokered deposits suggests that the FDIC staff is developing a proposal that would shift the law's focus from the role of the deposit broker to the nature of the deposit, specifically its stability. This appears to be consistent with Basel III, which requires regulators to distinguish between "stable" and "less stable" deposits for purposes of measuring liquidity risk. We applaud this focus and hope that the FDIC is able to construct a regulatory solution mindful of affinity-based banks so as to avoid treating their core deposits as brokered deposits or disfavoring their deposits in any other proposed classification.

As you continue to study the issue, we request that the FDIC modify the affinity group exception to the brokered deposit framework by deleting the compensation component, while retaining all other elements of the test. This would provide immediate relief for affinity-based banks.

We look forward to reviewing the FDIC's report under Section 1506. Thank you for your attention to this important matter.

Sincerely,

(b)(6)

Frank D. Lucas
Member of Congress

(b)(6)

Randy Neugebauer
Member of Congress

DISCOVER
FINANCIAL SERVICES

May 4, 2011

Via Electronic Mail: *coredepositstudy@fdic.gov*

Ms. Sheila C. Bair
Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attention: Comments

Re: H. R. 4173—847 Sec. 1506. Study On Core Deposits And Brokered Deposits

Dear Chairman Bair:

Discover Bank appreciates this opportunity to comment on the Federal Deposit Insurance Corporation's ("FDIC") study of core and brokered deposits pursuant to Section 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R. 4173).

Discover Bank is one of the largest issuers of general purpose credit cards and student loans in the United States. Discover Bank, a subsidiary of Discover Financial Services, is chartered by the State of Delaware. As one of the nation's largest insured depository institutions, with deposits of $35 billion as of February 28, 2011, Discover Bank is vitally interested in the FDIC's study of the definition for core deposits.

EXECUTIVE SUMMARY

As set forth below, we believe that the definition of what constitutes core deposits has not kept pace with changes in the deposit markets.

In summary, we believe that:

1. The current definition for core deposits is ineffective, outdated and penalizes certain deposit classes that exhibit stability characteristics that should qualify them as core deposits

2. Formally or informally, regulators and the industry will continue to apply a notion of core deposits and therefore an appropriate definition needs to be developed

3. A revised definition for core deposits should focus on characteristics that promote funding stability

4. The definition of core deposits needs to incorporate factors related to deposit insurance, product structure, customer relationship, and customer experience. The channel through which the deposits are obtained should not dictate whether a deposit is classified as core

5. Supervisory examiners should be empowered with a principle based approach in determining institution specific core deposit characteristics based on the revised criteria and other examination tools.

We believe that an approach of applying objective criteria in assessing the stability of deposits, one that is not biased against the channel through which the deposits are sourced, will produce the following clarifying conclusions:

- Certain brokered deposits, in particular brokered CDs of a certain term, should be appropriately recognized as core deposits by virtue of their term to maturity, stability and structure (i.e., the significant limitations on early withdrawal)

- Direct-to-consumer deposits, supported by the evolution in technology and acceptance by consumers of the direct channel, can exhibit stability characteristics comparable to similar deposits at traditional brick and mortar institutions.

DISCUSSION

The Current Approach To Defining Core Deposits Is Outdated, Not Well Defined, Subject To Interpretation, And Can Adversely Impact Bank Funding Decisions

Discover Bank believes that the current approach to classifying core deposits, effectively by relying only on the nature of the origination channel and the size of account balance, requires significant reconsideration and modification.

What constitutes core deposits is not well defined in banking regulations or regulatory guidance. A recent white paper[1] by the law firm Seward & Kissell LLP, notes that the term lacks specificity:

- Neither FDIA nor FDIC regulations utilize the term "core deposit"

[1] Seward & Kissel LLP, "Definitions of Brokered and Core Deposits", March 18, 2011

- The concept is mentioned, but again not defined, in various examination manuals
- For reporting purposes the UPBR has recently adopted a classification that includes: demand deposits, interest bearing checking accounts, ATS accounts, money market demand accounts, savings accounts, and total time deposits under $250,000. This classification explicitly excludes all brokered deposits.

Due to the lack of a robust definition, the term core deposit is inherently subject to different interpretation and application among users. Informally, there exist well-entrenched criteria that are often used to characterize certain deposits as non-core or volatile, including: interest rate paid, origination channel, and geographic proximity.

In the absence of a formal core deposits definition, it should not be expected that industry participants, examiners, investors, analysts, and others will cease to employ this concept in evaluating the health and performance of banking institutions. As such, it is critically important to identify an appropriate definition.

The core deposit assignment affects financial institutions through its influence on supervisory examination results, public market perception, and ultimately management decisions related to balance sheet strategy or tactics. Counterproductive to prudent risk management practices, in some instances banks may decide it is preferable to fund with deposits they believe are relatively less core simply to avoid the stigma of reporting higher non-core deposit ratios under the current outdated guidance.

For example, brokered deposits, regardless of their potentially attractive maturity or product design characteristics, are not considered core deposits under existing guidance and have the negative association with prompt corrective action. Direct-to-consumer deposit accounts under $250,000, while currently considered core, often have a negative connotation in the marketplace and from the perspective of regulators because they leverage a different business model. As such, we believe that direct-to-consumer deposits are inappropriately viewed as "lesser core".

Discover believes that the negative association regarding both products is incorrect and demonstrates a lack of appreciation for their true value and stability attributes. With appropriate management and proper assessment, both sources can act as stable funding, are consistent with a responsible business model, and are inherently valued by consumers.

Discover Bank urges the FDIC to use this opportunity to improve and clarify the appropriate criteria by which to assess the stability of deposits. With appropriate

criteria established to replace the current focus on deposit channel, we believe that certain brokered deposits will be broadly viewed as core and that there will be a more positive affirmation of the core deposit characteristics of direct-to-consumer deposits.

The Incumbent Core Deposit Definition Ignores Meaningful Changes That Have Occurred In Customer Behavior, Business Models, And Risk Management Within The Depository Landscape

The intention of the core deposit designation should be to characterize those deposit liabilities that promote funding stability for an institution. At the highest level, the current criteria for core deposit assessment, while convenient, are simplistic and overly broad. They fail to address more important, yet complex industry-level factors.

1. *Customer preferences have changed over the years with advancements in technology*

   The manner through which customers interact with their chosen financial institution and how they place deposit funds has evolved through time making a core definition that overly relies on channel of origination misaligned with the market place.

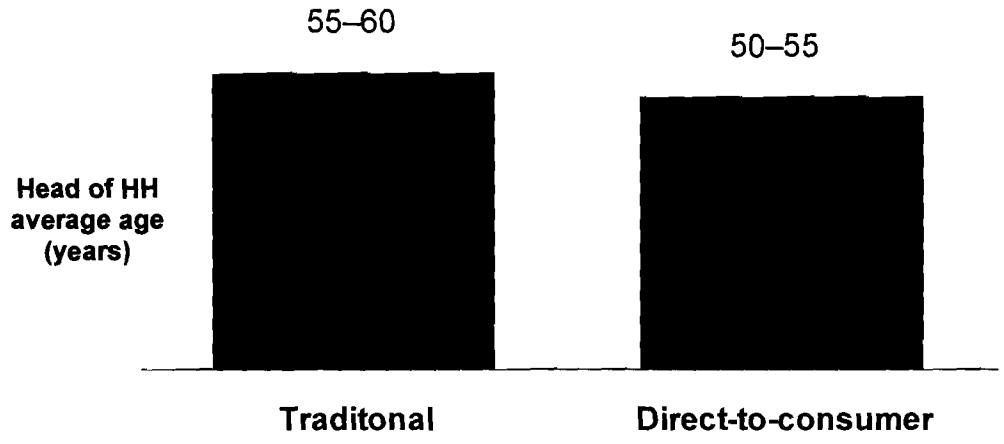
   Advancements in technology have increasingly altered the way in which customers handle their funds. Financial services customers seeking convenience now regularly interact through multiple non-branch channels including: phone, the internet, and mobile devices. Between 2005 and 2010, U.S. households using online financial services channels increased at a 27% compounded annual growth rate, rising to 60% of the population[1].

   The shift in channel preference is not exclusive to certain segments of the population. Within this population, approximately 80% of generation "X" and "Y", 70% of baby boomers, and 40% of seniors were represented. As seen in the following chart, the resulting age demographic of the average household depositor in either a traditional branch based bank or a direct-to-consumer[2] franchise is not meaningfully different.[3]

[1] Forrester Research; U.S. Census Data, First Manhattan Consulting Group

[2] Direct-to-consumer deposits are defined as consumer deposit liabilities that are largely gathered and serviced through non-branch, or "branch light" configurations. This includes direct mail, phone, and the online channels

[3] First Manhattan Consulting Group



2. *The introduction of new business models to the deposit taking business has altered customer behavior and needs to be explicitly incorporated in defining core deposits*

   Banks employ different business models based on specific strategies for delivering value to clients. The implication of this is that the metrics used to identify the degree of core or stable deposits can not be simplified to a limited set of rigid values. Rather, the approach to evaluating the core characteristics of a deposit base must be viewed in relation to how an entity attracts and serves it customers.

   An assessment of core deposits must be evaluated in the context of a specific institution's business strategy and success in delivering value to customers. Only in doing so can appropriate consideration be given to the impacts of asset selection, noninterest expense structure and consistency with customer experience.

   In some instances a specific bank's ability to pay higher deposit rates may be driven by an operating cost structure advantage and be entirely consistent with the value expected by customers. Similarly, certain business models are more cohesively understood by customers to be national or direct rather than locally executed.

   Customer awareness and acceptance of emerging business models has increased rapidly. The direct-to-consumer banking model is relatively new to banking, generally having developed over the last fifteen years. However, recent industry research indicates that direct-to-consumer institutions enjoy high levels of customer advocacy. Data indicates that when asked if they would recommend their bank to a friend or relative, the results for direct banks exceeded many

national and regional branch model performance by a significant degree[1]. Such evidence of loyalty implies an appreciation for the value of services offered.

Similarly, recent industry research also shows that when polled regarding their preferred banking channel, over 50% of consumers would prioritize direct opportunities.[2]

The Discover business model emphasizes direct-to-consumer deposit gathering and the prudent use of brokered deposits because we feel they are consistent with our brand affiliation and risk management objectives. Our long-term asset growth projections are between 5 and 10%[3], which is evidence that our deposit raising strategy is not intended to support the need for funds that can be raised quickly, at any cost, to support risky behavior. Rather the direct-to-consumer deposit channel:

- Aligns with our strategy of playing a leading role in being a national consumer credit provider

- Offers opportunities to establish multi-account client relationships that promote brand loyalty

- Provides high customer value

The consistency of our product offering aligned with our customer expectations allows us to drive stable deposit relationship development.

3. *The stigma of non-core funding inhibits the use of certain deposit products for sensible asset/liability and liquidity management activities and ignores the increased and evolved understanding of customer behavior that banks have developed*

Financial services industry requirements for measuring and assessing asset/liability and funding risk have become increasingly sophisticated. This is based on advancements in technology, the ability to analyze more customer data and an objective to satisfy more sophisticated supervisory, investor, and management expectations.

As a consequence, banks are better prepared to understand their balance sheet management needs. Discover Bank conducts sophisticated and detailed analysis

[1] Bain & Company, Inc. "Customer Loyalty in Retail Banking", North America 2010
[2] American Bankers Association Survey 2010
[3] Discover Financial Services Investor Day presentation, March 23, 2011

in conjunction with our contingent funding and capital management plans. As part of this analysis we have more explicitly modeled expectations for deposit balance behavior based on our customer base. Our research is developed based on a combination of the products we currently use to fund our assets and data driven assumptions for how our deposit customers will perform under different interest rate scenarios. In short, individually and collectively across the industry banks have more data and increasingly sophisticated tools to use in assessing the core liquidity behavior of our deposit base. Employing an overly simple classification scheme to characterize a bank's deposit base would be to ignore these advancements.

Increased sophistication in asset/liability and liquidity risk management also allow Discover's Corporate Treasury personnel to more precisely understand the duration of liability funding we require. The brokered deposit market, specifically, offers unique opportunities in this context:

- Brokered certificates of deposit are often available to Discover Bank at duration points that are either unavailable or too expensive through retail clients (either direct-to-consumer or branch based). This allows for match funding to occur in managing interest rate risk. Discover's brokered CD funding is typically over two years in average original maturity, which increases our flexibility in managing liquidity risk prudently. However, these deposits are not classified as core and therefore are inferred to be more volatile. We find it inherently incongruent that using these liabilities in such a prudent manner unilaterally could be deemed a more risky approach to using alternative short term retail CDs

- Regardless of maturity, brokered deposits can be originated with either fixed or floating coupon rates, based on our asset/liability management preferences and needs

- Where our loan customers possess a prepayment option, callable brokered CDs offer Discover opportunities to hedge option risk far more effectively than traditional retail sources

- Because brokered deposits can be redeemed prior to maturity only in very rare conditions, they provide significant liquidity forecasting advantages

- Because they are distributed in a highly efficient manner, brokered deposits can be raised more quickly than retail CDs, should an unexpected funding need occur and are also less sensitive to market disruptions

– Brokered sources allow institutions without capital markets access additional balance sheet management flexibility.

The risk management activities described above provide financial institutions with the confidence to diversify liquidity management practices by utilizing multiple sources of funding. As of November 2010, Discover Bank's balance sheet was diversified across direct-to-consumer (40%), asset back securitization (30%), and brokered CDs (26%)[1]. Attractive balance sheet management characteristics exist in all of these funding vehicles if used appropriately. Attaching a stigma or financial or regulatory cost or burden for using a particular source of funding relying on uninformed and simplistic criteria restricts our ability to manage the balance sheet effectively.

Many Deposit Products Currently Considered Non-Core Or "Lesser Core" Have Attractive Stability Characteristics

Discover Bank believes the current application of the core deposits term, as well as the perception of some in the industry regarding deposits obtained through non-traditional channels, understates the value and stable liquidity characteristics of these types of funds.

Structurally, brokered deposits can have superior stability attributes with the following characteristics:

– Contractually stable because they are redeemable prior to maturity only in the case of death or adjudication of incompetence of the underlying depositor

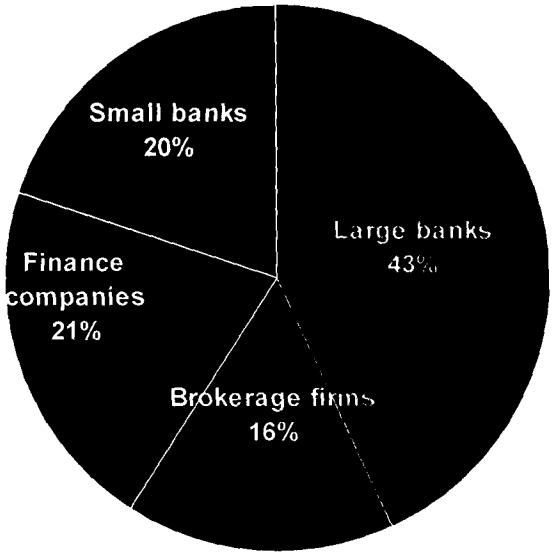
– Even during extreme financial crisis, brokered deposits are "non-runnable"

– Funds can be raised quickly at maturity terms that allow for liquidity warehousing

– The existence of an active secondary market allows for easier issuance of longer dated fixed and floating rate products

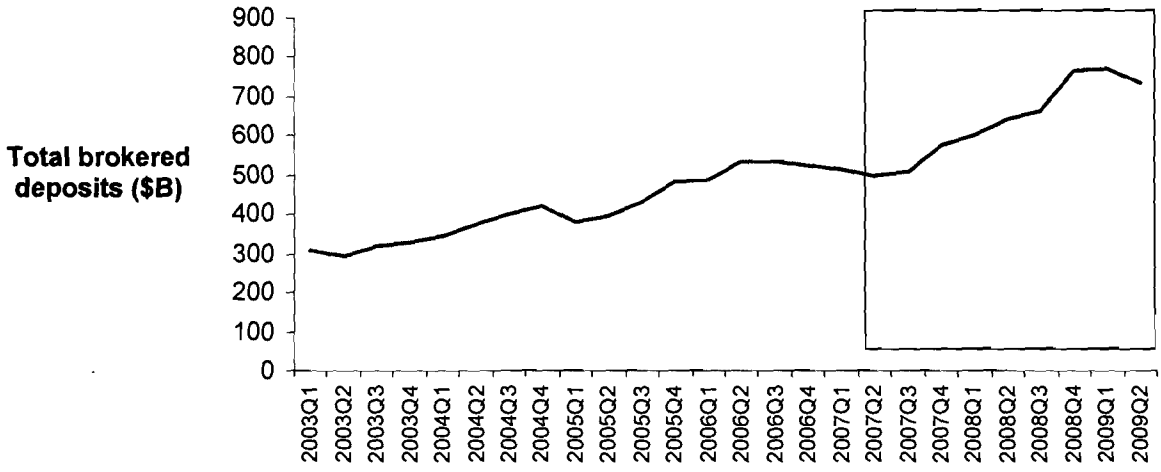
Brokered deposits have been highly effective in providing stable liquidity to financial institutions, even during the recent liquidity crisis. Their use during this period was attractive to small and large firms across different sectors of the financial services industry.

[1] Discover Financial Services Investor Day presentation, March 23, 2011



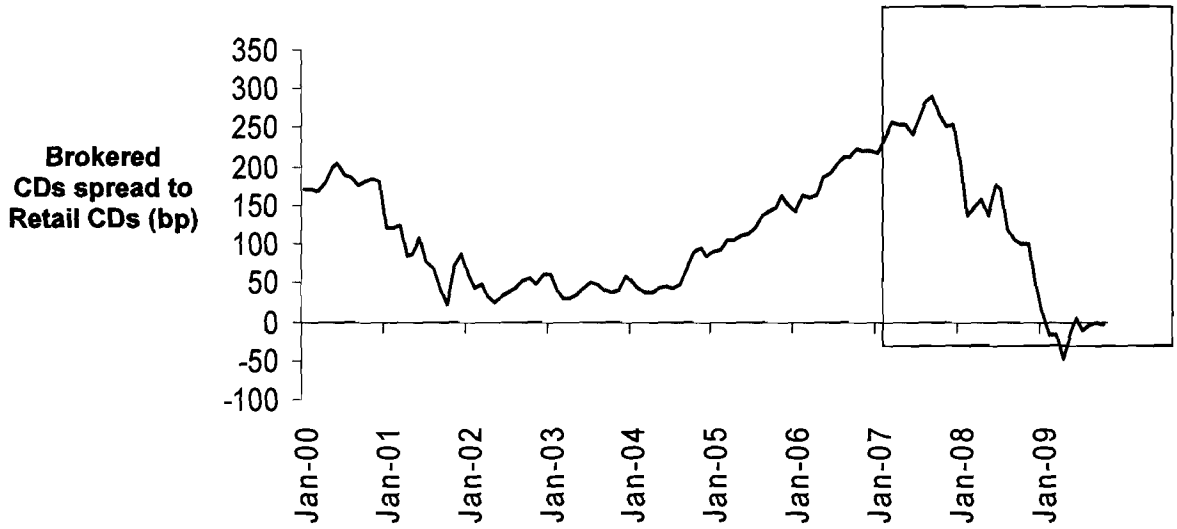
% of 3Q '09 brokered deposits by institution type

As illustrated by the chart below[1], at the depth of the financial crisis, from the second quarter of 2007 to the first quarter of 2009, brokered deposits continued to grow and provide system-wide liquidity. This demonstrates the accommodative nature of the brokered CD product to step into a market where liquidity was strained and to play a supporting role for liability managers.



[1] First Manhattan Consulting Group, regulatory filings, Bloomberg. 3-month term CD comparison. Brokered rates exclude commissions

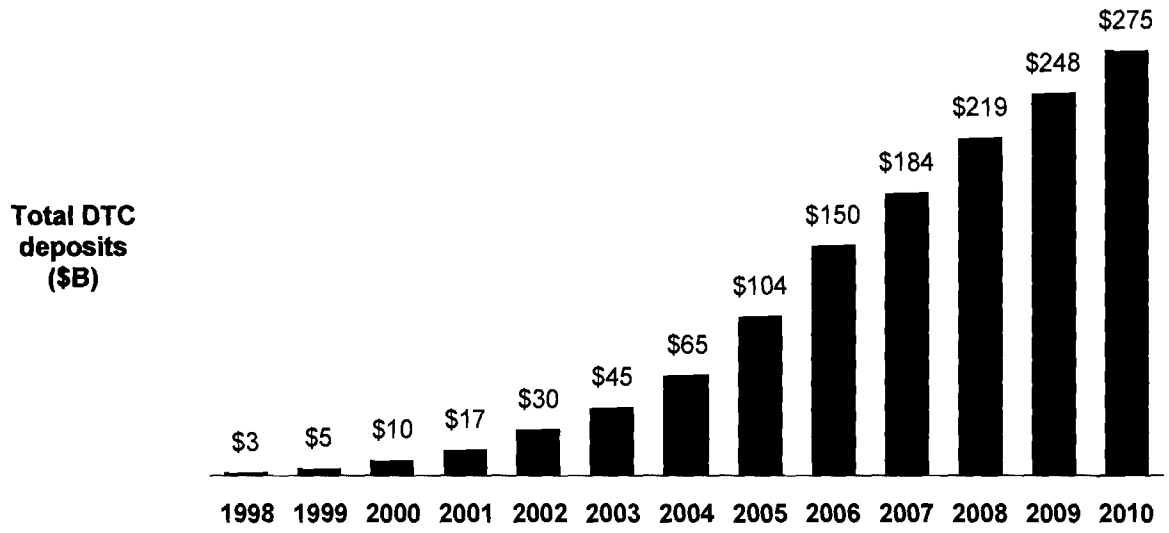
Furthermore, during the same period when the brokered market was providing important market funding, its pricing became comparatively more rational to retail CDs.



The direct-to-consumer deposit market also exhibits strong liquidity characteristics. Similar to brokered deposits, direct-to-consumer deposits have proven to be a strong and resilient funding source.

Industry level estimates show that between 2003 and 2010, the compounded annual balance growth for direct-to-consumer deposits was nearly 30%. This included the liquidity crisis period when balances grew between 10-20% on a year-over-year basis.[1]

[1] First Manhattan Consulting Group estimates



On an estimated basis, direct-to-consumer deposits represent less than 5% of the total U.S. deposit market today, so it remains an area for opportunity, particularly in light of the increased customer acceptance previously described.

Discover Bank also finds that the balances associated with this product are comparatively attractive from a stability perspective. Over the past twenty-four months, virtually all of our monthly deposit money market and savings vintages have grown to larger dollar balances today than they had at opening. This consistent pattern of balance growth has come against a backdrop of gradual and measured reductions in rates paid relative to industry and peer benchmarks. Based on discussion from the FDIC Core Deposit Roundtable, we believe that this is consistent with industry experience.

To a significant degree, we believe that this positive balance retention performance reflects the manner in which we interact with our customers. While our deposits are sometimes classified as "internet", in reality we service our customers in many of the same ways that a traditional banking franchise would and have multiple channels through which we develop relationships:

- Discover Bank solicits and manages its deposits through multiple channels. About 50% of our direct-to-consumer deposits are originated through the phone or mail/branch[1]

[1] Discover Financial Services internal data as of March 2011

- Nearly 60% of our one-year CD balances have multiple deposit relationships with our Bank

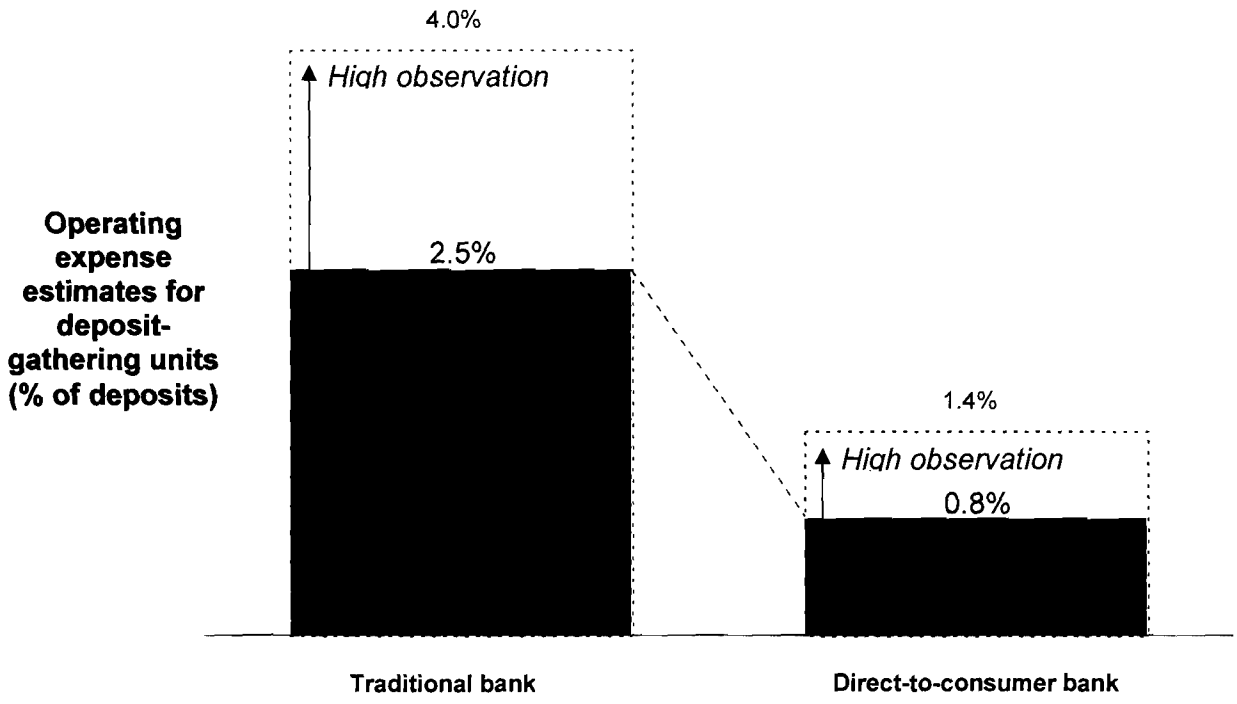
- Approximately 40% of depositors also have a card relationship with the Bank and an additional twelve percent of deposit accounts have an affinity relationship with a Discover partner

Rather than requiring customers to engage with Discover Bank through a single channel, we provide multiple opportunities for interaction that we believe customers find important from a convenience standpoint.

Direct-to-consumer and brokered deposit gathering activities are often criticized for paying higher customer rates. The concern is that paying above a national or regional average rate indicates that the funding is less stable.

What is not appropriately addressed in this argument is that Discover and other banks utilizing the direct-to-consumer model have developed a distribution approach that is far lower cost to operate. As part of the value we provide to consumers, we pass along that advantage. Therefore, comparing traditional bank deposit rates with other business models is a fundamentally flawed practice.

As can be seen in the following chart, estimates of the cost advantage for direct-to-consumer deposit models are significant.[1]



By utilizing our cost structure advantage and with prudent asset/liability management, Discover Bank is not only able to offer customers relatively higher rates versus traditional models, but we can also offer this value on a consistent basis. Direct-to-consumer deposit gathering is a well understood business activity within Discover Bank and one that we consider to be a long-term activity for the company in supporting our business model.

Similar to direct-to-consumer deposits, brokered deposits also have an attractive operating cost structure relative to retail CDs and one we understand well through our consistent involvement with the product over the preceding decades.

- Brokered deposits have a known up-front non-interest expense level
- Non-interest expenses are driven by multiple advantaged factors:
  - There are no marketing costs

[1] First Manhattan Consulting Group

– The issuing bank only has to complete paperwork for the 1 Master CD; the dealer/broker absorbs the paperwork issues for breaking-up into smaller deposit portions

FDIC's Revised Core Definition Should Address The Drivers Of Deposit Stability

The core deposit designation should be aligned more closely with characteristics that indicate deposit stability. Such a bottom-up, principle based approach to assessing deposit stability would be completely consistent with supervisory expectations for financial institutions regarding how funding and liquidity risk appetite is either implicitly or explicitly developed and expressed.

Discover Bank believes that assessing the stability of core deposits could be accomplished through the development of a consistent and actionable "checklist" of comprehensive criteria that would provide the basis of core deposit evaluation. Under this approach the deposit base of a particular institution would be characterized against important factors of stability, including:

1. *What proportion of the deposit account balances are protected by a deposit insurance scheme?*

   The recent U.S. financial crisis has illustrated the power and relevance of deposit insurance in instilling confidence for individual depositors and the system itself.

2. *What deposit product structures or characteristics that promote stability are evident in an institution's approach to deposit product management?*

   Certain product design aspects or origination focus by management serve to increase or reduce the stability of deposit products. For CDs, the presence of a meaningful early withdrawal penalty will reduce the incentive for depositors to move funds out of an institution with little advance notice. Brokered CDs are the most fully evolved example here, where withdrawal prior to maturity can only occur under very limited circumstances.

   In addition to the structural design of a deposit product, core characterization should also look to how a product is managed by the institution. As an example, an internal philosophy of focusing CD marketing around products with longer maturity profiles creates a different core deposit profile than one where the

focus is on shorter-term funds[1]. To better illustrate this practice, consider that as of March 2011, the weighted average contractual maturity at origination for Discover Bank's direct-to-consumer CD portfolio was slightly less than three years and the weighted average contractual maturity of new production was nearly two and a half years.

In a normal upward sloping yield curve, institutions issuing longer maturity funding are promoting prudent liquidity management and in doing so incurring the real cost of higher interest rates. This type of responsible behavior should be recognized and rewarded.

Direct-to-consumer deposits are often characterized as high rate and therefore structurally less stable. As we have commented, this assertion is flawed because it fails to consider operating cost structure relative to interest rate. Additionally, the consistency of rate offered needs to be considered as it reinforces a stable value proposition to customers.

3. *How stable and consistent is a particular institution's deposit pricing approach? (this is different from an isolated focus on what absolute rate an institution pays to customers)*

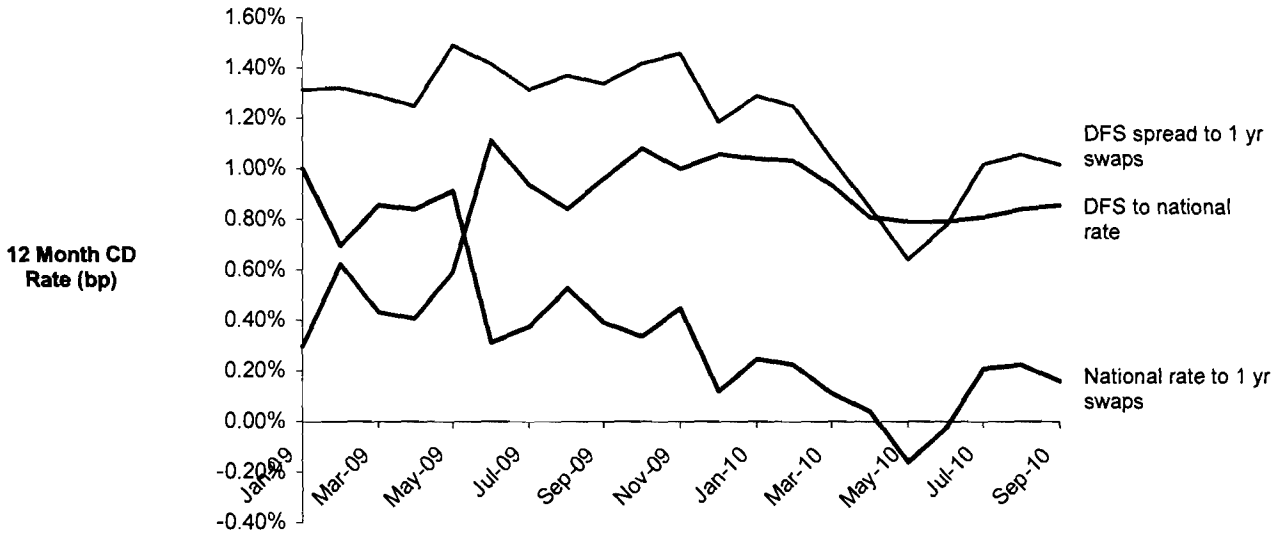
Direct-to-consumer banks' major deposit product types are CDs, money market accounts, and savings products. Our lower operating cost structure allows Discover Bank to pay a comparatively higher rate to consumers for their funds. Arguments have been made that higher rates paid to customers lead to more volatile deposit balance characteristics and less resulting core deposit funds.

We believe that in providing a higher rate to customers, one that nonetheless provides Discover with a profitable relationship, we are creating value for customers. Our offering is understood and appreciated by our customer base. We have internal fact-based data that our renewal rates on CDs and vintage-based balance growth rates for non-maturity deposits are attractive.

Therefore, within reasonable levels, we disagree that higher rate deposit accounts are inherently less stable than lower rate deposit accounts. Discover finds that the more important practice in driving stability is to remain consistent in the value that customers derive from our deposit products. The following chart shows Discover Bank's 12 month CD rate paid versus a national weighted average market price for branch based institutions. From June 2009 onward, one

[1] Assuming the appropriate early withdrawal policies are in place.

notices that our direct-to-consumer rate is not only higher than branch comparisons, but also stable in its incremental value provided to customers. [1]



As such Discover Bank finds that consistency in rate, aligned with an institution's business model, should be the focus of core deposit assessment, not the absolute rate offered.

4. *What evidence of customer relationship development is observed within an institution's deposit base?*

Evaluating core deposits must explicitly recognize the relationship the depositor has with an institution, e.g., aspects related to the length of time a customer has been with a bank and the number of times they have renewed maturing product in the past. The use of ancillary services (e.g., CD laddering programs) is another element in determining both the expected "stickiness" of that individual customer and also their sensitivity to rate paid.

As an example,

– Internal Discover Bank data show that for customers where we have more than one deposit relationship, the likelihood of CD renewal at maturity is measurably higher. Our renewal rates for multiple deposit account holders

[1] We note in the chart above that volatility in the difference between Discover and national rates around the June 2009 time period is caused primarily by a decline in national CD rates during that period.

are in excess of 90%, regardless of whether they have renewed with us before

- The rate of renewal for all customers where a previous renewal has already occurred is meaningfully higher than for first time CD buyers where a commitment to the relationship has not been previously observed.

5. *What elements of value and satisfaction are provided to customers through an institution's deposit product offerings?*

   Discover Bank believes that the best way to generate sustainable core deposit relationships is to offer tangible value and serve individuals well. Consistent or improving customer satisfaction is a key aspect for developing long-term relationships.

   The growth in Discover Bank's and the industry's level of direct-to-consumer deposits is evidence that the business model proposition resonates with a meaningful segment of U.S. depositors.

   As pointed out in a recent industry survey report "The pattern abundantly evident... is that customers are inclined to value banks that value them. Direct banks were the clear loyalty winners. With their simple, low-cost business model of providing just a few attractively priced product delivered and serviced online and through efficient call centers, they score high with respondents because they invest in servicing them well."[1]

Once these criteria have been identified, more flexibility should be provided to examiners in assessing the core deposit profile of a specific franchise by evaluating a bank's business model, liquidity management approach, and relevant internal deposit behavioral data.

Refined Data Collection And A More Principle Based Assessment Approach Should Be Developed

Driving the industry to assess core deposits using more robust criteria will require additional data. Discover Bank believes, however, that all of the elements previously described that we identified as more appropriate indicators of core deposit behavior can be supported with incremental, straight-forward data collection by banks.

[1] Bain & Company, Inc. "Customer Loyalty in Retail Banking", North America 2010

Supervisors should look to financial institutions to provide additional factual characterizations of their deposit portfolios. This information could include:

- A description of the CD contractual early withdrawal agreements with customers
- A distribution of the original and remaining maturity structure for their brokered CD balances
- Analysis of renewal behavior for the current CD customer base
- Supporting data on the time on book for existing deposit account holders
- Vintage analysis showing balance behavior over time for non-maturity deposit accounts
- The number of deposit or other banking product accounts that each deposit account holder currently possess with a specific institution
- A description of the banks deposit pricing philosophy and recent practices, particularly related to the consistency in deposit pricing
- An assessment of and key trends in customer satisfaction results.

The purpose of providing this information would be so that supervisory examiners could avoid the need to apply overly broad or one-size-fits all criteria to evaluate core deposits at an institution. Rather, examiners would have the ability to view key data elements that reflect the consistency of deposit management within the institution's specific business model, funding mix, risk governance, and measurement capabilities to determine how the concept of core deposits would most effectively be applied to a particular institution.

Clearly the expectation for data analysis would need to accommodate the size of a particular organization. However, in our view the information suggested above is for the most part readily accessed. Where it is not, qualitative discussions would likely provide meaningful value as well.

CONCLUDING REMARKS

Discover Bank believes that the simple approach currently in place fails to recognize the key facts and conditions that must be recognized as part of any evaluation that addresses the classification of core deposits. By employing an effective set of criteria to evaluate core deposits based on stability, we believe that some products currently

viewed as less attractive will be more appropriately understood to have beneficial liquidity characteristics. In particular, brokered deposits given their advantaged structural characteristics and direct-to-consumer deposits with their growing acceptance and appreciation by consumers will be more accurately appreciated for the real value that they provide.

Ultimately, we believe additional data should be made available to supervisory bodies so that determinations of funding reliability are better aligned with an institution's overall business model and historical experience.

Discover Bank once again appreciates the opportunity to comment on the FDIC's study for core and brokered deposits. Please contact Chris Greene, Vice President and (b)(6) Associate General Counsel, at [redacted] if you have any questions.

Pepper Hamilton LLP
Attorneys at Law

Hamilton Square
600 Fourteenth Street, N.W.
Washington, DC 20005-2004
202.220.1210
Fax 202.220.1665

May 2, 2011

Via Electronic Mail & Online Filing
Sheila Bair
Chairman
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429
coredepositstudy@fdic.gov

Re: Core and Brokered Deposit Study as Mandated by Section 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act

Dear Chairman Bair:

Pepper Hamilton LLP appreciates this opportunity to submit comments to be considered as part of the above referenced Core and Brokered Deposit Study (the "Study"), being conducted by the Federal Deposit Insurance Corporation ("FDIC"). Pepper Hamilton LLP is a law firm which, among other things, represents financial institutions in connection with financial services regulatory issues. The views expressed herein are based upon our representation of credit card issuing banks (collectively, the "Credit Card Banks"). Additionally, the undersigned served as the Delaware State Bank Commissioner from 1994-1999 and supervised various financial institutions that relied on wholesale funding models. That experience also helps to shape these comments submitted in connection with the Study.

We strongly believe that regulatory changes will need to be taken as a result of the Study. We readily acknowledge, however, the limitations in connection with analyzing core and brokered deposits without the availability of industry wide aggregate data concerning which types of core or brokered deposits are appropriately characterized as being volatile, or as being stable. We therefore stress the importance of the need for the FDIC to obtain and provide to the general public, as well as to industry participants, aggregate data demonstrating such volatility measurement with respect to both core and brokered deposits.

We further believe that the Study is an important opportunity for the FDIC, in light of changes in technology and due to market innovations, to revisit its longstanding presumption that wholesale deposits are more volatile. The nature of deposit taking has changed

during the past generation and continues to evolve in the internet age. While such technological evolution continues, we would suggest that the FDIC take a flexible regulatory approach in connection with deposit taking. It is critical that financial institutions' deposits remain competitive with other investment choices for individuals, companies and governmental units. In light of the ongoing technological revolution, we would suggest that the FDIC reevaluate any changes in the future, possibly five or ten years from now, to determine appropriate measures.

We appreciate the FDIC's willingness to ask important questions as part of the Study, which include:

- Does the presence of certain kinds of deposits inherently increase an institution's risk?
- In times of financial stress, what types of deposits are likely to remain at or possibly leave the institution?
- What are some recommendations for legislative or regulatory changes with respect to core and brokered deposits?

Wholesale deposits are successfully utilized by many depository institutions. It is the experience of the Credit Card Banks that wholesale deposits are not more volatile than core deposits. In fact, in many circumstances, wholesale deposits are more stable sources of funding than core deposits.

I. Insured Depository Institutions Successfully Utilize Wholesale Deposits as a Stable Source of Funding and Such Deposits Do Not Necessarily Increase Risk to an Institution

To respond to the FDIC's specific Study question concerning whether the presence of certain kinds of deposits inherently increase an institution's risk, it has been the Credit Card Banks' experience that the presence of certain wholesale deposits do not inherently increase risk to a financial institution. Many insured depository institutions utilize wholesale deposits successfully as a stable source of funding. Indeed, the large banking institutions, and the Credit Card Banks, have relied upon business models with deposits derived from internet listing services ("Listing Services Deposits") and brokered deposit arrangements, even in times of volatile macroeconomic market conditions. It is the Credit Card Banks' experience that these types of deposits do not inherently increase risk to a depository institution or result in more volatility with respect to an institution's funding base.

The wholesale deposit market has become increasingly sophisticated over the past thirty years providing well capitalized Credit Card Banks, and large financial institutions with a reliable source of funding at reasonable cost. The Credit Card Banks have developed successful business models for utilizing both Listing Services Deposits and brokered deposits. The Credit Card Banks have substantial market experience with such deposits, especially with respect to consumer demand for various interest rate levels and the desired duration of the investment period for the deposits depending on the prevailing general market interest rate conditions. This

market-tested knowledge allows the Credit Card Banks, and other large financial institutions on an ongoing basis, to use the Listing Services Deposits and brokered deposits as steady sources of funding akin to core deposits.

Financial institutions are not under greater distress, nor are they more likely to fail, simply because they maintain wholesale deposits as a source of funding. Rather, financial institutions typically fail as a result of poor lending decisions. The wholesale deposits maintained by failed institutions are not the determinative factor in their failures, nor is it likely that a "deposit run" at a weak bank and any such concurrent liquidity problem is due to utilizing wholesale deposits. Indeed, it is the view of the Credit Card Banks, based on their experience, that it is more likely that the core deposits may be withdrawn due to an adverse local news item, or due to some other negative publicity.

Moreover, the Credit Card Banks believe that it is inappropriate to assess risk by simply considering the amount of a financial institution's assets that are Listing Services Deposits or brokered deposits, or to focus solely on the growth in these wholesale deposits in a financial institution's funding base. Instead, regulators should consider the financial institution's ability to manage its asset and liability growth.

II. Not All Wholesale Deposits Utilized by Financial Institutions Should be Treated in the Same Manner

To respond to the FDIC's specific study question concerning what types of deposits are likely to remain or leave an institution in times of financial stress, it has been the Credit Card Banks' experience that brokered deposits and Listing Services Deposits are no more likely to leave a financial institution than an institution's core deposits in such circumstances. It is the Credit Card Banks' view that, when properly utilized, certain forms of both brokered deposits and Listing Services Deposits are a predictable and steady source of funding for the large banking institutions and the Credit Card Banks. Therefore, for the reasons elaborated below, these stable products, when utilized by knowledgeable financial institutions should not be viewed as volatile forms of funding.

In the case of brokered deposits, some observers would undoubtedly characterize all brokered deposits as volatile, and therefore likely to be quickly removed by a depositor from a financial institution in times of financial distress. Based upon the Credit Card Banks' experiences, that simply is not the case. In actuality, most brokered deposit contracts prohibit early withdrawal for any reason other than the death of the depositor. Conversely, local bank products can often be withdrawn early – both with, and without, any penalty for early or immediate withdrawal.

With respect to Listing Services Deposits, it is the Credit Card Banks' experience that there is not a complete withdrawal by depositors from a financial institution upon the end of the term of such deposits. Customers often renew Listing Services Deposits, with the same financial institution, as a result of: the level of service provided by the financial institution; customer loyalty; the brand name of the financial institution; and the customer's comfort level in

dealing with the financial institution. As a result, these Listing Services Deposits are stable products that are akin to traditional core deposits.

In the case of both Listing Services Deposits and brokered deposits, the Credit Card Banks' generally do not utilize deposits that offer interest rates which are significantly above the prevailing market rate, a telltale signal that a deposit is more volatile. In addition, Credit Card Banks find Listing Services Deposits and brokered deposits to be stable because the rates offered generally are not at a premium since the wholesale deposits are viewed by depositors as safe, low risk government guaranteed products. These types of deposits (provided that they are fully FDIC insured) are likely to remain at depository institutions, including the Credit Card Banks and the large financial institutions, even in times of financial stress.

Based on the above, we strongly suggest that the FDIC abandon any bright-line tests in determining whether there should be a higher insurance premium on certain funding products. Rather, we respectfully suggest that the FDIC should consider the attributes of the product, decide if it is in fact volatile or stable, and then make a determination as to whether volatile deposits should pay a higher premium to the deposit insurance fund.

In addition, any new FDIC requirements should also consider the management abilities and the quality of the financial institution's systems in assessing and managing the various risks associated with funding and investment strategies. While certain levels of wholesale deposit growth might be viewed as increasing risk to a financial institution, we suggest that the assessment of risk be based on a more comprehensive view of the financial institution as opposed to simply a review of the absolute growth in brokered deposits and Listing Services Deposits.

III. Recommendations

In response to the FDIC's request for legislative or regulatory recommendations, we respectfully would suggest that the FDIC should not simply assess a higher premium on a deposit because it is brokered. That methodology is overinclusive and unfairly captures certain brokered deposits that should be treated as core deposits. Rather, based upon the Credit Card Banks' experience, we would recommend that the FDIC revise its regulatory requirements to take into account certain considerations in connection with brokered deposits including but not limited to the following:

- The interest rate of the deposit compared to other rates in a financial institution's market;
- The ability or inability for the deposit to be withdrawn early;
- The term of the brokered deposits;
- Any call features inherent in the brokered deposit;
- Any concentration of maturities of the brokered deposits; and

- The length of a financial institution's experience with brokered deposits.

Based on an analysis of the above considerations, the FDIC should establish a clear, bright line test that would enable banks to determine if any deposit insurance assessment premium would be warranted.

Finally, in determining which products should be considered brokered deposits, and as part of the Study, FDIC should compile and develop data to determine which types of brokered deposits are more volatile than core deposits. It would be useful, for example, as part of its Study, for the FDIC to obtain data on: 1) the interest rate paid for certain types of brokered deposits and if such rates are higher than market rates; and 2) whether there are standard non-interest rate characteristics for stable deposits, such as penalties for early withdrawals, and if the non-interest rate characteristics of certain brokered deposits are not consistent with the generally prevailing practices in this context. Such information would help the FDIC make sound regulatory determinations as to which types of brokered deposits are indeed stable and therefore should be included in a core deposit definition rather than a brokered deposit category.

IV. Conclusion

We hope these views are useful as the FDIC completes this important Study. We believe it would be prudent for the FDIC to focus on risk reduction for bank funding products, while also considering appropriate changes or weaknesses in the current regulatory approaches in this context. While it is desirable to reduce the overall risk for deposits utilized by financial institutions, it is also important to properly characterize the risk in funding sources.

We also believe that the FDIC should move deliberately in evaluating any new regulatory regime for core and brokered deposits and pertinent data should be gathered and studied. This is an important Study and inevitably some changes will need to be made to the current regulatory regime for core and brokered deposits. However, during the past few years, there have been multiple, significant changes with respect to the FDIC's deposit insurance methodology and assessment base calculations. Stakeholders need predictability in the deposit insurance regulatory framework and the related cost associated with obtaining bank deposits, and the possible surcharges they will be required to pay, so they can appropriately manage their businesses. Based upon our experience as counsel to the Credit Card Banks, we believe that appropriate regulatory changes by the FDIC can reduce risk, while still permitting access to a variety of sources of funding to depository institutions.

Sincerely,

(b)(6) 

Timothy R. McTaggart

StoneCastle Cash Management, LLC
120 West 45th Street, 14th Floor
New York, New York 10036
212-354-6500 (T)
212-354-6565 (F)

STONECASTLE
CASH MANAGEMENT

May 1, 2011

Sheila C. Bair, Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Dear Chairman Bair:

Thank you for the opportunity to comment as the FDIC studies how core and brokered deposits should be defined pursuant to its directive from Congress in Section 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

StoneCastle Cash Management, LLC ("StoneCastle") is a wholly owned subsidiary of StoneCastle Partners, LLC, one of the largest investors in community banks during the past decade and has developed a large network of relationships with banking institutions located throughout the U.S. StoneCastle is an investment adviser registered with the Securities and Exchange Commission and offers cash management services to its customers, including its Federally Insured Cash Account ("FICA"). The FICA account allows depositors to place their funds into interest bearing FDIC insured accounts at multiple banks with the assistance of technology to ease the administrative burdens of accounting for the funds held at each bank. FICA depositors open their accounts directly with the bank that acts as the custodian for the program. Under the current FDIC rules, StoneCastle may be considered a deposit broker under existing banking laws because it assists in the placement of deposits of third parties with insured depository institutions. Consequently, the deposits themselves may be deemed to be brokered rather than core deposits.

The current rules that define deposits as core or brokered are too narrowly focused on the mere existence of a third party in the process of a deposit account being opened at a bank, rather than the specific attributes and quality of the deposit.

For example, if a Fortune 500 company opens an account and deposits funds in a bank after using an external asset liability consultant to assist in the corporation's cash management functions, the deposit may be considered brokered under current rules. However, even if the account type, features, term, and rate, among other deposit attributes, were exactly the same, but the person advising the corporation is an employee rather than a consultant, the deposit would likely not be considered brokered. In fact, it is unlikely that the bank would have enough information to determine if the account is brokered or not when it is opened. It would seem clear that the performance and ultimate quality of this deposit account, whether opened through the recommendation of an external or internal party would be the same.

Clearly the presence of an asset-liability consultant to the Fortune 500 Corporation does not, in and of itself, change the quality of the deposit. Moreover, a bank would not necessarily know whether a depositor was assisted by a third party if the depositor were to open an account at a bank. As a result, if the same depositor was to open accounts at two banks, these two banks could treat the same depositor in two different ways (brokered and non-brokered) while both are

acting in their best faith. Either way, the quality of the deposit has not changed. In analogy, StoneCastle's role as an asset-liability consultant to its corporate, municipal and institutional depositor does not change the nature or quality of the deposit made by these corporations, municipalities or institutional depositors, if they were to make the deposits themselves at each bank rather than taking advantage of the administrative benefits of FICA.

The difficulty with the current brokered deposit rules for banks is that it does not always draw the correct distinction between a higher quality deposit (one with longer duration and lower volatility of balance for a bank) and a lower quality deposit (one with shorter duration and higher volatility of balance for a bank).

In § 337.6 Brokered Deposits, the definition of a Brokered Deposit is "any deposit that is obtained, directly or indirectly, from or through the mediation or assistance of a deposit broker." In addition, the definition of Deposit Broker is "(A) Any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions, or the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties."

According to the definition, while extreme, if a corporation identified a bank in a region of the country other than its locale, and contracted with a law firm or financial professional to open the account for the bank, that party might be considered a deposit broker and consequently the deposit would be brokered. However, if an employee for the company traveled by air to visit the bank, it would not be considered a brokered deposit. We would submit that the presence of the third party does not, in and of itself, change the quality of the deposit or the nature of the relationship of the depositor to the bank and that the current framework for categorization of deposits as "brokered" or "core" are not sufficient for banks or the FDIC to determine the quality of the deposit.

As we will set forth in this letter, we believe that the FDIC study is timely because it is important to move away from the broad generalization of brokered deposits that currently exists and move toward a more specific categorization that centers on the quality of deposits. We believe that deposits in the FICA Program are stable sources of relatively low cost deposits that are not interest rate sensitive and that the features of the program clearly differentiate it from other methodologies being used to place deposits with banks. We also agree that rapid advances in technology are changing the landscape in every industry and banking is no exception. The ability of consumers and businesses to use technology to gather information quickly, make choices and act upon them efficiently will only increase in the future. This evolution will impact the manner in which deposits are made as well as the traditional flow of deposits. In light of this fact, it is wise for Congress to ask the FDIC to re-examine the definition of brokered deposits. Today, certain deposits that are higher risk are not deemed as such, and are considered core deposits. Other deposits that are relatively stable, e.g., ten year certificates of deposit that are sourced by a third party, are frequently discouraged by regulators despite their long and fixed-rate duration.

In the case of FICA, StoneCastle has developed proprietary technology that specifically enables community and regional banks to obtain stable deposits that would normally flow to large money center banks or to money market funds. This is accomplished with minimal administrative burden and the deposits earn interest at the same rate that the participating bank pays to its other deposit customers.

We are mindful of concerns that have arisen in the past over the use of brokered deposits by banks to grow too quickly, to fund lending, withdrawals and other activities in reliance on deposits that might not be stable and to pay higher interest rates for such deposits. Many banks that failed, particularly in the 1980's and 90's, and in the financial crisis of 2008, had relied heavily on brokered deposits. In response, Congress placed new restrictions on deposits obtained through a third party broker including preventing undercapitalized banks from accepting them. In the ensuing years, the nature of deposits placed with banks with the assistance of a third party has evolved considerably and with additional sophistication created by enhanced telephonic systems, the internet and mobile banking related networks. Of course, not all of these developments have negative consequences. Some of these advancements, which StoneCastle utilizes in the FICA Program, make it possible for large corporate, municipal and high net worth depositors to place certain of their core savings deposits in community banks. FICA helps to redistribute deposits away from money center banks, money market funds and United State Treasury securities back into community banks to promote lending in their local communities which are often rural and serve small business owners and borrowers in the agricultural industry. We would submit, after discussions with various state and federal banking regulators, that the FICA Program does not give rise to the concerns of the past.

Our view is that banks should be able to accept deposits under the FICA Program and other, similar methods of placing deposits without being subjected to harsh economic consequences or additional regulatory scrutiny by the FDIC, provided that such deposits meet certain standards of quality and are taken by banks in moderation.

Overview of the FICA Program

StoneCastle developed its FICA Program after numerous meetings and consultations with banking industry professionals, federal and state banking regulators and corporate depositors in order to deliver a program consistent with the needs and concerns of each of these constituencies. Unlike other deposit programs, depositors affirmatively choose to place their money with a FICA Program custodian bank. Each depositor signs an account opening agreement with the custodian bank, the same as they would do for any other traditional bank account, to participate in the FICA Program. The custodian serves as an agent and administrator and as a fiduciary for the depositors' funds. Pursuant to directions from StoneCastle, as the depositors' asset/liability consultant, the custodian places the funds in multiple insured depository institutions so that the depositors' funds are FDIC insured. We refer to this deposit, where the deposit is a traditional bank deposit but divided into smaller FDIC insured amounts, as an "Administrative Deposit".

The funds are deposited by the custodian, taking direction from StoneCastle, in participating community and regional banks around the country. StoneCastle performs extensive due diligence on each prospective FICA Program bank before asking a bank if it wishes to participate in the FICA Program. If a bank permits the custodian to open an account with it, a standard money market or savings account is opened and the interest rate is set by the bank at a rate that is no higher than the rate paid to other depositors at the bank. Depositors are not permitted to shop for rates among the banks but rather accept the rates paid by each bank. In addition, there are no contracts, special processes, technology or ongoing human resource involvement required and virtually no ongoing service requirements imposed on the bank. Thus, FICA deposits are originated by the bank on a cost efficient basis and can be maintained at lower costs than other deposits which may result in higher profits for the bank. Because each bank sets the amount of growth or absolute balance level and can change these variables as warranted, it can fit its FICA deposits into its broader asset/liability management strategy.

These deposits are not similar to the "hot money" deposits that have in the past been synonymous with certain brokered deposit programs. They are not time deposits with fixed maturities; rather they are overnight deposits, akin to traditional checking or savings account deposits. The characteristics noted above, among others, distinguish Administrative Deposits from those programs and can be assessed by the FDIC in determining the cost to banks that should be associated with such deposits. In addition, the fact that the deposits brought in through FICA would ordinarily flow to larger banks and can be deployed by smaller banks in their own communities should be a positive industry factor considered by the FDIC in assessing these deposits.

Stability

Stable funds are essential to a bank's ability to manage its balance sheet and deploy its resources most efficiently. The FDIC should consider the stability of deposits placed with banks with the assistance of third parties as a factor in determining how to classify deposits and whether such deposits should warrant additional financial costs or regulatory scrutiny for banks. FICA provides banks with deposits that are quite stable because of the nature of the customers, the source of the cash from those entities and StoneCastle's screening, monitoring and product features.

Banks which accept deposits through other sources, such as services which advertise interest rates for banks on the internet, will experience much more volatility with these deposits as the depositors are likely to move their funds whenever another bank is offering a higher interest rate. Yet this method of deposit taking, when paired with fixed rate advertising fees, is considered to yield core deposits under current FDIC regulations. Depositors in the FICA Program do not use day to day operating cash, which is subject to more variability, but rather their core cash reserves, cash that represents their long term liquidity position. When potential depositors are sourced, StoneCastle ensures that this is the case. StoneCastle also monitors deposits to ensure that no individual customer is using the program as a more transitory account and will take action to exclude any depositor that is using the deposit account in a volatile manner.

In considering stability, it is not necessarily the presence of a broker but rather the nature of the bank's relationship with the depositor and the purpose of the deposit which can cause a lack of stable funding. If a banks posts its certificate of deposit rates on the internet via a portal and a customer deposits funds, these deposits are considered core because there is no third party assistance. Yet, it is likely that the customer will move those funds to another bank once the certificate of deposit matures if it finds a bank offering higher interest rates.

In the FICA Program, the depositor is not seeking the best rate of interest or a specific term for its deposit. The primary appeal of FICA and other Administrative Deposits to customers is the safety of their funds and the benefit of a single bank statement through the custodian process. Our customers choose to deposit their money in a FICA account rather than invest it in a money market fund or keep non-insured funds at a money center bank. In fact, the rate earned by most FICA depositors is often lower than what a bank might offer to a single depositor as FICA depositors value safety over interest rate.

The FICA Program is structured in such a manner that it is more attractive to customers who are seeking to place funds in longer term deposits and who want to ensure that their deposits are FDIC insured. Many depositors are institutions which, under law or policy, are limited in the

types of deposits or investments they can make. For these depositors, fully insured bank deposits are a permissible and desirable long term investment strategy.

In addition, withdrawals under FICA are currently limited to once a week and StoneCastle has the right to terminate a depositor's participation in FICA if it were to make frequent deposits or withdrawals. Depositors who choose to open a FICA Account are clearly informed of the limited nature of withdrawals and thus participate in the program with the intent of keeping their funds on deposit for a long term period although the balances may increase or decrease slightly over time, similar to balances from traditional retail and savings accounts. Adding to the stability of the funds, a depositor's cash is allocated among many banks when it opens a FICA Account; therefore, the impact on any single bank is mitigated in the event of a withdrawal as the withdrawal will never be funded from a single depository institution. Conversely, other deposit programs may aggregate deposits across the fewest number of banks and therefore may have slightly larger balances at any given bank (but in all cases, less than $250,000).

Interest Rates

One of the causes of volatility in bank deposits is rate shopping by depositors. Such rate shopping is available through various services and is as simple as a click on a virtual box to open, close or move deposits from bank to bank. To open a FICA Account, however, a depositor signs the account opening agreement directly with the custodian bank. StoneCastle determines into which banks a customer's funds will be deposited and so advises the custodian. The banks are selected based upon a number of factors including extensive analysis of the bank's balance sheet and capital structure using industry information and StoneCastle's proprietary data and models. A bank would not be asked to accept deposits from the custodian if the analysis led one to conclude the bank was under stress, regardless of whether it was well capitalized.

While interest rates are a consideration in approaching banks and in allocating customers' deposits, it is not the dispositive factor. In the case of FICA or any Administrative Deposit, the custodian accepts, on behalf of our customers, whatever rate a bank is offering to its other deposit customers. Neither StoneCastle, nor any custodian, negotiates or contractually binds a bank to a particular rate or rate formula. Customers are interested in the safety of their deposits first and understand that their rate will be competitive but may not be equivalent to what they could obtain if they chose to open individual accounts with banks across the country. In fact, in addition to safety, the value the depositors receive is convenience because the FICA Program is administered for them by StoneCastle and the custodian bank. StoneCastle makes no guarantee to customers when they open an account, or at any time, as to what interest rate they will earn from the bank.

A depositor's funds are not withdrawn or reallocated from a bank if it lowers its interest rates after funds are allocated to that bank. Customers do not select the banks into which their funds are deposited (they are permitted to exclude certain banks which is typically done when a customer already has funds in that bank and its FDIC insurance may be compromised if more money is deposited at such bank.) FICA provides no mechanism for rate shopping by our customers nor does it induce banks to pay higher rates of interest on deposits sourced through our program. Thus, the deposits placed with banks under our program are not subject to the volatility associated with interest rate shopping.

Advantages for Banks

One factor that has long been used in determining whether a deposit is core is whether the depositor is located in the same community as the bank and could have other commercial relationships with the bank. While participants in FICA or another Administrative Deposit program may not be located in the communities in which their funds are deposited, FICA deposits are often sourced from corporations, municipal entities, endowments and other institutional investors that have a presence in many communities. Absent a program such as FICA, these entities will often seek deposit and investment opportunities beyond their own local communities. As we have noted, the deposits brought to the participating banks under our program are stable and therefore allow the recipient banks to deploy them for the benefit of local residents and businesses. The banks that currently participate in FICA are all smaller community and regional banks rather than large money center banks. The funds that these banks receive under FICA can supplement their balance sheets and allow them to help to meet the needs of their local customers, to diversify their sources of funding and to replace more volatile liabilities. This can be critically important in times of ongoing economic growth or stress and, in our view, this should outweigh the fact that FICA Account depositors may or may not develop deeper financial relationships with these banks. These deposits can also replace amounts that banks lose to other investments such as money market accounts or mutual funds. And currently deposits that banks obtain through "rate boards" that advertise to consumers directly on the internet are considered core and those depositors are much less likely than FICA depositors to develop other relationships with the depository bank.

The FICA Program does not impose any additional burdens on participating banks. The FICA custodian bank opens a bank account on behalf of the depositors with each bank that participates in the program. The accounts are opened using the account opening documents of the community bank. The custodian is responsible for compliance with the Bank Secrecy Act and all anti-money laundering requirements so the community bank does not have additional compliance burdens as a result of participating in FICA. In fact, the cost of acquiring and administering the accounts is minimal relative to other accounts.

FICA depositors do not have access to these deposits via checking accounts or other easy access mechanisms so no individual client support is required of the community bank. A depositor can only withdraw its money by completing a withdrawal request that it sends to StoneCastle and to the custodian bank. The ability of community banks to access deposits from around the country to which they would not otherwise have access, at no additional costs to them and at the same interest rates as they pay to local depositors, should mitigate in favor of the FDIC concluding that these deposits are high quality (or core) deposits. If banks were not subject to additional charges or enhanced regulatory scrutiny based on the amount of brokered deposits they hold, it is likely that more banks would choose to participate in the FICA Account or similar, high quality Administrative Deposits.

Lastly, under the FICA Program, amounts deposited in any single participating bank are limited to a small percentage of the bank's total deposits. Therefore, even if StoneCastle were to receive an unusually high amount of withdrawal requests in any given week, no participating bank would experience large decreases in their FICA deposits as the withdrawals would be made from a majority or all of the depository banks to satisfy the withdrawal requests.

Third Party Placement

In our view, deposits should not be considered inherently flawed simply because a third party is involved with the bank deposit process. Brokered deposits constituted only about 18% of the deposits held in banks that have failed since 2004. What should be evaluated is the nature of the brokered deposits and how banks utilize them. For example, if a significant percentage of a bank's brokered time deposits have terms that expire simultaneously, there may not be replacement deposits available to the bank at expiration. This creates more volatility than a deposit opened under the FICA Program. Conversely, if a bank properly manages its maturity ladders for its time deposits, the refinancing risk on liquidity will be significantly lower and the bank should pay a lower assessment for the reduced risk to the Deposit Insurance Fund. With a FICA deposit, since all the deposits are available to the depositor on a weekly basis, there are no specific maturity dates that would represent a concentrated risk for refinancing.

We believe that the concerns that the FDIC may have about the role of brokered deposits in a bank failure could be mitigated by regulatory supervision of the manner in which a bank uses its brokered deposits rather than by an absolute limit on such deposits. Bank examiners should evaluate, among other factors, the pace of growth of brokered deposits by a bank, the related pace and type of lending, the concentration of such deposits on a bank's balance sheet and the timing of the maturity of such deposits. Another important factor should be an analysis of how such funds are deployed by the bank in its local community. FICA levels the playing field between community banks and larger money center banks by allowing a custodian bank to break down large corporate, municipal and not for profit institutional deposits and distribute them to these smaller banks. These banks would likely never have an opportunity to solicit deposits from these large reputable depositors. We believe that a deposit program such as FICA provides an invaluable service by reallocating funds from these larger banks and from uninsured money market funds into smaller communities throughout the United States.

Conclusion

We recommend that the FDIC end the use of the terms "core" and "brokered" to define the deposit liabilities of FDIC insured banks. Instead, the FDIC should adopt a system whereby a number of factors are analyzed to determine whether a deposit is of high quality. The factors should include those enumerated in this letter including stability, cost of deposits to the banks and the benefits to the bank and the bank's community of accepting the deposits. Deposits that fall into higher numerical categories as a result of applying the rating system should be available for placement at well capitalized banks without any additional FDIC costs or charges adhering to them. The fact that a third party places or assists in the placement of the deposits should not compromise the characterization of such deposits as high quality.

We hope this letter is helpful to the FDIC as it completes the study. We appreciate the opportunity to be a part of that process.

Sincerely,

StoneCastle Cash Management, LLC

Joshua S. Siegel
Managing Principal

Morgan Stanley

1585 Broadway
New York, NY 10036

April 30, 2011

Via Email
Federal Deposit Insurance Corporation
550 – 17th Street, N.W.
Washington, D.C. 20429
coredepositstudy@fdic.gov

Re: Study on Core and Brokered Deposits

Ladies and Gentleman:

Section 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires that the FDIC conduct a study to evaluate the current definitions of core and brokered deposits. The FDIC has indicated it "is particularly interested in: (1) understanding how new methods of obtaining deposits have affected deposit stability and franchise value; and (2) whether we should recommend changes to the core and brokered deposit definitions and develop new classifications of deposits that depend on characteristics like relative stability or volatility."[1] Morgan Stanley welcomes the opportunity to comment on the FDIC's study and share internal analyses which illustrate the stability of deposits that have inherent franchise value.

Morgan Stanley believes the classification of deposits as "brokered" is outdated, particularly as it applies to deposits gathered from affiliated broker dealers. Under existing definitions, a brokered deposit means any deposit that is obtained, directly or indirectly, from or through the mediation or assistance of a deposit broker.[2] This definition of a brokered deposit does not distinguish between deposits collected through affiliated or unaffiliated broker dealers. Consequently, deposits collected by Morgan Stanley's banks through clients of their affiliated broker dealers are classified as brokered. In economic terms, these deposits are generated through broad and deep relationships that Morgan Stanley has with its client base. A franchise relationship plays an integral role in generating these deposits as opposed to merely procuring them from a third party on a wholesale basis.

Morgan Stanley therefore recommend that the FDIC eliminate the concepts of core and brokered deposits and replace them with a system to identify deposit characteristics that

[1] See http://www.fdic.gov/regulations/reform/coredeposits.html
[2] 12 C.F.R. § 337.6

contribute to deposit stability. Morgan Stanley also recommend that the FDIC request that Congress repeal the brokered deposit provisions in the Federal Deposit Insurance Act and, pending Congressional action, expand the primary purpose exemption from the definition of deposit broker to include all deposits from an affiliated broker dealer, particularly affiliated sweep deposits.

The Morgan Stanley Bank Deposit Program

Most broker-dealers offer clients the ability to automatically invest or "sweep" the uninvested cash in their brokerage accounts to a money market fund ("MMF") or deposit account at an FDIC-insured institution (a "bank deposit program"). The excess cash is derived from daily net activity in the brokerage account including the purchase and sale of securities, interest payments and dividends on securities, and client deposits to and withdrawals from the brokerage account.

Morgan Stanley has a bank deposit program in which cash from Morgan Stanley Smith Barney, LLC ("MSSB") brokerage accounts sweeps to Morgan Stanley Bank, N.A. and Morgan Stanley Private Bank, National Association (collectively, the "Morgan Stanley Banks"). This program (the "BDP") is currently the default cash sweep investment for all eligible brokerage account types.

The Morgan Stanley Banks tier deposits based on overall client relationship with the firm. In this manner, Morgan Stanley is able to offer relationship based pricing competitive with other market offerings of similar products. Morgan Stanley does not perceive an ability to use the BDP as a means of generating significant additional deposits on short notice, i.e. as a quasi-wholesale funding source. Morgan Stanley also does not believe that it is viable to re-price its entire deposit base to generate incremental funding, i.e. the deposits exhibit relative balance insensitivity to level of rates, much the way that banks view their "core" deposits today.

Studies on Affiliated Deposit Stability

Morgan Stanley has conducted numerous internal studies to understand the stability of its deposits and Morgan Stanley strongly believes that its affiliate deposits should be treated on par with and classified similarly to deposits considered "core" today. Morgan Stanley is of the view that deposits sourced from affiliated broker dealers have superior stability characteristics as illustrated by the four studies discussed below.

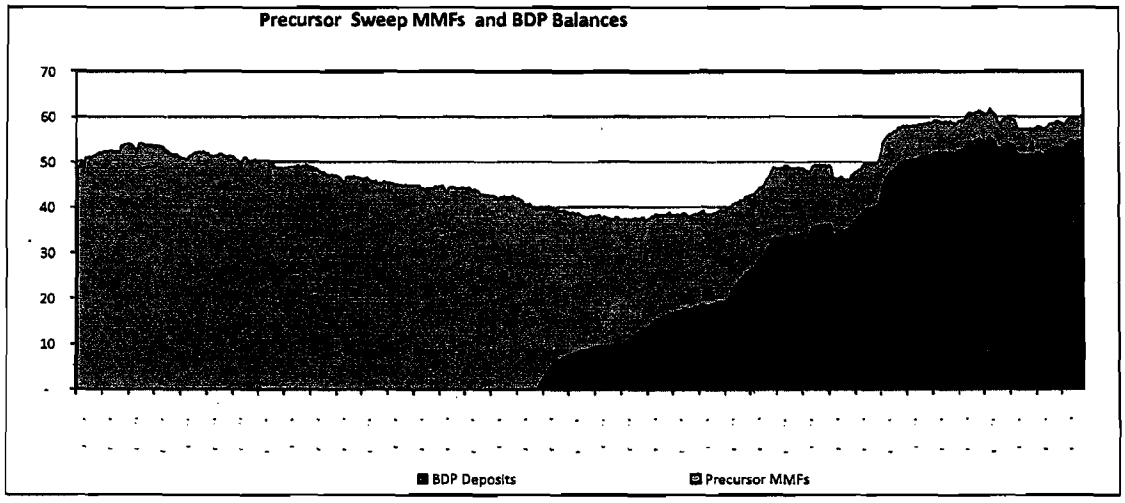
Morgan Stanley

A) Stability of Sweep Deposits Generally

In late 2005, Morgan Stanley launched a strategic plan to migrate cash swept from brokerage accounts into certain MMFs into the newly launched BDP. This was done to offer clients the benefit of FDIC insurance through two Morgan Stanley Banks (currently aggregate coverage is up to $500,000 for single accounts and $1,000,000 for joint accounts) as well as to respond to competitive offerings from other brokerage firms which had begun to include a deposit sweep program in addition to MMF sweeps.

The migration of the MMF sweeps into the BDP was undertaken in five phases utilizing a "drain and fill" method with negative consent from affected clients. "Drain and fill" means that all cash debits to the brokerage account (e.g., for securities purchases, check writing, outgoing wires, etc.) were taken or drained from the precursor MMF while all cash credits to the brokerage account (e.g., from the sale of securities, check deposits, incoming wires, etc.) were deposited to or filled up the BDP. The "drain and fill" process introduced a positive bias in BDP balances and therefore a long-range analysis of BDP and precursor MMFs was considered most meaningful to draw conclusions on stability.

The long-range analysis of the BDP deposits and precursor MMFs indicates the strong presence of a stable long-lived component of deposits, which is relatively immune to interest rate changes, equity markets, economic conditions and any idiosyncratic stress borne by the firm. In fact, the graph below demonstrates the cumulative stability of Morgan Stanley's sweep assets over more than 10 years in which both equity and credit markets fluctuated significantly.



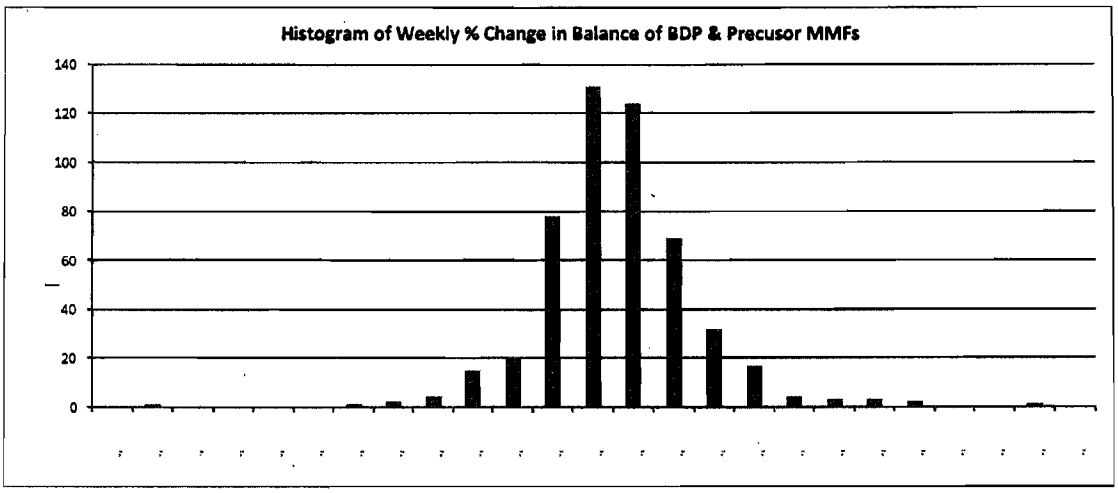
Precursor Morgan Stanley MMFs, MS Active Assets Government, MS Active Assets Money, MS Liquid Asset Fund and MS US Government Money, were included to construct historical time series, as they were considered most significant in studying behavioral pattern of BDP clients.

Morgan Stanley

The table below represents the range of movements in the equity and government credit markets during the period of this study.

	Max	Min
S&P 500	1565	677
1 month T-Bill	5.27	0
30yr TN	5.89	2.53

A histogram of the weekly balance changes, statistically, displays an approximate normal distribution with a slight positive bias. For a 99% confidence level (i.e., a 3 standard deviation measure based on the normal distribution), close to 84% of the balances would be retained over a 1-year period thus representing strong stability characteristics and therefore very low funding liquidity risk.



Therefore, we would contend that the stability afforded by the deposits generated from our affiliated broker dealer should not be unfairly penalized by being labeled "brokered". These deposits have the inherent stability afforded by tenured broad relationships and should be recognized as such.

B) Longevity of Franchise Relationships

The length of a client's relationship with the firm can often be a predictor of the relative stability afforded by their deposits. MSSB has nearly 2 million retail brokerage accounts from its legacy Morgan Stanley business. A look at median household length of relationship indicates a median tenure of 7.3 years. A tenured client base is likely to be

Morgan Stanley

less fickle in terms of moving its deposits, thereby translating to low funding liquidity risk.

Notably, as of December 2010: [3]

- Total Brokerage Accounts: 1,929,274
- Total BDP Balances ($MM): 54,598
- Total Client Assets ($MM): 710,521
- Account Length of Relationship - BDP Accounts median (Yr): 5.0
- Household Length of Relationship - BDP Accounts median (Yr): 7.3

C) Stability of Deposits in an Idiosyncratic Stress Environment

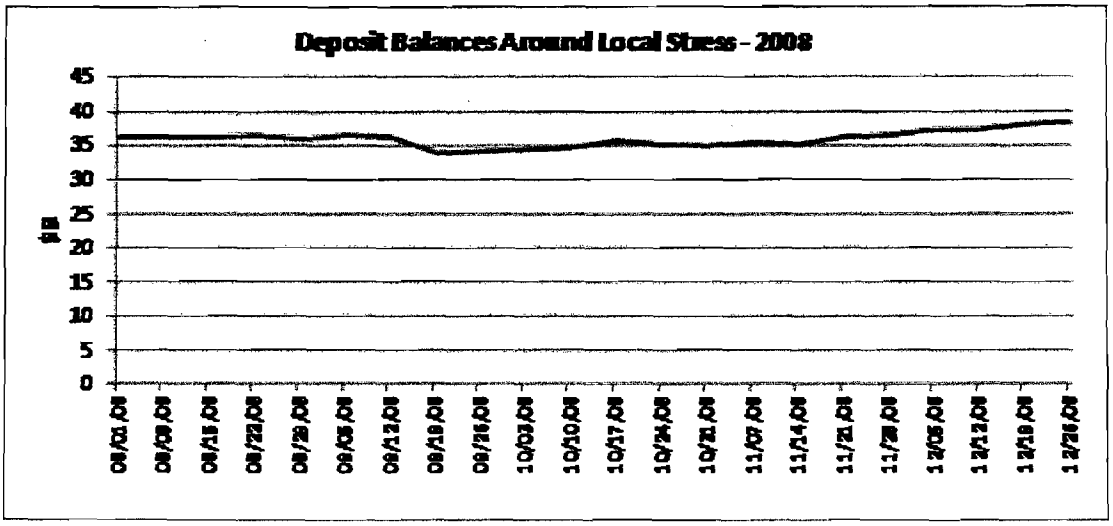
Morgan Stanley welcomes the FDIC's desire to define stability of deposits in terms of their proclivity to stay with a firm in the time of a crisis. Morgan Stanley is relatively unique in that we came under particularly severe idiosyncratic stress, a virtual "run on the investment bank" scenario, in September 2008 in the midst of an industry wide financial crisis. John Mack, CEO of Morgan Stanley during the crisis, told the FCIC, "In the immediate wake of Lehman's failure [in] September, Morgan Stanley and similar institutions experienced a classic 'run on the bank,' as investors lost confidence in financial institutions and the entire investment banking business model came under siege."[4]

The failure of Lehman Brothers and the merger of Bank of America/Merrill Lynch in September 2008 meant that for a short period of time the markets perceived Morgan Stanley as particularly vulnerable. In the face of this extreme scenario, MSSB depositors displayed great resilience and declines were small and locally concentrated in the September period as shown below. In general, deposits exhibited significant stability in this period of extraordinary stress with some amount of credit sensitivity limited to uninsured deposits.

[3] This letter does not address the bank deposit program available to MSSB clients from the legacy Smith Barney business and all of the statistics in this letter are derived solely from the legacy Morgan Stanley business.

[4] John J. Mack, written testimony for the FCIC, First Public Hearing of the FCIC, day 1, panel 1: Financial Institution Representatives, January 13, 2010, p. 6.

Morgan Stanley



D) Cash Management Features of Affiliated Brokerage Accounts

Over time, brokerage firms have purposely added cash management functionality and features to their menu of services to deepen and strengthen franchise relationships with clients. These types of services are usually associated with traditional bank deposit accounts as well. Morgan Stanley has found that the more cash management services our brokerage clients utilize, the more likely they are to bring more of their assets and cash to the firm. Some of the cash management features associated with MSSB brokerage accounts are:[5]

- Check writing
- Debit card
- ACH / wires
- Online money movement
- Direct deposit
- Direct debit

The presence of these cash management features lends greater stability to the cash balances in the BDP and causes them to behave more like traditional "core" deposits.

[5] Where appropriate, MSSB has entered into arrangements with licensed banks and other third parties to assist in offering these banking-related services. The Morgan Stanley Banks do not provide these services to MSSB clients.

Morgan Stanley

Conclusion

Morgan Stanley believes that classification of deposits based on their source of origination is inherently flawed when it ignores affiliate brokerage relationships. Morgan Stanley's analyses, as described above, indicate that affiliate generated deposits have excellent stability characteristics. The current classification regime unfairly stigmatizes these deposits as "brokered" whereas in economic substance they display characteristics very similar to deposits currently recognized as "core". This is also true as these deposits are garnered through broad and deep franchise relationships.

Morgan Stanley therefore recommends that the concepts of core and brokered deposits be eliminated and replaced with a defined system of identifying deposit characteristics that contribute to deposit stability. Sweep arrangements between a broker and its affiliated banks should be treated as highly stable deposits under this new system, whether or not they are technically brokered.

Morgan Stanley also recommends that the FDIC request that Congress repeal the brokered deposit provisions in the Federal Deposit Insurance Act as they are out dated. The purposes of those provisions can be better achieved by closer attention to the characteristics of deposit funding, asset quality and rapid asset growth. Specifically, we feel affiliated deposits should not be unfairly penalized with increased insurance premiums or restrictions on accepting, renewal or rolling over these deposits in the event of a bank becoming less than well capitalized. Morgan Stanley also submits that banks may make sub-optimal economic decisions based on perceived binary risk associated with the remote but extreme outcome of becoming less than well capitalized.

Morgan Stanley

Finally, pending Congressional action, the FDIC should expand the primary purpose exemption from the definition of deposit broker to include all sweep arrangements between a broker and its affiliated banks. All such arrangements share the same purpose: providing a highly liquid and safe haven for customer funds while they are utilizing cash management services offered by the broker and awaiting investment in securities offered by the broker. That alone should be sufficient to satisfy the primary purpose exemption.

Respectfully submitted,

(b)(6)

Susan E. Carroll
Chief Operating Officer
Morgan Stanley Bank, N.A.

Paul Hastings

Paul, Hastings, Janofsky & Walker LLP
875 15th Street, N.W.
Washington, DC 20005
telephone 202-551-1700 • facsimile 202-551-1705 • (b)(6)

(b)(6) Atlanta
Beijing
Brussels
Chicago
Frankfurt
Hong Kong
London
Los Angeles
Milan
New York
Orange County
Palo Alto
Paris
San Diego
San Francisco
Shanghai
Tokyo
Washington, DC

May 2, 2011

Via E-Mail*: *coredepositstudy@fdic.gov

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Core and Brokered Deposit Study ("Study") Pursuant to § 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")

Dear Mr. Feldman:

We are writing to provide comments on the Study on behalf of several bank clients affiliated with securities brokerage firms that conduct deposit sweep programs with their bank affiliates and other unaffiliated depository institutions. Pursuant to the Study, the Federal Deposit Insurance Corporation ("FDIC") is soliciting industry views and public comment to assist the FDIC in evaluating statutory considerations relating to core deposits and brokered deposits. As noted in the FDIC's request for comments on the Study, this issue has repercussions for insured depository institutions in a number of areas, including the calculation of insurance premiums, the evolving nature of traditional deposit types, and the role of different types of deposits in the U.S. economy and banking sector.

In connection with the Study, the FDIC is specifically seeking comment on "how industry changes have affected deposit stability and franchise value and whether these innovations warrant changes to statutory or regulatory treatment of deposits." In particular, the FDIC is interested in:

(1) understanding how new methods of obtaining deposits have affected deposit stability and franchise value; and

(2) whether the FDIC should recommend changes to the core and brokered deposit definitions and develop new classifications of deposits that depend on characteristics like relative stability or volatility.

Clearly, significant changes have shaped the banking industry and the financial products and services that customers have come to expect from insured depository institutions and other financial services firms. A particularly dynamic area is the growth of conglomerated financial services firms, large and small, that now provide a

wide array of financial products and services to meet all customers' needs. Integrated product offerings are the norm in these structures, creating both significant consumer opportunities and some risks, all of which must be fully understood and managed by both the institutions providing these important financial services and regulators overseeing these product offerings. We believe the changes, improvements and developments that continue to shape and reshape the banking and financial services sectors are critical considerations in the development of regulatory policy. In many respects, outdated laws and policies may not only provide a disservice to the American consumer, but may also have unintended consequences that, left unchecked, may go far to erode both the pace of change and the overall development of our banking system.

With this context, and in connection with the FDIC's Study, Paul, Hastings, Janofsky & Walker LLP ("Paul Hastings") appreciates the opportunity to submit the following comments and observations to the above and following questions and issues on behalf of our institutional clients.

A. Background

As the FDIC has recognized, use of the internet as a delivery channel for financial services continues to expand as more depository institutions use the Web to offer products and services or otherwise enhance communications with consumers.[1] The internet offers consumers the potential for safe, convenient new ways to shop for financial services and conduct banking business, any day, any time. According to leading industry research, a vast majority of U.S. households that use the internet already access financial services online and this trend is expected to continue as financial institutions take advantage of technological advances to find innovative ways to offer consumers greater and easier access to financial products and services.[2] In particular, competition is fierce for the growing percentage of investable wealth in the U.S., with financial institutions seeking new and innovative ways, including more efficient channels, to meet the financial services needs of their customers.

Paul Hastings represents a number of the world's leading financial institution conglomerates that offer both retail securities brokerage services through a registered

---

[1] *See* FDIC Safe Internet Banking, Tips for Safe Banking Over the Internet, *available at* http://www.fdic.gov/bank/individual/online/safe.html.

[2] *See, e.g.*, U.S. News and World Report, "*5 New Banking Trends for 2011*" (April 13, 2011) (noting that a number of banks now have mobile apps that allow users to check their balance, make transfers and even scan checks, and that overall, "the move to online banking is a net positive for consumers, who can access their account easily, transfer funds, and save paper"), *available at* http://money.usnews.com/money/blogs/my-money/2011/04/13/5-new-banking-trends-for-2011); and "*How Often Do You Visit Your Bank*" (October 30, 2010) (reporting that a recent survey "found that consumers are using online tools for varied banking tasks; 83 percent use online banking to track account balances, 60 percent pay bills and transfer funds, and more than one-third are using financial management tools"), *available at* http://www.banking2020.com/2010/10/30/how-often-do-you-visit-your-bank/.

broker-dealer subsidiary as well as deposit and other banking products through an insured depository institution subsidiary. Intra-company product offerings of securities broker-dealers and their depository institution affiliates typically include offering linked brokerage and deposit accounts held at each respective entity. In addition, products and services offered by a securities broker-dealer may include features that permit customers' uninvested cash or "free credit balances" in central assets brokerage accounts, Individual Retirement Accounts ("IRAs") and similar accounts to earn income on such amounts swept into deposit accounts held at an affiliated depository institution and unaffiliated insured institutions during the interim while the customer determines how and when the funds should be invested. In a typical "bank sweep" program, a broker-dealer will automatically make deposits to and withdrawals from deposit accounts held at an affiliated depository institution and unaffiliated institutions on behalf of their brokerage customers; typically, the customer may opt out of the sweep program.

B. Discussion and Questions Presented

In connection with the Study, the FDIC has posed four specific questions on which it seeks public comment. In addressing these questions, we have focused primarily on the nature of deposits held at a depository institution affiliated with a securities brokerage firm. We note, however, that many of the same characteristics of deposits swept from a brokerage firm to its affiliated depository institution are exhibited in deposits swept from the same brokerage firm to unaffiliated depository institutions participating in the same sweep program.

(1) In times of financial stress, what types of deposits are likely to remain at an institution and what types of deposits are likely to leave the institution?

As evident in the most recent financial crisis and pursuant to the long-standing experience of the FDIC and the other federal banking agencies, when an insured depository institution comes under financial stress and public confidence in the institution erodes, uninsured deposits at such institution typically are the first to leave. The reasons for this are obvious given the potential risk of loss to an individual depositor for the uninsured amount of the deposit, and this phenomenon is particularly evident for large institutional deposits that exceed the standard maximum deposit insurance amount and are therefore uninsured.[3]

In contrast, however, what we learned during the most recent financial crisis is that where the entire financial industry is under stress, *i.e.*, not just an individual institution, it has been the experience of our depository institution clients that insured deposits increase – often dramatically – in response to the perceived threat to systemic stability

[3] Typically, this phenomenon is evident even when the rate paid on uninsured deposits is significantly above market.

and a pursuit of safety for depositors' funds. Not surprisingly, this is the case for all types of deposits, including those placed for a fee by independent third parties.

During the financial crisis of 2008-9, several of our depository institution clients with broker-dealer affiliates reported experiencing an unprecedented inflow of funds to deposit accounts linked to securities brokerage accounts held at their affiliated broker-dealers in connection with FDIC-insured deposit sweep programs. During this period, there was a "flight to safety" in which many clients increased their proportion of cash to total investments (including stocks and bonds). Even as the crisis eased in 2010, our clients have reported that there was not a significant outflow of those deposits. This, of course, is a testament to the strength of our federal deposit insurance system, including the extremely important "FDIC brand" that American consumers seek out during times of overall financial stress.

In summary, it is the experience of our clients that times of systemic stress are far more likely to increase deposit stability than detract from it; whereas, individual institution stress, depending on the circumstances, should be expected to cause uninsured (and sometimes even insured) deposits to flee from a financially stressed depository institution.

(2) Does the presence of certain kinds of deposits (*e.g.*, brokered, internet, listing service) inherently increase an institution's risk? Does their presence facilitate increased risk-taking?

The current one-size fits all approach reflected in both the statutory and regulatory definitions of "brokered deposit" does not achieve the FDIC's objective of decreasing risky behavior by insured depository institutions. By the FDIC's own interpretation, not all brokered deposits are high-rate deposits fueling rapid growth by banks,[4] which was the genesis of the restrictions on brokered deposits in the first place. Moreover, we believe that statutory and regulatory exemptions from the definition of "brokered deposit" have been applied inconsistently, guided at times by the circumstances of a particular bank rather than the source of the deposit. Accordingly, it is important to distinguish between and understand the nature of different types of deposits to avoid unintended consequences.

The excess risks taken in the lead up to the most recent financial crisis were taken primarily on the asset side of the balance sheet, and many of the adverse liquidity situations that institutions found themselves in during the crisis were the result of asset problems that manifested themselves as overall balance sheet liquidity problems. Nothing about the classification of deposit sources as "brokered" or the fact that a bank's delivery channel for deposits is internet-based inherently causes an institution to take more risk. For depository institutions with broker-dealer affiliates, acceptance of sweep deposits from an affiliated broker-dealer is an example of a program under

---

[4] *See, e.g.*, 12 C.F.R. § 337.6 and FIL-69-2009 (a brokered deposit that does not pay a rate that exceeds a prevailing national or local (if approved) rate cap would not be considered a high-rate deposit).

which the deposits technically could meet the current definition of "brokered," as these deposits are not retail deposits generated by the insured bank, yet the institution's funding is very stable and this can be empirically documented. Rather than using swept deposits to fund risky assets, our clients have reported that the vast majority of these funds are used to invest in low risk, highly stable assets, including government-guaranteed and similar investments, consistent with the need to manage liquidity and sustain earnings growth and maintain profitability.

In contrast, higher-priced deposits will typically cause an institution to seek out higher yielding assets in order to create a large enough spread to cover those costs. High-priced deposits are not automatically classified as "brokered" (unless the institution becomes less than well capitalized, in which case the FDIC looks at the rate paid to attract the deposits[5]), nor are they necessarily internet-based deposits. Under the typical fee structure of our bank clients participating in FDIC-insured sweep programs with their broker-dealer affiliates, generally the bank pays the same rate for deposits that the affiliated broker-dealer pays for customer free credit balances. In many cases, the average rates paid by broker-dealers for free credit balances are lower than more traditional bank rates.

In today's competitive e-commerce environment among financial institutions offering both securities brokerage services and deposit products, practically all of a depository institution's swept funds from an affiliated broker-dealer may technically be sourced from the internet, yet the rate paid on the deposits is typically not the determining factor in a customer's decision to leave money in a sweep program. Rather, other factors such as high consumer satisfaction leading to loyalty to a particular brand or company, or simply convenience to the depositor with respect to linked deposit and securities accounts, may typically be the driving forces. Consistent with this observation, our clients have reported experiencing high retention rates with swept deposits, which have historically been very "sticky."

Based on the above, we do not agree with any implication that swept deposits that technically meet the broad definition of "brokered" under current rules or that are gathered via the internet are any longer a driver of risky behavior on the part of a financial institution, as was observed in the Congressional hearings leading up to the enactment of the statute addressing brokered deposits in 1989, as discussed below.[6] Even if there is a so-called "correlation" between bank failures and the acceptance of traditional types of "brokered" deposits, that does not mean that all institutions that accept historically non-traditional deposits should be penalized or somehow be thought of as engaging in unsafe or unsound behavior warranting greater regulatory oversight and/or safeguards. As we recommend below, each institution's source of funding should be scrutinized in the examination process.

---

[5] 12 C.F.R. § 337.6; *see* FIL-69-2009 (December 4, 2009).

[6] See discussion and associated footnotes in Sections B(4)(a) and (b) below, addressing the current statutory and regulatory guidance on brokered deposits.

(3) What types of deposits are likely to enhance a failed institution's franchise value and what types of deposits are likely to reduce it?

Stable, low cost deposits generated from customers with which the organization has a deep, multi-product relationship have the most value to investors of a failed institution. In the experience of our clients, the deposits received from an affiliated broker-dealer behave much more like traditional "core" deposits, because:

- **Swept deposits are stable.** Our clients have reported that, within the last decade, free credit balances at securities broker-dealers have grown steadily and substantially, which has consistently occurred through both the so-called bull- and bear-markets, including, most importantly, through the recent financial crisis in late 2008 and early 2009, *i.e.*, the bottom of the worst economic cycle since the Great Depression. Even with some easing of the crisis, our depository institution clients and their affiliated broker-dealers offering free credit balances have not seen a significant outflow of these funds. In particular and with respect to one client, approximately 59 percent of the total free credit balances held at its broker-dealer affiliate are in accounts with less than $100,000 in cash, while less than 5 percent are in accounts with over $1 million in cash. This is typical of the experience of our other clients with similar sweep programs anchored by a bank affiliate. Thus, we see that these swept deposits are not vulnerable to large swings created by the outflow of a few large accounts.

- **There is a pre-existing relationship with the depositors.** Deposit customers that are referred to our banking clients through their broker-dealer relationships typically have had long-standing relationships with the broker-dealer. These are low cost deposits generated from customers through which the enterprise has a deep, multi-product relationship. As noted above, brand loyalty or sheer convenience to the depositor with respect to linked deposit and securities brokerage accounts or interest earning free credit balances typically play a role in a depositor's decision to maintain funds at a particular institution, including unaffiliated institutions participating in a sweep program, and should not be underestimated in regard to offering a depository institution a low-cost and stable source of funding.

- **The deposits are not rate-sensitive.** Based on current practices, our clients have reported that customers of their broker-dealer affiliates typically earn interest on their cash balances based on the same tiered interest rate schedule, regardless of whether they participate in the sweep program or not. The broker-dealer affiliates of our depository institution clients typically do not proactively advertise the interest rates paid on customer cash balances, and historically the customer cash balance levels have not been sensitive to interest rate changes. In contrast, above market rate deposits, such as those gathered through a promotional rate CD, while not categorized as "brokered," are

significantly less stable than those generated in these types of brokerage sweep programs.

(4) What recommendations would you make for legislative or regulatory changes with respect to core and brokered deposits?

(a) <u>The statutory and regulatory definition of "brokered deposit" should be clarified in terms of scope to avoid uncertainty and inappropriate regulatory classification of what otherwise are low-cost and stable sources of funding for many depository institutions.</u>

Pursuant to Section 29 of the Federal Deposit Insurance Act ("FDIA") and the implementing regulations of the FDIC, a "brokered deposit" is "any deposit that is obtained, directly or indirectly, from or through the mediation or assistance of a deposit broker."[7] A "deposit broker" is "any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions."[8] Since the enactment of Section 29 and through the development of e-commerce and innovative means for the provision of products and services by banks and other financial institutions, such broad definitions of "brokered deposit" and "deposit broker" have resulted in the need for interpretive guidance and research into the legislative intent of Section 29.

It is clear from the legislative history of Section 29 that the statutory definition of "brokered deposit" and restrictions placed on such deposits were driven by Congress' concern about "the ready availability of brokered funds, obtained through the payment of above-market rates, [and used] to support risky and speculative asset investment by weak and insolvent institutions."[9] In contrast, swept deposits held at depository institutions and originating from broker-dealers seeking to offer customers security for and a means to earn interest on their uninvested funds may appropriately be characterized as stable, low-rate, and long-term deposits. The swept deposits associated with the sweep programs in which our banking clients and their affiliated broker-dealers participate carry none of the indicia of "hot" money, and to characterize them as brokered deposits is to lose sight of the purpose of Section 29. Accordingly, the legislative history of Section 29 supports the recognition of a distinction in the characteristics of swept funds versus other types of deposits that may otherwise fall within the broad definition of "brokered deposit."

---

[7] 12 U.S.C. § 1831f(g); 12 C.F.R. § 337.6(a)(2).

[8] 12 U.S.C. § 1831f(g)(1)(A); 12 C.F.R. § 337.6(a)(5).

[9] *See* Senate Proceedings and Debates of the 101st Congress, First Session, on the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") at 135 Cong. Rec. S4084 *S4096 (April 18, 1989).

Given the broad definition of what constitutes a "brokered deposit" under existing FDIC guidance, several of our clients have had to report swept deposits as "brokered" on periodic reports filed with their regulators not because the deposits contained the typical features of brokered deposits, but because the affiliated broker-dealer's sweep program did not fit squarely within the technical requirements of the FDIC's existing and technically non-binding[10] advisory opinion exemption for swept deposits ("Advisory Opinion 05-02").[11] With respect to the regulatory classification of such deposits, we note that some financial institutions do not report swept deposits falling outside of the parameters of the FDIC's Advisory Opinion as "brokered." In addition to leading to a competitive disadvantage down the road for institutions that do report swept deposits as such, a lack of uniform and consistent FDIC guidance creates uncertainty with respect to the appropriate treatment of swept deposits and the potential for inconsistent treatment of such deposits during the examination process.

With respect to the definition of a "brokered deposit," we believe that a broad one-size fits all definition is not appropriate. Rather, examiners should review each institution's situation to identify risks, and be guided by uniform rules and guidance, consistently applied to all institutions based on an accurate assessment of their deposit base reflected in the institution's own historical experience. We believe that the underlying stability and price volatility of deposits is a more appropriate focus of inquiry as opposed to the delivery channel. The fact that an account was opened on the internet or that the institution does not have a physical location in the immediate geography of the customer does not increase the volatility or stability of a deposit. Technology is such that even in a one-bank small town, a local long-term customer who is nervous about the stability of the institution can and will electronically move excess or uninsured balances to another financial institution. Similarly, large, long-term uninsured institutional deposits will typically become market sensitive, and thus volatile, when a bank encounters difficulties. Accordingly, the designation of some deposits as "brokered" is not as relevant in determining whether such deposits should be considered "core" deposits, as a designation of "potentially volatile" or "market sensitive" might be.

(b) Current FDIC guidance on the regulatory treatment of sweep deposits imposes an arbitrary 10 percent standard that does not

---

[10] *See* Introduction to FDIC Advisory Staff Opinions, *available at* http://www.fdic.gov/regulations/laws/rules/4000-300.html ("The letters express the views and opinions of individual FDIC staff lawyers and are not binding on the FDIC, its Board of Directors, or any board member; any representation to the contrary is expressly disclaimed. The letters should only be considered advisory in nature, and the reader bears the responsibility for relying on them.").

[11] FDIC Advisory Opinion 05-02, William F. Kroener, III, General Counsel (February 3, 2005).

adequately take into account different business models and therefore should be withdrawn or significantly revised.

Pursuant to Advisory Opinion 05-02, the FDIC provides that it will not treat as "brokered deposits" certain funds swept from a brokerage firm's cash management and retirement accounts to an affiliated bank's money market deposit or transaction accounts, provided certain conditions are satisfied.[12] Under the Advisory Opinion and as referenced in the FDIC's October 16, 2008 notice of proposed rulemaking on deposit insurance assessments,[13] funds swept from a brokerage firm into an affiliated bank are not viewed as "brokered deposits" by the FDIC where:

1. The funds are swept for the primary purpose of facilitating customers' purchase and sale of securities rather than the placement of funds into the bank, and the deposits are not time deposits at the bank;

2. The swept funds do not exceed 10 percent of the brokerage firm's cash management and retirement account assets (referred to as the "Permissible Ratio" in the Advisory Opinion), calculated on a monthly basis;[14] and

3. The payment of fees by the bank to the brokerage firm are for administrative services rather than for the placement of deposits, and are not based on the amount of the funds placed at the affiliated bank but rather are paid on a "per customer" or "per account" basis.

Advisory Opinion 05-02 interprets the "primary purpose" statutory exemption to the definition of "deposit broker" under Section 29 of the FDIA, and the purpose and rationale for such exemption appears clear from the statute's legislative history.[15] Specifically, in providing for the restrictions on brokered deposits under Section 29, Congress' concern was the threat posed by "hot" money to troubled depository institutions. In the hearings leading up to the enactment of Section 29, "hot" money is described as short-term funds that a deposit broker seeks to place in whichever depository institution providing the

---

[12] *Id.*

[13] 73 Fed. Reg. 61560, 61566 n. 26 (October 16, 2008).

[14] With respect to the 10 percent threshold in the second condition above, the FDIC Advisory Opinion provides that the calculation of the "Permissible Ratio" is based on the "total Central Assets Accounts and Retirement Account assets" of the brokerage firm. Similarly, the Permissible Ratio is described in the FDIC's proposal amending its deposit insurance assessment rule as "10 percent of the brokerage's cash management account and retirement account assets."

[15] 12 U.S.C. § 1831f(g)(2)(I).

highest rate.[16] The legislative concern addressed by Section 29 was to prohibit high-rate brokered deposits that frequently served as an unstable deposit base to a struggling institution.[17] As described in this letter, the swept deposits at issue here are stable, low-rate, long-term deposits that carry none of the indicia of "hot" money or risks that Congress sought to eliminate.

Although applied by the FDIC to a number of bank sweep programs seeking to utilize the "primary purpose" exemption, Advisory Opinion 05-02 should not be applied to financial institutions that have a completely different business model than the particular institution and its affiliates that requested, and are thus subject to, the interpretive guidance. In particular, the 10 percent of brokerage assets test imposes an arbitrary threshold, proffered for one institution that is now being forced upon many in dissimilar circumstances. The application of a rigid standard unfairly disadvantages financial institution structures where the brokerage firm does not significantly outsize its bank affiliate, as the denominator of the Permissible Ratio is not based on whether a customer chooses to participate in the bank sweep program, but on the assets in accounts at the brokerage firm that are eligible to participate in the sweep program, *i.e.*, sweep-able deposits. Accordingly, a less diversified and/or smaller financial services company may therefore have less sweep-able deposits with which to calculate the 10 percent threshold. In this regard, a single Advisory Opinion should not alter the plain statutory language of Section 29, which clearly states that any agent "whose primary purpose is not the placement of funds with the depository institution" is not a deposit broker.[18]

More importantly, it is entirely unclear why a 10 percent asset test applied at an affiliated brokerage firm is at all predictive of the stability of deposits placed at a depository institution pursuant to a bank sweep program. In fact, what the 10 percent threshold has come to assure is the stability of deposits that necessarily must be swept to unaffiliated banks due to the 10 percent asset cap. Clearly, this is a perverse result lacking any credibility with respect to the true stable nature of the swept deposits in these programs.

As an example, in the context of a simple discount brokerage model, the broker-dealer affiliate may not provide any investment advice, nor does it conduct any proprietary trading. In reviewing the broker-dealer's competitors with sweep programs that have obtained exemptive relief from the FDIC consistent with the Advisory Opinion, it appears these firms are able to fit

---

[16] *See* Statement of Robert L. Clarke, Comptroller of the Currency, before the House Subcommittee on General Oversight and Investigations of the Committee on Banking, Finance and Urban Affairs, Washington, D.C., May 17, 1989, published in 8 OCC Q.J. 32 (September 1989).

[17] *See* Remarks of Sen. Murkowksi in connection with his amendment to the brokered deposit provision in FIRREA at 135 Cong. Rec. S4238 (April 19, 1989).

[18] *Id.*

within the technical parameters of the FDIC's opinion letter because their businesses are more diversified and emphasize asset accumulation, which provides a larger denominator against which to measure the 10 percent permissible ratio under the "primary purpose" test outlined in the Advisory Opinion. This does not appear to be an intentional policy outcome, nor does it appear to have been the intent of the FDIC to have its Advisory Opinion operate to differentiate among financial institutions on this basis alone. Accordingly, we recommend that Advisory Opinion 05-02 be withdrawn or significantly revised to eliminate, or substantially expand on an interim basis (*i.e.*, pending permanent legislative improvements reflecting the stable nature of swept deposits in bank-affiliated sweep programs), the arbitrary 10 percent threshold and take into account the actual business activities of a broker-dealer affiliate, including the structure of its bank sweep program, when considering whether the level of sweep activity qualifies the broker-dealer for the "primary purpose" exemption with respect to the treatment of brokered deposits.

(c) **Congress and the FDIC should consider the significant and evolving role of e-commerce in the provision of financial services and should narrowly tailor the definitions of core and brokered deposits to place appropriate weight, if any, to the fact that a deposit was solicited through the internet.**

We believe that a suggestion by the FDIC that certain types of deposits are somehow "riskier" because of being gathered by new delivery channels than deposits gathered at a traditional brick and mortar bank ignores all of the technological advances made in the marketplace and is fundamentally counterproductive to the development of e-commerce. As addressed above, there is a rapidly evolving trend in the provision of financial products and services by financial institutions through the internet, and this trend is expected to increase with technological advances.[19] Accordingly, in evaluating what types of deposits should constitute "core" deposits of a bank, it is important for the FDIC to consider the increasingly globalized financial marketplace and generational preferences, where geographical limitations between a financial institution and consumer play a diminishing role in the consumer's choice of a financial services provider, and to take into account new ways in which products and services of a financial institution are offered to the consumer.

(d) **Regulatory classifications of "core" and "non-core" deposits should take into account the distinctions highlighted in this letter between swept deposits from affiliated broker-dealers, which are stable and have a predictable cost, and more traditional rate-sensitive brokered deposits placed at a depository institution from unaffiliated deposit brokers or deposit placement services.**

---

[19] *See supra*, note 2.

As emphasized in the Interagency Guidance on Funding and Liquidity Risk Management issued by the federal banking agencies in 2010, effective liquidity risk management depends on the specific circumstances and size of each institution.[20] Specifically, there is no one-size-fits-all approach and financial institutions are expected to manage their funding and liquidity risk using processes and systems that are commensurate with the institution's complexity, risk profile and scope of operations. In evaluating a depository institution's liquidity position and assessing the adequacy of the institution's liquidity management, the FDIC and other federal banking agencies distinguish between "core" and "non-core" deposits, and consider the degree to which an institution funds longer-term assets (*e.g.*, loans, securities that mature in more than one year, etc.) with non-core funding. Non-core funding includes funding that can be sensitive to interest rate changes and includes large time deposits, borrowings, brokered deposits, and foreign deposits. Used as a measurement tool by banking regulators in evaluating an institution's liquidity, a high net non-core funding dependence ratio reflects a reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

As noted above, certain types of deposits currently deemed to be "brokered deposits," including the vast majority of swept deposits in many bank sweep programs, have features, including stability, stickiness and low-cost, more akin to traditional "core" deposits. Given these features, we believe it is appropriate from a policy perspective to treat such deposits the same as traditional "core" deposits. Accordingly, we recommend that the following be included as "core" deposits:

- Insured deposits at or below market rates; and
- Deposits placed by affiliated companies where a broader customer relationship exists.

Similarly, we recommend that the following be included as "potentially volatile" or "non-core" deposits:

- Uninsured deposits;
- Above market rate deposits; and
- Unilateral, "placed" deposits with no other organizational connection to the customer.

C. Conclusion

Significant changes in the marketplace – spawned in large part by technological innovations – have shaped the banking industry and the financial products and services that customers have come to expect from insured depository institutions and other

---

[20] FIL-13-2010, Interagency Guidance on Funding and Liquidity Risk Management (April 5, 2010), *available at* http://www.fdic.gov/news/news/financial/2010/fil10013.html.

financial services firms. These developments have also varied the deposit-gathering process. Such changes and advances certainly warrant a re-evaluation of, and changes to, the statutory and regulatory treatment of deposits gathered via these new delivery channels that bank customers have come to rely on and expect, including swept deposits pursuant to bank-affiliated deposit sweep programs. In particular, while swept deposits currently meet the broad definition of "brokered deposit," the long-standing experience of our clients is that swept deposits in bank-affiliated sweep programs are stable and have a predictable cost, and therefore behave precisely as traditional core deposits.

Accordingly, we encourage the FDIC to pursue guidance and/or regulatory changes – and to make recommendations for statutory changes where appropriate – to take into account the characteristics of deposits gathered outside brick and mortar branches. In particular, with respect to swept deposits, we strongly encourage the FDIC to withdraw Advisory Opinion 05-02 (and forgo further citing it as precedent) and/or replace it with regulatory or other supervisory guidance either eliminating the 10 percent of brokerage assets requirement or significantly expanding (perhaps on an interim basis pending permanent improvements to recognize the stable nature of bank-affiliated sweep program deposits) the 10 percent threshold for swept deposits. Further, it is extremely important that such guidance be uniformly applied to all affected insured depository institutions.

Paul Hastings appreciates the opportunity to provide comments to the FDIC on the questions presented in connection with the Study. If we or our clients may provide you with any additional information or you would like to discuss our comments further, please feel free to contact me at [redacted] or at (b)(6) [redacted] Thank you.

(b)(6)

Sincerely,

(b)(6)

Kevin L. Petrasic
of PAUL, HASTINGS, JANOFSKY & WALKER LLP

ARNOLD & PORTER LLP

May 2, 2011

VIA E-MAIL

The Honorable Sheila Bair
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Re: Comments on Core and Brokered Deposits

Dear Chairman Bair:

Arnold & Porter LLP hereby submits comments for consideration by the Federal Deposit Insurance Corporation ("FDIC") in connection with its study of core deposits and brokered deposits pursuant to Section 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Core Deposits Study").[1] We believe the Core Deposits Study provides the FDIC with a much-needed opportunity to reevaluate certain aspects of the categorization and treatment of "brokered deposits," particularly in connection with the agency's regulation on assessments, 12 C.F.R. Part 327 (the "Assessments Rule"). Our comments aim to assist the FDIC in addressing certain of the questions it has raised in seeking input from the public, including whether brokered deposits inherently increase an institution's risk, or facilitate increased risk-taking, and what legislative or regulatory changes should be made with respect to core and brokered deposits.

In particular, our comments focus on how the current definitions of a "brokered deposit" and a "deposit broker," and the FDIC's historical interpretation of that term in various contexts, have led to treatment of certain deposits in a manner that appears inconsistent with the purposes of Congress in enacting the brokered deposit provisions of the Federal Deposit Insurance Act ("FDIA"), codified at 12 U.S.C. § 1831f ("Section 1831f"), as well as the FDIC's objectives underlying the brokered deposits adjustment in the Assessments Rule.

For example, there are circumstances in which a business strategy specifically contemplates that deposits will be solicited through exclusive agents of a bank, who are independent contractors but, by contract with the bank, may perform banking-related

[1] Pub. L. No. 111-203 (July 21, 2010).

activities solely on behalf of that bank and no other depository institution. Such exclusive agents of a bank are also often exclusive agents of a securities or insurance firm affiliated with the bank, and may perform activities exclusively for these affiliated entities to service their shared customers. Because these exclusive agents cannot solicit deposits for any institution other than the affiliated bank, they do not "shop" interest rates among competing depository institutions or move their clients' funds around among various depository institutions. Accordingly, the deposits solicited by such exclusive agents are neither "hot money" nor volatile – in stark contrast to traditional "brokered deposits."

We urge the FDIC, in forming recommendations and taking action based on the Core Deposits Study, to address the overbreadth of the definition of "deposit broker" in connection with these exclusive agent-solicited deposits. There are three specific steps we strongly believe the FDIC should take in this regard:

- *Assessment amendment.* Exempt from the brokered deposits adjustment under the Assessments Rule deposits of an insured depository institution solicited by an agent of that institution who is contractually bound by a written agreement with the institution to solicit deposits solely for that institution and no other depository institution;

- *Regulatory amendment.* Revise the FDIC's regulation implementing Section 1831f, 12 C.F.R. § 337.6, to exclude from the definition of "deposit broker" an agent of an insured depository institution who is contractually bound by a written agreement with that institution to solicit deposits solely for that institution and no other depository institution; and

- *Legislative amendment.* Recommend to Congress that the definition of "deposit broker" in Section 1831f be amended as described above with respect to the FDIC's regulatory definition.

We recommend that all three of these steps be taken simultaneously; although they could be pursued individually, they are not mutually exclusive but, rather, complementary and mutually reinforcing.

I. Regulatory Background: Congressional and FDIC Objectives in Regulating Brokered Deposits

In enacting Section 1831f, Congress was primarily concerned about the volatility and higher interest rates generally associated with brokered deposits and how such deposits might contribute to the risk of a bank failure. Between 1984 and the enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), Congress heard extensive testimony regarding the perceived relationship between certain institutions' acceptance of brokered deposits and such institution's excessively risky investments. This testimony discussed the specific reasons why an institution's acceptance of brokered deposits might be an indicator of risk to the federal deposit insurance fund ("DIF"). As explained in 1985 by then-FDIC Chairman William M. Isaac:

> Prior to decontrol of interest rates [pursuant to the Deregulation and Monetary Control Act of 1980], banks and thrifts were pretty much prohibited from bidding for deposits. Funds generally flowed to institutions that were perceived to be strong and could offer the best and most convenient services.
>
> * * * * *
>
> . . . In a few short years money brokering has become a very big and enormously lucrative business. . . . Money brokers scour the country in search of hot money seeking the highest available risk-free return. The funds are packaged in fully-insured blocks and then sold to the highest bidder, which all too often is a marginal, high-risk institution. A survey conducted by the FDIC last year revealed that of the $24 billion in brokered funds in FDIC-insured institutions, over $9 billion was held by troubled institutions.[2]

[2] *Impact of Brokered Deposits on Banks and Thrifts: Risks Versus Benefits*, Hearing before the House Banking, Finance and Urban Affairs Committee's Subcommittee on

Footnote continued on next page

The problem perceived by Chairman Isaac and others was not with the use of deposit brokers *per se*; it was the use of deposit brokers seeking to deposit large amounts of money, in blocks fully insurable by the FDIC, in institutions without regard to the overall health of those institutions or the soundness of decisions likely to be made by those institutions' management.[3] Chairman Isaac clarified that:

> [T]he FDIC is not against the use of brokered deposits or the practice of deposit brokerage, *per se*. We do not seek to deny brokered funds to any sound institution that uses them prudently in the normal course of business. What we object to are money market investment decisions predicated exclusively on the existence of a full federal deposit insurance guarantee rather than on a proper credit analysis of the bank or thrift borrowing the funds.
>
> * * * * *
>
> [Rather than looking] beyond the promises of a high yield to the underlying strength of the financial institution in which they invest . . . , many deposit brokers and their investor clients [are] splitting funds in order to obtain full federal deposit insurance protection. . . . We are now faced with a situation where deposit brokerage is being utilized for the purpose of obtaining the highest available risk-free return on investment funds.
>
> * * * * *

Footnote continued from previous page

General Oversight and Investigations, Serial No. 99-36 (July 16, 1985), at 11-12 (testimony of William B. Isaac).

[3] *See id.* at 75 ("[I]t is not the brokered deposits that create the problem; it is how the banks use those brokered deposits. As a matter of fact, with problem banks which do not have brokered deposits, more times than not it is a case of management using the local deposit base to make bad loans.") (statement of H. Joe Selby, Acting Comptroller of the Currency).

> . . . In one instance a major brokerage firm, in less than a week, placed $60 million in new funds in an FDIC-insured savings bank, which used the funds to speculate in high yield, corporate (so-called "junk") bonds.[4]

Based on numerous hearings and other investigative avenues through which the House and Senate collected information on brokered deposits in the context of bank failures, the House and Senate Conferees on FIRREA summarized their findings by observing that:

> Failed institutions have a number of similar traits including inadequate board of director supervision; poor internal controls; poor underwriting and loan administration standards; and a reliance on brokered deposits or other highly volatile sources of funds. These problems are the result of poor management. . . .
>
> Many failed thrifts relied on volatile funding, such as brokered deposits controlled by a few individuals, which could be quickly withdrawn, paralyzing the institution. At one failed thrift, Jumbo Certificates of Deposit (usually deposits of $100,000 and over) made up 96 percent of total deposits. At another failed thrift, brokered deposits grew from 14% to 86% of all deposits in just one year. Because these funds are generally more expensive to obtain they cut into the interest margin earned on investments. Lower net interest margins encourage managers to take greater risks in order to maintain adequate earnings. Higher risks are all too often translated into higher failures.[5]

---

[4] *Brokered Deposits*, Hearing before the Senate Banking, Housing, and Urban Affairs Committee's Subcommittee on Financial Institutions and Consumer Affairs (June 5, 1985), at 8-9 (testimony of William B. Isaac).

[5] H.R. Rep. 101-54(I) (1989), at 300, *reprinted in* 1989 U.S.C.C.A.N. 86, at **96. Congress also identified other factors associated with thrift failures, including inadequate supervision by boards or directors or the presence of one dominating individual on the

Footnote continued on next page

Although made two decades earlier, these statements express the same concerns the FDIC voiced as reasons for including the brokered deposits adjustment in the Assessments Rule. As the FDIC stated in releasing the Assessments Rule in 2009:

> The FDIC is adding this new risk measure for a couple of reasons. A number of costly institution failures, including some recent failures, involved rapid asset growth funded through brokered deposits. . . .
>
> Significant reliance on brokered deposits tends to increase an institution's risk profile, particularly as the institution's financial condition weakens. Insured institutions – particularly weaker ones – typically pay higher rates of interest on brokered deposits. When an institution becomes noticeably weaker or its capital declines, the market or statutory restrictions may limit its ability to attract, renew or roll over these deposits, which can create significant liquidity challenges.[6]

None of the concerns expressed by Congress and the FDIC in this regard is an issue with respect to deposits solicited by an exclusive agent of a depository institution. The FDIC should use the opportunity created by the Core Deposits Study to ensure that exclusive agent-solicited deposits are not treated as "brokered deposits" under the Assessments Rule.

Footnote continued from previous page

board of directors; poor loan underwriting and administration standards; poor loan documentation; inadequate credit analysis; and appraisal deficiencies. *Id.*

[6] *FDIC Amended Restoration Plan; Assessments; Modification of Temporary Liquidity Guarantee Program; Notice, Interim Final Rule, and Final Rule*, 74 Fed. Reg. 9522, 9541 (Mar. 4, 2009) (codified at 12 C.F.R. Parts 327 & 370).

II. Factual Background on Exclusive Agents of Depository Institutions

A. Typical Exclusive Agent Arrangements

In a number of cases, certain affiliated securities firms and insurance companies, recognizing that their customers might appreciate the ability to pursue their financial objectives on a consolidated basis, have established or acquired depository institutions to serve those customers' objectives and to maximize efficiency. In cases where the affiliated companies market their products through exclusive agents, the business plans of such newly established or acquired depository institutions have been designed around the use of the affiliated entities' exclusive agents for marketing purposes. Federal regulatory approval has been obtained to train and engage the affiliates' existing exclusive agents in introducing the affiliates' customers to the products of the depository institution. In this way, the new depository institutions have been able efficiently and effectively to offer the customers of the affiliated entities the opportunity to consolidate their financial services relationships within the affiliated entity group.

Generally, the role of the exclusive agent is strictly limited to marketing. The exclusive agents do not open customer deposit accounts, make deposits, or otherwise conduct banking transactions for their clients. Rather, the exclusive agents provide information regarding the products and services of the depository institution they represent by, *inter alia*, displaying in their offices product and service information and brochures; mailing marketing materials; and otherwise apprising customers and potential customers of the availability of the depository institution's products and services through telephone, e-mail and in-person contacts. Exclusive agents also assist individuals in completing applications for the depository institution's products – for example, an exclusive agent may provide a customer with application forms for a deposit account, assist the customer in completing the forms, and transmit the completed forms to the depository institution. Alternatively, an exclusive agent may refer customers to a representative of the depository institution who will assist the customer in obtaining one or more deposit products or services. In virtually all such arrangements, the exclusive agents never accept any cash deposits or make any withdrawals on their clients' behalf.

A. Certification and Regulation of Exclusive Agents

In the typical case, to be eligible to market a depository institution's products and services on an exclusive basis, an agent must undergo extensive training that has been approved by the federal regulators. In order to complete this training successfully, such exclusive agents must become fully familiar with and educated about the depository

institution's products and services and the laws and regulations applicable to all aspects of marketing those products and services.

Exclusive agents of insured depository institutions also are *directly* subject to federal regulation, examination, supervisory and enforcement authority. For example, under the Examination Parity and Year 2000 Readiness for Financial Institutions Act (the "Exam Parity Act"),[7] the Office of Thrift Supervision ("OTS") – which regulates many of the depository institutions affiliated with securities firms or insurance companies – has explicit regulatory and examination authority over all of the services performed by the exclusive agents on behalf of a federal savings bank "to the same extent as if such services were being performed by [the Bank] on its own premises."[8] The other federal banking agencies have the same authority over agents of other federally insured depository institutions.[9] In this manner, the exclusive agents of such depository institutions are regulated exactly as if they were employees of those institutions.

Indeed, in light of the special relationship between a depository institution and its exclusive agents, such agents are, in effect, the functional equivalent of divisions or departments of the depository institution. As the OTS stated in one case involving a federal savings bank with exclusive agents:

> [T]he [Bank] controls and reviews the activities the Agents perform on behalf of the [Bank], and no other entity exercises effective operating control over the Agents' activities on behalf of the [Bank]. Where an association exercises sufficient control over an agent's performance of authorized banking activities, the agent, like an operating subsidiary of a federal savings association, will be subject to OTS regulation and supervision, . . . just as [such

---

7 Pub. L. No. 105-164, 112 Stat. 32 (1998).

8 *Id.* § 1464(d)(7)(D)(i). The OTS also has direct examination and enforcement authority over the Agents as "institution-affiliated parties." *See* 12 U.S.C. § 1464(d)(1)(A) and 12 U.S.C. § 1818.

9 *See* 12 U.S.C. § 1867(c).

> regulation and supervision] would apply to an operating subsidiary.[10]

The OTS thereby recognized that exclusive agents of a depository institution perform marketing activities in essentially the same manner as would employees within a department or division of the institution.

III. Need for Reform of the "Deposit Broker" Definition To Account for Exclusive Agents of a Single Insured Depository Institution

Treating deposits solicited by exclusive agents of a single depository institution does not serve the objectives of Congress or the FDIC with respect to regulation of brokered deposits. The Core Deposits Study affords the FDIC an opportunity to initiate action in recognition of the sharp distinction between the brokered deposits of concern to Congress and the FDIC, and exclusive agent-solicited deposits.

A. Current Definitions of "Brokered Deposit" and "Deposit Broker"

Currently, there is no statutory definition of a "brokered deposit." The FDIC has defined the term solely by reference to a "deposit broker," stating that a "brokered deposit is "any deposit that is obtained, directly or indirectly, from or through the mediation or assistance of a deposit broker." 12 C.F.R. § 337.6(a)(2).

Under both Section 1831f and the FDIC's implementing regulation, in pertinent part, a "deposit broker" is:

> any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions or the business of placing

---

[10] OTS Legal Op. P-2004-7, 2004 WL 3272094 (O.T.S. Oct. 25, 2004), *available at* http://www.ots.treas.gov/docs/5/560404.pdf, at 13. As the OTS explained, an operating subsidiary of a federal savings bank "is the equivalent of a department or division" of the bank for regulatory purposes. *Id.* at 9 (noting the "OTS's long-held view that because an operating subsidiary may only engage in activities permissible for its parent federal savings association and must be controlled and majority owned by the association, *an operating subsidiary is the equivalent of a department or division of the parent federal savings association for regulatory and reporting purposes*") (emphasis added).

> deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties.[11]

This definition expressly excludes certain entities and individuals, including, *inter alia*:

> (A) an insured depository institution, with respect to funds placed with that depository institution;
>
> (B) an employee of an insured depository institution,[12] with respect to funds placed with the employing depository institution; . . . [and]
>
> (I) an agent or nominee whose primary purpose is not the placement of funds with depository institutions.[13]

B. Characteristics of Exclusive Agent-Solicited Deposits

By its terms, the definition of "deposit broker" exempts "agent[s] whose primary purpose is not the placement of funds with depository institution*s*."[14] An exclusive agent of a depository institution could not have *any* purpose, much less a "primary purpose," to

---

[11] 12 U.S.C. § 1831f(g)(1); 12 C.F.R. § 337.6(a)(5)(i).

[12] An "employee" as defined in Section 1831f is "any employee – (A) who is employed exclusively by the insured depository institution; (B) whose compensation is primarily in the form of a salary; (C) who does not share such employee's compensation with a deposit broker; and (D) whose office space or place of business is used exclusively for the benefit of the insured depository institution which employs such individual. 12 U.S.C. § 1831f(g)(4); *see also* 12 C.F.R. § 337.6(a)(6).

[13] 12 U.S.C. § 1831f(g)(2); 12 C.F.R. § 337.6(a)(5)(ii). The statute also provides, however, that notwithstanding the first two of these exclusions, a "deposit broker" includes any insured depository institution that solicits deposits by offering rates of interest that are "significantly higher than the prevailing rates of interest in the institution's normal market area." 12 U.S.C. § 1831f(g)(3). The FDIC has interpreted "significantly higher" interest rates to mean more than 75 basis points over the prevailing rates offered by other insured depository institutions having the same type of charter in such depository institution's normal market area.

[14] 12 U.S.C. § 1831f(g)(2)(I); 12 C.F.R. § 337.6(a)(5)(ii)(I) (emphasis added).

place funds with "depository *institutions*" (*i.e.*, more than one depository institution) because such agents are contractually bound to perform banking-related services *only* for the single depository institution they represent. The main purpose of an exclusive agent's activity in soliciting deposits for a depository institution is to introduce customers of one or more affiliates of the depository institution to that particular institution's products and services, as a means to solidify and strengthen the enterprise-wide relationships with those customers. Thus, the placement of funds is clearly not an exclusive agent's "primary purpose." Rather, the primary purpose of such exclusive agents is to generate good will and build stronger relationships with customers across the enterprise.

Exclusive agents therefore do not – and could not – act in the manner that has concerned Congress with respect to brokered deposits – *i.e.*, facilitating volatile deposits by seeking to break up large deposits and place them at different insured financial institutions, particularly on the basis of higher interest rates. Indeed, the way exclusive agents offer deposit products has no resemblance whatsoever to the manner in which typical deposit brokers place deposits. Typical deposit brokers present a wide selection of deposit products from different depository institutions for their customers to choose from and offer their customers the opportunity to compare interest rates offered by different institutions. As Congress and the FDIC have observed, deposits placed by such brokers could be volatile and could carry higher interest rates, because the depositors generally use the brokers to obtain the highest rates available, and they tend to move their deposits on the basis of rates.

In stark contrast to typical deposit brokers, an exclusive agent of a depository institution would not refer customers to the depository institution on the basis of high interest rates, because an exclusive agent, by definition, is contractually bound to make any banking referrals *exclusively to that depository institution*, regardless of the interest rates the institution pays. Thus, the concern about volatility underlying the brokered deposits adjustment in the Assessments Rule is not an issue with respect to any exclusive agent-solicited deposits. Neither volatility nor higher interest rates are characteristics of these deposits. Indeed, exclusive agent-solicited deposits are essentially "core deposits" – *i.e.*, low-cost and long-term sources of funding that are much less expensive than wholesale funds with comparable terms.[15]

---

[15] *See, e.g.*, "The Other Side of FAS 159: Valuing Non-Demand Core Deposits," *Bank Asset/Liability Management*, Vol. 24, No. 8, August 2008, at 2.

Thus, for purposes of the Assessments Rule, the exclusive agents of a depository institution should be viewed as the functional equivalent of such institution's employees – whom, as noted above, are excluded from the statutory and regulatory definition of "deposit broker." Just like a depository institution employee "who is employed exclusively by the insured depository institution,"[16] such exclusive agents act on behalf of a single depository institution. And, in so doing, those agents are regulated and supervised in precisely the same manner as the depository institution's employees. Thus, although exclusive agents do not meet the narrow definition of "employee" in Section 1831f(g), for all purposes relevant to the FDIC's regulation of brokered deposits, such agents are, in effect, the functional equivalent of depository institution "employees."

In summary, imposing brokered deposit assessments on deposits solicited by exclusive agents of a single depository institution is flatly contrary to the critical federal objectives of expanding credit distribution channels and lowering the cost of credit. Because it serves none of the objectives of Congress or the FDIC with respect to preventing risks to the DIF, the application of the Assessment Rule's brokered deposits adjustment to exclusive agent-solicited deposits undermines, rather than protects, "the safety and soundness of our deposit and insurance system and the reserves of the system, . . . in behalf of the American public, and in the interest of a sound and stable depository institutions system in our country."[17]

IV. Recommendations

For the reasons stated above, and based on the foregoing facts and legal analysis, we urge the FDIC to include in its plan of action emerging from the Core Deposits Study the following three items:

- *Assessment amendment.* Exempt from the brokered deposits adjustment under the Assessments Rule deposits of an insured depository institution solicited by an agent of that depository institution who is contractually bound by a written

---

[16] 12 U.S.C. § 1831f(g)(4)(A).

[17] *Impact of Brokered Deposits on Banks and Thrifts: Risks Versus Benefits*, Hearing before the House Banking, Finance and Urban Affairs Committee's Subcommittee on General Oversight and Investigations, Serial No. 99-36 (July 16, 1985), at 115 (testimony of Edwin J. Gray, Chairman, Federal Home Loan Bank Board).

agreement with the institution to solicit deposits solely for that institution and no other depository institution.

- *Regulatory amendment.* Revise the FDIC's regulation implementing Section 1831f, 12 C.F.R. § 337.6, to amend the definition of "deposit broker" an agent of an insured depository institution who is contractually bound by a written agreement with that institution to solicit deposits solely for that institution and no other depository institution. This could be done with or without a corresponding legislative amendment, exercising the FDIC's inherent powers to provide reasonable interpretations and clarifications of the statutes it administers.[18] Such an amendment could, for example, add the following italicized words to the existing exemption from the "deposit broker" definition set forth in 12 C.F.R. § 337.6(a)(5)(ii)(I), such that "deposit broker" would not include: "An agent or nominee (i) whose primary purpose is not the placement of funds with depository institutions *or (ii) who is contractually bound by a written agreement with a single insured depository institution to solicit deposits solely for that institution and no other depository institution.*"

- *Legislative amendment.* Recommend to Congress that the definition of "deposit broker" in Section 1831f be amended as described above with respect to the FDIC's regulatory definition.

We appreciate your consideration of these comments. If you have any questions or need further information, please contact either me (by e-mail at (b)(6) [redacted] or my colleague Nancy Perkins (by e-mail at (b)(6) [redacted].

Respectfully submitted,

(b)(6) [redacted]

A. Patrick Doyle

[18] Under established United States Supreme Court precedent, federal agencies have the authority to interpret statutes they are charged to administer. *See, e.g., Smiley v. Citibank (S.D.), N.A.*, 517 U.S. 735, 739; *Chevron, U.S.A., Inc. v. National Resources Defense Council, Inc.*, 467 U.S. 837, 842-45 (1984).

American Bankers Association
Building Success. Together.

Mark Tenhundfeld
Senior Vice President
(b)(6)

May 2, 2011

Diane Ellis
Deputy Director
Division of Insurance and Research
Federal Deposit Insurance Corporation
1776 F Street, NW
Washington, DC 20006

Re: Core and Brokered Deposit Study Mandated by the Dodd-Frank Act

Dear Ms. Ellis:

The American Bankers Association[1] appreciates the opportunity to share our views on the definition of "core" and "brokered" deposits with the FDIC as the FDIC prepares the report required by section 1506 of the Dodd-Frank Wall Street and Reform Consumer Protection Act. That section directs the FDIC to evaluate –

- The definition of core deposits for the purpose of calculating insurance premiums;
- The potential impact on the Deposit Insurance Fund of revising the definitions of brokered deposits and core deposits to better distinguish between them;
- Differences between core deposits and brokered deposits and their role in the economy and U.S. banking sector;
- The potential stimulative effect on local economies of redefining core deposits; and
- The competitive parity between large institutions and community banks resulting from redefining core deposits and brokered deposits.

This study is an important step in the process of modernizing the rules to reflect industry innovations, and we commend the FDIC for its efforts.

We respectfully submit that the current rules apply outdated labels in an inflexible manner. This has the unintended adverse effect of placing stable sources of funding off-limits for many banks, often at precisely the time when the banks most need this funding. To address this problem, we urge that the rules be amended in a way that balances the simplicity of bright lines with the flexibility to demonstrate stability of a deposit when those bright lines are inappropriate.

The ABA has long advocated for changes to the rules governing brokered deposits. The current law was enacted in response to the use of volatile deposits that increased the severity of the thrift

[1] The American Bankers Association brings together banks of all sizes and charters into one association. The ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.3 trillion in assets and employ over 2 million men and women.

crisis of the 1980s. These deposits typically were generated from out-of-market customers and generally paid interest rates considerably higher than those paid on "core" deposits. Given that these customers typically were chasing rates offered by banks[2] with whom the customer had no other relationship, funds generated by a bank through brokered deposits tended to disappear when another bank offered a higher rate.

To address this situation, Congress limited the use of brokered deposits only to "well capitalized" banks as that term is defined in the Prompt Corrective Action (PCA) rules[3] and, with the FDIC's permission, to "adequately capitalized" banks as defined in the PCA rules.[4] As defined by the FDIC, a deposit is deemed brokered if, in essence, a third party has either placed, or facilitated the placement of, deposits for someone else or if the rates paid for a deposit by a bank that is less than well capitalized "significantly exceed" the prevailing rates paid by other insured depository institutions in the bank's normal market area.

Advances in financial products since the statute was enacted and implemented have rendered this definition of brokered deposit obsolete. Many innovations, including those that facilitate the swapping of deposits by banks that are members of a reciprocal network and those that allow a bank to obtain funds through various sweep programs, have provided banks of all sizes with the ability to attract new, and larger, deposits that are as stable as any deposit that would be considered "core." However, deposits obtained through many of these innovations are considered by the FDIC to be "brokered" given that there is an intermediary between the customer and the bank.

Banks often will avoid using a deposit simply because of the "brokered" or "noncore" labels. The analysis of a bank's noncore funding dependence ratio under the Uniform Bank Performance Report can be skewed by inclusion of stable, albeit "noncore," funding, causing many banks to rely more heavily on more restricted "core" funding as currently defined despite the operational disadvantages of doing so. Many banks are concerned about the potential sudden disruption in funding sources that can occur when the bank's PCA capital category declines. Indeed, banks often are criticized by their examiners for using "brokered deposits" in part because of the risk that a PCA downgrade could render those deposits unavailable.

Ironically, then, the statute creates volatility where none may exist. Many of the deposits considered "brokered" have all the characteristics of a stable deposit but become unstable solely

---

[2] As used herein, the term "bank" refers to all insured depository institutions.

[3] To be deemed "well capitalized," a bank must have total risk-based capital of at least 10%; tier 1 risk-based capital of at least 6%; a leverage ratio of at least 5%; and not be subject to a written requirement to meet a specific capital level. 12 CFR 325.103(b)(1).

[4] A bank will be deemed "adequately capitalized" under the PCA rules if it is not well capitalized but has total risk-based capital of at least 8%; tier 1 risk-based capital of at least 4%; and a leverage ratio of at least 4% (or 3% if the bank is a CAMELS 1 and not experiencing or anticipating "significant" growth). *Id.* at 325.103(b)(2).

by application of the law. A bank that is experiencing capital-related problems will have to contend with a pro-cyclical rule that adds artificial funding problems to the more real problems that led to the PCA downgrade.

By compounding a bank's problems in this fashion, the rule can have the effect of making it more difficult for a bank to meet the credit needs of its community, as fewer deposits taken in translates into fewer loans going out. Forcing banks that are less than well capitalized to rely more on narrowly-defined "core" funding can force the cost of funds to increase dramatically for all banks in the market as competition for finite core deposits increases. In extreme cases, the rule can create reputational risk for a bank, as large customers whose deposits are fully insured through a reciprocal deposit-swapping network are effectively forced by the rule to withdraw deposits and place them elsewhere to remain insured. Moreover, the current policy may increase volatility in the banking system as a whole, as depositors, no longer able to obtain the desired insurance protection through one bank, spread deposits around several banks by using a deposit broker who seeks to maximize the yield for the customer. A bank can avoid these outcomes by avoiding deposits obtained through new delivery means, but in so doing it either may chase off good customers or increase exposure to truly volatile funding.

We submit that a better approach is one that focuses on the stability of a deposit.[5] The label attached to a given deposit is growing progressively less relevant as new technologies permit banks to attract stable sources of deposits through sweep programs, deposit-swapping networks, and other sources. The rules should avoid classifying deposits based on the channel through which the deposit was obtained and rely instead on the characteristics of the deposits. This will become an increasingly important issue as customers become more familiar and comfortable with alternative distribution channels and transacting business outside of a traditional brick-and-mortar branch.

When reviewing the stability of a given source of deposits, we believe it is appropriate as a threshold matter to distinguish transaction accounts from time deposits. Transaction accounts traditionally are viewed as among the most stable forms of deposits and are obtained from customers that are not looking primarily to maximize the rate of return on the transaction account balances. This is reflected in the inclusion in the Federal Financial Institutions Examination Council's Uniform Bank Performance Report (UBPR) of all transaction accounts (as well as money market deposit accounts and other savings deposits) within the definition of "core" deposits. Customers typically are reluctant to disrupt an established transaction account in the absence of dissatisfaction with the service associated with the account. Thus, we suggest that the

[5] While we recognize that Congress has directed the FDIC to focus in the Section 1506 study on core and brokered deposits, we urge the FDIC to focus its supervisory efforts apart from the study on the broader issue of core funding and not just deposits. Brokered deposits can play an important role in ensuring that a bank has appropriately diversified funding, but, as FDIC staff has recognized, the supervisory issue clearly is broader than the narrow issue of what should be considered "core" or "brokered" deposits.

FDIC adopt an approach that is consistent with the UBPR treatment of transaction accounts and view them as stable.[6]

As a starting point, all fully insured transaction accounts should be viewed as stable. In the event that a determination of stability hinges as a general rule on whether the account is insured, we suggest that banks have the flexibility to demonstrate that uninsured amounts are stable as well. Customers that maintain large balances often will have other accounts with, or obtain other services from, a bank that contribute to the stability of the relationship and the customer's willingness to keep uninsured balances in the bank. When reviewing uninsured transaction account balances, we suggest that a bank have the flexibility to demonstrate the stability of such balances by showing these other relationships with the bank and related information, such as the length of the relationship, the number of renewals of time deposit products, and use of ancillary services.

The stability of time deposits also will depend in large part on whether they are fully insured and whether there are other relationships with the depositor. Thus, when assessing whether a time deposit is stable, we would urge the FDIC to consider those factors. In addition, we suggest that the FDIC take into consideration the following:

- Duration. Certificates of deposit (CDs) with long durations and restrictions on early withdrawals typically are very stable. Indeed, some CDs may be terminated early only upon the death of the customer. When assessing duration the focus should be on the remaining duration and not the duration at origination.

  It is difficult to establish a bright line for how long a CD's term should be in order for the deposit to be deemed stable. While further analysis of this question may be productive, we suggest that the issue of duration should be analyzed in the context of other characteristics of the deposit, with duration being one factor that may indicate a source of funds that is likely to remain with the bank for an extended period of time.

  The relevance of deposit duration also should be viewed in part as a function of the duration of the bank's assets. Diversification of terms and a bank's overall interest rate risk management and liquidity management are important factors when assessing stability of funding. Poorly matched assets and liabilities can lead to increased interest rate risk, liquidity problems, and a resulting decrease in the franchise value of a bank.

- Interest rate paid. Deposits that are priced significantly above the prevailing market rates may be more volatile and can reduce franchise value. However, there may be exceptions to this general rule. For instance, banks that have demonstrably lower operating costs may be able to offer more attractive rates. Thus, pricing consistency also is an important factor to consider. If a bank suddenly increases its rates to attract deposits, deposits attracted by the "rate special" may prove to be volatile.

[6] We also urge continuation of the consideration of MMDAs and other savings deposits as stable.

The principles outlined above would enable banks to demonstrate the stability of their deposits while leading to a supervisory response that is appropriate to a particular bank's risk profile. While bright-line rules of what will be treated as stable would provide certainty and ease of implementation, banks should have the flexibility to demonstrate that other sources of deposits – including those obtained from reciprocal deposit networks, sweep programs, and other delivery channels – are stable and should be treated as such. This would allow room for the industry to innovate and better serve their customers while providing a supervisory framework to guard against the abuse of "hot money."

Rules that incent banks to rely more on stable deposits regardless of the delivery channel will increase the banks' franchise values. A stable base of deposits provides many advantages to a prospective buyer, including more reliable pricing of deposits, greater control over interest rate risk, and a better understanding of funding needs going forward. Buyers thus are willing to bid up the price of an institution that affords these benefits. Conversely, rules that discourage several stable sources of funding will diminish franchise value.

When evaluating franchise value, the FDIC needs to consider both sides of the balance sheet. As noted above, maturity mismatches between assets and liabilities can lead to heightened interest rate risk and liquidity problems. A bank needs the flexibility to manage these risks through funding that is appropriate for that bank's business. Many banks use diversified funding sources, including deposits, Federal Home Loan Bank advances, and other funding vehicles. While issues may arise in connection with some of these funding sources once a bank has failed, these issues should not drive the policy regarding what types of deposits banks should be incented to use. The focus should be on whether the funding *reduces the likelihood of failure* on the front end and not on whether the funding complicates the *resolution* of a failed bank on the back end.

We also urge the FDIC to avoid setting the policy regarding liabilities based on concerns about the inappropriate growth of assets. Clearly, rapid growth can lead to problems and should be addressed by the bank regulators. However, attacking the problem of inappropriate asset growth by limiting funding sources penalizes the entire industry in order to address the problems of a few. There is nothing inherently unsafe or unsound about any deposit-generating channel, regardless of whether it is obtained from a "core" customer, a deposit broker, the Internet, or some other source. Rather, it is the bank's use of the deposit that can create safety and soundness problems. Accordingly, we believe it is more appropriate and effective to respond to asset growth-related issues directly through measures aimed at curtailing unsafe and unsound growth in assets at a specific bank rather than through a one-size-fits-all deposit rule that focuses on the wrong issue.

In addition to changing the rules to focus on whether a deposit is stable instead of whether it is brokered, we urge the FDIC to change its rules regarding the ability of a bank to rely on a particular funding source once the bank's PCA capital category declines. As noted above, currently there is a "cliff effect" built into the rule: once a bank's capital category declines, the bank no longer may accept, renew, or roll over certain deposits except in limited circumstances.

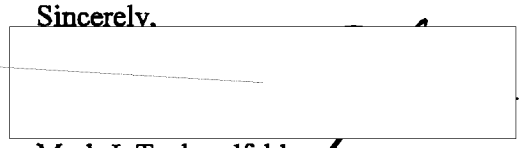
This procyclical implementation of the PCA and brokered deposit rules can exacerbate problems in a bank that already is struggling. The rules should permit a bank at least to renew or roll over existing CDs that mature. Alternatively (or perhaps in addition), the rules could allow a bank a certain period of time -- perhaps 12 months -- within which to achieve certain deposit-related benchmarks.

* * *

By moving away from artificial and increasingly meaningless labels of "brokered" and "core," the FDIC can preserve the industry's access to stable funding sources, decrease volatility in the system as a whole, and minimize procyclical disruptions. We urge the FDIC to support changes to the law that are easy to implement while sufficiently flexible to permit banks to rely on sources of demonstrably stable deposits. We appreciate the FDIC's consideration of these comments and would be happy to discuss these issues further with you if you would find that helpful.

Sincerely,

(b)(6)



Mark J. Tenhundfeld

THE FINANCIAL SERVICES ROUNDTABLE

Financing America's Economy

1001 PENNSYLVANIA AVE., NW
SUITE 500 SOUTH
WASHINGTON, DC 20004
TEL 202-289-4322
FAX 202-628-2507

E-Mail info@fsround.org
H www.fsround.org

Via e-mail

May 2, 2011

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

Re: Core and Brokered Deposits Study Mandated by Section 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act

The Financial Services Roundtable (the "Roundtable"[1]) appreciates the opportunity to provide the Federal Deposit Insurance Corporation (the "FDIC") with comments concerning the Core and Brokered Deposits Study (the "Study") mandated by Section 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[2] Section 1506 of the Dodd-Frank Act mandates that the FDIC conduct a study to evaluate (i) the definition of "core deposits" for purposes of calculating the insurance premiums of banks, (ii) the potential impact on the Deposit Insurance Fund ("DIF") of revising the definitions of "brokered deposits" and "core deposits" to better distinguish between them, (iii) the assessment of the differences between core deposits and brokered deposits and their role in the economy and banking sector of the United States, (iv) the potential stimulative effect on local economies of redefining core deposits, and (v) the competitive parity between large and community banks that could result from redefining core deposits.

The Roundtable urges the FDIC to: (i) re-conceptualize how the approach to regulation of brokered deposits in light of the contemporary environment facing insured depository institutions ("IDIs"), (ii) change and upgrade its regulatory treatment of brokered deposits, and (iii) Recognize the stability of deposits arising from long-term relationships between IDIs and affiliated broker-dealers.

At the outset, the Roundtable acknowledges that in certain situations, an IDI may utilize brokered deposits to engage in suboptimal amounts of risk-seeking behavior. In these situations, the FDIC, and the IDIs that pay for the failure of risky IDIs through higher DIF premiums, have a valid basis for seeking regulation of an IDI's utilization of deposits. As an empirical matter, the Roundtable believes that certain **indicia** are highly correlated with such situations, such as (i) the IDI offering above-market interest rates for brokered deposits, (ii) an IDI relying on "out of network" certificates of deposit to fund itself, and (iii) the IDI being at or near failure. The Roundtable believes that when such **indicia** are present, an IDI's overreliance on and abuse of brokered deposit funding should indeed be limited under the existing statutory and regulatory framework. The Roundtable requests that when

---

1 The Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $92.7 trillion in managed assets, $1.2 trillion in revenue, and 2.3 million jobs.

2 *See* http://www.fdic.gov/regulations/reform/coredeposits.html.

undertaking the Study, the FDIC seek to distinguish between these situations (situations where an IDI's utilization of "brokered deposits" warrants prudential regulation) and situations where an IDI utilizes deposits in a safe and sound manner and as part of a prudent funding program. In cases where the indicia mentioned above are present, regulation is indeed warranted under the existing brokered deposits framework. It is with respect to situations where such indicia are not present that the Roundtable offers it comments, and believes that a rethinking of the existing framework is warranted.

The Roundtable offers the following additional comments.

I. Brokered Deposits and the Contemporary Environment for Brokered Deposits is Significantly Different

Much of the FDIC's approach to brokered deposit regulation seems to be based on market conditions that existed prior to passage of the Gramm-Leach-Bliley Act (the "GLB Act"). The pre-GLB Act approach to regulation of brokered deposits reflected the concern that brokered deposits were an unstable source of funding for IDIs, meaning that significant amounts of brokered deposits could be removed from an IDI with little or no warning. The Roundtable notes that the events that gave rise to the current statutory and regulatory treatment of brokered deposits occurred with respect to IDIs that had vastly different liability structures than most of today's IDIs.[3] This past paradigm seemingly still exercises an influence over the FDIC: as discussed at the March 18th roundtable on brokered deposits, the FDIC seems to assume that IDI excessively relying on brokered deposits necessarily can lead to the institution's failure. The Roundtable believes that although excessive reliance on brokered deposits may be a *symptom* of underlying variables that affect IDI failure rates, such as excessive risk-seeking behavior, there does not seem to be a significant causal relationship between reliance on brokered deposits and IDI failure in the 21st century.[4]

Rather than causing IDI failures, brokered deposits are an essential and often risk-mitigating element of IDI funding strategies. It is clear that the FDIC itself recognizes that the use of brokered deposits is a "legitimate" method of IDI funding.[5] In the context of its ongoing supervisory relationships with some IDIs, the FDIC in fact seems to recognize that effective use of brokered deposits can help to mitigate the risks associated with normal asset/liability management activities. Indeed, as an empirical matter, the aggregate amount of some categories of brokered deposits actually *increased* during the recent crisis. International regulatory organizations also recognize the legitimacy of brokered deposits as a funding tool. For example, in situations where there is no early withdrawal option, the Basel III Liquidity Coverage Ratio only requires outflows of 10% for term deposits actually maturing within 30 days.

Brokered deposits also have desirable attributes from a safety and soundness perspective. IDIs can and do calibrate brokered deposits to match fund the IDI's asset duration, markedly reducing and for some effectively eliminating the IDI's liquidity risk as well as minimizing interest rate exposure. In certain situations, brokered deposits display safety and soundness-enhancing attributes of callable bonds, such as in cases where a brokered deposit can only be terminated by death or adjudication of incompetence. In all these and other situations, the use of brokered deposits limits, rather than enhances an IDI's risk profile. The Roundtable believes it is appropriate for the FDIC to take into account the risk-reducing function of brokered deposit funding.

---

3 *See, e.g.*, Christine M. Bradley and Lynn Shibut, *The Liability Structure of FDIC-Insured Institutions: Changes and Implications* (2006).

4 *See, e.g.*, Clifford Rossi, *Decomposing the Impact of Brokered Deposits on Bank Failure* (2010).

5 *See* Bradley and Shibut at 5.

The Roundtable also notes that for many IDIs, brokered deposits are quite often used in the context of established, multi-iterative business relationships between the IDI and another entity. As will be discussed in greater detail, certain sources of brokered deposits (such as deposits brokered through an individual customer's relationship with an affiliated broker-dealer, an exclusive insurance agent, or an unaffiliated insurance agent) often come from customers that have established relationships with the broker-dealer or agent that are as stable as retail deposit relationships. The Roundtable submits that the Study should recognize the importance of these relationships, as well as the fact that these relationships often give rise to risk-mitigating, rather than risk-enhancing, sources of deposits.

II. FDIC Should Make Updates and Changes to the Regulatory Treatment of Brokered Deposits

The Roundtable believes that with respect to updated regulatory treatment of brokered deposits, the Study should address five key issues.

First, the Study should recognize the relationship between brokered deposits and the FDIC's DIF assessment system.[6] In this regard, the Study should consider reductions in assessments for IDIs that utilize brokered deposits as part of an asset/liability management program that enhances their safety and soundness.

Second, the Study should recognize that in certain respects, the FDIC has ample flexibility as to how it can address the issue of brokered deposits. For example, the FDIC retains the flexibility to implement changes to the assessment system's treatment of brokered deposits; similarly, the FDIC retains the flexibility to alter its treatment of brokered deposits in the supervisory context. The Roundtable submits that even without modifications to the existing statutory framework, it is still possible for the FDIC to exercise its discretion in a manner that properly addresses IDI utilization of brokered deposits.

Third, the Study should recognize that brokered deposits may be re-classified based on the duration of the account relationship. After a set period of time, if deposits arising from sweeps or referrals have remained with an IDI, those deposits should no longer be classified as brokered deposits. Similarly, if new funds are added to a deposit account that was originally funded by sweeps or referrals but has remained with the IDI for a set period of time, the new funds should not be treated as brokered.

Fourth, the Study should clarify that non-retail sources of deposit funding that are demonstrably "sticky" should not be treated as brokered deposits. The Roundtable further believes that the "stickiness" of a deposit can be demonstrated by looking to, *inter alia*, (i) the aggregate average duration of the account relationship between the specific IDI and all accounts of the type in question (*e.g.*, the average duration of the broker-dealer sweep or other referral accounts utilized as a source of sweep deposits by the specific IDI), (ii) the duration of the individual account relationship (*e.g.*, after a set period of time, if deposits arising from sweeps or referrals have remained with an IDI, those deposits should no longer be classified as brokered),[7] and (iii) the amount of time that the funds have been deposited with the IDI (*e.g.*, once a deposit has stayed with an IDI for a year, it should no longer be viewed as brokered).

---

6 *See* 76 Fed. Reg. 10,672 (Feb. 25, 2011).

7 Similarly, if new funds are added to a deposit account that was originally funded by sweeps or referrals but has remained with the IDI for a set period of time, the new funds should not be treated as brokered.

Fifth, the Study should recognize the stability of brokered deposits that arise from established referral relationships. These referral relationships can be one-way or cross-referral relationships. Specific types of referral relationships include, but are not limited to, deposits referred by an IDI's affiliate and deposits referred by an agent of the IDI's affiliate (including insurance agents). Because whether a source of deposits is "referred" often provides little or no information about the risk characteristics of the deposit, the fact that a deposit is referred (whether the referral is compensated or uncompensated) should not determine whether the deposits that result from the referral are treated as brokered.

III. Sweeps and Transfer Transactions from Broker-Dealers Are Not Brokered Deposits

The Roundtable believes that brokered deposits arising from relationships between an IDI and an affiliated broker-dealer deserves in-depth analysis. Brokered deposits arising from an IDI's relationship with an affiliated broker-dealer are currently analyzed under the "primary purpose" exception established under the FDIC's interpretive precedent.[8] This interpretive precedent has been influenced by the pre-GLB Act paradigm, where IDIs and brokers often existed as part of separate corporate structures, making it less likely that a customer would do business with an IDI that had an affiliated broker-dealer. In the post-GLB Act world, where many large IDIs have a single, interstate IDI and a broker-dealer affiliate, some of the FDIC's existing interpretive precedent seem grounded in market realities of the past.[9]

The Roundtable strongly believes that deposits arising from sweep or transfer transactions between an IDI and its affiliated broker-dealers are not brokered deposits, for the following reasons. First, because employees of an IDI's affiliated broker-dealer have little or no incentive to drive customers of the IDI to open deposit accounts at an IDI other than the affiliate, customers are more likely to be loyal to, and hence more likely to do business with the IDI and its affiliated broker-dealer.

Second, because deposits arising from sweep transactions represent funds from consistent and stable clients of a broker, the deposits are stable, not volatile. In some cases, the average age of deposit accounts arising from an IDI's affiliated broker-dealer is ten years, indicating a stable and non-volatile customer relationship. Indeed, the attrition rate for customers who have a deposit account in the context of an established broker-dealer relationship is often *lower* than the attrition rate with respect to "normal" retail deposit relationships.

Third, sweeps from affiliated broker dealers arise in the context of broad product offerings to the customer. Sweep arrangements are often provided for the convenience of a customer that has an established relationship with the affiliated broker-dealer, IDI and other entities in a company's structure. These established relationships often encompass a variety of product offerings. Because the sweep arrangement arise in the context of multiple product offerings, the customer's loyalty to the institution is often stronger than would otherwise be the case if the customer's relationship with the IDI was restricted to an individual deposit account. Thus, the FDIC's concerns with brokered deposits and deposit volatility are significantly diminished in this context.

Fourth, IDIs do not pay above-market rates with respect to deposits arising from sweep arrangements. This fact mitigates any "hot money" concerns with respect to these types of brokered deposits. Unlike historical situations where IDIs offered interest rates significantly above market in

---

[8] *See* FDIC Interpretive Letter 05-02 (Feb. 3, 2005).

[9] *See, e.g.*, FDIC Interpretive Letter 92-68 (Oct. 21, 1992).

order to attract deposits, sweep-based accounts offer rates that are generally in line with existing market conditions.

Fifth, large IDIs that utilize sweep arrangements are not dependent on such arrangements as a principal source of funding. During the recent crisis, the FDIC focused on whether risky IDIs were dependent on "non-core" brokered deposits for liquidity as a principal source of funding. Because sweep arrangements do not constitute a significant source of funding for many large IDIs, the Study's treatment of brokered deposits at large IDIs that arise from sweep arrangements should recognize this fact.

As discussed, the Roundtable does not believe that changes to the existing statutory framework are necessary to treat deposits from sweep and transfer accounts as non-brokered. As a historical matter, the FDIC has interpreted the "primary purpose" exception to avoid classifying non-volatile deposits as brokered.[10] The FDIC should recognize that deposits from an IDI's affiliated broker-dealer display many of the positive attributes of "stable" deposits (such as high retention rates) and few if any of the negative attributes of "unstable" deposits (such as excessive risk-seeking behavior on the part of the IDI), and the FDIC should align its interpretive guidance with this recognition.

Finally, the Roundtable requests that the Study address the question of fair and consistent enforcement of existing regulation in the broker-dealer context. As noted *supra*, the Roundtable believes that once an account is funded with brokered deposits, deposits arising from the same account *need not* be classified as brokered simply because of initial funding with brokered deposits. Contrary to this sensible approach, the FDIC has suggested that in certain cases an account funded with brokered deposits must *always* be accounted for as a brokered deposit, notwithstanding the inflow and outflow of funds from the account. The Roundtable believes that the FDIC's approach in these instances may be at odds with its own interpretations,[11] and thus the Roundtable requests that the FDIC utilize the Study to clarify that its supervisory approach with respect to brokered deposits will be implemented in a fair and consistent manner.

IV. Conclusion

The Roundtable believes that the Study offers an important opportunity for the FDIC and IDIs that utilize brokered deposits to engage in a dialogue about what statutory, regulatory and supervisory regime is best suited for contemporary economic reality. The markets for IDI funding, and IDIs themselves, have changed significantly since the events that gave rise to the statutory and regulatory framework currently applicable to brokered deposits. The Study should be informed by this new market reality, especially with respect to the established and stable relationships that exist between customers and IDIs that are part of a structure with non-IDI affiliates.

---

[10] *See* FDIC Interpretive Letter 92-91 (Dec. 14, 1992) (determining that an automated clearing house is not a deposit broker when it acts as a conduit for customers to move money between accounts); *See also* FDIC Interpretive Letters 93-30 and 93-31 (noting that certain "affinity groups" are not considered deposit brokers based on analysis of criteria such as (i) the exclusivity of the relationship, (ii) little or no compensation paid by the IDI for a referral, and (iii) high retention rates associated with the relationship).

[11] *See* FDIC Interpretive Letter 92-69 (Oct. 23, 1992) (determining that a troubled IDI's renewal of certificates of deposit acquired through a broker did not result in brokered deposits because (i) the broker was no longer involved in the transaction, (ii) the customer had to request or acquiesce to the renewal directly and (iii) the certificates of deposit were styled in the name of the customer instead of the broker).

The Roundtable thanks the FDIC for inviting comments on the Study, and welcomes the opportunity to comment. If you have any questions, please do not hesitate to contact Brian Tate at (b)(6)

Sincerely,

(b)(6)

Richard Whiting
Executive Director and General Counsel

May 2, 2011

Via electronic mail to coredepositstudy@fdic.gov

Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Re: Core and Brokered Deposit Study

Ladies and Gentlemen:

Thank you very much for the opportunity to provide our comments to the study regarding core and brokered deposits being conducted by the Federal Deposit Insurance Corporation ("FDIC") as mandated by Section 1506 of the Wall Street Reform and Consumer Protection Act (the "Act").[1] TD Bank, N.A. and TD Bank USA, National Association ("TDBNA" and "TDUSA", respectively and collectively, the "Banks") are national banking associations organized under the laws of the United States and are the two subsidiary insured depository institutions of TD US Holding Company, the 14th largest bank holding company in the United States. TD US Holding Company had approximately $179 billion in assets as at January 31, 2011 held primarily through the Banks. TDBNA is one of the 10 largest banks in the United States, based on deposits, with approximately $143 billion on deposit as at January 31, 2011. The Banks are affiliated with TD Ameritrade [a [State corporation] registered as a broker-dealer with the Securities and Exchanged Commission and primarily regulated by the Financial Industry Regulatory Authority "TDA"]. Of the amount noted above, the Banks currently have on deposit approximately $47 billion which are "swept" into the Banks from brokerage clients of TDA (the "sweep program").

For the reasons set forth below, the Banks believe that core and brokered deposits should be distinguished based on the economic behavior of the deposits, the relationships between the parties that give rise to the deposits, the duration, or "stickiness" of the deposit relationship and the risk the type of deposit poses to the Deposit Insurance Fund.

[1] Pub. L. No. 111-203, Sec. 1506, 124 Stat. 1376 (2010)

Overview

The events that gave rise to the current statutory and regulatory treatment of brokered deposits occurred during the "thrift crisis" twenty five years ago. Based on its experience dealing with bank failures during that period, the FDIC was, and is, of the opinion that there is a direct correlation between high cost deposits obtained through third-party intermediaries and the risk profile of an insured depository institution. Simply put, to the extent that higher premiums are paid to purchase deposits through third-parties, higher yielding, and therefore riskier, assets must be purchased to generate those premiums. The conclusion reached is that brokered deposits adversely affect a bank's risk profile.

However, the FDIC's belief that reliance on brokered deposits is a cause of insured depository institution failure perhaps confuses cause with symptom. Recent evidence suggests that although reliance on brokered deposits may be a symptom of a number of variables, including excessive risk-taking, that affects such failures, according to some there does not seem to be a significant causal relationship between reliance on brokered deposits and insured depository institution failure over the past decade.[2] In contrast to the market conditions that gave rise to the existing statutory and regulatory framework, multiple sources of funding, including those that are currently characterized as brokered deposits, can be an integral and risk-mitigating element of a bank's funding strategy and can be calibrated to an institution's asset mix reducing a bank's interest rate exposure.

The FDIC's recently published final rule on assessments and large bank pricing indicates a recognition that brokered deposits can function as a safe and stable funding source.[3] And we further believe that deposits having the characteristics noted below should not be deemed to be brokered deposits at all. We will discuss our view in the context of funds swept from TDA to the Banks under the sweep program.

Relationship Driven

The arrangement between the Banks and TDA is a natural extension of the Banks' customer driven focus and allows TDA to deepen its relationship with its clients by giving them access to a secure financial institution to place excess cash. Deposits in the sweep program are not raised as a source of liquidity; rather they are a product of the relationship between the Banks and their affiliate TDA. Sweep depositors maintain a brokerage account with TDA. The nature and history of the sweep program demonstrates

---

[2] *See* Rossi, Decomposing the Impact of Brokered Deposits on Bank Failure (2010).

[3] 76 Fed. Reg. 10,716 (making the brokered deposit adjustment inapplicable to large and highly complex insured depository institutions with a CAMELS composite rating of 1 or 2).

that these deposits are a stable source of funding and are inconsistent with the characteristics normally associated with third-party brokered deposits. These deposits do not exhibit any of the volatility of traditional brokered deposits and are more akin to branch-raised money market accounts. When given a choice of which type of account TDA clients would like to place excess cash balances into (a TDA cash account, money market fund or a cash account with the Banks) clients overwhelmingly choose placing their excess cash with the Banks through the sweep program.

Sweep program deposits are not used to fund high-risk assets

The Banks view balances swept from TDA as core deposits and, as such, invest the funds in a manner similar to that in which we invest funds from other deposit accounts. The Banks analyze these deposits for both permanence and rate sensitivity. This modeling drives the ultimate investment and hedging decisions. Once modeled, the Banks manage the portfolio of deposits within prudent boundaries established in order to balance re-pricing and market risk. Within this framework, the sweep program is considered a non-maturity deposit product, similar to demand and money market accounts. Balances are analyzed to assess balance permanence (under normal and stressed scenarios) and growth over time to establish appropriate liquidity and investment profile. Our analysis of the sweep program supports the stable profile of these deposits under normal, market-wide stress or idiosyncratic stress to the Banks. We measure the profitability of all deposits, including the sweep deposits, against a credit of funds. This credit of funds is the return on a low risk, high quality investment portfolio holding agency securities, AA-rated debt instruments and AAA-rated asset backed securities.

Sweep program deposits are not interest rate driven

As noted above, deposits in the sweep program are a product of the Banks' relationship with TDA and are not raised as a source of liquidity. Similarly, the interest rates paid on these deposits are typical of rates paid on the Banks' core deposits not aggressive rates that might be paid to attract "hot" money. Market volatility tends to drive fluctuations but these balances have been stable. Our research also indicates that these accounts have an average duration of two to three years, similar to the duration of a typical checking account. The history of these deposits through interest rate cycles demonstrates that they are not interest rate sensitive. Cash balances have increased as a predictable event during the financial crisis. Market events have resulted in clients shifting their cash allocation to the sweep program from other available alternatives. The need for many money market fund sponsors to subsidize their funds in order not to "break the buck" triggered investor realization that such funds were not as safe as deposits like those in the sweep program. Thus new and existing TDA customers choose the sweep program for its safety and liquidity despite near zero yields. It is this safety

and soundness principle that is driving the pricing of deposits in the sweep program, not the need for liquidity or hot money.

Conclusion

The Banks believe that core and brokered deposits should be distinguished by their economic behavior and the risks they pose to insured depository institutions, the FDIC and the Deposit Insurance Fund. As noted above, deposits that are technically deemed to be "brokered" under existing regulations may in fact have more of the characteristics of, and be treated by insured depository institutions as, core deposits. We believe that to be the case with deposits obtained by the Banks through the sweep program. These deposits are raised through ordinary customer relationships and not for purposes of liquidity. They have durations similar to deposits raised through the Banks' branch network and are not interest-rate sensitive. Most importantly, they are not used to fund risky assets but are rather risk-managed as non-maturity deposits with the result that they are used to purchase government, agency or AAA credit rated securities. Accordingly, we believe deposits obtained by the Banks through the sweep program should be treated as core and not brokered deposits for purposes of calculating FDIC deposit insurance assessments.

Thank you very much for the opportunity to let the opinions and observations of the Banks be heard on this important topic and we very much look forward to working with FDIC going forward. Please feel free to contact me at [redacted] with any thoughts or comments you may have. (b)(6)

Very truly yours,

(b)(6) [redacted]

Edward B. Pollock
Executive Vice President
Head of Regulatory Relations and
Government Affairs
TD Bank, N.A. and TD Bank USA, N.A.

PMA Financial Network, Inc.
2135 CityGate Lane, 7th Floor
Naperville, IL 60563
info@pmanetwork.com
630.657.6400

June 2, 2011

Diane Ellis
Deputy Director
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington D.C. 20429

Re: Federal Deposit Insurance Corporation ("FDIC") Core and Brokered Deposits Study

Dear Ms. Ellis:

Thank you for the opportunity to meet regarding the FDIC's Dodd-Frank Study on Core and Brokered Deposits. We appreciate the time you and your colleagues have provided us.

I hope that we were successful in delivering relevant information for your study on the funding for financial institutions, including our concerns with the current negative perception on wholesale funding and the effect on funding diversification and the overall stability of financial institutions. As we described in our meeting, PMA has been working with political subdivisions and financial institutions for over 25 years. Our client base is comprised of over 1,400 political subdivision clients in CA, IA, IL, MN, OK, SD, and WI, who have invested over $100 billion in nearly 2,000 financial institutions (community, regional, and money center). PMA employs nearly 100 individuals and has offices in IL, MN, and WI.

As a registered broker dealer, investment advisor and municipal advisor we have a great deal of industry knowledge regarding political subdivisions and the various ways in which they utilize information intermediaries to facilitate investments with financial institutions.

In response to the question on whether we are **"seeking changes in legislation or changes to the assessment schedule?"**, we emphasized our concern that the current negative perception on wholesale funding may be having a negative effect on funding diversification and the overall stability of financial institutions. As we explained, from our perspective and that of our banking partners,

regulations and examiners have created a negative aura around brokered deposits causing many banks to avoid these deposits entirely. By moving away from brokered deposits, we have observed banks either shifting to other wholesale funding sources that do not meet the definition of a "brokered deposit" (preferred sources) or seeking other loopholes to avoid the harmful brokered classification. The result as we have witnessed through this crisis is the migration of funding to the preferred sources even to the detriment of cost and diversification.

Given this set of facts, our overall message is that any law, regulation or insurance assessment that favorably or adversely classifies any particular type of deposit will have unintended consequences. Our recommendation, therefore, is to change any laws, regulations or assessment schedules that would tend to create a tiered status for deposits. All wholesale deposits should be treated equally. Furthermore, we recommend a transparent system that provides regulators and the market with greater visibility into a bank's funding strategy.

Finally, to emphasize our message regarding local government depositors, these deposits represent stable sources of funding for banks whether invested directly or through a third party financial professional. Local governments often utilize third party financial professionals to aid in investment planning and execution due to the size and complexity of their budgets. Local governments have significant budgets with predictable cash flows and highly restrictive investment options making it necessary to have multiple stable deposit relationships.

When third party financial professionals are assisting local governments in their planning and investment activities, banks gain the diversification provided by the number and location of the advisor's local government clients and the bank gains the insight provided by the advisor. If classification rules are established that provide a disincentive for banks to work with local governments, due to the presence of third party financial professionals or local government investment pools, both banks and local governments are harmed.

In summary, we request that there be no deposit classifications. If however, the FDIC is inclined to continue its classification of deposits through laws, regulations and/or insurance assessments, we request that local governments that utilize third parties not be negatively harmed, whether it be by exempting them by legislation, issuing favorable Advisory Opinions or not imposing negative assessments for such deposits.

Please feel free to contact me with any questions you may have or if you would welcome an additional meeting.

Sincerely,

(b)(6)

Michael R. English
President & Chief Executive Officer
PMA Financial Network, Inc.

(b)(6) **From:** James Livingston

Sent: Monday, May 02, 2011 11:40 AM

To: Core Deposit Study

Cc: David Hemingway

Subject: Comment on Core and Brokered Deposit Study

Zions Bancorporation is commenting on behalf of itself and its banking and financial affiliates with respect to the definition of brokered deposits. If the FDIC is going to base policy on the amount of brokered deposits that are booked in a depository institution, there needs to be a clear standard for determining which deposits will be classified as brokered that is not open to interpretation by each examiner. Zions believes that a simple definition is needed that is easy to apply and that is fair, makes sense and comports with financial and banking realities.

Accordingly, Zions proposes the following simple, two-part definition of brokered deposits, which would meet all of the foregoing concerns;

A deposit would constitute a brokered deposit if either:

> (1) A fee is paid with respect to the deposit to any third party outside of the depository institution and its affiliates (affiliated through common ownership of a bank holding company, etc.). For this purpose "fee" means the payment of a commission, or the sale of a deposit at a discount to an unaffiliated third party who has the intent to resell the deposit; or
>
> (2) A certificate of deposit (CD) is issued through the Depository Trust Company's book-entry system and, at the time of issuance, the identity (i.e., name, address and tax identification number) of the deposit holder is not known by the depository institution or one of its affiliates. For this purpose "deposit holder" does not include intermediaries such as broker/dealers who purchase CDs for resale.

Thus, a deposit with respect to which a fee is paid to a third party (outside of the depository institution and its affiliates) would constitute a brokered deposit, even if the depository institution or one of its affiliates knows the name, address and tax identification number of the deposit holder. Similarly, a deposit whose holder is not known to the depository institution or one of its affiliates would also constitute a brokered deposit, even if no fee were paid to any third party in connection with the deposit.

The obvious corollary of this definition is that if the depository institution or one of its affiliates knows the name, address, and tax identification number of the deposit holder, and no fee is paid with respect to the deposit to any third party outside of the depository institution and its affiliates, then the deposit would not constitute a brokered deposit. This approach would allow affiliated depository institutions to sell CDs of their affiliates without classifying the CDs as brokered.

Furthermore, if an affiliated broker/dealer sold a CD of an affiliate depository institution to the broker/dealer's customer and held the CD in that customer's brokerage account, the CD would not be classified as a brokered CD. However, if a broker/dealer sold a CD of an affiliated depository institution to a third party broker/dealer, thus delivering the CD into the marketplace, that CD would be a brokered CD (because neither the affiliated broker/dealer nor the affiliate depository institution would know who owns the CD).

Zions believes that the foregoing definition of brokered deposit is not only easy to understand and to apply, but it is also fair and corresponds to realities of relationship-banking that exist in the financial and banking world today, and it is not subject to being interpreted and applied differently by different banks and examiners. If such a definition did not apply, then deposits such as money market deposits from a broker/dealer into an affiliated bank may constitute brokered deposits. Zions does not believe that deposits with one affiliate that are sold to customers by another affiliate

should be treated as brokered deposits.

Zions believes that adopting this approach would separate those depositors who have a relationship with a depository institution and its affiliates from those who have no relationship and only seek FDIC insurance. It is these non-relationship FDIC insurance commodity shoppers who should be subject to additional scrutiny, not deposit customers of a depository institution and its affiliates.

In summary, a deposit made and sold within the same family of institutions owned under a bank holding company should not be treated as a brokered deposit where the depository institution or one of its affiliates knows the identity of the customer, which can easily be shared with the depository institution, and where no fee is paid with respect to the deposit to a third party outside of the affiliated entities. To determine otherwise would be to unfairly disadvantage and punish multi-bank holding companies.

For these reasons, Zions proposes the foregoing simple definition for brokered deposits.

ZIONS BANCORPORATION

By: W. David Hemingway
Its: Executive Vice President

Promontory Interfinancial Network, LLC
1515 North Courthouse Road
Suite 1200
Arlington, Virginia 22201

T 703-292-3400
F 703-528-5700

www.promnetwork.com

May 1, 2011

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Core and Brokered Deposit Study

Dear Sir/Madam:

Promontory Interfinancial Network, LLC ("Promontory Interfinancial") submits this letter in response to the invitation by the Federal Deposit Insurance Corporation (the "FDIC") for input relating to the FDIC's study of core and brokered deposits (the "Deposit Study").[1] The Deposit Study is mandated by Section 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").

Executive Summary

As discussed below, we suggest that the FDIC consider the following revisions to the existing framework regulating the use of funding sources:

- The obsolete concept of brokered deposits should be retired. To the extent deposit characteristics, rather than asset quality, are the subject of efforts to prevent risky asset growth, the brokered deposits concept should be replaced by a measure for evaluating the stability and value to the institution of bank funding.

- The FDIC should consider re-focusing on rapid bank growth. Unlike regulation based on the brokered deposit category, measures focused on rapid growth directly address the behavior that gives rise to failure risk.

- The current prohibition of brokered deposits for institutions that encounter capital issues should be replaced for some institutions by a cap on the level of wholesale liabilities.

[1] Promontory Interfinancial provides services that enable depository institutions to attract stable deposits at cost-effective rates. These services include CDARS® Reciprocal℠, a reciprocal deposit allocation service which enables banks to place deposits primarily for local customers at local market interest rates, and IND®, a deposit sweep service which enables broker-dealers to place stable customer funds at unaffiliated as well as affiliated banks. Promontory Interfinancial also allocates non-reciprocal deposits through its CDARS® One-Way℠ service.

Introduction

The current, decades-old definition of brokered deposits in Section 29 of the Federal Deposit Insurance Act is based on the origination of a deposit using a "deposit broker."[2] With limited exceptions, a deposit broker includes any person engaged in the business of placing or facilitating the placement of deposits with FDIC-insured depository institutions. As a result, the existing category of brokered deposits encompasses virtually any deposit for which a third party has been involved with its placement.[3]

From the standpoint of safety and soundness of depository institutions, the category of brokered deposits, if it was useful in the past, has lost much, if not all, of its usefulness today. The category is both under- and over-inclusive. The narrow focus on the involvement of a third party as a differentiator of liquidity management that is safe, and liquidity management that is not safe, has in and of itself very little, if any, probative value.

Furthermore, using the brokered deposit definition as a differentiator of safety, excludes consideration of more important deposit characteristics, including attributes we will discuss below that more demonstrably and directly affect safety and soundness. The focus on the source of deposits completely ignores the fundamental characteristics of deposits from a true safety and soundness perspective. Even more, this focus on the source of the deposit ignores how they are actually used, which is the ultimate policy concern.

Finally, as the FDIC has itself noted, the banking industry has seen significant technological advances and other innovations in the deposit-gathering process since the brokered deposit category was defined, and the definition fails to reflect these important changes, as well as the growth of alternative non-deposit sources of funding. Some of these innovations have enhanced the safety and soundness of banks, as well as their ability to serve their local communities. As a result, the lack of correspondence between the existing brokered deposits category and the goals it was intended to accomplish leads to less effective or even counterproductive regulation.

The Policy Context of the Deposit Study

The context for the questions posed by the FDIC for input appears in Section 1506 of Dodd-Frank, which outlines the topics to be addressed in the Deposit Study:

- the definition of core deposits for the purpose of calculating the insurance premiums of banks;

---

[2] Section 29 also characterizes as "brokered" deposits solicited by an institution that is not well capitalized where the interest rate on the deposit is significantly higher than comparable interest rates being offered by other depository institutions in the normal market area of the institution.

[3] Only "well-capitalized" institutions may accept brokered deposits without restriction for purposes of Section 29. "Adequately capitalized" institutions must seek a waiver from the FDIC to accept or renew brokered deposits, and all other depository institutions are flatly prohibited from accepting brokered deposits or renewing them when they mature.

- the potential impact on the Deposit Insurance Fund of revising the definitions of brokered deposits and core deposits to better distinguish between them;

- an assessment of the difference between core deposits and brokered deposits and their role in the economy and banking sector of the United States;

- the potential stimulative effect on local economies of redefining core deposits; and

- the competitive parity between large institutions and community banks that could result from redefining core deposits.

This policy framework makes it clear that Congress did not intend the Deposit Study to be a narrow, technical exercise, but rather expects it to take into account the important positive role of deposits in the banking sector and in the economy as a whole. In particular, by explicitly citing "the potential stimulative effect on local economies" of changing the existing definitions, Congress underscored the critical need for deposit policies that promote continued economic recovery and growth. Deposits, however labeled, are the key component of funding for banks. All the critical functions that banks perform in a healthy economy – including the increased lending that is essential to any strong and sustained recovery – depend critically on the ongoing availability of reliable bank funding. Such funding is unlikely to be adequate if it is arbitrarily limited to sources that were prevalent a half century ago. The objectives that Congress has defined point toward policies that support the development of responsible new deposit-gathering methods.

The objective of competitive parity between large institutions and community banks is important not only for the sake of fairness, but also because it is closely related to the policy goal of stimulating the growth of local economies. Community banks have long played an indispensible role in lending to small businesses. Banking institutions with large regional or national franchises have the advantage of being able to originate deposits through extensive "brick and mortar" branch networks and otherwise engage in sophisticated wholesale funding exercises. To be effective in competing and in serving local communities and small businesses, including local small businesses that often face a shortage of available credit,[4] community banks must rely on taking full advantage of all available safe funding sources and relationship building tools, including modern techniques that allow them to build their relationship-based franchises. And all banks, large and small, should be able to realize the cost savings that can be achieved by utilizing recent technological developments and techniques, so long as they do so in a safe and sound manner.

Prudent bank strategies strive for stable deposit funding sources, cost-effective deposit pricing, sound liquidity planning, and responsible standards of credit. Regulation should

[4] See Darling Consulting Group, Letter to the FDIC Core and Brokered Deposit Study Group, Apr. 12, 2011 at 2 (noting that, with respect to deposits with core-like attributes, "[t]here simply are not enough of these deposits to support the credit needs of communities, especially during good economic times").

facilitate these objectives. But the characteristic that defines brokered deposits – whether they are facilitated by the efforts of an intermediary – is a poor proxy for the characteristics of the deposits themselves and how they are used. The current approach arbitrarily presupposes that the involvement of a financial intermediary in the generation of a deposit makes the deposit somehow less safe or less sound. Such a presupposition is at odds with the very concept of a bank, which by definition is a financial intermediary. It also disregards key supervisory concerns, which include whether the deposits are stable, whether they are priced moderately so that they do not cause banks to go out on the risk curve to earn decent rates of return, and whether they help build the bank franchise itself. Moreover, merely relying on the deposit broker definition as the litmus test of safety and soundness does not address the all-critical asset-side issue which is: Are the deposits from whatever source being used for promoting poor underwriting standards and excessive growth, or for responsibly meeting credit needs?

Response to the FDIC's Questions

1. **In times of financial stress, what types of deposits are likely to remain at an institution and what types are likely to leave the institution?**

As emphasized in the accompanying paper by Oliver Wyman (Attachment 1),[5] when an institution experiences financial stress and depositors learn of that stress, the deposits that are most likely to leave the institution are deposits that are not FDIC-insured. FDIC-insured deposits, even if they are high-rate deposits, are unlikely to leave an institution in times of stress because a stressed institution will not voluntarily relinquish such deposits when it needs them most. And FDIC-insured deposits do not run; indeed, that is one of the primary purposes of FDIC insurance.

The main case in which FDIC-insured deposits do not remain in a stressed institution is when government regulations require the institution to divest itself of the deposits. In such cases, it is government policy that causes deposit flight. This outcome occurs because institutions are prohibited from accepting any further brokered deposits, including the replacement of brokered deposits that mature or otherwise roll off, whenever they cease to be well-capitalized (or drop to adequately-capitalized without receiving an FDIC waiver). A better approach would be to cap the amount of brokered deposits at, say, their then-current levels whenever an institution drops below well-capitalized.

Within the category of FDIC-insured deposits, the deposits that are most likely to remain at an institution in the event it experiences financial stress (if law and/or regulation do not deprive the institution of the deposits) are the following types of deposits, to which we refer as examples of "relationship deposits" of a bank:

---

[5] Oliver Wyman, "Revisiting Core and Brokered Deposits: Contribution to Bank Stability and Value," Apr. 29, 2011. Oliver Wyman, an international consulting firm, advises clients in the financial services industry on matters relating to risk and financial management.

(1) deposits of customers with whom the bank has regular relationships and who interact with the bank at least in part through personal visits to the bank, rather than, for example, solely through the Internet;

(2) reciprocal deposits placed by other banks, acting as custodians for customers with whom those banks have ongoing relationships;[6] and

(3) sweep deposits placed in banks by broker-dealers, acting as custodians for customers with whom they have ongoing relationships.[7]

In each type of relationship deposit, the customer has an ongoing relationship with the entity that holds or places the deposit – a relationship that goes beyond (usually well beyond) any one specific deposit transaction. This typically much broader relationship, coupled with the FDIC-insured status of the deposits, makes it unlikely that the customer will seek to remove the funds from the bank merely because the bank becomes stressed. This conclusion is consistent with the finding reported in the accompanying paper by Professor Mark Flannery (Attachment 2),[8] who finds that CDARS Reciprocal deposits are not associated with increased failure risk and are associated with lower resolution costs.

Notably, none of the definitions currently employed by the FDIC distinguishes between relationship deposits and non-relationship deposits. Deposits that result from private Internet rate boards where there is no other customer relationship are classified as non-brokered, while relationship deposits placed through reciprocal deposit services or deposit sweep services are classified as brokered. As observed in the accompanying paper by Thomas Farin (Attachment 3),[9] the brokered classification is simply obsolete.

---

[6] A prominent example of a reciprocal deposit placement service is Promontory Interfinancial's CDARS Reciprocal service. CDARS Reciprocal deposits are predominantly with local relationship institutions, and customers often have multiple accounts of various kinds. More than 80 percent of CDARS Reciprocal deposits are made by customers residing within 25 miles of a branch of the placing institution, and reinvestment rates for these deposits are approximately 80 percent.

[7] One example of such a deposit sweep service is Promontory Interfinancial's IND service. IND broker-dealer deposits are funds of customers for brokerage services, and broker-dealers typically enter into agreements with multi-year terms to place funds at depository institutions with defined target balances.

[8] Mark J. Flannery, Ph.D., "Data-Driven Deposit Insurance Assessments," May 1, 2011. Professor Flannery is on the faculty of the Department of Finance, Hough Graduate School of Business Administration, University of Florida. Among other things, he served as "Resident Scholar" in the New York Federal Reserve Bank Research Department (2009-2010) and has been the Bank of America Eminent Scholar in Finance since 1989. He also was Co-Director, FDIC Center for Financial Research (2003-2007), and Senior Fellow, FDIC Center for Financial Research (2007).

[9] Thomas A. Farin, "Response Letter to FDIC Core and Brokered Deposits Study." Mr. Farin is President and Chief Executive Officer of Farin & Associates, Inc., a firm providing asset-liability analysis and consulting services to community banks and credit unions. He is also a 25-year member of the faculty of the Graduate School of Banking at the University of Wisconsin-Madison; lead author of the ABA Liquidity and Funds Management Toolbox released in February 2011; and a former instructor to the Federal Savings and Loan Insurance Corporation and the Office of Thrift Supervision for asset-liability education.

Farin also points out, in regard to the issue of funding stability, that this matter has been recently considered in the context of the recent Basel III liquidity framework. Farin proposes that the Basel Net Stable Funding Ratio, and more specifically, the Basel Available Stable Funding numerator, might be considered in some form by the FDIC. Farin's comments parallel the findings of Oliver Wyman, concluding that the most stable funds are those that are fully insured and those with remaining maturity terms of a year or more or (in the case of sweep deposits) defined contract terms.

2. **Does the presence of certain kinds of deposits (e.g. brokered, internet, listing service) inherently increase an institution's risk? Does their presence facilitate increased risk-taking?**

As discussed in all three accompanying papers, the failure risk of a bank depends much less on its liabilities than on the risk that its assets will lose their value. Banks that pursue a risky asset strategy are more likely to experience problems regardless of which kinds of deposit liabilities they use to fund the growth.

Of course, banks cannot have assets without also having liabilities. In that sense, any liability can "facilitate" taking risks with assets. As the accompanying papers note, however, although purchased liabilities can be used in business models dependent on risky assets, traditional deposit funding can serve exactly the same purpose. As stated in the Farin paper, an institution that is inclined and permitted to grow rapidly will fund that growth one way or another.

The Oliver Wyman and the Flannery studies do show some correlation between brokered deposits and bank failure. Correlation is not causation, however, and it also does not follow that all deposits classified as "brokered" are correlated with bank failure when separately considered. In fact, the Flannery study shows the opposite with respect to the category for which separate data are most readily available, namely reciprocal deposits.[10] Moreover, the association with bank failure is weaker for brokered deposits than when non-brokered, non-deposit funding is also considered. As indicated in the Oliver Wyman discussion of Deposit Revenue, to the extent that funding characteristics are relevant to an institution's risk, the key characteristic is the cost of funding, not the channel from which it originates.

In addition, as the FDIC has pointed out on a number of occasions, there does appear to be a linkage between bank failures and very rapid asset growth that is funded with non-relationship deposits or purchased funding. However, as we will discuss in response to question 4 below, the FDIC can return to a simple process it once used to help flag such behavior – and thus to prevent such risk-taking when appropriate – without relying on the brokered deposit classification. It is also worth emphasizing that it is the quality of the assets and the speed of asset growth that causes safety and soundness problems. If asset quality and the growth rate issue are not dealt with, the same problems will arise regardless of how liabilities are obtained.

---

[10] Flannery's findings in this regard parallel the conclusion of Blinder and Shastri in their study "Estimated Effects of CDARS Reciprocal Deposits on the Likelihood of Bank Failure," which was attached to Promontory's comment letter to the FDIC dated January 3, 2011.

3. **What types of deposits are likely to enhance a failed institution's franchise value and what types of deposits are likely to reduce it?**

The types of deposits that are most likely to enhance a failed institution's franchise value are "relationship deposits" (as we have defined the term above), including those that involve "face-to-face" depositor-to-institution relationships and those that are obtained at some margin below the cost of non-relationship wholesale funds, particularly where they arise from stable contractual relationships. The lower deposit cost generally means that the customer attributes some other value to the relationship itself or to other services provided by the relationship institution. In contrast, the types of deposits that are likely to reduce a failed institution's franchise value are non-relationship deposits and other forms of purchased funding, at least when their cost to the institution is at or above the wholesale funding rate.

The Farin paper applies marginal-cost analysis to understand how franchise value may be enhanced and, in so doing, addresses the factors that affect relative funding costs. Such an analysis demonstrates that, even if the average cost of traditional "core" deposits is below that of non-traditional funding sources, the marginal cost of core deposits may nevertheless exceed that of non-traditional funding sources. That is because institutions seeking to accelerate growth of core deposits often will raise rates on those deposits, which includes deposits that are not rate-sensitive. The institution's costs therefore increase not only by the rate paid on new funds, but also by the change in rates paid on funds that are not rate-sensitive. In such circumstances, non-core funding can be part of an effective funding strategy that is less costly to the institution and enhances its franchise value. In contrast, deposits that are currently defined as core or non-brokered may not increase franchise value at all if they are costly or not relationship-based.

Both the Flannery paper and the Oliver Wyman paper conclude that banks with relatively high franchise values have a lower likelihood of failure. Thus, the study and measurement of franchise value is crucially important. That said, Professor Flannery found no correlation between the cost of failure and the use of either brokered deposits or non-brokered, non-core funding. Accordingly, to the extent that the FDIC's interest in bank franchise value is driven by its concern over the cost of resolving banks that fail – wanting to ensure there is some value that can be auctioned off to other institutions in the resolution process – the Flannery findings suggest that the concern is best served by focusing on the asset side of the balance sheet rather than on the source of funding.

4. **What recommendations would you make for legislative or regulatory changes with respect to core and brokered deposits?**

   a. *The obsolete concept of brokered deposits should be retired. To the extent deposit characteristics, rather than asset quality, are the subject of efforts to prevent risky asset growth, the brokered deposits concept should be replaced by* a measure for evaluating the stability and value to the institution of bank funding.

Any categorization of funding sources for regulatory and supervisory purposes should be based on characteristics that actually affect safety and soundness, unlike the current definition of brokered deposits. The narrow focus on whether a deposit was placed through an

intermediary excludes consideration of important deposit characteristics that may positively or negatively impact safety and soundness. All three accompanying papers – by Oliver Wyman, Farin, and Flannery, and the Blinder/Shastri paper submitted by Promontory in January 2011 – suggest that whether a deposit adds to a bank's franchise value is a relevant way of considering whether a funding source helps or detracts from bank safety and soundness. Accordingly, the FDIC should find ways to evaluate the safety and soundness attributes of bank funding, including ways to consider the franchise value of different bank liabilities.

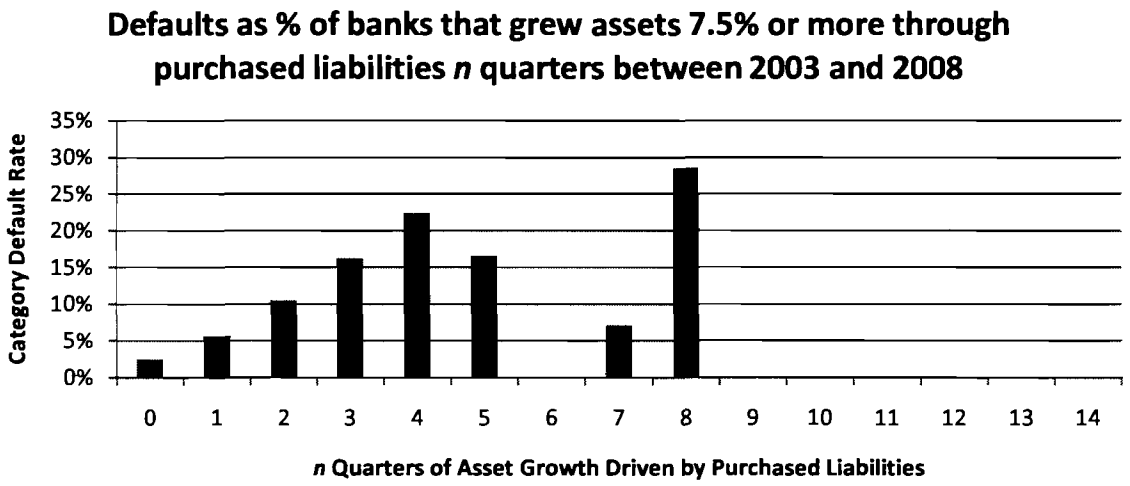
Although a precise calculation of franchise value itself may be too complex to impose on most banks, we recommend that the FDIC consider a deposit to be considered adding franchise value if (1) the deposit arises from the bank's face-to-face relationship with a customer who initiates the deposit relationship, including where a customer initiates a reciprocal deposit arrangement, (2) the deposit arises not from an auction, but from a contractual relationship for a fixed term with an interest rate that is below the median of market rates for deposits of such term, such as from a brokerage firm deposit sweep program, or (3) the bank's overall liabilities were obtained at rates below wholesale funding rates. By using such measures, the FDIC would capture high-rate deposits obtained through traditional channels and at the same time would avoid unnecessarily and counterproductively discouraging banks from seeking deposits through non-traditional channels if the rates indicated such deposits were accretive to franchise value. The FDIC could further give banks the option to provide more detailed information so that they might, for example, demonstrate that wholesale funds, even those obtained at wholesale rates, enhance bank franchise value. Banks have been successful using a wide variety of funding models and should be given the opportunity to demonstrate that success through more robust voluntary measures of franchise value.

b. *For riskier and recently-chartered banks, the FDIC should consider re-focusing on rapid asset growth. Unlike regulation based on the brokered deposit category, measures focused on rapid growth directly address the behavior that gives rise to failure risk.*

As described in the answer to question 2 above, an institution's assets have a more significant impact on its risk profile than the presence of any particular funding type. The Oliver Wyman paper finds that the most predictive characteristics of bank failure are found on the asset side of the balance sheet. Accordingly, it concludes that the most important protection is likely to be enhanced scrutiny of business models that involve higher-risk assets. Oliver Wyman notes that, although not always the case, banks that quickly grow their assets tend to be riskier than banks that do not, and statistical analysis shows that well above average asset growth serves as an indicator of potentially increased risk for many institutions. For this reason, although we have outlined above the deposit characteristics that would be more pertinent to policy focused on deposit types, we believe that a potentially more useful policy focus is one aimed at the growth of high-risk assets, not at the presence of particular deposit products or other funding types.

The FDIC has repeatedly expressed its concern that some banks have used non-core funding in order to expand rapidly into risky asset classes. Although, as outlined above, the brokered deposit category is not well-suited for management of this problem, our research has validated the concern that the exclusive use of purchased funding more broadly (defined in this instance as the sum of brokered deposits, FHLB advances, Federal Funds purchased, and repos) has been used in some

cases to support the rapid growth of risky assets.[11] Below is a chart showing defaults as a percentage of banks that grew by at least 7.5 percent over at least one quarter through the exclusive use of purchased funding between 2003 and 2008.[12]



Of more than 1500 banks that grew by more than 7.5 percent in this manner during this period, 128 failed, resulting in a failure rate of 8.4 percent of this more rapidly growing type of bank. The comparable rate for institutions that did not meet these growth criteria was 2.4 percent. The 128 banks represented 35 percent of all failures since 2003. Of the banks that met these criteria but did not fail, 33 percent were downgraded to a LACE rating of E for at least one quarter subsequent to their rapid growth.[13] On an overall, national basis, approximately 21 percent of all institutions were rated E by LACE (now KBRA) for at least one quarter during the same time period. Overall, approximately 39 percent of the 1523 banks in this subset either failed or became seriously troubled.

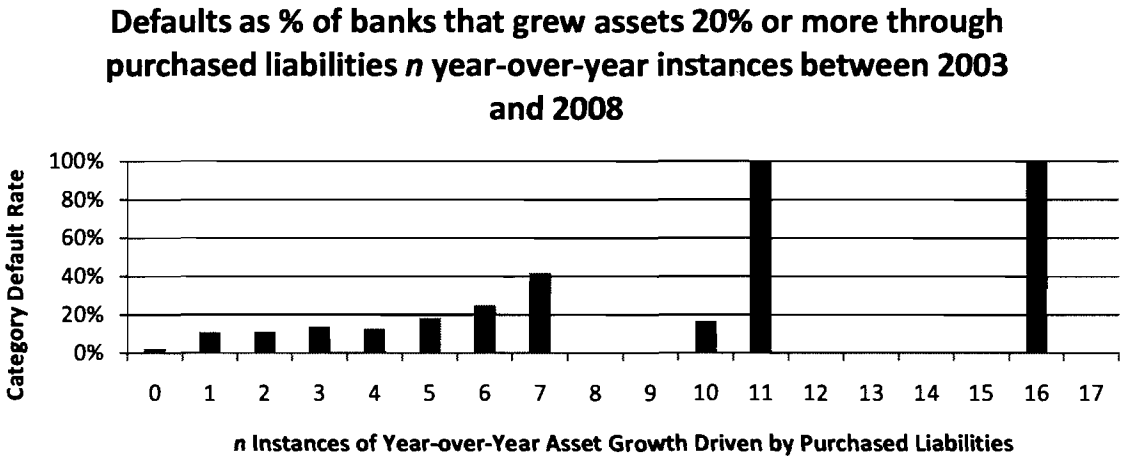
We also examined another measure of rapid growth, looking at banks that experienced 20 percent year-over-year growth through the exclusive use of purchased liabilities during the period from 2003 to 2008.

---

[11] Flannery finds that the combined effects of asset and brokered deposit growth are not influential in predicting failure. However, the Flannery model defines asset growth as the percentage change in assets over a two-year period, rather than the type of rapid growth over a single quarter or multiple successive quarters that we have measured.

[12] For purposes of this analysis and the one that follows, de novo institutions were excluded as were banks that may have grown as a result of an acquisition. We defined a bank as de novo for the five years from the date of establishment.

[13] LACE (now KBRA) is a private bank rating service. An E rating is deemed equivalent to a CAMELS rating of 5.



Almost 700 banks met the 20 percent year-over-year growth through purchased liabilities criterion and, of those banks, 96 failed – a failure rate of 13.8 percent. This is in comparison to the 2.6 percent failure rate for institutions that did not meet these criteria. The 96 banks represented 26 percent of all failures since 2003. Of those banks that did not fail, 42 percent were eventually downgraded to a LACE rating of E for at least one quarter subsequent to their period of rapid growth. Thus, 50 percent of the 694 banks in this subset failed or became critically troubled.

Until 1994, the FDIC maintained a "Rapid Growth Rule" that required an institution to give the FDIC advance notice if it planned to grow by 7.5 percent or more in a quarter using purchased funds. We suggest that the FDIC re-emphasize the issue of rapid asset growth. Such growth can and should be directly addressed, rather than being dealt with only indirectly at best through funding restrictions. However any new guidance pertaining to bank growth rates should be flexible and carefully tailored. Doing otherwise could cause adverse effects that defeat the policy objectives of economic recovery and growth that Congress has explicitly defined.

c. *The current prohibition of brokered deposits for institutions that encounter capital issues should be replaced for some institutions by a cap on the level of wholesale liabilities.*

The current prohibition on accepting or renewing brokered deposits by a less than well capitalized institution can have a counterproductive, destabilizing impact. The current prohibition (which can be waived for an adequately capitalized institution) requires affected institutions to pay out brokered deposits at maturity, and prevents them from continuing to receive brokered deposits that maintain balances in non-time deposit accounts such as money market deposit accounts, cutting off a stable funding source and exacerbating liquidity pressures at the worst possible time.

The current prohibition on brokered deposits for institutions that encounter capital issues should be eliminated where the deposits are stable forms of deposits that add to the franchise

value of the company. Where the deposits are less stable the current brokered deposit limitation should be replaced by a cap on the level of wholesale liabilities.

* * *

Thank you for your consideration of our comments. Please let us know if you would like additional information.

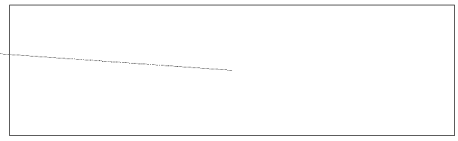
Sincerely,

(b)(6) 

Eugene A. Ludwig
Chairman

(b)(6) 

Alan Blinder
Vice Chairman

(b)(6) 

Mark Jacobsen
President & Chief Executive Officer

Attachments:

Attachment 1 – Oliver Wyman – Revisiting Core and Brokered Deposits: Contribution to Bank Stability and Value – April 29, 2011
Attachment 2 – Mark Flannery – Data Driven Deposit Insurance Assessments – May 1, 2011
Attachment 3 – Thomas Farin – Response Letter to FDIC Core and Brokered Deposits Study – May 1, 2011

Attachment 1

Oliver Wyman

Revisiting Core and Brokered Deposits: Contribution to Bank Stability and Value

April 29, 2011

April 29, 2011

Revisiting core and brokered deposits: Contribution to bank stability and value

OLIVER WYMAN

Oliver Wyman provides this report to Promontory Interfinancial Network, LLC ("Promontory"), which is submitting the report to the Federal Deposit Insurance Corporation ("FDIC") in response to the FDIC's request for input relating to its study of core and brokered deposits. This report may not be reproduced or redistributed, in whole or in part, by any private party other than by Promontory without the written permission of Oliver Wyman, and Oliver Wyman accepts no liability whatsoever for the actions of third parties in this respect. This report may not be sold without the written consent of Oliver Wyman. This report is intended to be read and used as a whole and not in parts. Separation or alteration of any section or page from the main body of this report is expressly forbidden and invalidates this report.

There are no third party beneficiaries with respect to this report, and Oliver Wyman disclaims any and all liability to any third party. In particular, Oliver Wyman shall not have any liability to any third party in respect of this report or any actions taken or decisions made as a consequence of the results, advice or recommendations set forth herein.

This report does not represent investment advice or provide an opinion regarding the fairness of any transaction to any and all parties. The opinions expressed in this report are valid only for the purpose stated herein and as of the date hereof. This report was prepared in reliance upon information provided by or on behalf of Promontory, and on information from published sources, without independent verification by Oliver Wyman. Oliver Wyman makes no representation or warranty regarding, and accepts no responsibility for, the accuracy or completeness of any such information. Public information and industry and statistical data are from sources Oliver Wyman deems to be reliable; however, Oliver Wyman makes no representation as to the accuracy or completeness of such information and has accepted the information without further verification. No responsibility is taken for changes in market conditions or laws or regulations and no obligation is assumed to revise this report to reflect changes, events, or conditions that occur subsequent to the date hereof. All decisions in connection with the implementation or use of advice or recommendations contained in this report are the sole responsibility of Promontory or the FDIC, as applicable.

This report is not to be used, reproduced, copied, quoted, or redistributed by third parties for any purpose other than those that may be set forth herein without the prior written permission of Oliver Wyman. Any violation of Oliver Wyman's rights in this report will be enforced to the fullest extent of the law, including the pursuit of monetary damages and injunctive relief in the event of any breach of the foregoing restrictions.

For questions about this report, please contact:

(b)(6) John Bovenzi –
(b)(6) Aaron Fine –
(b)(6) Dov Haselkorn –

Contents

1. Introduction

The FDIC began to focus on brokered deposits during the banking crisis of the 1980s. At that time, many financially weak banks and thrifts used the newly developed brokered deposit market to fuel rapid and risky asset growth. These institutions saw rapid growth as the means to recover from their financial difficulties. By paying higher interest rates than their competitors, these banks and thrifts found that they could use the brokered deposit market to raise the large amounts of deposits they needed to fund that growth. Many of these institutions subsequently failed. Their period of rapid growth only added to the costs incurred by the deposit insurance funds and taxpayers.

Following this experience, Congress restricted the use of brokered deposits at weak banks and thrifts. Bank regulators have also discouraged the use of brokered deposits both through the supervisory process and through the risk-based deposit insurance pricing system.

In the time since the 1980s, however, the marketplace for brokered deposits, and for deposits in general, has changed drastically. Where, previously, deposit brokers were the only method of quickly raising deposit funding, banks now have additional options through rate boards, internet-only accounts, and high rate branch offerings. Additionally, the recent banking crisis saw a period of dramatically increased use of Federal Home Loan Bank ("FHLB") advances as a non-deposit source of funding. Furthermore, the types of deposits termed "brokered" have evolved and expanded to include deposits with different characteristics from those originally targeted. In essence, the definition has shifted from one focused on demonstrated economic drivers of bank failure to a legalistic one focused on defining what constitutes "brokering" a deposit.

It is in this context that the Dodd-Frank Act required the FDIC to undertake a study of deposit categorization and in which the FDIC has solicited industry input. In our response, we return to what we believe were the FDIC's original goals in examining and in restricting the use of brokered deposits:

- Increasing the stability of the banking system,
- Minimizing the number of bank failures, and
- Minimizing the expected losses suffered by the Deposit Insurance Fund.

In our analysis, we investigate the underlying characteristics of bank deposits, along with other factors potentially related to overall funding stability and bank failures in the context of the current deposit and banking landscape.

2. Executive summary

In asking for comment, the FDIC solicited a broad array of input on the characteristics of different types of deposits, as well as on their contribution to an institution's riskiness, funding stability, and franchise value. The FDIC has specifically noted the need for input on how technological and other shifts have led to innovation in the industry that may demand changes to existing frameworks regarding deposit classifications.

In preparing this response[1], we conducted a detailed statistical analysis of the banks that weathered the financial crisis of 2008 as well as those that succumbed to the hostile environment. This analysis has yielded a predictive model that identifies key risk factors both associated with and, we believe, causative of bank failure. In conducting this assessment, it was critical to identify and separate two key areas of bank risk that lead to failure:

- Capital depletion due to erosion of the value of a bank's assets (e.g., as a result of increased losses), and
- Funding instability and a liquidity crisis that leaves an institution with an inability to meet its near-term obligations

In assessing the impact of brokered and non-core deposits, we believe the two risk factors above are often conflated into a single designation of "potentially risky deposits," or, less generously, "bad deposits." In order to make a sound judgment on how to treat brokered deposits as a source of funding, however, we believe it is critical to separate the two factors and understand the impact of brokered deposits in that context. Against this backdrop, our study finds:

- Capital depletion – There is no credible statistical evidence or logical argument to suggest that the desire to compensate for the relatively high cost of brokered deposits was anything more than a marginal influence in the decision of banks to originate the high risk assets that later led to depletion of capital.
- Liquidity – There is no evidence, empirical or logical, that *insured* brokered deposits are an unstable source of liquidity that contributed to bank failure in the recent crisis. In fact, there are reasons to believe that insured brokered deposits provided liquidity to troubled institutions.
- Nevertheless, as is found in other studies, brokered deposits were statistically linked to a higher rate of failure during the recent crisis, but they were not as predictive as other factors.

These three findings together lead us to conclude that brokered deposits, in and of themselves, do not cause banks to fail, but rather are indicative of banks that operate, based on other characteristics, higher risk business models. Instead, our analysis finds

[1] This report was requested and funded by Promontory Interfinancial Network. It was conducted independently by Oliver Wyman, and it reflects the views of the Oliver Wyman team that conducted the analysis and wrote the report.

that far from brokered deposits being the only, or even largest, such indicator, significant funding reliance on a broader class of "purchased liabilities" (in which we include brokered deposits as well as Fed Funds purchased, repurchase agreements, FHLB advances, and large time deposits) is even more indicative of failing institutions.

Since the use of brokered deposits was not a driver of liquidity challenges, and funding profile in and of itself cannot cause economic losses on the asset side, we believe that the role brokered deposits, and all purchased funds, played in the financial crisis was that of facilitating the growth of business models largely dependent on the acquisition of high yield (and, as it turned out, high risk) assets. This theory is further borne out by our finding that a bank's tier 1 capital ratio, "risk weight," and rate of asset growth were also highly predictive of bank failure.

None of these findings are ultimately surprising, and, with the exception of a direct measure of asset growth, they are already incorporated in the recently revised FDIC assessment scorecard. The major finding that is not incorporated in the current framework is our conclusion that "deposit revenue contribution" provides a useful predictor of bank survivorship both on its own and in a multifactor model incorporating the attributes listed above (excessive use of purchased funds, low tier 1 capital ratio, high rate of asset growth). The greater the proportion of revenue that a bank derives from deposit taking, the lower its likelihood to fail.

It is unlikely that "deposit revenue contribution" has ever been studied in connection with bank failure before because it is neither featured in regulatory filings nor in the SEC disclosures of most banks. Despite this, the concept is far from abstract since the general principles are embedded in the Core Deposit Intangible calculation[2] conducted in association with the accounting of bank acquisitions. As well, while few banks report deposit revenue or earnings, Bank of America has done so for its retail unit since at least 2005, and many banks conduct this calculation internally even if not publicly reported.

The industry standard measure of deposit revenue or value includes both fees as well as the cost-of-funds advantage associated with deposits (that is to say, deposits generate "net interest margin" based on the discount between their rate and what it otherwise would have cost the bank to acquire similar funding). This fee and net interest margin revenue is substantial—and it carries very limited risk.

Why does deposit revenue contribution reduce bank riskiness? While there is no definitive explanation, there are at least two strong reasons to consider. First, the deposit revenue represents a diversified stream of earnings and value, so when the asset business is troubled, the institution has alternative sources to rely on for cash-flow and, potentially, capital. Second, the presence of the deposit revenue stream, which does not require significant incremental capital beyond that associated with the institution's assets,

[2] The Core Deposit Intangible calculation is required at acquisition by SFAS 141 to record deposit franchise value as an identifiable intangible asset separate from goodwill.

represents a substantial source of value that prudent management and ownership might be less compelled to put at risk with more speculative, and potentially risky, asset strategies.

The calculation of "deposit revenue," which we describe further in the body of the paper, represents a more complex deposit classification than core and non-core, or any other distinction based on channel of origination alone. Nevertheless, we believe that the FDIC should begin incorporating at least some of the associated principles into its future classification of deposits. When the classification of "core" vs. "non-core" was initially established, it is likely that "brokered" represented the greatest potential source of low-value deposits. In the current environment, that is not the case, and thus the "brokered deposits" designation has become increasingly artificial over time.

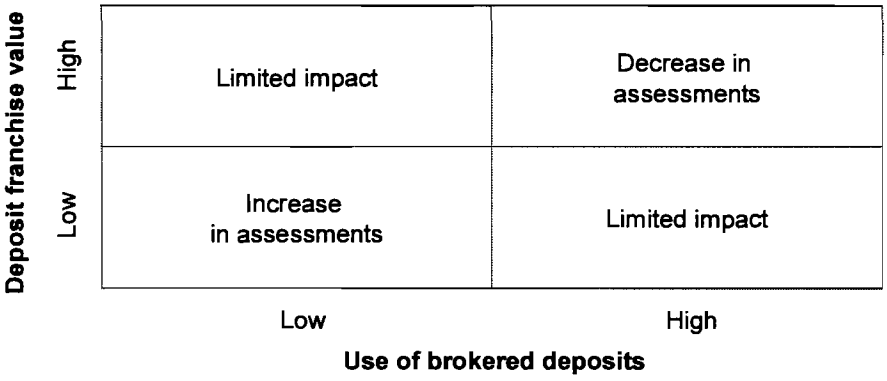
The internet represents the most high-profile source of non-brokered, low-value deposit growth. But to simply expand the "non-core" designation to cover this channel as well fails for two reasons. First and foremost, all internet deposits are not the same, and the diversification of this channel is occurring at a very rapid pace. Several internet-only or branchless banks have already established significant deposit value, and as technology evolves to overcome historical roadblocks (e.g. remote deposit capture), the possibility for continued value growth in this area is high. Secondly, high rate deposit growth is not restricted to the internet or even to non-branch channels—several of the highest profile bank failures relied heavily on branch channels to originate high-rate, low-value balances.

In short, we find that the most predictive characteristics of bank failure are found on the asset side of the balance sheet, and therefore the most important protection for the future is likely increased scrutiny of those business models that hold higher risk assets. This finding clearly is in-line with many of the changes that the FDIC has made to date.

Additionally, liabilities should continue to be monitored in line with their impact on bank stability and contribution to franchise value. Therefore, in addition to changes being made regarding the evaluation and assessment of the asset side, the FDIC should make changes to its designation of core and non-core deposits in order to improve its holistic measurement of risk and potential franchise value at failure. These changes should focus in principle on the fact that the presence of valuable deposits enhances banking soundness and in practice on measuring that value (or lack thereof) regardless of the channel of origin or other artificial distinctions.

Specifically, we suggest that the FDIC review the feasibility of incorporating some of the underlying principles of the Core Deposit Intangible calculation into an ongoing measure of deposit franchise value or earnings contribution. If the FDIC seeks a less invasive measure of deposit value (with a lower operational burden on banks) it could seek to use the same building blocks used in the Oliver Wyman calculation of deposit revenue, which only utilizes data from current Call Report filings but therefore cannot account for the cost of deposit gathering as does the Core Deposit Intangible calculation. In practice then, all else being equal, banks that are deemed to have value-generating deposit franchises would be assessed at a lower rate than those that do not.

We have not endeavored at this point to conduct an impact study of what change this type of a framework would drive, however key expected outcomes would be:



NYC-PXA00111-002

Given that our key finding regarding the contribution of deposits to banking soundness is the franchise value that those deposits add, we recommend the FDIC to consider how to potentially incorporate non-asset related franchise value from other sources as well. This could, for example, include payment businesses or other sources of proprietary value not easily measured from the review of current regulatory filings.

And to the extent any channel-based classifications remain, we recommend brokered deposits be considered as a part of a broader definition of "purchased liabilities," in which we include brokered deposits, as well as Fed Funds purchased, repurchase agreements, FHLB advances, and large time deposits.

Lastly, this discussion of our results has been specifically focused on the designation of core deposits and brokered deposits. Having not found evidence that insured brokered deposits caused liquidity problems and, therefore, bank failures, we have not emphasized the role of deposit classifications or other aspects of bank funding vis-à-vis liquidity. Given that these areas have already been commented on globally in regard to the Basel III consultative paper, we have left them largely out of scope for this discussion. In our view, it will be important for the FDIC to ensure that any action taken with regard to core deposit designation for liquidity measurement is well-fitted to Basel III and other ongoing regulatory and compliance changes.

The following sections of this study consider current deposit classifications and our suggested improvements with respect to better reflecting the probability of bank failures, considering both asset-side losses and liquidity crises, and the FDIC's losses at failure.

3. Probability of failure

In this section, we describe our analysis of U.S. bank failures during the 2008 financial crisis. To conduct our analysis, we gathered data on all failed[3] and surviving banks between January 1, 2007 and February 22, 2011 from the FDIC's Statistics on Depository Institutions (SDI) database. We then constructed two different datasets, which are described in Table 1.

Table 1: Attributes of historical datasets

Financial data as of:	Attributes
Year-end 2006	▪ All banks receive a consistent observation date prior to the start of the financial crisis, but prediction horizons vary ▪ This provides a view of each bank's financial position and business model going into the crisis
One year before failure	▪ Non-failed banks are randomly paired with failed banks to determine their observation date ▪ This is consistent with standard one-year prediction horizons for default modeling in other areas (e.g. Basel II probability of default parameters)

Again, we note that bank failures occur primarily through two separate, though often related, events:

- Capital depletion through losses on the asset side of the balance sheet, and
- A liquidity crisis driven by the rapid disappearance of unstable funding on the liabilities side of the balance sheet

We reviewed various methods of deposit characterization through these two lenses, attempting to discern which of the available metrics are the most clearly indicative of increased bank risk.

3.1. Asset-side losses

Brokered deposits are thought to be indicative of future asset losses as they may be used to fuel the growth of risky assets; however, the focus on brokered deposits entangles several different economic drivers that can be best measured separately. We believe the true underlying driver is a decision by management to focus on increased growth and higher asset returns, which typically requires taking on greater credit risk, but this decision is not directly observable. Instead, we can only see the results of that decision

[3] We utilized the FDIC's list of Failures and Assistance Transactions. For the purposes of this study, any bank listed as having failed or received significant government assistance is considered to have failed.

play out over time in the bank's financial results[4]. In addition to the tier 1 capital ratio, with its evident relationship to risk, we identify two additional factors that we believe warrant consideration—high asset growth and lack of "deposit revenue contribution"—and we suggest that brokered deposits are best viewed along with other purchased liabilities in the context of their contribution, or lack of contribution, to "deposit revenue."

Brokered deposits may be correlated with high asset growth and lack of deposit revenue, but focusing on brokered deposits alone is not the right approach. In order to capture only those brokered deposits which exhibit these negative drivers, and to capture all deposits (brokered or non-brokered) which exhibit these negative drivers, the FDIC framework should operate directly on metrics that describe the relevant characteristics. Nevertheless, we do include a measure of brokered deposits in our analysis, in addition to a broader measure of "purchased liabilities," which we define as brokered deposits, Fed Funds purchased, repurchase agreements, FHLB advances, and large time deposits, to test whether brokered deposits do, in fact, exhibit unique risk characteristics not shared with other similar methods of funding.

We first introduce each of these three factors and describe the economic reasoning for their predictive power. We follow this up with detailed statistical results.

3.1.1. Asset growth

The asset growth factor is reflective of the fact that banks that grow their assets quickly tend to be riskier than banks that do not. This is of course not always the case, but our statistical results do show that asset growth well above average serves as an indicator of potentially increased risk.

If it were possible to deploy a robust measure of the riskiness of the lending policies of these institutions (and particularly those that failed), we would likely identify substantial differences in the quality of their credits versus other institutions. While this is a highly challenging endeavor, even if we were able to utilize the sort of non-public data the FDIC is able to obtain through the examination process, the outward facing market indicator—rapid growth—is readily apparent.

The FDIC has recognized the effectiveness of asset growth measurements as a predictor of bank failures through its inclusion of a "Growth-Adjusted Portfolio Concentrations" factor in the assessment pricing scorecard for "Large" banks[5]. This factor is a more refined, and thus more complicated, measure of growth that attempts to penalize only growth in risky assets above a historical average growth rate. We find this factor to be a

[4] This view is not unique. See, for example, Decomposing the Impact of Brokered Deposits on Bank Failure: Theory and Practice by Clifford Rossi (2010).

[5] Defined as banks with more than $10 billion in assets but not classified as "Highly Complex." The definition of Highly Complex institutions is far more complex but only applies to approximately ten insured depository institutions.

very strong predictor of failure during the financial crisis and better than a simple measure of asset growth. However, we have largely excluded it from our analysis due to the complexity of the calculation and the fact that the FDIC has chosen to apply it to only the approximately 100 banks that fall into the "Large" bank category.

3.1.2. Deposit revenue contribution

Deposit side revenue is calculated from Call Report/TFR data based on a proprietary Oliver Wyman methodology[6], incorporating both rate and stability of deposits. The metric indicates what percentage of a bank's revenue comes from the below-market cost of funding and fees on deposits. In many ways it represents the revenue the bank is able to generate for its services as a repository of customer wealth and as a payment processor. While few banks publicly report "deposits" as a revenue stream or profit center, many now produce this calculation internally—and this revenue represents a substantial portion of earnings for lower risk banks. As noted above, Bank of America has reported similar "deposit revenue" results since at least 2005[7].

The willingness to pay high rates for funding, and thus reduce deposit revenue, is a further indicator that management has decided to increase return, and thus often risk, by focusing primarily on the asset side of its business. Whether the high-cost funding comes through the use of brokered deposits, high-rate online deposits, high-rate branch deposits, or other purchased liabilities such as FHLB advances is almost immaterial. In most cases, only an expected high return on assets and an exhaustion of lower cost funding would justify a high cost of funds.[8]

There are three primary reasons why this factor would be a powerful predictor of bank safety.

1. Since "deposit revenue" is calculated as a percentage of total revenue, and is essentially risk-free[9], the higher this percentage is, the lower the contribution from riskier lines of businesses.
2. For institutions that have a strong absolute level of deposit revenue but that also take on significant credit risk, the revenue generated by deposits can help offset the impact of credit losses when they do occur.
3. It is also possible that the management and owners of banks with substantial deposit "franchise value," in the sense we define it here, are more prudent risk-takers given their substantial risk-free source of earnings. In other words, this metric reveals which

[6] While we view the calculation to be proprietary and thus provide few details in this paper, we would be willing to provide the detailed methodology to the FDIC on a confidential basis if so desired.

[7] See for example Bank of America 2005 Form 10-K section "Consumer Deposit and Debit Products," pg. 33-34.

[8] Of course, alternative reasons for utilizing a modest amount of purchased funds exist. For example, a bank may choose to access a small amount of purchased funds at a higher rate rather than increase in-branch rates in order to avoid impacting its low-cost retail deposit relationships.

[9] Here we mean it is free of credit risk. It is still subject to normal business risks from competition on its services to depositors as a wealth repository and payment processor and to some degree of operational and market risks.

banks are focused on developing strong businesses on both sides of their balance sheet rather than just the asset side—and, without due care, it is the asset side that leads to capital-depleting losses.

This estimation of "deposit revenue" can be thought of as a more robust calculation of what has come to be defined as "core" vs. non-core deposits and been featured as a key element of bank assessment for many years. While we agree with the desire to measure the value of deposits, in our view, the evolving banking landscape, with more complex ways of gathering assets as well as deposits, requires a more complex way of defining "valuable" and "less valuable" deposits than the relatively simple, channel-based mechanism deployed in the past. Particularly, while many traditional brokered deposits may offer little value versus classic "core" sources of funding, so too do other similarly high-rate deposits gathered via the internet—or, just as probably, through traditional branches. That is to say, along with other positive characteristics such as stability, low-cost deposits are valuable, and high-cost deposits are less valuable, but no simple channel of origination or size designation can easily make the distinction.

To highlight this point, if you observe the deposits of many of the largest failed institutions from the recent crisis, you will often see brokered deposits among the mix, but this will just be the tip of the iceberg of the high-rate, FDIC-insured balances that the institutions gathered. Additionally, and often, far more sizable balances were generated both on-line and through branch networks, the latter of which generated the vast majority of the funding, quite possibly at the highest overall cost once both rates paid and the cost of maintaining the branch network are taken into account.

While this calculation is more complex than the current FDIC framework, it is similar in approach to metrics already common in the industry. The deposit revenue calculation we reference above is quite similar to the calculation of Core Deposit Intangible that institutions must conduct at the point of acquisition. The primary difference is that deposit revenue does not consider the costs of gathering deposits, as these are nearly impossible to estimate with any accuracy from regulatory filings. The Core Deposit Intangible calculation essentially provides a franchise value of the deposit base, calculated from the difference between the "all-in cost of funds" of the deposits and wholesale market rates for similar funding, which are expected to be higher. While neither calculation is by any means easy, they are relatively formulaic and could be adapted into an ongoing Call Report based approach, though potentially kept private to avoid disclosing competitive information.

This calculation, however, even in somewhat simplified form, may not be practical for every institution to compute and doing so might come at significant expense. As a result, the FDIC could implement a graduated approach, as it has done in other areas, by requiring a progressively more sophisticated calculation for larger and more complex institutions. The FDIC could also offer the ability to "opt-in" to the more rigorous calculation if smaller institutions are willing and able to undertake the added burden. At its most basic, this metric could be approximated quite simply by a broad measure of

funding cost, which we also tested and find to be predictive of failure. This approach is not ideal, as we find it less predictive, and it leaves out important components of the value of a deposit to an institution (the fee income collected from deposit accounts, the term structure of the deposits, and the costs of the branch network used to collect the deposits), but it may be justified by pragmatism required in implementing a risk-based pricing framework for institutions of varying size and capabilities.

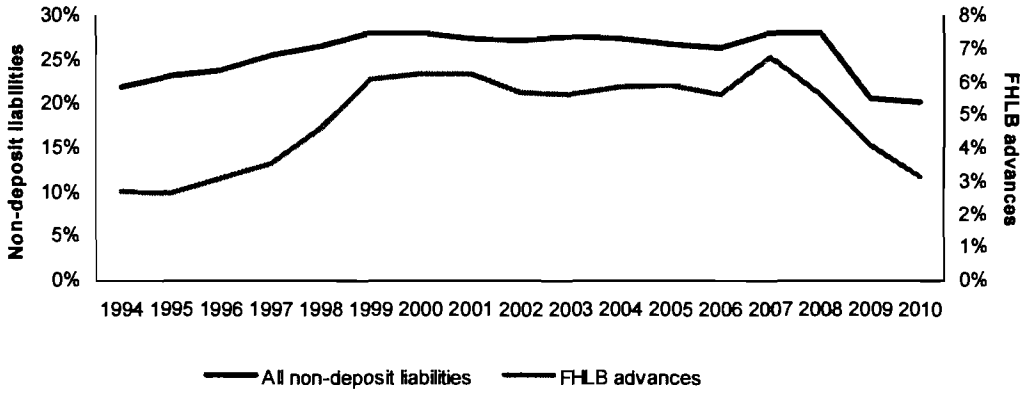
Although the specific details of an accurate pricing mechanism based on the factors described above may be complicated, what is clear is that a simplistic definition of "good" and "bad" deposits based solely on channel of origination is insufficient for understanding the riskiness of an institution or valuing its deposit franchise value if it were to fail.

3.1.3. Purchased liabilities

Acquiring funding, deposit or non-deposit, that does not require building client relationships relaxes a natural constraint on growth and serves as an additional signal of management's focus on an asset-led strategy. Indeed, even when controlling for the factors described above, we find statistical significance for brokered deposits as a predictor of bank failure, likely due to this line of reasoning, though they are a less powerful individual predictor of failure than is either asset growth or deposit revenue.

As with the other drivers noted above, the ability to attract funds from outside a bank's geographical footprint is not limited to brokered deposits. Notably, out-of-geography liabilities include all non-deposit funding sources—FHLB advances, Fed Funds, and repos—which, as shown in Figure 1, became increasingly important sources of bank funding in the years after the S&L crisis before retreating at the start of the recent crisis.

Figure 1: Use of non-deposit liabilities[10]



NYC-PXA00111-002

[10] In addition to the SDI data used throughout, the FHLB advances data are sourced from the consolidated FHLB system financial statements.

To these non-deposit liabilities, we would add many large time deposits, deposits obtained through rate boards and some online-only accounts as measures of "out-of-geography" deposits. However, available data do not track "out-of-geography deposits," which prevents the construction of an appropriate factor to measure this driver directly.

We can nevertheless construct a factor to track "purchased liabilities," which we define as brokered deposits, Fed Funds purchased, repurchase agreements, FHLB advances, and large time deposits. We note that this is analogous to the "core deposits/total liabilities" factor already included in the FDIC deposit insurance pricing model for Large and Highly Complex institutions. In our analysis, as would be expected from economic intuition, this factor performs better than brokered deposits alone. Also too, the addition of the other purchased liabilities to the factor is not trivial in terms of magnitude of funding: brokered deposits made up less than 27% of the total purchased liability volume at year-end 2006.

While we do include brokered deposits in the purchased liabilities factor, we note that some brokered deposits may nevertheless be considered "relationship deposits" that we would like to exclude. For example, reciprocal brokered deposits are included despite the fact that the depositor maintains a relationship with the originating bank and the bank's total deposits are not increased due to their reciprocal nature. Additionally, broker-dealer sweep deposits are often considered brokered deposits even though the client maintains a relationship with the broker-dealer. While the relationship aspect may not "pass through" from the broker-dealer to the bank in all cases, there are some cases where it may, such as where the broker-dealer has signed a long-term contract to sweep its deposits to the same bank or where the bank and the broker-dealer are corporate affiliates. In these cases, the broker-dealer is not acting as an active intermediary in placing the funds. In addition, long-term contracts may not permit the bank to rapidly increase the amount of these brokered deposits to fund an asset-side growth strategy. These funding sources are also quite actively monitored and managed by banks themselves with associated liquidity and concentration policies.

Similarly, economic analysis would indicate that certain deposits traditionally considered "core" should also be included in the "purchased liabilities" category given the lack of a relationship aspect. For example, deposits gathered through rate boards, online accounts (particularly if the customer has no other active accounts at the institution), and even some high-rate in-branch deposits which attract new customers by rate alone.

Given the current inability to make these additional distinctions[11], we would recommend that the FDIC and the other bank regulators begin to collect additional data through Call Report and TFR changes to track these additional aspects. We note that there are currently three types of brokered deposits reported: brokered deposits generically, fully insured brokered deposits, and reciprocal brokered deposits, but there is no specific data collected on other deposits with many of the same attributes.

[11] While reciprocal brokered deposits are now reported in regulatory filings, they were not reported in all periods during our analysis, which prevented us from excluding them from the definition of purchased liabilities.

3.1.4. Statistical results: Year-end 2006 dataset

We began our analysis utilizing the year-end 2006 dataset. As we discuss below, the one-year before failure data set provides a theoretically more predictive model, but one that may have been "overfit" to the data due to the observations being taken so close to failure that it cannot be used for prediction. The year-end 2006 dataset provides a view of each institution's business model prior to the start of the financial crisis along with an indication of whether that business model sustained them through the crisis.

In evaluating the statistical power of these factors, our first step was to determine their individual predictive power. We did so using the "accuracy ratio," a test of pure rank ordering ability that ranges from 0% to 100%. In narrowing down the universe of possible factors, we evaluated a much longer list of possible factors. The long list of factors is detailed in Appendix A. The definitions of the specific factors we will discuss here are described in Table 2.

Table 2: Factor definitions

Factor	Numerator	Denominator
Deposit revenue contribution	Deposit revenue as calculated by Oliver Wyman's proprietary methodology	Total revenue
Funding cost	Total interest expense	Total liabilities - trading liabilities - other liabilities[12]
Asset growth (2 years)	Percent change in total assets between 2004 Q4 and 2006 Q4	N/A
Risk weight	Total risk weighted assets	Total assets
Tier 1 capital ratio	Total tier 1 capital	Total risk weighted assets
Brokered deposit ratio	Brokered deposits	Total deposits
Purchased liabilities ratio	Fully insured brokered deposits[13] + Fed Funds + FHLB advances + large time deposits	Total liabilities

A factor in the table, but not discussed previously, is "risk weight." While this factor is less predictive as a single factor than asset growth, we introduce it here as it turns out to be an important factor in constructing a multifactor model as will be discussed below.

Prior to generating the accuracy ratio of each factor, we ordered each factor in its intuitive direction to ensure the accuracy ratio would be positive. Table 3 below therefore shows

[12] Trading liabilities are excluded as they represent temporary liabilities due to trading activities and are not intended to fund the bank's operations. Similarly, other liabilities consist of non-funding-related liabilities such as salaries and accounts payable.

[13] Fully insured brokered deposits are used because large time deposits includes the uninsured portion of brokered CDs.

the accuracy ratio of each factor as well as the "direction of good." An "ascending" factor is one where a higher value is indicative of an institution that is less likely to fail. Conversely, "descending" indicates that a lower factor value indicates decreased risk of failure.

Table 3: Accuracy ratio of selected factors

Category	Factor	"Direction of good"	Accuracy ratio
Liabilities strategy	Deposit revenue contribution	Ascending	55.7%
	Funding cost	Descending	55.5%
Asset risk	Asset growth (2 years)	Descending	49.5%
	Risk weight	Descending	42.9%
	Tier 1 capital ratio	Ascending	39.3%
Funding source	Purchased liabilities ratio	Descending	55.1%
	Brokered deposit ratio	Descending	46.9%

As noted above, brokered deposits contain important attributes of each of the underlying drivers we have identified as causative or indicative of failure, and it is in fact a direct component of purchased liabilities. It is thus unsurprising that it appears as a predictive individual factor, though less predictive than others.

We then examined how these factors perform in a multifactor model to determine whether brokered deposits provide unique information regarding failure that cannot be captured more accurately by the other factors. To make finding the best multifactor models a manageable task, we first narrowed our long list of factors to a shorter list. We filtered the long list based on:

- Individual factor power: factors with accuracy ratios below 15% were eliminated
- Number of observations: factors with significant missing values were eliminated
- Overly complex factors: factors with complex calculations were eliminated so long as an analogous simple factor with similar power existed
- Nearly equivalent factors: factors that are nearly equivalent to other factors with greater power were eliminated
  - For example, Tier 1 capital / Total assets (AR = 19.6%) was eliminated in favor of Tier 1 capital / RWA (AR = 39.3%)

Once narrowed to a short list, we utilized an optimization algorithm to find the best[14] four factor models. We found that models with greater than four factors typically include factors with very low weight, only marginally contributing to model predictive power, and models with fewer factors have significantly less power than four factor models. For

[14] As with many optimizations, the algorithm may or may not find the global maximum unless every possible model is tested, which would require excessive computing time; nevertheless, the algorithm will find very good models.

each model we discuss below, we report the model's overall accuracy ratio, each factor's weight in the model, and each factor's p-value.

Factor weights are derived by standardizing each factor to have a common mean and standard deviation prior to performing the regression. This ensures that the resulting coefficients are all in a "common currency"—the number of standard deviations from the mean. As noted above, we also converted all the factors to be in a uniform direction with respect to risk of failure. This insures that all coefficients will be positive. This procedure allows for the straightforward comparison of the magnitude of the coefficients across factors. A factor with a larger coefficient contributes more to the prediction than does a factor with a smaller coefficient.

P-values indicate whether the individual factor's coefficient is statistically significantly different from zero and thus contributing meaningfully to the overall model. A p-value of less than 5% is a standard level at which factors are typically deemed significant. As will be seen below, the p-values for all of the factors on all of the models presented easily clear this hurdle.

From our analysis, the best four factor model found is shown in Table 4.

Table 4: Best four factor model – AR = 69.7%

Category	Factor	Weight	P-value
Liabilities strategy	Deposit revenue contribution	22%	<.0001
Asset risk	Risk weight	37%	<.0001
	Asset growth (2 years)	18%	<.0001
Funding source	Purchased liabilities ratio	23%	<.0001

Beyond merely its high predictive power, this model is attractive due to its clear economic intuition. Deposit revenue contribution indicates the extent to which the bank is funding itself at high cost and establishing little deposit franchise value. Asset growth indicates that those high cost deposits are being used to fund a focus on the asset side of the business. Risk weight complements this factor with a view of how risky those assets are. The purchased liabilities ratio, despite the imperfections noted above, indicates the extent to which the bank is using liabilities that relieve a natural constraint on growth and by their nature are both high cost and add little to franchise value.

The weights are indicative as well: the asset risk factors hold a total of 55% of the weight. This is reasonable as the losses driven by asset-side risk-taking are the proximate cause of capital depletion and thus bank failure. But, the liabilities side nevertheless contributes 45% of the total weight, split approximately evenly between a view of deposit franchise value and a view, though imperfect, into the relationship aspect of the funding.

Nevertheless, while risk weight is quite predictive, actual implementation of this factor will become challenging once large banks begin converting to Basel II-driven risk weights. To the extent that Basel II risk weights are not calibrated to the same level as current Basel I risk weights, this will make comparing risk weights across institutions difficult. One solution would be to maintain separate pricing models for banks utilizing Basel II risk weights and for banks that remain on Basel I. Given that risk weights would be expected to be a better measure of asset risk under Basel II than under Basel I, this may be a reasonable area for the FDIC to investigate. Nevertheless, we realize these implementation issues may argue against the inclusion of this factor. We therefore tested models that excluded risk weight and optimized for the best replacement. This analysis yields the results in Table 5.

Table 5: Four factor model excluding risk weight – AR = 68.7%

Category	Factor	Weight	P-value
Liabilities strategy	Deposit revenue contribution	11%	<.0001
Asset risk	Tier 1 ratio	62%	<.0001
	Asset growth (2 years)	12%	<.0001
Funding source	Purchased liabilities ratio	15%	<.0001

Excluding risk weight does hurt overall model power by 1%, which while not ideal, does not represent a substantial loss of power. The factor that replaces risk weight is tier 1 ratio, a common measure of a bank's risk of failure and indeed one that is already included in the FDIC pricing scorecard. This factor also absorbs a significant amount of the weight in the scorecard. While we still categorize it as an "asset risk" factor since the purpose of leverage is typically to increase the return on asset-side risks, it in reality contributes more than just a view of asset risk: balance sheet leverage in many ways spans both the assets and liabilities sides of the balance sheet and thus accounts for its out-sized weight.

In order to understand how much better the use of the purchased liabilities ratio is than looking at brokered deposits only, we substitute in the brokered deposit ratio for purchased liabilities, which yields the results in Table 6.

Table 6: Four factor model with brokered deposits – AR = 68.6%

Category	Factor	Weight	P-value
Liabilities strategy	Deposit revenue contribution	16%	<.0001
Asset risk	Tier 1 ratio	63%	<.0001
	Asset growth (2 years)	12%	<.0001
Funding source	Brokered deposit ratio	9%	<.0001

While this change has a barely noticeable impact on the accuracy ratio (a decrease of only 0.1%), the weight on the brokered deposit ratio must be decreased by 40% to achieve this. The vast majority of this decrease in weight is transferred to deposit revenue contribution making the brokered deposit ratio the least important factor and indicating that a singular focus on brokered deposits is less justified. In essence, this analysis confirms that although brokered deposits can proxy to some extent for the true economic drivers of risk, it is a poor proxy and a significantly better model can be developed using the deposit revenue contribution and purchased liabilities directly[15].

As we suggest above, deposit revenue contribution (and its analogue Core Deposit Intangible) may be difficult for some smaller banks to calculate if it were to become a mandatory part of FDIC assessment pricing or other analysis. As a further effort to ensure a practical set of recommendations, we note that funding cost may be a suitable replacement for these institutions. We therefore returned to the preferred measure of funding source (purchased liabilities ratio) and examined the impact of removing deposit revenue contribution and replacing it with funding cost. This is shown in Table 7.

Table 7: Four factor model with funding cost – AR = 68.4%

Category	Factor	Weight	P-value
Liabilities strategy	Funding cost	25%	<.0001
Asset risk	Tier 1 ratio	54%	<.0001
	Asset growth (2 years)	10%	<.0001
Funding source	Purchased liabilities ratio	11%	<.0001

Again, the decrease in power is minimal (0.3%), suggesting that funding cost is a suitable replacement in our historical dataset; however, looking forward, logic dictates that using the more sophisticated metric may allow banks with particular business models or competitive advantages to be rewarded for their good performance while at the same time properly penalizing banks which may keep funding costs low by attracting only short-term, unstable deposits. We additionally note that in relatively flat yield curve environments, such as at year-end 2006, cost of funds and deposit revenue will provide similar rank orderings, but this will not be the case when the yield curve is steeper. We therefore suggest that the FDIC consider how it may be possible to include a metric more in line with the deposit revenue or Core Deposit Intangible calculation for at least the larger and more complex institutions.

[15] As noted previously, we would expect an even better model could be achieved through an improved definition of "purchased liabilities."

3.1.5. Statistical results: One-year before failure dataset

In addition to the year-end 2006 analysis, we constructed a dataset with observations one year prior to failure as is typical of default modeling in other areas and similar to the modeling done by the FDIC in support of the new pricing scorecards. To do so, we collected financial data on all failed institutions as close to one year prior to their failure as possible. We then randomly paired each non-failed institution with a failed institution and observed it over the same one year period. Thus we create cohorts of institutions with equivalent observation dates, with some who failed and some who did not.

We conducted this analysis primarily to ensure completeness and verify that it did not challenge any of the conclusions we reached utilizing the year-end 2006 dataset. However, we found that observations so close to failure likely provide models that are "overfit" to the data and cannot be reliably used for prediction. For example, the tier 1 ratio, as a single factor, has an accuracy ratio of 74% in this dataset, which is better than the best four factor model using the year-end 2006 data. It therefore seems that one year prior to failure, especially during a banking crisis, the factors that cause banks to fail are well known and provide little insight into the business model decisions that are likely to provide stability in the future.

We therefore will not focus on this analysis except to note that many of the same factors are relevant in this analysis as were powerful in the year-end 2006 dataset. The only significant difference is the inclusion of a measure of profitability (losses) in predicting failures, which is intuitive given that it is these very losses that cause the later failure, directly or indirectly.

3.1.6. Illustrative example

The practical impact of our suggestions can be more easily understood through comparing the results of our preferred model to the FDIC's current pricing scorecard. An exact comparison is not possible as we have not generated a complete pricing model with a dollar assessment. Instead, we score two illustrative institutions using our preferred model and a model that excludes our suggested factors and replaces them with factors similar to those in FDIC's current pricing model.

For this exercise, we will utilize the four factor model excluding risk weight described in Table 5 above and reproduced here.

Table 8: Four factor model excluding risk weight – AR = 68.7%

Category	Factor	Weight	P-value
Liabilities strategy	Deposit revenue contribution	11%	<.0001
Asset risk	Tier 1 ratio	62%	<.0001

Category	Factor	Weight	P-value
	Asset growth (2 years)	12%	<.0001
Funding source	Purchased liabilities ratio	15%	<.0001

This model will be compared to a "pseudo-FDIC" model. The FDIC model will be approximated by replacing our suggested factors as follows:

- Deposit revenue contribution – This factor is aimed at achieving a more refined measure of deposits in our scorecard than is present in the FDIC scorecard. The FDIC scorecard contains only a measure of funding source while our model contains both a measure of source as well as deposit franchise value. We therefore combine these factors in the pseudo-FDIC scorecard into a single purchased liabilities ratio factor with a 26% weight.
- Asset growth – This factor is aimed at achieving a more long-range view of asset risk at an institution. The FDIC model contains measures of asset risk in the "criticized and classified items" and "underperforming assets" ratios. We therefore replace the asset growth factor with the "underperforming assets" ratio. We choose this factor, a more near-term measure of asset risk, to represent the FDIC model despite the availability of the FDIC "Growth-Adjusted Portfolio Concentrations" measure because this measure is only included in the Large bank scorecard and relatively few Large banks failed in the recent crisis. In contrast, the "underperforming assets" ratio is included in the scorecards for all banks.

We compare two illustrative institutions in Table 9 based on an assumed evaluation in the middle of a business cycle, prior to any stress from a downturn.

Table 9: Business models of two illustrative institutions

Institution	Strategy	Implications
Bank A	▪ Traditional retail bank with branch banking focus ▪ Moderate growth strategy ▪ Moderate use of purchased liabilities ▪ Moderate leverage	▪ High deposit revenue contribution ▪ Low asset growth and low underperforming assets ratio ▪ Well capitalized
Bank B	▪ Bank focused on high-rate retail deposit gathering to finance lending ▪ High growth strategy ▪ Moderate use of purchased liabilities ▪ Moderate leverage	▪ Low deposit revenue contribution ▪ High asset growth, but significant losses have not emerged in the underperforming assets ratio ▪ Well capitalized

The two illustrative banks are distinguished along the two factors we have identified as warranting additional consideration but are equivalent along the remaining factors. Notably, the purchased liabilities ratio is equivalent for each bank. Bank B is funding

itself with high-rate retail deposits, which are considered "core" under current definitions. The deposit revenue calculation reveals the difference in the quality of these deposits relative to Bank A's traditional retail deposits. As we noted above, we would ideally refine the definition of "purchased liabilities" to include certain online and rate board deposits and to exclude reciprocal brokered and certain broker-dealer sweep deposits, which would further distinguish the results of our preferred model relative to the pseudo-FDIC scorecard depending on the source of Bank B's high-rate deposits.

Note that while we are utilizing the asset growth factor in the illustration, the scenario's logic would not be disturbed by using risk weight. Bank A is a balanced institution pursuing revenue on both the asset and liabilities side and finding moderate success at each. Its risk weight would therefore be relatively low. Bank B is focusing entirely on loan growth through more risky lending, which would yield a higher risk weight.

Calculating results for our model requires us to determine how each bank performs on each input factor in terms of number of standard deviations relative to the mean. We therefore assign the following results to each institution based on their respective strategies. For ease of display, we also convert these to a zero to 100 scale where zero represents the least risk of failure and 100 the most risk. The scale places the mean at 50, utilizes a standard deviation of 25[16], and aligns all factors in the same direction with respect to risk of failure.

Table 10: Performance of illustrative banks on scorecard factors

	Bank A		Bank B	
Factor	**Factor results**	**Score**	**Factor results**	**Score**
Deposit revenue contribution	0.25 SDs above mean	43.75	1 SDs below mean	75
Tier 1 ratio	At mean	50	At mean	50
Asset growth (2 years)	0.25 SDs below mean	43.75	1 SDs above mean	75
Purchased liabilities ratio	At mean	50	At mean	50
Underperforming assets ratio	At mean	50	At mean	50

Weighting each score and producing the total score under the pseudo-FDIC scorecard and our preferred model yields the results in Table 11.

[16] This scale is therefore not formally bounded at 0 and 100. However, approximately 95% of banks would fall between the 0 and 100 limits, which is sufficient for the purposes of our illustration.

Table 11: Comparison of scorecard results

	Pseudo-FDIC scorecard			Our preferred model		
	Factor weight	Bank A weighted score	Bank B weighted score	Factor weight	Bank A weighted score	Bank B weighted score
Deposit revenue contribution	0%	0	0	11%	4.81	8.25
Tier 1 ratio	62%	31	31	62%	31	31
Asset growth (2 years)	0%	0	0	12%	5.25	9
Purchased liabilities ratio	26%	13	13	15%	7.5	7.5
Underperforming assets ratio	12%	6	6	0%	0	0
Total score		50	50		48.56	55.75

The pseudo-FDIC scorecard views these two banks as having equivalent risk of failure despite their very different strategies. While not drastic, these differences are revealed by our preferred model yielding a score which is over 10% worse for the higher risk institution. Two reasons drive the differences:

- Inability of the pseudo-FDIC scorecard to evaluate the quality of deposits other than by channel, which fails to account for the lack of franchise value in Bank B's high-rate deposits.
- Lack of a long-range measure of increased credit risk-taking in the pseudo-FDIC model. The asset growth factor accounts for this, as would a risk weight factor. The pseudo-FDIC factor will not reveal this credit risk until the risky assets begin to exhibit stress, at which point it is often too late to resolve.

As a further exhibit, we have calculated the pseudo-FDIC model's accuracy ratio to be only 56.8%, which represents a nearly 12% decrease compared to the preferred model's accuracy ratio of 68.7%. In our experience, this represents a substantial drop in model power. While the example itself is highly stylized as noted above, this result nevertheless suggests that a non-trivial improvement in the FDIC assessment scorecards is attainable through the addition of factors similar to those we have recommended.

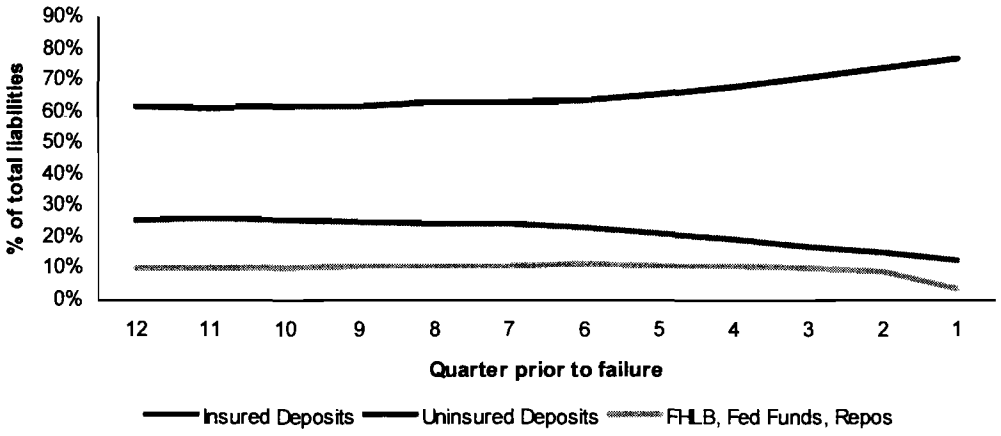
3.2. Liquidity crises

Brokered deposits, along with other non-core funds, are additionally thought to be unstable and thus predictive of liquidity risk. To the extent that they represent rate-sensitive depositors, brokered deposits will of course be unstable and prone to flight if rate is decreased. While this may hamper the bank's funding flexibility in ordinary times, flight of brokered deposits near failure is not a significant risk as the bank would not

lower the rate and voluntarily precipitate a liquidity crisis. As well, for a troubled bank, the rate required to attract brokered deposits, while possibly high relative to other deposits, is well below the rate that would be required on wholesale funds.

On the other hand, from both a logical and statistical viewpoint, we find the underlying economic driver of deposit stability near failure to be the existence or non-existence of FDIC insurance—indeed the goal of deposit insurance is to make covered deposits stable, and we see historical evidence, as shown in Figure 2, that indicates insured deposits do replace uninsured sources of funding that are running off as failure approaches.

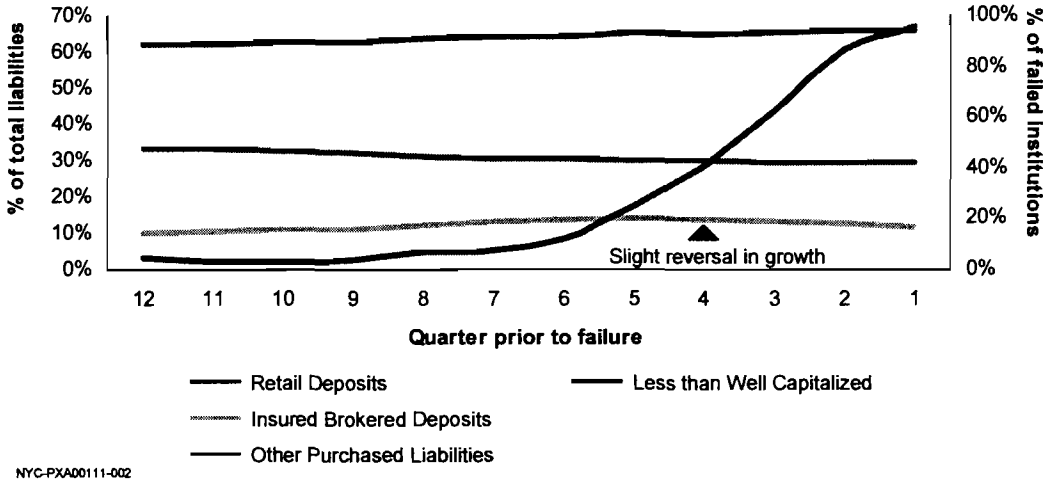
Figure 2: Changes in insured and uninsured deposits leading up to failure



NYC-PXA00111-002

Furthermore, Figure 3 demonstrates that retail and insured brokered deposits, specifically, replace other uninsured purchased liabilities leading up to failure. While the data show a slight reversal in the growth of insured brokered deposits beginning in the fourth quarter prior to failure, this is likely due to the FDIC's imposition of restrictions on the acceptance of brokered deposits for institutions that are less that well capitalized. As shown, the number of institutions that are less than well capitalized increases dramatically in the four quarters prior to failure.

Figure 3: Changes in purchased liabilities leading up to failure



This viewpoint is both consistent with the Basel III liquidity measures, which consider deposit insurance to be a key determinant of deposit stability, and the FDIC's runoff assumptions for loss severity calculations, which similarly distinguish between insured and uninsured deposits without any special treatment for brokered deposits.

Table 12: FDIC runoff assumptions for loss severity ratio calculations

Liability type	Runoff rate[17]
Insured Deposits	-10%
Uninsured Deposits	58%
Foreign Deposits	80%
Federal Funds Purchased	100%
Repurchase Agreements	75%
Trading Liabilities	50%
Unsecured Borrowings <= 1 Year	75%
Secured Borrowings <= 1 Year	25%
Subordinated Debt and Limited Liability Preferred Stock	15%

By providing an easy mechanism for large deposit customers to split their balances across institutions, deposit brokers and reciprocal deposit services that split large deposits across a number of banks within the insured limit likely contribute to substantially reduced liquidity risk in the US financial system. Put simply, deposit customers have faith in the FDIC, and deposits, regardless of other characteristics, that are 100% backed by FDIC

[17] A negative rate implies growth

insurance are likely to be stable during times of financial stress. Services that ease a large deposit customer's access to increased deposit insurance therefore improve stability.

The FDIC has defined non-core funding as brokered deposits, uninsured time deposits, and non-deposit liabilities. These are considered within the current pricing model for Large and Highly Complex institutions as predictors of a bank's "Ability to Withstand Funding-Related Stress." This is similar to measuring uninsured liabilities as a number of the components are in fact uninsured. Brokered deposits, however, are typically insured, and thus their inclusion in the measure serves to weaken its ability to accurately measure susceptibility to liquidity stress.

While our statistical analysis shows that brokered deposits are a significant predictor of failure when measured one year prior to failure, the relative stability of these deposits near failure and the ability of weakening institutions to acquire them at lower rates than unsecured wholesale funds explain their presence at many failed institutions: weakening institutions are replacing increasingly expensive wholesale funds with what are now relatively inexpensive brokered deposits. This not only suggests correlation without causation, but also calls into question the ability to use brokered deposits as a unique indictor of risk of failure even if a lack of causation is recognized. If wholesale funding is running off and being replaced with brokered deposits, the marketplace is already aware of distress at the failing institution and an increase in brokered deposits is a symptom of that recognition, not a leading indicator.

With that said, this improved stability does not come without cost—a cost borne primarily by the FDIC in the form of an expansion of insured deposits at weakening institutions. Indeed, the FDIC recognizes that brokered deposits serve to replace uninsured funding that is running off as failure approaches at the possible expense of a more costly resolution. This would seem to be the impetus for the Prompt Corrective Action limitations on an institution's use of brokered funding when it becomes less than well capitalized. Nevertheless, brokered deposits are not the only source of insured or secured funding for banks near failure. Given that, it may be reasonable to expand the type of funds that receive increased scrutiny once an institution becomes less than well capitalized.

4. Losses at failure

Given that the FDIC framework for considering losses at failure does not focus on brokered deposits or other measures of deposit quality, we only briefly consider their role in determining FDIC losses at failure. We consider this question from two perspectives, noting that the FDIC manages the potential losses to the Deposit Insurance Fund from bank failures through both insurance assessments and the supervisory process.

4.1. Deposit insurance assessments

The FDIC's new pricing scorecard provides for an explicit consideration of loss severity. As noted above, brokered deposits impact the loss the Deposit Insurance Fund may suffer at failure due to the fact that brokered deposits are generally fully insured and thus increase the DIF exposure. However, as recognized in the FDIC's loss severity calculation, this risk is properly measured through measuring the insured deposits that the FDIC is explicitly liable to guarantee and secured liabilities insofar as they rank senior to insured deposits and thus reduce the assets available to satisfy insured depositors' claims.

4.2. Supervisory process

The FDIC also manages potential losses at failure outside of the assessment pricing system through the imposition of restrictions on the acceptance of brokered deposits for institutions that are less than well capitalized. These rules are a reasonable way for the FDIC to manage the potential tradeoffs between allowing the continued acceptance of brokered deposits as a source of liquidity, which may stave of failure, and the increased risk of losses to the DIF should the institution nevertheless fail. As above, we note that brokered deposits are not the only source of funds that banks may turn to that are insured or secured and thus causative of losses if the institution fails. We therefore suggest that the broader set of purchased liabilities receive increased scrutiny for less than well capitalized institutions.

5. Conclusion

In order to put our findings in context, we conclude by answering the six questions posed by the FDIC.

4. *How have new methods of deposit gathering affected deposit stability and franchise value?*

New approaches to deposit gathering—in which we include deposit brokers, rate boards, reciprocal deposit services, the on-line channel, wealth managers, and the establishment of large scale high-rate deposit taking through branch channels in order to support disconnected asset businesses—have made the evaluation of deposit franchise value and stability far more complex.

It has become impossible to evaluate the quality of an institution's deposits based solely on its channel of marketing, origination, or service. As well, with the development of multi-channel institutions that offer on-line only products in addition to branch based products, many of the boundaries are blurring to the extent that they may eventually become meaningless.

5. *Should we recommend changes to the core and brokered deposit definitions and develop a new classification of deposits that depend on characteristics like relative stability or volatility?*

Deposit value has been demonstrated as a critical component of bank stability. However, we have demonstrated that the historical mechanisms to differentiate "high" and "low" quality deposits are insufficient. As a result, we suggest that the FDIC develop a more robust measure of deposit value that captures the true stability, volatility, and value components of an institution's deposits. We suggest that this future measure look to well-established measures of deposit characterization, for example, as represented in the Core Deposit Intangible calculation used when a depository is acquired as a guide.

Moving the industry in this direction would require a shift in information gathering and analysis for many institutions, so the final mechanism may require a graduated approach gauged to the size of the institution, with a simple, but characteristic-driven, substitute allowable at least for some institutions.

6. *Does the presence of certain kinds of deposits (e.g., brokered, internet, listing service) inherently increase an institution's risk? Does their presence facilitate increased risk taking?*

We do not believe that any specific type of deposit inherently increases an institution's risk. Rather, the lack of low-cost deposits that offer a discount to wholesale sources of funding can contribute to an institution's riskiness, or at least indicates an underlying business decision to focus primarily on the asset business. While these low-cost deposits are traditionally associated with branches, branches are also likely a large source of high-rate deposits for many institutions. As well, non-traditional channels such as wealth managers (through sweep deposits) and on-line banks (through increased promotion of checking products) are increasingly gathering low-cost deposits.

Brokered, internet, listing service and other mechanisms for quickly gathering FDIC-insured funding increase an institution's ability to fund risky assets. However, other sources of deposit funding—including high-rate but branch-based offerings—as well as sources of non-deposit funding serve the same purpose. As a result, restricting one source of funding without focusing on the root issues will not solve problems, but rather lead to new channels designed to skirt regulatory boundaries.

7. *What types of deposits are likely to enhance a failed institution's franchise value and which are likely to reduce it?*

Deposits that generate stand-alone "revenue" enhance the value of an institution; those that do not are far less likely to do so. A deposit can generate revenue in two ways:

- Providing the institution with below-market cost of funding (e.g., in the case of a checking account where the bank pays no interest, the value of the deposits is the

spread between zero and the market rate—such as LIBOR or rates on FHLB advances—for similar duration funding).
- Fees associated with the account (service fees, debit interchange, incident fees)

As a result, checking accounts (which provide low-cost funding and generate the majority of fees) and low-rate savings accounts generate substantial value. Higher rate products generate less value. In the current banking environment, it is not possible to make the distinction between high and low value deposits purely on the basis of channel of origination or type of account.

The most common estimation of deposit franchise value is conducted in the calculation of the Core Deposit Intangible at the point of acquisition of a depository. This calculation incorporates not only the revenue characteristics discussed above, but the physical cost of deposit gathering as well. A true measure of deposit value should incorporate the operating cost of gaining and serving the balances, which will differ dramatically across channels (typically in inverse to the deposit revenue).

8. What recommendations would you make for legislative or regulatory changes?

We recommend that the FDIC change its focus from brokered deposits to the underlying economic drivers of failure that are currently imperfectly proxied by brokered deposit metrics.

These factors are:
- Risky asset growth
- Low deposit revenue
- Reliance on "purchased funding" sources with no relationship component

We also recommend further data collection on new methods of obtaining deposits. Call Reports currently require reporting of three categories of brokered deposits: brokered deposits generally, insured brokered deposits, and reciprocal brokered deposits. Given the focus on this deposit channel, it seems worthwhile to improve data collection and thus future analysis on other channels such as the online-only channel, those placed through rate boards, and broker-dealer sweeps.

We also reiterate that our analysis suggests that the use of brokered deposits is not a question of funding stability, at least not in the "run on the bank" sense, as the FDIC has suggested. Any high rate source of funds is likely rate sensitive and may constrain a bank's ability to manage its liabilities strategy in ordinary times. But, banks approaching failure will gladly pay an increased rate on deposits to stave off failure, especially as that rate will be vastly lower than any rate available on the wholesale market. This is a result of the presence of deposit insurance which allows the bank to benefit from the FDIC's backing. It is the presence or absence of this insurance, however, that is the key determinant of funding stability near failure. This fact is recognized in the new Basel III

liquidity measures, and we recommend that any measures the FDIC implements in this area be consistent with other supervisory standards such as Basel III.

The reliance banks naturally place on insured deposits as failure approaches naturally leads into a consideration of DIF losses at failure. Here again, brokered deposits are not the correct distinction. This is recognized by the FDIC in its loss severity calculation, which focuses on the insured and secured distinctions, and we therefore recommend no changes in this area.

The FDIC has an additional tool to control the losses it may suffer at failure: restrictions on a bank's use of brokered deposits when it becomes less than well capitalized under Prompt Corrective Action. This too seems reasonable, especially if it is expanded to include all purchased funds. As a bank approaches failure, risk is slowly transferred from the bank's equity holders to its debt holders and finally to the FDIC. It is thus reasonable to grant the FDIC authority to control the extent to which a bank may increase its potential losses as failure becomes a more likely prospect.

9. *In times of financial stress, what types of deposits are likely to remain at an institution, and which to leave it?*

As we discuss above, the key determinant of deposit stability during stress is whether or not the deposit is FDIC insured. Quite simply, depositors trust the FDIC's over 75 year track record of resolving bank failures with zero losses to insured depositors.

We find no evidence that brokered deposits as a category represent an unstable source of funds for institutions under financial stress. In fact, given that they are typically fully insured, we find that they, along with other insured funds, often serve to replace the runoff of other uninsured and unsecured liabilities and thus in fact provide a stable source of funding. This of course must be controlled given the fact that it is the FDIC that is subsidizing this stability.

Appendix A. Summary of factors examined

Category	Factor
Liabilities strategy	Funding cost
	Deposit revenue contribution
	Non deposit funding cost
Funding source *Each item as a ratio to total liabilities.* *Deposit items also as a ratio to total deposits.* *Each item also measured as 1 and 2 year changes.*	Total deposits
	Retail deposits
	Domestic deposits
	Foreign deposits
	Estimated insured deposits
	Uninsured deposits
	Brokered deposits
	Reciprocal brokered deposits
	Fully insured brokered deposits
	Uninsured brokered deposits
	Fed funds purchased
	Repurchase agreements
	Trading liabilities
	Other borrowed funds
	Unsecured other borrowed funds
	Secured other borrowed funds
	Subordinated debt
	All other liabilities
	FHLB advances
	CDs > 1 yr
	Secured liabilities
	Purchased liabilities
Size	Total assets
	Total tier 1 capital (and 1 year and 2 year change)
Asset risk	Asset growth (1 year and 2 year)
	Risk weighted asset growth (1 year and 2 year)
	Tier 1 capital / assets (and 1 year and 2 year change)
	Tier 1 capital/ risk weighted assets (and 1 year and 2 year change)
Profitability	Return on equity (and 1 year and 2 year change)
	Return on assets (and 1 year and 2 year change)

OLIVER WYMAN

1166 Avenue of the Americas, 29th floor
New York, NY 10036
[redacted] (b)(6)

Attachment 2

Mark J. Flannery, Ph.D.

Data Driven Deposit Insurance Assessments

May 1, 2011

Data-Driven Deposit Insurance Assessments

Mark J. Flannery, Ph.D
Hough Graduate School of Business Administration
University of Florida
(b)(6)

First draft: March 4, 2011

This revision: May 1, 2011

Thanks to Promontory Interfinancial Network, LLC for providing some of the data underlying this analysis, and Atay Kizilaslan for research assistance.

Data-Driven Deposit Insurance Assessments

Executive Summary

FDIC seeks to set deposit insurance premia in proportion to the risks posed to the deposit insurance fund by insured depository institutions (IDIs). Ideally, risk-based insurance premia should correspond to FDIC's expected loss for each IDI, given its accounting information at the time premia are charged. If new risks can be identified in advance, risk-based insurance premia discourage risk-taking and should result in a more stable financial system. Although this concept is well-founded and desirable, identifying IDI risk exposures presents a very difficult empirical challenge. This paper uses the failure experience of 325 IDIs during 2008-2010 to estimate how an IDI's probability of failure and the FDIC's loss given a failure vary with prior accounting information.

The FDIC's risk exposure can be expressed as

$$EL_{it} = PD_{it} * LGD_{it}$$

where EL_{it} = expected loss from IDI_i, given its characteristics at time t.

PD_{it} = probability of default: the probability that IDI_i will fail during a specific time interval, given its characteristics at time t.

LGD_{it} = loss given default: FDIC's expected cost of resolving the i^{th} bank's failure via deposit payout, assisted merger, etc.

Ideally, each IDI's insurance premium should equal EL_{it}.

During the period 2008-2010, the mean values for PD (1.5%) and LGD (26.6% of total assets) are historically high, but close to the bank experience in the 1980s. Taken literally, these parameters imply that FDIC should charge an average annual insurance premium equal to roughly 40 basis points of total assets. In addition, future FDIC premia must re-capitalize the deposit insurance fund. By comparison, total FDIC premia collected in 2007 amounted to about 5 (2.9) basis points of assessable deposits (total assets) (FDIC (2007). At the same time, it must be recognized that the 2008-10 financial crisis was an extreme situation, and this period included an extraordinarily large number of failures. Accordingly, the estimated PDs probably overstate the failure propensities that should be used to set insurance premia in normal times.

Within the past few years, FDIC has introduced special treatment for brokered deposits in computing insurance premia, maintaining that this sort of funding increases IDI risks and raises FDIC resolutions costs:

> A number of costly institution failures, including some recent failures, involved rapid asset growth funded through brokered deposits. Moreover, the presence of brokered deposits in a failed institution tends to reduce its franchise value, resulting in increased losses to the Deposit Insurance Fund (DIF). (*Federal Register*, Vol. 76, No. 38 / Friday, February 25, 2011, page 10682).

In other words, the FDIC justifies higher insurance premia for brokered deposit on the grounds that such funding increases both PD and LGD.

In order to assess the statistical evidence about brokered deposits, this report pays particular attention to the liability side of insured firms' balance sheets. I find that reliable models of bank failure can be constructed to predict IDI failures up to three years in advance. Replacing core deposits with brokered deposit funding tends to raise an institution's default probability, but there is little evidence that brokered deposit growth, asset growth, or their combination substantially affects PD. Moreover, unlike the FDIC's current brokered deposit adjustment, the marginal probability of failure associated with brokered deposits is lower at higher levels of such funding.

The estimation results presented here provide no statistically significant evidence that brokered deposits affect estimated resolution costs (LGD). Neither does greater reliance on non-brokered, non-core funding significantly increase resolution costs.

Even if reported brokered deposits indicate higher default risk, a specific category of these deposits – reciprocal time deposits allocated through Promontory Interfinancial Network, LLC (CDARS) – arguably should be treated differently. These balances retain loanable funds in the originating bank, do not necessarily pay rates that reflect nationwide competition for "hot money", and enjoy a very high retention rate. When I incorporate CDARS balances into failure prediction models, the associated coefficients are generally indistinguishable from zero, meaning that the effects of CDARS deposits and core deposits are statistically indistinguishable. I conclude that CDARS have no significant effect on an IDI's PD. CDARS balances are also associated with substantially and significantly lower resolution costs (LGD).

Conclusions can be summarized as follows. IDI failures can be predicted up to two years in advance. Proper interpretation of the coefficients in prediction models requires care in specifying the model. The failure probability for an IDI increases significantly with its reliance on brokered deposits, although that funding source has no significant effect on the cost of resolving failed institutions. When I define asset growth as the two-year percentage change in total assets (without separating out the effects of mergers), there is some evidence that higher asset growth predicts failure. However, the interaction between asset and brokered deposit

growth influential —identifying IDIs with both of those features – does not significantly affect estimated PD. Unlike brokered deposits, reciprocal (CDARS) deposit balances do not affect an IDI's failure probability, suggesting that FDIC should reconsider its policy of treating reciprocal balances the same as brokered deposits when setting insurance premia.

However, these results should also be interpreted with an important proviso in mind: the implied impact of brokered deposits on failure probability is implausibly large, and asset categories – even those that were known to cause failures during the recent crisis – show little difference in their implications for IDI failure. This may reflect the fact that book asset values show little evidence of credit problems until an IDI is very close to failure. The prominence of brokered deposits in my failure prediction models may not indicate that brokered deposits are themselves risk; perhaps they are somehow correlated with certain types of asset expansion that were peculiar to the 2008-10 failures. In short, further research must be undertaken if FDIC is to use data-driven evidence to set risk-based insurance premia.

Data-Driven Deposit Insurance Assessments

Since implementation of the Federal Deposit Insurance Reform Conforming Amendments Act of 2005, FDIC has been free to assess risk-based insurance premia on insured depository institutions (IDIs).[1] The goal is to assess premia that reflect the Corporation's exposure to loss from each IDI. Losses include the funds paid out (net) to insured depositors and other claimants, plus the Corporation's cost of administering the failure. Appropriately, FDIC wishes to identify risk exposures when they first arise, rather than when their negative effects first impact a bank's performance.

Ignoring the FDIC's fixed administrative costs, the theoretically appropriate insurance premium for bank i is given by

$$\text{Premium} = EL_{it} = PD_{it} * LGD_{it} \quad (1)$$

where EL_{it} = expected loss from IDI_i, given its characteristics at time t.

PD_{it} = probability of default: the probability that IDI_i will fail during a specific time interval, given its characteristics at time t.

LGD_{it} = loss given default: FDIC's expected cost of resolving the i^{th} bank's failure via deposit payout, assisted merger, etc.

FDIC needs to identify indicators at time t that predict subsequent failures and losses. Applying the (unconditional) population means for PD and LGD from the 2008-10 period implies that

[1] Federal Deposit Insurance Reform [Conforming Amendments?]Act of 2005, § 2102, Pub. L. No.109-171, 120 Stat. 9.

$$\text{Premium} = EL_{it} = 1.5\% * 26.6\% = .399\%.$$

That is, the recent three years' experience implies an annual FDIC insurance premium equal to about 40 basis points of the banking system's total assets.[2] Recognizing the need to restore the DIF to a prudent level would make average premia even higher.

The insurance premium rules adopted on April 1, 2011 include plans to raise premia when the designated reserve ratio (DRR) is below 1.15% and to lower premia when it exceeds 2%.[3] That documents says that an average "long-term moderate" insurance assessment of 5.3 basis points would "maintain a positive fund balance throughout past crises." (FDIC 2011, page 6).

While conceptually clear, assigning appropriate risk-based premia to IDIs (or to categories of IDIs) is a daunting empirical challenge. In this report, I estimate appropriate insurance premia in two steps:

1) A probit model that predicts failures during the 2008-10 period using Call Report-TFR information from 1, 2, or 3 years preceding the failure year.
2) A regression model that estimates LGD as a function of the failed IDI's asset and liability composition one or two years prior to failure.

Combining the output of these two models, one can estimate expected losses for an IDI with given balance sheet characteristics. Given the Corporation's current focus on brokered deposits, the models estimated here pay special attention to noncore funding sources.[4]

---

[2] Some might conjecture that the 26.6% loss on reported bank assets is unusually large, reflecting the special financial market circumstances that characterized the 2008-10 period. However, James (1991) reports that an average loss of 30% of failed banks' assets on 791 bank failures between 1985 and mid-1988.

[3] The DRR is defined as the ratio the deposit insurance fund's value to insured deposit balances.

[4] For example, the FDIC recently has asserted that brokered deposits and secured liabilities tend to increase the cost of resolving a failure: "The FDIC believes that heavy reliance on secured liabilities or other types of noncore

Failure probabilities are difficult to estimate for several reasons. To begin with, bank failures were infrequent before late 2008. Only 36 banks failed between 1995 and the end of 2007. With a bank and thrift population of nearly 8,000 in recent years, the incidence of failure has been microscopic.[5] The more recent years have included a substantial number of IDI failures: 25 failed in 2008, 140 in 2009, 157 in 2010, and 39 to date in 2011. While these events provide an opportunity to identify the cause(s) of failure, they are unlikely to represent future probabilities perfectly because so many problems derived from the real estate loans that played such a large part in the financial crisis. We therefore have rather few distinct examples of IDI failure and LGD. Second, the identification of failed firms is incomplete. We observe failures administered by the FDIC, but cannot accurately identify failing institutions that are taken over by a strong acquirer, perhaps following regulatory encouragement.[6] It is difficult to distinguish ex ante between weak firms that will be acquired and those that will fail at some cost to the FDIC. Third, IDI failures may not be identified in a timely manner, particularly if the pace of failure resolutions is limited by the Corporation's available manpower. The observed set of IDI "failures" in any time interval probably excludes firms that are already identified as likely to fail eventually. This makes it difficult to find systematic relationships between an IDI's current condition and its potential future failure. Finally, some of the key variables used to identify weak or risky firms may not be reliably reported. For example, book equity capital substantially exceeds its mark-to-market value at troubled firms, and the integrity of some reported data – specifically brokered deposits – is questionable.

---

funding reduces an IDI's potential franchise value, thereby increasing the FDIC's potential loss in the event of failure." (FDIC (2010), page 72618).

[5] The IDI failure rate in 2008-10 was about 1.5%. Commercial bank failures last exceeded this proportion of the population in 1987-89.

[6] FDIC might be able to identify "failures" avoided by private merger, but this information is not available outside the regulatory agencies.

Setting appropriate risk-based insurance premia also requires estimating a statistical relationship between an IDI's current condition and the cost of resolving its failure, should failure occur. Promontory Interfinancial Network, LLC has provided me with estimated loss data for 325 failures that occurred in 2007-2010.[7] These losses can be regressed on the failed firms' balance sheet conditions one or two years preceding failure.

I. Model Specifications – General Principles

This paper uses IDI balance sheet information to estimate the two statistical models required to compute data-based, fair deposit insurance premia: a probit model of failure probability and a regression model of estimated losses given default. Both empirical models must include (nearly) all of a firm's balance sheet components in order to yield reliable estimates of how particular components influence FDIC's expected loss. The next section discusses this requirement in terms of the probit failure model, but identical considerations apply to a regression model of losses.

A. Omitting Balance Sheet Components

It is common to estimate a probit model predicting IDI failure as a function of (inter alia) the firm's equity ratio, liability shares, and assets shares. Consider a hypothetical firm with the following balance sheet, in which each variable is expressed as a *percentage of total assets*.

Assets	**Liabilities**
Cash (C)	Core Deposits (CORE)
Securities (S)	Noncore Deposits (NC)
Loans (L)	Equity Capital (EQ)

[7] An FDIC press release announcing a failure generally includes an estimate of the Corporation's expected resolution cost.

Because balance sheet accounting requires that a change in one asset or liability share be offset by a change in at least one other share, omitting more than one balance sheet share makes it impossible to interpret the estimated coefficients (probabilities) properly. To see this, suppose we estimate

$$\Pr(\text{failure}) = \Omega(\alpha 0 + \alpha 1\ \text{CORE}_{it}) \tag{2}$$

It is tempting to interpret $\widehat{\alpha 1}$ as the effect on failure probability of an increase in core deposit funding. But a higher CORE is only part of the IDI's balance sheet change. If higher core deposits are offset by a reduction in NC deposits, $\widehat{\alpha 1}$ measures the impact of liability-composition on PD. If, instead, higher CORE is offset by a reduction in EQ, $\widehat{\alpha 1}$ measures the impact of a change in IDI leverage. An increase in CORE could also be accompanied by a rise in one or more asset categories, again increasing leverage. Within a sample, the offsetting changes associated with a rise in CORE will vary across IDIs, and $\widehat{\alpha 1}$ will measure the mean effect of sample IDIs' changes – not simply the effect of higher or lower CORE funding. In order to interpret the resulting coefficients and marginal probabilities, all the IDI's balance sheet ratios (except one) must be included among the model's explanatory variables. Yet the asset shares (C + S + L) sum to unity, as do the liability shares (CORE + NC + EQ), so at least one asset or liability share must be omitted from the any regression to avoid singularity.[8] Without explicitly

[8] Suppose we wish to determine the impact of core deposits on this firm's risk by including the Core Deposits variable in a probit model predicting IDI failures. If this is the only explanatory variable from the balance sheet, its coefficient cannot be clearly interpreted. The coefficient on Core Deposits indicates the impact on PD of a change (say 10% of TA) in Core Deposits. Unfortunately, the change in Core Deposits is only part of the effect: some other balance sheet component must change at the same time, but the regression has no way to determine which one(s). The impact of higher Core Deposits almost surely depends on which other component(s) of the balance sheet changes when Core Deposits rise. If Core Deposits rose because equity was falling, a higher PD seems likely. If Core Deposits rose and the proceeds were invested in Treasury bonds, a lower PD seems likely.

controlling for all balance sheet proportions except one, a probit model's estimated coefficients do not correspond to any particular sort of balance sheet change. When a single balance sheet proportion is omitted from the regression, the resulting coefficients must be interpreted in terms of the omitted asset or liability share.

Instead of (2), we should estimate something like

$$\Pr(\text{failure}) = \Omega(\beta 1\ C + \beta 2\ S + \beta 3\ L + \beta 4\ \text{CORE} + \beta 5\ \text{NC}) \tag{3}$$

Each coefficient in (3) measures how a change in the associated balance sheet share affects the probability of failure. Because only EQ is excluded from the regression, a change in an included balance sheet share implies an offsetting change in EQ. The coefficient $\beta 5$ therefore measures the impact on failure probability of raising non-core deposit funds and retiring a like amount of equity. Thus leverage rises with NC, and we'd expect a large positive coefficient ($\beta 5$) in (3). If instead of (3) we omit CORE and include EQ among the explanatory variables, we get the model[9]

$$\Pr(\text{failure}) = \Omega\ (\gamma 1\ C + \gamma 2\ S + \gamma 3\ L + \gamma 4\ \text{NC} + \gamma 5\ \text{EQ}) \tag{4}$$

Now, the coefficient $\gamma 4$ measures the effect of a change in NC accompanied by an offsetting change in CORE, with no change in leverage. The impact of NC therefore reflects only the differential failure-related effects of NC vs. CORE funding.

[9] Of course, other explanatory variables can, and should, be added to the specifications shown in (1) and (2). But the basic principle in such regressions is that the explanatory variables must include all balance sheet components, except one.

Table 1 illustrates the importance of these specification issues by reporting estimated probit models like (3) or (4) with alternative balance sheet ratios omitted. The financial data are taken from the year-end preceding the failure prediction interval. Column (1) omits the IDI's equity ratio, so coefficients on the liability shares measure the impact on failure probability of simultaneously changing the liability composition *and* leverage (EQ). Column (2) omits CORE from the specification, so the estimated liability coefficients indicate the impact of re-arranging funding sources, holding leverage constant.[10] The coefficients on asset proportions and the control variables are not reported in Table 1 in order to focus on the implications of model specification on the liability coefficients.

When EQ is omitted from the regression, Brokered Deposits (BD) carry a significantly positive coefficient, which indicates that a 10% increase in this funding source (e.g., from 10% to 20% of total assets) raises PD by a statistically significant 3.7 basis points. (Similarly, the 0.34 coefficient on nonbrokered, NC implies that a 10% point change in this funding source raises the default probability by a statistically significant 3.4 basis points.) Does this effect reflect some risk associated with BD? Not necessarily. Because EQ is omitted from this regression specification, a change in BD funding implies an offsetting change in the equity account. If BDs rise, EQ falls. A more levered IDI is more likely to default, almost regardless of its funding sources. Indeed, the leverage effect is likely to dominate. The coefficient on BD (0.37) thus reflects the combined effect on failure of a leverage change and a change in liability composition. In the same regression, we see that a 10% change in Core Deposit funding <u>also</u> raises failure probability, in this case by a statistically significant 3.2 basis points. Similar coefficients are associated with other liabilities. In short, <u>any</u> increase in liabilities that is

[10] When FDIC discusses brokered deposits (as in its NPR of 11/24/10), it asks what premium is appropriate for IDIs funding with noncore (including brokered) deposits, relative to what is charged for core deposits.

accompanied by a change in leverage significantly raises failure probability. Brokered deposits are not so special after all!

The leverage effect is excluded from the coefficients reported in column (2) of Table 1, which return EQ to the specification and omit CORE. These estimated coefficients are much smaller than those in column (1). Replacing 10% of CORE deposits with another type of other liability changes the IDI's default probability by 0.1 – 0.3 basis points. Why? Because the specification in column (2) does not change the firm's leverage, which (quite apparently) has a large effect on the typical IDI's failure probability.

B. Failure during Which Time Interval?

Any regression estimating failure probabilities must identify the time interval within which failure might occur. If the connection between financial variables and failure were tight and quick, one might use quarter-end data to predict failures during the subsequent quarter. But such a narrow window would exclude many firms that might eventually fail two of more quarters later. The other extreme – predicting failures over an infinite future – is also problematic because current financials may reflect nothing about failure in the far-distant future.

In this report, I take two complementary approaches to this timing problem, by varying both the "failure interval" and the "forecasting horizon." First, I predict failures during a single-year interval using data from one, two or three years preceding the prediction year. I estimate a probit model predicting failure in the first, second, or third year following the firm's observed financial information. Specifically,

- The "1-year ahead" probit model predicts failures during 2008 (2009, 2010) with data from yearend 2007 (2008, 2009)
- The "2-year ahead" probit model predicts failures during 2008 (2009, 2010) with data from yearend 2006 (2007, 2008)

- The "3-year ahead" probit model predicts failures during 2008 (2009, 2010) with data from yearend 2005 (2006, 2007)

For each forecasting horizon, the three failure-interval results are estimated within a single regression.

Note that this "one year failure interval" specification imposes a specific lag between an IDI's financial condition and the year of its failure. It may be more appropriate to use Call Report and TFR information to predict failures "in the near future," without being so restrictive about the exact time. I therefore estimate a second set of probit models to predict failures that occur any time during the 2008-2010 period, based on financial data from the end of 2005, 2006, or 2007.

Somewhat surprisingly, these two methods yield very similar conclusions about the balance sheet determinants of IDI failure. Less surprisingly, both approaches also indicate that it is easier to predict failures closer to the failure's date.

C. Estimating FDIC's Loss Given Default (LGD)

The expected losses in equation (1) require estimated costs of resolving failed IDIs, in addition to estimated default probabilities (PD). To determine the impact of balance sheet composition on LGD, I use the FDIC's initial loss estimates for 325 IDIs that failed during 2007-10. A regression model explains those losses (as a percentage of total assets at failure) using the failed firm's balance sheet information from approximately one or two years preceding failure.[11] As for the probit models, one asset or liability share must be omitted from these estimated loss regressions, and the estimated coefficients must be interpreted in terms of the

[11] The failed IDIs' characteristics are taken from the fourth and eighth quarter ends prior to failure.

omitted share. For example, if we estimate a regression that includes all balance sheet shares except CORE[12]

$$\text{Estimated loss} \equiv \text{LGD} = \lambda 1\ \text{C} + \lambda 2\ \text{S} + \lambda 3\ \text{L} + \lambda 4\ \text{NC} + \lambda 5\ \text{EQ} + \tilde{\varepsilon} \tag{5}$$

the estimated λ4 would indicate whether NC deposits are associated with higher or lower resolution costs than are the omitted CORE deposit balances.

D. Computing Data-Driven Insurance Premia

With estimated models for PD and LGD, we can evaluate the impact on FDIC's expected loss of a change in one of the balance sheet ratios, "X":

$$\frac{\partial EL}{\partial X} = \frac{\partial PD}{\partial X} LGD + PD \frac{\partial LGD}{\partial X} \tag{6}$$

The probit model (like (4)) estimates the effect of alternative balance sheet proportions on failure probability ($\frac{\partial EL}{\partial X}$). The coefficients from (5) provide estimated values for ($\frac{\partial LGD}{\partial X}$). I am particularly concerned with any differential effects of CORE vs. NC funding on the risk exposure.

II. Estimating PD with Probit Models

The general probit model is specified as:

$$\Pr(\text{failure}_{i\tau}) = \Omega(\sum_{j=1}^{J} a_j (A_{ijt} / TA_{it}) + \sum_{k=1}^{K} b_k (L_{kit} / TA_{it}) + \gamma Z_{it}) \tag{7}$$

where $\text{failure}_{i\tau}$ = unity if the j^{th} IDI fails during period $t+\tau$, otherwise zero.

TA_{it} = total assets of the i^{th} IDI at time t.

[12] As for the probit results in Table 1, the coefficients in the estimated loss regression must be interpreted in terms of the omitted balance sheet variable.

L_{ikt} is the k^{th} type of liability held by IDI i at the end of period t.

A_{ijt} is the j^{th} type of asset held by IDI ij at the end of period t.

Z_{it} is a set of other variables (noncurrent loans, asset growth, IDI size, charter type) that might affect the probability of default in year $t+\tau$.

Data were obtained from the bank Call Reports and Thrift Financial Reports, and provided to me by Promontory Interfinancial Network, LLC. Table 2 presents summary statistics for the set of asset and liability shares used in (7), and these variables are defined in Appendix A.

Some of the control variables (Z_{it}) are worth discussing in some detail. I use noncurrent loans as an indicator of asset quality, and the loan loss allowance (LLA) is one element of the balance sheet. However, bank accounting is notoriously slow to recognize developing problems and I am concerned that asset value changes are not generally recognized until very close to an IDI's failure. I also include four variables to capture possible interactions between asset growth and the growth of brokered deposits, which seems to be a major concern of FDIC policymakers. These include the asset growth rate, the brokered deposit growth rate, and two interaction terms: the produce of the level of brokered deposits and the asset growth rate, and the product of the brokered deposit and asset growth rates. The last variable is particularly related to the concern that asset growth funded by brokered deposits raises IDI risk.[13]

Because of the attention recently paid to brokered deposit balances in setting risk-based FDIC insurance premia,[14] I provide some summary information about this funding source. Of the dataset's 231,024 IDI-quarters, 85,312 (36.9%) report positive brokered deposit balances. Of

[13] FDIC has regularly expressed concern about the risk implications of rapid asset growth – particularly funded by brokered deposits. Beginning in February 2009, risk-based premium assessments have included a "brokered deposit adjustment" defined by the level of brokered deposits, with no reference to their growth.

[14] "[T]he FDIC remains concerned that significant reliance on brokered deposits tends to increase an institution's risk profile, particularly as its financial condition weakens." (*Federal Register*, February 25, 2011, page 10682).

these, the mean (median) value of brokered deposits is $171.5 million ($9.7 million), or 8.39 (4.73%) of total assets. Figure 1 provides a histogram of BD balances as a proportion of total assets, for the set of nonzero reports. Relatively few IDIs rely heavily on brokered deposits funding: only 23,351 (27.4%) of the IDI-quarters with positive BD fund more than 10% of their assets from this source. 8,793 (10.3%) of the positive BD ratios exceed 20%. Still, a few institutions finance very large proportions of their assets with brokered deposits. It will be important to capture this range of BD usage in probit models.

Table 3 reports probit model results for estimating IDI failure probabilities within a single calendar year using year-end data from 1, 2, or 3 years earlier. For each time lag, I report two specifications. The first (leftmost) three columns of Table 3 estimate failure during a single year (2008, 2009 or 2010) using financial data from December of one, two, or three years earlier.

The effect of BD is shown in the first four rows, which permit various concentrations of BD to have distinct effects on failure probability. An IDI's use of BD is positively and significantly associated with failure probability two and three years before the failure year, but not for the one-year forecasting horizon.[15] For example, replacing 10% of core deposits with brokered deposits raises an IDI's default probability two years later by about 11 basis points (= 10% of 0.11). At the three year forecasting horizon, a 10% increase in BD raises default probability by 19 basis points (= 10% of 0.19). However, the impact of BD on failure probability does not increase with greater BD concentrations. Table 4 reports the total effect of BD, reflecting all the BD-related coefficients in Table 3. For the 2- and 3-year forecast horizons, the effect of BD on PD is smaller at higher BD concentrations. At the 1-year horizon, BD has no significant effect at lower levels (below 10%), but the BD coefficient becomes statistically

[15] An unreported model predicts failures for a 1-quarter failure interval with a 1-quarter forecasting horizon. (In other words, we use end-of-quarter t data to predict failure in the subsequent quarter.) Like the 1-year forecasting horizon in Table 3, the coefficients on brokered deposits are all indistinguishable from zero.

positive when it is used to fund 10-25% or 25-50% of an IDI's total assets. Table 3 reports that replacing core deposits with nonbrokered, noncore deposits or FHLB advances also increases failure probability, but the effects are smaller than those of BD. Note that the model's pseudo-R^2 statistic increases as the forecasting horizon shortens.[16] Surprisingly, the three-year-ahead forecasts explain nearly as much of the failure variation (pseudo-R^2 = 0.176) as the two-year ahead forecasts (pseudo-R^2 = 0.233). The one-year ahead forecasts are dramatically more informative (pseudo-R^2 = 0.567). This pattern in the models' explanatory power is typical of the various specifications I ran, but do not report.

The results of estimating three-year failure probability models are presented in the right half of Table 3. Note that one must divide the reported failure probabilities by three to make them comparable to the one-year probabilities reported in the left half of Table 3. The estimation results for the 3-year failure intervals in Table 4 are remarkably consistent with those for the one-year interval (in Table 3). We see again that the regression's pseudo-R^2 falls as the forecasting horizon lengthens. BD significantly predicts failure, and this effect is now significant at all three forecasting horizons.

The asset coefficients in Table 3 generally indicate that higher proportions of most asset categories tend to reduce failure probability when these marginal assets are funded with CORE deposits. In other words, the expected profit margin associated with funding assets with CORE deposits more than offsets the leverage effect of increasing both an asset and a liability category.[17] The obvious exception is Other Real Estate Owned (OREO), which makes failure

[16] The pseudo-R^2 is computed as $(1-LLR_{full} / LLR_{constant})$, where LLR_{full} is the log likelihood function value for the full model (as shown in Table 3) and $LLR_{constant}$ is the log likelihood value from a model that includes only a constant (intercept) term.

[17] Replacing Total Loans with three components (C&I Loans, Commercial Real Estate, and Other Loans) has no effect on the reported coefficients, and the three components have significant coefficients very close to the one reported for Total Loans.

more likely – although this effect is not generally statistically significant. The ratio of noncurrent loans to total assets is significantly positively correlated with default probability at all forecasting horizons. Controlling for asset composition, we also see that asset size (Ln (Assets)) has a small but significantly positive effect on failure probability. (Omitting this variable affects the size and significance of several other explanatory variables.)

Table 3 includes four variables that capture an IDI's asset growth, brokered deposit growth, and their interaction. Asset growth is generally associated with significantly higher PD, but this effect is generally unrelated to the level of brokered deposits.[18] The trailing, two-year growth of brokered deposits is unrelated to failure probability. The evidence on the interaction between asset and brokered deposit growth is mixed, with two significant coefficients and four insignificant. Overall, the evidence that brokered deposits permit injudicious asset growth is not strongly supported by the coefficients on these variables.

III. Estimating LGD with a Linear Regression Model

Upon accepting responsibility for a failed IDI resolution, the FDIC estimates how much it will cost to resolve the failure. These estimates are provided in the news release announcing an IDI's closure, and were collected for me by Promontory Interfinancial Network, LLC. I thus have estimated loss information ($Loss_i$) on 325 IDI failures during the 2007-10 period and estimate linear regressions of the form[19]

$$Loss_i = \sum_{j=1}^{J} a_j(A_{jit}/TA_{it}) + \sum_{k=1}^{K} b_k(L_{kit}/TA_{it}) + \gamma Z_{it} + \widetilde{\varepsilon_{it}} \quad (8)$$

[18] Asset growth is measured as the percentage change in on-book total assets over the prior two years' Call Report dates. When the forecasting data come from December 2005, the growth rate is over the preceding seven quarters because the dataset starts in 2004-I.

[19] Only three of these failures occurred in 2007. The loss data therefore overlap almost completely with the failures in the probit samples underlying Tables 3 and 4. I omitted the Washington Mutual failure from the loss regression, because it had zero estimated resolution costs. Missing variable values also reduced the number of observations slightly in some of the regressions reported in Table 5.

where $Loss_i$ is the FDIC's estimate of its loss in resolving the failure of IDI_i, expressed as a proportion of its total assets at failure. The explanatory variables in (8) generally coincide with those in (7) above, and are defined in Appendix A. Note that the mean (median) loss in Table 2 is quite substantial – 26.6% (26.1%) of total assets. FDIC contends that noncore funding – including brokered deposits, large deposits, and secured liabilities – raises the Corporation's LGD by reducing a failed IDI's franchise value. Estimating a regression like (8) provides empirical evidence about this claim.

The results from estimating (8) are reported in Table 5, using data from approximately one or two years prior to the failure date. Considering first the one-year-ahead failure estimates, note that the regression's $\overline{R^2}$ is very high: 86%. One year ahead of failure, BD balances up to 10% of assets have a negative, but insignificant, effect on estimation resolution losses. Larger BD funding proportions tend to move this effect closer to zero, and the first four rows of Table 5 indicate that no level of BD has a statistical effect on losses. (Results for coefficient sums are not tabulated.) No other liability category affects losses at the one-year horizon. On the asset side, cash and other assets have no effect on losses, but the other asset categories raise losses by statistically significant amounts. Losses are significantly higher for smaller IDI.

The next four rows report estimated coefficients for asset and brokered deposit growth rates. More rapid asset growth raises resolution costs, and this effect is more substantial when the IDI has higher brokered deposits at the time of its failure. Brokered deposit growth also raises resolution costs, but a casual inspection of the time series leading to failure suggests that brokered deposits generally decline in the last few quarters before failure. Most strikingly, the interaction of asset and brokered deposit growth carries a very significant negative coefficient. The charter class categories at the bottom of Table 5 provide some interesting results. IDI

overseen by FDIC (NM – "nonmember"), OTS (SA – "savings association"), and Federal Reserve (SM – "state member") cost significantly more to resolve than IDIs overseen by the OCC (Office of the Comptroller of the Currency). These effects may reflect something about the quality of supervisory oversight or the nature of IDIs supervised by the various regulators.[20]

Estimation results for the two-year forecasting horizon in Table 5 maintain a high explanatory power ($\overline{R^2}$ = 85.1%), indicating that losses can be forecasted equally well with a longer lead time. (In contrast, recall that the failure models' explanatory power improved substantially between the two-year and the one-year horizons.) BD again shows no significant effect on losses, regardless of its level. (Results for coefficient sums are not tabulated.) FHLB advances now carry a (marginally) significant negative coefficient, indicating that FDIC benefits from FHLB lending (despite its senior claim), presumably because the collateral underlying FHLB advances is valuable. Asset growth continues to be associated significantly with higher FDIC losses, but the effects of BD growth and the interactions between BD and asset growth are now statistically insignificant. Effects of the other balance sheet categories are similar to those for the one-year forecast horizon.

IV. The Effects of BD funding on Risk-Based Insurance Premia

The unconditional failure probability and LGD from 2008-10 imply that the appropriate average risk-based insurance premium for that period would have been (with hindsight) about 40 basis points of total assets (= (1.5% PD)(26.6% LGD)). This premium level far exceeded the amount actually collected in 2007, which totaled about 5 (2.9) basis points of assessable deposits (total assets) (FDIC (2007), page 74). If future LGD is expected to remain at this level – as evidence from the 1980s suggests it might – implied insurance premia could be very large by

[20] Unlike these regulatory effects on LGD, Table 3 indicates little variation across regulators in PD.

historical standards. In addition to covering expected losses (as in equation (1), FDIC premia must also cover the Corporation's fixed administrative expenses. Furthermore, the recent depletion of the DIF requires premium income beyond expected losses, to rebuild the fund. The PD estimates I have generated are thus most relevant in setting relative premia (e.g., how much should an IDI's premium change if it replaces one sort of funding with another?)

Equation (6) implies that the impact of BD funding on FDIC's expected loss for an insured IDI is

$$\frac{\partial EL}{\partial BD} dBD = (LGD \frac{\partial PD}{\partial BD} + PD \frac{\partial LGD}{\partial BD}) dBD \quad (6)$$

Because Table 5 indicates no significant effect of BD on LGD, this simplifies to

$$\frac{\partial EL}{\partial BD} dBD = LGD \frac{\partial PD}{\partial BD} dBD \quad (8)$$

We can then compute the fair insurance premium increment for a 10 percentage point increase in BD funding that replaces CORE funding. Averaging across all the BD coefficients in Table 4 (after dividing the three-year failure probability coefficients by three) yields the estimated $\frac{\partial PD}{\partial BD}$ values shown in the middle column of this table:

Range of BD / TA	$\frac{\partial PD}{\partial BD}$
0 < BD < 10%	0.13
10% < BD < 25%	0.08
25% < BD < 50%	0.06
BD > 50%	0.04

The marginal effect of BD financing declines with its amount. For example, increasing BD from 0 to 10% raises failure probability by 1.3%.[21] Increasing BD from 10 to 20% raises failure

[21] The average value of $\frac{\partial PD}{\partial BD}$ measures the change in default probability for a 100% change in the associated liability category. The PD effect of a 10%-of-assets change in BD is obtained by multiplying the indicated $\frac{\partial PD}{\partial BD}$ values by 0.10.

probability by only 0.8%. Compared to an unconditional failure probability during this period of 1.5%, these marginal effects seem implausibly large! Could introduction of 10% BD funding really raise an IDI's default probability by 1.3% even controlling for asset growth, portfolio composition, and loan quality?[22] This seems most unlikely, and suggests a problem with either the data or the failure model. One possible cause is that the asset data do not reflect potential losses until examiners require that problem assets be written down. If this does not occur until shortly before failure, the asset data cannot provide any information about potential failures, even if asset quality is the ultimate cause of failure.

V. Effect of CDARS on Failure Probabilities

The FDIC first introduced a "brokered deposit adjustment" to risk-based insurance premia in/on February 2009. Institutions with brokered deposits in excess of 10% of total domestic deposits were assessed a 25 basis points premium on those excess brokered balances, up to a maximum premium increase of 10 basis points of the total assessment base. Initially, FDIC distinguished between reciprocal deposit balances (placed through services such as Promontory's CDARS Reciprocal) and other sorts of brokered deposits.[23] The most recent (April 1, 2011) insurance assessment rules no longer exempt reciprocal deposits from the "brokered" category, but well-capitalized and highly rated (CAMELS = 1 or 2) institutions are

[22] If the piecewise linear specification here is replaced with a quadratic specification, the implied effects of BD on PD are slightly smaller, but still implausibly large.

[23] "The final rule introduces a new financial ratio into the financial ratios method. This new ratio will capture certain brokered deposits (in excess of 10 percent of domestic deposits) that are used to fund rapid asset growth. The new financial ratio in the final rule differs from the one proposed in the NPR in two ways. It excludes deposits that an insured depository institution receives through a deposit placement network on a reciprocal basis, such that: (1) for any deposit received, the institution (as agent for depositors) places the same amount with other insured depository institutions through the network; and (2) each member of the network sets the interest rate to be paid on the entire amount of funds it places with other network members (henceforth referred to as reciprocal deposits)."

now exempt from the brokered deposit adjustment (*Federal Register*, February 25, 2011, page 10682). This rule change makes it particularly interesting to test whether reciprocal deposits affect failure probabilities or LGDs in the same way as brokered deposits do.

In this section, I describe reciprocal CDARS and the data provided by Promontory, and then incorporate CDARS into the probit and LGD models estimated above.

A. What are CDARS Reciprocal Balances?

Promontory Interfinancial Network, LLC operates CDARS, the Certificate of Deposit Account Registry Service which facilitates the placement of CD deposits by participating institutions at other participating institutions in increments below the FDIC insurance limit. For example, suppose that "Bank 1" has a customer wishing to deposit $900,000 in multiple banks, so that her entire investment is FDIC insured. The Bank 1 banker and the customer negotiate an acceptable maturity and interest rate for the entire balance. Bank 1 contacts Promontory to request that other member banks each accept a deposit from Bank 1's customer at the agreed interest rate. In turn, through CDARS Reciprocal, Bank 1 will receive $900,000 in deposits (of the same maturity) from the customers of other Network banks. If the rate negotiated by Bank 1 for the CDs it placed for its customer differs from the average rate it is required to pay on the funds placed with it through CDARS, the present value of the difference in interest payments is exchanged between the participating institutions when the transaction is booked.

Several features distinguish CDARS Reciprocal deposits from other types of brokered deposit solicitations. First, "Bank 1" negotiates a deposit rate that becomes its own effective cost of $900,000 in new deposit balances. The banker therefore pays a rate that reflects local market competition, not necessarily the nationwide competition that is accessible through traditional deposit brokers or over the Internet. Second, "Bank 1" receives a deposit inflow equal to the

initial customer's full $900,000. Loanable funds can thus remain in the community from which they originate, provided there is demand for them. Finally, the initial customer interacts only with "Bank 1" and receives the convenience of a single statement (and tax reporting). The depositing customer might be entirely new to "Bank 1", which therefore has an opportunity to cross-sell other services. Alternatively, a bank can use CDARS transactions to strengthen its relationship with pre-existing customers. These balances tend to be renewed with high probability and Promontory has argued that reciprocal CDARS balances are a more stable source of funding than other sorts of brokered deposits.

B. CDARS Data

Promontory Interfinancial Network, LLC allocates funds among approximately 3,000 member-IDIs wishing to place large customer balances. Promontory provided confidential data on CDARS Reciprocal deposit holdings for all banks and thrifts at quarter ends from 2003-I through 2010-III. Promontory restricts the IDIs with which it will deal, and not all of the (approximately 3,000) qualified IDIs hold CDARS balances at all times. Out of 228,188 bank-quarters in the dataset, 30,613 bank-dates have non-zero CDARS. The IDIs with non-zero CDARS balances hold an average of $13.1 million each, or 2.95% of their total assets. As of September 30, 2010 Promontory reports approximately 1,844 IDIs with reciprocal CDARS balances. The average institution held $17.4 million in CDARS, or 3.16% of total assets. Figure 2 provides a histogram illustrating the concentration of CDARS balances at IDIs holding reciprocal balances on September 30, 2010. High CDARS concentrations are much less frequent than form reported BD, shown in Figure 1. 1,493 (81%) of the CDARS banks were funding less than 5% of their assets from this source. Only 121 (8.1%) funded more than 10% of total assets from this source, and only 31 (2.1%) funded more than 20%. In the regressions below, I

construct dummy variables that interact with CDARS funding proportions, permitting the effect of CDARS balances on PD and LGD to vary with the extent of CDARS funding.

The reported CDARS balances are sometimes inconsistent with the BD balances reported on the Call Reports or Thrift Financial Reports, calling into question the accuracy of reported brokered deposits. Specifically, 4,030 (13.16%) of the bank-quarters with CDARS balances report smaller BD than the CDARS balances Promontory records for them. It does not seem likely that this reflects the FDIC's initial classification of reciprocal deposits as not "brokered", because these data inconsistencies occur throughout the sample period. Perhaps these entries represent some ambiguity in the instructions for reporting brokered deposits. With the information available to me, I cannot infer exactly how each bank reported its CDARS balances. Accordingly, I incorporated the CDARS into the Call/TFR database in two alternative ways. (Of course, neither data treatment should be expected to eliminate all data errors in reported BD.)

A) I assumed that all IDIs reported CDARS as non-brokered deposits. I subtracted CDARS balances from core deposits and introduced CDARS (as a proportion of total assets) as explanatory variables to the PD and LGD regressions. Reported BD were not adjusted. This method tends to overstate BD and to understate CORE if some CDARS balance should be recorded as BD.

B) I assumed that CDARS were included in reported brokered deposits except for the 4,030 bank-dates for which CDARS > DEP_BD. I omit these 4,030 from the analysis, subtract CDARS from DEP_BD for the remaining 26,583 bank-dates, and then introduce reported CDARS balances (as a proportion of total assets) as explanatory variables to the PD and LGD regressions. This method tends to understate BD and overstate CDARS if some CDARS balance should be reported as BD.

The coefficients on the CDARS variables measure the effect of raising CDARS while reducing CORE deposit funding.

C. Results

Table 6 reports the effect of adding CDARS variables to the explanatory variables in the PD (probit) regressions reported in the left half of Table 3. Table 6 reports two regressions for each forecasting horizon, which differ in the treatment of CDARS and BD data. The liability coefficients – including those on BD and its interaction terms -- are very similar to those estimated in the left half of Table 3. (The results corresponding to Table 4 are not reported.) The new information in Table 6 concerns the CDARS variable and its interaction with two dummy variables indicating two high levels of CDARS funding, 10-20% of total assets and more than 20%. In the 1- and 2-year forecasting horizon equations, the dummy for CDARS balances exceeding 20% of assets equals zero for all failed banks. Accordingly, there are no estimates of this variable's coefficients. The estimated coefficients on all CDARS variables are insignificant, indicating the absence of any relation between CDARS and subsequent default probabilities. Panel B of Table 6 indicates that combining the CDARS coefficients with its interactions' coefficients also yields statistically insignificant effects in nearly all cases. The two significantly positive coefficients on CDARS both rely on the "B" method of reconciling BD and CDARS data. These results may therefore reflect an inappropriate attribution of BD balances to the measured CDARS data.

Table 7 reports three-year probability estimates analogous to those in the right half of Table 3. (Recall that these probability estimates must be divided by three to give an annual default probability.) The missing ("na") coefficients for CDARS interacted in Table 7 the absence of CDARS balances in the indicated ranges for any banks that failed. When CDARS

provides less than 10% of an institution's funding, the extent of this funding is not generally related to failure. The most obvious exception occurs in the "Method A", 2-year horizon regression, which indicates that the three-year failure probability is significantly negatively related to CDARS balances in the [0, 10%] range. A second significant effect of CDARS occurs in the 1-year horizon estimates based on the "Method B" treatment of CDARS data. Here, the presence of 0 – 10% CDARS funding is associated with a significantly positive effect on failure. The presence of a large negative coefficient based on Method A and a large positive coefficient based on Method B raises the possibility that the treatment of CDARS data has introduced errors to the variables. Without further information about the CAMELS ratings of reporting institutions, it is not possible to do anything further to investigate this possibility. Panel B of Table 7 indicates that higher CDARS balances have no significant effect on failure probability.

Table 8 reports the estimated effects of CDARS balances on LGDs in Panel A. These regression specifications add only CDARS and its interaction variables to the regressions in Table 5. The estimated coefficients on BD are similar to the corresponding estimates in Table 5: highly insignificant for both forecasting horizons. By contrast, CDARS balances quite substantially and significantly reduce expected LGD at the one-year forecasting horizon. For CDARS balances lower than 10% of total assets, LGD falls by 0.7 basis points for each percentage point of CDARS. When CDARS balances are slightly larger (10-20% of total assets), this effect remains the same. It becomes statistically insignificant only when CDARS funding exceed 20% of assets. (But recall that this occurs very infrequently.) At the two-year forecasting horizon, CDARS balances less than 10% of total assets have no significant effect on LGD, but the higher concentrations are significantly associated with lower failure resolution costs.

In short, CDARS funding has no significant effect on default probabilities and seems to reduce FDIC losses at failed IDIs.

VI. Summary and Conclusions

Statistical evidence derived from IDI failure data should be used to inform the process of assessing risk-based FDIC insurance premia. The results reported here indicate that balance sheet data can predict the 2008 – 2010 failures surprisingly far in advance, albeit imperfectly. For example, using data from year end to predict failures during the subsequent calendar year yields a pseudo-R^2 statistic of approximately 0.57. Predictions based on data from one or two years earlier yield pseudo-R^2 statistics of roughly 0.225 and 0.175 respectively. These results are at least moderately encouraging for FDIC's ability to design insurance premia that capture the Corporation's future default losses.

Generally speaking, IDI failures are positively related to brokered deposit funding. However, the estimated effects do not support FDIC's stated view that brokered deposits enable rapid growth, which ultimately leads to failure. I define asset and brokered deposit growth as the percentage change over the preceding two years, without adjusting for the effect of mergers on either variable. Given these definitions, little evidence from the estimated failure prediction models supports the notion that rapid asset growth funded by brokered deposits constitutes exceptionally risky behavior. Moreover, the estimated effects of brokered deposit funding are implausibly large: for example, brokered deposits funding 10% of assets implies a 1.3% higher failure probability than if the funding had been provided by core deposits. These results might reflect data reporting problems, or a poorly-measured deterioration in asset values that happen to

be correlated with brokered deposit use. More research is required to provide statistical evidence for the FDIC's current brokered deposit adjustment.

In explaining failure resolution costs, more rapid recent asset growth is quite robustly associated with higher LGD. At the one-year forecasting horizon, this asset growth effect increases with the importance of brokered deposit funding, as well as the growth rate of brokered deposit balances themselves. Curiously, however, the combination of high asset and high brokered deposit growth – the situation about which FDIC expresses the most serious concerns – actually reduces resolution costs. At a two-year forecasting horizon, by contrast, brokered deposit growth and the interaction between brokered deposits and asset growth have no significant value in predicting subsequent failures.

The empirical results include a sharp distinction between typical brokered deposits and reciprocal deposits of the sort represented by Promontory Interfinancial Network's CDARS program. CDARS balances have essentially no statistical effect on an IDI's probability of failure and significantly reduce failure resolution costs. These results suggest – not for the first time – that FDIC should reconsider its inclusion of reciprocal deposits in the brokered deposit adjustment to risk-based insurance premia.

Finally, statistical evaluations of this type would be improved if regulators were to collect more nuanced data on core and brokered deposit balances. Core deposits now include all retail funds raised directly by the IDI, regardless of what rate is paid or how the funds are solicited. Not all of these balances constitute "core deposits" in the sense of inexpensive and reliable funding! My experience merging reported brokered deposits with CDARS data suggests that brokered deposits do not always include funds actually raised through a broker. Nevertheless,

further analysis of failure prediction models should investigate the extent to which reported "core" or "brokered" deposits actually constitute homogeneous deposit categories.

References

Federal Deposit Insurance Corporation, 12 CFR Part 327, "Assessments, Large Bank Pricing," Proposed Rule," *Federal Register* Vol. 75, No. 226 / Wednesday, November 24, 2010, pp. 72611-72651.

Federal Deposit Insurance Corporation, *12 CFR Part 327*, "Assessments, Large Bank Pricing, Final rule." *Federal Register* Vol. 76, no. 38, February 25 2011, pp. 10672-10733.

Federal Deposit Insurance Corporation, *Annual Report*, 2007.

James, Christopher, "The Losses Realized in Bank Failures," *The Journal of Finance*, Vol. 46, No. 4 (Sep., 1991), pp. 1223-1242.

Murton, Arthur J. and Craig R. Jarvill, "Final Rule on the Deposit Insurance Assessment Base, Assessment Rate Adjustments, Dividends, Assessment Rates and Large Bank Pricing Methodology", February 1, 2011 (Memorandum to FDIC Board of Directors).

APPENDIX: VARIABLE DEFINITIONS

Panel A: variables collected from Call Reports and Thrift Financial Reports, downloaded from http://www2.fdic.gov/sdi/main.asp),

Variable name used here	FDIC VARIABLE NAME on web site ([a])	Definition/concept
TA	asset	Total_Assets
LNS_NET	lnlsnet	Net_Loans
LNS_CI	lnci	Loans_Commercial_Industrial
LNS_CRE	lnrenres	Loans_Commercial_RE
LNS_INS	lnexamt	Insider_Loans
CASH	chbal	Cash & Balances Due From Depository Institutions
SEC	sc	Total Securities
TRADE	trade	Trading Account Assets
OREO	ore	OREO
FFS	frepo	Fed Funds Sold & Reverse Repurchase
TL	liab	Total_Liabilities
DEP_TOT	dep	Total_Deposits
DEP_BD	bro	Brokered_Deposits
FHLB	othbfhlb	FHLB_Advances
DEP_CORE	coredep	Core Deposits
DEP_DOM	depdom	Total Domestic Deposits
FFP	frepp	Fed Funds Purchased & Repurchase Agreements
EQ	eq	Total_Equity
LIAB_VOL	voliab	Volatile_Liabilities
TIE	eintexp	Total_Interest_Expense
COFEA	intexpy	Cost_of_Funding_Earning_Assets
ROA	roa	Return_on_Assets
ROE		Return_on_Equity

[a] http://www2.fdic.gov/sdi/main.asp

Panel B: Constructed Variable Names and Definitions:

DEP_NC	Noncore deposits = DEP_TOT – DEP_CORE
DEP_NC	Noncore deposits = DEP_TOT – DEP_CORE
DEP_NC_NB	Non-brokered, noncore deposits = DEP_NC – DEP_BD
LIAB_OTH	Other liabilities = TL – DEP_TOT – FHLB – FFP
LNS_OTH	Other loans = LNS_TOT – LNS_CI – LNS_CRE – LNS_INS - LLA
ASS_OTH	Other Assets = TA – LNS_NET – CASH – OREO – SEC – TRADE – FFS

The Charter Class definitions (as defined by the FDIC) are as follows:

N -- commercial bank, national (federal) charter and Fed member, supervised by the Office of the Comptroller of the Currency (OCC)
NM -- commercial bank, state charter and Fed nonmember, supervised by the FDIC
SA -- savings associations, state or federal charter, supervised by the Office of Thrift Supervision (OTS)
SB -- savings banks, state charter, supervised by the FDIC
SM -- commercial bank, state charter and Fed member, supervised by the Federal Reserve (FRB)

Table 1: Coefficient Interpretations Depend on the Excluded Balance Sheet Share

$$wr(Failure_t) = \Omega(X_{t-1}) + \varepsilon_t$$

Where the explanatory variables come from the end of the year preceding failure. Variables are defined in Appendix A. Robust standard errors are clustered at the firm level and the resulting t-statistics are reported in parentheses beneath each estimated coefficient. (***), (**), * indicate significance at the 1%, 5%, and 10% levels respectively. Other explanatory variables included in these models and summary statistics are not reported for the sake of brevity. Tables 3 and 4 present complete results.

	Failure Probability, data from year t-1	
	(1)	(2)
Core Deposits	0.32**	
	(2.07)	
Equity		-0.37**
		(-2.26)
Brokered Deposits	0.37**	0.03
	(2.50)	(1.16)
Non-Brokered, Non-core Deposits	0.34**	0.02***
	(2.23)	(3.37)
FHLB	0.35**	0.02**
	(2.35)	(2.00)
FFP	0.31**	-0.01
	(2.00)	(-0.78)
Other Liabilities	0.36**	0.02
	(2.31)	(1.39)

Table 2: Summary Statistics

Panel A: IDI-Quarter observations used in Probit Models

	4th Quarters of 2005-2009					
	N	Mean	10%	Median	90%	Std Dev.
Brokered Deposits	42,319	0.035	0.000	0.000	0.112	0.081
Non-Brokered, Non-core Deposits	42,319	0.126	0.032	0.123	0.239	0.107
FHLB	42,319	0.048	0.000	0.022	0.135	0.066
FFP	42,319	0.016	0.000	0.000	0.047	0.045
Other Liabilities	42,319	0.013	0.003	0.006	0.019	0.035
Equity	42,319	0.120	0.075	0.100	0.168	0.086
Other Loans	42,319	0.656	0.430	0.687	0.844	0.173
Other Assets	42,319	0.052	0.022	0.047	0.083	0.038
Cash	42,319	0.056	0.016	0.036	0.113	0.065
FFS	42,319	0.036	0.000	0.011	0.094	0.074
Total Securities	42,319	0.205	0.033	0.175	0.413	0.154
Trade Account Assets	42,319	0.001	0.000	0.000	0.000	0.011
Ln(Assets)	42,319	18.85	17.30	18.71	20.49	1.38
OREO	42,319	0.003	0.000	0.000	0.009	0.008
Asset Growth, winsorized	41,986	0.050	-0.035	0.031	0.149	0.093
Noncurrent Loans						
Core Deposits	42,319	0.643	0.492	0.664	0.784	0.136
BD Growth, winsorized						
CDARS	42,319	0.005	0.000	0.000	0.008	0.019
Non-Brokered, Non-core Deposits (CDAR1)	42,319	0.121	0.023	0.120	0.237	0.112
Brokered Deposits (redefined for CDARS2)	42,319	0.035	0.000	0.000	0.114	0.082
Non-Brokered, Non-core Deposits (CDAR2)	42,319	0.764	0.594	0.806	0.894	0.151
Insider Loans	42,319	0.014	0.000	0.008	0.035	0.018
Dummy: Young Banks						
PD (per year)						

Panel B: IDI-quarter Observations used in Loss (LGD) Estimations

	Estimated Loss 1 year Lagged					
	N	Mean	10%	Median	90%	Std Dev.
Brokered Deposits	324	0.144	0.000	0.107	0.344	0.151
Non-Brokered, Non-core Deposits	324	0.061	-0.138	0.093	0.254	0.187
FHLB	324	0.075	0.000	0.057	0.175	0.082
FFP	324	0.018	0.000	0.000	0.044	0.062
Other Liabilities	324	0.013	0.003	0.007	0.023	0.024
Equity	324	0.079	0.049	0.079	0.105	0.027
Other Loans	324	0.764	0.648	0.778	0.877	0.108
Other Assets	324	0.056	0.025	0.051	0.097	0.029
Cash	324	0.045	0.009	0.028	0.104	0.052
FFS	324	0.029	0.000	0.010	0.084	0.040
Total Securities	324	0.107	0.011	0.091	0.216	0.091
Trade Account Assets	324	0.000	0.000	0.000	0.000	0.002
Ln(Assets)	324	19.66	18.01	19.50	21.57	1.47
OREO	324	0.017	0.000	0.008	0.042	0.024
Asset Growth, winsorized	324	0.026	-0.095	0.013	0.139	0.098
Noncurrent Loans						
Core Deposits	324	0.609	0.434	0.619	0.770	0.133
CDARS	324	0.009	0.000	0.000	0.033	0.028
Non-Brokered, Non-core Deposits (CDAR1)	324	0.051	-0.166	0.091	0.250	0.192
Brokered Deposits (redefined for CDARS2)	324	0.144	0.000	0.107	0.344	0.151
Non-Brokered, Non-core Deposits (CDAR2)	324	0.660	0.421	0.693	0.876	0.183
Insider Loans	324	0.013	0.000	0.007	0.034	0.016
Dummy: Young Banks	324	0.080	0.000	0.000	0.000	0.272
LGD (as % of total assets at failure)	324	0.266	0.119	0.261	0.425	0.123

Table 3: Probit Models of IDI Failures

The first three columns in this table report estimates for a model that predicts failures during a one-year time period, using data 1, 2, and 3 years before the start of the failure year. In the "one year ahead" probit, for example, calendar 2008 failure/survival results are matched with year-end 2006 balance sheet information, 2009 failure/survival results are matched with year-end 2007 data, and 2010 failure/survival results are matched with year-end 2008 data.

The right half of the table reports estimates for a model that predicts failures during a three-year period (2008-2010), using data from year-end 2005, 2006, or 2007. Reported coefficients are marginal probabilities. Robust standard errors are used to compute t-statistics, which are reported in parentheses beneath the estimated marginal probabilities. All explanatory variables are scaled by total assets, and are defined in Appendix A. The coefficients on firm size (Ln(assets)) and asset growth have been multiplied by ten.

	One-year Failure Interval			**Three-year Failure Interval**		
Data from:	1-year lag	2-year lag	3-year lag	Dec. 2007	Dec. 2006	Dec. 2005
Brokered Deposits	0.03	0.11***	0.19***	0.46***	0.45***	0.37***
	(1.08)	(3.84)	(7.15)	(5.73)	(5.45)	(4.35)
Dummy: 10%≤ Brokered Dep. ≤ 25%*BD	0.01	-0.01	-0.08***	-0.18**	-0.19***	-0.14*
	(0.50)	(-0.59)	(-3.57)	(-2.55)	(-2.81)	(-1.95)
Dummy: 25%≤ Brokered Dep. ≤ 50%*BD	0.00	-0.04	-0.12***	-0.27***	-0.29***	-0.22***
	(0.12)	(-1.37)	(-4.87)	(-3.59)	(-3.83)	(-2.75)
Dummy: Brokered Dep. ≥ 50%*BD	-0.01	-0.06**	-0.15***	-0.34***	-0.36***	-0.24***
	(-0.45)	(-2.03)	(-5.34)	(-3.99)	(-4.53)	(-2.91)
Core Deposits						
Non-Brokered, Non-core Deposits	0.02***	0.02***	0.03***	0.08***	0.08***	0.08***
	(3.43)	(3.41)	(3.78)	(3.70)	(3.97)	(3.67)
FHLB	0.02*	0.02**	0.01	0.06**	0.05*	0.07**
	(1.93)	(2.31)	(1.46)	(2.33)	(1.75)	(2.51)
FFP	-0.01	0.02	0.01	0.04	0.04	0.01
	(-0.58)	(1.19)	(0.80)	(1.01)	(1.02)	(0.13)
Other Liabilities	0.02	-0.06*	-0.02	-0.05	-0.05	-0.10*
	(1.42)	(-1.78)	(-0.94)	(-0.83)	(-0.91)	(-1.74)
Equity	-0.37**	-0.08	0.00	-0.11	-0.03	0.06
	(-2.26)	(-1.36)	(0.20)	(-1.08)	(-0.38)	(1.36)
Total Loans	-0.04	-0.10***	-0.10***	-0.24***	-0.24***	-0.23***
	(-1.34)	(-6.57)	(-8.61)	(-6.23)	(-6.87)	(-7.15)

Table 3, continued

	One-year Failure Interval			Three-year Failure Interval		
Data from:	1-year lag	2-year lag	3-year lag	Dec. 2007	Dec. 2006	Dec. 2005
Other Assets	0.02	-0.07*	-0.13***	-0.24**	-0.41***	-0.39***
	(0.36)	(-1.72)	(-4.22)	(-2.23)	(-4.19)	(-4.60)
	104	104	104	104	104	104
Cash	-0.04**	-0.13***	-0.23***	-0.55***	-0.46***	-0.33***
	(-2.06)	(-4.55)	(-6.19)	(-5.30)	(-6.28)	(-5.98)
FFS	0.00	-0.09***	-0.10***	-0.17***	-0.25***	-0.26***
	(0.05)	(-4.69)	(-6.31)	(-3.28)	(-5.58)	(-6.29)
Total Securities	-0.05**	-0.13***	-0.13***	-0.29***	-0.30***	-0.29***
	(-2.23)	(-8.36)	(-9.54)	(-7.36)	(-7.63)	(-8.19)
Trade Account Assets	-0.50	-0.23***	-0.26**	-0.80***	-1.55*	-0.49
	(-1.55)	(-2.86)	(-2.37)	(-3.56)	(-1.72)	(-1.60)
OREO	0.05	0.01	0.10	0.44*	0.45	0.42
	(1.54)	(0.12)	(1.30)	(1.71)	(1.23)	(0.84)
Ln(Assets)	0.001*	0.002***	0.002***	0.006***	0.006***	0.005***
	(1.66)	(4.02)	(3.52)	(3.32)	(3.45)	(3.10)
Non Current Loans	0.18***	0.28***	0.25***	1.08***	1.03***	0.62***
	(3.51)	(7.98)	(4.96)	(6.32)	(4.81)	(2.70)
Asset Growth	-0.09*	0.02	0.14***	0.03***	0.06***	0.06***
	(-1.95)	(0.61)	(4.54)	(2.86)	(6.42)	(6.34)
BD growth	0.00	-0.01	-0.02	0.06	-0.04	-0.05
	(0.03)	(-0.23)	(-0.77)	(0.80)	(-0.38)	(-0.39)
BD*Asset Growth	0.04***	-0.03	-0.03	0.00	0.00	-0.08
	(2.89)	(-1.64)	(-1.60)	(0.07)	(0.01)	(-1.00)
(BD growth) * (Asset Growth)	0.03	0.14**	0.10*	0.09	0.09	0.35
	(0.63)	(2.36)	(1.66)	(0.54)	(0.51)	(1.51)
Charter Class: NM	-0.00*	-0.00	-0.00	-0.01	-0.01	-0.00
	(-1.80)	(-1.55)	(-0.66)	(-1.31)	(-0.96)	(-0.58)
Charter Class: SA	0.00	0.00	0.00	0.01	0.01	0.00
	(0.06)	(1.01)	(1.58)	(1.33)	(1.39)	(0.66)
Charter Class: SB	-0.01***	-0.01*	-0.00	-0.02	-0.01	-0.01
	(-2.62)	(-1.72)	(-1.10)	(-1.37)	(-0.83)	(-0.51)
Charter Class: SM	0.00	-0.00	-0.00	-0.01	0.00	0.00
	(0.16)	(-0.41)	(-0.03)	(-0.84)	(0.05)	(0.48)
N	22,661	23,283	23,928	7,752	7,983	8,193
Pseudo r-squared	0.567	0.233	0.176	0.262	0.213	0.172

Table 4: Interacted Effects of Brokered Deposits

This table combines the coefficients in Table 3 to indicate the total effect of an increase in brokered deposits for different concentrations of those deposits. The indicated coefficients measure the sum of relevant coefficients from Table 3 and a t-statistic indicating significance of that sum.

Reported coefficients are marginal probabilities. Robust standard errors are used to compute t-statistics, which are reported in parentheses beneath the estimated marginal probabilities.

	One-year Failure Interval			**Three-year Failure Interval**		
Forecasting horizon:	1-year	2-year	3-year	1-year	2-year	3-year
Brokered Deposits	0.03	0.11***	0.19***	0.46***	0.45***	0.37***
	(1.08)	(3.84)	(7.15)	(5.73)	(5.45)	(4.35)
Dummy: 10%≤ Brokered Dep. ≤ 25%*BD	0.04***	0.09***	0.11***	0.29***	0.26***	0.23***
	(2.76)	(7.11)	(8.10)	(6.72)	(5.74)	(4.60)
Dummy: 25%≤ Brokered Dep. ≤ 50%*BD	0.03***	0.07***	0.07***	0.19***	0.16***	0.15***
	(2.89)	(6.45)	(5.40)	(4.83)	(3.74)	(3.21)
Dummy: Brokered Dep. ≥ 50%*BD	0.02	0.05***	0.05***	0.12**	0.09**	0.13***
	(1.64)	(3.84)	(3.03)	(2.19)	(2.01)	(2.68)

Table 5: OLS Model of Estimated Losses on Failed IDIs ("LGD")

OLS results for LGD. The estimated loss comes from FDIC's initial estimated loss at the failure date (Source: Promontory Interfinancial Network, LLC). Dependent variable is estimated loss as a proportion of total assets at the failure date. Explanatory variables (from Call Reports/Thrift Financial Reports) are alternatively measured approximately one or two years before failure. Robust standard errors are used to compute t-statistics, which are reported in parentheses beneath the estimated marginal probabilities.

Part A: Estimated OLS Coefficients

Forecasting Horizon:	**One-year**	**Two-year**
Brokered Deposits	-0.14	0.07
	(-0.48)	(0.28)
Dummy: 10%≤ Brokered Dep. ≤ 25%*BD	0.03	-0.20
	(0.13)	(-0.90)
Dummy: 25%≤ Brokered Dep. ≤ 50%*BD	0.15	-0.06
	(0.55)	(-0.24)
Dummy: Brokered Dep. ≥ 50%*BD	0.15	-0.06
	(0.54)	(-0.26)
Core Deposits		
Non-Brokered, Non-core Deposits	-0.02	0.00
	(-0.41)	(0.02)
FHLB	-0.16	-0.17*
	(-1.63)	(-1.87)
FFP	-0.01	-0.01
	(-0.09)	(-0.11)
Other Liabilities	0.20	0.31
	(0.98)	(1.48)
Equity	0.23	-0.17
	(0.60)	(-0.56)
Total Loans	0.40***	0.46***
	(3.54)	(3.70)
Other Assets	0.14	0.38
	(0.50)	(1.33)
Cash	0.16	-0.04
	(0.87)	(-0.10)
FFS	0.54**	0.42**
	(2.40)	(2.13)

Total Securities	0.44***	0.56***
	(3.05)	(3.40)
Trade Account Assets	5.33***	1.07
	(3.02)	(0.58)
OREO	1.19***	2.44***
	(3.80)	(3.61)
Ln(Assets)	-0.01**	-0.01**
	(-2.28)	(-2.45)
Non Current Loans	0.27*	0.31
	(1.74)	(1.00)
Asset Growth	0.05***	0.05***
	(2.86)	(2.77)
BD growth	0.30**	0.11
	(2.37)	(0.66)
BD*Asset Growth	0.15**	0.11
	(2.57)	(1.15)
(BD Growth)* (Asset Growth)	-0.58***	0.08
	(-3.16)	(0.39)
Charter Class: NM	0.06***	0.06***
	(3.62)	(3.52)
Charter Class: SA	0.09***	0.10***
	(3.14)	(3.20)
Charter Class: SB	0.05	0.06
	(1.11)	(1.27)
Charter Class: SM	0.07***	0.06***
	(2.81)	(2.61)
N	318	303
Adjusted R^2	86.0%	85.1%

Panel B: Interacted Variables and Their Significance

Brokered Deposits	-0.14	0.07
	(-0.48)	(0.28)
Dummy: 10%≤ Brokered Dep. ≤ 25%*BD	-0.11	-0.12
	(0.98)	(0.85)
Dummy: 25%≤ Brokered Dep. ≤ 50%*BD	0.01	0.02
	(0.10)	(0.14)
Dummy: Brokered Dep. ≥ 50%*BD	0.01	0.01
	(0.14)	(0.89)

Table 6: Effect of CDARS Variables on Failure Probability: 1-year Failure Interval

This table reports estimates for a model that predicts failures during a one-year time period, using data 1, 2, and 3 years before the start of the failure year. In the "one year ahead" probit, for example, calendar 2008 failure/survival results are matched with yearend 2006 balance sheet information, 2009 failure/survival results are matched with yearend 2007 data, and 2010 failure/survival results are matched with yearend 2008 data. CDARS data are combined with Call Report/Thrift Financial Report data using two alternative methods ("A" and "B"), described in the text.

Reported coefficients are marginal probabilities. Robust standard errors are used to compute t-statistics, which are reported in parentheses beneath the estimated marginal probabilities. All explanatory variables are scaled by total assets, and are defined in Appendix A. The coefficients on firm size (Ln(assets)) and asset growth have been multiplied by ten.

Robust standard errors are used to compute t-statistics, which are reported in parentheses beneath the estimated marginal probabilities. Asset coefficient estimates are not reported in order to focus attention on the effects of brokered and CDARS deposits.

Part A: Estimated Marginal Probabilities

Forecasting Horizon:	**One-year**		**Two-year**		**Three-year**	
CDARS data treatment Method:	A	B	A	B	A	B
Brokered Deposits	0.03	0.05*	0.11***	0.12***	0.20***	0.19***
	(1.21)	(1.93)	(3.98)	(4.28)	(7.20)	(6.75)
Dummy: 10%≤ Brokered Dep. ≤ 25%*BD	0.01	-0.01	-0.02	-0.02	-0.08***	-0.07***
	(0.43)	(-0.46)	(-0.78)	(-0.90)	(-3.68)	(-3.08)
Dummy: 25%≤ Brokered Dep. ≤ 50%*BD	0.00	-0.02	-0.04	-0.05*	-0.13***	-0.12***
	(0.00)	(-0.87)	(-1.54)	(-1.77)	(-4.96)	(-4.51)
Dummy: Brokered Dep. ≥ 50%*BD	-0.02	-0.04	-0.06**	-0.07**	-0.15***	-0.14***
	(-0.61)	(-1.41)	(-2.21)	(-2.56)	(-5.43)	(-4.96)
Core Deposits						
CDARS	-0.03	0.02	-0.07	0.03	-0.06	0.08
	(-0.75)	(0.58)	(-1.52)	(0.79)	(-0.91)	(1.13)
(Dummy: 10%≤ CDARS ≤ 20%)* CDARS	-0.01	-0.00	0.07	0.06	-0.02	-0.07
	(-0.24)	(-0.03)	(1.21)	(1.13)	(-0.20)	(-0.68)
(Dummy: 20%≤ CDARS)*CDARS	na	na	na	na	0.11	0.06
					(1.25)	(0.67)
Non-Brokered, Non-core Deposits	0.02***	0.02***	0.02***	0.02***	0.03***	0.03***
	(3.50)	(3.34)	(3.21)	(3.18)	(3.69)	(3.71)

FHLB	0.02*	0.02*	0.02**	0.02**	0.01	0.01
	(1.86)	(1.70)	(2.27)	(2.20)	(1.40)	(1.42)
FFP	-0.01	-0.01	0.01	0.02	0.01	0.01
	(-0.62)	(-0.62)	(1.12)	(1.19)	(0.77)	(0.78)
Other Liabilities	0.02	0.02	-0.06*	-0.06*	-0.02	-0.02
	(1.42)	(1.46)	(-1.84)	(-1.85)	(-0.92)	(-0.86)
Equity	-0.37**	-0.37**	-0.08	-0.08	0.00	0.00
	(-2.26)	(-2.24)	(-1.37)	(-1.35)	(0.15)	(0.11)
Ln(Assets)	0.00	0.00	0.00***	0.00***	0.00***	0.00***
	(1.60)	(1.52)	(4.02)	(3.88)	(3.49)	(3.53)
Non Current Loans	0.18***	0.18***	0.28***	0.28***	0.25***	0.25***
	(3.49)	(3.49)	(7.94)	(7.95)	(4.92)	(4.96)
Asset Growth , winsorized	-0.01*	-0.01*	0.00	0.00	0.01***	0.01***
	(-1.90)	(-1.76)	(0.65)	(0.96)	(4.59)	(4.83)
BD growth, past two years, winsorized	0.00	0.01	-0.00	-0.00	-0.02	-0.02
	(0.15)	(0.51)	(-0.09)	(-0.01)	(-0.73)	(-0.78)
BD*Asset growth (winsorized)	0.04***	0.04***	-0.04*	-0.03	-0.03	-0.04*
	(2.87)	(2.94)	(-1.70)	(-1.62)	(-1.59)	(-1.72)
BD growth * (asset growth)	0.03	0.02	0.14**	0.12**	0.10*	0.10*
	(0.69)	(0.43)	(2.37)	(2.06)	(1.69)	(1.65)
Charter Class: NM	-0.00*	-0.00*	-0.00	-0.00*	-0.00	-0.00
	(-1.89)	(-1.94)	(-1.59)	(-1.69)	(-0.63)	(-0.64)
Charter Class: SA	0.00	0.00	0.00	0.00	0.00	0.00
	(0.04)	(0.08)	(0.94)	(1.03)	(1.62)	(1.64)
Charter Class: SB	-0.01***	-0.01***	-0.01*	-0.01*	-0.00	-0.00
	(-2.65)	(-2.61)	(-1.78)	(-1.78)	(-1.10)	(-1.12)
Charter Class: SM	0.00	0.00	-0.00	-0.00	-0.00	-0.00
	(0.17)	(0.23)	(-0.38)	(-0.55)	(-0.04)	(-0.04)
N	22,618	22,073	23,257	22,894	23,927	23,611
Pseudo r-squared	0.57	0.57	0.23	0.24	0.18	0.18

Panel B: Interacted Variables and Their Significance

CDARS	-0.03	0.02	-0.07	0.03	-0.06	0.08
	(-0.75)	(0.58)	(-1.52)	(0.79)	(-0.91)	(1.13)
(Dummy: 10%≤ CDARS ≤ 20%)* CDARS	-0.04	0.02	-0.00	0.10**	-0.09	0.01
	(1.17)	(0.58)	(0.00)	(2.53)	(1.12)	(0.00)
(Dummy: 20%≤ CDARS)*CDARS	na	na	na	na	0.04	0.14***
					(0.87)	(2.46)

Table 7: Effect of CDARS Variables on Failure Probability: 3-year Failure Interval

Same specification as in Table 3; some explanatory variables are not reported here for the sake of brevity. "na" indicates that a coefficient could not be estimated because the CDARS dummy variable equals zero for all failed institutions.

Reported coefficients are marginal probabilities. Robust standard errors are used to compute t-statistics, which are reported in parentheses beneath the estimated marginal probabilities. Asset coefficient estimates are not reported in order to focus attention on the effects of brokered and CDARS deposits.

Part A: Estimated Marginal Probabilities

Data from:	**Dec. 2007**		**Dec. 2006**		**Dec. 2005**	
CDARS data treatment:	A	B	A	B	A	B
Brokered Deposits	0.47***	0.45***	0.48***	0.48***	0.37***	0.39***
	(5.75)	(5.51)	(5.66)	(5.68)	(4.33)	(4.57)
Dummy: 10%≤ Brokered Dep. ≤ 25%*BD	-0.18**	-0.15**	-0.22***	-0.21***	-0.15**	-0.18**
	(-2.52)	(-2.05)	(-3.06)	(-2.99)	(-1.99)	(-2.38)
Dummy: 25%≤ Brokered Dep. ≤ 50%*BD	-0.28***	-0.26***	-0.31***	-0.33***	-0.22***	-0.24***
	(-3.62)	(-3.38)	(-4.06)	(-4.16)	(-2.77)	(-3.01)
Dummy: Brokered Dep. ≥ 50%*BD	-0.35***	-0.33***	-0.39***	-0.39***	-0.25***	-0.27***
	(-4.06)	(-3.74)	(-4.78)	(-4.78)	(-2.93)	(-3.21)
Core Deposits						
CDARS	-0.13	0.30*	-0.44**	-0.06	-0.11	0.13
	(-0.80)	(1.73)	(-1.96)	(-0.24)	(-0.44)	(0.52)
(Dummy: 10%≤ CDARS ≤ 20%)* CDARS	na	na	0.33	0.15	na	na
			(1.21)	(0.53)		
(Dummy: 20%≤ CDARS)*CDARS	na	na	na	na	0.28	na
					(0.96)	
Non-Brokered, Non-core Deposits	0.07***	0.07***	0.08***	0.08***	0.08***	0.08***
	(3.53)	(3.53)	(3.80)	(3.80)	(3.71)	(3.68)
FHLB	0.06**	0.06**	0.05	0.04	0.07**	0.07**
	(2.24)	(2.28)	(1.62)	(1.52)	(2.53)	(2.50)
FFP	0.03	0.04	0.04	0.04	0.01	0.01
	(0.93)	(1.00)	(0.93)	(0.95)	(0.12)	(0.15)
Other Liabilities	-0.05	-0.06	-0.05	-0.05	-0.10*	-0.10*
	(-0.83)	(-0.85)	(-0.99)	(-1.01)	(-1.74)	(-1.74)

Forecasting Horizon:	One-year		Two-year		Three-year	
CDARS data treatment:	A	B	A	B	A	B
Equity	-0.11	-0.11	-0.04	-0.04	0.06	0.06
	(-1.09)	(-1.06)	(-0.45)	(-0.47)	(1.35)	(1.37)
Ln(Assets)	0.01***	0.01***	0.01***	0.01***	0.00***	0.01***
	(3.24)	(3.17)	(3.39)	(3.40)	(3.11)	(3.20)
Non Current Loans	1.07***	1.07***	1.03***	1.04***	0.62***	0.57**
	(6.29)	(6.28)	(4.76)	(4.79)	(2.67)	(2.45)
Asset Growth	0.03***	0.03***	0.06***	0.06***	0.06***	0.06***
	(2.99)	(3.36)	(6.54)	(6.69)	(6.32)	(6.07)
BD growth	0.07	0.09	-0.02	-0.03	-0.05	-0.05
	(0.86)	(1.05)	(-0.25)	(-0.34)	(-0.39)	(-0.45)
BD*Asset growth	0.00	-0.01	-0.00	-0.00	-0.07	-0.06
	(0.00)	(-0.19)	(-0.04)	(-0.04)	(-0.93)	(-0.80)
(BD growth) * (asset growth)	0.10	0.04	0.09	0.07	0.35	0.36
	(0.62)	(0.24)	(0.52)	(0.43)	(1.52)	(1.52)
Charter Class: NM	-0.01	-0.01	-0.01	-0.01	-0.00	-0.00
	(-1.34)	(-1.39)	(-0.97)	(-0.97)	(-0.53)	(-0.35)
Charter Class: SA	0.01	0.01	0.01	0.01	0.00	0.01
	(1.37)	(1.43)	(1.47)	(1.53)	(0.66)	(0.84)
Charter Class: SB	-0.02	-0.02	-0.01	-0.01	-0.01	-0.00
	(-1.37)	(-1.42)	(-0.84)	(-0.82)	(-0.51)	(-0.43)
Charter Class: SM	-0.01	-0.01	0.00	0.00	0.00	0.00
	(-0.80)	(-0.97)	(0.09)	(0.10)	(0.47)	(0.54)
N	7,708	7,600	7,981	7,890	8,187	8,078
Pseudo r-squared	0.26	0.27	0.21	0.22	0.17	0.18

Panel B: Interacted Variables and Their Significance

CDARS	-0.13	0.30*	-0.44**	-0.06	-0.11	0.13
	(-0.80)	(1.73)	(-1.96)	(-0.24)	(-0.44)	(0.52)
(Dummy: 10%≤ CDARS ≤ 20%)* CDARS	na	na	-0.11	0.09	na	na
			(0.69)	(0.54)		
(Dummy: 20%≤ CDARS)*CDARS	na	na	na	na	0.17	na
					(1.11)	

Table 8: Effect of CDARS reciprocal deposits on expected LGD

Same specification as in Table 5; some explanatory variables are not reported here for the sake of brevity. The estimated loss comes from FDIC's initial estimated loss at the failure date (Source: Promontory Interfinancial Network, LLC). Dependent variable is estimated loss as a proportion of total assets at the failure date. Explanatory variables (from Call Reports/Thrift Financial Reports) are alternatively measured approximately one or two years before failure.

Robust standard errors are used to compute t-statistics, which are reported in parentheses beneath the estimated marginal probabilities

Part A: Estimated OLS Coefficients

Lag: / CDARS data treatment Method:	**One-year** A	**One-year** B	**Two-year** A	**Two-year** B
Brokered Deposits	-0.13	-0.07	0.09	0.17
	(-0.42)	(-0.23)	(0.35)	(0.62)
Dummy: 10%≤ Brokered Dep. ≤ 25%*BD	0.02	-0.08	-0.21	-0.28
	(0.08)	(-0.32)	(-0.93)	(-1.26)
Dummy: 25%≤ Brokered Dep. ≤ 50%*BD	0.15	0.09	-0.08	-0.15
	(0.54)	(0.32)	(-0.33)	(-0.63)
Dummy: Brokered Dep. ≥ 50%*BD	0.11	0.02	-0.09	-0.17
	(0.39)	(0.08)	(-0.35)	(-0.69)
Core Deposits				
CDARS	-0.70**	-0.61*	-0.23	0.05
	(-2.07)	(-1.81)	(-0.41)	(0.10)
(Dummy: 10%≤ CDARS ≤ 20%)* CDARS	0.00	0.08	-0.08	-0.43
	(0.00)	(0.19)	(-0.14)	(-0.78)
(Dummy: 20%≤ CDARS)*CDARS	0.63*	0.52	0.02	-0.24
	(1.80)	(1.50)	(0.03)	(-0.43)
Non-Brokered, Non-core Deposits	-0.03	-0.04	-0.00	-0.00
	(-0.58)	(-0.70)	(-0.03)	(-0.04)
FHLB	-0.17*	-0.18*	-0.18*	-0.17*
	(-1.71)	(-1.89)	(-1.93)	(-1.86)
FFP	-0.01	-0.02	-0.02	-0.02
	(-0.17)	(-0.23)	(-0.13)	(-0.18)
Other Liabilities	0.31	0.33*	0.34	0.34
	(1.50)	(1.65)	(1.56)	(1.63)
Equity	0.15	0.19	-0.18	-0.19
	(0.40)	(0.49)	(-0.60)	(-0.63)

Ln(Assets)	-0.01***	-0.01**	-0.01**	-0.01**
	(-2.62)	(-2.44)	(-2.48)	(-2.46)
Non Current Loans	0.24	0.23	0.29	0.28
	(1.50)	(1.48)	(0.96)	(0.92)
Asset Growth , winsorized	0.06***	0.05***	0.05***	0.05***
	(2.98)	(2.73)	(2.75)	(2.59)
BD growth, past two years, winsorized	0.34***	0.38***	0.13	0.11
	(2.66)	(2.85)	(0.77)	(0.68)
BD*Asset growth (winsorized)	0.16***	0.18***	0.11	0.12
	(2.91)	(3.42)	(1.15)	(1.30)
BD growth * (asset growth)	-0.55***	-0.59***	0.07	0.12
	(-3.00)	(-3.06)	(0.33)	(0.55)
Charter Class: NM	0.06***	0.06***	0.06***	0.06***
	(3.54)	(3.62)	(3.52)	(3.58)
Charter Class: SA	0.09***	0.09***	0.10***	0.10***
	(3.07)	(3.05)	(3.22)	(3.28)
Charter Class: SB	0.05	0.05	0.06	0.06
	(1.03)	(1.15)	(1.28)	(1.28)
Charter Class: SM	0.07***	0.08***	0.06***	0.06***
	(2.86)	(3.15)	(2.59)	(2.62)
N	318	316	303	301
Adjusted R^2	86.2%	86.4%	85.0%	84.9%

Panel B: Interacted Variables and Their Significance

Brokered Deposits	-0.13	-0.07	0.09	0.17
	(-0.42)	(-0.23)	(0.35)	(0.62)
Dummy: 10%≤ Brokered Dep. ≤ 25%*BD	-0.11	-0.15	-0.12	-0.11
	(0.95)	(1.37)	(0.77)	(0.75)
Dummy: 25%≤ Brokered Dep. ≤ 50%*BD	0.02	0.02	0.01	0.02
	(0.26)	(0.22)	(0.14)	(0.17)
Dummy: Brokered Dep. ≥ 50%*BD	-0.02	-0.05	0.00	0.00
	(0.17)	(0.52)	(0.00)	(0.00)
CDARS	-0.70**	-0.61*	-0.23	0.05
	(-2.07)	(-1.81)	(-0.41)	(0.10)
(Dummy: 10%≤ CDARS ≤ 20%)* CDARS	-0.70**	-0.53**	-0.31**	-0.38***
	(2.38)	(2.22)	(2.24)	(2.88)
(Dummy: 20%≤ CDARS)*CDARS	-0.07	-0.09	-0.21**	-0.19*
	(0.52)	(0.73)	(2.31)	(1.68)

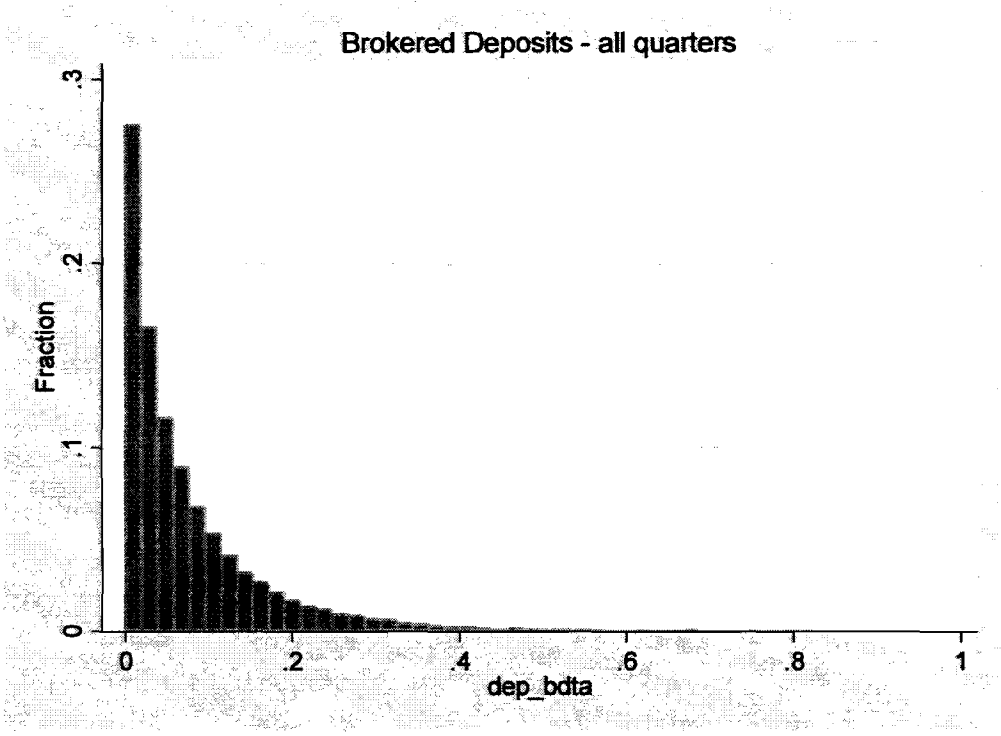


Figure 1: Distribution of IDIs' reliance on brokered deposits, 2005 - 2010

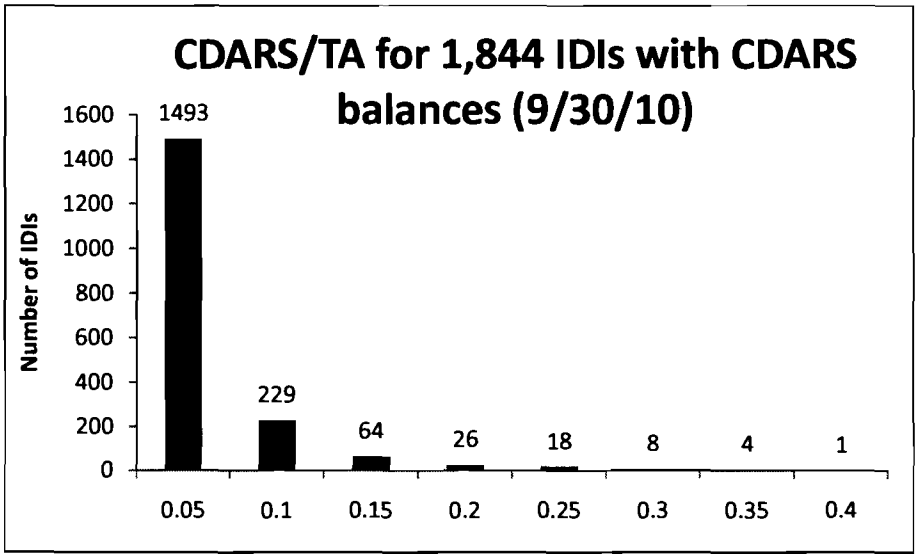


Figure 2: Histogram of CDARS/TA, for IDIs with CDARS balances on 9/30/10. Source: Promontory Interfinancial Network, LLC.

Attachment 3

Thomas Farin

Response Letter to FDIC Core and Brokered Deposits Study

May 1, 2011

McHenry Kane
Vice President
Attorney

SunTrust Banks, Inc.
303 Peachtree Street, N.E.
Suite 3600
Atlanta, Ga. 30308
Tel 404.588.8627
Fax 404.230.5387
(b)(6)

May 27, 2011

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429-9990
Attn: Comments
coredepositstudy@fdic.gov

Re: Adjustment Guidelines

Ladies and Gentlemen,

On behalf of SunTrust Bank, I would like to take this opportunity to provide certain comments to the Federal Deposit Insurance Corporation's ("FDIC") notice of proposed rulemaking that would determine how discretionary adjustments would be made to the total scores used in calculating the deposit insurance assessment rates of large and highly complex insured institutions (the "NPR").

First, SunTrust would like to applaud the FDIC for proposing a process that is designed to ensure that the adjustment process is fair and transparent and results only in adjustments that are well-supported. We genuinely appreciate the efforts and procedures set forth in the guidelines to meet these goals. In particular, permitting requests from the industry for adjustments reflects your willingness to work with financial institutions and desire to reach fair and just results. Also, only permitting adjustments that are material goes a long way towards allaying fears of capricious or arbitrary application of these rules. SunTrust acknowledges your responsiveness to those concerns that were raised by the industry in earlier comment letters and thanks you for addressing these concerns in this NPR.

Second, we find it difficult to reconcile the FDIC's public remarks similar to those made in "Supervisory Insights: Regulatory Actions Related to Foreclosure Activities by Large Servicers and Practical Implications for Community Banks,"[1] in which the FDIC describes how it encourages institutions to avoid unnecessary foreclosures and consider loan modifications, with the FDIC's rules that classify performing restructured loans as both underperforming assets for the life of the loan and as criticized and classified items for the life of the loan to the extent the restructured loan meets other criticized or classified criteria, resulting in higher deposit insurance premiums to institutions that enter into loan modifications with borrowers. The final rule on the new assessment scheme (the "Final

1 http://www.fdic.gov/news/news/press/2011/pr11082.html. See also FIL-35-2007, Working With Residential Borrowers: FDIC Encourages Institutions to Consider Workout Arrangements for Borrowers Unable to Make Mortgage Payments, http://www.fdic.gov/news/news/financial/2007/fil07035.html; FIL-76-2007, Servicing for Mortgage Loans: Loss Mitigation Strategies http://www.fdic.gov/news/news/financial/2007/fil07076.html.

FARIN
KNOWLEDGE-BASED SOLUTIONS

Response Letter to FDIC Core and Brokered Deposits Study

Thomas A. Farin
President & CEO
Farin & Associates, Inc.

Introduction

I was asked to write this white paper in response to the FDIC's request for comments on the issue of Brokered CDs and Core Deposits. I want to thank the FDIC for taking the time to review this paper and hope it will be helpful in your attempts to address some of the issues raised in your request for comment. I am President of Farin & Associates, a firm providing asset-liability analysis and consulting services to community banks and credit unions. I am a 25-year member of the faculty of the Graduate School of Banking at Wisconsin and section leader of both the Funding and Bank Performance Analysis tracks. I also am Faculty Coordinator and lead instructor at the Financial Managers School, a joint program offered by GSB and the Financial Managers Society. I was also the lead author of the rewrite of the ABA Liquidity and Funds Management Toolbox, released in February of 2011. In my distant past I was a contract instructor to FSLIC then OTS, delivering introductory and advanced A/L education to examiners during the thrift crisis. I spend the majority of my consulting time today working with financial institutions on developing core funding strategies.

Overview

The FDIC is currently conducting a Core and Brokered Deposit Study with the goal of obtaining input into potential legislative or regulatory changes with respect to core and brokered deposits. Since the laws and regulations were drafted, a number of innovative deposit products have been developed that don't fit comfortably into these definitions. In addition, the regulations do not consider the full range of sensitivity and volatility of deposits categorized as core deposits.

Bank regulators appear to be headed in the direction of using some form of graduated scale for grading the variety of funding sources that appear on financial institution balance sheets, rather than the black/white distinctions that currently exist for core versus non-core funding and brokered versus non-brokered deposits. I fully support a move in the direction of a graduated scheme for grading sensitivity/volatility of funding sources.

While a graduated scale is the goal, the FDIC appears to want to address this issue in a manner that does not require massive call report changes and, at the same time, is relatively simple to explain.

It is my intention in this white paper to lay out a potential framework for assessing volatility of funding in relation to the effects of a liquidity stress event, like a catastrophic capital failure. This paper will discuss:

- Historical models – Brokered vs. Non-brokered, Core vs. Non-core
- Change agents that broke the historical models
- Characteristics/attributes most closely associated with the brokered CD debate
- Appropriate uses of non-core funding
- Regulatory agency options for dealing with funding liquidity and volatility/stability issues- recommendations will be made at all three levels:
    - Level 1 – Call Report and UBPR
    - Level 2 – Guidance documents, regulation, legislation
    - Level 3 – Examination
- Developing a graduated funding approach
    - Approach taken in ABA Liquidity Toolbox – Aimed at Level 2
    - Criteria for a Level 1 volatility/stability measure
- Level 1 model recommendation – Simplified Basel Net Stable Funding Ratio (NSFR)
- Issues with call reports feeding the NSFR – Objective is to implement a simplified NSFR with minimal call report changes
- Discussion/recommendation on what is to be included in each of the five ASF levels of the numerator of the NSFR
- Recommendations of changes to Level 2 (guidance documents, regulation, legislation) and Level 3 (examination)

While this paper is not in the same sequence as the questions provided by the FDIC in requesting comments on this issue, the questions are addressed in this white paper. I wanted to go beyond just responding to the questions and make recommendations as to how the FDIC might develop a solution to this issue.

While the majority of the content of this paper focuses on deposits, any graduated grading scheme needs to consider all sources of funding, including borrowings and capital. These portions of the liability and capital side of the balance sheet will be brought into the discussion at appropriate times.

Historical Models

In the past, deposits were distinguished by fairly broad, black/white definitions designed to place funding into different categories.

Brokered vs. Non-Brokered

One such distinction written into regulations is the difference between brokered and non-brokered deposits. Regulators felt it important to make this distinction as it is believed there has been a correlation between the levels of brokered deposits in a financial institution balance sheet and the likelihood of failure due to asset quality problems. Of course, the use of brokered CDs does not directly cause asset quality problems. But institutions growing loan portfolios too quickly in an unsafe and unsound manner often fund this growth with brokered CDs.

Brokers charge a fee for putting together the parties and counterparties to a brokered CD transaction. So it seemed appropriate to categorize brokered CDs as those where a fee is involved in putting together parties and counterparties.

When financial institutions fall below PCA Well capitalized minimums, their ability to participate in the brokered CD markets is revoked unless they obtain a waiver from their regulator.

Core vs. Non-Core

FDIC's DSC Risk Management Manual of Examination Policies defines core deposits as:

> "Core deposits are generally stable, lower cost funding sources that typically lag behind other funding sources in the need for repricing during a period of rising interest rates. These deposits are typically funds of local customers that also have borrowing or other relationship with the institution. Convenient branch locations, superior customer service, dense ATM network and/or no fee accounts are significant factors associated with inertia of these deposits.[1]"

On the other hand, in its Final Rule, Assessments, Large Bank Pricing, Appendix A, the FDIC defines the numerator of the Core Deposits/Total Liabilities ratio as:

> "Total domestic deposits excluding brokered deposits and uninsured non-brokered time deposits."

I prefer the former definition as it comes much closer to how I would define core deposits in working with financial institutions on developing core funding strategies. On the other hand, the latter definition is probably the best the FDIC can do in calculating a ratio like Core Deposits/Total Liabilities given the definition of brokered CDs written into the statutes and the limitations placed by using data presented at the present time in call reports.

The distinction between core and non-core is significant in that one of the primarily historical regulatory measures of liquidity is the non-core funding dependency ratio and because field regulators closely watch levels of non-core funding and trends in concentrations in non-core funding. An institution with high levels of non-core funding and trends showing increasing levels of non-core funding can expect that topic to be a major discussion point in examinations. In addition, the definition of core plays an important role in determining deposit insurance assessments for large banks.

Institutions are asked under current liquidity guidance to set policy limits on overall use of non-core funding and on levels of non-core funding from individual sources. In addition, the loan/deposit ratio is also driven in part by the level of deposits gathered on the call report. The loan/deposit ratio and the net non-core funding dependency ratio are the two liquidity ratios highlighted on the Summary Ratios page of the UBPR.

[1] DSC Risk Management Manual of Examination Policies at p. 6.1-7.

FARIN
KNOWLEDGE-BASED SOLUTIONS

Change Agents

Emergence of Innovative Funding Products

Loan growth has exceeded deposit growth in banking for 13 out of the last 18 years. The exception years were 2008-2010 (great recession) and 2001-2002 (9/11 years). In other words, loans outgrow deposits whenever the economy is healthy. Of course the difference between the loan and deposit growth rates must be funded – generally by reducing investments or increasing use of non-core funding.

A variety of new products have emerged to help financial institutions bridge this funding gap. The design of these products has challenged some of the historical models mentioned in the previous section. Here are a few examples:

- CDARS Reciprocal Deposits – This product extends FDIC insurance well beyond the FDIC maximum of $250,000 through a network that allows multiple financial institutions to provide deposit insurance on a single deposit up to their cumulative $250,000 caps. These deposits are technically brokered deposits under the current definition. Yet, unlike traditional brokered deposits, they are typically gathered from a financial institution's own customers. If you read the core deposit definition cited earlier from the Examination Manual, CDARS Reciprocal deposits sound like core deposits. Yet they are excluded from core in the Large Bank Assessment definition because of their classification as brokered CDs under the current law.
- Rate Board CDs – Rate boards are private boards that serve as a clearing point for financial institutions that wish to gather funds by issuing CDs and other financial institutions, primarily credit unions, that wish to invest in FDIC-insured CDs. But because the rate board charges an annual fee for membership in the board, but no fee for clearing transactions, funds raised through rate boards are technically non-brokered. They are also included in call report core deposit totals based on definitions like that in the Large Bank Assessment Rule. Yet rate board CDs clearly do not meet the definition of core based on the definition in the Examination Manual, as they are not gathered from customers of a financial institution through any of their normal deposit-gathering processes.
- Insurance Company Banks – Insurance companies are increasingly chartering banks with the goal of gathering a greater share of wallet from their insurance customers or improving services delivered to their agents. In some cases, agents are paid a fee for bringing in deposits. I know of at least two insurance company banks that have been told their entire deposit base is made up of brokered deposits because agents were paid a fee for bringing in the deposits. Yet at the same time, the insurance company has a core insurance relationship with those customers that may be as meaningful as the relationships discussed in the FDIC Examination Manual definition. On the other hand, given that their regulator has classified the customer deposits as brokered, those deposits would be classified as non-core under the Large Bank Assessment Rule.

Emergence of New Marketing Channels

The Internet has emerged in the last decade as an effective way of attracting deposits. It could easily be argued that the Internet is just an additional marketing channel that supplements television, radio, and newspaper

advertising, direct mail, billboard, and other traditional marketing techniques. On the other hand, the reach of Internet marketing allows a local or regional financial institution to gather deposits in a much broader geographic market at a level of cost effectiveness that cannot be achieved through other channels. The Internet channel creates some interesting challenges to historical models used to classify deposits in the past.

- MoneyAisle, a CD auction site, initially charged a fulfillment fee for placing deposits. As a result, they were classified by the FDIC as a brokered source. They have since changed to a click-through pricing model, placing them in the same general category as Google Adwords and BankRates.com, both technically non-brokered sources. Yet the deposit-gathering process worked in the same way before and after the MoneyAisle pricing model was changed. Should MoneyAisle still be considered a brokered source? Is how MoneyAisle is compensated for putting together banks and CD customers a relevant factor in assessing the volatility/stability of deposits gathered through MoneyAisle?
- Google Adwords, BankRates.com and MoneyAisle all allow the institution to define the market area in which they wish the deposit products they are attempting to market to be visible. That means they can be used as an additional channel in going after deposits from an institution's defined market area. Or they can be used to expand an institution's market area well beyond the geographic area that could be reasonably reached through brick and mortar channels. Should locally gathered deposits through these channels be handled differently from those gathered in expanded markets?

Conclusions from Examination of Change Agents

It is apparent to me that some of the historical models used in categorizing funding sources are broken, most notably the brokered vs. non-brokered and the core vs. non-core definitions.

- It makes little sense to break brokered and non-brokered deposits into two separate groups based on how an intermediary is used or compensated for its efforts in putting together the party and counterparty. Intermediary compensation has little to do with the volatility/stability of a funding source.
- The traditional break point between core and non-core fails to consider the wide variety of rate sensitivity and stability of funds in the FDIC Examination Manual definition of core deposits. It also fails to recognize that some 'non-core' funding sources (CDARS Reciprocal, for example) match the Examination Manual definition of core funding, while some 'core' funding sources bring in deposits from customers that are well outside the Examination Manual definition of core customers.

It would appear to make sense to develop a method for grading funding sources based on a sliding scale rather than around black/white definitions like core/non-core and brokered/non-brokered.

In the remainder of this document, I will adopt the following convention in categorizing funding sources

- Core funding – Funding gathered from customers through traditional funds-gathering channels as part of a core funding growth/retention strategy. In other words, I will use the definition of core funding the FDIC published in the Examination Manual. I will further define a core funding growth/retention strategy later in this white paper.

- Non-core funding – Any source of funding that falls outside the Examination Manual definition of core. This definition covers all forms of wholesale funding (FHLB Advances, Fed Funds Purchased, Repos, etc.), as well as deposits gathered using non-traditional techniques from sources other than those defined in the FDIC Examination Manual definition of core deposits.

I am not suggesting the FDIC adopt the Examination Manual definition for call report purposes. In fact doing so could require major call report changes. Rather, I am merely identifying the terminology that will be used through the remainder of this white paper. Later in this paper I will suggest a number of call report modifications and legislative/regulatory changes that will bring the definition of core deposit ratios used in call report-based core deposit calculations closer to the spirit of the definition of core deposits in the FDIC Examination Manual.

Characteristics/Attributes Most Closely Associated With Core/Brokered CD Debate

If funding sources are to be graded in assessing their volatility or potential role in funding risky assets, it makes sense to examine the attributes of funding sources that might be a factor in slotting funding sources in a graduated scale. For each I will offer an opinion as to whether the characteristic or attribute can be easily measured, the source of the data needed to measure the attribute, and whether it makes sense to include this characteristic/attribute in a funds grading scheme.

Ease of Acquisition

Does the presence of certain kinds of deposits (e.g. brokered, Internet, listing service) inherently increase an institution's risk? To the extent any of the above sources are more volatile in times of liquidity stress, they would increase liquidity risk. However, the same could be said for uninsured retail deposits and other uninsured or uncollateralized sources of funding, like Fed Funds purchased. One of the reasons a graduated grading scheme for grading funding volatility is being proposed later in this paper is to allow an institution's overall trends in funding volatility to be tracked over time and compared to peers.

Does non-core funding facilitate increased risk-taking? I'm sure there are numerous examples of failed financial institutions that funded risky assets with brokered, Internet, and listing service deposits. But the FDIC needs to keep in mind that loans have outgrown deposits 13 out of the last 18 years. The bulk of the industry plugged the funding gap with non-core funding. The vast majority of financial institutions used those funding sources wisely.

I inherently mistrust statistical correlation studies that relate one event to another. For example, in Wisconsin it would be very easy to show a correlation between the appearance of daffodils and the disappearance of snow in April. But is it valid to conclude the appearance of daffodils causes the snow to disappear? It is my belief that an institution inclined to grow using risky assets is going to find the funding to fund that growth in one way or another. For example, were non-core funding not available, an institution might elect to pay particularly high deposit rates for core funding. That approach not only damages the institution's franchise, it also damages competitors. Does the availability of brokered CDs lead to increased risk-taking? I think not, no matter what the statistical correlation studies say.

A concern expressed by many is that when funding is available too easily, it contributes to inappropriate levels of growth and to the acquisition of risky assets. The Federal Home Loan Banks were criticized during the thrift crisis because the easy access to FHLB advances by their members allowed some institutions to rapidly build portfolios of high risk assets. Traditional brokered CDs received similar criticisms, both during the thrift crisis and more recently during the 2008-2010 recession. Many sources of non-traditional funding exhibit features that allow funds to be raised rapidly through these sources. On the other hand, it takes time and effort to grow portfolios of traditional core deposits like CDs and non-maturity deposits in a cost-effective manner through core funding strategies.

It is certainly possible to assess how quickly funds can be brought on line from a particular funding source. Institutions are expected to document ease of availability and periodically test availability of funding sources authorized in their liquidity policy and relied on as part of their contingency funding plan.

However, I feel it would be inconsistent to downgrade a funding source because it allows quick and easy availability of funds, when that very feature causes it to be a desirable contingent funding source in responding to liquidity stress events. For this reason, I wouldn't recommend ease of access as a grading attribute in grading the desirability of funding sources. Furthermore, there are better ways to evaluate whether a funding source is being used to support inappropriate asset growth or acquisition of risky assets than merely downgrading a funding source because of this characteristic/attribute.

Volatility/Stability

Volatility and stability are arguably the most important issues in grading a funding source. The fundamental question is whether the funds will be there in a stressed situation or whether they will disappear, partially or completely. There is a fairly extensive list of factors affecting volatility/stability.

Insured vs. Uninsured

Stability of an institution's core deposits and many of the non-core funding sources lean heavily on the FDIC insurance shield to protect depositors' principal and accrued interest. Many of the change agent funding sources discussed earlier in this white paper use the FDIC insurance shield for protection. CDARS Reciprocal deposits, traditional brokered CDs, and rate board CDs are all examples of non-traditional funding sources using the FDIC insurance shield for protection. There is no question uninsured deposits are more likely to run in a stress situation than insured deposits. It is relatively easy to determine whether deposits are covered by insurance. Call reports already break out insured from uninsured deposits. For all of the above reasons, availability of full insurance coverage is always going to be an important criterion in any deposit volatility/stability grading scheme.

Collateralized vs. Uncollateralized

Some funds providers insist on collateral coverage to back up the funds they are providing. Most notable collateralized funding sources are the FHLB system, the Federal Reserve, the Repo markets, and providers of government funds. Many of these sources are non-core funding sources. Government funds are a special case

in that they are generally gathered locally, but because of their size, they are generally protected by collateral coverage and/or through FDIC insurance coverage obtained through sources like the CDARs Reciprocal Network.

Collateral coverage requirements on funding sources are a two-edged sword. On one hand, collateral backing allows these providers to stick with a troubled institution much longer than funding sources with neither collateral coverage, nor FDIC insurance protection. Collateralization greatly enhances the stability of these funding sources. On the other hand, depending on the kind of collateral backing up the transaction, an institution with significant collateralized funding might find itself short of the asset-based liquidity needed to deal with stress events. This is especially true of collateralized sources requiring high quality liquid assets, like the Repo markets.

Call reports provide limited insight into form and amount of collateral coverage pledged to individual funding line items. Extensive call report changes would be necessary to gather this information. On the other hand, in many cases, sources of funding can be broken down between those that require collateral coverage and those that do not. For example, FHLB borrowings are never offered unsecured and always require collateral coverage.

Any deposit classification system grading volatility/stability of funding sources needs to consider whether the funds are protected with collateral and possibly consider the quality of collateral required. It also needs to consider the fact that during times of performance-based liquidity stress, collateralized funding sources often increase collateral haircuts. Should an institution find itself short of collateral, the increased collateral haircuts could reduce funding availability from the source. Additional pledging requirements caused by increased collateral haircuts could also reduce an institution's asset-based liquidity buffer that could be needed to deal with liquidity stress events.

Term Structure and Options

Contractual Structure of Funding

Generally speaking, the longer the term the funding provider has committed to, the more stable the funding source. It is hard to deny that a recently issued, 5-year FHLB advance is a more stable funding source than a newly issued, 6-month bank CD, in spite of the fact the FHLB has historically been considered a non-core funding source while the CD, if under $250,000, is considered to be core.

In addition, remaining term to maturity is the more important factor than the original term at time of issue. A 5-year bank CD maturing next month would be viewed as a less stable funding source than a 24–month, traditional brokered CD issued yesterday.

Call reports generally ask for maturity information on funding sources based on maturity ranges and remaining maturity. Hence, the data exists in the call report to consider contractual structure of funding in a deposit stability/volatility grading scheme.

Ability to Run

Instruments often provide options to those providing funds to call those funds from the institution prior to scheduled maturity. These options might be formally stated, like a 5-year FHLB advance with a 1-year call option. Or they might be left to the discretion of the user, like a CD customer who is generally expected to pay some kind of penalty for early withdrawal from the contract.

The concern in this context is the likelihood the funds will leave early should an institution experience a liquidity stress event. Most non-traditional funding sources charge a mark to market penalty for early withdrawals or do not allow early termination at all. The major potential problem area with ability to run is retail CDs, because early withdrawal penalties are often inadequate to hold funds in the event of a liquidity stress event.

Information on adequacy of early withdrawal penalties is not gathered as part of the call report process. Unless significant revisions are made, it is difficult to factor this issue into any funds grading system other than making some fairly non-institution specific runoff assumptions. On the other hand, such issues should be taken into consideration in an institution's internal modeling and analysis systems, especially when running liquidity stress events.

Actual Behavior of Funding Source

For many funding sources, behavior of those providing the funding may be materially different than the contractual terms and conditions imply. Here are a few examples:

- Non-maturity deposits can be immediately withdrawn by depositors. However, because they are used to support transactions (checking accounts) and are used to park pools of liquidity that may or may not be earmarked for specific needs, they exhibit long-term behavior characteristics that are different than their contractual characteristics. Under normal circumstances, a pool of these deposits will gradually decay off the books over time. Decay rates are used regularly by financial institutions in projecting cash flows coming off pools of non-maturity deposits when performing EVE and liquidity calculations. While a financial institution suffering economic stress may see increases in decay rates, data from recent failures indicates it is unlikely all of these deposits will disappear entirely, even though the contract would allow that to happen,
- Term funding often remains at an institution after maturity. Most institutions retain 65% to 90% of renewing CD funds at maturity. Liquidity stress could reduce these retention percentages, but data from recent failures indicates it is unlikely that all would disappear at maturity. Funds provided by sources like FHLBs are often renewed at maturity even though an institution is suffering from economic stress as long as there is adequate collateral to back the renewing funds.
- While data on these behaviors is not gathered at the institution level on call reports, it is possible to make generic assumptions based on behavior across the industry or across a specific funding source.

Depositor Relationship

I think that most would agree that a depositor, particularly an insured depositor, is likely to stay with an institution for a longer period of time than a number of other funding sources. But the devil is in the details.

Deposits classified by call reports as core are treated equally, in spite of significant differences in features and behaviors between classes. While some core and non-core deposit balances are broken out in memo entry areas, they are not broken out at the same level of disaggregation as in deposit categories. For example, reciprocal deposits balances are not broken out between CDs and non-maturity deposits, nor are the reciprocal CD balances broken out by remaining maturities on call reports.

Depth of Depositor Relationship

Depth of the relationship is also an important factor in volatility/stability of a deposit funding source. If the relationship with the customer includes an actively utilized personal or business checking account or an operating credit facility, the funds in a checking account are likely to be far more stable than balances in a CD brought in by a single relationship customer. In addition, other deposit accounts owned by a customer who has a relationship-based checking account are also likely to be less volatile.

Call reports do not ask that deposit balances be broken out based on relationship criteria. Development of call report changes needed to provide this information would require a firm definition of what constitutes a stable relationship, fairly significant changes to call reports, and potentially significant development work by the providers of core systems to the industry.

Actions by Counterparties, Intermediaries, and Regulators

Most of the stability/volatility discussion to this point has focused on actions potentially taken by funding source counterparties, should an institution be undergoing a stress event. This group includes most depositors, FHLBs, the Federal Reserve, and other funding sources where an institution obtains funding directly from a provider of funds.

In other cases intermediaries are involved in putting together institutions needing funds with those providing funds. Traditional brokered CDs fall into this category. Most providers of Fed Funds Purchased also fall into this category. It could be argued that reciprocal deposits fall into this category, in spite of the fact the relationship is negotiated between the bank and its customer. That's because the network providing deposit insurance beyond $250,000 intermediates the transactions necessary to provide the additional insurance coverage.

Some intermediaries are willing to intermediate transactions as long as there is FDIC insurance backing up the deposits. Other intermediaries may use third-party scoring models to grade institutions. In the latter case, results from scoring models could lead to restrictions being placed on an institution's ability to gather funds through the intermediary, either in the form of exclusion from any further transactions or by placing a cap on outstanding balances at current levels.

Regulators also play a role in volatility/stability of funding sources through legislation, guidance documents, examination, and regulatory policy. For example, volatility of traditional brokered CDs is significantly influenced by regulatory actions when financial stress causes an institution to drop below well-capitalized status. In most cases, those institutions are blocked from further use of traditional brokered CDs, causing funds provided to roll off an institution's balance sheet as they mature.

Because potential volatility of funds gathered through intermediaries can be measured at the source level, it is relatively easy to consider volatility of a funding source due to actions taken by both the intermediary and regulator, as long as those balances are broken out on call reports.

Cost of Funding

This is a potentially important input into a funding classification system. A good general rule in considering this issue is that the more features of an account that are important to parties to a transaction other than rate, the less sensitive they will be to rate paid. This rule affects the relationship between a bank and its customers. It also affects the relationship between a bank and its potential sources of non-traditional funding.

- In the case of core deposits, high-cost funding is likely to be more volatile than lower-cost funding with a similar duration. In the case of non-maturity deposits, rate-sensitive funds are likely to be more volatile than non-rate sensitive funds. For CDs, rate sensitive customers are less likely to renew CDs with the same institution if competition is willing or able to pay a higher rate. In all these examples, the imposition of interest rate caps on troubled shops by regulators will have a greater affect on the volatility of rate sensitive funds than on non-rate sensitive funds.
- In the case of non-core funding, a bank may chose a high-cost provider over a lower-cost provider based on other attributes of the relationship with the provider. For example, a non-collateralized source might be selected over a collateralized source in spite of lower costs for the latter if the institution is pushing against collateral or asset-based liquidity policy limits. A higher-cost, non-brokered source might be selected over a brokered source if the institution is concerned about the potential of having its access to brokered funding pulled by its regulator or to avoid the stigma associated with the use of brokered funding.

Relative cost of funding can be measured in a number of different ways:

- Differentials in rate paid at the time of the analysis. This can lead to misleading results at extreme ends of the rate cycle. This is particularly true at the bottom of the rate cycle when the relationship between all rates is compressed and when central bank actions to stimulate the economy may cause current rate relationships to deviate from history. A good example is the current unusually low cost of FHLB advances in relation to other comparable duration funding sources.
- Average differentials in rates over time through complete rate cycles. This measure would probably be better than a single point measure. However, in comparing cost of an institution's core deposits to non-core funding alternatives, servicing costs need to be factored into spreads, as it costs money to service core deposits, while it costs far less to service other funding sources.
- Pricing betas which measure the extent to which a change in market rates is passed along in the form of rates paid on various products.

While it is relatively easy to gather relative cost data for most non-core funding sources, gathering data on all-in core deposit costs or pricing betas at the individual product level for individual institutions is much more difficult. Call report income statement data is not sufficiently disaggregated to calculate average funding costs for balance sheet categories listed on call reports. Survey data from third-party survey firms lack information on

balances associated with the survey rates, so weighted costs cannot be calculated. Because of the way in which it is provided, survey data means and medians are also influenced by the extent to which banks employ tiering structures, promotional accounts, and by the number of branches an institution has within a market. While betas are important inputs into A/L models and important outputs from core deposit studies, there is currently no mechanism for regulatory oversight of this analysis other than through guidance documents and as part of the examination process.

In summary, no institution-specific data on deposit pricing is available from call reports, nor is it reliably available from survey firms. Cost data is also not available on retail deposits at the product level. As a result, as desirable as it might be to consider cost data in grading funding sources, it is impractical without major call report changes. The issue of relative funding costs can be much more accurately assessed in the examination process by evaluating the internal systems used by financial institutions in making pricing decisions.

Appropriate Uses of Non-Core Funding

While inappropriate use of non-core funding can play a role in financial institution failures, it is important to recognize when use of non-core funding sources makes a great deal of sense.

As a Structural Tool

Big banks raise funds where they are cheap relative to the curve then use tools like interest rate swaps to move their funding duration where needed to fund the asset side of the balance sheet. Most smaller institutions lack the expertise to use these tools. As a result they use tools like term and amortizing FHLB advances to structure their funding to properly support their assets.

As a Cost Management and Franchise Enhancement Tool

What types of deposits are likely to enhance a failed institution's franchise value and what types of deposits are likely to reduce it? I feel this question should be broadened to focus on both healthy and failed institutions. I'll address the healthy institutions first, then comment on the impact on failed institutions. It should be obvious from the title of this section that I believe non-core funding, when used as part of an effective funding strategy, can enhance franchise value.

Under most circumstances, average cost of core deposits is below that of non-traditional funding sources, even considering cost of servicing. But in order to accelerate growth of core deposits, institutions will generally raise rates paid relative to competition. In doing so, they increase rates on a portion of their non-rate sensitive funds in order to attract rate sensitive funds. So funding costs increase by not only the rate paid on the new funds, they also increase by changes to rates paid on non-rate sensitive funds. As a result the marginal cost of funds raised can be well above the average cost of non-traditional funding.

It makes sense to fund growth of the balance sheet with non-core funding when the marginal cost of core funding is materially above the cost of non-core funding. This is often the case when the industry finds itself in the situation where loans are outgrowing deposits (as they have in 13 out of the last 18 years) as the pressure to grow core funding to maintain liquidity drives up core deposit rates relative to non-core funding costs.

FARIN
KNOWLEDGE-BASED SOLUTIONS

Let's illustrate this point with an example. Say XYZ bank has $100 million in money markets priced in such a way that the all-in cost of funding (including servicing) is 1.0%. This portfolio of MMDAs is modeled in Strategy 1 of Figure 1. The cash flow duration of 4.07 years is derived based on recent OTS money market decay rates of 20% per year. Match funding the cash flows of this portfolio with appropriate term FHLB advances would result in a weighted average alternative funding cost of 3.154%, the Investment Retail Benchmark shown in Figure 1. This analysis assumes that at an all-in cost of 1.0%, XYZ bank is seeing neither growth nor shrinkage in its MMDA portfolio, thus the 100% retention percentage assumption in Strategy 1. Marking future principal and interest cash flows from the MMDAs to market using the FHLB curve as discount rates results in a market value of $91.672 million or the core deposit intangible shown on the right side of Figure 1 of $8.328 million. That $8.328 million would increase Economic Value of Equity (EVE) relative to book capital by an identical amount. EVE is arguably the most important component of an institution's deposit side franchise value.

FIGURE 1 – CURRENT PRICING

Marginal Cost Analysis

Strategy Name:	Current Pricing				Date:	4/23/11 8:29			
Strat Sumry	Balance	Wtd Cost	Duration	Int Expense	Investment Rtl Bench	Spread	FTP Income	ROE	Diff - MV to Book
Strategy 1	100,000.00	1.000%	4.07	1,000.00	3.154%	-2.154%	6,624.60	0.00%	(8,328.06)
Strategy 2	-	0.000%	0.00	-	0.000%	0.000%	0.10	0.00%	(0.13)
Marginal Effect (S2-S1)	(100,000.00)	1.000%	4.07	(1000.00)	3.154%	-2.154%	(6,624.50)	0.00%	8,327.93

Deposit Detail		**Strategy 1**				**Strategy 2**			
Deposit Type	Maturities	Rate	Ret %	Balance	Duration	Rate	Ret %	Balance	Duration
Summary	100,000.00	1.000%	100.00%	100,000.00	4.07	0.000%	0.00%	-	0.00
Detail									
MM - 100K	100,000.00	1.000%	100.00%	100,000.00	4.07	0.000%	0.00%	-	4.07

Let's assume XYZ Bank finds itself in a rising rate environment where market rates (FHLB rates) move up 200 bp. The market rate increase is the result of the Federal Reserve raising rates to slow down a recovering economy. As a result of the recovering economy, our institution experiences increased loan demand and now needs $10 million in additional funding to fund loan growth.

Assume XYZ finds that in order to retain 100% of its $100 million in Money Markets that it needs to move MMDA rates by 75% of the change in market rates (beta = 0.75, Rtn% = 100%). Figure 2 Strategy 1 reflects the new all in cost of 2.5%, an increase of 1.5%. The core deposit intangible has increased from $8.328 million (Figure 1) to $8.843 million (Figure 2, Strategy 1). That increase is a byproduct of the fact the gap between the discount rates used in market value calculations and all-in cost opened up by 50 bp as the MMDA Beta is 0.75 while the FHLB Beta is 1.0. XYZ Bank could plug the funding gap by borrowing $10 million in cash flow matched FHLB advances at 5.06%. Those advances at time of origination would have a market value equal to book, or in other words are neutral to XYZ's EVE. So the total effect of this transaction on EVE is $8.843 million in EVE enhancement relative to book.

FARIN
KNOWLEDGE-BASED SOLUTIONS

On the other hand, XYZ management feels it could raise the $10 million of additional funding needed by moving MMDAs by 90% of the change in market rates (beta = 0.9), raising all-in costs 1.8% to 2.8%. Many would argue that franchise value would be enhanced by using the MMDAs (Strategy 2) to fund loan growth as compared to the FHLB advances (Strategy 1) as the 2.8% average cost of the MMDAs after the pricing change is 226 bp less (Strategy 2 line in Figure 2) than the cost of the FHLB advances. They would be mistaken!

FIGURE 2 – WHOLESALE VS PAYING UP

Marginal Cost Analysis

Strategy Name:	Wholesale vs Pay Up				Date:	4/23/11 8:52			
Strat Sumry	Balance	Wtd Cost	Duration	Int Expense	Investment Rtl Bench	Spread	FTP Income	ROE	Diff - MV to Book
Strategy 1	100,000.00	2.500%	3.80	2,500.00	5.060%	-2.560%	7,996.51	0.00%	(8,843.27)
Strategy 2	110,000.00	2.800%	3.80	3,080.00	5.060%	-2.260%	7,827.04	0.00%	(8,401.65)
Marginal Effect (S2-S1)	10,000.00	5.800%	3.79	580.00	5.060%	0.740%	(169.47)	0.00%	441.62

Deposit Detail		**Strategy 1**				**Strategy 2**			
Deposit Type	Maturities	Rate	Rat %	Balance	Duration	Rate	Rat %	Balance	Duration
Summary	100,000.00	2.500%	100.00%	100,000.00	3.80	2.800%	110.00%	110,000.00	3.80
Detail									
MM - 100K	100,000.00	1.000%	100.00%	100,000.00	3.80	2.800%	110.00%	110,000.00	3.80

When an institution raises rates to go after market share they pay up on a portion of their non-rate sensitive funding in order to attract rate sensitive funding. The difference between these Strategy 1 and Strategy 2 is shown on the Marginal Effect Line. Strategy 2 raises an additional $10 million in money markets. Interest expense is up by $580 thousand. If the increase in interest expense ($580K) is divided into the increase in balances ($10,000K), the marginal cost of the new funding raised is 5.8%. Why is the marginal cost so much higher than the average cost? XYZ bank incurred two separate costs in raising the $10 million in new MMDAs. They paid 2.8% for $10 million of new money costing $280,000 per year. They also paid an extra 30 bp on $100 million in MMDAs they could have retained at 2.5%. That 30 bp increase in rates on non-rate sensitive funds cost them an additional $300,000 per year for a total cost increase of $580,000. The marginal cost of the $10 million is 74 bp above the FHLB alternative (Marginal Effect Line Spread), an increased cost of $74,000 per year.

In the upper right corner of the screen, the effect of the Strategy 2 pricing action is translated into economic value. As a result of incurring a higher marginal cost for MMDAs than the wholesale funding alternative, the MMDA deposit intangible drops from $8.843 million in Strategy 1 to $8.402 million in Strategy 2 in spite of the fact there are $10 million more in MMDAs. In the process they destroyed $441 thousand of EVE. While this is a very simple example, it is neither contrived, nor an irrelevant academic concept. Examples like these have been in my teaching arsenal ever since TB 13 and TB 13-1 were issued by OTS in 1989. Managing economic value was a focus of the Advanced A/L seminar I delivered to OTS examiners during that period. Over the last 20 years we've seen the relationship between marginal cost of funds and the effect on franchise value play out over and over as customers develop strategies to optimize funding costs while meeting growth goals.

In this example, FHLB advances were the alternative non-core source of funding. But any non-core source (brokered CDs, rate board CDs, Internet listing service CDs, etc) could be substituted for the FHLB advances with very similar results. Ironically, the further the non-core source is away from the definition of core in the FDIC Examination Manual, the greater the positive effect on franchise value. That's because non-traditional funding raised from local markets (CDARs Reciprocal CDs, for example), is more likely to cause an upward repricing of some existing customer deposits than funds raised from outside the market (CDARs One Way buys, for example).

Now let's move our focus to failed institutions. One might argue that in an assisted transaction, an acquirer has the ability to break CD rate contracts and to reduce market rates on both non-maturity deposits and CDs. Thus, the higher cost of Strategy 2 (above) would arguably be preferable to Strategy 1, which utilizes a FHLB advance. I would counter by saying that any intelligent management team considering acquiring a failed shop with high-cost deposits is likely to assume the deposit base is loaded with rate-sensitive customers. Breaking contracts on CDs and reducing rates on non-maturity deposits would be likely to cause large quantities of these deposits to flee. As a result, any bid package the management team would submit would be discounted to reflect the volatile nature of this high cost funding. The FDIC is paid less for the funding, increasing the costs of resolving the failed institution. Effective management of funding costs through intelligently constructed core/non-core strategies enhances franchise value for both healthy and failed institutions.

As a Contingent Funding Source

The previous two items illustrate the role non-core funding plays as part of the base funding strategy built into a bank's business plan. But non-core funding sources are also important resources for an institution's contingency funding plan. The Interagency Guidance on Liquidity and Funds Management encourages institutions to diversify funding sources and avoid being overly concentrated in any specific source of non-core funding. It also indicates institutions need to develop contingency funds to deal with stress events that could put a strain on their liquidity. These contingency funding plans need to specify which sources of liquidity will be tapped in dealing with stress events.

Summary on Appropriate Uses

It is important that any funds grading system deployed by the FDIC not discourage or prevent the appropriate uses of non-core funding. Yes, each institution should set overall policy limits on the use of these resources. Yes, limits should also be set at the individual source level. And yes, monitoring systems need to be in place to measure utilization against limits. And finally, it makes sense to ask institutions to define how they plan to use various sources of non-core funding in their balance sheet funding strategy.

Regulatory Agency Options in Dealing with Liquidity and Funding Volatility

Regulatory agencies like the FDIC have a variety of tools to use in monitoring, supervising, and managing financial institution performance and risk management practices. Those tools are implemented and used at three different levels. While the three levels specified in this section represent oversimplification of options available to regulatory agencies, they do represent three key break points in the data collection, analysis, and

supervision process that will be addressed in the rest of this white paper. Note that these levels are my definitions and are not derived from any regulatory definition.

Level 1 - Call Reports and the UBPR

The primary purpose at Level 1 is to monitor trends in performance and risk management and compare the performance of institutions to peers. Call reports will always be backward looking. That's because balance sheets and income statements are always dated by the time they are received by FFIEC and translated into UBPRs.

In spite of the fact that many recently released guidance documents focus on performance and risk in business plans or strategies, it is unlikely that regulators will ever ask institutions to communicate business plans or strategies as part of call reports.

In asking for input on this study, I understand the FDIC has expressed concern about any solutions requiring massive call report changes. The FDIC also expressed a desire to keep the solution simple. Given the complexity of the issues discussed in the previous section, both requests represent a significant challenge to anyone attempting to design a solution.

Many of the ratios used to track risk in the UBPR are rather easily calculated from existing call report data. That is true of the two major measures of liquidity tracked on the Summary Ratios page of the UBPR, the Net Non-Core Funding Dependency ratio and the Net Loans & Leases to Deposits ratio. Most reading this document are familiar with the issues in using these ratios as primary liquidity risk policy limit and measurement tools.

In addressing the issue of use of non-core funding to support inappropriate asset growth, the above two UBPR ratios do not necessarily point out negative trends that may have been occurring in how funding is being used. In the case of loan/deposit ratio, all non-core deposit funding sources are included in the denominator of the ratio. In the case of the net non-core funding dependence ratio, some non-traditional deposit insured sources are included in the core funding totals. As a result, in the liquidity ratio area of the UBPR, these two primary ratios are supplemented with roughly eight additional ratios.

On the positive side, many of the ratios currently used to measure liquidity are cross-balance sheet ratios that examine what is happening on one side of the balance sheet relative to the other side. Cross-balance sheet ratios are desirable in that a properly constructed cross-balance sheet ratio can relate changes in volatility/stability of funding to the portion of total assets requiring stable funding. In my opinion, neither of the above two Summary Ratios page liquidity ratios pass the 'properly constructed' test.

In the ABA Liquidity Toolbox (Toolbox) released in February, 2011, we suggested that a number of the traditional liquidity ratios should be tracked by banks as triggers. Triggers are ratios tracked on a regular basis that are leading indicators of developing problems or areas into which more investigation is merited. We have serious reservations about setting policy limits around any of the current call report liquidity ratios because of their shortcomings. We feel regulators should view the UBPR liquidity ratios in the same manner we recommended in the Toolbox for banks - as trigger ratios that call attention to an area requiring further drilling down and analysis. Such an approach is consistent with how examiners should use call report data and the resulting UBPRs. The

UBPR helps identify areas requiring additional investigation either in an examination or between examinations. The exception might be in the case of a troubled shop where a regulator might enforce limits on these ratios.

The major shortcoming of the ratios currently being calculated to measure liquidity is there is no reliable master ratio that attempts to integrate information contained in the other ratios as an overall liquidity volatility/stability assessment tool. Hopefully, that issue will be addressed by the US banking regulatory agencies as part of this study. It is certainly one of the major recommendations in this white paper.

Level 2 - Legislation, Regulations, and Guidance Documents

Regulators have a right to expect an institution's internal systems to be more sophisticated than those used to produce call report data. If an institution is to evaluate risk in a business plan or strategy, whether the risk be credit, interest rate, concentration, liquidity, or capital, the risk being measured should be addressed with internal measurement systems and internal policy limits.

In the area of liquidity risk, the Interagency Guidance document clearly states liquidity risk should be evaluated in the context of a business plan or strategy. Examiners have every right to expect that an institution will have internal systems in place to meet requirements specified in guidance documents. They also have a right to expect that larger institutions with more sophisticated balance sheets will have more sophisticated measurement and monitoring systems than smaller, less sophisticated institutions. Guidance documents and examinations offer the potential to implement different expectations based on different levels of sophistication.

One of the problems with legislation is that if too specifically defined, it removes regulatory flexibility in dealing with a rapidly evolving banking system, and specifically new, non-traditional funding vehicles. Legislation that hard wired the definition of brokered CDs is a good example of what should be avoided to the extent it is possible.

Level 3 - Examination

Information gleaned from the call reports and UBPR are early warning indicators that may trigger changes in examination frequency and help identify areas of exam emphasis. Of course, the majority of the examination will focus on a review of performance data, results from internal systems, evaluation of quality of internal systems, and quality of management.

While there are a variety of outputs from an examination, the best known is the institution's CAMELS rating based on a combination of quantitative and qualitative measures of performance in key performance, risk management, and overall management areas. A variety of enforcement actions are available to motivate management to correct performance deficiencies.

Developing a Graduated Funding Approach

As developers of the ABA Liquidity Toolbox, we were forced to deal with the above three levels out of sequence. The purpose of the Toolbox was to provide the industry with a set of tools to address the Interagency Guidance on Liquidity and Funds Management - Level 2 in the above hierarchy. Our hope was that institutions taking the

approach recommended in the Toolbox would pull higher scores on the "L" in CAMELS, and be better prepared to deal with liquidity stress events in the future.

If I was to offer a general criticism of the Interagency Liquidity Guidance document it would be that the document is long on "what to do" and short on "how to do it." Of course, "how to do it" is somewhat dependent on the size and complexity of the bank reacting to the guidance document, so I can understand why the document might be long on "what" and short on "how." Similar issues exist with the Interagency Guidance on Interest Rate Risk.

Because the target audience of the ABA Toolbox was primarily community banks, we felt it was important to show how a community bank might implement measurement systems and policy tools that were consistent with the intent of the guidance document. We researched regulatory presentations on the subject and found a general lack of quantitative examples of how to measure liquidity risk and set policy guidelines based on a dynamic approach to measuring liquidity risk in the context of a business plan or strategy.

Our search for regulatory examples captured the Basel Consultative Document on Liquidity and Funds Management. That document introduced two new measurement tools, the Liquidity Coverage Ratio and the Net Stable Funding Ratio. It also discussed the desirability of using a measurement system based on cash flow analysis. While the Toolbox was being developed, the Consultative Document morphed into the Basel III International Framework for Liquidity Risk Measurement, Standards, and Monitoring, released in December, 2010. That document focuses on "how to do it," the part we felt was missing in the Interagency Guidance.

Liquidity Coverage Ratio (LCR)

One of the issues we were attempting to address in the ABA Toolbox was how to determine the minimum acceptable asset-based liquidity buffer called for in the guidance document. We have fielded repeated reports from our bank customers indicating they had been criticized on examinations for having inadequate levels of asset-based liquidity. When they asked the examiner, "How much is enough?" the response was along the lines, "That's for you to figure out and for us to review and criticize if we don't agree with what you established." It is my belief that examiners haven't been provided with tools for making asset-based liquidity buffer assessments and, as a result, are looking at peer group data. The peer data approach is inconsistent with the Liquidity Guidance Document's statement that asset-based liquidity buffers need to be based on an institution-specific assessment.

After reviewing the Basel III LCR calculation, we concluded that setting minimum levels of asset-based liquidity buffers was exactly what the LCR is designed to do. It begs the question, "If a 30-day duration liquidity stress situation occurs, will you have sufficient asset-based liquidity to make it through the 30-day period without tapping into your wholesale borrowing capacity?" The Basel LCR is a stress test incorporating assumptions as to deposit and wholesale funding runoffs caused by the stress, while blocking draw-downs of unused borrowing capacity. It also considers the quality and marketability of unpledged liquid assets, as well as cash flows coming off loans and investments in the 30-day period. While it is a static test, we reasoned, "How much is a business plan likely to affect balance sheet mix in a horizon as short as 30 days?" It also takes a graduated approach to assessing volatility/stability of funding sources.

After reviewing other alternative ways of setting standards for asset-based liquidity buffers, we recommended the Basel LCR as an internal tool (Level 2) for measuring and monitoring asset-based liquidity with some modifications to reflect unresolved US specific issues that have not yet been addressed by US regulatory agencies. We felt the information needed to complete an LCR calculation was available from internal bank systems. We encouraged institutions to adopt the LCR as an internal measurement tool and provided them with a spreadsheet to perform the calculation. Finally, we advised them to set policy limits around this ratio as their primary floor on minimum levels of asset-based liquidity.

Net Stable Funding Ratio (NSFR)

The Basel III Net Stable Funding Ratio is another static stress test ratio introduced in the Basel III Liquidity Framework. It measures whether there is sufficient stable funding in an institution's balance sheet to cover its need for stable funding on the asset side of the balance sheet over a 1-year horizon. Like the LCR, the NSFR makes assumptions as to deposit runoffs and renewal of maturing non-traditional funding over that 1-year horizon.

We rejected the NSFR as a measurement system and policy-setting tool for Level 2 internal liquidity analysis for the following reasons:

- It is a ratio calculated from a static balance sheet. The Guidance called for evaluating liquidity risk in the context of a business plan or strategy. Significant changes to the content of a balance sheet could occur over the 1 year horizon of the NSFR that would not be considered in the NSFR calculation.
- It is already a generic stress test. As so, it wasn't very well suited to add stress test assumptions for the institution-specific stress events called for in the guidance document. We'd be laying stress tests on top of stress tests.

We instead recommended that institutions use their Asset/Liability models to generate sources and uses reports for a business plan or strategy that roll into a 1–year, cumulative liquidity gap/asset ratio. While the focus is on the 1-year ratio, we recommended that the cash flow analysis extend over 2-3 years. Pre-stress policy limits would be set around the 1-year gap. Then the sources and uses report could be stressed with assumptions causing changes in cash flows. Based on the changes in cash flows, the stressed 1-year liquidity gap/asset ratio would be calculated. If necessary, results of the stress test might cause the institution to make changes in the policy limits. Based on liquidity gaps opening as a result of a stress test, a contingency funding plan could be written describing the actions that would be taken and the funding sources tapped into to survive the stress event being tested. Note that while the Basel NSFR was rejected as a primary tool for measuring liquidity using internal systems (Level 2), we encouraged those designing stress tests to review assumptions used in the NSFR and apply them in running their own sources and uses based stress tests.

Level 2/Level 3 Summary

When we completed the work on the ABA Toolbox, we felt we had defined a measurement system framework that would comply with the directives in the Liquidity Guidance document. Institutions implementing the measurement systems and putting the required policy components in place would be likely to be judged to be out in front of the regulatory compliance curve from the standpoint of measurement systems.

In addition we devoted an entire tool to describing the various sources of non-core funding. In that tool, we took them through the thought process on setting overall limits on use of non-core funding and setting limits at the source level. In addition, we encouraged them to define how these funding sources would be used – as part of their base business plan strategy, and/or as a contingent funding resource should a stress event occur. We also provided them with forms they might use in documenting their thought process.

If the measurement system recommended in the ABA Toolbox showed solid levels of liquidity, and the institution had the appropriate role definitions and policy limits in place for non-core funding, we felt they would have taken major steps in the direction of receiving a positive rating for the "L" in CAMELS.

It would be my recommendation that regulatory agencies, including the FDIC, place no restrictions on the use of non-core and near-core funding for institutions with solid ratings for the "L" in CAMELS, solid overall ratings, and who are in compliance with risk-based capital regulations.

However, a better early warning indicator is needed at Level 1 that considers the graduated levels of volatility and stability found in the various forms of financial institution funding. In addition, through trend and peer analysis, the early warning indicator would need to help identify trends in the use of volatile funding to fund risky assets.

Criteria For Level 1 Volatility Measure for Inclusion in UBPR

If I were to define one or more ratios that considered the stability/volatility of funding sources for inclusion in the call report data collection framework with results output to the UBPR, that ratio (or ratios) would meet the following criteria:

- It could be readily calculated from call report data. That means it would need to be a static (rather than a dynamic) measure of liquidity. Call report changes to implement the measure would need to be minimal over the short haul with the ability to ramp up sophistication as needs to do so evolve.
- It would need to be a cross-balance sheet measure that does a comparison over a sufficiently long horizon to be meaningful. Trend and peer comparisons could lead to meaningful conclusions.
- It could be deconstructed into an asset-side and a liability-side measure for trend and peer analysis purposes in much the same way as net interest margin can be deconstructed into yield and cost of funds.
- For the purposes resolving the black/white brokered CD and core deposit issue, it would need to incorporate a graduated approach to measuring volatility/stability of various funding sources.
- It would need to be relatively easy to explain and understand.
- It would need to be sufficiently flexible to deal with new, non-traditional funding products as they become available.
- It would need to consider the most meaningful subset of the attributes in determining volatility/stability discussed earlier in this white paper, while at the same time minimizing call report changes.

FARIN
KNOWLEDGE-BASED SOLUTIONS

Level 1 Recommendation – Basel Net Stable Funding Ratio

A number of potential models were constructed and reviewed that would have the potential of meeting the above criteria. The review of each model led back to the same basic question. Does the industry need yet another model to deal with and implement?

One model reviewed was the Basel Net Stable Funding Ratio. That model, which comes to the industry through Basel is likely to be implemented in some form by US banking industry regulators. It meets most, if not all, of the above criteria for a call report/UBPR ratio. Phase-in date internationally for the NSFR is set for January 1, 2018, a date well into the future.

As discussed earlier, in implementing internal measurement systems (Level 2) for the ABA Liquidity Toolbox, I rejected the Basel Net Stable Funding Ratio as it is a static measure. I felt a sources and uses based tool looking at business plans made more sense with the governing ratio being the 1-year liquidity gap/asset ratio. I also made the point that we cannot ever envision the call report gathering business plan projections so the 1–year, cumulative liquidity gap/asset ratio cannot and is unlikely to ever be displayed on the UBPR.

On the other hand, it is feasible that the Basel Net Stable Funding ratio could be calculated and presented in a simplified form on the UBPR, assuming sufficient changes were made to the call report and some simplifying assumptions made. It meets much of the criteria listed in the previous section.

- It is a cross-balance sheet ratio that measures the extent to which stable funding (numerator) is available to cover assets needing stable funding (denominator). The Basel target for the NSFR is 100% or greater.
- The numerator has the potential to provide an overall index of volatility/stability of an institution's funding base. Trends in this index could be tracked over time and compared to peers. The numerator could be brought up independently of the denominator. For example, the numerator could be brought up first to address some of the needs coming out of the FDIC Brokered CD/Core Deposit study. The denominator and combined ratio could be brought up later, once appropriate asset-side call report changes were made.
- The time horizon of the NSFR is one year, a horizon looking sufficiently far enough into the future to deal with significant stress events and management actions taken to mitigate those events.
- The NSFR is a standard stress test employing parameters like deposit runoffs suggested by Basel. However, in deriving a volatility/sensitivity measure, the FDIC could easily modify some of the volatility assumptions to reflect the complex array of non-traditional funding products being offered by the industry. As new products are introduced, they could be assessed, then dropped into this framework.
- The NSFR applies a graduated scale to different funding products with runoff (volatility/sensitivity) factors ranging from 0% runoff (100% retention) to 100% runoff (0% retention).
- It considers the most important brokered CD debate attributes discussed earlier in this paper – or at least those that can be measured using call report data without huge modifications.
- At a conceptual level, it would be fairly easy to explain.

- While call report changes would be necessary, most of the raw numbers are already being produced by bank core systems. Changes would be mostly restricted to how the raw numbers are aggregated for call report purposes.

Most of the remainder of this document will focus on the numerator of the NSFR (the Available Stable Funding ratio) as funding is the focal point of this paper. While the process in designing the denominator of the NSFR ratio (the Required Stable Funding ratio) would be similar to the numerator, I anticipate this task will be taken on later, and it is not addressed in this paper.

Issues with Current Call Report Feeding NSFR ASF Ratio

Call reports aggregate all insured deposits into a relatively small number of lines on schedule RC-E. Uninsured deposits are aggregated into another set of lines. Within each of these two general categories, non-maturity deposits are broken out from CDs and CD breakdowns by remaining maturity are gathered on Schedule RC-O. RC-E also breaks deposits down by source. Balances for reciprocal deposits (RC-O) are not broken down by type or term. Schedule RC-M breaks down borrowings between FHLB advances and other. Within each of these RC-M categories, balances are broken by remaining term.

The call reports provide no information on imbedded options in term instruments, like call options and early withdrawal options. Significant additional call report breakdowns would be necessary to have institutions provide that data at a time when bank regulatory agencies are walking away from the similar detailed data requirements needed to feed the OTS NPV model.

Anyway, call report breakdowns on funding will need to be modified to deal with the transition of FDIC insurance limits from $100,000 to $250,000. The 12/31/10 call report appears to be partially through that transition. Changes to the call report needed to implement the limited form of the NSFR ASF ratio discussed in the remainder of this document would involve pulling data at the same level of detail for all items reported on RC-E, RC-O, and RC-M. Where appropriate, non-maturity deposit balances should be reported separately from term balances and term balances broken down by remaining term.

Core systems providing information for call reports already are doing this level of disaggregation to complete schedule RC-O, so it is a matter of computing subtotals for balances that are already being disaggregated and reporting to a reorganized call report section.

This is the only major area of call report modifications needed to prepare the numerator of the Level 1 NSFR as recommended in the following section. Note there is precedent for regulatory agencies taking a relatively complex measure designed for internal use (Level 2) and making a number of simplifying assumptions in order to make use of the concepts embodied in the measure at the call report level (Level 1).

A good example of a simplified ratio is the Balance Sheet Liquidity Ratio, one of the two ratios used in measuring "Ability to Withstand Funding-Related Stress" in the large bank assessment. If the calculation of the Balance Sheet Liquidity Ratio is examined, it clearly embodies the concepts of the Basel Liquidity Coverage ratio and even draws its deposit runoff assumptions from that ratio. But simplifying assumptions have been made that:

FARIN
KNOWLEDGE-BASED SOLUTIONS

- Eliminate the need to deal with the differentiation between Level I and Level 2 assets and their associated haircuts in the LCR – a breakdown not currently in the call report.
- Eliminate the need to separate investments pledged from those not pledged as they are in the LCR – information not gathered in the call report.
- Eliminate the need to compare asset and liability cash flows as they are compared in the LCR – as insufficient data to do so is gathered on the call report.
- Eliminate the need to make assumptions as to draw down of unused credit lines as they are in the LCR – as insufficient information to do so is on the call report.

What we end up with is a useful ratio for the purpose of insurance assessment that required minimal call report changes to implement. Yet most would agree that the LCR calculation that properly lives at Level 2 is a superior measure as compared to the Balance Sheet Liquidity Ratio as it takes all of the above factors into consideration.

The author feels that a simplified ASF ratio is a viable candidate to replace the other ratio used in measuring "Ability to Withstand Funding-Related Stress" in the large bank assessment, the Core Deposit/Total Liabilities ratio that has flaws exposed elsewhere in this document.

NSFR Funding Layout Discussion and Issues

Figure 3 is the Basel Available Stable Funding (NSFR numerator) definition.

FIGURE 3 – BASEL AVAILABLE STABLE FUNDING DEFINITION

124. Available stable funding (ASF) is defined as the total amount of a bank's:

(a) capital;
(b) preferred stock with maturity of equal to or greater than one year;
(c) liabilities with effective maturities of one year or greater;
(d) that portion of non-maturity deposits and/or term deposits with maturities of less than one year that would be expected to stay with the institution for an extended period in an idiosyncratic stress event; and
(e) the portion of wholesale funding with maturities of less than a year that is expected to stay with the institution for an extended period in an idiosyncratic stress event.

125. The objective of the standard is to ensure stable funding on an ongoing, viable entity basis, over one year in an extended firm-specific stress scenario where a bank encounters, and investors and customers become aware of:

- A significant decline in profitability or solvency arising from heightened credit risk, market risk or operational risk and/or other risk exposures;
- A potential downgrade in a debt, counterparty credit or deposit rating by any nationally recognised credit rating organisation; and/or
- A material event that calls into question the reputation or credit quality of the institution.

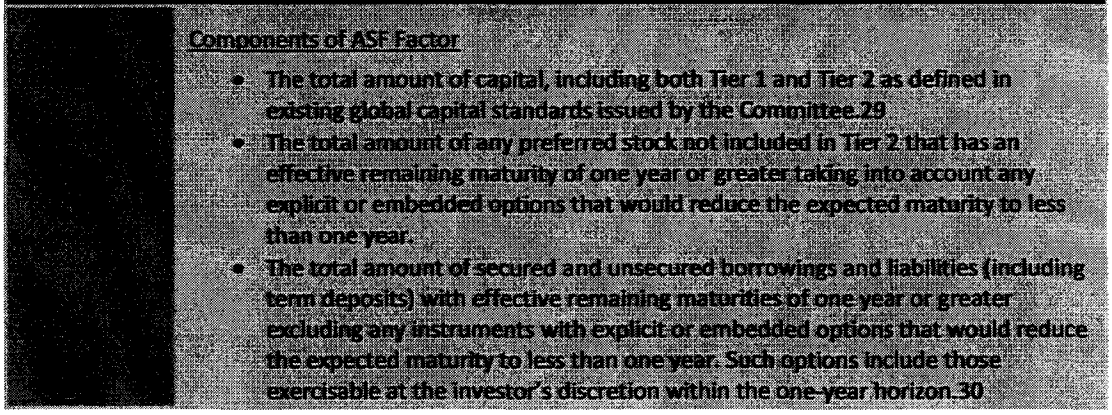
FARIN
KNOWLEDGE-BASED SOLUTIONS

In implementing the ASF measurement, Basel breaks funding into 5 groups and assigns an ASF factor (availability as a percent of the total) to each group. If an institution's funding balances can be broken down into these 5 groups from call report data, total ASF can be computed. By dividing a total ASF by total funding a measure of the liquidity/stability of an institution's funding can be reported on the UBPR. It can them be tracked over time (trend analysis) and compared to peers.

100% ASF Factor Funding and Issues

Figure 4 indicates what is included in the group carrying a 100% factor.

FIGURE 4 – 100% ASF FACTOR FUNDING



The first two items are capital items, Tier 1 and Tier 2 capital and preferred stock with a remaining maturity of greater than 1 year as long, as the preferred stock is not subject to investor executed options that can be exercised within 1 year. The third item is all term borrowings and deposits with remaining maturities of 1 year or more, as long as the term funding does not contain an option that allows the funding to be called inside of 1 year.

As recommended in this section of the white paper, the simplified ASF would be a Level 1 UBPR ratio. It would be entirely reasonable for regulators to ask institutions to consider the impact of imbedded options in analysis performed in internal systems (Level 2). In fact, standards for interest rate risk analysis call for A/L models to consider most forms of imbedded options. On the other hand, the cost of gathering data needed to assess call options in call reports would exceed the benefit in a ratio used for this purpose. I recommend that call options be ignored in calculating Level 1 NSFRs. This is the first major simplifying assumption.

General Discussion Relating to the 90%, 80%, and 50% Categories

The following three sections beg the issue of which deposits are actually bank customer deposits. Keep in mind, I lean strongly in the direction of the definition in the FDIC Examination Manual. One of the issues in that definition is the geographic area over which the deposits are gathered in relationship to the bank's 'market.' While it is theoretically possible to separate core customers from other depositors based on bank service area

definitions as employed in the implementing regulations of the Community Reinvestment Act, neither core systems nor call reports provide an effective mechanism for doing so. Issues include:

- Into which category should traditional brokered CDs or rate board CDs, where the depositors are other financial institutions, be reported. The same question can be raised about deposits gathered through various Internet marketing techniques (Bankrates.com, Google Adwords, MoneyAisle) from well outside an institution's normal deposit-gathering area.
- Into which category should large government deposits that are either protected by collateral pledging or cleared through reciprocal networks be reported.
- Into which category should products like CDARS Reciprocal deposits that are typically gathered from local customers, but are insured to balances beyond $250,000, be reported.

While the following section does not directly address where all of these funding sources should be slotted, it does propose guidelines that will help slot the above items and any other non-traditional funding sources that currently exist or might be developed. These issues will be discussed as we work through the next three sections.

90% ASF Factor Funding and Issues

Figure 5 indicates what is included in the group carrying a 90% factor.

FIGURE 5 – 90% ASF FACTOR FUNDING

Components of ASF Factor:

- "Stable" non-maturity (demand) deposits and/or term deposits (as defined in the LCR in paragraphs 55-61) with residual maturities of less than one year provided by retail customers and small business customers.[31]

55. These retail deposits are divided into "stable" and "less stable" portions of funds as described below, with minimum runoff rates listed for each category. The runoff rates for retail deposits are minimum floors, with higher run-off rates established by individual jurisdictions as appropriate to capture depositor behavior in a period of stress in each jurisdiction.

(a) Stable deposits (run-off rate = 5% and higher):

56. Stable deposits, which receive a minimum run-off factor of at least 5% in every jurisdiction, are those deposits that are fully covered by an effective deposit insurance scheme or by a public guarantee that provides equivalent protection and where:

- the depositors have other established relationships with the bank that make deposit withdrawal highly unlikely; or,
- the deposits are in transactional accounts (eg accounts where salaries are automatically deposited).

The LCR definition comes very close in concept to the definition of core deposits in the FDIC Examination Manual with the exception that the Basel definition indicates that deposit insurance is a criterion in defining deposits as stable. This category receives balances from retail (consumer) and small business deposits, including non-maturity deposits and CDs with maturities of less than 1 year that are considered to be stable. Large business deposits that are fully insured are also included in this category.

Current call reports collect data that separate fully insured deposits from those not fully insured in most cases. On the other hand, most bank systems do not have the criteria and tools designed to separate customer deposit files into pools based on the relationship criteria specified in the Basel or FDIC Examination Manual definitions.

It is our recommendation that the FDIC include all insured deposits in this category that come from sources where the majority of deposits can be assumed to be customer deposits gathered directly from customers, as long as the deposits are fully insured. Reciprocal deposits should be included in this category as they are consistent with both the FDIC Examination Manual and Basel Stable definitions.

This is the second major simplifying assumption. It is assumed if deposits are gathered through normal core deposit channels, the majority of deposits will have a relationship that would qualify under Basel relationship criteria. Because there is no mechanism to differentiate deposits raised via the Internet, as opposed to traditional marketing channels, deposits gathered from customers using Google Adwords, Bankrates.com, MoneyAisle, and other similar sources would be included in this category, as long as they were fully insured.

The following insured funding sources would be among those excluded from this category:

- Traditional brokered CDs – not typically gathered directly from customers and are clearly lacking a significant business relationship. These deposits can be easily excluded as they are currently broken out on the call report.
- Rate Board CDs – Gathered from banks and credit unions, not from retail, small business, or large business customers – again, no significant business relationship exists. These deposits can be easily excluded as they are also currently broken out on the call report.

Note that funding in the 90% ASF factor group includes all non-maturity deposits, but only the portion of term funding with remaining maturities of less than 1 year. Term funding with a maturity greater than 1 year would be reported with the 100% ASF group.

80% ASF Factor Funding and Issues

Figure 6 indicates what is included in the group carrying an 80% factor.

FARIN
KNOWLEDGE-BASED SOLUTIONS

FIGURE 6 – 80% ASF FACTOR FUNDING

Components of ASF Factor:

- "Less stable" (as defined in the LCR in paragraphs 55-61) non-maturity (demand) deposits and/or term deposits with residual maturities of less than one year provided by retail and small business customers.

(b) Less stable deposits (run-off rates = 10% and higher):

57. Supervisory authorities are expected to develop additional buckets with higher run-off rates as necessary to apply to buckets of potentially less stable retail deposits in their jurisdictions, with a minimum run-off rate of 10%. These jurisdiction-specific run-off rates should be clearly outlined and publicly transparent. Buckets of less stable deposits could include deposits that are not covered by an effective deposit insurance scheme or sovereign deposit guarantee, high-value deposits, deposits from sophisticated or high net worth individuals, deposits that can be withdrawn quickly (e.g. internet deposits) and foreign currency deposits, as determined by each jurisdiction.

This definition appropriately places uninsured deposits into a higher runoff category. It also focuses on the fact deposits from sophisticated individuals may be less stable. As we interpret this wording, this category would include the following funding sources:

- Retail and small business deposits that are not fully insured. Note that call reports fail to provide the information needed to screen fully insured deposits into this category based on a lack of a meaningful business relationship. The call reports also fail to identify individuals who are sophisticated investors or high net worth individuals. Given call report limitations, the only retail and small business deposits that would be added to this category are balances that are not fully insured. This is another simplifying assumption.
- Traditional brokered CDs – not gathered directly from customers and lacking a significant business relationship.
- Municipal deposits insured through reciprocal networks – not a retail or small business customer.
- Rate Board CDs – Gathered from banks and credit unions, not from retail, small business, or large business customers – no significant business relationship.

In assessing whether the items listed above other than retail and small business deposits belong in this category, the FDIC should consider:

- Whether actions taken by an intermediary in the above funding sources might restrict or eliminate access to the funding source should an institution find itself under performance-based liquidity stress.
- Whether actions taken by the regulatory agencies might restrict or eliminate access to the funding source should an institution find itself under a performance-based liquidity stress.

FARIN
KNOWLEDGE-BASED SOLUTIONS

Should either the intermediary or the regulator be likely to restrict or eliminate access to the above funding sources in performance-based liquidity stress situations, consideration should be given to moving that funding source to the 50% ASF level.

The NSFR materials do not specifically address the treatment of collateralized wholesale funding. However, there is a much more extensive discussion relating secured wholesale funding in the section of Basel III Liquidity Framework covering the Liquidity Coverage Ratio. Basel applies runoff factors ranging from 0% to 25% based on the liquidity of the collateral pledged against the source of secured wholesale funding. The runoff factors apply a haircut to the collateral assuming that if the funding source was not renewed, the collateral would be sold to fund the outflow. Pledged securities are removed from available highly liquid securities in the LCR. So sale of pledged securities to fund outflow of collateralized borrowings would not reduce asset-based liquidity as measured by the LCR. It makes sense to use the same criteria in dealing with secured wholesale funding in the NSFR as in the LCR.

The call report provides no mechanism to match collateral against secured funding sources. A conservative approach would be to assume a weighted average 20% runoff factor, or an ASF of 80% for secured wholesale funding. Doing so would allocate secured wholesale funding to this category. These sources would include, but not be limited to:

- FHLB advances
- Collateralized government deposits
- Borrowings from the Federal Reserve
- Secured Fed Funds transactions
- Other forms of collateralized borrowings

Note that funding in the 80% ASF factor group includes all non-maturity deposits but only the portion of term funding with remaining maturities of less than 1 year. Term funding with a maturity greater than 1 year would be reported with the 100% ASF group.

50% ASF Factor Funding and Issues

Figure 7 indicates what is included in the group carrying a 50% factor.

FIGURE 7 – 50% ASF FACTOR FUNDING

Components of ASF Factor

- Unsecured wholesale funding, non-maturity deposits and/or term deposits with a residual maturity of less than one year, provided by non-financial corporates, sovereigns, central banks, multilateral development banks and PSEs.

The 50% ASF funding category is designed to capture wholesale funding sources that are neither insured nor backed by collateral. This group breaks into two major subcategories:

- Deposits that are not fully insured and that are supplied by non-natural persons (other than retail or small business).
- Borrowings secured from funding sources that are not backed by collateral.

The thought process used by Basel in assigning a 50% runoff factor to large business customers is that the businesses are likely to have more sophisticated CFOs who are more likely to pull uninsured deposits from troubled financial institutions when a financial institution finds itself in a liquidity stress situation caused by performance issues.

The current call report structure has no mechanism for dealing with the Basel distinction between small and large business deposits. That break point is defined by Basel as aggregate funding in excess of 1 million Euro, approximately $1.4 million US at the time this paper was written. There is currently no mechanism in the call report to break out balances based on this criterion. This breakout could be accomplished by adding an additional break point on the call report at $1.5 million in addition to the $250,000 break point that is already in place.

The major source of uninsured borrowings is the uninsured Fed Funds purchased market. When a financial institution gets into a liquidity stress environment caused by performance issues, actions taken by intermediaries cause this to be one of the first funding sources to disappear.

In the discussion for the 80% group, I mentioned that availability of certain insured non-traditional funding sources is affected by actions taken by regulators when a financial institution finds itself in liquidity stress brought on by performance issues. To the extent the FDIC and other regulatory agencies plan to continue to revoke or restrict access to these funding sources in performance–driven, liquidity risk situations, those insured sources should be placed in the 50% (rather than 80%) group. That recommendation is based on the fact the availability of these sources would be more consistent with other funding sources placed in the 50% group, in spite of the fact the funds are fully insured.

Note that funding in the 50% ASF factor group includes all non-maturity deposits, but only the portion of term funding with remaining maturities of less than 1 year. Term funding with a maturity greater than 1 year would be reported with the 100% ASF group.

0% ASF Factor Funding and Issues

Figure 8 indicates what is included in the group carrying a 0% factor.

FIGURE 8 – 0% ASF FACTOR FUNDING

	Components of ASF Factor
	• All other liabilities and equity categories not included in the above categories.[32]

FARIN
KNOWLEDGE-BASED SOLUTIONS

The 0% ASF factor group captures all other sources of funding not identified in the earlier 100%, 90%, 80%, and 50% groups. For most financial institutions this is a relatively small percentage of funding made up of such items as accounts payable and the like.

Calculating the Available Stable Funding (ASF) Ratio

Once the funding balances on a financial institution's balance sheet has been allocated to the 5 ASF factor groups, a balance weighted ASF ratio can be calculated. Figure 9 shows an example of such a calculation for a $500 million institution.

FIGURE 9 – WEIGHTED ASF CALCULATION

100% ASF	$200 mm	100%	$200 mm
90% ASF	200 mm	90%	180 mm
80% ASF	50 mm	80%	40 mm
50% ASF	48 mm	50%	24 mm
0% ASF	2 mm	0%	0 mm
Total	$500 mm	88.8%	$444 mm

In this case, ASF weighted funding is $444 mm on a $500 million funding base or 88.8% of total funding. ASF weighted funding could be tracked over time through multiple call reports providing trends identifying whether an institution is becoming more or less reliant on more volatile funding over time. ASF values could also be calculated for peers, allowing values for an institution to be compared with peers, to gain a sense for the relative level of volatile funding on their balance sheet. Trends in peer data could also be used by regulators to gain a sense for whether the industry is becoming more or less reliant on less stable funding. And as pointed out earlier it could be used to replace the Core Deposits/Liabilities ratio in the Large Bank Insurance Assessment model.

Using a similar approach of working through data already available on call reports and making simplifying assumptions would also allow regulators to create an index focusing on trends in an institution and peer group averages in concentration of assets in groups requiring support by stable funding (RSF ratio), the denominator of the NSFR. This analysis could be conducted concurrently with or subsequent to development of the ASF index. Once the two studies are complete and implemented in the call report and UBPR, regulators would have a simplified form of the Basel NSFR that measures the extent to which assets requiring stable funding are covered by stable funding, a cross-balance sheet ratio that would help identify trends in the NSFR both at the institution level and peer level.

Developing these simplified NSFR based ratios at the call report/UBPR level (Level 1) would help the industry prepare for introduction of the more detailed version of the NSFR proposed by Basel, should it ultimately be adopted as an internal policy and measurement standard (Level 2) by US banking regulators. It would provide a sufficient period of time to test application of the NSFR concepts to financial institutions with ample opportunity to ferret out unintended consequences of this measure.

2924 Marketplace Drive | Fitchburg, WI 53719 | 1-800-236-3724 | www.farin.com

FARIN
KNOWLEDGE-BASED SOLUTIONS

Recommendations at Level 2 and Level 3

Level 2 - Legislation, Regulations, and Guidance Documents

Basel III Liquidity Ratios

Earlier in this document we discussed our ABA Liquidity Toolbox recommendations aimed at banks attempting to deal with some of the measurement system and policy issues raised in the Interagency Guidance on Liquidity and Funds Management. We rejected the NSFR ratio as an internal measurement tool for reasons discussed earlier and instead recommended a dynamic sources and uses approach based on the institution's business plan or strategy with the governing ratio being the 1–year, cumulative liquidity gap/asset ratio. We made that recommendation in spite of the fact that with the NSFR coming down from Basel, there is at least some possibility US banking regulators will require use of that ratio for internal analysis at some point in the future.

While the simplified call report versions of the component parts of the NSFR AFS ratio recommended earlier in this white paper wouldn't be used directly to set policy limits at Level 2, once those ratios are developed and produced on the UBPR, banks should be encouraged to use those ratios as early warning ratios and triggers in their liquidity policies in much the same way as loan/deposit and net non-core funding dependency ratios have been used in the past.

We did recommend institutions adopt the Basel Liquidity Coverage Ratio as their primary tool for setting policy limits around their asset-based liquidity buffer and adopt the LCR as an internal tool in measuring asset-based liquidity levels. It is certainly possible that call reports could be modified to produce the LCR on UBPRs, but call report modifications would need to be fairly extensive. The FDIC has already faced this issue in the development of the Balance Sheet Liquidity Ratio in the large bank assessment rule. We see the full LCR as a Level 2 tool.

Brokered CD Definition

It is our feeling that the brokered deposit definition should be eliminated from the statutes and regulations as it has outlived its useful life as a tool for identifying volatile funding sources. I suspect that the FDIC will be reluctant to release its power under current rules to cut off access to brokered CD markets for institutions falling below well-capitalized minimums unless that power is replaced with something allowing greater power or flexibility in cases where use of any form of funding is deemed to be a part of taking on inappropriate levels of risk. Therefore, we believe the FDIC and other banking regulators should be empowered to restrict access or cut off access to any funding source a troubled financial institution may be using in what the regulator feels to be an inappropriate manner. Certainly that power exists with core funding when the regulator imposes caps on rates paid for troubled institutions. In addition to providing that general power, the FDIC might consider:

- Use the simplified ASF ratio as a factor in any deposit insurance assessment scheme so institutions with high levels of unstable funding are financially induced to address the situation.
- For institutions with performance problems evidenced by CAMELS ratings, falling below well-capitalized status, or other criteria:

- Require that institutions judged to have insufficient levels of available stable funding be required to raise their AFS ratios to a defined acceptable level within a stated time frame. We prefer this approach over current approaches that totally cut financial institutions off from a particular funding source like traditional brokered CDs. Based on the structure of the current brokered CD statutes, this sanction can be easily circumvented by switching over to a non-brokered funding source that might be every bit as volatile.
- Place caps on levels of funding at the source level for funding sources considered to be less stable.
- Continue to use interest rate caps as a tool to prevent institutions from paying high rates on core funding that have the potential to damage other financial institutions competing in the same markets.

As pointed out earlier, the likelihood of the regulator capping or eliminating access to a particular funding source (like traditional brokered CDs) should be taken into consideration in deciding whether these funding vehicles are slotted into the 50% or 80% groups in the simplified NSFR.

Dealing with Imbedded Options

One issue that should be addressed in future guidance documents is the importance of internal systems measuring the potential effect of call options on term deposits and borrowings in a liquidity stress situation. Stress tests should assume some outflow of funding, especially when CD early withdrawal penalties are less than adequate to hold onto funding. Similarly institutions should be encouraged to develop methods to separate stable from less stable funding along the lines of the Basel definition for internal reporting and analysis. It might also be helpful for the FDIC to incorporate a methodology in future guidance documents that sets minimum standards for early withdrawal penalties on CDs that would allow an institution to make assumptions relative to the level of customers likely to break CD contracts in stress situations.

Core Funding Strategies

Another issue that should have been addressed in the guidance document is the importance of developing a core funding strategy aimed at meeting core funding growth goals while managing funding costs. Core funding is identified in the guidance document as the most critical non-capital funding source. Yet most of the attention in the Liquidity Guidance document is focused on non-core funding.

There are a number of recommendations and considerations in the AFS grading scheme recommendations that heighten the importance of this portion of the liquidity plan.

- The potential factor of relative rate paid on volatility didn't make the cut in developing the final AFS grading scheme because of difficulties in collecting data on call reports and in other ways, particularly on core funding. Yet this information can be or should be found in internal systems.
- When the economy recovers it is likely that loans will begin outgrowing deposits as they have 13 out of the last 18 years. When that happens, liquidity will tighten to levels seen prior to 2008. Institutions will be competing aggressively for deposits in funding loan growth.

- The CD population is aging. When wealth transfers from seniors to Gen X, Gen Y, and boomers, the funds to a great extent are not flowing back into CDs. With my typical customer seeing 50% of core deposit funding in CDs, you have to ask where the funding will come from to fund future loan growth.
- With interest rate floors under a significant portion of bank loan portfolios (VR commercial loans and home equity), many financial institutions will see net interest margin compression for the first 200 bp of rate rise.

An effective core funding strategy and plan:

- Sets overall goals for growth in core funding.
- Sets overall goals for levels of non-core funding in the business plan.
- Is consistent with remaining inside liquidity policy limits.
- Sets goals for evolution of funding mix over time.
- Considers the nature of funding needed to mitigate interest rate risk on the asset side of the balance sheet.
- Provides a plan for meeting core funding growth and mix goals while effectively managing cost of funds.
- Provides the analytical tools to make deposit pricing decisions and to determine when it makes more sense to use non-core funding than core in funding the balance sheet. An example of the kinds of analytics that leads to more effective deposit pricing decisions was highlighted in Figures 1 and 2.

We recommend that the next time the liquidity guidance document is updated, the gaping hole in the liquidity guidance relating to the importance of developing a core funding strategy and plan be plugged.

Level 3 – Examinations

We don't see any major changes being made to the examinations themselves or to the manner in which CAMELS ratings are determined. Certainly some ratios might be swapped out in setting quantitative ratings for the "L" in CAMELS. As pointed out numerous times in this white paper, call report ratios provide a set of early warning triggers that will point examiners to the internal systems and performance areas that need to be examined in depth.

In the previous sections we pointed out a number of areas where the liquidity guidance documents might be upgraded. We also pointed out where changes at the call report level might improve examiners ability to detect developing problem areas.

Clearly the simplified NSFR components (AFS and RFS) would help examiners see trends in bank funding and asset allocation which would help identify areas where greater depth needs to be explored in examinations. The examinations themselves continue to benefit from a focus on the quality of internal systems for measuring and monitoring liquidity risk and the resulting analysis coming out of those systems.

One of the areas we would have liked to address in the volatility/stability analysis at Level 1 was the relative cost of various core and non-traditional funding sources. As pointed out in the previous section, we eliminated it as a criterion in measuring volatility/stability of various funding sources because data was not available from call reports to perform meaningful comparisons, especially as it relates to core funding.

We recommend that in the examination process, examiners review the mechanisms a bank has in place to make deposit pricing decisions and how the institution goes about making funding decisions relating to the use of non-core funding. Institutions claiming that they used non-core funding because it was cheaper overall than core funding should have analysis in place to support that decision. Figures 1 and 2 are examples of analysis tools that might be used to support a decision to use non-core funding, rather than core funding, to support balance sheet growth. Those choosing a higher-cost funding source over a lower-cost source of the same duration should be able to explain why the higher-cost source was chosen.

Finally, in the previous section we recommended a number of changes to regulation and legislation, with a particular focus on the brokered CD issue. Hopefully the changes we recommended would provide examiners an improved tool set in dealing with performance issues, particularly in the area of liquidity, without introducing some of the anomalies brought on by current legislation and regulation.

May 1, 2011

Core and Brokered Deposit Study as Mandated by Section 1506 of the Dodd Frank Wall Street Reform and Consumer Protection Act.

Submission of Public Comment.
April 18, 2011.

Brokered Deposits (BDs) serve very little, or no, valid purpose. They benefit mainly the Broker Dealers and small private intermediary companies ("Brokers") who take substantial placement fees. Brokered Deposits have contributed to failure of many banks, at tremendous expense. Now is the time for regulators to finally step up to the special interests, to stop considering only modifications suggested by the Brokers, and to eliminate Brokered Deposits entirely.

1. Is there a basic rationale for BDs? Are there any strong and well-thought out arguments for BDs coming from the banks, regulators, or the depositors? I am not aware of any independent or government study over the last 30 years that objectively analyzes and presents a meaningful contribution of BDs to economic growth, to sound banking practices, to prudent liability management, etc. Instead, there are back-ward looking justifications and weak support (at best) along the lines of "if used properly, BDs can be a useful funding tool for banks". In fact, the support for BDs is coming not from the banks, depositors, or regulators but overwhelmingly from the Brokers, who are clearly not in a position to provide an objective or balanced rationale. This lack of a basic rational for BDs is telling, and the product should not exist until this is clear and agreed upon. The FDIC is the only party in the proper position to determine, in a rigorous analysis, if there is a fundamental rationale to justify this controversial product.

2. Which banks support BDs and why? Over 30 years, many banks have used BDs and signed up for the programs for various reasons (mainly aggressive marketing by intermediaries) but the real support and the actual use of BDs by the vast majority of banks is very thin and weak. There are several reasons for this but a key reason is that most higher-quality banks do not need or want BDs and most lower-quality banks use them out of some degree of need. BDs are widely viewed by bankers as a marginal, near last resort source of funding, and as a product created by the Brokerage industry that is not really core to their banking business or their customers.

3. Supporters argue today that the focus of regulations should be more on the volatility (or conversely, the stability) of the deposit. The idea is some forms of BDs are stable deposits and so can enhance a bank's liability management. A common statistic quoted is the high rollover rate of certain BDs, sometimes as high as 60 - 90% of BDs rolling over. However this is usually calculated with a simple count of rollovers regardless of the ultimate term of the deposit. For example, a 4 week CD rolling over 8 times before being withdrawn has a rollover / re-investment rate of 89%, which certainly sounds very stable. In reality this is a short-term, 9-month BD, that is at the bank based entirely on FDIC insurance, on the continuing health of the bank, and on a high-enough rate being paid. The BD will be withdrawn at the first sign of any weakness in any of these factors. In addition, there are other fundamentally misleading calculations in the numbers used by the industry to support stability. The FDIC needs to conduct an independent study to measure and validate stability. In addition, it is important to recognize the Brokers themselves have the ability to subjectively cut off the banks from issuing BDs if there condition deteriorates – and the sudden withdrawal of BDs by Brokers have been a critical factor in our largest bank failures. The stability of BDs must be much more critically analyzed in independent study by the FDIC.

4. It is said BDs can be an efficient and cost-effective source of funding for banks compared to raising actual client deposits through branches, advertising, etc. Ignoring the purported 'benefit' of speed in raising BD funds, the FDIC needs to examine the actual fees charged by Brokers for BDs. Today certain Brokers charge a fee for short-term BD placements that, when annualized, exceeds the entire interest rate paid to depositors! In addition, the overall fees for BDs are substantially higher over time than the all-in fees and costs for the other common sources of funding such as Bank Notes, FHLB, MBS, repo, etc. This is a calculation made often by banks with professional liability management capabilities and it is a primary reason why most high-quality banks with access to multiple funding sources do not actively use BDs. Another example of fees that need to be analyzed is in the sweep product where the fees are split heavily toward the Broker/Dealer and the BD Broker, leaving little or nothing for the retail customer. Overall, BDs carry the highest transaction costs among their various funding options for banks and the FDIC must justify this in a full evaluation of BDs.

5. It is argued that BDs allow banks to target certain maturities that are desirable from a liability management perspective, such as 2-5 year maturities, and that these may not be available locally in size. The fact is the volumes available in these maturities is very small (ie a few mln in maximum volume per week) and just "not worth it" to most banks unless they are 'bottom-fishing'.

6. "Callable CDs." are one of the biggest forms of BD. Example: The BD has 7 year final maturity and the bank has a call option at year 3 for example. The banks pays a slightly higher rate for the option. Callables allow the bank to "buy" the call option from the depositor at a much lower rate than they sell it to the Broker at, producing a better all-in cost for the bank at the expense of the depositor (who doesn't know the value of the call option). If rates stay low or drop, the bank calls it in year 3 while if rates rise the bank keeps it outstanding and the depositors are extended into a 7 (or 10, 15) year maturity at then below market rates with no redemption option. The only reason the Callable market has not imploded in a public dispute is we've been in a prolonged period of falling and low interest rates. Another consideration for the FDIC must be the Brokers usually arrange the swaps for the issuing banks to sell off the "optionality" and this area is also a very profitable one for the Brokers, while the depositors assuming all the interest rate risk in the Callable.

7. Reciprocal BDs (RBDs). It is being suggested that RBDs serve the bank's "core " customers in a more stable relationship context. The difference in RBDs is the depositors do chose their bank, unlike other forms of BDs. However this does not make RBDs any more stable than other BDs. In fact, they are probably less stable. RBDs are large deposits (often far above the bank's own $250k insurance limit) and the RBD depositors include large institutions and corporations - the depositors are highly sophisticated in making this decision to concentrate risk, and so they are especially attuned to any deterioration in their agent bank's condition. If their bank weakens, they need to move as quickly as possible to move these deposits. In addition, in the higher-quality banks, the priority is to retain the client's large deposit in their own bank on an uninsured basis based on their own credit strength and relationship with the client. This is a much more desirable overall outcome than 'scattering' their client's deposit to many other banks in a complex RBD transaction. The FDIC must again question the stability and value of this type of BD.

8. The FDIC must examine the Risk Management units of the Brokers. They typically consist of, at most, a few people with limited overall experience. The fact is the Brokered Deposit companies are entirely sales-driven organizations, without any lender

mentality like that of banks, regulators or depositors. Brokers take the position they are not taking any risk and they are not making any credit judgments on individual banks in selling insured BDs (so as not to be deemed securities). The paradigm is, in virtually all cases, that as long as the FDIC is allowing a bank to issue BDs, the Broker will sell them without imposing their own credit judgments. This endemic weakness in Risk management of the Brokers makes it difficult for the supervisory regulators to keep up with BD funding between supervisory and reporting periods. The FDIC must analyze the Risk management quality and fiduciary responsibility of the Brokers and seriously consider this in the overall evaluation of BDs.

9. Coupon rates. The FDIC needs to examine the actual rates and volumes achieved by specific banks. The industry posts "average' rates for BDs – many of these are lower than the prevailing BD market and do not attract meaningful BD volume. They are included to bring down the nominal rates shown to the public, to banks, and regulators. The reality of the BD market, for all types of BDs, is the real volume of funding goes to the banks paying the highest rates. It is well-known in the industry who the frequent issuing banks are and the fact they pay the higher rates. These tend to be the same banks, who use BDs because they have limited core deposit raising ability and/or they are the faster growers or weaker performers. The FDIC must analyze actual coupon and volume data by week to see the extent this is a high rate, high cost source of funding.

Summary Policy perspective:

The main argument for Brokered deposits seems to be that banks should be able to access to BDs as another source of funding to the bank and their loan growth, provided they are heavily regulated and limited to contain the inherent dangers in the product. This is hardly a valid argument when we have created an efficient, productive FHLB system with plenty of capacity to help fund the industry. The industry's liquidity position today proves banks have more-than-adequate funding sources that do not have the moral hazard and harmful track record of BDs.

Virtually all decent and strong banks today have excess liquidity and in addition, they have ample capacity at the FHLB, and in other secured markets. For the stronger banks, they also have all the wholesale funding markets. The reality is the only banks that use BDs today in a substantial way are 1. those without adequate deposit franchises or 2. those that are in a weaker condition and need to raise funds based on FDIC-insurance. Why does the FDIC accept and tolerate this? For the rights of brokers to offer the product? To satisfy the demands of depositors for the product (when they do not publically "demand" the product at all)?

BDs are a marginal, dubious source of funding for the vast majority of banks, not needed nor demanded by depositors today. Brokered Deposits undeniably create moral hazard and cost the FDIC, the Government, and Taxpayer billions of dollars. Soundly managed banks do not need them and indeed do not want to compete with banks that use them because they create a false, unsustainable platform for competition that harms the market and the banking system. Now is not the time to bend to the lobbyists and brokers and to only tinker again with the definitions of acceptable forms of BDs. Now is the time to stand up to the Brokers and special interests, and eliminate Brokered Deposits, before the industry increases their use and dependence on them again in the next cycle, and we suffer the same abuse and costs as we have repeatedly in the past.

May 1, 2011

VIA E-mail: coredepositstudy@fdic.com

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Dear Mr. Feldman:

Thank you for the opportunity to comment on the proposed rulemaking associated with the core and brokered deposits study.

Our comment is focused on the proposed core and brokered deposit study mandated by section 1506 of the Dodd Frank Wall Street Reform and Consumer Protection Act. Section 1506 requires the FDIC to conduct a study to evaluate:

- The definition of core deposits for the purpose of calculating insurance premiums.
- The potential impact on the Deposit Insurance Fund of revising the definitions of brokered deposits and core deposits to better distinguish between them.
- Differences between core deposits and brokered deposits and their role in the economy and U.S. banking sector.
- The potential stimulative effect on local economies of redefining core deposits.
- The competitive parity between large institutions and community banks resulting from redefining core deposits and brokered deposits.

UMB Bank, n.a.

1010 Grand Boulevard
Kansas City, Missouri 64106

816-860-7000

The FDIC is interested in the following: 1) understanding how new methods of obtaining deposits have affected deposit stability and franchise value; and 2) whether changes should be recommended to the core and brokered deposit definitions and to develop new classifications of deposits that depend on characteristics relative to stability or volatility.

Outlined below are UMB's response comments to the requested study questions.

- In times of financial stress, what types of deposits are likely to remain at an institution and what types of deposits are likely to leave the institution?

    - Wholesale deposits of all types are less likely to remain at a stressed institution. Wholesale funding (whether or not in the form of deposit liabilities) has liquidity implications that can exacerbate the stress of a troubled institution.

- Does the presence of certain kinds of deposits (e.g., brokered, internet, listing service) inherently increase an institution's risk? Does their presence facilitate increased risk-taking?

    - The argument has been made that high brokered deposit levels can help predict a financial institution's failure. However, the actual availability of this type of funding, whether brokered or core (through the internet or a listing service), does not inherently cause increased risk-taking. Once increased risk-taking has occurred, the resulting growth in assets may steer an institution to obtain certain types of funding; however, it is not the mere presence of these types of deposits that encourages risk-taking.

- What types of deposits are likely to enhance a failed institution's franchise value and what types of deposits are likely to reduce it?

UMB Bank, n.a.

1010 Grand Boulevard
Kansas City, Missouri 64106

816-860-7000

- During the roundtable discussion on this question, Dr. Haluk Unal declared from his evidence that core deposits enhance franchise value and brokered deposits reduce it. Although we appreciate management of the insurance fund's cost of liquidations, the salvage value of failed institutions should not have such overriding importance that it constrains the sound practices of healthy institutions. We expect that the notion of franchise value may become more complicated over time as the financial markets react to technology and specialization.

- What recommendations would you make for legislative or regulatory changes with respect to core and brokered deposits?

  - The notion of the "core" deposit will certainly change over time, in UMB's opinion. Technology and how the next generation uses that technology will drive the model. The idea that good asset managers will have to be good core deposit gatherers in order to operate is short-sighted in our view. The world is specializing and as such there will be those that will be better at managing the client experience than either the asset manager of the deposit gatherer. A positive client experience will attract deposits into financial institutions in the form of insured deposits. Classifying them as "deposit brokers" and then attaching a negative stigma to those deposits is not a sustainable strategy for the oversight of a modern banking industry.

    Instead the focus should be on liquidity and asset management which is where potential problems can best be avoided. These risk areas, particularly liquidity management, are truly impacted by wholesale deposits and need adequate institutional management and regulatory oversight. This is where the focus should be directed. We are in favor of broadening the definition of what a core deposit is according to how it behaves in terms of volatility, purpose, and effect on an institution's liquidity risk management. However, the longer term solution will require a shift in focus to the asset management practices that are creating the overall risk to the system.

UMB Bank, n.a.

1010 Grand Boulevard
Kansas City, Missouri 64106

816-860-7000

UMB

We provided comment on June 11, 2010 to the original proposal to place a special assessment on brokered deposits. A copy of that comment is attached for reference as we believe that many of the points of that comment are still applicable.

We wish you success in your overall endeavors to improve the management of the insurance fund and to achieve the goal of general health and stability of the banking system.

Sincerely,

James M. Rundberg
Executive Vice President
UMB Bank N.A.
(b)(6)

UMB Bank, n.a.

1010 Grand Boulevard
Kansas City, Missouri 64106

816-860-7000

June 11, 2010

VIA E-mail: comments@FDIC.gov

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Dear Mr. Feldman:

Thank you for the opportunity to comment on the proposed rulemaking change related to the risk-based assessment system and the associated assessment rates.

Our comment is focused on the proposed elimination of risk categories and long-term debt issuer ratings when calculating assessment rates for "large" depository institutions as defined in your notice. The proposed rule triggers the possibility of additional assessment points when a large institution exceeds a 10 percent ratio of brokered deposits.

We are concerned by this provision for the following reasons: The idea of decoupling risk categories from the assessment equation for large banks enforces the stereotyping of large banks, and does not promote the advancement of individual bank accountability that we would like to see. It seems logical that an effective long-term strategy to reduce the risk of bank failure and stress on the insurance fund would be to discriminate as much as possible based on risk analysis of individual institutions, thereby providing advantage to the institutions that are demonstrating the desired behaviors.

Without the existing exclusion of the additional brokered deposit assessments for the Risk Category I banks, the 10 percent threshold appears arbitrary and carries the implication that brokered deposits are inherently undesirable within the context of the FDIC objectives. We agree that brokered deposits can be undesirable under certain conditions within certain financial institutions and do not question the need for a risk management policy for them. However, given the broad definition of a deposit broker we are concerned with the generalization in the proposed rule. It is well known and your organization has had to take steps to address the fact that funding-related stress can be increased through the direct CD market. We believe that some of the direct instruments are more problematic than certain brokered deposit arrangements.

UMB Bank, n.a.

1010 Grand Boulevard
Kansas City, Missouri 64106

816-860-7000

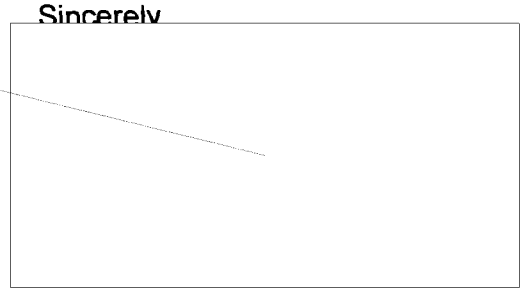
UMB®

Our primary concern is for the growing consumer oriented programs such as broker/dealer FDIC sweep accounts, third party administrator distributed HSA deposits and 529 Plan participant deposits placed in large institutions which will have to compete for a spot within the 10 percent threshold. It is our view that these are legitimate programs that provide beneficial alternatives for consumers. Bank capacity is needed to support them. Because of the rising costs of FDIC premiums, we believe banks will refuse to service these programs as they near the 10 percent threshold.

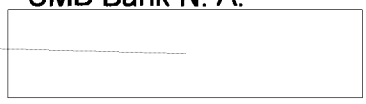
It is our position that prior to implementing the final rule, the FDIC should rethink whether a Risk Category exemption as currently exists should be incorporated for the brokered deposit adjustment. Otherwise, we would suggest that the FDIC work toward discriminating within the broad class of brokered deposits and create more meaningful categories for the various arrangements that exist today. Perhaps life and volatility metrics can be incorporated in the assessment strategy so that these consumer oriented programs are not generalized with the undesirable effects of the brokered CD market which has created a concern for the FDIC and others. It is reasonable to suspect that more third party deposit arrangements will be created in the future as the non-bank financial services channel grows. To the extent that consumers in these non-bank programs desire or require an FDIC insured deposit position, the banking industry and regulatory bodies should nurture appropriate methods for accommodation.

We wish you success in your endeavors to improve management of the insurance fund and the general health of the banking system in these difficult times.

Sincerely

(b)(6) 

Peter J. deSilva
Chairman and CEO
UMB Bank N. A.

(b)(6) 

UMB Bank, n.a.

1010 Grand Boulevard
Kansas City, Missouri 64106

816-860-7000

BRYAN CAVE

April 30, 2011

Bryan Cave LLP
1155 F Street, NW
Washington, DC 20004
(b)(6)

Core Deposit Study Group
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, D.C. 20429-9990
Attn: The Honorable Sheila Bair, Chairman, FDIC
By Email to coredepositstudy@fdic.gov

Re: Comments Relating to the Core Deposits Study: Prepaid Cards and Brokered Deposits

Dear Chairman Bair:

Thank you for the opportunity to share our comments regarding the important issue of should be considered to be brokered deposits. We are writing on behalf of MetaBank, a federally chartered savings association with principal offices in Sioux Falls, South Dakota, and a major issuer of prepaid cards. We are concerned that some have suggested that third party companies that market, distribute or manage prepaid cards programs ("program managers') are likely to be deemed "deposit brokers" with the result that the funds underlying prepaid cards might be "brokered deposits." We believe that the FDIC's deposit broker regulations were never intended to cover such deposits and we urge the Core Deposit Study Group to clarify that funds underlying prepaid cards, such as payroll and general purpose reloadable cards, are *not* brokered deposits.

I. Brokered Deposits: Background.

A. From a practical standpoint: the genesis and commonly held meaning of the terms "brokered deposit" and "deposit broker" does not include prepaid cards

The term "brokered deposit" is defined by statute and regulation to mean a bank deposit that is obtained from or through the mediation or assistance of a "deposit broker." The term "deposit broker" is commonly used and understood to refer to an entity whose purpose and intent to is to market a bank's deposit products to non-accountholders as a means of investment, often in contrast to the term "stock broker":

What is a Deposit Broker? A deposit broker is a type of financial broker that will take money from clients and put it with insured financial institutions. This type of broker seeks to provide an alternative to a traditional stockbroker that allows you only to put money into stocks. With a deposit broker, you can put your money into a variety of fixed income investments. For example, you might decide to purchase a certificate of deposit or a guaranteed investment certificate from the deposit broker instead of stock. Investors that utilize deposit brokers traditionally value safety over pure capital appreciation. The investments of deposit brokers are typically very low risk securities, and they seek to provide regular returns to investors. .[1]

***

Although most investors have traditionally purchased CDs through local banks, many brokerage firms now offer CDs. These brokerage firms - known as "deposit brokers" - can sometimes negotiate a higher rate of interest for a CD by promising to bring a certain amount of deposits to the institution. The deposit broker can then offer these "brokered CDs" to their customers.[2]

***

Buying a brokered certificate of deposit is one possible way to get high CD rates. Basically, deposit brokers use the bargaining leverage they get by referring multiple clients to a bank to help them negotiate for better CD rates. However, that high CD rate does not come without some strings attached. Brokered CDs are far less straightforward than CDs you buy directly from a bank. Here are some things you need to know:

Deposit brokers are not necessarily licensed. Don't let the expression "broker" fool you. Deposit brokers do not have to go through any state or federal licensing process. They may happen to be licensed securities brokers, but this is by no means a requirement. Therefore, you shouldn't assume that qualification or oversight standards are in place for regulating deposit brokers. ...

Identify the financial institution issuing the CD. A broker acts as a go-between, so ultimately there is an unaffiliated financial institution that actually issues the certificate of deposit. You'll want to know the identity of that institution for a couple of reasons. First, you'll want to make sure they are an FDIC-insured bank. Second, you'll want to know in case you have other deposits with that bank -- the $250,000 deposit insurance level is applied per depositor at each financial institution, so having an amount in excess of that

[1] Article on www.Finweb.com, at http://www.finweb.com/investing/what-is-a-deposit-broker.html

2 Article on www.Infotrak.com, at http://www.infotrak.com/Financial-Article/Certificates-of-Deposit_73.html

> limit at one bank would leave a portion of your deposit uninsured, even if it happens to be split into two CDs or accounts.[3]

The above descriptions of deposit brokers, taken from a range of financial service websites, reflect the broadly held view that deposit brokers market a bank's deposit products as investments to non-accountholders. In particular, deposit brokers promote deposit products based on the high level of investment return that such products generate.

This view of deposit brokers and brokered deposits has also been supported and reinforced by federal regulators. The perspective that deposit brokers market bank deposits to potential investors seeking a high rate of return has also been accepted by the FFIEC, which observed, in its 2001 "Joint Advisory on Brokered and Rate Sensitive Deposits":

> Deposit brokers have traditionally provided intermediary services for banks and investors. Recent developments in technology provide bankers increased access to a broad range of potential investors who have no relationship with the bank and who actively seek the highest returns offered within the financial industry. In particular, the Internet and other automated service providers are effectively and efficiently matching yield-focused investors with potentially high-yielding deposits. Typically, banks offer certificates of deposit (CDs) tailored to the $100,000 FDIC deposit insurance limit to eliminate credit risk to the investor, but amounts may exceed insurance coverage. Rates paid on these deposits are often higher than those paid for local market area retail CDs, but due to the FDIC insurance coverage, these rates may be lower than for unsecured wholesale market funding.[4]

In contrast to the typical function of brokered deposits, as described above, payroll and general use reloadable prepaid cards are generally obtained by consumers as a genuine alternative to a bank account. Many users of payroll cards and general use reloadable prepaid cards are otherwise unbanked or under-banked. Those consumers seek payroll cards not for investment opportunities but to obtain the convenience of a bank account with card access. Consumers do not obtain prepaid cards for the opportunity to earn interest. We do not believe that most card issuers even pay interest on such cards.

> B. Bank Regulatory Concerns Regarding "Brokered Deposits" have focused entirely on rate-sensitive depositors and "volatile deposits"

Bank regulators are well-aware of the existence and benefits of deposit brokers. But they are also cognizant of the risks when it comes to reliance on deposit brokers as a source of funds:

---

[3] Richard Barrington, "Buying a Brokered Certificate of Deposit," on www.money-rates.com,at http://www.money-rates.com/advancedstrategies/cd/brokered_certificates_of_deposit_offer_high_cd_rates_with_some_strings_attached.htm

[4] FFIEC "Joint Advisory on Brokered and Rate Sensitive Deposits" (2001) found at http://www.federalreserve.gov/boarddocs/press/general/2001/20010511/attachment.pdf

> Customers who focus exclusively on rates are highly rate-sensitive and provide less stable funding than do those with local retail deposit relationships. These rate-sensitive customers have easy access to, and are frequently well informed about, alternative markets and investments, and may have no other relationship with or loyalty to the bank. If market conditions change or more attractive returns become available, these customers may rapidly transfer their funds to new institutions or investments. Rate-sensitive customers with deposits in excess of the insurance limits also may be alert to and sensitive to changes in a bank's financial condition. Accordingly, these rate-sensitive depositors, both under and over the $100,000 FDIC insurance limit, may exhibit characteristics more typical of wholesale investors.[5]

The concerns underlying deposit brokerage restrictions are focused on the fact that such deposits "are typically attractive to rate-sensitive customers" and are a source of "volatility" for banks.[6]

II. Until the recently revised General Counsel's Opinion No. 8, the funds underlying prepaid cards were not deemed "deposits" and there has been no subsequent indication from the FDIC that its position was that such deposits would be deemed to be brokered.

While the prepaid card industry has been growing since the late 1990's, it was not until 2008, when the FDIC amended its General Counsel's Opinion Number 8, that the prepaid card industry first learned that most prepaid card accounts issued by banks were in fact "deposits" and were insured by the FDIC. The General Counsel's Opinion never mentioned or suggested that, given the new status of prepaid card funds as deposits, such funds would also be deemed brokered deposits. Nor did the two earlier Notices of Proposed Rulemaking on "Stored Value" issued in April 2004, and August 2005 raise the possibility of such a determination. We believe is it reasonable to conclude that that lack of any mention of this important issue reflects an intention *not* to categorize prepaid card funds as brokered deposits.

III. Why the prepaid card industry has succeeded and the "primary purpose" which prepaid products were designed to achieve.

Prepaid cards are a relatively recent payment product that have become increasingly popular over the last 20 years. A recent Federal Reserve Board report on electronic transactions noted the growth of the prepaid card industry, observing that "[p]repaid card transactions had the lowest transaction volume of all noncash payments at 6 billion; however, these transactions represented the fastest growing payment type, increasing 21.5 percent annually from 2006 to 2009."[7]

A 2007 Report published by the Philadelphia Federal Reserve Bank's Payment Card Center (well before General Counsel's Opinion No. 8 was amended and re-issued) explained how "open loop" or "general use" prepaid cards worked and why they were gaining mainstream acceptance:

---

[5] *Id.*
[6] *Id.*
[7] Federal Reserve Board Press Release, December 8. 2010, found at http://www.federalreserve.gov/newsevents/press/other/20101208a.htm

What Are Prepaid Cards?

Simply put, prepaid cards are a payment card product built around a pay early, spend later model, rather than the pay-at-purchase model of debit cards and the pay later model used by credit cards. In other words, they allow users to set aside funds in advance in a prepaid "account" and to draw on those funds for subsequent transactions. Prepaid cards have other distinguishing characteristics as well: They are either single load or reloadable, are limited in acceptance to single or a small set of merchants - or very broadly accepted like traditional branded debit and credit cards and lastly, have either very focused functionality or broader applications. (p. 4)

***

Network-branded or general-purpose prepaid cards are common industry terms that can refer to a number of product configurations. However, for the purposes of this discussion, we use the term "general-use prepaid cards" to describe prepaid products that are: 1) branded with a network logo, such as MasterCard, Visa, American Express, or Discover; 2) reloadable, so that users can direct recurring revenues such as salaries or government benefits to the card or make nonrecurring cash or check "deposits" to replenish the funds as they are depleted; and 3) functionally interchangeable with traditional debit cards for all types of online and offline usage, often including ATM access. These attributes mean that general-use cards can provide a number of critical bank-like services outside traditional banking account relationships. This, in turn, also enables wider, nonbank distribution, including via retail establishments, employers, or government agencies. However, with this added potential for flexibility and advanced functionality come higher costs. (p. 6)

***

Payroll disbursement is another example of an area where general-use prepaid cards deliver increased utility to employees, especially those who lack bank accounts, while dramatically reducing the payroll processing costs of the companies that use them. By successfully addressing the cost issues and providing added consumer benefits, payroll cards are among the most successful of the general-use prepaid applications. According to Mercator Advisory Group, payroll card volume reached $10 billion in 2006, a 60 percent increase over 2005. The research firm estimates that payroll cards in use will grow to 14.2 million by 2008 from just 812,500 in 2004. While estimates for payroll card volumes vary, all sources note rapid growth that affirms the attractiveness of this product to consumers and employers. (p.13)

***

Much of the payroll cards' success can be attributed to their strong value propositions to both sides of the market — employers and employees. Payroll cards offer substantial cost savings to employers. Many employers and payroll processors suggest that electronic delivery of payroll funds can save between $1 to $2 per employer per pay period when compared with the processing costs of paper checks.

Added to these basic costs are other expenses generally associated with check-based payroll systems, including the expense of investigating the inevitable lost or stolen checks, complying with escheat regulation, correcting errors, and issuing replacement checks. Each

of these costs could amount to an additional several dollars per incident. In contrast, after the initial administrative investment and the distribution of the card itself, the marginal cost of subsequent loads on a payroll card is around 20 cents.

This presents a sizable opportunity for sponsors and issuers. MasterCard estimates that $200 billion is paid to unbanked workers annually, through paper checks, which are then typically cashed for a fee, ranging from 1.5 to 3.0 percent at check cashing outlets, keeping these funds and consumers largely outside the financial services industry. Payroll cards offer an efficient means for bridging this gap.(p.13-14)

***

The market opportunity this practice presents for prepaid cards appears to be considerable. ...Notably, many of the banks active in this area do not necessarily expect to make sizable profits from the remittances themselves but see the program as a means to create interest in their other banking products and potentially create cross-selling opportunities.(p.17) [8]

As the above article demonstrates, the prepaid card industry arose to fill important needs not previously addressed under existing payment systems. The genesis of this new payment industry was not focused on facilitating deposits; instead, the prepaid industry grew as an effort to find workable financial solutions for the unbanked population, a way to create cross-selling opportunities for banks, a solution for cutting costs for businesses and governments, and a basis for building additional fee revenues for banks and program managers.
Taken together, we believe that the above research and guidance clearly demonstrates that the "primary purpose" of prepaid cards is not, and has never been, the facilitation of deposits or the placement of funds in insured depository institutions.

IV. The funds underlying prepaid cards are not "volatile" deposits.

We believe that one of reasons that the FDIC has concerns about brokered deposits is the tendency for such deposits to be "volatile," that is, to move repeatedly and quickly from one bank to another. It is a hallmark of brokered deposits that they tend to move from one institution to another, with little or no ties to the bank in which they are deposited at any given time. This is certainly true for investment products such as brokered certificates of deposit, where the only tie to a bank is the interest rate afforded to the funds deposited. This characteristic is not typical, however, for prepaid card deposits. In fact, consumers generally earn no interest on the value loaded to prepaid cards.

There are two ways that prepaid card deposits could move between depository institutions. Neither of these demonstrate the characteristics of a "brokered deposit."

- First, the consumer could choose to cancel a prepaid card and replace it with another card. However, once a consumer has reloaded a prepaid card and/or arranged for

[8] James McGrath, "General Use Prepaid Cards: The Path to Gaining Mainstream Acceptance," *Philadelphia Federal Reserve Bank Payment Cards Center*, available at http://www.philadelphiafed.org/payment-cards-center/publications/discussion-papers/2007/D2007MarchGeneralUsePrepaidCards.pdf.

automatic direct deposit of payroll or benefits onto a prepaid card, the consumer becomes less likely to change prepaid card programs or banks.

- Second, the issuing bank together with its program manager will sometimes agree that a program should be moved to another depository institution. No matter how simple this process may appear on paper (based on the contracts between the parties), such movement is also rare, because a bank's prepaid card program cannot be moved to another bank without complying with the Interagency Bank Merger process. Each such move requires board approval from both bank boards involved, as well as regulatory approval.

Therefore, prepaid cards funds not only have a different purpose from the purposes typical for brokered deposits, but they also do not behave in the same volatile manner that is normally attributed to brokered deposits.

V. Why a broad finding that prepaid card funds are brokered deposits would create serious disruption to the prepaid card industry.

A determination that the funds underlying prepaid cards were brokered deposits would create significant difficulties for nearly every bank that issues prepaid cards.

- First, plainly, it would mean that bank Call Reports going back many years would have been inadvertently incorrect, requiring remedial filings.

- Second, because brokered deposits are considered higher risk and are looked upon with disfavor by many regulators, it would discourage banks from offering prepaid cards and would likely lead some regulators to cap or restrict prepaid products - even for banks that are "well capitalized."

- For many smaller banks that are adequately, but not well, capitalized, such a determination will remove the ability to issue prepaid cards, and thus eliminate an important and stable source of fee revenues, fees that - in this economy - are more important than ever. Given the potential impact of the Durbin Amendment and the Dodd-Frank Act, such banks are also likely to lose significant interchange revenues from their debit card products. General use prepaid cards, which are exempt from the Durbin Amendment, could provide a welcome opportunity to these institutions - - that is, unless prepaid cards are deemed to be brokered deposits.

- Finally, any reduction in prepaid cards will have the unintended consequences of reducing competition and limiting access to financial services to a broad array of underbanked and underserviced consumers who currently rely on prepaid cards for basic financial services.

We hope this Comment Letter is helpful, as you and the Core Deposit Study Group assess these critical brokered deposit issues. If we can be of further assistance, do not hesitate to contact either (b)(6) myself, at [redacted] or my colleague John ReVeal at [redacted] Thanks again for your consideration. (b)(6)

Very truly yours,

(b)(6) [redacted]

Judith Rinearson

Cc: John Hagy, General Counsel, MetaBank
John ReVeal, Bryan Cave LLP

COX | SMITH

ATTORNEYS

April 29, 2010

Karen M. Neeley
(b)(6)

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 Seventeenth Street, NW
Washington, DC 20429

Re: Core and Brokered Deposit Study Mandated by Section 1506 of the Dodd Frank Wall Street Reform and Consumer Protection Act (Act); Submitted to coredepositstudy@fdic.gov

Dear Mr. Feldman:

I am writing on behalf numerous clients of the firm. We represent both federally insured banks, vendors to such banks, and the Independent Bankers Association of Texas.

Section 1506 of the Act requires the FDIC to evaluate: (i) The definition of core deposits for the purpose of calculating insurance premiums; (ii) The potential impact on the Deposit Insurance Fund of revising the definition of brokered deposits and core deposits to better distinguish between them; (iii) Differences between core deposits and brokered deposits and their role in the economy and U.S. banking sector; (iv) The potential stimulative effect on local economies of redefining core deposits; and (v) The competitive parity between large institutions and community banks resulting from redefining core deposits and brokered deposits. On April 1, 2011, the FDIC invited input regarding the following: (i) In times of financial stress, what types of deposits are likely to remain at an institution and what types of deposits are likely to leave the institution?; (ii) Does the presence of certain kinds of deposits (e.g., brokered internet, listing service) inherently increase an institution's risk? Does their presence facilitate increased risk-taking?; (iii) What types of deposits are likely to enhance a failed institution's franchise value and what types of deposits are likely to reduce it?; and (iv) What recommendations would you make for legislative or regulatory changes with respect to core and brokered deposits?

Our bank clients strongly urge the FDIC not to place additional restrictions on a bank's ability to utilize brokered deposits and non-core funding. Direct or core deposits are generally harder to obtain and serves as a natural constraint on growth if not supplemented, to some extent, with brokered deposits. While the existence of brokered deposits at a bank may or may not necessarily enhance franchise value in the event of a bank failure, they help facilitate lending by banks and in today's fragile and slow economic recovery, prudent lending by banks should be encouraged, not discouraged.

We believe that there is no definitive evidence reflecting that a bank's utilization of brokered deposits causes banks to engage in risky lending behavior. Statistics reflect that brokered deposits constituted only 18% of the deposits held in banks that failed since 2004. It wasn't brokered deposits that made these banks fail. It appears to have been a large number of bad loans which can, in the future, be more closely scrutinized by regulators.

Brokered deposits provide a safe, low-cost and reliable source of funds for well-capitalized banks by offering a safe and efficient investment primarily by institutional investors such as money market mutual funds. Most investors place brokered deposits in the same category as government securities and other government-guaranteed obligations. Once placed, a brokered deposit is very likely to remain undisturbed until it matures. Brokered deposits are also less susceptible to bank runs, partly due to long durations and restrictions on withdrawal before maturity, while core deposits are somewhat more susceptible to a run usually precipitated by a local public panic. Brokered deposits allow banks to attract deposits nationally from outside of their local marketplace; thus, diversifying their portfolios.

The key factor in the safe management of a deposit base containing brokered deposits is the ability to obtain new deposits to replace maturing ones. This is not an issue for a well-capitalized bank and the utilization of brokered deposits facilitates this process. Most banks that rely on brokered deposits maintain a portfolio of loans matched to stable brokered deposits of equal maturity. Profits are locked in. Rate risk is eliminated. These banks must hold higher capital ratios to avoid slipping below well-capitalized. The beneficial use of brokered deposits greatly outweighs the few isolated instances where they are misused to fund risky loans.

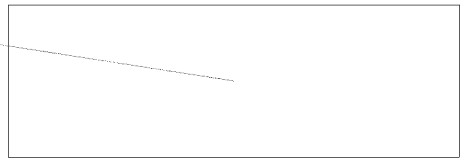
We also believe that the term "brokered deposit" has been, at times, read too broadly especially in light of technological advances in gathering deposits and modern bank business practices. We would respectfully suggest that the term "brokered deposit" has been subject to numerous interpretations, which while helpful, reflect the difficulty in analyzing and truly understanding when a relationship could be tagged as a brokered deposit. As a result of this complex web of statute/rule/interpretations, a wide variety of funding sources have been identified as "brokered deposits" that, are in fact stable. Even if the current definition of "brokered deposit" is not amended, IBC hopes that the FDIC will exercise its significant flexibility in evaluating a bank's liquidity and brokered deposit risk exposure in a reasonable and flexible manner so as not to unduly restrict its use. For example, while the customer's relationship with the bank is an important factor when valuing a deposit, this relationship should not be the determinative factor. The FDIC also has significant flexibility in charging higher deposit insurance premiums for certain high-risk bank products and services.

In particular, we would strongly recommend that spread CDs should specifically be excluded from the definition of "brokered deposits." These funds are stable and do not present the usual characteristics of "hot money." They typically come from existing bank customers who simply want to assure deposit insurance coverage of their funds. Often that desire is driven by requirements from their accountants, or in the case of public funds, statutes.

As representative primarily of community banks, we truly hope that the FDIC's study will not result in the imposition of additional restrictions, on a community bank's ability to utilize brokered deposits and non-core funding, putting such institutions at a competitive disadvantage with respect to obtaining diverse funding sources.

Thank you very much for this opportunity to comment.

(b)(6)



Network Branded Prepaid Card Association
110 Chestnut Ridge Road, Suite 111
Montvale, NJ 07645-1706
201-746-0725

April 28, 2011

The Honorable Sheila Bair
Chairman
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429-9990

Re: Comments Relating to the Core Deposit Study: Prepaid Cards and Brokered Deposits

Dear Chairman Bair:

The Network Branded Prepaid Card Association (NBPCA) is a nonprofit, inter-industry trade association that supports the growth and success of network branded prepaid cards and represents the common interests of the many participants in this new and rapidly growing payments category. The NBPCA's members include banks and financial institutions, major payment card networks, processors, program managers, marketing and incentive companies, card distributors, payment industry consultants and law firms.

We are providing this comment letter regarding Brokered Deposits because we understand that it has been suggested that third-party companies that market and distribute prepaid cards ("program managers") might be "deposit brokers" with the result that the funds underlying prepaid cards might be "brokered deposits."

The brokered deposit statute and regulation, passed during the Savings & Loan crisis of the 1980s, both define "deposit broker" as "any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions, or the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties."[1] Significantly, the statute and regulation both exclude from the definition any agent or nominee whose "primary purpose" is not the placement of funds with depository institutions.[2]

[1] 12 U.S.C. § 1831f(g)(1); 12 C.F.R. § 337.6(a)(5)(i)(A).

[2] 12 U.S.C. § 1831f(g)(2)(I); 12 C.F.R. § 337.6(a)(5)(ii)(I).

The views expressed in this letter do not necessarily reflect the views of all of the individual members of the Network Branded Prepaid Card Association.

e believe that funds underlying prepaid cards should not be considered "brokered deposits," and we urge the FDIC to not to enlarge the scope of its regulations to incorporate prepaid card funds, for the following reasons:

- Program managers do not market and distribute prepaid cards for the primary purpose of creating deposits for banks. Prepaid cards have long been financial products that serve market needs, such as payment of payroll, providing financial access to the under-banked, streamlining expense management, and convenient gift-giving.

- Indeed, the prepaid card industry was flourishing well before the FDIC even designated such funds as "deposits" in its 2008 General Counsel's Opinion No. 8. The industry could not have been developed for purposes of creating deposits, if they weren't even deemed deposits at that time.

- The term "brokered deposits" is often used to refer to volatile deposits that can move quickly and frequently between institutions. In fact, individual prepaid card accounts - especially those reloadable cards that receive regular direct deposits - are generally stable. In addition, entire prepaid card programs cannot be moved easily between banks. If one bank wanted to transfer its program to another bank, a bank merger application would be required, the BIN (bank identification number) for the cards would need to be transferred to the other bank, new cards would need to be issued, and all cardholders would need to receive disclosures and new cardholder agreements.

- While well capitalized banks can theoretically accept brokered deposits without prior regulatory approval, we believe that bank regulators in practice discourage even well capitalized banks from accepting brokered deposits. If prepaid card funds are deemed brokered deposits that are discouraged by regulators, such a result could be highly detrimental for the prepaid card industry and the millions of cardholders who rely such products for basic financial services, as well as for the businesses, governments and employers who use prepaid card to make cost-effective payments.

We urge the FDIC not to include prepaid cards within the definition of brokered deposits. Should you have any questions or require more information, please do not hesitate to contact us at (201) 746-0725.

Very truly yours,

(b)(6)

Kirsten Trusko

NBPCA President and Executive Director

The views expressed in this letter do not necessarily reflect the views of all of the individual members of the Network Branded Prepaid Card Association.

April 28, 2011

VIA ELECTRONIC MAIL (coredepositstudy@fdic.gov)

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Attention: Comments

Re: Core and Brokered Deposit Study

Ladies and Gentlemen:

Total Bank Solutions, LLC ("TBS") appreciates the opportunity to submit comments in connection with the Federal Deposit Insurance Corporation's ("FDIC") Core and Brokered Deposit Study, as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] TBS provides customized deposit management services to the financial services industry through strategic partnerships with financially strong depository institutions.

BACKGROUND

Section 1506 of the Dodd-Frank Act requires the FDIC to conduct a study to evaluate:

- The definition of core deposits for the purpose of calculating insurance premiums
- The potential impact on the Deposit Insurance Fund of revising the definitions of brokered deposits and core deposits to better distinguish between them
- Assessment of differences between core deposits and brokered deposits and their role in the economy and U.S. banking sector
- The potential stimulative effect on local economies of redefining core deposits
- The competitive parity between large institutions and community banks that could result from redefining core deposits and brokered deposits

[1] Pub L. No. 111-203, 124 Stat. 1376 (2010).

In connection with its study, the FDIC requests public comment on the following issues:[2]

- In times of financial stress, what types of deposits are likely to remain at an institution and what types of deposits are likely to leave the institution?
- Does the presence of certain kinds of deposits (*e.g.*, brokered, Internet, listing service) inherently increase an institution's risk? Does their presence facilitate increased risk-taking?
- What types of deposits are likely to enhance a failed institution's franchise value and what types of deposits are likely to reduce it?
- What recommendations would you make for legislative or regulatory changes with respect to core and brokered deposits?

CURRENT DEFINITION OF BROKERED DEPOSITS

FDIC rules define a "brokered deposit" very broadly. Under current rules, a brokered deposit is:

> Any deposit that is obtained, directly or indirectly, from or through the mediation or assistance of a deposit broker.[3]

A "deposit broker" is:

> (A) Any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions, or the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties; and
>
> (B) An agent or trustee who establishes a deposit account to facilitate a business arrangement with an insured depository institution to use the proceeds of the account to fund a prearranged loan.[4]

The term "deposit broker" also includes any insured depository institution that is not well-capitalized which engages in the solicitation of deposits by offering rates of interest which are significantly higher than the prevailing rates of interest on deposits offered by other insured depository institutions in such depository institution's normal market area.[5] Deposit listing services whose only function is to provide information on the availability and terms of accounts do not facilitate the placement of deposits and therefore such services generally are not regarded as deposit brokers under the FDIC's rule.

Accordingly, brokered deposits include deposits in which the entire beneficial interest in a bank deposit account is held by a single depositor, as well as those in which multiple depositors have interests in a given bank deposit account. In some cases, brokered deposits are issued in the name of the

[2] Federal Deposit Insurance Corporation, Press Release, Core and Brokered Deposit Study as Mandated by Section 1506 of the Dodd Frank Wall Street Reform and Consumer Protection Act (Mar. 18, 2011).
[3] 12 C.F.R. § 337.6(a)(2).
[4] 12 C.F.R. § 337.6(a)(5)(i).
[5] 12 C.F.R. § 337.6(a)(5)(iii).

depositor whose funds have been placed in a bank by the deposit broker. In other cases, a bank's deposit account records may indicate that the funds have been deposited in the name of a third party custodian for the benefit of others (*e.g.*, "XYZ Co. as custodian for the benefit of its customers").

As is apparent from the above, the FDIC brokered deposit rule treats all deposits received by depository institutions though the auspices of a broker as brokered deposits, regardless of the reasons. In an historical sense, the broker function has been equated by the FDIC with "instability" in terms of the volatility of funding sources and potential asset choices by a depository. We submit that such an assumption is far too sweeping. The FDIC needs to better understand the volatility of a given type of deposit, brokered or "core," as part of its assessment as to the safety and soundness implications of a given type of funding.

ALL BROKERED DEPOSITS ARE NOT THE SAME

The FDIC has expressed its concern that significant reliance on brokered deposits tends to increase an institution's risk profile, particularly as its financial condition weakens.[6] Moreover, the FDIC has stated the following with regard to the relationship between bank failures and the use of brokered deposits:

> A number of costly institution failures, including some recent failures, involved rapid asset growth funded through brokered deposits. Moreover, the presence of brokered deposits in a failed institution tends to reduce its franchise value, resulting in increased losses to the [Deposit Insurance Fund].[7]

Notwithstanding the FDIC's expressed concerns, the rule makes no distinction for the inherent characteristics of such funds nor does it take into account the financial strength of the institution. Moreover, deposits received through means such as deposit listing services or via the Internet are generally not regarded as brokered even though they may possess characteristics that are virtually identical to those received by means of a deposit broker. Based upon our experience, we believe that it is appropriate for the FDIC to consider the circumstances under which depositors make use of deposit brokers and take into account factors such as the anticipated duration the deposits are likely to remain with the institution. For example, the FDIC needs to subject new types of "core" deposits, as with Internet deposits that have no penalty for early withdrawal, to similar scrutiny.

Certain Customer Funds Are Highly Stable

Customers of more than 25 banks and registered broker-dealers currently maintain deposits aggregating in excess of $10 billion at more than 100 depository institutions participating in TBS's proprietary deposit sweep program. Banks and broker-dealers participate in TBS's program primarily in order to provide their customers with a secure place to maintain investments and temporarily idle funds awaiting investment or other purposes. TBS's program enables customers to obtain pass-through FDIC insurance while obtaining a reasonable return on their funds. Unlike broker deposit programs with which the FDIC has expressed concern (*e.g.*, unstable balances at above market rates), customers at banks and broker-dealers participating in TBS's program are not reaching for yield, but rather are

[6] 76 Fed. Reg. 10672, 10683 (February 25, 2011).
[7] 76 Fed. Reg. at 10682.

seeking a safe, federally-insured repository for their investments and idle funds at a reasonable rate. These customers typically have longstanding relationships with, and a high degree of loyalty to, their banks and broker-dealers.

TBS's experience is that such funds are extremely stable and do not exhibit sensitivity to rate movements. As evidence of this stability, we have attached information regarding our experience with 48 depository institutions participating in the program. As indicated, $ 7.9 billion of the deposits participating banks agree to accept from depositors ("Target Balances") have been maintained at these institutions for the entire time each of these 48 institutions have been participants in TBS's program. Almost 80 percent of the funds placed by participants in TBS's program banks have virtually no volatility associated with them. Our experience has been that once placed, such funds simply do not move from participating institutions regardless of where we happen to be in the economic cycle. Accordingly, it is our view that deposits that exhibit low volatility and which are not issued at above market rates should not be regarded as brokered deposits by the FDIC. Indeed, in view of their stability, depository institutions should be encouraged to solicit the sources of deposits such as these to fund their loan and investment portfolios.

Strong Depository Institutions Should Not Be Hamstrung

We believe that depository institutions that are in sound financial condition should not be required to treat deposits obtained through deposit brokers as brokered deposits so long as the institution remains in strong financial condition. Depository institutions participating in TBS's program that are recipients of customer funds are selected based upon their financial strength and stability by an independent third party, after meeting stringent financial criteria. These criteria include four key ratio requirements:

- Risk Weighted Ratio > 6%
- Leverage Ratio > 5%
- Gross Revenue Ratio > 60%
- Texas Ratio < 50%

TBS's program banks are monitored by the independent third party on a quarterly basis. These institutions must meet the applicable financial and performance criteria continuously in order to remain in the program. Depository institutions that are in sound financial condition should not be penalized for accepting deposits through deposit brokers. The FDIC recognized this concept in its 1995 interpretive letter which stated the following:

> The prudent use of brokered deposits within legal requirements is entirely acceptable. Brokered deposits should be treated and assessed as any other funding alternative having its own special advantages and disadvantages. Furthermore, the acceptance of brokered deposits should not be grounds for criticism *per se* by virtue of the nature or origin of such deposits without considering the manner in which they are used and the impact of such use on the institution's overall condition and operations.[8]

[8] FDIC Interpretive Letter 95-24 (April 26, 1995).

Accordingly, we urge the FDIC to address its concerns by considering prudential limits on the ability of weaker financial institutions to rely upon brokered deposits as a funding source.

CONCLUSION

We applaud the FDIC's willingness to consider issues regarding its brokered deposit rule. We believe that it is important for the FDIC to take into account the dynamic nature of the marketplace and the inherent nature of the deposits now covered by the brokered deposit rule as well and the financial strength of institutions that serve as repositories of such funds.

TBS appreciates the opportunity to provide its views in connection with the FDIC's study of brokered deposits.

Sincerely,

(b)(6)

Signed:
Dennis Borecki
Managing Partner

(b)(6)

Signed
Ronda K. Feldman
Managing Partner

(b)(6)

Signed:
Eric Pierce
Managing Partner

Total Bank Solutions, LLC

Attachment: Target Balance Duration Report

tbs TOTAL BANK SOLUTIONS

Target Balance Duration

Attachment

Bank	Start Date	Target Balance	Months At Target Balance
Bank A	April-07	$ 60,000,000.00	46
Bank B	April-07	$ 20,000,000.00	46
Bank C	April-07	$ 20,000,000.00	46
Bank D	April-07	$ 10,000,000.00	46
Bank E	April-07	$ 10,000,000.00	46
Bank F	April-07	$ 30,000,000.00	46
Bank G	April-07	$ 5,000,000.00	46
Bank H	July-07	$ 10,000,000.00	43
Bank I	October-07	$ 5,000,000.00	40
Bank J	October-07	$ 500,000,000.00	40
Bank K	October-07	$ 10,000,000.00	40
Bank L	October-07	$ 70,000,000.00	40
Bank M	April-08	$ 1,000,000,000.00	34
Bank N	April-08	$ 50,000,000.00	34
Bank O	July-08	$ 6,000,000.00	32
Bank P	July-08	$ 3,000,000.00	32
Bank Q	July-08	$ 400,000,000.00	32
Bank R	July-08	$ 25,000,000.00	32
Bank S	July-08	$ 2,000,000.00	32
Bank T	July-08	$ 165,000,000.00	32
Bank U	July-08	$ 150,000,000.00	32
Bank V	October-08	$ 7,000,000.00	29
Bank W	October-08	$ 5,000,000.00	29
Bank X	October-08	$ 125,000,000.00	29
Bank Y	October-08	$ 1,000,000.00	29
Bank Z	December-08	$ 3,000,000.00	26
Bank AA	December-08	$ 1,000,000,000.00	26
Bank BB	December-08	$ 7,500,000.00	26
Bank CC	December-08	$ 5,000,000.00	26
Bank DD	December-08	$ 15,000,000.00	26
Bank EE	December-08	$ 50,000,000.00	26
Bank FF	December-08	$ 3,000,000.00	26
Bank GG	December-08	$ 200,000,000.00	26
Bank HH	December-08	$ 5,000,000.00	26
Bank II	December-08	$ 3,000,000.00	26
Bank JJ	December-08	$ 175,000,000.00	26
Bank KK	January-09	$ 3,000,000.00	25
Bank LL	January-09	$ 13,500,000.00	25
Bank MM	January-09	$ 2,000,000,000.00	25
Bank NN	January-09	$ 5,000,000.00	25
Bank OO	April-09	$ 25,000,000.00	22
Bank PP	April-09	$ 500,000,000.00	22
Bank QQ	April-09	$ 10,000,000.00	22
Bank RR	April-09	$ 20,000,000.00	22
Bank SS	April-09	$ 126,000,000.00	22
Bankl TT	April-09	$ 50,000,000.00	22
Bank UU	July-09	$ 2,000,000.00	20
Bank VV	July-09	$ 1,000,000,000.00	20

Independent Bank

230 West Main Street, Ionia, Michigan 48846
IndependentBank.com

April 29, 2011

VIA E-Mail:coredepositstudy@FDIC.gov

RE: Comments of Independent Bank on the Federal Deposit Insurance Corporation's "Core and Brokered Deposit Study as Mandated by Section 1506 of the Dodd Frank Wall Street Reform and Consumer Protection Act"

Dear Federal Deposit Insurance Corporation:

This letter is submitted on behalf of Independent Bank (IB). In this letter, Independent Bank provides its comments to the Federal Deposit Insurance Corporation (FDIC) on its Core and Brokered Deposit Study as mandated by Section 1506 of the Dodd Frank Wall Street Reform and Consumer Protection Act.

IB has been an active participant in the DTC brokered CD market for the past 15 years, issuing short term bullets as well as long term bullets and callables through primary and regional dealers.

IB has been a member of Promontory Interfinancial Network since the fourth quarter of 2008 utilizing the Certificate of Deposit Account Registry Service (CDARS).

IB has limited experience with a national internet CD listing service.

The request for comment addresses specific questions for consideration. The questions and Independent Bank's responses and comments are contained hereafter.

Question: In times of financial stress, what types of deposits are likely to remain at an institution and what types of deposits are likely to leave the institution?

The deposits most likely to remain in times of financial stress are insured deposits. Insured deposits include non-maturity deposits, time deposits obtained via the branch network, time deposits obtained through an internet CD listing service, DTC issued brokered deposits and CDARS deposits. DTC issued brokered deposits only have early withdrawal risk in the event of the death of a depositor. This feature greatly mitigates funding risk via early withdrawal. The other deposits mentioned do not have this covenant. Couple this with the ability to obtain term funding in the DTC issued brokered deposit market, and term brokered CDs become one of the most likely of all deposits to remain in times of financial stress.

The deposits most likely to leave in times of financial stress are uninsured deposits.

Comments of Independent Bank on the FDIC's Core and Brokered Deposit Study

Question: Does the presence of certain kinds of deposits (e.g., brokered, internet listing service) inherently increase an institution's risk? Does their presence facilitate increased risk-taking?

Concentrations of certain deposits may increase an institution's risk, but an increase in risk is not inherent. IB does not believe the presence of certain deposits facilitates increased risk-taking. Loan underwriting and funding decisions are made independent of one another at IB and there is no feedback loop between these departments which would facilitate increased risk-taking.

Question: What types of deposits are likely to enhance a failed institution's franchise value and what types of deposits are likely to reduce it?

IB feels that insured, low cost non-maturity deposits (particularly DDA accounts) are most likely to enhance a failed institution's franchise value. Alternatively, uninsured, high cost deposits are the most likely to reduce a failed institution's franchise value. The aforementioned costs are in relation to current market rate conditions.

Question: What recommendations would you make for legislative or regulatory changes with respect to core and brokered deposits?

There are a couple recommendations IB would make.

Recommendation #1
IB would encourage the FDIC to reconsider current restrictions on brokered deposits and acknowledge that in some cases this funding source provides stable core funding. There are several reasons for this.

1) IB has historically been able to obtain brokered deposits at or below the cost of alternative time deposits. Alternative time deposits being time deposits obtained via the branch network and/or time deposits obtained through an internet CD listing service. At present, brokered and time deposits obtained through an internet CD listing service have similar rates. It is our understanding that historically, the rates paid on deposits obtained through an internet CD listing service have been slightly higher than brokered. A comparison of current rates in IB's market shows that brokered rates are generally in the top quartile of rates posted by local competitors (which is in line with rates offered through IB's branch network). It should be noted that these rates do not reflect the cost savings of using brokered deposits from an operational perspective.

Processing time deposits obtained via the branch network entails certain costs, namely: marketing, occupancy, deposit operations, employee salaries and benefits, audit and IT support. Meanwhile, it is IB's experience, that considerable brokered CD volume can be managed by a small number of employees and has a significantly lower impact on the other departments mentioned.

2) The brokered deposit market is the most efficient facility for obtaining term deposits at a reasonable cost. In IB's experience, obtaining term funding through CDs originated via the branch network is difficult and costly. Furthermore, IB's deposit customer base has a preference for short term saving vehicles. Thus, obtaining a meaningful volume of term funding from the local customer base is difficult regardless of the rate offered. The

ability to procure a substantial volume of term funding from the brokered market is not only cost effective but absolutely instrumental in the management of interest rate risk and liquidity for a community bank such as IB.

In a similar vein, the brokered market affords IB the ability to issue callable term funding (where IB holds the call option). A callable deposit structure is not readily available in IB's retail banking footprint. The issuance of callable brokered CDs provides IB with tremendous flexibility with respect to interest rate risk management as well as liquidity at a reasonable cost.

3) The brokered CD market is very deep, and funding is reliable. In times of market dislocation, the brokered CD market has remained open when other markets have become prohibitively expensive or closed to new issuance.

4) There is a minimal amount of early withdrawal risk on DTC issued brokered deposits. These deposits are only redeemable before maturity in the event of a depositor death. In IB's experience, individual death puts are small and in aggregate have not posed a significant funding risk.

Recommendation #2

IB would encourage the FDIC to reconsider the categorization of certain CDARS deposits as "brokered".

IB believes that CDARS reciprocal transactions where an institution places current customer deposits in the CDARS system should not be categorized as brokered deposits.

In IB's experience, there is typically a strong customer relationship between the institution and the entity placing deposits into the CDARS system. IB usually has other deposit account relationships as well as treasury management services with the client. The CDARS deposits are fully insured so the incentive for the depositor to withdrawal these CDs if the institution were to experience financial stress is diminished. Finally, the rates paid to depositors on the CDARS have generally been similar to the rates offered on CDs originated in the branch network and the brokered market.

Sincerely,

(b)(6)

Robert N. Shuster
Chief Financial Officer

(b)(6)

April 28, 2011

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Email: coredepositstudy@fdic.gov

Re: Core and Brokered Deposit Study as Mandated by Section 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act

Dear Mr. Feldman:

On behalf of the Millennium Trust Company, LLC ("Millennium"), a non-depository state trust company headquartered in Oak Brook, Illinois, we would like to offer the following comments to the Federal Deposit Insurance Corporation's (the "FDIC") study regarding core and brokered deposits as mandated by Section 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. We thank the FDIC for giving us the opportunity to listen to and review the transcript of the Core and Brokered Deposits Roundtable Discussion held on March 18, 2011 (the "Roundtable Discussion") and to provide our comments of the FDIC's study.

Introduction, General Comments and Recommendations

Section 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires the FDIC to conduct a study to evaluate, among other things, the potential impact on the Deposit Insurance Fund of revising the definitions of brokered deposits and core deposits to better distinguish between them, differences between core deposits and brokered deposits and their role in the economy and U.S. banking sector, the potential stimulative effect on local economies of redefining core deposits, and the competitive parity between large institutions and community banks resulting from redefining core deposits and brokered deposits.

If the FDIC deems custodial demand deposits, similar to those used by Millennium in its business as described in more detail below, to be brokered deposits and therefore subject to additional limitations and restrictions, community banks would not be able to readily avail themselves of these custodial demand deposits. The characterization of custodial demand deposits as brokered deposits would have a discernable negative impact on community banks while benefiting large banking institutions.

Millennium agrees with the FDIC that focusing on volatile versus non-volatile deposits is a critical element in the core versus brokered deposit discussion but Millennium believes that the FDIC should treat custodial demand deposits as core deposits. A key aspect of Millennium's use of custodial demand deposits with community banks is the stable relationship Millennium maintains with such community banks. These deposits do not increase risk taking since Millennium does not change the bank in which it maintains custodial demand deposits with the purpose of seeking a higher rate elsewhere. Each time Millennium faces a decision about where to deposit its clients' funds, Millennium satisfies its duties to its clients by depositing funds with the banks Millennium already has a long-term stable relationship with to the extent that such banks have the capacity to accept more deposits from Millennium. If none of the banks with which Millennium has a long-term stable relationship can accept any further deposits from Millennium, Millennium would then go into the marketplace to seek a community bank that is able to accept custodial demand deposits from Millennium and with which Millennium would seek to establish a long-term relationship. Because custodial demand deposits provide stability to community banks based on the long-standing relationships community banks have with their depositors, Millennium recommends that the FDIC clarify that custodial demand deposits are treated as core deposits.

Cash deposits from custody accounts maintained at banks are neither volatile nor similar to "brokered deposits". These deposits are ultimately controlled by the individual owners of custodial accounts at Millennium. These owners are not chasing rates for their idle funds awaiting investment or distribution. When the funds of a large number of custody accounts, most with relatively small amounts of idle cash, are placed with a bank under an omnibus account structure, the balances in that omnibus account have proven to be very stable. Thus, these non-volatile balances enhance the franchise value of the community and regional banks Millennium uses to hold these custodial funds. Millennium does not act as a deposit broker and does not receive any fee, commission or other compensation from the bank. Thus, if the FDIC decides to continue or to impose additional constraints or limitations of some sort on brokered deposits or other types of deposits determined to be volatile, such constraints or limitations should not be applied to the custodial demand deposits discussed herein.

Summary of Millennium's Business

Millennium is a non-depository state-chartered trust company located in Oak Brook, Illinois, a suburb of Chicago. Millennium acts as a directed custodian for client accounts, including individual retirement accounts ("IRAs"), health savings accounts ("HSAs"), investment advisors, small pension plans and other custody accounts. As an agent for these account owners, Millennium invests the funds in the accounts as directed by them in assets of their choosing. For cash awaiting investment or distribution, where not directed otherwise, Millennium offers a cash investment tool that sweeps such client funds into a bank interest-bearing demand account. The account owners choose to use this program for administrative convenience and the added safety of FDIC insurance. The manner in which this program is administered by Millennium creates a relationship with the banks holding the balances, and provides those banks with stable balances which enhance the value of their franchises. These balances, like other demand deposits, do not chase interest rates and are not otherwise volatile.

Millennium does not provide investment advice or management. All investments in client custody accounts are directed by the account owners or their investment advisors. Millennium does not sell or solicit any investment. Millennium provides custody for traditional investments, while specializing in the custody of alternative assets such as private equity, promissory notes, precious metals, real estate, and privately placed funds and various types of pooled investment vehicles.

Millennium's primary purposes in acting as custodian are (i) to provide custody for the traditional and alternative assets held in the custodial accounts and (ii) to perform the administrative responsibilities required by applicable law (e.g., reporting to the IRS for IRAs and HSAs). The vast majority of Millennium's custodial accounts are IRAs. Currently with regard to the deposits discussed here, Millennium acts as an agent/custodian and is therefore excluded from the definition of a deposit broker under Section 29(g)(2)(I) of the Federal Deposit Insurance Act (the "FDIA"). Millennium is also excluded from the definition of deposit broker under Section 29(g)(2)(H) of the FDIA in instances in which it acts for qualified pension or profit sharing plans. If Millennium was not excluded from that definition, the FDIA would characterize these individuals as holding brokered deposits because the IRS and the Department of Labor ("DOL") require the use of a custodian for the funds and other assets in their accounts. Millennium has a significant number of IRAs established by employee benefit plans for non-responding and missing participants where the plan fiduciaries are seeking to take advantage of the DOL's safe harbor.[1] The safe harbor specifically requires that the funds in those IRAs be placed in an investment that seeks stability of principal such as a bank account.

Millennium currently holds approximately $566 million in demand deposits for approximately 132,000 custodial accounts in 10 different banks. The relatively small average account balance is indeed a factor in the stability of the total balances in a given omnibus account. Millennium may or may not receive additional banking services from these banks.

Custodial Demand Deposits Are Stable Deposits

In certain instances with troubled banks the FDIC has treated custodial demand deposits from Millennium and other custodians as "brokered deposits" possibly because the FDIC perceived these deposits to be volatile. As discussed herein, Millennium believes, and its experience has shown, that its custodial demand deposits are not volatile, are placed in banks with a conscious effect to limit concentration and are placed with banks where a substantial relationship is formed between Millennium and such bank. If Millennium withdrew its funds to chase rates, the community banks that it has relationships with as well as other community banks would be less willing to accept custodial demand deposits in the future.

The FDIC and the participants at the Roundtable Discussion recognized that demand deposits tend to be more stable than certificates of deposit. Millennium has also found that to be true of the custodial demand deposits generated by its custody accounts.

[1] *See* 26 U.S.C. § 401(a)(31).

Mechanics of Custodial Demand Deposits

Each custody account owner has the ability to direct the investment of cash in their custody account awaiting investment or distribution as they choose. Millennium's clients have made it clear that for cash in their custody accounts not otherwise being invested they have just two concerns; (i) ease of administration and (ii) the safety of their cash through FDIC insurance. Therefore, Millennium, like other custodians, implemented and administers a program for cash for which there is no investment direction required from the account owner. In its custodial agreements with its clients, Millennium provides for an automatic sweep which moves idle cash into an interest-bearing demand account at an FDIC-insured bank. In fact, to accommodate the occasionally substantial amount of cash in a given account owner's custody account (perhaps associated with a large IRA coming from an employee benefit plan rollover or the sale/liquidation of an interest in an alternative asset) the cash sweep program uses up to four banks to provide up to $1 million of FDIC insurance. The cash from each individual custody account is placed in omnibus accounts at banks selected by Millennium. Each omnibus account is titled and records are maintained as required by the FDIC in order to pass through the FDIC insurance to the participating accounts. The only types of accounts placed in these omnibus accounts are those held for individuals, non-profit organizations and other owners which qualify for negotiable order of withdrawal accounts.

At any point in time, an account owner may find the interest paid by the bank or banks holding the cash from such account owner's custodial account on-line or by calling Millennium. Because cash in these custody accounts represents funds awaiting investment or distribution, including income derived from other assets in such client's account, current interest rate inquiries occur infrequently. Millennium has endured no pressure from account owners to chase rates.

Stable Relationships with Community Banks

The FDIC is appropriately considering the relationship between the depositor and the bank as a key factor in judging core versus brokered deposits, and volatile versus non-volatile deposits. The individual custody account owners will not have a personal relationship with the banks selected by Millennium as custodian, however, Millennium has long recognized the necessity and benefits of developing a strong and lasting relationship with each bank where custody account balances are maintained. Millennium focuses predominately on community and midsized regional banks where Millennium's CEO and COO can meet and converse with senior bank executives. Millennium reviews candidate banks for reputation, safety and soundness, and stability; and ensures they are well capitalized. The concentration limit for deposits in an individual bank is typically set by Millennium at somewhere between 3% and 5% of the bank's total assets, depending on the specific situation. Millennium purposefully establishes relationships with community banks because community banks are willing to enter into a long-term relationship with Millennium due to the fact that they do not have the access to the capital markets that the large banks have.

Before Millennium opens an omnibus bank account with a candidate bank, the nature of the custodial demand deposits are explained to the bank, including the fact that Millennium's clients, not Millennium, are the account owners of the individual accounts in the omnibus

account and that such account owners decide when his or her funds will be withdrawn. Millennium discusses with the candidate bank its experience with these custodial demand deposits and how it has been able to establish and successfully manage a target range with a maximum for the level of balances in any one bank. The key to the stability of the total deposits in any one bank is the large number of custody accounts invested by Millennium in any one omnibus account, while balances for the average account remain small. Some account owners will make deposits, while others will make withdrawals. The account owners are not withdrawing funds from their custody account at the bank to chase rates, but for individual and personal reasons such as to meet a required minimum distribution from an IRA or to make an investment.

Naturally, with each new bank the issue of interest rate is part of the discussion. Millennium recognizes that with custodial demand deposits a bank may change the rate it offers to its depositors at any time. When searching for a new bank, either to accommodate funds from new accounts or an increase in cash from existing accounts (due perhaps to reactions to market or other economic factors), all other criteria being equal, Millennium typically chooses the bank with the highest rate. As the FDIC is aware, given the interest rates available today, the term "highest rate" is somewhat of a misnomer.

Millennium and a candidate bank enter into a non-binding letter of understanding prior to custodial demand deposits being deposited in such bank. The letter of understanding summarizes the points discussed above and provides for on-going quarterly discussions between Millennium and the bank designed to review the operation of the omnibus account, address any changes in the situation of either the bank or Millennium, and to build the relationship between Millennium as agent and custodian for its account owners and the bank. Millennium receives no fee or commission from the bank. Its sole compensation is received in the form of custodial fees charged to its accounts and disclosed to its account owners.

To date, Millennium has moved balances in only two instances: (i) where the bank dropped its rate below the market rate, as the bank desired to shrink its deposit base for its own reasons and (ii) at the request of a bank at the behest of the FDIC where the particular bank was having difficulties and Millennium's concentration of custodial demand deposits was deemed to be too high. In both of these situations, due to Millennium's relationship with these banks, Millennium was able to work with the banks to withdraw its deposits in a controlled manner over an agreed upon time frame. If and when deposits are required to be withdrawn from a community bank, Millennium's relationship with the community bank allows Millennium and the bank to come to an understanding about moving the custodial demand deposits and would not be the cause of a liquidity event at the bank. While brokered deposits might intuitively be seen to as the first to flee, actually under the current FDIC regulations they are the first and only deposits that might be required to flee. The custodial demand deposits are not brokered deposits and therefore should not be so affected. As with individual depositors, the assurance of the FDIC that the deposits remain insured when a bank runs into difficult times is the best glue possible for keeping all custodial demand deposits with that bank.

While Millennium has the authority to withdraw funds from any given bank, Millennium sees no value in jumping from one bank to another to chase whatever rate increase might be

available in the demand deposit market place. Rather, the stability of a bank's appetite for custodial demand deposits and a minimum of changes to the banks in a given custody account are recognized as essential to the success of Millennium's cash investment program.

Current Market Conditions for Custodial Deposits at Community Banks

A primary concern for Millennium is finding banks with capacity and willingness to accept custodial demand deposits. Many banks have cut back on lending which has affected their appetite for even stable deposits; a side of the deposit issue that was not discussed at the Roundtable Discussion. Finding community and midsize regional banks willing to establish a long-term relationship, plus the time and effort it takes to establish that relationship, makes it difficult to move such balances and adds to the "stickiness" of these deposits, and thus their value to the banks.

Conclusion

The FDIC should recognize that custodial demand deposits of the type administered by Millennium are core deposits. These deposits are stable deposits that add to the franchise value of the community banks at which they are deposited. Millennium maintains strong, long-term relationships with the community banks holding these deposits and does not withdraw the funds to chase rates. The FDIC's treatment of these custodial demand deposits like brokered deposits would make these deposits less available to community banks and would have a discernable negative impact on community banks.

Millennium appreciates the opportunity to share its comments with the FDIC on the study regarding core and brokered deposits. Should you have any questions or require additional information please contact Brad Markham, General Counsel, at (b)(6) or by e-mail at (b)(6)

Sincerely,

(b)(6)

Gary A. Anetsberger
Chief Operating Officer
Millennium Trust Company, LLC

This comment letter is being submitted on behalf of Atlantic Central Bankers Bank, a bankers' bank serving the mid Atlantic region with over 300 shareholder community banks.

The area of consideration being addressed is the definition and interpretation of core deposits.

While the increase in FDIC insured deposits from $100,000 to $250,000 is being considered for 'call report' reporting purposes, a concern is being raised as relates to the regulatory interpretation of true core funds.

Historically, even though the FDIC insured limit was $100,000, an institution such as ours was able to successfully demonstrate that the underlying liability was consistently stable by documenting its duration and the long standing relationship of the depositor as one of our shareholder community banks.

Utilizing the characteristic of the underlying liability has been a long standing litmus test throughout the financial institution community and is also one of the options being discussed to determine the definition of brokered and non brokered deposits.

This is especially true of bankers' banks and banks which maintain large portfolios of corporate clients. All of these institutions maintain large demand deposit positions with their customers who have different characteristics than the average consumer, yet are vital to the success of the communities they serve.

Should the $250,000 limit become a hard cap in terms of considering deposits as "core" unilaterally, it would negate the true characteristics of the underlying liability.

The negative effects to consider are as follows:

- An immediate large scale transfer of business to the Federal Reserve Banks. The Federal Reserve Banks already are exempt from the costs associated with FDIC insurance and with the exception of the Federal Home Loan Banks, community banks would have little alternative other than the Federal Reserve Banks. This would reverse the trend of providing the private sector with the opportunity to make the payment system a more efficient process. Ultimately, more costs would have to be passed along to the consumer due to the lack of competitiveness.

- An onerous burden for community banks which would now have to open a myriad of demand deposit accounts with an untold number of correspondent or bankers' bank institutions.

- Significantly decrease the effectiveness of lending to small businesses. The best example would be the 19 bankers' banks that transact business with over 5,000 community financial institutions, inclusive of loan participations. If the funding source for bankers' banks is severely limited, the higher priced alternative funding sources

would result in a diminished ability to fund loan participations with community financial institutions. Not only would the funding capability be diminished, but a higher cost of funds would result in more risk being sought to maintain margins.

- It provides a distinctive advantage for large banks which have cheaper alternative funding sources and are still thought of as 'too big to fail.' This disadvantage is felt most by the small banks on Main Street.

In summary, we feel it is in the best interest of bankers' banks, correspondent banks, and ultimately community banks and the consumer to allow for the determination of core funding to be linked to the underlying characteristics of the liability.

(b)(6)

From: Browne, Bob
Sent: Thursday, April 28, 2011 9:13 AM
To: Core Deposit Study
Subject: RE: Internet Deposits

I met yesterday with the Director of a State Division of Banking and he was unclear about this difference and how they were viewed differently by Regulators. Clarity on the use of Internet CDs versus Brokered CDs would be greatly appreciated.

Robert T. Browne
Director
McGladrey
(b)(6)

We are now known as McGladrey. Please note that my email address has changed to: (b)(6)

From: Core Deposit Study [mailto:CoreDepositStudy@FDIC.gov]
Sent: Wednesday, April 27, 2011 12:51 PM
To: Browne, Bob
Subject: RE: Internet Deposits

Thank you for providing your comments. We will consider them as part of the process of developing our Study. If you have any additional comments, please feel free to post them to this mailbox by May 1, 2011.

(b)(6)

From: Browne, Bob
Sent: Monday, March 07, 2011 12:55 PM
To: Core Deposit Study
Subject: Internet Deposits

I would like the FDIC to address the use of internet based CDs versus Brokered CDs and the regulatory position with regard to their use. I have found these very useful for our clients to obtain funds at rates below their market rates and can be used to raise deposits quickly.

Robert T. Browne
Director
McGladrey
(b)(6)

We are now known as McGladrey. Please note that my email address has changed to: (b)(6)

Experience the power of being understood℠.

Click here to learn **the power**.

DISCLAIMER:
This e-mail is only intended for the person(s) to whom it is addressed and may contain confidential information. Unless stated to the contrary, any opinions or comments are personal to the writer and do not represent the official view of the company. If you have received this e-mail in error, please notify us immediately by reply e-mail and then delete this message from your system. Please do not copy it or use it for any purposes, or disclose its contents to any other person. Thank you for your cooperation.

Circular 230 Disclosure: Any advice contained in this email (including any attachments unless expressly stated otherwise) is not intended or written to be used, and cannot be used, for purposes of avoiding tax penalties that may be imposed on any taxpayer.

Alternative Practice Structure Disclosure: McGladrey is the brand under which RSM McGladrey, Inc. and McGladrey & Pullen, LLP serve clients' business needs. The two firms operate as separate legal entities in an alternative practice structure.

DISCLAIMER:
This e-mail is only intended for the person(s) to whom it is addressed and may contain confidential information. Unless stated to the contrary, any opinions or comments are personal to the writer and do not represent the official view of the company. If you have received this e-mail in error, please notify us immediately by reply e-mail and then delete this message from your system. Please do not copy it or use it for any purposes, or disclose its contents to any other person. Thank you for your cooperation.

Circular 230 Disclosure: Any advice contained in this email (including any attachments unless expressly stated otherwise) is not intended or written to be used, and cannot be used, for purposes of avoiding tax penalties that may be imposed on any taxpayer.

Alternative Practice Structure Disclosure: McGladrey is the brand under which RSM McGladrey, Inc. and McGladrey & Pullen, LLP serve clients' business needs. The two firms operate as separate legal entities in an alternative practice structure.

Core and Brokered Deposit Study as Mandated by Section 1506 of the Dodd Frank Wall Street Reform and Consumer Protection Act.

Submission of Public Comment.
April 18, 2011.

Brokered Deposits (BDs) serve very little, or no, valid purpose. They benefit mainly the Broker Dealers and small private intermediary companies ("Brokers") who take substantial placement fees. Brokered Deposits have contributed to failure of many banks, at tremendous expense. Now is the time for regulators to finally step up to the special interests, to stop considering only modifications suggested by the Brokers, and to eliminate Brokered Deposits entirely.

1. Is there a basic rationale for BDs? Are there any strong and well-thought out arguments for BDs coming from the banks, regulators, or the depositors? I am not aware of any independent or government study over the last 30 years that objectively analyzes and presents a meaningful contribution of BDs to economic growth, to sound banking practices, to prudent liability management, etc. Instead, there are back-ward looking justifications and weak support (at best) along the lines of "if used properly, BDs can be a useful funding tool for banks". In fact, the support for BDs is coming not from the banks, depositors, or regulators but overwhelmingly from the Brokers, who are clearly not in a position to provide an objective or balanced rationale. This lack of a basic rational for BDs is telling, and the product should not exist until this is clear and agreed upon. The FDIC is the only party in the proper position to determine, in a rigorous analysis, if there is a fundamental rationale to justify this controversial product.

2. Which banks support BDs and why? Over 30 years, many banks have used BDs and signed up for the programs for various reasons (mainly aggressive marketing by intermediaries) but the real support and the actual use of BDs by the vast majority of banks is very thin and weak. There are several reasons for this but a key reason is that most higher-quality banks do not need or want BDs and most lower-quality banks use them out of some degree of need. BDs are widely viewed by bankers as a marginal, near last resort source of funding, and as a product created by the Brokerage industry that is not really core to their banking business or their customers.

3. Supporters argue today that the focus of regulations should be more on the volatility (or conversely, the stability) of the deposit. The idea is some forms of BDs are stable deposits and so can enhance a bank's liability management. A common statistic quoted is the high rollover rate of certain BDs, sometimes as high as 60 - 90% of BDs rolling over. However this is usually calculated with a simple count of rollovers regardless of the ultimate term of the deposit. For example, a 4 week CD rolling over 8 times before being withdrawn has a rollover / re-investment rate of 89%, which certainly sounds very stable. In reality this is a short-term, 9-month BD, that is at the bank based entirely on FDIC insurance, on the continuing health of the bank, and on a high-enough rate being paid. The BD will be withdrawn at the first sign of any weakness in any of these factors. In addition, there are other fundamentally misleading calculations in the numbers used by the industry to support stability. The FDIC needs to conduct an independent study to measure and validate stability. In addition, it is important to recognize the Brokers themselves have the ability to subjectively cut off the banks from issuing BDs if there condition deteriorates – and the sudden withdrawal of BDs by Brokers have been a critical factor in our largest bank failures. The stability of BDs must be much more critically analyzed in independent study by the FDIC.

4. It is said BDs can be an efficient and cost-effective source of funding for banks compared to raising actual client deposits through branches, advertising, etc. Ignoring the purported 'benefit' of speed in raising BD funds, the FDIC needs to examine the actual fees charged by Brokers for BDs. Today certain Brokers charge a fee for short-term BD placements that, when annualized, exceeds the entire interest rate paid to depositors! In addition, the overall fees for BDs are substantially higher over time than the all-in fees and costs for the other common sources of funding such as Bank Notes, FHLB, MBS, repo, etc. This is a calculation made often by banks with professional liability management capabilities and it is a primary reason why most high-quality banks with access to multiple funding sources do not actively use BDs. Another example of fees that need to be analyzed is in the sweep product where the fees are split heavily toward the Broker/Dealer and the BD Broker, leaving little or nothing for the retail customer. Overall, BDs carry the highest transaction costs among their various funding options for banks and the FDIC must justify this in a full evaluation of BDs.

5. It is argued that BDs allow banks to target certain maturities that are desirable from a liability management perspective, such as 2-5 year maturities, and that these may not be available locally in size. The fact is the volumes available in these maturities is very small (ie a few mln in maximum volume per week) and just "not worth it" to most banks unless they are 'bottom-fishing'.

6. "Callable CDs." are one of the biggest forms of BD. Example: The BD has 7 year final maturity and the bank has a call option at year 3 for example. The banks pays a slightly higher rate for the option. Callables allow the bank to "buy" the call option from the depositor at a much lower rate than they sell it to the Broker at, producing a better all-in cost for the bank at the expense of the depositor (who doesn't know the value of the call option). If rates stay low or drop, the bank calls it in year 3 while if rates rise the bank keeps it outstanding and the depositors are extended into a 7 (or 10, 15) year maturity at then below market rates with no redemption option. The only reason the Callable market has not imploded in a public dispute is we've been in a prolonged period of falling and low interest rates. Another consideration for the FDIC must be the Brokers usually arrange the swaps for the issuing banks to sell off the "optionality" and this area is also a very profitable one for the Brokers, while the depositors assuming all the interest rate risk in the Callable.

7. Reciprocal BDs (RBDs). It is being suggested that RBDs serve the bank's "core " customers in a more stable relationship context. The difference in RBDs is the depositors do chose their bank, unlike other forms of BDs. However this does not make RBDs any more stable than other BDs. In fact, they are probably less stable. RBDs are large deposits (often far above the bank's own $250k insurance limit) and the RBD depositors include large institutions and corporations - the depositors are highly sophisticated in making this decision to concentrate risk, and so they are especially attuned to any deterioration in their agent bank's condition. If their bank weakens, they need to move as quickly as possible to move these deposits. In addition, in the higher-quality banks, the priority is to retain the client's large deposit in their own bank on an uninsured basis based on their own credit strength and relationship with the client. This is a much more desirable overall outcome than 'scattering' their client's deposit to many other banks in a complex RBD transaction. The FDIC must again question the stability and value of this type of BD.

8. The FDIC must examine the Risk Management units of the Brokers. They typically consist of, at most, a few people with limited overall experience. The fact is the Brokered Deposit companies are entirely sales-driven organizations, without any lender

mentality like that of banks, regulators or depositors. Brokers take the position they are not taking any risk and they are not making any credit judgments on individual banks in selling insured BDs (so as not to be deemed securities). The paradigm is, in virtually all cases, that as long as the FDIC is allowing a bank to issue BDs, the Broker will sell them without imposing their own credit judgments. This endemic weakness in Risk management of the Brokers makes it difficult for the supervisory regulators to keep up with BD funding between supervisory and reporting periods. The FDIC must analyze the Risk management quality and fiduciary responsibility of the Brokers and seriously consider this in the overall evaluation of BDs.

9. Coupon rates. The FDIC needs to examine the actual rates and volumes achieved by specific banks. The industry posts "average' rates for BDs – many of these are lower than the prevailing BD market and do not attract meaningful BD volume. They are included to bring down the nominal rates shown to the public, to banks, and regulators. The reality of the BD market, for all types of BDs, is the real volume of funding goes to the banks paying the highest rates. It is well-known in the industry who the frequent issuing banks are and the fact they pay the higher rates. These tend to be the same banks, who use BDs because they have limited core deposit raising ability and/or they are the faster growers or weaker performers. The FDIC must analyze actual coupon and volume data by week to see the extent this is a high rate, high cost source of funding.

Summary Policy perspective:

The main argument for Brokered deposits seems to be that banks should be able to access to BDs as another source of funding to the bank and their loan growth, provided they are heavily regulated and limited to contain the inherent dangers in the product. This is hardly a valid argument when we have created an efficient, productive FHLB system with plenty of capacity to help fund the industry. The industry's liquidity position today proves banks have more-than-adequate funding sources that do not have the moral hazard and harmful track record of BDs.

Virtually all decent and strong banks today have excess liquidity and in addition, they have ample capacity at the FHLB, and in other secured markets. For the stronger banks, they also have all the wholesale funding markets. The reality is the only banks that use BDs today in a substantial way are 1. those without adequate deposit franchises or 2. those that are in a weaker condition and need to raise funds based on FDIC-insurance. Why does the FDIC accept and tolerate this? For the rights of brokers to offer the product? To satisfy the demands of depositors for the product (when they do not publically "demand" the product at all)?

BDs are a marginal, dubious source of funding for the vast majority of banks, not needed nor demanded by depositors today. Brokered Deposits undeniably create moral hazard and cost the FDIC, the Government, and Taxpayer billions of dollars. Soundly managed banks do not need them and indeed do not want to compete with banks that use them because they create a false, unsustainable platform for competition that harms the market and the banking system. Now is not the time to bend to the lobbyists and brokers and to only tinker again with the definitions of acceptable forms of BDs. Now is the time to stand up to the Brokers and special interests, and eliminate Brokered Deposits, before the industry increases their use and dependence on them again in the next cycle, and we suffer the same abuse and costs as we have repeatedly in the past.

(b)(6)

From: Jim Peters

Sent: Monday, March 14, 2011 6:23 PM

To: Core Deposit Study

Subject: Brokered Deposit Comments

In order for a bank to utilize the brokered deposit market, I would propose that several conditions would need to be met:

1) ***Risk-based capital would need to be above 10%, maybe even 12%. The bank must be very strong and stable.***
2) ***Non-performing loans, 90-day past dues, and other troubled assets such as OREO are to be marketed to market (discounted to their anticipated valuation at liquidation) and subtracted from Risk-based capital to the extent that they exceed established loss reserves before determining the 10% minimum capital requirement. All assets should be marked to market.***
3) ***Exceptions are not to be granted to the 10%minimum rule.***
4) ***Banks should be strongly encouraged to attract deposits and loans from the geographical market(s) that they serve, or that aligns with the original bank charter application and approved amendments for both depositors and for loans before the brokered deposit market can be utilized.***
1) ***Banks not meeting the above requirements would need to reduce dependency on brokered funds (limit growth) in some ratio according to the inherent risks that are imbedded in the balance sheet, but not adequately reserved for.***

Conclusion - Well-managed banks should not be penalized for adding brokered deposits in order to fund loan production or to meet the liquidity needs of the bank. Banks with loans that are not backed by adequate capital and loss reserves should be unable to fund further growth with brokered deposits.

James S. Peters

(b)(6) Chief Accounting Officer I

Allegiance
Premium Finance Company

(b)(6)

From: Mark Heugly

Sent: Tuesday, April 26, 2011 12:34 PM

To: Core Deposit Study

Subject: Definition of "brokered deposits"

I have been a banker for a long time. I remember when regulators were not concerned about brokered deposits they were concerned about hot money. The issue is a valid concern but I would suggest you have the wrong label. What you really should be looking for is "high priced deposits." You are looking for volatile deposits that depend on the FDIC guarantee to maximize their rate.

I would suggest two rule changes. Pick a number that makes sense but let's say for this example the number is 20%. Any deposit that is priced more than 20% over the national average would pay a higher FDIC charge. Also any bank that is not well capitalized should not be allowed to issue deposits more than 10% over the national average.

I believe this would simplify your rule making and target the real problem.

Mark Heugly
Senior Vice President
Department Manager
Correspondent Banking
One South Main, 16th Floor
Salt Lake City, UT 84133
(b)(6)

www.zionsbank.com
www.zionscbg.com

ZIONS BANK
WE HAVEN'T FORGOTTEN
WHO KEEPS US IN BUSINESS.®

(b)(6) **From:** Mike Morse

Sent: Friday, April 15, 2011 4:33 PM

To: Core Deposit Study

Subject: Core Deposit Study

April 15, 2011

To Whom It May Concern:

Over the years, I have attempted to get clarity on the definition of a listing service and why the FDIC Legal Division does not recognize deposits placed through a listing service as brokered deposits. Two of the goals of the FDI Act were to identify wholesale funds and to keep unhealthy banks from obtaining such deposits without oversight and approval.

We believe that over the years, the FDIC Legal opinions and market conditions have created a loophole that needs to be closed. When banks use rate listing services to avoid the classification of wholesale funding as "brokered" funding, a loophole is created which has become an attractive way for bank management to hide "brokered" funds. These wholesale deposits should be considered "brokered" funds because of their characteristics and the resulting risks to the financial system. I have summarized some of the "brokered" deposit abuses in this letter and made some suggestions about classifying deposits so that the regulatory focus is on the characteristics of the deposit funds and not on the delivery method.

We strongly urge congress to close the loophole and require banks to classify rate listing service deposits as "brokered" deposits (using the current definition of "brokered" deposits).

We also believe the regulatory emphasis on wholesale funding should shift from a definition-based deposit classification to a deposit characteristic-based focus. The definition of "brokered" deposits needs to be modernized to more accurately reflect the risks of "hot money" to each bank and ultimately to the FDIC.

Current "Brokered" Deposit Definition Loophole Abuses:

* **Avoiding the brokered deposit FDIC insurance assessments:** Banks make the deposits acquired from rate listing services look like core deposits. This reduces fees that should be paid to the FDIC for funds that are used for wholesale funding.

* **Incorrectly Assessing Risk:** Rate Listing Service acquired deposits have the same characteristics as brokered deposits. In most cases, these deposits are only at the bank because the bank paid a good CD rate. There are no other banking relationships. If the funds mature and the bank becomes unstable, the deposits would close. Uninsured deposits would have these same characteristics even if they were from local sources. The risk of funds leaving the bank increase as CDs mature and as a bank becomes less healthy.

* **Reduced Franchise Value:** Recently, it has become obvious that deposits acquired through rate listing services reduce the franchise value of failed banks. When Bank of Elmwood was placed into receivership, the FDIC identified "Market Place Deposits" as those deposits which "may have been solicited via a money desk, internet subscription service (for example, Qwickrate), or similar programs." The FDIC posted on the Internet that $80 million of these "Market Place Deposits" were placed at Bank of Elmwood. These "Market Place Deposits" were less attractive to buyers bidding on the failed bank deposits. The FDIC received less for the liquidated bank because these deposits were removed from the Bid Premium calculation. If the FDIC receives less for these wholesale deposits, banks using these deposits should be paying higher FDIC premiums. The current definition-driven regulation is allowing a loophole for these "Market Place Deposits" to be hidden within a bank's core deposits which ultimately reduces the bank's franchise value.

*** Hiding Wholesale Funding:** Rate-listing services can operate as an information provider and allow deposit funds to be placed using their information through various delivery methods without classifying the funds as "brokered" funds. Information about CD rates and deposit terms that are creating deposit relationships should be treated as "facilitating" wholesale funding. A listing service is facilitating the placement of funds and should not get an "brokered deposit exception" because they charge a subscription fee. The difference between a listing service deposit and a brokered deposit should not be based on how the fees are collected. Both deposit brokers and listing services "facilitate" the placement of wholesale funds that must be monitored. Congress should level the playing field and classify rate listing services as deposit brokers.

Modernize the Classification of Deposits to More Accurately Assess Risk - Change the Regulatory focus from Method of Delivery of Deposits to Characteristics of Deposits measured by the characteristics of "Hot Money."

I have been working in the national CD market since June 1985. The current definition and exemptions for what makes a CD a "brokered CD" have always bothered me. And let me give you an example to illustrate.

On Monday, Credit Union A places a direct CD with Bank B through their Rate Listing Service. Bank B is allowed to classify this deposit as a core deposit when in fact there is no actually relationship between the two other than the CD.

On Tuesday, Credit Union A places a 2nd direct CD with Bank B through their "broker". Because they pay their broker on a per transaction basis, the same funds are classified by the FDIC as a brokered deposit. In this case, the investor (Credit Union A) doesn't actually think of this CD as being brokered. The Credit Union is the holder of the CD, not some third-party safekeeping agent.

The fact is neither of these CDs is a core deposit. In fact both CDs will behave the exact same way at maturity. Some clients will just roll their CD for a reasonable rate. Some clients will need the funds back regardless of the rate. And some clients will move their CD if another bank is offering 5 Basis Points more.

"Hot Money" fund characteristics should be the filter used to assess risk to the bank and ultimately to the FDIC. I think the "Core Deposit" classification should be reserved for relationship deposits such as savings accounts linked by ownership to checking accounts and longer-term CDs (because of the long-term duration of the deposit). Accounts that receive payroll direct deposits are also much more "sticky". These are not "Hot Money" deposits and do not leave the bank easily.

Characteristics of "Hot Money" can be used to help regulators determine if a bank is placing more risk on the insurance fund by becoming more dependent on "Hot Money" funds. "Hot Money" characteristics have been identified in banks using the following funds:

> Uninsured and liquid deposits not tied to direct payroll deposit or checking accounts (deposits tied to direct payroll deposits tend to be "sticky" relationship deposits).
>
> CDs with short-term maturities of less than 1 year or with low early withdrawal penalties.
>
> Deposits that are maturing within the next 30 days
>
> And generally any deposit that is easy to move in and out of the account.

"Hot Money" deposit behavior should be the test for negative deposit characteristics and ultimately assessing risk. As deposit funds take on the characteristics of "hot money", they should be more heavily scrutinized.

If a bank can adequately manage their funding sources and can take a $1 million dollar block of deposits at a rate well below the local competition rate levels, why not? The deposit is extremely efficient, very cost effective, and will add to their bottom line assuming they are using the funds wisely (making good loans). Hundreds of community banks enhance their funding sources with out-of-area funds with no problems at all. These banks should be required to assess

when their deposit funds become more risky to the FDIC. The risk should be measured by "Hot Money" deposit characteristics.

Sincerely,

Michael Morse
Jumbo CD Investments, Inc.
800-234-4605 | Phone
707-455-6023 | Fax
Dixon, CA
www.jumbocdinvestments.com
Securities offered through Gill Capital Partners, Inc.
Member: FINRA - SIPC

JCDI
"Your Bridge To Better Banking"

ANOVA

FINANCIAL CORPORATION

April 14, 2011

Mr. Paul Nash
Deputy to the Chairman for External Affairs
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: ANOVA Presentation to the FDIC - 3/24/11

Dear Mr. Nash:

Anova Financial Corporation ("ANOVA") is submitting this comment letter in response to the requirements under Section 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act") that a study be conducted to address concerns arising in connection with the definitions of core deposits and brokered deposits and as a follow-up to our meeting on March 24, 2011.

FDIC Attendees:
Paul Nash - Deputy to the Chairman for External Affairs
Melinda West – Chief, Policy & Program Development, Division of Risk Management Supervision
Kymberly Copa – Senior Counsel, FDIC Legal Division
Christopher L. Hencke – Counsel, FDIC Legal Division
Munsell St. Clair - Chief, Banking & Regulatory Policy Section

Presenters:
Kim Winslow - CEO
Derek Blair AVP Operations

Introduction

Anova is a North Carolina corporation originally founded in 2003 to provide wholesale funding solutions for banks located principally in North Carolina. Anova has since expanded its operations to more than ten states. Anova provides services to our network of participating Insured Depository Institutions (IDIs) to enable them to attract stable deposits at cost-effective rates. Anova provides banks a low-cost stable wholesale funding solution (average retention >1 year) without collateral or credit limits and a high yielding treasury service as an alternative to Fed Funds for banks with excess liquidity that provides excess FDIC insurance coverage. In addition, through Anova's Reciprocal Exchange Deposit Program bank depositors can benefit from the same peace of mind knowing their accounts are also protected through excess FDIC insurance (balances >$250,000). More than 50% of Anova's depositors are local governments who have benefitted particularly in these times of economic crisis knowing their accounts are fully FDIC insured, daily liquid, and earn a competitive yield over non-banking investment alternatives. Anova's deposit programs keep funds in the community banking system spurring economic growth in the local economy. Anova's product suite is endorsed by the NC, VA, TX, NY and ID Bankers Associations.

Anova does not initiate the deposit or withdrawal of funds. Only the Depositor through a withdrawal request, the Receiving Bank due to lowering its demand for funds, or the Receiving Bank as a result of regulatory requirements precipitates the reduction or withdrawal of funds. Despite this policy since inception in 2003 Anova has had only one participating bank fail (<1%) while holding funds from Anova depositors. This validates Anova's claim that our deposits are stable and reflect a high franchise value to the receiving banks.

Anova Product Suite (see attached sales literature):

1. Reciprocal Deposits
2. Public Deposits
3. Wholesale Funding
4. Treasury Service

Currently deposit services such as Anova's Wholesale Funding (WF) and matching reciprocal deposit services such as Anova's Reciprocal Exchange Deposit Program (REDP) and the CDARS deposit network established by Promontory Interfinancial Network are included in the definition of brokered deposits. We contend that traditional brokered deposits involve a third-party deposit broker that acts as the agent for the depositor. Brokered deposits usually apply to large deposits with a certificate of deposit included. The broker pools this certificate of deposits and bargains them to financial institutions so that they can negotiate for a higher rate. Brokered deposits are sold to the broker who then divides the amount to smaller pieces for purchase. Anova's Wholesale Funding and Reciprocal Deposit services, by contrast, involve no brokers, are initiated by the depositor or the depository institution (Relationship Bank) in which the Depositor's funds are currently held; and with reciprocal deposits, involve providing deposits matching the maturity, interest rate and other key terms and conditions of the original deposit back into the originating depository institution. Traditional brokered deposits are typically rate-driven; while Anova's Wholesale Funding and Reciprocal Deposit services are security-driven. The discussion in the 4/1 09 Final Rule indicates that the FDIC was persuaded that "reciprocal deposits may be a more stable source of funding for healthy banks than other types of brokered deposits and that they may not be as readily used to fund rapid asset growth" and therefore exempted them from the brokered deposit adjustment for Risk Category I IDIs. We contend that the same is true for Anova's Wholesale Funding as a stable, low cost alternative source of funding.

Because the depositor is seeking safety for the entire amount on deposit, the deposit is likely to remain on deposit in the bank of initial deposit so long as full deposit insurance coverage can be provided. An alternative to Anova's wholesale and reciprocal deposit services is typically not a deposit broker, but collateralizing the account in excess of the deposit insurance limit, so that the entire amount on deposit remains secure. The notice of proposed rulemaking published in the November 24, 2010 Federal Register, where the FDIC proposed new Assessments, Assessment Base and Rates proposes to eliminate the adjustment for collateralized liabilities whereas it continues to impose a brokered deposit adjustment designed to compensate the deposit insurance fund for IDIs that rely heavily on brokered deposits.

Banks have found that Anova's Wholesale Funding and Reciprocal Deposit services allow them to retain deposits that might otherwise seek an alternative deemed a safer haven. As a result, they increase the bank's lendable funds base and serve all the traditional functions of core deposits. Anova's Wholesale Funding and Reciprocal Deposits are stable funding sources that originate from banks and their depositors seeking the protection of other well capitalized banks to secure their FDIC insurance clearly fulfilling our claim of "Banks Supporting Banks". We believe that these Wholesale Funding and Reciprocal Deposit sources should be properly characterized as "preferred deposits" and at a minimum should be excluded from the definition of brokered deposits.

Brokered Deposits - and for that matter Core Deposits - are NOT all Created Equal!

Currently based on the FDIC's definition Anova's Wholesale Funding and Reciprocal Deposits are classified as "Brokered Deposits" and "Reciprocal Brokered Deposits", respectively. However, we contend that a closer review of both deposit sources reveals that they exhibit many of the characteristics that the FDIC values in assessing stability, franchise value, and a lower overall risk profile. We believe that the first step to understanding why they exhibit these characteristics is to understand how these deposits originate, the relationship between the Relationship Bank and the Depositor, who initiates and controls the movement of funds, what control the depositor has over which banks receive the funds, interest rates, the franchise value to the receiving Wholesale Funding and Reciprocal Deposit Banks ("Receiving Banks"), and what role Anova plays in the process.

1. Anova provides Depositors through their Relationship Bank and Anova's network of Receiving Banks a transaction platform and allocation model (www.Anovafinancial.com) that enables participating Relationship Banks and their registered Depositors to place funds within FDIC-insured increments into Anova's network of

participating Wholesale Funding Banks and Reciprocal Deposit Banks collectively referred to as Receiving Banks.

2. All Relationship Banks must be U.S. domiciled banks or thrifts.
3. Depositors must have a transaction account at a Relationship Bank and have been screened for customer identification or know your customer requirements including but not limited to regulations issued by the Office Office of Foreign Assets Control (collectively, the "*OFAC Laws*"), regulations and rules for ongoing compliance with any money laundering and bank secrecy requirements, and that none of the Depositors appear on the Specially Designated Nationals List maintained by OFAC. MMDA Depositors are limited to 6 withdrawals per month in compliance with Reg. D restrictions. In addition, Anova only accepts stable deposit sources – no hot money, sweep funds, or brokerage accounts are acceptable sources of funding.
4. The Receiving Banks (Wholesale Funding Banks and Reciprocal Deposit Banks) must be U.S. domiciled federally insured banks or thrifts that are classified as "Well Capitalized" or if "Adequately Capitalized" have a waiver from the FDIC. Participating Receiving Banks must have one Master MMDA account for non-public funds and one separate Master MMDA or NOW account for public funds deposits.
5. Deposits are stable funding sources that originate typically from banks and their depositors seeking the protection of other well capitalized banks to secure their FDIC insurance – clearly fulfilling our claim of "Banks Supporting Banks".
6. The Depositor and/or his Relationship Bank initiate all transactions from the Depositor's bank account (referred to as his "Linked Account") at the Relationship Bank by placing a transaction request through secure login to Anova's online transaction platform (www.Anovafinancial.com). The Depositor eliminates all Receiving Banks within the network in which they already have a banking relationship as well as any other banks in the network which for whatever reason they want to exclude from receiving their funds – in other words the Depositor chooses the banks who receive his funds. The Depositor designates the amount of the deposit or withdrawal, and the timing of the transaction. Once the transaction request has been authorized and the allocation been determined by Anova's allocation model the Depositor, the Custodial/Clearing Bank, and the Receiving Banks are all notified of the pending transaction and date the transaction will be processed. All funds withdrawn by the Depositor can only be withdrawn back to his linked account at his Relationship Bank through the third party Custodial/Clearing Bank.

Depositor Advantages:

- **Safety** – all funds are 100% FDIC Insured. "Since 1934 when the FDIC was formed nobody has ever lost $1 of FDIC insured funds."
- **Liquidity** - daily liquid alternative to CDs and TAG program.
- **Yield** — the Relationship Banks set the depositor interest rates within Anova's Reciprocal Deposit program and Anova posts a monthly rate indexed to LIBOR for Wholesale Funding participants.
- **Relationship** - depositors retain their existing banking relationship and all funds originate from their existing transaction account ("Linked Account") at their Relationship Bank.
- **No pledged collateral** – for public depositors there is no daily safe-keeping deposit receipt requirements and provides a less complicated audit trail for public depositors when collateral does not have to be tracked.
- **No market risk**—this is a bank deposit, not an investment, so there is no market risk to these depositors.
- **Enhanced Public Relations** – taxpayer funds remain in the local economy.
- **Local Government Funds** – alternative to the TAG program for local governments who utilized NOW accounts to FDIC insure deposits and earn a competitive yield - 55% of Anova's deposits are stable reserve funds from local government sources which in times of market crisis like we have recently experienced are a viable funding alternative due to "Safe Harbor" aspect of Anova's 100% FDIC-Insured Program.
- **Set-up** - No Fees or Transaction costs of any kind.
- **Ease of Use** - One Account/One Statement/One 1099 - Convenience & Low Maintenance.

Bank Advantages:

- **Retain Existing Depositors** – Relationship Banks retain direct relationship with their Depositors while providing Depositors additional FDIC Insurance up to $10 million per account. All transaction activity is processed through the Depositor's linked account at his Relationship Bank.
- **Retain Market Interest Rates** – rates are typically at or below local market rates. For Reciprocal Deposits the Relationship Bank sets the depositor interest rates. For Wholesale Funding ANOVA posts

monthly rates for both the Depositor and the receiving Wholesale Funding Banks. The wholesale funding rate is indexed to the 1-Year LIBOR rate and discounted 0-20 BPS this typically equates to 20-30 BPS less than the FDIC's Weekly Rate Cap. For Depositors providing funds in the wholesale funding program they earn an interest rate that is typically .5 BPS+ or - of the FDIC's Weekly National Rate.

- **Stable Source of Deposits** – funds placed with Receiving Banks are stable over one-to-three year time frames and more closely resemble core deposits as opposed to brokered deposits.
- **Eliminates Collateral Commitments** – no collateral or compensating balance requirements. The opportunity for IDIs to offer public and corporate depositors an alternative form of principal risk protection other than collateral segregation. Freed up collateral provides a potential opportunity for IDIs to increase asset utilization and ROA when loan demand increases.
- **Reduces Credit Exposure** – significantly reduces the Receiving Bank's risk exposure on pledged collateral for public funds.
- **Enhanced Public Relations** – political benefits of retaining local government funds in the local economy working on behalf of local taxpayers.
- **Liquidity** – MMDAs vs. CDs means there is no management of maturity dates.
- **Contingency Funding Sources** - diversifies and improves the quality of short and medium term money.
- **Lowers Cost of Funding** – for Receiving Banks the cost of funding is typically 25-30% less than comparable alternative sources (FHLB and conventional brokered deposits). Also eliminates the cost of collateral in cost of funding.
- **Regulatory (Basel III)** – increased liquidity helps Receiving Banks prepare for new Basel III regulatory requirements.
- **Ease of Use** – for Receiving Banks affords transaction efficiency through one master account and maintenance is as simple as adjusting the interest rate monthly.
- **Banks Supporting Banks**— additional FDIC insurance coverage is provided through our network of member banks. All funds are retained within the US banking system.
- **No set-up fees, no transaction costs, no licensing fees or Hidden Fees of any kind.**

Anova Financial's platform meets many of the requirements of traditional core deposits. The Depositor maintains their existing account at their local bank. This keeps the relationship between the Banker and the Depositor. In many instances, the bankers themselves will have access to the account to oversee account activity. This further strengthens the relationship between the depositor, his bank, and his relationship banker.

The Depositor controls the amounts that are in the Anova network of banks at all times. There is no account analysis "magic" or duration limits placed on the Depositor. When the Depositor wants to deposit or withdraw funds, they simply place a request on our platform similar to a Depositor making an online transfer of funds from a checking account to a savings account at their local bank.

Many of Anova's Depositors are referred to us directly by their local banks. We feel that deposits of this nature are geographically local and should be considered high franchise value to our network banks.

Historically Anova's rates have offered Depositor's a higher yield than investment alternatives. We recognize that Depositor's can go elsewhere to get even higher yields, however the security of FDIC insurance allows us to offer rates in line with the FDIC's Weekly National Average. Currently our rates are 0.28% and 0.33% with the national average at 0.34% as posted on 4/11/2011.

Conclusion

We concur with the feedback that was discussed during the 1/20/11 FDIC Advisory Committee Meeting and the 3/18/11 Panel Discussion for Community Banks Brokered Deposits/Core Funding Issues - that rather than Core vs Brokered Deposit categories a continuum categorization is preferable that assesses risk and franchise value based on various characteristics such as:

- **Relationship** – direct interaction between the Relationship Bank and the Depositor provides deposits with a higher franchise value. The Depositor retains control of the movement of funds, the placement of funds, and access to those funds. Third party control of funds increases risk profile particularly in times of stress.

- **Retention of the Funds** - deposits should be a stable source of funding. Volatility increases funding risk profile.
- **Geography** – measure of where the deposits originate from. Local deposit sources should be preferred over remote deposit or internet funding sources. The FDIC could possibly use Statistics on Depository Institutions (SDI) or Metropolitan Statistical Areas (MSA) as a guide for assessing local vs. out of market sources. Local deposit sources should have higher franchise value than remote funding sources.
- **Interest Rate Environment** – deposits should fall within a tolerance of the standard local market rates. The FDIC Weekly National Rates and Rate Caps could be used as a starting point as a measure.
- **Source of Funds** – preference should be given to banks that have diverse funding sources within their contingency funding plans. This is particularly beneficial in times of stress.
- **Public Funds Participation** – we contend that public funds participation should be retained as a preferred source of funding.

If a weighted average was applied to the various characteristics this approach would provide a spectrum that would match risk to the DIF vs. the outdated labels of Core vs. Brokered approach.

We contend that deposit sources like Anova's Wholesale Funding Program and matching reciprocal deposit programs like Anova's REDP and Promontory's CDARS deposit network provide IDIs a stronger customer relationship, stable high retention deposits, market or below market rates, and have high participation of local government depositors are lower risk deposit sources than conventional brokered deposits, or for that matter internet and/or listing services that are currently categorized as core deposit sources. We hope that this feedback will be considered by the FDIC panel as part of the Section 1506 study.

Very truly yours,

(b)(6)

Kim B. Winslow

President/CEO
Anova Financial Corporation

Enclosures

cc: Ms. Melinda West - Chief, Policy & Program Development, Division of Risk Management Supervision
Ms. Kymberly Copa - Senior Counsel, FDIC Legal Division
Mr. Christopher L. Hencke - Counsel, FDIC Legal Division
Mr. Munsell St. Clair - Chief, Banking & Regulatory Policy Section

(b)(6)

From: Jorge Coloma
Sent: Friday, April 15, 2011 3:21 PM
To: Core Deposit Study
Subject: Core Deposits/Brokered Deposits

To Whom It May Concern:

RE: Effect on "franchise value" brokered deposits have on a failed institution.

I posit that "all" deposits of a failed institution result in an enhanced franchise value.

The reason is very simple. In a normal economic cycle an institution is closed during a low interest rate period. As a result brokered deposits which have been raised in prior months or years, usually carry a higher rate of interest that is available in the current market. This results in a "negative franchise value". It is cheaper for the FDIC to allow for the pre-payment of those deposits and the acquiring institution can always go to the market and raise "brokered deposits" at a current lower cost if they need them. So if there was a negative value to those brokered deposits due to the rate of interest being paid, it is eliminated by their pre-payment. This results in an enhanced franchise value for the failed institution (the original negative franchise value is eliminated).

I would like to add that should the brokered deposits carry a lower rate of interest than what is available in the market at the time of the sale of the failed institution it would result in a "positive franchise value", and the acquiring institution "will not pre-pay" those deposits. Investors in brokered deposits carry that risk.

With regards to the "core" deposits, those usually carry a positive "franchise value" as the law allows the acquiring institution to disregard the prior's institution legal obligation to its customers of continuing to pay the contracted rate of interest. As a result, acquiring institutions usually contact the clients and re-negotiate the interest rate on those deposits or return them to the depositor who is happy to get his money back after the bank failed. If on the other hand the failed institution was paying a contract rate of interest that is lower than current market dictates, then the acquiring institution will honor that rate to maturity.

There are the facts that are analyzed by anyone buying a failed institution from the FDIC.

Sincerely

From the Desk of:
Jorge H Coloma*
Managing Director
The Coloma Group LLC
SEC Registered Investment Advisors
Coral Gables, Florida 33134
(b)(6)

As president of FAIC Securities Inc. I succesfully stopped the FDIC from implementing a regulation that would have stripped the FDIC insurance from brokered deposits. I also testified twice in Congress as an expert on brokered deposits. My testimony, which is in the public records, included suggestions for dealing with the issues of brokered deposits. Some of those suggestions where eventually included in new laws and regulations.

April 12, 2011

FDIC
Core and Brokered Deposit Study Group
550 17th Street, NW
Washington, DC 20429

Dear Core and Brokered Deposit Study Group,

Darling Consulting Group (DCG) appreciates the opportunity to provide the FDIC with input relating to Section 1506 of the Dodd-Frank Wall Street and Reform Consumer Protection Act. DCG is a 75 person consulting firm that provides balance sheet advisory services to over 300 insured financial institutions throughout the United States with combined banking assets of approximately $250 Billion. DCG has worked with client banks and federal regulatory agencies through difficult economic environments since the late 1970s. As a result, DCG is highly qualified to comment on the subject of "Core and Brokered Deposit" funding.

In response to the four specific questions asked relative to your study we offer the following for your consideration. Our responses are based on our experience working with banks not only in this current crisis, but over a longer horizon that includes "good" and "bad" times.

Question 1: In times of financial stress, what types of deposits are likely to leave the institution?
Uninsured deposits have been more susceptible to flight risk, particularly as an institution crosses the technical line from "well capitalized" to "adequately capitalized." Through the current crisis, we have noted that *insured* deposit balances at banks in weakened financial condition have been highly resilient, both in absolute terms and relative to prior periods of industry stress. While this has been particularly the case for those deposits with more than one relationship with the institution, it has also been quite true for insured deposits gathered through the brokered, national and internet markets. This stability has no doubt been impacted by the FDIC's active promotion at the onset of this current crisis of the strength of insurance being provided to depositors. In this regard we have observed numerous occasions over the past two years where troubled banks have actually grown insured deposit balances (transaction and term) at a reasonable cost.

Question 2: A) Does the presence of certain kinds of deposits (e.g. brokered, internet, listing service) inherently increase an institution's risk? B) Does their presence facilitate increased risk taking?

A) Inherent Risk: We do not feel that an institution's financial risk is a direct result of its funding strategy. More specifically, we do not believe in a cause and effect relationship between funding strategy and credit problems. The failure of a bank (especially community banks), with few exceptions, is driven by the inadequacy of capital to support the risk associated with an asset strategy. Bad lending (excessive exposure to risky loan classes, out of market lending risks, etc.) is bad lending, independent of the funding source.

When asset quality problems develop, it is the presence of liquidity (on balance sheet and available off balance sheet sources) that creates the staying power for an otherwise troubled bank to "buy time" for working through its problem asset situation. We continue to observe numerous cases being played out in the current crisis whereby troubled banks will survive primarily because of their access to *insured* deposit sources such as brokered, internet, national and listing services (as well as borrowings such as FHLB advances). It is well known that numerous banks have been told by examiners to get set-up on listing services as a form of contingency liquidity.

"Does the presence of certain kinds of deposits inherently increase an institution's risk?"
The danger of this question is that it is difficult to answer anything other than "yes" without qualifying the question. Clearly, relative to a balance sheet fully funded with insured local zip code monies skewed heavily towards multi-relationship transaction oriented deposits, one would have to answer that the deposit classes in question reflect a greater "inherent risk" (especially during tough times). However, such a deposit mix is more reflective of a Utopian state than it is of reality for the vast majority of the banking industry. There simply are not enough of these deposits to support the credit needs of communities, especially during good economic times.

Accordingly, a more pertinent question in our opinion is how much "*additional* inherent risk" exists for such referenced insured deposit classes relative to the more common
deposit strategies such as CD specials, high rate savings and money market products, public funds (especially if non-pledged), etc.? In this case we believe very little, if any.

Additionally, are the "inherent risks" sufficient in magnitude to warrant special broad brushed regulatory treatment resulting in such referenced deposits being financially penalized and/or viewed and treated as a "scarlet letter?" Again, for the many reasons addressed within this letter we believe the answer is "No."

B) Facilitate Increased Risk Taking: Notwithstanding the FDIC observation that failed institutions have been noted to have above average levels of brokered funds, we find the very nature of the question "*Does the presence of certain types of deposits facilitate increased risk taking?*" to have a troubling premise. The implication is that banks raise brokered, internet, listing service deposits, etc. *then,* given that they have these funds, embark on increased risk taking. We are not aware of any banks in this current or past cycles that operated in this manner. In fact, the behavior pattern has been the opposite.

Our observations reflect that banks, having access to what they believed at the time to be bona fide lending opportunities, determined that the most cost-effective marginal sources of funds were the wholesale deposit/borrowing markets (vs. bidding up local monies attracted purely by above market offering rates). If the brokered markets were not available these loans would have been funded anyway, by either the same bank (likely using higher costing local deposit specials) or one of the other banks competing for the credit at that time. The point is that loans that have

soured in this cycle *would have been originated* with or without the existence of brokered deposits.

Our concern with this question, therefore, is that it inappropriately deflects the focus from banks getting into trouble because of where they put their money, to where they got their money. The business issue at hand is more related to inappropriate credit concentrations, inadequate reserve and capital levels, poor credit administration, inadequately controlled rapid loan growth, etc. than it is related to funding strategy. Accordingly, we continue to believe strongly that "higher than peer" brokered deposit utilization should be seen only as a *potential* symptom, not the disease; and therefore, addressed accordingly in any forthcoming guidance. We believe that any funding concentration concerns are best addressed within bank liquidity and funds management policies, with particular emphasis on contingency liquidity monitoring and planning.

We would like to point out that the above thought process is consistent with the recent change in FDIC insurance assessment methodology, now based on assets rather than insured deposit levels/funding.

Question 3: What types of deposits are likely to enhance a failed institution's franchise value and what types of deposits are likely to reduce it?
For a failed institution in a liquidation sale, the acquirer is usually willing to pay a premium for low cost non-maturity deposits. This might also include reciprocal money market account balances. On the other hand, time deposits (whether generated locally or through a broker) are of little interest unless the rate being paid on these funds is significantly below then current replacement costs, which is seldom the case (except in a rising rate environment).

The nature of the question "what types of deposits are likely to reduce franchise value" requires context. For example, Bank A and Bank B both fail. They are identical in all regards, and therefore, their franchise values are the same. Now assume one change: Bank B has the same deposit mix for 90% of its deposits with the remaining 10% in brokered funds. Clearly, Bank A would garner a higher deposit premium (franchise value). Does this mean that Bank B "reduced" franchise value by growing brokered? Or did they get full value for the 90% and no value for the brokered? What if instead of using brokered deposits the funding came from CD Specials (likely at above market rates); would the franchise values of the brokered vs. CD Special scenarios be materially different?

Furthermore, with interest rates down and most brokered monies being term deposits, there is negative value associated with these because they are above current market rates rather than simply because they are "brokered." Accordingly, we believe that an above market non-brokered CD base would also similarly create negative value in the current low interest rate environment. Which begs the question "What if rates were higher and brokered deposits were on the books at below market rates?" We believe the answer would be different.

The point here is that there are many variables at work in unusual environments such as the current one. Accordingly, one must be careful when drawing cause and effect conclusions without a thorough assessment of all attendant variables and interrelationships.

Question 4: What recommendations would you make for legislative or regulatory changes with respect to core and brokered deposits?
We have a number of suggestions and thoughts we offer for consideration that would reduce risk to the financial system and ultimately the FDIC insurance fund:

A.) Grant Better Access to Brokered Funding in Periods of Difficulty: While the brokered markets have curtailed access by weak banks, we have noted through this period of financial crisis that the regulatory community has been far quicker to not only curtail, but forbid, a weakened bank's access to brokered funding. While we understand the regulatory desire to see a bank curtail bad lending practices that likely have led to their weakened state, and to head off any ill-conceived bank notion that they can simply "grow out of their problem", we disagree with

a perception that restricting access to funding markets helps improve financial stability (or keeps it from getting worse).

In fact, we have noted in many regulatory orders a provision that forbids *the extension of new credit*. Since this clearly addresses the above noted concern, it begs the question: why reduce the availability of funding at precisely the time when it is most critical that a bank has it? By being unpredictable or "tight" in granting waivers to access brokered deposits (including CDARS), the resulting actions by the bank are often inconsistent with what we believe the regulatory community wants during the resolution process. For example:

1. Banks hoard liquidity, ballooning the balance sheet and tying up capital.

2. In the hoarding process, banks will often stretch the maturity of funding at increased costs to reduce rollover risk in fear of losing access to a funding channel (e.g. brokered, CDARS) based on what can be inconsistent, and even arbitrary, decisions by their regulator (further impairing capital via higher interest costs).

3. It eliminates what is often a more cost effective funding channel from the strategic funding mix a troubled bank can choose from (e.g. brokered deposits inclusive of broker fee currently run near half the cost for most retail and internet based deposit alternatives).

4. The elimination of brokered funding at a troubled institution prompts deposit specials in the local market (subject to brokered definition pricing limitations) that needlessly run up the cost of funds of "innocent neighbors" who have to compete with the higher rates. This ironically can create a "vicious cycle" making it more difficult and more expensive to maintain/roll these deposits at troubled banks, thereby increasing rather than lowering financial risk relative to maintaining brokered balances.

5. Elimination of brokered funding access promotes the liquidation of high grade investment securities that otherwise would provide valuable on balance sheet contingency liquidity for potential uncertainties (vs. being used for the forced pay down of brokered FDIC maturities). It also promotes the liquidation of quality assets (e.g. loans) for cash at pricing levels lower than what could be arranged in a more orderly manner, including in more extreme cases what the FDIC could likely negotiate in receivership. Additionally, we have seen banks "run off" good quality loans in order to facilitate "forced shrinking" via mandated non-renewals of maturing brokered deposits.

Accordingly, a review of what appears to be a very subjective and inconsistent brokered deposit waiver granting process appears to have merit. At the very least, the FDIC should enable forbidden banks to manage their exit from the brokered markets in a more orderly fashion. This could be accomplished through a combination of reasonable limits on the level of brokered funds (other than zero) and/or a time horizon over which such limits needed to be attained (e.g. 12 months).

B.) Eliminate Reciprocal Deposits (such as CDARS) From the Definition of "Brokered": Other than an administrative fee paid to the custodian of the service for administrative costs, the rate paid on the reciprocal deposit is negotiated by the bank. Further, the bank is the only representative facing the deposit customer. While CDARS may cap a troubled institution at a certain level of reciprocal funding in a weakened financial state, it will roll the funding already outstanding. The technical definition of CDARS reciprocal deposits as "brokered" funding can remove a valuable core customer retention tool that may prove counter-productive in limiting the losses to the FDIC insurance fund in the event of liquidation.

C.) Exercise Caution with the Practical Use of Term "Core Deposit": We urge the regulatory community and the legislature to be extremely cautious with the end use of the definition of "core deposits." It should not be confused with the concept of "stable / core funding." If the intent of this exercise is to discourage the use of anything but a narrowly defined class of deposits or funding sources available to a bank, we fear the unintended additional risks that will be added to the banking system. The risks associated with curtailing the use of funding sources that fall out of the current and prospective definition of a "core deposit" include:

1. *A likely increase in borrowing rates for consumer and business loan customers* as banks seek to cover what will inevitably be the "bidding up" of rates on deposits that fit the definition of "core deposits." "Non-traditional funding sources" can often prove the most cost effective; particularly at the margin, and especially when funding is required in bulk.

2. *A likely reduced availability of credit,* especially in certain geographic markets that lack meaningful sources of deposit funding that fit the definition of a "core deposit." There are numerous markets within which loan growth has historically outstripped total deposit growth, let alone "core deposit" growth.

3. *A definite reduction in ability to manage interest rate risk* as the brokered deposit market (along with repo market and Federal Home Loan Bank system) provides cost effective funding that can much better match asset duration than the funding available in the "local market" (the latter a result of depositors' preferences and general unwillingness to lock their money for extended terms, especially if accompanied by appropriate early withdrawal penalties).

4. *A definite increase in liquidity risk* as these "non traditional" funding sources are often available in bulk, upon demand, and at rational market rates (which cannot always be said about "core deposits"). Additionally, brokered deposits are more predictable in regards to retention (since the vast majority are not subject to early withdrawal with the exception of death covenants) and rollovers (since availability determined by a broader supply of national market driven deposit dollars).

Closing Comments: Core funding should be defined as any stable funding source that can be reasonably depended upon under stressful conditions. Core deposits would be a subset of core funding. This subset would consist of customer deposits that would remain available even if the financial condition of the insured institution were to deteriorate. These funds would most likely consist of insured deposits, including CDARS reciprocal deposits. Additionally, core funding might also include collateralized borrowings from the Federal Home Loan Bank as long as the collateral and borrowing capacity is still available. Were it not for statute under FDICIA, brokered deposits might also be considered core funding since they are also insured deposits.

Our ultimate concerns with the tenor of the discussions at hand regarding "core vs. brokered" funding are the following:

1. Healthy institutions will be impeded relative to their ability to prudently utilize a broad array of funding sources for purposes of managing cost of funds, operating liquidity, contingency liquidity, and interest rate risk.

2. Troubled banks will continue to be put at increased financial risk (with elevated exposure to the FDIC fund and taxpayers) because of the forced shrinkage associated with the current treatment of brokered/CDARS deposits when banks are deemed to be less than well capitalized.

3. An environment could be created whereby certain types of funding, by definition, will be deemed *bad* regardless of context, use and risk management practices; with the result being a combination of lower earnings and a likely curtailment of overall credit availability from the banking sector.

Rather than institute broad-brushed rules based upon the "sins of a few" and with material potential unintended consequences, we believe that the prudent solution is to place the focus where it belongs: meaningful and robust liquidity risk management practices, including contingency liquidity planning and stress testing.

Darling Consulting Group, Inc. thanks the FDIC for taking the time to read our comments and would welcome the opportunity to discuss our views in more detail.

Sincerely,

DARLING CONSULTING GROUP, INC.

(b)(6)

From: Royce Ogle

Sent: Wednesday, April 13, 2011 12:03 PM

To: Core Deposit Study

Subject: BROKERED DEPOSITS

The ability to issue long term certificates of deposits (five years or longer) when the bank often retains a call option, allows an institution to help mitigate its IRR on the liability side of it's balance sheet. These types of structures are not found in our local markets but are available through the use of broker dealers at rates lower than we could issue in our local markets. These types of deposit are more stable than many core deposits as defined in current regulation. While there have been abuses by some institutions to use these deposits to fund speculative lending activities, access to these markets have a great benefit to prudent community banks and the markets they serve. It is my contention the definition of core deposits should also include the characteristics like relative stability or volatility term of the deposits and not be restricted by the source. The ability to access these markets can also be crucial to contingent funding planning and other liquidity risks. Brokered certificates of deposits should be allowed and encouraged as a interest rate risk mediation tool. .

Royce G. Ogle

Peoples Independent Bank

(b)(6) **From:** Steve Bumann

Sent: Thursday, March 31, 2011 5:52 PM

To: Core Deposit Study

Subject: Brokered Deposit Discussion

Our Bank has been following with interest the FDIC discussions surrounding brokered deposits. BankWest has been using brokered deposits in one form or another for over a decade now and we feel very strongly that they have a valid position in our Bank's funding plan.

BankWest has never engaged in issuing short (less than one year maturity) brokered CD's in order to fund asset growth. When we first started using them we attempted to match up the term of the CD with the term of the assets that we were funding. Thus, if we were doing a lot of 3 year adjustable rate loans we would issue 3 year CD's. In recent years we have begun to use the brokered market as an efficient way to manage our interest rate risk. We have issued long maturity CD's (up to 20 years) in order to protect us from rising interest rates. We have also been issuing our brokered CD's with a call option which has allowed us to call and re-issue at rates that have averaged 100 bps less than the original CD's. In the last 3 years we have called nearly 80 million dollars of brokered CD's and saved on average over 100 bps of interest cost annually.

The following are reasons that BankWest has for using the brokered CD market

- There is a much lower risk of early withdrawal and an ability to extend maturities with brokered CD's. We have a hard time getting local customers to buy CD's with maturities beyond one year, but when we do we have found that if interest rates go up our customers will not hesitate to cash them in, take the penalty and reinvest at the higher rates. With the brokered market the CD cannot be cashed early (The exception is that there is a death put option, but we do not see large numbers of those). This gives us a lot of rates up protection that cannot be achieved in our local markets. If brokered deposits were eliminated it would subject our Bank to substantially more interest rate risk, both in terms of shortening the length of the deposit and in the risk of early withdrawal.

- In addition to being able to protect ourselves from rising rates by issuing long term CDs that cannot be cashed early, we are able to issue the brokered CD with a call option which protects us if rates fall. If rates fall we can (and have) called these CDs and reduced the interest costs of the Bank. Our Bank has chosen not to buy callable agency bonds as an asset. In a down rate environment the agency will call the bonds and the bond holders get to invest at a lower rate. In a down rate environment investing in a callable bond is a good way to assure yourself of having a fairly long low rate portfolio. On the flip side if we issue callable CD's we are able to call them as rates drop and reissue at lower rates thus helping us to have a long-term low rate deposit in a rates down environment. I would also point out that we do not want to issue callable CD's in our local markets. There is a lot of risk of offending VIP customers if we call their CD and ask them to reinvest at a lower rate.

- I hinted in the first bullet about interest rate risk management. We have used the brokered market to manage our interest rate risk. 75% of our current brokered CD portfolio has an original maturity of 5 years or longer and 35% of it has an original maturity of 10 years or longer. The weighted average rate of the maturities 10 years and beyond is 3.23%. We feel this is giving us substantial protection in an up rate environment.

- The brokered CD market has a much lower cost of issuance. I can order $10 million of deposits and we can generally have it within 10 days and it takes an hour of Finance department time (or less). To raise $10 million worth of CDs in our local markets would take closer to 200 hours of staff time.

- We monitor the brokered market pricing in relation to our pricing and primarily use the brokered market when it is cheaper than our local markets.

- If we are in need of funding and want to offer a higher rate we can do it without cannibalizing our internal accounts. We have found over the years that if we offer a CD special to attract funds that close to 50% of the money that goes into these specials comes out of another BankWest account and it is one with much lower interest rates.

- Industry standards generally place the average life of a core deposit in our local markets at less than 10 years. It could be argued that a brokered deposit of 10 years or longer is a core deposit due to its length of term.

In summary we believe very strongly that used properly a brokered deposit portfolio can be additive to the earnings of the bank versus funding purely with "core deposits", that it can provide a lot more interest rate protection against rising (or falling rates) and it can do both in a low cost and efficient manner.

(b)(6)

CFO
BankWest, Inc
(b)(6)

(b)(6)

From: Chris, Tompkins

Sent: Thursday, March 31, 2011 12:12 PM

To: Core Deposit Study

Subject: Core Deposit Study

Thoughts to consider when attempting to answer your questions:

1) Rules and thinking around deposits within the regulatory bodies were created pre internet, making them extremely outdated today.
2) These rules/definitions define brokered deposits and internet deposits in to two distinct and different categories, when in reality they have very little differences between them.
3) Banks are penalized for using too much internet funding and rewarded for having local/core deposits. Local/core cd's can typically only be gathered by paying very competitive/above market rates. The characteristics of those depositors are that they are highly rate sensitive, i.e. highly volatile money, and are attracted by the highest rates, i.e. very expensive money. No relationship follows these customers. Contrast that to internet deposits that are not rate sensitive, stable, easily replaced, and very inexpensive. However, the deposits above with the worst characteristics are what the regulatory agencies are ok with and the deposits with the most attractive characteristics are looked at unfavorably. There was a time when out of market deposits was a red flag. That was when the definitions and rules were created. Today, the world has changed dramatically, but the definitions, rules, and thinking regarding bank deposits has lagged significantly behind.

-

(b)(6)

From: Larry Haggard

Sent: Tuesday, March 29, 2011 5:07 PM

To: Core Deposit Study

Subject: Core and Brokered Deposit Study

March 29, 2011

The issue of 'hometown' deposits has drastically changed since my employment in 1974. Once, the dependence on local (core) money could be counted on, mainly because customers parents had always banked here, and their children were led to believe that this bank was the place to go to keep their money and to borrow when needed. You could trust this bank! Well, all this has changed, but not necessarily for the better.

Even for small community banks, the playing field is very even now because communications are available to everyone in rural areas by satellite TV, computers, etc. Our community friends and neighbors come to the bank, now, knowing what the markets are doing today, and are very much abreast of the value of money. Loyalty to any one institution no longer exists, for the most part. Five or ten basis points will sway customers to leave your bank for the neighbor institution, or to some other deposit arena.

Today's financial climate doesn't provide the opportunity or incentive for most younger people to save substantial amounts of savings. Being located in a rural area where commercial deposits are scarce leaves the larger deposits (CD's) belonging to older customers who have saved through years of meager income and hard times. When these customers die, the children in most cases have moved away and are interested in dividing the family savings before going back to their home. Those funds are lost forever, and with fewer younger savers, the opportunity to replenish these funds may only come from outside sources.

Our cost of money on the local level has been twenty-five to one hundred basis points over 'brokered' funds. Also, as mentioned above, the communication factor, coupled with the lack of loyalty on a local level, leaves me to believe that any stress experienced by a local institution would cause abandonment on the local scene first.

The deposit landscape has changed dramatically, and the foreseeable horizon appears to favor the current trend. Please consider rethinking the issue.

Sincerely yours,
Larry Haggard, President
Wayne County Bank
Waynesboro, TN 38485

To the Core Deposit Study of FDIC

Submitted March 29, 2011

From Gren Blackall, SVP and Chief Deposit Officer of Gorham Savings Bank, Gorham, Maine, FDIC Certificate # 17748.

(b)(6) **Email** [redacted]

My comments concern a subset of your study relative to one type of brokered deposit – the reciprocal balances produced by deposit sharing services such as those offered by Promontory Interfinancial Network (e.g. CDARS and ICS). For the remainder of my comments, I will refer to these as SCD's or Shared Core Deposits. I strongly believe that the FDIC should classify these as Core Deposits, and further feel not classifying them as Core raises the risk and cost to participant banks unnecessarily and unfairly.

I will address this with an example, and then respond to your survey's questions relative to SCD's.

Example for illustration: Let's assume there are two banks, Bank A and Bank B. They both have no outside purchased deposits - brokered or wholesale - meaning all their deposits are core. They both have customers over their FDIC insurance limit, which ask the bank to coordinate the sharing of their deposits with other banks to diversify their deposit "portfolio." Both banks oblige by using a product such as CDARS. Each move 25% of their deposits to the other bank (they are the same size). For purposes of illustration, assume that these are the only two participants and the sharing is exactly matched so 25% of Bank A goes to Bank B and the same dollar amount goes from Bank B to Bank A. Both banks pay Promontory a small percentage for their accounting and sharing efforts.

So far, the impact to the bank deposits is almost imperceptible.

1. No dollars have actually moved. Both banks have exactly the same dollars in deposits.
2. The banks still manage the entire relationships as they did before. The bank does not alter their relationship management as a result of a portion of the deposits being put into a SCD program.
3. All deposits on each bank's balance sheet were generated through local relationship building.
4. The fee paid to the company who does the accounting for Shared Core Deposits has nothing to do with "generating deposits". Before and after the SCD is put in place, the banks' deposits are the same amount, and thus there are no new deposits created. The fee is paid to perform an accounting function to coordinate between banks and to create monthly statements (among other things). "Brokered Deposits" are defined as, Bank deposits "solicited by a third-party broker." There are no new deposits generated, and there is no soliciting going on by that third party.

FDIC guidance requiring each bank to book the reciprocal dollars as "Brokered Deposits" Causes some unintended consequences.

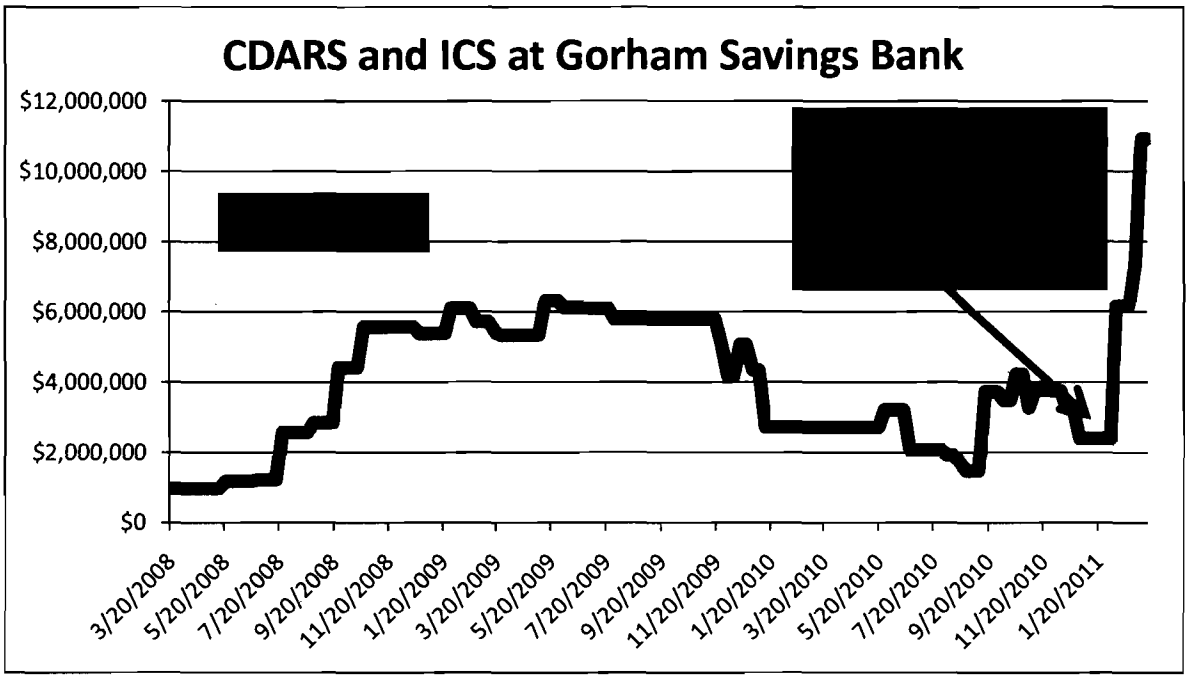
1. Even though the dollars are just as "core" as they were before the transaction, the amount of core deposits and the liquidity ratios related to them are significantly altered.
2. The sum of "core deposits" for Bank A and Bank B also decreases by the sum of the two banks' reciprocal balances. This looks like a net outflow of core deposits from "the system" when in fact, they haven't gone anywhere. This will make the total picture of Core Deposit for the whole system look worse, but maybe unfairly so.

3. Regulators will look at both banks as riskier. This will lead to more scrutiny, requiring the banks to make decisions they would not otherwise make.
4. Because of the "brokered deposit" designation and impact to liquidity ratios, banks will be less likely to use a Shared Core Deposit product like these for Public deposits. This will push banks to use investment securities such as Repo or as pledged collateral to provide protection for Public funds, which will in turn introduce liquidity pressure on the investment portfolio.
5. Relative to #4 above, many states have specifically allowed using SCD's for public entities, even though the deposits are technically "out of state" because they see that ultimately the deposits are benefiting the home state. This is the same rationale I feel should allow them to be considered "core deposits" because they are still benefiting the local community. See the State of Illinois for example: http://www.cdars.com/documentviewer.aspx?name=IL_statelaw.pdf . Here's how Promontory describes it: http://www.vgfoa.org/Regional_Events/VA%20Public%20Funds%20use%20of%20CDARS.pdf
6. The banks' access to funding from the wholesale, brokered, Fed Funds, or borrowed funds markets could be more expensive as they are perceived (through the eyes of the regulators) as being riskier. This decreases their liquidity, creates more stress on the balance sheet, and increases the chance of a bigger problem.

Let's look at the questions you posed for responders of your Study, applied to this illustrative example:

- ***In times of financial stress, what types of deposits are likely to remain at an institution and what types of deposits are likely to leave the institution?*** Because Shared Core Deposit products are 100% FDIC insured, they are very likely to stay in a bank. They are as likely to stay as any FDIC insured core deposit, even though they are in larger dollar amounts.
- ***Does the presence of certain kinds of deposits (e.g., brokered, internet, listing service) inherently increase an institution's risk? Does their presence facilitate increased risk-taking?*** Since my comments are restricted to specifically the reciprocal deposits generated by Shared Core Deposit products, the answer is no. Reciprocal deposits do not create any funding need (?) that was not there already, and therefore does not lead to changes in risk taking in loans. The only way reciprocal deposits increase risk is that the current method of making them "brokered" makes their liquidity ratios look worse, even though they really are not.
- ***What types of deposits are likely to enhance a failed institution's franchise value and what types of deposits are likely to reduce it?*** Again, relative to SCD's, a failed institution with SCD's would have a higher likelihood of more deposits from local depositors, because without SCD's, customers would be more likely to pull out their uninsured deposits before the failure. Since deposits are the coveted component of a bank purchase, the FDIC would have an easier time selling the failed bank with more deposits.
- ***What recommendations would you make for legislative or regulatory changes with respect to core and brokered deposits?*** Relative to SCD's, my recommendation is to allow banks to record all reciprocal deposits created by Shared Core Deposit products as Core Deposits and not Brokered Deposits.

Finally, Gorham Savings Bank's experience: We have seen high interest in SCD's in the last few months. Since introducing the Promontory product ICS the demand has been dramatic, with another $3 million in the pipeline. This product is allowing us to grow relationships and core deposits. But because of the "Brokered" designation, we are in a position where our liquidity ratios are being impacted. As a result, we have discussed holding back on this product, which would lead us to forgo some important growth. A change in designation to "Core Deposits" would be a wonderful and appreciated change!



Thank you for allowing these comments. Having a voice in these discussions has great value to us.

(b)(6)

Gren Blackall

(b)(6)

From: Tony Romero

Sent: Monday, April 18, 2011 5:16 PM

To: Core Deposit Study

Subject: FDIC deposit study feedback

My name is Tony Romero and I am the CEO of Suncoast Capital Group, Coral Gables, FL. I have been in the brokered CD business for over 20 years and I would like to offer my insights which you may find useful with regard to the definition of core deposits and brokered funds.

The term "hot money" is often one used to describe deposits which are widely believed to be more interest rate sensitive and consequently potentially less stable than what we currently refer to as "core deposits". At this point in time, brokered certificates of deposit would be viewed as "hot money".

Many banks consider brokered funds or "hot money" to be short term deposits that move from bank to bank always chasing higher rates. The fact is, the vast majority of brokered CD transactions done by Suncoast Capital Group (and I would suspect other brokers as well) are 24 to 60 months in duration. I would argue that a more relevant measure of whether a deposit may be considered a "core deposit" is not the source of the deposit but the length of time the deposit will remain with the bank. In my opinion a deposit of 2yrs or longer is a long term stable deposit and should be classified as a core deposit.

I agree that well capitalized banks should not be permitted to accept brokered funds without an FDIC waiver. One way banks have found to circumvent this rule is through the use of rate listing services. The FDIC does not currently require banks who acquire deposits via the use of a rate listing service as brokered and consequently many banks who were not well capitalized were able to load up on brokered deposits at a great cost to the FDIC fund.

I have often wondered why the rules permit this. The rate listing services will argue that the distinction between deposits gathered via their service or a "traditional broker" is that they are compensated by a periodic subscription fee rather than a margin earned per transaction. While this may be true, this does not change the nature of the deposits themselves and the manner in which the broker is compensated is irrelevant in my opinion.

Consider this example: First National Bank needs a $250 deposit for 36 months. If they call Suncoast Capital Group I would arrange to purchase the $250k CD from them through our custodian bank and I would sell it to ABC credit union. In effect, the issuing bank has taken in a deposit from this credit union who may be located across the country.

Suppose now that First National Bank was a member of a rate listing service and decided to post a 3yr CD rate. They would be contacted by ABC credit union and the credit union would arrange to wire funds directly to the bank to purchase the 3yr CD.

In both cases the issuing bank has in effect issued a CD to ABC credit union, only when the deposit is obtained via a rate listing service it is a "core deposit" and when the deposit is obtained from my company it is "brokered" , yet for all practical purposes the two deposits are identical except that the bank does not have to classify the deposit obtained via a rate listing service as brokered. Do you see the folly in this anomaly of the market and how it may be exploited by rate listing services?

The solution of course is to make no distinction between deposits obtained through a traditional broker or through a rate listing service. If one is brokered, so must be the other. In my opinion this will save the FDIC a great deal of money since no longer will rate listing services be able to provide brokered deposits to undercapitalized banks under the guise that they are not brokered due to the manner in which the rate listing service is compensated.

Tony Romero

Tony Romero

SUNCOAST CAPITAL GROUP

2655 Le Jeune Road Suite 902
Coral Gables, Florida 33134
Phone: 305-443-2138
Fax: 305-443-7350
(b)(6) Email:

(b)(6)

From: Brian Perry

Sent: Tuesday, March 29, 2011 2:43 PM

To: Core Deposit Study

Subject: Discussion on core & brokered deposits, specifically, the nature of stable and volatile deposits.

I recently had a discussion with a fellow community banker about how we monitored "volatile" deposits. I thought my response to my colleague would be helpful to the recent discussion on core & brokered deposits, specifically, the nature of stable and volatile deposits. The Call Report statistics (UBPR Ratios) for volatile deposits are poor indicators because they gather the wrong data. They track account types and account balances, not the potential volatility of individual deposits.

Colleague: "Here is an open-ended question. Would anybody care to share their definition of 'Potentially volatile deposits?'"

My response: "This is a liquidity question and I define volatile deposits as deposits that could leave within 30 days: 1) parked money; 2)seasonal; 3)known to be rate sensitive. Your branch staff know their customers and can point out the obvious "suspects." Could be large corporate/partnership balances, municipal balances including school districts, certain IOLTA accounts, and consumers parking substantial funds from a home sale, estate closing, retirement rollovers, etc. Choose your own balance threshold. All CDs maturing in one month have some percent of volatility in that customers invest in CDs for the rate, not so much for the convenience. If you offer CD specials with an above market rate you can assume a higher percentage are rate sensitive at maturity. We don't consider our brokered CDs as volatile deposits because the maturity on them ranges from 5 – 8 years. There is no early withdrawal feature on these, except death. When they get closer to maturity then the definition will change. We have corporate checking balances that once swept into money market funds but cancelled the sweep during the crisis in 2008-2009 when money market rates went to zero. When overnight rates start rising we know those corporate accounts will want the sweep service once again."

"Of course, the regulators have their own definition of volatile deposits for examination purposes which I do not find useful for liquidity management. Here is a quote from the **Risk Management Manual of Examination Policies Section 6.1 - Liquidity and Funds Management** "deposit accounts generally viewed as volatile funding (e.g., CDs larger than $100,000) might be relatively stable funding sources." Now, how can they say volatile and stable in the same sentence? But, they give examiners latitude in the definition. "For examination purposes, large deposits are defined as those concentrations of funds under one control, or payable to one entity, which aggregate 2% or more of the bank's total deposits. By virtue of their size, such deposits are considered to be potentially volatile liabilities; however, examiners may determine that certain large deposits actually remain relatively stable for long periods. Therefore, examiners must also look at the nature of the relationship between the large depositor and the institution when assessing the volatility of large deposits." When you read the full text of the examiners manual you will see that it encourages field examiners and banks to assess volatility at the customer level as I described above."

My point to my colleague is this, funding sources can be stable or volatile based on the needs of each depositor. We need to identify the volatile depositors. "Core" and "brokered" categories are not indicators of volatility. Core deposits can be volatile and brokered deposits can be stable. If the concern is about volatile deposits as a liquidity risk that needs to be monitored then we need to identify and aggregate volatile deposits and report the totals on the quarterly Call Report. Every bank is different and would have to develop its own identification methodology. The field examiner would review the methodology during each exam. The Board can help us with guidelines to be used to develop this methodology.

Sincerely,

Brian J Perry
Vice President
Webster Five Cents Savings Bank
136 Thompson Road
Webster, MA 01570
(b)(6)

(b)(6)

From: Barry Fruechte

Sent: Friday, March 25, 2011 7:04 PM

To: Core Deposit Study

Subject: Core Deposits

The Bank where I'm employed, New Albin Savings Bank, does not currently have any brokered deposits. However, we do have a substantial amount of certificates of deposit in the amount of $100,000 and over. These $100,000 certificates are owned by depositors from our trade area and are just as stable as smaller deposits, maybe more so. Core deposits per the FDIC's criteria are understated at this Bank.

Barry Fruechte, President
New Albin Savings Bank

(b)(6)

From: Ed Schuler

Sent: Friday, March 25, 2011 10:49 AM

To: Core Deposit Study

Subject: CD market

We used brokered CDs to provide match funding for our AG loan cycle. It provides a favorable cost structure compared to alternative funding.

Security Warning: This message is being sent over an unsecure medium (the internet). Recipients should not reply to this message with sensitive or confidential account information. If the need arises to communicate sensitive or confidential account information, customers should visit or contact the nearest branch office."

CHARTWELL CAPITAL LTD.
www.ChartwellCapital.com

CHARLES J. THAYER
Managing Director
(b)(6)

March 25, 2011

Sheila C Bair, Chairman
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

RE: Core & Brokered Deposit Study

Chairman Bair,

Chartwell Capital (Chartwell) respectfully requests that the Federal Deposit Insurance Corporation (FDIC) consider the following observations and the attached information (Exhibit 1 -previously provided) in the FDIC's Core & Brokered Deposit Study (Study) as required by Section 1506 of the Dodd Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

We compliment the FDIC on the diversity and quality of the participants (Exhibit 2) selected for the Roundtable on Brokered Deposits (Roundtable) the FDIC hosted on Friday March 18, 2011. The webcast of the Roundtable provided any interested party (including us) with the opportunity to view a very informative discussion.

We sincerely hope that your opening remarks accurately represent the official position of the FDIC. We are certainly encouraged that you indicate you are "open in your thinking" that the FDIC "doesn't have it right" and the study presents an "open playing field for consideration for how the FDIC approaches this (question)."

As indicated in this letter and the attached materials, past FDIC policy concerning the issuance of Brokered Deposits at both "well-capitalized" and "adequately capitalized" institutions operating under a regulatory consent order (Order) has not been "right." The undersigned sincerely appreciated the opportunity to discuss this topic (among others) with you and your staff in December 2007 (prior to the 2008 liquidity crisis) and with members of your staff earlier this year. We want to make certain these views are considered in the context of the FDIC Study.

We compliment you for inviting Bill Isaac to participate on the Roundtable as his views provide important historical and current perspective. We are personally acquainted with Bill and sincerely hope that his views are very carefully considered.

We were also pleased that three smaller community banks (including a CDFI bank) were included as members of the Roundtable. However, we were disappointed that no representation was provided for "troubled" community banks even though such banks were clearly a significant topic of discussion.

Although their views are important, we are always careful when considering the views expressed by "experts" who have not worked within a bank and have little if any practical experience in the day-to-day management of a bank when such "experts" present what they view as "best" asset & liability practice for community banks based only upon "empirical" evidence. Statistics seldom tell a complete story and may only represent an effect and not reflect the cause.

I hope that my past experience (Exhibit 3) as a senior bank financial executive (CFO & EVP) responsible for asset & liability management, as a financial advisor to troubled community banks in both the early 1990's and the past four years and as a bank investor and community bank board member add some credibility to the following observations. More information is available at *www.ChartwellCapital.com*

Asset & Liability Management

Asset & Liability (ALCO) management at community banks is a complex process that must consider liquidity, interest rate risk, credit risk, reputation risk, customer requirements (both loan & deposit), economic conditions (current & anticipated), regulatory requirements, capital (current & projected), etc. The regulatory CAMELS reflect the complexity and inter-relationships of each component that must be considered by ALCO management.

The FDIC Study must consider the positive role that Brokered Deposits can and do play in ALCO management and not be considered in isolation. For example Brokered Deposits help fund local credit needs with a stable source of insured deposits and help reduce interest rate risk with better matching of asset and liability duration.

Brokered Deposits can also provide a lower cost of funding to banks operating in a very competitive deposit market. It is a myth that all Brokered Deposits represent a high cost of funding and the Study needs to examine the economics of Brokered Deposits from an industry perspective (including healthy banks) and not just focus on a few institutions that failed after they 'paid up' to fund rapid asset growth.

Liquidity Management

The recent financial crisis once again confirmed that deposit stability is directly related to depositor confidence in the FDIC Insurance Fund. The only significant withdrawals of insured deposits in my experience (including the 1980s) were related to the TV coverage of IndyMac. The uncertainty created by TV coverage of the lines of people at IndyMac created a spillover withdrawal of insured deposits at other western banks, including one of our clients.

The best decision made by the FDIC during the financial crisis was the increase in deposit coverage to $250,000 and the expanded coverage for demand deposits. This decision clearly reflected the fact that the early failures (both banks and brokerage firms) were triggered by liquidity. As AmericanWest and other banks have demonstrated, banks with liquidity can manage through an asset quality crisis and complete a successful recapitalization.

History indicates that insured deposits (including Brokered Deposits) do not present a liquidity risk. Representatives from both Promontory and QwickRate testified that the placement of insured Brokered Deposits was not disrupted during the crisis. In our experience, the issuance of deposits via the QwickRate system became an important liquidity tool for institutions operating under regulatory Orders.

Promontory testified that their policy was to 'cap' the amount of CDARS issued by a financial institution that no longer met their credit criteria. In our view this is a sound policy that prevents the use of CDARS to fund additional growth and avoids the creation of an unnecessary liquidity crisis at the bank.

During the past four years the only liquidity problem related to insured Brokered Deposits was created by the FDIC when it did not grant waivers for the renewal or issuance of Brokered Deposits (including CDARS) when requested. As described in Exhibit 1, this "cold turkey" inflexible and punitive approach by the FDIC contributed to unnecessary liquidity problems during the system wide bank liquidity crisis.

We hope this Study will conclude that such punitive regulatory action is not constructive, is disruptive to the financial system and disruptive to local competitors. Therefore, we strongly recommend that the FDIC adopt a more flexible approach and grant waivers that "cap" the issuance of Broker Deposits as permitted under FDICIA.

Brokered vs. Core Deposits

Participants at the Roundtable did a good job of outlining the difficulty of defining Core and Brokered Deposits. The continuing evolution of technology will continue to blur any precise definition. Local bank customers have a very wide selection of channels (branch, Internet, mobile, ATM) for bank deposits and the growth of new products/accounts (401K & brokerage IRA) divert historical local savings to other non-local investments (stocks, bonds, money market funds & brokered CDs).

In addition, a wide variety of local credit needs are now being met by non-local institutions (auto loans, home loans, credit card). This dramatic shift in the competitive landscape for both loans and deposits prohibits any simple definition of Core or Brokered Deposits and we offer no precise recommendation.

We agree with Dr. Unal that Customer Deposits generally represent more value than Brokered Deposits when viewed in isolation. But we strongly disagree with his view that community banks should be restricted to funding with only Core Deposits.

Chartwell has been a financial advisor on numerous community bank mergers and branch transactions and our experience clearly indicates that buyers place value on customer relationships – including loans, deposits and fee services. 'Money' is today an electronic commodity that flows freely across state and local borders and arbitrary deposit restrictions would inhibit a community banks ability to serve its community and compete effectively against large national banks.

Regional Economics

As described above, community banking markets do not operate in isolation. The banking system and capital markets have always facilitated the movement of money from areas (towns, states, countries) with excess funds to those that require funding for growth. Correspondent banks, banker's banks and brokers have historically provided this redistribution function.

High interest rates, Regulation Q, disintermediation and the introduction of money market funds dramatically changed the banking landscape in the late 1970's and early 1980's and many financial institutions (including community banks) found it necessary to utilized money brokers to repurchase deposits that had been channeled to money market funds.

Although Bill Isaac's testimony clearly outlined Brokered Deposit abuses that occurred in the 1980's we submit that the losses incurred by the deposit insurance funds were the direct result of the assets purchased and not by the manner in which such assets were funded.

Brokered Deposits now play an important role in the redistribution of funds from areas with excess funding to those that require funding for growth. Not every community bank can support local loan customers with local deposits and the banking system has always utilized an interbank flow of funds to balance the source and use of funds across the country.

Regulatory Oversight

The best method to protect the FDIC Insurance Fund from loss is to focus on asset quality rather than restrict access to funding and liquidity.

We submit that the FDIC and other bank regulatory agencies already have the necessary authority to restrict asset growth and asset concentrations. This authority is clearly evident in the Orders issued over the past several years.

Capital leverage ratios that exceed the "well-capitalized" definition are being required by Orders when risk is deemed to be excessive. Community banks have limited access to capital and requiring a 1% increase in capital requires about a 10% reduction in assets when new equity is not available from existing shareholders or the capital markets.

Our review indicates that the vast majority of Orders require a reduction of specific loan concentrations. Bank regulators don't need to restrict funding and available liquidity for all banks to limit the excess growth of risky assets by a few institutions. FDICIA already gives bank regulators the ability to restrict growth and reduce concentrations following an unsatisfactory examination.

Summary & Conclusion

The views expressed in this letter are based on my banking and financial advisory experience over the past forty-two years. Like others, I am deeply troubled by the events of the past several years and sincerely hope that 'lessons learned' will help our nation avoid future financial crisis.

This Study provides the FDIC with a unique opportunity to examine and reflect on the impact the FDIC's current Brokered Deposit policy has on economic activity and bank liquidity.

Recent events have demonstrated that insured deposits (Core & Brokered) do not present a liquidity risk. On the other hand, uninsured deposits (Core & Brokered) were subject to withdrawal following events that created reputation risk (including the issuance of an Order). We suggest the focus of the Study be the potential volatility (liquidity) of uninsured deposits.

We don't question that Brokered Deposits can and have been abused to fund inappropriate and risky asset growth. However, we believe it's important to recognize Brokered Deposits can provide a sound economic function when used prudently. All good things (food, medicine, exercise) can be abused – but the answer is to control the abuse not eliminate access by those who are not guilty of abuse.

Bank boards have oversight responsibility and management has the day-to-day responsibility to manage their institution in a safe and sound manner. Bank regulators have the authority to limit asset growth, reduce asset concentrations, increase capital levels and take other actions when this does not occur.

We sincerely appreciate the opportunity to share our views and are prepared to answer any questions.

(b)(6)

Respectfully submitted,

(b)(6)

Exhibit 1

To: coredepositstudy@fdic.gov
(b)(6) **From: Charles J Thayer**

Subject: Statement on Brokered Deposits
Date: March 10, 2011 10:10:14 AM EST

1 Attachment, 264 KB

FDIC Study Group

Please accept and consider the attached information in your analysis of Brokered Deposits as required by the Dodd-Frank Act.

By way of background, 2011 marks my 42nd year in the banking business - 20 years as a commercial banker (12 as CFO) and 22 years as an investor/investment banker.

Brokered Deposits are a valuable tool that helps local financial institutions fund the credit requirements of their local communities - but like any tool they can be misused. Careful consideration must be given to the role Brokered Deposits play in helping redistribute funding from geographic areas with surplus deposits to local communities that require credit to support sound economic growth (including local jobs). Brokered Deposits are not the problem - the inappropriate use (rapid growth of risky loans) of such deposits was the problem.

Chartwell (my firm) is not engaged in offering or dealing in Brokered Deposits - our primary business is providing financial advice to the boards and management of financial institutions.

I am also mailing the attached material with a copy of the book ("It Is What It Is") that describes the impact that regulatory policy has on the day-to-day management of liquidity at a financial institution.

I believe my experience provides insight on the importance of liquidity and capital management for financial institutions and welcome any questions.

Charles J Thayer
(b)(6)

Dodd-Frank Act – Core Deposit Study

Statement on "Brokered Deposits"

Charles J Thayer
Chairman
Chartwell Capital Ltd

Charles J Thayer is Chairman and Managing Director of Chartwell Capital Ltd., a private investment firm providing specialized advisory services to the board of directors and executive management of banks and institutional investors. Thayer also serves as Chairman of the American Association of Bank Directors.

Chartwell has performed "Management Studies" required by Consent Orders for five commercial banks during the past four years. These assignments combined with other client relationships provide insight from inside troubled institutions.

Thayer has extensive banking experience; he was elected to the board of Republic Bank in Florida in 1999 and served as a board member of BB&T Bank (Florida) for two years following BB&T's 2004 acquisition of Republic Bank. Prior to organizing Chartwell Capital in 1990, Thayer had a 20-year career in commercial banking serving as EVP-CFO of Citizens Fidelity, Kentucky's largest bank and EVP-Finance for PNC Bank Corp.

Based on Chartwell's experience we do not advocate "adequately capitalized" institutions be permitted to increase "brokered deposits"; however, we believe waivers should be granted that permit the renewal of "brokered deposits" for a reasonable period of time that will permit a bank to reduce reliance on "brokered deposits" in an orderly manner.

FDIC policy of not granted waivers is unnecessarily punitive and is disruptive to a bank's good core loan customers and other local banks. It is obvious that asset reduction is required to help offset the maturities of "brokered deposits" and the only loans that can be reduced are to loan customers with good credit – the very customers the bank should be encouraged to retain. Every banker knows higher rates are required to shift a bank's share of limited local deposits – a competitive situation that creates a higher cost of funds for all banks in the local market.

Past FDIC policy places unnecessary pressure on liquidity and the cost of deposits for all banks in a local market. In addition, replacing "brokered deposits" with local core deposits does not reduce exposure to the FDIC Insurance Fund. In our view, the "Cold Turkey" approach has been disruptive and served no economic purpose.

Thayer recently published *"It Is What It Is"*, a book describing the recapitalization of AmericanWest Bank. The topic of "brokered deposits" was address in the "real world" context of the bank's path to recapitalization and the following excerpts address the author's view of regulatory policy related to "brokered deposits". A copy of this Statement and the book are also being mailed to the FDIC.

CJT

Excerpts from the Book: "It Is What It Is"

ISBN: 978-1-4583-0002-7

The following excerpt is from Chapter 13 the concluding chapter that describes the consequences of various regulatory policies. Highlights added for emphasis.

Excerpt: Chapter 13 – Regulatory Policy

FDIC: Liquidity & Brokered CDs

The unintended consequences created by the failure of the FDIC to approve the issuance of brokered CDs by "adequately capitalized" banks to replace maturing brokered CDs was one of the most disruptive policy decisions made during the past several years.

The banking system was experiencing a serious liquidity challenge and this FDIC policy contributed to the problem, not towards a solution. This issue is further described in Chapter Five.

Excerpt: Chapter 5

The following excerpt from Chapter Five describes the consequences of various regulatory policies and management's successful actions to address liquidity when a "brokered deposit" waiver was not granted in August 2008.

Liquidity Management

Liquidity was the first order of business, but it needs to be made very clear that all of the other actions described in this chapter occurred simultaneously. It was the start of a very challenging time.

The fallout from IndyMac had contributed to $50 million of deposit withdrawals at AmericanWest, and balance sheet liquidity had declined from $100 million to about $50 million for a time – too close for comfort. Rusnak and his team had already taken steps to apply to the Federal Reserve Bank (FED) "discount window" and to expand their borrowing capacity at the Federal Home Loan Bank (FHLB).

The most immediate challenge to be faced by the Bank was related to $250 million of maturing brokered Certificates of Deposit (CDs). The Federal Deposit Insurance Corporation Improvement Act (FDICIA) passed by Congress in 1991 following the last banking crisis had established new capital standards and steps ("prompt corrective action") that were to be taken by regulators and bank management when capital ratios fell below the established benchmarks.

At the time this legislation was enacted in 1991 the "adequate" capital category was intended to provide regulatory flexibility and not be a trigger for punitive measures. One such feature was the ability for a bank to request and receive a waiver that would permit the bank to issue new brokered CDs to replace

maturing broker CDs. AmericanWest made such a request but based on my previous experience, approval was not anticipated.

The unpublished FDIC policy of not approving brokered CD waivers for "adequately capitalized" banks, in my view, reflects a serious lack of understanding at the FDIC concerning the reality of available funding for community banks. Adequately capitalized community banks are forced to replace maturing brokered CDs by increasing their share of deposits in their local markets. Paying more for local deposits than your competitors pay is the only way for a community bank to shift share of market. The net result is an increase in the cost of money for all community banks in that bank's home market – a terrible economic outcome for every bank in the market.

I had previously shared this view with senior officials at the FDIC, to no avail. No additional exposure is created to the FDIC's Deposit Insurance Fund (FDIC Fund) when maturing insured brokered CDs are replaced with new insured brokered CDs rather than insured local deposits; however, unnecessary liquidity failures do create losses for the Deposit Insurance Fund. I now find it interesting that some regulatory officials have acknowledged that many of the early failures were caused by lack of liquidity – not asset quality and lack of capital.

Furthermore, regulatory interest rate caps are imposed on troubled banks that are being forced to replace brokered deposits by obtaining deposits in their home markets. It was clear to any banker on the front lines that many community banks were facing their own liquidity crisis, and regulatory policy was not helping – FDIC policy was a contributor to both higher local funding costs and the liquidity problem.

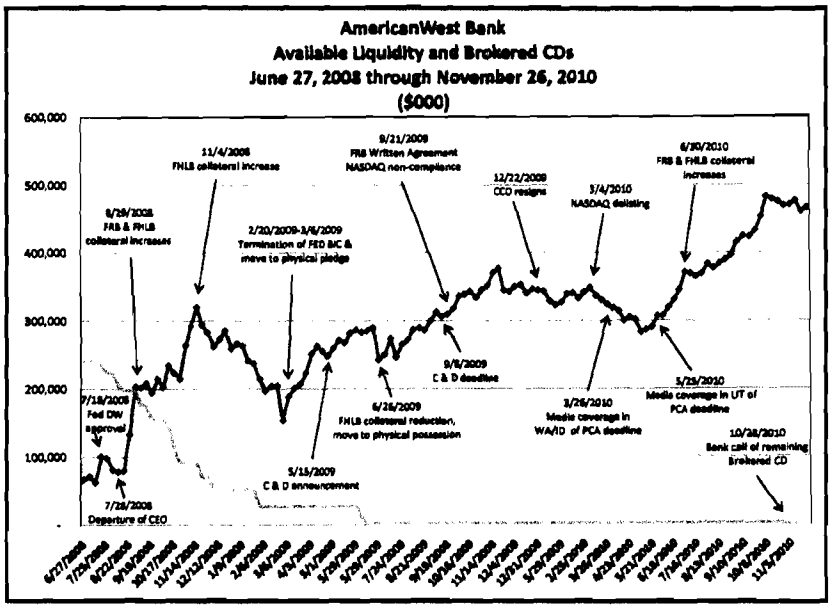
It was in this economic and regulatory environment that the Bank faced the challenge of replacing $250 million of brokered deposits. If the funding currently provided by the outstanding brokered deposits was ignored, then the Bank had negative net liquidity in excess of $150 million!

The maturity schedule of the brokered deposits provided only a few months to implement a plan to both reduce assets and increase core deposits. Rusnak brought immediate focus to the management of liquidity and it became the most important daily measure. A daily liquidly report was circulated to all key managers – everyone knew what was needed and expected.

ALCO and the Treasury staff served as the navigation center for financial forecasting and future management strategy. Accurate financial forecasts provided by key mangers are essential for executive management to anticipate and avoid financial storms - just as the Captain of a ship at sea requires an accurate weather forecast to avoid storms. I observed a management team that understood forecasting was about accuracy, not unattainable goals. The ALCO team clearly helped navigate the Bank through the financial hurricane of 2008-09.

Members of the Bank's Asset/Liability Committee (ALCO) focused their attention on balance sheet forecasting and liquidity. Williams shared back test results with all ALCO members and forecasting consistently improved.

The chart illustrates the success of the liquidity story - one of the most significant management achievements at AmericanWest. The dark line represents total liquidity and the light grey line represents outstanding brokered CDs. Most important, the focus for the newly restructured branch management network was deposit retention and growth, not loan growth. AmericanWest was fortunate to have a strong branch network and great branch personnel in multiple markets located in Washington, Idaho and Utah. The execution of the deposit marketing plans by Nicole Sherman (Chief Banking Officer for Utah), Bob Harris (Chief Banking Officer for Washington & Idaho) and the Bank's branch personnel throughout the system was amazing.



AmericanWest Liquidity

Chart reproduced courtesy of AmericanWest

Rusnak had frequent conference calls with all employees to explain any news (good and bad), regulatory issues, management's objectives, and to answer questions. There was a clear positive reaction to Rusnak's open style of leadership.

As a result of this powerful team effort, when the agreement to recapitalize the Bank was announced in October 2010, total net liquidity was over $450 million - management had achieved a $600+ million liquidity improvement in just over two years time!

# # #

Exhibit 2

Core and Brokered Deposits Roundtable Participant List March 18, 2011

Sheila C. Bair, Chairman
Martin J. Gruenberg, Vice Chairman
Thomas J. Curry
John Walsh
John E. Bowman

Participants

Hon. William Isaac
LECG Global Financial Services Sarasota, Florida

Randy Dennis
DDF Consulting Little Rock, Arkansas

David Hayes
Security Bank Dyersburg, Tennessee
$160 million assets, broker 0%, profitable > 9% ROE, 10.4% Leverage

Larry J. Lanie
Farm Bureau Bank San Antonio, Texas

Shawn O'Brien
QwickRate Marietta, Georgia

Kim D. Saunders
Mechanics and Farmers Bank Durham, North Carolina
CDFI, $300 million assets, broker 33%, profitable > 3%, Leverage 10.4%

Sara M. Cline
West Virginia Division of Banking

Leton Harding
The First Bank and Trust Company Lebanon, Virginia
$1.2 billion assets, broker 7%, profitable 12% ROE, Leverage 9.4%

Mark P. Jacobsen
Promontory Interfinancial Network, LLC Arlington, Virginia

Jennifer Marre
Bank of America New York, New York

Todd Sandler
ING Direct Wilmington, Delaware

Dr. Haluk Unal
University of Maryland
College Park, Maryland

Christopher Whalen
Institutional Risk Analytics Croton on Hudson, New York

Jeffrey Zage
Financial Northeastern Companies Fairfield, New Jersey

Exhibit 3

Charles J Thayer

Thayer is Chairman and Managing Director of Chartwell Capital Ltd., a private investment firm providing specialized advisory services to the board of directors and executive management of banks, corporations and institutional investors.

He had a twenty-year career in commercial banking prior to organizing Chartwell Capital in 1990. As Executive Vice President of PNC Financial (NYSE), Pittsburgh, he had management responsibility for finance, merger and acquisitions, investor relations, strategic planning, and he served as Chairman of PNC Securities Corp, PNC's capital markets subsidiary.

Prior to its acquisition by PNC in 1986, Thayer served as Executive Vice President and Chief Financial Officer of Citizens Fidelity Corporation (NASDAQ), Kentucky's largest bank holding company.

Republic Bank, a $2 billion asset commercial bank, elected Thayer to the Board of Directors in October 1999 and to the Board of Republic Bancshares, Inc., St. Petersburg, Florida (NASDAQ) in May 2000. Republic was acquired by BB&T Corporation in 2004 and Thayer served on the board of BB&T Bank (Florida) until July 2006.

He served on the board of the Louisville Development Bancorp (LDB) and Metro Bank, its banking subsidiary, from 1997 to 2009 and he continues to serve on the LDB board. LDB's shareholders include Kentucky's major banks and corporations and the bank (a CDFI) is dedicated to job creation and home ownership in the Louisville metro area.

Thayer was named Chairman of the American Association of Bank Directors in 2007. The AABD is the national non-profit organization dedicated to serving the information, education and advocacy needs of financial institution directors. Outside directors who are not professional bankers make up 95% of AABD membership.

The National Association of Corporate Directors invited Thayer to be a founding board member of NACD Florida. The NACD is the premier source of corporate governance information, education and training for directors and CEOs who are committed to raising standards and improving boardroom performance. Thayer has been awarded the Certificate of Director Education by the NACD Corporate Directors Institute.

Thayer was elected to the Board of Trustees of the national Cystic Fibrosis Foundation, Washington, DC, in 1980. He currently serves as Vice Chairman of the Foundation and Chairman of the Foundation's investment committee. He served as Chairman of Cystic Fibrosis Services, Inc., the Foundation's national mail order pharmacy, from 1994 to 2004.

CogenAmerica (NASDAQ), an independent power producer headquartered in Minneapolis, Minnesota, elected Thayer to its Board of Directors in April 1996. He served as a member of the Independent Directors Committee (IDC) until CogenAmerica's acquisition by Calpine Corporation in December 1999. The IDC was given full control of the acquisition process.

Thayer served on the Board of Directors of Sunbeam Corporation (NYSE) from October 1990 until his resignation in April 1997. In January 1993 he was elected Chairman and CEO of Sunbeam, providing interim management until the election of a new CEO in August 1993.

(b)(6)

From:
Sent: Friday, March 25, 2011 9:32 AM
To: Core Deposit Study
Subject: core deposits

My name is Wayne Merritt. I was in banking for 34 years and now have a blog found at www.bank-scores.com, the purpose of which is to identify great community banks in Texas.
There are two points I respectfully submit:

A bank that grows assets at a moderate pace (my recommended maximum growth rate is less than 12% per year) and that maintains excellent credit quality will more likely use funding that is core to that institution. In other words, a bank with moderate growth would have no need of higher cost, less reliable funding.

The second point is that core deposits are one source of funding and should be considered in light of the bank's other funding sources that a bank needs to fund growth which exceeds its core deposit growth. The links below address the most unreliable funding sources: brokered CD's, trust preferred securities and Federal Home Loan Bank advances.

The links below are brief articles which address my points. I would be happy to further discuss my views.

http://bank-scores.com/?p=1522

http://bank-scores.com/?p=1525

http://bank-scores.com/?p=1537

http://bank-scores.com/?p=1547

http://bank-scores.com/?p=1559

Wayne Merritt

Williams, Gina D.

(b)(6)

From: Steve Genereau
Sent: Thursday, March 24, 2011 1:30 PM
To: Core Deposit Study
Subject: RE: Link for the Webcast, Agenda, and Participant List - March 18th FDIC Roundtable

Thanks Mike.

I will be in touch as we get our arms around it here.

I think it would have been useful to have a representative or two from the securities industry at the rdtble to learn their perspective and so they can learn/better appreciate the FDIC's and bankers perspective. A good amount of the brokered funding originates from the securities side of the fence and it may be useful to tear down that fence and get everyone on the same page. Just a thought.

Regards,
Steve

Steve Genereau | SVP, Chief Deposit Officer | Reich & Tang | Reich & Tang Distributors, Inc. | 1411 Broadway, 28th Floor | New York, NY | 10018-3450 |
(b)(6)

-----Original Message-----
From: Core Deposit Study [mailto:CoreDepositStudy@FDIC.gov]
Sent: Thursday, March 24, 2011 12:13 PM
To: Steve Genereau
Subject: RE: Link for the Webcast, Agenda, and Participant List - March 18th FDIC Roundtable

Steve,

Right now, we are asking for feedback and comments through our mailbox - we've gotten quite a few already. You cand e-mail us at the address above.

Did you have specific questions for us, or is there a certain point you want to emphasize?

Thanks,

Mike

(b)(6) **From:** Neil Joiner

Sent: Thursday, March 24, 2011 11:13 AM

To: Core Deposit Study

Cc: Carol Arflin; Connie Edwards

Subject: Brokered Deposits

I appreciate the regulatory authorities taking a look at the current position on brokered deposits. I understand the concern about growing a bank too fast by use of such funding. The current banking problems, however, seem more directly related to loan problems and have little to do with how these loans were funded. Had brokered deposits not been available to fund these loan opportunites, financial institutions would have found other means and no doubt would have increased their cost for local deposits.

Brokered deposits have proven to be a stable, convenient, and inexpensive source of deposits. The severe restrictions now in place will do little to resolve the many banking problems. They will instead contribute to those problems by causing bank's to pay more for deposits than they could readily obtain them for in the brokered market. Asset quality is the issue that warrants focus, not the funding sources in most cases.

Thank you for your consideration.

Neil Joiner, President
Bank of Dooly
(b)(6)

(b)(6)

From: Bill Sharp

Sent: Wednesday, March 23, 2011 6:03 PM

To: Core Deposit Study

Subject: brokered deposits

While true brokered deposits may have been abused in some bank failures you should not punitively discourage the prudent use of such funding.

Our bank is receives significant funds from the city, county, public schools, etc. We have utilized the CDARS network to take care of these funds without having to pledge securities or put up letters of credit as collateral. The funds are relatively stable and local. But the TFR and Call Reports classify the funds all as brokered and might lead someone analyzing our bank to conclude that these funds are hot money from out of territory, etc. Many banks have the same issue as ours and the treatment of CDARS type funds should at least be designated as being different from actual brokered deposits.

One friend of mine at another bank told me that his bank was told it had to eliminate all brokered deposits (including CDARS) and was advised by FDIC examiner to just replace those funds with internet CDs. The internet CDs truly were from out of territory and hot money compared to local funds that had been with CDARS.

Perhaps some type of reporting that could separate short term (< 1 year) from longer term (> 1 year) brokered type deposits. Allow separate reporting of CDARS.

I would tend to think it might be appropriate to also include reporting of internet deposits. The same issues are prevalent with internet CDs as with brokered and there is no reporting at all for the internet CDs.

Another issue that may be outside your focus is how you treat FHLB advances. Our institution uses FDIC term advances for asset-liability purposes. We have a hard time locking CDs in for 5 or more years whereas we can almost always get longer term FHLB advances at favorable rates to fund longer term assets and reduce interest rate risk. Examiners in recent years have a tendency to treat FHLB advances with the same broad brush as they treat brokered. And at the same time ignore any risk due to internet CDs.

Thanks

(b)(6)

From: Bruce Hanke

Sent: Thursday, March 17, 2011 12:49 PM

To: Core Deposit Study

Subject: Core and brokered deposit study

March 17, 2011

To whom it may concern:

In response to FDIC's request for input please consider the following:

1. In times of financial stress the most likely deposits to remain at an institution are insured deposits. In addition funds that are in investments with additional risk such as stocks will flow to safety in a time of financial stress. Deposits that are not insured would be the most likely to leave as well as funds held by whichever segment of the economy is stressed at the time.

2. The presence of certain types of deposits does not increase the risk to the institution. It is the leverage of the institution that plays a more important role. Leverage decreases capital and liquidity no matter how you are funding the assets you have. We have taken the stance that brokered deposits are unacceptable to regulators and as a result we are paying twice as much for local deposits on a one year maturity. This does not make sense as earnings are hurt and local rates are artificially high. It also does not make sense that CDARs deposits are considered brokered deposits. Our bank participates in the CDARs program only with our large customer's funds. Why are our own customer deposits considered brokered and reported as such on the call report?

Bruce J. Hanke
CFO

First Bank Blue Earth
306 South Main Street
P.O. Box 40
Blue Earth, MN 56013

(b)(6)

March 15, 2011

Federal Deposit Insurance Corporation
Attn: Core Deposit Study
550 17th Street, NW
Washington, DC 20429

RE: Brokered Deposits

Dear Committee Members:

I have been watching regulatory bodies criticize banks for utilizing brokered deposits. I hear comments and see the direct correlations between banks failing and having a large brokered deposit funding component. I can understand how people rationalize that brokered deposits must be bad because many young banks that failed had a large funding component of this deposit type. The appropriate question is "Are brokered deposits the cause of the failures or a symptom of some other cause of the failure?" To put it another way, most everyone with pneumonia has a fever. The question to ask is "Is the fever the cause of the illness or just a symptom?" Treating the symptom will not cure the disease. I would propose to all of you that brokered deposits are a symptom of some bank illness, not the infection that caused the illness.

Bank losses and resultant failures most always occur as a result of asset related losses. Loans or securities become worthless and capital erodes as a result of these losses. However, the loss is created from asset erosion, not liabilities such as brokered deposits or Federal Home Loan Bank borrowing. Asset erosion is derived from liquidating collateral losses or investment security principal losses. Stating that brokered deposits or Federal Home Loan Bank borrowing causes losses is disingenuous at best.

Brokered deposits and Federal Home Loan Bank borrowings allow banks to grow. Growth can be a great thing if management is strong and invests in good assets. However, growth can be the cause of failure if management is weak and invests in poor assets. Brokered deposits and Federal Home Loan Bank borrowings are present in well run banks and poor banks alike. Growth is present in well run banks and poorly run banks alike. Weak management is always present in failed banks. Weak management is the cause of the banks illness. Brokered deposits, Federal Home Loan borrowings and related growth are symptoms of the illness at times, but they aren't the cause of the illness. The question is "Do we harm strong management teams by limiting their tools of growth because some weak management teams also use these

4091 Mount Royal Blvd., Allison Park, PA 15101-2917
www.enterprisebankpgh.com, Main Phone 412-487-6048, Fax 412-487-4622

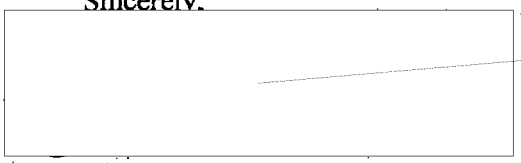
same tools?" To say yes to this question is fundamentally wrong and not representative of the spirit in which this country was built. We do not treat pneumonia by filling the patient with aspirin. We treat the illness with an antibiotic to kill the infection. In the same logic, we cannot treat a bank failing because of poor management by taking away the tools of growth. The bank will only be cured of its illness by changing the management team. Treating the symptoms will only prolong and/or cover up the underlying infection until it is too late to save the bank.

It is the regulators' job to make sure the banking industry is safe and sound. It is their job to find and correct weak management teams. It is not their job to limit the tools of the trade. It may be their job to limit growth if the bank in question needs to improve a weak management team. Repairing the management team or limiting their growth should not be stretched into limiting the tools of the trade unless that tool is detrimental in all occasions. This is not the case with brokered deposits or Federal Home Loan Bank borrowings.

In our bank's market, brokered CD's are less expensive than local CD's. The brokered CD is less volatile than those issued by the bank as they are not redeemable early except if the CD owner passes away or is declared incapacitated. The brokered CD is less expensive to issue because we document one master agreement with the broker versus numerous CD agreements with retail customers. In summary, this funding source is less expensive, less costly to issue and less volatile than local options. Why should our usage be limited or our FDIC premiums be increased because some weak management teams have used this tool improperly? Regulators should review management teams and possibly limit growth not limit the tools the industry can use in a positive manner.

We appreciate the opportunity to comment.

Sincerely,



(b)(6)

Charles H. Leyh
President and CEO

March 10, 2011

Sheila C. Bair
Chairman
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC

Dear Chairman Bair:

As the FDIC prepares its study of core and brokered deposits as required by the Dodd-Frank Act, I would like to offer the following view as a result of watching the depositor behaviors behind deposits every day for the past six years. I would like to commend on the questions posed on the official FDIC website.

Q & A:

- **In times of financial stress, what types of deposits are likely to remain at an institution and what types of deposits are likely to leave the institution?**
    - **Likely to remain**
        - **If there is severe stress, it is impossible to predict the behavior of depositors who are normally rational in their decision-making. Under severe stress, any stable deposit can become unstable.**
        - **That being said, there are ways for banks to protect themselves as much as possible.**
        - **If the funds are 100% covered by FDIC deposit insurance, these funds are more likely to stay.**
        - **If the funds have early withdrawal penalties, these funds are more likely to stay – at least until maturity**
        - **Community Public Sector deposits are more likely to stay for two reasons:**
            - **Community Public Sector customers must abide by very conservative Investment Policies that hold safety of funds as their primary objective. As such, these funds are not at risk, even under times of the bank's financial stress.**
            - **Community Public Sector customers are public servants who place the well-being of their community at the center of their decision-making. For example, I had a Community Public Sector customer who knew that one of their two primary community banks was under financial stress. Because of this knowledge, they decided to not bid and/or move their funds to another healthier bank offering better terms for their money –**

solely because of the potential damage that moving those funds may cause to the struggling community bank. Their words: "If we move these funds, the bank could fail, so we have decided to keep the funds there for awhile."

- **Examiners tend to label Public Funds as "hot money". This is a common misperception and is not justified by data. The funds are large, and, while there are concentrations (large sums of money with one customer), each Public Sector Customer needs to be considered a separate funding source, not the group at large.**
- **However, banks can diffuse concentration risk by having diverse funding sources (the ability to replace exiting funds with new funds) and by laddering maturities (splitting funds up into multiple maturities with early withdrawal periods) and reducing the withdrawal amounts to specific amounts per month that are manageable from a liquidity risk standpoint.**

- **Likely to leave**
  - **Funds controlled by depositors who react to the financial stress of the bank. Impossible to predict because these behaviors are dormant until the event happens.**
  - **Funds that are not covered by FDIC deposit insurance.**
  - **Liquid funds in DDA accounts with no restrictions on withdrawals.**
  - **Funds controlled by depositors with shallow or no relationship with the bank.**

- **Does the presence of certain kinds of deposits (e.g., brokered, internet, listing service) inherently increase an institution's risk?**
  - **No, the kind of deposit does not increase risk to the institution.**
  - **However, if the bank decides that it wishes to sell a branch, merge, or sell it's entirety, the presence of certain kinds of deposits, by definition, are currently considered brokered or non-core, and they limit the options for the selling bank due to a lack of sufficient franchise value. Said a different way, more franchise value gives a merging or selling bank more options to facilitate the transaction. Not having sufficient franchise value puts more risk on the FDIC fund and creates more expensive transactions. This can be changed by removing the stigma attached to these deposits by bank examiners.**
  - **Brokered deposits, Internet Deposits and Listing Service Deposits have different forms of franchise value.**
    - **Pick up the phone brokered deposits have no franchise value.**
    - **Reciprocal deposits have total franchise value and should not be labeled non-core or brokered. They are core deposits.**

- Listing Service Deposits and Internet Deposits, given proper boundaries set by the bank, may also carry full franchise value, but today would be spurned by purchasing banks due to the threat of negative dependency ratios.

- Does their presence facilitate increased risk-taking?
  - Only to the FDIC fund, due to the stigma attached to them by bank examiners.
  - The risk-taking described here involves the use of the funds, not the characteristics of the funds themselves.
  - Bank examiners are responsible for ensuring that banks are not engaging in excessive risk-taking in the lending area.
- What types of deposits are likely to enhance a failed institution's franchise value and what types of deposits are likely to reduce it?
  - As mentioned earlier, franchise value has been defined in some instances by bank examiners. Without the stigma attached to some deposits, franchise value would be there.
  - FDIC insured deposits add franchise value.

  - Reciprocal Deposits and Deposits like Reciprocal (covered by pass-through deposit insurance approved by the FDIC) – add franchise value unless brought to the bank by a broker (where the relationship is between the broker and customer, not the customer and depository bank).
  - Listing services add franchise value if not stigmatized.
  - Internet Deposits add franchise value if there is a relationship between the customer and the bank.
  - Pick up the phone brokered deposits add no franchise value. No relationship between customer and bank exists. The broker is not a customer because they do not own the funds.
- What recommendations would you make for legislative or regulatory changes with respect to core and brokered deposits?
  - I would eliminate the present archaic definitions of core, non-core and brokered deposits. Technology has changed and customers have changed. Almost all deposits can be stable deposits, unless a trigger event happens. Today, valued deposits should be determined by the franchise value they bring to the bank. This is determined by the relationship with the bank.
  - Unlimited FDIC insurance coverage on DDA accounts should be made permanent. This stabilizes large deposits and eases concentration concerns. It's one of those sticky features.
  - Unlimited FDIC insurance coverage, or an elevated FDIC base amount for Public Sector depositors would stabilize those valued community dollars. These customers are having a difficult time today finding anyone who will take their deposits because of the additional cost to the bank to protect them.

- When a bank becomes less than well capitalized - rather than eliminate funding sources I would provide a "glide path" which allows the bank to have the liquidity needed to heal their balance sheet over a defined time frame. Just taking away funding sources during the times that they need them the most, takes the air out of the bank and kills it, rather than allowing it to survive and heal. Small community banks are the fiber of this country. Current regulatory restrictions on funding sources on banks when they become less than well capitalized contributes to their eventual demise and adds significant cost to the deposit insurance fund.

- How have the new methods of obtaining deposits affected deposit stability and franchise value?
  - With technology advancements, the new methods of obtaining deposits, have given banks the ability to diversify their funding sources and protect themselves against deposit concentrations.
  - Deposit stability should be more stable, but has been artificially reduced due to stigmatizing definitions of core deposits, noncore deposits and brokered deposits. Fixing these definitions to match the truth of historical deposit stability data would allow banks to be able to operate within a comprehensive and diverse ALCO- approved and Examiner-Approved funding plan that increases liquidity and decreases risk.
  - Franchise value determines risk to the DIF. As such, a definition of franchise value should replace the definitions of core, non-core, and brokered deposits. Community banks, at their essence, take in deposits from their customers and lend them out to their customers. Relationships with customers create franchise value. This should be the measuring stick for the funding plan for the majority of banks.
- What changes should be recommended to the core and brokered deposit definitions and what new classification of deposits should be developed that depend on characteristics that address relative stability or volatility?
  - Based on franchise value:
    - Pick up the phone brokered deposits carry no franchise value. There is a place where their use may be needed, but they should be limited and the bank should always be looking to replace these funds with deposits that carry franchise value.
    - FDIC-Insured Deposits, include reciprocal and pass-thru FDIC insured deposits carry franchise value. These deposits should be encouraged and gathered from local bank depositors in the bank's footprint.
    - Listing Service Deposits and Internet Deposits, provided the parameters do not encourage brokered funds, provide for relationship driven deposits and carry franchise value.

- **Relationships drive franchise value. Banks must be in a position to be able to justify their usage of these funding sources by showing the relationships behind them.**
- **Funding sources that carry no franchise value may be used for balance sheet and income statement purposes, but must be restricted by the bank's funding plan that is ALCO and FDIC approved.**

Brokered/Core Deposit Study
Kelley Sanders
Sr. Deposits Officer
SpiritBank

(b)(6)

From: Brooks Wise

Sent: Monday, March 07, 2011 7:15 PM

To: Core Deposit Study

Subject: Core Deposit Study

Dear FDIC:

I appreciate the opportunity to make comment on the importance of making modifications to the existing regulatory definitions of what is consider "core deposits" versus non-core funding.

First and foremost, please consider revising the definition of "core deposits" from up to $100,000 to match the current FDIC coverage of $250,000. This will have a positive impact on accurately reflecting the current level of core deposits housed within most community banks. In our experience, deposits grew nearly 20% during 2010, however, non-core funding increased. This was a result of clients bringing our Bank more money and adding them to our CDs. As a result, our CDs under $100,000 decreased while our CDs over $100,000 (non-core deposits) increased. As a small community bank, changing this one definition on the call report so it matched the permanent FDIC level of $250,000 would result in a 20% improvement in our core deposit ratio.

The second modification I would appreciate your consideration of relates to the CDARS program. If you are not familiar with CDARS, please let me know and I will gladly refer you to the appropriate website. That said, CDARS has been an excellent tool in assisting our local depositors in maximizing their FDIC insurance coverage. 100% of our Bank's CDARS deposits are from relationships with individuals, non-profits and other businesses within our local community. None of the "reciprocal" CDARS deposits are truly "brokered", yet all are treated as such for call reporting purposes. I would like to suggest that all "reciprocal" CDARS deposits also be considered a core deposits. They are our client's funds that are being placed and are not the same as funding that is being purchased from the open market. While I understand that their may be higher perceived risks associated with brokered deposits, our CDARS relationships are quite stable and less rate sensitive than true brokered deposits. We work with our clients to create laddering strategies that helps our clients in managing liquidity. As a result, I support the notion that these are core deposits and not brokered.

I would happy to discuss these two recommendation with the FDIC and provide further support as well. Thank you for the opportunity to make comment. I look forward to the results of your roundtable discussions.

Sincerely,

Brooks W. Wise

President

Mission COMMUNITY BANK

3380 South Higuera Street

San Luis Obispo, CA 93401

(b)(6)

(b)(6)

From: Steve Crouse

Sent: Friday, March 04, 2011 10:08 AM

To: Core Deposit Study

Cc: Bob Hatley; Matt Davis; Michael Story; Jennifer Terry

Subject: Core/Brokered Deposit Study

In response to the Core/Brokered Deposit study, I'd like to make a few comments on the areas that the FDIC solicited responses. As the Chief Financial Officer of a $1.2 billion commercial bank whose original business plan approved by the FDIC included that 70% of its funding come from brokered deposits, I feel like I have plenty of experience in wholesale funding. In my opinion, when used properly, brokered deposits can be an extremely valuable source of funding for certain types of financial institutions. Certainly, no bank should use wholesale deposits without a blend of core or local deposits. Core deposits are the relationship accounts that drive the franchise value of the bank. With no local funding, a bank just becomes a deal maker, not a community focused, relationship driven, fiscally sound institution. That having been said, the days of the Savings and Loans are long gone. No longer are people bringing in all of their savings to put in a passbook account and taking out a traditional mortgage, both of which are held at the same bank. There are too many other alternatives available for the consumer. With e-banking and online trading accounts with low minimums, you no longer have to be extremely wealthy to have a stock portfolio. With everyone from brokerage firms to insurance companies lined up to manage your funds, banks are becoming less attractive to the sophisticated, technology driven younger deposit customer base. However, without funding, banks can't make loans. Without lending, our economy grinds to a halt as is evidenced this current economic crisis. As a result, banks, and specifically community banks, have to look across a wider geographic scope to meet their funding needs. There are pockets across the country where there are large sums of deposit dollars with relatively little growth or lending needs and there are pockets across the country where the growth has outpaced the market funding availability. Our market, the Research Triangle area of North Carolina, has increased its population by 25% over the last 10 years and with this growth has come the need for new schools, subdivisions, and infrastructure, all of which takes funding of some sort. Brokered deposits can help bridge the gap between loan needs and local deposit gathering and even be a lower cost source of funds with lower operational costs. To specifically answer the questions posed by the FDIC:

- *In times of financial stress, what types of deposits are likely to remain at an institution and what types of deposits are likely to leave the institution?*
  - Ironically, brokered deposits are the most stable deposit in a time of financial stress. They are held in the bank under a contractual obligation which can only be unwound through the death of each individual depositor inside that large block of funding. Since typical brokered deposits are made up of multiple small blocks, they are also 100% insured. Brokered customers are also far removed from the institution itself and therefore not influenced by media coverage about the bank. I would argue that if Wachovia Bank was 100% broker funded, it might still be around. It would not have suffered the liquidity crisis that lead to the merger with Wells Fargo.
- *Does the presence of certain kinds of deposits (e.g., brokered, internet, listing service) inherently increase an institution's risk? Does their presence facilitate increased risk-taking?*
  - I believe the presence of wholesale funding does not inherently increase a bank's risk. The deposits don't cause the risk. The risk comes from what is done with the funding. If a bank uses brokered deposits to grow out-of-market loans or to grow at a pace faster than its infrastructure can support, then certainly those deposits increased the risk profile of the bank. But if a bank uses brokered funds as an alternative, low cost source to help fund managed growth in its local market, I think access to brokered funding actually reduces risk. When a bank sees a potential shortfall in local deposits or the likelihood that a large block of funding might go away, the ability to use brokered as "fill-in" funding can be a valuable resource.
- *What types of deposits are likely to enhance a failed institution's franchise value and what types of deposits are likely to reduce it?*
  - Certainly core funding is a primary driver of franchise value and a total reliance on wholesale funding would reduce it. However, a proper blend that combines the customer relationships associated with local

funding and the economy of scale and efficiencies derived from brokered deposits might also make an institution attractive in a normal economy where brokered funding hasn't been saddled with the current "stigma" placed upon it by some regulators. In addition, even if a bank has a large majority of deposits in relationship deposits (which is a value enhancer), there is still a large risk of deposit defection in the case of failure if these deposits are held in high cost CDs. Even if the CDs are "core", if the purchasing bank doesn't maintain the pricing, these deposits will leave.

- *What recommendations would you make for legislative or regulatory changes with respect to core and brokered deposits?*
  - I believe that the regulators should closely monitor the use of brokered funding to ensure those funds aren't used to take excessive risk. Monitor the growth created by the brokered funds to ensure it is prudent growth; in the Bank's market, in line with their business plan, etc. I would suggest that regulations could be expanded to those Banks with larger portion of brokered deposits to insure that they are not used to encourage "unsafe" lending practices. This could include lower concentration limits, lower lending limits, or limiting loan participations. This would only apply to those banks that have more than some predefined larger percentage of brokered deposits.

In summary, brokered funding should be an important part of a bank's funding strategy but not its entire strategy. With it, a bank can manage its funding needs to be in line with the growth of the community. Without it, some communities might find themselves unable to grow at the pace that demand for the area dictates. As banking becomes more mobile and our country and world get smaller and smaller as a result of improved technology, it will be increasingly difficult for the community banks, who not only lend but are important corporate citizens in their local communities, to survive.

PARAGON
COMMERCIAL BANK

Steve Crouse
EVP/Chief Financial Officer
Paragon Commercial Bank
3535 Glenwood Ave.
Raleigh, NC 27612
(919) 788-7770 Main Line
(b)(6)
www.paragoncommercial.com
(b)(6)

U.S. STERLING CAPITAL, CORP.

1593 Veterans Memorial Highway · Suite 412N · Hauppauge, NY 11788
631 760 2829 · 800 955 9300 · Fax 631 360 2841

April 30, 2011

The Honorable Shelia C. Bair
Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

Comments Re: Roundtable – March 18, 2011
Study on Core and Brokered Deposits

Dear Chairman Bair and Members of the FDIC Board of Directors:

We thank the FDIC for the opportunity to comment on the recent roundtable discussion on core and brokered deposits in relation to the study the FDIC is conducting as mandated under Section 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. It is very encouraging to see that the FDIC and Congress recognize the need to open new dialogue over the current definitions of core and brokered deposits. We feel this recent roundtable was very constructive and will hopefully result in much needed change to the treatment of core and brokered deposits.

Summary of Recommendations

The FDIC and Congress should abolish the current statutory definitions of core and brokered deposits and replace them with metrics that appropriately capture the stability characteristics of deposits. Factoring in aspects like rate, effective term, and reinvestment/rollover ratios would be a more comprehensive approach to addressing the concern over deposit volatility and franchise value. However, if the FDIC and Congress decide not to end the use of these overly broad and misaligned definitions, we strongly recommend the FDIC to at least revise their interpretation of the brokered deposit definition to include deposit listing services that are compensated by subscription fees.

Discussion

We agree with the overall sentiment shared at the roundtable event that moving away from oversimplified definitions like core or brokered and shifting towards metrics that appropriately capture the stability characteristics of deposits would accomplish what the FDIC and Congress had set out to do in the 1980's and most recently in the 2009. The problem with the current definitions is that they are strictly procedural and quantitative; they lack the ability to qualify the true nature of deposits. We believe that rate, effective term, and reinvestment and rollover ratios would be a more comprehensive approach to addressing the concern over deposit volatility and franchise value.

Brokered deposits are a constructive and necessary tool for funds acquisition and liquidity management when used appropriately and monitored judiciously. Many deposits placed using brokers are extremely cost effective and stable. In fact institutional clients that purchase brokered deposits are buy-and-hold investors. They understand FDIC insurance coverage and don't "run" on the bank when it weakens or fails, which is more characteristic of retail depositors. Yet, the current statutory definition of brokered deposits in combination with the new deposit assessment rates enacted in 2009 are prompting banks to seek out and utilize other funding channels that provide access to unregulated and unrestricted non-marketplace deposits, as demonstrated by the extensive use of exempt subscription fee based deposit listing services. Obviously, compensation by means of a subscription fee has absolutely no bearing on whether a deposit is stable or volatile.

We stress that these definitions are imprecise and outmoded. The brokered deposit definition has created a massive unintended loophole. Since the FDIC issued a Final Rule[1] in 2009 to revise insurance assessments on brokered deposits (12 CFR 327), (which excluded non-brokered deposits obtained through deposit listing services), numerous well capitalized banks have turned away from accepting stable and valuable brokered deposits just to avoid scrutiny and pressure by bank regulators and examiners, even if the bank can demonstrate that its use of brokered funds would be a more cost effective and stable means of liquidity. Instead, they turn to unregulated and opaque deposits from listing services as an alternative (and less scrutinized) source for their non-marketplace funding. Furthermore, the Final Rule's exemption for deposit listing services has paved the way for more aggressive use by less than well capitalized banks, without any adequate regulatory oversight or restrictions; all at the expense of the DIF. This action has undermined federal rules that restrict undercapitalized institutions from accepting brokered deposits, and the intent of the Final Rule, which is to reduce the risk of imprudent asset growth at depository institutions and the loss of franchise value. In essence, these labels are causing more harm than good and are creating more systemic risk to the Deposit Insurance Fund (DIF), not less.

Unfortunately, the negative stigma over brokered deposits influences banks to model their liquidity funding plans to avoid this perceived regulatory landmine to the detriment of financial prudence. Because of the deficiencies described above, these definitions are falling far short of their intended purpose and instead are having the opposite effect. The absence of regulation over listing service deposits has opened the door for banks to self-regulate. Self-regulation and insufficient oversight, as we have recently witnessed, was at the heart of the latest banking crisis.

---

[1] Under the Final Rule, banks that rely heavily on deposits acquired through deposit brokers (generally considered non-core deposits by the FDIC because they originate from outside a bank's market area) must pay higher FDIC insurance assessments to accommodate what the FDIC perceives to be an increased risk of institutional failure. Special Assessments: 12 CFR Part 327 - RIN 3064-AD35

The brokered deposit definition is primarily concerned with whether the person or entity involved charges a subscription fee instead of a per transaction fee and whether or not it facilitates the placement of deposits. The fact remains that the characteristics of these listing service deposits are no different than brokered deposits. Stability is defined by pricing, effective duration, and reinvestment/retention rates, not by broad statutory definitions. Furthermore, deposit listing services do more than just compile information about rate offerings, they facilitate deposit placements and go even as far as generating safekeeping receipts...even deposit brokers don't do that. We are sure the FDIC and Congress would agree that a subscription fee does not denote or determine a deposit's volatility characteristics. We are also confident the FDIC and Congress would agree that services such as deposit offer and acceptance solutions, portfolio tracking, maturity management, deposit trade confirmations, and advice on rate pricing in the marketplace (to name a few), clearly constitute "facilitation" of deposit placement and not just "collection" of information on deposit rates.

However, it is encouraging to see the FDIC has instituted a new memorandum line item requirement on call reports for rate listing service deposits. Early call report data shows just how extensive the use of deposit listing services has become. Of all the undercapitalized banks that have reported 1Q-11 financials so far, close to half of them had listing service deposit levels well in excess of 10% of total domestic deposits. A few of these banks had levels of more than 50%. On average, listing service deposits at undercapitalized institutions was approximately 11%, while brokered deposits represented just over 5%[2]. This data gives you an idea of how banks are turning to listing services to generate brokered-like funding that has been shut-off or restricted because they are no longer well capitalized. We are not insinuating that listing service deposits are inherently bad or precarious. Any deposit, regardless of its source, can be either stable or volatile; but when labels like "brokered" exclude a large and unregulated portion of the banking industry's overall funding, a conduit that has exhibited rapid growth over the years, then we have a situation that poses serious concerns.

One roundtable participant at the meeting even stated that when a bank starts having difficulties the FHLB is the first to shut off the spigot, then CDARS gets cut off followed by brokers "and God bless the Qwickrate folks. They are at least a source of liquidity." In addition, Shawn O'brien from the deposit listing service Qwickrate said at the meeting "And just to follow-up a little bit sometimes why we ended up in the autopsy is quite frankly, because we were the only source of liquidity available to them. It didn't mean that we were there when the problems arose. I think it's an important distinction to recognize that we did play a critical role for banks that had no other sources. But in many instances, we were not there when the problems arose." So its appropriate to allow banks to scourer these listing services for funds in desperation when the whole point of the deposit restrictions is to stop imprudent and unabated funds acquisition? Deposits from such listing services are no different than brokered funds, except for the distinction in

[2] Ratios calculated using 1Q-2011 FFIEC Call Report data as of March 31,2011, Highline Financial 1Q-11 bank data updated as of April 30, 2011.

compensation by subscription fee vs. per transaction fee. How does a subscription fee produce a more stable deposit? It doesn't. Why is it acceptable for undercapitalized banks to accept listing service deposits, whilst brokered deposits are prohibited? It is not.

A prime example is Nexity Bank which failed just prior to the end of 1Q- 2011 had a rate listing service deposit to total domestic deposits ratio of 46%, compared to just 2.5% of brokered deposits[3]. Furthermore, industry sources have indicate that Nexity bank had relied heavily on one particular rate listing service for the last few years leading up to its failure. This is just one out of many examples, and why the current brokered deposit definition is broken and must be rewritten to include deposit listing services if the FDIC and Congress deem it appropriate to retain the "brokered" classification.

Summary

As we have clearly demonstrated in this paper, deposits placed through deposit listing services are no different than that of brokered deposits. Unfortunately, these listing service deposits remain exempt from any regulation or comprehensive oversight.

We stand firm in our belief that brokered deposits in and of themselves are not inherently risky, especially when used to assist with liquidity management and prudent asset growth. The brokered deposit rules that are in place today were intended to promote healthy asset growth while discouraging risky behavior among banks – however, this cannot be said for unregulated deposits placed through deposit listing services. The current interpretation of the deposit broker definition to exclude deposit listing services is contrary to Congressional intent[4] and at a disconnect with the FDIC's stance on brokered deposits.

The current definition permits only well capitalized and certain adequately capitalized institutions to accept brokered deposits, while the FDIC's Final Rule on assessment fees and brokered deposits places emphasis primarily on certain adequately capitalized and undercapitalized banks with brokered deposits. This means that when a bank's financial condition deteriorates from well capitalized to less than well-capitalized, any "brokered deposits" on its balance sheet will now be subject to assessment fees, thus prompting the bank to cull those deposits and replace them with listing service deposits. Not only has the bank given the FDIC an artificial perception of reducing its reliance on brokered

[3] Ratios calculated using 1Q-2011 FFIEC Call Report data as of March 31,2011, Highline Financial 1Q-11 bank data updated as of April 30, 2011.

[4] When adopting the definition of "deposit broker" in 1989 as part of the Financial Institutions Reform, Recovery and Enforcement Act, the Senate amended the legislation to remove a proposed exclusion of listing services from the definition. Senator Murkowski, the author of the amendment, said the amendment ".. basically includes more people in the definition of deposit broker, now it includes listing services, specifically hot money houses in which we share the same concern..." Despite Congressional intent, the FDIC has exempted deposit listing services from the deposit broker definition, permitting banks including less than well capitalized institutions to raise billions in non-core assets without reporting the deposits as "brokered." See CONG.REC. 84266, *et seq.* (daily ed., April 19, 1989) (Amendment No. 58 to S. 774, the Financial Institutions Reform, Recovery and Enforcement Act.)

deposits, but remains in a position to continue amassing large amounts of unregulated deposits when using these listing services.

This lapse in regulatory rules and oversight over deposits placed through listing services has and will continue to result in unfettered deposit acquisition practices. Given the information provided in this paper, it should be apparent that the lack of regulation over deposit listing services has spurred an increase in the usage of unregulated deposits by banks, including those that have become financially weakened. Based on our industry knowledge, we believe there has been a significant and hidden monetary impact to the FDIC Insurance Fund and the purchasing institutions.

With all the extended services these subscription based listing services offer, they clearly facilitate deposit placements well beyond what the definition states as a "compiler" of deposit rate information. By allowing listing service deposits to fly under the regulatory radar as non-brokered, the FDIC's current interpretation of the term "deposit broker" is having the reverse effect. It is greatly amplifying the potential for imprudent funding, not diminishing it.

- Early 1Q-11 call report data for undercapitalized banks shows close to half of them had a listing service deposit to total domestic deposit ratio well in excess of 10%.
- This data also shows some undercapitalized banks with listing service deposit ratios of over 50%.
- The average 1Q-11 listing service deposits ratio for undercapitalized banks stood at 11% compared to brokered deposits of 5%.
- And one very recent bank failure with a listing service deposit ratio of 46%; an institution that had been utilizing one particular listing service prior to it ending up in the autopsy.

Recommendations

We believe it to be a necessary and prudent action by the FDIC and Congress to end the use of these oversimplified and ineffective definitions of core and brokered deposits and replace them with metrics that appropriately capture the stability characteristics of deposits. Factoring in aspects like rate, effective term, and reinvestment/rollover ratios would be a more comprehensive approach to addressing the concern over deposit volatility and franchise value. Brokered deposits are a constructive and indispensable tool for funds acquisition and liquidity management when used appropriately and monitored judiciously. Not all brokered deposits are created equal; not all brokered deposits are volatile and transient.

However, if the congress and the FDIC decide not to replace the definitions of core and brokered deposits with a more comprehensive and characteristic driven approach, we

appeal to the FDIC to, at the very least, revise their interpretation of the brokered deposit definition to include deposit listing services (as defined in the call report instructions FFIEC 031 and 041, section RC-E, memoranda item no. 1.f). We recommend the FDIC to modify its interpretation of these listing services from "compiler of information" to a "facilitator", thus requiring banks to classify any new and rollover deposits placed through deposit listing services as brokered deposits on call reports and thrift financial reports. This action would be easy to implement given that all deposits placed through these deposit listing services are currently being captured in electronic format by these listing services and provided to banks to report on memorandum item no. 1.f , Section RC-E of FFIEC Call Report Forms 031 and 041. Doing anything less renders the current definition and the security of the DIF seriously compromised as more and more banks flock to these unregulated and unrestricted listing service deposits.

Please feel free to contact me if you have any questions about the information we have presented in this letter.

Sincerely,

(b)(6)

Herbert A. Orr, Jr.
President & CEO

April 30, 2011

Federal Deposit Insurance Corporation
Attn: Core and Brokered Deposit Study Participants
550 17th Street, NW.
Washington, DC 20429

RE: **Comments for** Core and Brokered Deposit Study as Mandated by Section 1506 of the Dodd Frank Wall Street Reform and Consumer Protection Act.

Ladies and Gentlemen:

I appreciate the opportunity to provide my comments for the Core and Brokered Deposit Study, and thank you for your invitation to participate in the recent Roundtable discussion on this matter. As outlined below, I have serious concerns about any changes to the core and brokered deposit definitions. However, while I firmly believe that the existing definitions should be retained and that no reclassifications should be developed, I would like to offer other recommendations relative to the clarification and application of the current language. A brief background is in order first.

Several factors are driving the push to reevaluate the definitions of core and brokered deposits:

- Disintermediation of deposits in the banking industry leaves banks with an increasing need to cultivate as many funding sources as possible.
- Technology advances have expanded the ability for customers to be served by banks outside of their local markets.
- Regulatory limitations and restrictions associated with funding sources such as brokered deposits have unintentionally promoted the perception of those funding sources as unfavorable.

Although regulatory opinions seem to support banks' use of a diversified mix of funding, field examiners generally will discourage and criticize funding sources outside of a bank's local market. Because of concern about examiner reactions to the use of certain types of deposits, banks have limited their use of these deposit types. As a result, companies that offer brokered deposits are pushing for the agencies to redefine what is meant by core and brokered deposits, and to eliminate regulatory restrictions on the products they offer. We believe that this strategy is ill advised for the following reasons.

Changing the definitions of core and brokered deposits amounts to a superficial approach to addressing the true concerns of banks and the industry.

Instead, we believe that the ultimate goal of the agency — to mitigate the risk associated with a bank holding an excessive amount of non-core funding — will be better served if the agency applies clear and consistent expectations regarding the definitions already in place. Without such guidelines, many banks will simply choose not to utilize a funding source because they fear criticism from their examiners. That tendency counteracts the agency's original intent: to encourage the controlled and prudent use of multiple funding types in a diversified funding plan.

Definition of a core deposit under the current guidelines

QwickRate understands the agencies' definition of a *core deposit* to be non-brokered time deposits with balances under $250,000, including negotiable order of withdrawal (NOW) accounts, automatic transfer service (ATS) accounts, money market deposit

accounts (MMDA), and other savings deposits. We believe the core deposit definition should always include all direct, non-brokered deposits up to the insurance limit.

The advance of technology has rendered irrelevant the geographic locations of depositors. Today with investors' ability to access the Internet, deposits of under $250,000 can come from anywhere. Previously examiners could assume that local deposits inferred low rates and stability. Thus local deposits were judged to be less volatile, and therefore more valuable. Now that technology has erased geographic distinctions, we believe that the definition of core deposit should stay the same except for the elimination of the geographical requirement. Direct deposits originating outside of the local market should not be automatically considered non-core if a depositor exhibits characteristics of stability.

QwickRate has always made it easy for our subscribers to determine the identification and characteristics of each investor, to assure that the investments are direct and non-brokered. Our marketplace provides banks with direct access to a stable and consistent investor base of credit unions and other institutional investors that place CD deposits into banks of their choice, and have done so for the past 25 years. The investors prioritize the value of deposit insurance coverage over deposit rates; consequently, they distribute their portfolios over multiple institutions. QwickRate provides automated eContact tools that enable banks to easily identify their depositors and confirm that the depositors exhibit stability in order to meet the core definition. In addition, QwickRate generates reports and other information that clearly identify deposits which are made by QwickRate subscribers. These details are readily available for examiner review.

Definition of a brokered deposit

By any definition, a *brokered deposit* is any deposit which is facilitated by a third party that does not qualify for one of the FDIC's established exemptions. In a brokered deposit transaction, the third party chooses the destination bank, may arrange for the transfer of funds, and is typically paid on a per-transaction basis.

Trade associations such as the American Bankers Association suggest that some deposits, such as a reciprocal deposit, blur the line between brokered and non-brokered and should receive preferential consideration by the regulatory agencies. Singling out reciprocal deposits for exceptional treatment will benefit individual companies, not the industry. *Any deposit that is touched by a non-exempt third party is a brokered deposit.* To define it otherwise would only add to the ambiguity and confusion that already exist.

The agencies attempted to establish a reasonable standard for the use of brokered deposits as a funding source by incorporating a 10% benchmark on the adjusted brokered deposits ratio for the purpose of insurance assessments. Unfortunately, this guideline was interpreted in different ways by examiners and then the industry. Many banks feared that even deposits below that threshold would be judged negatively.

We believe that the definition of brokered deposits should not change. And we believe most banks would agree that: 1) reasonable regulatory guidelines should be established for all deposits and wholesale borrowings, 2) the guidelines should be clearly explained, and 3) the guidelines should be consistently applied. That goes for deposits placed through deposit listing services, as well as brokered deposits such as reciprocal products.

If the agency declines to put such guidelines into place, changes the definition of brokered deposits, and eliminates the limits imposed on any one funding source, history has shown that the result will be inevitable over concentrations of that source.

We firmly believe that this course of action by the agency will lead to higher liquidity risk for banks. This outcome could be devastating for the smaller, community banks.

Consider the consequences:

- ***Changing the definition of brokered deposits may expose banks to higher volatility.***

CD investors, by nature, are looking for the highest returns from their deposits — whether they are investors within a bank's market area or investors in other locations. A brokered deposit can come from any source, anywhere — locally or across the country. If a better rate is offered, they are likely to leave one bank to secure better returns from another bank.

Reciprocal deposits, by nature, are large deposits made by one investor. The movement of one reciprocal deposit will have a much greater impact than that of a $250,000 CD investment from a retail consumer or from an institution purchasing individual CDs from multiple banks. Thus a bank holding a large sum of brokered reciprocal funds is at risk of being forced into a liquidity crisis when that deposit leaves.

Furthermore, if the definition of a brokered deposit is relaxed for reciprocal products, the use of that product will no doubt increase as a commodity investment option. Its proliferation will result in the higher probability that more and more large deposits will be chasing after higher and higher rates.

A significant percentage of large-dollar depositors work through brokers to place their investments. Currently banks must adhere to limits on brokered deposits or requirements to collateralize large block deposits. Both restrictions discourage over concentrations. Removing governing controls on reciprocal deposits would enable brokers to deposit funds in the bank's reciprocal program, skirting the controls in place for brokered deposits. And, again, this practice would create a volatile situation when the CD comes due.

- ***Changing the definition of brokered deposits will not protect investor relationships.***

Some say that certain reciprocal products should receive special consideration because those deposits carry an inherent local depositor relationship established with the bank. In the case of reciprocal deposits, funds may themselves originate from a broker or third party and emanate from all types of investing sources. When a third party is arranging the placement of funds, the resulting depositor relationship is established with the third party, not with the bank. In that case, the bank would be twice removed, by third parties, from the actual depositor. Such a transaction could hardly be classified as involving a "relationship" between the bank and the entity originally holding the funds. There is no way to identify the originating source of the deposit. Contrary to what has been previously suggested, the current 10% limit on brokered deposits does not preclude banks from accommodating their "true" local, large depositors through a reciprocal network. Rather this limitation does provide a deterrence to prevent over concentrations. Changing the regulatory definition of a brokered deposit will not necessarily encourage local relationships, but it will encourage an ongoing escalation in the volume of third party relationships.

- ***Changing the definition of brokered deposits will lead to higher concentrations of certain funding sources operating in a certain product category.***

The easy availability of wholesale funding was a primary driver of the banking crisis that occurred in the 1980s and again in 2008. Unfettered access to this funding source enabled poorly managed institutions to operate outside of their business plans. If the

regulatory agencies are considering changing the current definitions, or exempting any particular third party product from the current restrictions and limits, the result will be higher risk for the banks and additional abuses that could lead to potential liquidity events in the future.

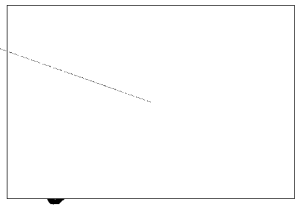
Removing concentration controls and limits will create a dangerous situation in which banks will be able to secure large deposits through a loophole in the regulatory system. This practice will lead to excessive concentrations and over reliance on a particular deposit source.

In conclusion

- We strongly urge the agency NOT to change the definitions of core and non-brokered deposits. Instead, we recommend that the agency take definite actions that establish clear guidelines and limits for all funding types.
- We urge the agency to take actions to ensure that regulatory guidelines for each deposit type are applied and enforced unilaterally by all examiners. Too much is left to the interpretation of individual examiners today.
- We believe that the diversification of funding sources is critical to a bank's ability to successfully manage risk. This agency has not only sanctioned this funding principle, but encouraged its adoption. Accordingly, we believe that all funding sources presently permitted should be available with limits and controls established to maintain the safety and soundness of institutions. However, we are convinced that preferential treatment should not be given to reciprocal deposits, as this will create a regulatory loophole with detrimental consequences. Excessive concentrations of reciprocal deposits will greatly increase the likelihood of undue liquidity risk, and can result in significant harm to community banks and the financial industry as a whole.
- In light of advancing technology, any reference to geographic delineations is irrelevant, and we recommend that such references should not be included in regulatory guidelines.
- Finally, banks want and need clarity from the agency to ensure that they are able to maintain regulatory compliance. We believe that any actions taken by the agency at this time should further that end.

Sincerely,

(b)(6)



Shawn O'Brien
President
QwickRate

(b)(6) From: Todd parodi

Sent: Saturday, April 30, 2011 4:22 PM

To: Core Deposit Study

Subject: Core Deposit Study

April 29, 2011

FDIC Round Table Discussion On Core Deposits

RE: Wholesale Funding, Brokered, Non-Brokered, and Core Deposits

To Whom It May Concern:

We would like to provide you with our input in regard to the above funding methods. We have included several discussion points and examples. We strongly believe that this is an issue which needs an ***urgent*** resolution for all parties concerned.

BROKERED VS CORE DEPOSITS

1. Core Deposits:

In the highly technological world in which we live today, what truly is a core deposit? Is an individual or an entity that only has a CD investment with a bank, locally or not, a core deposit? Any banker will tell you, most individual investors, "your average mom & pop, "who lives off of their interest income will unhesitatingly move their funds to another local depository for just 5-10 additional basis points. With a click of a button, they will also use the internet to locate a higher rate at another bank anywhere in the country. These would, in our opinion, be described as ***very volatile deposits.*** The reason being, core deposits by definition are not what they used to be. We feel that a core deposit only consists of those depositors who hold multiple accounts with a single financial institution. These would consist of checking accounts, savings accounts, money market accounts, direct deposit accounts and loan accounts. They are considered "sticky" accounts which are not as easily changed and/or closed.

2. Brokered Deposits:

In working directly with a broker, the depository has the ability to bring in deposits at a lower cost than their local market is dictating. First, there are no upfront fees; we do not charge the depository for our services. Secondly, brokers save the depository monies by eliminating the need for extra advertising, special promotions and additional administration. Brokered deposits can be tailored to fit the needs of the depository and can be available in higher denominations rather than numerous amounts of smaller CD'S. Should the investor need their funds returned upon the maturity of the CD, the broker is able to ***immediately*** replace those funds at no additional cost. This is our "niche," and why we consider these nonvolatile funds. Brokered deposits have actually been proven to be the most stable and cost effective deposits available, when used properly.

BROKERED VS LISTING SERVICES

1. Listing Services:

When deposits are done through a listing service, there is no relationship between the investor and the depository. Both institutions; the depository AND the investor, must be members of the listing service; therefore, BOTH parties must pay for the service, even when ***not*** in use. Conversely, when working with a

broker, only the investor is charged a fee, when deposits are needed, which actually ***saves*** the depository money.

Additionally, when depositories place their rates with a listing service, they are unnecessarily forcing the market rates upward in order to bring in and/or retain their deposits. They do this as a result of being in competition with so many other depositories whose rates are also offered with the same listing service. We constantly see banks raising their rates in order to jump over the other so that they can be listed in the top 5 in order to obtain the largest share of the market. This is a practice which we believe raises the cost of funds for the depository. Regulators have promoted this by telling banks, whether they are undercapitalized or adequately capitalized, to utilize these services because they are considered "core deposits." The facts remain that this is a ***very*** untrue statement. Furthermore, the majority of the banks that have recently failed are ***also*** the ones that are listed at the ***top*** of these pages, while brokered deposits constitute only 18% of deposits held in banks that have failed since 2004.

2. Brokered Services:

When working directly with a broker, both the depository and the investor develop long lasting, trustworthy relationships. The broker becomes very familiar with both entities and they, in turn, are familiar with their broker: something which is an immensely important asset, particularly in today's environment. This is what allows the depository to tailor their funding needs. The broker never sets the rates, ***the market does***.

CURRENT FDIC REGULATIONS

The "broker vs. non-broker" argument has persisted since the 1980's. This has now resulted in extremely unnecessary high costs to even the very strongest of financial institutions.

Example #1:

A very strong capitalized institution, who has been a customer of ours for over 20 years, is now paying ***25-30 basis points higher*** thru a listing service for their funding needs because regulators are telling them that this is the only way that they should be accepting deposits as they are considered "core deposits." They are also being told to eliminate broker services, period. This institution feels that if they do not accept these terms, they will ultimately be written up and/or penalized in another area of the bank at some point in time.

Example #2:

Last week, another scenario took place. Bank "A" had $2.1M maturing in CD'S that where facilitated through our company. There were no fees paid by the depository, only by the investor. As many of the regulators are currently requiring, the depository was told to return those funds to the investors and replace them through a subscription based listing service where they would be considered "core deposits." This makes entirely no sense, as these are ***not*** core deposits and the depository had to list their rate ***10 basis points higher*** to replace the monies they were just told to wire out. That alone incurred $3,150 in additional interest. This of course, does not include any other additional cost such as wiring out the initial $2.1M, the additional paperwork involved and the cost of the subscription fee to the depository. All of these additional costs are totally unnecessary and very counterproductive when the depository could have just ***renewed*** the funds. This is, unfortunately, becoming a weekly occurrence.

In conclusion, none of these deposits; wholesale funding, brokered, non-brokered and/ or core deposits caused the S&L crisis in the 80's, the real estate bubble that exist today, or the demise of loans in the current banking industry. There will ***always*** be risks involved with loans. The evaluation of these loans by regulators should be the top priority and not the avenue to which these loans are funded.

There is nothing wrong with using a listing service, rate line or brokered funds. They should ***all*** be used

equally by institutions. This creates a competitive market for the banks to receive the funds at the lowest cost, which in turn, allows for a larger spread between the loan and cost of funds. The main issue to be considered is not ***how*** financial institutions receive their deposits, but what they ***do*** with their deposits. How wholesale funding, listing services, rate lines and/ or brokers ***receive compensation*** for their services should not be ***the*** determining factor in whether they can provide a depository with funds when needed. With the current FDIC weekly cap rate and the use of multiple avenues, banks will be able to maintain the lowest cost possible. Competition breeds a stable and fair market. Our country was built on free enterprise and if monopolies are allowed to develop and flourish, free enterprise dies.

It has taken several decades for this open dialogue to come to fruition. And we are very grateful to have this opportunity to share our views. United American Investments has been in business for over 25 years and with your help will continue to serve the financial world for a long time to come.

Your review and consideration into the issue regarding wholesale funding, brokered, non-brokered and core deposits would be greatly appreciated. Creating a more stable and cost effective depository environment is beneficial to ***all parties involved***.

Respectfully,

Todd M. Parodi,
President
United American Investments, Inc.

To: Coredepositstudy@fdic.gov

From: Michael A. Bilski, North American Banking Company

Subject: Core and Brokered Deposit Summary Study

Thank you for the opportunity to submit my comments on Core and Brokered Deposits used in financial institutions. I have outlined my specific comments to the four specific questions outlined in your request for comments and then included some specific data from our bank that supports my overall thoughts.

In times of financial stress, what types of deposits are likely to remain at an institution and what types of deposits are likely to leave the institution?

All insured deposits are likely to remain with an institution up until the institution is closed. Once an institution is closed most deposits will remain for a period of time until term, rates and fees are changed by an acquiring institution. Most checking and savings customers pick a branch location to bank at because of convenience or a relationship with a banker(personal) or the bank(loan). In today's world of electronics the most convenient branch might be an internet banking site that the bank as established.

Does the presence of certain kinds of deposits (e.g. brokered, internet, listing service) inherently increase an institutions risk? Does their presence facilitate increased risk taking?

Any deposit that is gathered outside of competitive market terms will increase the ability of banks to take more risks. Brokered, internet and listing service deposits used properly will allow an organization to grow beyond its community's ability to fund loan growth thereby hopefully growing the community. Used properly these deposits can help control overall funding costs and operational costs as local banks grow.

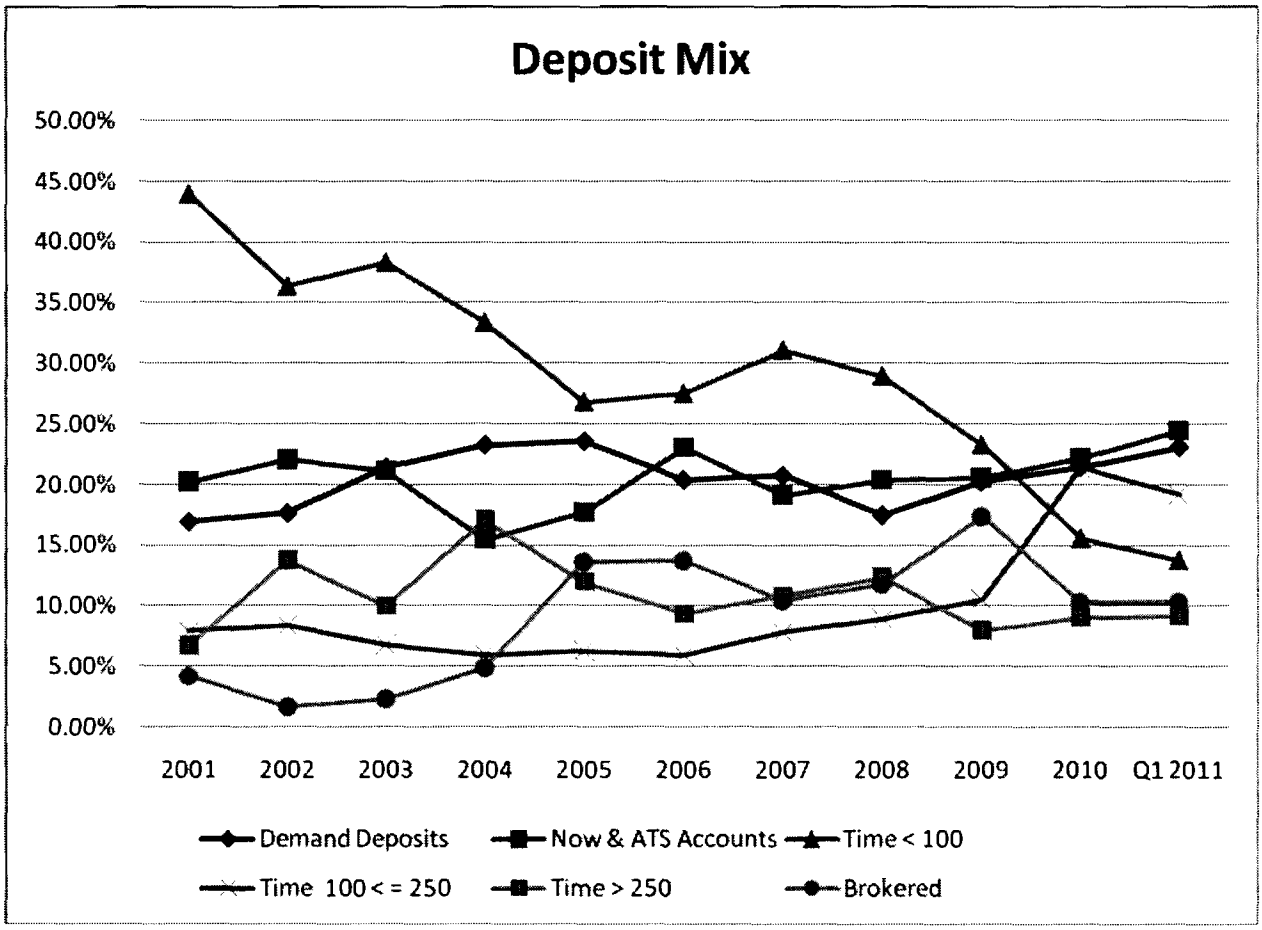
I do believe that the presence of these types of deposits did allow from some additional risk taking by bankers because it allowed them to book assets outside of their local markets, local customers and expertise. It is the search for asset growth that pushed banks outside of their local areas in which they operate and easier deposit gathering helped fuel that growth, it was not raise deposits first and find assets second.

What types of deposits are likely to enhance a failed institution's franchise value and what types of deposits are likely to reduce it?

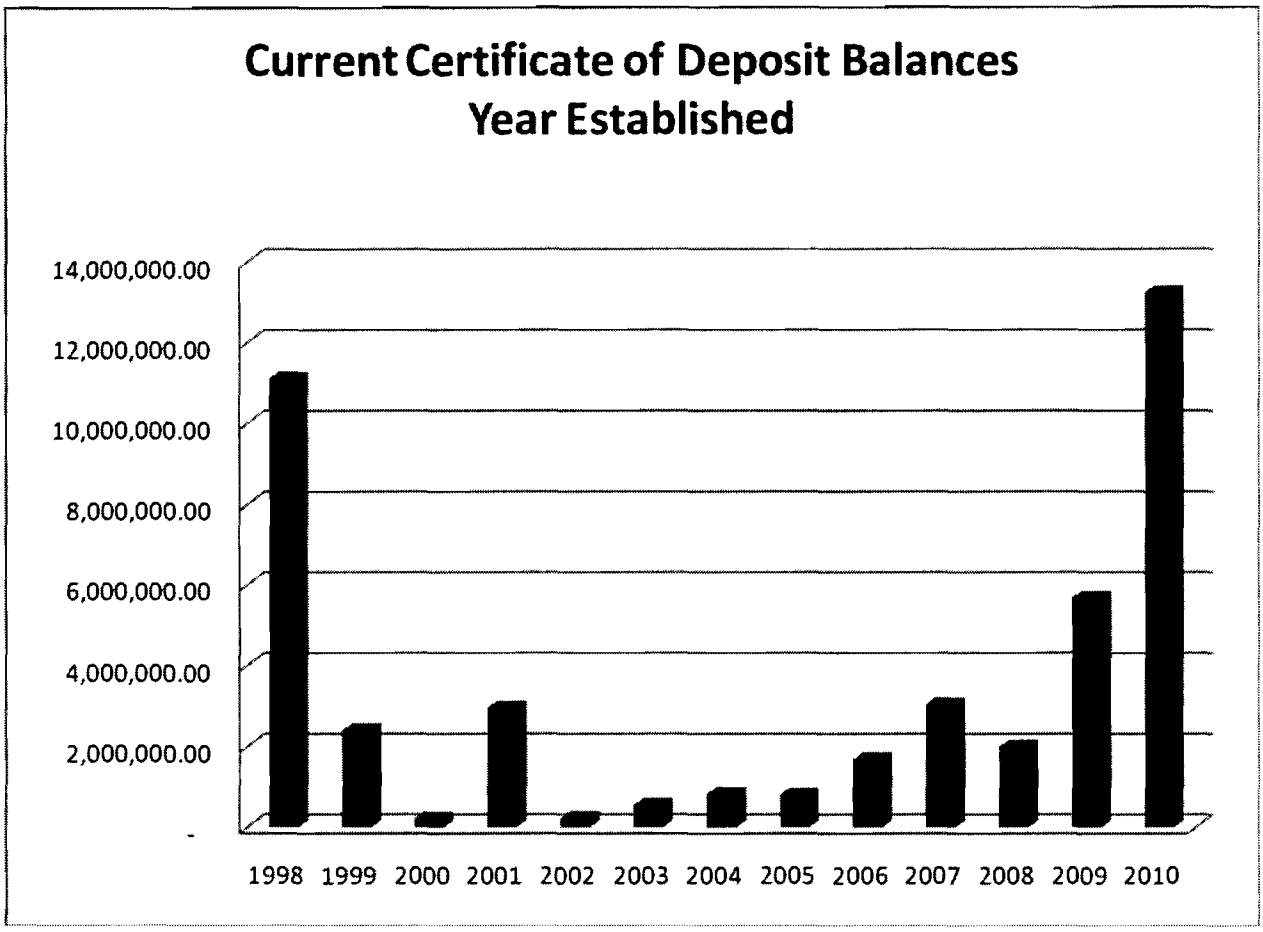
Long term customer relationships created by the bank, because of the location or specific employees at the branch offices. Any deposits that are tied to existing loan relationships as well will enhance fanchise value.

What recommendations would you make for legislative or regulatory changes with respect to core or brokered deposits?

With the respect to the current core deposit definition, obviously the dollar amount needs to be adjusted. Below is a chart and data points of our bank's deposit composition. We went back ten years and charted all deposits and specifically broke out certificates of deposit by the following size's 0 to $100,000.00, $100,001.00 to $250,000.00 and greater than $250,000.00. The chart shows that we have always had a component of our deposits that was greater than $250,000.00. It also shows the dramatic change in our mix of certificates since the FDIC insurance limits were changed.

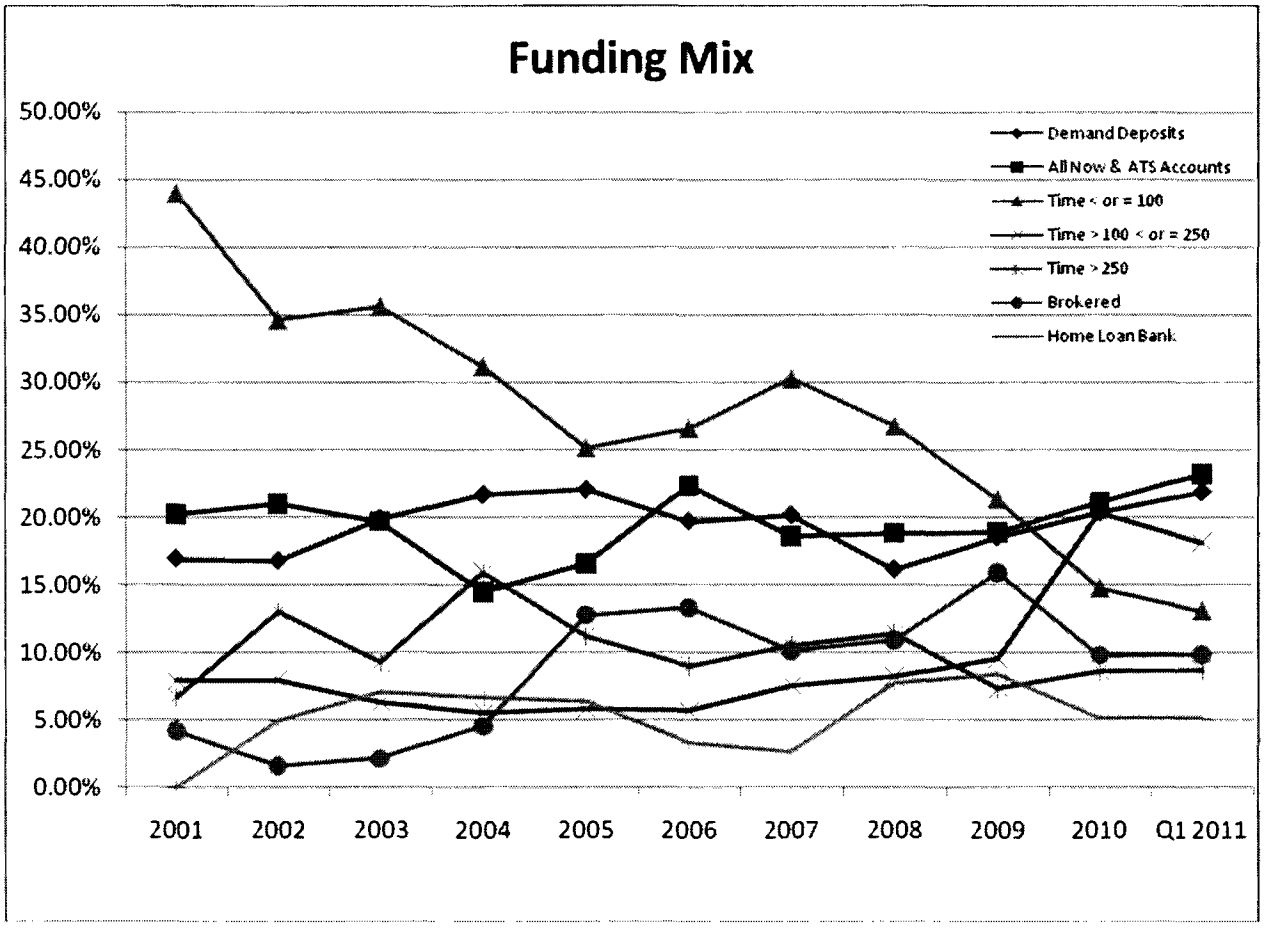


The current definition does not include any reference to how long a relationship has been established with a bank. Below is a chart of our certificate of deposit holders that have greater than $100,000.00 dollars in a certificate of deposit. More than 50 percent of the dollars outstanding have been with us at least 4 years and just slightly over 30% of the dollars outstanding have been with us for at least 10 years. Some of these certificates have been established with multiple names for FDIC insurance coverage and some haven't, it does seem a bit extreme not to call any of these deposits core.



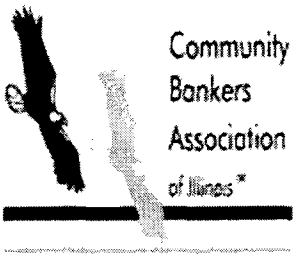
Relationship Year	CD Greater Than $100,000.00	Percent of Total	Cummaltive Percentage
1998	11,109,804.68	24.79%	24.79%
1999	2,394,692.92	5.34%	30.13%
2000	216,514.79	0.48%	30.62%
2001	2,954,447.24	6.59%	37.21%
2002	227,990.40	0.51%	37.72%
2003	548,108.83	1.22%	38.94%
2004	823,421.94	1.84%	40.78%
2005	802,711.83	1.79%	42.57%
2006	1,685,885.03	3.76%	46.33%
2007	3,040,692.58	6.78%	53.11%
2008	1,999,084.25	4.46%	57.58%
2009	5,683,308.79	12.68%	70.26%
2010	13,229,823.82	29.52%	99.78%
	$44,816,487.10		

Lastly, I don't believe you can look at any deposit definitions on a standalone basis without including the other types of funding that a bank might use such as Fed Funds Purchased, Home Loan Bank Advances, Repurchase Agreements. Below is an overall history of our funding mix.



In conclusion the whole definition of core deposits should be eliminated. Banks should be monitored using a local funding ratio and a wholesale funding ratio as a percent of total assets. The local funding ratio would include checking, savings and certificates of deposit. The certificates of deposit should be further refined to balances less than $250,000.00 and greater than $250,000.00. The wholesale funding ratio would include the following; Fed Funds Purchased, Federal Home Loan Bank Advances, Brokered CD's, Internet CD's (out of market listing service), CDARS(should be made illegal) and Repurchase Agreements. By tracking these specific ratios over time, with specific policy guidelines, all agencies would have the proper tools to supervise the liability side of a bank. These guidelines would then allow bank managers to use all funding mechanisms at their disposal to help contribute to over economic growth while be able to diversify liability sources.

Thank you again for the opportunity to comment.



April 28, 2011

The Honorable Sheila Bair
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

RE: Dodd Frank Brokered Deposit Study

Dear Chairman Bair:

The Community Bankers Association of Illinois (CBAI) proudly represents 425 community banks and thrifts throughout the state of Illinois. We welcome this opportunity to comment on the FDIC's Core and Brokered Deposit Study (Study). Section 1506 of the Dodd Frank Reform and Consumer Protection 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. The objective of the study is to determine if changes are warranted to statutory or regulatory treatment of brokered deposits. The FDIC must report back to Congress by July.

We respectfully provide our observations regarding brokered deposits and key principals the FDIC should strongly consider in designing the study, and only if clearly warranted, in any new rules, regulations or guidance.

Brokered deposits, if used properly, are a valuable resource for community banks. They can assist a community bank in asset liability management, executing funding strategies, and depending on market conditions, even provide a lower cost of funds. Brokered deposits are not by their very nature something to be avoided. Banks that utilize brokered deposits in their

funding mix must not automatically be criticized for using these resources. The stigma of brokered deposits has ebbed and flowed during varying economic cycles and banking industry conditions. Hopefully, this Study will shed sufficient light, change the misconceptions, and promote the acceptability of banks using brokered deposits.

The assumption that reliance on brokered deposits is the sole determining factor in excessive risk taking is an oversimplification. At most, it is symptomatic rather than the cause. Further, the view that if the "fuel" of such growth (i.e. brokered deposits) is cut off then risky growth slows down is contrary to existing evidence. If a bank is looking to engage in and fund risky growth it will do so and find a way without brokered deposits.

Each community bank is unique in its complexity and sophistication. Clearly, the overwhelming majority of bank managers are very capable of properly managing their deposit concentrations including brokered deposits. Therefore a one size-fits-all approach with respect to categorizing and assessing brokered vs. core deposits clearly will not work.

Every community is also unique. What may be "hot money" in one bank and community may be solid franchise deposits in a bank located in a more competitive market. Therefore, any blanket requirement that all deposits over a certain threshold are to be considered "hot money" is inappropriate.

Moreover, community banks in general would find it impossible to meet all of the demand for credit from their customers solely from local deposits. It was the need for funding to meet local credit demand that led to the development of alternative funding sources.

Banks should be given the greatest flexibility to include as many deposits as possible in core deposits. Absent significant evidence to the contrary, all of the bank's deposits should be considered core unless the deposits fall into a very small number of reasonable, easily, and clearly defined categories. Clearly, however, it appears the FDIC is heading towards developing a new way to view funding sources. In the new

methodology it would certainly be a mistake to categorize deposits as brokered solely as a result of a third party relationship, and any requirement for a granular analysis of each and every deposit and depositor would be an unreasonable and unnecessary regulatory burden.

CBAI members currently use a variety of funding sources, including but not limited to: QwickRate, PMA Financial Network, Promontory Interfinancial Network's CDARS, and the Federal Home Loan Banks. These are an integral part of diversified funding sources for community banks. Community bank usage of these diversified funding sources should not be discouraged if they are part of a prudent A/L management and funding program. Regulators should certainly not pick the winners and losers among these non-core funding sources by favoring one versus the other.

Any suggestion that banks should refrain completely from using brokered deposits for fear of the potential negative impact on franchise value is misguided. Equally misguided are arbitrary hard cap percentages for brokered deposits above which financial institutions experience heightened regulatory scrutiny and criticism.

Community banks are currently dealing with, and rightly anticipating, a glut of new regulation as a result of the Dodd Frank Act. Any additional new rules/regulations or guidance concerning brokered CDs would only add to this already unacceptable regulatory burden and would be inappropriate. Any new rules/regulations or guidance resulting from the Study must help relieve the regulatory burden and make it easier to distinguish core versus non-core deposits.

Banks that are adversely classified or under regulatory enforcement actions, but have prudently used brokered deposits in the past, should not be barred from renewing brokered deposits - as long as the renewed deposits are consistent with their past usage of brokered deposits. It is an unnecessary disruption of A/L management, and could even exacerbate a liquidity problem, when a bank that is adversely classified cannot at least renew existing maturities of brokered deposits. Moreover, forcing banks to run off local relationship deposits now defined as brokered lowers the franchise value, something that cannot possibly be in the best interest of either the bank or the FDIC. The current requirement under Section 29 of the FDI Act places an

unnecessary stress on institutions that are already stressed but that are being very closely monitored by their regulators. We recommend Section Section 29 as implemented by Section 337.6 of the FDIC Rules and Regulations be amended accordingly.

If, as a result of the Study, a potentially revamping of regulator's classifications of and assessment on various types of bank deposits and other funding is recommended, CBAI urges the FDIC to carefully consider: any unintended consequences of its recommendations (i.e. impact on community banks, small business lending, and municipal governments), the existing regulatory burden on community banks, preserving a wide variety of funding sources for community banks, and not further stressing adversely classified community banks and those under regulatory enforcement actions.

Thank you for the opportunity to comment on these issues of importance to Illinois community banks. If you have any questions or need additional information, please feel free to contact me (b)(6) by telephone at

Sincerely,

(b)(6)

David G. Schroeder
Vice President Federal Governmental Relations

Community Bankers Association of Illinois
901 Community Drive
Springfield, Illinois 62703-5184

April 29, 2011

FDIC
Core and Brokered Deposit Study Group
550 17th Street, NW
Washington, DC 20429

Dear Core and Brokered Deposit Study Group,

FirstBank Puerto Rico appreciates the opportunity to provide the FDIC with input relating to Section 1506 of the Dodd-Frank Wall Street and Reform Consumer Protection Act. FirstBank Puerto Rico has been an active and significant participant in the brokered deposit market over the years.

The notably high use of brokered deposits in Puerto Rico is a result of a particular set of circumstances unique to Puerto Rico. In a nutshell, brokered deposits in the Puerto Rico banking industry have been used to substitute other deposit funding sources that were transferred out of the Island in response to changes to the U.S. Internal Revenue Code (the "Code"). These specific amendments to the Code affected only Puerto Rico. Here is some background on the subject.

Section 936 of the Code's 1976 reform provided US corporations operating in P.R. a full credit for the federal tax on their business and qualified investment income in Puerto Rico. The credit provided an effective 100% federal tax exemption for operating and qualifying investment income from Puerto Rico sources. This treatment of investment income from Puerto Rico sources under Section 936 of the Code attracted business establishment and significantly increased the amount of deposits of these corporations in Puerto Rico banks and branches of foreign banks in Puerto Rico. The incentives created by Section 936 added more liquidity to the banking industry as a whole and promoted growth of manufacturing sector as well as the general economic development of the island. Particularly, it enabled local banks to enter into business transactions that were exclusively done by branches of foreign banks in Puerto Rico and other institutions such as insurance companies and pension funds.

However, as a result of amendments to Section 936 made in 1996 (the "1996 Amendments"), the tax credit was being phased out over a ten-year period for companies that were operating in Puerto Rico in 1995 and would no longer be available for corporations that established operations in Puerto Rico. The 1996 Amendments also eliminated the credit previously available for income derived from certain qualified investments in Puerto Rico. The Amendments effectively meant the end of this source of funding for Puerto Rico, and in ten years, 936 funds went from $9 billion to zero. This situation, unique to Puerto Rico, confronted the Puerto Rico banking industry with the challenge of effectively substituting such source of funding and liquidity in a relatively short period of time. Empirical data supports the conclusion that deposits from 936 Corporations were actually substituted by brokered deposits.

1519 Ponce de León Ave.; Stop 23
PO Box 9146
San Juan, PR 00908-0146

Telephone: (787) 729-8200
Telex: 325-2842 FBPR / 345-0645 FBPR

Another factor that affected the ability of Puerto Rico banks in their deposit taking activities was the development of a local investment company industry over the past 15 years. Since 1993 many securities firms in Puerto Rico sponsored the creation of investment companies under the local Investment Companies Act which were also exempt from the federal Investment Companies Act of 1940. Most of these new investment companies offered tax advantageous products that competed directly with bank deposits. This industry has grown to $14.2 billion in total assets as of December 31, 2011. Fifteen years later, the outcome remains as a structural deficiency of core deposits in relation to the loan volume outstanding in the P.R. banking sector.

The use of brokered deposits in Puerto Rico has essentially been to substitute other sources of liquidity and funding that dried up as explained above. This use does not represent added risks because this funding source has been used for the same banking activities that were previously funded with the other sources such as deposits from 936 Corporations and retail deposits that now fund local mutual funds. We understand that generally the use of brokered deposits in Puerto Rico does not represent added risks to the banking sector, the FDIC or its insurance fund.

In response to the four specific questions asked relative to your study we offer the following for your consideration. Our responses are based on our experience with multi-billion dollar brokered deposit issuance not only in stable times, but also in periods of market liquidity crisis. We are also presenting these comments with respect to the role brokered deposits have played in the Puerto Rico banking industry as described above.

Question 1: In times of financial stress, what types of deposits are likely to leave the institution?

Uninsured deposits are more likely to be withdrawn from the institution. Principal of non-brokered time deposits may be withdrawn at any time upon clients' demand, albeit subject to potential forfeiture of interest, Brokered time deposits issued by our institution are typically issued in volumes within the FDIC insurance cap. And while branch deposits may be withdrawn at any point in time, brokered time deposits, except in case of death or disability, can only be withdrawn at maturity. Having experienced two crises in the last three years – the capital markets crisis of 2008, and a capital-related consent order with the FDIC in 2010, we were able to witness the resilience of the brokered deposits market. In the first crisis numerous sources of liquidity and funding became dry, while the brokered deposits market remained wide open, and even provided an alternate source of funding to new issuers. In the second crisis, since brokered deposits are issued in amounts within insurance limits, en-masse withdrawal of those deposits has not been triggered. We have been able to issue brokered deposits under FDIC-approved waivers to the extent needed and without material resistance from depositors. On the other hand, during the same period we have experienced measurable withdrawal of some large non-brokered deposits.

Question 2: A) Does the presence of certain kinds of deposits (e.g. brokered, internet, listing service) inherently increase an institution's risk? B) Does their presence facilitate increased risk taking?

A) Inherent Risk: Risk is a broad term – in banking institutions it is manifest and managed in several forms such as credit risk, liquidity risk, market risk, re-pricing risk, concentration risk,

etc. Based on our experience, brokered deposits have served as a tool to manage and reduce interest rate risk. The breath of the market over diverse market cycles allow issuers to target deposit maturities to better manage liquidity risk and interest rate risk. Implying that certain sources of funding such as brokered deposits are correlated with credit problems, may erroneously lead to restrictions on such sources. It is during periods of distress when securing access to a greater number of liquidity sources is of paramount importance to avoid having ripple effects of liquidity issues for an institution facing challenges. When asset quality problems develop, it is the presence of liquidity (on balance sheet and available off balance sheet sources) that creates the staying power for an otherwise troubled bank to "buy time" for working through its problem asset situation.

Does the presence of certain kinds of deposits inherently increase an institution's risk? There may be certain kinds of deposits that inherently increase an institution's risk. But the certain kinds are not distinguished by brokered or non-brokered. Certain kinds might include high concentrations of jumbo (uninsured) deposits, or large concentration of sector deposits, such as public funds, regardless of the channel used to gather the deposits. However not all markets provide the ideal mix of deposit distribution; something that can be partially mitigated though the brokered deposits market.

B) Facilitate Increased Risk Taking: Sound risk management practices are not driven by the sources of funding used. A spurious correlation between a failed institution's credit problems and the used of certain source of funding should not be an excuse for aggressive lending practices or poor risk management. Additional and diverse kinds of deposits should serve to enhance risk management, not increase risk.

Question 3: What types of deposits are likely to enhance a failed institution's franchise value and what types of deposits are likely to reduce it?

A failed institution's franchise value is likely to be enhanced by low cost non-maturity and time deposits representing relationships. Value is likely to be reduced by holdings of high concentration of large uninsured deposits, most likely to be volatile in nature and subject to liquidity risk in events of failure. Commoditized deposits, such as brokered time deposits would neither enhance nor reduce a failed institution's franchise value. Such deposits could easily be replaced, so no premium would be warranted in a transaction for such a component of the balance sheet. One exception is brokered time deposit of longer terms carrying below-market interest rates. In other words, low-cost deposits with staying power and deposits representing client relationships would likely enhance value.

Question 4: What recommendations would you make for legislative or regulatory changes with respect to core and brokered deposits?

We have the following suggestions for consideration that would reduce risk to the financial system and ultimately the FDIC insurance fund:

Brokered Funding: Brokered deposits have served as a very efficient mechanism for the allocation of deposits from deposit-rich communities to growth or developing markets with pent up demand for loans. The financial intermediation function of commercial and community banks

has been enhanced with the growth of the brokered deposits market. It has also served as a price discovery and stabilization mechanism for deposits nationally. We believe restrictions or conditions for participation in the brokered deposits market would hamper the benefits of a national open deposit market. Restrictions on the use of brokered deposits will have adverse effects on local markets by increasing competition for deposits in deposit-poor markets. The scarcity of funding would increase deposit rates, which would in turn translate in higher rates on consumer loans. It could also compromise the availability of funding to support adequate liquidity management.

Reciprocal Deposits: Eliminate reciprocal deposits (such as CDARS) from the definition of brokered deposits. Other than an administrative fee paid to the custodian of the service for administrative costs, the rate paid on the reciprocal deposit is negotiated by the bank. Further, the bank is the only representative facing the deposit customer. While CDARS may cap a troubled institution at a certain level of reciprocal funding in a weakened financial state, it will roll the funding already outstanding. The technical definition of CDARS reciprocal deposits as "brokered" funding can remove a valuable core customer retention tool that may prove counter-productive in limiting the losses to the FDIC insurance fund in the event of liquidation.

Core Deposits: We urge the regulatory community and the legislature to update the definition of core deposits based on the characteristics and behavior of the deposits and not based on the source, type or size of deposits. It should be broader to include other sources of funding, and as such be defined as core funding, regardless of source. And it should be related to the stability and staying power of deposits and other type of funding during defined periods of time and under varying economic conditions or stress scenarios.

FirstBank Puerto Rico thanks the FDIC for taking the time to read our comments.

Sincerely,

FIRSTBANK PUERTO RICO

(b)(6)

From: Mary Fowler
Sent: Friday, April 29, 2011 7:41 PM
To: Core Deposit Study
Subject: Core deposit study
Attachments: FDIC 4-29-11 core deposit study.doc

April 29, 2011

Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429-9990

Re: Core and Brokered Deposit Study

Ladies and Gentlemen:

Thank you for the opportunity to comment on the core and brokered deposit study which is mandated by Section 1506 of the Dodd Frank Wall Street Reform and Consumer Protection Act.

I am commenting from my perspective as a CEO and 4th generation banker in a small family owned bank in Arkansas. These comments are my opinion only. I am 56 years old and have worked in the bank for over 40 years. Our bank is $146 million in assets and is 100 years old.

Calculating Insurance Premiums

I think insurance premiums should be assessed only on the amount of deposits at risk. Assessing insurance premiums on other liabilities or based on assets makes no sense to me.

Core Deposits Definition

- The definition of core deposits for the purpose of calculating the insurance premiums of banks

My assumptions:

1. Insurance premiums should be calculated based on risk.

2. Core deposits have historically been considered an indicator of lower risk than non-core deposits and brokered deposits are considered non-core.

3. The only definition for core deposits that can be found is: demand deposits, NOW accounts, ATS accounts, MMDAs, other savings deposits, and total time deposits of $250,000 or less, minus any brokered deposits that are included in that total.

4. The FDIC assumes that core deposits are stable, low cost, of local origin, and relationship connected.

My opinions:

The term core deposits should not be used when calculating insurance premiums of banks. There are too many variables possible in deposit products to categorize them as stable or low-cost simply by type of account or size of

account alone.

If you insist on redefining the term "core deposits", it should be all non-interest-bearing deposits. Once you introduce the interest factor into deposits, the amount of interest being paid on the deposit is the driver.

Brokered deposits in and of themselves should not automatically be considered high cost or high risk. Our brokered deposits are our most stable and lowest cost source of funds.

It is undeniable that many deposits that have traditionally been considered core are unstable and volatile, while brokered deposits are stable once they are on the books.

Core deposits are difficult to obtain, and their volatility is unpredictable. Brokered deposits are easy to obtain as long as the bank is well capitalized.

All it takes is a customer on a whim and the "core" deposit can be gone. Even so-called core CD's can be withdrawn at any time. Neither of these is true for brokered deposits.

It is safe to say that banks paying huge premium interest rates on Reward Checking accounts (currently 3, 4, or 5%) do not have core deposits in those accounts. In today's interest rate environment, a bank paying a 2% rate for a one year CD should not be able to call that a core deposit even if it is a small dollar amount CD.

If the purpose of this study is to identify and address factors that make a bank more likely to fail, and are detrimental to the value of a failed bank, I can confidently state that our bank's use of brokered deposits makes us much less likely to fail, and would enhance our value if we did fail.

Thank you again for considering my suggestions.

Sincerely,

Mary Fowler, CEO
(b)(6)
Peoples Bank
P O Box 340
Magnolia, AR 71754

April 29, 2011

Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429-9990

Re: Core and Brokered Deposit Study

Ladies and Gentlemen:

Thank you for the opportunity to comment on the core and brokered deposit study which is mandated by Section 1506 of the Dodd Frank Wall Street Reform and Consumer Protection Act.

I am commenting from my perspective as a CEO and 4th generation banker in a small family owned bank in Arkansas. These comments are my opinion only. I am 56 years old and have worked in the bank for over 40 years. Our bank is $146 million in assets and is 100 years old.

Calculating Insurance Premiums

I think insurance premiums should be assessed only on the amount of deposits at risk. Assessing insurance premiums on other liabilities or based on assets makes no sense to me.

Core Deposits Definition

- The definition of core deposits for the purpose of calculating the insurance premiums of banks

My assumptions:

1. Insurance premiums should be calculated based on risk.

2. Core deposits have historically been considered an indicator of lower risk than non-core deposits and brokered deposits are considered non-core.

3. The only definition for core deposits that can be found is: demand deposits, NOW accounts, ATS accounts, MMDAs, other savings deposits, and total time deposits of $250,000 or less, minus any brokered deposits that are included in that total.

4. The FDIC assumes that core deposits are stable, low cost, of local origin, and relationship connected.

My opinions:

The term core deposits should not be used when calculating insurance premiums of banks. There are too many variables possible in deposit products to categorize them as stable or low-cost simply by type of account or size of account alone.

If you insist on redefining the term "core deposits", it should be all non-interest-bearing deposits. Once you introduce the interest factor into deposits, the amount of interest being paid on the deposit is the driver.

Brokered deposits in and of themselves should not automatically be considered high cost or high risk. Our brokered deposits are our most stable and lowest cost source of funds.

It is undeniable that many deposits that have traditionally been considered core are unstable and volatile, while brokered deposits are stable once they are on the books.

Core deposits are difficult to obtain, and their volatility is unpredictable. Brokered deposits are easy to obtain as long as the bank is well capitalized.

All it takes is a customer on a whim and the "core" deposit can be gone. Even so-called core CD's can be withdrawn at any time. Neither of these is true for brokered deposits.

It is safe to say that banks paying huge premium interest rates on Reward Checking accounts (currently 3, 4, or 5%) do not have core deposits in those accounts. In today's interest rate environment, a bank paying a 2% rate for a one year CD should not be able to call that a core deposit even if it is a small dollar amount CD.

If the purpose of this study is to identify and address factors that make a bank more likely to fail, and are detrimental to the value of a failed bank, I can confidently state that our bank's use of brokered deposits makes us much less likely to fail, and would enhance our value if we did fail.

Thank you again for considering my suggestions.

Sincerely,

Mary Fowler, CEO
(b)(6)
Peoples Bank
P O Box 340
Magnolia, AR 71754

UNIVERSITY OF ILLINOIS
AT URBANA-CHAMPAIGN

George G. Pennacchi
Investors in Business Education Professor of Finance
College of Business
4041 BIF, Box 25, MC-520
515 East Gregory Drive
Champaign, IL 61820

1867

April 29, 2011

Federal Deposit Insurance Corporation
Division of Insurance and Research
550 17th Street, NW
Washington, DC 20429-9990

Dear Sir/Madam:

The accompanying document is a comment on the FDIC's Core and Brokered Deposit Study as Mandated by Section 1506 of the Dodd Frank Wall Street Reform and Consumer Protection Act.

I hope my views are helpful to you when completing your study.

Sincerely,

(b)(6)

George G. Pennacchi

Telephone 217-244-0952 • *Fax* 217-244-6917• *Email* gpennacc@illinois.edu

Comments on the FDIC Core and Brokered Deposits Study

as mandated by Section 1506 of the

Dodd Frank Wall Street Reform and Consumer Protection Act

by

George G. Pennacchi
IBE Professor of Finance
University of Illinois

April 29, 2011

This note contains my thoughts on how the Federal Deposit Insurance Corporation (FDIC) should treat different types of deposits when supervising banks and setting deposit insurance premiums.[1] To understand my perspective on this specific issue, it is helpful if I first provide background on how prior research has shaped my views on FDIC insurance. Let me begin by recalling the public policy rationales for deposit insurance.

Deposit insurance has been justified for two main reasons. One is that insuring deposits creates a safe savings vehicle for financially unsophisticated individuals or institutions. Such savers may be unable to judge the risk of investments and lack access to other safe savings vehicles (such as Treasury bills or Treasury-only money market mutual funds).[2] Because it would be costly for many small savers to screen and monitor a bank's financial condition, it may be more efficient if a single agent, the deposit insurer, performs these functions on their behalf.

The other main argument for deposit insurance is that it enhances financial and monetary stability by alleviating bank runs that would trigger the failure of viable banks. The failure of such banks could reduce credit to bank-dependent borrowers and contract the money supply.[3]

But while government deposit insurance has these potential benefits, it also has costs. Deposit insurance removes some or all of the market discipline that uninsured depositors may impose on riskier banks. When depositors are uninsured they require higher credit spreads or may refuse to make deposits in riskier banks. This loss of market discipline is particularly great if insurance covers deposits of not only financially unsophisticated individuals but also financially sophisticated ones. An absence of market discipline can create moral hazard incentives reflected in a bank's choice of higher leverage and greater loan and investment risk. Such moral hazard behavior could lead to more bank failures than in the absence of deposit insurance.

[1] My views on a broader range of deposit insurance reforms are given in Pennacchi (2010)

[2] This rationale for deposit insurance can be found in Merton (1977) and Gorton and Pennacchi (1990).

[3] See, for example, Diamond and Dybvig (1983) and Friedman and Schwartz (1960).

In principle, a government deposit insurer could replace this lost market discipline by proper supervision and regulation of banks and by setting deposit insurance premiums that would mimic the credit spreads that uninsured depositors would require from banks. Unfortunately, political constraints handicap governments from properly assessing bank risk.[4] While assessments of risk reflected in market credit spreads may be imperfect, they tend to be more timely and less likely to create the large subsidies that most banks receive under government deposit insurance.

The FDIC's premium setting policy has a structural flaw that leads to premiums that are subsidized relative to the credit spreads that would be charged by uninsured market investors. Understanding this point is important because such underpricing of deposit insurance creates incentives for banks to prefer insured deposits over uninsured deposits and to lobby for expanding deposit insurance to cover as many types of deposits as possible.

The underpricing of deposit insurance stems from the FDIC's objective of adjusting the general level of deposit insurance premiums to target a particular ratio of Deposit Insurance Fund (DIF) reserves to total insured deposits. By targeting a Designated Reserve Ratio (DRR), the average premium paid by banks per deposit will be approximately equal to the average FDIC loss from bank failures per deposit.[5] On the surface, equating premiums to expected losses sounds reasonable and can be described as "actuarially fair" premiums. However, this is not how uninsured depositors would set credit spreads.

Why? When insurance is written on a large pool of independent risks such as losses from automobile accidents, a competitive insurer can set annual premiums equal to expected annual losses and, due to the high predictability of these losses, experience minimal net profits or losses each year. This is not the case for deposit insurance due to the skewed nature of bank failures. If at the beginning of each year FDIC premiums are set to what losses are expected to be over the next year, the FDIC will tend to experience small net profits in most years that will be wiped out by significant net losses in a smaller number of crisis years. Moreover, because bank failures tend to occur during economic recessions, the net profits

[4] For example, Stiglitz (1993) states "Government, however, faces a tremendous disadvantage in assessing risks and charging premiums based on risk differences. The reason for this, at least in part, is that risk assessments are basically subjective. ...The market makes such differentiations all the time, converting the subjective judgments of many participants into an objective standard. If some bank ... complains about the risk premium it is being charged by the market (in the form of a higher rate it must pay to attract uninsured depositors), there is a simple reply: Provide evidence that the risk has been overestimated, and the market will render a verdict. If the information is credible, the risk premium will be reduced. In short, government inevitably has to employ relatively simple rules in assessing risk - rules that almost certainly do not capture all of the relevant information, since political considerations will not allow government to differentiate on bases that the market would almost surely employ. The difficulties government has in assessing risk, and that citizens face in evaluating the government's performance on this score, provide an opportunity for granting huge hidden subsidies."

[5] The approximation is exact if total insured deposits grow at a Treasury interest rate equal to the return on DIF reserves. If the long-run growth rate of insured deposits is greater (*less*) than Treasury security returns, the average premium will be greater (*less*) than expected losses. Pennacchi (2000) gives details. Recent FDIC decisions continue this policy of adjusting premiums to target the DRR. In the FDIC's rule on assessment rate adjustments that took effect on April 1, 2011, it states "the final rule adopts progressively lower assessment rate schedules when the reserve ratio exceeds 2 percent and 2.5 percent, as discussed below. These lower assessment rate schedules serve much the same purpose as dividends in preventing the DIF from growing unnecessarily large."

and losses of underwriting FDIC insurance will have risk that varies systematically with the economy and the value of other assets.

In terms of the Capital Asset Pricing Model (CAPM), underwriting deposit insurance is a positive 'beta' investment: during economic expansions (*recessions*) when stock market returns are high (*low*), the deposit insurer will make profits (*losses*) because premiums will be greater (*less*) than loss claims from bank failures. Thus, to compensate an insurer for the risk that losses will be highest during severe recessions, ***fair market premiums must exceed expected losses***. In other words, fair market deposit insurance premiums contain a systematic risk component in addition to expected losses so that the insurer earns positive average profits. Importantly, empirical evidence finds that firms' actual credit spreads on uninsured debt contain, in addition to an expected loss component, a significant systematic risk premium.[6] Moreover, empirical studies of fair deposit insurance pricing find that this systematic risk premium is substantial. It typically equals more than twice the level of expected losses from bank failures (twice the actuarially fair rate).[7] An implication is that if the FDIC charged fair market premiums, then the DIF ratio would be expected to grow over time rather than have a steady state target level. Instead, by following a policy that adjusts premiums to target the DIF to a DRR (say 2%), the FDIC forces deposit insurance to be underpriced.

Why should underpriced deposit insurance matter? It creates several distortions to the financial system. Because uninsured bank deposits and debt requires a fair market credit spread that includes a systematic risk component while FDIC premiums do not, a bank will prefer insured deposits over comparable uninsured ones. Banks will have an incentive to lobby for higher deposit insurance limits (such as the "temporary" increase from $100,000 to $250,000) and seek ways to expand their insured deposits, such as through deposit brokers. In addition, banks will have a competitive advantage relative to lending institutions that rely on uninsured debt, such as finance companies. Non-bank financial institutions will have an incentive to acquire banks or convert to a bank holding company to gain access to insured deposits.[8]

Furthermore, as shown in Pennacchi (2006), deposit insurance premiums that lack a systematic risk component create an incentive for banks to take excessive systematic risk. The intuition for why this occurs is the following. If a bank's cost of deposit funding includes an insurance premium that reflects expected losses, but the bank can invest in competitively priced securities or loans whose returns reflect expected losses plus a systematic risk premia, then the bank has an incentive to invest in those loans and

---

[6] See Elton, Gruber, Agrawal, and Mann (2001).

[7] For example, see Duffie, Jarrow, Purnanandam, and Wei Yang (2003) and Pennacchi (2005). This systematic risk premium becomes larger when insurance premiums are smoothed across the business cycle.

[8] A prime example occurred after passage of the Financial Services Modernization (Gramm-Leach-Bliley) Act of 1999 which allowed securities firms to acquire banks. Recall that during the period 1996 to 2006, deposit insurance premiums clearly were subsidized because they were set at zero for the vast majority of banks. As a result, retail securities firms chose to transfer hundreds of billions of dollars of their customers' sweep accounts out of money market mutual funds and into FDIC insured money market deposit accounts (MMDA). During the five years from the end of 1999 to the end of 2004, balances in MMDAs grew at a 16.4 percent annual rate while assets of retail money funds *declined* at a 3.0 percent annual rate, a phenomenon that Crane and Krasner (2004) refer to as "re-intermediation."

securities with the highest systematic risk premia (highest betas). Such an incentive provides a possible explanation for why many large and small banks failed during the recent crisis due to large investments in mortgages, mortgage-backed securities, and CDOs.[9] Thus, the FDIC's DRR targeting policy can not only excessively expand the government's safety net but also exacerbate financial system instability.

Underpriced FDIC insurance that leads to overexpansion of insured deposits may also indirectly impact the U.S. Treasury's borrowing costs. As federally guaranteed savings vehicles, insured deposits and Treasury securities are close substitutes. Expanding the supply of insured deposits lowers the price of federally guaranteed investments, thereby raising their yields and the Treasury's borrowing costs.

Underpriced federal deposit insurance has direct costs to taxpayers. While some have argued that the policy of setting premiums paid by the banking industry to maintain a target level of DIF reserves insulates taxpayers from deposit insurance losses, the political economy of banking crises is incompatible with such a commitment by the banking industry.[10] As occurred when FSLIC loss claims soared, surviving depository institutions argue that they should not be responsible for the imprudent behavior of their failed members.[11] Politicians accepted this argument in the 1989 FIRREA by agreeing that taxpayers should help cover the thrift industry's losses. Curry and Shibut (2000) calculate that as of year-end 1999, resolving the savings and loan crisis cost the thrift industry $29 billion, but the cost borne by taxpayers was $124 billion.

Another more opaque example occurred in the Fall of 2008 when a federal policy change imposed losses from bank failures on taxpayers rather than have the losses be absorbed by a further decline in the DIF. On September 30, 2008 the U.S. Treasury issued Internal Revenue Service Notice 2008-83 which abolished limitations on tax shelters derived from an acquiring bank's use of an acquired bank's prior losses. The value of this tax break benefited Wells Fargo's acquisition of Wachovia, PNC's acquisition of National City, and Banco Santander's acquisition of Sovereign, thereby shielding the FDIC from several billion dollars in losses that would have been required to resolve these failed banks. However, this rule change cost taxpayers approximately $25 billion in lost revenue.[12] As these examples illustrate, taxpayer

---

[9] Coval, Jurek, and Stafford (2009) show that these investments had very high systematic risk.

[10] If taxpayers truly had no exposure to bank losses, a DIF targeting policy would represent an unrecorded liability of surviving banks that would exceed expected premiums because premiums would tend to be higher during economic downturns when the DIF is below target. However, if taxpayer bailouts occur when the DIF is sufficiently depleted, the magnitude of this liability declines. In any case, under a DIF targeting policy creates a distortion where individual banks will have an incentive to over-issue insured deposits even if doing so increases the liability of the aggregate banking industry.

[11] As FDIC loss claims rose during the most recent financial crisis, banks facing higher FDIC premiums needed to replenish the DIF made the same arguments. For example, see "FDIC's New Assessment Lambasted as Unfair," the *American Banker*, March 2, 2009.

[12] Congress had intended to restrict the amount of an acquired firm's losses that an acquiring firm could deduct in order to prevent mergers that were motivated only by tax benefits. The Treasury's ruling exempted only loan losses of acquired banks from this restriction. Some have questioned whether the U.S. Treasury had the authority to amend this tax law. See "Obscure Tax Breaks Increase Cost of Financial Rescue," *The Wall Street Journal*, October 18, 2008. The 2009 American Recovery and Reinvestment Act signed into law on February 17, 2009 repealed IRS Notice 2008-83 for future acquisitions, but grandfathered the tax benefits received for the aforementioned previous acquisitions.

bailouts become likely during systematic economic downturns that lead to large numbers of bank failures. Whether intended or not, these bailouts represent a subsidy to the banking industry.

To summarize, the general level of FDIC premiums lacks a systematic risk component and is below credit spreads that would be charged on comparable uninsured bank liabilities. Absent regulatory constraints, most banks will prefer insured to uninsured deposits, seek to over-issue insured deposits, and have an incentive to choose investments that have excessive systematic risk. When DIF losses become substantial, political pressure tends to result in explicit or implicit taxpayer bailouts, so that FDIC insurance is not a purely industry-funded program but is taxpayer subsidized.

Given that deposit insurance is underpriced, banks would have the incentive to issue large amounts of insured deposits were it not for particular constraints. One sometimes binding past constraint was Regulation Q ceilings on deposit interest.[13] But the constraint that historically may have been most effective was that insurance was limited to "retail" deposits below a legislated size limit and these retail deposits were in inelastic supply.

Why were limits placed on the size of deposits that would receive full FDIC coverage? Thomson (2000) reports that when FDIC insurance was established by the Banking Act of 1933, the dangers of bank moral hazard were well-recognized. Congress sought to protect only small, unsophisticated savers by keeping the insurance limit at modest levels. Large savers were not protected because it was intended that they continue to impose market discipline on banks. Thus, while the wave of bank runs during the early 1930s clearly was an event that triggered the creation of the FDIC, FDIC insurance was intended to protect only small savers not wealthy ones.[14]

While FDIC coverage was initially set at modest levels, it has tended to rise over time. The Figure 1 below gives the real value (in 2011 dollars) of the deposit limits on FDIC insurance. As can be seen, the current real deposit insurance limit is near the 1980 historical high of $287,000 ($100,000 1980 dollars).[15] Thus, if one looks solely at this limit, it would appear that the current constraint on insured deposit issue is relatively loose. But attracting uninsured deposits is currently likely to be even easier than this figure suggests. During the financial crisis the FDIC liberalized ownership category rules that individuals and families can establish that would each qualify as separate deposits.[16]

---

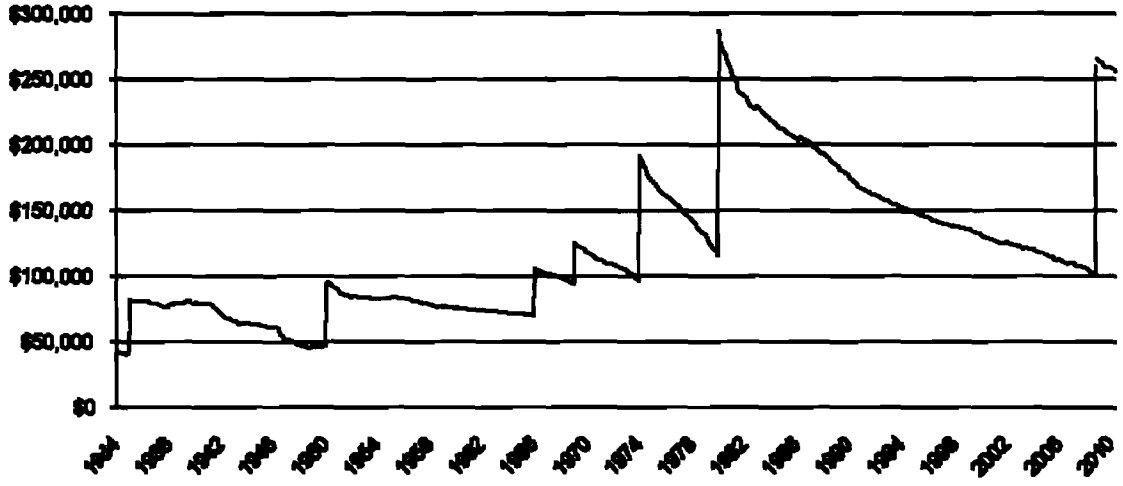
[13] When market rates rose above Regulation Q ceilings, banks would not be able to compete for deposits by raising rates. Effective July 2011, Regulation Q interest rate ceilings will be completely removed with the lifting of interest rate restrictions on business checking accounts.

[14] Decisions by uninsured small depositors to withdraw deposit may be more prone to misinformation. By insuring these small depositors, bank runs at truly viable banks might be lessened.

[15] The large increase in the limit to $100,000 during 1980 was intended to mitigate the disintermediation that banks were experiencing due to Regulation Q ceilings. Former FDIC Chairman Sprague (1986, p.261) states that he attempted to stop Congress from approving the increase in this limit.

[16] For example, different revocable trust accounts can be set up that each qualify for $250,000 where the beneficiary need no longer be a family member. The FDIC website http://www.fdic.gov/deposit/deposits/insured/faq.html shows other ways that a family of four can qualify for $3 million in insurance at a single bank. Thomson (2001, footnote 6) also mentions that a family of four can set up 15 distinct joint accounts at a single bank, implying total deposit insurance coverage of 15×$250,000 = $3.75 million.

Figure 1
Real Value of FDIC Deposit Insurance Limits
($ 2011)



Which depositors likely benefit from rises in the deposit insurance limit? Thomson (2001) reports that few households are constrained by deposit insurance limits, including many high-income households. From the 1998 Survey of Consumer Finances (SCF), the median sum of checking and CD deposits for households whose income exceeded $100,000 was $41,000, much below the contemporaneous single-account limit of $100,000. So relatively few small and medium savers were likely affected by the 2008 increase in the deposit insurance limit to $250,000. The higher limit was likely a factor primarily for wealthy entities.

Moreover, even multi-million dollar depositors can avoid deposit insurance limits due to the spread of new methods of allocating deposits under the FDIC limit to multiple banks. Attracting non-local deposits through traditional deposit brokers, reciprocal deposit services, and brokerage sweep accounts are increasingly possible. Internet advertizing can also attract non-local deposits more easily due to listing services. Thus, what would have been uninsured wholesale deposits can now be easily transformed into several insured retail deposits below $250,000. Such market innovations are a form of regulatory arbitrage that make limits on FDIC insurance close to meaningless.

The higher limits, along with new ways of attracting large brokered deposits, have expanded FDIC insurance much beyond its public policy objective of protecting only small, unsophisticated savers. By giving relatively wealthy, and arguably financially sophisticated, depositors access to complete insurance, few depositors will find it attractive or necessary to hold uninsured deposits and monitor the financial condition of their banks. This loss of market discipline will likely increase bank moral hazard and lead to larger losses from bank failures because the entire burden of supervising and disciplining banks is left to federal regulators.

Some may argue that the loss of large, uninsured deposits has stabilized banking. But such arguments neglect the possibility that partial bank runs by uninsured depositors can be beneficial in several ways. First, if financially sophisticated uninsured depositors flee a troubled bank, it may act as a ex-post penalty to risk-taking that reduces the bank's ex-ante moral hazard incentives. This is the disciplining role played by better-informed, uninsured depositors in the model of Calomiris and Kahn (1991) that controls bank moral hazard. It prevents banks from "gambling for resurrection" becomes they may lose funds that could be used to make further risky bets. Second, when uninsured depositors flee a bank, it can alert federal regulators to problems. Regulators will be forced to decide whether to lend the lost funds via the Federal Reserve's Discount Window or, if they find the bank has a negative market value of capital, close it. If the investors lose confidence in a bank by withdrawing uninsured deposits, it is quite likely that the market value of the bank's capital has been wiped out, even if the book value of capital has not declined sufficiently to trigger "prompt" corrective action by regulators. Hence, the market discipline from uninsured deposit withdrawals can mitigate regulatory forbearance. This early-warning mechanism might prevent larger DIF and taxpayer losses due to delayed closure.

The potential market discipline arising from a withdrawal of uninsured deposits is made less effective by easy access to brokered deposits. Billett, Garfinkel, and O'Neal (1998) show that prior to a bank's failure, the bank tends to replace uninsured deposits with insured deposits, including brokered deposits. Such behavior appears to have continued during the most recent crisis. For example, from August 2007 to March 2008, IndyMac increased its use of brokered deposits from $1.5 billion to $6.9 billion, eventually equaling about 37% of total deposits. This occurred as its uninsured funding declined. One wonders whether if IndyMac did not have access to brokered deposits, it would have been forced to close earlier and FDIC's losses would have been less than the eventual estimated $10.7 billion.

Clearly fully insured deposits, both local retail deposits and brokered deposits, are a more "stable" source of funding than many other uninsured bank liabilities. But if stability of funding is the only goal of bank regulation, then clearly the FDIC should seek to insure all bank debt. In recent years, this appears to be the direction that bank regulation has taken because bank regulators have allowed banks to use many loopholes so that little, if any, bank debt is uninsured.

But I believe complete adherence to this goal of funding stability is dangerous because it exacerbates bank moral hazard that amplifies systematic risk and also worsens regulatory forbearance, eventually leading to greater taxpayer bailouts. It is wrong to think that there is no role for market discipline by investors in uninsured bank debt.

I now turn specifically to the five general aspects that the Dodd Frank Act requires in the FDIC study. In addressing these issues, I will assume that the current system of setting premiums to target the DIF will not change. My views on more far-reaching reforms are in Pennacchi (2010).

I. The definition of core deposits for the purpose of calculating insurance premiums.

In addressing this issue, I assume that "core" deposits, however defined, will be given preferred status when setting deposit insurance premiums whereas all other "noncore" deposits will not. Given the twin public policy rationales of deposit insurance discussed earlier, the general principle in defining core

deposits should be to ask whether they are likely to come from small, financially unsophisticated entities.[17] These depositors lack the ability to impose informed market discipline on banks. In turn, the general principle for defining all other non-core deposits should be that they are likely to come from more wealthy, financially sophisticated entities who very likely have access to other safe investments. With few exceptions, it would appear that most brokered deposits would fall into this latter category of non-core deposits because they are likely to come from entities with several million dollars in savings.

Ideally, the marginal insurance premiums charged for a particular bank's non-core deposits should be approximately equal to what the bank would pay as a credit spread on a comparable uninsured deposit. That way, the bank would not have a preference for insured versus uninsured non-core deposits and there would be a role for at least some market discipline by uninsured depositors. A related idea would be to require some market discipline by brokered depositors. For example, the FDIC might require that brokered deposits have a ***minimum*** size of $300,000, so that at $50,000 of the deposit would not be FDIC insured. Such a requirement would provide incentives for brokered depositors to seek out safe, rather than risky, banks.

Give the general underpricing of deposit insurance that I described earlier, it would be more efficient to subsidize only core deposits of small savers. The reason is that these deposits tend to be in more inelastic supply, so given that they are underpriced, banks would not be able to over-issue them as easily as more elastic noncore (brokered) deposits.

The supply of these core retail deposits are relatively inelastic because most lower and moderate wealth individuals have a strong preference for making deposits at banks that are physically close to where they live. The 2004 Survey of Consumer Finance (SCF) reports that the median distance between a household and its bank is two miles for checking accounts and three miles for savings accounts and Certificates of Deposit (CDs). These median distances are unchanged from those of reported by the 1992 SCF. If small savers are reluctant to deposit funds at banks farther from where they live, banks will be able to exert market power. Empirical research consistently finds evidence of uncompetitive pricing for retail deposits. For example, Park and Pennacchi (2009) use 1998-2004 deposit rates from Bankrate and confirm that MMDA and CD rates are lower in more concentrated markets.

The ability to set retail deposit rates below comparable Treasury yields is the major source of many banks' "franchise values" or what economists refer to as "monopoly rents." Hutchison and Pennacchi (1996) analyze a sample of banks from the Federal Reserve's "Monthly Survey of Selected Deposits" and find that the median monopoly rent for NOW accounts is 6.6% per dollar deposit and for MMDAs is 7.9% per dollar deposit.[18] Besides setting these retail deposit rates below competitive rates on average, banks are also slow to adjust retail deposit rates in response to changes in competitive market rates. Such slow adjustment gives retail deposits a longer duration, with the median duration of NOW accounts being 6.7 years and the median duration of MMDAs being 0.4 years.

[17] These entities would include less wealthy individuals, small businesses, and small non-profit organizations.

[18] Monopoly rents on retail CDs were found to be relatively small.

If most of the deposit insurance subsidy is reflected in deposits of small savers, at least part of the subsidy may flow to them, thereby increasing their consumer surplus and partially offsetting the market power that banks derive from them. I believe this is a worthy goal to consider. In too many discussions of bank regulation, the objective appears to be to increase a bank's welfare (producer surplus) with little regard to the welfare of the bank's retail customers.

II. The potential impact on the Deposit Insurance Fund of revising the definitions of brokered deposits and core deposits to better distinguish between them.

It follows from my earlier arguments that if core deposits are defined as retail, non-brokered deposits and non-core deposits are everything else, there will be scope for greater market discipline by uninsured depositors because brokered deposits will be less likely to crowd them out. Quantifying the effect of greater market discipline in reducing a bank's moral hazard behavior and regulatory forbearance is hard to do, but it will surely play a role in reducing systematic risk and the likelihood of a major banking crisis that would be costly to taxpayers.

Because banks have more market power in setting the deposits of small savers (since they have less access to other competitive savings vehicles), banks will tend to have more franchise value (monopoly rents) the greater is their core deposits. All else equal, it may be less costly for the FDIC to resolve a failed bank with large amounts of core deposits. However, if the knowledge that a bank has relatively large amounts of core deposits affects the closure decision of the FDIC so that it forbears to a greater extent, this behavior may negate the FDIC's savings because loan and security losses may be greater.

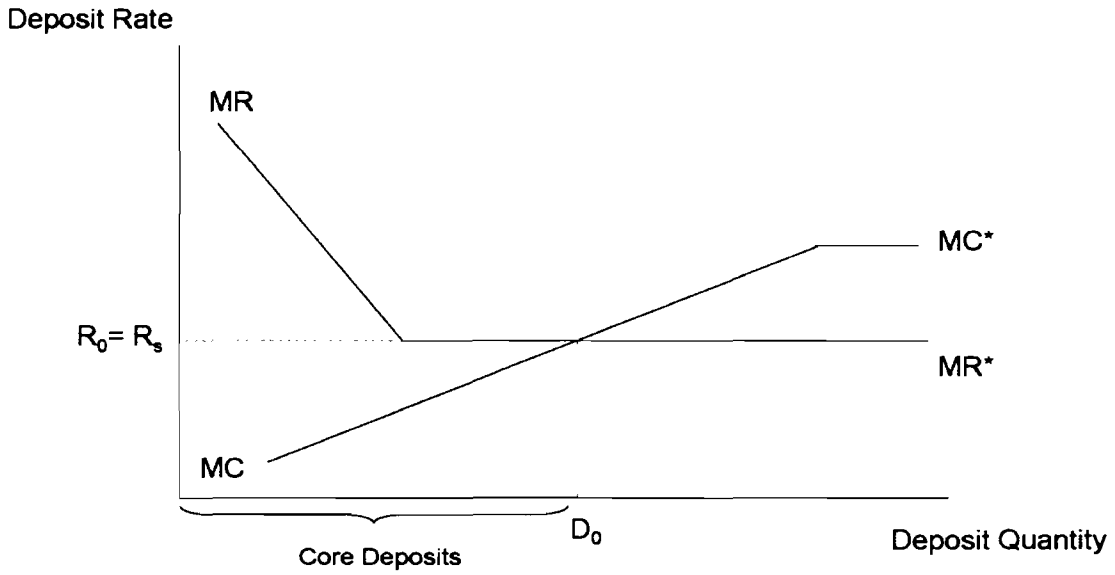
While it is tempting to advocate a policy where banks are encouraged to have more core deposits because it increases their franchise values, one should remember that this franchise value is likely to come at the expense of small savers' consumer surplus. In my view, the FDIC should not necessarily be an advocate for a more profitable banking industry if these profits derive from less competitive retail deposit markets. The FDIC should have an objective of promoting public welfare, which could include more competitive deposit rates paid to small savers.

III. Differences between core deposits and brokered deposits and their role in the economy and U.S. banking sector.

As discussed earlier, if core deposits are defined as deposits from relatively unsophisticated, small "retail" savers that live close to the bank where they make deposits, then such deposits are in relatively inelastic supply. Brokered deposits and uninsured deposits that come from more wealthy entities will tend to be more competitively price and in more elastic supply. A bank's choice between these core deposits, brokered deposits, and uninsured deposits depends on the particular market conditions that a bank faces.

One way that banks' market conditions may differ is that some will operate in "Loan Poor, Deposit Rich" environments and others will operate in "Loan Rich, Deposit Poor" environments.[19] A graph of the marginal loan and security revenue curves and marginal funding cost curves for a Loan Poor, Deposit Rich bank is given in Figure 2 below.

Figure 2
Loan Poor, Deposit Rich Bank



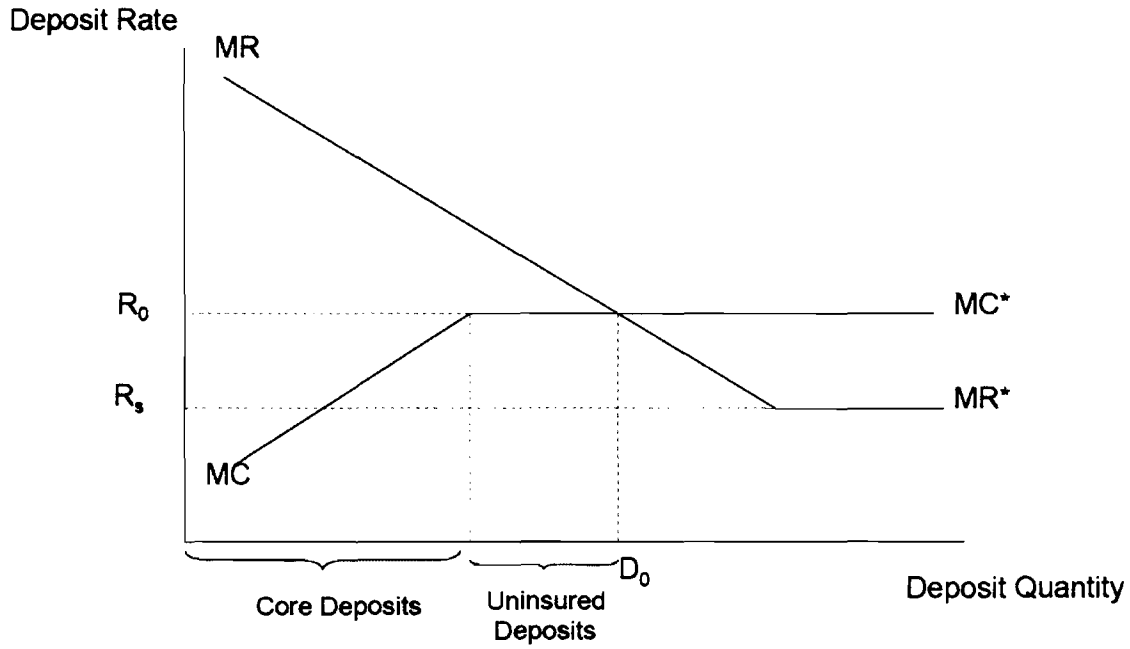
The shape of this bank's marginal revenue curve, MR-MR*, indicates relatively few profitable loan making opportunities. When the marginal loan revenue declines to R_S, the return on investing in securities, the bank stops originating more loans. Because this bank has access to a large supply of "cheap" retail core deposits, its marginal funding cost curve MC-MC* intersects to the right of the point where the marginal revenue curve begins equaling the security return.[20] Thus, at the margin, this bank will be investing its plentiful core deposits in securities. Such a bank would be unlikely to seek brokered deposits or uninsured deposits due to their likely higher cost. A bank in this situation may still be subject to moral hazard because, as noted earlier, it may have an incentive to invest in securities with high systematic risk if the FDIC premium on its insured deposits is less than or equal to the FDIC's expected losses from the bank's failure.

The marginal revenue and cost curves of a "Loan Rich, Deposit Poor" bank that has access to core and uninsured deposits is given in Figure 3.

[19] I attribute these phrases to Edward Kane.

[20] The marginal cost of funds would actually reflect a weighed cost of deposit funding and equity capital funding. I assume the cost of equity capital is constant.

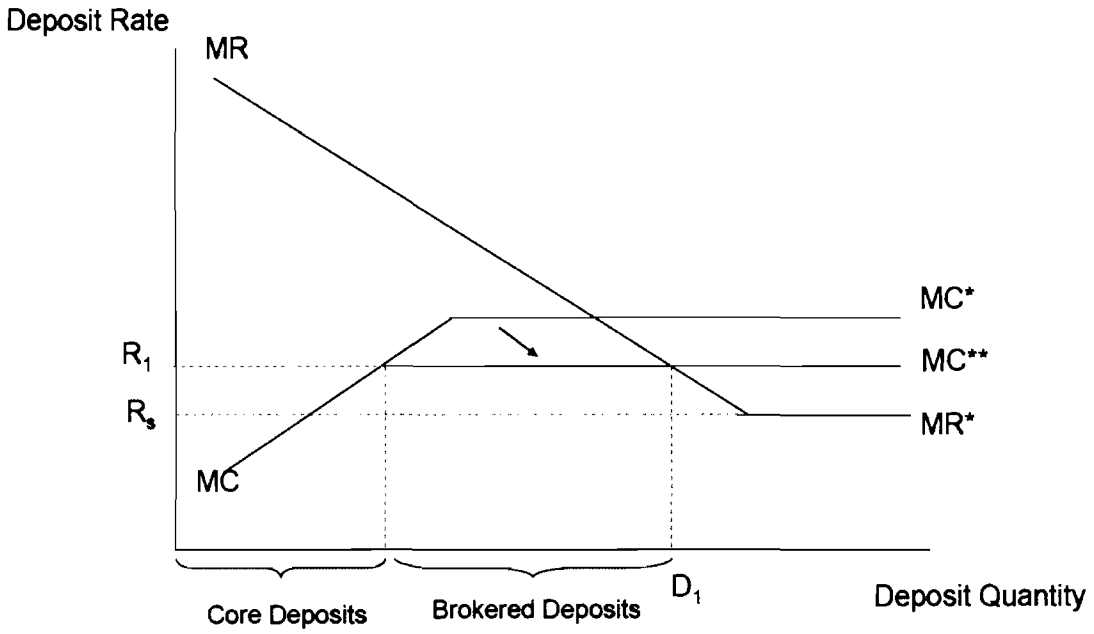
Figure 3
Loan Rich, Deposit Poor Bank with Uninsured Deposits



A bank in this situation has plentiful loan-making opportunities but few cheap retail deposits. Its marginal revenue curve intersects its marginal revenue curve at the point to the left of where marginal revenue reflects a security return. At the margin, this bank is still investing in loans and will not find it profitable to invest in securities. Moreover, the bank will chose to issue uninsured deposits because it would be less profitable to continue raising retail core deposits to meet loan demand. The equilibrium total deposit and uninsured deposit rate is given by D_0 and R_0, respectively.

Consider this same Loan Rich, Deposit Poor Bank but where it now has access to brokered deposits. Its new situation is given in Figure 4. Its marginal cost of funding curve has now shifted down from MC-MC* to MC-MC** because brokered deposits have replaced uninsured deposits. The reason why brokered deposits are assumed to be less costly than uninsured deposits is that the credit spread on uninsured deposits reflects a systematic risk premium while the actuarially fair FDIC insurance premium on brokered deposits does not. If this is the case, the marginal cost of deposit funding falls with brokered deposits to R_1 and total deposits increases to D_1. While total loans will also expand, it is not clear that the expansion of lending is economically efficient. Moreover, the bank using brokered deposits will have an added incentive to choose systematically risky loans compared to the bank that funds loans using uninsured deposits. This is because the bank relying on uninsured deposits will pay a higher credit spread if it chooses more systematically risky loans.

Figure 4
Loan Rich, Deposit Poor Bank with Brokered Deposits



In equilibrium, unless the FDIC premium on brokered deposits reflects systematic risk (and is comparable to the uninsured deposit credit spread) or brokered deposits are required to be partially uninsured (as suggested above), then the bank's moral hazard incentives will increase. Also as discussed earlier, regulatory forbearance is likely to be greater when brokered deposits replace uninsured deposits.

IV. The potential stimulative effect on local economies of redefining core deposits.

If core and noncore deposits were defined as I suggest, and noncore brokered deposits carried a higher deposit insurance premium and/or were required to be partially uninsured (say by having a minimum size of $300,000), then there would be little impact for local economies characterized by the "Loan Poor, Deposit Rich" situation of Figure 2. This is because banks in such local markets do not issue much, if any, uninsured or brokered deposits. They would continue to reply almost solely on the core deposits of less-wealthy savers.

My suggested reforms would have some effects on "Loan Rich, Deposit Poor" banks by moving from an equilibrium similar to Figure 3 to one more similar to Figure 4. This is because the relative preference for insured, brokered deposits versus uninsured deposits would decline. Total lending may decline somewhat, but this is relative to a situation where lending was previously too systematically risky and aggressive. Thus, reforms may reduce procyclical lending may have been at least partially responsible for the overly-aggressive mortgage lending that stimulated the housing bubble of the previous decade.

V. The competitive parity between large institutions and community banks resulting from redefining core deposits and brokered deposits.

The situation of most large banking institutions is one of being "Loan Rich, Deposit Poor." As a result, they are typically in the situation of Figure 3 and, at the margin, rely on uninsured wholesale funding. For example, many large money-center banks consider their marginal cost of deposit funding to be LIBOR.

Prior and during the financial crisis, uninsured depositors may have considered many large banks to be "Too-Big-to-Fail (TBTF)." Arguably, the credit spreads that they paid on uninsured deposits did not reflect their true credit risk because these depositors perceived that they would be bailed out by the federal government. In my view, the Dodd Frank Act requires substantial reforms that should reduce, if not end, TBTF. Moreover, changes in the FDIC's insurance premium policy are forecasted to raise premiums paid by large banks by 12% while reducing premiums paid by small banks by 30%.[21]

Thus, these reforms by the Dodd Frank Act may move large institutions closer to an equilibrium like that in Figure 3 where they are paying a fairer credit spread on uninsured liabilities. Assuming these large institutions do not have the ability to access large amounts of insured, brokered deposits, then their moral hazard incentives may be improved by these reforms.

My suggested changes for redefining core versus noncore deposits will primarily affect small- and medium-sized banks. These changes should reduce the marginal subsidy that some small banks face from brokered deposits. Reducing this subsidy would make competition between large and small institutions be determined by efficient economic considerations rather than government subsidies.

Conclusion

My recommendations in this note are based on my interpretation of the economics of federal deposit insurance, retail and wholesale deposit markets, and the moral hazard incentives of banks. The recommendations derive from a public policy perspective, rather than a banking industry perspective. As a entity of the federal government, I believe that the FDIC should keep a broader public policy objective in mind.

[21] See the February 1, 2011 Memorandum to the FDIC Board of Directors by Arthur Murton (FDIC Director of Division of Insurance and Research) and Craig Jarvill (FDIC Acting Director of Division of Finance). The change in the premiums reflect a change in the assessment base to total non-equity liabilities from total deposits. Effectively, this would appear to charge deposit insurance premia for uninsured liabilities, such as funding at LIBOR.

References

Calomiris, Charles and Charles Kahn. 1991. The Role of Demandable Debt in Structuring Optimal Banking Arrangements. *American Economic Review* 81: 497-513.

Coval, Joshua, Jakub Jurek, and Erik Stafford. 2009. Economic Catastrophe Bonds. *American Economic Review* 99: 628-66.

Crane, Peter and Michael Krasner. 2004. Brokerage Cash Sweep Options: The Shift from Money Funds to FDIC-Insured Bank Deposit Accounts. *iMoneyNet*, Inc., Special Report (November).

Curry, Timothy and Lynn Shibut. 2000. The Cost of the Savings and Loan Crisis: Truth and Consequences. *FDIC Banking Review* (December).

Diamond, Douglas and Philip Dybvig. 1983. Bank Runs, Deposit Insurance, and Liquidity. *Journal of Political Economy* 91: 401-419.

Duffie, Darrell, Robert Jarrow, Amiyatosh Purnanandam, and Wei Yang. 2003. Market Pricing of Deposit Insurance. *Journal of Financial Services Research* 24(2/3): 93-119.

Elton, Edwin, Martin Gruber, Deepak Agrawal, and Christopher Mann. 2001. Explaining the Spread on Corporate Bonds. *Journal of Finance* 56: 247-277.

Friedman, Milton and Anna Schwartz. 1963. *A Monetary History of the United States: 1867 – 1960.* Princeton University Press. Princeton NJ.

Gorton, Gary and George Pennacchi.1990. Financial Intermediaries and Liquidity Creation. *Journal of Finance* 45: 49-71.

Hutchison, David and George Pennacchi. 1996. Measuring Rents and Interest Rate Risk in Imperfect Capital Markets: The Case of Retail Bank Deposits. *Journal of Financial and Quantitative Analysis* 31: 399-417.

Merton, Robert. 1977. An Analytical Derivation of the Cost of Deposit Insurance and Loan Guarantees. *Journal of Banking and Finance* 1: 3-11.

Park, Kwangwoo and George Pennacchi. 2009. Harming Depositors and Helping Borrowers: The Disparate Impact of Bank Consolidation. *Review of Financial Studies* 22: 1-40.

Pennacchi, George. 2000. The Effects of Setting Deposit Insurance Premiums to Target Insurance Fund Reserves. *Journal of Financial Services Research* 17 (1): 153–80.

———. 2005. Risk-based Capital Standards, Deposit Insurance, and Procyclicality. *Journal of Financial Intermediation* 14: 432–65.

———. 2006. Deposit Insurance, Bank Regulation, and Financial System Risks. *Journal of Monetary Economics* 53: 1–30.

———. 2010. Deposit Insurance Reform. In Jeffrey Brown, ed, *Private Markets and Public Insurance Programs*. AEI Press, Washington, D.C.

Sprague, Irvine. 1986. *Bailout: An Insider's Account of Bank Failures and Rescues*. Basic Books. New York.

Stiglitz, Joseph. 1993. Perspectives on the Role of Government Risk-bearing within the Financial Sector. In Mark Sniderman, ed. *Government Risk Bearing*. Boston MA. Kluwer Academic.

Thomson, James. 2000. Raising the Deposit-Insurance Limit: A Bad Idea Whose Time Has Come? *Economic Commentary Federal Reserve Bank of Cleveland*. April 15.

———. 2001. Who Benefits from Increasing the Federal Deposit Insurance Limit? *Economic Commentary Federal Reserve Bank of Cleveland*. September 15.

McHenry Kane
Vice President
Attorney

SunTrust Banks, Inc.
303 Peachtree Street, N.E.
Suite 3600
Atlanta, Ga. 30308
Tel 404.588.8627
Fax 404.230.5387

(b)(6)

April 29, 2011

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429-9990
Attention: Comments
coredepositstudy@fdic.gov

Ladies and Gentlemen,

On behalf of SunTrust Bank, I would like to take this opportunity to provide certain comments to the Federal Deposit Insurance Corporation' s ("FDIC") requested as part of its study, mandated by Section 1506 of the Dodd-Frank Wall Street and Reform Consumer Protection Act (the "Act"), of the definition of brokered deposits for the purpose of calculating insurance premiums (the "Study"). In your press release requesting comment to help you evaluate the meaning of core deposits versus brokered deposits, you pose four (4) questions:

- In times of financial stress, what types of deposits are likely to remain at an institution and what types of deposits are likely to leave the institution?
- Does the presence of certain kinds of deposits (e.g., brokered, internet, listing service) inherently increase an institution' s risk? Does their presence facilitate increased risk-taking?
- What types of deposits are likely to enhance a failed institution' s franchise value and what types of deposits are likely to reduce it?
- What recommendations would you make for legislative or regulatory changes with respect to core and brokered deposits?

This letter will address three of the four questions posed and generally contend that while the FDIC has a legitimate concern and should risk-assess on the basis of brokered deposits, the current understanding is too expansive to the extent it includes deposits of clients referred to depository institutions by affiliated entities or deposits that are transfers from client accounts held at affiliated entities. Further, this letter will argue that the FDIC has the power to change its understanding of brokered deposits without congressional intervention by either (i) publishing guidance with respect to the primary purpose exemption for deposits of clients referred to a depository institution by affiliated entities and deposits sourced from transfers to a client' s account from accounts at affiliated entities or (ii) defining "brokered deposits" for the purpose of measuring the risk of depository institutions and assessing deposit insurance premiums. This letter will not address whether the presence of certain kinds of deposits inherently increases an institution' s risk or facilitates risk-taking because we do not see a correlation between the type of deposits held by an institution and the riskiness of an institution; rather, risk-taking seems to us to be entirely a function of management' s temperament and the inherent riskiness of an institution appears to us to be far more dependent upon the assets of a financial institution than the

liabilities.[1] This letter will instead focus on the other three questions posed. Seeking high interest deposits and placed deposits may be a typical reaction to bad assets due to overly aggressive management philosophy in an attempt to mask this problem; however, it would not be the only possible reaction nor should the symptoms be confused with the ailment.

In times of financial stress, what types of deposits are likely to remain at an institution and what types of deposits are likely to leave the institution?

It would be difficult to draw conclusions from this most recent financial crisis because SunTrust' s experience, like many of its peer banks, was that deposits rose throughout the entire financial crisis. While this may be in part due to depositors moving accounts as a result of the failure of other banks in SunTrust' s footprint and SunTrust organically increasing market share, it was also probably due to exogenous factors such as people pulling funds out of a falling stock market and a cultural shift towards more thrift and savings. In fact, products SunTrust has always considered brokered deposits, such as wholesale funding and deposits placed by a third party broker, were drastically reduced because those forms of liquidity became unnecessary in light of the dramatic increase in what SunTrust has always considered core deposits, such as people putting cash in their checking and savings accounts. However, the amount of brokered deposits reported by SunTrust recently have been elevated primarily because the numbers include deposits we have traditionally understood to be core, such as retail transaction accounts which have been re-categorized as brokered deposits because they permit clients to transfer funds directly from the transaction accounts to the client' s brokerage accounts or because the client was referred to the bank by an affiliate. SunTrust has always understood the Study as important to clarifying the definition of brokered deposits to address the tension between what bankers would categorize as core deposits and what qualifies as brokered deposits under the FDIC interpretative guidance. In particular, the change in application of brokered deposits as a means of assessing the risk of a depository institution for purposes of deposit insurance assessments has made understanding what is a brokered deposit important to the entire industry and is an opportune time to reflect on how the FDIC' s understanding of brokered deposits may have evolved.

SunTrust recognizes the FDIC has a legitimate concern when the relative health of a depository institution is masked by volatile deposits, which deposits may disappear[2] and cause a liquidity crisis for that financial institution, and may precipitate an FDIC take-over of a depository institution. SunTrust supports the FDIC' s goal of requiring depository institutions to fairly present on the Report of Condition and Income ("Call Report") their stable deposits and less stable deposits. Consequently, defining brokered deposits in terms of deposits that are most volatile should be paramount. Presently, however, what is reported on the Call Report does not always reflect this.

An example of the difference between what we have traditionally understood to be brokered deposits and what we have traditionally understood to be core deposits are deposits obtained through a

---

1 We note that the former Chairman of the FDIC concurred with this assessment in his testimony before the House Committee on Banking, Finance and Urban Affairs when Mr. Seidman stated "[w]e believe the problem in not primarily brokered deposits per se, but controlling how these funds are used, particularly when they are used to fund fast growth. Losses in banks do not occur by virtue of the source of their deposit liabilities, but rather from the quality of loans and investments made with those funds." Arnold & Porter LLP Legislative History: P.L. 101-73 (1989).

2 We note here, for instance, many deposit brokers have termination clauses if a bank's rating by a third-party, which rating is meant to reflect a bank's supposed CAMELS rating, falls beneath a certain level, which would result in a large transfer of funds, and loss of liquidity, for a bank so situated.

deposit wholesaler versus retail transaction accounts that have been referred to the bank by a bank affiliate. In certain retail wholesale deposit agreements, a trigger is oftentimes imbedded in the contractual agreement between the financial institution and the bank that, if tripped, would cause all the wholesale deposits to leave the bank. An example of a trigger may be if the institution ceases to be classified as well-capitalized. If the depository institution ceases to be well capitalized, the deposits can be withdrawn immediately. Additionally, wholesale deposit contracts usually have a set period of time in which the funds will be deposited at the depository institution. As the maturity date approaches, the depository institution has the opportunity to renegotiate the contract at different terms and rates, but also the risk that the deposits may leave the institution. Conversely, deposits in retail transaction accounts that are from funds transferred from a client' s account at an affiliated brokerage account or that came to the bank by referrals of affiliates do not have the types of contractual triggers and maturities that are discussed above.

SunTrust contends that clients who have accounts at affiliates and are referred to open accounts at the bank are stable and are likely to remain at an institution in times of financial stress. While in the vast majority of instances affiliates are not compensated for the referral, affiliates generally only refer clients to the affiliated bank because the affiliates understand that clients who have several products with the enterprise as a whole are more likely to be loyal to the enterprise, notwithstanding that the products are sourced by different affiliates within the enterprise. Consider the attrition rates of SunTrust accounts in the table below over a sample period of four (4) consecutive quarters:

	Attrition Rates (b)(4)
(b)(4) Clients with only Active Checking Accounts (or more transactions per month)	
Clients with Active Checking Accounts and other SunTrust Products (at the Bank or other SunTrust affiliates)	
Clients with SunTrust Products, but no Active Checking Account	
Clients with a single SunTrust Product, not an Active Checking Account	

The table illustrates that clients with more than one account, whether at the bank or another SunTrust affiliate, are much more loyal to the enterprise than clients with only one product. Consequently, clients who have purchased products or services from affiliates and are referred to open deposit accounts at the affiliated bank, in our experience, produce more stable and less volatile accounts than a client whose only interaction with the enterprise is a single deposit product. Therefore, we encourage the FDIC consider the differences between its historical experience with deposits referred to a depository institution by a third-party and deposits referred to depository institutions from an affiliate, particularly now that the FDIC uses brokered deposits to risk assess depository institutions for the purpose of deposit insurance assessments.

This begs the question why the FDIC has historically considered deposits referred to a depository institution to be brokered. A review of past interpretative letters tends to show that because the consequences of carrying brokered deposits were minimal in the past, the FDIC took a very expansive view of brokered deposits to prevent circumvention of the registration of deposit brokers. For example, FDIC Interpretative Letter 94-15[3], the FDIC considers arguments sent by an investment bank and broker-dealer affiliate of a bank that deposits they refer should be exempt under the primary purpose exemption. The FDIC had previously informed the investment bank that a hyper-technical understanding of the word "facilitate" in the statute means that referrals the investment bank makes of its customers to its affiliate bank result in brokered deposits to the bank. The investment banker points out that the "primary purpose exemption" within the statute appears to apply in this instance because the investment banker is not primarily engaged in brokering deposits, but rather refers its customers to the bank on an informal basis without compensation. The FDIC argues that it has interpreted brokered deposits very broadly in order to prevent circumvention of the rule and, in any event, the requirements for compliance with the rule are not onerous. The author of the guidance also theorizes that even if the affiliated investment bank is not directly compensated, it is possible it may be indirectly compensated through a quid pro quo arrangement with the bank, thus in order to avoid the possibility of circumvention of the brokered deposit rules a strict interpretation must be followed. The FDIC goes on to note that occasionally the investment bank wires its client funds to the bank for the convenience of its clients, which is placing deposits and further holds that even if the investment bank were never in possession of a client' s principal or interest, any form of "freeing from impediment", "match-making" or "finding" activities makes the investment bank a deposit broker. The FDIC then reaches a conclusion that runs counter to the evidence presented above: a company making informal referrals to its affiliate bank, which this guidance holds are brokered deposits, is clearly distinguishable from situations where a disinterested, unaffiliated advisor makes casual and occasional referrals to a bank. The letter concludes by noting that if the bank is well-capitalized, the referrals from the affiliated investment bank are not inhibited in any fashion and the registration requirement for the investment bank is not burdensome.[4]

Recently, the consequences of brokered deposits have become more onerous to depository institutions because the FDIC has decided to use brokered deposits as an upward adjustment to deposit insurance premiums as well as a factor within the general risk assessment. The FDIC has justified its consideration of brokered deposits on the basis of its stated observation that brokered deposits fund rapid asset growth and result in costly institution failures, but accurately tracking deposits that result in rapid and volatile liquidity growth to fund expansion of assets on a financial institutions balance sheet is undermined by the previous interpretations of "brokered deposits" which captures both volatile and non-volatile deposits. Consider the Basel III: International framework for liquidity risk measurement, standards and monitoring.[5] Under Basel III, a consumer transactional account that is insured is described as a stable deposit with an attributed run-off rate of 5%, without consideration of whether the funds in the consumer transactional accounts are the result of a referral or not.[6] Moreover, consumer accounts that are non-transactional, but where the consumer has other relationships with the bank, are also attributed a 5% run-off rate and deemed stable.[7] Conversely, deposits placed through wholesale markets where the person

3 1994 WL 393703 (F.D.I.C.).

4 Note that the registration requirement for deposit brokers was repealed by Congress as part of the Financial Regulatory Relief and Economic Efficiency Act of 2000 (Pub.L. 106-569, Title XII, §1203. The repeal of Section 29A of the Federal Deposit Insurance Act did not, however, repeal the restrictions on banks receiving brokered deposits.

5 Basel Committee on Banking Supervision, December 2010, ISBN print: 92-9131-860-4.

6 Basel Committee, paragraph 56.

7 Id.

placing the deposit does not have an operational relationship with the bank are attributed a 75% run-off rate.[8] It is our view that the Basel III framework comports more closely to our experience with which funds are more volatile than the FDIC' s emphasis on source of funds. Therefore, while the overall correlation cited by the FDIC between rapid growth in brokered deposits, reductions in CAMELS ratings and costly failures may be correct, by treating retail consumer accounts sourced by an affiliate referral as brokered the FDIC is lumping together what both SunTrust and the Basel Committee consider stable accounts with unstable accounts. SunTrust contends that if the FDIC excluded deposits of client accounts referred by affiliates of the depository institution, the FDIC is likely to achieve an even stronger correlation than it previously had because it eliminates some noise that is inadvertently captured by its historically broad understanding of brokered deposits. Furthermore, is our contention that by labeling deposits in accounts referred by affiliates or funds in consumer accounts that are linked to brokerage accounts at an affiliated brokerage as non-brokered deposits, the FDIC is not creating volatile liquidity threat to its member banks; on the contrary, it is distinguishing between the stability of these funds and truly volatile deposits.

What types of deposits are likely to enhance a failed institution's franchise value and what types of deposits are likely to reduce it?

It is SunTrust' s view that deposits that enhance a failed institution franchise value are those that are stable, or colloquially "sticky," whereas types of deposits that reduce franchise value are volatile and leave the institution. While the assets of a failed institution are equally, if not more, important in evaluating the franchise value of a failed institution, deposits of that institution are only worthwhile to the extent they would remain with the institution. When SunTrust evaluates the deposits of a failed institution to determine "stickiness", we consider the following factors:

- *Rates paid at the failed institution versus the rates SunTrust pays for similar products*: accounts with rates that are lower than SunTrust' s rates are more likely to stay after transaction as opposed to accounts that pay rates higher than SunTrust, which are more likely to leave the institution due to a reduction in interest rates;

- *Location of deposits*: specifically whether they are in or out of the failed institutions' branch network because deposits that are from outside the branch network of a depository institution are more likely to have been attracted on the basis of rates alone, unless the failed institution had a strong on-line banking presence; and

- *The ratio of certificates of deposit to total deposits*: a very high ratio of certificates of deposit to total deposits suggests to us that the deposit base is unstable because non-transactional accounts tend to be, in our experience, very rate sensitive.

This analysis would be consistent with our traditional understanding of brokered deposits; namely, high rate deposits placed by an unaffiliated third party, usually in certificates of deposits. Notably absent from our analysis are referred deposits, specifically deposits that may have been referred by a broker-dealer or other affiliate of the bank where the client opens a transactional account. As we point out in the prior question, the most stable, or "sticky" deposits are those where the customer has a number of

8 Basel Committee, paragraph 81.

products with the institution and its affiliates. The logic of this is that the client has higher personal costs to leave to another enterprise that would offer similar products (this higher cost is not necessarily monetary, but also the time of unwinding everything from one enterprise and setting it up at another enterprise, which is a cost to the client because of the implicit value of time). In many instances, the number of products a client has is more indicative of the stability or "stickiness" of the funds than even the longevity of the relationship between the client and the institution.

What recommendations would you make for legislative or regulatory changes with respect to core and brokered deposits?

It is SunTrust' s recommendation that the regulatory understanding of core and brokered deposits more closely reflect the intent of the statute, that guidance be issued which expands the primary purpose exemption to include deposits of clients referred to the depository institution by affiliates and funds in client accounts transferred from client accounts at affiliates, and application of the rules with respect to brokered deposits be consistent at each FDIC regional office. To be clear, SunTrust agrees with labeling deposits sourced by third parties that offer rates of interest which are significantly higher than prevailing rates of interest on deposits offered by other insured depository institutions in the normal market area as brokered deposits because the logic of a customer who is only interested in placing money where it can earn the greatest amount of interest and has no loyalty to any institution results in volatile money makes sense to us. Moreover, SunTrust does not take issue labeling deposits sourced by a third party engaged in the business of placing deposits or facilitating the placement of deposits of third parties with insured depositories or the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties as brokered deposits because this captures the funds of clients who are loyal only to the person placing the deposits and not any particular depository institution, thus resulting in volatile deposits for any depository institution in which those funds are placed. SunTrust, however, recommends that the FDIC review and revise their guidance with respect to the understanding of the statutory exception to the term deposit broker of an agent or nominee whose primary purpose is not the placement of funds with depository institutions (the "Primary Purpose Exception")[9]. It is SunTrust' s view that prior interpretations and application of the Primary Purpose Exception is narrower than what would serve the FDIC' s interests in capturing volatile deposits for the purpose of assessing deposit insurance.

From the time of the adopting of the brokered deposit rules in the late 1980' s, the FDIC has understood the definitions of "brokered deposits" and "deposit broker" as broad and far reaching[10] consistent with its understanding of legislative intent to limit the use of brokered deposits by troubled institutions. The legislative intent was summed up by Senator Murkowski, who offered the amendment in the Senate to limit the use of brokered deposits by financially troubled institutions, as "to prevent the flagrant abuse of the deposit insurance system by troubled institutions that take excessive risks and leave the taxpayers to suffer the consequences.[11]" In one of the earliest interpretative letters written with respect to the Primary Purpose Exception[12] to the definition of deposit broker, the FDIC states that "the FDIC

9 12 U.S.C. §1831f(g)(2)(I).

10 FDIC 90-21, 1990 WL 711344 (F.D.I.C.)

11 House Report 101-54(I), 1989 WL 168164.

12 FDIC Interpretative Letter 89-51 (1989 WL 609501, F.D.I.C.) also briefly address the Primary Purpose Exception, the context being whether fund held by a trustee for "C.D.-backed public housing bonds." Here, the trustee, except for placing funds in certificates of deposits, had only ministerial functions except for a trustee's duty to enforce its rights and the rights of the bondholders under the terms of the indenture, which the FDIC held was a general duty of all trustees.

does not construe ' primary purpose' to mean primary activity; rather, we construe ' primary purpose' as primary intent." Consequently, curbing efforts by people in the industry to subvert the purpose of the rule by working around the rule, the FDIC has sought to employ a highly subjective test to understand the Primary Purpose Exception.

Many early interpretations of the Primary Purpose Exception distinguished between funds of clients loyal to an institution are less volatile than funds of clients loyal to another party. For instance, in FDIC Interpretative Letter 90-24[13] and several subsequent interpretative letters[14], the FDIC considers factors that would make listing agents deposit brokers. The FDIC concludes that to the extent a listing agent is merely publishing information about interest rates on certificates of deposit and is paid by subscribers to the service, but not depository institutions, then the listing agent is not a deposit broker. If, however, any of (i) the depository institutions must pay a fee to the listing agent to list their rates; or (ii) subscribers gave their contact information to the listing agent to pass along to the depository institution, this would then be facilitating the placement of deposits and brokering deposits. It may be possible to draw out of this distinction that if the loyalty of the client is to the listing agent, as opposed to the bank, then the listing agent is acting as a deposit broker because the client will move their deposits wherever the listing agent suggests they should go instead of keeping them with a single depository institution where the client has a relationship.[15] This would appear to capture the volatility concern associated with brokered deposits as well as the behavior of those deposits that only seek higher returns wherever located. This logic is bolstered by FDIC Interpretative Letter 92-66[16] where the trustee of a trust offers investment portfolios for its clients. Under the terms of the trust, one such optional investment portfolio is certificates of deposit, which are placed by the trustee upon the direction of the client. At issue here is that the client specifies only that the funds be invested in certificates of deposit, but not in any particular bank (the particular bank is chosen by the trustee as fiduciary). Therefore, the client' s allegiances are to the trustee and not any particular bank where the funds are placed because the placement has been facilitated by a trustee and the client may not even know where the funds are being placed.

However, FDIC Interpretative Letter 92-77[17] holds that a broker-dealer is a deposit broker if it

---

13 1990 WL 711277 (F.D.I.C.).

14 FDIC Interpretative Letter 92-50 (1992 WL 813417, F.D.I.C.); FDIC Interpretative Letter 92-53 (1992 WL 813420); FDIC Interpretative Letter 93-44 (1993 WL 603986).

15 This rationale would appear to make sense of example in which the client gives its funds or information to the listing agent and the listing agent passes the funds or information on to the depository institution, but not if the subscriber calls the depository institution directly after reviewing the information on the listing service. Admittedly, it makes less sense of why a listing agent is a deposit broker if it paid by the depository institution to list its rates as opposed to subscribers; however, Interpretative Letter 92-86 (1992 WL 813437, F.D.I.C.) seems to suggest that an agent who is not paid by depository institutions and helps municipalities and corporations find depository institutions that are willing to take large deposits, the agent is a deposit broker, thus throwing exception set forth in 90-24 entirely into doubt. Note also that FDIC 92-53 (1992 WL 813420) appears to suggest that where the listing agent sends information to a client as to how to contact a depository institution, this is facilitating the placement of deposits for purposes of the definition of "deposit broker" and the exception in 90-24 for instances where the client contacts the depository institution directly is cast into doubt. Interpretative Letter 02-04 (2002 WL 32068162, F.D.I.C.) holds that acceptance of flat fees from depository institutions would not render the deposits from the listing site to be brokered deposits, thus changing the holding in Interpretative Letter 92-86 significantly, though rationally in that the listing service is not receiving commission and is thus more disinterested from how many deposits are placed and where they are placed. The rationale is well stated in Interpretative Letter 04-04 (2004 WL 1962081, F.D.I.C.) where the FDIC holds "[a]gain, the purpose of the FDIC's criteria is to distinguish between the following: (1) 'listing services' that merely provide information about deposits; and (2) 'listing services' that participate in the placement of deposits. The latter are 'deposit brokers.'"

16 1992 WL 813396 (F.D.I.C.).

17 1992 WL 813384 (F.D.I.C.).

merely advises its clients of banks were it can establish accounts and the client calls the bank directly to establish the account. The FDIC makes the point that the fact the broker-dealer never is in possession of the investor' s principal or interest and never acts as trustee or agent for the investor, it is a deposit broker. Furthermore, the FDIC holds that where the investor, after having been contacted by the broker, calls the depository institution directly to establish an account, the broker would be a deposit broker because it conducted "match-making" or "finder" activities and cites to the regulations published in 1983 for its holding.[18] It is important to note that FDIC Interpretative Letter 92-77 was published prior to the adoption of Financial Services Modernization Act of 1999 that permits financial holding companies to own both a depository institution and broker-dealer subsidiaries; consequently, FDIC Interpretative Letter 92-77 would not have evaluated whether referrals from affiliated institutions should be exempt under the Primary Purpose Exemption because of the very different intent of an affiliate referring clients to an affiliated depository institution. At this point, the scope of the rule is extremely broad and would be understood to capture anytime anyone refers anyone to one bank or another and exempting only those accounts opened by customers of which a bank has no idea how the customer ended up at such bank[19].

There are, however, examples of Interpretative Letters that hold that some deposits do not constitute brokered deposits, but the reasons given present some interpretative issues. In FDIC Interpretative Letter 93-30,[20] a bank markets its deposits to affinity group members. The bank seeks an affinity group to endorse the bank and the bank markets its products to members of the affinity group with the endorsement. In return, for a list of members of the affinity group, the bank pays the affinity group a nominal royalty for the use of the affinity groups' names and trademarks. The FDIC decided that the affinity groups were not deposit brokers (the "Affinity Group Exception"), despite endorsing the bank to their members and being paid for it, because (a) the affinity groups were non-financial institutions, (b) the affinity groups did not market directly for the bank[21], (c) members directly deposit with the bank and do not give funds to the affinity group to place on their behalf, (d) the affinity groups have exclusive relationships with the bank and do not endorse other financial products, (e) the royalties received by affinity groups for endorsing the bank' s products is small compared to what is paid to traditional deposit brokers, (f) the retention rate for endorsed money market accounts from affinity group members ranges from 80% to 85% and for certificates of deposit from 60% to 75% of such accounts and are regarded as core deposits to the bank and (g) the affinity groups do not know which members have made deposits with the bank nor keep any records of the amounts, rates or maturities of the deposits. The numerous reasons

18 It is important to note that the reference to 48 FR 50339-01, 1983 WL 108310 (F.R.) should not be controlling for a number of reasons: (i) the language is part of proposed rules which primarily ask the industry for input in answering various questions; and (ii) the rule that was adopted was subsequently struck down and, although the purpose of both rules is similar, the rules that were struck down should not control rules that were subsequently adopted under separate statutory authority.

19 Interpretative Letter 92-73 (1992 WL 813399, F.D.I.C.) does state that "if an insured depository does not know the identity of the depositor or is not aware of the fact that a broker is involved with the placement of a deposit, then a different issue is presented which we do not address." Presumably, not knowing that a deposit was referred by a third party to the bank is a defense that a deposit is not a brokered deposit, though the FDIC reserves judgment on this matter. It would be helpful for the FDIC to clarify the circumstances under which a bank must report as brokered deposits funds it receives when a bank doesn't know that a deposit has been referred by someone.

20 1993 WL 603952 (F.D.I.C.).

21 Note that this distinction is drawn into relief by Interpretative Letter 95-9 (1995 WL 788897, F.D.I.C.) which distinguishes between an insurance agent that would refer clients to a bank versus an affinity group that endorses, but direct marketing is sent by the bank. The interpretation of "solicit" to include "referrals" but exclude "endorsements", including an informal referral but a formal written endorsement, is a very fine line. Query whether or not payment should factor into whether or not a referral or endorsement is a solicitation, and whether or not advertisements featuring celebrities constitute a referral or endorsement, depending upon the language used in the commercial.

given for the Affinity Group Exception are a testament to the hurdles created by past interpretative guidance set up and which this interpretative letter maneuvers[22]; however, given the totality of the circumstances, it appears to be a judicious use of the Primary Purpose Exception.

The further application of the Affinity Group Exception in FDIC Interpretative Letter 93-31[23] may require additional clarification on the distinctions reached. In that instance, the Affinity Group Exception is applied to a bank that offers tuition-linked certificates of deposit which are sold by the bank' s financial planners and directly by a state, a college and a corporation to its employees[24]. In addition, accountants and lawyers may refer their clients to the bank to purchase this product. The FDIC held that sales by the state, college or corporation meet the Affinity Group Exception because, primarily, they do not receive a commission for the sales and they are not financial institutions. There is no discussion about whether the state, college or corporation are directly marketing the product on behalf of the bank by submitting it to employees as an investment option within a "cafeteria plan" of employee benefits[25], whether the state, college or corporation are receiving the funds directly and forwarding them to the bank, the retention rate for the accounts created or, at least in the case of the corporation, whether any record is kept of the people selecting this product by the state, college or corporation.[26] Financial planners and broker dealers are deposit brokers because, primarily, they are in the financial services business and they receive a commission, notwithstanding that the affinity groups received a royalty[27], which, presumably, makes the fact that they are in the financial services business the deciding factor. However, referrals from accountants for lawyers are deemed to result in brokered deposits even though (1) they are not the financial services business, (2) they market no more or less directly than the state, college or corporation, (3) they never handle funds on behalf of the customers, (4) they presumably receive no royalties, (5) the retention rate for the product is the same as the products endorsed and offered by the state, college and corporation and (6) the accountant or lawyer has no idea whether or not the client takes his or her advise unless the client volunteers the information. One may infer that the distinguishing factor must be that an accountant or lawyer is a deposit broker is because they may recommend other financial products and the client' s loyalty lies with the accountant or lawyer and not the recommended bank. Extending the logic to a referral to a client from an affiliate of a bank, such a deposit would not be a brokered deposit under the Affinity Group Exception because the affiliate is not likely to endorse financial products other than what is offered by the affiliated bank.

However, there are examples of the Affinity Group Exception being extended to commercial

---

22 Specifically, reconciling this exception with the statement in Interpretative Letter 94-15 that "[u]nless the activity in question comes within one of the statutory or regulatory exclusions, the FDIC must consider the activity deposit brokering" and the determination that because the person referring customers is a commercial enterprise, the Primary Purpose Exception cannot apply seems impossible.

23 1993 WL 603953 (F.D.I.C.).

24 As described above in the discussion of Interpretative Letter 95-9, query how direct sales are not a solicitation, but an informal referral is.

25 It should be noted that the Primary Purpose Exemption here appears to borrow from the trust exemption for pension plans and employee benefits in 12 USC §1831f(g)(2)(D), but the trust exemption could not apply because the state, college and company are not trustee or administrators of the funds.

26 Presumably, the corporation keeps records of benefits selected by its employees.

27 Note Interpretative Letter 93-34 (1993 WL 603956, F.D.I.C.) makes this explicit because financial planners and broker-dealers are considered deposit brokers even if they don't receive any direct compensation or royalties because it is possible the financial planner or broker-dealer may be compensated indirectly by taking a cut of the interest or a quid pro quo arrangement. Curiously, the FDIC ignores any possibility of a quid pro quo with people exempted under the Affinity Group Exemption, though given the vagueness of the concept, there is no reason to assume it wouldn't exist elsewhere.

enterprises[28], particularly in FDIC Interpretative Letter 94-40.[29] FDIC Interpretative Letter 94-40 holds that where a nursing home that teams with an accounting services group and bank to offer a single NOW account to each nursing home and where the nursing home acts as a fiduciary agent for sub-accounts opened by the nursing home' s residents, the accounting services group is not a deposit broker. The FDIC reaches this conclusion despite the fact (i) the nursing home collects checks from the residents and sends them to the bank for handling; (ii) the accounting services group tracks the funds in each resident' s accounts and transmits this information to the bank; and (iii) presumably the accounting services organization is a commercial enterprise. The conclusion is based on the Primary Purpose Exception and the FDIC believes the accounting services group is not primarily engaged in the business of placing deposits but is engaged in ministerial and administrative functions. If the funds are brokered deposits to the bank because the nursing home sometimes collects checks from residents, but not the accounting service, this may be somewhat consistent with prior guidance; however, the interpretative letter is curiously silent on this point. The FDIC should clarify how the Primary Purpose Exception works with respect to the nursing home[30] and whether there are instances in which a third-party can place money, be it a commercial enterprise and meet the Primary Purpose Exception. Moreover, the FDIC should opine whether or not a commercial enterprise that exclusively refers clients to a single bank and performs ministerial tasks, like the transfer of funds as directed by the client without direct or indirect compensation from the bank for the transfer, may avail itself of the Primary Purpose Exception, through the Affinity Group Exception, under these circumstances.

FDIC Interpretative Letter 05-02[31] discusses the transfer of funds in part by construing sweeps from a broker dealer to a bank to create brokered deposits, but applies the Primary Purpose Exception if the swept funds meet certain criteria. The broker dealer maintains an omnibus account on behalf of its customers at a bank and free credit balances are placed by the broker dealer in an FDIC insured bank account. The FDIC held that so long as the swept funds do not exceed 10% of the total brokerage accounts, such ratio is applied on a monthly basis and the ratio is not breached during any consecutive months or for more than three months in any 12 month period, the swept funds will meet the Primary Purpose Exception. This test focuses entirely on volatility and ignores the intent of the person placing the funds, which is a valid methodology for approaching the brokered deposit issue, though a significant departure from past guidance. It is unclear if the ability of the broker-dealer to change financial institutions where the deposits are placed is the reason for the criteria because the ability to terminate such a presumably large relationship, no matter how stable, has inherent volatility in it. Also, FDIC Interpretative Letter 05-02 is focused on an omnibus arrangement for the purpose of having the subaccounts receive pass through FDIC insurance and not when a broker dealer is merely performing the administrative function of transferring funds from one client account to another client account at another institution at the direction of the client. This last question about how banks should understand client

---

28 The commercial enterprise part is important because Interpretative Letter 94-11 (1994 WL 393742, F.D.I.C.) had reached the conclusion that "non-profit" status of a person soliciting deposits was determinative whether the entity was a deposit broker because of its activities. Interpretative Letter 94-15 also holds that (a) unless the activity in question comes within one of the statutory or regulatory exclusion, the FDIC must consider the activity deposit brokering and (b) commercial enterprises are not to be exempted from the definition of deposit broker because of the risk that the commercial enterprise may be compensated indirectly and circumvent the rule.

29 1994 WL 566357 (F.D.I.C.).

30 It could not, for instance, be contended that the nursing home meets the criteria of the Affinity Group Exception because (i) the do place handle funds on behalf of residents and (ii) they do track how much has been deposited because they relay the sub-accounting information to the bank.

31 2005 WL 1276372 (F.D.I.C.).

directives to move money from one account to another is particularly important in light of the advent of on-line banking and the ease of wire transfers between institutions executing these orders as opposed to using checks. The FDIC may need to clarify whether it is significant that a bank would execute an on-line transfer request between institutions as opposed to a broker-dealer executing such an order at the client' s request and whether one way results in brokered deposits to the bank, but another would not.

Other Interpretative Guidance Requiring Further Clarification

Some representatives of the FDIC that we have spoken to have suggested that once an account is funded with brokered deposits, the funds must always be accounted for as brokered deposits notwithstanding the inflow and outflow of funds. This conclusion appears to be at odds with FDIC Interpretative Letter 92-69[32] in which a troubled bank asks whether it violates the brokered deposit rule by renewing certificates of deposits that were acquired through a broker. The FDIC in this instance determined that renewing the certificates of deposit did not result in brokered deposits because (i) the broker is no longer involved in the transaction, (ii) the customer must request or acquiesce to the renewal directly and (iii) the certificates of deposit are styled in the name of the customer and not the broker. This logic is consistent with the idea that by renewing the certificate of deposit, the customer is now a customer of that bank and its loyalties are to the bank and not the broker who facilitated the initial transaction. It is SunTrust' s view that the FDIC needs to clarify its position on this matter because it has been advised otherwise by representatives of the FDIC with respect to how accounts that were initially facilitated by a broker are always brokered deposits, for reporting purposes, until the account leaves the depository institution. SunTrust also requests that the FDIC clarify how this rule would operate with respect to products other than certificates of deposit, such as savings and transaction accounts established by a customer through the facilitation of a deposit broker or, in the event the FDIC determines that all amounts swept into a client' s transaction account from that client' s affiliated brokerage account are brokered deposits, when, if ever, those amounts cease to be brokered deposits.

Conclusion

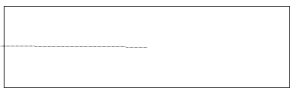
SunTrust always understood the Study as not only an opportunity for the FDIC to suggest proposed legislation to Congress, but also an opportunity to look at past guidance and provide clarifying guidance on rules that may be unclear to the banking industry or update past guidance to reflect changes in law. We hope that the FDIC will take this opportunity to opine on cross-selling and affiliate referrals, as well as how client transfers between accounts at affiliated banks and broker-dealers interact with the brokered deposit rules. As stated above, it is our view that treating affiliates the same as unaffiliated third parties in order to enforce a rule meant to slow growth funded by "hot money" doesn' t comport with the risk associated with these accounts or correspond with how Americans understand financial institutions work for them. Worse, we are concerned that not addressing this issue will mean the significance of the brokered deposit number reported in the Call Report will be unclear to regulators and investors because, to the extent brokered deposits are the result of cross-selling as opposed to high-interest CD' s purchased by a deposit broker, evaluating the riskiness of a financial institution based on brokered deposits will become murkier. Furthermore, there appears to be a policy conflict between the stance the FDIC takes on brokered deposits and the limits on inter-affiliate transactions under Sections 23A and B of the Federal Reserve Act because, ironically, the bank can refer its clients to its affiliates, but an affiliate referring deposits to the bank creates brokered, and thus more expensive, deposits to the bank.

32 1992 WL 813392 (F.D.I.C.)

If the FDIC determines that its hands are tied and it cannot fix its past understanding of brokered deposits, SunTrust would appreciate if its concerns were voiced in your study to Congress and suggest that parts of the rules are outdated and no longer reflect the realities of (i) financial institutions that have both banking and broker-dealer subsidiaries or (ii) how Americans conduct their financial affairs, both on-line and exercising greater control over their funds and how they want those funds allocated. We do note that the Act requires that the Study focus on the definition of "brokered deposits" for the purpose of making deposit insurance assessments, which is a separate issue from the statutory requirement that troubled banks not accept brokered deposits. Therefore, for purposes of understanding which depository institutions have greater volatility in their funding for purposes of risk assessing deposit insurance premiums, SunTrust' s view is that the FDIC is not strictly bound to the statutory definition of brokered deposits that has evolved to serve a different purpose. Instead, the FDIC may choose to keep an expansive understanding of brokered deposits for the purpose of limiting the ability of troubled institutions to source or renew such deposits, but adopt a different definition for the purpose of accurately risk assessing deposit volatility in deposit insurance premiums.

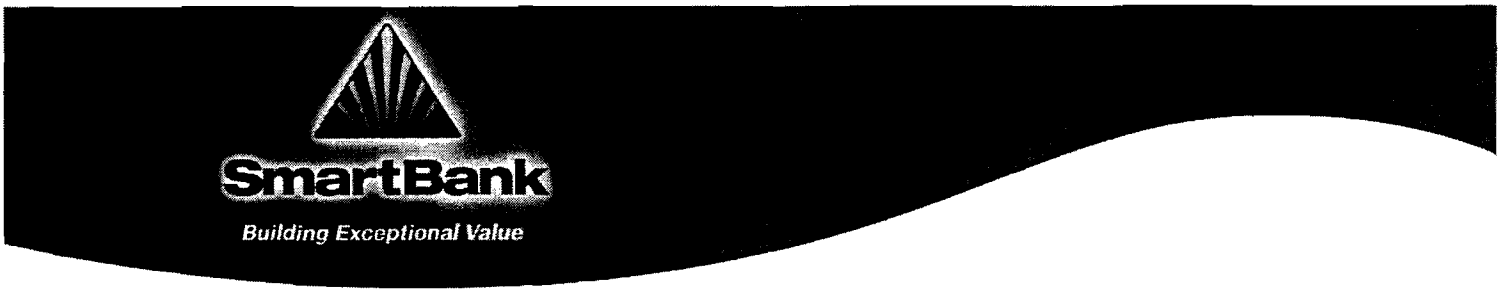
Finally, whatever the FDIC decides, SunTrust can support any decision that is consistently enforced. If the FDIC determines that cross-selling by broker-dealer and bank affiliates results in brokered deposits, then so long as we are on an even playing field with our competitors, we can live with this. While such a decision may not yield meaningful information with respect to the underlying riskiness of deposits at an institution or, to the extent depository institutions must adopt procedures to avoid tainting client funds as brokered deposits such as issuing checks to clients to move funds between accounts at affiliated entities, frustrating clients, knowing that our competitors faced the same requirements, obstacles and choices would be helpful. To this end, guidance on how long a brokered deposit that results from the referral of an affiliated broker-dealer remains a brokered deposit on the books of the affiliated bank for a variety of ordinary financial products would be appreciated.

Regards,

(b)(6) 

McHenry Kane

Cc: Ray Fortin
Jim Sproull
Aleem Gillani
Martha Suggs



April 29, 2011

VIA ELECTRONIC COMMUNICATION

The Honorable Sheila C. Bair, Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Dear Chairman Bair:

Thank you for inviting the public to provide comments as part of the FDIC's Core and Brokered Deposit Study as mandated by Section 1506 of the Dodd-Frank Wall Street and Reform Consumer Protection Act (the "Dodd-Frank Act"). I am respectfully submitting comments on behalf of SmartBank.

First, I will provide a brief background of SmartBank. Then, I will provide some preliminary comments regarding the commoditization of deposits. Finally, I will address each question on which the FDIC has sought comments from the public.

Background

SmartBank was chartered in January 2007, and is headquartered in Pigeon Forge, Tennessee. As of March 31, 2011, our bank had $292 million in assets. We are located at the foothills of the Great Smoky Mountains National Park, and, not surprisingly, our local economy is heavily dependent on tourism.

During our first four years, SmartBank has relied on brokered deposits (including CDARS reciprocal and one-way buy) and deposits gathered through the use of a deposit listing service. Despite our use of certain types of deposits during this period of rapid growth, our bank has grown in a safe and sound manner as evidenced chiefly by the credit quality of our loan portfolio.

SmartBank was profitable by our third year of operation, and our profitability has increased at an accelerated rate since then. We expect to become cumulatively profitable during the second quarter of 2011.

FDIC Comments – Page 2

Commoditized Deposits

Several of the questions below use the phrase "certain kinds of deposits," which are parenthetically described as "brokered, internet, and listing." As a threshold matter and for clarity's sake as it relates to our responses below, we will frequently use the term Commoditized Deposits in our responses. What follows is a brief explanation of what a Commoditized Deposit is, and in one case, what it is not.

We consider Commoditized Deposits to include the following:

- Brokered CDs
- CDARS One-Way Buys
- Above-market rate CDs
- CDs with no (or low) early withdrawal penalties
- Listing service CDs (e.g., Qwickrate)

We do not believe that internet deposits are necessarily Commoditized Deposits, particularly checking accounts. Many customers have banked remotely for many years, first through the mail and then through an internet channel.

In times of financial stress, what types of deposits are likely to remain at an institution and what types of deposits are likely to leave the institution?

In times of financial stress, deposits that are likely to leave an institution generally have some or all of the following characteristics:

- Uninsured
- Highly sensitive to changes in interest rates
- No or low financial penalty for withdrawal
- No or low "hassle" to change to another bank
- Accountholder has no personal relationship with the bank

On the other hand, deposits that are likely to remain at an institution generally will have some or all of the following characteristics:

- Insured
- Less sensitive to changes in interest rates
- Significant financial penalty for early withdrawal
- A real or perceived difficulty to move the account to another bank
- Accountholder has a personal relationship with the bank

FDIC Comments – Page 3

Does the presence of certain kinds of deposits (e.g., brokered, internet, listing service) inherently increase an institution's risk?

No. The presence of Commoditized Deposits alone does not inherently increase an institution's enterprise risk. The presence of Commoditized Deposits, however, can affect – but does not necessarily increase – certain *sub-categories* of enterprise risk (e.g., liquidity risk, interest rate risk, etc.).

In our local market, we find that it is extremely difficult, especially in a depressed rate environment, to find depositors who are willing to extend the maturities of their time deposits. What we are unable to accomplish in our own market can be accomplished in the brokered market. Thus, we are able to decrease our interest rate risk profile by using Commoditized Deposits, particularly brokered deposits.

Certain federal regulations disfavor certain types of Commoditized Deposits, and this in turn increases an institution's liquidity risk profile. Regulations which come into effect when an institution is less than well-capitalized (1) limit an institution's access to the brokered market and (2) restrict the rate that can be paid on deposits based on a national rate cap.

By way of example, let's assume that we have two financial institutions, Bank A and Bank B, both of which use a liability-based liquidity strategy. Bank A accepts brokered deposits, while Bank B does not accept brokered deposits. Assuming all else is equal, Bank's A liquidity risk profile is more risky than Bank B's. But what is the cause?

In the example above, federal regulations are driving the increased liquidity risk at Bank A, not the deposit type. Nothing is inherently more risky about a brokered deposit. Federal regulations simply make them that way. Absent the regulations, the liquidity risk profile of Bank A would not be greater than that of Bank B. In fact, one could reasonably argue that Bank A's liquidity profile would be lower than Bank B's because, according to Roundtable Participant Mr. Jacobsen, at least some brokered depositors will deposit funds at any institution "as long as there's a gold eagle on the glass door."

In any event, a bank that properly manages its liquidity risk does not necessarily have an elevated enterprise risk profile.

Does the presence of certain kinds of deposits (e.g., brokered, internet, listing service) facilitate increased risk-taking?

No. The mere presence of Commoditized Deposits does not facilitate increased risk-taking as it relates to bank assets. At its most basic, the rate a bank charges on a loan is determined by the level of risk to its capital. Banks that engage in safe and sound lending practices do not take into consideration what types of deposits are used to fund its loans when deciding whether to extend credit or what rate to charge.

FDIC Comments – Page 4

Some banks that accept brokered, internet or listing service deposits do engage in unsafe and unsound lending practices, but the presence of those types of deposits does not necessarily facilitate increased risk-taking. In general, bankers who engage in unsafe and unsound lending practices are not motivated to do so simply because they have certain types of deposits. In fact, some financial institutions have engaged in unsound and unsafe lending practices even though the institution has no brokered deposits, no internet deposits, and no listing service deposits.

The key point is that some bankers will run unsafe and unsound banks, regardless of the types of deposits they use to fund their loans. In such a case, the problem is not the deposit type; the problem is the banker. Bank regulators have the necessary tools to address unsafe and unsound banking practices without categorically disfavoring certain types of deposits.

What types of deposits are likely to enhance a failed institution's franchise value and what types of deposits are likely to reduce it?

A deposit with some or all of the following characteristics is likely to enhance a failed institution's franchise value:

- Transaction account
- Below-market interest rate
- Matched off closely, individually or in the aggregate, to a particular income-producing asset or assets

On the other hand, a deposit with some or all of the following characteristics is likely to reduce a failed institution's franchise value:

- Time deposit for which the owner has no other deposit products at the financial institution
- Above-market interest rate
- Poorly matched off, individually or in the aggregate, to a particular income-producing asset or assets

What recommendations would you make for legislative or regulatory changes with respect to core and brokered deposits?

We believe that deposit insurance is a vital component to the stability of the U.S. banking system. As with any insurance product, the insurers should be adequately compensated for the risk assumed. During the FDIC's Roundtable on Core and Brokered Deposits held on March 18, 2011, Mr. Isaac, Former FDIC Chairman, stated:

> *[T]he question is: Can we afford deposit insurance without...any restrictions? And we've got a lot of aggregators out there now that are taking the deposit insurance limit well beyond $250,000 to millions and billions. Can we afford it? And if not, should we allow it?...Is the system coherent anymore? Or do we need to really do something to*

FDIC Comments – Page 5

change it in a fundamental way? I happen to think it's the latter, we need some fundamental changes.

While we do not agree with Mr. Isaac on all matters related to core and brokered deposits, we do agree that the insurance system should be changed in a fundamental way. However, in recognition of the narrowly tailored purpose of the study mandated by the Dodd-Frank Act, our recommendations for legislative and regulatory changes are limited to those specifically related to core and brokered deposits.

Absent a fundamental change to the insurance system, as Congress and the FDIC consider revisions to current statutes and regulations, we ask that you consider the following:

- Increasingly, deposits that traditionally would have been held at community banks are moving to internet banks in pursuit of higher yields. Technology is leading to the commoditization of deposit products, particularly non-transaction deposit products such as money market accounts, savings accounts, and time deposits. We expect this trend to continue at an accelerating pace.
- At the same time, community bankers remain the principal lenders to small businesses. Many markets, including our own, do not have sufficient deposits to support the small business lending needs of our local economy.
- Unless community bankers in these "net loan markets" can reasonably access Commoditized Deposits, the lending needs of their local economies will be unmet and our local and national economies will suffer. In addition, the community bankers will be forced to pay higher rates to keep deposits, which reduces net interest margin, hinders capital growth, and increases enterprise risk. In fact, the higher a bank has to pay for a local deposit, the more and more it is going to look like a Commoditized Deposit.
- Large national financial institutions may issue CDs at a branch in a net deposit market and in turn lend those funds to borrowers in a net loan market. At a community bank, Commoditized Deposits are the equivalent of a distantly located bank branch.
- Commoditized Deposits allow for efficient redistribution from net deposit markets to net loan markets.

If you have any questions, please do not hesitate to contact me at [redacted] or [redacted] (b)(6)

(b)(6) [redacted]

Kind regards,

(b)(6) [redacted]

William Y. Carroll, Jr.
President/CEO

FARM BUREAU BANK

April 29, 2011

Via e-mail (coredepositstudy@fdic.gov)

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

RE: Study and Report on Core Deposits and Brokered Deposits

Ladies and Gentlemen:

Farm Bureau Bank, FSB (the "Bank") appreciates the opportunity to comment as part of the study the Federal Deposit Insurance Corporation ("FDIC") is conducting on core deposits and brokered deposits, as required by Section 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] ("Section 1506"). As explained in more detail below, we ask that any regulatory or legislative changes recommended in your report under Section 1506 avoid disfavoring deposits referred from within an affinity group, such as the Farm Bureau.

The Farm Bureau and the Bank

The Farm Bureau is a collection of over 2,800 cooperative organizations governed by, representing, and serving farm, ranch, and other rural families across the United States. Each state has an independent Farm Bureau federation, which is organized as an alliance of local, county, and state nonprofit organizations. This alliance makes cooperative services available to its members through a variety of related entities.[2]

Members of the Farm Bureau pay a membership fee to their local Farm Bureau. Representing 6.2 million member households, the Farm Bureau's mission is to provide "the unified voice of agriculture, working . . . to enhance and strengthen the lives of rural Americans and to build strong, prosperous agricultural communities." Attachment A illustrates the reach of the Farm Bureau's membership in the 43 states that endorse the Bank and recommend its products to member households.

[1] Pub. L. No. 111-203, § 1506, 124 Stat. 2222.

[2] Services made available to Farm Bureau members include: (i) various insurance products, including automobile, home, health, life, and crop insurance; (ii) vehicle and agricultural equipment discount purchase programs from Ford, GM, Dodge, and Case IH; (iii) cooperative agricultural commodities marketing programs; and (iv) other member service programs, such as fertilizer purchases, hotel discounts, tax preparation services, and other member group buying services.

The Bank was chartered in 1999 to provide banking services to Farm Bureau members. By marketing its products and services primarily through the network of Farm Bureau organizations, the Bank is able to minimize overhead costs and maintain an efficiency ratio of less than 52 percent, which is substantially below its peers. The Bank is wholly owned by FB BanCorp, a savings and loan holding company. The American Farm Bureau and Farm Bureau organizations representing 23 states provide the capital support for FB BanCorp and the Bank. The Bank serves approximately 192,000 households in all 50 states. Attachment B illustrates the geographic reach of the Bank's deposit account customers.

The Bank's Primary Source of Deposits are Farm Bureau Referrals

The Bank's acquisition of new deposit accounts depends on the network of Farm Bureau organizations and focuses on the preexisting relationship that potential customers have with the Farm Bureau. The Bank creates awareness through advertising in Farm Bureau publications, exposure at various Farm Bureau member meetings, and direct mail and statement inserts in Farm Bureau mailings and billings.

Various people within the Farm Bureau organization refer Farm Bureau members to the Bank. These people include county Farm Bureau secretaries, Farm Bureau customer service representatives, Farm Bureau insurance agents, Farm Bureau member volunteers, and Farm Bureau member services staff (collectively "Referral Agents"). Most of these Referral Agents work in one of over 4,000 local Farm Bureau offices that have been established to provide member benefits and other services to members. Whatever their individual titles may be, Referral Agents have a common and primary purpose—promoting the Farm Bureau and helping farmers and ranchers collectively to benefit from their membership in the Farm Bureau.

Referral Agents assist in referring new deposit accounts by answering questions about the Bank's products and services, generally providing information about rates and terms through the use of a computer terminal in the Farm Bureau office, and helping to forward completed applications to the Bank. Referral Agents do not open accounts or have any role in evaluating the applications. Customers open accounts and place their deposits directly with Farm Bureau Bank.

The Bank compensates the Referral Agents with a modest fee that is designed to cover the cost of their referral activity. It is important to note that the Referral Agents' primary business is not the referral of deposit account customers to Farm Bureau Bank or any other bank and that their compensation for such referral activity is very small. In addition, the Referral Agents do not refer members or clients to any other banking institution, as they have an exclusive referral arrangement with Farm Bureau Bank.

Core Deposits Required to be Reported as Brokered Deposits

For years the Bank relied on the affinity group exception to the deposit broker rules, but since 2009 the Bank has been required to report all deposits as brokered deposits when a Referral Agent receives compensation. Even the Bank's checking and savings accounts are reported as brokered deposits if a Referral Agent is compensated for referring the Farm Bureau member to the Bank.

As you know, the term "brokered deposits" is defined administratively as any deposit obtained through the assistance of a deposit broker.[3] The term "deposit broker" is, in turn, broadly defined in Section 29 of the Federal Deposit Insurance Act ("Section 29") to include anyone engaged in the business of facilitating the placement of deposits with a depository institution.[4] The FDIC has, by interpretation, created an affinity group exception to the definition of "deposit broker." As originally articulated by FDIC General Counsel Alfred J. T. Byrne, the factors relevant to determining when third parties are affinity groups are:

> (a) . . . Affinity Groups are non-financial institutions, and the vast majority are non-profit organizations;
>
> (b) . . . none of the Affinity Groups directly markets the deposit products for the Bank;
>
> (c) . . . Affinity Group members who decide to place deposits with the Bank do so directly with the Bank (the Affinity Groups do not receive funds from their members for deposit with the Bank or otherwise process any member deposits);
>
> (d) . . . the Affinity Groups have exclusive relationships with the Bank and do not endorse deposit products of other institutions;
>
> (e) most, but not all, of the Affinity Groups receive royalties for endorsing the Bank's deposit products, the amount of which represent[s] a small fraction (in the order of ***)[5] of the market rates paid to others who are considered deposit brokers within the meaning of section 29 of the FDI Act;
>
> (f) . . . historically, as reported by the Bank, the retention rate for endorsed money market accounts obtained from Affinity Group members ranges from 80% to 85% and for certificates of deposits from 60% to 75% and such accounts and deposits are regarded by the Bank as core deposits of the Bank and are not used to replace core deposit run-off; and
>
> (g) . . . the Affinity Groups do not know which members have made deposits with the Bank, nor do they keep any records of the amounts, rates or maturities of the deposits.[6]

---

[3] 12 C.F.R. § 337.6(a)(2).

[4] 12 U.S.C. § 1381f(g)(1); *see* 12 C.F.R. § 337.6(a)(5)(i).

[5] Although the amount of compensation was redacted from the original legal opinion, a later legal opinion expressly stated that certain clubs, which received compensation of 8 to 10 basis points on all deposits referred, would qualify as affinity groups if they changed certain marketing practices. FDIC Legal Opinion 93-71 (Oct. 1, 1993).

[6] FDIC Legal Opinion 93-30 (Jun. 15, 1993).

The Farm Bureau qualifies as an affinity group under all of these criteria. However, since 2009, after discussion with FDIC staff which generally affirmed the use of the affinity exception by the Bank, the FDIC has applied the compensation element differently, requiring that any compensation paid to an affinity group be a flat fee, which is a fee that is not calculated on the basis of the number or dollar amount of deposits. It appears as though this requirement comes from a separate line of FDIC legal opinions that consider when a listing service is a deposit broker.[7] The Bank has developed new metrics for compensation that would qualify as flat fees under the FDIC's more recent position, but the calculation is very complicated and so costly to implement that the Bank currently reports all new deposits referred by Referral Agents as brokered deposits. This includes virtually all of the Bank's new core deposits, such as checking accounts, money market deposit accounts ("MMDAs"), and small-balance certificates of deposit ("CDs").

To the Bank, the important point is that restructuring the compensation paid to the Farm Bureau entirely misses the point—deposits referred from within the Farm Bureau network should not be treated as brokered deposits. They are core deposits that meet all of the criteria for stable, reliable, and long-term deposits.

The Bank's Deposits are Stable

The Bank's deposits exhibit the characteristics of core deposits, which are "generally stable, lower cost funding sources that typically lag behind other funding sources in the need for repricing during a period of rising interest rates."[8] These characteristics include: (i) strong, overlapping, and reinforcing relationships between depositors and the Bank and the Farm Bureau; (ii) no reliance on pass-through insurance or aggregators; (iii) relatively small account balances; (iv) stable account balances; and (v) high retention rates.

As the FDIC has recognized, deposits tend to be more stable when they are the funds of local customers that also have a borrowing or other relationship with the depository institution.[9] A typical customer receives multiple products from the Bank, which in addition to deposit products include agricultural equipment loans, credit cards, installment loans, and agricultural lines of credit. The use of multiple Bank products signals a level of trust between the Bank and its customers. In addition, the typical Bank customer has a strong relationship with its local Farm Bureau organization and accesses various other services through the Farm Bureau network. Experiences with each of these member services reinforce the customer's ongoing and overlapping relationship with, and loyalty to, the Bank and other Farm Bureau organizations.

Customers referred to the Bank from within the Farm Bureau open their accounts and interact directly with the Bank. Neither the Farm Bureaus nor anyone else aggregates

[7] *See* FDIC Legal Opinion 04-04 (Jul. 28, 2004).

[8] Division of Supervision and Consumer Protection, FDIC, "Liquidity and Funds Management," *Risk Management Manual of Examination Policies* 6.1-7 (Dec. 2004).

[9] *Id.*

members' deposits to place them with the Bank. Accounts referred from within the Farm Bureau do not rely on pass-through insurance because they are directly placed by the depositor yet approximately 99.9 percent of all Farm Bureau members' deposits at the Bank are FDIC-insured.

The Bank's deposit accounts have relatively small balances—they are not jumbo deposits, which are typically associated with deposit brokers. Of the Bank's total CD balance, 80 percent is in accounts having balances of less than $50,000 and 93 percent is in accounts having balances of less than $100,000. The average CD account balance is $28,793. For interest bearing checking accounts and MMDAs, the average balances are $1,651 and $21,035, respectively. Additional details about the Bank's deposit account balances are provided in Attachment C.

The Bank's deposit accounts have stable balances. Even during the past few years, which have been a time of unprecedented stress in the banking industry, MMDA balance retention rates have remained over 57 percent for 4 years after account opening. Similarly, transaction account balance retention rates are over 90 percent. Additional details about the Bank's account balance retention are provided in Attachments D and E.

The Bank's deposit accounts have high retention rates. More than 85 percent of the Bank's MMDAs and transaction accounts remain open after one year. Over the past 8 years, well over 70 percent of the Bank's CD accounts were renewed at maturity. Among CDs with maturity dates of less than one year, the retention rate has consistently been at 80 percent. Additional details about the Bank's account retention rates are provided in Attachments E, F, G, and H.

Thus, deposits referred to the Bank from within the Farm Bureau have the characteristics of stable deposits and should not be classified as brokered deposits.

Recommendations

As the charter held by the Bank demonstrates, the business landscape has changed since Section 29 was adopted, creating a situation where the statute does not precisely match the concerns it was designed to address. When originally enacted, Section 29 focused on the involvement of a third party and intentionally defined "deposit broker" in a "broad and far-reaching" manner because Congress's approach to regulating volatile deposits was to require all deposit brokers to register with the FDIC.[10] Even though the deposit broker registration requirement was repealed in 2000,[11] the legal framework remains focused on the involvement of a third party and retains the same broad definition of "deposit broker." For the Bank, this results in its core deposits being treated as brokered deposits.

[10] FDIC Legal Op. 90-21 (May 29, 1990).

[11] Financial Regulatory Relief and Economic Efficiency Act of 2000, Pub. L. No. 106-569, § 1203, 114 Stat. 3032.

April 29, 2011

Diane Ellis
Financial Risk Management and Research, Deputy Director
Federal Deposit Insurance Corporation
coredepositstudy@fdic.gov

Re: Study of Core and Brokered Deposits

Dear Ms. Ellis:

United Services Automobile Association (USAA), on behalf of its bank subsidiaries, USAA Federal Savings Bank and USAA Savings Bank (referred to jointly as the Bank), is pleased to provide our comments with respect to the Core and Brokered Deposit study that the Federal Deposit Insurance Corporation (FDIC) is mandated to conduct by section 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

USAA is a member-owned association. Our members include present and former commissioned and noncommissioned officers, enlisted personnel, retired military, and their families. Since its founding in 1922 by a group of U.S. Army officers, USAA has been a different kind of financial services provider, pursuing a mission of facilitating the financial security of our members and their families by providing a full range of highly competitive financial products and services, including insurance, retail banking and investment products. Our core values of service, honesty, loyalty and integrity have enabled us to perform consistently and be a source of stability for our members, even in the midst of the unprecedented financial crisis of recent years.

I. Summary

The Dodd-Frank Act charges the FDIC with evaluating the definitions of and differences between two "types" of deposits – brokered and core. In this letter, we urge the FDIC to re-think its methodology of relying on "types" to characterize the risks associated with deposits. Using a methodology based on "types" of deposits over-simplifies the complexity of financial institutions and deposit accounts and inappropriately measures risk. Specifically, our letter advocates that a new framework for the supervision of funding risks be built, and we urge the FDIC to incorporate into this framework USAA's own experience that:

1. The primary driver of retention is the depth of the customer relationship with the Bank and its financial services affiliates as a whole, and not the type of deposits.

2. Balances for accounts opened by employees of third-party call centers acting on behalf of the Bank, over the internet, or by employees of the Bank's financial services affiliates are as stable as those opened by Bank employees.

Defining "types" of deposits by reference to the manner in which a deposit account is first opened places undue emphasis on one small event – the opening of the account – and fails to appreciate the impact of the multitude of other interactions with customers on the retention of deposits. It is an outdated approach that needs reshaping to a more modernized risk-based assessment.

It is, therefore, our recommendation that the FDIC not regulate accounts based on how they are opened, but address overall risk management of funding sources.

II. The Depth of Relationships is the Primary Driver of Retention

We have studied the question of customer retention for many years, and we have concluded that the primary driver of the retention of our deposits is the nature and depth of a customer's relationship with the Bank and with USAA as a whole. Our experience during the recent financial crisis only reinforced this conclusion.

A. USAA depends on its long-term relationships with American military families

USAA focuses on a mission of supporting American servicemembers. USAA's Bank lacks a conventional branching structure or traditional physical presence in its members' communities. USAA was founded to provide stable financial services for the inherently mobile military families regardless of their constantly changing physical locations. As a result, the Bank operates nationwide, primarily over internet and mobile applications, and via telephone from the USAA campus in San Antonio. Yet, despite (and perhaps *because of*) the absence of conventional branches or lack of a need for traditional physical presence, the Bank remains successful in building strong relationships with U.S. military service-members and their families.

As part of our effort to be responsive to the needs and interests of our members, we closely study the factors that influence a member to stay with USAA or to leave and seek products from other institutions. Like all responsible financial institutions, we know that we depend on long-term relationships, and we are successful only to the extent that our members and their families are well served.

B. Retention rates are closely linked to strong USAA member relationships

USAA's member retention rate is over 98%, and we believe that the Bank has one of the highest deposit retention rates in the industry. The principal reason for our success in retaining depositors is not the manner in which a deposit account is opened, but rather the relationship that we create with our members. That relationship is an outgrowth of USAA's mission – to

facilitate the financial security of our members, the U.S. military community, through provision of a full range of highly competitive financial products and services. But more than the link with our members that is created by our shared vision, is our level of service and our focus on constantly strengthening the relationship with those members.

The information we generated in studying our own operations leads us to believe there are three principal reasons why accounts are retained and they bear no relationship to the "type" of account:

1. *Account utilization strengthens retention*

We have found that the more a depositor utilizes an account, the more likely the depositor is to keep the account. For example, the extent to which the depositor uses direct deposit or an associated debit card has a positive impact on whether the depositor will keep the account.

2. *Bank product diversity strengthens retention*

Our data indicates that if a depositor uses at least one other non-deposit banking product, that depositor is more likely to keep deposits in the Bank. A depositor who also has, for example, a home loan, credit card or auto loan, is much more likely to keep deposits in his account than a depositor who has only deposit products.

3. *Affiliate product diversity strengthens retention*

Our data indicates that a depositor who uses the products of affiliates is more likely to retain Bank deposit balances. For example, a depositor who also has bought auto or home insurance or who obtains investment products or services from one of the Bank's affiliates is much more likely to keep Bank deposit balances.

C. Integration of member services is key to strengthening member relationships

Based on information generated by studying our members, in 2009 we commenced efforts to strengthen our ability to respond quickly and comprehensively to all of the financial needs of our members. To do this, we created a corps of highly trained, qualified and licensed service representatives who provide an immediate, integrated and comprehensive response to member needs across multiple product lines. These representatives are employed by an affiliate of the Bank to enable the handling of insurance, banking and/or investment needs more efficiently. But, because deposits opened by these representatives are considered "brokered" because the reps are not direct employees of the Bank, the current rules significantly undermine our efforts to provide heightened service to our members.

There are numerous examples in which using a "type of deposit" methodology results in a stable and enduring deposit being improperly characterized as brokered. USAA has seen many instances when a soldier calls a USAA service representative to ask a question about his insurance policy. In the course of that conversation, the representative may realize, perhaps because the soldier is about to receive a claims settlement or re-enlistment bonus, that the soldier also needs to open a deposit account. Considering the communication difficulties that such calls entail, transferring the member to a Bank employee to address those needs runs a significant risk that information will be lost or the member's call will be dropped and his needs will go unaddressed. Yet, if the same service representative opens the account, it will be considered a brokered deposit simply because it was opened by a non-Bank employee. USAA should not need to transfer those calls when providing comprehensive integrated service. One call strengthens the relationship with the member, which in turn strengthens the retention of the deposit account.

D. The FDIC should study and evaluate factors that influence retention or loss of deposits

The strengthening of the relationship with USAA members is shown by the number of connections that we create with our members. For example, bank depositors:

1. Use multiple banking tools such as direct deposits and debit cards.

2. Obtain multiple Bank products, including credit cards, home equity, auto or other loans.

3. Acquire other USAA financial products, including insurance, investments and retirement advice.

Ultimately, we believe that success in providing numerous connections with members is the primary reason behind exceptional retention rates and the reason our Bank's retention rates are higher than our peers. In our experience, multiple connections between depositor, Bank and the Bank's affiliates increases the likelihood that the depositor will retain the deposit account at the Bank.

We recommend that the FDIC conduct a larger study to evaluate the factors that we have seen influence retention or loss of deposits.[1] To the extent that these factors are evident among institutions with high retention rates, and lacking in institutions that have lower retention rates, we would suggest that the FDIC conclude and report to Congress that these factors are more relevant to the riskiness of deposits as a funding source than the manner in which a deposit account is first opened.[2]

---

[1] This larger study could ask for business information on a confidential basis from a cross section of the banking industry. We would be happy to participate in such a detailed study if given adequate assurances of confidentiality.

[2] The FDIC's study should also address the extent to which depository institutions no longer rely on deposits as the sole source of funding, but rely instead on funding from loan sales and securitizations. Any evaluation of the risk of

III. The "Types" Of Deposits – How a Deposit Account is Opened – Should not be Used to Characterize the Instability and Riskiness of Deposits

We have studied information regarding retention of our depositors' balances to evaluate whether retention depends on the way in which a deposit account was opened. We believe that the primary driver of retention is *not* the manner in which the account was opened. Rather, the principal force is the relationship of the customer with the Bank and its affiliates.

A. Accounts opened through alternate origination channels are as stable and enduring as accounts opened by Bank employees

We have tracked the retention of Bank deposit balances and correlated that information with whether the accounts were opened (1) by the Bank's full-time employees, (2) by trained service representatives at a call center run by an outside vendor, (3) over the internet, or (4) by qualified representatives at insurance and investment management affiliates of the Bank.

We made sure we were comparing apples to apples. Across all these originating channels, there was *no* difference in the nature of the deposit products offered, the account terms or conditions, including the rate, or how the accounts were serviced by the Bank after the accounts were opened.

Over the period studied, we found that the balance retention of accounts opened through any of the alternate origination channels were *as stable* and enduring as Bank-employee-opened accounts.

1. Deposits generated by non-commissioned third-party call center employees acting on behalf of the Bank are as stable and enduring as Bank-employee generated deposit accounts

It came as no surprise that deposits made through a third-party call center perform as well as accounts opened by full-time Bank employees because (1) calls are routed randomly to the third-party call center on an overflow basis and (2) callers are unaware that the call is handled by someone other than a full-time Bank employee.

Third-party call center representatives receive the same training as Bank employees and no commissions are paid to such third-party call center representatives, whether based on the number or dollar amount of the deposit accounts opened or otherwise. So there is no reason to expect that the "brokered" deposits received through this channel would behave differently than

---

a bank's failure, or increased losses, because of funding risks should reduce the emphasis and focus on the riskiness of an institution's deposits when deposits are not the primary source of risk. The evaluation instead should consider in a balanced way the risks of all funding sources.

"core" deposits received by full-time Bank employees – yet the Bank is required to report and treat these deposits as brokered. Our data show that the deposits behave just as well, and we believe these deposits should be treated the same as bank-employee generated deposits.

2. *Internet originated deposits are as stable and enduring as bank-employee generated deposit accounts*

Internet-originated deposits behave like accounts opened through other channels and are as stable and enduring as Bank-employee originated accounts. Regardless of how an account is opened, every member has full access to the account online. In a sense, *every account becomes an internet account* once the account has been opened in *any* channel.

In addition, as discussed above, the extent to which a depositor makes multiple connections with USAA and the extent to which USAA is able to make ongoing contacts with the member, *e.g.*, through electronic banking tools, the stronger the relationship with the depositor and the more likely he or she will keep the deposit account. Such connections are much more predictive of retention than how the account was opened.

So, again, it came as no surprise to us that if deposit accounts were defined by "type" as "internet" because the accounts were first opened over the internet, the retention of those deposits was at least equivalent to those opened by Bank employees.

3. *Deposits generated by non-commissioned employees of financial services affiliates are as stable and enduring as bank-employee generated deposit accounts*

As with the third-party call center employees, the representatives of the financial services affiliates of the Bank do not receive a commission based on the number or amount of accounts opened with the Bank. Rather, their focus is on addressing the entirety of a member's needs for financial services.

Accounts opened through these affiliate representatives also reflect balance retention on par with the accounts opened by Bank employees. Yet, along with the accounts opened through the third-party call center, the Bank is required to report and treat these accounts as "brokered" deposits – and therefore treat them as a higher regulatory risk – despite the fact that they are *not* more risky, from a funding, liquidity or retention perspective, than the Bank's "core" deposits.

B. Internet originated accounts are a valuable asset to the Bank and, therefore, would be valuable to an acquiror

We recognize that the FDIC has raised the question of whether internet deposits are less valuable in an acquisition context than deposits opened in branches. Our sense is that the value of the account should depend on the way the account performs, rather than how it was opened. If a relationship exists between the Bank and the customer, and the services and products to which

the customer has become accustomed continue to be provided post-acquisition, the fact that the account was opened online should be of no concern. In this case, the deposit should provide the same value to the acquiror as it did to the original bank. Obviously, all "types" of deposit accounts, core, brokered, or internet, are at risk if a successor institution fails to provide the same products and support for the relationship on which the customer initially depended.

C. The manner in which the account was opened does not lead to instability

USAA believes that depositors are much more likely to stay with a bank, regardless of whether the account was originally opened by a bank employee, over the internet, by a vendor call center, or by an affiliate who provides non-banking services to customers, if other indicia of customer involvement are considered. Our data supports the conclusion that the manner in which an account is opened does not lead to instability. We believe the same holds true even in times of financial stress.

IV. New Legislation and Regulations Should Address Overall Risk Management of Funding Sources, not Restrict Accounts Based on how They are Opened

A. Excessive growth strategies lead to bank failure, not how an account was opened

Our data suggest that studies previously performed by the FDIC and other analysts are suspect in finding a connection between brokered deposits and failures or increased losses, because those studies ordinarily take as a given the amount of deposits that are listed as brokered on an institution's call reports. From our study of our own deposits, we can tell that a large amount of deposits that are required to be characterized as "brokered" under current rules have *no impact* on liquidity risks. Rather, accounts opened in several ways (that count as "brokered") are just as stable and enduring and perform in all respects like other "core" deposits of the Bank. We expect that any study using call reports as the primary source of data will therefore improperly characterize a significant number of non-risky deposits as though they were volatile and likely to disappear in a crisis.

We note that the FDIC, even though it seems to have relied on such data in its deposit insurance premium rulemaking, found that a significant use of brokered deposits was associated with higher rates of bank failure – but *only* when accompanied by high rates of growth. We believe that assigning higher premiums for brokered deposits or restricting the use of these funding sources wrongly focuses on the deposits rather than the excessive growth that underlies the risk of bank failure.[3]

---

[3] This is consistent with the conclusions in "Decomposing the Impact of Brokered Deposits on Bank Failure" Clifford V. Rossi, PhD, University of Maryland Robert H. Smith School of Business (September 9, 2010) (Study prepared for the Anthony T. Cluff Fund of the Financial Services Roundtable).

B. The FDIC should focus on an institution's risk management from funding sources

The FDIC should view deposits in the context of an institution's management of its overall risks from its funding sources. In the case of a multitude of "types" of deposits now viewed as brokered and therefore risky (which perhaps the FDIC views as including "internet" deposits), USAA has found that these "types" of deposits are no more risky than any "core" deposit of the Bank.[4]

Fundamentally, the FDIC should approach the liability side of the balance sheet in much the same way that it approaches the asset side. Each institution is expected to undertake a risk management analysis with respect to its risk taking, growth strategies, and funding sources, including sources other than deposits, and appropriately manage those risks. The FDIC has greater access to data with respect to all institutions and especially with respect to institutions that failed (since FDIC is the receiver every time), than any one institution or analyst. So we recommend that the FDIC not only obtain comments from the industry and other interested parties, but also conduct detailed analyses of the likelihood that an institution will lose deposits once it becomes a troubled institution, and the factors influencing those risks, including account utilization and product penetration.

V. Conclusion

The current rules on brokered deposits ignore what we have learned is the fundamental driver of stability in deposits – the relationship between the depositor and the financial institution as a whole. By striving to satisfy all of a member's needs for financial services and thereby building relationships with the customer across the USAA brand, including enabling the member to address insurance or investment needs, reduces the likelihood that the member will withdraw his deposits. We believe stability of the relationship would be strengthened to the extent that a member is able to talk to one representative who can address *all* of the member's financial needs.

We urge the FDIC to conclude that a focus on the manner in which deposits originate is a false, archaic, and overly simplistic approach to risk management and one that fails to take into account the changes in corporate affiliations permitted under the Gramm-Leach-Bliley Act as well as the advances in technology, including internet and mobile banking, that enhance the ability of Bank customers to build sustainable relationships with financial institutions without walking into physical spaces. Each institution's funding risks should be measured as a whole and any variance in deposit insurance assessments levied on a risk evaluation more meaningful than just whether the account was opened by an employee of the depository institution.

---

[4] We recognize that some "types" of deposits, in the sense that they are obtained under certain structures or relationships, may involve a higher liquidity risk – such as bulk deposits at high rates placed by brokers for a fee where no banking institution has a significant relationship with the depositor. But the risk of even these deposits must be put into the context of the bank's management of its liquidity risk as a whole.

USAA appreciates the opportunity to provide comments with respect to the FDIC's Core and Brokered Deposits study. If you have any questions regarding our comments, please do not hesitate to contact the Bank's General Counsel, Deneen Donnley at (b)(6)

Sincerely,

(b)(6)

Steven Alan Bennett
Executive Vice President
General Counsel & Corporate Secretary

INDEPENDENT COMMUNITY BANKERS *of* AMERICA

April 29, 2011

The Honorable Sheila Bair
Chairman
Federal Deposit Insurance Corporation
550 Seventeenth Street, NW
Washington, D.C. 20429

Re: Study on Core Deposits and Brokered Deposits

Dear Chairman Bair:

The Independent Community Bankers of America[1] (ICBA) welcomes the opportunity to comment on the study that the FDIC is conducting on core and brokered deposits as required under Section 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Among other things, the Dodd-Frank Act requires the FDIC to evaluate (1) the differences between core deposits and brokered deposits and (2) the potential effect on the Deposit Insurance Fund and on local economies of revising the definitions of brokered deposits and core deposits.

ICBA's Position

ICBA commends the FDIC for holding the March 18th Roundtable discussion on this important issue. We agree with many of the comments that community bankers made at the Roundtable discussion.

For instance, we agree that the definitions of core and brokered deposits are outdated because changes in technology have resulted in new and different ways that banks attract deposits. The notion that most of a bank's branch deposits are derived without the use of some intermediary may have been true twenty years ago but is no longer realistic. No longer are community bank deposit-taking efforts based solely on customers walking into

[1] The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever changing marketplace.

With nearly 5,000 members, representing more than 20,000 locations nationwide and employing nearly 300,000 Americans, ICBA members hold $1 trillion in assets, $800 billion in deposits, and $700 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

their offices and opening a checking or a savings account. Community banks are using all sorts of information intermediaries to attract deposits including websites, advertisements, and money managers. As a result of the currently broad definition of "deposit brokers" and "brokered deposits", many of these intermediaries are considered deposit brokers. By placing limits on "brokered" deposits, the FDIC has hampered the ability of community banks to raise deposits necessary to fund their operations and to support lending in their communities.

As was discussed at the Roundtable discussion, many community banks use CDARS (Certificate of Deposit Account Registry Service) which is a deposit placement service offered by Promontory Interfinancial Network that allows banks to place their customers' funds in FDIC-insured certificates of deposits at other banks and, at the same time, receive an equal sum of funds from the customers of other banks in the CDARS Network. Currently, CDARS are also considered "brokered" deposits by the FDIC and consequently Risk Category II, III and IV community bank institutions have the potential of paying higher DIF premiums because of CDARS deposits. Furthermore, community banks that have been downgraded to "adequately capitalized" because of tough safety and soundness exams are experiencing liquidity problems if they are using CDARS deposits, since these banks must receive a waiver from the FDIC before they can continue accepting "brokered deposits."

ICBA believes that CDARS deposits should not be considered "brokered deposits" for a number of reasons. First, they have a high reinvestment rate. According to Promontory, the average reinvestment rate across the network has exceeded eighty-three percent. Second, CDARS deposits are overwhelmingly gathered within each bank's geographic footprint through established customer relationships. Eighty percent of CDARS placements are made by customers within 25 miles of a branch location of the relationship institution. Many of ICBA's members attest to the fact that CDARS allows them to retain local deposits and maintain relationships with existing customers that want the protection of FDIC insurance for all their deposits. Consequently, CDARS customers are much less likely to move deposits to other institutions based on rate alone.

Third, each bank sets its own rates on its CDARS deposits that reflect that bank's funding needs and local market. As a result, depending on maturity, CDARS deposits are gathered at a cost that is significantly less than the cost of traditional brokered deposits. Finally, CDARS deposits are a stable source of funding for community banks and do not present the same types of risks as other types of brokered deposits. In fact, it can be argued that CDARS reciprocal deposits may reduce the FDIC's exposure by helping banks retain important, large dollar deposit accounts.

Brokered deposits can also be a valuable source of funding for community banks, particularly for those banks in rural areas or markets which lack ample local deposits to meet the legitimate credit needs of the community. ICBA believes that community banks should not be unfairly penalized for using brokered deposits as long as adequate controls are taken to limit the risks. For instance, brokered deposits should not be an institution's

principal source of growth, nor should they cause the institution to grow at a rate significantly higher than the bank's market. Furthermore, we agree that regulatory policies should encourage institutions to use brokered deposits to fund loans in the bank's market.

However, regulatory policy should not discourage the use of brokered deposits in all situations. Although it is not relationship based money, it is funding which can be successfully managed and can often be reliable in a stressed environment. For this reason, banks that fall below "well capitalized" should be allowed to reduce their brokered deposits over an extended period time. Too often, banking regulators precipitate a liquidity crisis by requiring these institutions to immediately end their use of brokered deposits. An immediate prohibition to renew or issue brokered deposits (particularly CDARS deposits) destabilizes the institution and actually increases the risk to the Deposit Insurance Fund.

As was suggested by FDIC staff at the Roundtable discussion, ICBA supports the FDIC using a graduated scale for grading the variety of funding sources that appear on a bank's balance sheet rather than using the current distinctions of core vs. noncore funding or brokered vs. non-brokered deposits. Such a graduated scheme for assessing the volatility of different funding sources should ensure that community banks which have a need to fund legitimate credit demands and have the ability to manage the risk can benefit from a broad array of supplemental funding, including brokered deposits.

Conclusion

ICBA agrees with many of the points that were made by community bankers at the March 18th Roundtable discussion, including the need for amending the definitions of "deposit broker" and "brokered deposits." As we have stated in a number of comment letters to the FDIC, CDARS deposits should not be considered "brokered deposits" because they are a stable source of funding for community banks and do not present the same types of risks as other types of brokered deposits.

Furthermore, ICBA believes that community banks should not be unfairly penalized for using brokered deposits as long as adequate controls are taken to limit the risks. Brokered deposits can be successfully managed and can often be reliable in a stressed environment. For this reason, banks that fall below "well capitalized" should be allowed to reduce their brokered deposits over an extended period time and should not be subject to an immediate prohibition on the renewal and issuance of brokered deposits.

ICBA also would support the FDIC using a graduated scale for grading the volatility of funding sources. Such a scheme should ensure that community banks that have a need to fund legitimate credit demands and have the ability to manage the risk can benefit from a broad array of supplemental funding,

ICBA appreciates the opportunity to comment on the study that the FDIC is conducting

on core and brokered deposits as required under the Dodd-Frank Act. If you have any questions about our letter, please do not hesitate to contact me at (b)(6) or (b)(6)

Sincerely,

Christopher Cole
Senior Vice President and Senior Regulatory Counsel

April 27, 2011

The Honorable Sheila Bair
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington D.C. 20429

RE: Local Government Investment Pool Deposits

Chairman Bair,

Thank you for soliciting comments on this important topic. We believe the outcome of this study is important to banks and local governments alike.

Recommendation
Local governments should not be penalized by new or existing rules for their partnership with financial services companies.

Background
The Wisconsin Investment Series Cooperative ("the Fund") was created in 1988 by school officials interested in investments that strive to maintain safety and liquidity while preserving capital. Fund participants include school districts, technical college districts, municipalities and other public entities in Wisconsin. The Fund offers its participants a variety of investment products and services, including two liquid pools that invest in money market instruments. A fixed rate investment program is also available to participants of the Fund. The Fund is overseen by a board of commissioners, each of whom serves without compensation and is a member of the governing body of a municipality or the chief executive or administrative officer of a municipality or an official charged with responsibility for financial matters. At the discretion of the commissioners, the Fund employs a number of vendors that provide services to the Fund and its participants including investment advisory, fund administration and fund marketing. It would be impractical for the volunteer commissioners to make investment decisions for the Fund and to implement the technology and infrastructure necessary to provide the Fund with administrative and recordkeeping services.

The Fund, through its financial services provider, purchases deposit products for the two liquid pools. In addition, under the fixed rate investment program, Fund

participants are able to purchase deposit products for their own individual accounts, through the Fund's financial services provider. Recently, it has come to our attention that because the Fund's deposits and those of its participants are opened through an intermediary (the deposits are opened in the name of the local government or local government investment pool), banks have been placed in the difficult position of determining how to properly classify the deposits. In numerous instances, banks and their examiners have determined that these deposits should be classified as "brokered deposits." This adverse classification has caused many banks to no longer accept deposits from the Fund or its participants. We believe that our participants have been affected by an unintended consequence of the "brokered deposit" classification. We request that the FDIC consider the needs of schools and local governments as it conducts its study of core and brokered deposits.

Schools and local governments are limited, by state statutes and investment policies, to investing in only the highest quality investments. Allowable investments generally include debt issued by the U.S. Government, debt issued by agencies of the U.S. Government, deposits at FDIC insured institutions and certain other money market investments. Schools and local governments actively invest in depository products because they provide a valuable combination of safety and yield.

Yield

Relative to debt issued by the U.S. Government and its agencies, time deposits normally offer a higher rate of return. This higher rate can be characterized as a liquidity premium over more liquid U.S. Government investments. For local governments that employ proper cash flow planning, time deposits represent an essential part of their investment portfolio.

Safety

Rules implemented by the Government Accounting Standards Board (GASB) require that unsecured investments be disclosed in governments' financial statements and therefore, such unsecured investments are undesirable for many local governments. Today, local governments have two methods of achieving a secured deposit: 1) FDIC insurance and 2) collateral pledged by the depository institution. (We understand that formerly, there were a number of financial guarantors and surety companies that provided excess FDIC insurance as a third method, but these products essentially vanished during the financial crisis and have not returned.) To attain security at the highest GASB standard, local governments encounter critical shortcomings of both FDIC insurance and pledged collateral.

> FDIC Insurance: The $250,000 of coverage at a single depository institution is insufficient to fully secure all deposits of most local governments.
>
> Collateral: Collateralizing deposits also has limitations. First, the local government must verify that the collateral agreement meets FDIC requirements and follows state laws to achieve a perfected security interest in the pledged collateral. Second, many banks either do not have sufficient and

allowable collateral to pledge or are unwilling to pledge the collateral due to the high cost.

As a result of these constraints, local governments often are required to open deposits at many banks – frequently including out-of-market banks – to acquire FDIC insurance and collateral on all of their deposits. Because the process of locating multiple depository institutions that are willing to accept these deposits requires a substantial amount of resources, many local governments rely upon a variety of intermediaries to open their deposits.

Unintended Consequences

This arrangement poses a significant problem for school districts and other public agencies in the current banking environment. Because local government deposits are opened through an intermediary, many banks are unwilling to accept the deposits of local governments because they are considered "brokered deposits."

Local government deposits represent a large portion of total deposits at FDIC insured institutions and these deposits are mutually beneficial to banks and local governments. Our Fund's administrator, PMA Financial Network, Inc., has told us that numerous depositories have said that local government deposits hold many positive characteristics from a bank's asset-liability management perspective. Local government deposits are normally opened at a fair, market rate and provide a stable form of bank funding. Furthermore, through banks' Treasury departments, government business officials, their advisors and bank managers are able to build long-term relationships which allow bankers to match their asset-liability strategies and policies with the investment goals of local governments. Finally, because these deposits are opened in the name of the local government or local government investment pool, the bank can know its customer and management is well-equipped to understand a particular depositor's investment objectives.

Our Request

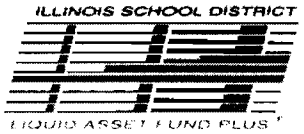
Please consider the needs of local governments as deposit classifications are studied. Managing the finances of local governments has become increasingly complex and frequently requires the expertise of investment advisors and other service providers. Local governments should not be penalized by new or existing rules for their partnership with financial services companies. Such partnerships should not cause our deposits to be negatively classified as "brokered" or "non-core."

As widely published, local governments across the country are struggling with budget deficits caused by the recession. These problems are exacerbated by the low interest rate environment and the recently limited investment opportunities at FDIC insured depository institutions due to these classification issues. Local government deposits are essential to local governments, beneficial to banks and should not be restricted.

Sincerely,

(b)(6)

Chad Trowbridge
WISC Chairman
Business Manager, Chippewa Falls Area Unified School District



April 28, 2011

The Honorable Sheila Bair
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington D.C. 20429

RE: Local Government Investment Pool Deposits

Chairman Bair,

Thank you for soliciting comments on this important topic. We believe the outcome of this study is important to banks and local governments alike.

RECOMMENDATION

Safety, liquidity and yield are paramount investment concerns to local governments and local government investment pools. As such, local governments and local government investment pools utilize financial professionals and intermediaries to assist in the management and execution of their portfolios. As the FDIC considers potential changes to the classification of deposits, we ask that local governments and local government investment pools not be penalized due to their use of professional service providers. Further, we believe that local governments and local government investment pools represent critical and stable funding sources for banks and should receive the most favorable classification, if any are developed through your study.

BACKGROUND

Schools and other local governments are responsible for the prudent management of their investment portfolios. These entities often utilize professional service providers or local government investment pools to meet this responsibility. The Illinois School District Liquid Asset Fund Plus ("the Fund") is a local government investment pool that is committed to providing comprehensive financial management resources for School Districts, Community College Districts and Educational Service Regions in Illinois. The Fund offers its participants access to a variety of investment products and services, including a liquid pool that invests in money market instruments and a fixed rate investment program. The Fund is overseen by a board of trustees, each of whom serves without compensation and either is a school or township treasurer or is employed by, or is a school board member overseeing, a Fund participant. At the discretion of the trustees, the Fund employs a number of vendors that provide services to the Fund and its participants including investment advisory, fund administration and fund distribution. It would be impractical for the volunteer trustees to make investment decisions for the Fund regarding a multitude of investment instruments and to implement the technology and infrastructure necessary to provide the Fund with administrative and recordkeeping services.

Recently, it has come to our attention that because the Fund's deposits and those of its participants are opened through an intermediary (the deposits are opened in the name of the local government or local government investment pool), banks have been placed in the difficult position of determining how to

properly classify the deposits. In numerous instances, banks and their examiners have determined that these deposits should be classified as "brokered deposits." This adverse classification has caused many banks to no longer accept deposits from the Fund or its participants. We believe that our participants have been impacted by an unintended consequence of the "brokered deposit" classification. We request that the FDIC consider the needs of schools and local governments as it conducts its study of core and brokered deposits.

Schools and local governments are limited, by state statutes and investment policies, to investing in only the highest quality investments. Allowable investments generally include debt issued by the U.S. Government, debt issued by agencies of the U.S. Government, deposits at FDIC insured institutions and certain other money market investments. Schools and local governments actively invest in depository products because they provide a valuable combination of safety and yield.

YIELD

Relative to debt issued by the U.S. Government and its agencies, time deposits normally offer a higher rate of return. This higher rate can be characterized as a liquidity premium over more liquid U.S. Government investments. For local governments that employ proper cash flow planning, the liquidity premium paid by time deposits represent an essential part of their investment portfolio.

SAFETY

Rules implemented by the Government Accounting Standards Board (GASB) require that unsecured investments be disclosed in governments' financial statements and therefore, such unsecured investments are undesirable for many local governments. Today, local governments have two methods of achieving a secured deposit: 1) FDIC insurance and 2) collateral pledged by the depository institution. (We understand that formerly, there were a number of financial guarantors and surety companies that provided excess FDIC insurance as a third method, but these products essentially vanished during the financial crisis and have not returned.) To attain security at the highest GASB standard, local governments encounter critical shortcomings of both FDIC insurance and pledged collateral.

FDIC Insurance: The $250,000 of coverage at a single depository institution is insufficient to fully secure all deposits of most local governments.

Collateral: Collateralizing deposits also has limitations. First, the local government must verify that the collateral agreement meets FDIC requirements and follows state laws to achieve a perfected security interest in the pledged collateral. Second, many banks either do not have sufficient and allowable collateral to pledge or are unwilling to pledge the collateral due to the high cost.

As a result of these constraints, local governments often are required to open deposits at many banks—frequently including out-of-market banks—to acquire FDIC insurance and collateral on all of their deposits. Because the process of locating multiple depository institutions that are willing to accept these deposits requires a substantial amount of resources, many local governments rely upon a variety of intermediaries to open their deposits.

UNINTENDED CONSEQUENCES

This arrangement poses a significant problem for schools and other local governments in the current banking environment. Because many local government deposits are opened through an intermediary, many banks are unwilling to accept the deposits of local governments because they are considered "brokered deposits."

Local government deposits represent a large portion of total deposits at FDIC insured institutions and these deposits are mutually beneficial to banks and local governments. Our Fund's administrator, PMA Financial Network, Inc, has told us that numerous depositories have said that local government deposits hold many positive characteristics from a bank's asset-liability management perspective. Local government deposits are transparent, opened at a fair market rate and provide a stable source of funds to a bank. Similarly, through the best practices employed by the Fund, the Fund's deposits also have these positive characteristics.

Furthermore, through banks' Treasury departments, local government business officials, their advisors and bank managers are able to build long-term relationships which allow bankers to match their asset-liability strategies and policies with the investment goals of local governments. Finally, because these deposits are opened in the name of the local government or local government investment pool, the bank can know its customer and management is well-equipped to understand a particular depositor's investment objectives.

OUR REQUEST

Please consider the needs of local governments and local government investment pools as deposit classifications are studied. Managing the finances of local governments has become increasingly complex and frequently requires the expertise of investment advisors and other service providers. Local governments and local government investment pools should not be penalized by new or existing rules for their partnership with financial services companies. Such partnerships should not cause our deposits to be negatively classified as "brokered" or "non-core."

As widely published, local governments across the country are struggling with budget deficits caused by the recession. These problems are exacerbated by the low interest rate environment and the recently limited investment opportunities at FDIC insured depository institutions due to these classification issues. Local government deposits are essential to local governments, beneficial to banks and should not be restricted.

Sincerely,

(b)(6)

(b)(6) Joseph J. McDonnell, CPA

Chairman

Illinois School District Liquid Asset Fund Plus

April 28, 2011

PMA Financial Network, Inc.
2135 CityGate Lane, 7th Floor
Naperville, IL 60563
o 800.783.4273
f 630.718.8701
www.pmanetwork.com

The Honorable Sheila Bair
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington D.C. 20429

RE: Core and Brokered Deposit Study

Chairman Bair,

Thank you for soliciting comments on this important topic. We believe the outcome of this study is important to banks and local governments alike.

RECOMMENDATION

The FDIC should end the use of terms such as "core" and "brokered" to describe deposit liabilities. If, however, the FDIC implements changes to the classification of deposits, we ask that local governments and local government investment pools not be penalized due to their use of professional service providers. Further, we believe that local governments and local government investment pools represent critical and stable funding sources for banks and should receive the most favorable classification, if any are developed through your study.

BACKGROUND

Safety, liquidity and yield are paramount investment concerns to local governments and local government investment pools. Business officials and governing boards are responsible for the prudent management of their investment portfolios. These entities often utilize professional service providers to meet this responsibility.

As a financial services company exclusively serving local governments throughout the United States, PMA Financial Network, Inc. and our affiliated companies (together, "PMA") provide clients with a variety of short-term and long-term planning solutions as well as a suite of investment products and services. PMA also provides advisory, administrative and recordkeeping services to local government investment pools such as the Illinois School District Liquid Asset Fund Plus. With a strong emphasis on cash flow planning services, we also provide fixed rate investment products.

LOCAL GOVERNMENT INVESTMENT POOLS

Local governments frequently invest in local government investment pools. Such pools are created when multiple local governments join together to attain more competitive investment options through economies of scale. Investments in a pool are restricted to those allowable under applicable state statutes and investments are further governed by an investment policy created by the pool's board of trustees. Local government investment pools are usually managed by an investment advisor hired by a board of trustees that is responsible for overseeing the pool. It would be impractical for the volunteer trustees to make investment decisions for the Fund regarding a multitude of investment instruments and to implement the technology and infrastructure necessary to provide the Fund with administrative and recordkeeping services.

PMA FINANCIAL NETWORK

FIXED RATE INVESTMENTS

Local governments are usually limited, by state statutes and their investment policies, to investing in only the highest quality investments. Allowable investments generally include debt issued by the U.S. Government, debt issued by agencies of the U.S. Government, deposits at FDIC insured institutions and certain other money market investments. Local governments actively invest in depository products because they provide a valuable combination of safety and yield.

YIELD

Relative to debt issued by the U.S. Government and its agencies, time deposits normally offer a higher rate of return. This higher rate can be characterized as a liquidity premium over more liquid U.S. Government investments. For local governments that employ proper cash flow planning, the liquidity premium paid by time deposits represent an essential part of a local government's investment portfolio.

SAFETY

Rules implemented by the Government Accounting Standards Board (GASB) require that unsecured investments be disclosed in governments' financial statements and therefore, such unsecured investments are undesirable for many local governments. Today, local governments have two methods of achieving a secured deposit: 1) FDIC insurance and 2) collateral pledged by the depository institution. (Formerly, there were a number of financial guarantors and surety companies that provided excess FDIC insurance as a third method, but these products essentially vanished during the financial crisis and have not returned.) To attain security at the highest GASB standard, local governments encounter critical shortcomings of both FDIC insurance and pledged collateral.

FDIC Insurance: The $250,000 of coverage at a single depository institution is insufficient to fully secure all deposits of most local governments.

Collateral: Collateralizing deposits also has limitations. First, the local government must verify that the collateral agreement meets FDIC requirements and follows state laws to achieve a perfected security interest in the pledged collateral. Second, many banks either do not have sufficient and allowable collateral to pledge or are unwilling to pledge the collateral due to the high cost.

As a result of these constraints, local governments often are required to open deposits at many banks – frequently including out-of-market banks – to acquire FDIC insurance and collateral on all of their deposits. Because the process of locating multiple depository institutions that are willing to accept these deposits requires a substantial amount of resources, many local governments utilize a variety of intermediaries to open these deposits.

UNINTENDED CONSEQUENCES

This arrangement poses a significant problem for schools and other local governments in the current banking environment. Because many local government deposits are opened through an intermediary (PMA client deposits are opened in the name of the local government), many banks are unwilling to accept the deposits of local governments because they are considered "brokered deposits." As described above, local government investment pools are another common investment tool for local governments. Here again, because these pools are managed by an investment advisor (PMA client deposits in pools are opened in the name of the local government investment pool), banks are required to label the pool's deposits as "brokered" and often, bankers are unwilling to accept additional "brokered deposits" given the harsh regulatory environment. Current laws and regulations surrounding brokered deposits are negatively affecting local governments.

Local government deposits represent a large portion of total deposits at FDIC insured institutions and these deposits are mutually beneficial to banks and local governments. Numerous depositories have told us that local government deposits hold many positive characteristics from an asset-liability management perspective. Local government and local government investment pool deposits are transparent, opened at a fair market rate and provide a stable form of bank funding. Additionally, banks' Treasury departments facilitate long-term relationships which allow bankers to match their asset-liability strategies and policies with the investment goals of local governments. Finally, because these deposits are opened directly in the name of the local government or local government investment pool, the bank can "know its customer" and management is well-equipped to understand a particular depositor's investment objectives.

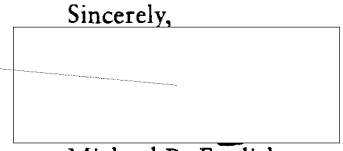
OUR REQUEST

Please consider the needs of local governments as deposit classifications are studied. Managing the finances of local governments has become increasingly complex and frequently requires the expertise of firms such as PMA. Local governments and local government investment pools should not be penalized by new or existing rules for their partnership with financial services companies. Such partnerships should not cause a local government's deposits to be negatively classified as "brokered" or "non-core." We would contend that the planning services provided by our firm make local government deposits more valuable to depository institutions because bank management teams are able to work with us, through their Treasury departments, to match the banks' asset-liability strategies and policies with the investment goals of our local government clients. More broadly, we see value in the relationships developed through Treasury departments and believe deposits opened through this channel should not receive any negative classification such as "brokered" or "non-core."

PMA provides value to banks and local governments through planning and investment products and services. We have found the current regulatory market to be particularly burdensome for our clients. As widely published, local governments across the country are struggling with budget deficits caused by the recession. These problems are exacerbated by the low interest rate environment and the recently limited investment opportunities at FDIC insured depository institutions due to these classification issues. Local government deposits are essential to local governments, beneficial to banks and should not be restricted.

Sincerely,

(b)(6)



Michael R. English

President and Chief Executive Officer

PMA Financial Network, Inc.

FEDERAL DEPOSIT INSURANCE CORPORATION

CORE AND BROKERED DEPOSIT STUDY AS MANDATED BY SECTION 1506 OF THE DODD FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT.

APRIL 29, 2011

COMMENTS SUBMITTED FOR THE RECORD BY THE NATIONAL ASSOCIATION OF INDUSTRIAL BANKERS

National Association of Industrial Bankers
60 South 600 East
Suite 150
Salt Lake City, Utah 84102
Frank Pignanelli, Esquire
Executive Director
(b)(6)

Statement of Interest

The National Association of Industrial Bankers (NAIB) [1] appreciates this opportunity to submit the following comments as part of the FDIC's study on brokered deposits mandated by Section 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. NAIB is a trade association representing the nation's industrial banks.

Before addressing the specific questions presented in connection with the study, NAIB believes the following background information will be helpful.

First, industrial banks have been among the best capitalized and most profitable banks in the nation. One characteristic of most industrial banks is that they are specialized and operate without a branch network or retail offices serving specific geographic areas. The primary source of funding for many of these banks is deposits obtained through brokers or brokerage sweep programs. For more than twenty years, these deposits have proven to be a safe, stable and cost effective funding source. In most cases, banks that primarily rely on brokered deposits described that plan in their original application for deposit insurance and have operated that way for years without any noteworthy problems. Today banks generally do not pay rates significantly above market for brokered deposits nor have they encountered any difficulty in replacing maturing deposits with new brokered funds.

For those reasons, NAIB members have a keen interest in the outcome of this study.

The experience of banks using brokered deposits, often as a primary funding source, can be summarized as follows:

- ***Brokered deposits are the most stable and reliable deposits available to banks.*** Unlike traditional "core deposits", brokered deposits are not susceptible to a run. Brokered certificates of deposit cannot be terminated before maturity except in the case of the death of the depositor or adjudication of mental incompetency, and in practice are almost always held to maturity with less than 1% being redeemed early.
- ***Today, brokered deposits are considered by customers to be the equivalent of high grade government instruments.***

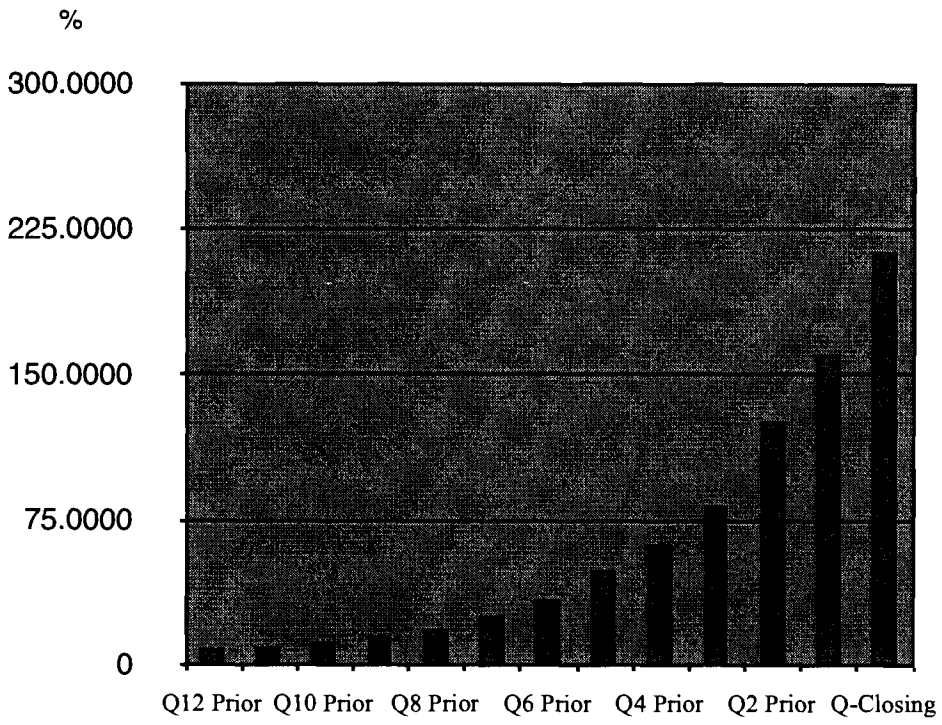
---

[1] First chartered in 1910, industrial banks operate under a number of titles; industrial banks, industrial loan banks, industrial loan corporations, thrift and loan companies. These banks engage in consumer and commercial lending on both a secured and unsecured basis. They are not permitted to offer demand checking accounts but do accept time deposits, savings deposit money market accounts and deposits that may be withdrawn through negotiable orders for withdrawal ("NOW" accounts). Industrial banks provide a broad array of products and services to customers and small businesses nationwide. NAIB member banks are chartered in the states of California, Nevada and Utah.

- ***Brokered deposits are readily available at market rates.*** Brokered deposits are attractive to customers because of their safe and reliable return and availability of a wide range of maturities, and not for premium rates. They are generally priced according to prevailing market rates. As of April 8, 2011, the interest rate on a one year brokered certificate of deposit was 45 basis points. The national average rate published at that time on Bankrate.com was 47 basis points.
- ***Brokered deposits are highly efficient and cost effective.*** Brokered deposits can be readily obtained and greatly enhance a banks' ability to match the duration of both assets and liabilities. Savings that result from the elimination a branch network and associated deposit servicing costs often reduces the all in cost of a brokered deposit below that of core deposits.
- ***Brokered deposits do not cause bank failures, poor asset quality causes bank failures.*** A study of failed institutions shows a trend of increasing troubled asset ratios prior to bank failures. Figure 1 below shows the dramatic growth of nonperforming assets in the preceding 12 quarters (3 preceding years) leading to the closure of troubled banks.

FIGURE 1: Troubled asset data: average ratio by quarter-prior-to-failure for all failed banks

(Source Call/TFR Data)



NAIB recognizes that some banks used brokered funds imprudently in the past. When brokered deposit programs were first offered more than twenty years ago, above market rates were more common and some banks misused brokered deposits to rapidly fund poorly conceived loan programs. In the 1980's, brokered deposit programs were not offered through the Depository Trust Company (DTC) as they are now. The DTC is a central securities certificate depository through which members electronically complete the issuance of brokered certificates of deposits thereby eliminating the physical movement of paper certificates. The DTC was set up to provide an infrastructure for settling trades in municipal, mortgage-backed and corporate securities in a cost-efficient and timely manner. It is the world's largest securities depository, holding about $20 trillion of assets in custody at any time. It is a member of the Federal Reserve System, registered with the Securities and Exchange Commission (SEC). Use of the DTC has increased the transparency of the brokered deposit market.

Early problems have been largely eliminated as brokered deposit programs have become better established and laws and regulations were adopted to address earlier problems with both pricing and use of brokered deposits. Today, the brokered deposit market is a well established mainstream source of cost effective funding for banks and it provides customer access to fully insured deposit accounts. It is not a product for people aggressively chasing rates and looking for ways to game the system. When properly utilized, brokered deposits have proven to be as safe and sound as any type of deposit, including core deposits--a fact that has been recognized by international banking bodies. [2]

Concerns About Brokered Deposits and Failed Banks Are Misplaced

Concerns about brokered deposits have resurfaced recently as a result of the failure of community banks that became dangerously concentrated in real estate lending in high growth housing markets as the housing bubble burst. The facts reveal that *some* of those banks utilized brokered deposits but all held much larger amounts of core deposits as well.

According to FDIC statistics covering the 336 banks that failed since 2004, brokered deposits comprised only 18% of the total deposits held in the failed banks.. This clearly shows that brokered deposits were a *secondary, not primary, funding source* for failed banks.

Simply stated, brokered deposits are just deposits and pose no inherent risk. The only real identifiable risk is the *misuse* of deposits of all kinds to fund high risk and poorly underwritten loans. The majority of banks that have failed since 2004 held no brokered funds, and thus cutting off access to brokered deposits will not prevent failures

---

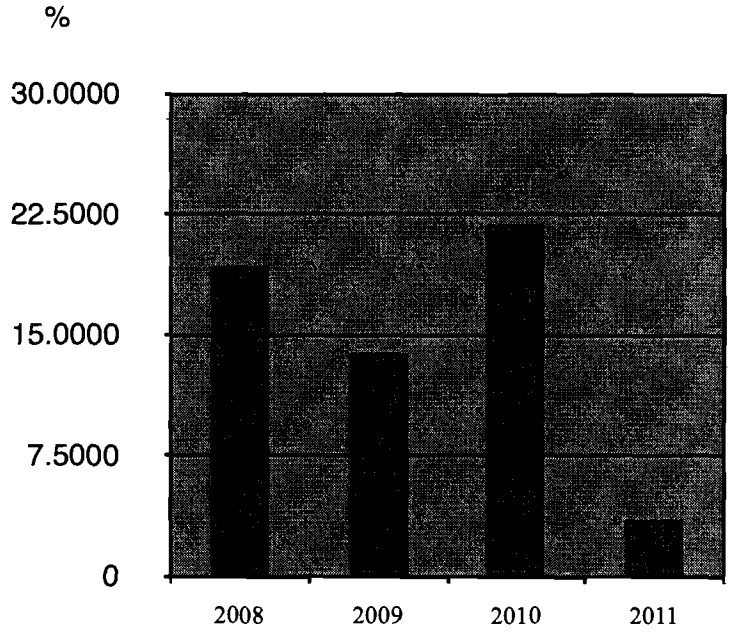
[2] In instances when there is no opportunity for early withdrawal, the Basle III Liquidity Coverage Ratio only requires outflows of 10% for term deposits maturing within 30 days.

to any significant degree because banks can and do misuse core deposits. In reality, the vast majority of brokered deposits are used responsibly and safely.

The FDIC's records clearly depict the minor role brokered deposits played in failed banks:

- 25 banks failed in 2008. 19.2% of the deposits held in those banks were brokered.
- 141 banks failed in 2009. In the aggregate, 13.8% of the deposits in those banks were brokered.
- 156 banks failed in 2010. In the aggregate 21.8% of the deposits in those banks were brokered.
- 34 banks have failed year to date in 2011. In the aggregate 3.4% of the deposits in those banks were brokered.

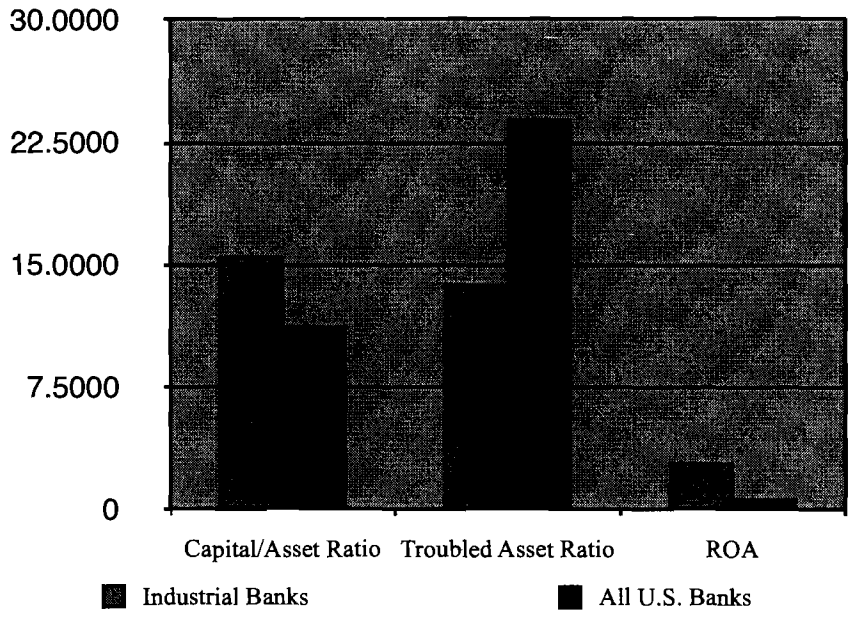
Figure 2: Percentage of Brokered Deposits at Failed Banks
(Source: FDIC Data)



The contrast between failed banks that primarily rely on brokered deposits for funding is stark. At the end of 2010, 86% of the deposits in industrial banks owned by companies engaged in diversified activities were brokered. None of those banks failed and collectively they are the best capitalized and most profitable in the nation. Not surprisingly, they also had significantly lower levels of troubled assets.

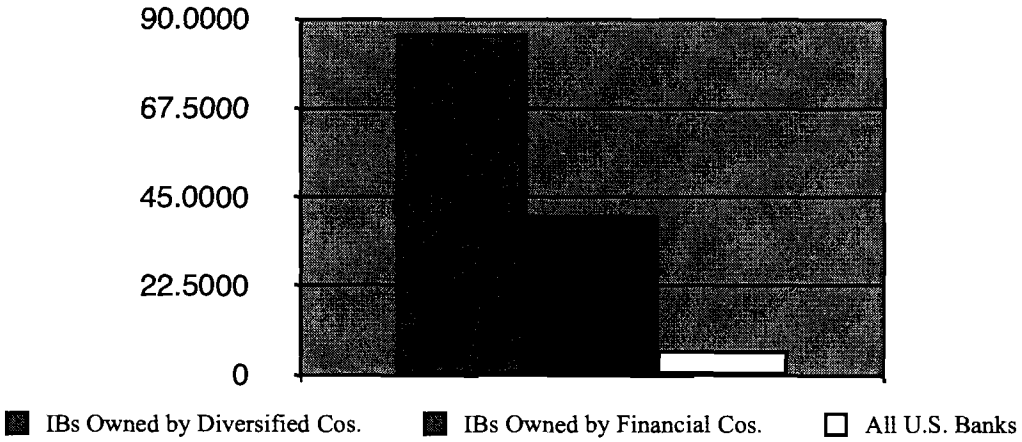
At the same time, 40.3% of the deposits in industrial banks owned by companies engaged primarily in financial activities were brokered. Only one of those banks, which specialized in small business lending, failed during the recession.

Figure 3: Performance of Industrial Banks vs. All U.S. Banks Expressed as %
% *(Source: Q4 2010 FDIC Data)*



The strong performance of industrial banks is especially significant and results in part from their reliance on brokered deposits. As the data in Figure 4 below show, this is especially the case among industrial banks that are owned by diversified parent companies.

Figure 4: Percentage of Brokered Deposits at Industrial Banks versus U.S. Banks
% *Source: Q4 2010 FDIC Data)*



Common Misconceptions about Brokered Deposits

Despite the success and proven resilience of brokered deposit programs over many years, there remain some common misconceptions, including the following:

Misconception: Brokered Deposits cause banks to fail. Banks generally fail because of poor asset quality and uncontrolled growth. We note that, in the most dramatic bank failures where the FDIC has brought personal liability law suits to recover as much as $2.5 billion, the grounds for those suits alleged causalities including disregarding credit policy by lending to individuals who were not credit worthy and failing to properly manage and supervise the bank and its commercial real estate lending program. In no case are we aware of a reliance on brokered deposits being cited as a cause of the high profile, well publicized failures.

Misconception: Brokered deposits pay premium rates. This is generally not correct as today the vast majority of banks pay rates comparable to "core" deposits. All-in costs are usually significantly less for a brokered deposit than for a core deposit due to the savings in marketing costs and the elimination of branch networks and associated servicing infrastructure. As of April 8, 2011, a one year brokered certificate of deposit interest rate was 45 basis points. The national average at that time published on Bankrate.com was 47 basis points. Actual rates paid on brokered deposits are market based and are comparable to the rates paid on similar low risk investments. As of April 6, 2011, a one year US Treasury bond had a yield of 30 basis points.

The "high rate" rate brokered deposit programs of the 1980s have long since been eliminated. Today, much of the money flowing through deposit brokers comes from depositors seeking a safe and efficient investment. These customers are more risk averse than rate sensitive. Brokered deposits are now viewed much like a government security because of deposit insurance. Money flows into these investments through many sources but ultimately there is little difference between a person that opens a time deposit in a local bank, a person that selects bank certificates of deposit as an investment option in a retirement account, or an account manager that selects bank certificates of deposit as a safe investment for funds it manages. The direct deposit by an individual at a local bank may be a "core" deposit because it is direct and often involves a broader relationship between the bank and depositor, but it is fair to describe the brokered deposits as "core" investments for institutions and money managers. All are motivated by the same concerns about safety and are generally not chasing *or receiving* premium rates.

Misconception: Brokered deposits are volatile and not "sticky". Brokered deposits are indeed not sticky in the sense that the depositor has a broader long term relationship with the bank to help hold the money in the bank. But "sticky" does not necessarily mean "stable" and "not volatile". In reality, brokered deposits have proven to

be very stable and core deposits have proven more susceptible to a run even when federally insured.

As described above, two key factors contribute to the stability of brokered deposits. One is provisions in many brokered deposit contracts prohibiting early withdrawal except for death or adjudication of mental incompetency. The second is that brokered deposit customers are not typically chasing the highest rate from day to day. They are looking for a safe investment that reliably produce market rate returns. As long as the particular deposit performs as anticipated, the customer is not likely to disturb it.

The facts surrounding the recent failure of a community bank that had operated for over 125 years illustrates this point. The bank's last call report showed that 25% of its deposits were brokered. Rumors that the bank was failing were already spreading in the community when a local newspaper published a letter written by an angry bank director to shareholders alleging mismanagement of the bank. That sparked a run on the bank. Depositors reportedly withdrew over 12% of all deposits in the bank the week before the bank failed, exhausting its liquidity and forcing closure. The deposits withdrawn were all core deposits.

In reality, only core deposits pose a risk of creating a "run on the bank" because the account agreement specifically allows the depositor to withdraw funds prior to maturity. The real value of core deposits is customer loyalty and the opportunity for a healthy bank to leverage the customer relationship to offer other products and services.

Effective Management of Brokered Deposits

Successfully managing brokered deposits today primarily involves the following considerations:

Liquidity risk. Brokered deposits can present liquidity problems if held in substantial amounts and access to new brokered deposits is disrupted for any reason. That could result from a lengthy disruption in the brokered deposit markets or imposition of a corrective order by a regulatory agency. This risk is mitigated as banks now appropriately price their brokered deposits and match the maturities of these deposits with their assets unlike the programs in the 1980's.

The more than 20 year history of brokered deposits shows that the risk of market disruption is very low. There have been no disruptions in the brokered deposit markets throughout their history, including during the recent economic downturn. Banks have been able to access the funds they need whenever they needed the money. And the risk of a market disruption is declining over time as federally insured brokered deposits have become the investment of choice in times of financial uncertainty. The recent economic downturn beginning in 2008 provided ample proof. The availability of brokered deposits

at low rates was not constrained in any degree from the beginning of the downturn to the present. In contrast, securitization markets severely constricted (which is what triggered the downturn). That caused a flight to safety and actually increased demand for brokered deposits. This helps illustrate how important brokered deposits have become for both the banks that rely on them as a funding source and as a favored investment for customers everywhere.

As noted earlier, the imposition of a corrective order by a regulatory agency can pose a problem for a troubled bank holding significant amounts of brokered deposits. Depending upon its capital classification a bank may be required to obtain specific approval to issue brokered deposits or may be prohibited from offering new brokered deposits. We note that banks reliant on brokered deposits are encouraged to maintain higher capital ratios than a bank with core deposits, which is one reason why most industrial banks maintain significantly higher capital ratios than other types of banks. Regulators also require banks reliant on brokered funds to develop a detailed and reliable contingency funding plan to ensure liquidity if access to brokered deposits is interrupted for any reason.

Franchise value. The second issue with brokered deposits is that they do not contribute to the franchise value of a failing community bank thus increasing the loss incurred by the FDIC when it is appointed as a receiver of the failed bank. The FDIC generally finds that potential acquirers of failed community banks have no interest in the brokered deposits held in failed banks.

NAIB does not believe that this warrants imposing new restrictions on access to brokered deposits by healthy, profitable and well managed banks. We understand that when a bank fails the FDIC tries to find other banks willing to assume the failed bank's deposits. If the depositors of the failed bank are perceived as potential long term customers for the acquiring bank the assumption transaction is completed at a nominal premium. That nominal premium is the franchise value of a deposit. Brokered deposits often have no franchise value to a community bank because they do not represent a potential long term customer to that bank. But the premium another bank would pay for a core deposit is a few basis points at most and represents only a very small fraction of the FDIC's total losses from any of the community banks that failed in the recent downturn.

It is also worth noting that brokered deposits might have franchise value in the other circumstances. Thus far, only one bank principally funded with brokered deposits has failed. It was liquidated, not acquired, because no other bank wanted its small business credit card portfolio, which was hit especially hard in the 2008 downturn. But many industrial banks match fund portfolios; bringing in brokered deposits, matching the duration of loan portfolios and locking in their net interest margin. this efficient process eliminates interest rate risk. In a rising interest rate environment, an acquirer of such a

loan portfolio might be interested in taking the matched deposits as well. The same is true if a failed bank with brokered deposits was acquired by another bank that also used brokered deposits. In that event, the decision to take or leave the failed bank's brokered deposits would likely depend on whether the acquirer could replace the failed bank's funds with new lower rate funds. In this scenario brokered deposits might create franchise value.

NAIB supports reasonable and balanced measures to address these issues and believes that regulators already have the tools to do that within the framework of existing authority.

Regulators already require banks with significant levels of brokered deposits to develop enhanced liquidity plans in case access to new brokered funds is interrupted for any reason. In addition to this, regulators can require a bank holding significant amounts of core deposits and experiencing increased loan losses to run off brokered deposits and either shrink the asset size of the bank or replace the brokered funds with core deposits before a liquidity problem develops.

The final issue is one of funding uncontrolled aggressive loan growth with brokered deposits. A bank taking undue growth risks can fund that growth with core deposits as well as brokered deposits. It is primarily a matter of the rates offered for the deposits. The issue is imprudent growth, not the source of the deposits. Bank regulators can deal with this utilizing their existing authority to restrain unsafe and unsound practices without having to significantly restrain the use of brokered deposits by all banks.

Taking the whole picture into account, NAIB believes the risks surrounding brokered deposits are minor compared to their overall safety and reliability and the increasingly significant role they play in the national economy. The vast majority of brokered deposits are used in a safe and sound manner and pose less of a risk to the deposit insurance fund than other kinds of deposits. Many of the strongest, safest and soundest banks in the nation rely primarily on brokered deposits for funding and have done so for several years without any significant problems. It is critically important not to unduly impact those banks with new measures governing access to brokered deposits, particularly when bank failures were not caused by brokered deposits and the few problems that do occur can be effectively addressed by other means.

NAIB's response to specific questions posed in the FDIC's study list

Should the definitions of brokered and core deposits be changed?

NAIB believes the current definitions of "core" and "brokered" deposits have no utility and are based on incorrect assumptions. Both are deposits and serve the same

purpose, funding loan growth. The only difference is the manner in which the money gets into the bank. As stated above, NAIB believes there is *no* substantive difference between an individual directly depositing money into a deposit account at a local bank, another individual selecting a federally insured deposit program to sweep idle funds into a brokerage account, and a mutual fund manager selecting bank certificates of deposit to invest a portion of the fund's cash. The deposit serves the same purpose as a safe repository of money in all three instances.

Distinguishing between different classes of deposits based on volatility and stability makes obvious sense for purposes of setting risk based deposit insurance premiums, and in that regard it would be logical to distinguish high rate from low rate deposits and deposits more susceptible to a run. In that type of analysis mainstream brokered deposits are the least risky and should carry the lowest premiums.

In general, deposits with the ability to be withdrawn at any time and without a relationship may be more volatile than fixed term products such as brokered deposits. A depositor who tracks rates frequently and selects a deposit product solely based on rate and who will quickly move to another bank for a higher rate creates volatility. However, because that depositor directly deposits money into the bank, the deposit is now classified as a core deposit.

Similarly, many local customers directly depositing into a bank may be rate conscious and frequently comparing rates between the bank and a local credit union. They also read the papers and can pick up bad news about a bank, which increases the risk of a run on the bank *by those local depositors*.

In contrast, a typical brokered deposit customer is looking only for rates that are consistent with the general market rates for other investments with a similar risk profile and duration. A brokered deposit is most often selected as part of an investment strategy and as long as it performs as expected it will not be disturbed until it matures and a new investment must be selected for those funds.

NAIB believes the actual characteristics of brokered deposits do not justify the current premium structure that imposes a surcharge on banks that use brokered deposits. While there may be an added insurance risk if a community bank that holds significant amounts of brokered funds fails before it can replace its brokered deposits with new core deposits, we believe that risk is more than offset by the stability and cost savings of brokered deposits. Generally speaking, it appears reasonably certain that a bank funded primarily with brokered deposits will have a more stable and cost effective deposit base than one funded by demand deposit accounts or short-time deposits sourced at sites frequented by customers chasing the highest rates.

NAIB believes that regulators should eliminate the penalties in the form of higher deposit insurance premiums assessed on banks using brokered deposits. For the same reason, we believe current generalized regulatory directives that are intended to reduce reliance on brokered deposits for all banks are misguided and should be discontinued. An approach considering the unique risk profile of each bank should be used instead.

The current risk adjusted premium structure could easily be modified to reflect actual risks to the deposit insurance fund. It makes sense to charge higher premiums to a community bank holding significant amounts of brokered deposits with little capital cushion in a high growth market. It does not make sense to assess a higher insurance premium on a stable and profitable industrial bank funded principally with brokered deposits paying market rates and holding a substantial capital cushion. NAIB believes this is how deposit insurance premiums should be determined in the future.

How have new methods of obtaining deposits affected stability and volatility?

Brokered deposits. As described above, NAIB believes the modern brokered deposit markets are a well established, efficient and cost effective source of funding for banks and a source of high quality low risk investments for individuals and institutional investors. The depositors are primarily concerned with safety and do not expect a premium rate. Contractually, the depositor is unable to withdraw the funds prior to maturity unless the depositor dies or is adjudicated to be mentally incompetent. The stability of the market and the deposits were proven beyond any reasonable doubt in the recent economic downturn. The brokered deposits market has proven very reliable in good economic times and performed even better during the downturn due to a flight to safety by customers wanting to eliminate market risk. *Unlike other deposits, brokered deposits are virtually immune to a run.*

Core deposits. Traditional core deposits, meaning direct deposits by people and businesses that reside near the bank and have a long term customer relationship with the bank, are mostly originated in the same way they were a hundred years ago. They are not as efficient and increasingly are not as cost effective as a brokered deposit. They require a branch network offering a full range of banking services to attract customers and marketing programs, which are costly and are not needed for brokered deposits. They are also more susceptible to a run if the bank gets in trouble. The primary value of a traditional core deposit is building customer loyalty and leveraging that to get other business from the depositor such as loans. That relationship is the primary business plan of a typical community bank. Other banks can operate more efficiently and cost effectively by relying on brokered deposits.

One new source of what are technically core deposits presents different issues. Deposits sourced via the internet represent a new and innovative opportunity for banks to raise deposits. While the internet channel can be an efficient way to raise deposits it

creates a customer base that is tends to be rate sensitive and therefore more volatile. That said, even these deposits have proven to be reasonably stable as long as the bank offers competitive interest rates.

What characteristics define stability and volatility?

Insurance coverage. For every kind of deposit, federal deposit insurance and regulation of the bank is crucial to protect and serve the public interest and to maintain the stability of the banking industry and the economy. No deposit is stable unless it is insured and held by a regulated bank.

Customer relationship. A customer relationship may be valuable for marketing a range of products and services over time but we believe any objective examination of failed banks shows that core deposits are more volatile if there is any public awareness of a bank's declining financial condition.

Geographic location of account holder. As many cases have shown, the risk of a run is greater if most of the bank's depositors reside near the bank and hear negative news and rumors about the financial condition of the bank. Some of those depositors may also tend to become increasingly loyal to a particular bank if well served in multiple ways over a long period of time, but that loyalty has proven fragile if the bank becomes troubled.

Interest rate. Obviously, the rate paid on a deposit is significant but we do not believe it is of paramount importance in terms of stability and volatility for most depositors. In practice, internet deposits are likely to be the most rate sensitive. In contrast, rates paid on brokered deposits may periodically be slightly higher than equivalent rates offered by local banks for core deposits but can actually be cheaper for the bank when overhead savings are taken into account. Today customers are typically more concerned with safety than getting an unusually high rate, but they do expect to get a competitive market rate.

Differences based on bank size and complexity. Depositors placing large amounts in a bank will typically prefer a larger bank or will look for a program like CDARS that will divide the deposit into fully insured parts and distribute the deposit among several banks in order for the entire amount to be covered by deposit insurance. Like other depositors, safety remains the primary concern for a large depositor, far more important than rate. Indeed, an unusually high rate would probably cause many large depositors to put their money elsewhere because the higher rate may signal higher risk.

Similarly, a party placing large deposits with pass through status is more likely to prefer a larger bank in good health because a smaller bank may not have the systems to manage that type of program.

For other depositors there does not appear to be much emphasis or concern regarding bank size.

How does creation of a customer relationship affect stability of deposits?

In person. NAIB does not believe there is a simple answer to this question. It will depend to a large degree on the depositor and the nature of the deposit.

One might hypothesize that an individual is more likely to place and keep a deposit at a bank where that person has been banking for some time and has a personal relationship with people at that bank, assuming rates are competitive. In actuality, these types of deposits are the most susceptible to a bank run because the depositor has the contractual right to withdraw his/her money at any time.

On the other hand, brokered certificates of deposit can only be withdrawn early in the case of death or adjudication of mental incompetence of the customer.

Internet. This may be the most rate sensitive type of deposit. On the other hand, many consumers like the convenience of banking online and will choose to open their deposit relationships online versus the inconvenience of visiting a local branch bank to open a relationship. Once the money is placed, it is likely to stay in place through maturity except for the few depositors that are aggressive rate chasers.

Brokered. As stated above, brokered deposits are the *most* stable kind of deposit during the term of the deposit. At the end of the term, the deposit is likely to be renewed if the rates are competitive. Acceptable rates do not usually equate to the highest rates offered. Customers look at market conditions generally and try to stay within a competitive range but with a higher emphasis on safety and reliability. These customers are less concerned with specific information about the bank issuing certificates of deposit.

Acquiring certificates of deposit typically occurs within the context of a retirement account or other brokerage account. An individual may select a money market mutual fund or a bank certificate of deposit as a safe and secure place to park otherwise idle cash.

Reciprocal. The structure of reciprocal deposits [3] differs from those discussed above. This form of brokered deposits, first introduced in 2003, allows member banks to place large deposits into multiple banks in fully insured amounts, receiving an equal

---

[3] "Reciprocal deposits" are defined as "[d]eposits that an insured depository institution receives through a deposit placement network on a reciprocal basis, such as that: (1) for any deposit received, the institution (as agent for depositors) places in the same amount with other insured depository institutions through the network; and (2) each member of the network sets the interest rate to be paid on the entire amount of funds it places with other network members." 12 C.F.R. § 327.8 (s)

amount of fully insured funding from those banks in turn. Thus, each participating depositor thus receives enhanced deposit insurance coverage. The customer deals directly with his or her local bank and not with a broker. NAIB believes that reciprocal deposits are no riskier than conventional brokered deposits and appear to have a high reinvestment rate.

Since June 2009, banks have reported reciprocal brokered deposits in Call Reports and there is no data to show the need to change their treatment.

Listing Service. These services, when simply compiling information about deposit rates, are not deposit brokers. Since 2002, the FDIC has grappled with criteria to determine when a listing service shall be treated as a "deposit broker." [4]

Sweep accounts. These accounts offered by banks affiliated with a broker are not classified as brokered based on an exemption established in a 2005 interpretive letter. Typically they are connected to a checking, brokerage, retirement or investment account. Some brokers offer an option to sweep idle funds in brokerage accounts into a MMDA or NOW account in a bank. In practice, these funds were, if anything, priced below market. The customers were mainly concerned about safety and wanted the idle funds put into a FDIC insured account. These customers proved to be very rate insensitive as long as some interest was paid. These deposits were also generally not volatile. The depositor did not withdraw funds to chase higher rates but usually to buy securities. These accounts behaved much more like a typical transaction account. Although money moved in and out regularly, the total of all account balances remained generally stable, much like checking or NOW accounts in a commercial bank.

What types of brokered deposits, if any, should be considered more stable?

In today's market, brokered deposits are more stable than other kinds of deposits, due to contractual early withdrawal limitations. The only brokered deposits that would qualify as volatile are those targeting people who are aggressively chasing rates and those are a rarity today.

How do banks promote stability in their deposit base? What regulatory changes would increase stability?

Industrial banks have not encountered any difficulty in managing the stability of brokered deposits.

---

[4] FDIC Advisory Opinion No. 04-04 (July 28, 2004) sets forth the criteria to determine when a "listing service" shall be treated as a "deposit broker."

As a matter of safety and soundness, all banks reliant on brokered funds must have contingency plans to provide funding in the event of any disruption in the flow of brokered funds. These often include establishing back up lines of credit at other banks, parent companies, federal home loan banks and/or the Federal Reserve. Some also securitize a portion of their loan portfolios and have standby plans to increase the volumes of loans securitized if needed. However, during the economic downturn, banks generally experienced the opposite effect – the supply of brokered deposits increased while the securitization markets became severely constricted.

NAIB believes the FDIC has sufficient existing statutory and regulatory authority in this area and would be better served concentrating its resources on ensuring that banks maintain high asset quality and pursue controlled measured growth— areas which we believe will prevent bank failures.

Is it possible to report new classifications of deposits based on characteristics like relative stability or volatility?

It is unclear as to how such classifications would be workable under the current definitions. For example, the FDIC's examination guidelines note that some core deposits (traditionally assumed to be stable) may exhibit volatility. Changing the underlying definitions could support a classification based on relative stability--a test under which brokered deposits, as discussed herein, would continue to prove among the most stable class of deposits.

How is a banking franchise valued when acquiring a failed bank?

NAIB believes that there can be no general rule here--it depends on the nature of the failed bank and the acquirer.

In the case of a failed community bank, another community bank will look most closely at the failed bank's market, the failed bank's standing in that market, the possible benefit to the acquiring bank of getting into that market or expanding its existing presence there, and the quality of the failed bank's assets, people and locations. Not surprisingly, brokered deposits are given no value in terms of capturing new customers in a limited geographic market, but can have some value if the rates are favorable and the terms are not short.

On the other hand, if the business of the target or failed bank is desirable to an acquirer and both banks use large amounts of brokered funds, the target or failed bank's brokered deposits could have some value to the acquirer depending on the rates and terms, particularly in a rising rate environment.

What, if anything, should be done about institutions paying high deposit rates?

This is inherently a safety and soundness issue that should be addressed on a case by case basis by each bank's regulators within the framework of existing supervisory authority.

Recommendations about legislation or regulatory changes concerning brokered deposits?

No new constraints should be imposed on the use of brokered deposits. Today, brokered deposits pose no inherent danger when used prudently and safely by a bank. Risks related to brokered deposits primarily relate to how they are used and that is a safety and soundness issue that will vary from bank to bank, and should be dealt with on that basis. NAIB believes existing deposit insurance premiums on brokered deposits and regulatory policies intended to discourage the use of brokered deposits should be eliminated

* * *

NAIB appreciates the opportunity to share our views and would be pleased to discuss any of them further. I may be reached at [redacted] (b)(6)

Respectfully Submitted,

(b)(6) [redacted]

Executive Director

Promontory Interfinancial Network, LLC
1515 North Courthouse Road
Suite 1200
Arlington, Virginia 22201

T 703-292-3400
F 703-528-5700

June 23, 2011

Ms. Diane Ellis
Deputy Director
Division of Insurance and Research
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Core and Brokered Deposit Study

Dear Ms. Ellis:

Promontory Interfinancial Network, LLC ("Promontory Interfinancial") submits this letter in further response to the request by the Federal Deposit Insurance Corporation ("FDIC") for comments in regard to the FDIC's study on core and brokered deposits pursuant to Section 1506 of the Dodd-Frank Act. This letter provides additional data and analysis pertaining to issues first raised in our comment letter of May 1, 2011. We believe that this further information may be useful to the FDIC as it completes its study.

With our original May 1 comment letter, we submitted a paper by Professor Mark Flannery entitled, "Data-Driven Deposit Insurance Assessments." Since that time, Prof. Flannery has collected more data and performed additional analysis so as to provide further statistical evidence on the determinants of insured depository institution failure. This additional analysis, set forth in "Data-Driven Deposit Insurance Assessments: Further Results," has led to new insights on several dimensions and is attached to this letter as Attachment 1.

In our prior comment letter, we indicated our belief that the costs of funding are more important than the channels of origination of that funding.[1] Prof. Flannery's new work provides evidence on this point; he finds that the cost of funding earning assets has a significant impact on the probability of default. *This impact is at least three times that of brokered deposits.* Furthermore, including the funding cost variable reduces the estimated effect of brokered deposits on failure anywhere from one-third to one-half. Higher funding costs also appear to be a far more important predictor of failure than, for example, lower ROA or the general composition of liabilities. In short, it's a crucial variable.

1 We note that a number of other comment letters, including those from the American Bankers Association, the National Association of Industrial Bankers, Pepper Hamilton LLP (on behalf of bank clients that issue credit cards) and Bert Ely of Ely & Company, also suggested that high cost plays a role in deposit stability and, by extension, in the general stability of an institution.

The FDIC has commented on the relative dearth of useful rate data with respect to some deposit products. We hope the FDIC might find useful the collection of rate data we provide in Attachment 2. The attachment contains monthly rate data, by deposit product, from late 2005 through early 2011. The data include: the average traditional brokered CD all-in rate, the average of the top ten rate listings as published on the nation's largest private rate board, the average Federal Home Loan Bank advance rate, and the average national retail rate, as provided by RateWatch. We examined these data ourselves and found it useful to segment an analysis of the rates into three distinct time periods: the pre-financial crisis period (Q4 2005-Q4 2007), the crisis period (Q1 2008-Q2 2009), and the post-crisis period (Q3 2009-Q1 2011). Due to the extreme demand for funding during the height of the crisis, and the retail/wholesale rate anomalies of the present period, we concluded that the most relevant data come from the pre-crisis period. We attach our summary review of these data as Attachment 3.

We observed in our prior comment letter that the failure risk of a bank depends less on the composition of its liabilities than on the composition of its assets. Prof. Flannery's new analysis looks at bank asset composition in greater detail. He found that high levels of construction and development (C&D) loans increase the probability of default. Of course, this finding is not surprising, given the circumstances of 2007-2011. We include as Attachment 4 a high level look at the 104 banks that failed in the states of Georgia and Florida (two of the states with the largest number of bank failures) over the same 2008 to Q1 2011 interval. The banks in those states had C&D loan concentrations well above the national average. And for those Georgia and Florida banks that ultimately failed, the C&D loan concentrations one year prior to failure were *multiples* of the national average.

In its solicitation of comments for the Core and Brokered Deposit study, the FDIC asked which types of deposits are likely to remain at an institution during a time of financial stress. In our May 1 comment letter, we stated our understanding that insured deposits of any type, including brokered, are likely to remain at an institution during times of stress, *except in a situation where government policy requires deposit run-off.* We have since reviewed historical call report information for the 20 bank failures that were responsible for the largest losses to the Deposit Insurance Fund (DIF) during the recent crisis. We include as Attachment 5 graphs of each of these institution's funding sources during the four or more years leading up to failure. In reviewing this information, we find that brokered deposits remained very stable within institutions that utilized such funding, up until the time the institutions became less than well capitalized. Obviously, at that point, federal law restricts the use of brokered funding and its use correspondingly declines.

The graphs in Attachment 5 also make apparent that some deposits classified as brokered played a potentially contributory role in the failure of *only* three of the 20 institutions that caused the largest losses to the DIF. The remaining 17 institutions used little or no brokered funds, increased their brokered funding at a time of flat or decreasing asset growth, or simply used brokered deposits to replace more volatile funding sources after the initiation of the financial crisis. In other words, although many institutions held material

amounts of brokered deposits at the time of their failure, these funds generally were not used to fuel rapid or risky asset growth, but rather to address liquidity shortfalls caused by the flight of other funding sources.

Thank you for your consideration of our comments.

Sincerely,

(b)(6)

Eugene A. Ludwig
Chairman

(b)(6)

Alan S. Blinder
Vice-Chairman

(b)(6)

Mark P. Jacobsen
President & Chief Executive Officer

Attachment 1: Flannery-Data Driven Deposit Insurance Assessments: Further Results
Attachment 2: Historical Term Funding Rates-Raw Data
Attachment 3: Historical Term Funding Rates-Comparison of "core" vs. "non-core" funding sources
Attachment 4: GA and FL C&D Loan Comparison
Attachment 5: Funding charts for the 20 bank failures that caused the largest losses to the DIF

Attachment 1

Data-Driven Deposit Insurance Assessments:

Further Results

Mark J. Flannery, Ph.D
Hough Graduate School of Business Administration
University of Florida
(b)(6)

ABSTRACT

My report of May 1, 2011 presented models of IDI failure prediction. I have collected further data and revised some model specifications to provide additional evidence on the determinants of IDI failure. The results presented here describe the effects of loan portfolio composition on failure probability, and identify several new variables with substantial and robust explanatory power. I also argue that the connection between accounting information and failure is less tightly structured than some previous estimations have assumed.

June 9, 2011

My report of May 1, 2011 describes models of IDI failure and the FDIC's loss associated with resolving failed institutions. This supplemental report describes some further analysis undertaken to assess the determinants of IDI failures. The extensions reported here include:

- New data
  - I have collected information about the IDIs that failed during the first quarter of 2011.
  - I have also collected more detailed information on IDI firms, including the composition of their commercial real estate portfolios, their holding company affiliations, and two cost-and-income measures of performance.
- Discussion of asset growth effects.
- Further examination of the time-variation in predictive power. I now conclude that IDI failure is not best predicted by a model that links point-in-time financial data with a specific, narrow failure window.

Extending the data to include more recent periods has had no substantial effect on the May 1 report's conclusions. However, the broadening of potential failure determinants has yielded some important new results.

I. Methodological Review

As explained in my May 1 report, the general probit model of IDI failure is appropriately specified as:[1]

$$\Pr(\text{failure}_{i\tau}) = \Omega\left(\sum_{j=1}^{J} a_j\left(A_{ijt}/TA_{it}\right) + \sum_{k=1}^{K} b_k\left(L_{kit}/TA_{it}\right) + \gamma Z_{it}\right) + \tilde{\epsilon}_{it} \qquad (1)$$

where $\text{failure}_{i\tau}$ = unity if the i^{th} IDI fails during period $t+\tau$, otherwise zero.

TA_{it} = total assets of the i^{th} IDI at time t.

L_{ikt} is the k^{th} type of liability held by IDI i at the end of period t.

A_{ijt} is the j^{th} type of asset held by IDI i at the end of period t.

[1] This is equation (7) in the May 1 report.

Z_{it} is a set of other variables (noncurrent loans, asset growth, IDI size, charter type) that might affect the probability of default in year $t+\tau$.

$\tilde{\epsilon}_{it}$ is a residual

In order to interpret the individual asset and liability coefficients accurately, it is crucial that the IDI's balance sheet constraint be incorporated by excluding one, and only one, balance sheet category from (1).

Omitting Core Deposits, for example, means that a change in any of the included assets/liabilities is offset by a change in Core Deposits. The other liability categories' coefficients thus measure the impact on failure probability of a shift from the included liability into Core Deposits – with no change in leverage, because total liabilities are unaffected. This is exactly the concept we need to assign FDIC insurance premia on the basis of liability composition.

However, the asset category coefficients in (1) include a compound effect when Core Deposits is omitted. An increase in loans, for example, is funded by an identical increase in Core Deposits, so the total effect measured by that coefficient incorporates both a change in asset portfolio composition and a change in leverage. In order to measure the effect of asset composition alone, we must include Core Deposits in (1) and omit one asset category. I choose to omit federal funds sold (FFS), which have minimal default risk and earn no monopoly rents. The included asset categories' coefficients then measure the failure impact of a shift between assets, with no change in leverage.

The regression model's total explanatory power is unaffected by the choice of which balance sheet category to omit. Nor does the choice of omitted variable change the estimated coefficients on the control variables (Z_{it} in (1)). The omission affects only the balance sheet categories' coefficients and their economic interpretations.[2]

A failure model like (1) must also specify the time period over which a firm's financial conditions affect its failure probability. My May 1 report investigates two versions of this timing. In one set of models, a firm's balance sheet at a specific date was constrained to affect default only during a specific, one-year failure interval. I estimated single-year models using balance sheet data from 1, 2 or 3 years before the start of the hypothesized failure interval. Alternatively, I broadened the failure interval to include 2008-2010 and predicted failure anywhere in that interval using accounting data from yearend 2007, 2006, or 2005. The second specification does not impose a fixed lag relationship between an IDI's condition and the timing of its possible failure. However, it may reduce the significance of specific balance sheet

[2] The leverage-free impact of a change in asset composition can be computed from regression coefficients from a model that excludes Core Deposits, but this calculation requires summing two coefficients and computing the sum's standard error.

information by failing to impose a specific lag relationship between IDI condition and potential failure. The multi-year failure interval permits financial variables at time t to affect default probability one or two or three years later, rather than restricting the effect to appear only within a narrower interval.

I will report here that some important risk indicators exhibit inconsistent statistical significance (and even signs) across alternative forecast horizons and failure intervals. One conclusion from this supplemental analysis is that some asset and liability categories differ in the horizons over which they predict default. This complicates the FDIC's job of relating balance sheet composition to failure for purposes of setting actuarially fair deposit insurance premia. For example, one must avoid judging the impact of a balance sheet item from a single probit model that considers only one forecasting horizon.

II. Probit Model Results

The results of estimating two variants of (1) are combined and reported in Table 1. Within each column, the asset-category coefficients are taken from a specification of (1) that omits FFS. The liability coefficients are taken from a specification of (1) that omits Core Deposits. The control variable coefficients do not differ between the two specifications, and the coefficients on the omitted variables equal one another.

The first three columns in Table 1 are based on one-year failure intervals; the last three columns are based on the 3.25-year failure interval (2008-2011Q1). I estimate separate probit models using yearend data preceding the start of the forecasting interval by zero, one, or two calendar years. For example, the rightmost three columns of Table 1 predict failure at any time during 2008 – 2011Q1 using yearend data from 2007, 2006, or 2005.

A. Three New Determinants of IDI Failure

I have identified three new variables that reliably predict IDI failure. Their coefficients are reported separately in Table 2. First, and most substantially, the cost of funding earning assets (SDI variable INTEXPY) is significantly positive for all forecast horizon-failure interval combinations. The standard deviation of INTEXPY is 0.86%, compared to a mean of 2.23%. So a one-standard deviation increase in INTEXPY raises an institution's one-year default probability by 30 to 60 basis points – a very large effect, implying a large increment to an IDI's fair insurance premium.

Not surprisingly, ROA is negatively related to failure probability, but its impact is smaller. The standard deviation of ROA is about 0.93%, implying that a one standard deviation increase in ROA lowers annual default probability by less than 1.1 bp. In addition, omitting ROA from the regression has little effect. On the other hand, omitting INTEXPY substantially affects other estimates.

The third variable in Table 2 is a dummy variable (HCTMULT) equal to unity when the IDI is owned by a multi-bank holding company. HCTMULT is significantly negative except in the 1-year ahead forecasting horizon, and the coefficients indicate that multibank holding company ownerships reduces the annual default probability by about 1%. This is a very large effect, compared to the annual mean default probability of approximately 1.5%. Apparently, an IDI that encounters difficulties has a better chance of resolving those problems if it can draw on the resources of a multi-IDI holding company. (This is the traditional "source of strength" doctrine describing a holding company's obligations to its subsidiary banks – which seems to work!)

To summarize, INTEXPY and holding company ownership status seem to convey a lot of important information about an IDI's failure probability. The ROA results are consistent with the INTEXPY results, but much weaker. The substantial impact of funding costs on failure probability is particularly relevant to the FDIC's recent interest in basing insurance premia on liability composition. Controlling for liability proportions and profitability, higher funding cost predicts subsequent failure.

B. Asset Composition Effects

A major puzzle from my prior report was the very large apparent effect of brokered deposits (BD) on failure probability, and the fact that this effect diminishes with higher BD concentrations. I speculated that there might be some asset-side or other features of the firm with which brokered deposit financing was correlated. My May 1 results did not differentiate much among various loan categories. Given the importance of commercial real estate in many recent bank failures – specifically construction and development loans – I have now paid further attention to these loan categories. Specifically, I divided a single "total loans" category into four components:[3]

a. Commercial and industrial ("C&I") Loans
b. Construction and Development loans
c. Other Commercial Real Estate loans
d. Other loans (total net loans, less the sum of the three loan types above)

(The two loan sub-categories above ("Construction and Development" and "Other Commercial Real Estate" had previously been combined in my analysis, and their estimated coefficients differed little from C&I or Other loans.)

The loan component results from Table 1 are repeated in Table 3. Note two important results. First, most loan categories reduce the likelihood of failure. In other words, an IDI is better off with less FFS and more of most loan types. The exception is C&D loans, which we know have played a large role in many recent failures. When predicting failures one year ahead,

[3] See the Appendix for variable definitions.

C&D loans carry a significantly negative coefficient much like the other three loan categories do. However, when predicting failure two or three years ahead (columns 2 and 3 of Table 3), C&D loans are associated with a significantly greater probability of default. And this effect is even larger when predicting failures during the 2008 – 2011Q1 interval. C&D loans in the rightmost three columns of Table 3 carry significantly positive coefficients.

Converting the rightmost three C&D coefficients into annualized failure probability effects implies that a 10% increase in the proportion of assets held as C&D loans increases failure probability by 18, 68, or 77 bps. (Another way to assess the magnitude of the C&D effect is to note that the same regression coefficients imply that a one standard deviation change in the C&D proportion of total assets (11.2%) raises default probability by 21, 76, or 86 bps.) These estimated effects are very large, even if they may be unusually severe for this particular time period. The only other asset category with a positive coefficient in Table 1 is OREO, but five of its six coefficients are statistically insignificant.

C. Asset growth

Rapid asset growth has long been viewed with skepticism by prudential supervisors, particularly if that growth is organic. The combination of rapid asset growth and brokered deposit funding recently has been a specific "hot button" for FDIC premium-setters. One might therefore expect that rapid asset growth (funded by brokered deposits or not) should be strongly related to subsequent failure probability.

Table 4 reports growth-related coefficients from Table 1. These variables were also included in my May 1 report, but it is interesting to assess their importance in the new, expanded probit specification. These growth-related variables include the growth rates of total assets and brokered deposits over the preceding two years, plus two interactions:

- The level of BD multiplied by the asset growth rate
- The product of the asset and BD growth rates.[4]

The "Asset Growth" effects are mixed across the three models estimating failure during a subsequent, one-year interval. Depending on the forecast horizon, Asset Growth has a significantly negative effect (at 1-year), zero effect, or significantly positive effect (at 3-year) on an IDI' failure probability. But these effects are offset by the third row in Table 4, which indicates that the scale of BD significantly reduces the effect of Asset Growth on failure probability. The effect of Asset Growth is unambiguously positive in the rightmost three columns of Table 4, and the offsetting effects in row (3) do not differ reliably from zero. The significant, direct effect of Asset Growth in the last two columns of Table 4 indicate that a one

[4] This variable most closely corresponds to FDIC concerns that BD may enable rapid, careless growth, which later raises the IDI's failure probability.

standard-deviation (22.95%) increase in the two-year growth rate raises annual default probability by about 80 bp.

Growth in brokered deposit balances has an insignificant effect on failure probability, except for the 2007 predictions of 2008-2011Q1 failures. This coefficient (0.15, t = 2.21) implies that a one standard deviation increase in BD growth (3.20%) raises annual default probability by 48 bps. This is a large effect, but its significance is not supported by any other model's estimates.

Finally, the interaction of BD growth and asset growth has only one significant coefficient in Table 4, which implies that a one standard deviation increase in this (interacted) variable (0.04) raises annual failure probability by 8 bps. However, the other five coefficients on this interacted variable are statistically insignificant.

To summarize, the results in Table 4 provide evidence that rapid asset growth can endanger an IDI. But the effects of this growth are not uniform across forecasting horizons. An IDI with more rapid Asset Growth is less likely to fail soon, but more likely to fail eventually. I consider the implications of this time pattern in Section IV below.

III. Brokered Deposits Again

One of the conclusions from my May 1 report is that the estimated models imply an implausibly large effect of BD on default probability. For example, one regression from that report implies that raising BD funding from zero to 10% of total assets (a 1.35-standard deviation increase) raises default probability by 1.3%.[5] Even with the historically high default incidence of 1.5% per year in 2008-10, this estimated effect of brokered deposits seems implausibly large. Perhaps the result is spurious, reflecting correlation between brokered deposit use and some other risky IDI characteristic.

To investigate this effect further, I have examined the effect of asset composition on the size of BD coefficients in some probit models of IDI failure. Brokered deposits might also be associated with failure because they raise funding costs. Indeed, much of the recent discussion about brokered deposits involves the presumed higher cost of these liabilities, compared to "core" deposits. Yet some brokered deposits are relatively inexpensive and some core deposits (e.g. those purchased over the internet) can be quite expensive. The variable INTEXPY directly measures an institution's cost of loanable funds, and thus provides a direct indicator of whether expensive funds significantly affect failure probabilities.

[5] BD usage above 10% was estimated to have a smaller marginal effect on default probability than when BD usage is less than 10%.

A. Univariate Statistics

Table 5 compares univariate summary statistics for failed vs. surviving IDI over the period 2008 - 2011Q1. Specifically, these statistics compare the year-end 2007 condition of firms that failed during the ensuing 3.25 years, against those that did not.

Consistent with FDIC's proposal to assess higher insurance premia for banks that rely on brokered deposits, note that brokered deposits finance a much larger proportion of failed banks' assets: 11% of total assets vs. 3% for surviving IDI. The difference in means and medians between the two groups is statistically significant at better than the 1% level. However, the two subsamples also differ substantially in other risk-related dimensions. Failed banks had significantly

- lower equity (10% vs. 12%)
- lower securities (13% vs. 21%)
- higher loans (77% vs. 66%)
- substantially higher C&D loans (38% vs. 11%)
- higher FHLB advances (8% vs. 5%).

These comparisons are all consistent with the failed banks stretching to cover loan demand. The failed banks' loans were significantly more likely to be non-current and they had a substantially higher cost of funding earnings assets (INTEXPY = 3.83% annually vs. 3.06%). Finally, the failed banks were less likely to be owned by a multi-bank holding company (13% vs. 20%), although this difference is not statistically significant.

These univariate statistics indicate that failed banks differ from survivors in a number of ways beyond their reliance on brokered deposits. A more complete analysis of brokered deposits requires a multivariate model.

B. Effect of Additional Explanatory Variables on Brokered Deposit Coefficients

Table 6 provides information about the effect of INTEXPY and loan decomposition on the implied effect of BD on failure. The first four rows are taken from Table 4 of my May report, describing a probit model that did not include INTEXPY or a separate measure of C&D loans. The effect of BD is large and (surprisingly) declines with the IDI's use of brokered funds. Rows 5 – 8 report the corresponding marginal probabilities from Table 1 here. Although the marginal effects still fall with BD concentration, the estimated impact of BD on default is uniformly smaller than it was in the specifications that did not include INTEXPY.

Conclusion: At least some of the risk effects of BD are therefore associated with institutions paying high funding costs, regardless of the source of those funds.

IV. Specifying the Forecasting Horizon and Failure Intervals for a Probit Model

Many determinants of IDI failure carry coefficients that differ in sign and/or significance across forecasting horizons and failure intervals. Some of these are discussed above, and others are summarized in Table 7. For example,

- BD are very slightly, or quite strongly, related to failure, at different forecasting horizons. (See the lower half of Table 6.)
- Asset growth is negatively related to failure probability in the short run, but positively related in the long run (Table 4).
- The multibank holding company dummy (HCTMULT) reduces failure probability in most estimations, but not when forecasting the ensuing year's failures (Table 7).
- Like other types of loans, C&D loans reduce default probability in the short term. But over a longer horizon, only C&D loans make an IDI more likely to fail.
- Non-Current Loans have no significant effect in models that specify one-year default intervals. Upon releasing the restriction that Non-Current Loans cause failure with a specific lead time, however, we find a robustly positive effect on predicted default (Table 7).

What do these apparent inconsistencies imply about computing data-driven deposit insurance premia?

First, it is important to avoid inferring a specific effect – or the absence of a significant effect – from any single probit model.

Second, some variables have different relations with subsequent default, depending on the time interval over which default is measured. The full implications of asset growth or C&D lending become apparent only when their effects are examined across several forecasting horizons.

Third, accounting data does not generally provide timely indications of asset impairments in the banking book. This may reflect an increasing supervisory influence on accounting statements as an IDI weakens.[6] The coefficient pattern for C&D loans is consistent with the possibility that they are more fairly valued closer to failure (column (4) of Table 1) than further away (columns (5) and (6) of Table 1).

The coefficient patterns across forecasting horizons and failure intervals indicate that a researcher (or policy maker) must be flexible in specifying IDI failure models. Any single model may include effects that are inconsistent with other, equally plausible, model specifications. The

[6] See J.W. Gunther and W.R. Moore (2003). Loss underreporting and the auditing role of bank exams, *Journal of Financial Intermediation,* **12**, 153-177.

most complete assessment of failure determinants can be obtained by examining a set of related probit models, as in Table 1.

V. Summary

This supplement to my May 1 report on "Data Driven Deposit Insurance Assessments" expands the time period and the IDI characteristics included in probit models of IDI failure. The conclusions from this supplementary analysis are as follows.

1. The (implausibly) large estimated effect of BD on IDI failure are appreciably reduced – although not eliminated – by controlling for an institution's cost of funding earning assets. The predictive ability of this variable (SDI name: INTEXPY) is substantial and robust.

2. IDIs affiliated with a multibank holding company are less likely to fail.

3. Asset growth and C&D loans are both associated with near-term survival, but longer-term failure.

4. It seems unlikely that an IDI's condition at one point in time can predict failure within a narrow time span. Rather, the effects of some important firm features change across forecasting horizons and/or do not manifest themselves in model estimates for narrow forecast intervals. Trying to infer the determinants of IDI failure from a probit model estimated for a single forecasting horizon and one failure interval is likely to generate incorrect or seriously incomplete assessments of IDI failure determinants.

Table 1: Failure Probability Models: Estimation Results

Marginal failures probabilities are reported, with t-statistics in parentheses beneath each estimate. Asset and liability items are reported as a proportion of total assets. Within each column, the liability coefficients are taken from model that excludes Core Deposits and the (shaded) asset coefficients are taken from a model that excludes Federal Funds Sold. The coefficients on the excluded items and on non-balance sheet items are identical between the two estimated models.

	Failures during one calendar year			**Failures during 2008 – 2011Q1**		
	1-year	2-year	3-year	2007	2006	2005
Brokered Deposits	-0.01	0.02	0.11***	0.22***	0.31***	0.21**
	(-0.28)	(0.92)	(5.29)	(2.83)	(3.75)	(2.27)
(Dummy: 10%≤ Brokered Dep. ≤ 25%)*BD	0.02	0.01	-0.05***	-0.07	-0.13*	-0.05
	(1.06)	(0.42)	(-2.83)	(-0.97)	(-1.94)	(-0.59)
(Dummy: 25%≤ Brokered Dep. ≤ 50%)*BD	0.03	0.00	-0.07***	-0.09	-0.17**	-0.08
	(1.58)	(0.18)	(-3.58)	(-1.18)	(-2.32)	(-0.99)
(Dummy: Brokered Dep. ≥ 50%)*BD	0.01	-0.01	-0.09***	-0.15*	-0.25***	-0.09
	(0.81)	(-0.47)	(-4.23)	(-1.79)	(-3.05)	(-1.08)
Non-Brokered, Non-core Deposits	0.01*	0.01	0.02***	0.04*	0.06**	0.06***
	(1.69)	(0.98)	(3.29)	(1.68)	(2.57)	(2.74)
FFS, CORE	0.00	-0.07***	-0.08***	-0.14***	-0.21***	-0.21***
	(0.08)	(-4.30)	(-6.15)	(-3.00)	(-4.64)	(-5.15)
FHLB	0.02*	0.02**	0.01	0.10***	0.06**	0.09***
	(1.70)	(2.45)	(0.95)	(3.75)	(2.19)	(2.94)
FFP	-0.01	0.01	0.01	0.01	0.05	0.04
	(-0.66)	(1.04)	(0.89)	(0.24)	(1.51)	(1.08)
Other Liabilities	0.02	-0.01	0.00	0.04	0.05	-0.00
	(1.03)	(-0.48)	(0.08)	(0.91)	(1.17)	(-0.03)
Equity	-0.31**	-0.02	0.02	0.02	0.05	0.07*
	(-2.46)	(-0.55)	(0.98)	(0.39)	(0.88)	(1.88)
C&I Loans	-0.04***	-0.01	-0.02**	-0.08**	-0.02	-0.01
	(-2.96)	(-1.00)	(-2.22)	(-2.11)	(-0.64)	(-0.14)
C&D	-0.03**	0.02**	0.02**	0.06*	0.22***	0.25***
	(-2.45)	(2.07)	(2.54)	(1.73)	(5.92)	(6.55)
OTH_CRE	-0.05***	-0.02**	-0.02*	-0.09**	-0.02	0.02
	(-4.50)	(-2.53)	(-1.84)	(-2.54)	(-0.60)	(0.72)
Other Loans	-0.05***	-0.03***	-0.02***	-0.11***	-0.05*	-0.02
	(-3.86)	(-2.91)	(-2.86)	(-3.24)	(-1.90)	(-0.61)

Other Assets	-0.04***	-0.03**	-0.05***	-0.17***	-0.14***	-0.06
	(-2.85)	(-2.06)	(-3.88)	(-3.08)	(-2.83)	(-1.31)
Total Securities	-0.05***	-0.02**	-0.02***	-0.08**	-0.03	-0.02
	(-3.38)	(-2.40)	(-2.58)	(-2.27)	(-1.05)	(-0.55)
Trade Account Assets	-0.37	-0.07	-0.05	-0.38*	-0.62	0.22
	(-1.31)	(-1.23)	(-0.87)	(-1.94)	(-1.30)	(1.00)
OREO	-0.01	-0.05	-0.15**	0.13	0.36	0.30
	(-0.29)	(-1.43)	(-2.07)	(0.56)	(0.90)	(0.59)
Ln(Assets)	0.00	0.00**	0.00**	0.00*	0.00*	0.00
	(1.51)	(2.07)	(1.97)	(1.87)	(1.78)	(1.35)
Non Current Loans/Equity	0.00	-0.00	-0.00	0.06***	0.08***	0.04**
	(0.85)	(-0.98)	(-0.43)	(3.96)	(4.97)	(2.23)
INTEXPY	0.35***	0.71***	0.70***	1.19***	1.08***	0.74
	(5.60)	(9.72)	(8.25)	(3.23)	(2.75)	(1.64)
ROA	-0.01***	-0.01***	-0.00*	-0.01***	-0.01**	-0.01*
	(-3.05)	(-10.02)	(-1.91)	(-5.25)	(-2.01)	(-1.79)
HCTMULT	-0.00	-0.01***	-0.01***	-0.02***	-0.03***	-0.03***
	(-0.42)	(-3.69)	(-4.07)	(-4.16)	(-4.46)	(-4.31)
Asset Growth	-0.01**	-0.00	0.01**	0.01	0.03***	0.04***
	(-2.09)	(-0.98)	(2.43)	(0.85)	(3.49)	(4.63)
BD growth	0.03**	0.01	-0.00	0.15**	0.02	0.03
	(2.21)	(0.97)	(-0.22)	(2.21)	(0.28)	(0.28)
BD*Asset growth	0.02*	-0.02*	-0.03*	-0.05	-0.04	-0.06
	(1.87)	(-1.79)	(-1.91)	(-0.92)	(-0.56)	(-0.88)
(BD growth) * (asset growth)	-0.03	0.08*	0.05	-0.12	-0.04	0.07
	(-0.77)	(1.91)	(1.33)	(-0.83)	(-0.28)	(0.37)
Charer Class: NM	-0.00**	-0.00***	-0.00**	-0.01**	-0.01*	-0.01
	(-2.57)	(-2.81)	(-2.11)	(-2.21)	(-1.83)	(-1.26)
Charter Class: SA	-0.00	-0.00	0.00	0.00	0.01	0.00
	(-0.25)	(-0.05)	(1.17)	(0.15)	(1.32)	(0.48)
Charter Class: SB	-0.01***	-0.01***	-0.01*	-0.02**	-0.02	-0.01
	(-2.99)	(-3.06)	(-1.86)	(-2.28)	(-1.55)	(-1.34)
Charter Class: SM	-0.00	-0.00	-0.00	-0.01	-0.00	-0.00
	(-1.42)	(-1.64)	(-0.77)	(-0.91)	(-0.46)	(-0.35)
N	30,289	30,660	31,479	7,752	7,984	8,191
Log Likelihood	-712.78	-1,196.68	-1,306.17	-806.41	-885.93	-947.76
Pseudo-R^2	0.598	0.290	0.211	0.368	0.301	0.243

Table 2: New Explanatory Variables with Robust Coefficients, from Table 1

Marginal failures probabilities are reported, with t-statistics in parentheses beneath each estimate.

	Failures during one calendar year			Failures during 2008 – 2011Q1		
Forecasting horizon:	**1-year**	**2-year**	**3-year**	**2007**	**2006**	**2005**
INTEXPY	0.35***	0.71***	0.70***	1.19***	1.08***	0.74
	(5.60)	(9.72)	(8.25)	(3.23)	(2.75)	(1.64)
ROA	-0.01***	-0.01***	-0.00*	-0.01***	-0.01**	-0.01*
	(-3.05)	(-10.02)	(-1.91)	(-5.25)	(-2.01)	(-1.79)
HCTMULT	-0.00	-0.01***	-0.01***	-0.02***	-0.03***	-0.03***
	(-0.42)	(-3.69)	(-4.07)	(-4.16)	(-4.46)	(-4.31)

Summary statistics across the entire sample:

	Mean	Median	Standard Deviation
INTEXPY	2.23%	2.18%	0.86%
ROA	0.75%	0.85%	0.93%

Note that these two variables have been winsorized at the 2.5% and 97.5% levels, to reduce the influence of extreme values.

Table 3: Loan Portfolio Composition Results, from Table 1

Marginal failures probabilities are reported, with t-statistics in parentheses beneath each estimate.

	Failures during one calendar year			Failures during 2008 – 2011Q1		
Forecasting horizon:	**1-year**	**2-year**	**3-year**	**2007**	**2006**	**2005**
C&I Loans	-0.04***	-0.01	-0.02**	-0.08**	-0.02	-0.01
	(-2.96)	(-1.00)	(-2.22)	(-2.11)	(-0.64)	(-0.14)
C&D	-0.03**	0.02**	0.02**	0.06*	0.22***	0.25***
	(-2.45)	(2.07)	(2.54)	(1.73)	(5.92)	(6.55)
OTH_CRE	-0.05***	-0.02**	-0.02*	-0.09**	-0.02	0.02
	(-4.50)	(-2.53)	(-1.84)	(-2.54)	(-0.60)	(0.72)
Other Loans	-0.05***	-0.03***	-0.02***	-0.11***	-0.05*	-0.02
	(-3.86)	(-2.91)	(-2.86)	(-3.24)	(-1.90)	(-0.61)

Table 4: Asset Growth as a Predictor of Failure, from Table 1

Marginal failures probabilities are reported, with t-statistics in parentheses beneath each estimate.

		Failures during one calendar year			Failures during 2008 – 2011Q1		
	Forecasting horizon:	**1-year**	**2-year**	**3-year**	**2007**	**2006**	**2005**
1	**Asset Growth**	-0.01**	-0.00	0.01**	0.01	0.03***	0.04***
		(-2.09)	(-0.98)	(2.43)	(0.85)	(3.49)	(4.63)
2	**BD growth**	0.03**	0.01	-0.00	0.15**	0.02	0.03
		(2.21)	(0.97)	(-0.22)	(2.21)	(0.28)	(0.28)
3	**BD*Asset growth**	0.02*	-0.02*	-0.03*	-0.05	-0.04	-0.06
		(1.87)	(-1.79)	(-1.91)	(-0.92)	(-0.56)	(-0.88)
4	**BD growth * (asset growth)**	-0.03	0.08*	0.05	-0.12	-0.04	0.07
		(-0.77)	(1.91)	(1.33)	(-0.83)	(-0.28)	(0.37)

Variable standard deviations:

Asset Growth	22.95%
BD growth	3.20%
BD*Asset growth	0.04
BD growth * (asset growth)	0.014

Table 5: Univariate Comparisons of 12/31/2007 Variables for Failed vs. Surviving IDIs

Summary statistics compare the yearend 2007 condition of firms that failed during the ensuing 3.25 years, against those that did not. All balance sheet categories expressed as a percentage of contemporaneous total assets. * (**) and (***) indicate significant differences between the Failed and Surviving samples at the 10% (5%) (1%) confidence levels.

	Failed IDIs				Surviving IDIs					
	N	Mean	Median	S.D.	N	Mean	Median	S.D.	Equal Means?	Equal Medians?
BD	304	0.11	0.07	0.13	7461	0.03	0.00	0.06	***	***
Equity	304	0.10	0.09	0.05	7461	0.12	0.10	0.07	***	***
Securities	304	0.13	0.10	0.11	7461	0.21	0.18	0.15	***	***
C&D Loans	304	0.38	0.34	0.26	7461	0.11	0.05	0.14	***	***
Total Loans	304	0.77	0.79	0.13	7461	0.66	0.69	0.17	***	***
INTEXPY	304	3.83	3.92	0.63	7451	3.06	3.11	0.74	***	***
HCTMULT	304	0.13	0.00	0.33	7461	0.20	0.00	0.40	***	
Non-Brokered, Non-core Deposits	304	0.09	0.11	0.17	7461	0.13	0.12	0.10	***	*
FHLB Advances	304	0.08	0.06	0.08	7461	0.05	0.02	0.07	***	***
OREO	304	0.01	0.00	0.01	7461	0.00	0.00	0.01	***	***
Non-current loans	304	0.03	0.01	0.03	7461	0.01	0.00	0.01	***	***
Core Deposits	304	0.59	0.60	0.14	7461	0.65	0.67	0.12	***	***

Table 6: Brokered Deposit Coefficient Variations

This Table reports the marginal probability effect of a change in BD balances, which depends upon an IDI's reliance on BD. Rows 1 – 4 reproduce results from my May 1 report (Table 4 there). Rows 5 – 8 combines the marginal probabilities reported in Table 1 here to yield marginal probabilities for the various levels of BD reliance.

		Failures during one calendar year			Failures during 2008 – 2011Q1		
	Forecasting horizon:	**1-year**	**2-year**	**3-year**	**2007**	**2006**	**2005**
	Results from May 1 Report						
1	**Brokered Deposits**	0.03	0.11***	0.19***	0.46***	0.45***	0.37***
		(1.08)	(3.84)	(7.15)	(5.73)	(5.45)	(4.35)
2	**Dummy: 10%≤ Brokered Dep. ≤ 25%*BD**	0.04***	0.09***	0.11***	0.29***	0.26***	0.23***
		(2.76)	(7.11)	(8.10)	(6.72)	(5.74)	(4.60)
3	**Dummy: 25%≤ Brokered Dep. ≤ 50%*BD**	0.03***	0.07***	0.07***	0.19***	0.16***	0.15***
		(2.89)	(6.45)	(5.40)	(4.83)	(3.74)	(3.21)
4	**Dummy: Brokered Dep. ≥ 50%*BD**	0.02	0.05***	0.05***	0.12**	0.09**	0.13***
		(1.64)	(3.84)	(3.03)	(2.19)	(2.01)	(2.68)
	Results with Expanded set of Explanatory Variables						
5	**Brokered Deposits**	-0.01	0.02	0.11***	0.22***	0.31***	0.21**
		(-0.28)	(0.92)	(5.29)	(2.83)	(3.75)	(2.27)
6	**Dummy: 10%≤ Brokered Dep. ≤ 25%*BD**	0.01	0.03**	0.06***	0.15***	0.18***	0.16***
		(0.32)	(2.53)	(5.61)	(3.47)	(3.71)	(2.93)
7	**Dummy: 25%≤ Brokered Dep. ≤ 50%*BD**	0.02	0.02***	0.04***	0.13***	0.14***	0.13**
		(0.74)	(2.68)	(4.49)	(3.43)	(3.19)	(2.43)
8	**Dummy: Brokered Dep. ≥ 50%*BD**	0.00	0.01	0.02**	0.07	0.06	0.12**
		(0.22)	(0.89)	(2.10)	(1.46)	(1.26)	(2.21)

Table 7: Time-sensitive significant variables, from Table 1

Marginal failures probabilities are reported, with t-statistics in parentheses beneath each estimate.

	Failures during one calendar year			Failures during 2008 – 2011Q1		
Forecasting horizon:	**1-year**	**2-year**	**3-year**	**2007**	**2006**	**2005**
C&D loans	-0.03**	0.02**	0.02**	0.06*	0.22***	0.25***
	(-2.45)	(2.07)	(2.54)	(1.73)	(5.92)	(6.55)
Non Current Loans / Equity	0.00	-0.00	-0.00	0.06***	0.08***	0.04**
	(0.85)	(-0.98)	(-0.43)	(3.96)	(4.97)	(2.23)
HCTMULT	-0.00	-0.01***	-0.01***	-0.02***	-0.03***	-0.03***
	(-0.42)	(-3.69)	(-4.07)	(-4.16)	(-4.46)	(-4.31)

Appendix: Variable Definitions

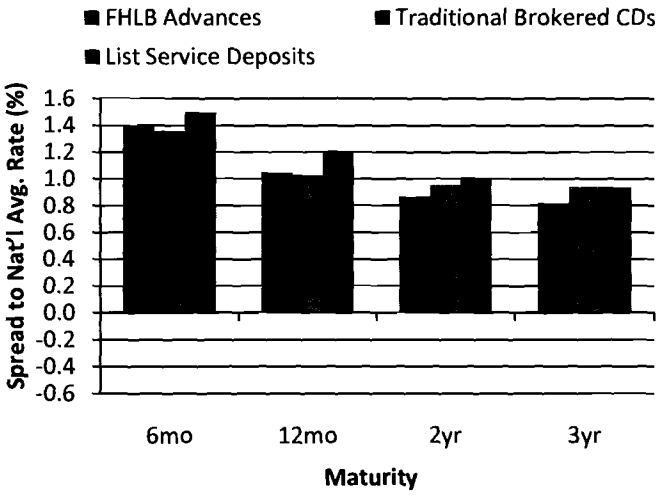
Items market with an asterisk (*) are deflated by contemporaneous total assets.

Brokered Deposits (BD) *	Total brokered deposits held in domestic offices. Brokered deposits represent funds which the reporting bank obtains, directly or indirectly, by or through any deposit broker for deposit into one or more deposit accounts. Thus, brokered deposits include both those in which the entire beneficial interest in a given bank deposit account or instrument is held by a single depositor and those in which the deposit broker sells participations in a given bank deposit account or instrument to one or more investors. (SDI variable: bro)
Bivariate dummies equal to unity if : (10%≤ Brokered Dep. ≤ 25%), or (25%≤ Brokered Dep. ≤ 50%), or (Brokered Dep. ≥ 50%)	
Non-Brokered, Non-core Deposits *	= total deposits – core deposits – brokered deposits (SDI variables: dep – coredep - bro)
FHLB *	Borrowings or "advances" from Federal Home Loan Banks (FHLB). (SDI variable othbfhlb)
FFP *	Total federal funds purchased and securities sold under agreements to repurchase in domestic offices. Thrift Financial Reports include only federal funds purchased. (SDI variable frepp)
Other Liabilities *	Residual liability category
Equity *	Total equity capital on a consolidated basis Equity (SDI variable: eqtot.)
FFS*, CORE*	CORE = core deposits, computed as t otal domestic office deposits minus (1) time deposits of $100,000 or more held in domestic offices. (SDI variable coredep) FFS = Total federal funds sold and securities purchased under agreements to resell in domestic offices (SDI variable frepo) CORE or FFS (each as a proportion of total assets) is omitted from each regression. When Core is omitted, coefficients on the other (included) liabilities indicate the impact of a change in liability-side composition with no change in leverage. When FFS is omitted, the coefficients on the other (included) asset shares indicate the impact of a change in asset-side composition with no change in leverage.
C&I Loans *	Commercial and industrial loans. Excludes all loans secured by real estate, loans to individuals, loans to depository institutions and foreign governments, loans to states and political subdivisions and lease financing receivables. (SDI variable: lnci)
C&D loans*	Construction and land development loans secured by real estate held in

	domestic offices. This item includes loans for all property types under construction, as well as loans for land acquisition and development. (SDI variable lnrecons)
OTH_CRE *	Other commercial real estate loans (besides C&D): Nonresidential loans (excluding farm loans) primarily secured by real estate held in domestic offices. Minus C&D Loans (SDI variables lnrenres – lnrecons)
Other Loans *	Residual loan category
Total Securities *	Total investment securities (excludes securities held in trading accounts). (SDI variable sc.)
Trade Account Assets *	Securities and other assets acquired with the intent to resell in order to profit from short-term price movements. (SDI variable: trade.)
OREO *	Includes direct and indirect investments in real estate. The amount is reflected net of valuation allowances (SDI variable ore.)
Other Assets *	Residual asset category
Ln(Assets)	Natural log of total (on-book) assets. (SDI variable for total assets: asset.)
Non Current Loans/Equity	Total noncurrent loans and leases, Loans and leases 90 days or more past due plus loans in nonaccrual status, as a percent of total equity. (SDI variables: nclnlsr*(lnlsnet + lnatres) / eqtot.)
INTEXPY	Annualized total interest expense on deposits and other borrowed money as a percent of average earning assets on a consolidated basis. (FDIC SDI variable name: intexpy.)
ROA	Net income after taxes and extraordinary items (annualized) as a percent of average total assets. (SDI variable name: roa.)
HCTMULT	Dummy variable = 1 if the IDI is owned by a multi-IDI holding company; else = 0.
Asset Growth	Percentage growth in total assets over the past two years (winsorized at 2.5%, 97.5%)
BD growth	Percentage growth in brokered deposit balances over the past two years (winsorized at 2.5%, 97.5%)
Charter Class	NM = "nonmember", SA = "savings association",. SB = savings banks (chartered and supervisied by FDIC). SM = "state member." Omitted category is "N", banks supervised by the OCC.

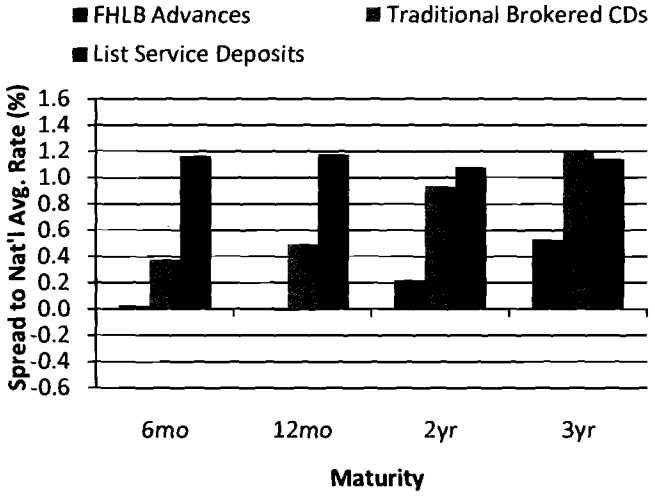
Attachment 3: Historical cost comparison of "core" and "non-core" funding sources

Pre-crisis: Average Monthly Spreads to National Average Jumbo CD Rates (4Q 2005 - 4Q 2007)



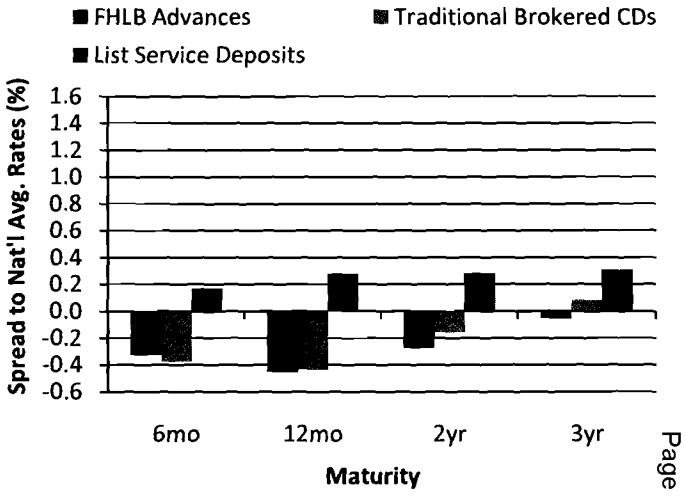
Funding Source	Avg. Spread to National Avg. Rate Across All Terms
FHLB Advances	1.03%
Traditional Brokered CDs	1.07%
List Service Deposits	1.16%

Crisis Era: Average Monthly Spreads to National Average Jumbo CD Rates (1Q 2008 - 2Q 2009)



Funding Source	Avg. Spread to National Avg. Rate Across All Terms
FHLB Advances	0.19%
Traditional Brokered CDs	0.76%
List Service Deposits	1.13%

Post-crisis: Average Monthly Spreads to National Average Jumbo CD Rates (3Q 2009 - 1Q 2011)



Funding Source	Avg. Spread to National Avg. Rate Across All Terms
FHLB Advances	-0.28%
Traditional Brokered CDs	-0.23%
List Service Deposits	0.26%

- National Average Jumbo CD rates reflect the monthly national average of charter-level jumbo CD rates, by term, as reported to RateWatch, Inc. RateWatch defines "jumbo CD" as a CD of $100,000 or more.
- FHLB Advances reflect the mean of FHLBs that report Advance rates for the applicable maturities on their websites. FHLB rate conventions my vary from bank to bank.
- Traditional Brokered CD rates reflect the monthly average of all-in costs, including fees paid to brokers, reported via survey by 5 leading brokers in the registered broker-dealer market. Data for the months of December 2008 and March 2011 were not available for this analysis.
- List service deposit rates reflect a monthly average of the top 10 rates for each applicable maturity, as posted by QwickRate, and do not include fees to the listing service. Data for the months of December 2008 and March 2011 were not available for this analysis.

Attachment 4: Construction & Development (C&D) Loans in GA and FL

Period	# of GA Failures	GA Failures' C&D Loans as a % of Total Capital 1yr Prior	GA Non-failed Banks' C&D Loans as a % of Total Capital 1yr Prior	National Non-failed Banks' C&D Loans as a % of Total Capital 1yr Prior
Q3 2008	1	655%	158%	70%
Q4 2008	4	697%	155%	70%
Q1 2009	4	501%	154%	70%
Q2 2009	5	360%	148%	69%
Q3 2009	10	434%	139%	68%
Q4 2009	6	350%	134%	66%
Q1 2010	7	298%	127%	62%
Q2 2010	2	234%	122%	59%
Q3 2010	5	383%	118%	56%
Q4 2010	7	310%	119%	53%
Q1 2011	6	406%	113%	51%

Period	# of FL Failures	FL Failures' C&D Loans as a % of Total Capital 1yr Prior	FL Non-failed Banks' C&D Loans as a % of Total Capital 1yr Prior	National Non-failed Banks' C&D Loans as a % of Total Capital 1yr Prior
Q3 2008	1	239%	126%	70%
Q4 2008	1	331%	120%	70%
Q1 2009	2	358%	121%	70%
Q2 2009	1	34%	111%	69%
Q3 2009	3	206%	109%	68%
Q4 2009	8	271%	107%	66%
Q1 2010	6	307%	100%	62%
Q2 2010	8	295%	97%	59%
Q3 2010	10	215%	97%	56%
Q4 2010	5	323%	58%	53%
Q1 2011	2	216%	87%	51%

* C&D Loans as a % of Total Capital reflects the average of individual charters' C&D loans divided by Total Risk-based Capital within each population of banks. Quarterly Call Report/TFR data from each period was used to identify levels of C&D loans and total capital at a charter level.

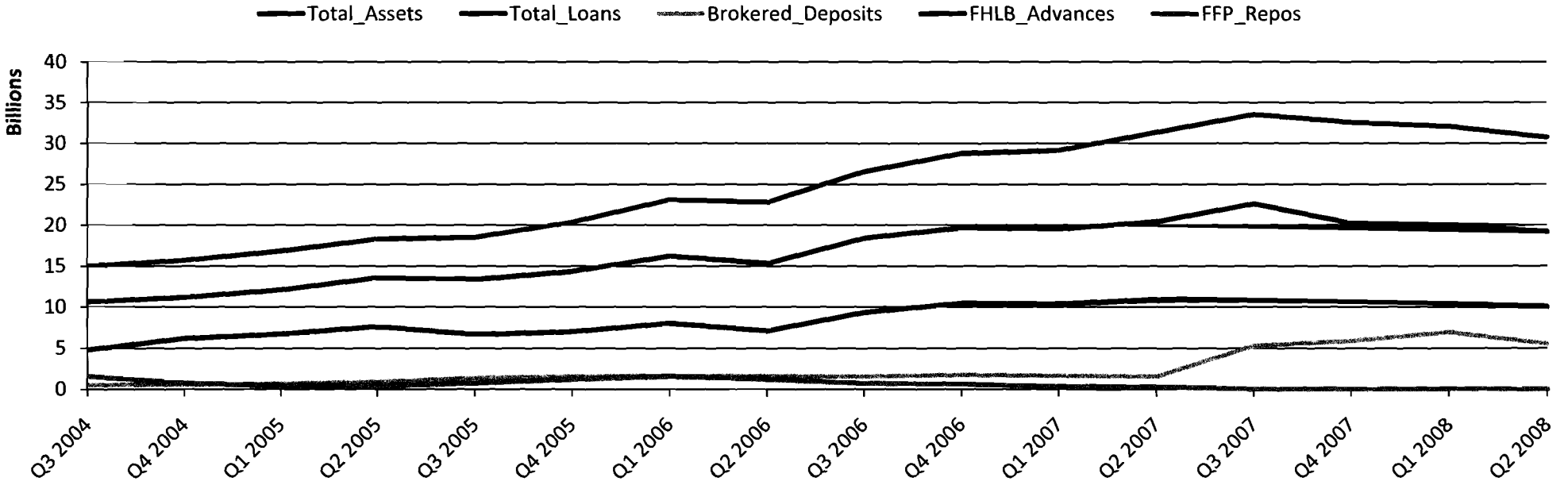
Attachment 5:

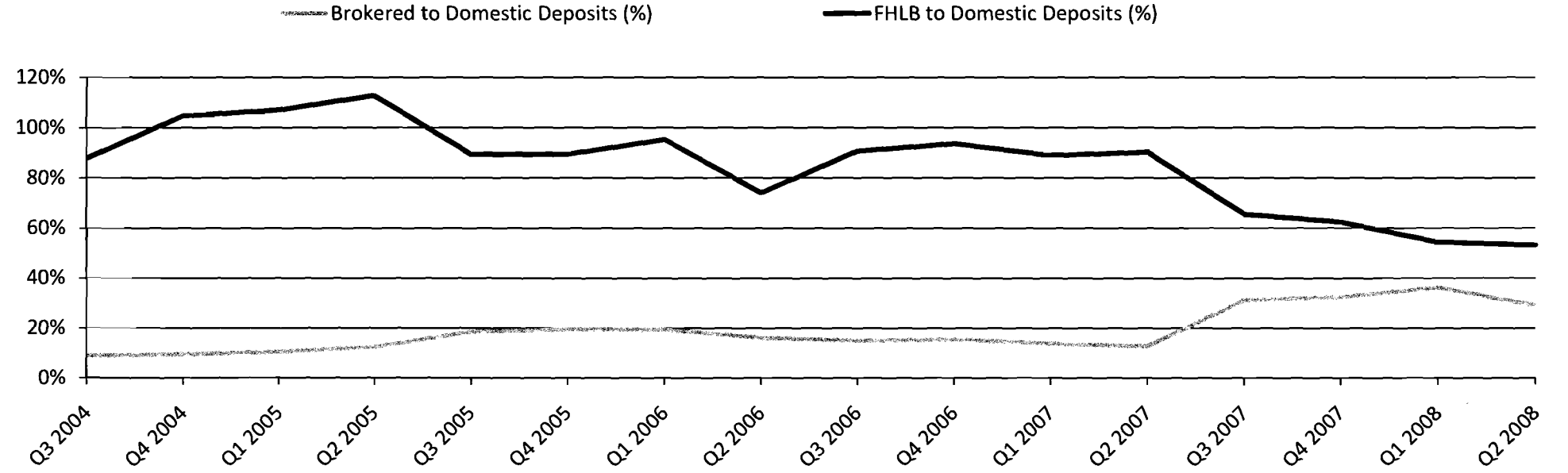
Funding charts for the 20 bank failures
that caused the largest losses to the Deposit Insurance Fund (DIF)

Bank: IndyMac Bank

Estimated cost to DIF: $10.7 billion
Rank: #1

Data show: Deposits classified as brokered were not used to advance asset growth except at the initiation of the crisis, when other forms of funding declined.

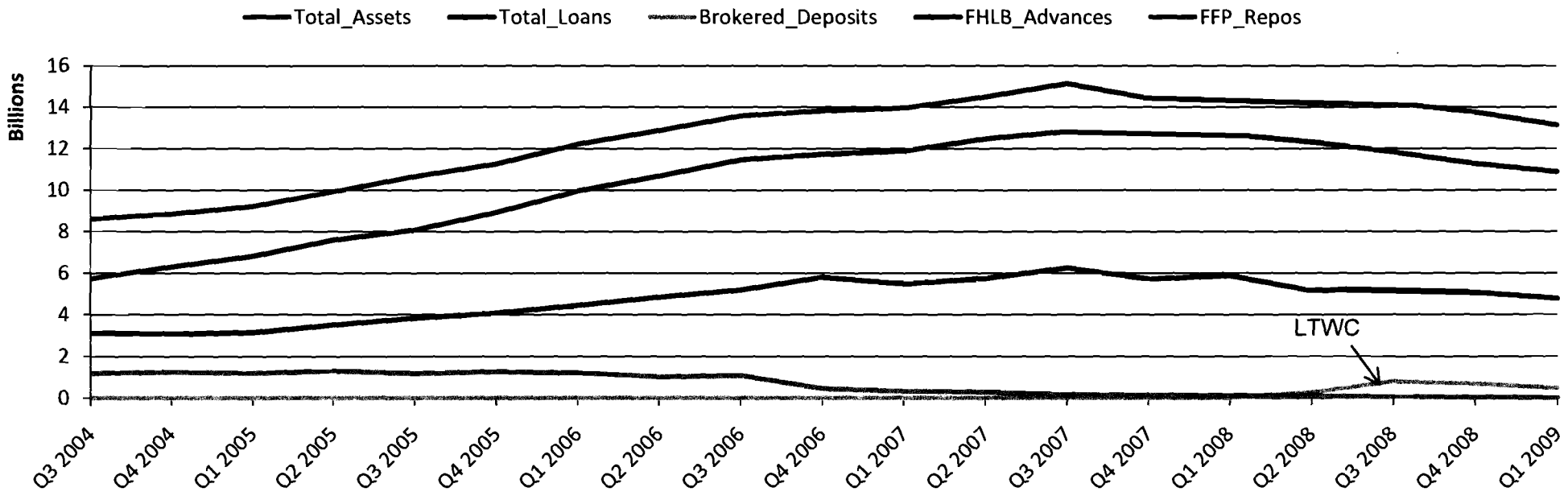


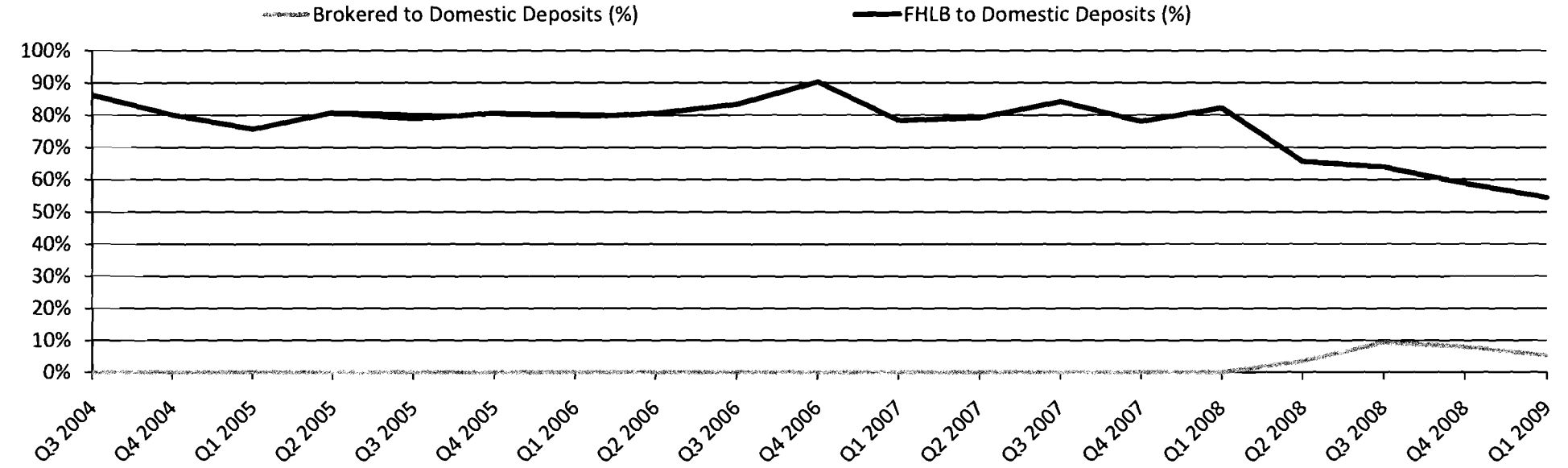


Bank: BankUnited, FSB

Estimated cost to DIF: $4.9 billion
Rank: #2

Data show: Deposits classified as brokered only were used to replace FHLB advances during a time of declining lending.

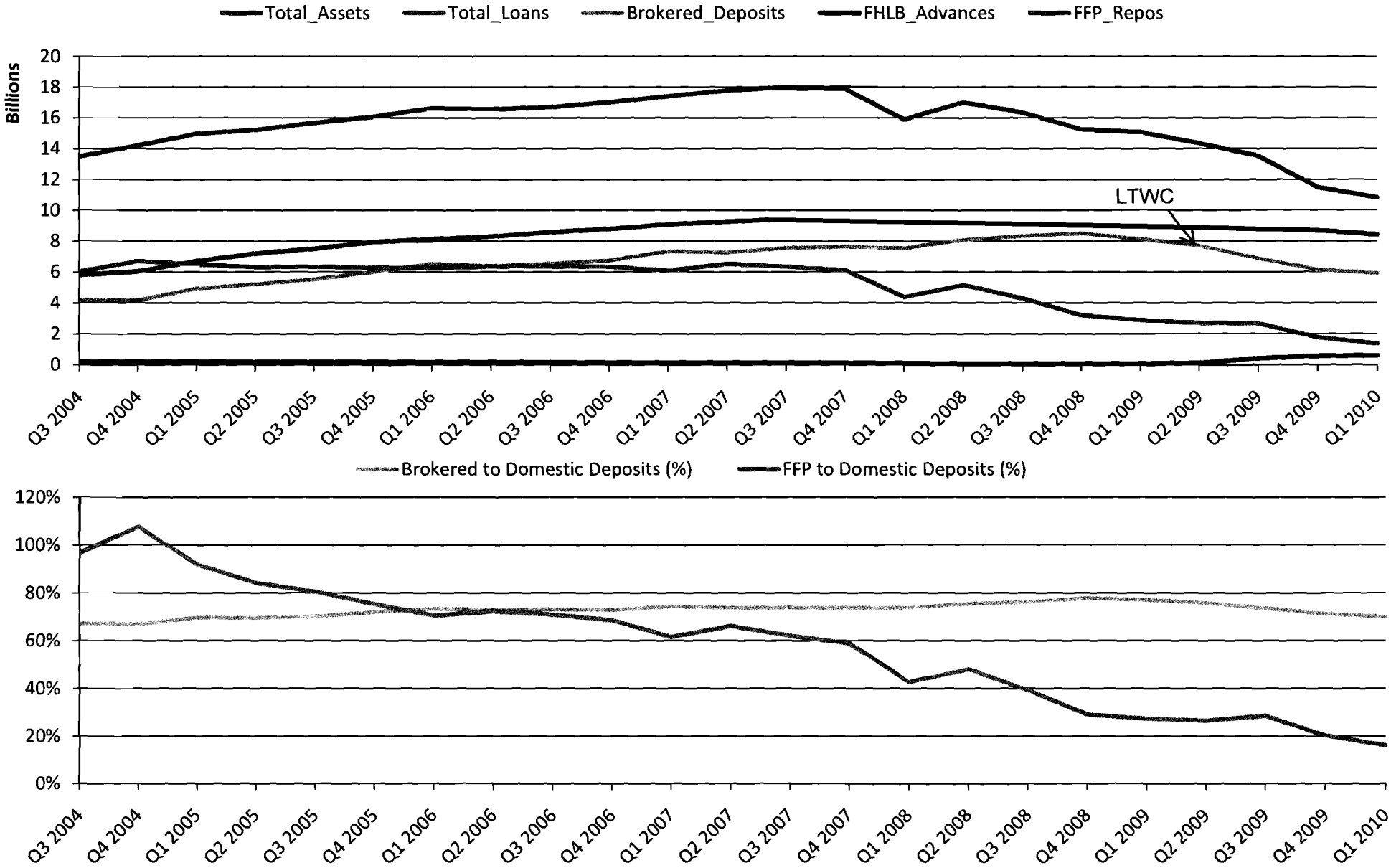




Bank: Westernbank Puerto Rico

Estimated cost to DIF: $3.31 billion
Rank: #3

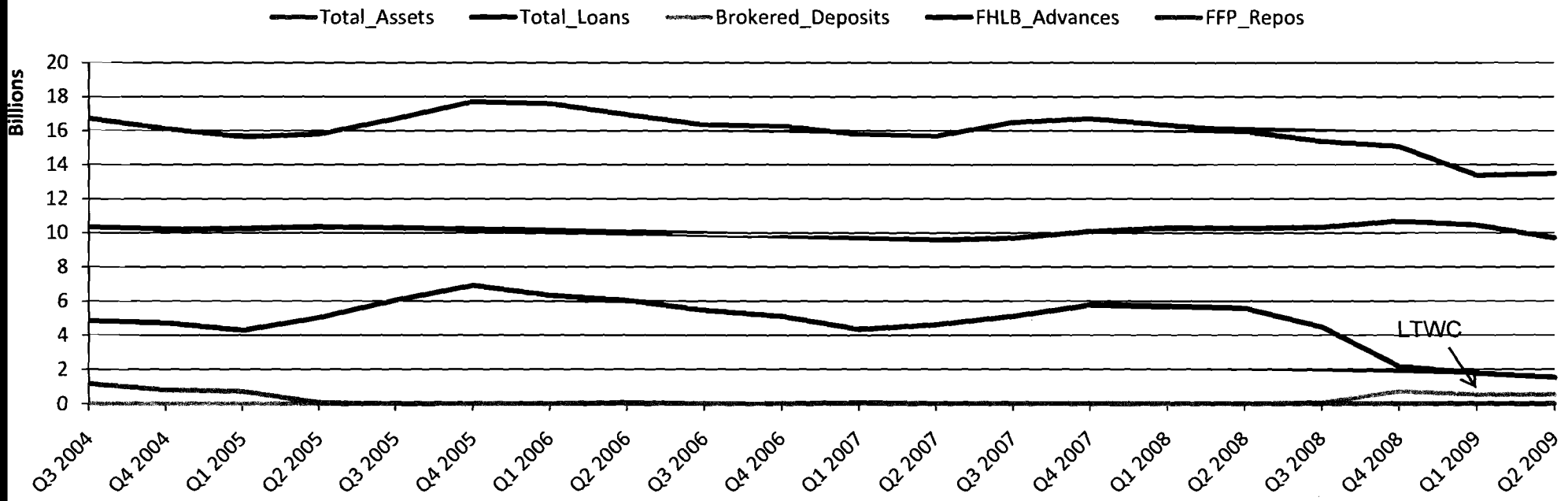
Data show: Like a number of Puerto Rican institutions, the bank's business model was highly reliant on traditional brokered deposits.

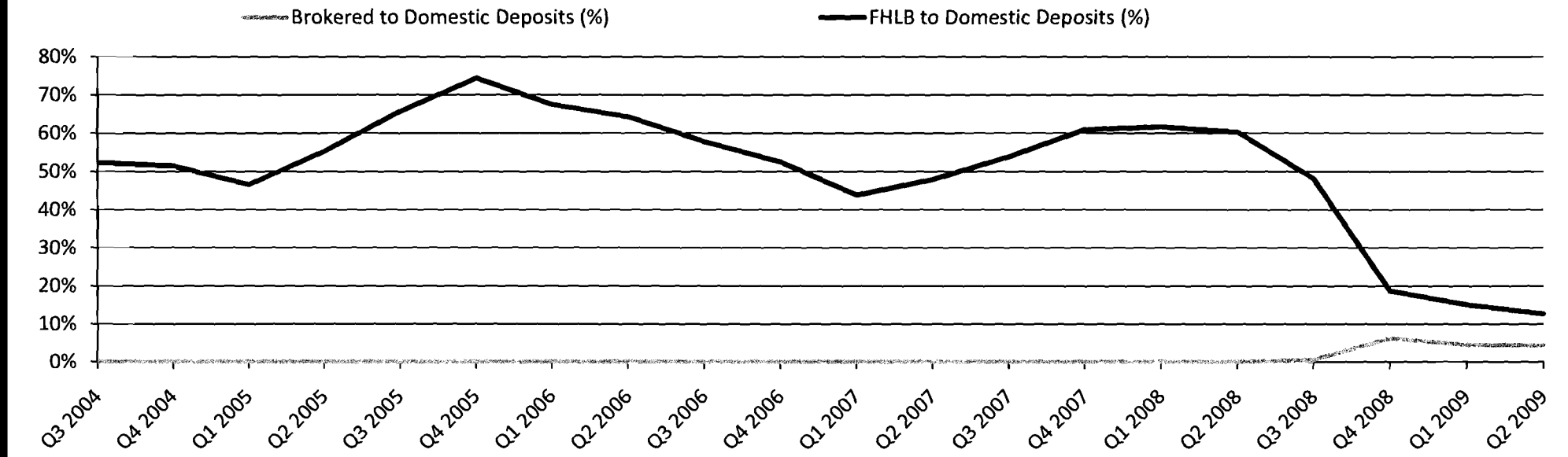


Bank: Guaranty Bank

Estimated cost to DIF: $3.0 billion
Rank: #4

Data show: Deposits classified as brokered only were used after the start of the crisis to replace FHLB advances during a period of flat or declining lending.

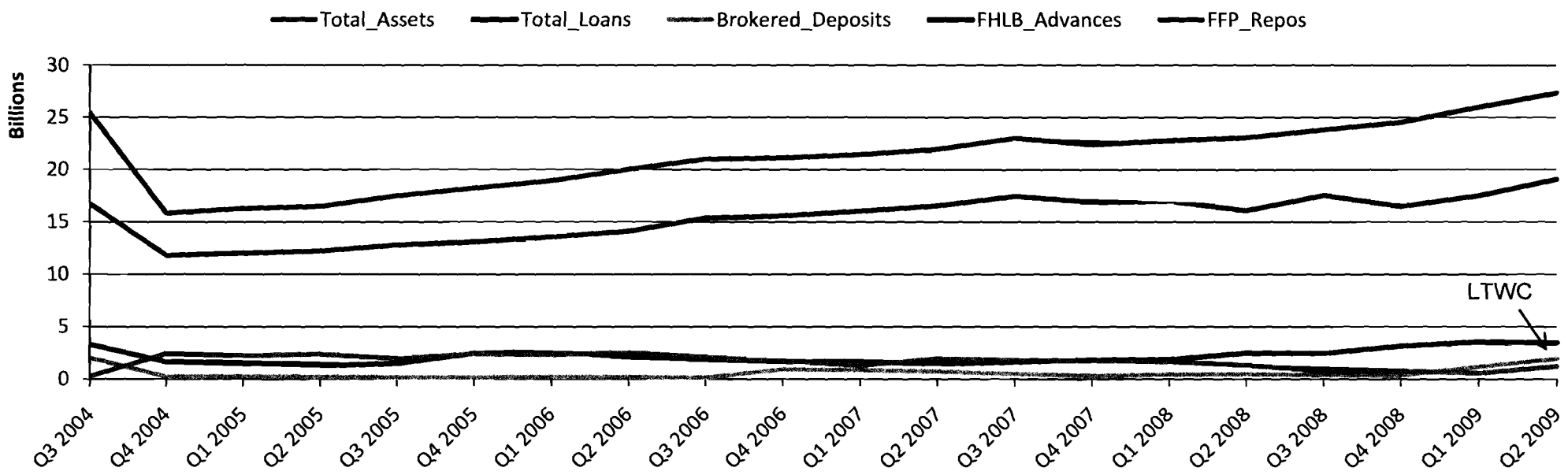


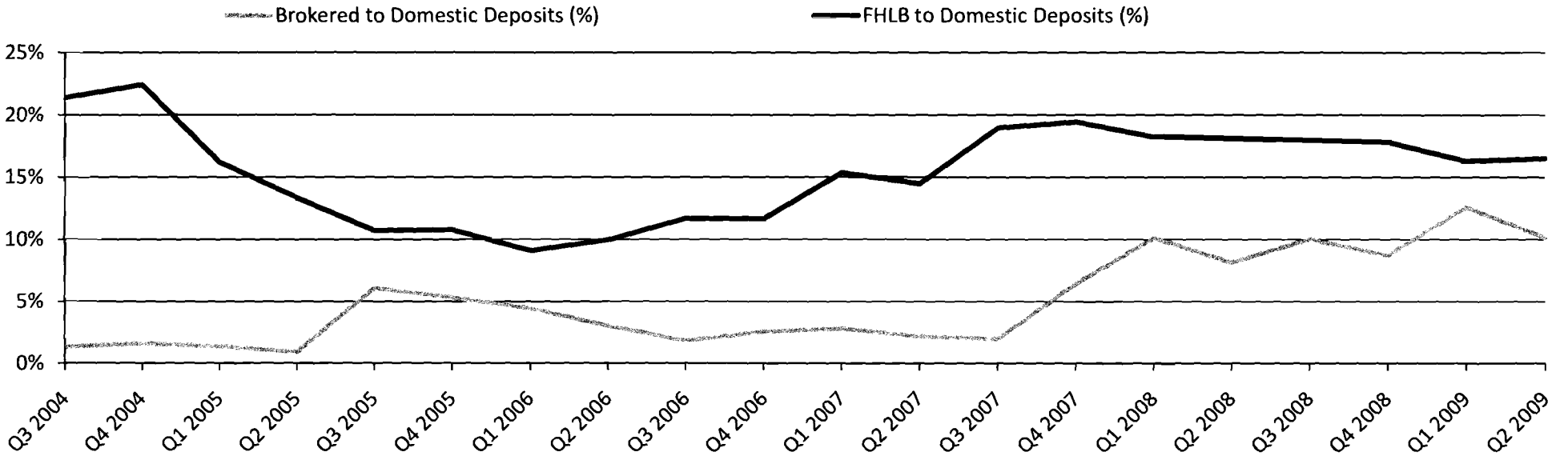


Bank: Colonial Bank

Estimated cost to DIF: $2.80 billion
Rank: #5

Data show: Deposits classified as brokered remained low during the primary periods of asset growth, growing only after the start of the crisis.



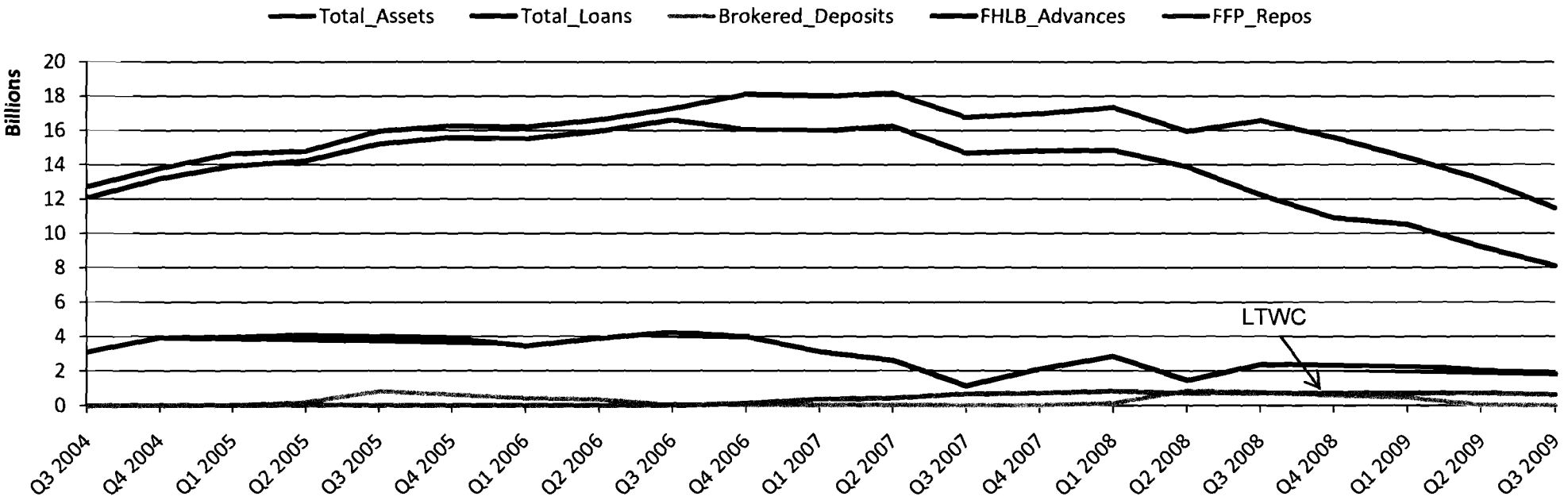


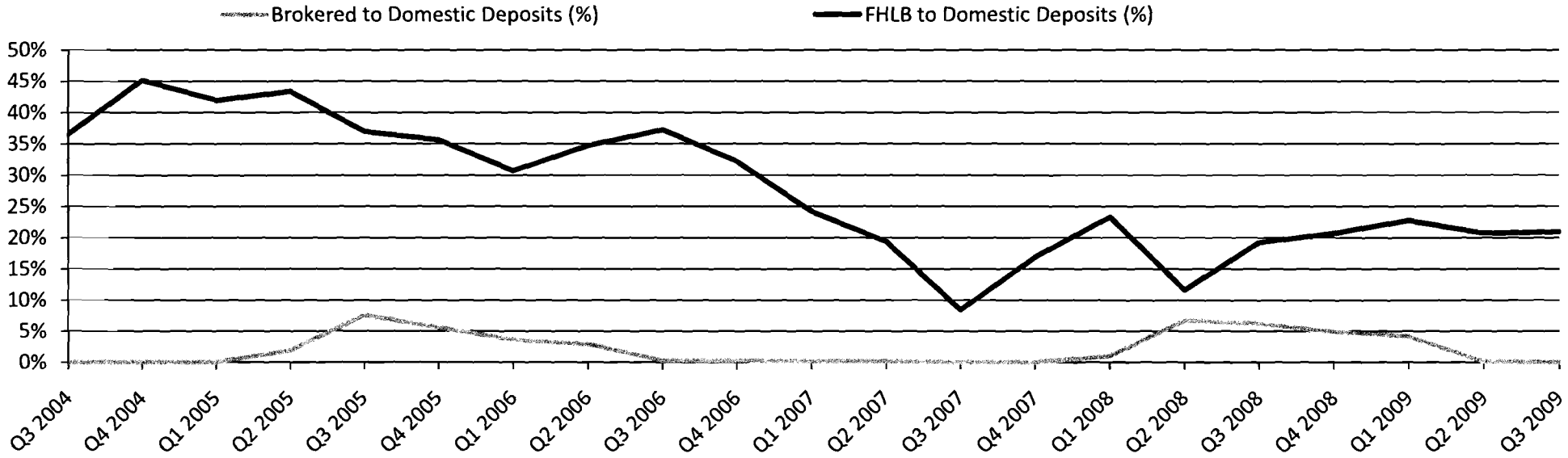
Bank: AmTrust Bank

Estimated cost to DIF: $2.0 billion

Rank: #6

Data show: Deposits classified as brokered remained low during periods of asset growth.

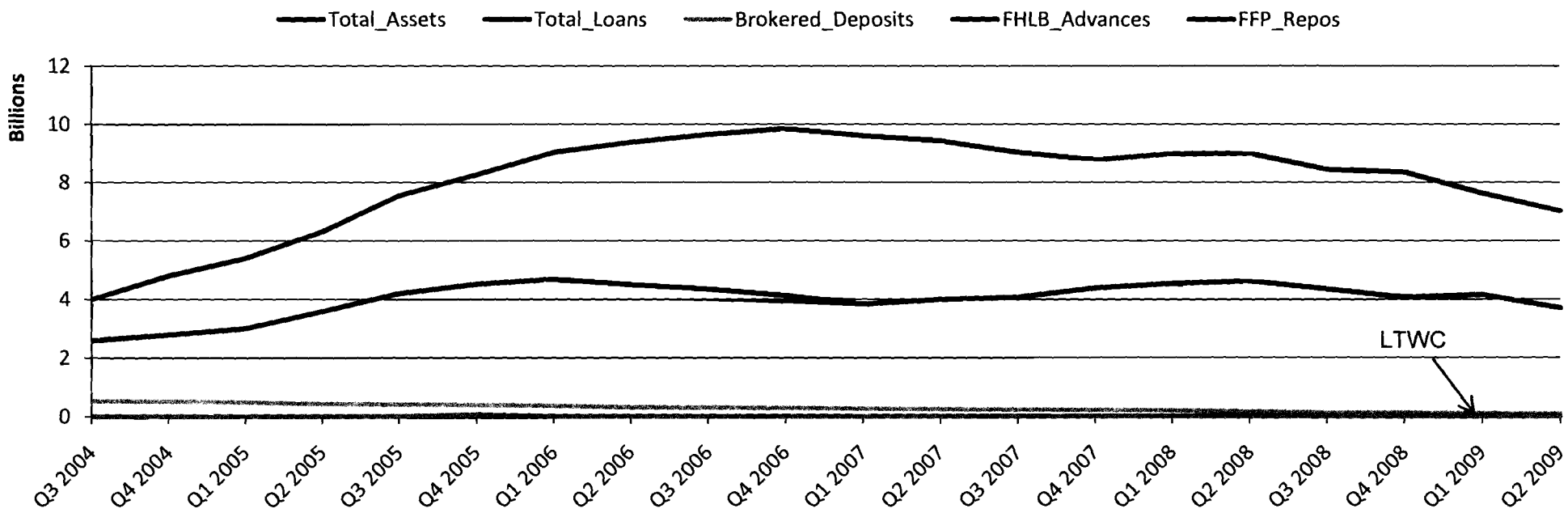


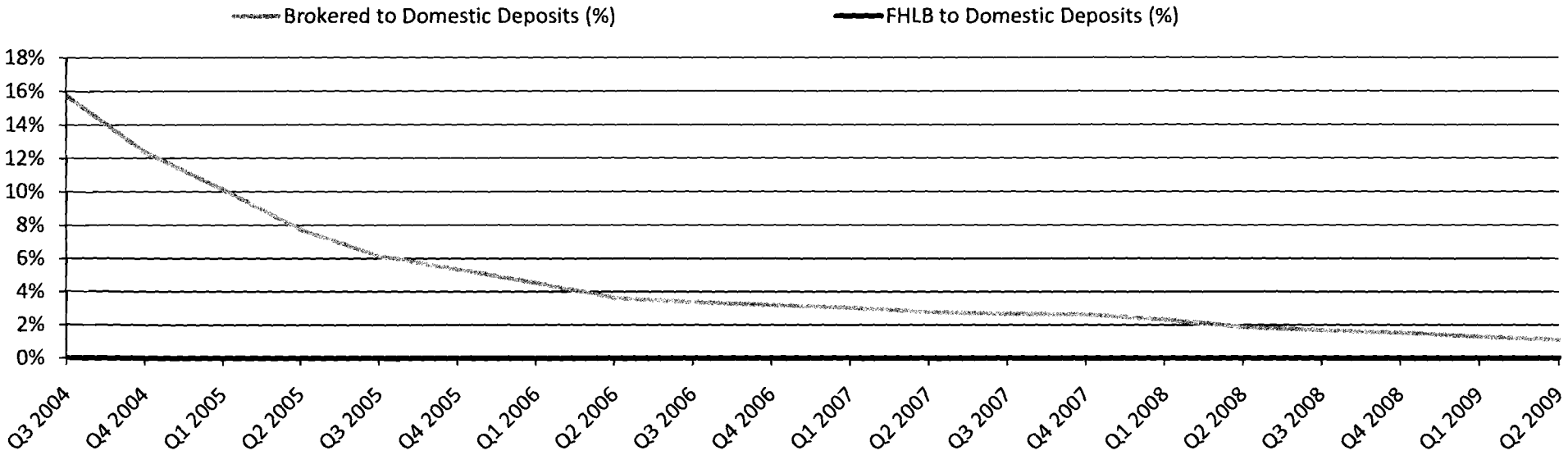


Bank: Corus Bank, National Association

Estimated cost to DIF: $1.7 billion
Rank: #7

Data show: Deposits classified as brokered declined during period of asset growth.

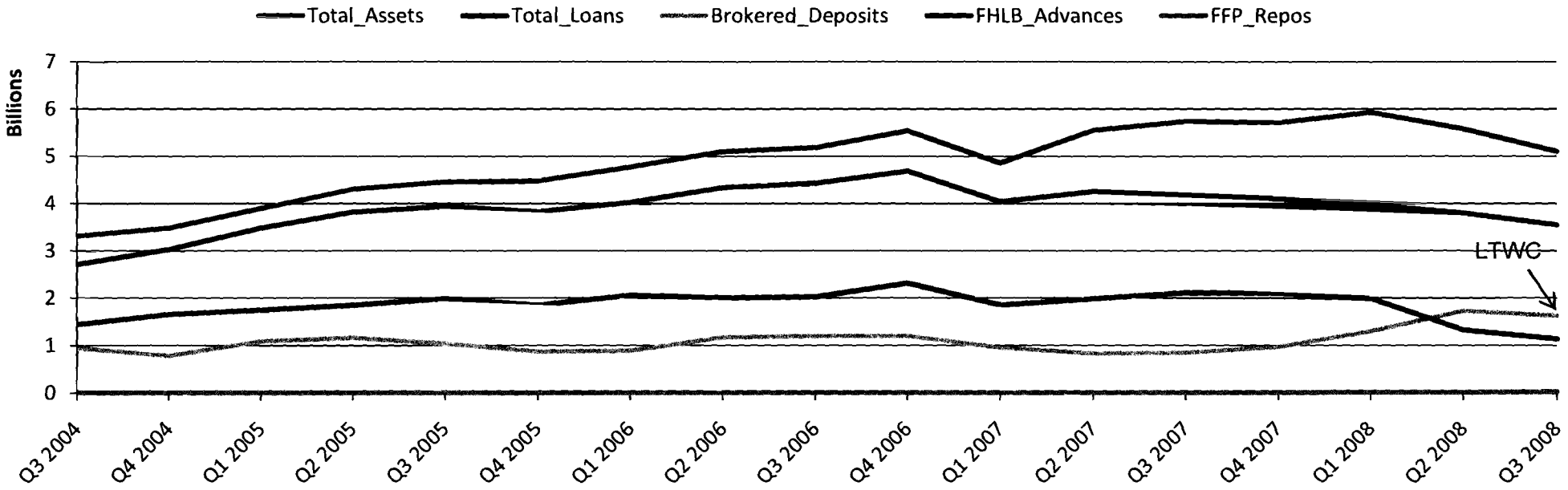


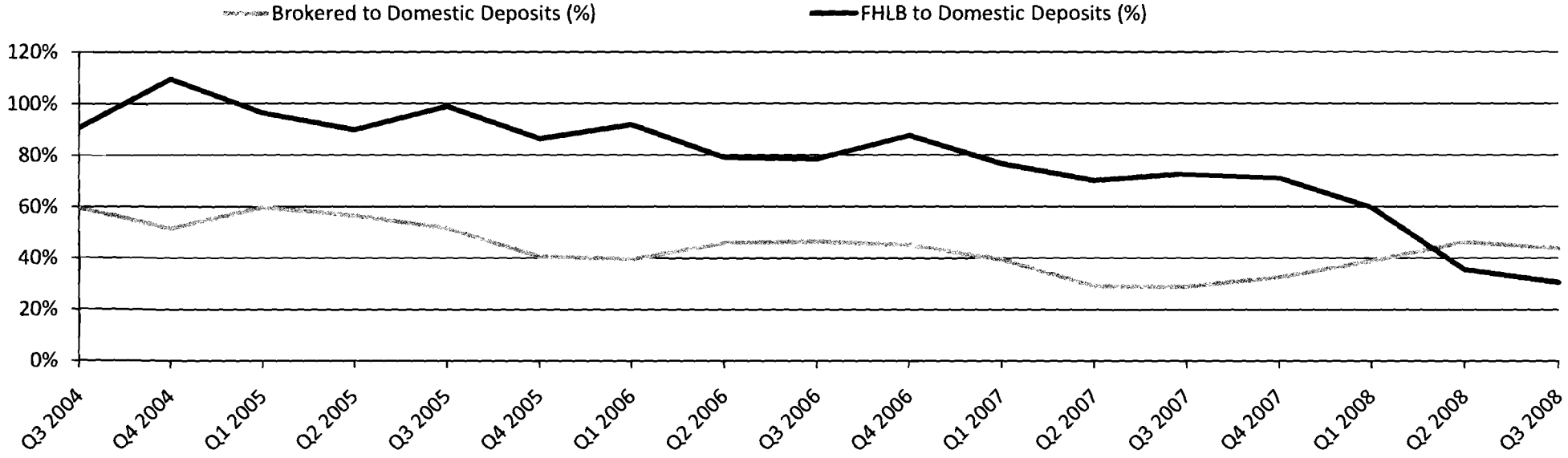


Bank: Franklin Bank, SSB

Estimated cost to DIF: $1.5 billion
Rank: #8

Data show: Deposits classified as brokered only grew during period of declining lending, replacing FHLB advances.

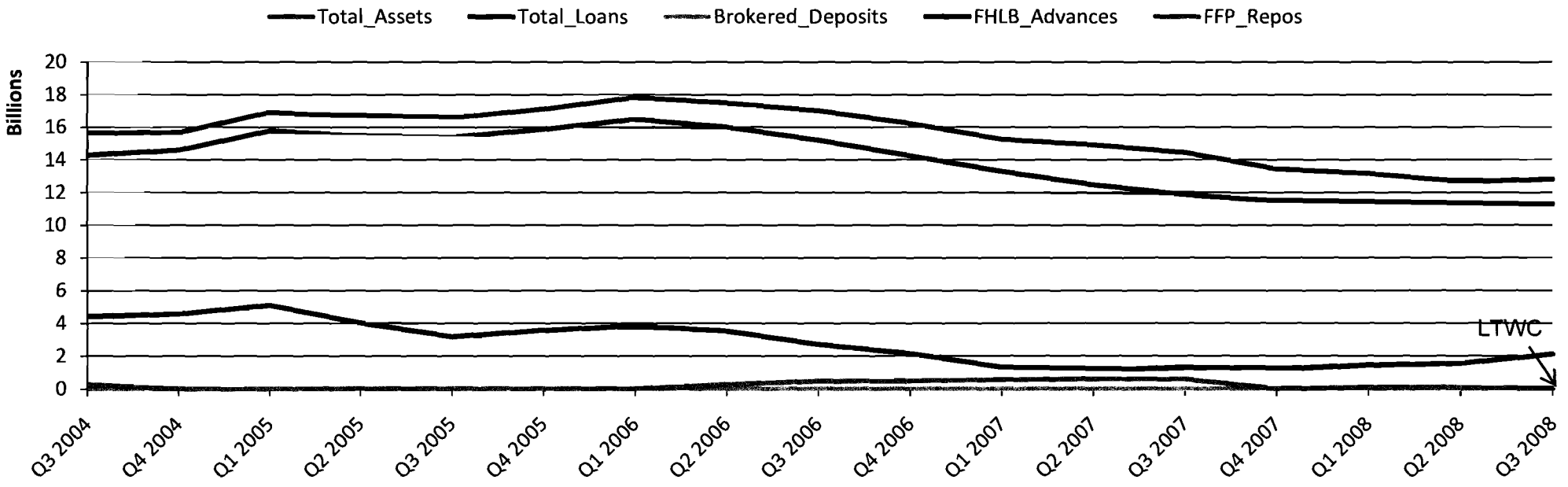


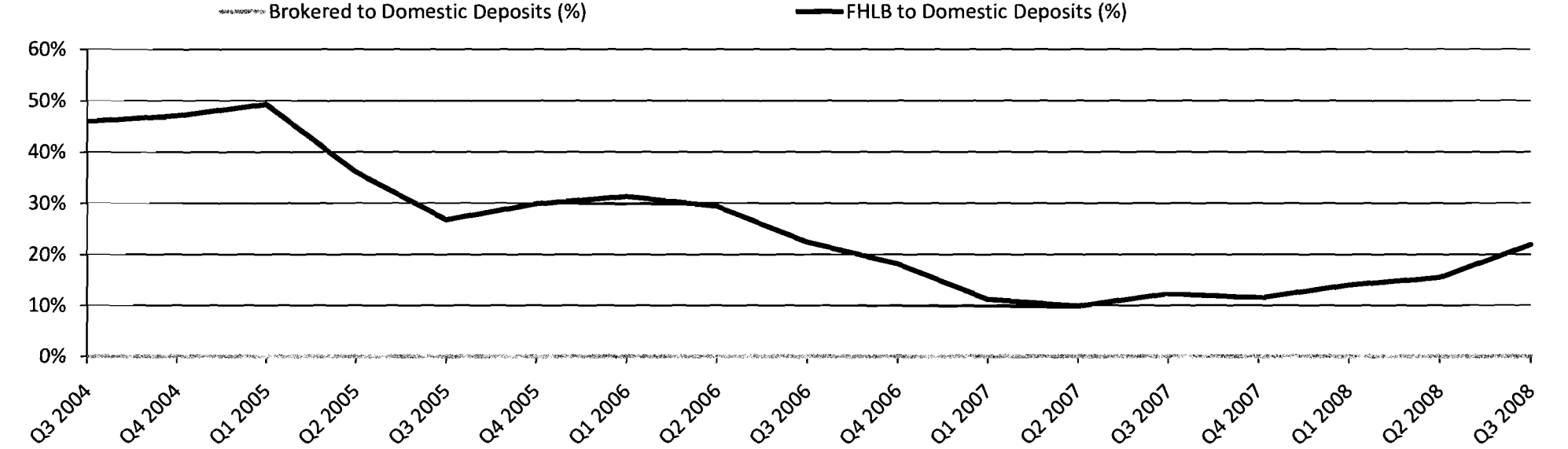


Bank: Downey Savings and Loan Association, F.A.

Estimated cost to DIF: $1.4 billion
Rank: #9

Data show: Bank did not use brokered deposits.

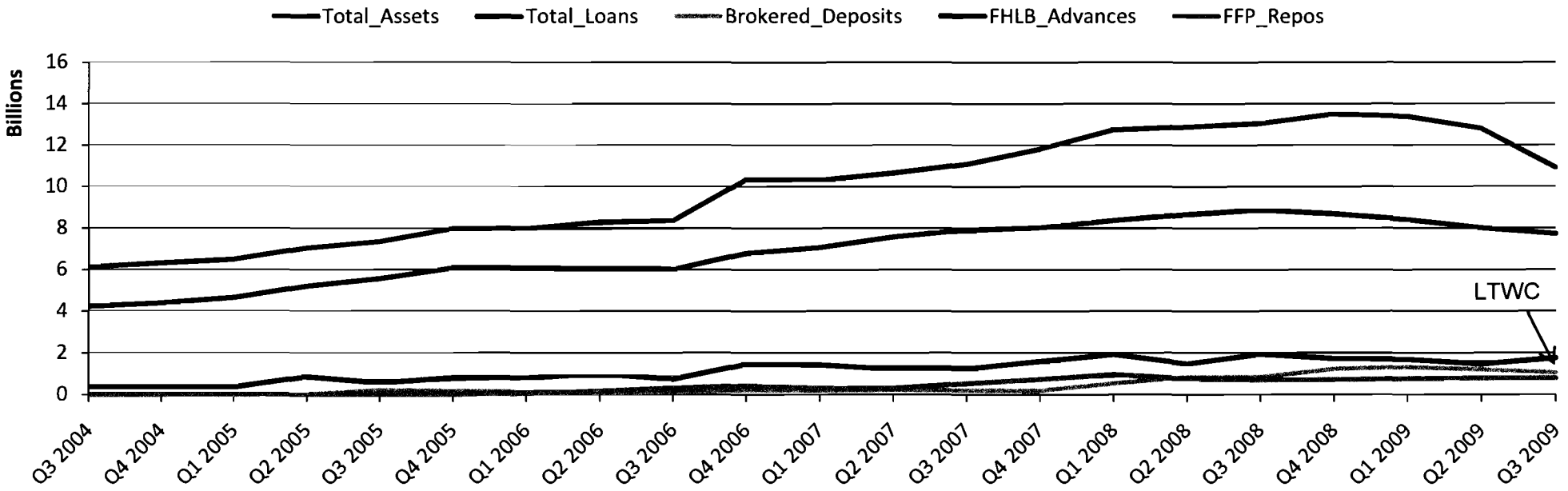


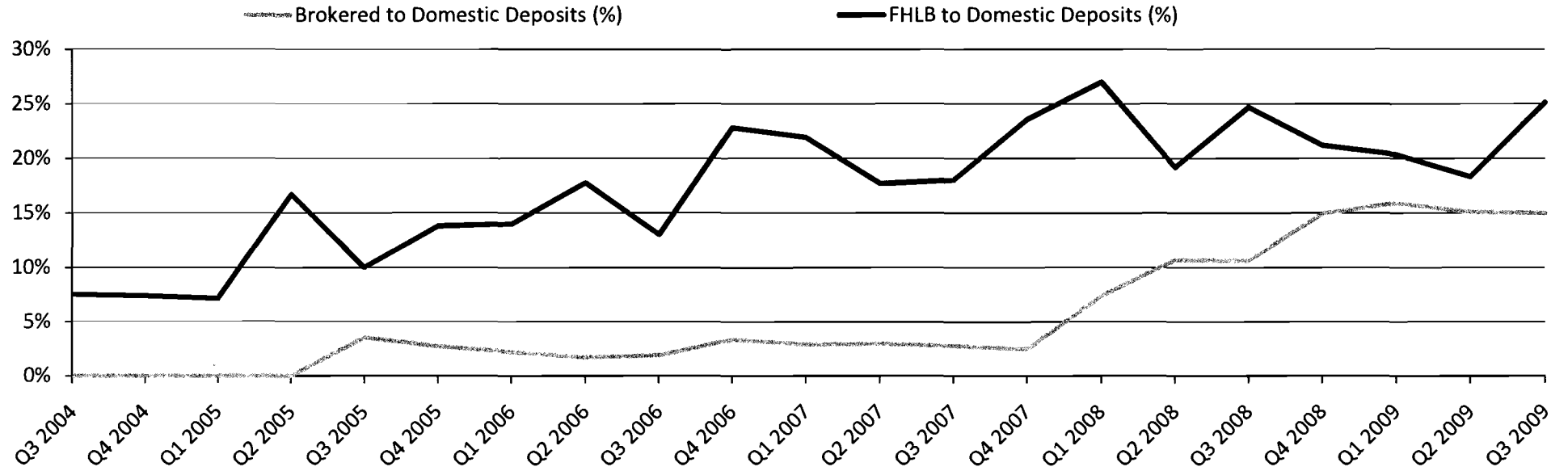


Bank: United Commercial Bank

Estimated cost to DIF: $1.4 billion
Rank: #10

Data show: Bank did not use deposits classified as brokered to a material degree until after the start of the crisis. Brokered funding was not used to support lending growth.

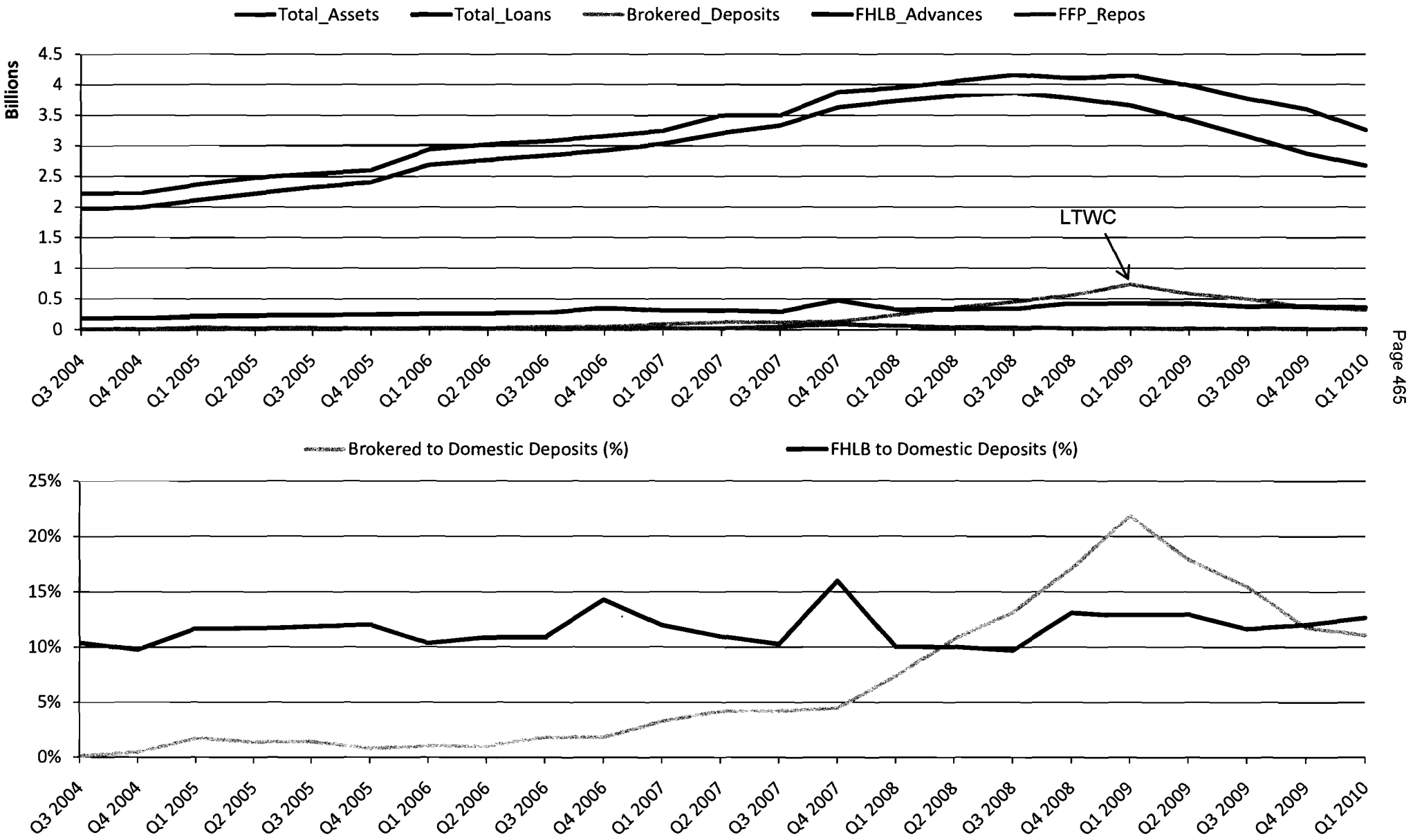




Bank: Frontier Bank

Estimated cost to DIF: $1.37 billion
Rank: #11

Data show: Bank did not use deposits classified as brokered to a material degree until after the start of the crisis. Brokered funding was not used to support lending growth.

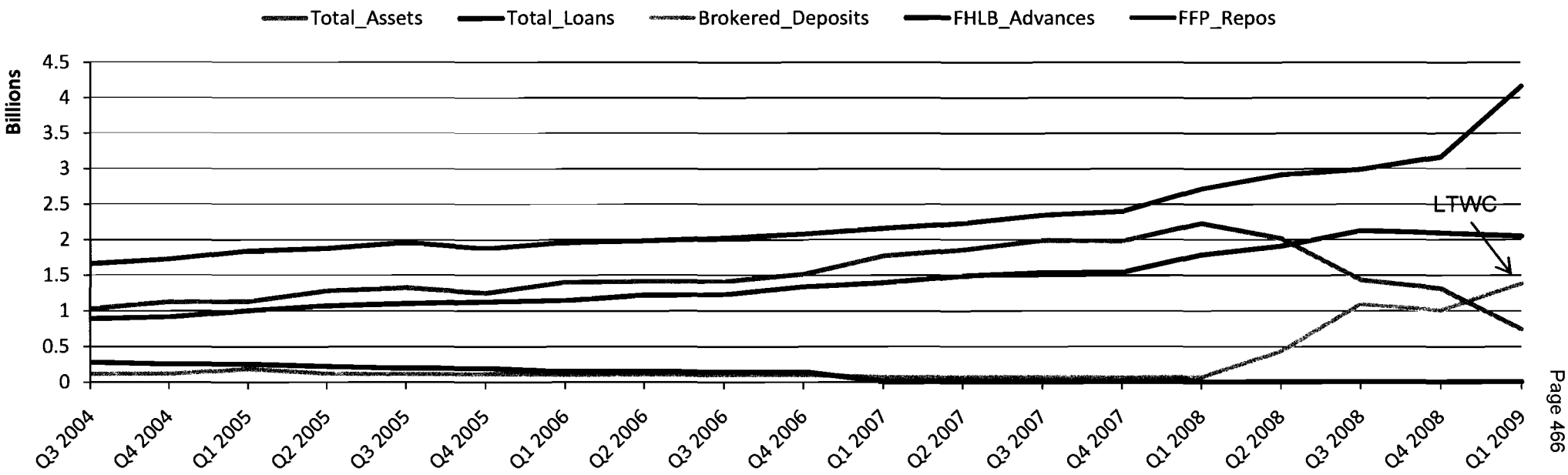


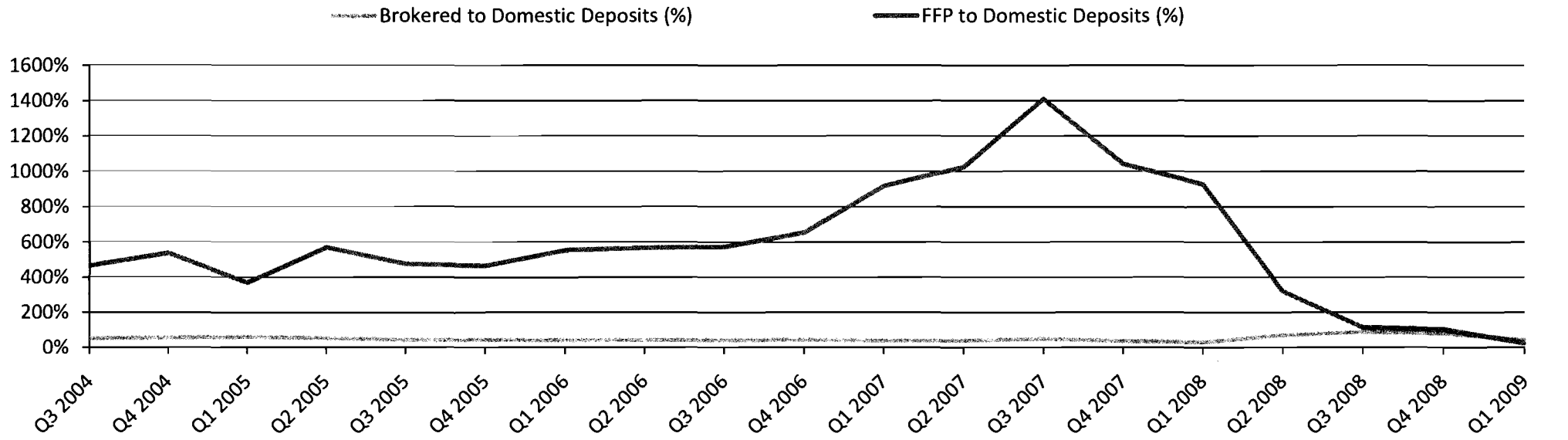
Bank: Silverton Bank, National Association

Estimated cost to DIF: $1.3 billion

Rank: #12

Data show: Bank did not use deposits classified as brokered to a material degree until after the start of the crisis.

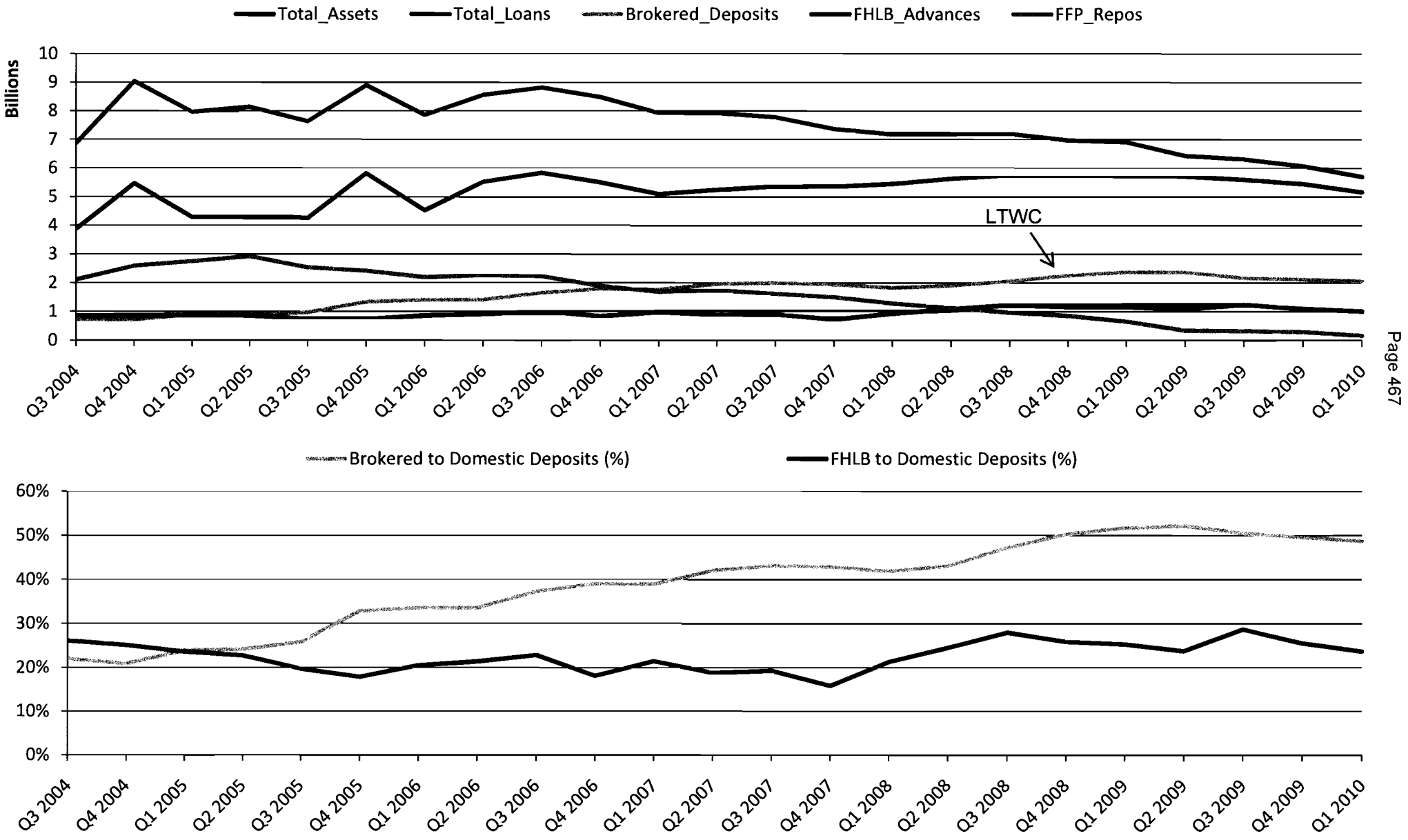




Bank: R-G Premier Bank of Puerto Rico

Estimated cost to DIF: $1.23 billion
Rank: #13

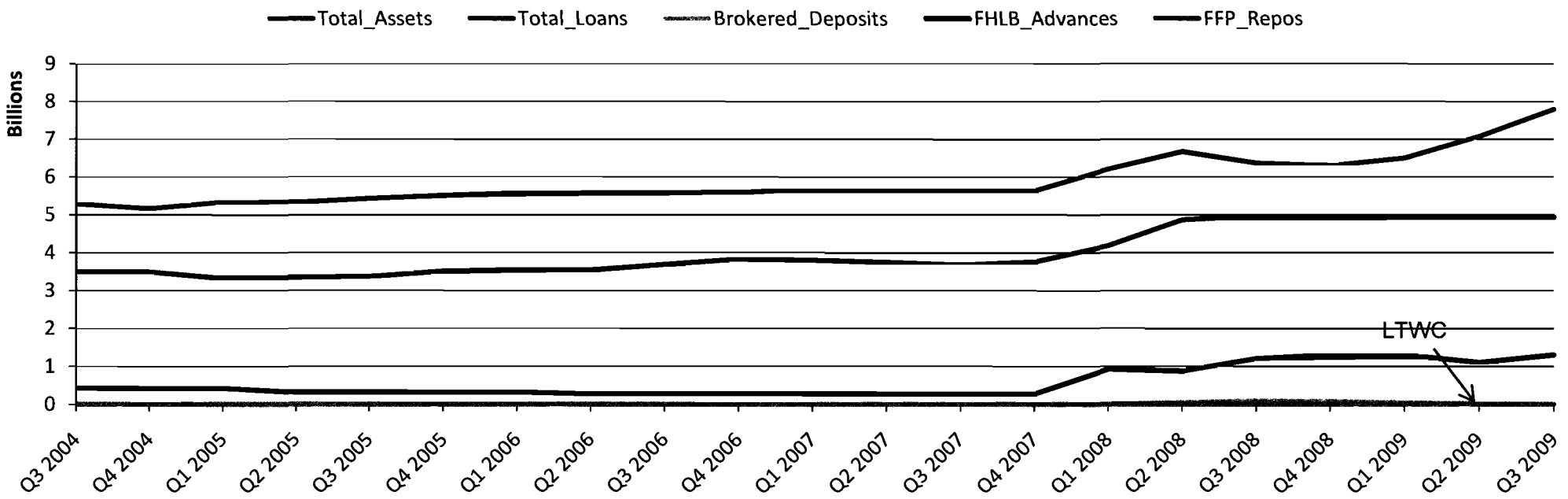
Data show: Like a number of Puerto Rican institutions, the bank's business model was highly reliant on traditional brokered deposits, however the growth in such deposits occurred during a period of declining assets, replacing other funding sources.

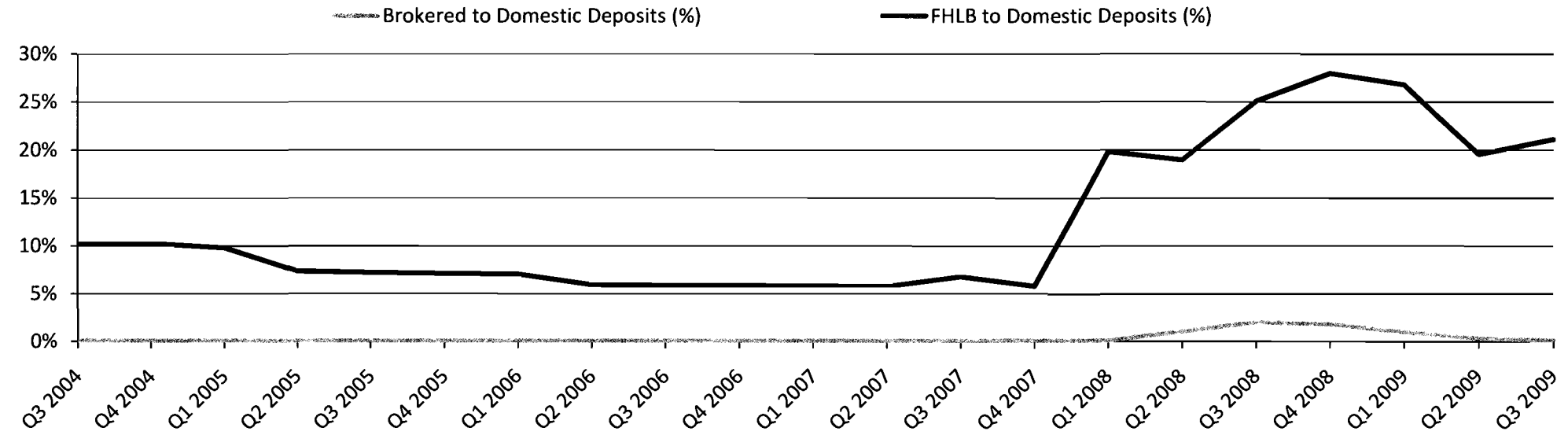


Bank: California National Bank

Estimated cost to DIF: $960.6 million
Rank: #14

Data show: Bank use of brokered funding was de minimis.

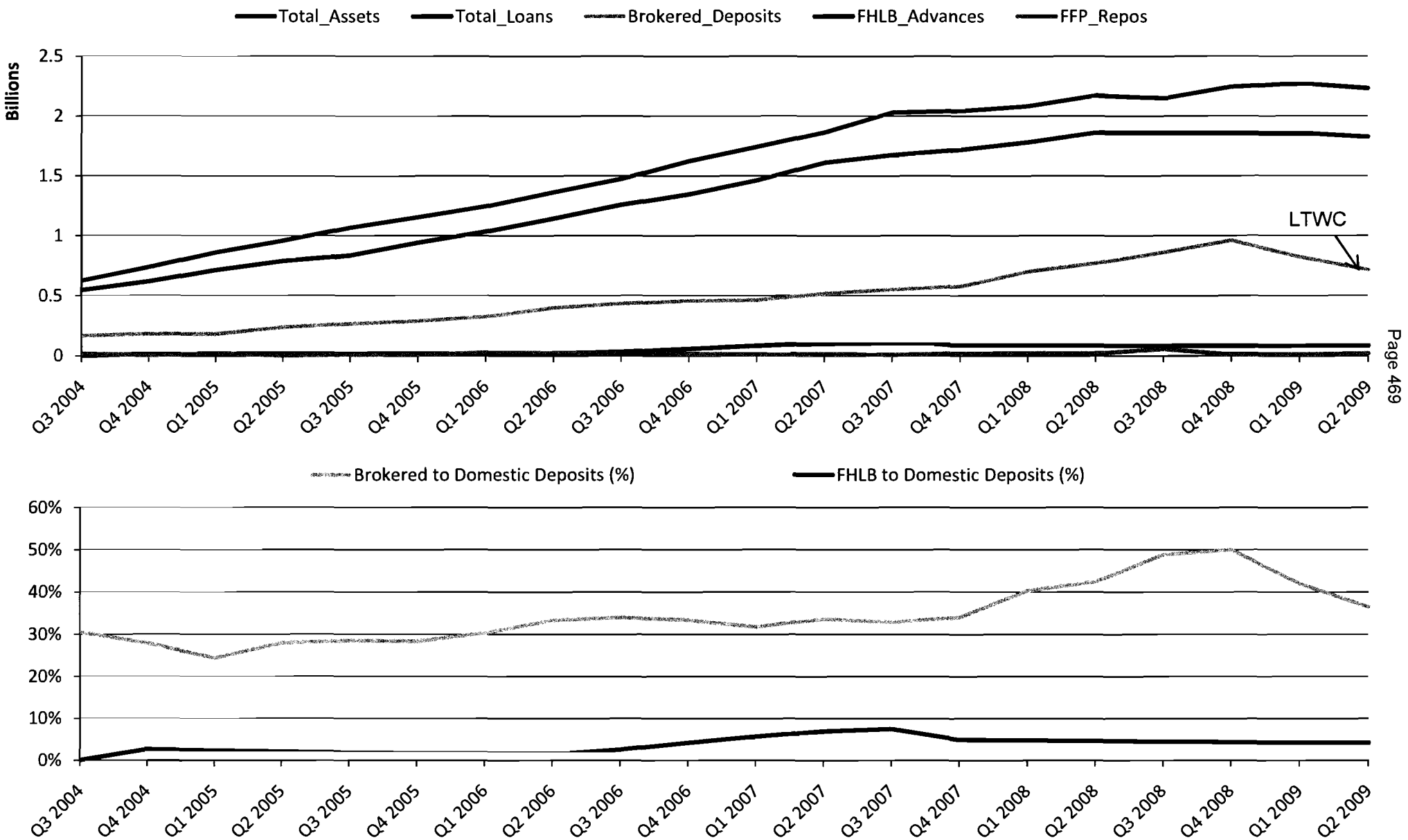




Bank: Georgian Bank

Estimated cost to DIF: $892.0 million
Rank: #15

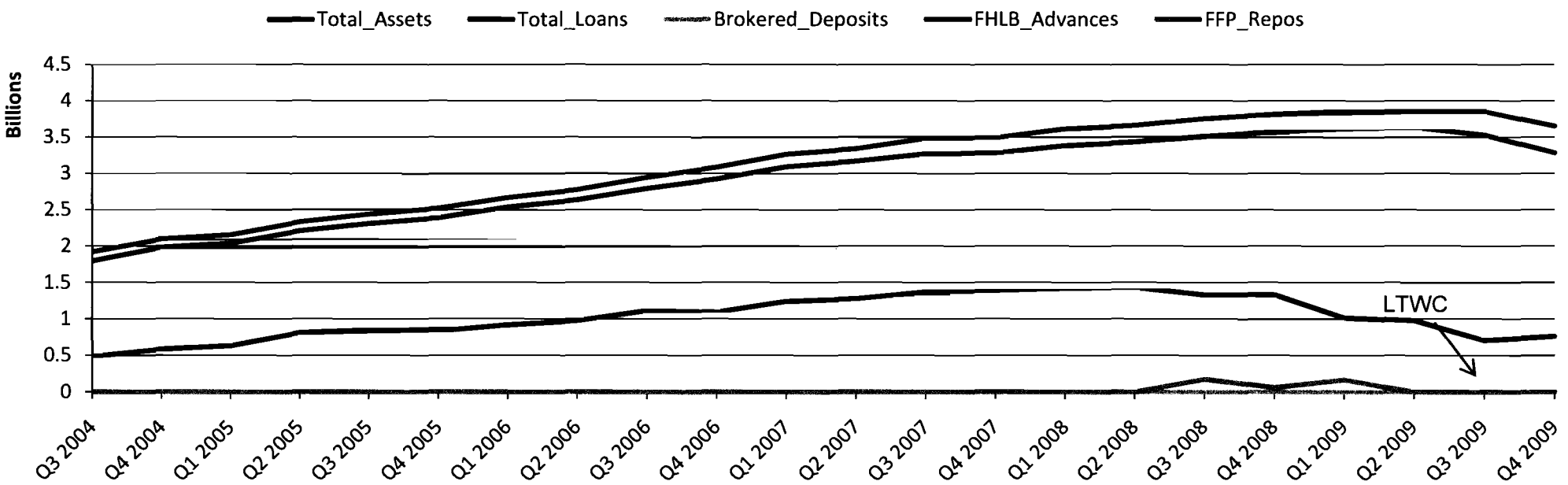
Data show: Some deposits classified as brokered likely enabled the bank to grow more rapidly than otherwise, thereby potentially contributing to its failure.

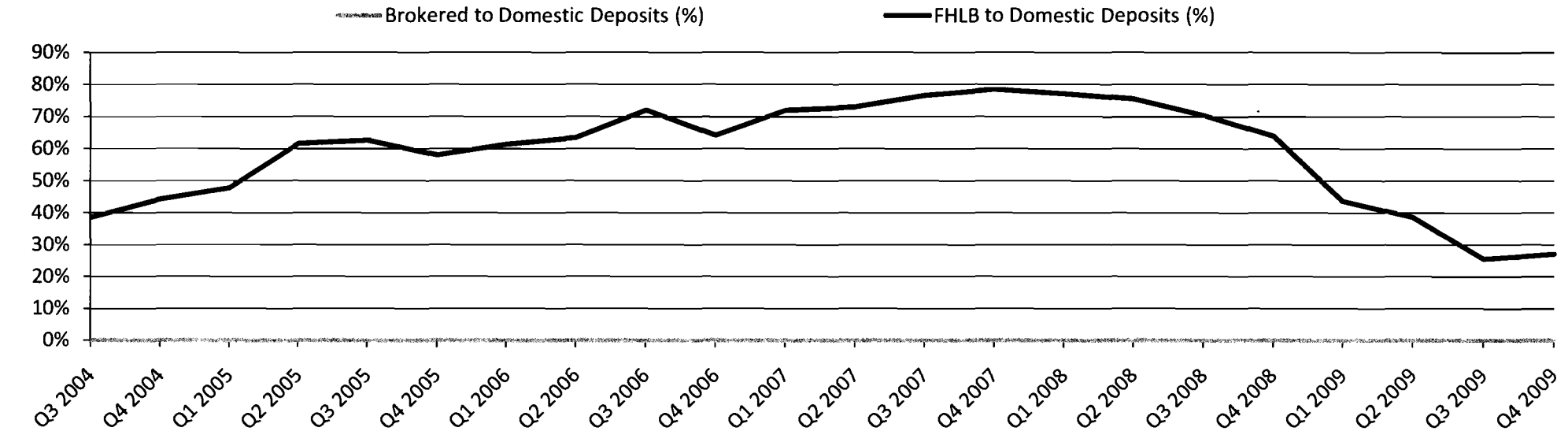


Bank: La Jolla Bank, FSB

Estimated cost to DIF: $882.3 million
Rank: #16

Data show: Bank did not use brokered funding.

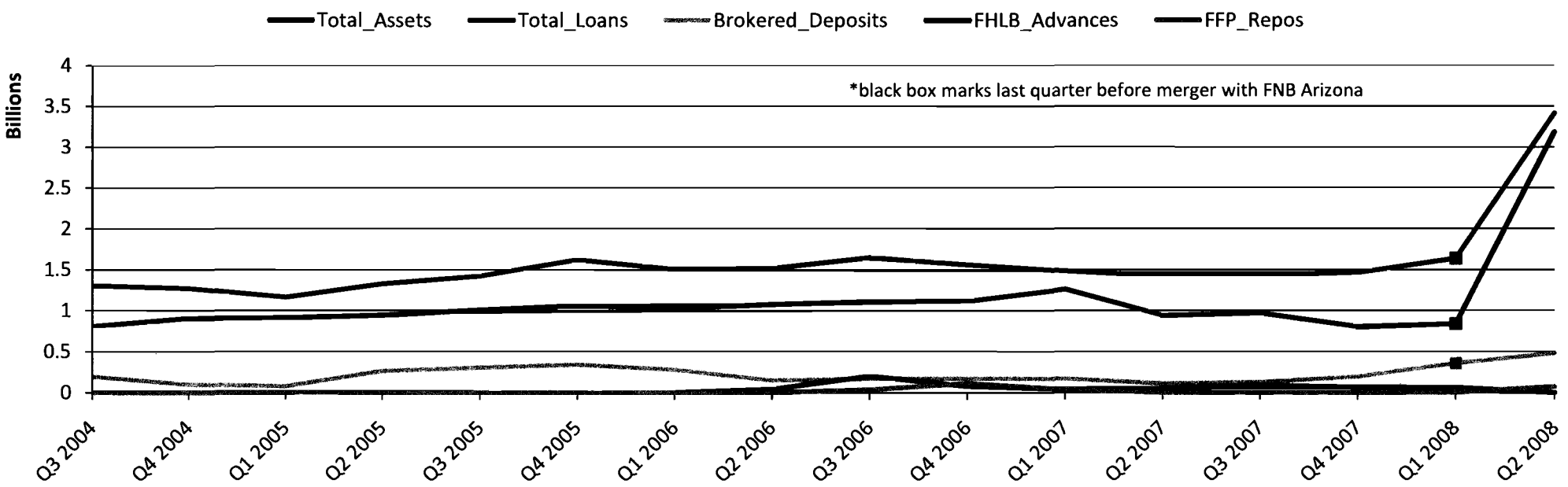


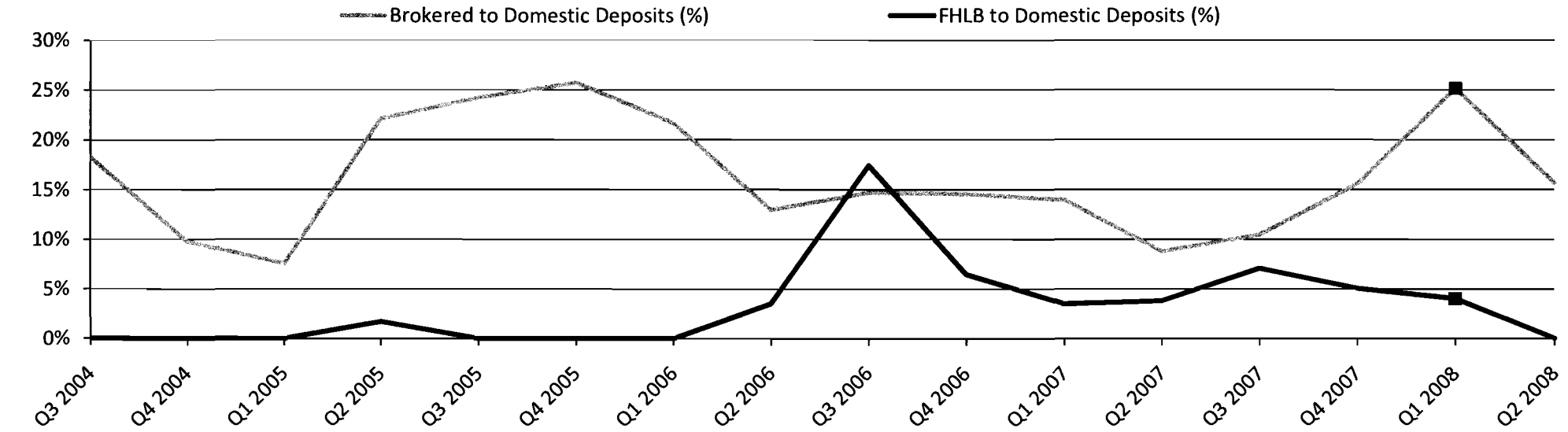


Bank: First National Bank of Nevada

Estimated cost to DIF: $862 million
Rank: #17

Data show: Deposits classified as brokered were not used to support asset growth.

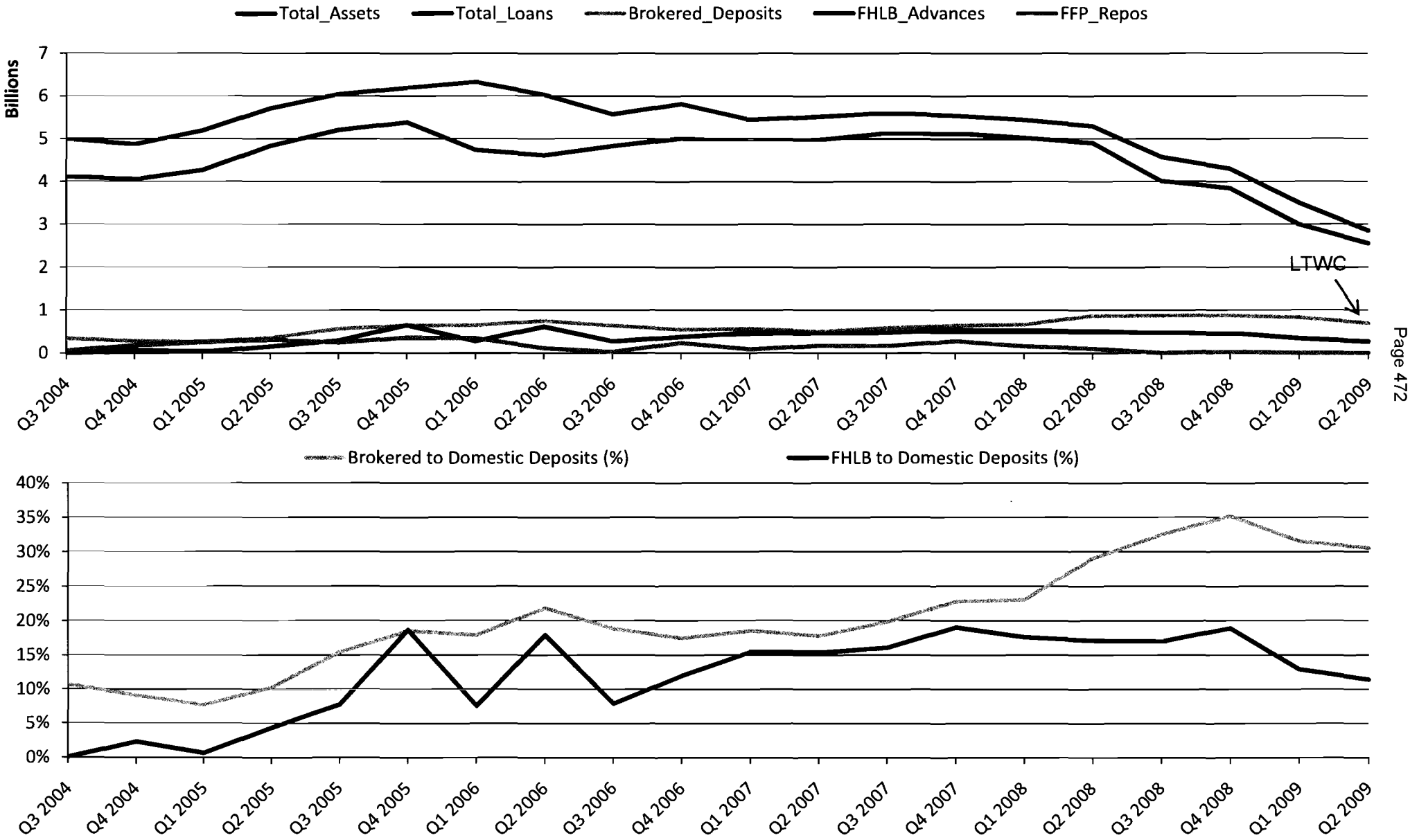




Bank: Irwin Union Bank and Trust Company

Estimated cost to DIF: $850 million
Rank: #18

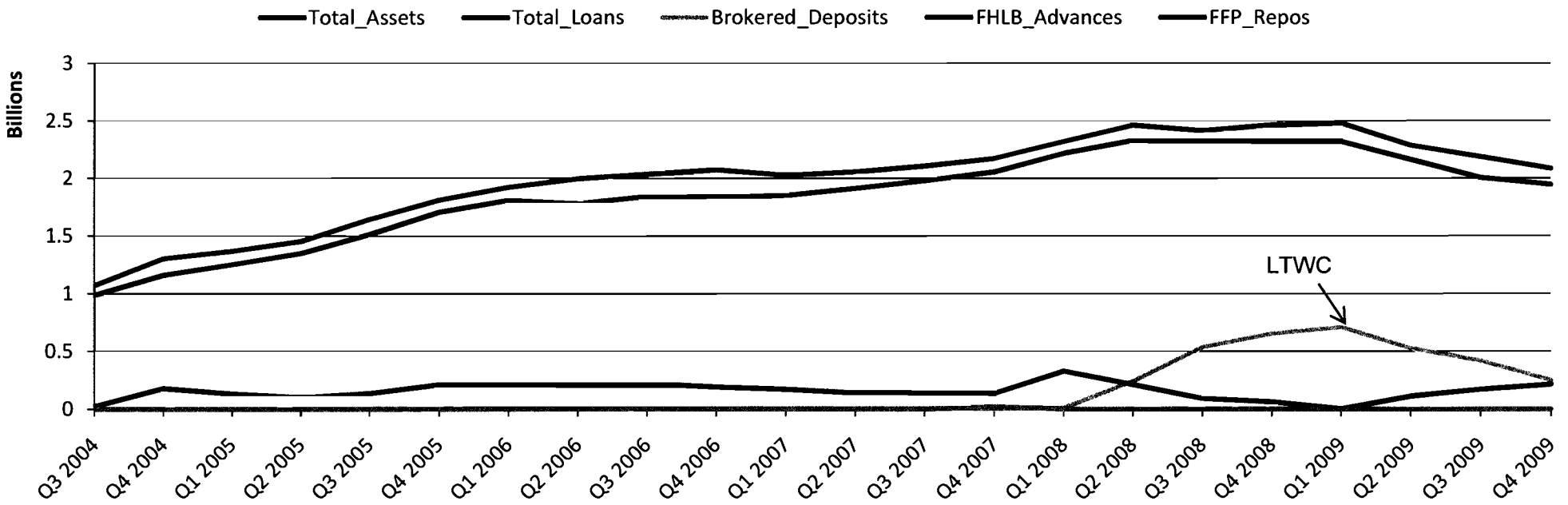
Data show: Purchased funding potentially enabled rapid asset growth in 2005. Subsequent growth in brokered deposits occurred after the start of the financial crisis and during a period of declining assets.

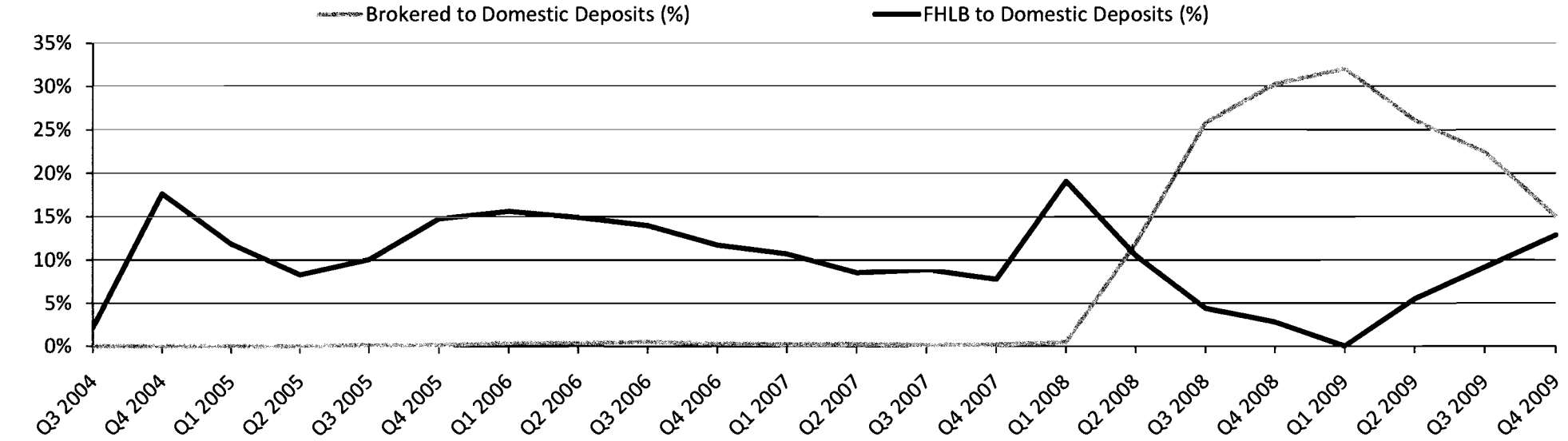


Bank: First Regional Bank

Estimated cost to DIF: $825.5 million
Rank: #19

Data show: Deposits classified as brokered were not utilized until the start of the crisis.

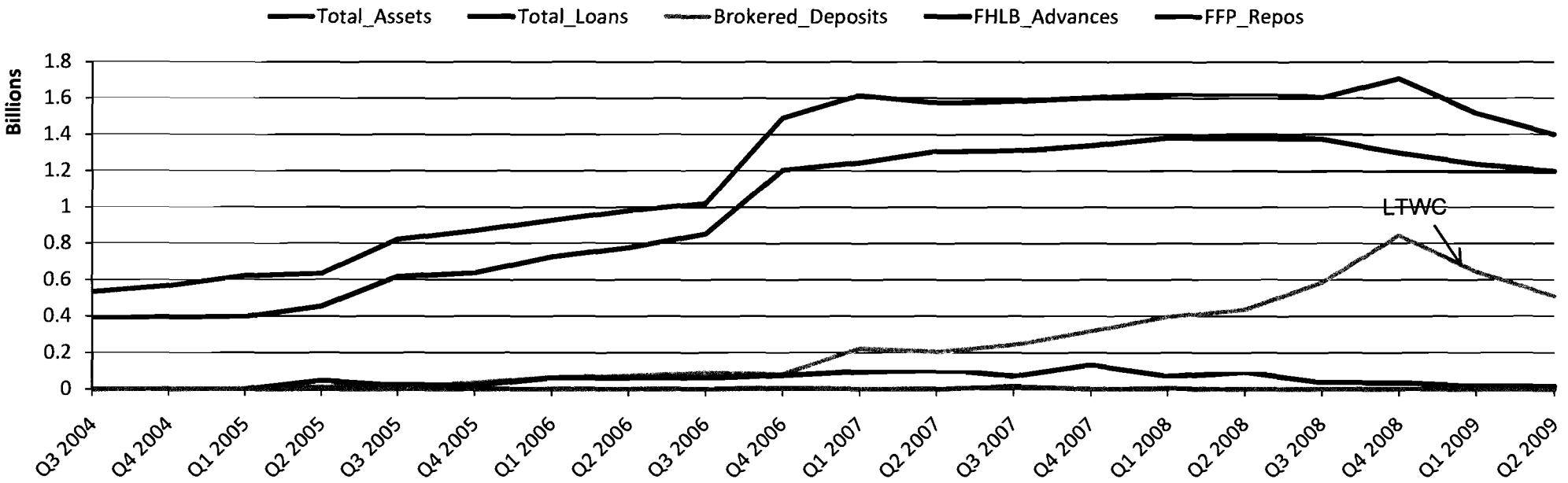


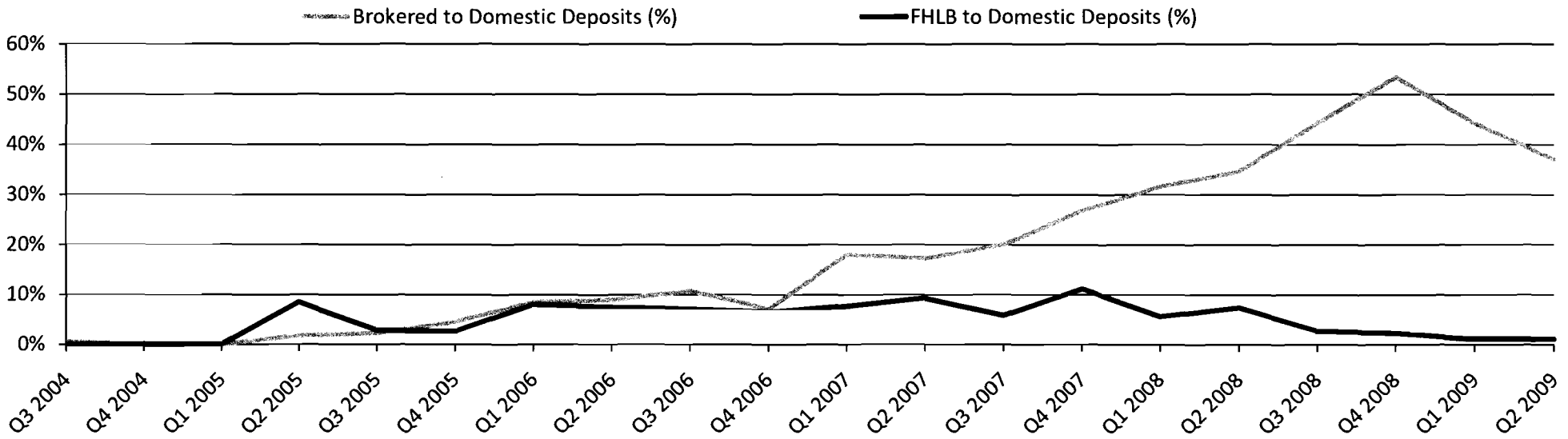


Bank: Community Bank of Nevada

Estimated cost to DIF: $781.5
Rank: #20

Data show: Except in Q4 of 2006, deposits classified as brokered were not a material factor in supporting asset growth. Most of the brokered funding was acquired after the start of the crisis.





SEWARD & KISSEL LLP

1200 G STREET, N.W.
WASHINGTON, D.C. 20005

PAUL T. CLARK
PARTNER
(b)(6)

TELEPHONE (202) 737-8833
FACSIMILE (202) 737-5184
WWW.SEWKIS.COM

ONE BATTERY PARK PLAZA
NEW YORK, NEW YORK 10004
TELEPHONE (212) 574-1200
FACSIMILE (212) 480-8421

April 26, 2011

Federal Deposit Insurance Corporation
550 Seventeenth Street, N.W.
Washington, D.C. 20429

Re: Study on Core Deposits and Brokered Deposits

Ladies and Gentlemen:

In connection with the study being conducted by the Federal Deposit Insurance Corporation ("FDIC") on "brokered" and "core" deposits, enclosed please find a paper written by Bert Ely of Ely & Company, Inc. titled Busting the "Good Deposit"/"Bad Deposit" Myth. Attached to Mr. Ely's paper are several appendices, including a memorandum prepared by Seward & Kissel LLP that examines the current definitions of "brokered" and "core" deposits.

Mr. Ely is a principal of Ely & Company, Inc., a consulting firm that has specialized in deposit insurance and banking structure issues since 1981. Among other papers on banking issues, Mr. Ely is the author of a 1991 study titled Retail Brokered Deposits: A Post-FIRREA Analysis.

Seward & Kissel has represented banks and broker-dealers on issues relating to brokered deposits since 1982. The firm has structured CD programs and so-called deposit "sweep" programs, and has represented trade associations on regulatory issues affecting brokered deposits. The firm regularly comments on regulatory proposals concerning brokered deposits.

I note that the FDIC has on several occasions referenced a study on the role of brokered deposits in bank failures, but has not made this study publicly available. We respectfully request that the FDIC publish this study so that interested parties can examine its premises and conclusions and provide relevant comments.

Mr. Ely and I would be pleased to meet with FDIC staff to discuss the enclosed paper.

Very truly yours,

(b)(6)

(b)(6)

Paul T. Clark

PTC:tv
Enclosure

SK 99031 0001 1191472

April 26, 2011

Busting the "Good Deposit"/"Bad Deposit" Myth

by

Bert Ely
Ely & Company, Inc.

Executive Summary

The study of core deposits and brokered deposits mandated by Section 1506 of the Dodd-Frank Act was driven by, first, the false premise that "core" deposits can readily be differentiated from all other deposits, or in effect, non-core deposits, and, second, the false belief that core deposits are "good" deposits while brokered deposits are "bad" deposits. This paper debunks both that premise and that belief.

Turning first to the false premise, any regulatory differentiation between "core" deposits and "non-core" deposits is arbitrary and subjective, as evidenced by the regulators' inability to arrive at a meaningful definition of "core" deposits. Consequently, any such differentiation cannot be relied upon for regulatory or bank supervision purposes or for setting deposit insurance premiums, the first stated objectives of this study. The notion of what is a core deposit is highly elusive – it is in the eye of the beholder, or in this case, the banker or the bank supervisor.

Turning to the false belief, what seemingly are core deposits – kept in a bank by loyal customers even as the bank is experiencing well-publicized troubles or is on the verge of failure – can disappear in a flash as core customers of the bank close out checking accounts and redeem CDs before they mature, even if their deposits are fully insured. Deposit flight becomes even easier, faster, and often silent if the customer has multiple banking relationships. This often is the case with long-time business customers who have an additional incentive to shift deposits to another bank – to establish a new borrowing relationship with a stronger bank.

Brokered deposits in the form of CDs, on the other hand, are more "core" than most so-called "core" deposits because, with rare exceptions, brokered CDs cannot be withdrawn from the bank prior to maturity. In a troubled bank, brokered deposits, including so-called "sweep" deposits, can quickly become one of the bank's most stable sources of funding. Far from demonizing brokered deposits, as many have done for many years, reasonably priced brokered deposits should be viewed positively by regulators.

Regulators should instead focus on a key underlying cause of many bank failures in recent years – excessively rapid asset growth – regardless of how that growth is funded.

Introduction

This paper has been prepared for submission to the Federal Deposit Insurance Corporation ("FDIC") as a comment on a study Congress, in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA"), directed the FDIC to conduct on core deposits and brokered deposits.

The paper commences by providing the statutory language setting out five parameters or objectives for this study. The paper then discusses the relevance of each of these objectives to the issue that apparently drove the inclusion of this study in the DFA – the belief by many that brokered deposits are a major underlying cause of the recent banking crisis, which has seen over 350 bank failures since 2007. Those failures have cost the FDIC's Deposit Insurance Fund ("DIF") over $80 billion. The paper then concludes with a list of recommendations the FDIC study should make.

Congress directed the FDIC to conduct a study of "core" deposits and "brokered" deposits.

The genesis of this paper is Sec. 1506 of the DFA which reads as follows:

SEC. 1506. STUDY ON CORE DEPOSITS AND BROKERED DEPOSITS.

(a) Study.--The Corporation shall conduct a study to evaluate--
(1) the definition of core deposits for the purpose of calculating the insurance premiums of banks;
(2) the potential impact on the Deposit Insurance Fund of revising the definitions of brokered deposits and core deposits to better distinguish between them;
(3) an assessment of the differences between core deposits and brokered deposits and their role in the economy and banking sector of the United States;
(4) the potential stimulative effect on local economies of redefining core deposits; and
(5) the competitive parity between large institutions and community banks that could result from redefining core deposits.

(b) Report to Congress.--Not later than 1 year after the date of enactment of this Act, the Corporation shall submit to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives a report on the results of the study under subsection (a) that includes legislative recommendations, if any, to address concerns arising in connection with the definitions of core deposits and brokered deposits.

The DFA conference report provides no guidance for this study so this statutory language must be taken at face value.

The rationale for this study apparently stems from the high rate of bank failures since 2007.[1] Some in Congress and elsewhere appear to believe that brokered deposits have in some fashion contributed to these failures or at least exacerbated the cost to the FDIC of resolving the failed banks. Put another way, the underlying premise of this study is that brokered deposits, however defined,[2] are "bad" deposits while core deposits, however defined, are "good" deposits. In fact, this characterization – brokered deposits versus core deposits – is increasingly irrelevant, for the following reasons that relate to the study's five objectives:

- Contrary to the implicit assumption of the first objective of this study, any regulatory differentiation between "core" deposits and "non-core" deposits is arbitrary and subjective, and therefore cannot be relied upon for regulatory or bank supervision purposes or for setting deposit insurance premiums.

- Revising the definitions of brokered deposits and core deposits to better distinguish between them – the study's second objective – is a fool's errand, specifically as to whether such a revision would impact the DIF.

- The role that various types of deposits play in the U.S. economy and the banking sector – the third objective of the study – is a function of factors other than any distinctions which can be drawn between core and brokered deposits.

- The potential stimulative effect on local economies of redefining core deposits – the fourth objective of the study – incorrectly assumes a linkage between a regulatory classification of deposits and local economic activity and bank lending.

- The fifth and final objective of the study – the competitive parity between different-size banks of redefining core deposits – incorrectly assumes that bank size should have some relationship to deposit classifications.

Each of these study objectives will be discussed below in greater detail.

Any regulatory differentiation between "core" deposits and "non-core" deposits is arbitrary and subjective, and therefore cannot be relied upon for regulatory or bank supervision purposes or for setting deposit insurance premiums.

The notion that a deposit can be identified as a "core" deposit sounds enticingly simple, but in fact it is a highly arbitrary and subjective notion because ultimately what is a core, or a non-core, bank deposit is very much in the eye of the beholder, or in this case the eye of the banker or the bank examiner. The arbitrary and subjective nature of identifying core deposits is readily demonstrated by the FDIC's attempts to describe core

[1] There is no legislative history stating the genesis or purpose of this provision of the DFA.

[2] A detailed discussion of the definition of brokered and core deposits is set out in a Seward & Kissel LLP memorandum, titled "Definition of Brokered and Core Deposits," dated March 18, 2011 (attached hereto as Appendix A) and will be referred to as the Seward & Kissel Memo.

deposits in its examination guidelines.[3] Since a deposit cannot readily be identified as a "core" deposit, it is equally clear that a deposit cannot be readily classified as its opposite: "non-core." Therefore, from a regulatory perspective, the terms "core deposit" and "non-core deposit" have no relevance. The FDIC should say as much in its report to Congress.

As noted in the Seward & Kissel Memo, evidence of the difficulty of defining the term "core deposit" is that Congress has never adopted a statutory definition of the term and the FDIC has never adopted regulations defining the term. Unfortunately, the absence of a meaningful definition has not stopped the FDIC from using the term "core deposit" in connection with significant regulatory initiatives. As recently as April 12, 2011, the FDIC Board of Directors issued for public comment "proposed assessment rate guidelines for large and highly complex institutions." These guidelines describe two "scorecards" the FDIC will use in establishing deposit insurance assessment rates for depository institutions with total assets exceeding $10 billion.

One of the scorecard measures, to assess a bank's "ability to withstand funding-related stress," is the ratio of core deposits divided by total liabilities.[4] Nowhere in the Murton Memorandum is the term "core deposits" defined nor is there a reference to a definition of that term.

Despite the absence of a statutory or regulatory definition, a bank's deposits are characterized as "core" and "non-core" for purposes of the Uniform Bank Performance Report, or UBPR. Until recently, the UBPR contained only a definition of "non-core" liabilities. As of the March 31, 2011 report, core deposits will be defined as: the sum of demand deposits, NOW accounts, ATS accounts, MMDAs, other savings deposits, and total time deposits of $250,000 or less, minus brokered deposits of $250,000 or less. No explanation has been given for defining core deposits in this manner or for excluding brokered deposits from this definition of core deposits.

As discussed in the Seward & Kissel Memo, a brokered deposit is merely a deposit placed, or facilitated, by a "deposit broker." And the definition of deposit broker does not include a reference to the rate, maturity or other terms of the deposits, merely to the presence of a third party who facilitated the deposit. Further, the regulators have conceded that deposits currently characterized as "core" may not in fact exhibit the characteristics that the regulators seemingly attribute to a core deposit.[5]

In light of these contradictions, the notion of what is a core deposit needs to be fundamentally rethought. The attached Appendix B discusses the notion of a core deposit

---

[3] *See* the FDIC's *DSC Risk Management Manual of Examination Policies*, at p. 6.1-7. *See also*, the Federal Reserve Board's *Commercial Bank Examination Manual*, Section 4020.1, at pp. 43-44.

[4] April 7, 2011, memorandum to the FDIC Board of Directors from Arthur Murton, director of the FDIC's Division of Insurance and Research, titled "Proposed Assessment Rate Guidelines for Large and Highly Complex Institutions," Table I (page 3) and Table 2 (page 4) ("Murton Memorandum") in the notice and request for comment appended to the Murton Memorandum.

[5] *See, e.g.*, *Proposed Agency Information Collection Activities; Comment Request*, 75 Fed.Reg. 60,497, 60,501 (September 30, 2010).

in the context of a bank customer's total relationship with her bank and demonstrates the futility of assigning simple labels to customer relationships.

Here is the essence of the core-deposit/brokered deposit contradiction. A core deposit presumably has, in the FDIC's eyes, two key characteristics. One, a core deposit is not especially rate sensitive. Two, a core deposit is less likely than a non-core deposit to flee from a bank if the bank is financially troubled and consequently suffering liquidity strains – deposits are leaving the bank and new deposits can be attracted only at above-market rates.

The premise that any bank deposit, however obtained, is rate insensitive has been questioned by both the FDIC and the Federal Reserve Board in their examination guidelines.[6] In addition, as the FDIC's guidelines clearly set forth, banks must engage in significant effort, and incur significant expense, to retain deposit customers.[7] Customer service, marketing, multiple ATM locations, branch networks, websites and other "bricks and mortar" costs of retaining deposit relationships must be factored into the cost of the deposit retention along with the interest rate on the deposits. Conversely, the failure to offer such services, it must be assumed, creates weaker customer relationships.

One of the participants at the FDIC's recent Core and Brokered Deposits Roundtable referred to the "Wal-martization" of CDs.[8] By this he meant that CDs have become standardized investment products and banks must compete in a market where rates are readily ascertainable over the Internet or from other sources.[9] In addition, pursuant to the DFA, in July banks will be authorized to pay interest on corporate checking accounts. This will require banks to compete on rate for those deposits.

An additional factor contributing to the rate sensitivity of deposits is the retirement of the baby boom generation. In a 2009 study, the global accounting firm Deloitte LLP stated that as of 2007 baby boomers had $14.0 trillion in investable financial assets. Of this amount, Deloitte estimates that 62% were "payout assets" -- assets that will be transferred or invested to produce retirement income. Deloitte cautions that competition among banks, insurance companies, mutual fund companies and brokerage/investment managers to provide income-generating products to these retired baby boomers will be fierce.[10] In other words, banks seeking deposits will increasingly compete with other financial services companies for consumer funds based upon rate.

---

[6] *See* the FDIC's *DSC Risk Management Manual of Examination Policies*, at p. 6.1-7, and the Federal Reserve Board's *Commercial Bank Examination Manual*, Section 4020.1, at pp. 43-44.

[7] *See* the FDIC's *DSC Risk Management Manual of Examination Policies*, at p. 6.1-7.

[8] *See* transcript of the Core and Brokered Deposits Roundtable (March 18, 2011) (the "Roundtable") (opening remarks of David Hayes, Security Bank, Dyersburg, Tennessee).

[9] *See also*, Dave Martin, *Nice, Cozy Branch. But Who's Going?*, AMERICAN BANKER, April 11, 2011, at p. 11, in which the author states that bank customers shop for banking products before ever visiting a bank branch.

[10] *See* Deloitte LLP, *Mining the Retirement Income Market* (May 2009).

Despite a bank's efforts to lock-in its customers, whether through superior service or through rates, the FDIC should recognize that so-called core depositors are frequently the first to withdraw their funds when a bank is troubled, and it is virtually impossible to identify which deposit relationships will stick in a crisis. As occurred numerous times during the recent financial crisis, customers with their entire banking relationship at one bank, often for many years, upon hearing troubling news or even rumors about that bank, quickly shifted their funds from that bank into accounts they had just opened at a second bank.[11] The July 2008 run on IndyMac is one notable example of supposedly core deposits suddenly fleeing a troubled bank.

Appendix C describes the attributes of the two basic brokered deposit products: CDs and "sweeps." Brokered deposits – whether CDs or "sweeps" – can exhibit the two characteristics attributed to a core deposit. Brokered CDs are priced in a large, competitive and deep marketplace where a broker's customers are willing to accept a rate that is less than higher rates available elsewhere in return for the convenience of purchasing CDs from their broker. Data submitted to the FDIC by the brokerage industry demonstrates that the costs of funds to banks in the brokered CD market, including fees to brokers, are consistently lower than the rates, excluding fees, on CDs offered through listing services.[12] In addition, CDs in the brokered market are exceedingly stable because funds can only be withdrawn upon the death or adjudication of incompetence of the depositor.

Sweep deposits also exhibit these characteristics. Data has shown that changes in interest rates do not affect customer balances placed through these arrangements. In the case of sweeps from a broker to an affiliated bank, the bank benefits from the relationship between the broker and its customers, and the view of many brokerage customers that the bank is part of the broker's "family" – a concept discussed in Appendix B. Sweeps from a broker to unaffiliated banks benefit from the efficiencies of the product and, potentially, from long-term contracts between the broker and the bank to sweep the funds.

On the other hand, many of the deposits the FDIC now classifies as core deposits, at least for UBPR purposes, are rate-sensitive and can readily flee a troubled bank. Of course, checkable deposits, which includes MMDA[13] deposits, can be withdrawn on a moment's notice, by check or wire transfer as well as a currency withdrawal. Term CDs, whether deposited by a local customer or obtained through the Internet or a listing service, can readily be cashed in, some with a penalty and, significantly, in many cases without a penalty.[14] As noted above, CDs are very much rate-sensitive deposits, especially for

---

[11] *See* Binyamin Appelbaum and Jo Craven McGinty, *Fed Help Kept Banks Afloat, Until It Didn't*, N.Y. TIMES, April 4, 2011. It is difficult to determine from call reports whether local depositors have withdrawn their deposits because call reports do not indicate whether a bank has stabilized its non-brokered deposits by turning to the Internet or to listing services.

[12] *See* December 17, 2008 comment letter of Seward & Kissel LLP in connection with the FDIC's Notice of Proposed Rulemaking (Assessments) (RIN 3064-AD35) and materials submitted to the FDIC by Jeffrey Zage of Financial Northeastern on March 18, 2011 in connection with the Roundtable.

[13] Money Market Deposit Accounts.

[14] As stated at the Roundtable, time deposits that are withdrawable without a penalty are merely demand deposits.

deposits solicited by a bank using the Internet, as well as deposits a bank obtains by having posted its interest rates with a "listing service," which in turn distributes those rates to individuals and organizations seeking high deposit interest rates.[15]

It is almost as if the FDIC is upside-down in its present classification of brokered deposits. Instead of being treated as second-class or non-core deposits, the FDIC should treat many types of brokered deposits as a superior form of bank funding because of their relatively low cost and their accessibility through the brokered-deposit marketplace or, in the case of sweeps, from broker-dealers with access to substantial customer cash.

Revising the definitions of brokered deposits and core deposits to better distinguish between them is a fool's errand, specifically as to whether such a revision would impact the DIF.

The following matrix illustrates a key conclusion that the FDIC's study should reach – the two types of deposit classifications, brokered deposits and core deposits, are not mutually exclusive. That is, brokered deposits can be core deposits (the northwest corner of the matrix) if they flow from well-established, third-party deposit-brokerage relationships. By the same measure, non-brokered deposits can be non-core deposits (the southeast corner of the matrix) if the deposits come, for example, over the Internet from purely rate-driven depositors living hundreds or several thousand miles from the bank.

		Core deposits: Yes	Core deposits: No
Brokered deposits	**Yes**	**Core brokered deposits**	**Non-core Brokered deposits**
	No	**Non-brokered core deposits**	**Non-brokered non-core deposits**

[15] Ironically, as The Wall Street Journal recently reported, the interest rates on Internet or online bank accounts have, in many cases, dropped below interest rates paid on accounts held at the online banks' "traditional brick-and-mortar competitors." Robin Sidel and Jessica Silver-Greenberg, *Online Accounts Lose Their Mojo*, WALL ST.J., April 9-10, 2011.

As discussed above, it is impossible to differentiate core from non-core deposits, especially in a troubled-bank situation. However, while it is possible to differentiate brokered deposits, as defined by FDIC regulations (i.e., deposits placed in a bank facilitated by a third-party), from non-brokered deposits, that differentiation does not address the impact that brokered deposits have on the DIF. In fact, brokered deposits should benefit a bank, and therefore the DIF in the following ways.

First, brokered deposits represent a reasonable-cost funding source for banks because depositors utilizing a deposit broker generally are not yield chasers, as is the case with depositors utilizing various sources to find banks paying the highest interest rates. Additionally, brokered deposits are much cheaper to raise, in terms of overhead costs, than deposits gathered through retail branches. Hence, while brokered deposits may in some instances carry interest rates somewhat higher than deposits gathered through branches, the limited overhead costs associated with brokered deposits (See Appendix C) makes them very competitive on a total cost basis with deposits raised through branches, and cheaper than deposits raised over the Internet or through listing services. In effect, brokered deposits represent an efficient source of funds for banks. Efficiently funded banks are more profitable and are much less likely to fail if they engage in a reasonable rate of asset growth.

Second, in the case of CDs, by virtue of the deposit contract with the bank, brokered deposits cannot be withdrawn prior to maturity except in very limited circumstances. In this regard, brokered CDs become locked into a bank no matter what happens to the bank once the deposit has been placed. Brokered CDs stay in a troubled bank as other deposits are fleeing, thereby reducing the bank's liquidity strains and the DIF's eventual loss, should the bank fail. Put another way, brokered CDs in a troubled bank are a positive for the DIF, not a negative, as some contend.

Third, because brokered CDs are raised in a national marketplace, any shift in a bank's funding strategy, such as to a specific maturity, is much less likely to disrupt the national brokered-deposit market than it might disrupt the bank's local retail market. That is, it is difficult for a bank to price CDs of a specific maturity to attract local depositors without impacting the bank's entire maturity spectrum and the rate on all CDs in the bank's local community. Because of the depth and efficiency of the national brokered deposit market, banks can access the maturities that they need without special pricing. Not only is accessing the brokered-deposit market good for the bank doing it, it also is beneficial for the bank's local competitors. A similar argument can be made for sweep deposits.

Fourth, brokered deposits are placed in banks by deposit brokers under well-established relationships. This is especially true where the broker and the bank are affiliated. Such placements are not casual, one-off affairs, which usually is the case with deposits gathered over the Internet or through a listing service. Therefore, deposit brokers become a reliable source of funding for banks, especially community banks, which cannot efficiently access the wholesale money markets. Hence, brokered deposits

help community banks to further diversify their sources of funding in a cost-effective manner. In this sense, deposit brokers become core depositors.

Fifth, the franchise value of core deposits in a failed bank is overstated. Many other factors enter into the valuation of a bank or a deposit franchise besides the nature or "quality" of its deposits. These include the value of the physical bank branches, the value of the branch locations, the non-deposit customer relationships linked to the acquired deposits, competition among bidders for the deposit franchise, and the acquirer's opportunity to consolidate the acquired branches with its own branch network, thereby building market share while reducing operating costs.

The deposit premium quoted in FDIC news releases also reflects the buyer's estimate of the net value of the related loss-sharing agreement for the assets of the failed bank that the acquiring bank has agreed to assume. If the loss-sharing agreement is especially generous for the acquiring bank, that could lead to a higher reported deposit premium. If the contrary situation exists – the loss-sharing agreement is not perceived by the acquiring bank as being particularly generous – then the result will be a lower premium or, as is often the case, no premium.

The role that various types of deposits play in the U.S. economy and the banking sector is a function of factors other than any distinctions which can be drawn between core and brokered deposits.

Because of the impossibility of differentiating core from non-core deposits, the distinction between core and brokered deposits is meaningless. As noted above, brokered deposits raised through stable, well-established relationships with deposit brokers are stable deposits. Certainly, brokered deposits are more "core" than many deposits currently characterized as "core".

Unfortunately, the current characterization of deposits as good (core) and bad (brokered) creates disincentives to use the "bad" deposits, even if they are more cost effective. This can be readily seen in the growth of listing service deposits during the last three years, even though such deposits are consistently more expensive than brokered deposits. Banks will pay a premium for these deposits because they are not reported as brokered on call reports. Further, banks are actually pre-paying brokered CDs, including interest through maturity, up to one year prior to maturity in order to avoid including the deposits on their call reports. In other words, the good deposit/bad deposit dichotomy creates incentives for a bank to act against its economic self-interest.

It is important at this point to acknowledge the positive role that brokered deposits play in the U.S. economy, specifically in funding special-purpose banks, such as credit-card banks. Special-purpose banks usually serve national markets; therefore, they should be funded on a national basis. Brokered deposits raised from depositors located across the country effectively represent national funding. Also, brokered deposits represent a much more efficient funding source for special-purpose banks than deposits raised

through branches. As a practical matter, special-purpose banks could not operate at the scale they do without access to brokered deposits.

The potential stimulative effect on local economies of redefining core deposits incorrectly assumes a linkage between the regulatory classification of deposits and local economic activity and bank lending.

Leaving aside the fact that it is impossible to define core deposits in any realistic manner, there is no way to link the concept of core deposits, however defined, with any stimulative effects on local economies. That is, a particular source of deposit funding cannot be linked to specific types of bank lending or where those loans are made. Put differently, the participants at the Roundtable agreed that the source of funds is immaterial so long as the funds are productively deployed by the bank in its community.[16]

Brokered deposits can have a positive effect on local economies to the extent that the ability of community banks to raise longer-term deposits through deposit brokers increases the banks' ability to lend at a fixed rate of interest for longer maturities. Over 50% of brokered CDs have maturities over one year, while only 5.9% of bank deposit liabilities have maturities over one year.[17] Using brokered deposits, a bank can avoid serious maturity mismatching that can be damaging to the bank, and ultimately to the community, as well as to the DIF.

Evaluating the competitive parity between different-size banks of redefining core deposits incorrectly assumes that bank size has some relationship to deposit classifications.

As noted above, it is impossible to differentiate core from non-core deposits. More importantly, though, brokered deposits help to level the playing field between community banks, which cannot access the wholesale money markets, and large banks, which can and do. While community banks can borrow funds at various maturities from a Federal Home Loan Bank, brokered deposits provide a second source of efficient, longer-term funding. A proposal by the Federal Housing Finance Agency to restrict the access by banks and thrifts to Federal Home Loan Bank advances will make brokered deposits even more important as a funding source for banks and thrifts, especially smaller institutions.[18]

Recommendations the FDIC study should consider

Based upon the above analysis, the FDIC should consider making the following recommendations to Congress, to itself, and to its fellow regulators.

---

[16] *See* transcript of the Roundtable (March 18, 2011) (comments of David Hayes, Security Bank, Dyersburg, Tennessee).

[17] Data is derived from the FDIC's *Statistics on Depository Institutions (SDI)* for the quarter ended December 31, 2010.

[18] Donna Borak, *Will FHFA Membership Plan Kill the Home Loan Bank System?*, AMERICAN BANKER, April 11, 2011.

First, Congress should repeal the definition of "deposit broker" and the restrictions on such deposits.[19] This will eliminate the nonsensical good deposit/bad deposit dichotomy and force the regulators to focus on a bank's asset strategy. It will also eliminate the capital-based eligibility for these deposits that creates a "cliff effect": a bank losing its "well-capitalized" status falls off a cliff and is precluded from using brokered deposits without a waiver.

Second, the FDIC should directly address the problem of excessively rapid asset growth, however funded, by explicitly including in its risk-sensitive deposit insurance assessment formulae a factor that increases the assessment rate for a bank as that bank's growth rate has accelerated over recent periods (last six months, the last year, etc.) regardless of how that growth was funded. The FDIC has sufficient statutory authority[20] to include a growth-rate factor in its assessment formulae.[21]

Third, the banking regulators collectively should abandon the term "core deposits" and develop a "stable funding scorecard" to better measure the extent to which deposits of various types, whether solicited directly or through third parties, will "stick" with the bank should it experience financial difficulty. Consideration should be given to the following factors:

- Account term; i.e., how long a specific deposit is locked into a bank before it can be withdrawn. Checkable deposits and deposits that can be withdrawn without advance notice and penalty should be treated as overnight funds regardless of their nominal term. Deposits that can be withdrawn, but with an insignificant penalty, should be treated as maturing on the first day they can be withdrawn. Deposits with a significant penalty for withdrawal should be treated as contingently stable. Sweep deposits subject to an agreement between the broker and the bank should be viewed as longer-term deposits.

- The bank's overall degree of maturity matching. Because cash flowing into and out of a bank is fungible, the degree of maturity mismatch of the bank's total balance sheet should be measured, regardless of the types of assets the bank owns and the types of liabilities it owes. For this purpose, it makes little difference whether a bank liability is a checkable deposit, a CD that can be withdrawn with a penalty, a brokered CD, which cannot be withdrawn before its maturity date, sweep deposits locked-in by contract, a Federal Home Loan Bank advance, a liability under a repurchase agreement, or whatever.

- The all-in cost of a particular source of funding, not just its explicit interest rate. While retail deposits, those gathered through branches, often look cheaper, in terms of rate, than brokered deposits, in fact, as noted above, banks

[19] 12 U.S.C. Sec. 1831f.

[20] 12 U.S.C. Sec. 1817(b)(1)(C)(i)(III), which reads "any other factors the [FDIC] determine are relevant to assessing such probability[that the deposit insurance fund will incur a loss with respect to the institution]."

[21] Alternatives to amending the assessment rate could also be explored.

incur substantial overhead costs to gather and service retail deposits. Granted that estimates of deposit-gathering and servicing costs are hardly precise, it still should be possible to reasonably estimate such costs for this purpose.

- Strength of the customer relationship. Whether or not a deposit, or some portion of a deposit, will be withdrawn from a bank when the bank's solvency appears threatened, is partially a function of the breadth and duration of the bank's overall relationship with a particular customer. As discussed in Appendix B, the nature of a bank's relationship with a particular customer can be quite complex, will likely change over time, and cannot easily be quantified. If the bank is owned by a holding company, then the customer's relationship with other elements of the holding company adds to the complexity which must be assessed. At present, bank call reports provide absolutely no basis for identifying a bank's customer relationships. However, many banks, through CRM (customer relationship management) software do identify customer relationships for, among other purposes, their cross-selling initiatives. The FDIC should assess the feasibility of tapping into CRM data as an input into a stable-funding scorecard.

- Repeat-business factor. From a funding perspective, a bank customer is not just an individual, family, or business, but also can include relationships with established funding sources, such as deposit brokers. Arguably, the long-standing relationship a bank has with a deposit broker ensures a more stable source of funding, including rolling over maturing CDs, than an individual depositor living some distance from the bank, who bought a three-year CD (withdrawable with three months' notice) over the Internet.

- Keeping it all in the family. The FDIC study should acknowledge that "brokering" deposits from one bank within a multi-bank holding company to another bank owned by that holding company or between a bank and an affiliated broker-dealer does not constitute deposit brokerage. Instead, bank-facilitated deposit-shifting among various entities within a holding company structure should be seen as providing a service no different than a bank customer shifting funds among his accounts in one bank, which would be the case if a multi-bank holding company consolidated down to one bank.

These indices of deposit quality should be utilized in making supervisory judgments about a bank. To the extent feasible, these deposit-quality measures should be reflected in deposit insurance assessment formulae. More specifically, assessment formulae should explicitly reflect the degree of overall maturity mismatch rather than focusing on a specific type of liability, such as a brokered CD.

Conclusion

The study mandated by Section 1506 of the DFA provides an excellent opportunity for Congress and the regulators to clear away the myths and misinformation

about brokered deposits. This can be done by first acknowledging the many false perceptions about brokered deposits and the myth of the "core" deposit. Then the underlying issue which apparently triggered this study – rapid, risky growth of banks that later failed, regardless of how that growth was funded – must be addressed directly. Congress can start the ball rolling by repealing the statutory term "deposit broker" and then the regulators can address the rapid-growth problem. In particular, the FDIC can add a rapid-growth penalty into its risk-based deposit insurance assessment formulae.

Appendix A

SEWARD & KISSEL LLP

March 18, 2011

Definitions of Brokered and Core Deposits

Introduction

Section 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") requires the Federal Deposit Insurance Corporation ("FDIC") to conduct a study to evaluate:

(1) the definition of core deposits for the purpose of calculating the insurance premiums of banks;

(2) the potential impact on the Deposit Insurance Fund of revising the definitions of brokered deposits and core deposits to better distinguish between them;

(3) an assessment of the differences between core deposits and brokered deposits and their role in the economy and banking sector of the United States;

(4) the potential stimulative effect on local economies of redefining core deposits; and

(5) the competitive parity between large institutions and community banks that could result from redefining core deposits.

A "brokered deposit" is a deposit placed, or facilitated, by a "deposit broker." This memorandum reviews the definition of "deposit broker" as set forth in the Federal Deposit Insurance Act, as amended, ("FDIA") and FDIC regulations. We have also reviewed over 40 FDIC staff interpretive letters[1] to determine the types of deposit arrangements that have been deemed brokered and the factors that the FDIC staff has considered in making its determinations. This memorandum also reviews exclusions from the definition of deposit broker as interpreted or granted by the FDIC staff.

Unlike the definition of deposit broker, the term "core deposit" is not contained in the FDIA or in FDIC regulations, has not been adopted pursuant to a notice and comment procedure and is not the subject of FDIC staff interpretive guidance. Therefore, we have examined the descriptions of core deposits contained in the examination guidelines and other

[1] The FDIC posts staff interpretive letters on its website. The earliest letters date from 1989. In addition, we have some interpretive letters that are not publicly available. We have assumed that all interpretations are valid unless specifically modified by a subsequent letter.

materials of the federal banking agencies and the way core deposits are determined for regulatory reporting purposes.

Conclusions

Dodd-Frank requires the FDIC to conduct a study to evaluate the definitions of "core deposit" and "brokered deposit" to determine whether such definitions are appropriate for use in making agency policy and whether revision of the definitions would have a beneficial effect on the economy and the banking sector. We have reviewed the definitions and believe that they: are inappropriate to use as the basis for any policy that relies upon an accurate characterization of type, term, characteristics or behavior of deposit accounts; do not permit a meaningful analysis of the last four issues ((2) through (5)) identified in Section 1506; and create confusion for banks in making deposit funding decisions.

A "brokered deposit" is a deposit placed or facilitated by a "deposit broker." The term "deposit broker" is defined in both the FDIA and in FDIC regulations, and is subject to over 40 published interpretive letters from the FDIC staff.

The definition of the term deposit broker does not turn on the type, term, characteristics or behavior of the deposits, or upon whether the deposit account is established by the broker or the depositor. It depends merely upon the presence of a third party that has either placed, or facilitated the placement of, deposits for someone else. For example, the placement of a customer's funds by a bank into deposit accounts at an affiliated bank as an accommodation to its customer is a brokered deposit even though a specific rate is not sought, a fee is not paid and the deposit account is established in the name of that customer.

The FDIC staff has interpreted the term "facilitate" quite broadly to mean activities that make the establishment of a deposit easier. A third party does not need to handle depositor funds to be a deposit broker. For example, services that make the availability of deposit accounts at banks known to prospective depositors are deposit brokers unless they charge a flat subscription fee for the service.

A number of exclusions exist in the regulations, including an exclusion for an agent or nominee whose "primary purpose" is not the placement of deposits. Certain broker-dealer deposit account "sweep" arrangements have qualified for this exclusion based, inter alia, on the purpose of the arrangement and the nature of the fee paid to the broker-dealer. Interest rates and other characteristics of the deposit accounts have not been factors in granting the exemptions. The FDIC staff has also acknowledged that certain deposit listing service arrangements and deposits obtained through postings on the internet are not brokered deposits, irrespective of the interest rate or term of the deposits.

Unlike the definition of deposit broker, the term "core deposit" is neither contained nor defined in the FDIA or FDIC regulations. While descriptions of the core deposit concept can be found in examination guidelines and other materials, FDIC staff interpretations of the term either do not exist, or are not publicly available.

The FDIC has set forth a general statement about core deposits in its examination guidelines, though the statement is a conceptual discussion and subject to a number of conditions, qualifications and assumptions. Essentially, core deposits are "stable, low cost funding sources that typically lag behind other funding sources in re-pricing during a period of rising interest rates." These deposits are "typically" funds of local customers that have borrowing or "other" relationships with the bank.

Without commenting on the significant overhead and maintenance costs, the FDIC examination guidelines state: "Convenient branch locations, superior customer service, dense ATM network and/or no fee accounts are significant factors associated with inertia of these deposits."

The FDIC examination guidelines note that some core deposits may exhibit volatility, noting time deposits and, specifically, CDs obtained from an internet listing service.

In its examination guidelines, the Federal Reserve Board provides an important cautionary note in connection with its discussion of core deposits: "...changes in customer sophistication and interest rate sensitivity have altered behavioral patterns and, therefore, the stability characteristics traditionally assumed by retail and other types of deposits traditionally termed 'core.'" A similar acknowledgement of increasing depositor sensitivity to rates is contained in the FDIC's guidelines on deposit retention programs, which are a part of its examination guidelines.

No specific methodology is set forth for delineating core from non-core deposits. As a result, it is virtually impossible to make useful distinctions between the two types of deposits. Further, there is no explanation or examination of why certain deposits labeled as brokered could not meet the subjective standards for core deposits set forth in the FDIC's deposit retention program guidelines.

Despite the absence of a definition of core deposits, and the significant ambiguities in the FDIC's discussion of them, the Federal Financial Institutions Examination Council ("FFIEC") recently adopted the following definition of core deposit for purposes of the Uniform Bank Performance Report ("UBPR"): demand deposits, NOW accounts, ATS accounts, MMDAs, other savings deposits, and total time deposits of $250,000 or less, minus brokered deposits of $250,000 or less. This definition reflects none of the qualifications set forth in the FDIC's examination guidelines. It should also be noted that the definition includes transaction accounts and MMDAs, which were so volatile at weak banks during the recent financial crisis that the FDIC was forced to adopt the Transaction Account Guaranty Program in an attempt to stop deposit run-off. In addition, the definition assumes without explanation that no deposit characterized as brokered can exhibit the qualities of a core deposit.

The conflict between the subjective, heavily qualified discussion of core deposits in the examination guidelines and the black and white definition in the UBPR can only be confusing to banks in making their deposit funding choices. This confusion will inevitably lead to funding decisions based on the UBPR definition, not the character of the funding.

Definition of Deposit Broker

The Statute

The FDIA does not define the term "brokered deposit." Instead, the FDIA contains restrictions on the acceptance of deposits by insured depository institutions from a "deposit broker." The statute permits "well capitalized" depository institutions to accept such deposits without restriction.[2] An "adequately capitalized" depository institution may accept deposits from a deposit broker only if it has received a waiver from the FDIC. A waiver may be granted by the FDIC upon a finding that the acceptance of deposits from a deposit broker does not constitute an unsafe or unsound practice with respect to that institution.[3] An "undercapitalized" depository institution is prohibited from accepting deposits from a deposit broker.[4]

The FDIA also characterizes deposits solicited by an insured institution that is not a "well capitalized" depository institution as having been placed by a deposit broker if the institution, or an employee of the institution, solicits deposits at an interest rate that is significantly higher than the interest rates offered on deposits by other insured depository institutions in the institution's "normal market area."[5]

The term "deposit broker" is defined to mean the following:

(A) any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions or the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties; and

(B) an agent or trustee who establishes a deposit account to facilitate a business arrangement with an insured depository institution to use the proceeds of the account to fund a prearranged loan.[6]

For purposes of this memorandum we have examined the more general definition in (A) and not the specific circumstances set forth in (B). Also for purposes of this memorandum we have utilized the definition of brokered deposit as it applies to well capitalized banks. As set forth above, an adequately capitalized bank is deemed to be a deposit broker solely on the basis of soliciting deposits at an interest rate that is significantly higher than interest rates offered on deposits by other institutions in the bank's normal market area.

---

2 12 U.S.C. § 1831f(a).

3 12 U.S.C. § 1831f(c).

4 12 U.S.C. § 1831f(a).

5 12 U.S.C. § 1831f(e).

6 12 U.S.C. § 1831f(g)(1).

A number of exclusions from the definition of deposit broker are included in the statute.[7] The complete text of the statute is included in Appendix A. The following exclusions are worthy of note:

- An insured depository institution or an employee of an insured depository institution with respect to funds placed with that institution.
- A trust department of an insured depository institution if the trust placing deposits has not been established for the "primary purpose" of placing funds with insured depository institutions.
- A trustee of a pension or employee benefit plan with respect to funds of the plan; a plan administrator or investment adviser in connection with a pension plan or other employee benefit plan if the person is performing management functions; and a trustee or custodian of a pension or profit sharing plan qualified under section 401(d) or 403(a) of Title 26 of the United States Code.
- An agent or nominee whose "primary purpose" is not the placement of funds with depository institutions.

FDIC Regulations

Unlike the FDIA, FDIC regulations contain a definition of "brokered deposit." The term brokered deposit means "any deposit that is obtained, directly or indirectly, from or through the mediation or assistance of a deposit broker."[8]

The definition of deposit broker in the FDIC regulations[9] mirrors the definition in the statute, with one significant exception. FDIC regulations except the following arrangements from the definition of deposit broker:

> An insured depository institution acting as an intermediary or agent of a U.S. government department or agency for a government sponsored minority or women-owned depository institution deposit program.[10]

---

7 12 U.S.C. § 1831f(g)(2).

8 12 C.F.R. § 337.6(a)(2).

9 12 C.F.R. § 337.6(a)(5).

10 12 C.F.R. § 337.6(a)(5)(ii)(J).

FDIC Staff Interpretations

The statutory definition of deposit broker does not turn on the type of deposit account (i.e., transaction account, savings deposit, time deposit) or the interest rate, term or other feature of the deposit account. Instead, it turns on the presence of an entity that is engaged in the business of (i) placing deposits of third parties or (ii) facilitating the placement of deposits of third parties. The staff has stated that the definition of deposit broker is "quite broad and, unless the activity in question comes within one of the statutory or regulatory exclusions, the FDIC must and will consider the activity deposit brokering."[11] The staff has supported its broad interpretation of the statute with its view of Congressional intent. "We believe Congress' intent in defining 'deposit broker' so broadly was to control the flow of funds to all but the best capitalized depository institutions insured by the FDIC."[12]

The staff has stated that a bank must report deposits as brokered even if the bank has not solicited the deposits or paid a fee to anyone for directing the deposits to the bank. If a bank has reason to know a deposit broker is involved, it must report the deposits as brokered.[13]

Placing Deposits

When an entity takes possession of a depositor's funds and transmits the funds to a bank, the FDIC staff, absent a specific exclusion, has typically found that activity to fall within the definition of deposit broker. The characterization of registered broker-dealers as deposit brokers with respect to their CD programs has never been questioned.[14] The brokers offer the CDs to their customers, transfer customer funds to the banks, have the CDs established in their name or the names of their nominee, act as custodian for the customer and receive a fee from the banks. The brokers are "placing" the funds and fit squarely within the definition. Similarly, broker-dealer programs that automatically place, or "sweep," customer funds to money market deposit accounts and/or NOW accounts fall clearly within the definition of deposit broker unless the program meets the criteria for the "primary purpose" exclusion discussed below.

Utilizing the "placement" element of the definition, the staff has determined that a bank that assists a customer in placing uninsured funds from the bank in a CD at an affiliated bank in response to customer demand for full deposit insurance was a deposit broker.[15] Neither the interest rate nor the receipt of a fee were cited as factors in this determination. The staff reached a similar conclusion when a bank periodically, at the request of a customer, placed

---

11 FDIC Advisory Opinion 92-84.

12 *Id.*

13 FDIC Advisory Opinion 92-73.

14 FDIC Advisory Opinion 92-52.

15 FDIC Advisory Opinion 92-68.

customer funds in another bank and "usually" charged a fee,[16] and when a bank, at the direction of a customer that was a municipality, placed excess funds at other banks and received no fee.[17]

In a recent draft letter to this firm, the staff has preliminarily concluded that a registered investment adviser that has investment discretion over the investments of a money market mutual fund is likely a deposit broker when it purchases large-denomination CDs for the fund. Money market mutual funds are not eligible for pass-through deposit insurance. The fact that the CDs were purchased in amounts substantially in excess of the FDIC insurance limit, that the fund was not formed exclusively for the purpose of purchasing CDs, and that the fund invests in a variety of assets in addition to CDs were considered relevant, but not mitigating, factors.[18] The receipt of a fee based on a percentage of the assets, including CDs, was considered to be significant.

Facilitating the Placement of Deposits

Utilizing the "facilitation" element of the definition, the staff has characterized a broad array of activities as falling within the definition of deposit broker. The staff has stated that the definition of the term "facilitate" means to "free from difficulty or impediment; to make easy or less difficult."[19] As a result, the staff has determined that facilitation can occur when an entity does not place, or even handle, customer funds. The staff has concluded that "finder" or "matchmaking" services are included in the definition of "deposit broker,"[20] assuming they do not meet the terms of the exclusion for listing services discussed below. In such arrangements, an entity provides information on available CDs to prospective investors and the investor establishes the deposit account directly with the bank. The finder or matchmaker typically receives a fee either from the bank or the depositor. Basing a fee on the amount of deposits placed appears to be relevant to the determination.[21]

Similarly, the staff has concluded that a company that managed CD portfolios of institutional investors was a deposit broker even though the company was never in possession of a client's principal or interest, and did not act as the client's agent. The company was facilitating the placement of deposits by gathering data on bank deposits and contacting institutional investors concerning the data. The company received a monthly fee.[22] The staff has also found that a company that assisted municipalities and others in locating banks that were seeking large

---

16 FDIC Advisory Opinion 92-71.

17 FDIC Advisory Opinion 92-92.

18 *See* also FDIC Advisory Opinion 92-66.

19 FDIC Advisory Opinion 92-77.

20 FDIC Advisory Opinions 92-52, 93-46 and 94-15.

21 FDIC Advisory Opinion 92-50.

22 FDIC Advisory Opinion 92-53.

deposits, and then directing its clients to such banks, was facilitating the placement of deposits even though the company was never in possession of the investors' principal or interest and never acted as trustee or agent for its investors.[23]

In a 1992 letter the staff concluded that an affinity group was a deposit broker because it actively assisted the bank in soliciting deposits from its members and received an incentive fee from the bank based on the average daily balance of deposits of its members at the bank.[24] The affinity group did not handle member funds or open accounts for members. In one of the few interpretive letters to cite the behavior of deposit accounts and use the term "core," the staff in 1993 modified its 1992 position on affinity group programs. The 1993 letter concluded that an affinity group was not a deposit broker because the bank solicited deposits from the group's members and only paid the group a licensing fee for use of its name and logo.[25] Among the other factors listed were that the retention rate of the money market deposit accounts obtained through the solicitations was 80 to 85% for MMDAs and that the retention rate for certificates of deposit was 60 to 75%. The staff noted that "such accounts are regarded by the Bank as core deposits of the Bank and are not used to replace core deposit run-off . . ." No definition of core deposit is offered. We have found no other letter that cites deposit behavior as even an incidental factor in the staff's decision, including subsequent letters addressing affinity group relationships.[26]

In certain limited circumstances the staff has determined that an entity is not a deposit broker because it is not engaged in the "business" of facilitating the placement of deposits. The staff has found that a fund that was established to increase the availability of low-cost housing loans that solicited deposits for its sponsoring bank was not engaged in the business of facilitating the placement of deposits. The staff concluded that the fund did not fall under the general definition of "business", which the staff noted in common usage generally refers to "employment, occupation, or activity engaged in for gain or livelihood; that which engages the time, attention, labor, and effort of persons as a principal serious concern or interest or for livelihood or profit."[27] The staff based its determination on the fact that the fund was a not-for-profit organization working for charitable purposes, had no salaried employees and accrued no formal benefits from the solicitation.

Employee Exclusion

Because the definition of deposit broker is so broad, many of the letters address requests for confirmation of the availability of one of the specified exclusions from the definition of deposit broker. The staff has addressed the issue of when a person employed by a bank is an

---

23 FDIC Advisory Opinion 92-86.

24 FDIC Advisory Opinion 92-79.

25 FDIC Advisory Opinion 93-30.

26 *See* FDIC Advisory Opinion 93-71.

27 FDIC Advisory Opinion 94-11.

"employee" for purposes of the exclusion for bank employees. For example, a person that is paid a commission for soliciting commercial checking accounts that pay no interest is not an "employee" for purposes of the regulations because they are not paid in the form of a salary.[28] Similarly, shared employees of two affiliated banks who would serve as a central clearing house for customer inquiries in connection with deposits did not fall within the definition of "employee" because neither person would be employed exclusively by either bank and their office space would not be used exclusively for the benefit of one institution.[29] Although the staff has opined that certain ministerial services may be performed without causing someone to be characterized as a deposit broker,[30] the employees were viewed as performing more than ministerial services because they would decide which of the two affiliated banks to which deposits would be directed. Rate was not cited as a factor.[31]

Primary Purpose Exclusion

The FDIC staff has issued a number of letters addressing the exclusion for "an agent or nominee whose primary purpose is not the placement of funds with depository institutions." In doing so, the staff has stated that "primary purpose" means "primary intent" and that the exclusion applies to "an agent who places funds into a depository institution for a substantial purpose other than to obtain deposit insurance coverage for a customer or to provide a customer with a deposit placement service."[32]

A number of arrangements have qualified for the exclusion. For example, a trust and estate lawyer who informs clients of available interest rates on deposit accounts at banks and advises the clients to open an account with the banks qualified for the exclusion.[33] Trust companies administering a trust are not deposit brokers when they open deposit accounts in connection with their administration of a "traditional type of trust."[34] And a parent acting as a custodian for a minor child under the Uniform Transfers to Minors Act is not a deposit broker.[35]

---

28 FDIC Advisory Opinion 92-56.

29 Unpublished letter dated September 25, 2002.

30 FDIC Advisory Opinion 94-40.

31 The staff has also found the activities of a banker's bank in placing deposits with shareholder banks to be the activities of a deposit broker. FDIC Advisory Opinion 92-88.

32 FDIC Advisory Opinion 05-02; *see also* FDIC Advisory Opinion 92-87 (absent the availability of deposit insurance, a program providing bank trust department customers with CD investments would not have been created).

33 FDIC Advisory Opinion 93-46.

34 FDIC Advisory Opinion 93-47.

35 2011 draft letter to Seward & Kissel LLP.

The most significant letter addressing this exclusion was issued in 2005[36] and determined that a deposit account "sweep" arrangement offered by a broker-dealer to its customers in which customer funds were deposited in deposit accounts at two affiliated banks qualified for the exclusion. The factors that the FDIC staff considered relevant include the following:

- the customer funds were excess cash that was awaiting investment in securities and other investments.
- the affiliate relationship between the broker and the banks required their dealings to be arms length under Regulation W of the Federal Reserve Board.
- the broker was compensated by the bank for certain *bona fide* services provided to the bank and was paid a fixed fee per brokerage account for those services, not a fee based on the amount of deposits at the bank.
- the deposits did not exceed 10% of the total assets in the customer brokerage accounts, and the broker agreed to file monthly reports to demonstrate its compliance.

Neither the interest rate nor other features of the deposit accounts were cited in the letter.

Listing Service Exclusion

Although not grounded in a specific exclusion in the statute or regulations, the FDIC staff has taken the position that an entity is not a deposit broker when it provides a service to make the rates on deposit accounts at specified banks available to prospective depositors and the service does nothing more than offer such information. The staff's rationale is that the service is not facilitating the placement of deposits, rather it is facilitating the decision of a prospective depositor.[37]

The criteria for the exclusion have evolved over time. The most recent formulation of the criteria was issued in 2004[38] and permits qualification for the exclusion if

- the service is compensated solely by means of a subscription fee from the banks and/or depositors that is a flat fee,[39] not a fee based on volume of deposits;

---

36 FDIC Advisory Opinion 05-02.

37 FDIC Advisory Opinion 92-50.

38 FDIC Advisory Opinion 04-04; reaffirmed in April 3, 2009 letter to QwickRate.

39 FDIC staff has not provided any definition of a "flat fee." For example, can the service charge different fees to different banks based on criteria other than volume of deposits or usage of the service?

- the service performs no service except (i) the gathering and transmission of information concerning the availability of deposits and/or (ii) the transmission of messages between depositors and banks, including purchase orders and trade confirmations;

- the service does not attempt to steer funds to particular banks, except that the service may rank institutions according to interest rates and also may exclude institutions that do not pay a listing fee;

- the service is not involved in placing the deposits; and

- the deposit account is opened by the depositor.

The ability of the service to facilitate the transmission of messages between a bank and a depositor is a reversal of the staff's position in a 2002 letter.[40] In that letter the staff specifically stated that a listing service cannot serve as a liaison between depositors and banks. The FDIC's rationale for changing its position is that advances in technology permit an internet-based service to transmit messages so long as it acts as a "passive mechanism."

In order to qualify for the listing service exclusion the deposit accounts listed by the service are not required to meet any interest rate or other restriction.

Internet Deposits

Although we have found no letter solely on the issue of the status of deposits obtained by a bank as a result of posting an ad on the internet, the status of such deposits was addressed in the 2002 letter on listing services.[41] The staff stated that "no apparent reason exists to treat the internet differently than other forms of media (such as newspapers and television and radio)." An internet company could be characterized as a deposit broker if it (i) provides assistance to the depositor in placing deposits or communicating with the bank or (ii) charges a fee based on the volume of deposits placed at the bank.

It is possible that the FDIC would now permit an internet company to facilitate communication between a bank and a depositor based on its 2004 listing service letter discussed above.

The Term "Core Deposit"

Neither the FDIA nor FDIC regulations utilize the term "core deposit," and the FDIC staff has not issued interpretive guidance with respect to the term. While banks are required to report their brokered deposits on their Call Reports, banks are not required to report

---

40 FDIC Advisory Opinion 02-04.

41 *Id.*

deposits that would be characterized as "core," a term that is not defined in the Call Report instructions.

While "core deposit" is not defined by statute or regulation, the concept of core deposits is discussed in the FDIC's DSC Risk Management Manual of Examination Policies. The Manual provides the following description:

> Core deposits are generally stable, lower cost funding sources that typically lag behind other funding sources in the need for repricing during a period of rising interest rates. These deposits are typically funds of local customers that also have borrowing or other relationship with the institution. Convenient branch locations, superior customer service, dense ATM network and/or no fee accounts are significant factors associated with inertia of these deposits.[42]

The Manual cautions that

> . . . in some instances, core deposit accounts (e.g. time deposits) might exhibit characteristics associated with more volatile funding sources. Conversely, deposit accounts generally viewed as volatile funding (e.g., CDs larger than $100,000) might be relatively stable funding sources.

The Manual further cautions that

> . . . at a particular institution, core deposit account balances might fluctuate significantly or might be more prone to run-off. For example, out of area CDs less than $100,000 obtained from an Internet listing service are included in core deposits under the UBPR definition, but it is nevertheless likely that such deposits should not be viewed as a stable funding source.[43]

An important additional caveat is contained in the Federal Reserve Board's Commercial Bank Examination Manual. In discussing the use of financial ratios to measure the stability of funds, the Manual notes that the ratios "necessarily employ assumptions about the stability of an institution's deposit base" so liquidity managers and examiners should "take care in construing the estimates of stable or core liabilities. . . . This caution has become especially important as changes in customer sophistication and interest-rate sensitivity have altered behavioral patterns and, therefore, the stability characteristics traditionally assumed for retail and other types of deposits traditionally termed 'core'."[44]

---

[42] DSC Risk Management Manual of Examination Policies at p. 6.1-7.

[43] *Id.*, at p. 6.1-17.

[44] Commercial Bank Examination Manual, Section 4020.1 at pp. 43-44. Similarly, the FDIC notes in its guidelines for deposit retention programs that "[i]ncreased competition for funds and the desire of most depositors to not only minimize idle, non-earning balances but also to receive market rates of interest on investment balances, have given further impetus to deposit retention efforts."

No methodology is set forth for delineating core deposits from non-core deposits, and no guidance is provided with respect to when deposits characterized as core should be recharacterized as non-core. For example, if a bank reduces its staff and eliminates branches, thereby decreasing service, should deposits be recharacterized as non-core?

The FDIC provides general guidance on developing deposit retention programs.[45] These guidelines caution banks about certain types of deposit relationships that may be volatile, including brokered deposits, internet deposits, listing service deposits, deposits obtained from public bodies and large deposits controlled by one depositor. Other than noting that the deposits of a board member of a bank may be viewed as stable, the guidelines do not provide affirmative guidance on the types of deposits that exhibit the qualities of a core deposit.

Despite the subjective nature of the FDIC's discussions of core deposit, and the significant qualifications included in those discussions, the FFIEC recently adopted the following definition of core deposit for purposes of the UBPR: "demand deposits, NOW accounts, ATS accounts, MMDAs, other savings deposits, and total time deposits of $250,000 or less, minus brokered deposits of $250,000 or less."[46] It should be noted that the definition includes transaction accounts and MMDAs, which were so volatile at weak banks during the recent financial crisis that the FDIC was forced to adopt the Transaction Account Guaranty Program in an attempt to stop deposit run-off. In addition, the definition assumes without explanation that no deposit characterized as brokered can exhibit the qualities of a core deposit.

There is no line item on the UBPR for "non-core deposits," but the UBPR includes a line item for the bank's reliance on "non-core liabilities." These liabilities are defined as "total time deposits of $100M or more; other borrowed money (all maturities); foreign office deposits; securities sold under agreements to repurchase and federal funds purchased; and insured brokered deposits issued in denominations of less than $100M."[47]

A recent FDIC Office of Inspector General Report on the FDIC's waiver procedures for the acceptance of brokered deposits suggests the rationale for excluding brokered deposits from core deposits. The Report states that "core deposits are typically lower-cost funding sources than BDs [the term for brokered deposits used in the Report]," suggesting that a brokered deposit cannot be a core deposit. The Report goes on to state that "[c]ustomers making non-core deposits, including BDs, are generally focused on rates and may not have any other relationship with the institution. Thus, BDs can be a more volatile, higher cost source of funding than core deposits and can present increased asset quality, liquidity, earnings and interest rate risk."

---

[45] DSC Risk Management Manual of Examination Policies at p. 6.1-7.

[46] The new definition is set forth in materials distributed by the FDIC in connection with its Core and Brokered Deposits Roundtable scheduled for March 18, 2011.

[47] A User's Guide for the Uniform Bank Performance Report at p. III-50.

No reference is made to the definition of brokered deposits and no support for these conclusions is offered. Furthermore, the Report's reference to core deposits fails to note the numerous qualifications to that definition, or that many deposits that would be characterized as core deposits for purposes of the UBPR would be inconsistent with the discussion of core deposits set forth in the examination guidelines.

This conflict between the subjective, qualified discussion of core deposits in the examination guidelines and the black and white definition in the UBPR can only lead to confusion by banks about appropriate deposit funding choices and to choices that are driven by the UBPR, not the character of the funding.

Seward & Kissel LLP

APPENDIX A

12 U.S.C. 1831f

§ 1831f. Brokered deposits

(a) In general

An insured depository institution that is not well capitalized may not accept funds obtained, directly or indirectly, by or through any deposit broker for deposit into 1 or more deposit accounts.

(b) Renewals and rollovers treated as acceptance of funds

Any renewal of an account in any troubled institution and any rollover of any amount on deposit in any such account shall be treated as an acceptance of funds by such troubled institution for purposes of subsection (a) of this section.

(c) Waiver authority

The Corporation may, on a case-by-case basis and upon application by an insured depository institution which is adequately capitalized (but not well capitalized), waive the applicability of subsection (a) of this section upon a finding that

the acceptance of such deposits does not constitute an unsafe or unsound practice with respect to such institution.

(d) Limited exception for certain conservatorships

In the case of any insured depository institution for which the Corporation has been appointed as conservator, subsection (a) of this section shall not apply to the acceptance of deposits (described in such subsection) by such institution if the Corporation determines that the acceptance of such deposits—

(1) is not an unsafe or unsound practice;

(2) is necessary to enable the institution to meet the demands of its depositors or pay its obligations in the ordinary course of business; and

(3) is consistent with the conservator's fiduciary duty to minimize the institution's losses.

Effective 90 days after the date on which the institution was placed in conservatorship, the institution may not accept such deposits.

(e) Restriction on interest rate paid

Any insured depository institution which, under subsection (c) or (d) of this section, accepts funds obtained, directly or indirectly, by or through a deposit broker, may not pay a rate of interest on such funds which, at the time that such funds are accepted, significantly exceeds—

(1) the rate paid on deposits of similar maturity in such institution's normal market area for deposits accepted in the institution's normal market area; or

(2) the national rate paid on deposits of comparable maturity, as established by the Corporation, for deposits accepted outside the institution's normal market area.

(f) Additional restrictions

The Corporation may impose, by regulation or order, such additional restrictions on the acceptance of brokered deposits by any institution as the Corporation may determine to be appropriate.

(g) Definitions relating to deposit broker

(1) Deposit broker

The term "deposit broker" means—

(A) any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions or the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties; and

(B) an agent or trustee who establishes a deposit account to facilitate a business arrangement with an insured depository institution to use the proceeds of the account to fund a prearranged loan.

(2) Exclusions

The term "deposit broker" does not include—

(A) an insured depository institution, with respect to funds placed with that depository institution;

(B) an employee of an insured depository institution, with respect to funds placed with the employing depository institution;

(C) a trust department of an insured depository institution, if the trust in question has not been established for the primary purpose of placing funds with insured depository institutions;

(D) the trustee of a pension or other employee benefit plan, with respect to funds of the plan;

(E) a person acting as a plan administrator or an investment adviser in connection with a pension plan or other employee benefit plan provided that that person is performing managerial functions with respect to the plan;

(F) the trustee of a testamentary account;

(G) the trustee of an irrevocable trust (other than one described in paragraph (1)(B)), as long as the trust in question has not been established for the primary purpose of placing funds with insured depository institutions;

(H) a trustee or custodian of a pension or profitsharing plan qualified under section 401(d) or 403(a) of title 26; or

(I) an agent or nominee whose primary purpose is not the placement of funds with depository institutions.

(3) Inclusion of depository institutions engaging in certain activities

Notwithstanding paragraph (2), the term "deposit broker" includes any insured depository institution that is not well capitalized (as defined in section 1831o of this title), and any employee of such institution, which engages, directly or indirectly, in the solicitation of deposits by offering rates of interest which are significantly higher than the prevailing rates of interest on deposits offered by other insured depository institutions in such depository institution's normal market area.

(4) Employee

For purposes of this subsection, the term "employee" means any employee—

(A) who is employed exclusively by the insured depository institution;

(B) whose compensation is primarily in the form of a salary;

(C) who does not share such employee's compensation with a deposit broker; and

(D) whose office space or place of business is used exclusively for the benefit of the insured depository institution which employs such individual.

(h) Deposit solicitation restricted

An insured depository institution that is undercapitalized, as defined in section 1831o of this title, shall not solicit deposits by offering rates of interest that are significantly higher than the prevailing rates of interest on insured deposits—

(1) in such institution's normal market areas; or

(2) in the market area in which such deposits would otherwise be accepted.

Appendix B

What is a "core" deposit?

The term "core deposit" is used as if its meaning is crystal clear. It is not, as the FDIC's examination guidelines illustrate. The concept of a core deposit must be viewed in the context of a depositor's overall customer relationship with a bank, not in isolation as reflected in UBPR reporting. The following discussion demonstrates the difficulty of determining core deposits.

In its narrowest sense, a bank deposit is represented by a balance in an account on the liability side of a bank's balance sheet. Each account has an owner or owners and a unique account number distinguishing it from all other deposit accounts in that bank. Certain types of accounts, such as escrow accounts and accounts placed in the bank by deposit brokers or other agents, have subaccounts maintained by the owner of the account, with each subaccount having its own deposit insurance limit.

The owner of a deposit account, whether an individual, a family, an unincorporated business, a corporation, a not-for-profit organization, or a governmental unit can have one, two, several, or many deposit accounts in a particular bank. For example, an individual may have a non-interest-bearing checking account, a money market deposit account, one or several CDs, and one or more retirement accounts in her name at her bank. Account owners may maintain their accounts because it is convenient (e.g., the bank has a branch up the street), the bank offers superior service (e.g., responsive customer service personnel) or because the bank has offered incentives in the form of higher rates on deposits or lower rates on loans.

The deposit accounts of an account owner may be linked in some manner, either through pre-established arrangements to transfer funds among the accounts as a part of ongoing cash management program, or to cover overdrafts that suddenly arise in one account by transferring funds into that account from a linked account.

The owner of a deposit account may have no, a few, or many other customer relationships with the bank. For example, the account owner may also have one or several borrowing relationships with the bank. For an individual or family, this could be an installment loan, a credit card, a home mortgage, a HELOC, and/or an unsecured line of credit. Businesses, of course, have a wide variety of both term loans as well as lines of credit that they can draw against and pay down at will. Maintenance of deposits with the bank may be a condition for obtaining a credit product, or it may not.

The owner of a deposit account also may buy other types of services from the bank, such as trust services or renting a safe-deposit box or, if a business, lock-box, payroll and cash-transfer services, trust services, etc. This multiplicity of services purchased by the owner of a deposit account or accounts is the result of an increased

emphasis by banks in recent years in cross-selling – trying to lock in a customer by selling that customer as many banking products and services as possible.

The account owner may also have relationships within both bank and non-bank affiliates of the bank holding company that owns the bank where she has her primary customer relationship. For example, a bank depositor may have a stock-brokerage account at a broker-dealer owned by the holding company that owns her bank or she may purchase insurance from an insurance broker owned by the holding company that owns her bank. A multiplicity of such relationships is especially common within larger bank holding companies.

While there has been substantial "charter collapsing" within bank holding companies in recent years, there still are a number of multi-bank holding companies – large and small – in which deposit customers of one bank in the holding company may also have one or more deposit accounts in another bank or other banks owned by that holding company. There are numerous reasons why a depositor would have deposit accounts at two or more banks owned by a bank holding company, including maximizing the amount of her deposits explicitly protected by FDIC insurance.[1]

Common to these relationships is that they usually are linked, through cash transfers within the bank, or between the bank customer's deposit accounts and other bank and non-bank affiliates of the holding company. For example, a customer's monthly mortgage payment is automatically withdrawn on the first of the month from the customer's checking account or a customer routinely moves funds between her bank account and her brokerage account in an affiliated broker-dealer through an automatic sweep program.

There is another aspect of the customer relationship with a bank that must be considered in this discussion – the extent to which that customer has linked her bank account or accounts to non-bank entities through pre-established direct-deposit and automatic bill payments via ACH transactions. Payroll direct deposits and utility bill payments are the most common types of ACH transactions. The ongoing effort by businesses to shift from checks to ACH transactions will steadily increase the number of such linkages.

It takes time and initiative by a bank customer to establish those linkages. The greater the number of these linkages, the more time consuming it is for that customer to switch her deposit-banking relationship to another bank. This is another aspect of the customer "lock-in" effect. Locking the customer's deposit balances into the bank is at the core of that "lock-in" process.

---

[1] Uninsured depositors have been fully protected in 92.4% of all banks that have failed since IndyMac failed in July 2008. Consequently, the likelihood of suffering a loss on the uninsured portion of a deposit in a failed bank has declined dramatically in recent years. Nonetheless, risk-adverse depositors still spread large deposit balances over multiple banks, both within a bank holding company as well as to banks outside that holding company so as to absolutely protect themselves against any loss should one of their banks fail.

A customer's relationship with a bank must be viewed, though, beyond the scope of her relationship with a bank or bank holding company – it must extend to her relationship with other banks and thrifts. While a substantial number of individuals or families bank with just one bank or group of affiliated banks, many bank with two or more unaffiliated banking organizations. Multiple banking relationships are much more common among businesses.

Customers with relationships with two or more unaffiliated banking organizations or with two or more banks owned by the same bank holding company therefore can, on a moment's notice, shift cash balances from one bank to a second bank. Hence, core customers of a bank who are core depositors holding core deposits at that bank can quickly move some or all of those core deposits to another bank. What appears at one moment to be a core deposit is, the next moment, no longer a deposit – it is gone, literally out the door in some cases. A customer may keep her accounts open at the troubled bank, but only carry a nominal balance in them. For all practical purposes, though, the core deposits have vanished!

Businesses that both deposit in and borrow from a bank have an additional incentive to move some or most of their deposits from a troubled bank to a stronger bank – to establish a borrowing relationship with the stronger bank without being in a rush to do so. There have been numerous instances in recent years where businesses with lines of credit in a troubled bank have had those lines canceled when the bank failed, leaving the businesses scrambling to line up new lenders.

The impossibility of differentiating core deposits from non-core deposits is illustrated by data collected on bank call reports[2] and thrift financial reports[3] and how that data is utilized for the purpose of preparing the Uniform Bank Performance Report, or UBPR, for individual banks and thrifts and for various peer groups of banks.

Deposit data are collected on these reports based on very explicit, quantifiable measures, e.g., components of total nontransaction accounts, maturity of time deposits of less than $100,000 and less than $250,000[4], number of deposit accounts, etc. None of these measures can even remotely be considered as the basis for differentiating core from non-core deposits, much less core depositors or core customers. For example, there is no reported measure of how many accounts were opened in a branch office versus being opened through an Internet transaction, nor is data collected that links accounts together so that a bank can report how many depositors it has. Contrary to the first stated

[2] Call report schedules RC-E Part I – Deposits in Domestic Offices and Schedule RC-O – Other Data for Deposit Insurance and FICO Assessments.

[3] Thrift financial report schedule DI – Consolidated Deposit Information.

[4] Memoranda Items 3(a) and 4(a) of call report schedule RC-E Part 1 require the reporting of time deposits of less than $100,000, and $100,000 or more, respectively, with a remaining maturity or next repricing date of (1) three months or less, (2) over three months through 12 months, (3) over one year through three years and (4) over three years. Memoranda Item 3(b) requires the reporting of time deposits of less than $100,000 with a remaining maturity of one year or less. Memoranda Items 4(b) and 4(c) require the reporting of time deposits of $100,000 through $250,000, and more than $250,000, respectively, with a remaining maturity of one year or less.

objective of the FDIC study of core and brokered deposits that Congress mandated, there is not and cannot be any factual or analytical basis for utilizing a "definition of core deposits for the purpose of calculating the insurance premiums of banks."

As this discussion makes quite clear, it is extremely difficult to fully identify all aspects of a bank's relationship with a particular customer or set of affiliated customers (such as family or several businesses under common control). Many banks try to identify such relationships through their CRM (customer relationship management) software. However, CRM software is far from perfect in identifying all aspects of a customer's relationship with a bank, much less the affiliates of that bank. That difficulty further undermines the notion of classifying deposits as "core" or "non-core." Put another way, a "core deposit" can be identified as such only in the context of the customer's overall relationship with a bank and its affiliates. To the extent that the FDIC lacks the capacity to identify customer relationships and linkages within a bank, how can it even entertain the idea of differentiating core from non-core deposits?

Appendix C

Description of the National Brokered Deposit Market

Sweep Programs

Although broker-dealers have offered MMDAs at FDIC-insured depository institutions ("Insured Institutions") as an alternative to money market mutual funds for the sweep of excess cash in customer brokerage accounts since the early 1980's, interpretations by the Federal Reserve Board (the "Board") of Regulation D (Reserves) precluded offering these arrangements to customers seeking transaction capabilities on their brokerage accounts (*e.g.*, checkwriting, debit card, automatic bill paying).[1] In the mid-1990's the Board issued interpretive guidance that permitted Insured Institutions to link an MMDA to a NOW or other transaction account and maintain the MMDA as a "savings deposit" for reserve purposes under Regulation D.[2] This interpretive guidance permitted broker-dealers to offer these linked deposit accounts to customers holding brokerage accounts with transaction features and not limit the customers' access to their funds.

In addition, the adoption of the Gramm-Leach-Bliley Act ("GLBA") in 1999 permitted the affiliation of Insured Institutions with full-service broker-dealers. GLBA encouraged the cross-marketing of products between an Insured Institution and its affiliated broker.

Since 2000, dozens of broker-dealers have replaced money market funds with deposit accounts for the sweep of excess cash in customer brokerage accounts. These "Sweep Programs" can be established by a broker-dealer with Insured Institutions that are affiliated with the broker-dealer and Insured Institutions that are not affiliated, or a combination.

In a Sweep Program the broker-dealer establishes the deposit accounts on the books of the Insured Institution in its name as agent and custodian for its customers. The manner of recordation complies with FDIC requirements for "pass-through" deposit insurance. The broker-dealer maintains records of the deposit accounts held by each of its customers and those records would be submitted to the FDIC in the event of the failure of the Insured Institution.

In a Sweep Program the customer relationship is between the customer and the broker-dealer, not between the customer and the Insured Institution. The Insured Institution does not know the customers for recordkeeping purposes, though marketing of an affiliated bank's lending products to the broker's customers may occur. The broker-

---

[1] *See* letter dated June 22, 1983 from William W. Wiles, Secretary of the Board, to Roger M. Zaitzeff, Esq.; and letter dated June 22, 1988 from Oliver I. Ireland, Associate General Counsel, to Gilbert T. Schwartz, Esq.

[2] *See* Board Staff Opinions dated February 7, 1995, August 1, 1995, August 30, 1995 and October 18, 1996.

dealer, as agent for the customers, sends the customers periodic account statements of all assets held by the broker for the customer, including deposit accounts, and year-end tax reporting statements (*i.e.*, IRS Form 1099). Since there may be tens of thousands of broker-dealer customers, the Insured Institution does not incur the overhead of maintaining individual deposit accounts for their customers.

Funds obtained by a bank through a broker's Sweep Program are stable, typically behaving like long-term funding.[3] The Sweep Program is a feature of a customer's brokerage account that automatically deposits excess cash in the customer's brokerage account in the Insured Institution. The excess cash comes from interest payments and dividends on securities, sales of securities and deposits to the brokerage account. Customers do not need to give their broker a specific direction to deposit funds. As a result, funds are constantly flowing into the Insured Institution to offset customer withdrawals. Furthermore, the Sweep Program may be the only, or one of the few, options made available by a broker-dealer to its customers for sweeping excess cash in the customer's brokerage account.

Although the funds have the stability of term deposits, they are priced as short-term deposits. The Insured Institution typically pays interest on a "tiered" basis. The tiering may be tied to the value of customer assets with the broker-dealer or to the amount the customer has on deposit with the Insured Institution as calculated by the broker-dealer. The rates vary among Sweep Programs, but the average rate is substantially below the yield on money market funds. Because of the minimal overhead to the Insured Institution (*e.g.*, no statements, tax reporting, etc.) associated with the funds, they are comparatively inexpensive to the Insured Institution.

Although some Sweep Programs qualify for the primary purpose exemption from the definition of "deposit broker" and, therefore, are not 'brokered," the programs all exhibit similar features and characteristics.

CD Programs

With respect to CDs offered by registered broker-dealers utilizing The Depository Trust Company ("DTC") as a sub-custodian, and banks participating in deposit placement programs such as CDARS ("CD Programs"), the broker-dealer or bank acts as a placement agent. Insured Institutions must agree to certain conditions, including their eligibility to accept brokered deposits. Most offerings of CDs are priced at the beginning of a business week and CDs are offered to the broker's customers during the week. Settlements of transactions are typically the following week. However, banks may offer and settle CDs at any time during a week. In other words, this is an organized market that operates in many respects like the market for different types of securities.

Because offerings are conducted weekly, "well capitalized" Insured Institutions can readily access the market to replace deposits or attract new funding. The market is

[3] Deposits placed by broker-dealers through a Sweep Program in unaffiliated Insured Institutions may be subject to long-term agreements.

also highly competitive. We estimate that at least 20 broker-dealers act as underwriters in this market, and over 3,000 banks participate in CDARS, so Insured Institutions are not limited to one or two sources to obtain pricing quotes on funding. This ensures that an Insured Institution can obtain the lowest cost funding available in this market.

Like Sweep Programs, CD Programs provide certain efficiencies not available to Insured Institutions with direct deposit relationships. The vast majority of CDs issued in this market are represented by a Master Certificate of Deposit ("Master Certificate"), a negotiable instrument representing a number of individual CDs, typically in denominations of $1,000. The Master Certificates are held by DTC as sub-custodian for the broker-dealers. The CDs are recorded on the books of the Insured Institution in the name of DTC, in a manner designed to permit the "pass-through" of deposit insurance to the broker's customers. The broker-dealer maintains records of the CDs held by its customers and these records would be submitted to the FDIC in the event of the failure of the Insured Institution.[4]

As a result of these arrangements, Insured Institutions do not need to send customer statements or tax reporting forms. They do not need to maintain customer service personnel to answer customer questions. The savings in overhead to an Insured Institution has been estimated at 90 basis points, though there are no empirical data to verify this conclusion.

The funds deposited through this market are stable because the CDs have very limited early withdrawal provisions. CD holders can withdraw the funds only upon death or adjudication of incompetence. As an alternative to early withdrawal, CD holders can liquidate their CDs in a secondary market offered by most brokers to their customers. Because CD holders have a means to liquidate their CDs as an alternative to early withdrawal, an Insured Institution can issue CDs with maturities out to 10 years without facing early withdrawal demands. Current data from various broker-dealers indicates that CDs with maturities over one year are currently over 50% of this market. This is in contrast to the industry-wide figure of 5.9% of deposit liabilities with maturities over one year.

SK 99031 0001 1191414

[4] CDARS utilizes a "book entry" arrangement through The Bank of New York Mellon that creates substantially the same relationship among the parties, with bank participants acting as a custodian for their customers.

June 23, 2011

WHY THE DEPOSITS OF STATE FARM BANK ARE NOT "BROKERED DEPOSITS"

I. Introduction

Pursuant to Section 1506 of the Dodd-Frank Act, the FDIC is currently conducting a study on "core deposits" and "brokered deposits." Under the statute, the FDIC is directed to evaluate, among other things (i) the potential impact of revising the definitions of core deposits and brokered deposits and (ii) the "differences between core deposits and brokered deposits and their role in the economy and the banking sector of the United States."

In the course of conducting the Core Deposits study, the FDIC is considering the risks to FDIC-insured institutions of traditional brokered deposits. Traditional brokered deposits are large sums of money that readily move from one insured depository institution to another based on competitive interest rates. Traditional deposit brokers seek to place funds, frequently packaged in blocks, with the highest bidder offering a risk-free return. Those high bidders have tended to be high-risk institutions.

The system of controls Congress and the FDIC designed to address these high-risk situations is in need of reconsideration, as the mandate for the Core Deposits study reflects. One area the FDIC has been urged to consider in this context is the role of exclusive agents of a single depository institution, who solicit deposits solely and exclusively for that depository institution and no other. The agents of State Farm Bank, F.S.B. (the "Bank") are an example of such exclusive agents, and the deposits they solicit are not properly considered, and should not be characterized, as "brokered deposits" for purposes of the brokered deposits adjustment in the FDIC's Assessments Rule.[1]

II. Background on State Farm Bank

The Bank, which is located in Bloomington, Illinois, is an FDIC-insured federal savings association and a wholly-owned subsidiary of State Farm Mutual Automobile Insurance Company ("State Farm Mutual"). State Farm Mutual and its affiliates comprise six property and casualty insurance companies, three life insurance companies and several noninsurance entities, including the Bank. The vast majority of State Farm Mutual's customers are individuals and families.

The Bank was established effective March 12, 1999 as a means to enhance State Farm Mutual's present and future customer relationships through the offering of new

---

[1] 12 C.F.R. Part 327.

financial products and services. The Bank offers a variety of deposit and loan products and services, including checking/savings accounts and CDs, on a nationwide basis.

As of March 31, 2011, the Bank had total assets of approximately $14.9 billion and liabilities of approximately $13.3 billion, including deposits of approximately $9.6 billion. As of that date, the Bank was well capitalized with a Tier 1 (Core) Capital Ratio of 9.75%; a total Risk-Based Capital Ratio of 13.78%; and a Tier 1 Risk-Based Capital Ratio of 12.51%. Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act,[2] the State Farm Mutual is required to serve as a source of strength to the Bank and, indeed, over the past 12 years, State Farm Mutual has contributed approximately $1.919 billion to the Bank as capital.

III. The Exclusive Agents of State Farm Mutual and State Farm Bank

State Farm Mutual markets its insurance products almost entirely through independent contractor agents who work exclusively for State Farm Mutual (the "Agents") in the insurance market. Currently, there are more than 17,700 exclusive Agents in approximately as many different locations. These exclusive Agents also are the primary means through which the Bank markets its products and services – indeed, the Bank's marketing is done almost entirely by the exclusive Agents. As set forth in the Bank's business plan approved by the OTS and the FDIC, the Bank does not maintain any branches or offices open to the public – the Bank was established on the understanding that it would conduct its marketing through the exclusive Agents, thereby building on the established relationships and goodwill between the Agents and the insurance customers of State Farm Mutual. Approximately 88% of the Bank's deposits are currently gathered through the Agents.

Although the Agents are independent contractors, all of the banking-related activities they conduct are subject to OTS regulation, examination, supervisory and enforcement authority – just as though those activities were being conducted by the Bank itself (*i.e.*, by Bank employees). The OTS therefore deems the exclusive Agents to be the functional equivalent of operating subsidiaries of the Bank: like operating subsidiaries, the exclusive Agents function much like divisions or departments of the Bank. The OTS expressly stated this in an official opinion letter to the Bank in 2004:

> [T]he [Bank] controls and reviews the activities the Agents perform on behalf of the Association, and no other entity exercises effective operating control over the Agents' activities on behalf of the [Bank]. Where an association exercises sufficient control over an agent's performance of authorized banking activities, the agent, like an operating subsidiary of a federal savings association, will be subject to OTS regulation and supervision, . . . just as [such

[2] Pub. L. No. 111-203 (July 21, 2010).

> regulation and supervision] would apply to an operating subsidiary.[3]

In soliciting deposits, therefore, the exclusive Agents perform marketing activities in essentially the same manner as would employees within a department or division of the Bank, if the Bank used employees for marketing purposes.

IV. The Agents Should Be Excluded From the Definition of "Deposit Broker"

Section 1831f defines the term "deposit broker" to include, in pertinent part:

> any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions or the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties.[4]

Section 1831f expressly *excludes* from the definition of deposit broker employees of an insured depository institution.[5] For purposes of the Assessments Rule, the Agents should be viewed as the functional equivalent of the Bank's employees. Just like a depository institution employee "who is employed exclusively by the insured depository institution,"[6] the Agents act on behalf of a single depository institution. And, in so doing, the Agents are regulated and supervised in precisely the same manner as the depository institution's employees. Thus, although the Agents do not meet the narrow definition of "employee" in Section 1831f(g),[7] for all purposes relevant to the FDIC's regulation of brokered deposits, the Agents are, in effect, the functional equivalent of depository institution "employees."

Moreover, Section 1831f also expressly excludes from the definition of deposit broker "an agent or nominee whose primary purpose is not the placement of funds with depository institutions.[8] The Agents could not have any purpose, much less a "primary purpose," to place funds with "depository institutions" (*i.e.*, more than one depository

---

[3] OTS Legal Op. P-2004-7, 2004 WL 3272094, at 13 (O.T.S. Oct. 25, 2004), *available at* http://www.ots.treas.gov/docs/5/560404.pdf; *see also id.* at 9 (noting the "OTS's long-held view that because an operating subsidiary may only engage in activities permissible for its parent federal savings association and must be controlled and majority owned by the association, an operating subsidiary is the equivalent of a department or division of the parent federal savings association for regulatory and reporting purposes.").

[4] 12 U.S.C. § 1831f(g)(1). *See also* 12 C.F.R. § 337.6(a)(5)(i) (same).

[5] 12 U.S.C. § 1831f(g)(4).

[6] *Id.* § 1831f(g)(4)(A).

[7] The Agents do not meet the "employee" definition because, *inter alia*, their compensation is not "primarily in the form of a salary" and their office space is used for their insurance marketing activities for State Farm, not only for the benefit of the Bank. *Id.* § 1831f(g)(4)(B)&(D).

[8] 12 U.S.C. § 1831f(g)(2).

institution) because they are contractually bound to perform banking-related services *only for State Farm Bank and no other depository institution.* The Agents therefore do not – and could not – act in the manner that concerned Congress with respect to brokered deposits – *i.e.*, facilitating volatile deposits by seeking to break up large deposits and place them at *different* insured financial institutions, particularly on the basis of higher interest rates.

To the contrary, the primary purpose of the Agents with respect to Bank deposits is to introduce State Farm insurance customers (principally individuals and families) to the Bank's deposit products as a means to solidify and strengthen their insurance agency relationships with those customers. By introducing State Farm customers to the Bank's products and services, the Agents generate good will and build stronger relationships with those customers. Customer satisfaction with the Bank's products augments customer loyalty to State Farm Mutual and thus contributes to the success of the Agents' business.

V. State Farm Bank Deposits Bear None of the Risks Typically Associated With Brokered Deposits.

In enacting the "brokered deposits" provision, Congress was primarily concerned about the volatility and higher interest rates generally associated with such deposits. This same concern underlies the provision for the brokered deposits adjustment in the FDIC's Assessments Rule.

Neither volatility nor higher interest rates, however, are characteristics of the deposits of State Farm Bank. As the past decade of experience shows, the interest rates on the Bank's deposit products generally have been no higher than those of other banks competing in the same geographic areas. Moreover, the Agents do not and would not refer their insurance customers to the Bank on the basis of high interest rates, because they are contractually bound to make any banking referrals *exclusively to the Bank, regardless of the interest rates the Bank pays.*

State Farm Bank pays the Agents a direct, fixed fee for each new savings account, or money market account that is opened, regardless of the dollar amount of deposits involved, and pays a fee based on a limited-range sliding scale ($25 to $150) for each new certificate of deposit that is purchased. Because the Agents essentially have no incentives to seek out customers with large deposit amounts, they solicit deposits without regard to the dollar amount of those deposits. Thus, the concerns about the volatility of brokered deposits is not an issue with respect to the Agent-solicited deposits.

Indeed, far from attracting volatile deposits, the Agents encourage stable deposits. The Agents specifically benefit from the endurance of their insurance customers' relationships with the Bank. The statistics on rollovers of Bank deposits bears this out: over the past decade, almost half of the Bank's regular, 12-month personal CDs have been rolled over at least once; about 35 percent have been rolled at least twice, about 25 percent have been rolled over at least three times, and about 20 percent have been rolled over at least four times. For 12-month regular non-personal CDs, almost 33 percent

remain with the Bank for more than three years, and more than 30 percent of 24-month regular business CDs remain with the Bank for approximately five years. Comparable statistics exist for the Bank's "Jumbo" CDs and for CDs of shorter and longer duration. (*See* Exhibit 1, attached.) Thus, the Agent-solicited deposits are essentially "core deposits" – *i.e.*, long-term sources of funding that are much less expensive than wholesale funds with comparable terms.

In summary, imposing brokered deposit assessments on deposits solicited by exclusive agents of a single depository institution serves none of the objectives of Congress or the FDIC with respect to preventing risks to the DIF, the application of the Assessment Rule's brokered deposits adjustment to exclusive agent-solicited deposits undermines, rather than protects, "the safety and soundness of our deposit and insurance system and the reserves of the system, . . . in behalf of the American public, and in the interest of a sound and stable depository institutions system in our country."[9] And, because virtually all of the Bank's deposits are solicited by the Agents, defining the Agents as "deposit brokers" for purposes of the Assessments Rule would unnecessarily and inappropriately penalize the Bank for maintaining a business model that was expressly approved by both the OTS and the FDIC itself.

Taking into account the unique business model of the Bank and the stability and modest interest rates of its deposit products, penalizing State Farm Bank for its use of its exclusive Agents to market its deposit products by imposing "brokered deposit" assessments on the Bank would serve no sound public purpose and would frustrate the critical federal objectives of expanding credit distribution channels and lowering the cost of credit.

---

9 *Impact of Brokered Deposits on Banks and Thrifts: Risks Versus Benefits*, Hearing before the House Banking, Finance and Urban Affairs Committee's Subcommittee on General Oversight and Investigations, Serial No. 99-36 (July 16, 1985), at 115 (testimony of Edwin J. Gray, Chairman, Federal Home Loan Bank Board).

State Farm Bank Certificates of Deposit: Rollovers for Period January 2003-December 2008

(6-year period for which data have been recorded)

	Tier	Term	Begin	Roll 1	Roll 2	Roll 3	Roll 4	Roll 5	Roll 6	Roll 7	Roll 8	Roll 9	Roll 10	Roll 11	Roll 12
Personal	Jumbo	3_month	100%	51%	35%	24%	18%	15%	12%	10%	9%	7%	6%	4%	3%
	Regular	3_month	100%	55%	41%	32%	27%	24%	21%	19%	17%	15%	13%	11%	9%
	Tier	Term	Begin	Roll 1	Roll 2	Roll 3	Roll 4	Roll 5	Roll 6	Roll 7	Roll 8	Roll 9	Roll 10	Roll 11	
	Jumbo	6_month	100%	45%	27%	19%	14%	10%	8%	6%	5%	5%	4%	3%	
	Regular	6_month	100%	56%	39%	31%	25%	21%	18%	15%	13%	13%	11%	8%	
	Tier	Term	Begin	Roll 1	Roll 2	Roll 3	Roll 4	Roll 5							
	Jumbo	12_month	100%	39%	23%	12%	10%	6%							
	Regular	12_month	100%	54%	37%	25%	21%	16%							
	Tier	Term	Begin	Roll 1	Roll 2										
	Jumbo	24_month	100%	29%	12%										
	Regular	24_month	100%	42%	22%										
	Tier	Term	Begin	Roll 1											
	Jumbo	36_month	100%	24%											
	Regular	36_month	100%	33%											
	Tier	Term	Begin	Roll 1											
	Jumbo	48_month	100%	7%											
	Regular	48_month	100%	24%											
	Tier	Term	Begin	Roll 1											
	Jumbo	60_month	100%	12%											
	Regular	60_month	100%	24%											
Summary		Jumbo	100%	30%	24%	18%	14%	10%	10%	8%	7%	6%	5%	4%	3%
		Regular	100%	41%	35%	29%	25%	20%	19%	17%	15%	14%	12%	10%	9%

	Tier	Term	Begin	Roll 1	Roll 2	Roll 3	Roll 4	Roll 5	Roll 6	Roll 7	Roll 8	Roll 9	Roll 10	Roll 11	Roll 12
Business	Jumbo	3_month	100%	56%	39%	26%	20%	15%	13%	10%	9%	7%	6%	5%	4%
	Regular	3_month	100%	64%	51%	43%	37%	34%	31%	28%	25%	23%	20%	18%	16%
	Tier	Term	Begin	Roll 1	Roll 2	Roll 3	Roll 4	Roll 5	Roll 6	Roll 7	Roll 8	Roll 9	Roll 10	Roll 11	
	Jumbo	6_month	100%	47%	29%	21%	16%	12%	9%	7%	4%	3%	3%	3%	
	Regular	6_month	100%	62%	47%	40%	32%	28%	23%	20%	16%	14%	13%	11%	
	Tier	Term	Begin	Roll 1	Roll 2	Roll 3	Roll 4	Roll 5							
	Jumbo	12_month	100%	40%	26%	14%	6%	3%							
	Regular	12_month	100%	65%	46%	33%	27%	22%							
	Tier	Term	Begin	Roll 1	Roll 2										
	Jumbo	24_month	100%	24%	9%										
	Regular	24_month	100%	54%	32%										
	Tier	Term	Begin	Roll 1											
	Jumbo	36_month	100%	13%											
	Regular	36_month	100%	48%											
	Tier	Term	Begin	Roll 1											
	Jumbo	48_month	100%	20%											
	Regular	48_month	100%	30%											
	Tier	Term	Begin	Roll 1											
	Jumbo	60_month	100%	6%											
	Regular	60_month	100%	35%											
Summary		Jumbo	100%	30%	26%	20%	14%	10%	11%	8%	6%	5%	5%	4%	4%
		Regular	100%	515	44%	39%	32%	28%	27%	24%	20%	18%	17%	15%	16%

CDBA Community Development Bankers Association
1444 Eye Street, Suite 201 • Washington, D.C. 20005 • (202) 689-8935 • (202) 689-8938 (fax)

July 6, 2011

Ms. Diane Ellis
Deputy Director, Division of Insurance and Research
Federal Deposit Insurance Corporation
550 – 17th Street NW
Washington DC 20429

Dear Ms. Ellis:

I wish to sincerely thank you for participating in the 2011 Peer Forum of Community Development Bankers Association (CDBA) on June 7, 2011. The Peer Forum attendees were grateful for the opportunity hear about the agency's observations and share their thoughts as the Federal Deposit Insurance Corporation (FDIC) prepares its finding for the study on core and brokered deposits as mandated by Section 1506 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. We would also like to take this opportunity to summarize the views expressed by CDBA members at the Peer Forum on this important matter.

As you work to finalize your study, we ask that you consider the important consequences of the brokered and core deposit definitions on credit availability and access to capital in low income, credit starved communities. Amending the core deposit definition to include Reciprocal Certificate of Deposit Account Registry Service (CDARS) will have a stimulative effect on local economies – particularly low wealth communities that often lack sufficient organic sources of deposits from residents to support new lending. In particular, banks and thrifts that are U.S. Treasury Department certified Community Development Financial Institutions (CDFIs) – as well as other small community banks in distressed communities – have found CDARS to be a critical source of stable deposits that we use to invest in underserved communities. Amending the core deposit definition to include Reciprocal CDARS will aid recovery in the places hardest hit by the recession and facilitate economic stabilization. To best understand our recommendations, it is critical to understand the work of CDBA and its members.

Who We Are

The Community Development Bankers Association represents Federal and state chartered banks and thrifts that are CDFI banks (a.k.a. Community Development Banks (CDBs)). Our members serve as engines of economic inclusion throughout the United States. We share a common mission of improving communities and lives. All of our members are certified by the U.S. Treasury Department's Community Development Financial Institutions (CDFI) Fund as targeting 60% or greater of our total business activity to low income communities and people.

CDFI banks and thrifts make a difference – perhaps the difference – in the lives of tens of thousands of people in the communities we serve. Our members are often the only source of credit and financial services in these communities. We make loans to build and renovate housing so that people have a decent place to live. Our housing lending, in turn, sparks revitalization of other housing in our neighborhoods. We make loans to small businesses so that people will have jobs. The businesses we lend to, in turn, act as magnets that draw other businesses into the community. Our lending has a ripple effect throughout the community far beyond our direct customers, changing a community's dynamic.

Why CDARS is Different from Brokered Deposits for CDFI Banks and Thrifts

CDBA members serve our nation's most distressed and credit starved communities. We operate in places with modest discretionary income and insufficient means to raise deposits to meet the demand for credit. As an integral part of our strategy, we raise deposits from civic-minded and socially-motivated individuals and institutions within our defined market areas. Our experience demonstrates that investors are willing to invest much larger deposits in a CDFI bank or thrift if they are assured those deposits are safe. CDARS provides that assurance.

Without access to large institutional deposits, many of our loans could not be made. Most of CDBA's members have or do participate in Promontory Interfinancial Network. Today, our members collectively hold more than $500 million in CDARS Reciprocal deposits. The vast majority of these deposits are made by local customers that want to invest in their communities – rather than seek the highest rate of return. In communities we serve, one half billion dollars in deposits is a tremendous resource. Without Reciprocal CDARS as a magnet for attracting socially motivated investors, we will not be able to originate loans at a scale sufficient to have a positive social impact. We urge the FDIC to ensure Reciprocal CDARS can continue to play this critical role.

The service is a relatively new technological innovation. Often, however, it takes time for the law to catch up to such innovations. CDARS does not, however, present the type of risk to individual institutions and the Deposit Insurance Fund that the law was designed to address. With CDARS there is no traditional deposit broker – the banks within the Promontory Network exchange deposits. CDARS customers are not interested in chasing high interest rates; they are interested in keeping their money safe. There is no evidence that CDARs Reciprocal deposits contribute to banks engaging in risky lending activities. To the contrary, CDARS reciprocal customers have a relationship with their bank. CDARS deposits tend to remain in the bank for the long term.

Why CDARS is Important to Our Low Income Communities

Since CDARS creation, local reciprocal deposits have enabled us to reach out, increase our lending, and better serve credit starved communities by underwriting loans for affordable housing, small-business, and community

projects, including charter schools, day care centers, community health clinics, neighborhood revitalization projects, and other facilities that provide critical community services. We strongly believe that CDARS Reciprocal deposits are an invaluable tool to help CDFI banks and thrifts meet the needs of our communities – as well as promote financial institution and communities stability.

Reciprocal CDARS as a Source of Stable Deposits and Risk Mitigator: Contrary to traditional brokered deposits, CDARS Reciprocal deposits provide an exceptionally stable source of funds.

- Reinvestment Rates: Our CDARS Reciprocal deposits share the same characteristics as our other core deposits. We experience very high reinvestment rates with an average rate of 83% across the CDARS network – even throughout the recent economic period when many small banks have experienced real distress. In fact, our civic-minded CDARS depositors have been among our most stable and strongly committed supporters.
- Pricing: We rarely pay interest rates above other local banks in our markets. Nationally CDARS deposits are 20-40 basis points less than the cost of traditional brokered deposits. A real "hot money" depositor would be highly unlikely to find a deposit in a CDFI bank or thrift as attractive. You do not find our banks on any of the Internet rate boards advertising high rates and likely never will. In most cases, the CDARS Reciprocal customer of a CDFI bank or thirft is a civic minded individual or institution that is already a customer or is located within our market area.
- Local Depositors: Nationwide 80% of CDARS placements are within 25 miles of a branch location. Our CDARS Reciprocal customers are social motivated institutions, including state and municipal governments, foundations, local businesses, educational institutions, churches, nonprofits, and others that choose to invest with their values by placing capital in a bank that will use it serve their local community and neighborhoods that need capital. Finally, for depositors in which CDARS is their first engagement with our banks, we are often able to cross sell these clients other bank products and cultivate a stronger commitment to our mission and activities. Rather than undermine deposit stability or increasing an institution's risk, reciprocal CDARS allows banks – particularly small banks – to build stronger face-to-face old fashioned banking relationships with traditional customers that want stable banking relationships with an institution committed to their communities.

Please help us help our communities. We strongly urge you to exempt CDARS reciprocal deposits from the definition of brokered deposits in future rule making. Alternatively, we urge the FDIC to support a legislative amendment to the core and brokered deposit definitions to support our efforts to stimulate economic activity and recovery in distressed and under served communities through access to credit.

Thank you for consideration of our views and recommendations.

Sincerely,

The Members of Community Development Bankers Association

Albina Community Bank — *Portland, OR*
BankPlus — *Ridgeland, MS*
Broadway Federal Bank — *Los Angeles, CA*
Carver Federal Savings Bank — *New York, NY*
Central Bank of Kansas City — *Kansas City, MO*
City First Bank of DC — *Washington, DC*
City National Bank of New Jersey — *Newark, NJ*
Community Bank of the Bay — *Oakland, CA*
Community Capital Bank of Virginia — *Christiansburg, VA*
First American International Bank — *Brooklyn, NY*
First Eagle Bank — *Hanover Park, IL*
Franklin National Bank — *Minneapolis, MN*
Guaranty Bank and Trust Company — *Belzoni, MS*
International Bank of Chicago — *Stone Park, IL*
Metro Bank — *Louisville, KY*
Mission Valley Bank — *Sun Valley, CA*
Native American Bank, NA — *Denver, CO*
Neighborhood National Bank — *National City, CA*
One PacificCoast Bank — *Oakland, CA*
OneUnited Bank — *Boston, MA*
Pan American Bank — *Chicago, IL*
Park Midway Bank — *St. Paul, MN*
Peoples State Bank — *Many, LA*
Southern Bancorp — *Little Rock, AR*
Start Community Bank — *New Haven, CT*
Sunrise Community Banks — *St. Paul, MN*
United Bank — *Atmore, AL*
University National Bank — *St. Paul, MN*
Urban Partnership Bank — *Chicago, IL*