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May 7, 2019

VIA EMAIL: ***comments@fdic.gov***

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Re: Unsafe and Unsound Banking Practices: Brokered Deposits
RIN 3064-AE94

Dear Mr. Feldman:

I am writing in response to the FDIC's Advance Notice of Proposed Rulemaking (ANPR) concerning the FDIC's regulatory approach towards "brokered deposits" as that term is defined and interpreted under Section 29 of the Federal Deposit Insurance Act and the regulations issued thereunder.

By way of background, I have been a bank analyst for over 40 years, with a specialty of analyzing and predicting bank and thrift failures. As such, I was one of the first persons to publicly predict, in 1986, the onset of the S&L crisis. As part of my analysis of the S&L industry's problems and later of problems in commercial banking, I assessed the role that brokered deposits did, or did not, play in the failure of hundreds of bank and thrift institutions. Accordingly, in 1991, I co-authored a report titled "Retail Brokered Deposits: A Post-FIRREA Analysis." I have since continued to monitor brokered-deposit activity and issues.

Summation of this comment letter

As I have personally observed, since the 1980s the FDIC has sought to blame brokered deposits (BDs) as a major cause of bank and thrift failures even though deposits, and other sources of bank funding, do not generate the losses that drive banks and thrifts (hereinafter "banks") into insolvency that then causes losses to the FDIC's Deposit Insurance Fund (DIF). The losses that have bankrupted banks in recent years have come from the asset side of a bank's balance sheet and/or from its ongoing operations. The FDIC errs in asserting otherwise.

Greatly aggravating the underlying causes of many bank failures is rapid asset growth, and especially a bank growing its loans at too rapid a pace. The data are clear, though, that substantial BD funding does not mandate or even imply rapid asset growth – a bank's management can use any type of funding to fuel such growth.

While management drives that growth, bank supervisors, and specifically the FDIC, are charged with preventing rapid, risky asset growth, and specifically rapid loan growth, that time and again has led to losses and bank failure. The FDIC should stop blaming brokered deposits for bank failures and instead admit to its own shortcomings as a bank supervisor, specifically with failing to constrain excessively rapid asset growth.

The balance of this comment letter is divided into two sections. The first section summarizes my analysis of every bank and thrift failure since 2007. The second portion of this letter comments on data and assertions set out in the ANPR.

Analysis of bank and thrift failures since 2007

As noted above, I have analyzed the failure of every FDIC-insured bank since three failures in 2007. There were no bank failures in 2005 and 2006, so there was a clean break between failures related to the most recent financial crisis and prior bouts of bank failures As of the filing of this comment letter, there have been 530 failures post 2006, excluding Washington Mutual, which imposed no loss on the DIF.

One of the most interesting aspects of the post-2006 failures is how many failed banks had no reported BD funding during the five years preceding their failure. Specifically, of the 63 failures in the 2013-2017 period, 21 reported no BDs outstanding at their quarter-ends one, two, three, four, and five years prior to failure; many of these failed banks were small institutions, some with total assets of less than $100 million. A few of these banks may have had relatively small amounts of BD funding between the quarter-end dates, but that occasional BD funding cannot have caused any bank to fail!

Several of the larger failed banks also never reported any BDs outstanding on the quarter-end dates referenced above. For example, Guaranty Bank of Milwaukee, which had $1 billion of deposits when it was closed on May 5, 2017, reported no BDs on any of the quarter-end dates within five years of its failure. Clearly, BDs did not contribute to Guaranty's failure.

Most of the remaining failed banks relied upon a relatively minor amount of BD funding within one, two, three, four, and five years preceding closure. It is unsupportable for anyone to assert that a modest level of BD funding during the five years preceding a bank's failure would have caused it to fail. This observation certainly holds true for the most recent failures (closures in the 2014-17 period). Conversely, the data show that high[er] levels of BD funding do not correlate with rapid asset growth, asset weakness, and the probability of bank failure.

The ANPR, on page 2370, discusses a large failed bank, ANB Financial, which was closed on November 25, 2008; it later was the subject of a Material Loss Review prepared by the Treasury Department's Office of Inspector General. The ANPR considers ANB to be an example of a misuse of BDs. In fact, ANB is an excellent example of supervisory failure, specifically for permitting its loans and leases to more than quadruple, from $411 million in 2003 to $1.725 billion in 2007, before dropping to $1.678 billion in 2008, at the onset of the financial crisis.

Almost all of ANB's asset growth was in commercial real estate loans, which rose from $76 million in 2003 to $1.33 billion in 2007 before dropping slightly to $1.305 billion in 2008. The unanswered question: Why did ANB's regulators, and specifically the FDIC, tolerate such a sustained, torrid pace of asset growth, regardless of how it was financed?

The FDIC has long held a negative view on BDs and in doing so has failed to recognize important nuances. Rather than holistically analyzing the role of BDs in asset growth and bank failures, the FDIC has adopted a blanket, one-size-fits-all regulatory approach that has no analytical basis and therefore is highly inappropriate. The better solution would be for the FDIC to use its supervisory processes to develop an institution-specific, fact-based approach to BDs.

Comments on certain assertions set forth in the ANPR

The ANPR (page 2369) discusses "three characteristics of brokered deposits that have posed a risk to the DIF" – rapid growth, volatility (i.e., deposits might flee a troubled institution), and franchise value, or rather the lack of franchise value.

All other factors being equal, rapid growth of a bank's assets increases the likelihood of failure because rapid asset growth stresses accounting and control systems

as well as management, regardless of how that growth is funded, whether through retail deposits, BDs, deposits gathered through listing services, Federal Home Loan Bank advances, or other borrowings. Rapid growth also increases the likelihood that the bank, in order to grow so rapidly, is making riskier loans that more prudent banks will not make. Those will be the loans more likely to default, contributing to the bank's eventual insolvency.

Put another way, much more critical to a bank's long-term success, or lack thereof, is its rate of asset growth, not the extent to which it relies on BDs to fund that growth. It falls to banking supervisors, and specifically the FDIC, as the deposit insurer, to closely monitor rapidly growing banks and when necessary to restrain excessively rapid growth, particularly in fast-growing markets and fast-growing asset categories, such as ADC (acquisition, development, and construction) and commercial real estate lending.

Although risk-based deposit-insurance pricing lies outside the scope of comments this ANPR solicits, it is essential to ask if the FDIC's risk-based premium assessments include a sufficient pricing deterrent against excessively rapid asset growth, regardless of how that growth is funded. In my opinion, the FDIC's premium-setting formulae lack a sufficient deterrent, as demonstrated most explicitly by the following premium-pricing limitation stated in a footnote to the current rule for deposit-insurance pricing for small banks. That footnote reads: asset growth (merger adjusted) over the previous year in excess of 240 percent . . . will not further increase a bank's assessment rate.[1] [Emphasis supplied] In fact, there should be no upper limit on a bank's deposit-insurance premium rate, provided there is an actuarial justification for whatever rate is charged. Imposing such a premium cap effectively incentivizes an asset growth-rate in excess of that cap, regardless of the type of funding fueling such growth.

The ANPR defines volatility as "the extent to which deposits might flee if the institution becomes troubled or the customer finds a more appealing interest rate or terms elsewhere." This definition completely ignores a key virtue of BDs – except in rare circumstances, BDs cannot be withdrawn from a troubled bank before they mature; BDs are locked into the bank until maturity while other forms of deposits – checking account balances, passbook savings, and CDs issued directly by the bank – can quickly be withdrawn from a troubled bank, albeit sometimes with a penalty. Why the FDIC does not acknowledge the funding certainty BDs provide to troubled banks is a most interesting question.

Franchise value, or rather the lack of it in failed banks, is the third risk the FDIC believes BDs pose to the DIF. The FDIC further opines on page 2388 of the ANPR that "banks with heavy reliance on brokered deposits may have a low franchise value

[1] Federal Register, Vol. 81, No. 98, May 20, 2016, pg. 32208, footnote 4 to the table at the top of the page, Definition of Measures Used in the Financial Ratios Method. Codified in 12 CFR Sec. 327.16(a)(1)(ii)(A).

because they lack a large core deposit customer base." The use of the word "may" indicates that this is nothing more that a very tentative, and unsupported, opinion by FDIC staff.

The franchise value of failed banks can be derived from the news releases the FDIC issues about each failed bank when it is closed. The release reports the total assets and deposits, estimated loss to the DIF, and sometimes other information about the failed institution, including the treatment of brokered deposits. In the case of a purchase-and-assumption (P&A) transaction or the occasional deposit transfer, the news release also will report the amount of deposit premium paid by the acquirer, if any. Often, the premium is expressed as a percentage of the failed bank's deposits.

Of the 530 banks that failed in the 2009-2017 period, a premium was reportedly collected by the FDIC in just 165, or 31%, of those failures. Those premiums effectively represented the franchise value of the failed banks. The estimated amount of premium collected in those failure resolutions was approximately $1 billion, about one-third of one percent of the estimated deposits in those 530 banks at the time of closure. It is estimated that approximately two-thirds of those failed banks had no BDs at the time of failure and in the remaining cases just a minimal amount of BDs.

Assuming the FDIC accurately reports the deposit premiums it collects, they almost always are quite modest. In most failures, though, no premium is collected even if the bank had few, if any, BDs at the time of failure. This lack of franchise value is probably due to two factors. First, almost all failed banks have been troubled for at least a few years, a factor negatively impacting franchise value as many good customers and employees will have left the bank by the time it is closed.

Second, bank closures over the last decade were concentrated in 2008, the year the financial crisis struck, and in the subsequent years when the economy, and the banking industry, were recovering from the worst economic downturn since the Great Depression. Much as was the case after the S&L crisis erupted in the late 1980s, the FDIC faced a buyer's market for deposit franchises, which meant buyers of failed-bank franchises did not have to pay much, if anything, to acquire a failed bank's deposits, good assets, branches, and employees.

While the FDIC reported collecting a premium in 14, or 58%, of the 24 failures it resolved in 2008, at the onset of the crisis, that percentage dropped to 29% in 2009, when 140 banks were closed, and then rose slightly, to 31% for the 2010-2017 period when 363 banks were closed. The substantial decline after 2008 in the percentage of failures where the FDIC collected a premium, however modest, was hardly a surprise.

One important aspect of the bank failure experience since 2008 has been the geographical distribution of bank failures, or rather the maldistribution of those failures.

Failed banks headquartered in just four states – California, Florida, Georgia, and Illinois – accounted for 271, or 51%, of the 530 failed banks and 56% of the DIF's loss in the post-2007 failures, as estimated at the time of failure. Six states and territories – Alabama, Nevada, Ohio, Puerto Rico, Texas, and Washington – were home to another 59, or 11%, of the failed banks. The other 32 states headquartered the remaining 200 failed banks while eight states and the District of Columbia had no failures.

This geographical failure data does not reflect the multistate branching of many of the failed banks or the fact that many failed banks engaged in out-of-market real estate lending, specifically in fast growing, or "hot," real estate markets. For example, some Illinois-based banks lent on real estate projects in Florida and other out-of-market locales. This was especially true for ADC lending. This important geographical aspect of bank failures, which parallels what occurred in the 1980s and 1990s, reflects another major shortcoming of the FDIC's supposedly risk-sensitive deposit-insurance premium assessments – there is no recognition of geographic risk in calculating premium assessments.

One very questionable proposition in the ANPR (page 2385) is that BDs "are frequently used as a substitute for bank core deposits and, less frequently, for equity." [emphasis supplied] By no stretch of the imagination, or even regulatory interpretation, can BDs be viewed as a substitute for equity capital. BDs are just as much a liability of a bank as any other type of deposit instrument or other types of borrowings.

A bank that increases its deposits, borrowings, or any other liability has effectively increased its leverage because its equity capital has declined as a percentage of its total assets. It will be readily evident from the bank's published financial statements and call reports that it had increased its leverage. Excessive leverage, of course, should ring regulatory alarm bells, sparking more intense FDIC oversight of the bank. It appears that in the run-up to the last financial crisis, that alarm bell did not ring at the FDIC as often as it should have.

Most interestingly, despite negative comments about BDs, at numerous places in the ANPR the FDIC noted its own skepticism about any link between BDs and bank failure, notably the following:

- On page 2366, the FDIC noted that "most institutions that use brokered deposits and higher-rate deposits have done so in a prudent manner." [emphasis supplied]

- On page 2385, the FDIC stated that its analysis of a statistical relationship is merely "suggesting that banks with core deposits have lower failure probability." That certainly is not a strong endorsement of the virtues of core deposits relative to BDs.

- On page 2386, left column, the FDIC states that "there is a positive and statistically significant relationship between lagged asset growth rate and bank failures . . . other things being equal banks experiencing rapid growth are more likely to fail within the next 3 years." On the other hand "brokered deposits are clearly associated with an increase in bank failure probability, but the reason for the increase is unclear." [emphasis supplied]

- Page 2388, right column, the FDIC states that holding other control variables constant, "when equity and core deposits are unchanged, increasing brokered deposits and decreasing other bank liabilities has no statistically measurable effect on loss rates." [emphasis supplied]

Despite the FDIC's negative sentiments about BDs, BDs have played an important yet stable role in funding the banking industry in recent years, a time of solid economic growth and few bank failures – the last failure was 28 months ago. The following table is based on year-end call reports filed by every bank and thrift.

December 31 year-end	Percent of banks with BDs outstanding	BDs as a percent of total domestic bank deposits
2018	40.9%	8.49%
2017	44.2%	7.95%
2016	42.4%	7.59%
2015	41.1%	8.58%
2014	36.3%	8.10%
2013	32.6%	7.71%

In conclusion, going forward, the FDIC should focus its supervisory concerns on bank asset growth, rates especially rapid growth in risky loan categories, and view BDs as an important, stable funding source that complements retail deposit-gathering.

I would welcome the opportunity to discuss the substance of this comment letter with FDIC staff as well as other interested parties. I can be reached at 703-836-4101; my email address is: bert@ely-co.com.

Respectfully submitted,

Bert Ely