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

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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.