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The Many Benefits of Brokered Deposits

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Brokered deposits first emerged in the 1980s and promptly got a bad reputation as crooks like Don Dixon took control of a sleepy one office savings and loan in Vernon, Texas, and then used brokered deposits to expand it into a multibillion-dollar banking travesty with a mountain of bad loans when it closed.

Though brokered deposits were intended to serve a different purpose, unrestricted access to deposits by a financial industry in a state of collapse proved too prone to abuse. Congress reacted by imposing restrictions on the acquisition of brokered deposits by banks with less-than-abundant capital.

To some regulators, the use of brokered deposits by many recently failed community banks is reminiscent of the earlier period. Those community banks fed on the real estate bubble in high-growth areas. Direct or "core" deposits are generally harder to obtain and serve as a natural constraint on growth if not supplemented with brokered deposits. Compounding the problem, brokered deposits had no franchise value to potential acquirers of the failed banks, which increased losses to the Federal Deposit Insurance Corp.

So it is not surprising that Congress in its zeal to address every apparent cause of the Great Recession mandated in the Dodd-Frank Act a study of brokered deposits by the FDIC. That study is now under way. But some misapprehensions about brokered deposits must be corrected for this study to fulfill its purpose.

A review of the underlying facts shows that brokered deposits got a bad rap in connection with recent failures. Brokered deposits constituted only 18% of the deposits held in banks that failed since 2004. It wasn't brokered deposits that made those banks fail. It was bad loans. That is where the regulators must focus their attention.

Critics claim brokered deposits are also risky because they are not "sticky." They involve no broader relationship between the bank and the depositor, and are more likely than a core deposit to leave the bank if a better rate is offered elsewhere. While it is true that brokered deposits are not sticky, they have actually proven to be the most stable and cost-effective deposits available today when used properly. The brokered-deposit markets matured in the past 20 years and now provide a safe, low-cost and reliable source of funds for well-capitalized banks by offering a safe and efficient investment primarily for institutional investors such as money market mutual funds. Investors put 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.

In practice, stickiness is not a factor in the safe management of a deposit base containing brokered deposits. The key is the ability to obtain new deposits to replace maturing ones. That has not been an issue for any well-capitalized bank at any time to date. The brokered-deposit markets have been stable and flush in good times and even more so in bad times as investors "flee to safety." Rates are generally not premium because these deposits are very low-risk, government-guaranteed investments. Even when rates are slightly above market relative to core deposits, the all-in cost is typically lower than other deposits.

The stability of brokered deposits can be seen in the fact that they have proven to be immune to runs while core deposits are somewhat susceptible to a run even when federally insured. A 125-year-old community bank in my state recently failed when core depositors withdrew about 12% of the bank's total deposits in one week after rumors of problems were published in a local newspaper. That bank also held brokered deposits, none of which were withdrawn. That is in part because of restrictions on withdrawal before maturity and also because brokered depositors don't follow local news about the banks holding their money.

Efficiency is another outstanding feature of a brokered deposit. Call the broker, place an order and the funds arrive when needed. This is a huge benefit for many well-run banks. Banks that primarily use brokered deposits do not need a branch network. That cost savings is considerable.

Unfortunately, that efficiency has been abused by some banks making bad loans. That is where the problem lies. But obviously it should be addressed by blocking bad loans, which is a basic function of regulators and affects every kind of deposit.

In contrast, banks relying primarily on brokered deposits generally performed better than other banks during the recent economic downturn. None of those banks found the supply of brokered deposits crimped. Most of these banks 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, but that was a positive during the downturn.

Brokered deposits are not ideal for all banks. Community banks rely heavily on customer loyalty to source business and build that loyalty through multiple relationships. Those banks would lose many customers if they didn't offer deposit products in addition to loans.

But other banks, such as large credit card issuers, are able to originate a large volume of loans without offering deposits to their borrowers. For those banks brokered deposits are the safest, most efficient and cost-effective way to fund their business.

This beneficial use of brokered deposits vastly outweighs the few isolated instances where they are misused.

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