

BB REVIEW

Financial Services and Transactions

BROKERED DEPOSITS: WHAT WILL YOUR EXAMINERS BE LOOKING FOR?

For Further Information Contact . . .

Jennifer R. McCain
205-226-8777
jmccain@balch.com

Matthew P. McLaughlin
601-965-8162
mmclaughlin@balch.com

Katharine F. Musso
205-226-8707
kfmusso@balch.com

W. Brad Neighbors
205-279-2940
wneighbors@balch.com

Michael D. Waters
205-226-8720
mwaters@balch.com

W. Clark Watson
205-226-3466
cwatson@balch.com

Lois S. Woodward
205-226-3478
lwoodward@balch.com

Stephen A. Yoder
205-226-8791
syoder@balch.com

Visit our website:
www.balch.com

For Address Changes,

Contact:

Nora Yardley
205-488-3476
nyardley@balch.com

INTRODUCTION

The high rate of brokered deposits at most of the banks that have recently failed in the United States has understandably caused the federal banking agencies to warn of the risks in such deposits. Banks that have such deposits can expect inquiries from their bank examiners both before and during scheduled examinations, and can expect that examiners will want to review liquidity policies and procedures.

The FDIC defines "brokered deposit" to mean "any deposit that is obtained, directly or indirectly, from or through the mediation or assistance of a deposit broker". As described below, there are some express requirements for being able to offer these deposits at all. In addition, examiners are likely to look closely at deposits obtained over the internet and through CD listing services (where the only function is to provide information on the availability and terms of accounts), even though they are not technically considered to be "brokered" deposits requirements.

RISKS OF BROKERED DEPOSITS

Banking examiners see a variety of risks in brokered deposits that could threaten liquidity and the other elements of safety and soundness of a bank:

"Hot Money" Risks. Investors in brokered deposits, and in CDs listed on the internet or in listing services, often have no relationship with the bank and are seeking the highest returns offered in the financial industry. These rate-sensitive customers may rapidly transfer their funds to new institutions or investments if market conditions change. These customers are also often well-informed about a particular bank's financial condition, and may transfer their funds if there is any hint of a negative change in a bank's condition. All of these characteristics

make for liquidity risk management challenges for a bank.

"Moral Hazard" Risks. Conversely, the fact that there is FDIC insurance up to \$100,000 on bank deposits may cause investors to choose banks for deposits without regard to their financial condition. That might cause unsound banks to grow more rapidly than they are capable of growing.

Credit Risks. Deposits carrying high rates of interest may also tempt banks to make loans to riskier borrowers that carry higher rates of interest, in order to maintain an adequate net interest margin. That raises a bank's credit risk profile.

Know Your Customer Risks. Finally, the physical and psychological distance that often exists between a bank and a high interest rate CD customer gives rise to "know your customer" and other anti-money laundering concerns.

WHICH BANKS MAY ACCEPT BROKERED DEPOSITS

Only "well capitalized" banks may accept brokered deposits. Banks that are only "adequately capitalized" must obtain a waiver from the FDIC to do so. Adequately capitalized banks also face restrictions on the rates that they are permitted to pay on brokered deposits. Finally, banks that are less than adequately capitalized are not permitted to accept brokered deposits at all, and they may not solicit any deposits with a rate exceeding the market rate by more than 75 basis points.

WHAT LEVEL OF BROKERED DEPOSITS WILL CAUSE CONCERN

There is no law or regulation that imposes a cap on the permissible amount of brokered deposits. Banking examiners will, however,



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1901 Sixth Avenue North
Birmingham, Alabama 35203

1710 Sixth Avenue North
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105 Tallapoosa Street
Suite 200
Montgomery, Alabama 36104

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Atlanta, GA 30308

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most likely look most closely at those banks whose brokered deposits, and other high-interest rate deposits exceed industry averages.

The FDIC reports that for banks having between \$100 million and \$1 billion in total assets as of December 31, 2007, brokered deposits comprised 5.6% of total deposits. The average amount for smaller banks was only about 2.3%. Nearly 90% of the deposits of ANB Financial, N.A., the bank in Bentonville, Arkansas that recently failed, came from brokered deposits. If your bank has more than an average amount of brokered deposits or high interest rate deposits shown in its most recent call report, this is likely to cause concern with your banking supervisors.

The following would also be warning signs for bank examiners that would trigger scrutiny of brokered deposits:

- Rapid increase in growth rate of brokered or other high interest rate deposits;
- Use of such deposits at newly-chartered institutions;
- Significant funding shifts from traditional sources;
- Deterioration in asset quality indicators; and
- Deterioration in the general financial condition of the bank.

FUNDS MANAGEMENT POLICY

Examiners will expect to see a written funds management policy that has been adopted by the board of directors and is periodically reviewed by the board. The policy should be clear as to what the bank's risk tolerance is and should clearly identify exactly which member of management is responsible for making funds management decisions.

DUE DILIGENCE ON DEPOSIT BROKERS

A bank's funds management policy should require that management conduct due diligence on deposit brokers. Due diligence should include a background check of references, a review of business and marketing methods, client-acceptance and due diligence practices, methods for compensating the broker's employees and the broker's sources of funds. If a broker has ever appeared on one of the bank's own

suspicious activity reports, that would heighten the bank's due diligence obligations.

MANAGEMENT INFORMATION SYSTEMS

Examiners will expect that a bank's management information systems will be able to clearly identify non-relationship or other higher-cost funding programs. The bank's systems should have a listing of funds obtained through each broker or program, the rates paid on each instrument and an average for each program, information on the maturity of instruments and concentration percentages for each program. Examiners likely will cross-check deposit records with the amount of brokered deposits reported in the Consolidated Reports of Condition and Income (Schedule RC-E – Deposits).

CONTINGENCY FUNDING PLANS

Banks with brokered deposits and other high-interest rate deposits should have written contingency plans that address the possibility that such deposits will not "roll over". These plans should identify other liquidity sources in such situations. Banks should also have in their contingency plans the effect that a reduction in capitalization levels (well capitalized vs. adequately capitalized, etc.) would have on the bank's access to brokered deposits and their overall liability structure.

EXAMINER TRANSACTION TESTING

Bank examiners will often select a sample of deposit broker and other high-interest accounts for "transaction testing". In such tests, examiners will consider new relationships with brokers, the method of generating funds for the account (i.e., use of the internet), and whether the customers are nonresident or offshore customers or "politically exposed persons". Examiners may also ask to see if a subpoena has ever been served on the bank for a particular deposit broker. Such testing is a part of examiners' review of know-your-customer policies and procedures.