In Brief
Economic Capsules

New Findings on Brokered Deposits

The development of the market for brokered deposits—funds placed in commercial banks or thrift institutions through money brokers—has led to certain well-publicized abuses that pose unwarranted risk to the federal deposit insurance funds. Depository institutions in distress can obtain federally insured liabilities more easily through this market and therefore avoid normal market or regulatory discipline. In addition, heavy reliance on insured brokered funding can enable an institution to grow faster or take on greater risk than sound banking practices normally would allow.

We have investigated possible linkages between bank weakness or failure and use of brokered deposits at over six hundred commercial banks.[1] The first question we addressed is whether some level of brokered deposits can be considered a threshold above which a failed bank would impose a disproportionate cost on federal insurance agencies. (This cost depends on the disparity between the market value of the bank's assets and liabilities.) In reviewing the costs incurred by the FDIC due to commercial bank failures between September 1983 and March 1984, we found that banks with brokered funds in excess of 5 to 10 percent of their total deposits tended to impose a greater relative cost burden on the FDIC than other failed banks. However, this burden did not appear to increase proportionately at threshold levels of 15 to 20 percent.

The second issue we considered is whether financially weak commercial banks are more likely than stronger banks to use substantial amounts of brokered deposits. Financial weakness was measured by an index of financial ratios. Previously published studies have found these ratios to be reasonably good indicators of financial weakness.[2]

Using data from the March 1984 call reports, we found that weaker banks (as measured by the rankings of their index scores) on average held significantly more brokered deposits as a percentage of total deposits than stronger banks This result was evident for both total brokered deposits and fully insured brokered deposits [3] We then considered whether there was a level of use of brokered deposits at which there was a particularly clear distinction between stronger and weaker banks. The strongest distinction was found for levels of use at about 3 percent of total deposits; also at 1 percent and 5 percent At higher levels of use the relationship was weaker. On average, banks with brokered deposits less than 5 percent of total deposits (comprising nearly two-thirds of the sample) had strong index scores

Similar results appeared when we focused on the weakest subsample of banks using brokered funds Banks whose scores were more than two standard deviations worse than their peer group means were found to hold significantly more brokered deposits than

[1]The results presented here are extracted from "Brokered Deposits and Bank Soundness Evidence and Regulatory Implications" by Sherrill Shaffer and Catherine Piché, Federal Reserve Bank of New York Research Paper No 8405 The research discussed in this report is based on evidence from the 671 commercial banks using brokered deposits as of March 1984, and the 560 banks using them as of September 1983 We also studied 18 commercial banks that failed between October 1983 and March 1984, half of which used brokered funds

[2]See, for example, the articles and bibliography in *Economic Review*, Federal Reserve Bank of Atlanta, November 1983, especially pages 27-34 We used the following four ratios loans and leases to total funds, capital to risk assets, expenses to revenues, and commercial and industrial loans to total loans

[3]Fully insured brokered accounts are brokered accounts with balances not exceeding $100,000 Nearly 23 percent of the banks that accepted brokered funds reported that all of their brokered accounts exceeded $100,000

other banks.[4] Among these especially weak banks, we found that the relationship between increased use of brokered deposits and weakness was not significant at threshold levels of 1 to 5 percent of deposits, but was strong at threshold levels of 10, 15, and (for fully insured brokered deposits) 20 percent

Overall, these findings would appear to support the case for some form of prudential regulation on the use of brokered deposits, particularly on a fully insured basis. If a percentage limitation on the use of such deposits were to be considered, then these results would suggest that an appropriate ceiling would be in the range of 5 to 10 percent of total deposits

[4]There were nine such banks, or 1 3 percent of the sample Thirty-eight, or 5 7 percent, of the banks had scores more than 1½ standard deviations worse than the norm, and these banks were also found to be heavier-than-average users of brokered deposits Three peer groups were defined domestic banks smaller than $300 million, other domestic banks, and banks with at least one foreign office

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