Money Morning

SPECIAL INVESTIGATIVE REPORT

The Cold Truth About "Hot Money:"
How Brokered Deposits Became the Third Rail of the American Banking System

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Danger looms. One cause of recurring boom-to-bust cycles plaguing American banks has been known to regulators since the 1960s. The plague persists because an alliance of bankers, brokers and Washington insiders have diluted and changed laws and regulations meant to safeguard the banking system from excessive and inappropriate misuse of "brokered deposits."

Not addressing the consequences of the spreading systemic problem with brokered deposits guarantees another boom-bust wave will follow this one.

Starting in the 1960s, brokers amassed pools of depositor funds and delivered them to banks that were willing to pay above-local-market interest rates. Banks use these brokered deposits to pump up growth and profits by making loans and acquiring assets. The deal got better for brokers, depositors and banks in 1980 when Federal Deposit Insurance Corp. (FDIC) insurance on deposit accounts was raised from $40,000 to $100,000. Deposits are now insured up to a maximum of $250,000.

Brokered deposits are often referred to as "hot money." Because yield-hungry depositors who canvas the country for high interest rates on certificates of deposit (CDs) are not generally loyal to any one bank, they're apt to move their money to the institutions offering the highest returns when those CDs mature.

As long as depositors are insured, if banks eventually fail from bloated balance sheets, it's the FDIC and taxpayers that end up footing the bill. The too-often-overlooked scheme of funding inordinate bank growth with insured deposits fuels the boom-to-bust cycles whose ending almost always causes damage and pain.

During the 1980s savings and loan (S&L) crisis, brokered deposits were widely known to have been a principal cause in the failure of 1,043 thrifts, resulting in a bailout and fix-up program that cost taxpayers $124 billion.

The tab for the current crisis is much larger: Taxpayers are looking at a potential bill of $1 trillion after all the bailout funds have been spent, federal debts incurred and long term interest payments on bailout debts are counted. Brokered deposits again fueled the cycle and caused the price tag of rescuing the banking system to balloon.

The Problem With Brokered Deposits

As defined in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), a "brokered deposit" is a deposit "obtained, directly or indirectly, from or through the mediation or assistance of a deposit broker." In other words, for a fee, brokers match up depositors seeking a good yield with banks looking or needing to take in funds.

The term itself had to be specifically defined in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 because FIRREA actually resulted from the abuse of brokered deposits. FIRREA had been enacted to *clean up* the S&L mess. It included a host of programs, most famously, the Resolution Trust Corp. (RTC), which sold off billions of dollars worth of "distressed" assets from banks that had been shuttered by regulators.

Depositors like their funds FDIC insured. The FDIC's insurance fund is supported by the premiums that banks pay. And if the FDIC fund runs dry – which it has – the fund is backed by the *de facto* full faith and credit of the United States government, which the FDIC is now leaning on.

Because the *fallout* from bank failures do not directly fall on depositors or deposit brokers, questions about moral hazard and systemic risk arise. Does the removal of any market discipline depositors might otherwise be subject to – coupled with the removal of any market discipline banks might otherwise be subject to – distort markets and exacerbate the whipsaw effect of boom-and-bust cycles?

As far as not being subject to market discipline, "There's no homework necessary because supposedly regulators have done it," joked Sherrill Shaffer, a former New York Fed chief economist who is now a professor of banking and financial services at the University of Wyoming. Prof. Shaffer was one of the many experts who were interviewed for this report.

To make his point, and to further illuminate the inherent moral hazard issue, Prof. Shaffer related a story that he'd heard from a neighbor. This neighbor was visiting Yellowstone National Park, watching as a camera-toting tourist started to walk up to a herd of bison. The neighbor warned the tourist how dangerous the animals were – only to be rebuked by the tourist who said: "Nonsense … this is a national park and the U.S. government would not allow dangerous beasts to roam a national park."

There is no general market discipline being imposed on deposit brokers. And brokers are not called upon to consider the health of institutions to which they send their deposits. I asked Paul T. Clark, a partner with the Washington law firm Seward & Kissel LLP, and a nationally recognized expert on brokered-deposits, whether brokers have any obligation to not provide funds to floundering banks.

"None of these entities have a legal obligation to verify or do due diligence on an asset strategy [for banks receiving brokered deposits], any more than I do as a depositor walking into my bank," Clark said.

The Truth and Consequences of Hot Money

According to an ***FDIC Banking Review*** research paper "The Cost of the Savings and Loan Crisis: Truth and Consequences," brokered deposits are listed as one of 10 reasons "documented by scholars for more than a decade" that caused the collapse. The research paper also underscores the point that the "use of taxpayer funds to meet the guarantee to insured depositors is the reason the term *cleanup* is used rather than *bailout*."

Still, not everyone agrees that brokered deposits are a problem.

The question of whether brokered deposits are banks' and depositors' best friend, or in the long run their worst enemy, is like asking which came first, the chicken or the egg?

In fact, backers of brokered deposits claim three beneficiaries: depositors, banks and borrowers.

Depositors, it seems easy to argue, have a right to seek out the highest yields available on their bank deposits.

Banks are able to grow their businesses because they get access to deposits they otherwise wouldn't be able to gather due to the limitations of local market conditions and geography.

"Banks also get an efficiency in the form of reduced overhead costs, which are transferred to brokers who do the work of gathering deposits," says Clark, the Washington attorney and brokered-deposits expert whose firm represents several large deposit brokers.

And borrowers benefit because brokered deposits provide a source of funding that enables the extension of credit where it might otherwise be constrained.

In an argument whose logic resembles the adage "guns don't kill people, people kill people," brokered-deposits advocates contend that it's not the access to brokered deposits that causes banks to fail, it's the bad management of assets that leads to those failures.

"Brokered deposits are a useful tool as part of funding and liquidity strategies," says Nicholas J. Ketcha Jr., the executive managing director of FinPro Inc., a Liberty Corner, N.J.-based financial-services-consulting firm.

Adds Ketcha, a former director of supervision at the FDIC and former Basle Committee member, "The governing shouldn't be how much brokered deposits should be; the governing should be how are you going to use those funds and are they matched on the risk curve?"

On the other side of the philosophical and economic divide sit the detractors. Without enumerating a host of unintended consequences, they point to one overriding issue: Brokered deposits fuel inordinate and unhealthy growth at banks. In fact, it's a simple argument, opponents say: You can't grow exponentially and inappropriately if you don't have extraordinary access to depositor funds. It's sort of like saying that you're not likely to get fat and die of a heart attack if you don't have access to a buffet table for every meal.

Shaffer, the University of Wyoming banking professor, makes his own case.

"The use of brokered deposits may, in some cases, fund rapid growth which has its own risks – and [which], in some cases, substitutes for an outflow of deposits from individual depositors who are becoming concerned about the health of the bank," Prof. Shaffer said. "In either of those applications, the use of brokered deposits can permit a bank to take on more risk than it otherwise would and that's the main way in which moral hazard arises."

A Common Denominator

While there were clearly a host of problems that fueled the S&L crisis, there was only one common denominator in all the bank failures: brokered deposits.

"The record of the 80's is clear," William M. Isaac, chairman of the FDIC from 1981-1985, told me in an interview for this report.

And while our present banking crisis is immeasurably more complicated than the S&L crisis, that same common denominator is present today in 99% of the FDIC Office of Inspector General reports that I read about banks that failed in 2008 and 2009.

Every time a failure costs the FDIC's insurance fund $25 million, a "material loss review" is conducted and the resulting audit is published by the Office of Inspector General. Almost invariably, every failure in

2008 and 2009 evidenced the same toxic mix of inordinate growth fueled by a reliance on volatile wholesale funding and borrowings, including brokered deposits, and management's failure to control the quality and concentration of ballooning assets.

Core deposits are the garden-variety deposits at a bank. You walk in and deposit your paycheck, or open up a savings account, or a business account. Non-core deposits include brokered deposits, Internet "listing service" deposits and a new breed of brokered deposits called "reciprocal deposits." Rather incongruously, the new breed of reciprocal deposits were conceived, designed and are promoted by some very powerful and very smart former household-name banking regulators.

Additionally, the other major and often larger component of banks' non-core deposits, are borrowings from Federal Home Loan Banks. FHLB loans, known as "advances," are made to member banks and secured by the borrowing bank's assets. The FHLB system is another monster that needs to be tamed.

A Brief But Troubled History

Brokered deposits have been around since the 1960s. And they were trouble even back then. The result of intense competition for depositors drove up interest rates on deposits and caused accelerated growth issues for banks. They also threatened upward pressure on the general level of interest rates around the country.

In July 1963, the Federal Home Loan Bank Board (FHLBB) regulated thrifts and S&Ls, and also managed the Federal Savings and Loan Insurance Corp. (FSLIC), a sister insurance corporation to the FDIC. The FHLBB imposed a limit on the amount of brokered deposits an institution could purchase to only 5% of total deposits. That limit stood until a massive deregulatory push began in 1980.

As 1980 approached, a complex and comprehensive set of problems were plaguing both banks and the economy. The 1973-74 Arab oil embargo quadrupled the price of oil and raised the cost of distillate products. The bills for Lyndon Johnson's Great Society social programs were running headlong into the cost of funding the Vietnam War. Because Vietnam was an undeclared war (technically a "police action"), Congress did not appropriate funds to pay for the effort. Instead, successive administrations printed money to pay for the war. The loose-money policy resulted in a devastating bout of stagflation.

Additionally, the U.S. economy seemed mired in complicated regulations that some politicians blamed for the country's "malaise". Then, in a bold bid to battle inflation, on Oct. 6, 1979, in what became known as "the Saturday night massacre," U.S. Federal Reserve Chairman Paul A. Volcker abandoned the Fed's traditional role of controlling interest rates and instead targeted soaking up excess monetary aggregates sloshing around in the economy. Volcker's prescription was one of pain. Interest rates would rise to whatever level they would ascend, but by hook or by crook, he was going to squeeze inflation out of the system.

Rising interest rates and a slew of other domestic and international failures sank U.S. President Jimmy Carter's bid for a second term that November, and a lightening rod ushered in the era of what subsequently became known as Reaganomics.

Banking Sector Foundation Undercut by Waves of Deregulation

The Deposit Institutions Deregulation and Monetary Control Act of 1980 was a bonanza for long-suffering and constrained banks and for the brokered-deposits business. President Ronald Reagan's treasury secretary, Donald Regan, was a principal architect and promoter of the 1980 act. He was also the chairman of the act's offspring, the hard-charging Deposit Institutions Deregulation Committee.

As fate would have it, Regan came to the Treasury Department from Merrill Lynch, where he had run

the very firm that was one of the biggest players in the brokered deposits business. Back then it was Merrill – not Goldman Sachs Group – running on the Washington inside track

The 1980 Deregulation Act removed the 5% limit on brokered deposits that the FHLBB had imposed in 1963. It raised deposit insurance provided by the FDIC and FSLIC to $100,000 from $40,000 per insurable account at depository institutions. And it phased out "Reg Q," which previously disallowed interest on checking deposits and had established interest rate ceilings on other deposit accounts. On a macro level the 1980 Deregulation Act generally de-clawed any grip that federal regulations had on U.S. banking institutions.

Two years later, the second wave of federal deregulation broke in the form of the Garn-St. Germain Depository Institutions Act of 1982. While continuing to un-tether depository institutions from their moorings, Garn-St. Germain had an apocalyptic provision that perhaps foretold of lurking dangers. Included in this 1982 law was a "Net Worth Certificate Program" designed to empower the FDIC to buy wacky paper from institutions that had shaky capital levels. The paper would be redeemed when institutions built themselves back up.

Not surprisingly, access to brokered deposits was viewed by the Deposit Institutions Deregulation Committee as a tonic that would help sickly banks outgrow their problems.

It didn't work in 1982. Nonetheless, Office of Thrift Supervision (OTS) regulators in 2008 made the same gamble with brokered deposits when they inappropriately helped pump-up an ailing IndyMac Bank in a failed attempt to save it from itself.

Back to the Future

Starting in 1980, the pullback in federal regulations caused some of the states – particularly Texas and California – to embark on their own statewide deregulatory push. To avoid the loss of revenue that would result from banks swapping their state charters for national charters, states sought "parity" in deregulation, and went well beyond. A host of well-heeled special interest groups were pushing legislators for what was most wanted – access to the newly anointed wellspring of growth funding: brokered deposits.

By July 1982, the first crack had developed. Penn Square Bank, headquartered in an Oklahoma City shopping mall, became the poster-child for out-of-control banks. Penn Square was playing the growth game with brokered deposits to reap the bonanza of zooming oil-and-gas prices.

It went bust.

At the time, it was the sixth-largest bank failure in U.S. history. When I asked William Isaac – who was the FDIC chairman at that time – why the government didn't bail out Penn Square, his voice conveyed the conviction of its decision.

Said Isaac: "We were trying to impose some discipline by letting it fail."

In 1984 the secondary shock wave resulting from the Penn Square Bank failure hit the Chicago-based money-center banking giant, Continental Illinois National Bank and Trust. Back then, Continental's collapse was the largest bank failure in history and required a $4.5 billion bailout, a staggering amount of money at the time.

A Frontal Assault

On Jan. 15, 1984, two stalwart captains of the old school of regulation tried to fill in the hole into which they saw banks sliding.

Isaac, the FDIC chairman, went to Ed Gray, Chairman of the FHLBB and shepherd of the FSLIC, the insurance corporation for thrifts and S&Ls, and said that he'd seen enough. For Isaac and Gray, regulation meant truly safeguarding the free markets, and fixing the problems, not just supervising a free for all.

Isaac and Gray proposed limiting to $100,000 the amount of federal insurance any one broker could place in any one institution.

It was a frontal assault on the entire brokered-deposits business. It was a concerted effort to save the insurance funds they were responsible for.

By now, the game was well understood. The lifting of the 5% limitation on brokered deposits – combined with an increase in federal insurance – had the "unintended consequence" of fueling disaster, according to those who benefited from the changes.

Deposit brokers were slinging around giant pools of cobbled-together, insured CDs in $100,000 packets. And public rate-shoppers were scanning newspapers around the country for juiced up returns. Banks bid up for these pools of depositor funds and used them to fuel the rising fever of speculation in anything that might yield a handsome positive spread over the high cost of the funding. It didn't matter to depositors if banks failed; they were covered as long as they or their brokers split up their funds into those neat little insurable $100,000 packets.

The banks' problems were obvious to Isaac and Gray. What they hadn't anticipated was the beating they were about to take from national and state legislators, lobbyists, banks, brokers, the Treasury Department, and even Treasury Secretary Regan himself. These players, and a host of other interested parties and opportunists, were getting rich from this new bank growth paradigm. And they didn't want to see it change.

"We got flat out opposition from Treasury," Isaac explained during our interview.

On June 20, 1984, the opponents of Isaac and Gray's efforts to end the brokered-deposits business were handed a sweeping victory when a federal district court ruled that the regulatory initiative they hoped would restore sound banking was illegal. Only Congress held that kind of authority, the court said.

The case against the initiative was brought by First Atlantic Investment Corporation Securities Inc. (FAIC), a substantial player in the brokered deposits game, with the Securities Industry Association joining in. FAIC, in a bitter irony, was subsequently found to have placed the second highest amount of brokered deposits into thrifts and S&Ls that would later fail.

Not a Team Player

Gray was not the good "team player" the treasury secretary had asked him to be. In fact, Gray was unlike his predecessor, Richard Pratt, who came to the FHLBB as a Reagan administration appointee in 1980. Pratt had cheered on the deregulation juggernaut from within and left to collect his just rewards heading up Merrill's mortgage-backed-securities unit.

Gray, on the other hand, left office a lot worse off for the wear and tear. But his integrity was intact. He was replaced in 1987 by Danny Wall. Wall had previously been a staff director for the Senate Banking and Urban Affairs Committee, and while in that job he had helped usher through Garn-St. Germain. Wall was close friends with William O'Connell, who was then the president of the U.S. League of Savings Institutions and a vehement opponent of the Federal Home Loan Bank Board's Gray. The thrift industry's powerful trade association had showered legislators with support to push through both the 1980 and 1982 laws.

In 1985, over at the FDIC, Isaac was replaced by L. William Seidman.

As an advocate for brokers and brokerages in the business explained to me in an interview for this report, Isaac was always "on his bicycle" about the perils of brokered deposits. But he had no choice but to keep peddling, because – as Isaac lamented to me – "Congress refused to back the regulators."

Seidman, on the other hand, never saw a brokered deposit he didn't like. Among his many duties as head of the FDIC from 1989 until he retired in 1991, Seidman was responsible for the RTC, the entity in charge of the S&L crisis cleanup efforts. Throughout Seidman's tenure, the RTC doled out distressed assets to investors.

Before his death in May 2009, Seidman was also a board member of Promontory Interfinancial Network LLC, the powerful firm of former banking regulators that would conceive and foster a new brokered-deposits-business model called "reciprocal deposits."

When *Bloomberg Markets* magazine asked for his opinion about the nature of the business of brokering FDIC-insured deposits at the newly created Promontory Interfinancial, Seidman candidly replied: "One man's loophole is another man's God-given right."

Although not echoing the exact same sentiments, Mark Jacobsen, Promontory's president, who is also an FDIC veteran, told me, "The fact is I have a different perspective now than I would when I was a former regulator."

A Game of Hide and Seek

It's no coincidence that the 1990s were a heady time for the brokered-deposits business and for bank growth.

Only a few hiccups interrupted the escalation in brokered deposits driven growth. In 1991, a ban was enacted that cut off banks from brokered deposits if they fell from statutorily "well capitalized" to "adequately capitalized." But even that bone was hollow. The FDIC later would grant "waivers" to banks that fell below the well-capitalized threshold to ensure continuing access to brokered deposits. Waivers were freely granted. From 2005 to 2007, 88 banks asked for – and were granted – waivers. A number of them later expired, having choked on bad assets acquired with hot money.

Also in 1991, Congress changed the assessment banks had to pay as contributions to the FDIC insurance fund from a flat premium to one based on capital and risk measures. There was no need to address the FDIC's sister fund, the FSLIC. That fund had been subsumed by a new outfit that had been put under control of the FDIC. The FHLBB was also abolished in 1989. Its functions were transferred to other agencies.

The idea of a risk-based-premium assessment was to not penalize banks that managed their growth prudently and that weren't taking on too much risk. That appeared to be happening by the mid-1990s. Or so it appeared to the FDIC. In 1995, the agency – under pressure from banks paying into a replenished insurance pool and complaining vehemently – cut premium payments to zero for 90% of the nation's banks. That bank holiday lasted for a decade.

There were two major developments that the FDIC wasn't watching. The first was a process of disintermediation at banks. The second was the development of the Internet. Both of these would hide an insidious brew starting to bubble.

Bankers had concocted pass-through conduits to channel money to themselves and throughout the

economy, and in the process leverage risk at the FDIC.

It amounts to "asset stripping," said Edward Kane, a Boston College finance professor and founding member of the Shadow Financial Regulatory Committee. Asset stripping involves "taking the best assets and collateralizing them against various kinds of financing, so that when banks close there's less available to support the FDIC in a liquidation or sale," he explained to me.

Kane has also worked as a consultant to the World Bank, the International Monetary Fund and the Federal Reserve.

Disintermediation vehicles became giant engines of short term funding. They include:

- Off-balance-sheet sheet funding sources.
- Securitization on a massive scale.
- Money-market funds.
- Cheap commercial paper.
- Auction rate preferreds.
- Traditional brokered deposits.
- And, most insidiously, the new Internet-driven model of brokered deposits called "listing services."

A Revolutionary Brokered Deposit

As people got familiar with the Internet, the cyberspace intersection where depositors looked for insured CDs and banks advertised CDs widened dramatically. Internet-listing services became a poster-child for a profitable business model based on a cyberspace "bulletin board." According to Greg McBride, senior financial analyst at Bankrate.com, the services are funded "by advertisers paying for icons, for a phone link, or an email link."

Listing-services-gathered deposits can be a good deal for shoppers, but a more expensive proposition for banks willing to compete on the Internet for customers. Bankrate's McBride should have an excellent handle on the listing services business: Bankrate.com is the largest and best known of the Internet bulletin boards.

Said McBride: "There's a significant premium, even in this low rate environment of over 100 basis points over the national average that can be had by shopping around."

Although listing services are included in the genre of brokered deposits, they are not brokered deposits; and that is a loophole through which a small planet could pass.

Because listing services do not involve a "deposit broker," meaning they are an exchange-of-information platform, they are statutorily not "brokered deposits." Listing services are considered a direct means by which banks acquire deposits, not unlike advertising on billboards or television. They are counted not as brokered deposits, but as "core deposits."

The effect of counting listing services as core deposits, instead of as brokered deposits, distorts the banking system in five fundamental ways:

1. Listing-service deposits are hot-money deposits advertised by banks that have to be rolled over or replaced when CDs mature, which creates liquidity issues.
2. When counted as core deposits, and not as hot money, listing-service deposits can mask capital adequacy problems.

3. Not correctly distinguishing between core deposits and hot money reduces the measurability of risk adjusted growth metrics.
4. Because listing-service deposits are not counted as brokered deposits, they are not assessed the risk premium the FDIC charges on hot-money deposits. The FDIC's fund insures listing-service deposits, but is being denied the additional risk-premium payments it should be receiving for assuming the risk of insuring them.
5. Because they are not counted – or even worse, are counted as something they are not – the true systemic impact of listing-service deposits on bank operations remains unknown.

According to the FDIC, the amount of brokered deposits stood at $740 billion as of Nov. 1, 2009. Best estimates put the size of listing-service deposits at equal to – or perhaps as much as twice that – of bank identified "brokered deposits."

One Trick Pony

The most recent egregious example of listing-service-type abuse is Ally Bank. You've seen their commercials on TV. One little girl gets a small plastic toy pony and another gets a real pony. Another version has a boy getting to play with a cool truck, only to have it replaced with a cardboard "piece of junk." The message is that some bank offerings incorporate lame terms. Too bad Ally Bank is the poster child for their own message as well as an insolvent piece of junk itself. Its parent company has already been bailed out and is hemorrhaging red ink, in spite of repeated government handouts and bond backstops.

Ally Bank is the commercial bank arm of GMAC Financial Services. GMAC, the former General Motors Acceptance Corporation, was a wholly owned subsidiary of General Motors Corp. until GM sold a majority stake in the company to private equity shop – Cerberus Capital Management – in 2006.

In its struggle to raise money at the bank level to support its ill-advised foray into mortgage-backed assets, as well as ramp-up lending to auto purchasers with low credit ratings, the bank has been desperately raising high-cost deposits by advertising on TV and predominantly on Internet listing services. Ally's high-yielding CDs attracted more than $1 billion a month until it was forced to ratchet down its offerings. As of the third quarter, it was only bringing in about $250 million a month.

"It amounts to raising deposits to do an arbitrage with mortgage-backed securities; an arbitrage, that is, with FDIC insurance. It's what Fannie and Freddie were doing," says Bert Ely, a banking analyst who consults on current legislative and regulatory trends in Washington, deposit insurance issues, and structural changes in the financial services industry.

Ely has also consulted on the role that electronic technology has played in fostering "regulatory arbitrage" within the financial system.

No-one is happy with Ally. Other bankers are furious that they are bidding up the cost of deposits for all other deposit gathering institutions and the FDIC is pushing down on them for exactly the same reason. But, it's an example of how listing services can distort markets and prop up ailing institutions that the FDIC ultimately will have to backstop.

Reciprocal Deposits: A Hot-Money Trojan Horse?

Who better than a group of former uber bank regulators to come up with a better mouse trap, a new brokered deposits model. In 2003, Promontory Interfinancial launched the Certificate of Deposit Account Registry Service (CDARS). Jacobsen, Promontory's president and co-founder, was the brainchild.

Jacobsen was the chief of staff at the FDIC from 1999-2002. The other co-founders of Promontory are Eugene Ludwig, comptroller of the currency from 1993-1998 and Alan Blinder, a Fed vice chairman from 1994-1996. Promontory's board of directors – which, prior to his death in 2009, included former FDIC Chairman Seidman – and the entire firm, for that matter, is populated with some of the smartest and best-connected executives to ever come out of Washington and banking circles.

The afore-mentioned Isaac, a former FDIC chairman who was historically a brokered-deposits detractor, is chairman of Promontory's bank advisory board. I asked Isaac how he ended up at Promontory, given his noted disdain for brokered deposits.

"What persuaded me," he said, "was first of all they went to the regulators and the regulators blessed it, including the FDIC."

Isaac explained that he had several good friends at the firm and they solicited him to join.

"That was some time ago," Isaac said. "The advisory board has never met and I've never gotten a check from them."

In hindsight, Isaac adds, "If I were making that decision all over again, maybe I shouldn't have done it." Isaac, thankfully, is still on his bicycle.

While Promontory's other product line, called CDARS One Way, has more traditional brokered deposit features, it is the "reciprocal deposits" CDARS product that stands to prove itself as a less-combustible fuel for bank growth or a strategically brilliant Trojan horse.

According to Promontory, the CDARS product affords the community banks, to which Promontory caters, the prospect of gathering deposits from more local sources. CDARS allows "community banks working together to take advantage of the insurance they have," says Jacobsen, the Promontory president and COO.

Promontory boasts that about 80% of its deposits are gathered within 25 miles of bank branches. CDARS also boasts the ability to place up to $50 million across its network of nearly 3,000 banks. Whether a depositor is an individual or an institution that wants or can only invest in insured instruments (meaning, government-backed), CDARS can accommodate them.

Ely, the bank analyst, agrees that CDARS have a place in a bank's funding strategy and that community banks are at a disadvantage when compared to the options their too-big-to-fail brethren have. He also notes brokered deposits are "less of an issue with the biggest banks because they have different ways of self destructing."

The brilliance of the reciprocal-deposit mechanism is that once a large deposit is placed in a bank it is split into $240,000 insurable packets and placed across Promontory's network of banks. The bank where the deposit was made, in turn, receives back from network banks a sum of funds that exactly equals the deposit that it spread through the network. The net result is that the original bank hasn't given up any of the new money it can now use to fund its growth.

Promontory maintains that its deposits are "stickier" than such hot-money deposits as traditional brokered deposits or listing-service deposits. That means that, because depositors are more local in nature, they are not as likely to rate shop and withdraw their funds. The firm also cites a bank's potential relationship prospects with its CDARS clients and the ability to cross-sell them other bank products.

"It allows banks to take full advantage of its customer relationships and increases their franchise

value," Promontory's Jacobsen says.

While Promontory's reciprocal deposits are estimated at only about $40 billion of the total of FDIC-counted brokered deposits of $740 billion – and an even a smaller piece of the pie when compared to the universe of listing-service deposits and "sweep" deposits skimmed from securities broker dealers and others – they may be on a very fast track.

CDARS reciprocals eerily mimic some of the funding benefits banks enjoy when they borrow from another network they belong to: The Federal Home Loan Banks (FHLB). And CDARS One Way deposits act eerily like a shadow Fed Funds "term" inter-bank lending facility. Whether or not this sophisticated business model is a road map out of the forest of bad-news brokered deposit schemes, or a Trojan horse being readied for a quiet coup, remains to be seen.

While I was contemplating the potential for Promontory's better mouse trap to capture the industry and command the high ground if the company and its products could additionally incorporate better systemic discipline into their funding conduit structure, the University of Wyoming's Prof. Shaffer offered a separate reality.

"If CDARS has signed up almost 3,000 banks out of the approximately 8,100 institutions it might attract, it already has 37% of banks in its network," Prof. Shaffer said.

The point he was about to make out of that statistic was provocative.

"If they set up all banks, Congress might as well say 'the $250,000 cap is meaningless, so we're just going to insure 100% of deposits regardless'," Shaffer said.

"The problem is from a social welfare perspective," Prof. Shaffer added. "It's actually a lot more efficient to do it by legislation than by creative entrepreneurship, because banks are paying fees. But, with the stroke of a pen Congress could accomplish the same outcome for free. And so, the whole thing creates a dead weight loss transfer of wealth from the banks, which they pass along to customers for the specific purpose of doing an end-around the limitation that results from the law."

A Deeper Look at Reciprocal Deposits

In the early fall of 2008, the FDIC sought public comment on a proposed ruling having to do with revisions to required bank filings of Consolidated Reports of Condition and Income (Call Reports) related to deposit insurance assessments. As a testament to the power and reach of Promontory, the FDIC got back an unexpected flood of comments on something it wasn't seeking comment on. According to the Federal Register, Vol. 74 No. 62 Thursday, April 2, 2009 Notices, "agencies received certain comments recommending the collection of additional deposit data related to deposit insurance assessments even though the agencies had not proposed to collect these additional data in their proposals. More specifically, one bankers' organization recommended that the Call Report and the TFR be revised to require "reciprocal deposits" to be reported separately from brokered deposits."

Innocuous or extraordinary? First, what was being commented on was not specifically on the FDIC's agenda. Second, the FDIC actually received 2,394 comment letters, not from just "one bankers' organization." Third, letters from banks around the country, as well as from bank lobbying groups, were full of the same facts, figures and arguments, making the case for carving out an exception for reciprocal deposits on Call Reports. And, on Jan. 30, 2009, when the FDIC released its final approved revisions on its Web site, it didn't even mention in the release the carve-out on Call Reports it had created for reciprocal deposits.

The carve-out was a monumental accomplishment. On quarterly Call Reports and Thrift Financial Reports (TFR), banks have to break out how much they are holding in brokered deposits. The FDIC was proposing to assess higher premiums on banks' brokered deposits. What they gave instead to Promontory – and to the few other firms that copy Promontory's reciprocal-deposits business model – was a line on Call Reports and TFRs that broke-out reciprocal deposits holdings as being separate from brokered deposits.

The Golden Fleece carve-out was created to exempt reciprocal deposits from being assessed the additional premium levy brokered deposits were going to be charged.

According to the University of Wyoming's Prof. Shaffer, "when losses go up at the FDIC, premiums (on brokered deposits) go up in the next quarter. So any banks not using CDARS end up cross-subsidizing those that do. To get around that – they have to sign up."

While reciprocal deposits are statutorily defined as brokered deposits, they are not brokered deposits when it comes to bearing the additional cost of insurance for what the FDIC believes are potentially problematic deposits.

The "one bankers' organization" letter that was pointed to must have been pretty powerful. It was probably the comment letter submitted by the American Bankers Association on Dec. 17, 2008.

Although it was not specifically identified anywhere as being the "one" letter, it was, by chance, submitted on the very same day that Promontory submitted its own comment letter signed by Ludwig, Blinder and Jacobsen – its chairman, vice chairman, and president/COO.

Stuffing Banks Like Thanksgiving Turkeys

Although not without a reasonable doubt, banks who stuff themselves with easy access to variable-cost deposits have demonstrated their ability to gobble up assets, and when the cycle of growth turns on a dime, choke themselves to death on what they can't swallow.

While the implosion of Washington Mutual – the country's largest-ever bank failure when it was shut down and sold off to JPMorgan Chase & Co. in September 2008 – was a travesty, it isn't as instructive of the web of intrigue surrounding brokered deposits as what was uncovered by the failure of IndyMac Bancorp.

Like WaMu, which had stuffed itself with brokered deposits and gorged on FHLB advances to fund rapid growth and then tried to stay alive by soaking up more of the same funds, IndyMac was an accident waiting to happen. It crashed on July 11, 2008, and cost the FDIC a truck full of money – $10.7 billion, to be exact.

IndyMac began life in 1985 as a real estate investment trust (REIT) called Countrywide Mortgage Investments. It was started by Angelo Mozilo – who founded Countrywide Financial Corp.– and became a bank in 1999. When the music started to fade for mortgage lenders dancing with subprime borrowers in 2007, the jig was up for IndyMac. The bank's portfolio was rapidly sinking into an abyss. Desperate for funds between August 2007 and March 2008, Indy increased purchases of brokered deposits from about $1.5 billion to almost $7 billion. To make matters worse, IndyMac later supplanted brokered deposits, which show up on Call Reports, with an undisclosed sum of uninsured deposits gathered over the Internet from yield shoppers sucked in by the desperate bank's dangling of some of the highest interest rates available in the country at that time. Many of the high-yielding jumbo CDs Indy was offering were uninsured CDs. Investors suffered the consequences.

What is particularly egregious is that IndyMac, with what amounted to the aiding and abetting of its

principal regulator, the Office of Thrift Supervision (OTS), backdated a capital infusion onto its books for the first quarter of 2008. The infusion of capital kept the bank above the 10% threshold for a risk-based-capital ratio that would allow it to keep taking in brokered deposits. In fact, the bank's ratio was 9.98% before the backfilled capital plugged the funding loophole.

The question remains: Was the OTS trying to keep the bank afloat with access to brokered deposits and listing-service deposits long enough to give it a chance to grow itself out of its problems?

In response to that question, Ely, the noted bank analyst, told me that "it's not an official policy, but they're letting banks stay open too long with the hope that the incumbent management can turn the bank around."

Kane, the Boston College finance professor, offered a more-pointed view, stating that "adding these kinds of deposits counteracts funds that are leaving. It doesn't necessarily mean you will be able to grow your assets, it does mean that the market discipline of shrinkage may not apply."

A Jan. 30, 2009 letter to newly installed U.S. Treasury Secretary Timothy F. Geithner, sought to explain the actions of the OTS. The letter's lame tone is echoed somewhat in the August 2009 Office of Inspector General's report on "The FDIC's Role in the Monitoring of IndyMac Bank."

The entire affair was a travesty of a mockery of a sham.

Once Vices, Now Habits

The immediate question to answer is whether the use of brokered deposits and other variable-cost and hot-money-funding schemes will be promoted as part of a policy to attempt to grow our banks out of this crisis. It didn't work in the 1980s, it didn't work recently, and it won't work in the future.

Brokered deposits – including such recent permutations as listing services and reciprocal deposits – are the "third rail" of the American banking system precisely because they sit immediately in the middle of the arguments for and against federal deposit insurance.

The same might be said for the question of whether we need more or less regulation.

Ketcha, the former Basel Committee member and former FDIC supervision director, summarized the issue most succinctly, stating that "you can de-regulate, but you shouldn't be de-supervising."

If the manifest problem of brokered deposits is the unhealthy and unseemly growth of banks in good times as well as their subsequent implosion when the trajectory of asset accumulation collapses under its own weight – perhaps it's time to bypass the third rail.

Would it be so wrong, or un-American to fire up the old locomotive of stable, manageable and prudent bank growth and let it chug down old, well-worn tracks? Who says banks should game taxpayers and jeopardize stability and economic growth for their own greed?

Maybe it's a lot simpler than we're making it out to be.

What if we took away the inside track of special interests who profit on the backs of taxpayers by insuring all bank deposits? What if we break up all the too-big-to-fail banks and spread their pieces around the country to place credit closer to folks on Main Street?

What if we rewarded banks that made good loans and financed jobs, manufacturing, product innovation and productive service industries with tax incentives that they could use to lower the cost of credit to deserving borrowers or pass along to public shareholders? What if we facilitated our banks

competing with other global players by making them share and diversify the risks and rewards associated with loan origination, underwriting, securitization and product innovation?

What if there wasn't more or less regulation, just effective regulators doing the jobs they were supposed to be doing?

Promontory's Jacobsen hit the nail with a sledgehammer when he summed up the naked truth, stating that "moral hazard is where the money is."

Since we can't take greed out of the human equation, maybe we can just make everything more transparent, so we don't have to "wait to see when the tide goes out who has been swimming naked ."

It would be improbable, if not impossible, to wean depositors off FDIC insurance that is ultimately government-backed. It would also be imprudent to impose strict growth limitations on banks. But what is possible and prudent is tying bank growth to banks' ability to manage that growth commensurate with a risk-adjusted requirement to increase capital and contribute accordingly to the insurance fund that bears the first burden.

Brokered deposits aren't the problem. Unintended consequences of concerted efforts to game this country's taxpayers are a problem. If there are developing and obvious systemic problems, why do we always have to wait until the special interests are fed and fat before hearing a few voices from Congress advocating on behalf of the public?

Like depositors chasing yield, we should follow the money that flows from special interest groups and openly debate the greater good of their profit agenda against the backdrop of what's best for America. If we ever get that right, "all boats will rise with the tide."

About the Author: Retired hedge-fund manager R. Shah Gilani has established a reputation as one of the leading experts on the global credit crisis. His savvy analyses have appeared in Money Morning and have been read by millions across the Internet.

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