"Cedars" Deposits: Will They Fly?

By Mark D. Vaughan and Timothy J. Yeager

CDARS—pronounced "cedars"—is the newest funding tool used by deposit-hungry community banks. CDARS stands for "Certificate of Deposit Account Registry Service." Through this service, small and medium banks can offer their customers insurance on deposits greater than $100,000—the usual maximum to be insured—because the excess is placed with other banks.

CDARS is the sole service of Promontory Interfinancial Network, a bank consulting firm based in Washington, D.C., that is led by Eugene Ludwig, former comptroller of the currency, and Alan Blinder, former vice chairman of the Federal Reserve System's Board of Governors. The service made its debut in January 2003. As of August, about 350 banks belonged to the Promontory network, and about half of those actively used CDARS. Over the long run, CDARS may help community banks compete for large-deposit customers. In the short run, CDARS will complicate the lives of bank supervisors.

Growing CDs with CDARS

Until recently, community banks have struggled to raise the funds necessary to cover loan growth. The long, robust expansion of the 1990s enabled community banks to book new loans at a brisk pace. At the same time, financial innovation generated a host of new investment vehicles to compete with deposits. As a consequence, the loan-to-deposit ratio at U.S. community banks rose sharply.[1] At year-end 1992, the aggregate ratio was 61.3 percent, meaning there was 61 cents in loans for every $1 in deposits in U.S. community banks. By year-end 2002, that ratio stood at 76.5 percent.[2]

Community bankers face stiff competition for deposits from credit unions and large banks. Credit unions enjoy tax-exempt status, which gives them a competitive edge in setting yields on deposits. Meanwhile, many jumbo depositors at large banks figure these banks still enjoy "too big to fail" status, which effectively would insure all deposits against losses. In addition, if depositors do have concerns about potential losses, large multibank holding companies can spread the jumbo deposits (those over $100,000) among their own bank subsidiaries to provide 100 percent insurance coverage. Community bankers argue that the playing field would be somewhat leveled if the coverage ceiling for deposits were raised from its current $100,000 level, but Congress has been unwilling to do so thus far.[3]

CDARS may help to fill a funding gap by attracting local and otherwise uninsured funds back to community banks. With CDARS, a community bank can spread large deposits across other institutions in the Promontory network in chunks under the $100,000 insured threshold. At the same time, an equal amount of funds from these other network institutions are placed in the initiating bank. So, each bank ends up with the same amount of deposits brought in by its customers, but the entire balance in each bank is insured instead of just the original portion under $100,000.

This deposit-insurance swap could benefit community banks by helping them attract and retain funds from customers who demand complete insulation from losses, customers such as retirees and local governments. But there is a price, of course. Promontory levies an "on-boarding" fee that varies with bank size, a transaction fee that varies with the maturity of the deposit swap and a quarterly account minimum fee, which is levied on members that fail to generate a minimum number of CDARS transactions. Included in the price of CDARS is all the attendant legal paperwork. This paperwork includes the consumer documentation required by bank disclosure laws, the 1099s reporting taxable interest required by the IRS and the contracts settling interest differentials among network banks with different jumbo-CD yields.

A Regulatory Perspective

At first glance, CDARS might raise some regulatory eyebrows. Funds placed in the Promontory network are immediately classified as brokered deposits on the reports that banks must file quarterly with their supervisory agency. Traditionally, the term "brokered deposits" has been applied to funds pooled in blocks just under $100,000 by securities broker-dealers and then placed in depository institutions offering the highest yield. In the thrift crisis of the 1980s, many insolvent institutions paid dearly for brokered deposits and then used them to make risky loans. These institutions, with one foot in the grave, did not care about the cost of brokered deposits because they were gambling on resurrection. The post-crisis reforms in federal banking laws restricted the use of brokered deposits by banks and thrifts with low net worth. Even for well-capitalized institutions, supervisors closely monitor dependence on brokered deposits because such funds have historically been considered "hot money"—that is, they could flee upon maturity at the slightest promise of a better yield, precipitating a funding crunch.[4]

CDARS are not likely to cause the problems that brokered deposits did during the thrift crisis. As noted, bank supervisors now have procedures in place to monitor the use of brokered deposits and prevent their misuse. Even more important, the CDARS deposit swap is generally initiated by a desire to retain local deposits, not by a desire to cover potentially unsafe-and-unsound loan growth. Moreover, any bank bent on acquiring funds to cover imprudent growth would find it much easier to sell jumbo deposits in the wholesale-funding market. Banks willing to pay the going rate can typically get all the wholesale jumbos they need. And wholesale jumbos would not have to be swapped with deposits from other banks, as is necessary with CDARS.

Any new funding instrument must also be judged on the moral hazard introduced to the deposit insurance fund. With CDARS, otherwise uninsured jumbo CDs placed into the network become insured. And because covered depositors are shielded from losses, FDIC insurance weakens depositors' incentives to monitor a bank's financial condition. Depositors are less likely to withdraw funding or demand higher interest rates as banks increase their risk; so, deposit insurance implicitly encourages risk-taking by allowing bankers to escape the full price of their behavior.

Recent research, however, suggests that jumbo-CD holders are not particularly sensitive to bank risk—at least in the current institutional and economic environment.[5] Because of deposit-preference laws—which give domestic jumbo-CD holders priority over foreign depositors in failure resolutions—and high bank-capital levels, expected losses on jumbo CDs are small. Therefore, little monitoring or disciplining by uninsured depositors is going on. Put simply, weakening already weak depositor discipline by transforming jumbo CDs into fully insured CDs should not exacerbate moral hazard.

But institutional and economic environments change; so, it is possible that CDARs could cause moral-hazard problems down the road. Evaluating the social losses from such a problem requires consideration of other policy alternatives on the table. For the past year, Congress has toyed with raising the deposit-insurance ceiling to $130,000 from $100,000. How would an implicit hike in the coverage ceiling arising from extensive use of CDARs compare with an explicit hike of $30,000 arising from congressional action?

Answering this question requires identifying the banks most likely to join the Promontory network. The most likely joiners are smaller, community-focused banks with relatively weak deposit bases—that is, institutions that hold less than $1 billion in assets, that do not belong to multibank holding companies and that fund growth with brokered deposits or Federal Home Loan Bank advances.[6] Other likely joiners are recently chartered banks *(de novos)*. If all such institutions joined Promontory, and every dollar of uninsured deposits on their balance sheets entered the CDARs network, then the liabilities of the FDIC would rise by about $38 billion. This figure is about 14 percent of the increase that would occur if the deposit-insurance ceiling were raised to $130,000 from $100,000. So, CDARS could be viewed as a less costly alternative to raising the ceiling.[7]

CDARS and Surveillance

CDARs could cause a short-run supervisory headache by significantly distorting ratios used in off-site surveillance. In bank supervision, off-site surveillance refers to the use of accounting data and anecdotal evidence to schedule on-site examinations and to monitor bank progress in addressing previously identified deficiencies. As noted, heavy dependence on brokered deposits has traditionally been a supervisory red flag. And, as also noted, funds placed in the Promontory network are automatically reclassified as brokered deposits on bank financial statements. Therefore, banks making use of CDARs could end up attracting unwarranted supervisory attention.

To see the problem, consider a representative balance sheet for the most likely joiners of the Promontory network. On this balance sheet, the brokered deposit to total deposit ratio is about 8 percent. If all uninsured deposits are put in the network, then the ratio of brokered deposits to total deposits ratio would soar to 36 percent. This latter ratio ranks in the 99th percentile for U.S. commercial banks. In the coming quarters, as more banks join Promontory, bank supervisors will have to watch brokered-deposit ratios carefully and follow up with "red-flagged" banks to identify the active CDARs users. Only such follow-up can prevent unnecessary supervisory intervention.

Conclusion

Of course, the full supervisory implications of CDARs will not be clear until evidence is available about how banks have reshaped their balance sheets in response to the product. And, community bank depositors may not respond as enthusiastically as expected to deposit protection afforded by CDARs—so this may end up as much ado about nothing. Still, securing the funding necessary to compete effectively with large banks and credit unions remains a continuing challenge for community bankers. CDARs could end up as an important new tool for meeting this challenge.

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ENDNOTES

1. For data-analysis purposes, we define a community bank as an institution holding less than $500 million in assets—the definition set forth for regulatory purposes in the Financial Modernization Act of 1999.
2. For a discussion of the funding challenges faced by U.S. commercial banks, see Stackhouse and Vaughan (2003).
3. For a discussion of the pros and cons of raising the deposit insurance ceiling, see Vaughan and Wheelock (2002).
4. For a discussion of the role of brokered deposits in the thrift crisis, see White (1991).
5. For recent evidence about monitoring and disciplining by the jumbo-CD market, see Hall, King, Meyer and Vaughan (2002).
6. For a discussion of the importance of Federal Home Loan Bank funding to community banks, see Stojanovic, Vaughan and Yeager (2000).
7. These figures are "back-of-the envelope" estimates based on Congressional Budget Office analysis (CBO 2002) and the authors' calculations. The actual numbers will vary because not all uninsured deposits will enter the Promontory network, and participating banks will reshape their balance sheets in response to the availability of CDARS.

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