Strategy
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Demystifying Insured Deposit Programs

The Other Government Cash Management Alternative

Abstract

This introductory product brief discusses insured deposit programs' potential safety, liquidity, yield, diversification and ease of use benefits. It also cautions on their servicer risk, liquidity, size restrictions, risks related to FDIC payoffs and sustainability. Such vehicles may be well suited for moderate-sized accounts with government mandate that desire higher yield potential than government funds. They also may form the more conservative portion of a traditional treasury portfolio.

Introduction

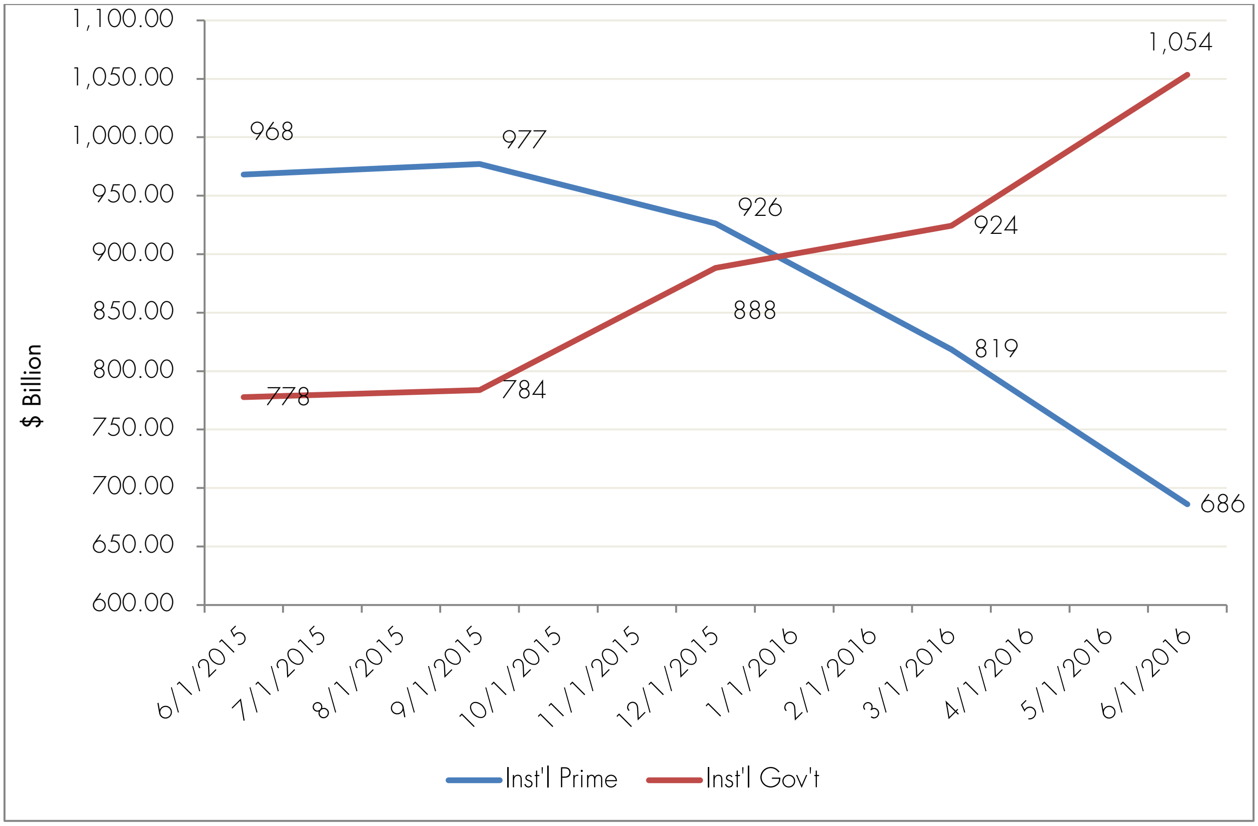
In 75 days, institutional cash investors will enter a new era of cash management – find an alternative liquidity vehicle or face the uncertain world of floating net asset values (NAVs) and possible redemption fees and gates on institutional prime money market funds. Government money market funds, with stable NAVs and no fees and gates provision, appear to be the logical choice for many, if not most, prime fund investors.

While government funds are a fine option, there are other choices worth exploring. One of them is the insured deposit programs (IDPs) - the other government cash management vehicle. In this introductory product brief, we seek to demystify this often overlooked liquidity option, discuss its pros and cons, and explain why now may be an opportune time to consider it.

Issues with Government Money Market Funds

Guessing the magnitude and timing of asset migration has been the money market industry's parlor game for much of the last year. Estimated outflows from institutional prime funds ranged from zero to 80%. Industry observers tend to agree on a two-wave prime-to-government migration pattern - one initiated by fund sponsors in whole fund conversions that have roughly amounted to $300 billion, and another driven by shareholder activities with estimates centered around $300-$500 billion yet to be realized.

Figure 1: Recent Institutional Fund Flows



Source: iMoneyNet "Domestic Market Share" as of 6/30/2016.

Figure 1 shows that, over the last four quarters through June 30 2016, institutional prime funds lost $282 billion, while institutional government funds gained $276 billion. Industry observers tend to agree that much of these flows were driven by sponsors' fund conversions, implying that shareholder-led fund activities have yet to start.

Supply Concerns: The one-two punch of prime-to-government asset migration will no doubt increase competition for eligible securities among government funds. Even prime funds, in an effort to boost portfolio liquidity, may join the scavenger hunt for Treasury securities as they are counted as liquid assets regardless of maturities.

The reverse repurchase agreement (RRP) program from the Federal Reserve, with a theoretical capacity of $2 trillion, helps alleviate this supply shortage, although the Fed is expected to re-impose a program cap as early as the end of 2016 to lessen systemic concerns. Only funds with assets greater than $5 billion for the previous six months are eligible repo counterparties to the Fed. The Treasury Department may expand its T-bill program before year-end, although long-term supply and demand dynamics remain unclear in a regulatory environment where financial institutions compete for "high quality liquid assets (HQLAs)" with money market funds.

Lower Yield Potential: In a competitive environment, even with sufficient supply of government securities, yield potential may be reduced. For example, the usage of the Fed's RRP has been low in recent months when private party repo rates often were greater than 0.40% while the RRP remained at 0.25%. With more competition, funds may tap the lower-yielding RRP more often, depressing portfolio yield potential.

Counterparty and Credit Risk: Contrary to common misconceptions, government funds are not without risk. Shareholders are exposed to major investment banks as repo counterparties. When a counterparty fails, a fund must take immediate possession of the underlying securities, including long-dated Treasury bonds and agency mortgage-backed securities that are ineligible for money fund portfolios. Government funds also hold debt from government sponsored enterprises (GSEs) not backed by the full faith and credit of the US Treasury. Counterparty and credit evaluation remains a relevant task for institutional cash investors.

Insured Deposit Programs Explained

For institutional investors looking to avoid floating NAVs and fees and gates in a prime fund and address the supply, yield and counterparty issues of a government fund, IDPs may be a viable alternative. Simply put, they represent a portfolio of deposits from several banks, each insured up to the $250,000 limit by the Federal Deposit Insurance Corporation (FDIC). Instead of acquiring deposits one at a time, depositors benefit from electronic technology and master bank custodial arrangements to conveniently own a bundle of them.

FDIC Insurance: The FDIC was created by the 1933 Banking Act to restore trust in the American banking system. Since 2011, its insurance covers $250,000 per depositor, per insured bank. The insurance is backed by the full faith and credit of the US government, although the agency's funding and reserves come from member bank dues. The FDIC has a $100 billion line of credit with the US Treasury. As of June 30, 2016, it provides insurance on 6,358 banks.

Bundled Deposits: For institutional depositors, a modest portfolio of $10 million would require deposits from at least 40 separate banks to be fully insured. The tasks of finding banks, opening accounts, transferring funds, receiving interest payments, recordkeeping and reconciling bank statements and keeping track of the insurance limit can be insurmountable. In recent years, a number of third-party providers with automated trading and accounting platforms, along with trust banks acting as master account custodians, have attempted to solve the cumbersome process by bundling insured deposits as packaged offerings. A universally recognized term has yet to emerge to describe this deposit aggregation practice. We use the term "insured deposit programs" for these platforms.

Brokered Deposits: IDPs are gathered through third party means and are brokered deposits[1]. The FDIC considers brokered deposits "a suitable funding source when properly managed as part of an overall prudent funding strategy." To prevent banks from unsound practices or rapid growth, the FDIC allows only "well capitalized" banks to borrow brokered deposits without restriction. "Adequately capitalized" and "undercapitalized" banks are prohibited from issuing brokered deposits in most cases.

Types of Deposits: Similar to directly placed deposits, IDP platforms may offer money market demand accounts (MMDAs) with relatively lower yield but allow daily deposits and withdrawals, or certificates of deposits (CDs) with higher yield potential but less flexible liquidity options. Program managers may impose additional liquidity restrictions separate from those imposed by the banks.

Insurance Eligibility: IDP platforms keep records of social security numbers (SSNs) for individuals and federal employer identification numbers (FEINs) for organizations as unique identifiers for depositors. They also keep track of the FDIC certification numbers for each insured bank. A bank holding company may have multiple subsidiary banks, each with a unique FDIC number that insures up to $250,000. The platforms perform cross checks of taxpayer IDs and position(s) held against FDIC numbers to ensure ongoing compliance.

Program Manager: The sponsor or manager of an IDP is responsible for developing and maintaining the automated platform for trading, deposit allocation, recordkeeping, income recognition, funds transfer, compliance checks and other related functions for depositors. It also manages a network of banks with which to

[1] Refer to the FDIC's Frequently Asked Questions on identifying, accepting and reporting brokered deposits, FIL-42-2016, June 30, 2016 on definitions of brokered deposits and deposit brokers. Quotes in this paragraph come from the FAQ. https://www.fdic.gov/news/news/financial/2016/fil16042.html

place the deposits, negotiates deposit rates with them and determines their identity and capitalization status. The experience and capability of the program sponsor is a key factor in IDP considerations.

Master Custodian Bank: The large number of depository transactions and associated entities requires a trust bank to act as a master clearing agent and bank custodian for depositor funds. Instead of having an account at each IDP member bank, a depositor keeps a single account at the custodian. Through a custody arrangement, this account is separate from the bank's normal deposits and is protected from the bankruptcy status of the bank. The custodian bank, in turn, establishes one or more "omnibus" accounts in its own name at each member bank to facilitate aggregate level deposit and income transactions. Trading breakdowns, recordkeeping, and reconciliation occurs between the program manager and the custodian banks at a regular interval.

Insured Brokered Deposit Then and Now

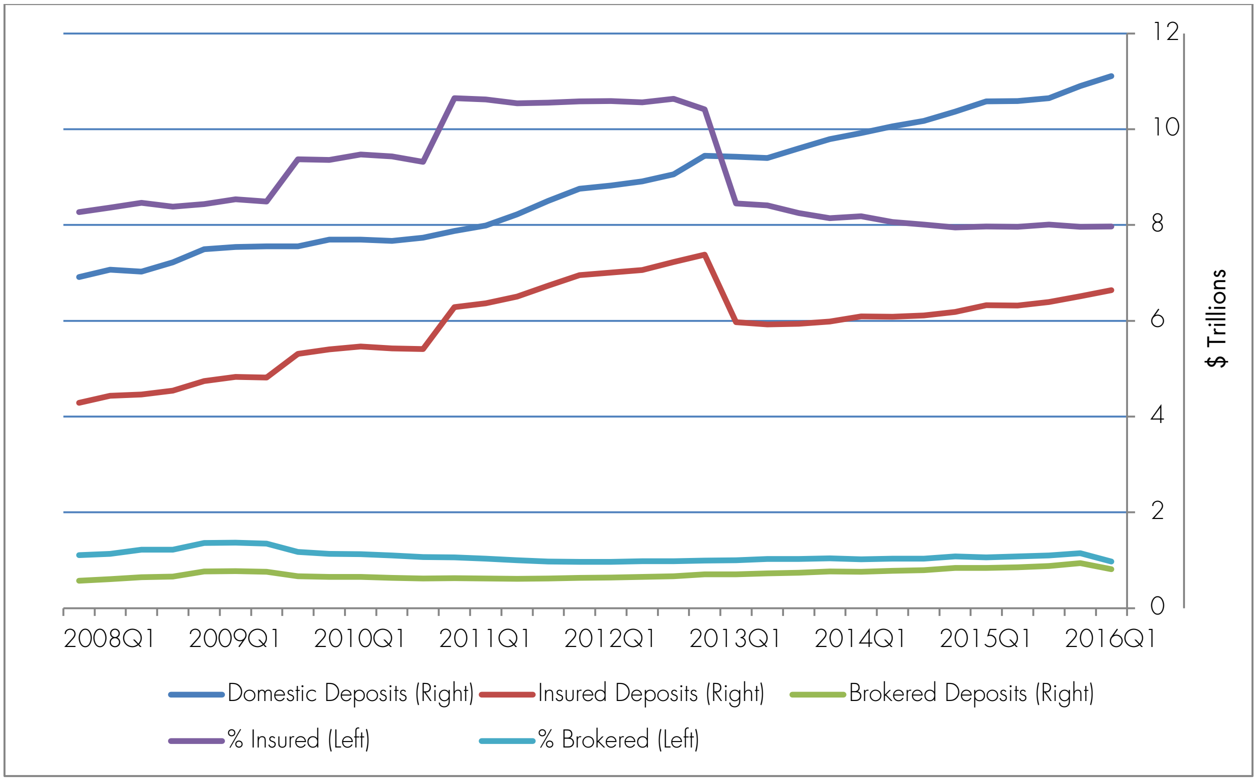
Stringing together insured deposits to increase FDIC coverage is not a new phenomenon. In a 2006 study on the liability structure of FDIC-insured institutions, two FDIC researchers discussed the evolution of brokered deposits since the 1950s[2]. Before 1970, the brokered deposit market consisted primarily of institutional uninsured depositors. The end of interest-rate ceilings on large deposits in 1973 ushered in an era of hyper growth for brokered deposits but also resulted in a wave of bank failures in the 1980s. Congress restricted banks not well capitalized from accepting brokered deposits in 1991. Growth continued nonetheless, allowing banks to access national markets without disrupting their local savings markets. As of the first quarter 2016, The FDIC reports $11.1 trillion domestic deposits nationwide, $813 billion of which are brokered deposits, representing an eight-fold increase from less than $100 billion in 1998[3].

The FDIC researchers discussed two groups of <u>insured</u> brokered deposits – "deposit splitting" by banks with assets greater than $1 billion and internet-based deposit-splitting. The first group was initiated by Merrill Lynch in providing its customers with deposits below $100,000 from its affiliated banks. Other brokerage firms eventually adopted this strategy into daily sweep vehicles as alternatives to money market funds. Internet-based deposit-splitting received attention with Promontory Financial Network's launch of the Certificate of Deposit Account Registry Service (CDARS) program in 2003. Described as a clearinghouse for small or mid-size banks, the program was primarily marketed to individuals initially, but is now available to institutional depositors as well.

Promontory, StoneCastle Partners, Reich & Tang, Deutsche Bank, Total Bank Solutions and a handful of other players compete for institutional cash in the IDP space, each with unique features, bank network, fee structure and liquidity provisions. No statistics exist on the total size of this market, but a Crane Data news update in April 2015 put the figure at over $600 billion[4]. This compares to the overall domestic brokered deposits, insured and uninsured, overnight and term, of $813 billion.

[2] Christine M. Bradley and Lynn Shibut. FDIC Banking Review: The liability structure of FDIC –insured institutions: changes and implications, 2006, Volume 18, No. 2. https://www.fdic.gov/bank/analytical/banking/2006sep/article1/article1.pdf
[3] Statistics on Banking, the FDIC, as of first quarter of 2016. "All FDIC-insured institutions". https://www5.fdic.gov/SDI/SOB/
[4] Deposits, FDIC "amalgamators' growing; going institutional, Crane Data Money Fund Intelligence, April 2015, Volume 10, Issue 4.

Figure 2: History of Brokered and Insured Deposits at FDIC Insured Institutions



Source: FDIC Statistics on Banking as of the first quarter of 2016.

Wholesale intermediation of institutional cash through brokered insured deposits raised concerns about the stability and reliability of funding for the receiving banks. On the other hand, the FDIC researchers noted that some industry observers viewed this type of funding more favorably than traditional brokered deposits during past banking crises. Today, total brokered deposits account for 7.3% of domestic deposits, below the ten-year average of 8.2% since the fourth quarter of 2007.

Benefits to Institutional Cash Investors

IDPs vary in features, manager expertise and custodian bank capabilities, so it is risky to generalize on their advantages to institutional cash investors. Broadly speaking, the following features may be common with IDPs that are beneficial attributes to this alternative vehicle.

Free from Credit Concerns: Principal preservation is a paramount objective for most cash investors. Insured deposits carry explicit full faith and credit of the US Treasury through the FDIC coverage. To the extent that deposits are verifiably under the $250,000 insured limit with verifiable FDIC insured banks, depositors are not exposed to the credit risk of the issuing bank. Though not directly comparable, insured deposits exhibit equal or better credit characteristics than those in stable NAV government money market funds.

New Source of Government Instruments: Recent financial regulations intensified competition for high-quality liquid assets (HQLAs) among financial institutions and money market funds. IDPs represent a new source of government instruments besides Treasury bills and notes, agency notes and government repurchase agreements. Since participating community banks are not subject to the liquidity restrictions faced by larger systemically important banks (SIBs), this source of funding is only limited by the number of banks on the network and the banks' need for wholesale deposits.

Reliable Liquidity Characteristics: Liquidity differs between the two types of deposits. CD-based term deposits come with contractual maturity dates and can be staggered to provide planned liquidity at a preset schedule. MMDA-based programs and broker sweep vehicles promise more frequent, sometimes daily liquidity. Marketable securities need the secondary market for liquidity. Prime money market funds will soon be subject to liquidity fees and gates. Insured deposits, on the other hands, remove these uncertainties by delivering contractual liquidity based on investors' preferences and program conditions.

Higher Yield Potential: The competition for HQLAs and a fragmented wholesale deposits market among community banks create an incentive for participant banks to offer yield levels competitive with, or higher than, other government instruments. In some cases, such deposits may yield higher than uninsured deposits with similar features from larger, systemically important, banks. Yield pickup potentials vary among programs, but funding demand and competition for institutional deposits will ultimately determine the yield advantage of IDPs over other cash instruments.

Simplified Processing, Accounting and Notifications: Unlike a portfolio of individually procured deposits, IDP platforms calculate and track accrued interest income from each bank and post a "blended" income payment at preset intervals. Such practices make income payments and accounting entries easier to manage. They also provide alerts on maturing deposits and rate change alerts to help depositors manage their positions as a portfolio. Unlike large wholesale deposits with fluctuating market values, these deposits are recorded at par value, so gain and loss recognition is largely avoided.

Risk Considerations

As with any potential alternatives, careful evaluation of IDPs' suitability as institutional cash management vehicles is warranted. The field is still in a nascent state with scarce publicly available information, so it is difficult to generalize the risks and concerns among programs. Here are a number of considerations for investors to start their search process.

Servicer Risk: The concept of bundling insured deposits for higher FDIC coverage is a fairly simple one. The linchpin of the strategy rests with the assumption that the IDP provider and the custodian bank are well qualified to ensure all participating banks as legitimate FDIC insured institutions in well capitalized status. System or human errors may result in total deposits exceeding $250,000 from any single bank. On rare occasions when banks do fail, the providers must send accurate depositor information with insured status to the FDIC quickly to expedite the recovery of insured funds. Ongoing and extensive due diligence into the providers' technological and operational capabilities is essential to minimize this risk.

Liquidity Restrictions: For term depositors, early redemption prior to maturity may incur pre-payment penalties of lost interest. For some programs, early redemption is not allowed. Liquidity in some MMDA programs may not be available on a daily basis, but may be delayed by a day. Program providers may also impose liquidity restrictions unrelated to the underlying depositing banks. Institutional depositors should evaluate each program's liquidity features to gain comfort.

Payment Delays in a Bank Failure: IDP providers attempt to avoid placing deposits with banks at the risk of triggering FDIC insurance. On rare occasions when the FDIC is unable to negotiate stronger banks to acquire the failed ones' outstanding deposits, brokered deposit holders may experience some payment delay from the FDIC. The FDIC says it will pay depositors by check "within a few days after the bank's closing"[5], although in practice depositors were generally paid immediately. There may be additional delay for brokered deposit payments due to third-party documentation and identification requirements. FDIC payoffs are so infrequent that it is difficult to determine the actual risk of payment delays in future instances.

[5] See the FDIC's Frequently Asked Questions. https://www.fdic.gov/deposit/deposits/brochures/your_insured_deposits-english.html

Lost Future Income with Payoffs: In a bank failure, neither the acquiring bank nor the FDIC is bound by the original deposit interest rate arrangement. This means that term depositors will receive principal and accrued interest up to the time of the failure, but lose the income stream as promised in the original deposit terms. This "pre-payment reinvestment" risk affects term deposits only but not MMDAs.

Deposit Size Restrictions: Program capacity may be a limiting factor for institutional cash accounts with sizable balances. Since IDP banks tend to be small regional banks, their participation may be limited by lending capacity, regulatory caution or self-imposed wholesale funding disciplines. On the other hand, a modest institutional cash account of $50 million requires deposit splitting among at least 200 banks. Since the banks' funding schedules may not coincide perfectly with the depositors' cash schedules, the bank network needs to be sufficiently large, in many hundreds or even thousands, to become a meaningful and reliable investment channel for institutional accounts.

Systemic Concerns: Bank regulators often point to the association of bank failures with third party deposits to discourage the growth of brokered deposits. In 1991, the US Treasury tried, and failed, to eliminate the "pass-through" insurance on brokered deposits[6]. The FDICIA Act of 1991 limited the unrestricted use of brokered deposits to well capitalized banks. After several staff letters, the FDIC issued updated "frequently asked questions" in 2015 to clarify and standardize the definitions of "brokered deposits" and "deposit brokers"[7]. Industry observers agree that brokered deposits exceeding 10% of national deposits may attract closer regulatory scrutiny. At an average of 8.2% over the last eight quarters, brokered deposits, insured plus uninsured, are about $300 billion below the threshold.

Conclusion: A Viable Cash Management Alternative Deserving a Closer Look

While brokered deposits and "deposit splitting" are not new, brokered insured deposit aggregation programs gained attention from institutional cash managers only in the last decade. The impending money market fund reform in October 2016 may provide a boost to this alternative liquidity vehicle. Limitations with government money market funds may further improve its popularity.

In the just released 2016 liquidity survey conducted by the Association for Financial professionals (AFP), 23% of corporate respondents who use bank deposits reported to be in "structured bank deposit products" and another 16% in "structured certificates of deposit"[8].

In this introductory product brief to brokered insured deposit programs, we discussed their potential safety, liquidity, yield, diversification and ease- of- use benefits. We also cautioned on servicer risk, liquidity drawbacks, potential size restrictions, risks related to FDIC payoffs and challenges as a sustainable investment option for institutional cash investors. In the final analysis, such vehicles may be well suited for cash accounts of moderate size restricted by a government mandate that also desire higher yield potential than government funds.

For institutional cash accounts with higher cash balances, insured deposits may form the more conservative portion of a treasury portfolio, while a well-structured and diversified separately managed account (SMA) portfolio may complete the picture with well-rounded risk-reward characteristics.

[6] William R. Keeton, The Treasury Plan for Banking Reform, Economic Review, Federal Reserve Bank of Kansas City. May/June 1991
[7] FDIC: Frequently Asked Questions, FIL-42-2016, June 30, 2016. https://www.fdic.gov/news/news/financial/2016/fil16042.html
[8] Association for Financial Professionals: 2016 AFP Liquidity Survey, Report of Survey Results, Page 15

About Us

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