Should You Pursue Brokered Deposits?

deposits capital

Summary: With rising rates for CDs, and a competitive deposit market, should your CFI pursue brokered deposits? We weigh the advantages of brokered deposits against their risks.

Sometimes it pays off to take risks. Frederick Smith, the founder of FedEx, took a gamble to get funding for his struggling business — literally. Smith was down to $5K to cover expenses in the early 1970s, and it looked like FedEx was going to fold…until he took that money to Vegas and played blackjack. He won $27K, which was enough money to keep FedEx afloat until they could secure more funding.

While not as dramatic, more community financial institutions (CFIs) are taking on the risk of brokered deposits to rapidly increase capital, to the point of offering their best deposit rates to brokered deposit customers.

The Federal Reserve increased the interbank lending rate 7x in 2022, ending the year at a targeted range between 4.25% and 4.5%. Rates have already increased as of this month, and are likely to go up again another 25bp in March, with increasing likelihood of another 25bp hike in May, and an additional 25bp hike in June.

Despite those higher interest rates, CFI customers haven't seen correspondingly higher rates paid on deposits. Some of them have gone instead to brokered deposits, which are paying substantially better rates. In October, for instance, the Wall Street Journal reported that while a standard certificate of deposit (CD) might pay 2%, brokered CDs were paying as much as 4.5%.

That's a clear advantage for a depositor. But are brokered deposits advantageous for CFIs to pursue?

The Pluses of Brokered Deposits

Third-party brokers place brokered deposits in financial institutions on a client's behalf, usually to maximize interest earned and sometimes also as a way to make sure that a client doesn't have more than the FDIC's $250K insurance limit deposited in any single account.

From a CFI's point of view, brokered deposits have multiple benefits. Brokered deposits can:

- **Reinvigorate a lending program.** To write loans, an institution obviously needs capital. Brokered deposits are a relatively quick route to gathering capital, which can then fuel your lending program and simultaneously drive both higher profits and greater community engagement.
- **Provide a less-expensive source of new capital**, especially over issuing debt or capital instruments to raise funds. Brokered deposits cost more than plain-vanilla deposits; the higher rate is the attraction. Even so, that higher rate is far cheaper than a stock offering or bond issue. Depending on the size of the brokered deposits, that option might even be cheaper than a modest marketing program.
- **Attract new core deposits.** Population and economic growth limit the demand for entirely new banking accounts, so institutions that want new core deposits often need to attract customers from competitors. Offering higher interest rates on deposit accounts is often an effective way to sway potential customers in your institution's favor. The new customer will then have an opportunity to see the other advantages of a relationship with your CFI, including other product offerings.

Treading Carefully with Brokered Deposits

The problem with brokered deposits, other than their expense, is baked into the concept. Customers who arrive at a CFI via brokered deposit are willing to leave one banking relationship for another, provided that the price is right. Brokers watch what rates a variety of financial institutions are offering and have an incentive to withdraw deposits quickly and move them to another financial institution offering higher interest rates, even by a small amount.

This makes brokered deposits less “sticky” than core deposits, which are a hassle for customers to move. Because they aren’t the most stable source of funding, they increase a CFI’s liquidity risk and even its chance of becoming distressed. That’s particularly true if an organization uses brokered deposits to increase its risk by lending in volatile or unfamiliar markets.

Because brokered deposits can be an efficient source of funds and may help a CFI drive higher profits, it makes sense to consider accepting them. If you use brokered deposits, however, do so thoughtfully and with an eye to your institution’s capitalization and its needs around liquidity and stability.

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ECONOMY & RATES

Rates As Of: 02/24/2023 09:59AM (GMT-0800)

Treasury	Yields	MTD Chg	YTD Chg
3M	4.84	0.14	0.42
6M	5.05	0.25	0.29
1Y	5.06	0.40	0.36
2Y	4.84	0.63	0.41
5Y	4.24	0.62	0.24
10Y	3.98	0.47	0.10
30Y	3.96	0.32	-0.01

FF Market	FF Disc	IORB
4.58	4.75	4.65
SOFR	**Prime**	**OBFR**
4.55	7.75	4.57