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Brokered Deposits and Community Banks; A 2017 Strategic Perspective

This is a follow up study to a report that originally ran in July 2016. We have utilized the same methodology. The only change is that we increased the size of the fifth peer group from $1B-$3B to $1B-$5B.

Brokered Deposits ("BDs") have long been available to community banks as both an alternative funding source and an interest rate risk diversification solution. Viewed as non-core deposits, BDs have often been a practical solution for banks with a loan portfolio growth rate that exceeds their core deposit growth rate.

But, then came the great recession. During this period, the use of BDs began to appear to be a tool to shore up banks with operating weaknesses. This led to bank regulators discouraging, or in some cases, forbidding the use of BDs. Most Consent Orders (or Formal Agreements/Cease & Desist Orders, MOUs, etc.) included restrictive or prohibiting language regarding BDs. Some now believe that this led to the perception that underperforming banks are more likely to use BDs compared to average and higher performing banks. It also led to the belief (real or perceived) by many that the regulators wanted to further restrict the use of BDs.

With that in mind, we decided to take a current look at banks that appear to strategically include BDs as a part of their funding strategy vs. those that do not (banks with no BDs). As a baseline, we chose banks which had 7% or more of their deposit portfolios classified as BDs at the end of 2017Q3. (NOTE: Banks with at least 7% in BDs in their portfolios at the end of each fiscal year are assumed to have maintained that level throughout our 2017 test year. We also acknowledge that BDs as reported in the Call Report may consist of broker-dealer provided CDs, various CDARS products, and sweep accounts.) Our analysis included 5,528 community banks with assets from <$100M to $5B. For purposes of our research we broke them out into 5 groups, based upon asset size.

Our objective was to compare the performance of banks with BDs to those without BDs during 2017. We focused on the following key performance indicators: ***Asset Growth, ROAA, ROAE, Net Interest Margin, Bank Efficiency, Asset Quality, and Capital***. *Finally, for those banks with BDs, we also compared their* ***Average BD Balances Maintained*** *and their* ***Percentage of BDs to Total Deposits.***

SUMMARY OF FINDINGS

Based upon our analysis comparing banks with BDs to those without BDs in their portfolios, we noted the following:

- 2,349 banks of 5,528 (42%) had some balance of BDs during 2017
- 893 (16%) had 7% or more in BDs in their deposit portfolio
- The number of banks using BDs increased with the asset size of the bank

From a performance standpoint banks with 7% or more in brokered deposits vs. banks with no brokered deposits:

- Grew at a greater rate
- Similar ROAA
- Generated slightly higher ROAE
- Net Interest Margin was higher
- Operating efficiency was better
- Asset quality was mixed
- Lower Tier 1 leverage capital level
- Average BD portfolio size was between 15% - 18%

Consistent with the 2016 study, the analysis indicates that during 2017, banks with 7% or more in BDs grew at a higher rate, matched earnings levels, created a slightly higher shareholder return, had stronger margins and operated more efficiently than banks that did not utilize BDs as a business funding strategy. Though all groups' capital levels were significantly well-capitalized, non-BD bank's Tier 1 leverage was higher. In short, the use of brokered deposits do not seem to weaken a bank, but may have enhanced their performance.

One could conclude that this study dispels the general perception that banks with BDs have an operating weakness, or that they underperform peer banks with no BDs.

ASSET GROWTH RATE

When analyzing the growth impact, it was not surprising to see the BD banks with a higher rate of growth. It is not uncommon for banks with a greater growth rate to utilize brokered deposits as a funding source. What is interesting is to see the magnitude of difference between the two groups. The difference in growth rates spanned between 94% to 444% greater.

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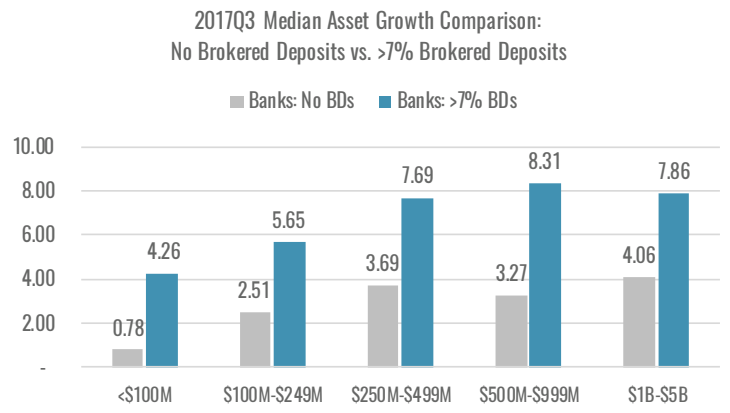
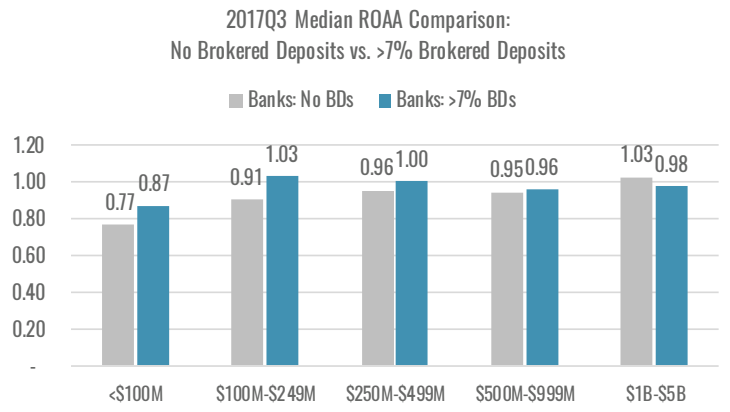


Asset Growth Rate	No BDs	>7% BDs	Variance
<$100M	0.78	4.26	444%
$100M-$249M	2.51	5.65	126%
$250M-$499M	3.69	7.69	108%
$500M-$999M	3.27	8.31	154%
$1B-$5B	4.06	7.86	94%

RETURN ON AVG ASSETS (ROAA)

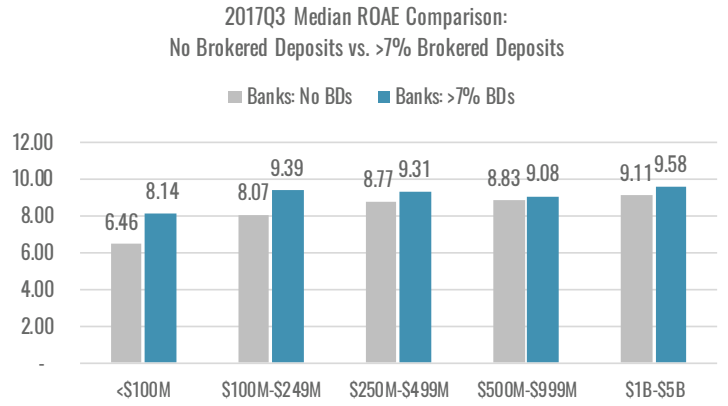
When reviewing 2017 annual earnings comparison, the difference between the groups narrows. The findings are more significant for the smaller bankers. Based on asset size the range of difference was from -5 basis points to 12 basis points.



ROAA	No BDs	>7% BDs	Variance
<$100M	0.77	0.87	13%
$100M-$249M	0.91	1.03	14%
$250M-$499M	0.96	1.00	5%
$500M-$999M	0.95	0.96	1%
$1B-$5B	1.03	0.98	-5%

RETURN ON AVG EQUITY (ROAE)

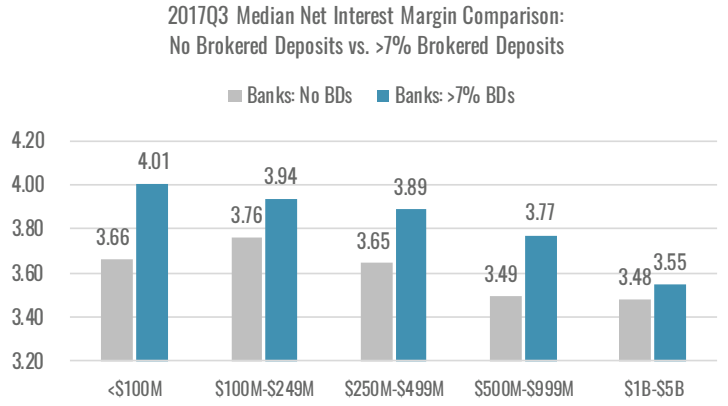
Board members will likely be surprised to discover that banks using BDs are providing equal to or greater than returns than those without. Over the last several years most directors have been discouraged from approving BDs as a part of their banks funding strategy. In this study, banks with BDs provided an 3% to 26% greater return to their shareholders.



ROAE	No BDs	>7% BDs	Variance
<$100M	6.46	8.14	26%
$100M-$249M	8.07	9.39	16%
$250M-$499M	8.77	9.31	6%
$500M-$999M	8.83	9.08	3%
$1B-$5B	9.11	9.58	5%

NET INTEREST MARGIN COMPARISON

The Net Interest Margin ("NIM") comparison, though perhaps a smaller percentage difference between the two groups, was the most consistent in terms of asset level performance. The range of improvement among the groups ranged from 7 to 35 basis points better for the banks with BDs.



Net Interest Margin	No BDs	>7% BDs	Variance
<$100M	3.66	4.01	10%
$100M-$249M	3.76	3.94	5%
$250M-$499M	3.65	3.89	7%
$500M-$999M	3.49	3.77	8%
$1B-$5B	3.48	3.55	2%

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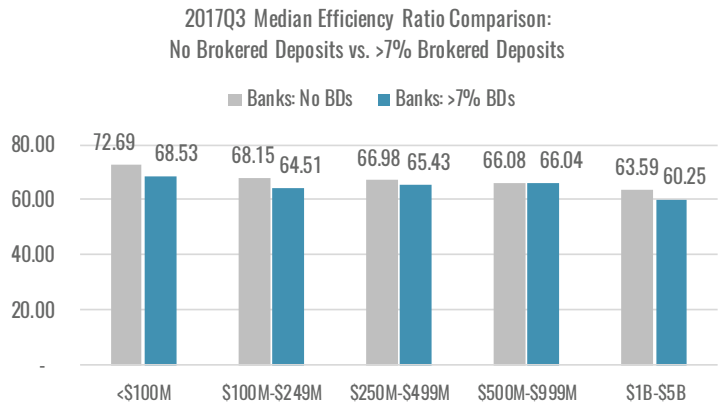
EFFICIENCY RATIO COMPARISON

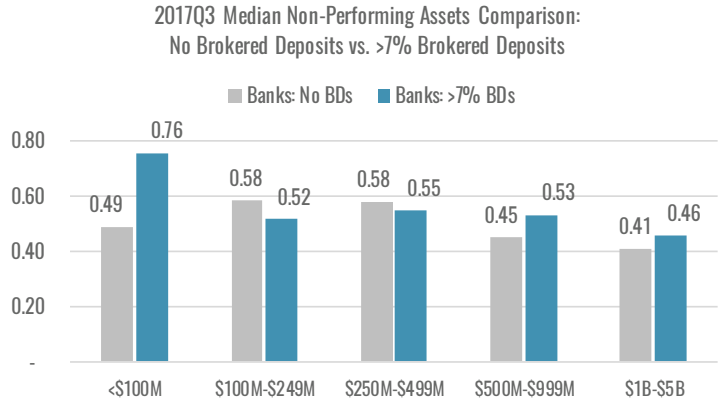
Banks without BDs are slightly more efficient than their counterparts with BDs, though the difference is not material.



Efficiency Ratio	No BDs	>7% BDs	Variance
<$100M	72.69	68.53	-6%
$100M-$249M	68.15	64.51	-5%
$250M-$499M	66.98	65.43	-2%
$500M-$999M	66.08	66.04	0%
$1B-$5B	63.59	60.25	-5%

NON-PERFORMING ASSETS

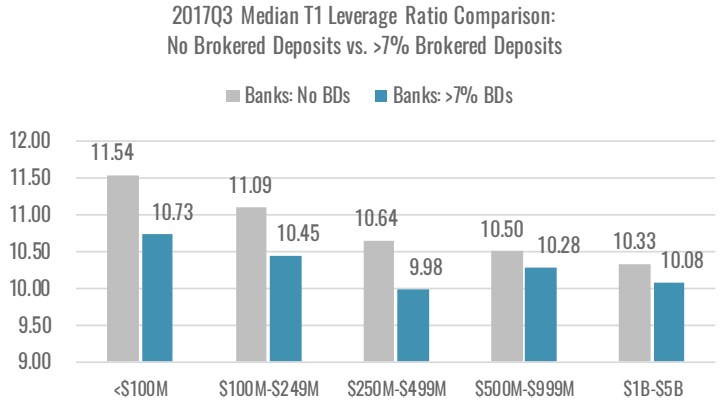
The analysis around asset quality was mixed. There are cases, as with banks under $100M where asset quality for non-BDs banks was materially better than their counterparts with BDs. When reviewing the overall performance within all groups, the asset quality of banks with BDs is in line with non-BD banks .



Nonperforming Assets	No BDs	>7% BDs	Variance
<$100M	0.49	0.76	54%
$100M-$249M	0.58	0.52	-11%
$250M-$499M	0.58	0.55	-5%
$500M-$999M	0.45	0.53	18%
$1B-$5B	0.41	0.46	11%

CAPITAL: TIER 1 LEVERAGE RATIO

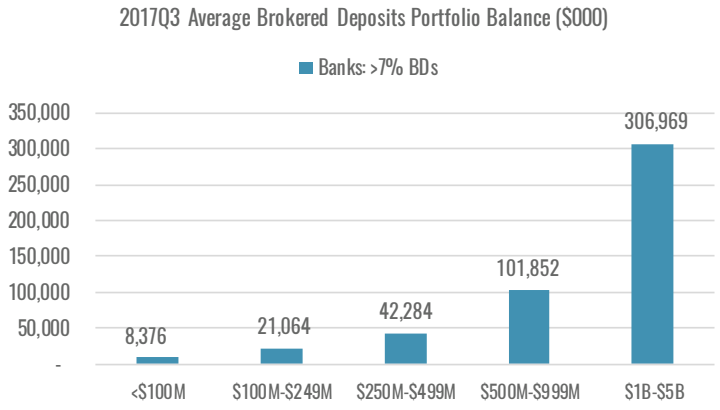
The median Tier 1 leverage level for all groups came in well above well-capitalized levels. Non-BD banks maintained a higher ratio than BD banks, though the difference for groups $500M to $5B was immaterial.



Leverage Ratio	No BDs	>7% BDs	Variance
<$100M	11.54	10.73	-7%
$100M-$249M	11.09	10.45	-6%
$250M-$499M	10.64	9.98	-6%
$500M-$999M	10.50	10.28	-2%
$1B-$5B	10.33	10.08	-2%

AVERAGE BROKERED CD PORTFOLIO SIZE

As mentioned at the outset of the study, we reviewed banks with 7% or more in BDs for comparison purposes. When reviewing each of the asset groups within the category, we found that the average BD deposits for each group ranged from $8M to just under $307M.



The actual average BD percentage for each asset group ranged from 14.41% to 18.65%.

CLOSING THOUGHTS

When we initiated this study, it was primarily driven by a curiosity about the performance levels of banks utilizing brokered deposits in their funding strategies. Over the last decade it is fair to say that there has been a

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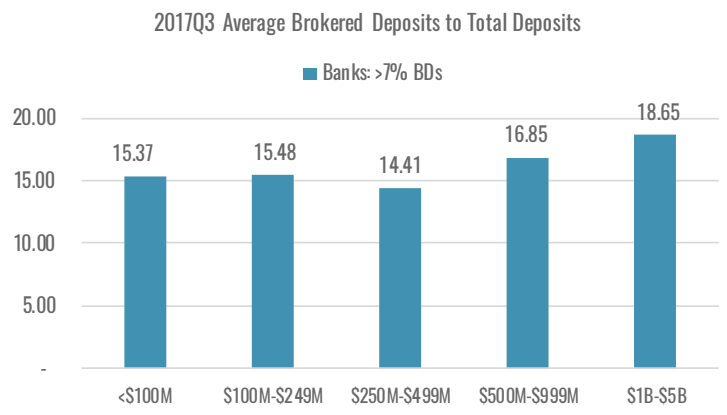

certain stigma associated with the use of brokered deposits, primarily due to regulator opinion.

These findings, based on 2017 financial performance (and consistent with 2016 findings) indicates that banks with brokered deposits as a group did register better results in key performance areas than those who choose not to use brokered deposits in their funding strategies. We included capital as a category this report period to provide a broader perspective when considering overall health of the two groups. The most significant difference between the two groups was growth, with no indication of credit quality issues or other types of weakness. If growth is a critical component of your strategy, and your lack of core deposits is inhibiting your plan, you may want to consider this study when assessing market ready funding solutions .