CD UPDATE: BANK FAILURES

Investors that understand the details behind FDIC coverage have an advantage in ensuring they're adequately compensated for the risks they're taking.

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Introduction

In the nineteen months between January 2007 and July 2008, the U.S. banking system has experienced "failures" at ten depository institutions, about the same as the number of banks that went out of business in the prior five years. That group of ten includes most notably IndyMac Bank, which was seized by the FDIC on July 11, making for third largest bank failure in history after Continental Illinois in 1984 and American S&L in 1988. The FDIC, or Federal Deposit Insurance Corp, an arm of the government charged with protecting depositors and the safety of the banking system is meanwhile anticipating further problems that could force the agency to seize as many as 90 more institutions before the ongoing financial crisis resolves itself. Against this back drop, it's more important now than ever for investors to understand the protections–and the limits on those protections–that they receive for investing in FDIC-insured instruments, namely brokered certificates of deposit, or CDs.

While we'll explain some of the concerns facing CD investors in more detail, there are a few major points that are particularly important to be aware of in today's environment:

- Understand the details behind FDIC insurance coverage limits.
- Beware of potentially overlapping coverage, for example: a checking account, an FDIC insured money market, and a brokered CD at the same institution count together against coverage limits.
- Know that accrued interest on a CD counts against FDIC coverage limits.

FDIC Insurance

The primary mechanism for ensuring the safety of consumer deposits in banks is FDIC Insurance, which is backed by the full faith and credit of the U.S. Government. FDIC coverage allows depositors to recover up to the insured amount in the event a bank does fail. While there are a number of complexities in calculating coverage limits, individuals generally have up to $100,000 coverage for individual accounts and up to $250,000 for self-directed qualified retirement accounts, such as IRAs. The coverage each account type is separate and not cumulative, meaning that a depositor in a bank with $110,000 in an individual account and $240,000 in an IRA account is not covered for the $10,000 overage. The same principles apply to coverage in an individual account versus a joint account–$100,000 per person, separate and not cumulative.

FDIC Insurance Coverage Limits

Account Type	Maximum FDIC Coverage
Individual	$100,000
Qualified Retirement Acct (IRA)	$250,000
Joint - 2 Person	$200,000
Trust - 1 Beneficiary	$100,000

Source: Janney FI Strategy; FDIC

While this coverage does represent a valuable protection for CD investors, it's crucial to understand the limitations on FDIC insurance coverage. First of all, insurance applies to a given individual at a given bank. As a result, no distinction is made between a checking account, traditional bank CD, and a brokered CD. For example, if an investor has a $50,000 checking account, and a $75,000 brokered CD at ABC Bank, both in individual accounts, only $100,000 of the total $125,000 is covered by FDIC insurance. Particularly for major national banks that handle many individuals' personal banking business and that issue brokered CDs, it's very important to ensure that there's no overlap that would exceed coverage limits. Even if a bank appears "safe," it doesn't make sense to invest in excess of coverage limits, as depositors aren't paid for taking on the extra risk and would be better served in other investments. This also applies to FDIC insured money market products offered by a number of broker/dealers, including Janney. **These products place cash balances into banks, so it's very important to be sure that there's no overlap between the banks in an FDIC money market fund, the banks at which an investor has a checking, savings, and/or CD account, and the banks from which an investor purchases brokered CDs offered by Janney and other broker/dealers.**

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At the same time, it's worth noting that many financial companies actually operate through separate banks. For example, a major national financial company may operate one bank headquartered in New York and another separately chartered bank headquartered in Utah. The two banks in this example are actually separate for insurance purposes, so an investor with an individual account can have $100,000 in protection from each bank.

FDIC Insurance Coverage Individual & IRA

Name	Account Type	Amount
Jane Depositor - Indiv.	Checking	$ 110,000
Jane Depositor IRA	1yr Brokered CD	$ 240,000
Total Value		**$ 350,000**
- Max Coverage Indiv		**$ 100,000**
- MaxCoverage IRA		**$ 250,000**
Uninsured Amount		**$ 10,000**

FDIC Insurance Coverage Individual & Joint

Name	Account Type	Amount
Jane Depositor & Jim Depositor - Joint	3m Brokered CD	$ 200,000
Jane Depositor - Indiv.	6m Brokered CD	$ 100,000
Total Value		**$ 300,000**
- Max Coverage (2 owners joint)		**$ 200,000**
- Max Coverage (Individual)		**$ 100,000**
Uninsured Amount		**$ -**

Source: Janney FI Strategy; FDIC

One other frequently overlooked point about FDIC insurance is that the $100,000 limit (or $250,000 for retirement accounts) covers both principal and accrued interest. Accrued interest is the periodic coupon payment than an investor earns on a CD or bond in the time between scheduled coupon payments. For example, for each day that an investor holds a $100,000 5% CD, that investor is owed $13.70 in interest payments, but the payments are typically only made on a semiannual basis. For FDIC insurance purposes, this accrued interest gets tacked back on to the principal amount to define an investor's full exposure. As a result, an investor who purchases a $100,000 CD in an individual account will actually exceed the coverage limits and will be exposed to the issuer in the amount of the accrued interest which, for a 5% CD with semiannual payments, could total as much as $2,500. As a result, we recommend purchasing CDs in an amount 5% below the applicable limit (i.e., $95,000 for individual accounts and $237,500 for retirement accounts).

> If there are two lessons from recent bank failures, they're simple: limit investment to the FDIC caps and be aware of bank exposure in all its forms, be it checking accounts, FDIC money market funds, or brokered CDs.

Bank Failures

In the U.S., depository institutions are basically not permitted to go out of business. Instead, when a bank or thrift becomes too distressed to continue operating, the FDIC steps in and effectively takes over the bank with the full backing of the federal government. For brokered CD holders, this takeover can result in one of two outcomes. In many cases, the FDIC lines up a buyer for a distressed bank and sells that bank within hours or days after taking it over. In this case, the acquiring institution can elect to acquire the brokered CDs of the distressed bank; if the acquirer chooses to do so, the brokered CDs remain outstanding, but become the obligation of the acquirer. Essentially, from an investor's perspective, the CDs simply change name. Typically, in such a case, FDIC coverage is based on the bank that initially issued the CD and not on the current CD obligor. For example, if XYZ Bank failed and its brokered CDs were acquired by ABC Bank, an investor owning CDs in XYZ and ABC prior to the acquisition would have up to $200,000 in coverage. In many cases, the additional coverage "lapses" after a 6 month period.

FDIC Insurance Coverage Limits

Name	Account Type	Amount
Jane Depositor	1yr XYZ CD (Failed Bank)	$ 95,000
Jane Depositor	5yr ABC CD (Acquirer)	$ 75,000
Total Value		**$ 170,000**
- Max Coverage - 6mos		**$ 200,000**
Uninsured Amount		**$ -**

Source: Janney FI Strategy; FDIC

The alternative to another institution taking over a failed bank's brokered CDs is for the FDIC to repay outstanding brokered CDs, up to the applicable insurance coverage limits. In such an event, the FDIC promises repayment within 60 days, though experience suggests that funds are usually returned within several weeks. During the period between bank seizure and CD repayment, however, investors do not continue earning interest, which represents a lost opportunity cost. In addition, investors with deposits in a bank above the applicable FDIC limits will likely experience a partial or total loss of the excess portion of their investment.

For additional information, see the FDIC website at http://www.fdic.gov