Passing the bucks

By Charles Ward

US banks have long been encumbered by the $100,000 cap on federal deposit insurance. Now a new mechanism lets them swap deposits, effectively extending insurance coverage and making them much more competitive.

Remember Sir Joseph Wilson Swan? He was the *other* inventor of the electric light bulb. While Swan and Thomas Edison filed their patents within a year of each other, it was Edison who more clearly understood—and acted upon—the commercial potential of the new invention. Swan was knighted for his contributions to science; Edison's various companies eventually counted their customers in the millions. The fact is, the history of business is mostly unforgiving of second-to-market entries.

So when a team of banking industry leaders came up with the idea to create a network mechanism to allow participating US banks to share and extend among themselves one of their strongest competitive advantages—government-backed deposit insurance—they knew they wanted to get it up and running quickly. The concept was to help the nation's 9,500 community banks address a decades-old problem—that Federal Deposit Insurance Corporation coverage on individual accounts is capped at $100,000 per account—by enabling them to swap their deposits over that amount. It would be the first time that community banks across the country had a way to offer their customers FDIC insurance on larger accounts.

"We thought it was a good idea, but thought someone else might think so too," recalls Alan Blinder, former vice chairman of the board of governors of the Federal Reserve System and now vice chairman of the new company, Promontory Interfinancial Network. "If you discover oil in your backyard, you can fairly assume it will be there next year. Ideas are not like that."

From that sense of urgency, Promontory was conceived, built and launched in just 20 months. The company was formed by Eugene Ludwig, former US Comptroller of the Currency and vice chairman of Bankers Trust Corporation; Mark Jacobsen, former chief of staff at both the Office of the Comptroller of the

Company profile: Promontory Interfinancial Network

Headquarters: Arlington, Virginia
Chairman and CEO: Eugene A. Ludwig
President and chief operating officer: Mark P. Jacobsen
Type of business: Banking services
Year founded: 2002
Total number of banks committed to the CDARS network: 500+

Currency and the FDIC; and Blinder. The team combined its knowledge of the banking industry with the technical expertise of its development partner, Accenture. The achievement—of instant scale, first-to-market arrival and reliability—is notable because Promontory created not only a company but its own market category, for the Certificate of Deposit Account Registry Service, or CDARS.

There was a clear market need for CDARS. Bankers throughout the country had been asking Congress to raise the $100,000 FDIC insurance limit for years, and customers in search of the security of coverage for larger amounts had been forced into increasingly convoluted means of getting it. For example, some individual depositors placed their funds at multiple institutions in $100,000 increments, a labor-intensive exercise that dilutes customer loyalty to a specific bank. Municipalities are obligated to require banks to pledge securities as collateral for any uninsured funds, a practice that is costly for banks, so the yield they offer municipalities is lower. Nonprofit groups, trusts and retirement plans were also constrained by the $100,000 cap. Corporations in need of secure liquidity often bypassed banks entirely, turning to Treasury bills and other avenues to meet their cash management needs.

The dramatic rise of money-market mutual funds run by large money-center and investment banks compounded the erosion of smaller banks' share of the customer wallet. The technology revolution in US financial institutions brought great efficiency and economies of scale to money-center banks, which were therefore able to attract more and more business from community and regional banks. Although the United States' nearly 9,500 smaller banks held more than $3 trillion in deposits in 2002, that figure represented just 25 percent of total deposits, half of what the small banks held in 1975.

The issue was not only market share. The shift of deposits out of communities to, in effect, the national capital markets had become a threat to the financial stability of individual community banks. "Core deposits are the straw without which you can't make the bricks of lending," notes Ludwig, Promontory's chairman and CEO. "The community banks have seen their loan-to-deposit ratios get markedly worse." Community banks are vital to the towns they serve, because they provide liquidity for local lending to small businesses and consumers.

CDARS, Promontory's new financial service, was conceived as a straightforward response to all these conditions. It enables member banks to offer customers FDIC coverage for multimillion-dollar deposits. When a bank joins the Promontory network, its customers can create a portfolio of CDs; each of the CDs is distributed to other network banks in increments of less than $100,000. A recipient bank sends back an equal amount of funds through CDARS, which allows the entire transaction to be booked as a deposit at the originating bank. Customers may choose among the network banks for their CDARS funds, but the entire chain of transactions is seamless to them. Importantly, the customer relationship stays with the primary bank, as no confidential financial information is forwarded to the other banks.

Collecting local deposits is the most inexpensive way for banks to fund their balance sheets. Participating banks base their CDARS interest rates on local conditions, as they do for any other CD, and they pay for Promontory's service only to the extent they use it. So, with CDARS, customers obtain security and convenience, banks obtain stable funding and customer relationships, and communities gain access to more funds for local borrowing. "From a public policy and macroeconomic perspective, this is the kind of thing we want to help lubricate our economy," says Ludwig.

The benefits of the CDARS idea seemed self-evident to its creators. Given the inherently conservative nature of community banking, though, Promontory needed to make a case for the safety, soundness and integrity of the system. To that end, it recruited a board of well-known figures from banking and the regulatory community, which conveyed both experience and integrity. In addition to Ludwig, Blinder and Jacobsen, the Promontory board includes two former FDIC chairmen, William Seidman and William Isaac; Edward Kelley Jr., recently retired from the Board of Governors of the Federal Reserve; and former US Senator Warren Rudman.

In addition, Ludwig actively invited feedback about the CDARS idea from banks. He particularly sought out banks that—because of their geographic dispersion, base of business experience, organizational structure or customer mix—would provide specific kinds of pre-launch input. Promontory's board composition, the outreach effort and the pre-launch testing of the CDARS system were instrumental in obtaining the endorsement of the American Bankers Association in early 2003.

Accenture, which had already worked on a number of similar projects, was approached and hired in August 2001. Promontory's funding partner, one of the world's premier clearing banks, was well aware of Accenture's role in managing the launch of FXall, an electronic foreign exchange portal. Accenture had also launched IntercontinentalExchange, a business-to-business commodities exchange, bringing the platform to market in just six months.

Working with Promontory's well-developed business plan, an Accenture team led by partner Chip Tsantes built out the design for the underlying CDARS technology platform over a 10-month period. Once the details of the plan were finalized and funding was secured, Promontory and Accenture opened the development throttle. Promontory owned no technology itself, so it relied upon Accenture to procure, customize, install and test its new system.

Building from scratch

The build-out phase—design, installation, testing and implementation—took just 26 weeks, and CDARS launched in January 2003. "We walked into an empty building, and six months later, we were transacting the first live CDARS," says Accenture's Tsantes. "Fortunately, we had the luxury of building from scratch, which meant we could create the system with a B2B information exchange at its core."

The CDARS platform uses some off-the-shelf components, such as a generic reporting package and sign-on pieces, and employs customized software to integrate systems for core transactions, reporting, security and accounting. Security is a critical aspect of the system, reflecting the paramount importance of the safety and privacy of data, both for the customer and the participating banks. Reliability was another pre-launch concern of the target banks, and so the CDARS technology platform was designed with system and function redundancy throughout.

Because the value of the Promontory network increases with expanded membership, quickly reaching critical mass of membership was a priority. Accenture developed training, operations and marketing modules in tandem with the technology installation to address both customer-facing issues and back-office issues. Banks can join the network and be online the same day. The entire system has been designed for intuitive ease of use. "Banks require the utmost in reliability and security, but at the same time, they place a premium on ease of use," says Jacobsen, Promontory's president and COO. "We set out to accomplish both: a state-of-the-art system that exceeds all bank regulatory guidelines while still being simple to use."

There are 9,500 banks in Promontory's target universe. Today, six months after launch, more than 500 of them are committed to the CDARS network. The combined assets of Promontory's target banks would make it one of the largest banks in the United States.

The advent of the CDARS service has allowed community banks to focus on their two chief competitive advantages—FDIC coverage and local relationships. The need by both household and business investors for greater security, particularly after the stock market crested in March 2000, has only highlighted these strengths. "Community banks, in the end, are relationship institutions, not processors of money," notes Ludwig. "CDARS is aimed at helping them reclaim their footprint in the economy." ■

Charles Ward is a New York-based business writer.