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October 14, 2010

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Re: Deposit Insurance Regulations; Unlimited Coverage for Noninterest-Bearing Transaction Accounts (RIN 3064-AD37)

Dear Mr. Feldman:

The Investment Company Institute[1] (ICI) appreciates the opportunity to comment on the FDIC's proposed rule implementing Section 343 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[2] Section 343 requires the FDIC to provide unlimited insurance for "noninterest-bearing transaction accounts" for two years starting December 31, 2010. On behalf of our member registered investment companies, which participate in the financial markets as both issuers of securities and major institutional investors, ICI has concerns about the potential implications of the proposed rule for the broader financial system.

Section 343 is intended to provide additional assurance to depositors of insured depository institutions, most notably corporations and other institutional investors, that their balances in noninterest-bearing transaction accounts will be safe as the financial crisis wanes.[3] As with any program

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $11.51 trillion and serve over 90 million shareholders.

[2] *Deposit Insurance Regulations; Unlimited Coverage for Noninterest-bearing Transaction Accounts,* 75 Fed. Reg. 60341 (Sept. 30, 2010) ("FDIC Notice").

[3] As the FDIC Notice indicates, Section 343 is similar to, but also differs in certain key respects from, the Transaction Account Guarantee Program ("TAGP") the FDIC first adopted in October 2008. Originally set to expire on December 31, 2009, the TAGP was extended through June 30, 2010 and subsequently through December 31, 2010. *See* FDIC Notice at 60342.

that insures customer funds, however, the insurance coverage authorized by Section 343 poses potential costs to taxpayers and raises the risk of dislocations elsewhere in the financial system. Presumably in recognition of these potential costs and risks, Congress granted circumscribed authority, requiring the FDIC to provide unlimited insurance for only specified accounts, and for only a two-year period.

Below we discuss the role of deposit insurance in promoting financial stability and the risks it can pose to the financial system. We then offer two specific comments on the FDIC's rule proposal:

- To help minimize costs to taxpayers and limit the risks of market dislocations, we urge the FDIC to assess a separate, transparent, and economically meaningful premium for the unlimited insurance on noninterest-bearing transaction accounts.

- We object to the FDIC's proposal to extend coverage to noninterest-bearing savings accounts into which funds from noninterest-bearing transaction accounts are swept. Covering these so-called "reserve sweeps" would increase the potential moral hazard and systemic risks associated with unlimited insurance and exceeds the authority granted by the Dodd-Frank Act.

1. Deposit Insurance: Benefits and Potential Risks

The economic role of a carefully designed deposit insurance program is to help promote stability across the entire economy. Banks have limited ability to liquidate assets quickly to meet large, unexpected withdrawals. Deposit insurance reduces the probability of bank runs by eliminating the potential advantage enjoyed by those depositors who are first to withdraw their money from a bank. Greater stability of bank deposits provides greater stability in the credit creation process and the overall economy.

Despite its demonstrated benefits, deposit insurance creates certain risks for the financial system. For example, insurance reduces the incentives for insured depositors to monitor the creditworthiness of banks, which in turn creates a moral hazard that can encourage banks to take additional risks, knowing that depositors will not withdraw their deposits if the bank's financial condition deteriorates.[4] In addition, deposit insurance can cause other systemic risks for financial markets by increasing the propensity for investors to sell off assets—such as stocks, bonds, mutual fund

[4] *See, e.g.,* Federal Deposit Insurance Corporation, The Deposit Insurance Funds: Options Paper (Aug. 2000), available at http://www.fdic.gov/deposit/insurance/initiative/optionpaper.html ("2000 Options Paper") (recognizing that "deposit insurance can create moral hazard and increase the risk and cost of failure if deposit insurance premiums do not fully compensate the FDIC for increases in risk posed by particular banks and thrifts. By assuming the risk of loss that would otherwise be borne by depositors, deposit insurance eliminates any incentive for depositors who are fully insured to monitor bank or thrift risk, thus reducing what is known as "depositor discipline." Management can therefore take greater risks without increasing the depository institution's cost of funds.").

shares, and other securities—and move the proceeds into insured deposits. As the FDIC itself has previously observed, this behavior can produce or exacerbate broader market dislocations during periods of financial stress.[5]

Indeed, recent experience demonstrates that such activity would worsen any future financial crisis and reduce credit available to businesses, state and local governments, and other borrowers. Depository institutions would be unlikely, and in many cases unable, to buy the assets investors were selling. As we saw with the financial crisis in 2008, such a series of events might cause the government to have to step in with other extraordinary measures to ensure ongoing functioning of the credit markets.

Historically, the risks posed by deposit insurance programs have been mitigated by capping the amount of a depositor's account that is insured (currently $250,000).[6] In the case of the insurance authorized by Section 343 of the Dodd-Frank Act, the statutory limits on the types of accounts covered and the December 31, 2012 termination date should serve to reduce the possible negative effects of the program while still providing a stable source of funding for banks as they continue to recover from the financial distress that emerged in 2008.[7] With the stability of the U.S. financial system at stake, the importance of these limits in Section 343 cannot be overemphasized.[8]

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[5] *See id.* ("There is also the possibility of a large shift of household assets into insured deposit accounts in the event of financial market volatility. There is currently more than $11 trillion outstanding in U.S. equity holdings (including mutual fund shares) alone. In a protracted bear market, some of these funds could be transferred to insured deposits."). *See also* Alan S. Blinder and R. Glenn Hubbard, *Blanket Deposit Insurance is a Bad Idea*, WSJ Asia (Oct. 16, 2008) (arguing that 100% federal deposit insurance would pull funds out of other assets, including money market funds and other money market instruments, as well as out of other countries, as occurred when deposits flowed from Britain to Ireland after Ireland instituted a deposit guarantee).

[6] *See* 2000 Options Paper, *supra* note 4 ("The coverage limit represents a balance between the goals of deposit insurance, on the one hand, and the need to limit moral hazard and the risk to taxpayers and the insurance funds, on the other.").

[7] For example, in proposing a limited extension of the TAGP beyond its earlier termination date of June 30, 2010, the FDIC noted that it was seeking to "maintain stability for [insured depository institutions] and to promote a continued and sustainable economic recovery. . . ." *See Amendment of the Temporary Liquidity Guarantee Program to Extend the Transactions Account Guarantee Program with an Opportunity to Opt Out*, 75 Fed. Reg. 20257, 20259 (April 19, 2010). The FDIC expressed its belief that a continuation of the TAGP would "help maintain community banks' ability to compete for and secure low cost large deposits, thereby preserving deposit franchise value and supporting the rebuilding of earnings and capital." *Id.*

[8] ICI pointed to similar concerns and risks associated with any potential unlimited federal guarantee of assets invested in money market mutual funds, notably the risk of exacerbating the financial crisis by drawing large sums of deposits away from banks. See Investment Company Institute, *Report of the Money Market Working Group*, March 17, 2009 ("MMWG Report"), at 64-65. As noted in the MMWG Report, these risks are not theoretical. As a result, during the development in September 2008 of the Treasury Department's Money Market Fund Guarantee Program, ICI was a strong proponent of limiting the coverage of that program.

2. A Separate Premium Would Reduce Moral Hazard and Systemic Risks

The FDIC Notice is vague on how the unlimited insurance will be priced. It indicates only that the FDIC does not intend to assess a separate premium for Section 343 insurance and "will take into account the cost for this additional insurance coverage in determining the amount of the general assessment the FDIC charges [insured depository institutions] under its risk-based assessment system."[9] The absence of greater specificity about how the costs of this insurance will be paid raises serious concerns.

First, insurance premiums can play an important role in moderating moral hazard.[10] ICI is concerned that the FDIC's proposed pricing approach may not result in premiums for the Section 343 coverage that depository institutions will view as economically meaningful and that it therefore may not provide an effective check against moral hazard and the resulting risks to other sectors of the money markets.

Second, if the unlimited insurance is not priced appropriately, this could provide a financial incentive for insured depository institutions to accept more transaction account deposits than would normally be warranted. For example, with balances in noninterest-bearing transaction accounts now fully insured, institutional cash managers would be more willing to place their excess cash in such accounts. Depository institutions would in turn seek to attract as much of that excess cash as possible—they pay no interest on those account balances, yet would be able to reinvest the cash at a positive rate of interest in either the federal funds market or in short-term Treasury securities.

Third, we do not believe it is appropriate to "lump in" the costs of the temporary, unlimited insurance coverage for noninterest-bearing transaction accounts required under Section 343 with the ongoing deposit insurance—capped at $250,000 per account—that depository institutions pay for under the FDIC's general assessments. The significant differences in these insurance programs suggest that they should be priced separately.

It is true that the unlimited nature of the Section 343 insurance coverage makes the insurance difficult to price; for example, it is impossible to predict how much money might flow into covered accounts in the event of another financial crisis. But this challenge arises regardless of whether the FDIC imposes a separate premium charge or seeks to reflect the cost of Section 343 coverage as part of

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[9] FDIC Notice at 60344 (citation omitted).

[10] *See, e.g.*, Federal Deposit Insurance Corporation, Keeping the Promise: Recommendations for Deposit Insurance Reform (April 2001) at III.B, available at http://www.fdic.gov/deposit/insurance/initiative/direcommendations.html; Christine Bradley & Valentine V. Craig, Federal Deposit Insurance Corporation, *Privatizing Deposit Insurance: Results of the 2006 FDIC Study*, FDIC Quarterly (Last updated July 3, 2007), available at http://www.fdic.gov/bank/analytical/quarterly/2007_vol1_2/.

the general assessment.[11] In either case, failure to align the price of the insurance with the expected benefits will increase the risk that taxpayers will be forced to share the costs with the depository institutions and account holders who are the direct beneficiaries of this unlimited insurance.

We urge the FDIC to assess a separate, transparent, and economically meaningful premium for the unlimited coverage of noninterest-bearing transaction accounts. A separate premium should serve to reduce moral hazard of the insured depository institutions by imposing a cost on the unlimited insurance and thus on risk-taking behavior by such institutions. A separate premium also may provide greater assurance that the costs of the insurance will be paid by those who benefit directly from it. As an additional advantage, an explicit premium would help the FDIC, Congress and taxpayers better monitor the net costs of the program.

3. The Proposed Coverage of Reserve Sweeps Exceeds the Authority Granted by Congress

Under the proposed rule, "reserve sweeps" would be treated as eligible for the unlimited insurance coverage required by Section 343 of the Dodd-Frank Act. The FDIC Notice states that "such accounts would be considered noninterest-bearing transaction accounts" for this purpose.[12]

As the FDIC Notice explains, reserve sweeps involve an arrangement in which where a single deposit account is divided into a transaction account and a savings account (typically, a money market deposit account, or MMDA). An algorithm designed to minimize required reserves dictates the amount and frequency of sweeps between the transaction and savings accounts. The Federal Reserve and bank regulators, including the FDIC, have long permitted depository institutions to link transaction accounts with one or more savings accounts to minimize required reserves.[13] Thus, in effect, the proposed rule would allow depository institutions to "have their cake and eat it too": they would be permitted to treat noninterest-bearing savings accounts as non-transaction accounts for purposes of avoiding reserve requirements, while treating them as transaction accounts to take advantage of unlimited insurance.

ICI opposes this aspect of the proposed rule. Extending unlimited insurance coverage to reserve sweeps significantly increases the pool of eligible assets. As a result, there is greater risk that the potential negative effects of unlimited insurance (*i.e.,* moral hazard and market dislocations) will come to pass.

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[11] Moreover, we note that under the TAGP, a separate premium is assessed for the insurance coverage provided through that program, suggesting that it would be feasible to take a similar approach in implementing Section 343. *See id.* at 60342.

[12] *Id.* at 60343.

[13] *See* 12 C.F.R. § 204.2(d)(2). See also, Op. Associate General Counsel (FRB), November 2, 1999; Op. Chief Counsel (OTS), March 2, 1998.

More importantly, the proposed treatment of reserve sweeps is at odds with the plain language of the Dodd-Frank Act. Section 343 clearly limits the availability of the unlimited insurance solely to "noninterest-bearing transaction accounts," defined as those:

- with respect to which interest is neither accrued nor paid;
- on which the depositor or account holder is permitted to make withdrawals by negotiable or transferable instrument, payment orders of withdrawal, telephone or other electronic media transfers, or other similar items for the purpose of making payments or transfers to third parties or others; and
- on which the insured depository institution does not reserve the right to require advance notice of an intended withdrawal.

Reserve sweeps do not satisfy this test and, in particular, its second prong. The account holder has no right to withdraw money from the savings account to make payments or transfers to third parties or others; rather, the depository institution manages transfers between the account holder's transaction account and the linked savings account for the depository institution's benefit. These transfers by the depository institution are opaque to the account holder. All account holder withdrawals are made from the transaction account.

In support of its proposal, the FDIC cites 12 CFR 360.8. But that regulation deals with the process by which the FDIC determines the amount of deposits in an account for insurance coverage purposes. It does not support treating reserve sweeps as transaction accounts for purposes of Section 343.

Moreover, while we recognize that reserve sweeps are covered under the TAGP, that fact is irrelevant given the express language of Section 343. Unlike the contours of the Section 343 insurance coverage, the terms of the TAGP are not based on a specific Congressional mandate.[14]

In short, Section 343 of the Dodd-Frank Act appears to preclude treating reserve sweeps as noninterest-bearing transaction accounts for purposes of the unlimited insurance coverage it requires. As discussed above, in enacting Section 343, Congress imposed certain limits in an effort to mitigate the potential negative effects of unlimited insurance. To avoid expanding such coverage—and its associated costs and potential risks—beyond the parameters established by Congress, the FDIC must refrain from extending unlimited deposit insurance to noninterest-bearing reserve sweeps.

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[14] *See, e.g.,* FDIC Notice at n.2 and accompanying text.

ICI appreciates the FDIC's attention to our comments. If you have any questions, please contact me at 202/326-5815 or Brian Reid, ICI's Chief Economist, at 202/326-5917.

Sincerely,

/s/

Karrie McMillan
General Counsel