Public Funds Investment Institute
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October 21, 2024

Federal Deposit Insurance Corporation
550 17th Street NW Washington, DC 20429
Attention: James P. Sheesley, Assistant Executive Secretary

Re: Request for Comments on Deposits--RIN 3064–ZA42

Greetings,

These comments are submitted by the Public Funds Investment Institute, an independent nonprofit organization whose mission is to inform, educate and advocate for the $4 trillion public agency investor community.

The Federal Deposit Insurance Corporation (FDIC) is seeking information on (1) how banks measure and monitor the stability of uninsured deposits, what additional data would be helpful to the FDIC, to the banking industry and to the general public to monitor deposit run risk and deposit stability generally and (2) the merits of insurance reform options described in the FDIC's May 2023 report on Options for Deposit Insurance Reform.

1. Information on Deposit Characteristics

Question 1.a. of the Request for Information specifically relates to collateralized or secured deposits (also known as "preferred deposits"). Preferred deposits are the predominant or exclusive form of deposit accounts for state and local governments. They differ from the general class of uninsured deposits in two key respects: 1) They are collateralized in accordance with state laws, and 2) they are an essential part of a payment system that is funded with taxpayer money and supports vital public services, including emergency and public safety services. These differences may lead public unit depositors to behave differently than the broader group of depositors in uninsured accounts, and we believe they also justify differences in the rules that should apply to protect preferred deposits and the assessment of deposit insurance premiums.

We hypothesize that public unit accounts provide a stable base of uninsured deposits, particularly for community banks, and that public unit depositors are less likely than the general class of uninsured depositors to run to large banks that are perceived to be too big to fail when the banking system is under stress.

We believe that these differences should be reflected in targeted insurance reforms, as described in part two of this submission, and if the FDIC implements risk-based insurance assessments the differences should be reflected in premiums paid by public unit depositors.

Among factors that may result in different behavior with regard to preferred deposits by account holders, by an Insured Deposit Institution (IDI), or by regulators we note the following:

1. Collateralization may alter the perception of risk that public unit depositors have.
2. Public agency banking activities are subject to a high level of public scrutiny and to the political process. This may result in different behavior related to run risk. For example, the high transparency arena in which public agency officials operate may raise the sensitivity of public officials to the risk of adverse publicity and reduce the threshold that precipitates deposit withdrawals. Or, public units could be reluctant to move money from a community bank during times of industry stress, lest the public unit be viewed by constituents as magnifying a local bank problem.
3. Public agency banking is often subject to laws and policies that indirectly affect run risk such as those that are designed to promote community reinvestment or linked to economic development lending. These factors may influence the choice of banks by a public agency or retard activities to move deposits quickly.
4. The essential public purposes that are supported by preferred deposit accounts may argue for prioritizing these accounts in resolution activities.

We support efforts of the FDIC to enhance data collection and reporting of deposits to improve transparency around their operation and urge that a data collection framework include elements that would enable testing of the hypothesis that preferred deposits have different run risk and liquidity requirements than the broader universe of uninsured deposits.

One objective of such enhanced data collection and analysis should be to enable bank regulators to better understand the run risk of state and local government deposits, compare the risk with that of other uninsured accounts, and compare the risks to the size and other key business metrics of IDIs. A second objective should be to better understand the ways in which government services would be affected by resolution actions. A third objective should be to provide uniform information on deposit flows and deposit account characteristics across the banking system to enable public units to better manage their individual deposit relationships.

The current requirement is for banks to report estimates of uninsured deposits from institutions with assets in excess of $1 billion. Banks report the total of preferred deposits on an annual basis but there is no detail on the nature of the collateral or the source of the deposit. This reporting requirement misses important information on flows and volumes of preferred deposits. The FDIC should consider collecting data on a frequent basis from all institutions, but also consider ways to minimize the burden of detailed reporting for small institutions or those where uninsured and/or preferred deposits constitute only a minor portion of their deposit base.

Enhanced reporting should gather information that would help the public better understand the dynamics of bank operations and help depositors assess the risks associated with uninsured deposits.

Among the data that specifically relate to preferred deposit accounts:

1. The extent to which community involvement, either through mandates or incentives such as linked deposit programs play a role in deposit gathering/retention.
2. The character of collateral, especially whether it is comprised of FHL Bank letters of credit, specific securities, or backed by pooled securities programs.
3. The use of deposit brokers.

To minimize the burden on IDIs the FDIC should consider alternatives to universal collection, particularly with regard to information whose sole or primary use would be to evaluate deposit insurance reform. IDIs, especially those that are small, complain about the overwhelming nature of requests for information. One-time surveys and sampling as alternatives to universal forms-based reporting of data may ease the burden on depositories.

2. Comments on Insurance Reform

The FDIC's May 2023 report on options for insurance reform evaluated three options: 1) maintain existing limited coverage, 2) expand coverage to be unlimited and 3) target coverage and changes in coverage to provide different levels for specific types of accounts. Much of the focus in the report and in follow-on commentary has been on the need for targeted coverage to increase the level of insurance for business payment accounts. This recognizes the vital role for business accounts in the payments system.

There is also a need to tailor insurance coverage to the needs of state and local government depositors. This would recognize deposit characteristics, limitations and behaviors that differ from those of other uninsured depositors—which are mainly businesses.

While public unit deposits are not treated separately under the current arrangement, there is historic precedent for separate treatment. In 1974 when the insured account limit was raised to $40,000 for depositors generally, it was raised to $100,000 for public unit time and savings deposits held by state and political subdivisions. Later changes eliminated this difference in favor of uniform limits, although there exists an expanded aggregate limit of $500,000 for accounts of state or local governments if the depository is in the state of the public unit.

There are three reasons to tailor insurance for public units:

1. There is a long-recognized objective of protecting taxpayer dollars and monitoring robust payment systems to support public services. We believe raising insurance limits for public unit accounts is an efficient way to do this without adversely affecting systemic run risk.

2. There is reason to believe that public unit accounts are a strong and steady source of deposits for community banks. The extent of this effect remains to be demonstrated—something that should be an objective of the effort to gather information on deposit characteristics that we commented on in the first part of this submission. That said, mandates to deposit public funds in local IDIs and linkages between deposits and community/economic development initiatives provide a baseline for this assertion.
3. Tailored insurance could reduce the use of collateral to support public unit deposits in excess of insurance limits. Specifically:

    - Collateralizing deposits is inefficient because the specific requirements are subject to state laws that vary by state.
    - Administration is costly for IDIs and depositors.
    - Positioning collateral may encumber its use to support back-up liquidity for the IDI. At a minimum this complicates speedily tapping liquidity facilities such as the Federal Reserve's Discount Window.
    - Access to and disposition of collateral related to preferred deposits that are subject to the differences in state laws is likely to complicate speedy resolution efforts, particularly where an IDI has collateralized deposits in multiple states.

While the most efficient way to address these issues might be to provide unlimited insurance for public unit accounts, we recognize that this raises a host of issues around fairness and moral hazard. A feasible alternative would be to raise insurance limits for public unit accounts which would provide widely understood assurance to smaller and mid-sized municipalities who lack to resources to conduct detailed ongoing surveillance of the financial condition of their depositories and of the valuation and administration of pledged collateral. We believe this would advantage community banks, deter the impulse to move deposits to the "too big to fail" banks, and reduce the use of collateral, limiting it for all but the largest state and local government depositors.

For example, we estimate that raising the limit to $2 million for all deposits in an IDI or by setting a maximum limit of $5 million per public unit could eliminate the need for collateral for all but the 50 states and the largest local governments. States that administer collateral programs on behalf of their local governments (e.g., California, Florida, New Jersey to name a few) would also experience savings because the need for collateral programs would be greatly diminished. Expanding data collected by the FDIC would help make this analysis more precise.

A targeted increase in insurance should not be considered an increase in security for public unit accounts. Rather it would shift the security from collateral to insurance. Insurance is more easily understood by depositors, it is more efficient to administer than collateral, and it is uniform across states. In these respects it should reduce run risk without inflating moral hazard and, over time if costs are evaluated comprehensively it should reduce the overall cost of protecting the banking system.

Public agencies had $751 billion in bank deposits at the end of the first quarter of 2024, roughly equally split between transaction accounts and time and saving accounts whose primary purpose is investment. That is about $8.3 million per public unit.

The current insurance limit for public units is $250,000 for all deposits in an out-of-state bank but can be expanded to $500,000 if the depository is in-state, the deposits are in demand deposit and time deposit accounts, and the maximum in either type of account is less than $250,000.

Public agencies address the requirement to secure deposits by limiting deposits in any single bank to $250,000 or by requiring collateral. Both are costly and cumbersome. Spreading deposits among many banks has led to the creation of a mini industry of reciprocal deposit services that help a single bank take a large deposit and parcel it out to multiple unrelated banks. But this is not without cost; the services charge 10 basis points or more, paid for by the bank which then passes the cost on to the depositor in the form of a lower interest rate.

Moreover, strict accounting for these deposits requires that the public unit record each separate bank deposit on its books, instead of the lump sum deposit in a single bank. This is so cumbersome that often public units simply book the deposit as a single entry, complying with the spirit if not the letter of accounting requirements. (They rely on and assume the deposit arranger maintains sufficient records of ownership that is within insurance limits.)

The alternative, requiring collateral from a bank, has its own costs and complexity. There is no single standard or short form for a collateral agreement; its terms depend on Federal banking law and the laws in both the state where the public unit is situated and the state where the depository is situated. Valuing and monitoring collateral is complex. Thus, best practice may not always be followed, especially by smaller governments.

From the bank's vantage point collateralizing is also cumbersome and expensive. The rules differ from state to state; only some assets are eligible for collateral and valuation requirements vary. And dedicating collateral to a public funds account limits its availability to support liquidity programs, such as borrowing from the Federal Reserve's Discount Window.

A $2 million limit targeted to state and local governments may seem like a large boost, but normalizing it against inflation or the growth of overall bank deposits suggests it would be modest. The current limit of $250,000 was set in 2008. The Deposit Insurance Reform Act of 2005 provided for inflation adjustments every five years but this provision was eliminated by the 2008 legislation to make permanent the $250,000 limit. Adjusting the $250,000 limit for inflation since 2008 would result in a limit for 2024 of approximately $365,000; adjusting the $500,000 aggregate limit would result in an aggregate limit of $730,000. Another context the growth in total bank deposits from $7.3 trillion in January 2009 to $17.4 trillion in January 2024. Applying this growth factor of 2.38 to the $250,000 limit results in a limit of approximately $596,000. Applying the factor to the $500,000 aggregate limit results in a limit of approximately $1.2 million.

Conclusion

We appreciate this opportunity to submit comments in response to the RFI. We recognize that insurance reform requires Congressional action. A robust banking system is vital to the operation of state and local governments and there is a strong history of protecting public unit deposits. We believe that increased transparency around these deposits and improved efficiency around protecting them will serve the banking system and the taxpayers well.

Sincerely,

Marty Margolis
Founder, Public Funds Investment Institute