Feature Article:

Increasing Deposit Insurance Coverage for Municipalities and Other Units of General Government: Results of the 2006 FDIC Study

Foreword

The Federal Deposit Insurance Reform Conforming Amendments Act of 2005 (FDIRCAA) required that the Federal Deposit Insurance Corporation (FDIC) study the feasibility and consequences of privatizing deposit insurance, establishing a voluntary deposit insurance system for deposits in excess of the maximum amount of FDIC insurance, and increasing the limit on deposit insurance coverage for municipalities and other units of general government. In February 2007, the FDIC sent its report to Congress. The results of the FDIC's findings on privatizing deposit insurance and establishing a voluntary deposit insurance system for excess deposits appeared in previous issues of the ***FDIC Quarterly*** *(available at www.fdic.gov/bank/analytical/quarterly/index.html).[1] This article summarizes the FDIC's findings on providing additional coverage for municipal and other public deposits.*

Introduction

Industry consolidation, globalization, the expanding use of technology, and other changes in the banking industry have dramatically altered the financial landscape. Accordingly, in March 2000, the FDIC began a comprehensive review of the deposit insurance system to ensure that it would continue to meet its responsibilities as deposit insurer in this new banking environment. Additional coverage for municipal deposits was one of many issues to emerge during this review, and the FDIRCAA required the FDIC to study the issue further. This article examines the findings from the FDIRCAA study, including the arguments for and against additional coverage for municipal deposits. It then considers whether options that are currently available in the private sector provide a viable alternative to traditional public deposit collateralization programs.

[1] Christine Bradley and Valentine V. Craig, "Privatizing Deposit Insurance: Results of the 2006 FDIC Study," *FDIC Quarterly* 1, no. 2 (2007): 23–32, and Bradley and Craig, "Establishing Voluntary Excess Deposit Insurance: Results of the 2006 FDIC Study," *FDIC Quarterly* 1, no. 3 (2007): 30–35.

Background

Municipal, or public, deposits are the funds of a state, county, municipal, or political subdivision that are held as deposits in an FDIC-insured institution.[2] Municipal deposits held in the same state as the public entity are insured up to $200,000 ($100,000 in time and savings accounts, and $100,000 in demand deposits) in any one depository. Out-of-state public deposits are insured up to $100,000.[3] To limit the risk to public entities and, ultimately, local taxpayers, most state laws require banks to collateralize public deposits, typically with high-quality government securities, to the extent that they are not covered by federal deposit insurance (see Text Box on page 36.) At the end of 2006, state and local governments had $2.4 trillion in financial assets.[4] Of this amount, FDIC-insured commercial banks held $289.7 billion, of which almost 76 percent ($219.3 billion) was uninsured and secured.

Throughout the 1990s and into the next decade, depository institutions faced new funding challenges as asset growth outstripped the growth of core deposits. It was against this backdrop that FDIC-insured institutions began to look more closely at municipal deposits as a potential source of liquidity.[5] Between 2000 and 2005, several bills were introduced in Congress that would have increased coverage of municipal deposits. A number of the bills recommended that the FDIC insure 80 percent of in-state municipal deposits above

[2] Public deposits also include deposits of Puerto Rico and other U.S. possessions and territories, and deposits of Indian tribes. 12 C.F.R. § 330.15(a)(2)-(5)(2007).

[3] 12 C.F.R. §330.15(a)(2) (2007). Insurance coverage for municipal deposits, as for general deposits, may be adjusted for inflation beginning January 1, 2011. Federal Deposit Insurance Reform Act of 2005, Pub. L. No. 109–171, § 2101–2109, § 2103, 120 Stat. 4, 9–11 (2006) (to be codified at 12 U.S.C. § 1821(a)(1)(F)).

[4] Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States*, December 6, 2007, www.federalreserve.gov/releases/z1/Current/z1.pdf (accessed January 3, 2008), p. 66.

[5] Christine M. Bradley and Lynn Shibut, "The Liability Structure of FDIC-Insured Institutions: Changes and Implications, *FDIC Banking Review* 18, no. 2 (2006): 1–37.

the basic insurance coverage limit, up to a maximum of $2 million. Other legislative measures suggested that the maximum coverage for in-state municipal deposits be raised to $5 million or that the FDIC provide 100 percent coverage of all municipal deposits, regardless of size. In August 2000, the FDIC evaluated various reform options, including additional coverage for municipal and other public deposits, but did not take an official position.[6] In 2003, then FDIC Chairman Donald E. Powell commented on one legislative proposal to increase coverage for municipalities:

> Raising the coverage level on public deposits could provide banks with more latitude to invest in other assets, including loans. Higher coverage levels might also help community banks compete for public deposits and reduce administrative costs associated with securing these deposits. On the other hand, the collateralization requirement places a limit on the ability of riskier institutions to attract public funds, while a high deposit insurance limit would not. Traditionally, we [the FDIC] have taken a dim view of treating one class of deposits—in this case, municipals—dramatically differently than the others, and we have communicated that concern to Capitol Hill.[7]

While Chairman Powell expressed reservations about raising the limit on municipal deposit insurance, proponents of excess deposit insurance presented a number of reasons for increasing the coverage amount.

Arguments for Increasing Municipal Deposit Coverage

Early proponents of excess deposit insurance for municipalities argued that increased coverage would allow municipal deposits to remain in local institutions, where they would be used to meet local needs.[8] In recent years, other arguments have emerged. Proponents contend that increased municipal deposit coverage would make bank operations more efficient and less costly, provide a higher degree of safety and additional protection for taxpayers, and permit smaller institutions to compete more effectively for these deposits.

Bank Costs. Increasing municipal deposit insurance coverage would benefit insured institutions by lowering bank costs. State collateralization laws that require banks to secure municipal deposits with low-risk, low-yield investments impose opportunity costs by preventing participating institutions from investing in higher-yielding assets. It is estimated that collateralization typically costs 15 to 25 basis points in yield on the assets used to collateralize the deposits.[9]

Safety of Public Deposits. Increasing municipal deposit insurance coverage would provide a higher degree of safety for public deposits. For collateralization to safeguard public deposits, the collateral must be adequate and the security agreement enforceable. In situations involving bank fraud, collateral may be missing or otherwise unavailable if an insured institution fails. The failure of Oakwood Deposit Bank in February 2002 illustrates this risk. When the Ohio bank failed, some municipal depositors discovered that the collateral securing their deposits was valued at significantly less than agreed, while other depositors found that the bank had pledged the same collateral multiple times. Even if there is no malfeasance, the market value of the collateral may have deteriorated at the time of the failure.

Proponents of additional coverage for municipal deposits argue that because these deposits primarily consist of taxpayer funds, increasing the coverage limits would reduce local government exposure to a bank's credit risk and, ultimately, provide additional protection to taxpayers.

Competition for Municipal Deposits. Increased insurance coverage for municipal deposits may allow smaller institutions to compete more effectively for these deposits without having to pay higher interest rates. However, recent data suggest that smaller institutions are already attracting these deposits. As of December 31, 2006, FDIC-insured institutions with less than

[6] Federal Deposit Insurance Corporation, *Options Paper*, Washington, DC: FDIC, August 2000, www.fdic.gov/deposit/insurance/initiative/OptionPaper.html (accessed January 8, 2008).
[7] Federal Deposit Insurance Corporation, *Reducing Regulatory Burden—Deposit Insurance Coverage*, Washington, DC, FDIC, 2003, www.fdic.gov/regulations/resources/reducing/comments/DI.html (accessed September 27, 2006).
[8] For example, U.S. Congress, House *Report on Federal Deposit Insurance Reform Act to May 16, 2002*, 107th Cong., 2nd sess. H. Rep. 467; (2002) and U.S. Congress, House *Report on Federal Deposit Insurance Reform Act to March 27, 2003*, 108th Cong., 1st sess. H. Rep. 50 (2003).
[9] Steve Cocheo, "You Want $5 Million in Deposits to Be Insured?" *ABA Banking Journal* 95, no.11 (2003): 28–30.

$1 billion in total assets held only 15.2 percent of total insured deposits but approximately 24 percent of all collateralized public deposits.

Arguments against Increasing Municipal Deposit Coverage

There are three primary arguments against increasing municipal deposit insurance coverage: (1) additional coverage is not justified on the basis of the traditional goals of deposit insurance; (2) increasing coverage for municipal deposits could adversely affect moral hazard and market discipline; and (3) excess coverage is likely to increase deposit insurance assessments.

Consistency with Traditional Goals of Deposit Insurance. The traditional goals of deposit insurance are to promote financial market stability by maintaining depositor confidence in the banking system; to protect the country's local, regional, and national economies from the disruptive effects of bank failures; and to protect the deposits of small savers.[10] While there are credible arguments for increasing the insurance coverage of municipal depositors, the traditional goals for the insurance program provide little justification for such an increase. In addition, as mentioned earlier, the FDIC does not generally advocate favoring one depositor class over another.[11]

Effect on Moral Hazard and Market Discipline. Greater insurance coverage for public deposits could remove an aspect of market discipline that is currently in the system.[12] State and local governments are generally considered more financially sophisticated than the average small saver and better able to monitor the performance of the depository institutions they use. Increasing insurance coverage on public deposits removes the incentive for public depositors to monitor the risk behavior of their depository institutions, thus increasing moral hazard. Also, to the extent that collateral requirements no longer constrain the investment options of depository institutions to investments in "safe assets," such as Treasury securities, depository institutions have an incentive to invest in riskier assets, increasing their overall risk profile.

Effect on Deposit Insurance Assessments. FDIC-insured deposits would likely increase by at least $277.8 billion (the total amount of uninsured, secured public deposits held by commercial banks and thrifts as of year-end 2007) if all municipal deposits were fully insured.[13] An increase of this amount at the end of December 2007 would have reduced the reserve ratio of the Deposit Insurance Fund from 1.22 percent to 1.15 percent, potentially leading to higher assessment rates.[14] The financial industry press has reported that industry support for additional coverage of municipal deposits diminished when it became apparent that deposit insurance premiums might increase as a result.[15]

Structuring Increased Municipal Deposit Insurance

Congressional authorization would be required for the FDIC to provide excess deposit insurance for municipalities and other general units of government. However, the FDIC has considered a number of options for structuring this additional coverage, including limiting its availability, restricting excess coverage to protect taxpayers and the insurance fund, and establishing a

[10] See, for example, Christine M. Bradley, "History of Deposit Insurance," *FDIC Banking Review* (13: 2) 2000, pp. 1–25; Gail Otsuka Ayabe, "The Brokered Deposit Regulation: A Response to the FDIC's and FHLBB's Efforts to Limit Deposit Insurance," *UCLA Law Review* (33), December 1985, pp. 594–641.

[11] Although the FDIC supported increased coverage for retirement accounts, it did so for unique reasons. First, increasing the coverage level for retirement accounts should help increase the saving rate by encouraging depositors to invest more of their retirement savings in insured bank deposits. Second, retirement accounts are usually held for the long term and depositors are less likely to respond to higher-yield offers or other attempts by riskier banks to gather deposits quickly. This would not necessarily be the case with insured municipal deposits.

[12] See, for example, Congressional Budget Office, *Modifying Federal Deposit Insurance*, 2005, www.cbo.gov/ftpdocs/63xx/doc6342/05-09-DepositInsurance.pdf (accessed March 5, 2008).

[13] As explained later in this article, excess coverage might be made available only on a limited basis, in which case the increase in insured deposits might be less.

[14] Under the FDIC Reform Act of 2005, whenever the reserve ratio for the Deposit Insurance Fund falls below 1.15 percent (or is projected to fall below 1.15 percent within six months), the FDIC must adopt a restoration plan that provides that the reserve ratio reach 1.15 percent within five years. 12 U.S.C. § 1817(b)(3)(E) (2007).

[15] See, for example, Steve Cocheo, "Community Bankers See Pluses and Minuses in FDIC Reform Plan," *ABA Banking Journal* 93, no. 6 (2001): 7–9.

premium pricing structure based on risk.[16] Each option seeks to limit the FDIC's loss exposure, constrain moral hazard, and restrict the ability of riskier banks to use municipal deposits as a source of deposit gathering. State legislatures could assist in meeting these goals by amending their laws so that excess municipal deposits could be placed only in institutions that are eligible to receive increased insurance coverage.

Availability. Excess municipal deposit coverage might be made available only on a limited basis. For example, term policies could be cancelled if an institution failed to maintain the qualifying standards, or only well-capitalized institutions might be eligible to offer increased coverage. If a participating institution lost its eligibility to offer extra coverage, the insurance coverage of existing municipal deposits could revert to the amount covered under the general deposit insurance rules after some period (unless the excess coverage were allowed to continue on existing municipal deposits).[17] Although a depository institution could be required to be responsible for informing public officials of any loss of coverage, this responsibility might be shifted to the FDIC to ensure that depositors received prompt and adequate notice.

Caps and Other Limits. A cap could be placed on the amount of additional coverage for a municipal depositor. In addition, the municipal depositor might share in any loss on the excess deposit. For example, insurance coverage for any municipal depositor could be limited to a maximum of $2 million per institution, or only 80 percent of the excess deposit might be insured up to the designated cap.

Despite the appeal of a system in which municipal depositors share in any losses, such a system has the potential to contribute to a bank run in the event of financial problems, as recently occurred in the case of Northern Rock in the United Kingdom. Under the British deposit insurance system, only 90 percent of the deposit above a basic level is covered by insurance.[18] As a result, most depositors stood to lose money if Northern Rock failed, which contributed to a run on the bank when it experienced financial difficulties.[19] Because deposits made by municipalities are typically quite sizable, public withdrawals during a period of financial difficulty would likely exacerbate a bank's liquidity problems. The prevention of bank runs has been one of the great successes of the U.S. deposit insurance system, and any change that might diminish the ability of this system to contain bank runs would need to be carefully considered.

Other limits could be imposed on additional insurance coverage for municipal deposits. For example, to control aggressive deposit gathering and consistent with some state requirements, increased insurance coverage could be limited to deposits from a municipality in the same state as the insured institution. Limits could also be placed on the aggregate value of the public deposits held by any one institution.

Pricing. A decision would need to be made as to whether all participating institutions would pay a uniform premium. One option might be to reduce the premiums of participating institutions based on the amount of low-risk assets held, but not pledged, as security. Another possibility would be to deduct low-risk assets from the total value of the municipal deposits assessed, which might reduce some of the administrative costs associated with a strict pledging arrangement.

Private Sector Options

There are public sector options currently available that allow depository institutions to satisfy the safety requirements of many municipal authorities without requiring collateralization or increased FDIC coverage. These options include surety bonds and deposit-placement services. (Reinsurance, which was discussed in a previous issue of the *FDIC Quarterly*, is a private sector option that could be used to limit the FDIC's exposure

[16] Because of the added costs involved, we have assumed in this part of the discussion that premiums for excess municipal deposit coverage would be paid only by institutions that offered the additional coverage. However, this need not be the case. Assessments for excess deposit insurance could be structured so that all insured institutions bore the additional cost.

[17] Pass-through coverage for employee benefit plans and coverage for brokered deposits do not terminate when a bank or thrift ceases to become eligible to accept them. 12 U.S.C. §§ 1821(d) and 1831f.

[18] Under the British deposit insurance system, approximately the first $4,000 is fully insured, and 90 percent of the next $68,000 receives insurance coverage. Unlike the U.S. system, deposits held at failed British banks are not immediately available.

[19] In the case of Northern Rock, the Bank of England and the British Treasury provided depositors with greater assurances than required under the law.

Current Practices in Supervising and Administering Collateral

All states currently require one of three options for the supervision and administration of collateral: uniform statewide collateralization; statewide collateral pools; or uncoordinated, autonomous collateral pledging.*

Uniform Statewide Collateralization. This model prescribes a single system of collateralization for all political subdivisions throughout the state. States that use a uniform statewide system commonly require that public deposits be fully collateralized. Local officials are typically responsible for enforcement and implementation of the collateral requirements under this system. Banks bear the full expense of establishing the custodial account and forgo the higher income they would normally earn by making loans.

Although full collateralization of public funds would appear to completely protect municipal deposits, a number of risks remain. For example, the market value of the collateral pledged by the bank may turn out to be less than the face value, making the protection inadequate. This can occur when the collateral accepted by the government entity is subject to interest rate risk, credit risk, or liquidity risk. One example is municipal bonds. These bonds, which are accepted as collateral in several states, are interest-rate sensitive and contain liquidity risk because they have a limited secondary market. A shallow secondary market can also delay recovery for the depositor. For example, mortgage-backed securities, which are accepted as collateral in some states, have recently lost market value because of their perceived credit risk. Finally, fraud can result in unexpected losses to the collateralized depositor. (Fraud is a potential risk in any of the three collateralization options.)

Statewide Collateral Pools. Some state legislatures have created statewide collateral pools. These pools are supervised by a central state agency that administers all collateral set aside by banks as security for the portion of the municipal deposits not covered by FDIC deposit insurance. For example, Florida requires that banks deposit with the state central agency acceptable securities equal to 50 percent of the deposit not covered by FDIC insurance. Statewide collateral pools reduce the costs to individual depository institutions in two ways. First, banks save the cost of individually supervising and administering the assets used as collateral. Second, because full collateralization is not required, a greater portion of an institution's assets can be invested in higher-yielding assets, such as loans. Local governments and agencies also save with this method, as a central agency manages the administration of the collateral. States typically require the collateral pool to exceed the total public deposits held by the largest institution in the state.

Uncoordinated, Autonomous Collateral Pledging. Some states permit public treasurers to obtain collateral for public funds at the treasurer's discretion. This method, called the "home rule" or permissive approach, places complete responsibility for collateralization practices with local officials. However, because of the lack of uniformity in collateralization agreements, each agreement must be separately negotiated by the depository institution and the public official. This lack of standardization results in an increased risk of error or negligence in market-monitoring processes and safekeeping procedures, as well as an increased cost to the depository institution. This increased cost is usually passed on to the municipality through deposits bearing a lower yield.

---

* Much of the information about the supervision and administration of collateral is derived from Corinne M. Larson, *An Introduction to Collateralizing Public Deposits*, Government Finance Officers Association, 2006.

to excess coverage of municipal deposits.[20] Reinsurance is not discussed further in this article.)

Surety Bonds. Most states allow municipal governments to protect their local deposits by means other than collateralization. At least 30 states allow the use of a surety bond. Surety bonds, which are issued by insurance companies, guarantee the payment of principal and interest on the covered deposits. Most states provide guidelines for insurance company eligibility. Surety bonds eliminate much of the administrative burden for both the municipality and the bank because they do not require custodial agreements, security agreements, or a continual revaluation of the collateral. In the event of a default, payment on the bond is generally made within two days. From the bank's perspective, these bonds are more economical and efficient because they do not tie up bank security, thus saving the bank administrative and opportunity costs normally associated with collateralization.

Despite their advantages, some public officials are wary of using surety bonds because the municipality must relinquish some control. For example, the municipality is not part of the contract negotiation, which is between the bank and the insurance company. Nevertheless, if proper precautions are taken, surety bonds can be a reasonable and efficient alternative to collateralization.

Deposit-Placement Services. As discussed in a previous issue of the *FDIC Quarterly*, the FDIC issued an advisory opinion in 2003 confirming that pass-through deposit insurance rules apply to funds placed with a deposit-placement service. As a result, FDIC-insured institutions that use deposit-placement services can, in effect, insure deposits in excess of the statutory limit.[21] Currently, a depositor can obtain insurance coverage for a $50 million deposit by using a deposit-placement service. These services can reduce the administrative costs of collateralization. They also reduce the opportunity costs incurred when the bank sets aside collateral necessary to secure municipal deposits.

Because most state laws clearly describe how public deposits must be secured, use of a deposit-placement service may require state legislative action. However, some states (for example, Missouri, Ohio, and Oregon) have amended existing laws to permit their use. Other states are allowing local governments to use deposit-placement services with certain restrictions, such as requiring municipal deposits to be kept within the state or placing a limit on the amount of the deposit.

Summary

Increased federal coverage for public deposits could benefit local communities, lower bank costs, and increase safety for taxpayers. However, additional municipal deposit insurance would represent a departure from the traditional goals of deposit insurance and would likely increase both moral hazard and deposit insurance assessments. Credible private sector options, in the form of surety bonds and deposit-placement services, currently offer protection for municipal deposits. If federal deposit insurance coverage were to be increased on municipal deposits, concerns about increased exposure to the Deposit Insurance Fund, moral hazard, and appropriate pricing of such coverage would need to be addressed.

Authors: Christine M. Bradley
Sr. Policy Analyst, cbradley@fdic.gov

Valentine V. Craig, CFA,
Sr. Program Analyst, mcraig@fdic.gov

[20] Bradley and Craig, "Establishing Voluntary Excess Deposit Insurance."
[21] Ibid. A bank belonging to a deposit-placement service can divide large deposits into $100,000 increments, which it transfers to other participating institutions, resulting in full coverage of the deposit.

REFERENCES

Ayabe, Gail Otsuka. 1985. The "Brokered Deposit" Regulation: A Response to the FDIC's and FHLBB's Efforts to Limit Deposit Insurance. *UCLA Law Review* 33:594–641.

Board of Governors of the Federal Reserve System. 2006. Flow of Funds Accounts of the United States, March 9. Federal Reserve Statistical Release. www.federalreserve.gov/RELEASES/z1/20060309/z1.pdf (accessed January 10, 2007).

Bradley, Christine M. 2000. History of Deposit Insurance Coverage. *FDIC Banking Review* 13 (2):1–25.

Bradley, Christine, and Valentine V. Craig. 2007. Privatizing Deposit Insurance: Results of the 2006 FDIC Study. *FDIC Quarterly* 1 (2):23–32.

_____. 2007. Establishing Voluntary Excess Deposit Insurance: Results of the 2006 Study. *FDIC Quarterly*, 1 (3):30–35.

Bradley, Christine and Lynn Shibut. 2006. The Liability Structure of FDIC-Insured Institutions: Changes and Implications. *FDIC Banking Review*, 18 (2):1–37.

Cocheo, Steve. 2001. Community Bankers See Pluses and Minuses in FDIC Reform Plan. *ABA Banking Journal* 93 (6):7–9.

———. 2003. You Want $5 Million in Deposits to Be Insured? *ABA Banking Journal* 95 (11):28–30.

Congressional Budget Office. 2005. Modifying Federal Deposit Insurance. http://www.cbo.gov/ftpdocs/63xx/doc6342/05-09-DepositInsurance.pdf (accessed March 5, 2008).

Federal Deposit Insurance Corporation (FDIC). 2000. Options Paper. http://www.fdic.gov/deposit/insurance/initiative/OptionPaper.html (accessed January 10, 2007).

———. 2003. Reducing Regulatory Burden—Deposit Insurance Coverage. FDIC. http://www.fdic.gov/regulations/resources/reducing/comments/DI.html (accessed September 27, 2006).

Larson, M. Corinne. 2006. *An Introduction to Collateralizing Public Deposits*. Government Finance Officers Association.

U.S. Congress. House. 2002. *Report on Federal Deposit Insurance Reform Act to May 16, 2002*. 107th Cong., 2nd sess. H. Rep. 467.

———. 2003. *Report on Federal Deposit Insurance Reform Act to March 27, 2003*. 108th Cong., 1st sess. H. Rep. 50.