



ABA Community Bankers Council Public Funds Advisory Group Overview and Findings August 16, 2000

I. OVERVIEW

Earlier this year, the ABA Board of Directors requested that the ABA's Community Bankers Council form a subgroup within the Council to explore issues related to the use of public funds by community banks. The Board requested that this subgroup advise ABA's leadership in the following areas:

- The advisability of expanding existing deposit insurance coverage on public funds;
- The extent to which state collateral/pledging and other requirements inhibit the use of public funds as a viable funding mechanism for community banks, and possible ways of overcoming such obstacles; and
- The potential role for the ABA, at both the federal and state levels, in facilitating the use of such public funds.

The ABA Public Funds Advisory Group, consisting of nine members of the Council from geographically diverse areas of the country, engaged in a number of discussions on this topic. The diverse perspectives expressed during these discussions illustrated the complexity of the issue and the differing impact that varying state and local approaches to public funds distribution have had on the availability of such funds to individual community banks.

EXECUTIVE SUMMARY

In general, the Advisory Group views public funds as a viable and important source of bank funding, and recommends that ABA work to maintain and improve the ability of community banks to access such funds. Importantly, many community bankers view the acceptance of public funds as part of their mission to serve their community's financial needs. For a variety of reasons, however, the Advisory Group recommends that the ABA pursue incremental, rather than broad-based, reform in this area.

The attractiveness of public funds is dependent upon a variety of local considerations and obstacles, such as the cost of these deposits, the availability of required collateral, the interest of the state/municipality in making such deposits available to insured depository institutions, and the potential volatility associated with holding such deposits. The Advisory Group recognizes that all of these local factors significantly affect the degree to which a community bank can rely on such funding, as well as the level of importance individual community banks place on the need for reform in this area. The Advisory Group also notes that the myriad of entrenched local approaches that states/municipalities have developed over the years may impose limits on the ability to obtain broad-based reform.

In addition to these local issues, the Advisory Group notes that public funds generally make up a relatively small portion (under 7%) of the overall deposit base of community banks. As a result, the Advisory Group believes that the ABA should view public funds as *one of many* potential funding sources for a community bank, and should carefully weigh the benefits of any reform in this area against the potential economic and political costs.

For example, the Advisory Group cites the potential “moral hazard” that could accompany 100% deposit insurance on these deposits, given the potential interest rate escalation that might result from riskier depository institutions in need of funding bidding up the rates associated with these deposits. Moreover, the Advisory Group remains concerned over the potential increased deposit insurance premium assessments that the banking industry could incur as a result of expansion of deposit insurance coverage in this and other areas. The Advisory Group questions the wisdom of incurring the potentially significant economic and political price that could accompany broad-based reform in this area.

Notwithstanding the above, the Advisory Group recommends that the ABA pursue incremental ways to facilitate the greater availability of public deposits to community banks, believing that the “more funding tools available to community banks, the better.” As set forth in the “Findings” section, below, the Advisory Group recommends that the ABA explore:

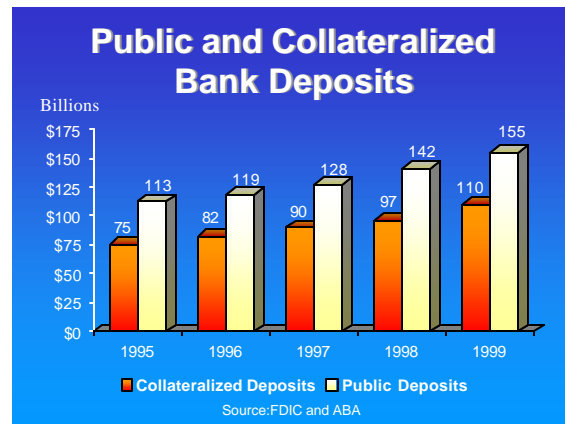
- The viability of supplemental deposit insurance for public deposits, including risk-based approaches to such insurance;
- Promoting the acceptability, at the state level, of broader categories of collateral eligible to be pledged against public funds;
- The feasibility of supplemental private insurance alternatives (such as the use of surety bonds), the effect of which would be to reduce collateral requirements;
- A study on the comparative pricing of various alternatives in the public funds area, including a “menu of options” for community banks to choose from to suit their particular needs; and
- Other potential opportunities that may arise in this area during continued debate on deposit insurance reform issues.

Potential advances in these areas would provide assistance to community banks in their continued use of public deposits as a source of funding for local economic development.

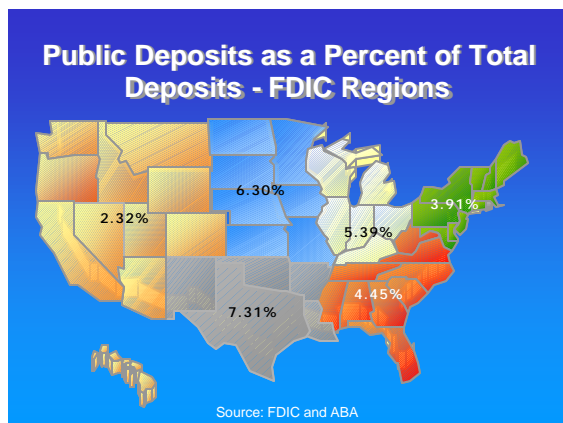
II. BACKGROUND

(a) Industry Snapshot

Public deposits held by commercial banks surpassed \$150 billion as of the end of last year. The vast majority, \$110 billion, of these deposits are collateralized as part of a state public deposit program. The high proportion of public deposits that are collateralized demonstrates the significant interest on the part of the states in protecting their public funds.



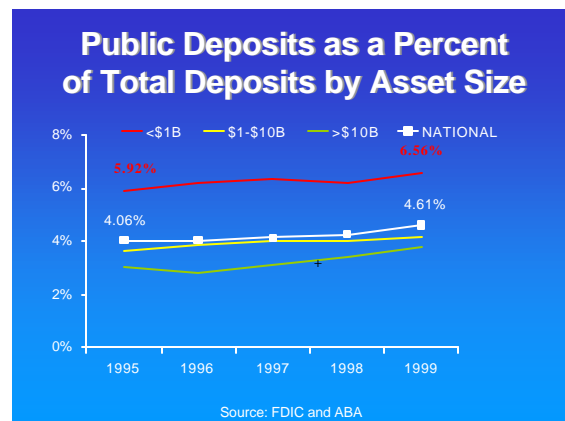
While public deposits make up only a relatively small proportion of all deposits, surveys by the ABA indicate that bankers increasingly view FHLB advances and public deposits as important to bank funding. Recent public deposit growth is consistent with these survey results. Since 1997, public deposits have been growing faster than total deposits, driving their percent of total up from 4.14 percent to 4.61 percent.



There are distinct regional differences in the existing reliance on public deposits for bank funding. Banks in the Southwest, Midwest, and Central FDIC regions have higher percentages of public deposits than other portions of the nation.

Banks in the West generally have markedly lower levels of public deposits than banks in other regions. California banks, in particular, have relatively few public deposits (two percent of total) in part due to competition from the state retirement fund and high collateral requirements.

Community banks with assets of less than \$1 billion tend to have higher percentages of public deposits than banks of larger size. Public deposits in these banks represented 6.56 percent of all deposits, nearly 2 percent higher than the national average. However, as evidenced by the differing levels of public deposits held by individual members of the Advisory Group, community banks will vary widely as to the degree to which they rely on such deposits.



(b) Effect on Deposit Insurance Funds

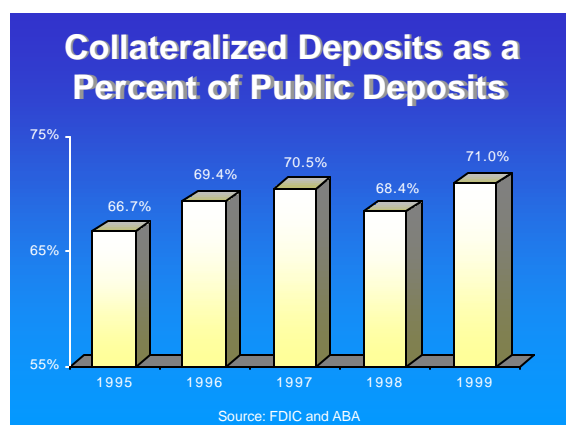
The Advisory Group examined the impact of any increase in public deposit insurance on BIF and SAIF reserves both by itself and in the context of other ABA priorities, particularly raising overall deposit insurance to \$200,000.

Presently, BIF and SAIF reserves are at historically high levels - the “coverage ratios” (the ratio of fund balances to insured deposits) of the two funds stood at 1.35 and 1.44 percent, respectively, as of March 31, 2000, comfortably above the designated reserve ratio of 1.25 percent. Because the overwhelming majority of financial institutions are well-capitalized and in the lowest possible risk category, over 92 percent of banks and savings associations currently do not pay an insurance assessment to the FDIC. Under existing law, as long as their risk and capitalization profile does not change, and the BIF and SAIF coverage ratios remain above 1.25 percent, these institutions will continue to be free of an insurance assessment.

The Advisory Group noted that expanding deposit insurance coverage would have a significant impact on the balance of the insurance funds. Based upon preliminary ABA Staff estimates¹, it appears that the BIF coverage ratio could drop to approximately 1.25 (the designated reserve ratio) if insurance on all deposits was raised to \$200,000. Looked at separately, fully insuring public funds would drop the BIF coverage ratio approximately six basis points, to 1.29 percent.

Taken together, it is estimated (again, preliminarily) that fully insuring public funds and increasing deposit insurance to \$200,000 would drop the BIF coverage ratio approximately six to seven basis points below the designated reserve ratio, resulting in the assessment of premiums on all BIF-insured institutions. In that SAIF’s existing coverage ratio is higher, and SAIF-insured institutions typically carry significantly fewer public deposits, increasing deposit insurance to \$200,000 and/or fully insuring public deposits does not drive that fund nearly as close to the designated reserve ratio.

(c) State Collateral Issues



At the same time that public funds have risen as a percentage of total deposits, particularly for community banks, deposits collateralized under state law have become an increasingly larger portion of all public deposits. Since 1995, collateralized deposits as a percent of public deposits have risen over four percentage points, to 71 percent.

Collateral requirements are not uniform across the fifty states. Forty-two states require the pledging of collateral against the uninsured portion of public deposits. In addition to their lack of uniformity, the

existing collateral requirements have a variety of negative consequences. Collateral is costly to

¹ The ABA leadership has instructed staff to undertake a full study of the potential economic impact of deposit insurance increases. This study will refine our current estimates.

Finally, the paper outlines a series of options for excess (supplemental) deposit insurance coverage that could be utilized for public funds. In the paper, the FDIC notes that this excess insurance could be either public (FDIC-backed) or private in nature. The paper also discusses the possibility of some form of coinsurance, whereby the FDIC would insure a proportion of deposits greater than \$100,000.³

III. FINDINGS

(a) Promote Supplemental Public Deposit Insurance

The Advisory Group recognizes that broadly expanded deposit insurance coverage for public deposits could present unacceptable economic and political risks to the banking industry. However, the Advisory Group does believe that supplemental insurance in this area could assist community banks in attracting these deposits, although minimal increases in insurance (*e.g.*, up to \$1 million) may provide insufficient benefits to all but a small number of community banks. In its option paper, the FDIC acknowledges the potential viability of some form of supplemental public deposit insurance above \$100,000.

- The Advisory Group recommends that ABA examine the viability and realistic cost of separate, supplemental FDIC deposit insurance at some level that would provide funding benefits to community banks. The Advisory Group believes that the cost of such supplemental insurance should be borne, on a pro-rata basis, by those using such public deposits, although concerns exist over the potentially prohibitive cost of such an approach. ABA should explore ways to reduce the pricing of such supplemental insurance, such as through the development of a risk-based system whereby strong institutions could obtain it at reasonable prices, with weaker institutions paying much higher rates or potentially being unable to obtain supplemental insurance at all.

(b) Encourage Acceptance of Broader Categories of Collateral at State/Municipal Levels

The Advisory Group finds that the costs, administrative burdens and availability of eligible collateral associated with state pledging requirements represents probably the most significant impediment to the use of public deposits by community banks as a funding tool. Importantly, members of the Advisory Group noted either a shortage of collateral generally, or in some cases, a lack of cost-effective collateral available to be pledged.

Moreover, they point out that it makes little economic sense to purchase additional collateral for the purpose of pledging against these public deposits, since the costs of such deposits and the returns from the collateral provide insufficient profit margins to justify this practice. As a result, community banks face significant practical impediments in this area. The Advisory Group strongly recommends that the ABA pursue a variety of ways to reduce these collateral burdens at the state level.

³ The paper notes that, although it was never implemented, the initial permanent plan for federal deposit insurance, adopted as part of the Banking Act of 1933, provided for coinsurance of deposits over \$100,000. The plan provided for full FDIC protection of the first \$10,000 of each depositor, 75 percent coverage of the next \$40,000 of deposits, and 50 percent coverage of all deposits in excess of \$50,000.

- The National Association of State Treasurers (NAST) is currently developing a set of best practices for public fund finance, including recommended collateral requirements. The Advisory Group sees this initiative as an opportunity for ABA to recommend improvements in state practices that can assist community banks in attracting and holding such deposits. For example, the ABA should:
 - Encourage NAST to endorse a broader range of acceptable collateral as eligible to be pledged against public deposits. States and municipalities vary greatly in their views as to what is acceptable here. ABA should encourage NAST to adopt positive recommendations on the acceptability of such collateral as Federal Home Loan Bank letters of credit, reinsurance and other alternatives (*e.g.*, various forms of collateral already deemed as acceptable by some state or states). Additionally, the use of sweep accounts to shift state and municipal monies out of traditional deposits and into investments accounts has the potential to add incentives for community banks to participate in the public funds market.⁴
 - Encourage NAST to recommend that states reduce the amount of collateral necessary to be pledged against public deposits held. States vary significantly in their approaches here, as well, with some requiring little or no collateral and others requiring collateral up to and sometimes exceeding the value of the public deposits held. A number of states have implemented pooled collateral programs that reduce the actual amount of collateral that a bank has to pledge against its public deposits, but which still ensure that the states remain adequately protected against risk.⁵ ABA should conduct further study on the issues involved in pooled collateral programs, and provide workable recommendations to the NAST on ways to reduce collateral requirements while protecting state funds.
 - Contact the Conference of State Bank Supervisors (CSBS) regarding the above points. In some states, the State Banking Commissioner has responsibility over aspects (*e.g.*, collateral administration) of the state's public deposits program. ABA should work with CSBS to accomplish the same ends that have been identified as to NAST.

⁴ A sweep account for a public entity can theoretically work in the same manner as business sweep accounts. The balances in the sweep customer's transaction account above a certain target are transferred automatically into a separate investment account. The sweep account could be attractive to the accountholder because the bank can offer a higher interest rate for the funds swept into the investment account, which in turn makes the account more competitive for the bank. The investment portion of the account is also taken off the bank's balance sheet.

⁵ In pooled collateral programs, each financial institution pledges collateral equal to a proportion – generally less than 100 percent – of its current public deposits, up to a certain net worth limitation. Any public deposits held by the institution in excess of the net worth limitation must be collateralized at one hundred percent. In addition, the depository must meet certain minimum financial requirements.

(c) Explore Feasibility of Private Insurance Alternatives

The Advisory Group discussed the potential that a variety of private insurance or bonding products can provide an alternative and/or supplement to public deposit insurance. Surety bonds, for instance, can be purchased in lieu of the pledging of securities to collateralize public deposits to the extent that a state allows it. Pricing of these bonds generally varies between 13 to 20 basis points, depending upon the financial institutions risk profile. Other forms of private “excess deposit” insurance follow the credit union model, whereby the institution provides the insurer with a non-refundable deposit equaling one percent of the deposits to be insured. The institution could also be subject to an insurance premium, depending upon their risk profile.

- The Advisory Group recommends that the ABA more fully evaluate supplemental private insurance alternatives that are accessible to community banks of varying sizes, including the potential development of products in this area. If it is determined that such products are viable, ABA should encourage NAST to recommend that states accept such products in lieu of, or as supplement to, existing collateral requirements.

(d) Conduct a Comparative Pricing Study/Develop a “Menu of Options”

Throughout the Advisory Group’s discussions, it became apparent that “price” is a primary factor in determining whether, and to what extent, community banks use public deposits as a funding mechanism. States and municipalities vary greatly in the degree to which they competitively price public deposits, and the costs associated with state/municipal collateral requirements likewise vary. When considering such things as the viability of supplemental deposit insurance, cost of collateral, and private insurance alternatives, the Advisory Group continued to discuss the relative cost of each alternative. Further work needs to be done in this area.

- The Advisory Group recommends that the ABA conduct a comparative analysis of the pricing, availability and feasibility of the alternatives recommended in this report. Such a study may also serve as an educational tool that can assist community banks in their use of public deposits as a funding mechanism, as well as provide assistance to NAST as that organization conducts its best practices review.
- The Advisory Group recognizes the difficulty in creating a single “broad-based” remedy for this complicated issue. As a result, the Group recommends that ABA provide a “menu of options” for community banks to choose from to suit their particular needs.

(e) Explore Other Opportunities

The Advisory Group is mindful that the continued debate on deposit insurance reform over the ensuing months may provide other opportunities for improvements in the public deposits area that facilitate the greater use of such funds by community banks. For example, as noted earlier, the FDIC’s Options Paper points out that in-state public deposits *currently* receive \$200,000 worth of deposit insurance coverage (\$100,000 in time and savings deposits, \$100,000 in demand deposits), as compared to \$100,000 coverage for out-of-state public deposits. Such

differentiation of “in-state” and “out-of-state” public deposits, whereby local deposits accrue greater deposit insurance benefits, creates incentives to keep public funds “local” and may provide important benefits to both community banks and their local communities. The Advisory Group would encourage the ABA to fully explore any future opportunities which arise in the public funds area that provide benefits to community banks.