Public Banks: FDIC Membership and the Collateral Requirement - Meritless Roadblocks

— Earl Staelin, attorney and chair, Rocky Mountain Public Banking Institute

Background:

“Public deposits” are deposits in a bank that belong to a government and its people, primarily consisting of tax and other revenues.

In the United States, laws governing the chartering of banks generally require a bank that holds public deposits to be a member of the Federal Deposit Insurance Corporation (FDIC) and/or to hold collateral equal to roughly 100% of the amount of its public deposits not insured by the FDIC. The collateral must be liquid or easily made liquid (e.g. short-term Treasuries). The percentage varies by state (in California it is 110%). In general, only major banks are big enough to qualify to hold most public deposits.

The requirements of FDIC membership and 100% collateral for uninsured public deposits were established solely with private banks in mind. For the reasons below, they are completely unnecessary for public banks that follow the Bank of North Dakota (BND) model and would substantially undermine their profitability and effectiveness.

A. Why FDIC membership should not be required of a public bank.

1. Under North Dakota law, all of the state’s revenues must be deposited in the BND. At a minimum, a public bank on that model will probably hold about $100 million in deposits. However, FDIC insurance only covers $250,000 per account. If the public bank has only one depositor, its government, then FDIC insurance covers less than ~1% of its deposits of $100 million. That means FDIC insurance is virtually worthless for such accounts, even if the bank divides up its accounts into a number of accounts of $250,000 or less. This is sufficient reason not to require FDIC membership for a public bank. Also, the Bank of North Dakota has done very well without it.

Other reasons for not having FDIC membership or insurance apply equally to the collateral requirement, presented below.

B. Why the requirement for ~100% collateral for public deposits not insured by FDIC should not apply to a public bank holding such deposits.

1. A prime purpose of FDIC insurance and the collateral requirement is to protect a bank from having many of its depositors panic and withdraw their deposits at once. A bank with the usual 10% reserves could become insolvent and collapse if more than 10% of its depositors withdrew their deposits at once. This “run on deposits” won’t occur with a public bank because the government is required by law to keep its deposits in the public bank. Todd Steinwand, president of BND, makes this point. Also, there are no other depositors to panic and withdraw their deposits. If local governments have deposits in the bank, they would commit to keeping their deposits in the bank in an economic decline to help ensure local economic stability.

2. Even if the government were not required to keep its deposits in the public bank, in an economic decline it would do so in order to increase lending enough to offset the decline. In that way the bank and economy will continue to prosper and generate needed tax income for the government. This is what the Bank of North Dakota did in 2008 and after, in partnership with community banks and credit unions with which it makes loans jointly, enabling North Dakota to be the only state to avoid the Great Recession and the BND to achieve record profits each year.

3. When a major private bank holds government deposits, it is handling "other people's money." Its goal it to maximize profit for the bank's shareholders, who mostly live outside the community. To pursue this goal, a major bank usually makes its loans and investments for projects outside the community, often for unsustainable purposes (weapons, war, toxic chemicals, private prisons, inflating real estate and stocks, etc.) at increased risk to itself and the economy. The major banks believe they are "too big to fail" and threaten to crash the economy unless they are bailed out or their uninsured deposits are "bailed in" (effectively confiscated) to prevent the bank from failing and "save" the economy. However, as economist and former Greek Finance Minister Yanis Varoufakis has recently argued, it would be better to let the banks fail and let the government take them over. The bank would then save the economy by immediately restoring and increasing lending to create new goods and services that do not create bubbles or endanger the economy. The bank would also avoid massive foreclosures of homes, businesses, and locally owned banks through refinancing, unlike the behavior of the major banks in the Great Recession, which caused widespread homelessness, business failures, massive unemployment, and poverty.

The major private bank's goal to maximize profit constitutes a significant conflict of interest with the goal of the government whose deposits it holds, which is to maintain a healthy and stable local economy. The public bank pursues its goal by lending for local businesses, infrastructure at lower cost, clean energy, affordable housing, home ownership without redlining, education and student loans, sustainable agriculture, health care, broadband, independent media, and other purposes that benefit everyone.

A public bank's goal to create a strong and stable economy is shared by the government that owns the bank. There is no conflict of interest between them.

The legislation creating the public bank establishes policies and guidelines that assure its soundness, providing stronger protections for the bank's profitability and solvency, safe lending, service to the community, and for a stable economy, which neither FDIC membership nor a collateral requirement addresses.

These policies and guidelines include:

a. Making loans only in its own state or community.
b. Making loans for projects that do not endanger health or the environment.
c. Operating with very low overhead (no branches, no ads, no ATMs, modest salaries and bonuses, no taxes, no private shareholders to pay dividends to).
d. Operating with safe lending practices that ensure consistent profitability, and avoiding derivatives, mortgage-backed securities, and similar unsound practices. With its safe practices, the Bank of North Dakota achieved an average return on

equity of 20% over the last 21 years and enabled North Dakota to be the only state to avoid the Great Recession.

e. Lending countercyclically: avoiding bubbles by not lending to inflate assets such as real estate or stocks but instead to create new goods and services; no commissions for making loans; and increased lending in an economic decline, just enough to prevent recession.

NOTE: Neither the FDIC, the Federal Reserve nor federal or state laws regulating private banks incorporate any of these sound practices and guidelines as they should. As a result, FDIC membership, the collateral requirement and other banking laws cannot prevent bubbles, inevitably followed by recessions, great or small, every six or seven years on average. Recessions destroy or seriously harm all kinds of businesses, banks, governments, other institutions, and individuals. As the economy crashes, major banks and corporations step in to buy up failed banks and businesses, real estate, and stocks for a fraction of their value, producing an even greater concentration of wealth and power in the 1% as well as more poverty and harm to our society and democracy.

Further, government deposits in TBTF banks will be at risk in a collapse because derivatives have first priority under bankruptcy law. Therefore, the unsecured deposits of the government are likely to be wiped out.

1. **A collateral requirement would strain the public bank's finances and unnecessarily reduce its profitability** by requiring the bank to hold large sums in liquid form at low interest rates that do little or nothing for the local economy and could be much better invested in loans that serve the local community.

2. **The government will guarantee its deposits held by the public bank with its full faith and credit, as BND's legislation does**. As noted, the Bank of North Dakota has never been a member of the FDIC. It has also never had a requirement for collateral for uninsured deposits. It has always done very well without such requirements. Based upon its sound operating practices, it regularly experiences a significantly lower default rate on its loans than private banks.

It is suggested that we enlist the support of experienced bankers, bank regulators, public banking experts and economists on our behalf concerning the inadvisability of imposing these requirements. They could help assure state and local legislators, treasurers, finance directors, governors, and local chief governing officials that a government's guarantee of its deposits in a public bank, plus the bank's governing laws, as described above, would be sufficient to ensure the financial soundness and accountability of the bank and that FDIC membership and a collateral requirement are unnecessary and would substantially undermine its profitability and effectiveness.

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