October 13, 2010

Mr. Robert Feldman
Executive Secretary
Attn: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: RIN # 3064-AD37

Dear Secretary Feldman:

Treasury Strategies is pleased to present our comments on your proposed implementation of Section 343 of the Dodd-Frank Act. As consultants specializing in treasury, payments and liquidity management for both financial institutions and corporations, we have a unique insight into the likely consequences of Section 343 and the Act itself.

Section 343, particularly in conjunction with the Act's Section 627 permitting interest on demand deposits (repeal of Regulation Q), poses significant systemic risks to banking and the financial system. The FDIC's proposed rules are generally an appropriate formalization of the Dodd-Frank legislation. We believe, however, that there are actions you should take to mitigate some of the negative effects. Further, we recommend that the FDIC join with other critical constituents to propose true financial system reform that will ensure the safety and soundness of the banking system.

We have highlighted below several shortcomings of Section 343 and offer three recommendations to mitigate some of the potentially destabilizing elements of the Act.

The move to provide unlimited deposit insurance to all banking institutions for a two year period poses several key risks to the U.S. banking system and, by extension, the economy. In short, it:

- Is unnecessary
- Duplicates other U.S. and global efforts to regulate banks
- Raises costs for consumers and businesses
- Nationalizes the cost of bank liquidity, transforming a "run on the bank" to a "run within the bank"
- Disadvantages money market mutual funds
- Substitutes FDIC assurances for bank capital
- Exacerbates the "too big to fail" problem
- Reduces the net stable funding within the banking system

Treasury Strategies, Inc.
309 W. Washington Street
13th Floor
Chicago, Illinois 60606
t 312.443.0840
f 312.443.0847

61 Broadway
Suite 905
New York, New York 10006
t 212.292.0856
f 212.292.0863

1 Northumberland Avenue
Trafalgar Square
London
WC2 N5BW
Great Britain
t +44 207 872 5551
f +44 207 872 5611
www.TreasuryStrategies.com

Unlimited deposit insurance is unnecessary

Banking institutions face little challenge today in raising deposits from consumers and corporations. U.S. bank deposits are at a record $7.8 trillion, up from $3.5 trillion ten years ago and $6.7 trillion at the beginning of 2008.

Banks currently hold $976 billion in excess reserves. That's up from a mere $2 billion in the first half of 2008, immediately prior to the introduction of unlimited deposit insurance. It's clear that deposit insurance resulted in a nearly one trillion dollar inflow of unneeded deposits.

Earlier this year, the FDIC permitted banks to opt out of TAG, the previous unlimited deposit insurance program that began in the fall of 2008. Banks representing over 70% of all U.S. deposits chose to opt out. There could be no clearer indication that unlimited deposit insurance is unnecessary.

It duplicates other U.S. and global efforts to regulate banks

The insurance is duplicative to requirements for higher capital, higher liquidity buffers and reduction in risk-taking activities. These activities, in concert, will create a banking system that is over-capitalized and overly liquid – which in theory sounds safe, but in actuality, would produce a system that fails to create the leverage needed to support economic growth.

Basel III, which is being implemented over the next several years, will require even more capital, liquidity and net stable funding. This is akin to a patient taking multiple remedies for the same illness.

The resultant compounding effect of duplicative regulation could have serious and unknowable consequences.

It raises the cost for consumers and businesses

The insurance provides a basis for significant deposit premium charges to be levied against banks; these costs will be recovered through lower spreads and higher fees directed toward consumers and businesses. Left unspoken in the Dodd-Frank Act is how the costs of these regulations will be recovered.

While our consulting work suggests it is too early to tell, it is reasonable to presume that higher capital and higher regulatory costs, including deposit premiums, will lead banks to charge higher fees, widen spreads on loans and deposits, and ration lower-risk activities on the balance sheet that carry a capital "tax."

It nationalizes the cost of bank liquidity

Banks need to maintain liquidity in order to meet withdrawals. They meet this liquidity requirement by investing in very short-term, low-risk securities. The cost of this liquidity is borne by the bank's shareholders in the form of slightly lower returns.

By designing a fully insured, non-interest-bearing transaction account (Section 343) alongside an interest-bearing transaction account (Section 627), the Act sets up a mechanism that changes the nature of a “run on the bank” to a “run within the bank.” With a single mouse click, depositors can instantly shift risk from the bank’s shareholders (a 627 account) to the FDIC (a 343 account). The bank still has sufficient liquidity since funds don’t leave. However, the cost of that liquidity is borne by the government, as it makes good on deposit guarantees, and not by the shareholders.

It disadvantages money market mutual funds

Unlimited deposit insurance disadvantages mutual funds and other substitute instruments relative to banking deposits.

Money market mutual funds pay dividends that approximate market rates of interest while at the same time providing customers with diversification, economies of scale and risk management.

While this is very attractive to both businesses and individuals, Section 343 upsets the market equilibrium and hands banks a huge competitive advantage.

In a 343 account, banks will be able to offer customers an “earnings credit.” Not explicitly interest, earnings credits offset fees and are provided at an imputed rate. Thus, companies will be motivated to move their cash into fully insured bank accounts and at the same time earn credits that will reduce their service fees.

It essentially substitutes FDIC assurances for bank capital

The insurance inappropriately positions the FDIC as the banking industry’s capital base, a role it is not positioned to play. In effect, this insurance removes the market as the guiding force for banks to appropriately manage risk and return. At a time when regulators are expecting banks to increase capital and limit risk, unlimited insurance implicitly encourages banks to take greater risks.

The first line of defense for this risk will be the FDIC insurance, which would enable even the riskiest banks to secure deposits, especially if those banks offer soft-dollar credits that enable deposit holders to receive transaction services. In effect, a bank taking on excessive risk could fund itself by compensating non-interest bearing deposit holders with “free” transaction services. Those services would carry an implicit interest rate at a premium to a short-term treasury obligation.

The Power of Experience®

It exacerbates the "too big to fail" conundrum

We demonstrated above that since the original expansion of deposit insurance in late 2008, bank deposits have grown by roughly $1 trillion, or 15%. At the same time, bank excess reserves have ballooned from virtually zero to $1 trillion.

Deposit insurance shifted $1 trillion from money market funds and other instruments into the banking system. The banks simply parked these funds as excess reserves at the Fed. Bank balance sheets remained high, even as U.S. consumers and businesses de-leveraged.

Now, the combination of side-by-side insured, non-interest-bearing transaction accounts (Section 343) and interest-bearing transaction accounts (Section 627) is an explosive cocktail that will increase flows into the banking system. "Too big to fail" banks will grow even larger.

It reduces the net stable funding of the banking system

An important measure of a bank's strength is the stability of its deposit base. One of the most stable forms of deposit is the "large time deposit." The depositor is locked in until the time deposit matures and thus cannot "run" during a crisis. Only shareholder equity and long-term debt are more stable.

Large time deposits are currently $1.8 trillion, fully 15% of the banking system's total funding. A large portion of these deposits is uninsured.

The Act shifts the basis for assessing insurance premiums from an insurance fee, based on deposits, to a tax, based on assets. Thus, when a bank takes on an asset (e.g., a small business loan) funded by a large time deposit, its insurance premium will increase, even though the large time deposit in excess of $250,000 is not insured. Effectively, this reduces the yield that a bank can pay on those time deposits by the amount of the premium.

The result is that the rate banks offer on large time deposits will fall by an amount equal to the new asset tax. Once that happens, some of these stable deposits will flow out of the banking system. This will leave the banking system with a deposit mix that is less stable and which poses a greater liquidity risk.

Our Recommendations

The above notwithstanding, we understand the FDIC has been instructed by Congressional action to develop rules implementing Section 343 of the Dodd-Frank Act.

1. **We recommend the FDIC define insurable non-interest-bearing deposits in a way that eliminates the one-sided "put" option the Act creates for interest-bearing depositors. Under the proposed rules, depositors with interest-bearing accounts could "put" those liabilities to the FDIC with the click of a mouse.**

Under the Act, customers simply need to transfer funds into the unlimited insured account when the bank is faced with failure. They receive interest up to the time of the transfer and unlimited insurance thereafter. By defining insured deposits as “the average balance collected within the insured account over the past 30 days,” rather than the actual balance at the time of a bank’s failure, the FDIC would eliminate the “put” option.

Implementing this definition would require more careful liquidity management on the part of the depositor. It would also free the FDIC from insuring the transaction float in those accounts.

2. **We recommend the FDIC join with other critical constituents to propose true banking reform that will ensure the safety and soundness of the banking system.**

   This reform should be done in concert with other regulatory changes impacting bank capital and liquidity rather than duplicate those efforts. Reform should also be done with an eye toward the needs of the end users of banking services.

   The accumulated impact of FDIC premiums, increased capital levels and more stringent liquidity buffers will weaken the banking system and lead institutions to raise fees and possibly take on more risk. Ultimately, the market will reach a new equilibrium to offset these costs and improve capital yield. The outcomes could include: higher fees, lower yields on deposits or higher rates on loans, contraction of bank balance sheets or an increase in off-balance sheet risk to rebalance the risk/return equation. While some element of these outcomes may be desired, these impacts should be more precisely understood before the FDIC and other constituencies introduce such a material risk into the financial system.

3. **The Act calls for the insurance extension to end on December 31, 2012 - the FDIC should make certain that date is absolutely the end of the program.**

   The nature of this extension reflects a lack of confidence in the banking system and the sooner the market realizes that this measure is temporary, the less likely deleterious impacts will become formalized in the system and thus difficult to unwind (e.g., if temporary, banks will not take long-term actions to rebalance the economics).

Again, we appreciate the opportunity to present our views and would be happy to discuss these ideas further.

Sincerely,

Anthony J. Carfang, Partner
David C. Robertson, Partner