FINDING CLOUT: REPOSITIONING MUNICIPALITIES IN THE BANKING MARKET

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ABSTRACT

American municipalities have a lot of cash but not a lot of clout in the local banking markets. Collateralization rules in most states means that only the biggest banks are interested in the deposits of even the smallest cities and yet those are the institutions least likely to loan those deposits within the borders of the investing municipality. It is possible to create an intermediate institution to accept municipal deposits and reinvest them in local banks. Such a structure would allow municipal deposits to be broken up into units small enough for any bank while avoiding the administrative burden on city bookkeeping. This would tend to redirect public funds to local investment and can reduce pressure on government budgets. Such an institution would be a natural place to launch local lending initiatives, and could provide a platform for a variety of programmatic initiatives to increase local economic activity or to consolidate services among a group of municipalities. Institutions like this can also be a concrete step forward in the attempt to inject consideration of the public good into the financial system, as well as a way to alleviate some of the financial pressures on municipalities.

WHAT IS THE PROBLEM?

American municipalities across the country keep a great deal of cash in their local bank. The Census Bureau counts 35,879 municipalities in the United States, many of which possess daily cash balances of several millions of dollars.[1] Even a fairly small town of 10,000 people is likely to

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1. JEFFERY L. BARNETT ET AL., U.S CENSUS BUREAU, 2012 CENSUS OF GOVERNMENTS: FINANCE—STATE AND LOCAL GOVERNMENT SUMMARY REPORT 1, 9 (2014), http://www2.census.gov/govs/local/summary_report.pdf; U.S. CENSUS BUREAU, LOCAL GOVERNMENTS BY TYPES AND STATE: 2012 (2013), http://www2.census.gov/govs/cog/2012/formatted_prelim_counts_23jul2012_2.pdf [hereinafter LOCAL GOVERNMENTS].

have more than a million dollars in the bank much of the time, and this count of municipalities does not include the nation's 3,031 counties, 12,880 independent school districts, or 38,266 special districts.[2] Collectively, county and municipal governments control over $1.6 trillion in cash and securities.[3] Putting aside pension funds still leaves over $637 billion as of 2012.[4]

Though municipal deposits are valuable for many banks because of their volume and their predictable ebb and flow,[5] there are drawbacks to accepting these deposits. One is the volume of small transactions that make up these deposits. Government is an enterprise with many small payments going in and many small payments going out, comparable to a utility company in some ways, but with a larger and far more diverse collection of employees and business lines.[6] A city government will accept tax payments, but might also accept water bill payments, permitting fees, license fees, sewer fees, court costs, rental payments, bus and transit fares, zoo admission fees, and more.[7] This is a drawback largely addressed by ample transaction fees, but still requiring substantial logistical support—dropbox service, night deposit locations, cash delivery—for a bank to manage.

The other, and more significant, drawback to a bank accepting municipal deposits is the existence of collateral requirements.[8] Even a small town's bank account balances are likely to be far in excess of the FDIC insurance limits.[9] Many states, if not most, have laws requiring banks who accept such deposits to put up some level of collateral against

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2. LOCAL GOVERNMENTS, *supra* note 1.

3. BARNETT, *supra* note 1, at 5.

4. *Id.* at 9.

5. Michael Corkey, *In Shift, Municipalities Turn to Banks for Loans*, WALL ST. J. (July 14, 2011), http://www.wsj.com/articles/SB10001424052702304584404576442290205497836.

6. *See, e.g.*, BARNETT, *supra* note 1, at 7-12 (appendixes reveal the plethora of revenues and expenditures of the state government).

7. *Id.*; *see also, e.g.*, *How Cities Work*, TEX. MUN. LEAGUE, http://www.tml.org/HCW/HowCitiesWork.pdf, *and* Ivy M. Washington & William T. Wisser, *Municipal Lending at Community Banking Organizations--Emerging Risks?*, COMMUNITY BANKING CONNECTIONS, https://www.communitybankingconnections.org/articles/2014/Q2/municipal-lending-community-banking-organizations (last visited Oct. 23, 2015).

8. *See, e.g.*, R.I. GEN. LAWS ANN. § 35-10.1-3 (2014).

9. The Federal Deposit Insurance Corporation (FDIC) only insures up to $250,000 of deposits. Given the millions of dollars deposited by municipal governments, the FDIC can only insure a small portion of a municipality's deposits. *See* M. Corinne Larson, *How to Use Collateralization to Safeguard Public Deposits*, 24 TREASURY MGMT. NEWSL. 9 (Sept. 1, 2006), http://www.estoregfoa.org/StaticContent/staticpages/PI0906.htm.

them.[10] Rules vary among the states.[11] In Rhode Island, state law requires banks to collateralize 100% of deposits with maturities over 60 days,[12] while in California, they must put up collateral equal to 110% of all deposits.[13] In Texas, all deposits are collateralized at 100% except for school districts, where the requirement is 110%.[14] In many states, it is common for municipal ordinances and local policy to create stiffer rules.[15]

The question for any bank that wishes to serve a municipality is where do they get the collateral? Purchasing collateral-grade securities with a customer's deposits is the activity of money-market funds, but seldom a workable strategy for a bank whose business model depends on finding higher returns for its deposits than are available with collateral-grade securities.[16] The result is that for most banks, it is not feasible to accept these deposits unless they can pledge securities they already own.[17] Consequently, the practical effect of these rules is to limit the market for most municipal deposits to a relative handful of the nation's biggest banks.[18]

There are a variety of reasons for wanting to move a municipality's deposits out of a specific bank, ranging from its perceived responsibility to the community to the cost of banking services. Historically, the

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10. All states require some form of collateral for municipal deposits exceeding the FDIC insured amount, including uniform statewide collateralization, statewide collateral pools, or uncoordinated, autonomous collateral pledging. *See generally* Christine M. Bradley & Valentine V. Craig, *Increasing Deposit Insurance Coverage for Municipalities and Other Units of General Government: Results of the 2006 FDIC Study*, 2 FDIC Q. 32, 32-37 (Mar. 2008), https://www.fdic.gov/bank/analytical/quarterly/2008_vol2_1/municipaldep.pdf

11. *Id.*

12. R.I. GEN. LAWS ANN., *supra* note 9.

13. Ronald A. Ratti, *Pledging Requirements and Bank Asset Portfolios*, ECON. REVIEW 13, 14 (Sept. 1979), https://www.kansascityfed.org/publicat/econrev/econrevarchive/1979/3-4q79ratt.pdf.

14. TEX. GOV'T CODE ANN. § 2257.022 (a)-(b) (Westlaw).

15. In Rhode Island, for example, law requires collateral for all deposits with maturities greater than 60 days, but state investment policy, set by resolution of the State Investment Council (SIC) demands collateral for all deposits.

16. *See* BANK OF AM. MERRILL LYNCH, GOVERNMENT ENTITIES: A NEW APPROACH TO DEPOSITS 2 (2012), https://corp.bankofamerica.com/documents/16307/451426/New_Approach_to_Deposits.pdf ("Banks are required to hold higher liquidity levels, including high quality securities, which were routinely used as collateral for public deposits.").

17. *See id.*

18. *See, e.g.*, Peter Schnitzler, *New Collateral Rules For Indiana Deposits May Favor Big Banks,* INDIANAPOLIS BUS. J. (May 22, 2010), http://www.ibj.com/articles/20053-new-collateral-rules-for-indiana-deposits-may-favor-big-banks (outlining the potential effect of collateralization rules on small banks in Indiana, which were unwilling to commit marketable securities it may need to sell at some point).

nation's big banks have been party to some appalling abuses of their institutional customers, another reason to patronize a different bank.[19] Banks in the United States have no fiduciary duty to their government depositors and the evidence of that is all around us. Many of the cities across the country experiencing financial stress have been victimized by financial deals, only some of which can be said to have gone wrong.[20] Increasing the clout our cities wield in the financial markets and their access to trustworthy financial advice may go a long way to reducing the distress of many governments.

Unfortunately, the logistics of moving money means there is a great deal of friction in this market. Most municipalities will have multiple bank accounts with a given bank, often at least one for each of the centers of spending authority in the bureaucracy.[21] Beyond separate accounts for payroll and general expenses, the author's experience has seen separate accounts for the library, the water authority, the sewer fund, the parks department, the redevelopment authority, the public housing agency, and so on, in several municipalities. The accounting requirements for grant funds, especially those from the federal government, are strict and easier to comply with by establishing separate bank accounts.[22] In other words, even a small city can have dozens of bank accounts with a single bank, making changing banks onerous and time-consuming. A review of the bank accounts for Reading, a small city in Pennsylvania (population 87,000) found 36 separate bank accounts for city departments alone, and three more were established while the review was ongoing.[23]

In addition to these factors, recent regulatory developments make large collateralized deposits unattractive to the large banks that have the

19. ALT. BANKING GRP. OF OCCUPY WALL ST., OCCUPY FINANCE 69, 69-83 (2nd prtg. 2014), https://www.dropbox.com/s/jb3tvdcvysq7afp/Occupy%20Finance_secondprinting.pdf (free download of the book available).

20. *See generally* Koshka, *supra* note 19. *See also* Tom Sgouros, *Predatory Public Finance*, 17 J. L. SOC'Y 91 (2015) (included in this issue).

21. This is a typical cash management practice for any large organization with multiple centers of authority. Other examples of such organizations include large corporations or small nations. *See* Sailendra Pattanayak and Israel Fainboim, *Treasury Single Account: An Essential Tool for Government Cash Management*, IMF FISCAL AFFAIRS DEP'T (Aug. 2011), https://www.imf.org/external/pubs/ft/tnm/2011/tnm1104.pdf.

22. Several federal grant programs strictly require municipalities to create a separate bank account for the grant funds. *See, e.g.*, 34 CFR § 668.163 (2008).

23. Author's 2013 review of banking practice, preparatory to the proposal described below. This number did not include bank accounts for quasi-independent agencies.

collateral to hold them, all together resulting in high fees and banks untroubled by concerns about how to keep municipal customers happy.[24]

WHAT IS THE SOLUTION?

One solution to these problems was designed for the city of Reading, Pennsylvania.[25] The proposal in Reading was to create a "municipal finance agency" (MFA) to act as a middleman to broker deposits into smaller banks.[26] The MFA would act as a bank to the city, accepting deposits, providing checkbooks, and managing separate accounts in the same way as a regular bank.

The MFA, however, is not a bank. Whereas a bank would use the deposits to make loans, the MFA simply takes the funds it has been trusted with and deposits them into one or more of a collection of partner banks organized to accept them. The MFA, essentially a cash management entity, can include banks of any size among its partners, offering deposits sized to their appetites (limited by their ability to offer collateral). Thus, even the smallest of banks and credit unions can benefit from the municipality's deposits.

Beyond managing and coordinating deposits among partners, the MFA absorbs the logistical overhead of multiple bank accounts. The relationship between the MFA and any of its partner banks becomes much simpler than the previous relationship between a city and its bank. By simplifying the relationship, the city will also gain the ability to move its money at short notice. This will dramatically reduce friction in the public deposit market, and create a playing field on which all banks can compete for public funds. Furthermore, the complexity of the banking relationship is under the control of an organization created to serve the city. If opportunities arise to simplify or economize on the city's behalf, these opportunities can be capitalized upon because the MFA's duty is to the city.

In truth, the function of the MFA is already available to any government with a robust enough accounting system. It does nothing

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24. This is true for non-municipal customers with large balances as well as municipal. *See, e.g.*, Kirsten Grind, James Sterngold, Juliet Chung, *Banks Urge Clients to Take Cash Elsewhere*, WALL STREET J. (Dec. 7, 2014), http://www.wsj.com/articles/banks-urge-big-customers-to-take-cash-elsewhere-or-be-slapped-with-fees-1418003852.

25. The author, with the office of Mayor Vaughn Spencer, designed the proposal in 2013. City council political considerations have prevented the proposal from being implemented to date, though it was tacitly endorsed by the Reading-area banks and the city's state-appointed financial overseer.

26. Mike Krauss, *Chairman's Report*, PA. PUB. BANK PROJECT (May 29, 2014), http://www.publicbankingpa.org/index.php/pages/chariman-s-report.

beyond that which a sophisticated cash management system does for many governments every day. However, not every government already has a sophisticated cash management system and the MFA offers a potentially simple way to build one—that can be shared. Apart from the accounting benefit, there are substantial secondary benefits created by structuring the MFA as an external agency.

Every city in America has seen the occasional establishment of a blue-ribbon commission of "business leaders" to accomplish this or that public purpose. Distressingly few of these—united over mere public service—last much beyond the tenure of the original group of executives who organized it. By contrast, the MFA's partner banks have a business reason to be together, and become a de facto standing committee of banks interested in the fate of the sponsoring municipality. This makes a natural forum in which to air the details of a new lending program, a new affordable housing project, or other public policy initiatives with credit requirements. The government may be in contact with a variety of potential loan customers who might be valuable new customers for any local bank. For example, a government-sponsored energy-efficiency program would benefit by having access to cooperating banks, and those cooperating banks might benefit by finding customers they would not have found otherwise.

The MFA governing board, a separate entity from the collection of partner banks, is also an advantage to consider. Chosen well, the board would over time become a group of people interested in the municipality's place in the local capital market, and familiar with various aspects of that market. It is in the nature of successful organizations to change and grow. Coming up with a structure that can start by being useful in a small way will be an effective path to create a much more ambitious organization with the passage of time. The MFA could become a platform for experiments in payment innovations, money transfers, risk-sharing, or any of dozens of other possible ways to benefit the local economy. For example, sharing a loan guarantee fund might reduce the risk of business lending for a collection of banks together.

Beyond all this, there is nothing limiting the MFA to serve a single government. In fact, the finances will be stronger with a collection of governments to participate, something important in the current low interest-rate environment. Once in place and serving multiple customers, the MFA creates an ideal platform through which to acquire other joint services, perhaps including consolidation of finance functions, joint bonding, joint purchases of financial services, and more.

HOW TO DO IT

The pieces of the MFA are relatively straightforward to assemble. The technical needs are little more than the software to run the accounting system, readily available from multiple industry vendors. Because so much of the financial industry has been outsourced over the past decades, it is possible to provide banking services using precisely the same software and customer service vendors used by many large banks.

Beyond the software, at least one bank must be available to be the payment processor for the enterprise, and there must be a plan to acquire the necessary deposit capacity. Because the MFA is not itself a bank, it is not a regulated entity, and the onus of compliance with banking regulations will remain with its partner banks. In Pennsylvania, where this proposal was developed, it would require no regulatory approval to create such an entity, because the regulated activity remains in the banks. Casual research indicates that the same would be true in many states.

According to projections developed for Reading, depending on the size of the deposits and the fee structure adopted, the MFA could support a director and a small staff of tellers. These staff members would be able to support cash deposits and longer-term deposits, such as bond funds for construction projects and the like, of the scale likely to be found in a small city like Reading, a small county, or a collection of a few towns or school districts. The exact mix of deposit maturities would vary widely according to the municipality's circumstances. The service can be provided at a cost to the government lower than the service available from the large commercial banks in the area. Alternatively, with fees set at the same level, the income generated might be adequate to amass a small amount of capital, perhaps to use as a loan guarantee fund for business lending at the participating banks, or to fund a small revolving fund for partnership lending or to buy down interest rates. The possibilities are numerous, and depend on the policy priorities of the sponsoring government.

The policy priorities of the sponsoring government will also control the choice of corporate structure. An independent non-profit might be best for an MFA hoping to serve multiple governments, the original plan for Reading. A larger city with enough of a deposit base within itself might favor the control of a municipal authority. A for-profit corporation owned in whole or in part by the municipality might be a good choice for some, since the value of the MFA itself would appear as an appreciating asset on the municipality's bottom line. A for-profit structure could also simplify raising capital in the future. A mutually-owned organization could be a useful way for several governments to cooperate and provide a platform for future consolidation of services. The exact nature of the organization will depend on political and legal considerations, and a nearly infinite variety of local circumstances.

DISCUSSION

The benefits of the MFA structure are several, but they begin with creating the possibility of directing locally-owned public funds toward investments that benefit the local economy. FDIC data consistently show that the small community banks empowered by a structure like the MFA proposal are generally more likely to use their funds to support the local economy than the big money-center banks that currently dominate the market for government deposits.[27] The 2013 Small Business Administration analysis of that data shows that banks with assets over $50 billion have 69.1% of banking industry's collective assets, but make only 38.8% of the value of small business loans.[28] With only 10.4% of the banking assets, banks under $1 billion make 30.6% of the value of small business loans.[29] There are, of course, no guarantees in life, and the simple fact of a bank being small does not guarantee a socially productive lending record. Nonetheless, the MFA creates a more responsive marketplace, allowing a government to move its funds with relative ease to the institutions most in line with its policy goals.

The MFA structure also creates a platform for innovation. A board, a staff, and a collection of partner banks are all in a position to imagine and implement new initiatives to consolidate municipal services, expand into new services or new lines of business. Too often, we demand innovation from our governments while providing only barely enough resources to run the systems already in place. Consequently, it is the rare government in the United States that has adopted the payments innovations—online bill pay, cell phone transactions, —seen in other spheres in our economy. Cash management is an important function of government that has seldom had the kind of attention it would receive under the MFA structure.

Though the original design of the MFA was motivated by a desire to see public funds invested more effectively in the local economy, it is

27. Smaller banks are much more likely to make small loans to small businesses, while large banks tend to prefer to make large loans. VICTORIA WILLIAMS, U.S. SMALL BUS. ADMIN., SMALL BUSINESS LENDING IN THE UNITED STATES 2013 at 1, 20 (2014), https://www.sba.gov/sites/default/files/2013-Small-Business-Lending-Study.pdf.

28. *Id.* at 22.

29. *Id.*

quite likely that the structure will also save money over the status quo. The potential exists to see substantially lower bank fees to the government, but that may not be where the most significant savings will lie. The egregious banking abuses of our nation's municipalities are not so much in the day-to-day banking business, but in the business that frequently leads from it: loan churning, shady bond issues, complicated swap deals, and so on.[30] A government working with many different banks will have many times the options of banks to work with than a government getting all its advice from a single bank.

Some will consider the establishment of a separate organization an unnecessary expansion of the governmental sphere. It is certainly true that many of the benefits of the MFA can be accomplished simply by actively managing the cash requirements of a government in a more sophisticated way than is common. However, not only are there secondary benefits to the MFA structure outlined above, there is a further consideration. From a global perspective, one can regard any kind of financial regulation as an attempt to impose social values on the individual actors in the financial markets. The specific kinds of social value vary widely. For example, capital requirements are to keep them solvent, and lending regulations are to make loans available to diverse communities.[31] Both of these are values beyond those of the business itself. Experience has shown us that few existing financial institutions incorporate those values into their business practices, so it makes sense to impose them via the legal and regulatory system. Through an entirely different route, new financial institutions like an MFA can also become ways to assert consideration of the public good in financial markets, in this case for the deployment of public resources into the banking market.

The legal and regulatory avenues to financial reform are perhaps not the only ways forward to better financial markets. Unlike the typical commercial bank, the founding principles of the MFA would include public goods: increased commercial lending, better municipal budget outcomes, and improved economic conditions. It would have an unquestioned fiduciary responsibility to its customer, something that is not true of the banks our governments patronize at present. Were this and comparable institutional models to proliferate, the result would be financial markets that better serve our economy and our communities,

30. *See* Sgouros 2014, op. cit.

31. *See, e.g.*, Stephanie Armour & Ryan Tracy, *Big Banks to Get Higher Capital Requirement: Increase in Leverage Ratio Will Require the Eight Largest Lenders to Add $68 Billion to Level*, WALL ST. J. (April 8, 2014, 5:07 PM), http://www.wsj.com/articles/SB10001424052702303456104579489643124383708; FED. DEPOSIT INS. CORP., FAIR LENDING LAWS AND REGULATIONS 1, 15 (2014), https://www.fdic.gov/regulations/compliance/manual/pdf/iv1.1.pdf.

the same goal of more conventional avenues for financial reform. As those conventional avenues become increasingly challenging to navigate, alternatives become ever more important to consider. Building institutions like the MFA should become an important "second front" in the struggle to create financial markets that serve our municipalities better, and our nation.