

May 1, 2008

WHAT IS A DEPOSIT AND SHOULD SECURITIES FIRMS BE ABLE TO ACCEPT THEM?

- Section 21 of the Glass-Steagall Act makes it a crime for any person or entity not a bank to take a deposit. This limits deposit-taking to banks.
- Deposits can be insured deposits, and if so then carry deposit insurance of up to \$100,000 per person per bank (or up to \$250,000 for certain retirement accounts).
 - FDIC insurance for bank deposits provides banks with an extremely liquid source of short-term funding, and removes the credit risk of the issuing bank for depositors.
 - Securities firms do not have a government backstop for their short-term obligations and therefore run the risk that counterparties will discontinue funding them at any time and for any reason.
 - Banks have a significant competitive advantage over securities firms because they face much less liquidity risk.
- What is a deposit?
 - Deposit is defined very broadly under federal law to cover virtually any means by which a bank funds itself. As the definition is targeted to bank liabilities, obligations issued by a non-bank that would just be liabilities can be deposits when issued by banks.
 - There are two definitions of deposit under federal law – one under the Federal Reserve Act (“FRA”) and one under the Federal Deposit Insurance Act (“FDIA”)
 - FRA is interpreted by the Federal Reserve – the definition of deposit relates to the Federal Reserve’s authority to impose reserve requirements on bank deposits as part of its authority to conduct monetary policy.
 - FDIA is interpreted by the FDIC – the definition of deposit relates to the FDIC’s authority to determine what is and is not a deposit for purposes of deposit insurance coverage and receivership windup.

- Deposit generally refers to a unpaid balance of money or its equivalent received or held by the bank in the normal course of business for which it has or is required to give credit. Also included as deposits are:
 - Escrow and collateral funds, drafts, cashier's checks, money orders, and similar items.
 - Any short-term liability of a bank affiliate used to supply funds to the bank.
 - Credit balances.
 - Due bills and certain bankers' acceptances.
- Certain obligations are explicitly deemed to not be deposits, such as federal funds, repurchase agreements of government obligations, subordinated notes that are the equivalent of capital, and one day borrowings from securities dealers.
- What deposits are insured?
 - FDIA defines "insured deposit" as the net amount due to any depositor for deposits in an insured depository institution. Insurance covers deposits payable in the U.S. and deposits denominated in a foreign currency.
 - Deposit insurance is not limited to U.S. citizens or residents; it is available to any person.
 - Deposits paid solely outside the United States, or IBF deposits, are not insured.
 - Amounts over the insurance limits are not insured.
- Why is this Governmental benefit given only to banks?
 - This decision was made by Congress in 1933 as part of the Glass-Steagall Act. Congress acted in the face of nationwide bank failures due to runs on the bank. In order to shore up bank liquidity, Congress in essence guaranteed all of the bank deposits through the FDIC.
 - In return, Congress barred banks from engaging in activities considered riskier than banking – such as securities activities – and required banks to be subject to a significant amount of federal supervision, regulation and examination.
 - Securities firms were permitted to engage in unlimited activities and to take on greater risk, or at least risk then perceived as

greater. Subsequently, the SEC adopted very strict “net capital” rules applicable to broker-dealers that created an incentive for broker-dealers to refrain from risky activities.

- Should securities firms be permitted to accept insured deposits?
 - Having a government-backed liquidity source would reduce their reliance on short-term financing.
 - Securities firms have been given access to the discount window, another government liquidity source.
 - If yes, securities firms would have to be supervised and regulated in the same manner by the bank regulator responsible for the deposit insurance fund.
 - Securities firms can now accept cash from clients, but they must deposit that cash (plus an amount of their proprietary cash) in a bank at a Special Reserve Account.
 - This cash is not a “deposit” to the broker-dealer, and is not permitted to be used by the broker-dealer in funding its business (as banks do with deposits). In fact, the receipt of cash is a drain to the broker-dealer’s own cash since the broker-dealer must supplement the Special Reserve Account with its own cash.