

**Bank Collateral Controls in Nervous Times**

July 2008

We have only to look back a few years, to the eighties and nineties, to remember the record number of bank failures and remember how trying that situation can be. No one currently expects bank failures of that magnitude – if at all, but the key to assuring the safety of public funds is to know that you have full contractual and statutory control over the situation.

There are a number of major checkpoints which are beneficial to verify that you have done enough to protect the assets sitting in time and demand deposits for your entity. The elements you need for safety – and peace of mind – are listed below as a quick review.

**FIRREA Compliance**

First and foremost, ensure that your depository/collateral agreement is FIRREA compliant. The Financial Institutions Resource and Recovery Enforcement Act is the statutory baseline for the FDIC when they come into close or bridge a bank. The Act has four key conditions; these four conditions must be met in order for the FDIC to honor the collateral agreement you have in place with your bank.

1. The agreement must be in writing. Is your depository agreement in place, in writing and up-to-date? If your bank has merged or been acquired and assignment was made, it might be a good time to re-execute the agreement with the new entity just to assure that all terms and conditions are met and assumed by all parties.

Remember that it is best to have all three parties to the relationship sign the agreement: the depository bank, the custodian and the public entity. This will not be possible if the bank is using the Federal Reserve as custodian but that case you will have a *Circular 7* form on file from the Fed which you executed.

2 The depository/collateral agreement must be approved by resolution of the bank board or bank loan committee. Does your agreement have the resolution number and date of the resolution on it? Is your depository agreement approved by resolution of the Bank Board or the bank's loan committee? You can ask for a copy of the resolution. This is critical because only these two bodies of the bank can put a record of the agreement into the "official" records of the bank. And the FDIC only looks at the official records of the bank.

3. As noted, the agreement must be in the official records of the bank. It is not a bad idea to get the resolution date and number of the action on the agreement itself or in written form to you.

4. Under FIRREA, the pledging of collateral must be contemporaneous or simultaneous with the agreement. In its purest form this means that the agreement, if it references particular securities pledged to the city, would have to be re-executed each time there was a substitution. However, that is why it is important to NEVER attach a copy of the collateral originally pledged to an agreement. This collateral will be substituted off or mature off and be replaced over time and the list will not be valid. Even with safekeeping receipts from new substituting collateral they will not be honored by the FDIC because they are not part of that *official record*.

Instead of an attached list which is part of the agreement, the terms of a depository/collateral agreement should state that ANY collateral pledged over the term of the agreement must comply with the terms of the agreement (such as margins, type, substitution etc.). The criticality of this point is that again the FDIC is very literal on the requirements and if a list of collateral is attached then they will only consider the actual securities on that list and none that were substituted afterwards - even if you have pledge safekeeping confirmations.

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It is important to also remember that when the FDIC is called in to close or bridge a bank the agency is working for the Fund to keep it strong enough to support any and all failures that might occur. As such, the agency will not be lenient on any conditions. You will lose any unsecured funds that do not follow these conditions.

### **Risk Control**

Secondly, to ensure safety you must be able to answer the three basic questions which control collateral risk.

*1. What is required by policy, or the banking services contract, as to type of collateral and is that what is currently pledged?*

The Investment Policy should include a reference to what the collateral requirements of the entity are. One of those conditions is exactly what type of collateral is authorized not by law but by Policy. A public entity can restrict collateral to any part of the authorized legal list. Of course, any type of collateral authorized should be fully understood by the investment officer and the governing body. For example, it may be prudent to restrict the authorized list to only what is marketable and can be priced accurately.

One issue to remember in limiting collateral is making it a win-win for you and the bank. A bank has a longer asset/liability mix than a public entity so their portfolio will, by definition, require longer securities. If you artificially restrict collateral by maturity, you are requiring the bank to buy non-cost effective securities for their portfolio which costs them – and ultimately you – money. Requiring high credit quality treasuries and agencies or instrumentalities and allowing mortgage backed securities (which pass the bank test) that fit a bank's portfolio goals and objectives is productive for both parties. The public entities' control is not a short maturity, rather it is a maintained margin and regular, monitored reporting.

*2. What is the required margin and is it in place?*

The margin set by Texas law is only 100% (Public Funds Collateral Act -2257 TX Local Gov't. Code). Every policy and collateral agreement should require an additional margin which absorbs the risk of market price fluctuation. The industry standard on collateral is 102%. The entity can and should demand that 102% coverage. The best place to demand this condition is in the bank RFP or bid process.

*3. Is the collateral truly there and is it pledged to my entity?*

The collateral report should be carefully scrutinized to assure that it is information directly from the custodian and not just a reporting agency and that it states clearly that it is pledged to your entity specifically. You should have safekeeping receipts or reports confirming safekeeping in your possession.

Another key to answering all these questions is the provision of monthly reporting of collateral. The public entity should require that the list of collateral come from the custodian and not the depository bank. You want independent confirmation of what is being held. You should demand and receive at least monthly a report of collateral from the custodian - not the bank. A key feature of reporting is that it comes from the independent custodial party. Check your reports and if they are being sent by the bank or a reporting service and not the custodian directly, you do not have a solid audit trail of what is pledged and where it is held.

By holding marketable securities you can easily determine the market value. If you are unable to price the collateral yourself, it is wise to have a third party verify the price/market value. An independent broker or adviser can do this easily for you.

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### **Public Corporations**

A particular situation is dangerous for water supply corporations and 4a and 4b corporations which do not share the definition of public units by the FDIC's definition. As such, they will be treated differently in the case of a bank closure or bridge. For all entities including public entities, FDIC coverage is determined by the tax id number only and every tax identification number has the coverage afforded it under FDIC coverage. A Development District or Water Corporation has the \$100,000 coverage for all of its interest bearing funds whether it is in time (CD) or demand deposits (accounts).

A defined public entity such as a city or school district (an FDIC defined public unit) –is clearly covered by the FDIC insurance and the FDIC will honor FIRREA executed collateral agreements.

However, a water supply corporation or a 4a or 4b corporation under separate tax id's stand alone. Under the FDIC regulations a non-public unit can be pledged collateral by the bank but, in the worst case scenario of a bank failure, the FDIC will NOT honor the collateral agreement (regardless of how it is executed) because under their regulations it is not a "public entity" and can not therefore be legally pledged collateral of the bank.

The issue is critical enough that any such corporation needs to get any money over \$100,000 out of any one bank. The pools provide an alternative (except for Texpool which also does not define these special entities as "public entities") for the funds as does an SEC registered money market fund or direct investment securities such as treasuries or agencies.

The TML and the Texas Rural Water Association and many of the banks are working on getting a mechanism to address this unusual situation to relieve the risk of the public corporations. Until this situation

is solved however it is a risk which has to be addressed proactively.

If you have any question about whether the collateral pledged to you is secure or what other alternatives you should look for to further diversify, please contact us. We will be glad to help you put controls in place and advise you on creating or tightening existing controls as well as pricing your collateral.