

Bank Safety – The Devil’s in the Details

(Written for GFOA publication April 2009)

We have only to look back to the eighties and nineties to remember the record number of bank failures and remember how that situation affected public entities. No one expects the same magnitude of bank failures. But, the key to assuring the safety of public funds is full contractual control. There are specific control checkpoints required by the depositor to assure the safety of assets in time and demand deposits. These critical elements revolve around understanding FDIC insurance coverage, developing strong contractual terms and establishing internal controls.

FDIC Insurance Assessments and Coverage

The FDIC has temporarily increased insurance coverage, until 12/31/09, to \$250,000 to bolster confidence in the banking sector. (It is scheduled to return to \$100,000 at that time so time deposits over that date should be restricted to \$100,000.) But increased insurance increases costs. Including the 47 bank failures to this point in 2009 the FDIC Fund has drained below its required capital limits. To restore the Fund, FDIC adopted, in February 2009, an emergency assessment and increased the ongoing assessment rates to all banks. FDIC assesses by bank risk category so assessments will vary and the comment period for the rule may affect some minor details however there will be a 20 bps special assessment sometime in 2Q which will then be collected September 30, 2009. The rule also allows the FDIC to impose additional special assessments of 10 bps during the seven year designated restoration period. Banks have an option on how this assessment will be paid. It can be directly charged to customers or spread across base fees (or interest rates), but, the balances you maintain in the bank during the assessment period will affect your banking costs unless those balances are reduced.

All FDIC insurance is tied to the customers tax id number. All accounts under the same id are considered as one to the FDIC. The coverage is also dependent upon (a) the type of account and (b) location of the bank. The FDIC recognizes only two types of accounts: interest bearing and non-interest bearing and may provide up to \$250,000 on each type – not each account. As to location, if your bank is headquartered in your state the FDIC will provide \$250,000 for all interest bearing accounts and an additional \$250,000 for non-interest bearing accounts. If the bank HQ is in another state, the FDIC provides only \$250,000 for all accounts regardless of type. Currently the FDIC is covering all non-interest bearing funds 100%. This *temporary* protection however is no reason to ignore public fiduciary responsibilities to earn market rates on funds.

When a government is holding deposits in *testamentary accounts* for others such as I&S accounts or court ordered accounts for later distribution, the insurance based on each end-recipient not the government. Each end-recipient is covered but the insurance does not extend to other accounts. Such accounts should be legally established and identified for such coverage to be extended.

Are you a “Public Unit”

The FDIC defines governments as “public units” and recognizes that public units may have collateral pledged against deposits under state law above the insurance coverage. As such, the FDIC will recognize and release collateral pledged to a public unit in the case of a bank failure if conditions are met as noted below. However, the definition of “public unit” is limited and work is proceeding now to clarify whether *public corporations* such as water supply corporations or economic development corporations fall under this protective shield.

Under FDIC regulations a non-public unit might be pledged collateral by the bank but, in a bank failure, the FDIC will not honor the collateral agreement because it is not a “public unit” and can not therefore be legally pledged collateral by the bank. An effort is underway to have FDIC approve a standardized collateral agreement for these quasi-public units which will be accepted.

Until a solution is found, the critical issue is for any such public corporation to restrict funds to the FDIC limits in any one bank. Alternative direct investments (securities or CDs) or money market mutual funds should be used.

Collateral Coverage

States differ on collateral arrangements but regardless of statutes, a viable depository/collateral agreement detailing terms and responsibilities of the public unit, the bank and the custodian is critical to bank safety. That agreement must also be *FIRREA* compliant. The *Financial Institutions Resource Reform and Enforcement Act* is the statutory baseline for the FDIC in the process of closing or bridging a bank. Only a compliant agreement will guarantee access to your collateral. The four conditions in the Act must be met in order for the FDIC to honor the collateral agreement. The Act's four conditions are:

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 of services or ownership was made it will be a good time to re-execute the agreement to ensure that all terms and conditions are met and have been assumed by the new parties.

There are three independent parties to any collateralized bank relationship: the government, the bank, and the independent custodian holding collateral. All three parties should be party to the agreement. (If the Federal Reserve is custodian only the government and the bank sign supported by an executed "*Circular 7*" form from the Fed.) Find and file these documents.

2. The written depository/collateral agreement must be approved by resolution of the Bank Board or the Bank's Loan Committee. Only an agreement approved by resolution of one of these two bank bodies will be acceptable to the FDIC. Only action by these two bodies create an "official" record of the collateral agreement. The FDIC determines asset allocations based only on the official records of the bank. Does your depository agreement have the resolution number and date of the resolution on it?

3. The agreement must be in the official records of the bank. Get a copy of the resolution including its action date and number in written form. Some banks have created a blanket resolution for this purpose which must be reviewed for applicability.

4. The pledging of collateral must be "contemporaneous" or simultaneous with the agreement itself. In its purest form this requirement means that the agreement would have to be re-executed on each collateral substitution if the list of pledged securities is part of the agreement. This can be avoided by never making a list of collateral a part of the agreement. It is important to NEVER attach a list of the collateral originally pledged to an agreement. This collateral will have been substituted off or matured off over time and the list will not be valid. Even with safekeeping receipts from new substituted collateral if the list is attached the new collateral will not be honored by the FDIC because they are not part of that original *official record*.

Instead of attaching a list of pledged securities as part of the agreement, the agreement should state that ANY collateral pledged over the term of the agreement must comply with the terms and conditions of the agreement.

Remember, when the FDIC is called in to close or bridge a bank it will pay only the deposits it must. It has to keep the Fund strong to support any and all failures that might occur. As such, it will not be lenient on any of these conditions. Unsecured funds can be lost for non-compliance.

Collateral Risk Control

Collateral risk extends beyond the bank agreement. A collateral policy should assure control on what and how collateral is pledged and held.

1. Define what collateral will be authorized in the investment policy and in the banking services contract.

Investment Policies should include specific collateral requirements which may be more restrictive than state law. Naturally, any type of collateral authorized should be fully understood by the investment officer and the governing body. Prudence would restrict the authorized list to only what is marketable and can be priced accurately and taken to market for sale if necessary. Standard collateral might be restricted to:

- Obligations of the US Government, its agencies and Instrumentalities, including mortgage backed securities which pass the bank test, and
- Obligations of states and municipalities rated A or better by two nationally recognized rating agencies.

Recognize that banks capital/asset liabilities are longer than most governments and therefore collateral needs to fit government's comfort level but also bank's portfolio from which collateral is pledged. In limiting collateral, make it a win-win situation. A bank requires longer securities. If you artificially restrict collateral the bank must buy costly securities mismatching their portfolio and costing them and ultimately you. Requiring high credit quality treasuries and agencies and allowing mortgage backed securities, which fit a bank's portfolio goals and objectives, is productive for both parties. The public entities' control is not in the maturity of the security, it is in constantly maintained margins and regular, monitored reporting.

2. Set a required margin.

A margin is critical and may be set by law and further restricted by your policy. The margin on collateral absorbs some of the risk of market price fluctuation. The size of the margin is tied to the reporting period. Monthly reports and constant monitoring allow for a comfortable 102%. The bank should be made contractually liable for monitoring and maintaining the margins on a daily basis.

You need to review your collateral reports received from the custodian (not the bank) once a month. Check the values reported and ask any necessary questions.

3. The collateral must be held by an independent custodian.

The custody of the collateral is even more important than type and margin. The custodian must be independent and outside the holding company of the pledging bank. Custodians work for the bank. The agreement will assure the custodian also works for the government. The responsibilities of the custodian as the government's agent (bailee) in a default is critical and those responsibilities must be laid out in the agreement which should be signed by all parties.

4. Assure that the collateral is pledged and maintained.

Original documents are vital. Original receipts place the securities with the custodian. Prior approval on substitution assures continuation. Monthly reports assure compliance. A recent move to outside firms or non-reporting by the banks has created a dangerous situation for governments.

Monthly collateral reports must be originated by the custodian and sent directly to the government to prove third party custody. Carefully scrutinize the monthly report to assure that it

is created by and sent directly from the custodian and not the bank or a separate reporting agency. The report should also clearly state that the securities are pledged to the governmental entity by name.

Only this provides independent confirmation of what is being held. If not, there is no solid audit trail of what is pledged and where it is held.

5. Know the current value of collateral.

The market value of collateral is not represented by par or book value as is often reported on collateral reports. The collateral's market value (par times market price) is the value to be received if the security had to be liquidated. Few custodians will price the collateral. If your custodian will not price securities, provide for a mechanism to price the collateral. Requiring marketable securities as collateral will improve the ability to price the security and calculate market value. If you are unable to price the collateral yourself it is wise to have a third party verify the price/market value at least quarterly. An independent broker or adviser can do this easily for you.

Setting collateral requirements and establishing controls will assure safety in both time and demand deposits above insured limits. The key to assuring the safety of deposited public funds is full contractual control.

Linda T. Patterson
Patterson & Associates, Austin
Linda@patterson.net