



## Controlling the Banking Relationship - What You Need to Know

By Linda Patterson

Changes from the new financial regulations legislation will be slow in evolving, but there are clear banking trends that have been developing for more than 20 years and continue to affect public finance. Before the 1980s, banking was paternal. For many decades, bank services were local and directed primarily at simple collection and disbursement. Services incorporated investments - almost exclusively in certificates of deposit. But the 1980s split banking and investments and changed the service profile of banks. As public entities moved toward the capital markets for returns and diversification, banks became service providers, building efficient services on emerging technologies.

The functional partition and automation have transformed banking from automated clearing house (ACH) to zero-balance accounts (where a balance of zero is maintained by automatically transferring funds from a master account in an amount just large enough to cover checks). The emergence of pools and public portfolios has changed the profile from the all-encompassing paternal relationship to a business relationship - an equal partnership. The finance director has to assume responsibility for obtaining and controlling the banking relationship, which requires researching and understanding the technology, managing the risks in the relationship, understanding the costs, and, ultimately, controlling the relationship.

### **Understanding the Impact of Technology**

Technological changes have affected every service aspect of banking. Check collections are becoming secondary to imaging and the dissemination of electronic information. The advent of remote deposit and instant credit cash drop-boxes has made couriers passe. Images have replaced statements and physical check records. Some services, such as controlled disbursements, can be replaced by new structures, such as sweeps.

Many electronic services can be implemented without changes to your operations. Additional verifications of payees and improved check stock lead to few changes - just efficiencies. However, you should thoroughly review your internal processes before moving forward on e-payables or e-receivables such as check re-presentation (RCK) and image lockboxes - any service in which the bank supplements or replaces your internal functions. Even a simpler move to cross-functionality on reporting requires consideration. Having ongoing discussions with your banker during the current contract period to explore new services and their applicability can provide time to prepare for adjustments and avoid major problems.

## **Managing the Risks**

There is nothing like a cascade of failing banks to remind us of the risk in banking. In addition to potential cost, float, and operational risks, the ultimate concern lies with the stability of the bank itself. If a public entity has funds maintained in a banking services institution, it needs to know those funds are safe. Most entities rely on Federal Deposit Insurance Corporation (FDIC) insurance and collateral, safety nets that have their own complexities and limits. Both require attention and periodic review.

FDIC insurance is basically straight-forward. It insures the deposits your entity has in one bank holding company by tax identification number. The current \$250,000 limit applies to all the accounts your jurisdiction has under that ID (with an exception for testamentary accounts), regardless of number. However, the FDIC does not define economic development corporations as public entities, and even if pledged, collateral will not receive any funds over the FDIC insurance limit. Exceptions such as these require jurisdictions to invest some funds outside of banks. The devil is in the details, and reviewing the FDIC rules (at <http://www.fdic.gov/deposit/deposits/FactSheet.html>) is crucial to understanding how deposits will be treated in case of bank failures. Remember, the FDIC works for its fund in collecting, selling, and distributing assets of a failed institution. Its goal is to minimize the impact on the FDIC fund. There is no leeway for non-public funds or contracts that are not correctly executed. Check your depository or collateral agreement to know your rights and responsibilities.

How do you know if a bank has problems? Look for public information on delisting and accounting problems. Check your collateral reports, which should come directly from your custodian (not your bank). Political exigencies may not allow an early termination, but a quarterly independent report from a bank rating company will alert you to troubling trends and allow you to take precautions and move funds. Also, if the bank does fail, you may have removed uninsured funds, but do you have checks printed on another bank to keep your operations functioning? A separate, unfunded "fire-escape" bank account with printed checks for one or two payrolls and some payables will allow you much-needed flexibility. It is too late to make these arrangements once a bank has failed, so make sure contracts and collateral are in place before a problem occurs. Ongoing monitoring is crucial.

Understanding the Costs Banking services are not free. The true cost of banking is a net of fees and potential interest earnings. High fees may be balanced by high interest potential, and vice versa. To accurately evaluate the net cost, look at the fees, the required target balances (on a compensating balance basis), and the historical interest rates where excess balances may be invested. Total cost is represented by fees charged netted against the earnings potential.

The target balance is calculated from the earnings credit rate (ECR), which sets the level of the target balance and reduces the amount of funds available for investment. Even if two accounts have equal interest rates, a higher ECR will reduce the target balance and increase net earnings.

Another aspect of cost is specialized services fees. These are more difficult to judge, especially during the proposal process, which is often based on old categories. A proposal should include all the service costs that will be charged. Public entities often find this process counter-intuitive. For example, a check image may be charged three times: for creation, for access, and for

retention. ACH detail may be charged for creation, transmission, and online access. To assure a valid comparison, require the use of the Association for Finance Professionals service codes to identify the actual service costs.

Retention or transition incentives from the bank can reduce costs. Ask for and calculate the impact of incentives, which can greatly affect overall costs.

### **Controlling the Relationship**

Controlling the banking relationship starts with the proposal process. The request for proposal (RFP) must set the contractual conditions that will control the relationship and reduce risks throughout the contract period. But the questions in the RFP need to be open-ended to demonstrate the differences between banks. Some key initial points include financial stability, contractual terms, and flexibility. You can monitor financial stability throughout the contract period if the bank is contractually required to notify you of any change in ratings. Contractual terms in the depository agreement and the service agreements must be reviewed before the contract is awarded, when any changes needed to items such as indemnity and reporting are much easier to achieve. Remember the golden rule: He who has the gold makes the rules. Use this position of strength in your initial and continuing negotiations. Flexibility over the contract period on the payment basis is as crucial as the ability to move funds out of the bank.

The tenor and success of the banking relationship is set early in the process. The public entity has to research services and look internally for the proper fit with existing or new operations. That requires ongoing research into new technologies and services. Periodic communications with the bank and between key players in the operational aspects of the contract is also needed. The knowledge gained will enable control of the risks and costs of banking and provide for an equal business relationship that serves both parties well.

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