Government Finance Officers Association

Collateralizing Public Deposits

BEST PRACTICE

BACKGROUND:

The safety of public funds should be the foremost objective in public fund management. Collateralization of public deposits through the pledging of appropriate securities or other instruments (i.e. surety bonds or letters of credit) by depositories is an important safeguard for such deposits. The amount of pledged collateral is determined by a governmental entity's deposit level and the policy or legal required collateral margin. Some states have established programs for the pooling of collateral for deposit of public funds.

Federal law imposes certain limitations on collateral agreements between financial institutions and public entities in order to secure governmental entity deposits. Under certain circumstances, as are discussed in recommendations below, the Federal Deposit Insurance Corporation (FDIC) may void an otherwise perfected security interest and leave the governmental depositor. with only the right to share with other creditors in the pro rata distribution of the assets of a failed institution for the amount of deposits that exceed the FDIC coverage. Separate governmental 'corporations' such as economic development corporations or water supply corporations, etc., do not fulfill the FDIC's definition of 'public unit'[1] and therefore even accurately completed collateral definition may not be honored by the FDIC on a bankruptcy.

RECOMMENDATION:

GFOA recommends the use of a written agreement with pledging requirements as protection for state or local government's deposits. GFOA encourages governmental entities to establish adequate and efficient administrative systems to monitor such pledged collateral, including state or locally administered collateral pledging or collateral pools. To accomplish these goals, GFOA recommends the following:

1. Governmental entities should implement programs of prudent risk control. Such programs could include a formal depository risk policy, credit analysis, and use of fully secured investments. In the absence of a state program for pooling collateral, public entities should establish and implement collateralization procedures, including procedures to monitor their collateral positions. Monitoring informs a public entity of undercollateralization, which may threaten the safety of an entity's deposits, and overcollateralization, which may increase the cost of banking services. Governmental entities however can not and should not accept the liability for maintaining collateral levels which liability must fall to the financial institution.

2. Governmental entities/depositors should take all possible actions to comply with state and federal requirements in order to ensure that their security interests in collateral pledged to secure deposits are enforceable against the receiver of a failed financial institution. Federal law provides that a depositor's

security agreement, which tends to diminish or defeat the interest of the FDIC in an asset acquired by it as receiver of an insured depository, shall not be valid against the FDIC unless the agreement:

- is in writing;
- was approved by the board of directors of the depository or its loan committee and[2]
- has been, continuously, from the time of its execution, an official record of the depository institution.[3]

3. Governmental entities should have all pledged collateral held at an independent third-party institution outside the holding company of their bank, and evidenced by a written agreement in an effort to satisfy the Uniform Commercial Code (UCC) requirement for control. The UCC states that the depositor does not have a perfected interest in a security unless the depositor controls it. Control means that swaps, sales, and transfers cannot occur without the depositor's written approval.

- The value of the pledged collateral should be marked to market monthly, or more frequently depending on the volatility of the collateral pledged. Some state statutes do dictate a minimum margin level for collateral based on deposit levels (e.g., Georgia and Minnesota statutes require 110 percent). If not, the margin levels should be at least 102 percent, depending on the liquidity and volatility of the collateral pledged. State statutes also govern whether minimum margin levels apply to principal only or to accrued interest as well. On a sale, accrued interest would be received. Governmental entities should review applicable state statutes and confirm compliance.
- Substitutions of collateral should meet the requirements of the collateral agreement, be approved, by the entity in writing prior to release, and the collateral should not be released until the replacement collateral has been received.
- The public entity should require reporting directly from the custodian. The custodian should warrant and be signatory to the agreement
- Reporting by the third party institution should at a minimum be monthly.

4. The pledge of collateral should comply with the investment policy or state statute, whichever is more restrictive. Governmental entities should know and understand securities pledged as collateral.

5. Governmental entities that use surety bonds in lieu of collateral should limit the insurers to those of the highest credit quality as determined by a nationally recognized insurance rating agency. A thorough review of the terms of the bond is required.

6. The governmental entity should thoroughly review the terms and conditions of any letters of credit, including those issued by a federal agency or government sponsored enterprise.

7. The governmental entity should establish and follow procedures for on-going review of collateral.

Note: As a result of the court case North Arkansas Medical Center v. Barrett, 963 F.2d 780 (8th Cir. 1992), the FDIC issued a policy statement in March 1993 indicating that it would not seek to void a security interest of a federal, state, or local public unit solely because the security agreement did not comply with the contemporaneous execution requirement set forth in Section 13(e) of the Federal Deposit Insurance Act 12 U.S.C.1823(e). The policy statement was officially enacted by Section 317 of the Riegle Community Development and Regulatory Improvement Act of 1994 (Public Law 103-325).

Notes:

[1] For deposit insurance purposes, the term "public unit" includes a state, county, municipality, or "political subdivision" thereof. Governments should review Section 330.15 of the FDIC's regulations (12 C.F.R. 330.15) to identify if they fall within the FDIC's definition of "public unit" and to determine whether they are public entity qualifying for collateral protection under the definition. This information can be found at http://www.fdic.gov/deposit/deposits/FactSheet.html

[2] The FDIC does not require every transaction to be reviewed by the board of directors. The board may fulfill this function by setting parameters and authorizing a particular officer to carry out its wishes. The officer would be performing ministerial acts on behalf of the board. (FDIC Interpretive Letters)

[3] Corporate resolutions that list specific officers who are authorized by the board of directors to execute agreements securing public deposits will meet this requirement.

References:

- GFOA Sample Security Agreement (long and short versions), www.gfoa.org, 2009.
- GFOA Sample Custodial Trust Agreement, www.gfoa.org, 2006.
- An Introduction to Collateralizing Public Deposits for State and Local Governments, Second Edition, M. Corinne Larson, GFOA, 2006.
- *Investing Public Funds, Second Edition*, Girard Miller with M. Corinne Larson and W. Paul Zorn, GFOA, 1998.
- FDIC Act (12 U.S.C. 1811 et seq. and 12 C.F.R. Part 330.330.15 Public Unit Accounts (www.FDIC.gov)