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New Challenges for Keeping Public Money Safe.

Governments across the country face a significant fiscal dilemma: sacrifice yield on their bank deposits or assume more risk.

Still reeling from the financial turmoil over the last few years, banks have recently told governments of all sizes that, because of changing regulatory requirements and business practices, the financial institutions may no longer be in a position to provide the mandatory amount of collateral to protect public deposits. This creates concerns about alternative ways to secure collateral as well as the need to develop new standards to protect taxpayer funds.

The yield on many depository accounts is stuck at record lows, yet the cost to financial institutions of collateralizing or otherwise securing these accounts continues to increase. Many governments are struggling to find depository accounts that meet their legal requirements and risk-tolerance levels. This is forcing officials to evaluate policies for mitigating risk without sacrificing yields on the deposits.

The Federal Deposit Insurance Corporation (FDIC) provides federal depository insurance up to certain thresholds for accounts maintained in FDIC-insured banks and savings associations. The standard insurance amount totals $250,000 per depositor, per insured bank, for each account ownership category. But what about bank balances of deposit accounts in excess of federal depository insurance?

Unfortunately, many governments' investment policies only address FDIC insurance and not other forms of depository insurance that may be available. Modifying investment policies would address this issue, barring statutory restrictions on accepting other forms of depository insurance.

To mitigate some of the risk of uninsured and uncollateralized deposits, some states allow use of single- or multiple-financial-institution collateral pools. In a single-institution pool, an institution pledges a group of securities against all of its public deposits. In a multiple-institution pool, various institutions pledge a group of securities to provide common collateral for their deposits of public funds. In this scenario, the assets of the pool and the power to make additional assessments against its members ensure that no loss of public funds occurs due to the default of a member.

Therefore, a multiple-institution collateral pool is considered depository insurance, while a single institution collateral pool is considered collateral. Many government investment policies don't address the use of either type of pool, which may limit a government's ability to improve the yield on its depository accounts. A change in a government's investment policy could address this issue for a single-institution collateral pool, but the creation of a multiple-institution pool may require a change in state laws.

Alternatives to collateral pools have surfaced to assist governments in improving yield without sacrificing risk. One example is Insured Cash Sweep services (ICS), where governments can access multimillion-dollar FDIC insurance on public funds placed into demand deposit accounts, money-market deposit accounts, or both, in increments below the $250,000 FDIC limit. The use of ICS services may require a change in state statutes — it's currently approved in 42 states — and a change in a government's investment policy.

Another alternative is public unit deposit letters of credit (LOCs), which offer a less-expensive alternative to collateral. A Federal Home Loan Bank issues the LOCs to pledging banks and assists them in mitigating risk for collateral pledged to local-government deposits. Using a LOC also may require a change in state statute or a local-government investment policy.

Governments often rely on yields on their deposits to fill budgetary holes, and this new era of collateralizing public deposits threatens a government's ability to make ends meet. Governments cannot afford to stand back and watch. It's time to be proactive, investigate alternatives and implement investment policies that align with the reality of today's banking sector.

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BY FREDERICK G. LANTZ | OCTOBER 30, 2014