GFOA Recommended Practice

Collateralization of Public Deposits (1984, 1987, 1993, 2000, and 2007) (CASH)

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 public entity's deposit level. 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 public entity deposits. Under certain circumstances, the Federal Deposit Insurance Corporation (FDIC) may void a perfected security interest and leave the public depositor with only the right to share with other creditors in the pro rata distribution of the assets of a failed institution.

Recommendation. The Government Finance Officers Association (GFOA) recommends the use of pledging requirements as protection for state or local government's deposits. GFOA encourages state and local governments to establish adequate and efficient administrative systems to maintain such pledged collateral, including state or locally administered collateral pledging or collateral pools. To accomplish these goals, GFOA recommends the following:

1. Public 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.

2. State and local government depositors should take all possible actions to comply with 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
   - has been, continuously, from the time of its execution, an official record of the depository institution.

3. Public entities should have all pledged collateral held at an independent third-party institution, 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. If state statute does not dictate a minimum margin level for collateral based on deposit levels (e.g., Georgia and Minnesota statutes require 110 percent), 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. Public entities should review applicable state statutes and confirm compliance.

- Substitutions of collateral should meet the requirements of the collateral agreement, be approved in writing prior to release, and the collateral should not be released until the replacement collateral has been received.

4. The pledge of collateral should comply with the investment policy or state statute, whichever is more restrictive.

5. Public 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.

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

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 government entity 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).

References:

- GFOA Sample Security Agreement, 1995.
- GFOA Sample Custodial Trust Agreement, 1995.
- *An Introduction to Collateralizing Public Deposits for State and Local Governments*, M. Corinne Larson, GFOA, 2006.
- *Investing Public Funds*, Second Edition, Girard Miller with M. Corinne Larson and W. Paul Zorn, GFOA, 1998.

Approved by the GFOA’s Executive Board, October 23, 2007.