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ACCOUNTANTS AND ADVISORS

Safeguards for Deposits in Public Banking Institutions

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Governments have a fiduciary duty to protect public funds that the government has collected. In addition, there also may be state laws regulating the deposits of public funds. While it has always been a "best practice" to perform due diligence on public depositories and manage the risks associated therewith, it is even more important in light of the recent bank failures.

The custodial credit risk for deposits is the risk that, in the event of the failure of a depository financial institution, a government will not be able to recover deposits or will not be able to recover collateral securities that are in the possession of an outside party.

Federal Deposit Insurance Corporation (FDIC) helps to reduce this custodial credit risk. Deposit accounts at each FDIC institution are insured up to $250,000 per depositor, per FDIC-insured bank, per ownership category.

Collateralization provides additional coverage in the event of bank failure. Depending on state law or separate agreements with the government, deposits may be secured by additional collateral. In the event of bank failure, the FDIC will honor valid collateralization agreements. However, there is no guarantee that the collateral will cover the amount of uninsured funds. Some states may have requirements for public depositories to maintain collateral for public monies. The government's own investment policy should also indicate how much of the deposits are to be collateralized, which securities are suitable and where the collateral should be held.

Governments have a number of options to reduce this custodial credit risk further. These options are included on the attached chart.

Note that certain accounts held in brokerage deposit accounts may not be covered by FDIC. However, they may be covered by the Securities Investor Protection Corporation (SIPC) insurance. SIPC protects against the loss of cash and securities (stocks, bonds, Treasury securities, certificates of deposit, mutual funds, money market mutual funds and certain other investments) held at a brokerage firm. The SIPC protection limit is $500,000, including a $250,000 limit for cash. SIPC only protects the custody function, not the loss in value of the security.

The recent bank failures may have resulted from poor risk management practices, specifically a lack of oversight on available liquidity-triggered panic across the nation. Additionally, rising interest rates, growing fears of a recession and deposit risks enhanced the already dire situation.

The following are state requirements for deposits of public monies in Connecticut, New Jersey and New York.

Connecticut

Connecticut state statutes (§7-402) govern deposits of public monies held by a municipality. These public deposits must be held in:

- any qualified public depository, or
- any out-of-state bank that is not a public depository as long as the amount does not exceed the FDIC insurance limit.

A qualified public depository is a bank, Connecticut credit union, Federal credit union or an out-of-state bank with a branch in Connecticut which receives or holds public deposits and segregates eligible

collateral for public deposits or arranges for a letter of credit to be issued. The municipality's deposits cannot be more than 75% of the total capital of the depository.

The balances maintained in each bank are covered by FDIC insurance up to $250,000 at each bank for each entity. The remaining balance is uninsured. Connecticut state statutes include additional protection for public deposits.

The state of Connecticut requires public depositories to maintain eligible collateral segregated from other assets to secure public deposits. If the bank is not under a formal regulatory order, generally this collateral must be at least 25% of all uninsured public deposits held by the depository. However, the collateral requirement may be higher (110%) or lower (10%) depending on the bank's tier one leverage ratio and risk-based capital ratio which are based on the most recent quarterly call report. These ratios and collateral percentages are specified in state statute §36a-333, which was last updated effective October 1, 2021.

Since the general collateral requirement is only 25% of uninsured public funds, the depository and public depositor may agree on additional collateral to be held. If the bank failed, the municipality would first receive funds from the FDIC insurance and then the collateral would be liquidated and paid to the municipality.

New Jersey

Although New Jersey governmental entities, which include school districts, municipalities and counties, are limited as to the types of investments and types of financial institutions they may invest in, these entities typically maintain significant average bank balances. The balances maintained in each bank are covered by the same Federal Deposit Insurance Corporation as non-governmental entities up to $250,000.

Fortunately, New Jersey governmental entities also have an added layer of protection for the public funds deposited in excess of the FDIC threshold through the Governmental Unit Deposit Protection Act (GUDPA). A governmental entity's cash management plan requires deposit of public funds in public depositories protected from loss under the provisions of the GUDPA. Moreover, local governmental units are required by law to deposit their funds in an eligible public depository pursuant to GUDPA. State and federally chartered banks, savings banks, savings and loan associations and credit unions having at least a branch office in New Jersey must be certified by the Department of Banking and Insurance for participation in the GUDPA system.

This Act, originally enacted in 1970 and amended and strengthened in 2010 as a direct result of the 2008 Washington Mutual Bank's failure, protects governmental units from a loss of funds on deposit with a failed banking institution in New Jersey.

All public depositories participating in the GUDPA system must pledge collateral equal to at least five percent (5%) of the average amount of its uninsured public deposits and 100% of the average amount of its uninsured public funds in excess of the lesser of 75% of the capital funds or $200 million. If a public depository fails, the collateral it has pledged, plus the collateral of all other public depositories, is available to pay the full amount of their deposits to the governmental units. If a governmental depository fails and the FDIC does not insure or pay out the full amount of public deposits, the collateral pledged to protect these funds would first be liquidated and paid out. If this amount is insufficient, other institutions holding public funds would be assessed pro rata up to four percent (4%) of their uninsured public funds. Although this protection does not constitute a 100% guarantee of the safety of all funds, no governmental unit under GUDPA has historically lost protected deposits.

New York

Based on New York State General Municipal Law, all public deposits in excess of the amount insured under the provisions of the FDIC Act must be covered through a pledge of eligible securities, or other permissible securities, to ensure that the amounts in excess are not lost in the event of a bank failure. Permissible securities may consist of one or a combination of the following:

- Security agreement or custodial agreement – The total market value of the pledged eligible securities must be at least equal to the total amount of public deposits in excess of the FDIC amount. The agreement shall provide that pledged securities will be held as an agent of, or for, the local government and will be kept separate and apart from the general assets of the custodial bank or trust company. The agreement shall provide for the frequency of revaluation of collateral and

include all provisions deemed necessary and sufficient to secure, in a satisfactory manner, the local government's interest in collateral.

- Eligible surety bond payable to such local government – The total amount payable must be 100% of the total amount of public deposits in excess of the FDIC amount. The terms and conditions must be approved by the governing board.

- Eligible letter of credit payable to such local government – The total amount payable must be 140% of the total amount of public deposits in excess of the FDIC amount. The terms and conditions must be approved by the governing board.

- Irrevocable letter of credit – The total amount payable must be 100% of the total amount of public deposits in excess of the FDIC amount. The irrevocable letter of credit shall be issued in favor of the local government by a Federal home loan bank whose commercial paper and other unsecured short-term debt obligations are rated in the highest rating category by at least one nationally recognized rating organization.

It is important that the municipality include authorized depository and eligible securities within their investment policies. Also depositors should consult with their attorneys and investment advisors to determine the most advantageous avenue and to determine its sufficiency.

The office of the New York State Comptroller has previously issued a local government management guide entitled, "Investing and Protecting Public Funds" that goes into further detail on these various options. Further, the State Comptroller has also prepared model security and custodial agreements to assist local governments, which you can find here.

Contact Us

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