HOUSE
RESEARCH
ORGANIZATION bill analysis | 3/22/2005 | HB 256 Hopson (CSHB 256 by Otto)

SUBJECT: Investments in certificates of deposit by governmental entities

COMMITTEE: Government Reform — committee substitute recommended

VOTE: 7 ayes — Uresti, Otto, Y. Davis, Frost, Gonzales, Hunter, Veasey

0 nays

WITNESSES: For — H.D. Barkett, Promontory Interfinancial Network; James Phillip Battey, Promontory Interfinancial Network; Steve Scurlock, Independent Bankers Association of Texas; *(Registered but did not testify:* Rachel Dennis, Texas Bankers Association; M.J. Nicchio, Texas Association of School Boards)

Against — None

On — Randall S. James, Texas Department of Banking; *(Registered but did not testify:* Everette Jobe, Texas Department of Banking)

BACKGROUND: Government Code, chap. 2256, subchap. A, outlines the requirements governmental entities, including school boards, local governments, and state agencies, must meet in order to invest public funds. An investment must be covered by some form of investment security or have Federal Deposit Insurance Corporation (FDIC) coverage for the principal and any interest earned. To meet this requirement, governmental entities must either deposit funds at multiple institutions so that the full investment receives FDIC coverage or they must invest the funds at a single depository institution that collateralizes the full amount of the investment.

A model exists in which an investment can be made at a single depository institution in an amount that exceeds FDIC coverage yet allows funds to be secured without having to collateralize. In this model, the depository institution would negotiate the interest rate for the investment and then the funds would be disbursed within a network of other institutions in certificates of deposit (CDs) in amounts that would receive full FDIC coverage. In return, the initiating institution would receive deposits from other institutions in the network such that this institution would have access to funds in an amount equal to that of the initial investment. Certificate of Deposit Account Registry Service (CDARS) is the largest and best known deposit placement service that arranges such deposits among its 750 member banks. CDARS charges initiating and transaction fees to its member banks in exchange for arranging the deposit of CDs that can receive up to $10 million in FDIC coverage.

DIGEST:

HB 256 would amend Government Code, sec. 2256.010, to specify that a certificate of deposit is an authorized investment under subchapter A if it is issued by a depository institution with its main office or branch office in Texas.

The bill would authorize governmental entities to invest in certificates of deposit through a method that met all the following requirements:

- the funds were invested through a depository institution that had its main office or a branch office in Texas;
- this institution arranged for the deposit of the governmental entity's funds in CDs with one or more FDIC-insured institutions such that the full amount of principal and interest on each CD was insured by the United States or an instrumentality of the United States;
- the depository institution acted on behalf of the entity as the custodian of all CDs issued for the entity's account; and
- the depository institution received from customers of other FDIC-insured institutions deposits in an amount equal to or greater than the amount of the CDs deposited in other institutions.

The bill would take immediate effect if finally passed by a two-thirds record vote of the membership of each house. Otherwise, it would take effect September 1, 2005.

SUPPORTERS SAY:

CSHB 256 would allow governmental entities the convenience of being able to make investments at a single institution with one negotiated rate, one statement, and the assurance of full FDIC coverage. According to an FDIC advisory opinion, the system that CDARS employs would fulfill these purposes.

Many expenses could be avoided through utilizing a system such as that of CDARS. Currently, administrative costs must be borne either by banks in collateralizing an investment or by governmental entities in setting up and monitoring multiple investments. CDARS mitigates these costs because, in exchange for low fees assessed to the bank, the CDARS software locates multiple institutions over which the investment may be spread to receive full FDIC coverage. The software then locates deposits from other consumers so that any part of the investment sent to another financial institution will be matched dollar for dollar with new consumer deposits.

This process would provide the added benefit to the bank because, in not having to collateralize an investment, the bank could loan the deposited funds to other consumers and profit from the interest. This would be particularly helpful to smaller banks, which often cannot bid for public funds investments because they cannot afford to tie up their funds in securing large investments. In addition, more loan dollars would be available to businesses for local economic development.

Although CDARS is the only business providing services under this model on a broad scale, the bill would not prevent governmental entities from seeking such services from other qualified businesses.

OPPONENTS SAY:

This bill inappropriately would allow a third-party vendor to enter into transactions between governmental entities and financial institutions. There is an inherent risk in using third-party vendors as a part of financial servicing because bad actors can misrepresent their services and improperly administer government funds in a manner that would not receive full FDIC coverage. This could jeopardize the investment or cause a cost to the financial institution if it was forced to compensate for the mismanagement of government funds.

Since CDARS has little competition within this deposit placement service model, they have greater flexibility in fee setting, and institutions would have little choice in the amount they pay for fees if they wished to utilize such a service.

NOTES:

The committee substitute made a technical change to sec. 2256.010(a) that would align the language of this section with interstate bank branching.