SUBJECT: Pooled collateralization of public funds

COMMITTEE: Financial Institutions — committee substitute recommended

VOTE: 5 ayes — Solomons, Flynn, Anderson, McCall, Orr

0 nays

2 absent — Chavez, Anchia

WITNESSES: For — John Heasley, Texas Bankers Association; Jeff Austin III; Jim Purcell; (*Registered, but did not testify:* Dan Donohoe, JPMorgan Chase; Shanna Igo, Texas Municipal League)

Against — Mary Mayes, Travis County Commissioners Court, Government Treasurers Organization of Texas; Dolores Ortega Carter, County Treasurers Association of Texas; Steve Scurlock, Independent Bankers Association of Texas; Willard Still, Independent Bankers Association of Texas; David Williams, Independent Bankers Association of Texas

On — Mike Doyle, Office of the Comptroller of Public Accounts; Karen Krug, Federal Home Loan Bank of Texas

BACKGROUND: The part of a deposit of public funds including accrued interest in excess of Federal Deposit Insurance Corporation (FDIC) coverage must be secured by eligible collateral. School district funds must be secured by collateral in the amount of 110 percent of the deposit. Funds for each public entity must be collateralized individually.

DIGEST: CSHB 345 would provide a new method for financial institutions to collateralize public funds. The comptroller would establish rules for a program for centralized, pooled collateralization of deposits of public funds and for monitoring collateral maintained by participating financial institutions. The comptroller could provide for a separate collateral pool for any single participating institution's public fund deposits and also could provide centralized collateralization of two or more participating institutions' deposits.

A financial institution could participate in the pooled collateral program only if, with comptroller approval, the institution had entered into a binding collateral security agreement with a public agency for a deposit of public funds and the agreement permitted the institution's participation in the pooled program. The pooled collateral program would provide for voluntary participation by financial institutions and would have uniform processing procedures subject to the security agreement. Participating institutions would pledge collateral securities using a single custodial account instead of an account for each depositor of public funds.

Each participating institution would secure its public fund deposits with eligible securities totaling at least 102 percent of the amount of funds secured, less the amount of FDIC coverage. The bill would exempt institutions using pooled collateralization from the 110 percent security requirement for school district deposits.

A participating institution would provide for the collateral securities to be held by a custodian trustee. The custodian trustee would be subject to existing eligibility requirements for custodians of individual collateralizations. Custodian trustees would be regulated by comptroller rules that ensured the custodian depository was independent of the financial institution depositing securities in trust. A federal home loan bank also would be an eligible custodian trustee, and a letter of credit from such an institution would be deemed an eligible security.

Each participating institution would file the following reports with the comptroller:

- a daily report of the institution's aggregate amount of deposits of public agencies participating in the pooled collateral program;
- a weekly summary report of the total value of securities held by a custodian trustee on behalf of the participating institution;
- a monthly report listing the collateral securities held by a custodian trustee on behalf of the participating institution together with the value of the securities; and
- as applicable, a participating institution's annual report that included the participating institution's financial statements.

Once each year, the comptroller would charge a fee to each participating institution proportional to the institution's participation in collateral pools. The participating institution would remit the payment to the comptroller

not later than 45 days after receiving notice of the fee assessment.
The comptroller could impose an administrative penalty of $100 for each day the institution was out of compliance for the following violations:

- failing to pay the fee assessed for administration of the pooled collateralization program;
- failing to file a required report; and
- failing to maintain collateral in the amount and manner required.

Penalty fees could be contested through standard administrative procedures included in the Government Code. The attorney general could sue to collect unpaid administrative penalties. Enforcement of a penalty could be stayed during the time the order was under judicial review if the participating institution paid the penalty or filed an affidavit stating the party could not afford to pay the penalty. Penalties and fees would be appropriated only for the purposes of administering the pooled collateralization program.

CSHB 345 would take effect September 1, 2007, and the comptroller would be required to establish rules for the pooled collateral program to begin operations the first business day of April 2008.

SUPPORTERS SAY:

CSHB 345 would streamline the public funds deposit collateralization process, lower the cost of holding public funds, and assure adequate protection of public monies. Twelve states have implemented similar pooled collateral concepts with positive results.

Pooled collateralization reduces the overall amount of funds necessary to collateralize deposits because the deposit level of a single entity's accounts can fluctuate widely from day to day or experience peaks and troughs over the course of the year. This fluctuation necessitates that banks pledge securities to cover an entity's highest deposit levels even if the pledges would be excessive for most of the year. Aggregating collateral requirements as proposed in CSHB 345 would balance deposit fluctuations from entity to entity, accounting for some entities having increased deposits while other entities' deposits had decreased. Pooled collateralization would increase pledging efficiency to address only the aggregate needs of the pool.

CSHB 345 would give depository institutions the opportunity to redirect excessively pledged collateral to lending and other economic development

activities. The bill also would reduce bank costs for monitoring as those duties were transferred to the state. The uniform contracting process would reduce legal fees associated with contract negotiations. Freeing these funds would reduce bank costs, which would allow banks to engage in competition to provide public entities with better rates on pooled collateral agreements. In the end, these savings for the public entity could be passed to the taxpayer.

By providing rulemaking authority to the comptroller, CSHB 345 would allow flexibility to address issues that could arise. In most states that have implemented pooled collateralization, the fiscal officer managing the program is given similar authority because it provides the flexibility to fully protect public funds if a risk was identified.

The 102 percent floor set for public fund collateralization would be higher than standards in current statute and an adequate basis for the protection of public funds because the pooling of funds reduces aggregate security needs. Entities that required higher collateralization levels could participate in a pool that had negotiated a higher security standard. Nothing would prevent public entities from using a bank in any county, so entities could search for the pooled collateralization arrangement that was best for the entity. CSHB 345 would be permissive, so a public entity that could not negotiate an acceptable pooled collateralization agreement still could negotiate individual collateralization.

The bill would decrease the chances for under-collateralization of public funds because banks would be required to report collateral daily to the state. The comptroller's experienced staff uniformly would provide better regulatory oversight and program knowledge than local oversight, as local officials often change office. The state would be providing a valuable service by removing the burden of monitoring from a public entity.

OPPONENTS SAY:

CSHB 345 could endanger the safety of taxpayer dollars by creating an unsound system for securing public funds. The current collateralization statutes work well by providing detailed guidelines that ensure adequate collateralization and thorough reporting to public entities about the level of securities pledged for their deposits. This bill would remove these protections by providing only broad guidelines in statute and then authorizing the comptroller to create rules for the new system. While there is no doubt that the comptroller would make efforts to devise rules that would protect public funds, agency rulemaking cannot provide the same

protections as using the legislative process to codify minimum standards for protection of public funds.

It is misleading to say that participation in collateral pools would be voluntary on the part of the public entity because the collateral pool system as proposed in CSHB 345 would create a no-win situation for public entities to fulfill their duty as good stewards of public funds. The 102 percent floor would be too low to meet the standards for collateralization to which most public entities strive. Many entities now contract to collateralize at as much as 115 percent of the deposit value. Banks naturally would negotiate toward 102 percent collateralization because this would be least costly to them. Simultaneously, banks would raise the cost to public entities for collateralizing individually to encourage public entities to participate in the pooled system that benefited the banks. These mechanisms would degrade public entity negotiating power in the depository contracts process because the public entity would have to choose between placing funds at greater risk in a collateral pool or paying a significantly higher price to collateralize deposits individually.

The lack of requirements for banks to provide reports on the level of collateralization to public entities would not allow these entities to effectively audit whether or not public funds were being protected. It would not make sense for the state to have sole oversight of collateral for a public entity when the liability for the public funds remained with the depositing entity. CSHB 345 also would have ineffective penalties for banks that under-collateralized public funds because the assessment of administrative penalties by the comptroller would be permissive.

Given that the current system of collateralization works, there should not be a rush to implement pooled collateralization. The Legislature should take more time over the interim to research the safest ways to implement pooled collateralization of public funds so that public deposits remain secure. A balance exists that would confer benefits to financial institutions while ensuring the security of public deposits, but CSHB 345 would not strike this balance.

NOTES: The companion bill, SB 1748 by Nichols, was scheduled for public hearing in the Senate Finance Committee on May 3. SB 1748 would not include provisions regarding a federal home loan bank being eligible to act as a custodian trustee.

CSHB 345 originally had been set on the April 30 General State Calendar, but was recommitted to committee on April 27. The earlier committee vote to report the bill as substituted was 6 ayes, 1 present, not voting (Anchia).