SUBJECT: Pooled collateralization of public funds

COMMITTEE: Pensions, Investments, and Financial Services — favorable, without amendment

VOTE: 6 ayes — Truitt, Anchia, Anderson, Flynn, Hernandez, Hopson

0 nays

3 absent — Parker, Veasey, Woolley

WITNESSES: For — John Heasley, Texas Bankers Association; Jim Purcell, State National Bank of Big Spring; (*Registered, but did not testify*: David Emerick, Randy Erben, JP Morgan Chase; Monty Wynn, Texas Municipal League)

Against — None

On — (*Registered, but did not testify*: Everette Jobe, Texas Department of Banking)

BACKGROUND: If a deposit of public funds, including accrued interest, is in excess of Federal Deposit Insurance Corporation (FDIC) coverage, it 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: HB77 would provide a new method for financial institutions to collateralize public funds.

Pooled collateral program. The comptroller would establish rules for a program for centralized pooled collateralization of deposits of public funds and for monitoring collateral maintained by participating institutions. The comptroller would provide for a separate collateral pool for any single participating institution's public funds deposits. The collateral of a participating institution pledged for a public deposit would be prohibited from being combined with, cross-collateralized with, aggregated with, or pledged to another participating institution's collateral pools for pledging purposes.

County deposits of public funds would not be eligible for participation under the program.

Participation in the program by a participating institution and each affected public entity would be voluntary. Uniform processing procedures for all collateral transactions would be subject to an approved security agreement. Additionally, the program would allow a participating institution to pledge its collateral securities using a single custodial account instead of an account for each depositor of public funds. A participating institution could pledge its pooled securities to more than one participating depositor under contract with that participating institution.

A financial institution could participate in the pooled collateral program only if:

- it 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 program;
- the comptroller had approved the institution's participation in the program and had approved or provided the collateral security agreement form used.

Required collateral held by a custodian trustee. 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 existing comptroller rules. The rules would ensure that a custodian trustee was independent of the financial institution depositing securities in trust. A federal reserve bank, a federal home loan bank, and a bank insured by the FDIC or a bank holding company that owns or controls an FDIC-insured bank could be a custodian trustee.

Monitoring collateral. Each participating institution would have to file electronically the following reports with the comptroller:

- a daily report of the aggregate ledger balance of deposits of public agencies participating in the pooled collateral program that were held by the institution, with each public entity's funds itemized;
- a weekly summary report of the total market 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 includes the participating institution's financial statements.

The comptroller would provide the participating institution an acknowledgment of each report received, provide a daily report of the market value of the securities held in each pool, and post each report on its website.

Annual fee assessment. Once each fiscal year, the comptroller would charge a fee, based on a formula, to each participating institution proportional to the institution's participation in the collateral pools after first providing a notice to the institution of the assessed amount. The participating institution would remit to the comptroller its assessment within 45 days after it received the notice. The assessment amount would be based on a variety of factors, including:

- the number of public entity accounts a participating institution maintained;
- the number of transactions a participating institution conducts; and,
- the aggregate average weekly deposit amounts during that year of each participating institution's deposits of public funds collateralized.

Penalties. The comptroller could impose an administrative penalty of between $100 and $1,000 a day for each violation. Violations would include:

- failing to file a required report within the required timeframe;
- failing to maintain collateral in the amount and manner required if the issue had not been remediated within three business days after receiving a notice from the comptroller; and,

- failing to pay the assessed administration fee of the pooled collateralization program.

The comptroller would by rule adopt a formula for determining penalty amounts, which would be based on several factors including:

- the aggregate average weekly deposits amounts during the year of the institution's deposits of public funds;
- the number of violations by the institution during the year;
- the number of days of a continuing violation; and,
- the average asset base of the institution as reported on its year-end report of condition.

Penalty fees could be contested through standard administrative procedures included in the Government Code. The attorney general could sue to collect unpaid 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.

The bill would take effect September 1, 2009, and the comptroller would be required to establish rules for the pooled collateral program to begin operating on the first business day of April 2010.

SUPPORTERS SAY:

HB 77 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. This concept has been thoroughly vetted and was recommended by the Senate Finance Committee in its interim report to the 81st Legislature.

Pooled collateralization reduces the overall amount of funds necessary to collateralize deposits. 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 requires 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 HB 77 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.

HB 77 would provide to deposit 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 would be transferred to the state. The uniform contracting process would reduce legal fees associated with contract negotiations. Freeing these funds would reduce bank costs, allowing banks to engage in competition to provide public entities with better rates on pooled collateral agreements. The savings for the public entity ultimately would benefit taxpayers.

The 102-percent floor set for public fund collateralization would be higher than standards in current statute and provide an adequate basis for the protection of public funds because the pooling of funds reduces aggregate security needs. HB 77 would be permissive, so a public entity that could not negotiate an acceptable pooled collateralization agreement still could negotiate individual collateralization. Those entities that required higher collateralization levels could participate in a pool that had negotiated a higher security standard.

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 would provide better regulatory oversight and program knowledge than local oversight, as local officials can often change office. The state would be providing a valuable service by removing the burden of monitoring from a public entity.

OPPONENTS SAY:

HB 77 would not guarantee the necessary protection of public funds that the current system, which allows public entities to negotiate a level of collateralization that meets their unique local needs and fulfill their duty as good stewards of public funds, now provides. A pooled collateral program, while allowing for voluntary participation, could alter the market by providing incentives for financial institutions to participate in the program to reduce their costs. This could 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.

NOTES: The companion bill, SB 638 by Nichols, passed the Senate by 31-0 on April 7 on the Local and Uncontested Calendar and has been referred to the House Pensions, Investments, and Financial Services Committee.

During the 2007 regular session, a similar bill, HB 345 by Flynn, passed the House and was referred to the Senate Finance Committee, which took no further action.