Banking Services: A Guide for Governments

Nicholas Greifer, Editor

GOVERNMENT FINANCE OFFICERS ASSOCIATION
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Foreword

Government finance officers regularly rely on a variety of service providers to help carry out financial operations, but no relationship is more important to the government than that which they establish with their depository bank. A government's financial performance hinges on this crucial relationship for several reasons:

- Every government, without exception, must have a place to deposit funds and to perform cash management activities;
- Banks are responsible for safeguarding billions of dollars in public-sector deposits;
- The quality of bank service determines the efficiency with which a government can move daily cash flows into and out of the government's accounts; and
- Banks are increasingly the locus for e-commerce initiatives that are improving government financial operations and enhancing customer service.

As a result, it is vital that a government finance officer develop a competency in the procurement of banking services. It is toward this goal that the Government Finance Officers Association (GFOA) is publishing Banking Services: A Guide for Governments, the first book-length treatment of the subject by the association since the mid-1980s. Junior-level cash managers will find the book to be a helpful guide in developing expertise on the subject of banking relations, while experienced practitioners will be able to use the book as a reference.

I would like to thank the many contributors to this publication, including the editor of this publication, Nicholas Greifer of the GFOA Research & Consulting Center. Stan Helgerson, Finance Director, Village
of Carol Stream, Illinois; Joseph Casey, Director of Finance & Management Services, Hanover County, Virginia; and James Beasley, President of J.F. Beasley & Co., Inc. served as the primary technical reviewers for the publication. Mr. Helgerson and Mr. Casey are the Chair and Vice-Chair, respectively, of the GFOA Committee on Cash Management.

Other reviewers included Anne Kinney, GFOA Director of Research & Consulting; Bill Stafford, Finance Director, City of Evanston, Illinois; Ned Connolly, Vice-President, Chandler Asset Management, Inc.; Steve Miles, Vice-President of Corporate Trust Division, SunTrust Bank; and Jeff McElravy, GFOA Senior Policy Analyst/Consultant. Finally, I want to thank the many contributors, identified in Appendix E, who volunteered their time and expertise in writing chapters for this book.

Jeffrey L. Esser
Executive Director
Government Finance Officers Association
CHAPTER 1

Introduction

Nicholas Greifer

Cash management is at the hub of a government’s financial operations, and at the core of the government’s cash management operations lays its bank. An effective relationship between a government and its bank is essential for enabling a government to perform critical cash management activities. The goal of this book is to provide guidance to state and local cash managers and treasurers on how to maximize the effectiveness of the banking relationship and obtain the best possible set of banking services.

The objectives of the book are fourfold:

- To increase the knowledge and level of professionalism of both established government cash managers and newer employees just beginning their cash/treasury management careers;

- To encourage governments to implement the recommended practices on cash management set forth by the Government Finance Officers Association;

- To provide an introduction to managing what is perhaps the most important financial relationship a government can have with an external financial services firm; and

- To expose cash managers to trends and emerging technologies in the field.

This chapter reviews the cash management function within the context of banking services and relates the fundamental tasks of collections, investment, and disbursement to the banking relationship. It concludes with a synopsis of the remaining chapters.
Cash Management Objectives and the Banking Relationship

Cash management can be defined as all activities undertaken to ensure maximum cash availability and competitive investment yield on a government's idle cash. The focus of cash management is on the efficient management of cash, from the time collection efforts are initiated to the time an expenditure payment clears the bank. In its most fundamental form, the cash management function can be categorized into three areas:

1. *Cash mobilization*. Cash mobilization or collections is the process of transforming financial claims into cash. For example, invoicing procedures should be reviewed to ensure that billings are current and actively monitored. Tax payments and other revenues should be deposited swiftly, so that collected funds are available for disbursement or investment. Collection procedures should be established to control aging receivables and to accelerate cash availability. Generally, governments are entitled to earn interest on the funds to which they have a claim. Funds should therefore be deposited as quickly as feasible to reduce collection float. Failure to pursue prompt payment can be viewed as an interest-free loan to a third party.

2. *The investment program*. A prudent investment program can help government officials generate additional income from their cash resources. Precautions should be implemented, of course, to ensure that undue risks are avoided. This necessitates setting an investment policy in which safety and liquidity come before yield. It also involves cash flow forecasting to determine the investment time horizon.

3. *Optimized disbursement*. Although prompt payment is desirable, premature disbursements result in lost interest income or higher borrowing costs. Many governments have implemented techniques that enable them to make disbursements "just in time." When handling large disbursements, such as debt service payments, special care should be taken so that cash is not released prior to the due date. In some cases, extra charges for wire trans-
fers are justifiable considering the additional interest earned during the time held.

The elements of cash management are illustrated in Exhibit 1.1.

With regard to investing, the cash management function generally is concerned with short-term investments. Although some governments invest pension funds, debt service funds, and trust funds for multi-year periods, this type of long-term investing is beyond the scope of this book's cash management discussions.

The banking relationship is central to all three cash management objectives. Cash mobilization or collections inevitably involves the government's financial institution, acting as depository. Similarly, a government relies on its banking partner to disburse funds, using either electronic or paper-based means. Additionally, governments often used the same financial institution to provide investment services.

How Cash Is Collected And Mobilized

Cash mobilization – the receipt of payments from citizens and businesses to the government – is the first task of a cash manager. That is, before funds can be invested and eventually disbursed, they must be 1) received and secured, 2) accounted for, and 3) deposited at a bank or similar financial institution. Cash collections (e.g., receipt of tax payments) may occur through another jurisdiction, such as a county government that collects property taxes for later transfer to subsidiary governments. Overall,
Technologies for Improving Collections

1. Fedwires
2. ACH-Based Payments
3. Credit Card Acceptance
4. E-Commerce
5. Cashiering Workstations (Point of Sale Systems)
6. Lockbox Service


though, most treasurers’ offices engage in at least some form of revenue collections.

The receipt of payments is a vital, but perhaps underappreciated, part of financial management. When functioning properly, cash receipting gets little attention; when operational breakdowns occur, however, they can lead to a public relations nightmare of embarrassing headlines about lost or stolen cash.

Consequently, as cash and negotiable items (checks, credit card payments, wire transfers, and other payments) are received, the cash manager has two immediate responsibilities. First, accountability must be established so that precise records of cash receipts are available and auditable. Second, an aggressive program should be implemented to accelerate the deposit of cash receipts so that those funds become available for investment as quickly as possible.

There are several technologies available that can be procured directly or indirectly as part of banking service agreements (see Exhibit 1.2.) The first three technologies – Fedwires, automated clearinghouse (ACH) payments, and credit card acceptance –replace cash and check payments with electronic payment alternatives. Because e-payments eliminate the manual handling associated with cash and checks, they are much less labor-intensive, less prone to errors in processing, and there are fewer in-
ternal control problems. In addition, electronic payments tend to accelerate cash availability.

Cash managers must pay special attention to high-dollar amount receipts. At 5 percent interest, a $1 million deposit is worth $200 per business day (after averaging in weekends and holidays). In these instances, Fedwires (which allow same-day transactions) can be used to expedite collection of investable funds. ACH-based payments (which can take two or three days to complete) are typically used for small, repetitive transactions such as water utility payments. On a per-transaction basis, they usually cost less than a check, credit card payment, or Fedwire.

In most cases, e-commerce requires a credit card payment to execute a transaction over the Internet; thus, the benefits and costs are similar to credit card acceptance. However, e-commerce actually goes a step further by making the customer (and/or the computer server tied to a Web site) perform the data entry to execute a transaction, instead of a government cashier. As a result, from the government's perspective it eliminates the "human intervention" needed to carry out a transaction.

Cashiering workstations are essentially sophisticated cash registers. They integrate cash-receipt systems with the central accounting operation, thereby establishing records at the "point of sale" that tie into the general ledger. Usually, cashiering workstations can do daily reconciliations of cash received instead of a manual reconciliation, which expedites the preparation of bank deposits and strengthens internal controls. In smaller jurisdictions, however, simpler cash-receipt systems may be more cost-effective.

Many jurisdictions retain the lockbox services of commercial banks to assist in the cash-receipts function. The lockbox is essentially a package of services that would ordinarily be done by a team of municipal workers – sorting and opening mail, recording payments, preparing payments for deposit, and verifying the accuracy of moneys to be deposited. Furthermore, banks can MICR-encode (magnetic ink character recognition) checks for internal bank processing and upload account receivable data to its government clients.

The lockbox service assures the timely deposit of funds by reducing the float between the public treasurer's office and the depository. Banks
have high-speed, high-volume equipment available for receipts processing, which adds efficiency. At the same time, original documents can be provided to the contracting governmental jurisdictions so that accountability is retained.

An increasing number of state and local governments accept credit card payments. Although the transaction fee absorbed by the government can be substantial, in some cases these can be passed on to the customer (e.g., by assessing convenience fees for credit card payments made over the telephone) or simply negotiated down. Like other electronic payments, however, it offers the government advantages of speed/accelerated payment of funds, avoided check handling costs, and increased certainty of collection. Moreover, credit cards have become the dominant form of e-commerce payment and enhance customer convenience.

The Investment Program: How Cash Is Put to Work

After collections, the subsequent task of a cash manager is to invest cash. Although the investment process has become increasingly complex and sophisticated,1 it is possible to make the following generalizations about the key activities of the investment process as follows:

1. Setting policy – An investor’s opportunity, constraints, preferences, and capabilities should be identified and specified explicitly in written investment policies.

2. Implementing strategy – Investment opportunities are identified and strategies are implemented through the purchase of financial securities and related instruments in the marketplace.

3. Monitoring portfolio – The investor’s circumstances, market conditions, and relative values of securities are monitored; results are documented and reported.

4. Adjustment of portfolio – Portfolio adjustments are made in response to new objectives and changing circumstances and results.2

Investment Activities That Can Be Outsourced to a Bank. In order to implement strategy (step 2 above), governments often outsource discrete activities to either banks or other specialized investment advi-
Activities of an Investment Program That Can Be Outsourced

Development/revision of investment policies
Preparation and update of a cash forecast
Determination of the investment horizon
Establishment of an investment outlook and strategy
Portfolio analysis (e.g., analysis of the yield curve)
Selection of instruments to confirm to strategy and policy
Monitoring of the markets and investment results
Reports on investment results
Adjustment and rebalancing of the portfolio

sors. Indeed, many of the activities identified in Exhibit 1.3 can potentially be outsourced to a third party, depending on the preferences, internal expertise, and resources of a government.

Often, governments rely on a financial advisor in preparation for the actual selection of investment securities. These preparatory activities can include the development or refinement of investment policies and cash forecasting. Investment policies provide the formal structure that governs the activities of investment officials, and are often required by state law. Even when state statutes specify permissible investments, local investment policies are needed to further clarify the entity's investment objectives, preferences, constraints, and procedures.

The goal of cash forecasting is to provide a road map for the investment officer so that a projection can be made of funds available for investment purposes over a specific time horizon (e.g., three months, six months, or one year). Because interest rates paid on longer-term investments typically are higher than those on shorter maturities, investors able to forego the liquidity of shorter-term investments should be compensated through higher yields. A properly constructed cash flow forecast can help governments extend the term on its investments. Thus, in the-
BANKING SERVICES

ory at least, a cash forecast should help to produce enhanced investment results.

**Short-term Investment Strategies.** Government treasurers typically invest part or all of their short-term portfolios either passively or actively. Because active management requires greater resources, staffing, and training than what is often available to a government, active investing is often done by a bank or other financial advisor. For additional information, refer to the Chapter 5 discussion on investment management.

**How Funds Are Disbursed**

The last function of a cash manager is to disburse funds. Often the accounts payable department manages these tasks. Regardless of whether the same department handles all the cash management functions, or if a separate department handles disbursement, financial managers need to coordinate disbursement. Like cash mobilization, the objectives of a sound accounts payable operation are efficiency, speed, and control. With the assistance of external vendors and the procurement of new technology, most governmental disbursement systems have become highly automated. Moreover, by obtaining state-of-the-art services from technology-savvy vendors (e.g., positive pay check fraud protection), governments can strengthen their internal controls over fund disbursement.3

Typically, disbursement activities center on payroll, debt service, capital outlay, and accounts payable. For example, many governments use batch processing for their accounts payable on a monthly, semi-monthly, or biweekly basis. These large accounts payable disbursements are not entirely predictable, although most cash managers quickly develop an intuitive sense for their size and the extent to which float can be anticipated. For example, a $250,000 semi-monthly accounts payable run might be projected during the previous week, based upon input available through the accounting system. Although the actual disbursements might prove to be $10,000 more or less on the day of disbursement, investment planning generally need not be quite that precise. Further, the cash manager should be able to estimate that on the first day following the disbursement, a certain percentage of the checks will still be in the mail, thereby permitting the jurisdiction to continue to invest perhaps
Introduction

$200,000. On the second day, however, as checks are presented against the jurisdiction’s depository, additional funds must be provided, and investments must be liquidated to cover the disbursement.

Towards a Floatless Economy

Several factors are moving financial managers toward a floatless economy marked by nearly instantaneous payment and settlement. First, technologies – ACHs, purchasing cards, credit card payments via telephone or the Internet – that replace cash and checks have increased the velocity of the national payment system. Secondly, the federal government has required the use of electronic funds transfers to either make a disbursement to, or receive a payment from, the federal government. Third, the Federal Reserve, operating under the mandate of the Monetary Control Act of 1980, aggressively acted to minimize the float in the banking system. Whereas checks drawn on geographically distant banks once required as much as a week or two to clear the banking system, the Fed-mandated procedures now have reduced this clearance time to two days, and even less in many locations.

Fourth, more recent legislation such as the Check Clearing for the 21st Century Act (Check 21) will shorten the payment cycle from the government payor to the government payee. Check 21 will expedite the clearance and settlement of checks by and between payor and payee banks (see Appendix A for additional information). The law takes effect in 2004.

Taken together, these factors have diminished the opportunities for public cash managers to aggressively “play the float.” Although a day of interest can still be significant, the opportunities for such earnings diminish as the payments system gradually improves. Consequently, the disbursement side of the cash management function will probably receive less attention as an area for opportunity to generate income.
Organization of Book

The book is organized into eight chapters, grouped into three parts. Part I provides background material on concepts—such as cash inflows (collections) and outflows (disbursements)—that are fundamental to managing a banking relationship, and that finance officers should learn prior to issuing a request for proposals for banking services. Part II reviews the array of services a finance officer can procure from a single bank. It covers core services that, at minimum, the vast majority of governments would select, as well non-core or ancillary services that a government may consider pursuing as well. Part III covers procurement and oversight issues that arise when issuing an RFP and then maintaining an effective relationship with a bank. This involves construction of an RFP document, compensation to a financial institution, and oversight of the bank that wins the government’s business.

Chapter 2 on collections covers the concept of float, which involves delays in the receipt of monies from one party to a counter-party in a transaction. It introduces the reader to electronic services provided by banks that help manage float, such as ACH and Fedwires. In addition, it covers internal control issues related to the collection process.

Chapter 3 on disbursement reviews disbursement-related float, check issuance, and electronic means of disbursing funds. In addition, a discussion of check- and payment-related fraud is presented, along with tools for managing these risks, such as positive pay.

Chapter 4 summarizes the core services available from a depository bank. A detailed discussion is presented of how a government should articulate its needs for core (collection and disbursement) services. For the purposes of this book, services that assist in managing cash inflows, cash outflows, and cash concentration are considered core services of a depository bank, as are overnight investing and lockbox services. Some governments may view lockbox services as a non-core service, depending on their needs and circumstances.

Chapter 5 discusses non-core or ancillary services available from a bank. Often, banks compete against other entities for the delivery of such services, which include investment management, credit card acceptance, credit, and trustee services related to bond issuance.
Introduction

Chapter 6 focuses on administering a request for proposals (RFP) for banking services. It is assumed that this method or a related method such as a request for information is used and that the definition of needs/requirements is the essential task in issuing an RFP. The chapter reviews the construction of the RFP document. In addition, it covers other issues that need to be considered when selecting a bank, such as political/policy considerations, indemnification, and the transition from the old bank to the new bank.

Chapter 7 addresses the critical aspect of negotiating the compensation structure and levels to pay for banking services. Typically, governments use what is known as a compensating balances approach to paying for banking services, and/or a direct payments based upon fees for particular banking services.

Chapter 8 deals with the oversight of the bank’s creditworthiness. Bank failures, while rare, are an issue that any government treasurer should be prepared to assess and act upon.

Lastly, the book provides several appendices as resources for a government cash manager. Appendix A traces the evolution of the banking industry over the past twenty years. Many types of financial institutions compete for public funds, in addition to banks. Deregulation of the financial services industry has blurred the lines separating banks, savings institutions, government securities dealers, and insurance carriers. Looking forward, it is reasonable to foresee the continued breakdown of industry barriers, and the rise of multi-purpose financial institutions due to (a) long-term consolidation within the overall financial services industry and (b) repeal of the Glass–Steagall Act, in place since the 1930s. The Financial Services Modernization Act of 1999 repealed this act, which once kept the banking, securities, and insurance industries apart. The new law explicitly permits the creation of new financial holding companies in all three lines of business.

Appendix B offers a case study of local governments that have procured banking services jointly. Joint procurement provides a greater level of service and better pricing, according to the authors. Appendix C includes the full text of GFOA recommended practices that are germane to
banking services. Appendix D provides a glossary of banking terms and Appendix E identifies the contributing authors of this book.

ENDNOTES


3. To a large degree, the success of a government's disbursement program will be determined by the kinds of services obtained from a bank. For example, obtaining positive pay is highly recommended by GFOA.

4. GFOA encourages public finance officers to consider using electronic means of payment. See Appendix C for the GFOA Recommended Practice, “Electronic Transactions for State and Local Governments.”

One of the critical roles of the cash manager is collecting revenues as rapidly as possible. Before any funds can be invested and before they can disbursed, they must be collected efficiently and prudently, and in conformance with internal policies. These policies are designed to mitigate leakage in the form of sluggish revenue intake and to deter outright fraud when internal controls are violated. To achieve these objectives, governments rely heavily on their bank to accelerate the intake of revenues and to safeguard those resources.

This chapter provides financial managers an overview of the collection process, the bank’s role in providing services that accelerate collections, and internal control challenges in establishing a sound collection program. In order to understand these issues, it is necessary to define a key concept and key metric used for collections: float. In addition, a review of common methods for receiving payments from a government’s customers will be provided.

Common Forms of Payment for Government Services

The collection of funds for various government services includes the following types of payment instruments: cash, checks, credit cards, debit cards, and ACH-based payments. Local governments may also collect funds using Fedwires, such as for large payments from the federal government, but consumer transactions usually are not done in this manner. These payment instruments are discussed in greater detail, beginning on page 21.

The collection options available to state and local treasurers are greatly influenced by the trends in consumer payment methods. In particular, the growing consumer preference for electronic payment has
promoted governments to adapt by allowing e-payments for some transactions. A Federal Reserve study of non-cash consumer payments shows that checks, while still dominant, are being gradually supplanted by other methods of non-cash payments (see Exhibit 2.1), such as credit cards.

As might be expected, credit cards are the most common means of executing an electronic transaction, accounting for nearly half of electronic payments in 2001 (see Exhibit 2.2). Automated Clearing House (ACH) payments represent the second most common form of payments in terms of volume (19 percent), but in terms of dollar value they are by far the most important. Seventy-nine percent of the nation's dollars for electronic payments move by ACH.

Further, each payment instrument can be used in one or more business processes for collection. For example, credit card payments can be made over the counter or over the telephone or over the Internet (see Exhibit 2.3).

Governments have moved swiftly to enable citizens to make payments electronically by using the government's Web site. Many governments use a Web hosting service, in which a vendor is linked to the
Types of Electronic Payments

Electronic Payments by Volume

- Private label credit cards: 9%
- Electronic benefit transfers: 2%
- Online debit cards: 10%
- General purpose credit cards: 42%
- Offline debit cards: 18%
- ACH: 19%


government’s Web site, and the vendor’s Web site allows for online processing of economic transactions.

In the early phases of e-government, the predominant form of payment over the Internet has been through credit cards, making it incumbent upon governments to assess the utility of credit card acceptance. To support Web-based payments, governments may incur: (a) development costs to establish a secure Web site for transactions, (b) Web site maintenance costs, and (c) ordinary credit card processing costs. Alternatively, a handful of governments allow citizens to pay online using the ACH network, thereby avoiding credit card processing fees. For example, Fairfax County, Virginia, allows its citizens to make payments by initiating an ACH transaction online. The costs and benefits of credit cards are discussed further in Chapter 5.
### EXHIBIT 2.3

## Collection Methods

<table>
<thead>
<tr>
<th>Government's Process for Collections</th>
<th>Typical Payment Instrument</th>
</tr>
</thead>
<tbody>
<tr>
<td>Centralized over-the-counter payment (through central treasury or collections department)</td>
<td>Check, cash, credit card, or debit card</td>
</tr>
<tr>
<td>Decentralized over-the-counter payment (through operating departments)</td>
<td>Cash. May also accept check, credit card, or debit card, depending on training and equipment provided to staff of operating departments.</td>
</tr>
<tr>
<td>Payments mailed directly to government</td>
<td>Check or credit card</td>
</tr>
<tr>
<td>Payments mailed to lockbox service provider</td>
<td>Check or credit card</td>
</tr>
<tr>
<td>Dropbox for depositing payment at government facility</td>
<td>Check</td>
</tr>
<tr>
<td>Telephone banking using interactive voice response (IVR) systems</td>
<td>Credit card or debit card</td>
</tr>
<tr>
<td>World Wide Web</td>
<td>Credit card or debit card. Some governments allow for direct payment by inputting data from customer’s checks</td>
</tr>
<tr>
<td>Direct payment (direct debit)</td>
<td>ACH debit</td>
</tr>
<tr>
<td>Direct deposit of state grant in municipal account</td>
<td>ACH credit</td>
</tr>
<tr>
<td>Bill-paying services*</td>
<td>Government receives a check from bill-paying service provider (intermediary)</td>
</tr>
</tbody>
</table>

*With the advent of Web-based payments and online banking, bill-paying services are becoming less popular.

## Types of Float

In its role as collectors of revenue, the government’s primary objective is to accelerate the receipt of payments. By doing so, government cash managers may maximize daily cash flow, invest excess collections, and boost
Cash Inflows

investment income. In pursuit of this objective, one should clearly understand collection float and the importance of minimizing it.

The concept of float broadly refers to the time required in the process of collection, concentration, or disbursement of funds. Increases in float are beneficial to the disburser because the float allows the disburser to keep funds invested for longer periods, accruing interest. Conversely, efficiencies in reducing float are beneficial to the receiver or collector as it allows the receiving entity to capture dollars and begin investment sooner. Cash managers spend considerable time focusing on managing disbursement and collection float. This chapter will focus on collection float. (See Chapter 3 for a discussion of disbursement float.)

Float is easier to understand when the activities required in getting a payment to the government's bank are understood. With respect to cash inflows, float occurs at various points, beginning with the time when a municipal or state service is requested or provided (or an order for a service is made) and ending when the payer's account is debited. Components of float include, in chronological order:

- Invoicing float;
- Credit float;
- Collection float;
- Bank float.

Collection float deals with three segments: mail, processing, and availability float. These are highlighted in Exhibit 2.4 and, depending on the government's organization structure, may by subject to greater control by the treasury unit.

Invoicing float pertains only to those payments (such as utility bill payments) that require the generation of an invoice. It simply refers to the passage of time from invoice generation to validation of invoice data (for accuracy), up to the point of mailing. Many governments use a batch process to generate invoices on a cycle, such as a monthly cycle, not so much to minimize float as to reduce the labor-intensive effort to generate thousands of invoices. Credit float is the time required for outbound mail to
arrive at the payer or customer. Mail float is the time funds are unavailable when an inbound payment is in transit through the postal system.

Historically, the revenue collection via check payment has been the most widely used collection method. Although the volume of check payments has decreased, it remains a heavily used payment method. Accordingly, float for this type of payment is demonstrated in Exhibit 2.4.

Once the payment is delivered to the government, processing float begins. Processing float is the time funds are unavailable because the payee is processing the check. The payment envelope is opened and dated. The payment is then posted to the appropriate customer account. The check is endorsed and balanced to the daily cash receipt documents, then prepared for deposit to the government’s bank account.
Once the payment gets to the bank, the bank processes the check for clearing; this segment of time is referred to as availability float. This is the time funds are unavailable because they are moving from the payer’s bank to the government’s bank. Processing includes encoding the check and sending it through the bank’s clearinghouse each night. The bank’s clearing process is the means by which the collected funds are credited to the payee’s bank account.\(^1\)

Bank float is the time from when the government’s bank account is credited and the payer’s bank account is debited.

Governments should consider the various services available through their financial institutions to minimize collection float (discussed below). These banking tools are available to most types of governments and efficiently utilize the banking system to enhance the revenue stream while minimizing the costs of the government’s collection efforts. As previously mentioned, there are several types of payment instruments and methods. Because many of these are available from banks, the next section explores the various services that governments can deploy to accelerate collection of revenues.

**Banking Services for Expediting Collections**

This section describes selected banking services available for accelerating cash receipts. By effectively utilizing various collection services available through banks and other financial institutions, a government can realize an increase in funds available for investment. Widely used banking services that may have the greatest impact on the primary objective of accelerating cash receipts include wire transfers, ACH, lockbox, and credit cards. In addition, some governments may turn to banks and other providers to make the process of check payment and settlement either fully or partially electronic.\(^2\)

Financial institutions provide several electronic banking services that expedite collections. Electronic fund transfers (EFTs) are automatic transfers of funds from specific banks to the government and encompass both ACH-based payments and wire transfers. The benefits provided by electronic transactions include: expedited revenue collection, greater cer-

Benefits of Electronic Transactions:
- Reduced bank fees;
- Faster deposit and investment of funds;
- Improved cash flow certainty allowing better investment decisions;
- Easier and less expensive bank reconciliations;
- Reduced check production and distribution costs;
- Reduced check fraud;
- Fewer lost, stolen, and reissued checks;
- Improved customer/employee relations; and
- Demonstrate to customers that the organization is customer oriented, technologically capable, and cost conscious.

*Note:* The full text of this recommended practice appears in Appendix C.

The certainty of payment, and greater ability to determine the government’s timing of receipts (i.e., greater certainty in cash positions), as indicated in Exhibit 2.5. At the same time, EFT payments avoid the problems associated with check payments: float on check receipts, paperwork, lost or stolen checks/warrants, check processing and reconciliation costs, payroll processing costs, and postage expense. Customers and employees also benefit—indeed, may demand—that the government establish electronic means of payment such as ACH-based utility payments or direct deposit.

**Wire Transfers**

Wire transfers are funds transferred from the paying bank to the receiving bank, using the Federal Reserve Communications System (Fedwire) for the settlement of transactions. Wire transfer deposits have no mail float and funds are immediately available. They can be transferred from one account to another in the same day. Although wire transfers result in im-
mediate availability, the cost per transaction is greater than for ACH-based transactions and is therefore used for larger-dollar transactions.

In order to execute a wire transfer, a government cash manager would need to provide the following information to its bank:

- American Bank Association (ABA) routing number for the receiving bank (typically a nine-digit identification number);
- Name of the receiving bank;
- Name and account number to be credited; and,
- Name of specific person to whom wire should be directed.

The bank deadlines for submitting wire transfer requests vary from bank to bank. Generally, online requests usually have later deadline requirements for wire transfer requests than offline requests (phone and fax requests), with some banks accepting requests as late as 1:00 p.m. Each government should confirm cut-off times at the time it establishes a relationship with a bank.

A wire transfer agreement may be incorporated into a comprehensive banking services agreement as an addendum, or as a separate agreement. In either case, it should outline the bank’s policies and procedures in handling wire transfers for clarification and reference.3

ACH

Automated Clearing House (ACH) is the other major type of electronic fund transfer. This process electronically clears and settles debits and credits between banks, using a network of Federal Reserve affiliated facilities (see Exhibit 2.6). There are multiple ACHs in the United States that comprise the national network, governed by National Automated Clearing House Association (NACHA) rules for inter-regional exchanges between the ACHs. All ACHs are either operated by the Federal Reserve System or by private companies.

Generally, the ACH network is designed for recurrent transactions and receivables such as utility bills, property tax payments, state and federal grants, sales taxes, etc. Because the cost per transaction of ACH-
based payments is lower than for Fedwire transfers and for paper-based checks, ACH is very beneficial when used to process smaller, recurring customer payments. Some governments utilize ACH for the payment of property taxes as well. Governments may consider actively encouraging their citizens to pay recurring fees for municipal services using ACH direct payment. While there may be some initial resistance, governments can educate citizens (through newsletters or mailings) about the significant benefits: there is no cost for enrollment and participation; ACH avoids the monthly exercise of check-writing and mailing; and payments are always on time.

By using ACH, mail float is eliminated, processing float is minimized, and availability float is reduced to one or two days. As with Fedwires, advantages experienced by using ACH are an increase in cash flow certainty, the expedition of receivables, and a reduction in late payments and delinquencies. Other benefits of ACH include the following:

• Reduction in operating costs due to reduced bank charges and mailing expenses;

• Improvement of cash controls (adds certainty to forecasting, facilitates reconciliation, and reduces manual involvement);

• Addition of quality and accuracy by reduced errors; and

• Reduction of time and effort required in the various steps in the preparation process.

At minimum, the information required for any ACH transaction will include the following items:

• Identification of a debit or credit transaction;

• Use of the ABA or transit routing identification number of the applicable bank account;

• Specification of the transaction amount; and,

• Provision of the settlement date.
Instructions are generally delivered from the originating bank, through an ACH operator, and ultimately to the receiving bank via electronic media pursuant to NACHA standards (refer to Exhibit 2.6). On the settlement date, the originator’s bank account is credited and a debit is generated at the receiving bank. In terms of collections, the originator is the government and the customer is the receiver.

Prior to executing an ACH entry for a new customer, the originator (the government) tests the transaction by sending a zero-value pre-notification transaction through the system prior to the first actual transaction. (Typically, a customer enrolls in a direct debit program by
completing an enrollment form and providing a voided check.) The pre-notification test is important in the verification of information for accuracy. If the test transaction is not rejected, then the real transactions may be subsequently executed. Transactions containing inaccurate ABA numbers, account numbers, or names will be rejected, in which case these data fields must be reviewed, corrected, and retested. Since this is a critical step in implementing ACH, government units should involve their local bank as soon as possible in the planning process.

Customers paying via ACH for government services such as utilities should be provided a written document informing them of the date and amount of the scheduled payment from their account. Typically, governments send the normal utility bill with the amount of payment due and due date. Furthermore, the utility bill contains specific language notifying the customer that an automatic debit will occur on a designated date, which helps to avoid duplicate payments.

A related service available from some banks is electronic bill presentation and payment, which often utilizes the ACH network to execute a transaction (see Exhibit 2.7).

**Lockbox**

The goal of the cash collection and concentration aspect of cash management is to speed up the collection and crediting processes of the government's accounts receivable department, and concentrate them into accounts where the money can be invested. Lockbox is a time-honored cash management tool used by treasurers to expedite the intake of payments via check. Processing float is reduced because mail is immediately opened and processed.

Banks can provide either wholesale or retail lockbox service. Typically, governments utilize retail lockbox service, which is designed for high-volume payments with low dollar size, such as taxes, utilities, licenses, and fees. Retail lockbox services are generally fully automated, process machine-readable documents, and require little manual intervention. Wholesale lockbox service is for businesses that have a low volume of items with high dollar size. The discussion below focuses on retail lockbox service.
Overview of Electronic Bill Presentment and Payment

Electronic bill presentment and payment (EBPP) is an online method for presentment, or delivery, of bills and their subsequent payment. There are three models:

- **Biller-direct** – A government issues a bill directly to participating customers, and the payment is made on the government’s Web site (no bank or provider acts as an intermediary).

- **Consolidator** – Banks can provide one form of EBPP under the consolidator model. Essentially, a bank (or a competing private entity) consolidates a customer’s bills from multiple billers, delivers the bills to the customers, and then collects online payments from the customers.

- **Consumer lockboxes** – Paper bills are routed to a customer’s lockbox provider; the bills are scanned and converted to an electronic billing statement. The customer then accesses the provider’s Web site to make the payment.

From a customer’s viewpoint, the first model (while free) requires accessing the Web site of each biller, including the government’s. In contrast, the latter two models only require accessing one Web site for making all payments. Historically, however, there has usually been a cost imposed upon the consumer. Payments are made via ACH, credit card, or other means.


Exhibit 2.8 provides an overview of the lockbox process. Central to the efficiency of a lockbox processor is (a) location near a postal facility, (b) specialized equipment for scanning invoices and checks, and (c) specialized training of bank processing staff.

At a detailed level, most lockbox services function in the following manner:

- The bank contracted to provide lockbox service maintains a separate post office box in the government’s name;

- Customers’ remittances (that is, the document indicating amount due) and enclosed check are mailed to the specific post
office box, rather than to the post office box for the government’s regular mail (often facilitated by using pre-addressed, bar-coded7 envelopes);

• The bank agrees to collect the remittances periodically during the day. Depending on volume, the bank may collect remittances perhaps as often as once every two hours or as infrequently as once a day;

• Bank staff opens the remittances and sorts the check payments and accompanying data;

• Checks that match the particular bill, invoice, or other data are processed for deposit that day;

• Exceptions (non-matching items) may or may not be processed by the bank. Any checks that are not processed are turned over to the government for action; and,

• Copies of all normal, accepted remittances and accompanying data are forwarded daily to the government (on CD-ROM and/or via the bank’s online reporting) for its internal posting process.

Regarding the latter point, the posting process is automated among some governments. That is, the responsible government financial manager can capture data from the bank’s online reporting tool and automatically post it to the government’s internal financial management system. Benefits of lockbox include:

• Reduced float, including mail and processing float;

• Accelerated funds availability;

• Receipts are transmitted for automated download and posting/crediting to individual accounts by government treasurers;

• Improved accuracy in the collection process;

• An audit trail is established;
EXHIBIT 2.8

Sequence of Activities in a Lockbox

Mail sent to PO box

Courier picks up mail; delivers to lockbox facility

Mail sorted by bank staff

Remittance data captured using OCR scanners

Data on checks captured using MICR scanners

Remittance data transferred to government

Checks deposited at bank*

Posting to internal financial system (government process)

Check clearing begins (bank process)

*Non-matching or exception items processed separately
BANKING SERVICES

- Reduced internal staffing costs due to outsourcing and/or the re-allocation of staff to higher-value tasks;

- Reduced processing delays that would have been associated with sick time, vacation, and holidays taken by internal staff; and

- Possible reduction in future hiring and training needs associated with growth in payments.

Banks that offer lockbox service are usually equipped with the latest automated scanning equipment to capture, store, and transmit data. For example, a lockbox service provider will operate equipment that will electronically capture the MICR data contained on a check, as well as the data contained on the remittance document or bill.

Lockbox providers will often require governments to use a billing document that meets the processor’s specifications. The primary specification required is that the document contains an optical character recognition (OCR) scan line that includes identification and payment information. Other document requirements typically include form size, character placement inclusion of a check digit, ink type, and paper quality. The type of printer used to produce the remittance document can have an impact on lockbox processing error rates, thus on overall costs. Laser printing is recommended. (See Appendix C for the GFOA Recommended Practice, “Use of Lockbox Services.”)

For lockbox services to function properly, governments must develop accurate and reliable remittance documents. Failure to do so causes an excessive number of rejected items, which in turn cause lost processing time and higher banking fees. Contracts for lockbox service should address exception items, turnaround time, document disposition, funds availability, and error tolerance.  

Credit Card Acceptance

As the use of credit (and debit) cards has become more and more popular in today’s economy, governments are experiencing pressure to accept them for transactions. The government's decision to accept payments via a credit card should be considered a business decision that weighs costs
Cash Inflows

and benefits. There is a cost to the government for accepting credit cards, and the government therefore must carefully analyze the pros and cons prior to making a decision to go forward with them. (See page 81 for more detailed information on credit card acceptance.)

The government should also examine state statutes to determine if certain payments made via credit card, such as for property taxes, are legal—since the government would not be collecting 100 percent of the amount that is due (i.e., it would receive the taxes due minus the discount fees owed to the credit card processor). It is possible to offset credit card processing fees by imposing “convenience fees” for certain transactions. For example, governments may use a third party to process credit card payments made over the telephone, using interactive voice response (IVR) technology. Using IVR, a customer would telephone a designated number, enter all of the necessary information including credit card information, and the third party would add a fee for the convenience of utilizing the service. The vendor would then pass on 100 percent of the amount due to the government.

Efforts to Make the Check Payment Process Electronic

Despite the clear advantages of ACH and other forms of electronic payment, governments will continue to receive a tremendous volume of payments by check for the foreseeable future. However, there are several services that may directly or indirectly benefit governments by making more steps within the check clearing and settlement process electronic. The digitizing of check payments can occur at several points in the check-clearing process:

- At the government’s bank;
- At the government; or
- At the lockbox provider.

Check Clearing at the Government’s Bank. The Check 21 law will permit more checks to clear electronically by allowing banks to use electronic image replacement documents that replace paper checks in the
bank-to-bank clearance and settlement process. Although this process may not be directly visible to governments, it may result in faster availability and allow government treasurers to discover returned checks more rapidly. The Check 21 clearing process is covered further in Appendix A.

Check Clearing at the Government. A handful of governments have the capabilities to convert check payments made over the counter (at the point of purchase or point of sale) using the government's own check scanning equipment. The process essentially converts a check payment into an ACH payment and is referred to as check truncation or check conversion. The physical check is actually returned to the customer making the payment, after the government captures the MICR data, converts it into an ACH-ready format, and initiates the ACH clearance and settlement process. NACHA refers to the process as point of purchase (POP) check conversion.

Check Clearing at the Lockbox Provider. The process is very similar to POP check conversion, with the primary difference being that the conversion takes place at the lockbox facility. NACHA refers to the process as ARC (accounts receivable check) check conversion. Like POP conversions, ARC conversions execute payments via the ACH network (see Exhibit 2.9).

Governments interested in any of the three services should be aware that different industry jargon is used to describe each service, and each financial institution may use its own terms. For example, ARC and POP check conversion is sometimes referred to as electronic checks or e-checks.

Analysis of Costs and Benefits
To determine if a particular banking service is economically justified, governments can perform a cost/benefit analysis to gauge the incremental costs of adding such a service. For example, government treasurers should consider performing an analysis to determine the additional costs associated with enhanced services such as wire transfers. Performing
such an analysis helps to determine a minimum threshold for which specific services will be cost-effective.

**Wire Transfer Services**

The calculation for determining the cost-effectiveness of wire transfers may be performed using the following formula:

\[
\text{Cost} / (\text{days} \times \text{interest rate per day}), \text{ where:}
\]

- \( \text{Cost} = \text{Unit cost of a wire transfer} \)
- \( \text{Days} = \text{days of collection float reduced} \)
- \( \text{Interest rate per day} = \text{interest rate earning on additions to short-term portfolio} \)

As indicated in Exhibit 2.10, large deposits—such as, for example, bond proceeds, investment maturities/redemptions, or grants—are apt to meet the cost-effectiveness threshold. Of course, cash managers should always be aware of the current market rates for interest income. The higher the interest rate paid on bank balances, the lower the break-even point amount will be.

**ACH Services**

Although ACH processing is generally less expensive than check processing, a similar cost-benefit analysis should be performed. This may help justify, for example, the government’s adoption of direct debit utility billing that would supplement traditional paper-based billing. The analysis should include the following cost factors for comparing ACH processing costs against check processing costs.

*Check processing:*

- Lockbox charges (if outsourced) or internal processing costs (if insourced);
- Item charge per check;
- Data transmission charges;
- Courier delivery of remittances;
- Reconciling bank account costs;
# Key Features of ACH Check Conversion and Check 21

<table>
<thead>
<tr>
<th>Subject</th>
<th>Check Conversion (ARC and POP)</th>
<th>Check 21</th>
</tr>
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<tbody>
<tr>
<td>Overview</td>
<td>Paper check payment is converted to an ACH electronic payment. This works as follows:</td>
<td>Paper check payment is imaged; the image is later converted into a substitute check. The substitute check is used in the paper check collection system. This works as follows:</td>
</tr>
<tr>
<td></td>
<td>• Paper check is tendered for payment.</td>
<td>• Paper check is captured and converted into a digital image. (This step is not covered by the Check 21 Act.)</td>
</tr>
<tr>
<td></td>
<td>• Using MICR scanner, payee scans MICR data from check.</td>
<td>• A financial institution – the reconvertor bank – uses the digital image to create a substitute check, which is a paper reproduction of the original check (front and back).</td>
</tr>
<tr>
<td></td>
<td>• Payee adds payment amount and name of payee, then transmits data through the ACH network to debit customer’s account.</td>
<td>The substitute check must bear this legend: “This is a legal copy of your check. You can use it the same way you would use the original check.”</td>
</tr>
<tr>
<td></td>
<td>• In ARC, the check is destroyed after conversion; in POP, the check is returned to the checkwriter at the time of payment.</td>
<td>These transactions do not flow through the ACH Network.</td>
</tr>
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<td></td>
<td>These transactions flow through the ACH Network.</td>
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<th>Enabling legislation or rules</th>
<th>NACHA Operating Rules</th>
<th>Check Clearing for the 21st Century Act</th>
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Key Features of ACH Check Conversion and Check 21

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<tr>
<th>Subject</th>
<th>Check Conversion (ARC and POP)</th>
<th>Check 21</th>
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</thead>
<tbody>
<tr>
<td>Type of allowable non-paper copy of the original paper check</td>
<td>ARC: Reproducible, legible, image, microfilm or copy (copy of front of check required; copy of back of check optional). POP: No copy required; consumer receives the check back at the time of payment.</td>
<td>This is not covered under the Act. It is anticipated that the reconverting bank is likely to have an image of the front and back of the original check. Other banks in payment system will have appropriate copies, such as microfilm or image.</td>
</tr>
<tr>
<td>When non-paper copy of original check is made</td>
<td>ARC: In lockbox processing. POP: No copy required; consumer receives the check back at the time of payment.</td>
<td>This is not covered under the Act. It is anticipated that a copy may be made at point of capture, branch, ATM, etc. Other banks in payment system may make copies during check processing.</td>
</tr>
<tr>
<td>Disposition of original paper check</td>
<td>ARC: Destroyed by payee within 14 calendar days. POP: Returned to customer at time of payment.</td>
<td>Not covered by the Act.</td>
</tr>
<tr>
<td>How checkwriter obtains:</td>
<td>ARC: Ask own financial institution or payee. POP: Checkwriter already has check.</td>
<td>May receive substitute check in bank statement; may request substitute check from paying bank.</td>
</tr>
<tr>
<td>• Paper copy of original check (ACH)</td>
<td></td>
<td></td>
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<tr>
<td>• Substitute check (Check 21)</td>
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Key Features of ACH Check Conversion and Check 21

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<tr>
<th>Subject</th>
<th>Check Conversion (ARC and POP)</th>
<th>Check 21</th>
</tr>
</thead>
<tbody>
<tr>
<td>Authorization required from checkwriter to convert or truncate</td>
<td>Biller or retailer obtains authorization from checkwriter to convert checks</td>
<td>None</td>
</tr>
<tr>
<td>Other names for the service</td>
<td>Electronic check, e-check</td>
<td>Check truncation; CTA; Check Truncation Act</td>
</tr>
<tr>
<td></td>
<td>ARC: Accounts Receivable</td>
<td></td>
</tr>
<tr>
<td></td>
<td>POP: Electronic check conversion</td>
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- Insufficient funds/closed account checks (bad debts); and
- Updating accounts receivable.

**ACH processing:**

- Preparation of electronic file;
- Delivery of media to ACH processor;
- Reconciling bank account costs;
- Item charge per ACH debit or credit; and
- Updating accounts receivable.

In addition to ongoing costs, ACH may entail start-up costs such as pre-notification to government customers.

**Lockbox Services**

As noted, using an external lockbox service expedites the collection of payments compared to an internal process. Not only does a lockbox reduce float, it also frees up staff to take on other higher value tasks. Exhibit
EXHIBIT 2.10

Example of a Cost/Benefit Analysis for a Wire Transfer

Assumptions:
Unit cost of a wire transfer = $10
Days of float reduced = 2
Investment earnings opportunity = 3% (annual)

Break-even point:
$10 / [(2 x .03/365)] =
$10 / .000164 =
$60,833

2.11 quantifies the benefits associated with float reduction and staffing. Costs are for processing normal payments that do not have exceptions.

Like any service, the level of competition for lockbox service provision may affect the costs. Although governments in large metropolitan areas may have several banks that provide a lockbox service, governments in rural areas may have limited options or no local provider at all. This problem can be ameliorated by using a non-local lockbox provider having a post office box that lies outside the government’s jurisdiction. (Alternatively, the government could have a local post office box, and arrange for a daily courier service to deliver mail to the non-local lockbox provider.)

Internal Controls

The establishment of a new bank service can prompt a government to re-examine internal controls over collections. Preservation of a government’s assets, financial and otherwise, is vital to the integrity and credibility of the finance department. As previously mentioned, wire transfer agreements and security procedures should be used to establish and implement standard operating practices that safeguard assets. With respect to revenue collection, proper internal controls include:
• Segregation of duties (authorization, recordation, and custodian functions);

• Daily processing (daily cash/collection total reconciled to subsequent deposit);

• Timely depositing of funds received;

• Timely reconciliation of the bank statement to the general ledger and other supporting accounting ledgers;

• Physical security procedures during work hours and non-working hours for all funds received and change drawers maintained. (See Appendix C for the GFOA Recommended Practice, “Revenue Policy: Cash Receipts Controls.”)

Because of the large dollar volume processed electronically, electronic funds transfers are prime targets for attempted fraud. Therefore, EFTs should be given priority for security measures. EFT controls should utilize the following elements (additional details can be found in the GFOA Recommended Practice, “Electronic Transactions for State and Local Governments” in Appendix C):

• Restriction on the issuance of passwords and protocols for changing passwords;

• Requirement for dual authorization of transactions;

• Confirmations of transactions from financial institutions;

• Restrictions on personnel authorized to use the software system that communicates with the bank to use online banking services;

• Establishment of dollar limits for each individual EFT transaction.

In addition, a given bank account can be protected by allowing only a pre-defined entity to participate in an EFT transaction, using a pre-approved account.
Analysis of Lockbox Costs and Benefits

Assumptions:
Number of items = 100,000
Item cost = $0.20
Average invoice = $20
FTE = .5 = $25,000
Prevailing interest rate = 3%
Additional days invested = float reduction = 3 days
  > Improved mail float .5 day
  > Improved processing float 2 days
  > Improved availability float .5 day

Annual Cost of Lockbox Service:
Item cost x Number of items
$0.20 X 100,000 = $20,000

Annual Benefits of Lockbox:
Float savings + Reduced staffing costs =
[Investable balance x Additional days invested x Daily interest rate] +
FTE reduction =
[Items x Average invoice x Float reduction x Daily interest rate] +
FTE reduction =
[100,000 x $20 x 3 x (.03/365)] + .5 FTE =
$494 + $25,000 =
$25,494

Annual Net Benefits = $5,494

Note: Data adapted from mid-sized Illinois municipality.
ENDNOTES

1. The government cannot directly control availability float. When a government issues an RFP and negotiates a banking service agreement, however, it can set a cut-off time for deposits so that it occurs later in the day. By doing so, it maximizes availability and reduces the amount of availability float experienced by the government.

2. In addition, some governments have requested that their primary bank locate an automated teller machine (ATM) on the premises of the government building. Often, there is an ATM activity threshold requiring the bank to report volume of activity and share any revenues with the government, once a predetermined threshold is exceeded. Aside from potential revenue-sharing, having an onsite ATM provides three benefits: (a) it provides government customers an additional payment option; (b) it results in immediate, assured payment (important when services such as municipal utilities can be restored only after a payment is received and clears); and (c) it provides a convenience to employees.


4. The average ACH transaction is valued at $3,000. In contrast, the average Fedwire is approximately $3 million, according to Stuart E. Weiner, “Electronic Payments in the U.S: An Overview,” *Government Finance Review* 16, no. 2 (April 2000): p. 44.

5. This type of ACH transaction is often referred to as a direct debit or direct payment. It is the converse of direct deposit, discussed in Chapter 3.

6. This is the same information found on a check MICR (magnetic ink character recognition) line.

7. Bar-coding provides computer instructions to the U.S. Postal Service detailing the mailing address. It results in faster delivery.

8. An additional consideration is the design of the return envelope. Return envelopes should take advantage of the “Zip + 4” zip code to speed the processing through the mail. In addition, bar codes are another effective method of processing envelopes, one that affects the design of the return envelope. Bank relationship managers may be able to assist in the design or redesign of the government’s return envelopes.


Disbursements are a critical element in the cash management process and require careful and complete controls in order to exercise proper fiduciary responsibility and management of the function. Managing cash disbursements requires knowledge of all cash flows, liabilities and due dates, investments, and investable cash.

This chapter describes the government disbursement process. It addresses the following topics that cash managers needs to understand in order to better manage disbursements:

- Advantages of disbursement centralization;
- Elements of the disbursement process;
- Techniques to optimize the disbursement process; and
- Techniques to deter disbursement-related fraud.

Centralization of the Disbursement Process

Because a government incurs significant costs in managing disbursements, centralization of the disbursement process is preferred over de-centralization as it can (a) help streamline the number of accounts that must be maintained, (b) reduce the number of transactions, and (c) thereby limit the amount of oversight needed to monitor account activity and related transactions. Most treasury analysts recommend centralization of the cash management process as a best practice, since it strengthens management controls and tends to reduce banking and internal cash management costs.¹

A variety of disbursement activities result in costs to a government. For example, there is a cost associated with every bank account estab-
lished by the government, with an additional cost increment if a zero balance is used (i.e., a cost for maintaining a zero balance account plus a cost for every transaction required to maintain the zero balance). In addition, every account must be reconciled and analyzed, signature cards maintained, and other disbursement tasks executed. Moreover, check issuance is particularly costly, since every check has a cost involving check stock, per item bank charges, printing supplies, equipment to print checks, and processing time. Some studies have determined that when considering the time required for invoice approval, account reconciliation, and all bank-related costs, the cost of generating a single check ranges from approximately $50 to as much as $125.

Although the disbursement function generally operates more efficiently when centralized, it is not a universal rule. Inevitably, governments may have to allow for some decentralized disbursements involving satellite locations or for emergency requirements where manually generated checks are needed. If some decentralization is required, it is important to have frequent reporting to a central location to monitor cash requirements, to manage account reconciliation, and to ensure proper controls. Quality training of personnel is necessary to manage a centralized and/or a decentralized disbursement function.

Elements of the Disbursement Process

The disbursement process typically includes paper and electronic processes. The traditional paper process involves checks or drafts; the use of electronic funds transfer eliminates the paper portion of the process. Whether a government uses paper or electronic means, the standard disbursement process usually requires the receipt of an invoice that must be matched to documents, including a purchase order and a receipt of goods or services.

Float Associated with Cash Outflows

Float represents the time required to receive an invoice, process documents needed to approve a payment, and ultimately issue a payment to
the vendor. During this period, the government possesses the good/service provided while retaining the cash before the disbursement is made. As a result, governments have a strong incentive to delay disbursements and maximize disbursement float. The incentives are balanced, of course, by the need to avoid late fees and maintain good vendor relationships.

As noted in Chapter 2, float consists of several components. Whether acting as a disburser or collector, the government experiences the same types of float: invoicing, credit, mail, processing, availability, and bank float (see Exhibit 3.1). Two kinds of float are especially germane to disbursement:

- **Mail Float** – This float tends to be the largest component of float and is difficult to control. Whereas a government as collector can influence mail float (e.g., by locating a post office box in a modern postal facility), as a disburser, a government can do little manage it.

- **Check-Clearing Float** – This is the time the check is in the banking system before it is presented against the disburser’s bank account (the government’s bank account). It encompasses both availability and bank float. Over the past several years, check float has been reduced considerably by the Federal Reserve Bank and through bank-to-bank clearing arrangements. Most clearing arrangements now take only one business day for the check to be presented against the disbursement account from the time the vendor deposits a government-issued check.

In the future, more checks will be converted to electronic presentments, which are a means for banks to settle transactions electronically. Electronic presentments are carried out in two ways: either in the form of ACH transactions or by the Federal Reserve Bank creating an electronic image of the check when presented to the Federal Reserve Bank District associated with the vendor’s bank. The image is then transmitted and the paper check recreated at the Fed District bank associated with the government’s bank, where the check would be finally presented to the government’s bank.
Although governments, as disbursers, have a natural interest in maximizing float, some state statutes require state agencies and local governments to pay promptly. Moreover, some government vendors may either provide discounts to encourage prompt payment and/or impose penalties for late payment. Because some vendors will provide a discount to the full invoice amount for payment by a certain date, this discount can be greater than the investment earnings potential related to float. If this is the case, then the government cash manager should act to take advantage of the discount. Many governments audit invoices and work with vendors to ensure discounts are taken. In addition, some governments have installed financial management systems that provide automatic alerts or
e-mails notifying them to act upon prompt payment discounts. Obviously, invoices should not be paid early if discounts are not available.

**Controlled Disbursement**

Controlled disbursement programs utilize bank accounts where checks are written on an affiliated bank of the government’s main operating bank. The check-clearing procedures provide the main operating bank with information on what checks are being presented to the affiliate before the checks are actually physically presented. The dollar amount of the checks to be cleared is provided to the check issuer early in the morning of the day the checks are to clear the controlled disbursement bank account. This advance information allows the issuer to have the exact amount of cash in the bank account to fund the checks presented. Funding of the controlled disbursement account is made from the main bank operating account daily. The funding and knowledge in advance of presentments gives the user more control over the cash management process.

Controlled disbursement accounts typically give the issuer one additional business day of check-clearing float versus a standard disbursement account. It is questionable, however, whether the extra investment and cash management control resulting from a controlled disbursement account justifies the associated higher cost. With the use of investment account sweep programs (see page 77 for a discussion of sweeps), there is no reason to have any idle cash in any bank account – eliminating the major reason controlled disbursement accounts are used. At the time of writing this chapter, overnight investments were yielding substantially less than one percent per annum, virtually eliminating the historical favorable economics of the one-day delayed clearing versus a standard checking account. Of course, if prevailing interest rates rise, the economics of a controlled disbursement account become more favorable.
Electronic Banking Services to Optimize Disbursement

There are many elements to electronic banking, but essentially all electronic options involve moving money between accounts without creating checks or converting checks to electronic presentment. As noted in Chapter 2, electronic funds transfer is quicker and often less expensive than using paper, and it also facilitates account reconciliation. Electronic banking services relevant to the management of disbursements include:

- Wire transfers;
- ACH payments;
- Electronic data interchange;
- Purchasing cards; and
- Payroll cards.

Wire Transfers

Using wires is the most expensive way to move funds electronically but it is also the fastest. Typically, funds transferred via wire are restricted to very large disbursements because of cost. Wires can be initiated via personal computer, telephone, or fax. When a wire is completed repeatedly, such as to the same bank account monthly to pay a large invoice or recurring payment, it is considered to be a repetitive wire. In contrast, one-time wire transfers are considered to be non-repetitive wires. Using a personal computer (PC) to initiate wires is more cost effective than using a phone, and repetitive wires via PC are even less expensive.

Automated Clearinghouse Payments (ACH)

ACH payments are the most frequently used means to disburse funds electronically. Notification to the bank to make an ACH transfer generally is made 48 hours in advance of when the cash transfer is desired to be received. The most common ACH transfer is direct deposit payroll where funds are placed into employee accounts. Large employers make thousands of ACH transfers to employee accounts on payday because of
convenience to both the employee and employer. Generally, it is less expensive to make an ACH payment than it is to write a check. Although most governments use direct deposit, governments can still make incremental improvements in cash management by increasing the employee participation rates in direct deposit (for example, some governments require newly hired and/or existing employees to participate).

Governments should seek ACH blocking capability from banks as well (see section on deterring fraud). ACH fraud may become a greater issue as more payments move from paper to online execution.\(^2\)

**Electronic Data Interchange (EDI)**

EDI is a term used to refer to a type of electronic payment between entities. The procedure involves linking two entities together to allow bills to be paid electronically, often using ACH initiated by the receiver or payor using a personal computer linked to the Internet (this can involve netting invoices between the two entities). For example, one type of EDI transaction would involve a government making an automated, ACH-based disbursement to a vendor through a bank that acts as an intermediary. Unlike other ACH-based transactions, the movement of financial data from government to bank to vendor would be enhanced by adding an addendum, which is information that describes the transaction and that can be read by the three parties' information systems (using a standardized format).\(^3\) Capturing addenda information describing the transaction eliminates the need for clerical staff to manually enter the data.

The EDI process allows the accounts payable department to schedule disbursements more precisely, which provides the treasury department with a better picture of the government's cash position. Overall, EDI can provide the following benefits:

- *Several payment options are available to facilitate funds transfer* – A single EDI file can be used to generate various payment instruments, including ACH transactions, wire transfers, and checks.

- *Flexible formats* – Banks can often accept files in various formats by direct computer-to-computer transmission or by using the Internet.
• **Convenience** – Payables can be submitted on a flexible schedule for payment.

• **Fraud prevention** – If the bank manages the payments using checks, the account can be set up using positive pay (a method of preventing check fraud, discussed on p. 55 of this chapter); if payments are made electronically, the payments are inherently fraud resistant because of direct file initiation involving the bank.

• **Remittance data options** – Banks can send remittance data separate from the payment or with it.

• **Reporting capabilities** – Banks offer a wide range of options for reporting remittance information to the trading partners.

• **Accurate and secure information** – Banks offer EDI payment origination services to build and maintain a database of trading partner information.

• **Prompt, responsive service** – Toll free access is typically available from banks to assist clients using EDI services.

**Purchasing cards**

Purchasing cards, sometimes called procurement cards or “P” cards, help minimize the use of purchase orders and checks. These cards can be used to procure items in any price range. By 2008 it is expected that over $160 billion per year will be spent using purchasing cards in the United States. Typically, a purchasing card is a Visa Card, MasterCard, Discover Card, or American Express Card that resembles an ordinary credit card. Personnel receive the cards for use in purchasing specific items. Unlike consumer credit cards, each purchasing card is assigned certain limitations, such as dollar value of credit, allowable items, daily purchasing limits, and/or merchant limits. For example, an assigned purchasing card might be used for purchasing airplane travel tickets, gas for a car, but not for the purchase of liquor. Each card would be imprinted with the employee’s name as well as the government’s name. Banks generally offer many billing cycle options to create flexibility with regard to cash flow restrictions.
Cash Outflows

Purchasing cards eliminate many procedures related to purchasing requisitions, invoices, checks, receipts, and expense reimbursements. The use of purchasing cards simplifies purchasing procedures and reduces the number of checks written, while at the same time allowing for quality controls, monitoring of card use, and giving employees the flexibility to obtain good prices for required items. According to *Business Finance*\(^4\), the consensus estimate is that procurement costs fall from $90 per purchase when using a paper-based process to $15 per purchase when using a purchasing card. (The costs reflect internal staff time, which is the primary cost driver in either method.)

Recent studies have determined that the advantages of purchasing cards go beyond simple transactional cost savings. Purchasing cards have contributed to reductions in processing time and redeployments of staff to higher value-added activities. According to *Treasury and Risk Management*, their use results in a 74 percent reduction in procurement cycle time, a 67 percent reduction in the number of petty cash accounts, and a 42 percent reduction in the number of suppliers.

Additionally, purchasing cards often generate rebates to the entity using the card, depending on the bank and the activity level. They provide extensive information used for monitoring procurement activity that is generally accessible via the Internet. Purchasing cards also provide liquidity to the vendor because the vendor is paid faster than through the standard paper-based system. Further, speed of payment and the information obtained by using purchasing cards give the user more leverage in negotiating discounts with suppliers.

Caution is necessary when installing a purchasing card program. The program must be supported by good internal controls, including the adoption of the following steps:

- Educate card users about card policies and procedures;
- Assure that managers are held accountable for card use by subordinates;
- Hold cardholders accountable for the use of the card;
- Implement card controls available through the card issuer; and
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• Audit the card program continuously.

Quality purchasing card programs provide electronic access to employee accounts. This enables government officials to view transactions online, assign tracking numbers to transactions, and export the data into multiple formats for additional usage (e.g., creating reports in spreadsheet programs). Employees can be given access to this system to view transactions and assign accounting codes. Data available online includes:

• Card number;
• Cardholder name;
• Transaction detail;
• Transaction date;
• Vendor name, city, and state;
• Settlement amount;
• Expense allocation;
• Merchant code;
• Transaction identification;
• Ticket number (number to identify a transaction); and
• Other information, depending on purchasing card vendor and per agreement.

In addition, certain purchasing card vendors provide online data that provide a description of each item purchased.

The Government Finance Officers Association (GFOA) recommends that governments use a competitive selection process for establishing a purchasing card program that results in a written agreement. Additionally, the association suggests an assessment of the software capability for (a) integrating with the government’s accounting system, (b) automating purchasing approvals and reconciliations, and (c) executing transactional controls such as those identified above. (See Appendix C for
the GFOA Recommended Practice, "Purchasing Card Programs (2003)."

**Payroll Cards**

These are a type of stored-value card\(^5\) that can be used to disburse payroll when an employee has no bank account or when an employee does not elect direct deposit to a bank account. Essentially, a payroll card is a type of debit card that can have value (dollars) placed in the card account via an ACH transfer initiated by the government. This is not a credit card because the cash value placed into the card account belongs to the cardholder.

The card can be used at any automated teller machine or bank to obtain cash, and can also be used to purchase items anywhere a debit or credit card can be used (e.g., supermarkets or stores). Compared to issuance of payroll checks, payroll cards are a low-cost alternative to making payments to employees. Compared to direct deposit, however, the costs are not necessarily lower and they involve start-up costs, such as furnishing the cards themselves.

If the payroll card is lost, it can easily be replaced and is generally less expensive than issuing a stop payment on a check and reissuing the check. In order to obtain cash, an employee must use a PIN number, which enhances security and deters fraud. Of course, transactions using a payroll card cannot be forged like paper checks. Aside from security benefits, they provide the following advantages to the government:

- Cost savings due to the elimination of paper checks;
- Instant payroll distribution to employees in remote locations;
- Can be used for employee incentives and awards;
- Universal employee eligibility;
- Reduction of replacement check costs; and
- Reduction of check reconciliation costs.

Benefits to employees include:
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- Money is immediately available;
- Access is given to the bankcard payment system for those that may not otherwise qualify due to age, income, or credit history;
- Eliminates check-cashing costs charged by payday lenders;
- Eliminates the need to travel to the work site to pick up a check;
- Access to account information 24 hours a day, either online or via telephone; and
- Receipt of monthly statement.

The primary drawbacks are that (a) it is more costly than direct deposit (although cheaper than payroll check issuance) and (b) certain fees may be imposed upon the employee, depending on the bank that is used by the government to establish the services and the bank that is used to withdraw funds. Governments may take into account the fee levels in selecting a payroll card vendor.

**Online Bank Reporting**

The foregoing discussion of disbursement methods illustrates the important role of a bank in providing governments the ability to execute transactions online. Online bank reporting should complement the disbursement capabilities of a bank. Indeed, governments may wish to consider limiting future banking relationships to those banks that have the capability of reporting activity using the Internet. (Many banks are transitioning from online reporting through a dial-up connection to Internet-based reporting. Both offer similar functionality. The advantage of Internet-based reporting is that, beyond a standard Web browser, no special software is required for the government treasurer's computer.)

An electronic reporting system offers governments several benefits, including:

- Significant time savings;
- Access to account balances;
Cash Outflows

• Check-clearing transaction details;

• Information on controlled disbursement transactions;

• Positive pay exception item reports; and

• Image information for check-clearing accounts.

In addition, it allows for reports on daily wire and ACH disbursement activities. Aside from the ability to initiate electronic funds transfers, certain banks with robust Web capabilities allow governments to electronically approve checks using positive pay, remove stale dated checks from the outstanding listing file, create stop payments, view images of checks clearing or being deposited from lockboxes, and so forth.

With respect to disbursements, benefits of a quality online bank reporting system include:

1. Support for online disbursements
   • Pay state and federal taxes automatically;
   • Pay employees through direct deposit payroll;
   • Initiate repetitive, semi-repetitive, and non-repetitive wire transfers; and
   • Pay vendors electronically.

2. Enhanced controls on disbursement fraud
   • Make pay/no pay decisions on positive pay accounts;
   • View positive pay check exception images; and
   • Research and view check images.

3. Better, more easily accessed information for decision support
   • Access information for investments;
   • Access monthly bank analysis statements;
   • Access information anywhere a computer is linked to the Internet; and

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- Import data from your spreadsheet or accounting package to streamline ACH and wire initiation.

Deterring Fraud

In today's electronic world of computers, scanners, and printers, fraud is a significant problem. Check fraud alone costs American businesses and public entities hundreds of millions annually.\(^6\) Using sophisticated technology available to almost everyone, criminals can easily reproduce or alter checks to appear virtually identical to valid checks. Government treasurers can take steps to minimize the potential of fraud from both internal and external sources.\(^7\) Public entities should observe "reasonable commercial standards" to minimize the potential for fraud. In addition, bank accounts must be reconciled promptly to detect unauthorized payments. If a public entity fails to exercise reasonable care in its accounting procedures or fails to find discrepancies in its bank statements in a timely manner, under the Uniform Commercial Code it can be held responsible for losses incurred as a result of fraudulent checks.\(^8\) If the government acts responsibly, however, it will not be held liable for such losses.

Internal Controls

Fraud control begins with good internal controls. Like other facets of cash management, sound internal controls over disbursements have the same objectives:

- To provide reliable data for management;
- To safeguard assets and records;
- To establish accountability for assets, with timely verification and appropriate follow-up;
- To promote operational efficiency, reduce unnecessary duplication of effort, and deter inefficient use of government resources; and
Cash Outflows

- To assure that transactions are recorded to permit preparation of financial statements in conformity with generally accepted accounting principles (GAAP).

To counter potential risks (e.g., embezzlement, conversion, collusion, mechanical transaction errors, judgmental errors, or cover-ups), government treasurers must have a sound organizational structure that segregates staff duties to create barriers to collusion, perform training, establish and enforce policies, conduct audits, and take other actions. The following checklist can be used to assess whether the government's internal control environment for disbursements is sound:

- Are all checks pre-numbered by the printer and reconciled?
- Are spoiled or voided checks properly filed or destroyed to prevent re-use?
- Is there a policy against making checks payable to cash, bearer, currency, and so forth?
- Are unused checks properly controlled?
- Are persons who sign checks other than those who:
  - Handle petty cash?
  - Approve disbursements?
  - Record cash receipts?
  - Post to ledger accounts?
- Is a positive pay disbursement system in place?
- Are persons who sign checks designated by the governing body?
- If signature facsimiles are used, is the signature machine properly controlled?
- Have banks been instructed to cash no checks payable to the order of the public entity?
- Is the signing of blank checks in advance forbidden?
- Are checks countersigned?
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• When checks are presented for signatures, are invoices and supporting documentation also presented?

• Are invoices and supporting documentation stamped paid at the time of payment?

• Are the preparation of checks and approval of invoices separated?

• Are bank accounts reconciled promptly upon receipt?

• Is the treasurer’s report prepared monthly?

• Is the treasurer’s investment portfolio prepared monthly for presentation to the governing body?

• Are bank statements and paid checks delivered directly to the person preparing the reconciliation?

• Does the government receive copies of the check images via CD-ROM and the Internet bank reporting system?

• Do the duties of the person preparing the bank reconciliation exclude:
  — Signing the checks?
  — Recording cash transactions?
  — Handling cash?

• Are transfers of funds from one bank account to another promptly recorded?

• Does the person who reconciles the bank account:
  — Account for all check numbers?
  — Examine signatures?
  — Examine endorsements?
  — Examine payee’s name?
  — Examine dates?

• Is authority for bank transfers limited to the treasurer?

• Are checks bearing improper endorsements returned to the bank for correction?
Cash Outflows

• Are long-standing checks properly followed and controlled?

• Are stop-payment notices on outstanding checks properly controlled, renewed, or removed from a positive pay file?

• Are the responsibilities of those investing funds separated from those:
  — Recording investments?
  — Preparing confirmation of purchases?
  — Matching securities purchases with confirmation from brokers, dealers, or institutions?
  — Preparing bank reconciliation and Treasurer’s reports?

• Are vacations mandatory?

• Is a surety bond required for employees disbursing cash?

Not all of the checklist items above may be capable of being implemented by all governments. Smaller governments, in particular, may not have the staffing necessary to establish segregation of duties.

Positive Pay and Reverse Positive Pay

The banking system offers a very powerful tool to control check fraud: positive pay. If positive pay cannot be implemented, reverse positive pay can also help, although it is a lesser tool and its use is discouraged.

Positive pay is a generic term for a bank service related to check disbursements. When checks are written, the government writing the checks creates a payment file that includes the following information for each check:

• Check number;

• Date; and

• Dollar amount.

A handful of banks identify the payee on the check as well, and more are likely to do so in the near future.
This file is delivered to the bank simultaneously with the creation of the checks and the bank maintains an “outstanding listing” file of all checks written by the government. As checks are presented against the account, the bank verifies each check against the outstanding list file. Only those checks that exactly match what the government informed the bank it issued will be allowed to clear automatically. Checks that clear are removed from the outstanding issue file and are placed into a paid file.

Any check presented to the bank that does not match the file exactly is considered to be an exception item. A report generated for the check issuer includes the front and back image of the check, allowing the issuer to review the check and determine if it was correctly issued. If the check is legitimate, the government can instruct the bank to make payment. If the check is not correct or appears fraudulent, the check is rejected and returned to the bank making presentation to the disbursement bank and the government’s entity’s account is not charged.

To err on the side of safety, the automatic default for exception items should be “do not pay” unless the checking account owner authorizes payment. Some banks desire that the exception checks be paid unless the bank is instructed otherwise, which may defeat the purpose of positive pay as a fraud control measure. This controversy results in the attempt by some banks to shift the liability for check clearing back to the account owner.

Reverse positive pay is a daily procedure wherein the bank sends the government a file that lists all checks presented against the account. The entity writing the checks must review the file against its own internal file of outstanding checks to determine if any are improper. If any improper check is found, the entity notifies the bank and the bank attempts to return the check to the presenting bank. This process is far more cumbersome than positive pay and creates more work and added risk for the check issuer. The author believes that positive pay is a better alternative to reverse positive pay; however, reverse positive pay may be less costly to the government.

GFOA recommends that a government adopt positive pay as an element in a banking services agreement, observing that it is a leading
method of check fraud deterrence. Additional benefits to positive pay go beyond fraud control.

- **Stale date check and stop-pay management** – Instead of issuing a stop payment order for a check that has been written, the entity using positive pay simply informs the bank which check it wants removed from the outstanding check file. If the check subsequently is presented to the bank, it becomes an exception item and is not paid. The entity issuing the check simply does not approve the payment of the check. Removing the check from the bank file is permanent compared to the need to renew a stop payment, usually every six months. In addition, the stop payment order is expensive and it costs virtually nothing to remove a check from an outstanding issue file. Stale dated checks can be removed from the issue file in a similar manner.

- **Automatic Account Reconciliation** – Using positive pay allows the bank to send a file monthly to the check issuer showing both checks cleared and the balance of outstanding checks. The entity processes the bank file automatically, reconciling the checking account used for the positive pay program. This eliminates manual checking account reconciliation.

Many banks are now taking an aggressive stance regarding the use of positive pay. Increasingly, banks are seeking to shift the cost of check fraud to the government issuing the check (and other bank customers), not only because of the large risk exposure but because of the growing acceptance of positive pay. Indeed, some banks that offer positive pay are beginning to inform their customers that any customer who elects not to use the program will be responsible for any fraud related to illegal checks.

**ACH Block**

Many banks offer a procedure allowing the government to block ACH transfers from clearing funds from their bank accounts. This procedure stops any attempt by an outside entity from processing an ACH transfer and removing funds from a checking account without prior permission.
This can be implemented either by placing a block on entire accounts (e.g., those not used for disbursements) or by placing restrictions on authorized accounts. For the latter, this would involve (a) giving prior permission to certain approved business partners to draw upon the account, (b) establishing an approval process for pending ACH transmissions, and/or (c) setting maximum dollar limits on ACH debit transactions.

Check Truncation and Imaging of Checks on CD-ROM

Most banks offer a service eliminating the return of cancelled checks and offering images of the checks placed on CD-ROM with software allowing the government to research all paid items. While this service obviously eliminates cancelled check storage problems, having information in computer readable form also accelerates paid item research. Images of both the front and back of each check allow copies to be made as necessary to verify who endorsed a check. Images of paid checks also are typically available from the bank reporting Internet site for at least 45 to 60 days, allowing research before the receipt of the CD-ROM.

Check Stock Enhanced with Anti-fraud Measures

Governments can purchase from either banks or third parties check stock with state-of-the-art features to combat check fraud. Advanced features such as special fibers, checks that reveal the word void if photocopied, border copy warnings, holograms, watermarks, color stains, special toner adhesives that make it difficult to erase original ink, magnetic ink, and other technologies are available to make checks more difficult to reproduce or alter. The U.S. Department of Treasury now issues checks containing many of these features.12 State and local governments would benefit from purchasing check stock with these types of enhancements as well.

Thumb Print Signature Programs

In selecting a bank, one consideration may be the use of inkless keypad technology to record the thumb prints of individuals who cash checks.
This program can deter people from attempting to cash fraudulent checks as it will aid law enforcement in tracking down the criminal cashing fraudulent checks.

ENDNOTES


5. Some state agencies also use electronic benefit cards, another type of stored-value card.


7. Measures to deter check fraud such as positive pay are discussed below. In addition, see Appendix C for the GFOA Recommended Practice, "Check Fraud Protection."

8. Uniform Commercial Code Article 4A.

9. The government would need financial management software that can generate such files.

10. If manual checks are generated, the bank must be notified promptly of these checks allowing the outstanding check file to be updated; otherwise, any manual check will appear as an exception item. A manual check is one that is not generated by a computer and a transmission file is not normally prepared as part of the check-generation cycle.

11. See Appendix C for the GFOA Recommended Practice, "Use of Positive Pay Versus Reverse Positive Pay."

CHAPTER 4

Core Banking Services

Kevin Lockhart

This chapter defines and reviews core banking services that governments may want to consider before issuing a banking services request for proposals (RFP). Core banking services, usually provided by a single depository bank, are those services that a government may deem as integral to supporting its daily cash management operations. For most governments, core services include many of the collection and disbursement services reviewed in the preceding chapters, as well as other complementary services such as cash concentration, overnight investing, reconciliation, and online reporting discussed below. In contrast, non-core or ancillary services are those that are not necessarily an integral component of daily cash management operations (one such example is credit card acceptance, covered in Chapter 5). Ancillary services are often provided by a separate vendor that specializes in a particular service.

Reviewing the Banking Relationship

While there can be no doubt about the importance of the banking relationship to the government’s financial operations, the relationship is more often inherited than it is established through a formal procurement process. In many instances, newly hired finance officers simply take over existing banking relationships. When this happens, a government’s operations and finances depend on how the finance officer manages, maintains, and improves that relationship. Regardless of whether or not there has been a leadership change, however, a periodic evaluation of the government’s banking relationship, benefits, services, and costs is desirable.
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Such an evaluation will help the finance officer to determine whether it would be beneficial to go through a competitive procurement process for banking services.

Finance officers often dread the prospect of reviewing banking services and the possibility of changing banks. At the same time, most realize that the regular review of services along with associated costs can be a very healthy exercise that may provide unanticipated benefits. As noted in Appendix A, the banking industry has gone and will likely continue to go through constant change. New technology, expanded banking services, and acquisitions have had an impact on every government’s cash management operations. A regular review of banking services is a good way to learn about and take advantage of such changes.

Before reviewing the current relationship, a finance officer may wish to address the following questions. While these are not formal questions, they may be a useful form of self-examination and the process of taking stock can lead to a more comprehensive review.

1. Do you believe the relationship is effective and beneficial?
2. Are you receiving competitive rates on your deposits?
3. Are your fees reasonable?
4. Are there additional banking services that you would like to have that you cannot currently get from your bank?
5. Are you getting the fastest availability of your funds?
6. Do you have enough accounts or too many accounts?
7. Do you have access to the best technology available?
8. How long has it been since an RFP for banking services was issued? Has one ever been prepared?
9. What are the costs of preparing an RFP?
10. Do bank personnel communicate with the government treasury department effectively?
11. What is the quality of the bank personnel?
12. Is the bank committed to being a leader in providing cash management services?
13. Is the bank committed to providing services to governments with their unique requirements?
Is the Relationship Effective?
The first question is typically the most critical. For many governments, the finance officer and banker may have known each other for years.\(^1\) A Government Finance Officers Association (GFOA) survey found that many governments rarely change banks and the relationship is remarkably durable. The banker may be quite familiar with the government's financial operations and needs and may have addressed those needs regularly. In this scenario, over a period of time trust has grown between the two parties. While this relationship may be beneficial to the government from an operating perspective, it may not be the best from a cost standpoint. Further, it is possible that the bank may have become complacent and, therefore, less diligent in service delivery, if it views its government relationship as unending. The finance officer needs to weigh the advantages of an effective, proven relationship against the potential cost savings and improved service delivery resulting from the RFP.\(^2\)

Fees and Rates
Fees and rates (questions 2 and 3) are more difficult to evaluate in isolation. The finance officer will be tempted to call neighboring governments to determine what they are paying for a given service or to find out what return they are getting on their deposits. The difficulty lies in making fair comparisons. As is discussed in Chapter 7, to get the best and most accurate pricing for banking services, the government must provide an accurate assessment of the number of transactions in various areas. Additionally, if the government's business is highly coveted by area banks, it might receive preferred pricing that is unavailable to surrounding jurisdictions. Return on deposits may be an easier comparison, although it does not take into account any preferred pricing considerations.

Available Services and Technology
Questions 4 through 7 could be addressed together. Advancements in technology have given the banking industry many new tools and services to deliver to clients. Many governments may not even be aware of some of the tools available to make their operations more efficient or effective. Conversely, the finance officer may be aware of services that the existing
banker is unable to provide. It is up to the finance officer (in conjunction with other stakeholders, such as the governing board) to determine if the new tools and services are important enough to warrant a change in financial institutions.

**Banking Services RFP**

The question regarding RFP issuance (question 8) is as important to the governing board as it is to the finance officer. If the finance officer likes the relationship, believes the rates and fees are competitive, and also thinks that the overall services and technology are strong, then he or she may conclude that no RFP is necessary. Stakeholders within the government (or monitoring the government externally) may not have the same view, however. In a Recommended Practice, “Procurement of Banking Services,” GFOA advises:

> Prudent procurement practices necessitate the reevaluation of banking services on a periodic basis. In addition, recent changes in technology, cash management practices, and banking-industry structure offer public investors opportunities to reevaluate banking services and costs.

The cost issue (question 9) is always crucial to governments. It takes a significant amount of staff time to prepare a sound RFP, and there also may be legal or consultant fees involved, depending on how the RFP is prepared. The preponderance of costs, however, will result from changing procedures, policies, and forms as well as training staff if a new bank is selected. Although the RFP process itself is costly, it enables the government to identify how competitive the current cost structure is and to potentially improve the quality of cash management services.

**Intangible Considerations**

The remaining questions (Questions 10 through 13) do not result in neatly defined, numerical answers. Nonetheless, finance and treasury officials are apt to develop a sense of overall customer service and bank commitment over the course of a multi-year relationship. If the bank is merged with another bank, then the bank staff, commitment, and cus-
customer service may change dramatically, prompting a need for a review of the relationship.

Bundled versus Unbundled Services

Governments may purchase a package, or bundle, of services from a single financial institution or may choose an unbundled approach. The unbundled approach allows the government to choose what it may deem the best provider of a given service – that is, the best lockbox operator, the best depository bank, and the best investment manager – while the bundled approach has other advantages.

Bundled services are usually described as the integration of banking services into an ideally seamless product. Specifically, bundled services are any collection of banking services offered to a government entity by one banking provider. The most common type of bundling of banking services is the combination of various treasury management products for a government’s operating accounts, money-market accounts for overnight investment, and lockbox services. Other non-core services described in Chapter 5 may also be included as part of a service bundle.

The bundled service approach offers four main advantages to the government entity. First, the bundling of core depository services (those core services described in this chapter) with a lockbox can provide efficiencies in the deposit of funds while reducing the amount of staff time spent in the collection process. Second, the government has the convenience of getting one monthly statement covering all banking services provided under the agreement. As a result, it is easier for a government to monitor the quality of the banking services. Third, having a single bank manage various services makes changing or adjusting services or getting questions answered much easier. Fourth, there is a possibility that the pricing of the banking services will be reduced since the bank is providing a broader and more lucrative package of services; therefore, the government could realize cost savings (conceptually, the bank is bidding on a larger set of services and can reduce profit margins).

The possibility of bundling of banking services may be greater than in the past, to the extent that (a) banks have become diversified “financial
supermarkets” with broad service offerings and (b) governments are willing to consider outsourcing more of their internal processes. Although providing certain benefits, bundling of services may also have drawbacks. All banks have service areas in which they excel—which necessarily means they may have weaknesses as well. By selecting a bundle of services, the government may obtain lower quality services in one area in exchange for gaining better quality in another area(s). For example, while it may be beneficial to select a bank that provides both depository services and a lockbox, it may be preferable to secure investment management from a separate vendor.

In contrast, unbundled services generally refer to those arrangements in which the respective banking components are delivered by different banks or even non-bank entities. In the unbundled environment, the government may choose individual banks or service providers to supply the needed services. The main advantage of this type of arrangement is the ability to obtain the specific expertise of a certain banking service. For instance, a particular bank may be able to provide enhanced investment management services unavailable from other banks. That same bank, however, may not be able to provide the depth and breadth of core depository services and related customer service available from another bank. By choosing two banks to provide two different services, the government may be enhancing the overall quality of its banking— that is, pursuing a “best of breed” approach. Of course, there may be higher costs associated with having two providers. Reconciling the accounts and managing relationships with two separate banks may mean some additional oversight costs to the government.

**Bank Capacity to Deliver Services**

A bank’s ability to deliver the entire set of core services as well as any ancillary services is determined, in part, by its resources. It is useful to consider the banking industry as having three tiers, as follows:

- **Tier I** – Large banks have the greatest financial resources and operate nationally, generally having the ability to offer all core and many non-core services to governments;
Core Banking Services

- **Tier II** – Regional or “super-regional” banks may offer some or all of the core and non-core services desired by a government; and

- **Tier III** – Local banks offer a limited set of core and non-core services.

These categories do not represent hard and fast rules, as some banks may grow in size and geographic scope.

As mentioned, Tier I banks are national. They can provide a wide array of services that are usually consistent throughout their market. They will usually have the latest technology and reporting techniques available and can therefore provide this to their customers. They are also financially strong and have the largest amount of deposits amongst the three tiers. One of the weaknesses of Tier I banks may be their flexibility on pricing. Since they provide their services nationally, they may attempt to keep their pricing relatively consistent. Additionally, many Tier I banks are quite centralized. In other words, decisions may not be made in the government’s area or region, a situation that could make decisions or changes more difficult.

Tier II banks are regional in geographic scope; they can also be “super-regional,” covering larger areas of the country. In most instances, the Tier II bank will have the same technology and reporting capabilities that the Tier I banks have and also be able to offer the same array of services. Although by definition not as large, many Tier II banks are as financially strong or stronger than the Tier I banks, depending on the government’s financial analysis. In other words, the deposits would most often be less, but the overall strength may be just as great or greater. The Tier II banks may have some of the same weaknesses as the Tier I bank when it comes to inflexibility. Neither of the top two tiers will “give away” their services. They might have some flexibility in pricing, but have to meet certain minimum returns. Second tier banks’ decision making may be somewhat more streamlined than that found in first tier banks, and may have fewer layers of management.

Tier III banks tend to be local banks. These banks are the smallest and in many cases are locally owned. They have the advantage of local decision making and can essentially “give away” services if they truly want the...
government's business. For example, they can offer lower loan rates or higher investment rates if they want to obtain the government's business. The weaknesses of these banks are usually in their inability to provide the full service banking that many government entities need. Tier III banks can usually contract out these services and become an intermediary, but usually at a high cost to the consumer.

An understanding of the market structure or tiers of banks helps government finance officers determine which banks should receive an RFP. It may also influence the decision about whether a government follows a bundled or unbundled approach (for example, when only Tier III banks submit proposals the government may be required to use an unbundled approach).

**Core Services Provided by a Depository Bank**

Most financial institutions can provide a government with some level of core services. These include basic cash management services: services to improve collections (inflows), disbursement services (outflows), online reporting, reconciliation services, account analysis, and the overnight investment of surplus funds. The costs and efficiency with which these services are provided may vary greatly from bank to bank, which underscores the need for the regular review of all banking services.

**Services to Expedite Cash Inflows**

Chapter 2 delineates the services that can expedite a government's revenue intake: (1) electronic fund transfers (EFTs), (2) lockbox services, (3) credit card acceptance, and (4) digital check processing.

**Electronic Fund Transfers.** Considered a basic depository bank service, EFT transactions can be implemented by using either the Federal Reserve Communications System (Fedwire) or the Automated Clearing House (ACH). The timing considerations of each option should be addressed when preparing the RFP (a Fedwire, for example, has a one-day turnaround while an ACH transaction could take one or two days). A
government may obtain clearly delineated availability schedules that doc-
ument, by type of transaction, the timing before funds become available.

Transferring funds quickly and reliably is a daily challenge for gov-
ernments. With respect to collections, ACH-based transactions are a fast,
cost-effective way to turn receivables into working cash. As noted in
chapter 2, this method is ideal for recurring payments such as lease or
loan payments, utility payments, subscriptions, and membership fees.
ACH transfers reduce expenses by eliminating paper-based payments to
or from vendors, customers, and employees regardless of where they
maintain their banking relationship. Utilizing ACH to transfer funds
electronically allows customers to increase collection and disbursement
speed, improve cash flow forecasting, and lower the cost of managing
payables and receivables. Traditional check services often take more than
one day to clear, whereas ACH payments can generally settle in one busi-
ness day.

**Lockbox.** Although many governments consider lockbox services a
core cash management service, this will vary depending on whether a
government has high-volume recurring payments that would benefit
from a lockbox service and whether it chooses to operate an internal
lockbox or outsource the function. For example, school districts may not
collect any utility payments or property taxes, obviating the need for a
lockbox service. Other governments, while having the need for an exter-
nal lockbox provider, may not necessarily use the same financial institu-
tion that it uses for other banking services. (For additional information
on lockboxes, please refer to the last page of this chapter.)

**Credit Card Acceptance.** For historical and other reasons, govern-
ments often bid for credit card acceptance separately from other services;
as such, it is not considered a core banking service. Most governments
have only recently accepted credit cards for payment, whereas their bank-
ing relationships have often been in place for longer time periods. (Refer
to Chapter 5 for further information on credit card acceptance.)

**Improving Check Processing.** As noted in Chapter 2, there are
several ongoing developments in the banking industry that will change
the previously paper-based process of check clearance into an electronic
process. First, the new Check 21 law will allow banks to avoid the physi-
cal transport of checks to settle interbank payments. Although this may not directly impact governments or how they construct an RFP, government treasurers should be cognizant of the changes brought about by the law, and consider if it will have any indirect impact on governmental operations (for example, changing availability schedules). In addition, “ARC” and “POP” check conversion are options that governments may explore before releasing an RFP.

**Services to Manage Cash Outflows**

Two key components of managing cash outflows are paper and electronic disbursements. Processing paper checks has been the mainstay in the banking industry for decades. With the proliferation of electronic payment alternatives, however, the need for paper disbursement is diminishing. A detailed discussion of disbursements can be found in Chapter 3; this section covers considerations of those services prior to issuing an RFP.

Payroll is one of the key applications of banking disbursement services. Historically, the payroll process has been one of laborious data entry into the government’s financial management system, with the eventual output of employee checks. In recent years, direct deposit options have streamlined that process. Additional technological advances have brought the advent of payroll cards. These have proven to be especially beneficial to employees who may not have a personal bank account or who are unwilling to share the information necessary to establish direct deposit.

The payroll process should be reviewed carefully when preparing an RFP. Nearly all banks will provide the direct deposit software as part of their treasury management services. The payroll card option can also be included in the RFP, especially for governments with a large number of seasonal or part-time employees. Payroll cards often are a convenience for such employees, since many may not have bank accounts and may incur fees to cash their paychecks (fees that typically exceed the cost for using payroll cards).

The second area to review closely is the accounts payable function. Historically, the government would prepare an accounts payable list and
process it on a recurring basis. Depending on the dollar threshold, the local governing board or senior level managers would approve the list and checks would be processed and mailed. Technological advances have given governments many new options in this area. ACH and electronic data interchange (EDI) are more efficient ways of making vendor payments, for example, and Fedwire transfers may be more efficient for large payments. The RFP process offers the government an opportunity to weigh the advantages and disadvantages of various options. These basic services should be coupled with security features, such as ACH blocking and other fraud deterrence measures outlined in Chapter 3.

**Controlled Disbursement**

As noted in Chapter 3, controlled disbursement is a service that some governments use to obtain advance information on checks that will be presented to its bank. Although this may result in a more precise determination of cash position and an additional day of float (allowing additional investment income), it must be weighed against the corresponding additional fees.

**Concentration Accounts and Zero Balance Accounts (ZBA)**

A concentration account used in conjunction with ZBAs assists a government in maximizing its returns on balances. In general, the zero balance accounts are swept into a concentration account on a daily basis (leaving the account with a zero balance). The concentration account balances then may be swept into an overnight investment vehicle or just credited with a fixed investment return amount based on balances. The investment return may be credited into the account or used to offset fees.

The ZBA works by linking multiple disbursement accounts and/or collection accounts into one central account. As indicated in Exhibit 4.1, a typical arrangement is to have a payroll account and accounts payable account for managing daily disbursements and an operating account for depositing daily collections of cash inflows; these three accounts or sub-accounts would then be linked to a master concentration account. The payments that are disbursed or deposited into the three individual ac-
accounts are debited or credited into a master concentration account as needed to maintain a zero balance in the individual ZBA accounts.

There are several advantages to a ZBA. The ZBA allows for a more productive use of cash since excess funds are concentrated into one single account. In turn, it should also lower the administrative costs associated with the daily transfer of funds in multiple accounts by allowing the entity to focus on one account. The ZBA should also provide the govern-
ment with better cash controls while still giving it the disbursement authority over one main account.

It is imperative that the government clearly identify its expectations for the use of the concentration account. Specific language stating where the funds should be invested or how the total balance of the account is to be used for offsetting fees will allow the government to maximize return. In addition, the benefits of ZBAs (reduction in idle funds, increase in invested funds) must be weighed against any additional account maintenance fees. In a low-interest rate environment, the utility of maintaining ZBA accounts is reduced.

**Reconciliation Services**

The management of disbursement and collection activity can be a daunting task. While recent advances in internal payroll and accounts payable systems have made it easier to manage these processes, there are a number of external services that financial institutions offer that further improve them. These services include account reconciliation programs, positive pay to help detect check fraud, and check imaging that offers improved operating efficiencies.

Governments need to reconcile their data tracking cash management activity against the bank’s data to ensure that they are consistent. Not only does reconciliation strengthen internal control, it is necessary to protect the government against liabilities. Article 4 of the Uniform Commercial Code obligates governments and businesses to verify monthly bank statements within a certain time frame to avoid fraud-related losses.4

Banks offer full and partial reconciliation. With partial reconciliation, banks simply provide a list of paid or cleared items (i.e., completed transactions such as paid checks), which the government must then reconcile against its data. Under full reconciliation, the reconciliation function is essentially outsourced to the bank: the bank reconciles issued and cleared items on behalf of the government. Governments using full reconciliation obtain several useful bank-generated reports, including reports on items (a) issued and paid, (b) issued but not yet paid, (c) paid but not yet “issued” (not entered on the government’s “daily issued file”5) and others.6
In order to use this service, clients are required to electronically transmit their check issuance information along with any check voidance activity to their financial institution. The bank subsequently uses the check issuance information provided by the client to compare against the paid checks to identify discrepancies. The bank then researches the unmatched information and makes corrections as necessary. At the end of the designated statement cycle, the bank will perform the account reconciliation and provide the government with paper reports only, or paper reports and an electronic data file(s). Both the paper reports and electronic data file reporting methods enable the government to efficiently manage its account reconciliation. Full reconciliation generally enables governments to reduce their monthly account reconciliation processes to hours per month from days or even weeks.

There are a number of benefits associated with full reconciliation. The following list itemizes a few of the most significant:

- The government receives correct paid check information due to the obligatory match to check issue information;
- The bank acts as an outsourced account reconciliation unit for the government;
- Encoding errors are quickly identified, improving the accuracy of cash forecasting;
- Full reconciliation serves as an internal and external audit control tool by providing an efficient and cost effective separation of duties;
- The bank corrects erroneous check number and amount information;
- Daily or monthly electronic data files can be provided to improve the efficiency of monthly reconciliation; and
- Governments using paid check files, in conjunction with full reconciliation, generally have no posting exceptions when clearing their outstanding checks.
Reconciliation Reporting Options

Full reconciliation users have two methods of receiving paid check information. The first and standard method is through a collection of paper reports. The second method is through electronic or online transmittal of information.

Under either method, the types of reports are similar. These reports detail all aspects of account activity, including paid checks, outstanding check issues, miscellaneous debits and credits, stop and void payments, stale-dated items, and daily list post reports. Full reconciliation reports generally coincide with the account statement cycle, which the bank likely maintains on a month-end statement cycle. Governments with special calendar account statement cycles could receive account reconciliation that matches the same periods. While a substantial improvement over the potentially incorrect information found on account statements, the second method of reporting is generally more beneficial than the paper.

There are several paper-only reporting options. They include:

- Daily account reconciliation;
- Monthly account reconciliation; and
- Special calendar account reconciliation (government provides reconciliation calendar).

Most full reconciliation customers take advantage of daily or monthly paid check files. These files contain all check-clearing activity for the given cycle. Governments use the paid check files to automatically clear their internal payroll and/or accounts payable systems, effectively reducing the amount of time and effort employees expend on manually checking off monthly statements.

Positive Pay

As indicated in Chapter 3, positive pay is a detailed check fraud detection service offered to customers. Like account reconciliation, the service deters check fraud by comparing the government's check information to the bank's. Positive pay, however, compares government data against its
bank's data before the bank releases the funds to the corresponding bank (that is, the bank which the payee uses). Governments collaborate with the bank to help detect fraud and reduce loss risk to both the government and the government’s bank. In order to utilize the positive pay system, the bank (a) usually requires that the government establish full account reconciliation and (b) requires its account reconciliation department to perform a daily reconciliation on the accounts.

Some of the key issues when considering positive pay include:

- The government must abide by a time deadline for submitting files to the bank, which may be either on the same day that the checks are issued or the prior night.7

- The account reconciliation department reviews suspect check activity after posting to “scrub” the list of items. Once the scrubbing process for an account is complete, the account is flagged for online reporting.

- Scrubbed exceptions are provided to the government by a set time the following morning, usually by file transmission. Online viewing is another option.

- Governments then must review and make decisions on all items before a set time the same day.

- The bank will follow the government’s instructions in returning identified items.

- The government should request a review of online decision history, allowing it to monitor employee activity.

Bank-maintained positive pay is a valuable product that, with proper training, can become a routine part of the government’s daily cash management operations. The most important task is to ensure that either bank personnel or senior government treasurers train the treasury staff in its use.
Overnight Investment

There are several options available to finance officers for investing unused balances at the close of the day. The default option is to leave funds in the account(s) of the depository bank, where they would earn interest to be credited toward any monthly service costs owed to the bank. This earnings credit rate is analyzed further in Chapter 7, which discusses the account analysis statement.

Alternatively, governments can receive interest on balances at the end of the day after surplus funds are swept or moved from disbursement accounts and/or depository accounts to investment accounts. The repurchase sweep and savings sweep are two examples of interest-bearing options. Some banks also offer a combination of both.

The repurchase or repo sweep links a depository account with an investment account and systematically sweeps funds to a predetermined target level by transferring collected balances to or from the investment account as needed. The savings sweep links a depository account with a savings account and systematically transfers collected balances in excess of the threshold to a savings investment. When the depository account reaches a zero balance, an automated transfer from the savings account is executed, returning the depository account to its threshold balance.

State statutes and local investment policies will significantly circumscribe the overnight investment options that a bank can pursue on behalf of a government. In addition, most banks benchmark interest earnings in accordance with widely used indices, such as the Fed funds rate or the three-month Treasury bill index. It may be possible to obtain better investment returns by requesting a different index when preparing the RFP.

Information Reporting

Although most banks provide basic online reporting, the ability to provide enhanced reporting, flexibility in allowing users to define new reports, and various types of reporting for their customers varies significantly from bank to bank. Thus, it is very important that the government assess each financial institution's information reporting abilities carefully.
Items to be considered when preparing an information reporting section for an RFP include:

- Timely reporting of information and ability to generate specialty reports to meet the needs of the government entity;
- All reports should have the capability to be downloaded and saved (using a common file format) to the government’s computer for later viewing; and
- Ability for system administrators to grant report access to individual users.

If the financial institution provides online access to accounts, there should be a separate, easily identified reporting section or “window.” This section should provide the user with various standard reporting options available through the online system. The reports will be viewed on the user’s computer screen with the option of printing the report or even downloading the information to the user’s system for further analysis.

**Check Imaging – CD-ROM**

Check imaging provides government entities with CD-ROM(s) containing images of all disbursement checks for their current statement cycle. Governments immediately benefit through ease of access and timely research, virtual elimination of check storage space, and better customer service. The government’s employees appreciate the service, too.

A compelling reason for using check imaging is to realize added efficiencies in the disbursement process. Governments with sufficient need and capabilities can choose to receive disbursement images via direct transmission, although this method of image delivery is costly and resource intensive for governments to implement and support.

**Lockbox Services**

As noted in Chapter 2, lockbox is a method that governments use to expedite the collection of accounts receivable. Lockbox processing reduces both mail float and processing float. In addition, fund availability is improved because lockbox accounts are assigned unique, accelerated avail-
ability schedules. For some governments, it is a core banking service and for others it is considered a distinct service that is to be procured separately.

These remittances are usually generated from a consumer for payment to a government utility. Consumer-to-government payments lend themselves to automation due to the standardized remittance forms that are returned with each check. The remittances usually (a) include the necessary addresses, account information, and balances, and (b) are required to have a machine-readable optical character recognition (OCR) scanline as well. The OCR and remittance requirements are both issues that need to be addressed in the RFP process. The finance officer needs to be able to take into account the costs that may be incurred if the remittance needs to be changed or if an OCR scanline needs to be added.

A final, significant consideration when looking into lockbox services is the mailing address of the lockbox. Many governmental officials prefer to have a lockbox within their jurisdiction. However, this type of political consideration has cost implications. Many banks can provide a pickup service for the lockbox items delivered to a city address, but a fee may be attached. This may be included as an option in an RFP.

ENDNOTES

2. Cost savings and better service may be attained by re-bidding even if the process does not result in a change in banks.
3. Perhaps the biggest recent change in the purchasing/accounts payable process is the procurement card, also known as the purchasing or “p” card. The government will need to ask the detailed questions in the RFP process to ensure that the selected bank is able to meet all of its specific needs. The government should also ask in the RFP if the bank provides a rebate program based on meeting certain minimum purchase levels. The cost of this type of program should be negligible to the government and could provide significant operational savings.
5. Some governments refer to these as manual checks that are manually issued. They are not automatically generated by the government’s financial management system.
7. Data for manually issued checks would need to be sent to the bank the same day as issued.
8. Non-overnight investment is discussed on page 95.
9. For example, the Village of Carol Stream, Illinois, requested in its RFP that balances in its depository bank accounts be tied to the prevailing rate of the state investment pool, plus 20 basis points.
Ancillary Banking Services

Janet Langenderfer, Nicholas Greifer, and Joseph Casey

This chapter provides a discussion of ancillary or non-core services a government can procure, either from its primary depository bank, or from competing banks or vendors that specialize in one area. For example, a government has the option of including credit card acceptance services in a request for proposal (RFP) for core depository services (making it a mandatory bidding requirement), bundling it while making credit card services an optional item, or simply procuring credit card services separately. The government can take a similar path when selecting other services discussed in this chapter: investment management, credit services, and trustee services related to governmental debt issuance. Banks can also provide custodial services, a subject outside the scope of this publication.

Credit Card Acceptance

This section offers an overview of how credit card transactions work, delineates important issues about credit card processing, and list the key contractual issues that a government may want to know before completing the vendor selection process.

Government acceptance of credit card transactions has increased throughout the United States, as it has in the private sector. Although relatively new to some governments, credit cards have been accepted by merchants for decades. (In the credit card industry, merchant has come to mean any entity accepting payment by credit card, including private and public entities.) Over time, credit card acceptance has become the domain of a few large processing companies, some of which are bank
owned. As of this writing, there are fewer than ten major processors in the United States. The business of credit card acceptance is operated separately from any other bank product area.

While governments have realized significant benefits from credit card acceptance, there are diverging interests among stakeholders. Constituents want to use a credit card to pay for utility and tax bills in the same manner that they pay for their groceries, clothing, and ordinary living expenses. Government staff seek payment processing efficiencies, administrative ease and compliance with statutes that, in many states, mandate that governments have to collect the entire amount of an invoiced item and still pay the credit card fee. Elected officials are concerned that some taxpayers will be paying for the convenience of a few. Lastly, as for-profit entities, card processing providers seek to maximize revenues and minimize their own risks of fraudulent payment. In many cases, these processors may not necessarily be the same financial institution that delivers depository and other services – indeed, they may not be a financial institution at all.

**How Credit Card Transactions Are Executed**

There are two kinds of credit card programs in the U.S. market today: single-provider and multi-provider systems. In single-provider systems, a single organization or card company contracts with each cardholder and each merchant for credit card services. The single-provider organization provides all transaction processing, billing, collections, risk management, and every other aspect of card distribution and usage. American Express and Discover operate two well-known single-provider systems in the United States. When a government contracts for processing credit card transactions, a separate contract is made with these single-provider card companies for acceptance of its cards. Rules and fees are generally straightforward and there is little room to negotiate. A single percentage rate of net sales made on the card is paid directly to the card company.

Multi-provider systems are much more complex; as such, a discussion of how they work will comprise the majority of this section. Visa and MasterCard are both multi-provider systems. Neither of these card companies have direct contracts with either cardholders or merchants.
Ancillary Banking Services

Rather, qualified financial institutions pay to become members of MasterCard and/or Visa, and the financial institutions then act as intermediaries. Visa and MasterCard only contract directly with their members – members’ subcontracting vendors may do “all the work” but all transactions have to be cleared through a member bank. (It is now common practice for transactions to be settled in the credit card system using one bank and then forwarding the funds to another bank via the ACH system.) The member bank does not have to be the bank with which you have your primary banking relationships.

As a member, a financial institution may (a) issue cards to individuals or businesses and/or (b) process all associated transactions according to a set of rules and product guidelines established by the card company. A member institution may contract with merchants (that is, any entity accepting credit cards, including governments) and process all of these transactions according to rules and product guidelines established by Visa or MasterCard. Based on these rules and guidelines, credit card transactions follow a standard process. There may be variations based on technology applications or the subcontracting vendors utilized by the financial institutions, but the fundamental model remains the same.

The credit card transaction process is shown in its simplest form in Exhibit 5.1. When a transaction occurs between a merchant (government) and a cardholder, the merchant’s bank – the “acquiring bank” – records the transaction into the credit card system for the merchant. The credit card system’s owner, MasterCard or Visa, then settles the transaction between the acquiring bank and the “issuing bank,” the cardholder’s bank. In the course of the settlement, the acquiring bank receives the value of the transaction less (a) a fee to the system owner for using the system and (b) fees to the issuer for receiving the cash before the money is received from the cardholder. All of these fees (called interchange fees) are established by the system owner based on a proprietary methodology that takes into consideration many factors, most significantly risk and the cost of money. It is then the issuing bank’s responsibility to collect the value of the transaction from the cardholder.

While all transactions go through this process, certain products within the card industry, such as online debit cards and corporate pur-
chasing cards, have specific processing requirements that involve different activities occurring during the transaction process. These activities are often only partially, if at all, noticeable to the merchant or the cardholder.

Vendors often handle many of the technical transaction processing activities for the banking institutions that are members of the Visa and MasterCard organizations. As a result, governments considering accepting credit cards are likely to be solicited by financial institutions as well as other qualified companies that offer the same credit card acceptance services.

**Issues Related to Credit Card Acceptance**

By accepting credit cards for many types of services, governments can simplify cashiering activities, reduce losses on checks, reduce cash theft, and improve overall cash flow. Other issues to consider when evaluating
the use of credit cards, looking for a service provider, or implementing a new credit card program include:

**Cash Flow.** Credit card payments reduce the collection float associated with payments by check. In most cases, credit card transactions that are completed on a Monday are submitted to the merchant's acquiring bank on Monday, and then submitted to the card system (MasterCard or Visa) on Tuesday, and the acquiring bank will receive the funds on Wednesday. Most acquiring banks will make the funds available to the merchant on Wednesday also, often by depositing the funds to the merchant's primary depository account via ACH transfer. Virtually all programs offer daily deposits, except in the case where average daily volume is less than $100.

Tracking and accounting for credit card transactions and associated fees are often more complicated than for transactions using other forms of payment. Transaction fees, transaction fee adjustments, transaction fee rejections, and chargeback fees all related to a single transaction may "hit" a single account as much as six months apart. While this example is extreme, be aware that the reconciliation process is subject to these tracking and accounting steps.

**Absorbing Fees versus Charging the User.** In some jurisdictions, the law requires that the amount collected for a given governmental service or tax be no greater than the amount owed for the service or tax itself. In such instances, the government would have to absorb transaction costs imposed by credit card vendors. Even in jurisdictions that allow an add-on or pass-through fee to the citizen making a payment by credit card, the credit card processor may have contractual provisions in place that sharply limit such fees (for example, to payments made by telephone).

While absorbing fees may be costly – especially for large-dollar transactions such as property taxes – some government cash managers consider credit card acceptance fees cost-effective and believe that such fees should be viewed like other cash management costs: just part of operating the organization and not separated out as a specific program or activity. (For example, the labor required to process an over-the-counter check or
GFOA Recommended Practice, “Acceptance of Credit Cards (1999 and 2002)” (excerpt)

GFOA recommends that governments evaluate credit card acceptance, analyzing the following factors:

1. Transaction fees imposed on the government
2. Administrative and other costs
3. Type of payment – applying credit card acceptance to discretionary government services (e.g., parks and recreation service) only, or both discretionary and non-discretionary services or taxes (e.g., property tax)
4. Benefits of credit card acceptance:
   - Increased certainty of collection;
   - Reduced return check processing costs;
   - Accelerated payments and the availability of funds;
   - Improved audit trail;
   - Reduced cashiering costs; and
   - Enhanced customer convenience.
5. Use of third-party processors
6. Cost analysis comparing cash, check, and other payment methods against credit card payments

Cash payment is not typically costed as a percentage of the transaction. Card acceptance fees need to be weighed against typical benefits:

- Greater on-time payment;
- Greater percentage of payments collected; and
- Reduced staff time for handling cash and paper payments (by using automated telephone payments and Internet-based payments, which usually require use of credit cards).

In general, the Government Finance Officers Association (GFOA) recommends that costs and benefits of credit card acceptance be compared to other payment mechanisms, such as checks or cash (see Exhibit 5.2).
Acceptance Limitations. MasterCard and Visa rules stipulate that merchants may not set a minimum or a maximum amount for transactions. Although some merchants have signs that prohibit credit card use for small purchases, this practice violates the rules of some credit card systems. Similarly, it also can be a violation to restrict purchases over a certain dollar limit.

Lockbox Processing. For governments currently accepting payments through a lockbox arrangement, adding credit payments requires additional consideration. Some lockbox providers can easily add credit card payments to the services they are currently providing by redesigning the remittance form to capture credit card data. Other providers may not be able to handle these transactions at all.

Risk Management. To process a typical over-the-counter transaction, a government employee swipes a credit card through a card reader and enters the dollar amount of the transaction. For additional security, some systems require the employee to also enter the expiration date and/or the last four digits of the card number from the card. Within seconds, an authorization code is displayed on the screen and on the receipt that is printed. The employee has the cardholder sign the receipt, compares the signature on the receipt to the signature on the card, and if they match, confirms completion of the transaction by pressing the appropriate button on the card-reading machine. By swiping the card and entering the value of the transaction, the card issuer verifies that the account is open and has the credit available to cover the value of transaction. This process was designed for face-to-face transactions and is effective in completing 99 percent of these transactions in an effective, low risk manner.

There are a variety of risks associated with credit card acceptance and not all of them are obvious. The first, and most significant risk, is that the person using the card is not authorized to use it. It is the merchant’s sole responsibility to ensure that the person who uses the card is the same person whose name is embossed on the card and whose signature is on the back of the card. If a stolen card is used and the merchant cannot provide evidence that all measures were taken to ensure that the cardholder was protected, the merchant will be responsible for the value of the transaction. Evidence, in this instance, means a copy of the credit card receipt
Illustration of Payment Risk

Consider a scenario in which a citizen makes an over-the-counter payment for a government service. The citizen comes to the city hall to pay for his $20 water bill. He wishes to pay using a credit card that bears his wife's name on the front and her signature on the back.

To protect the city from losing the value of the transaction, the city employee will have to tell the citizen at the counter that he cannot accept the card. The reason is as follows. If the wife tells her credit card bank (the issuing bank) that her credit card was stolen, then everything purchased using the card that she did not authorize with her signature is considered fraudulently purchased. The merchants who accepted those fraudulent purchases, based on a signature that did not match the one on the card, are responsible for their own losses. Therefore, the city would lose its $20 payment made by the citizen.

which includes a signature that matches the one on the back of the card (see Exhibit 5.3).

For mail-in payments, getting a cardholder's signature is possible, but it is impossible to compare that signature to the one on the card. As a result, these transactions always carry a higher risk. Some vendors offer specialized programs to help minimize the risk, but it will always be present.

A second type of risk is carrying out an unauthorized transaction, even if it involves a legitimate cardholder (for example, when the cardholder exceeds his or her credit limit). "Forcing" a transaction without an authorization is a very high-risk undertaking because, in effect, the government employee is overriding the card issuer's instructions. If the cardholder cannot or does not pay for the transaction, the government is responsible for payment.

Keeping up with the reconciliation process is another effective risk management tool. While the majority of financial institutions and vendors are honest, simple data entry errors (for example, double entries and missed entries) do occur. Ongoing reconciliation and tracking chargeback fees will help mitigate risks.
**Chargebacks.** As the credit card system evolved, strict federal laws were created to protect the consumer from fraudulent merchants who would place charges on a credit card and never deliver the promised product or service. As a result, a consumer has the right to contest any transaction placed on his or her account and is favored in most disputes.

In the government sector, chargeback rates are low, generally because (a) the type of fees being paid are often mandatory, and (b) government agencies have other mechanisms for penalizing a resident or business if the payment is invalid.

**Negotiation Topics**

With an understanding of the major issues regarding credit card acceptance, government finance officers are prepared to negotiate a credit card acceptance contract. When selecting a vendor and negotiating a contract, there are a limited number of factors that can be controlled by the government negotiating team.

**Vendor Selection.** Governments interested in accepting credit cards have a variety of options regarding vendors. Qualified vendors can be found in a number of places. The financial institution where the agency has its primary banking relationship is an obvious candidate to include in a vendor list. In addition, MasterCard and Visa both maintain current lists of financial institutions which offer acceptance services to governments. Discover and American Express sometimes can offer referrals as well. There are also highly qualified companies specializing in credit card acceptance that are not general purpose banks.

Like any service involving cash management, when considering an external vendor the prudent course of action is to check references carefully. In particular, it is beneficial if the vendor has experience in card acceptance with other government agencies.

**Size of Portfolio.** One of the most important factors in determining the cost of credit card acceptance is the number of transactions and dollars processed over the course of a year. Like so many services, rates are variable and volume discounts are available. Therefore, by grouping different departments from a single unit of government, lower rates can be obtained. Even better, combining units of governments in a consoli-
dated RFP can provide greater purchasing power. For instance, a park
district, a municipality, and a county that all serve the same geographic
area can have a single contract with an acquiring bank and get the benefit
of their combined transaction volume. At the same time, they can keep
their financial transactions and reporting separate.

When contacting potential vendors, two immediate questions arise:
What is the annual volume expressed in dollars, and how many transac-
tions will be processed per year? If card acceptance is replacing cash pay-
ments, then a government cash manager would project a small
percentage of payments by credit card in the first year, with the percent-
age growing in subsequent years as awareness of the credit card option
grows. Each government will have specific circumstances that would in-
fluence actual participation rates. Regardless of the eventual participation
rates and transaction volume, break points should be negotiated along a
scale of projected volume at the time of contract negotiations.

**Pricing Structure.** Credit card transaction pricing is not transpar-
ent. Acquiring banks work hard to find the best compromise between
passing through their costs with minimal mark-up and providing mer-
chants with rates that are understandable, easy to track, and simple to re-
port. The majority portion of the fees paid by a merchant are the
aforementioned interchange fees which the acquiring bank pays to the
cardholder's issuing bank, as established by the system provider (for ex-
ample, MasterCard or Visa). The concept behind interchange fees was
discussed in the first section describing the credit card process.

The interchange fee structure is designed so that every transaction is
priced independently. The price is based on as many as 70 criteria, in-
cluding the following four basic criteria:

- What type of card was used;
- When the transaction entered the provider's system;
- The dollar value of the transaction; and
- How the transaction entered the provider's system.
At the time a government establishes a credit card acceptance program, it is possible to estimate into which category most transactions will fit. Even so, that estimate will rarely be 100 percent accurate in application.

Further, at the time an acquiring bank submits a transaction to the system provider for settlement, the interchange fee can still only be forecasted. When the system provider completes the transaction, the acquiring bank's forecasted number is used. Within another two days if the transaction did not meet all of the criteria for the forecasted interchange rate, another rate needs to be charged, so the system provider charges the acquiring bank with an adjustment for the difference in interchange fees. The days indicated here refer to business days and continue regardless of calendar dates.

Because of the complicated method of pricing transactions, it is difficult to provide accurate pricing and reporting to merchants on a timely basis. Additionally, the reporting is often difficult to present in a manner that is easy to understand. Contracts are often written in such a way that it appears all transactions will be processed at the lowest interchange rate, but exceptions occur and higher rates can apply (often buried in contract provisions). Some vendors charge the higher rate and an additional fee for charging the higher rate; many acquiring banks do not charge an additional fee. Reading each paragraph in a proposal and the proposed contract is crucial to ensure complete understanding of the fee structure.

**Bundled versus Unbundled Pricing.** Is it better to pursue bundled or unbundled pricing? The answer depends in large part on the size and breadth of the program. For large programs (greater than $1 million per year), unbundled pricing makes sense. In this case, unbundled pricing means paying directly for interchange fees plus a flat per-transaction fee. Using this approach, interchange fees are passed through at cost (a non-negotiable cost) to the system provider (for example, routed through the government's card processing vendor to MasterCard or Visa), and each transaction will cost a certain number of pennies (for example, a payment to the card processor not passed on).

For very small programs (under $100,000 per year), bundled pricing makes sense. Let the acquiring bank estimate the total overall interchange
rate: the dollar amount at risk to the government is minimal and the ease of administration and oversight is greater. For either approach, the only way to determine a competitive rate is to speak to other merchants of a similar size. Whether these merchants are in the government sector or in the retail sector, it helps to get a perspective on prevailing rates.

**Equipment.** At the time of this writing, a single credit card terminal with a printer can be purchased for less than $750. Only your government can make the determination regarding lease/buy decisions, but it is important to first compare prices. Major office supply stores sell card acceptance terminals and a comparison of these prices to those paid by other agencies provides helpful baseline information.

**Service.** When negotiating for credit card acceptance services, customer service is an important differentiator among firms. Several measures can be taken to gauge quality: (a) ask for customer service phone numbers; (b) determine escalation procedures when satisfaction has not been reached; and (c) call the service number and talk to customer service representatives to get a sense of their attitude and competence, and the overall quality of service that can be expected.

Not all vendors offer extended hours of customer service. Governments should determine whether or not this will be a concern based on the frequency of evening and Saturday service needs. Additionally, if a service center is closed on the weekends, then Monday traffic is apt to be heavy. Assess how this will impact the operation of the revenue collection unit and identify requirements accordingly.

**Training.** Today’s card acceptance equipment is relatively simple to use and most vendors provide telephone training for their customers. This training is often available whenever it is needed, not necessarily just at the time of installation. For large programs, however, there may be appropriate times to request hands-on training, particularly if there are significant issues with closing out batches at unusual times. A government would need to identify its needs and specify requirements accordingly.

**Reporting.** Reports and reporting formats vary widely, just as the pricing configurations do. It is advisable that governments obtain sample reports covering a week. Ideally, a vendor will explain the various data fields, and demonstrate how to reconcile a week of statements. Some
vendors offer online reporting down to the transaction level. Others simply offer monthly summary statements. It is important for each government to determine its own needs.

**Comparing Proposals.** Vendors will provide bids with pricing that will be difficult to compare. It may sound obvious, but read every item in the proposal carefully, because some of the contracts and proposals have pricing information in multiple places. Further, it is not always clear how the pricing elements will be implemented. The three most common methods are listed here:

1. There will be a predetermined rate for all transactions. For any transaction that does not meet the requirements for the lowest interchange rate, the cost of the additional interchange fees will be passed through to the merchant. (These transactions that do not meet the lowest rate are often called downgraded transactions.)
2. Each transaction will cost a predetermined amount (expressed as number of cents per transaction) and interchange fees will be passed through at cost.
3. Each transaction will be charged one of three rates: lowest, middle, and standard. The vendor would determine which interchange rates are applied to which group but does not share any of this information with the merchant. This is a very simple program for the merchant and shares the risk of interchange accuracy with the merchant. For a very large government with high transaction volume, however, there is the potential to spend more on downgraded transactions than is necessary.

If all proposals were offered in terms of interchange fees plus a transaction fee (method 2), it would be easy to compare pricing. Of course, that is not always the best pricing method for the merchant or the best vendor overall for the merchant. If the third method is offered, then interchange rates are not even offered at cost, complicating matters even further.

The best way to compare bids is to create a sample scenario and apply the proposed prices to it. For instance, a standardized method could be imposed in the RFP as follows:
Create a set of assumptions where there will be $250,000 of transactions on credit cards in a year and the average transaction will be $50. This results in 5,000 transactions per year.

1. Create a set of assumptions where there will be $250,000 of transactions on credit cards in a year and the average transaction will be $50. This results in 5,000 transactions per year.
2. Develop another set of assumptions about how the transactions will be processed. For example, assume that 90 percent of the transactions will be swiped through the terminal at the counter, 7 percent will be key entered (typical of payments made over the telephone), and 3 percent will go through at the highest rate in the Visa or MasterCard systems. It is valid to ask the vendors to confirm that these are reasonable assumptions.
3. Apply the vendor’s proposed bids using these assumptions and judge the results.

If competing vendors have not given enough information to complete the pricing proposal, missing information can be requested or the proposal can be considered incomplete, depending upon on each government’s procurement process.

**Conclusion**

Merchants of all sizes and types around the world accept credit cards as payment for services rendered. Governments in the United States have been slow to adopt this methodology due in part to the fact that the banking system does not price this cash management product along with its other cash management products. However, economic realities and citizen preferences are causing many governments to reconsider and investigate the desirability of a card acceptance program.

In this section, the single-provider and multi-provider systems were described, the latter being examined in detail. Even in its simplest form, the transaction process (which includes two banks, a system provider, a merchant, and a cardholder) has a pricing mechanism that is complex in design and in application. The vendors supplying the merchants with services for acceptance struggle between providing detailed information
with precise pricing versus simplified information with straightforward pricing. It is a challenging business, yet, when established, the transaction itself happens very quickly and accurately. For all of its complexity, credit card acceptance is an important service that improves governmental cash management.

**Investment Management**

State and local finance officers initiating or renewing a banking relationship can obtain a variety of services from a diversified financial institution. Foremost among these services is the bank’s provision of investment or money management. Separate and distinct factors apply to investment management services that do not apply to other banking services. Those factors that should be reviewed when considering investment management services, whether offered by a bank or another provider, include:

- Legal and policy constraints;
- Investment objectives;
- Risk tolerance;
- Passive versus active management;
- Bundled versus unbundled cash and investment management services;
- Types of providers of investment management services; and
- Fees for the services.

The investment management services that are the focus of this section are defined as the management of a government’s short-term, fixed-income portfolio. It excludes portfolio management of pension funds, which are often managed by a separate department, board, or organization and usually involves much greater risk tolerances. In addition, this section does not cover supplementary investment services, such as brokerage or custodial services, which some banks provide as well.
Constraints on Public Investors

State and local investors of short-term portfolios face several constraints on how surplus assets can be invested in fixed-income and money market instruments. Because of these constraints, the value added by an active manager (whether a bank or some other provider) will be somewhat limited.

The first constraints to be considered are the state statutes that typically define the types of investments and transactions that are legal for governments subject to those statutes. Investments with low risk and high liquidity, such as Treasury, agency, and instrumentality securities, are typically included on the list. Excluded from the authorized list are investments that have the potential for high price volatility, low liquidity and/or default of interest and principal payments, such as low-grade corporate bonds and highly volatile structured securities.

In addition, local governments may specify additional limits that are more restrictive than state-imposed constraints. Whether through ordinances enacted by elected officials or through an investment policy crafted by appointed officers, these additional restrictions can further limit investment practices to fit the risk profile of a government and its treasury staff. For example, even if a state permits investment in high-grade corporate bonds, a local government’s investment policy may preclude their use.

A government’s investment policy is the definitive document that delineates that government’s investment program and the practices that comply with state statutes and are approved by the governing board. The investment objectives of a government are an important part of an investment policy. Whereas a pension fund may have an objective to earn a certain rate of return above a benchmark (for example, 2 percent above inflation or the actuarial rate of return) that necessitates investments in equities and other volatile assets, the objectives for investing short-term funds will most often be safety, liquidity, and yield (SLY), in that order of priority.

The objective of safety is usually understood to mean provisions to limit a portfolio’s exposure to credit risk (default) and interest rate risk (price depreciation), the two primary components of investment risk for
fixed-income securities. The liquidity objective reflects the notion that the investment program is to serve the government's cash management needs, and not vice-versa. Easily traded investments that can be readily converted or liquidated into cash are preferred, versus illiquid assets that cannot be easily sold or can only be sold with high transaction costs. The objective of yield signifies a government's goal of achieving a competitive return in its investment program, having satisfied safety and liquidity concerns.

GFOA has developed a sample investment policy that state and local governments may wish to reference in developing their own investment policy. The sample policy is excerpted in Exhibit 5.4 to illustrate common constraints on public investors of surplus governmental assets.

**Active and Passive Investment Management**

It is important for a government to determine its investment style. There are two broad styles to choose from: active or passive management. The style selection will drive the many other daily decisions involved in the implementation of an investment program.

Considerations that influence this decision include the investment policy, size of the portfolio, investment experience and market resources available (either internally or externally to a government), cost versus potential return, and a government's risk profile. Both active and passive strategies have a cost. For active strategies the cost is more obvious: training, technology, staff time allocated to investing, or an external money manager's fee. The cost for passive strategies is harder to quantify, but comes in the form of potential opportunity costs and possibly more expensive trade executions.

Neither strategy is inherently right or wrong. A candid assessment of a government's ability to maintain safety and liquidity while attaining appropriate returns in the portfolio should drive the decision of which strategy to employ. A government considering using the services of a bank or other provider for investment management should determine whether it prefers an active or passive approach to investment before going out to bid.
### GFOA Sample Investment Policy (excerpt)

#### Key Investment Constraints

- Investment objective of safety, liquidity and yield
- Limits on investments by type of issue (to manage credit risk)
  - U.S. government obligations, U.S. government agency obligations, and U.S. government instrumentality obligations, which have a liquid market with a readily determinable market value;
  - Certificates of deposit, bankers' acceptances, and commercial paper, rated in the highest tier (for example, A-1, P-1, F-1, or D-1 or higher) by a nationally recognized rating agency;
  - Investment-grade obligations of state, provincial and local governments, and public authorities;
  - Repurchase agreements whose underlying purchased securities consist of the foregoing;
  - Money market mutual funds regulated by the Securities and Exchange Commission and whose portfolios consist only of dollar-denominated securities; and
  - Local government investment pools, either state-administered or through joint powers statutes and other intergovernmental agreement legislation.
- Limits on investment by maturity (to manage interest rate risk and ensure liquidity)
  - To the extent possible, the [entity] shall attempt to match its investments with anticipated cash flow requirements; and
  - Unless matched to a specific cash flow, the [entity] will not directly invest in securities maturing more than five years from the date of purchase or in accordance with state and local statutes and ordinances. The [entity] shall adopt weighted average maturity limitations (which often range from 90 days to three years), consistent with the investment objectives.

This determination may be relatively easy in jurisdictions that have extremely restrictive investment policies. Such jurisdictions have tight constraints on the types of allowable investments, greatly limiting the ability of an active manager to add value through portfolio management techniques. Other jurisdictions may have somewhat more flexible investment policies that allow for an active manager to add value and poten-
tially outperform its investment benchmarks. For the latter, it may be profitable to retain a bank or other provider that employs an active management strategy.

**Passive Management.** Passive management, in a strictly traditional sense, is a strategy intended to attain market average rates of return and not intended to beat the market, as is the traditional objective of active management. Therefore, the implementation of a passive management strategy does not rely on any analysis of future changes to the risk factors that influence the return on an investment portfolio, such as fluctuations in interest rates, shifts in the shape of the yield curve, changes in credit quality, and spreads between market sectors. In this context, mirroring an index such as the Lehman 1-5 Year Government/Credit Index\(^2\) would be considered a passive investment strategy even though its implementation requires a high degree of investment sophistication and activity to create and maintain such benchmarking.

A possibly common impression among many investors is that only a low level of activity and sophistication is required to implement a passive program. This impression has formed largely because two of the common passive strategies, “buying and holding” and “laddering” (discussed below), require minimal market analysis and investment decision making. A compelling argument can be made that many public cash managers lack the time, expertise, and resources to support sophisticated investment strategies. Most public cash managers carry other responsibilities that detract from the time and resources they have to devote to the markets. Generally, one must ask whether a part-time official juggling three or four other tasks (such as budgeting, debt management, and tax collections) without access to online financial information can add enough value to the portfolio to make an active strategy worthwhile. In general, most government investment officials should seek to obtain market average rates of return through prudent strategies instead of seeking to outperform the market.

Passive investment management strategies usually begin with a liquidity pool. In the public cash management sector, this ordinarily means use of short-term money market instruments that can be liquidated
Passive Investment Management Strategies

Matching Disbursements. A popular approach in many smaller jurisdictions is the purchase of money market securities that mature on known disbursement dates, such as payroll and accounts payable dates. Using a first-in, first-out timing approach, the investment manager acts to ensure that funds are invested only as “far as the eye can see.” Incoming funds are invested to match the next uncovered disbursement date. By investing in specific maturities, incremental yield usually is obtained, and there is little risk that securities must be prematurely liquidated to meet disbursement requirements.

Cash Horizon Investing. A variation on this approach is to use the cash forecast to invest for the longest maturity possible according to the cash budget. Thus, a cash manager might purchase a one-year money market instrument, anticipating that future incoming cash receipts will provide the funding necessary for projected disbursements. This approach is suitable for entities whose cash flows are highly predictable, and works best when the term structure of interest rates (the yield curve) is positive. Under these circumstances, additional yield is obtained from the longer maturities that are purchased.

Laddering. Laddering refers to building a portfolio of securities that mature on a fixed schedule, such as monthly, quarterly, semi-annually, and so forth. When a security matures, if the funds are not needed for something else, then it is replaced by a new security that continues the same schedule. Thus, supposing a government has a portfolio consisting of twelve securities, which mature over each of the next twelve months, the next security to mature will be replaced by a security maturing in month 12. In addition to providing a regular source of liquidity through maturing investments, laddered maturities provide good protection against interest rate risk. The downside risk of an interest rate rise depressing the value of the portfolio would be offset by a new investment in a higher-yielding security. The laddered portfolio assures the investor receives, in the long run, an average rate of return.

readily. Once the liquidity base has been established, passive portfolio strategies can then take several forms (see Exhibit 5.5), including:

- Matching maturities to known disbursement cycles (maturities on an irregular schedule corresponding to the governments cash needs);
Ancillary Banking Services

- Cash horizon investing; and
- Ladder maturities (selecting securities that mature on a regular schedule).

Active Portfolio Strategies. As mentioned above, the traditional definition of active portfolio management is the use of investment strategies that are intended to produce returns that exceed the market average rates of return. The fixed income market is very efficient in that information about securities and news about marketing-moving events is immediately and universally available to investors, causing prices of securities to reflect that information instantaneously. Therefore, it is difficult for public cash managers to consistently achieve returns that exceed the market returns. Rather than attempting to outperform the market, a more appropriate goal for a government’s active investment management program is to ensure that it is getting full value from its investments. ³

Not surprisingly, active management requires much greater monitoring of the market, data resources, and specialized software to provide the kinds of analyses that drive security selection decisions. Since many government treasury departments lack these resources, those governments having a preference for active management are apt to outsource this function to an external money manager.

There are five basic fixed-income, active strategies as indicated in Exhibit 5.6. Considerable expertise, resources, and effort are required for public officials to actively manage their portfolios. However, this need not preclude the implementation of active portfolio management if the resources are available internally or through the hiring of an external investment manager.

Bundled versus Unbundled RFPs

Governments seeking external investment management have the luxury of choosing from a variety of organizations that deliver such services, including:

- Government investment pools – Some local governments and state agencies turn to an investment pool, which can be run by either a
Active Investment Management Strategies

1. **Interest rate anticipation** is a strategy of adjusting the duration of a portfolio based upon the expected direction of interest rates. Since prices of longer duration securities are more volatile than shorter duration securities, extending maturities in a falling interest rate environment would increase the rate of price appreciation in the portfolio, while shortening maturities in a rising interest rate environment would minimize losses. In theory, this is a very sound strategy. In practice, it can be difficult to implement because of the uncertainties of when and where rates will move. Poor timing can result in poor returns because of opportunity costs and investments that are “underwater.”

2. **Yield curve optimization** is a strategy of determining the best relative value on the yield curve given investment policy and cash flow constraints. Instead of matching an investment to a disbursement, one may choose to mismatch assets and liabilities if there is an advantage to do so. If the yield curve is steep, analysis may show that buying a security maturing beyond the date of a disbursement and then selling it on the date of the disbursement at the rates on that date would generate a higher return. If the yield curve is inverted, analysis may show that buying a security maturing shorter than the date of the disbursement and then reinvesting on that date to the date of the disbursement would generate a higher return. The risk exists in not knowing for certain what rates will be on the future date that you have to sell or buy a security to complete the strategy.

3. **Sector allocation** is a strategy that takes advantages of changing yield relationships between different groups or sectors of fixed-income securities. The major sectors of fixed-income securities are: Treasury, agency, instrumentality, corporate, municipal, and mortgage-backed securities. Sector allocation is based upon spread analysis, which compares the yield of one security to another, with the difference between the two known as the spread. When the spread is wider, the difference is greater. When the spread is narrower, the difference is smaller.

Treasury securities act as the benchmark in sector analysis because they have no credit risk and are very liquid. The other sectors differ from the Treasury sector in varying degrees of additional credit risk and lower liquidity. Investors expect higher returns for greater risk. Each sector trades at different spreads to the Treasury sector for a given maturity. These spread relationships are not static but are constantly changing and trade in a range over time.

continued
Active Investment Management Strategies

Sector allocation strategies move money out of low risk securities into higher risk securities when spreads are at the wider end of the range, giving the investor greater relative return for the additional risk. When spreads are at the narrower end of the range, the sector allocation is shifted into higher quality securities that have lower risk. Any sector allocation strategies must be done in compliance with the investment policy with respect to the maximum percentages of the portfolio in any one sector, maximum weighted average maturity, and minimum required liquidity.

4. Timing strategies are an attempt to purchase securities when they are in the higher end of their yield range. Yields fluctuate because of the overall supply and demand nature of the markets. Numerous factors influence supply and demand. Some investors analyze fundamental and/or technical data in an attempt to determine when is the most opportune time to purchase a security. Because the markets are very efficient, it is difficult for a money manager, especially a public investment officer who has many other responsibilities, to consistently outperform the markets through the timing of trades.

5. Portfolio realignment (swaps) is a strategy to change the profile of the portfolio because market conditions have changed. A portfolio realignment involves selling one or more securities and reinvesting the proceeds in one or more new, comparable securities. Changing sector allocation as described above because of changes in spread relationships would usually be accomplished through a portfolio realignment. Changing the duration of a portfolio could also be accomplished through a portfolio realignment, as well as through other strategies. There is software that can analyze the impact of the realignment in present value as well as future value based upon a horizon date and interest rate assumptions. Be aware that portfolio realignments have balance sheet and income statement implications as well as the more obvious investment implications.

Source: Ned Connolly, Chandler Asset Management, Inc.
• *Mutual funds* – Mutual funds essentially compete against government investment pools; GFOA recommends limiting consideration of mutual funds to the money market and short-term bond market sectors; funds are commingled with multiple public and private investors; a careful reading of the prospectus is required to determine if a mutual fund invests in instruments that are legal per statutes, investment policy, and any other governing regulations;

• *Banks* – A trust department or some other organizational unit within the bank may manage investments for clients, either in a commingled or non-commingled (separately managed) account;

• *Broker/dealers* – Some brokerages, many of which are household names, may offer investment management services;

• *Specialized money management firms* – These firms may specialize by serving solely government clients or by operating in one part of the investment universe (for example, short, intermediate, or long duration portfolios) and may be able to provide an informational edge and additional customer service.

Due diligence is required in the selection of any of these services to be sure the investment strategies match a government’s investment objectives. Special care must be exercised when using the investment management division of firms that also have other investment-related divisions, such as trading and underwriting. Banks and broker/dealers often fit this category. Prohibitions against self-dealing need to be included in investment management agreements so that a government is always getting best trade executions and avoiding conflicts of interest on the part of providers.

There are many choices to be made when selecting investment management services and the factors that need to be considered are complex. Each firm will have its own strengths and weaknesses. In most cases, therefore, it is best for a government to seek unbundled services when sending out an RFP. While there may be certain synergies or efficiencies gained by bundling depository services with investment management
services (as with any bundled procurement), an unbundled approach may generate greater competition and richer choices from service providers who excel in their specialty. Moreover, it facilitates transparency through “apples-to-apples” comparisons of RFP submissions.

Of course, governments may choose more than one service provider to execute the government’s investment management program. For instance, a government’s portfolio is usually composed of layers. There is the liquidity layer that could be invested with a local government investment pool. There is the cash management layer that covers inflows and outflows for twelve months forward. A provider that specializes in short-term portfolios could manage that layer. Then there is the core layer that would not be needed unless there is an emergency. A provider that specializes in intermediate-term portfolios could manage that layer. Viewing the portfolio in layers, the benefits of unbundled services becomes even more apparent.

**Selection Criteria**

When a government goes forward with a procurement for money management services, GFOA recommends that it specify certain criteria for awarding its business. These would apply to any type of competing organization, whether a bank or specialized boutique investment firm, and whether or not the RFP is bundled. These criteria include factors such as assets under management, investment style, and historical performance relative to a benchmark, among others (see Exhibit 5.7).

In addition, a government should establish a selection process that is merit-based and competitive. It should then exercise due diligence in learning about competing firms, including determining the firm’s investment philosophy (to find out if its investment style will mesh with your investment objectives), the costs, and other important factors that will drive the decision. This can all be accomplished through the RFP process, the use of a selection committee, and the creation of a matrix showing providers on one axis and required criteria on the other.
EXHIBIT 5.7


Factors for Selecting Investment Advisors

Criteria should include:
- Investment style;
- Years in business;
- Assets under management;
- Investment performance versus appropriate benchmarks over an agreed upon period of time; and
- Delivery of SEC Form ADV Part I and Part II.

The government should perform due diligence on candidates, using an RFP process including:
- Quantitative information (for example, financial stability and performance review);
- Organizational structure of firm;
- Experience and depth of personnel in firm, including turnover;
- Firm-specific investment philosophy and portfolio management strategies;
- Trading process;
- Management fees;
- References from other clients; and
- Interviews with finalists.

Credit Services

While the services described throughout this book focus primarily on the bank's provision of core depository services, there are times when the government needs to borrow funds from a financial institution. Just as businesses and individuals have cash flow constraints in meeting short-term and/or long-term obligations, so does a government in meeting operational and/or capital needs. Banks can help meet those needs.

This section describes bank products that pertain to credit services. These products address both short- and long-term credit services as well as operational and capital needs for such credit services. Exhibit 5.8 pro-
vides an overview of these bank-provided credit products that can support a government’s debt management program.

**Background**

In selecting a bank for depository services, governments usually do not address the credit services a bank can provide. Nonetheless, there may be advantages in assessing the availability and diversity of credit services that the bank can offer as part of the selection process for choosing the primary banking relationship for the government. Dealing with one bank is easier administratively, and there may also be a modest benefit of having transactions between the checking accounts and debt repayment process occur within the same bank. At a minimum, it may be worthwhile to incorporate credit services in the RFP as an *optional* item, in order to obtain such services when a need may arise in the future.

The bank representatives who serve as primary contacts for checking, savings, and investment accounts are usually different than those bank contacts who help deliver credit services. Therefore it is in the best interests of the government to also know the credit service contacts and in-
clude a review of such credit service products as part of its selection process in a banking relationship.

As with any debt management program, the government should have an established process to best determine that it is receiving the most favorable interest rate. Many governments have a contractual relationship with an independent financial advisor and utilize this relationship and expertise in evaluating interest rate quotes and formulating the best structure for any debt issuance. State and/or local procurement laws may also govern the manner in which such debt can be solicited.

**Short-Term Credit**

Generally, short-term services address those needs for cash due to projected cash flow deficits over the short term that will be alleviated at some future point(s). This may result from operational needs for cash (for example, when a timing difference exists between collection of revenues and disbursement of expenditures). Or, a capital project might need short-term financing during its early stages before being replaced by long-term financing at or near the end of the construction period. The short-term services the bank offers are generally for funds needed for up to two years, although many of these products can be renewed quite easily for additional periods of time.

The variability of banks’ interest rates for short-term services is often negligible, as short-term rates offered by banks are often tied to a national index. Standard indices include the Fed funds rate, London International Bank Overnight Rate (LIBOR), and prime rate. The bank then usually establishes a factor and timing for such rate (for example, 50 basis points above such index to be calculated monthly). Interest rates that are recalculated monthly or adjusted at specified intervals are called variable rate agreements. A fixed rate can also be established over the life of the short-term credit agreement.

The following types of short-term credit products are generally available from a bank:

- Line of credit
- Short-term notes:
Ancillary Banking Services

— Bond anticipation notes (BANs);
— Tax anticipation notes (TANs);
— Revenue anticipation notes (RANs); and
— Short-term capital lease obligations.

Lines of credit take a variety of formats, names, and agreements, but the intent of a line of credit is to provide flexible inflows of cash on demand. Through a line of credit agreement, the government is given access up to a certain dollar amount that it can draw down in time periods and increments that the government desires with interest accruing only to those balances that it has drawn down from the bank. Interest payments are usually made monthly, although the government can negotiate another schedule for interest payments. Principal payments are negotiated to an agreed-upon time period that meets the government’s ability to have such principal funds available to meet repayment schedules.

In addition to interest rate costs, some banks may also impose other service fees for providing access to an established line of credit. If the line is dormant for an extended time period, it may not be in the government’s best interests to maintain it. These fees can be negotiated as part of the overall banking services agreement, however, and can be eliminated or lowered as a result.

Short-term notes are correlated to a specific purpose and time period. For BANs, TANs, and RANs, this means the time when the government receives the expected infusion of cash (that is, receipt of bond proceeds for BANs, tax due date for TANs, or revenue receipt for RANs). At the conclusion of the time period, the government pays the bank the principal amount borrowed, along with any remaining accrued interest, and the note is retired.

BANs are issued in anticipation of a future long-term financing with an interest rate that is either fixed for a defined time period or through a formula correlated to an established index. Governments use BANs when they (a) are uncertain about the draw schedule for a construction project or (b) believe longer-term interest rates are not currently attractive and deem it beneficial to seek long-term financing later. This may be due to a variety of factors: (a) uncertain scope and final cost estimates for
the capital project; (b) desire to access short-term, low interest BANs early in the period of project construction; (c) risk avoidance in trying to meet IRS arbitrage regulations (e.g., spend-down provisions for tax-exempt debt); and/or (d) other factors.

TANs and RANs are similar in that they represent a timing difference between the expenditure of funds and the subsequent receipt of revenues as part of the fiscal year operating budget. As governments incur expenditures throughout the year (for example, payroll and accounts payable), the revenues may not be received in advance or in conjunction with the expenditure pattern. This is attributable to tax due dates after the beginning of the fiscal year, grants that are not received until after the expenditure is paid or at a later point in fiscal year, or receipts of other revenues that the government is dependent upon arriving after a related expenditure has occurred. While many governments have reduced the need for TANs and RANs through established fund balance policies that provide for appropriate cash reserves high enough to meet anticipated cash flow deficits, there are still many governments that annually need to go through the TAN and/or RAN process.

Capital lease financing\(^5\) is an alternative for governments that may need to acquire capital items that, while having a relatively short useful life, can best be financed over a period of years — rather than having to cash fund the item all in one year. Many capital lease agreements are usually between the governments and the vendor offering the capital item (for example, computers, technology equipment, vehicles, other equipment). The bank can easily serve as a third party in such capital acquisitions, however, by providing the appropriate funding to the vendor and then collecting principal and interest payments over the life of the capital lease. The lease term often ranges around three years, with the term being shorter than the useful life of the asset.

The government should address, as part of its debt management program, when to enter into a capital lease and when to pursue alternatives. For example capital lease agreements may work best for infrequent acquisitions. Cash funding may work best for any recurring capital program (such as computer replacement or vehicle replacement), since these recurring expenditures may result in layers of multiple-year leases out-
standing that may incur greater debt service annually than new capital acquisition for that same year. In addition, a capital lease should be weighed against issuance of tax-exempt bonds, which may be a more economical financing mechanism, depending on (a) the length of the financing period, (b) the capital item being financed (such as computers), (c) the amount being financed, and (d) transaction costs associated with a particular financing vehicle.

**Long-Term Credit**

Often the government either competitively bids long-term financing (whereby the firm with the lowest bid acquires the bonds) or negotiates it (whereby an underwriter is selected to market and sell the bonds). Because each bond issue or financing vehicle is bid or negotiated, they cannot be included within the parameters of a standard banking services contract. When initiating a banking relationship, however, it is useful to know if the bank has the ability to serve as an underwriter.

Long-term services are closely correlated with capital financing programs. Often, the government has a substantial need for cash to fund a project that it otherwise cannot afford to do within the constraints of an annual budget appropriation. The long-term services the bank offers are generally for funds needed for greater than two years, often in periods of five to fifteen years. A bank may have corporate policies that restrict the amount of credit it can provide and/or the length of time such credit can be outstanding, but as banks further compete with other common forms of financing (for example, bonds), these constraints may diminish. As with any capital financing, the length of a loan should not exceed the useful life for the asset being financed.

The following types of long-term credit products are generally available from a bank:

- Long-term loans:
  - Bank qualified loans;
  - Other long-term loans;
- Long-term capital lease obligations; and
• Bond agreements or indentures.

Long-term loans are formal debt agreements whereby the bank lends funds to the government. Perhaps the most attractive long-term loans are so-called bank-qualified loans, as they often provide the most competitive interest rate. These loans provide the opportunity to borrow up to $10 million in new debt capacity each calendar year annually as regulated by the IRS. However, the major constraint for such loans is that if the government has issued or is planning to issue any other debt during the calendar year, then the other debt is counted against such bank-qualified capacity.

Banks can also provide traditional long-term loans that, through a debt management program and assistance of a financial advisor, may be a suitable alternative to the issuance of bonds. These loans may be restricted in maturity compared to bond agreements. (For example, the bank may have a corporate policy to not have any loan with a maturity greater than fifteen years, whereas the government may seek bonds having maturities greater than fifteen years.)

Long-term capital lease obligations are similar in principle to short-term capital lease obligations discussed previously, except the amount of the loan is likely higher and duration of the loan is longer. These agreements are usually the result of the bank acting as a third party through a master lease agreement and trust agreement, whereby a capital facility has been constructed and is leased to the government through the bank. The bank or financial institution selected to provide the financing should be usually selected through a competitive bidding process, with the goal of the government to get the most attractive interest rate and lease terms.

Through mergers and acquisitions, banks have evolved into diversified financial institutions. The underwriting division of a bank may play a role in the competitive bidding for bonds or serve as an underwriter in the selling of bonds. These services are usually delivered through a separate unit of a bank. As part of the government’s due diligence, however, the government should learn about and evaluate the variety of services
and products that can be offered by the bank and seek their competitive bid for such underwriting services when needed.

**Trustee and Related Services**

In the preceding section, the role of a bank as a source of debt financing was reviewed. In addition, banks can provide a number of complementary services or roles that support debt issuance: trustee, paying agent, investment advisor (for the investment of bond proceeds) and provider of arbitrage management services. This section examines these complementary bank services.

Serving as a trustee, a bank administers large sums of funds for the government. This is usually the result of its role in holding bond proceeds from the date of bond issuance and then serving as the gatekeeper in ensuring that reimbursement requests to the issuer (that is, the government issuing a bond) are in compliance with bond document procedures. In addition, a bank can serve as the investment agent for such bond proceeds and any related reserve fund accounts created in conjunction with the bond issuance to ensure that investment objectives are attained and that liquidity exists to meet projected draw downs of bond proceeds. The bank can also serve as paying agent in ensuring that each and every bondholder receives principal and interest payments at established due dates and that the government has properly remitted its appropriate debt service payments.

This section will review the following services that a bank can offer to a government issuing a bond or bonds:

- Trustee services;
- Paying agent/registrar services;
- Arbitrage services; and
- Investment advisory services (for bond proceeds).
Procurement and Oversight for Trustee and Related Services

When going out to bid for core banking services, it may beneficial to assess whether to expand the scope of RFP services to include trustee and trustee-related services at the same time. Some governments bundle the trustee services with the RFP for core banking services, either requiring banks to bid on the trustee services or making it optional. On the other hand, many governments procure such trustee services through a stand-alone RFP process and/or in conjunction with each proposed new bond issuance. Whatever the strategy, the government should ensure that it has hired the proper trustee, arranged the most appropriate fee structure (usually an initial fee as part of debt issuance, then on-going maintenance fee structure), and pursued efficiencies through other banking contracts.

There are a number of compelling reasons for carefully selecting a bank with a well-established track record as trustee. First, the government issuing the bond is dependent on the bank officer who is assigned to the trustee account for quality service. Second, some bond issues are complex (involving the use of variable notes, for instance) and may require a high level of expertise. Third, after the closing or sale of the bonds, the trust relationship can continue for decades as long as the bonds are outstanding; indeed, in some cases for thirty years. An issuer therefore needs to invest time and exercise due diligence in the selection of a trustee.

Maintaining the same trustee relationship throughout the bond life may be difficult because of events that were not anticipated at the time when trustee agreements were first established. For example, if key personnel of the bank leave, or if the bank is acquired by another bank, it may trigger a review of the trustee relationship. Governments should consult bond counsel prior to switching trustees, since many trust agreements and indentures may need to be modified for continued compliance with bondholder agreements.

Because the bank’s trust department usually tends neither to be responsible for investment of bond proceeds nor involved with arbitrage compliance process, these services are usually performed through other
professional contracts that will be further addressed later in this section. Although these services can be viewed as part of overall trustee relationship, they are generally managed directly by the government with trustee-provided guidance in formation of an investment portfolio and provision of applicable information for calculation of arbitrage liability.

Selection of a bank for arbitrage management varies from government to government. Some governments select a firm issue by issue. Other governments contract for the service as a renewable agreement for all outstanding issues that are subject to being reviewed. For example, Hanover County, Virginia, issues an RFP every five years for selection of an external firm providing arbitrage services.

The Bank as Trustee

The role of the trustee has evolved since the early 1800s. With expansion in the early 1900s and the increased demand for capital by municipal and corporate issuers, the role of the trustee became an increasingly independent role. It was at this time that the trustee found its place inside commercial banks. The securities laws of the 1930s required municipalities and corporations selling debt to the public to have a trustee as party to the transaction.

The trustee's main function is administering the security provisions of the contract between the government issuing a bond or security, and the bondholders. Acting as a fiduciary, a trustee holds the following responsibilities:

- If the bond issue is secured, the trustee will hold the security. This security interest is usually secured by a mortgage or in the case of personal property such as equipment, it is secured by filing a financing statement showing a repayment schedule.

- The trustee is responsible for ensuring that the covenants and other indenture provisions are performed by the issuer. The provisions are documented in the indenture and must be followed. An indenture is the contract or governing document between a government and the bank that is serving as the trustee.
In the event of a default, the trustee is responsible for enforcing the contract's remedial provisions.

These responsibilities are outlined in the contract, also known as the governing indenture or resolution. This document must always serve as the source document for administering the trust.

**Debt Service Reserve Fund.** Some bond issues are partially secured by a debt service reserve fund (DSR), which is typically funded at closing with bond proceeds. Monies on deposit in a DSR are held by the trustee. In the event the trustee does not receive debt service payments when due from the issuer, the trustee may determine that debt service should be paid from the DSR. Since the appropriate balance of the DSR is determined in the bond documents indenture and this balance may change over time, the government is encouraged to work with the trustee in understanding what would make the DSR increase (or decrease).

**Construction Fund Requisitions/Draws.** Governments frequently issue bonds for construction projects. In these instances, disbursements for construction payments may be made only from authorized funds, as specified in the governing documents. When making a construction fund draw, the issuer should follow any previously established procedures.

**The Bank as Paying Agent and Registrar**

In addition to being appointed as trustee, the trustee can also be appointed as the paying agent and registrar. In the role of the paying agent, the bank will be responsible for the payment of principal and interest to bondholders, as documented on the books or system of the registrar. These services are priced according to the deal structure. The traditional long-term, fixed-rate structure still exists; however, there are many new financing structures available to issuers, such as variable rate (and structures allowing conversion between fixed and variable rates). With these newer features, the complexity and administrative cost is greater and strengthens the case for hiring an experienced bank.
The Bank as Provider of Arbitrage Services

Arbitrage is the difference between the yield on an issuer’s tax-exempt bonds and the investment income earned on the bond proceeds. Internal Revenue Service (IRS) regulations contain a complex set of compliance requirements, but can be simply stated in the following manner: Because a state or local government has the ability to issue tax-exempt debt at interest rates below that of the private sector, the IRS limits the amount of interest income a government can realize from the investment of bond proceeds (i.e., proceeds invested prior to funds being disbursed for capital projects).

When such interest income exceeds limits permitted by IRS regulations, it is described as positive arbitrage, while interest income earned below IRS regulations is described as negative arbitrage. To ascertain whether negative or positive arbitrage occurs, any government that issues tax-exempt bonds will have to perform an arbitrage rebate calculation (ARC) as required by the IRS.\textsuperscript{8}

Localities and states have many options for how to structure an arbitrage management program. Essentially, there should be two components: an investment vehicle and an administrative program to address arbitrage compliance. The investment component is discussed on p. 118 of this section.

In structuring the administrative side of the arbitrage management program, a government can pursue four options. First, the government can retain a bank to deliver these services. Second, localities can assemble the program themselves. This structure is used by Pennsylvania localities in the Pennsylvania Local Government Investment Trust (PLGIT, for example). The trust is sponsored by seven local government associations and managed by eleven trustees, all local government officials. A third option is creating an entity to sponsor the program. Louisiana created a non-profit corporation, LAMP, Inc., to operate the Louisiana Asset Management Pool (LAMP, Inc.). The Louisiana State Treasurer serves as the president of the corporation and a participant-elected board of directors governs the program. Fourth, a state may also sponsor a program for its localities. Virginia sponsors the Virginia State Non-Arbitrage Program (SNAP\textsuperscript{sm}) for the commonwealth, its authorities, and local governments.
Virginia’s Arbitrage Management Program

The Commonwealth of Virginia received the Government Finance Officers Association Award for Excellence in 1990 for development of the Virginia State Non-Arbitrage Program (SNAPsm). (The program is referred to as a “non-arbitrage program because...”) The program combines the services of an investment/program manager, custodian, depository, and rebate calculation agent to provide comprehensive arbitrage management. The investment/program manager provides a short-term money market fund, the SNAPsm Fund, which is comprised solely of bond proceeds, as well as the option of an individually structured portfolio. There is also a consulting resource for participants during the structuring process, as well as after issuance.

The program manager and rebate calculation agent work together to provide comprehensive management of arbitrage rebate liabilities (liabilities with respect to the IRS). The Virginia SNAPsm program manager provides compliance monitoring during the exception period, yield monitoring and optimization, estimates of liability for appropriate budgeting of proceeds, and complete accounting and recordkeeping for each bond issue. The program manager also provides the rebate calculation agent with all the necessary information to perform the rebate calculation. The program manager and rebate calculation agent also serve in a consulting capacity for participants through training programs and one-on-one communication during the issuance process. Participants receive all of these benefits at a cost lower than what they would generally pay just for investment management.

*IRS-defined schedule for spending down bond proceeds.

(Under this program, Virginia has an arrangement with a bank to provide arbitrage services, on which local governments can piggyback.) The Treasury Board, as an agency of the commonwealth, is responsible for implementing the program. The sponsor is then responsible for structuring the program and procuring the appropriate services from vendors.

The Bank as Investment Advisor

Governments are faced with challenges when investing bond proceeds because of the complex arbitrage regulations discussed above. These regulations place parameters on the yield that can be earned, as well as how
quickly the money should be spent. As a result, bond proceeds often require a specialized investment strategy separate from that of operating funds. Further, the additional investment and administrative demands created by arbitrage regulations make it difficult for governments’ staff to manage compliance efforts in-house with limited resources. Governments therefore tend to outsource these services to financial institutions or other external providers.

When banks perform the role of an investment advisor, communication is critical for the issuer’s trust account to operate smoothly. All monthly statements that illustrate how proceeds, reserves, and other trustee accounts are invested and what transactions have occurred should be reviewed promptly to determine that the bank’s records are aligned with the records of the government and report any discrepancies immediately. In essence, this review process should be similar to how other bank accounts of the government (such as depository accounts) are reconciled.⁹

Typically, the trustee will execute all investments in the trust accounts at the direction of the issuer. Administratively, the government should identify in writing who is authorized to provide such direction. If a third-party investment manager can initiate such investment management decisions, then this should be clearly communicated to trustee. Basically, investment management functions of the government (whether in-house or third party) should also include in their scope all trustee accounts with only a few additional parameters to consider: liquidity needs for bond proceeds to meet draw downs of project(s) funded, and consideration of investment decisions on identified positive (or negative) arbitrage. For example, if positive arbitrage already exists for the debt service reserve fund, then investment decisions may not need a higher return (and potentially riskier) investment strategy, inasmuch as such higher yielding investment returns may need to be refunded to IRS.

In holding the bond proceeds and related required accounts (for example, principal account, interest account, debt service reserve fund, construction fund, other reserve funds), the trustee can offer liquid investment vehicles that provide a short-term market rate and daily liquidity. These investments could include money market mutual funds, for
example. If funds are invested in these instruments, the bank and/or the trustee may receive an administrative fee that should be disclosed in any prospectus. The financial institution that operates the trustee unit would have a separate institutional investment management unit that would provide these services. Alternatively, governments may utilize a state or local government investment pool to carry out portfolio management. Whatever the investment vehicle, the investment program should adhere to specific investment guidelines (see Exhibit 5.10).
Attributes of an Investment Program for Bond Proceeds

The structure of the investment program for bond proceeds should meet the specialized needs of tax-exempt issuers, containing the following attributes:

1. **Unique investment strategy** – Bond proceeds can be difficult to invest because the overriding goal is often to spend the proceeds for construction cash flow needs, while taking into account the need to spend funds rapidly enough to comply with IRS arbitrage regulations. By having a pool consisting of only bond proceeds, the investment manager can tailor the investment strategy to the short, and sometimes cyclical, nature of the funds. Arbitrage regulations also impose certain restrictions on yield that influence the types of investment strategies and options available to government participants.

2. **Preservation of principal** – Investments can be restricted to high quality instruments based on the states or localities own investment guidelines.

3. **Competitive yield** – Governments often obtain economies of scale from pooling their proceeds into one larger fund. The investment management fees then become lower (as a percent of invested assets), which should translate into higher return for the participants.

4. **Daily liquidity** – Participants should not be confined by structured maturities based on a draw schedule and should not be penalized for early withdrawal.

5. **Diversification** – By investing in a larger pool, the government takes advantage of the ability to invest in different types of high quality investments.

6. **Professional money management** – Larger balances may attract the attention of the best investment managers, who may be able to provide the highest yields.

7. **Accounting and administrative ease** – Transaction and investment information is maintained by one entity for ease in preparing the arbitrage calculation. Additionally, the information format can be tailored to facilitate the arbitrage rebate calculation.

8. **Compliance monitoring and advice** – Governments have the benefit of experts who specialize in arbitrage management during every phase of the bond issuance process, from structuring the deal, to meeting spending requirements during the construction period, to rebate calculations every five years for the life of the bonds.
ENDNOTES

1. Although there are relatively few processing companies, there are many more organizations that issue credit cards.

2. In the context of pension investing, passive management is usually synonymous with indexed investments.


4. GFOA Recommended Practice, "Use of Various Types of Mutual Funds by Public Cash Managers (2003)."

5. The guidance that is used in both the public and private sectors to determine whether an agreement is an operating lease or a capital lease is Financial Accounting Standards Board (FASB) Statement No. 13, *Accounting for Leases*, as amended by several subsequent pronouncements.

6. Banks can also provide investment advisory services for the management of a government’s surplus funds. This type of investment management is discussed on p. 95 of this chapter.

7. Note that these are the services employed after the issuance of the bond. There are other professional services prior to and in conjunction with the bond issuance (for example, financial advisor, underwriter, bond counsel).


9. Accurate reconciliation is facilitated when debt service payments made by the government are recorded to the general ledger in conjunction with payments to trustee. With online banking, it is possible to view trust accounts on demand and to resolve discrepancies immediately.
Managing the Procurement Process

Kevin Lockhart, Alan Rolek, James Beasley, Joseph Casey, and Bill Jones

This chapter describes the procurement process for obtaining banking services. It assumes that a government will use a request for proposals (RFP) approach to selecting services, as recommended by the Government Finance Officers Association (GFOA). The chapter also discusses political considerations, legal and contractual issues, and the tasks associated with conversion to a new bank.

Preparation of the RFP

Once the decision has been made to prepare an RFP, government officials need to consider how it will be prepared and what it should contain. This section addresses the components of a banking services RFP for a typical state or local government, and describes the process for preparing the document.

The RFP is designed to elicit competitive pricing on a specified range of services, allowing the government to make equitable comparisons between proposals. The RFP specifically outlines and defines the organization’s needs while providing background information on the government itself. The background information includes the details of the government’s existing banking operations and relationship. The RFP should also outline the minimum vendor qualifications.

In developing the RFP, the government needs to determine the overall structure of the new banking relationship. In all likelihood, the act of issuing an RFP will result in a new relationship even if the incumbent bank is retained – given that there will be new pricing, new services, and possibly even new personnel once the process is completed.
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When preparing to draft an RFP, the finance officer may initially decide to seek out peer governments and obtain copies of their RFPs. This may be a good starting point, provided the sample RFPs are used simply as guides for general information on how other jurisdictions approach the process. While sample RFPs may offer useful insights, they are no substitute for developing an RFP specifically tied to the government's own unique needs.

An RFP generally should include the following sections:

• Section 1: Introduction
• Section 2: Scope of Banking Services
• Section 3: Bidding Instructions
• Section 4: Proposal Evaluation

In addition to the four sections, bidding forms should be included as an appendix to the RFP document.

Some governments may have standardized RFP formats that cover any external procurement, so this suggested format may need to be tailored to the specific procurement practices of the local or state government. The discussion below, however, uses this four-part structure to discuss RFP preparation.

Section 1: Introduction

The first part of the RFP introductory section should provide a historical perspective on banking in the government entity. The size of the community, number of current accounts, and services should be listed. Many banks might find it useful if the government provides a paper or electronic copy of its budget, annual financial report or, if available, comprehensive annual financial report as background material. Providing as much information to the vendor as possible goes a long way in helping the bank to determine how to best respond to the RFP.

The RFP introduction section should also include a calendar or timeline for the procurement process. Key milestones often include the following:
Managing the Procurement Process

- Issue date of the RFP;
- Pre-bid conference or timeframe for questions about the RFP, with specifics on how to submit questions;
- Date for submitting the bank's RFP response;
- Interview dates (if required);
- Contract approval; and
- Implementation.

Evaluation criteria should also be described. These criteria may include important factors such as a bank location within the government's boundaries, certain minimum financial requirements or depository ratings, ability to meet all requirements in the RFP, responses to all items on the bid form, lowest aggregate cost, and specific service requirements (for example, having one banking contact for issue resolution).

Contract duration should also be addressed in the document. There are various viewpoints on this issue. On the one hand, most governments do not like to change successful banking relationships frequently, all things being equal. On the other hand, new services, better technologies, or economics may force change. For example, a difficulty arises when either the bank or the government is locked into long-term rates or pricing that may not be beneficial to one or the other party over an extended timeframe. One way to address cost issues that may arise is to have a short-term agreement (two-three years) with reviews and adjustments, if both parties agree, along with an extension provision. A second option is to adjust costs according to a predetermined schedule or cost of living adjustment (COLA). Bank costs do not necessarily increase annually, and some services might even decline in cost. A third option is to establish a "most-favored nation clause," allowing the government to obtain the same pricing as other comparable bank clients (e.g., at the time of contract extension).

Standard procurement language in agreements should also be included to:
• Reserve the right to reject any or all bids, and select the best bid in the opinion of the government entity;

• Require banks to separately list their exceptions to RFP specifications, with the proviso that exceptions will otherwise be invalid;

• Prevent unauthorized changes of the specifications, forms or terms, which may render the response invalid;

• Declare that the failure to enter into a subsequent contract/agreement within a certain time period will render the response invalid; and

• Provide that a subsequent contract/agreement may be terminated by either party on 90 days (or some predetermined number of days) written notice. The time selected should be sufficient for a new RFP to be issued and an award made.

Many governments include a standard indemnification section that outlines the limited liability of the government. Exhibit 6.1 contains a sample indemnification statement.

Clearly, each jurisdiction will need to modify the language on indemnification to take into account state and local circumstances as well as the historical practices within the banking community that serves governments in a given area. For additional information on indemnification, refer to page 141.

The government entity should also include a statement describing certain minimum qualifications in order for a bank to be considered. Exhibit 6.2 lists some common qualifying criteria imposed by governments, such as geographic proximity, submission of annual financial statements, or provision of call reports. An alternative to call reports is to mandate that banks provide credit rating information from specialized firms (such as Fitch Ratings, Standard & Poor’s, and Moody’s) or banking industry analysts (such as Sheshunoff; see Chapter 8).

Additionally, a government may require compliance with bonding requirements, or submittal of a completed form affirming that the bank is in compliance with state and/or local law. For example, some Illinois mu-
EXHIBIT 6.1

Sample RFP Language: Indemnification

The contractor shall indemnify, defend, and save harmless the government, its officers, agents, employees, representatives and assigns, from lawsuits, actions, costs (including attorneys’ fees), claims or liabilities of any character brought because of any injuries or damages received or sustained by any person, persons, or property on account of any act or omission, neglect, or misconduct of said contractor, its officers, agents and/or employees arising out of, or in performance of any of the provisions of the contract, including any claims or amounts recovered for any infringements of patent, trademark, or copyright; or from any claims or amounts arising or recovered under the “Worker’s Compensation Act” or any other law, ordinance, order, or decree. In connection with any such claims, lawsuits, actions, or liabilities, the government, its officers, agents, employees, representatives, and their assigns shall have the right to defense counsel of their choice. The contractor shall be solely liable for all costs of such defense and for all expenses, fees, judgments, settlements, and all other costs arising out of such claims, lawsuits, actions, or liabilities.

Municipalities require compliance with the Illinois Public Funds Investment Act. In this situation, sample language could be added as follows: “In accordance with the [state statute], no bank shall receive any public funds unless it has furnished the corporate authorities of a public agency submitting a deposit with copies of the last two sworn statements of resources and liabilities which the bank is required to furnish to the Commissioner of Banks and Real Estate or to the Comptroller of the Currency.”

When addressing the issue of geographic proximity, larger county or state governments may need to specify more elaborate requirements. For example, a state government could require bank locations within a certain number or percentage of counties.

Every government should delineate its preferred account structure. This may be either its current account structure or its future account structure after it enters into a new agreement. As an illustration, the Vil-
Sample RFP Language: Minimum Qualifying Criteria

Qualified proposing banks must meet the following minimum criteria:

- Must be a banking corporation incorporated under the laws of the State of _______ or the United States;
- Maintain its home office or a full-service branch within ____ miles of the government’s main office;
- Must submit financial statements for the past two fiscal years (must include an unqualified opinion from a certified public accountant and appropriate notes to the financial statements);
- Must submit one copy of each of the last four quarterly call reports (Consolidated Report of Condition and Income required to be filed by the Federal Financial Institution Examination Council).

The village of Carol Stream, Illinois, a mid-sized municipality, has specified the following account structure in its RFP:

- Accounts for funds:
  - General corporate fund;
  - Water and sewer fund;
  - Payroll account;
  - Motor fuel tax fund;
  - Civic enhancement fund (hotel tax receipts);
  - Police pension fund;

- Other accounts:
  - Compensating balance account;
  - Flex 125 Plan (fringe benefit);
  - Narcotics forfeiture account;
  - Law enforcement block grant; and
  - Any new accounts opened during the term of this agreement.

A larger municipality or state government may need additional accounts.
Managing the Procurement Process

Many governments have found it useful to require that a bank assign a designated account representative or relationship manager to the government, and many banks are more than willing to comply. There are numerous advantages to having one contact person handling the government’s banking questions, including (a) clearer accountability, (b) easier communication and trouble-shooting of problems, and (c) greater ability to marshal bank resources to resolve a service problem. In the event a relationship manager is not available, a back-up staff person should be designated for customer service. In addition, an account representative has an important role to play in project management when converting from an old bank to a new bank. The government should request that this representative have a strong understanding of governmental operations to facilitate communication of issues and their resolution. Governments should also request that competing banks furnish biographies about personnel that would be assigned to the government.

**Community Reinvestment Act.** The Community Reinvestment Act (CRA) has become an important issue, especially to the elected officials of the government. It is very important that the bank demonstrate its commitment to the well being of the community; CRA scores provide a measurement of that commitment. Governments should request that the respondents to the RFP provide their overall CRA rating and the rating as it applies to the specific government if possible. In addition, some governments believe it is useful to ask about other community support a bank provides, in order to judge whether it is a good corporate citizen.

Many governments establish in the RFP that they will strive to maintain confidential responses. Governments cannot guarantee confidentiality in all cases, however, particularly when open record laws require them to furnish records to the public. For example, governments may have to disclose information about the winning bidders and related pricing.

**Section 2: Scope of Banking Services**

The section defining scope of services represents the heart of the RFP. It should include a list of core depository services as discussed in Chapter 4. In listing the services desired, the RFP should describe how the service should operate and what the government expects from the bank. The de-
Sample RFP Language: Wire Transfer Services

- **Incoming** — The government intends to consider all wire transfers received by the bank prior to the end of the business day as available for investment that day, regardless of the actual time of receipt by the bank. Should the bank not receive a wire transfer, the transfer will be traced from origin to destination to ascertain the party responsible for the delay in the transfer. If necessary, adjustments will be made for lost interest.

- **Outgoing** — The awarded bank agrees to execute any wire transfer order within one hour after notification by the finance department through the computer terminal, by telephone, or by fax if necessary. Wire transfers ordered and not received by the destination party will be traced by the bank from origin to destination to ascertain the party responsible for the delay in the transfer. If necessary, adjustments will be made for lost interest or charges from a “fail” [failed Fedwire transfer] to consummate an investment transaction or bond payment.

- **Other** — The government requires the capability to initiate outgoing wire transfers via personal computer. The government utilizes pre-formatted (repetitive) and free-form (non-repetitive) wire transfers. The government is to have online access for confirmation of wires executed for both incoming and outgoing wire transfers.

Descriptions should include specific needs or any unique qualities that the government might have. Deadlines or time constraints for receiving specified services should also be included.

The RFP must include specific usage numbers for all services currently being utilized. Typically, this is available from a monthly account analysis or banking statements, which can be presented on an annual basis. Governments seeking a new service that lacks historical data may (a) need to project usage statistics based on peer governments’ experience (or other methodology) and/or (b) estimate a range of transactions per service. This will allow all of the banks to provide specific pricing per item processed. It should be noted that these are estimates but not guarantees of service level requirements.
Managing the Procurement Process

The discussion below describes core services nearly every government needs from a depository bank. Additional services such as lockbox services, credit card acceptance, and purchasing cards can either be (a) included as part of the RFP document and be treated as a mandatory service, (b) included in the RFP as an option (that is, the bank has the option of not submitting a bid for the particular service), or (c) excluded from the RFP for banking services and bid separately, at a later date.

**Wire Transfer Services.** Governments need to define their requirements for incoming, outgoing, and other wire transfers. Some suggested terms for wire transfers are shown in Exhibit 6.3. Daylight overdrafts triggered by a Fedwire transaction should also be addressed in the RFP responses.

**ACH.** The government should request that the bank be both a sending and receiving bank on the Automated Clearing House (ACH) system. The RFP should also include a description of how ACH is going to be used by the entity. This might include direct deposit for payroll disbursements, collections for utility billing accounts, payments to credit card vendors, and any other anticipated payments.

**Direct Payment.** Direct payment or ACH direct debit is an optional service that is mostly utilized by governments providing recreational services or utility services. When requesting a proposal on direct debit, a description of how it is being utilized along with the estimated number of accounts, frequency of debits, and average dollar amounts should be provided. The bank should be requested to provide all costs associated with providing this service in its pricing proposal.

**Availability of Funds.** The government should also specify its expectations regarding the availability of funds. Banks often just provide a standard availability schedule as part of their RFP response, but there may be certain types of transactions where availability schedules may change or be negotiable, owing to changes in law or technologies (for example, Check 21). Exhibit 6.4 provides an example of how a government would elicit information about funds availability.

**Stop Payment Services.** Many governments add a statement requesting unlimited online stop payment services. The government should ascertain how long the stop payment is in effect (for example, six
Sample RFP Language: Funds Availability

Deposits will be made during the business day (generally between 9:00 a.m. and 3:00 p.m.) at the nearest branch of the awarded bank. The government is to be given credit as collected funds for all items that are cleared by the bank on the same day as the deposit is made. Items deposited that clear at institutions located within the Federal Reserve Region will be considered collected funds within one business day as a maximum. The bank will credit the government’s account for incoming wire transfers on the day received regardless of the time of receipt during the day.

Attach a copy of the bank’s current availability schedule to the proposal.

months or in perpetuity) and the cost of extending the effective period. Some governments request free stop payments. It stands to reason, however, that no service is free and that if a bank offers a costly service for free, somewhere else within the RFP proposal the costs may be recovered.

Stop payments may become less important as positive pay becomes more widely used, since positive pay essentially blocks a payment prior to release of funds (and it would thus prevent any charges for stop payment).

**Lockbox.** A government electing to include lockbox services in the RFP should give a detailed description of its needs for lockbox services. This should include the type, average amounts, number of transactions, timing requirements, file transmission requirement, and critical dates associated with the government’s billing cycle, in order to get the best pricing. In some instances, this is a mandatory item in order for the banks to respond to the RFP. The government should query banks about anticipated improvements in lockbox services, such as ARC conversions. Refer to page 24 for additional information on lockbox services.

**Online Banking Services.** The RFP should request a detailed description of the bank’s online services and all of its capabilities. Online or Internet banking can vary greatly from bank to bank. Indeed, this may be a key differentiator when selecting or short listing banks competing for
the government's business. The government and its treasury staff need to ensure that the online services meet their needs, and that they mesh with government operations. At a minimum, basic online services should be offered, such as:

- **Reporting:**
  - Daily balance reporting – summary;
  - Daily balance reporting – detail (with check detail);

- **Execution of transactions:**
  - Initiation of Fedwire transfers;
  - Initiation of stop payment orders;
  - Initiation of ACH transactions;
  - Maintenance of Fedwire transfer models (define models);
  - Stale-dating of checks;

- **Internal controls:**
  - Online cleared check information;
  - Multi-level security of various staff; and
  - Positive pay reports (including imaging of exception items).

Aside from the extent of functionality, governments may need to consider how banking data can be interfaced or integrated with their financial management system. For example, some governments can receive downloads from their bank which are captured in their financial system (that is, data is captured on customer, payment date, account number, and dollar amount). Naturally, some financial management systems are better able than others to capture and download such online data.

**Electronic Storage of Documents.** Governments should request pricing on a particular electronic document storage format (currently, compact disks (CDs) are frequently used). The use of CDs for storing copies of checks or other banking documents has proven to be a tremendous benefit, especially to those governments with limited storage space. Additionally, CDs typically are archived electronically so that data can be easily be found and retrieved. Governments should take into account any
Sample RFP Language: Other Banking Services

1. All checks returned due to insufficient funds will be automatically redeposited a second time. Please include your charge (if any) for this item with the other costs.*

   All checks that are returned a second time must be debited to the general account.

2. All debit and credit memos required to adjust errors caused by the bank will not be charged to the government. All deposit errors must be accompanied by a copy of the particular deposit slip. All bank errors must be corrected within five (5) business days of notification by the government.

3. The bank agrees to provide MICR check specifications to the check printer.

*An alternative method of re-presentation is to convert the returned check to an ACH transaction (specifically, an "RCK" ACH transaction).

state requirements governing document retention, as well as the possible obsolescence of a given storage technology.

Other Banking Services Requirements. The government should provide a detailed description of all other services or benefits that are requested (see Exhibit 6.5 for some sample language).

Section 3: Bidding Instructions

It is critical to the success of the RFP process that the government provides clear bidding instructions along with finite timelines for completion and submittal (see Exhibit 6.6). The timeline for the process needs to be described in detail and needs to allow ample opportunity and time for the banks to provide their responses.

The proposal forms should provide a brief description of the services being requested along with estimated annual usage of the services. This will give the banks the information needed to provide the most competitive and complete pricing possible.
EXHIBIT 6.6

Sample RFP Language:
Instructions for Proposal Forms

Submissions of completed proposal forms is required of all proposers. No proposal will be considered without completion of these forms. If the bank is unable to meet or exceed the requirements specified, then the phrase “no proposal” should be entered for that particular item.

The proposal will be on a variable cost basis. Under the variable cost method, actual monthly services will be counted and the volume of transactions will be computed to determine the compensating balance required to support the activity. Accordingly, the monthly compensating balance may be modified from time to time by the city based on previous volumes and charges.

The director of finance/treasurer reserves the right to eliminate any individual service contained in the proposal, if based on analysis, the fees for providing the service are excessive, or if the service proposed can be performed in an alternative manner.

All banks are requested to complete the form “proposal for banking services,” attach the requested forms, reports and exhibits and return the package (three copies) to the city in accordance with the instructions.

The city intends to enter into a formal banking services contract with the awarded bank which will incorporate all provisions of this request for proposal. Additional terms and conditions will not be included in the contract unless mutually agreed to by both parties.

Section 4: Proposal Evaluation

The evaluation process is crucial to the both the government and competing banks, since it determines the winning bank and influences how all banks respond to the RFP. Some governments may issue only a general statement that they will award the services to the financial institution that will provide the highest quality and number of services at the most competitive price. While this may be of benefit to the government, it will not give the banks the indication as to what the government’s specific priorities may be and factors it will use to differentiate or rank the banks’ proposals.
Below is a sample set of evaluation criteria that may be utilized and incorporated into an RFP:

- Completeness of response to all required items on the standard forms provided;
- Cost per identified activity, aggregate banking services cost, and corresponding compensating balances, if applicable;
- Ability to meet current and projected service requirements over the term of this banking agreement (any past experiences with the bank will be taken into consideration);
- Best rate of interest paid on accounts;
- Best earnings credit rate (ECR) on compensating balances;
- Best availability schedule for deposit items;
- Capacity to provide numerous electronic banking services;
- Experience and governmental knowledge of bank team;
- Ability to provide projected service requirements;
- Overall responsiveness to RFP; and
- References.

Financial strength may be an additional evaluation criterion, or it may be a minimum qualifying standard. Evaluating financial strength and creditworthiness is discussed in detail in Chapter 8.

While it is important to provide as much evaluative information to the banks as possible, governments should ensure that they have some flexibility in judging the proposals. In practice, this means not stating in the RFP that it would award banking services based solely on pricing, and not defining precise weights it might use to summarize the various responses. There may be non-quantifiable aspects of a bank that should be incorporated into the selection process, and imposing a precise weighting scheme may hamstring the selection team.
Use of Outside Consultants

Outside consultants can provide valuable benefits to governments looking to prepare a banking RFP. For example, a qualified consultant can deliver:

- *Time savings* – A reduction in staff time that would be needed to prepare an RFP;
- *Market knowledge* – A level of expertise in banking services that should include not only current services, but anticipated future products in the industry; and
- *Credibility* – Outside experts often are received more positively in a politically charged environment.

The costs of using an outside consultant can be recovered in a relatively short time period if the consultant is able to obtain better economic terms, for example, increased earnings on overnight investments or savings in services. Equally important, a qualified consultant can help design a better overall process of cash management that includes bank selection as one element.

Contractual Issues

Governments procuring banking services need to take into account certain contractual provisions that may affect a government's liability. In particular, governments should closely scrutinize indemnification language contained in a banking agreement. Positive pay services may help limit a government's exposure to liability related to check fraud.

Defining the Scope of Banking Service Contracts

Because of the complexity of banking services, the financial resources at stake, and potential liability, all governments should enter into a contract with each bank it uses for services. GFOA recommends that governments establish a contract that specifies services, fees, and other components of compensation. Ideally, the contract details all services and
Sample Banking Service Contract (excerpt)

In consideration of the mutual promises contained in this agreement, the parties agree as follows:

1. The bank shall provide banking services as described in the contract documents.

2. The term "contract documents" shall mean the following documents.
   a. This agreement;
   b. Contractual provisions attachment*;
   c. RFP #__________;
   d. The bank's proposal;
   e. RFP for _______ safekeeping services;
   f. The bank's proposal for safekeeping;
   g. Master repurchase agreement;
   h. Automated Clearing House service operating agreement;
   i. Terms and conditions governing wire transfers by _________ bank;
   j. Purchasing card agreement;
   k. Merchant bank agreement;
   l. Online computer access agreement.

3. The bank's standard agreements, i.e., the master repurchase agreement, the Automated Clearing House service agreement, the terms and conditions governing wire transfers by _________ bank and the merchant bank agreement, shall govern and control in the case of any conflict in the terms of the contract documents, with the following two exceptions. The exceptions are as follows:

   (1) Notwithstanding any provision to the contrary in any of the bank's standard form agreements, the entire agreement between the parties embodied in the contract documents shall be governed by and construed according to the laws of the State of _________ and venue for any litigation concerning the contract shall be in the District Court of _________ County, _________.

*This refers to procurement policies required by the government.
Sample Banking Service Contract (excerpt)

(2) Notwithstanding any provision to the contrary in any of the bank’s standard agreements, the ____________ shall not hold harmless or indemnify the bank for any third-party liability claims. The terms and conditions set forth in the contract documents are solely for the benefit and use of the ____________, and the bank and no third party shall receive any benefit or use thereby or be deemed to be a third-party beneficiary under the contract documents in any manner whatsoever.

Except as otherwise provided in this paragraph, in any conflict between the documents, the documents will control in the order of precedence set out in paragraph 2 above.

4. The term of the contract will be for __ years effective ____________ through ____________ with the option to renew for __ one-year extensions.

5. Any termination of this contract by either party will only be effective 90 days after the terminating party gives notice to the other party.

6. The prices proposed by the bank and accepted by the ____________ will remain in effect for the __-year term of the contract. The method of compensation** will be at the discretion of the ____________.

7. The ____________ may inform the bank at any time during the term of the contract that it wishes to begin implementation of any of the optional banking services under the terms and conditions proposed by the bank in its proposal.

8. Any notice, request, demand, payment, or statement required under this contract shall be in writing and shall be delivered or directed to the post office address of each of the parties as follows:

   For the government:
   For the bank:

9. This contract shall be binding on the parties and their successors and assigns.

10. The bank shall notify the ____________ of any change in its ownership or of any change in key personnel or in personnel assigned to the ____________ relationship.

**Compensating balances, direct service fees, or a combination of the two approaches.
related costs, outlines the relationship with the bank, and attaches all subsidiary contracts required for individual services utilized. For example, if the government uses the primary bank for certain services – such as wire transfers, ACH transactions, and sweep investment programs – every service will likely require a subsidiary contract.

In addition, if the government desires to impose various contract restrictions or requirements, those provisions should be in the main contract. For example, some governments have general procurement policies that they attempt to impose on all vendors, such as indemnification restrictions, compliance with anti-discrimination provisions, smoking in the workplace restrictions, use of third-party service provider’s restrictions, insurance or bonding requirements, and so forth. A banking relationship contract that incorporates these policies should clearly apply to all subsidiary contracts if any conflict occurs between contracts.

Please refer to Exhibit 6.7 as an example of a banking services contract that can be used to detail the scope of the relationship with each bank. It incorporates as many subsidiary service contracts as necessary for the complete banking relationship. A contract of this type should be included in any banking services RFP. As with any sample contract language, however, it (a) represents a guideline only, (b) should be examined by a government’s attorney before adoption, and (c) should be reviewed for other local requirements.

A version of this contract can be easily modified and used with other supplemental service contracts. Section 2 of Exhibit 6.7 identifies examples of supplemental services contracts that may be subsumed under the overall banking contract. The attachments to the contract detail services to be performed and the costs negotiated.

It is highly recommended that the government using a banking relationship contract attach the RFP used to select the banking service provider. The bank’s response to the RFP should also be attached to avoid any conflict with regard to pricing of individual services, and to ensure that services or functionality promised in the bank’s proposal are fulfilled.
Use of Standardized Contracts

All banks have standardized contracts required for each of the services utilized by governments. While certainly convenient, these contracts are designed primarily for the benefit of the bank, not the government that would use the service. GFOA cautions governments to avoid inadvertently waiving their rights by agreeing to boilerplate language in contracts. Furthermore, government cash managers should be aware that the standardized contracts are likely to vary from bank to bank, because there is not a model contract used by all banks in the United States. When comparing contracts among various banks, there are some similarities but the contracts are rarely identical and may contain important differences. Standardized contracts should be reviewed during RFP preparation so that the government understands what the differences are.

The question arises whether a government should create its own contract for each service or use the contract provided by the bank. In most cases, a government does not have sufficient resources, time, or financial leverage with the bank to provide a contract much different from what the bank provides. Very large public entities may be able to persuade their bank to use another contract, but in general, banks tend to resist substantial contract modification. Because of this situation, it is recommended that government officials negotiating the main banking services contract focus on high-priority contract issues such as indemnification. In addition, language in the primary banking contract should be defined so that it clearly takes precedence over the sub-service contracts whenever a conflict arises. It is easier to negotiate one main contract with key provisions important to the government than try to modify each of the services contracts. Language in the main contract must clearly show the precedence feature.

Indemnification

In today's litigious environment, a significant and controversial issue relates to indemnification by governments. Many contracts prepared by banks require cross-indemnification language. This means that the banks seek indemnification from the government for potential errors, wire transfer failures, and many other issues that may or may not be beyond
control of the bank in providing services. Some of these failures or service disruptions may arise from the reliance on third-party vendors, including entities such as a Federal Reserve Bank.

Many governments are beginning to take the position that they cannot indemnify banks because of state or local statutes, or policies that prohibit indemnification. As a result, obtaining services without indemnification can be difficult and may require substantial negotiation. Banks are frequently unwilling to change standard indemnification contract provisions. Indeed, some banks will not even bid on providing services if they are aware of the indemnification issue or they may refuse to enter into a contract if awarded services and they are not notified in advance of the indemnification contract requirement. Any indemnification or other required contractual issues should be fully disclosed at the time of issuance of the banking services RFP to save time in developing a contract for services.

Some governments that may be uncertain about the issue of being able to indemnify banks or other contractors may place the terminology indemnification is subject to statutory restrictions in the contract. This would allow the final interpretation of indemnification to be left to the courts if a conflict results in litigation. While this is not necessarily the best way to handle the indemnification issue, because of potential future legal expense, it affords some measure of protection to governments. As with any legal document, it is advisable to review this legal issue before signing any contracts with indemnification clauses.

Managing Liability with Positive Pay

In the Recommended Practice, "Use of Positive Pay versus Reverse Positive Pay," GFOA recommends that governments use positive pay to deter check fraud. In the past, banks would generally absorb losses caused by fraudulently generated checks. Increasingly, banks are taking the position that if they offer positive pay disbursement accounts and the government chooses to not use the service, any costs arising from check fraud will be absorbed by the government. This means that banks will no longer absorb check fraud related expenses. It is important to understand the posi-
tion of your bank with regard to positive pay since it may affect the government's liability exposure.

As noted in Chapter 3, positive pay is a fraud prevention and account reconciliation service that requires the government to inform the bank of all checks written on an account. This is accomplished by providing an electronic file detailing check numbers, dollar amount, and date for each check written. New developments in positive pay will also likely require the payee name for each check be provided in the future. The file must be promptly delivered to the bank electronically when disbursements are made to allow the fraud prevention program to operate correctly and efficiently. Only those checks presented to the bank with all detailed information as provided in the file will be allowed to clear the government's bank account. Any checks that do not exactly match the government information in the outstanding check listing file will appear as exceptions that require approval to clear the bank, thereby minimizing the potential for fraud.

With positive pay, a key contractual issue can exist with regard to the handling of exception items that do not match the outstanding check file provided by the positive pay user (that is, the government cash manager). The issue is acceptance or rejection of the check being presented to the bank as the automatic default provision. Positive pay procedures require notification to the government of the exception checks and there is a short time period available, measured in hours, to accept or reject the exception items. Some banks prefer to transfer the risk of paying the exception items to the government. This is accomplished by having the default provision be to pay the items rather than reject the items. However, this pay default conflicts with the reason positive pay is used—to prevent fraud. All governments are advised that when using positive pay disbursement programs, they should insist that the default provision for exception items be do not pay. If the bank makes payment without government permission, the risk of check fraud is transferred to the bank.
Considerations in Using Local Banks

Selection of a bank generally depends upon financial and service delivery considerations. In most cases, a government selects a bank based upon the perceived ability to deliver requested services, the financial viability of the institution, service costs, convenience, and other financially based factors.

Nonetheless, short-term political considerations often come into play and may influence the decision of which bank to use. This is especially relevant (but certainly not exclusively) in smaller communities where closer relationships may exist between government decision makers and the local business community. For state or regional governments that serve a larger area, finding a bank that neatly corresponds to its jurisdictional boundaries may simply not be an issue.

For many reasons, there may be pressure to keep the money at home and use a local, community-based banking institution instead of a branch of a larger regional or national institution. Further, when there is more than one local banking institution within a community, local policymakers may feel the need to “share the wealth.” This may result in dividing accounts among local institutions, periodically rotating banking services from one institution to another, or using different institutions for different services.

Whether government officials believe arguments for local banking are persuasive or not, it is important to have a clear definition of what constitutes local and to articulate this definition in the jurisdiction’s financial policy manual or procurement documents. While a bank may appear to be local, a closer examination of the facts may reveal otherwise. First, while its headquarters may be within a municipality’s boundaries, the majority of its business may lie elsewhere. Second, the bank owner may reside in another jurisdiction or even out of state. Third, the bank may itself outsource certain services or partner with firms that operate outside the government’s boundaries. Fourth, the bank may have low CRA scores for having underserved certain neighborhoods within the jurisdiction.
Common Arguments for Using Local Banks

The decision to use banking services, whether from local or out-of-town institutions, generally rests upon the ability of the bank to deliver the needed services in an efficient and cost-effective manner. With the advent of electronic and Internet banking services, it may be possible for smaller local banks to be competitive with their larger corporate counterparts. However, not all local banks offer these services on the same level as the larger banks. In addition, smaller local banks may lack the resources to service the myriad needs of the local government’s treasury operations. In particular, smaller banks may lack (a) the resources to update its technology platform for online banking and (b) the breadth of services of a larger bank. Regardless of such drawbacks, there are several reasons a government might consider choosing a smaller local bank over a larger bank from out of town.

One argument is that using a local institution keeps money working within the community, aiding the local economy. The public perceives that money deposited in the neighborhood bank is available for use by area residents and businesses. It is not uncommon for local bankers to be heavily involved in civic planning and community development projects, thereby reinforcing the perception that local money is remaining at home. Even so, it would be a fallacy to presume that all government funds (and funds from other customers) deposited in the local bank are used locally. In today’s global economy it is entirely possible and, indeed, probable that the business of the local bank reaches far beyond the physical boundaries of the community.

A second reason for considering a local bank is simply to reinforce appropriate government-to-business relationships at the local level. Building good community relations between government and business is an ongoing goal of civic leaders. It helps to build trust between government and business officials and encourages community involvement.

Whether or not these arguments are sufficient to influence the decision of using a local or out-of-town institution is debatable, although such political considerations may inevitably bear upon which institution is selected. Even if they are not a major selection factor, the lo-
cal/non-local criterion may serve as a tiebreaker when attempting to choose between similarly qualified banks that have been short-listed.

Options for Using Local Banks

Assuming that the decision has been made to use a local bank, other considerations may also come into play during the selection process. For example, what if there are multiple banking institutions in the community that seek the government's business? Should the government's banking business be divided among them? Should the business be rotated along some pre-determined timeline? Are there policies or other criteria that dictate how the local government divides its business among these institutions? In addition to these questions, there may be political factors to consider. There is no perfect solution, however, and what works for one community may be totally unacceptable for another. The following are possible methods for handling this decision and the pros and cons associated with the available options.

Use Local Banks for Investment Only. Rather than serving as a depository, local banks can be used simply as a means of carrying out the government's investment program. For example, the government could simply purchase CDs issued by the bank or utilize the bank's brokerage services. The advantage of this approach is that it would not significantly affect the government's daily cash management operations. However, a competitive bidding process should be used to ensure that adequate investment returns are achieved.

Dividing the Local Government Accounts Among Banking Institutions. This may appear to be a natural solution, and it may work well for some governments. If the local government maintains more than one account, why not divide them among the local banks? It does effectively divide the local government's business among those interested local banking institutions. It keeps them involved with the local community.

However, segmenting the government's accounts creates significant logistical problems. For instance, if a small government would need to maintain only one demand deposit account, should it be divided into multiple accounts solely to provide business to local institutions? This
would seem contrary to sound cash management, especially for smaller governments with limited staff, since it:

(a) Results in greater banking costs (for example, monthly account maintenance fees);
(b) May make it difficult to pool cash for investment purposes; and
(c) Multiplies staff workload and increases materials costs.

Regarding the latter point, performing multiple account reconciliations, maintaining separation of funds for each account, traveling to different banks to make deposits, maintaining check stock and other supplies for each account, general oversight, and other concerns add to the difficulty and cost of managing the government’s resources. In general, good cash management practices argue for minimizing the number of accounts used by any government.

**Rotating Banking Services Among Local Institutions.** Rotation is another method of sharing the wealth among local banks. Although this may be a workable solution for many local governments, it, too, raises questions: Does rotation reduce competition and thereby increase costs? How often should the business be rotated? What are the costs of changing materials (such as check stock) every few years? How much staff time is needed to manage the transition period? Converting from one bank to another is an onerous undertaking that burdens not only the government’s treasury staff but, in some cases, its citizens as well.

**Dividing Banking Services Among Local Institutions.** There are certainly other services provided by banking institutions beyond the core depository function. As discussed in Chapter 5, investment services, trustee services, credit service, and other services could allow for government entities to divide their banking needs among local banks. For example, an entity may have its demand deposit accounts at one institution while using another institution for credit services. This can be an effective way to share the government's business among banking institutions. However, not all local banks may offer some of these services. Moreover, the government may forfeit potential economies of scale from bundling services with one bank. If this method of spreading services among local banks is used, the government entity will need to exercise due diligence
to ensure that the needed services can be provided by the selected bank and that it meets its procurement criteria (for quality and cost).

**Arguments for Using Regional or National Institutions**

Using an out-of-town banking institution for banking services may be a legitimate option under many circumstances. As mentioned, for regional and state governments it may be the only viable option because only larger banks may have the geographic coverage to effectively serve the larger governments (for example, they would offer collection points throughout the state to expedite a state government’s intake of revenues). Even when political realities dictate that a government entity use local banks for most services, there may be services that are not available from a local institution, making it necessary to use an out-of-town institution for such services. For example, a regional or national bank may have the resources to provide greater online banking services.

The cost of providing a service may also play an important role in selecting an out-of-town institution over a local bank. Larger institutions have the economies of scale to offer certain services at a much lower cost than a local institution could. With public sensitivity to government operating costs and increasing budgets, this is but one more area to contain operating costs.

**Making a Transition to a New Bank**

In an era of increased bank competition for government business, technology change, and industry consolidation, governments face a challenging environment for maintaining smooth cash management operations. Because of the evolving nature of what services are offered and how such services can be best utilized, the government must ensure that it adequately addresses key points as it transitions from its current bank (and existing business processes) to a new bank (requiring new processes).

This section addresses change management as it relates to banking services. First, the trigger points for banking changes are described, followed by a discussion of the bank conversion process.
Trigger Points for Change

Governments change banks for a variety of reasons. Clearly, a government can initiate the change, often as part of a normal contract review process every three to five years. Often, this would result in the issuance of an RFP. Alternatively, the bank itself changes because of technology or mergers, prompting governments to rethink the relationship, as discussed below.

Single Product/Platform Changes. Intense competition within the banking industry has led to dramatic and frequent enhancements to the financial institution’s product and service offerings. As new technologies are developed and delivered to the marketplace, aggressive banks are quick to move these new applications into production. In some instances, these enhancements not only bring a competitive advantage to the bank, but they also yield substantial cost savings and efficiencies to their delivery platforms. Examples of such enhancements include positive pay and various electronic banking processes that enable a government to disburse or receive funds in the most desired manner.

In order to realize these cost savings, the financial institution will, in many cases, require that its clients utilizing the old product/technology migrate to the new. This forced migration is designed to shift all of the bank’s customers (government and business included) to a single operating platform, resulting in cost savings to the bank – but an implementation challenge for the government. Recent examples of this scenario can be seen in the evolution of data transfer protocols from hand delivery of computer tape/cartridge/diskette to direct transmission (dial-up) or Internet access. While the benefits of this change are tangible, the challenge of implementing it remains. Questions arise such as:

- How does the government treasury department accomplish the conversion?
- Will its bank help the government through the process?
- What is the government’s plan of action?
- Does the government have sufficient resources?
Bank Mergers. In the past twenty years, the banking industry has continued to consolidate at a rapid rate. Banks look to mergers to expand geographic presence, gain market share, and become more efficient. Efficiency gains include making costly, technology-intensive operating platforms more cost-effective.

The financial justification for most bank mergers is based on the acquiring institution’s ability to quickly combine operations and consolidate costs through economies of scale. Multiple competing operating platforms will be consolidated, leaving a surviving set of bank products and services. As the acquiring bank is generally larger than the bank that has been acquired, their platform and systems are usually maintained and the acquired bank’s platform is discarded. This strategy normally means that the fewest number of clients will be impacted by this decision.

The implementation burden the government entity will assume is in most instances directly related to whether their bank was the acquirer or the acquired, although recent bank mergers have taken a “best of breed” approach. Under this scenario, the preeminent products/services of both banks survive the merger, placing some transition and implementation burdens upon virtually all of the bank’s clients.

With the high probability that bank mergers will continue, the government entity needs to be aware of the possibility of an implementation challenge. Although similar to the scenario discussed with single product conversions, the merger scenario represents the potential for greater disruption in that multiple services/products may be affected. Because of this, more planning and a larger resource commitment may be required to ensure a successful conversion.

Government-Initiated Change. Financial institution initiated change gives the government relatively little flexibility. Whether it is the introduction of a new product or service, the consolidation of an operating platform, or a complete bank merger, the impact of the change is absorbed by the government. There is little or no choice for the government under this scenario. If the desire is to continue to utilize the particular product or platform, the government will need to conform to the new operating environment and implement appropriately.
On the other hand, the RFP process gives the government control over the timing and scale of change. As the decision maker, the government enjoys a number of alternatives. The first default option is to renew the contract for banking services, which is appropriate if the government is adverse to change and/or content with the existing bank. Although the simplest option, the choice to stay with the status quo may preclude the government from exploring enhanced products and services that could be of great benefit. Change may be perceived as cumbersome and undesirable, but the resistance to change could prove to be more adverse over the long term.

Competitive bidding allows the governmental entity to structure banking services to suit its needs and to manage the timeframe of conversion. In particular, appropriate language in the RFP regarding government expectations for implementation can greatly minimize the obstacles associated with a conversion. Guidelines around the timeframe, the level of assistance, the training provided, or any other activity that raises concern can be articulated in the RFP.

**Elements of a Bank Conversion**

Managing the change from an incumbent bank to a newly chosen bank is an exercise in project management. Like any project, it requires building consensus, selecting bank and government implementation teams, developing project timelines, communicating effectively, as well as training in and testing of new procedures.

**Building Consensus.** At some point the government will probably implement either a new service or a completely new set of services from a new bank. Whether initiated by the bank or by the government, the goal is the same: the timely and seamless movement from one product or institution to another, while minimizing operational impact and delivering the desired result. The means will be the same as well, regardless of the size or scope of the conversion: building consensus among governmental stakeholders; formation of government and bank implementation teams; development of project timelines; close communications; and testing and training.
Consensus must be built throughout all levels of each of the organizations. The government needs to build agreement with each of its internal business units that will be affected, and this must occur well before the implementation begins. Moving forward before all parties understand the full scope and impact of the impending changes could delay the process. Further, a lack of agreement (conceptually, operationally or financially) by all internal partners could end the implementation prematurely. While government Department A may have a solid business case for change, Department B may not have the resources, the time, or the desire to participate. Uncovering this scenario during an implementation will prove not only embarrassing, but costly.

**Implementation Team.** After consensus is obtained, both parties should build their implementation teams (see Exhibit 6.8). The government team should be led by an implementation project manager (IPM). Selection of the right IPM is critical to the project’s success. This individual should have a thorough understanding of the task at hand, and be well
Managing the Procurement Process

c connected to the various organizational units affected by, or party to, the implementation (operations, accounting, finance, information technology, and so forth).

The IPM should also have at least some knowledge of the existing financial services provider and staff. Understanding how to navigate the bank departments associated with the transition (treasury management, relationship management, customer service, and so forth) will prove helpful as the implementation progresses. In addition, the IPM should be at a high enough level within the government to make critical decisions as needed during the process. Delays brought on by indecision or the need to look for answers from other departments will hinder the government’s ability to meet crucial deadlines.

Once the IPM is selected, this individual will create sub-teams responsible for the specific aspects of the implementation. All business units affected by the transition should be included on the implementation team. For single product conversion (for example, a new information reporting system), it may be as simple as coordinating the individuals responsible for using this tool and providing training. For a full bank conversion, it should involve all departments of the organization, such as the information technology, finance, operations, and accounting departments. The IPM should assign a senior member from each business unit to oversee the implementation as it affects their individual group. These sub-team managers will coordinate the activities within their teams to ensure conversion tasks are completed and critical dates are met.

Banks will utilize different structures to meet their client’s needs. In general, the bank’s treasury service team will have responsibility for the implementation process, but different banks have varying views on the selection of the IPM. Many financial institutions will assign the IPM role to the treasury sales officer, because he or she maintains day-to-day contact for cash management services and issues and has a detailed understanding of the government’s needs. While the treasury sales officer may have extensive knowledge of the organization, the officer may not have the time or expertise required to manage all the aspects of the conversion. Further, the treasury sales officer generally has numerous clients and spe-
cific sales obligations which tend to conflict with the extensive time required for a successful implementation.

Therefore, to ensure the appropriate effort and care is applied to banking conversions, more progressive banks have employed dedicated implementation teams. Under this scenario, a bank assigns its own project manager with extensive experience to government. Like the government IPM, he or she is totally responsible for the implementation. They will coordinate the efforts of all the internal bank departments that are assisting with the conversion, work closely with the government IPM and sub-team leaders, and drive the process from beginning to end.

Regardless of how your bank structures their support team, the bank should:

- Provide a single point of contact for all implementation issues;
- Deliver a complete analysis identifying all of the government's specific processing requirements;
- Manage all aspects of each product setup including confirmation of the processing, and coordinating the timing requirements with the appropriate operating departments (within the bank and the government entity);
- Maintain regular and proactive communication with the government and internal business partners throughout the implementation; and
- Confirm the government's satisfaction with the implemented products or services and then provide a smooth transition to day-to-day contacts.

Although not actively managing the process under this model, the treasury sales officer should remain engaged to provide assistance as required. Any situations that arise that cannot be resolved by the implementation manager may need to be escalated to the officer to advocate on your behalf.

The key to the implementation process starts with a strong team led by a dedicated IPM. This must be true for both the government and the
bank. Resources committed specifically to the task at hand are critical to the success.

**Creating the Project Timeline.** The government project manager needs to budget sufficient time to ensure the applications implemented meet the schedule, which is often timed to a specific event. For example, a lockbox conversion may be scheduled for completion with the start of the tax season. In this situation, the government entity will work back from that date to determine the length of time required to have the service operational.

A conservative approach to timing is the best course of action. The more difficult the implementation (those with multiple products and platforms, for instance), the more time required to complete the conversion. As more business units are asked to participate, competing internal priorities could delay the process. Also, implementing multiple products may absorb disproportionate time from a particular internal team. For example, when implementing services that require data transmission or Internet access (account reconciliation, ACH, wires, lockbox, and so forth), the government’s information technology department may be asked to work with the individual bank sub-teams responsible for these products. Because they must deal with the multiple contacts and applications related to the conversion (as well as handling their day-to-day responsibilities), their resources could be stretched. The bank and/or government’s IPM should anticipate these challenges and build sufficient time into the process to accommodate the needs of all their internal partners.

While determining the time required internally for implementation, the government will also need to take into account the bank’s preferences. Specifically, the bank’s IPM should provide the government’s IPM with a detailed schedule of the lead time required for each specific banking product. The government’s IPM should then compare the two sets of requirements for compatibility. Should gaps exist both IPMs should discuss alternatives. There may be situations where the bank can commit other resources to expedite the process.

Meeting the deadlines associated with an implementation can be the most stressful part of the conversion process. Depending on a successful
system or product conversion to meet an impending, date-specific event can be a risky endeavor, particularly if there are no back-up systems in place to accommodate for slippage in the start date. Thoughtful time management is critical to the success. Where possible, build in additional time to accommodate unforeseen events.

Communication. Perhaps the most critical factor in any implementation is effective communication. Information flow should occur at all levels and involve all participants in the conversion. A meeting schedule should be developed, agendas set, and comprehensive meeting records maintained. Throughout the process, decision makers should continue to identify "next steps" and include them in future agendas. These procedures apply to both internal meetings of government staff as well as joint meetings with banking officials.

A project plan containing individual product checklists (Exhibit 6.9) is central to the implementation process. This information, created by the bank, should be provided to all parties responsible for the conversion. The checklists provide a road map for the specific steps involved in the implementation, timing, and the individual responsibilities of the government and the bank. These checklists should be reviewed during each conversion meeting to ensure tasks are on track and on time. 8

The identification of product checklists should be driven by the bank's implementation project manager. Aside from developing the checklist, this individual should be responsible for the coordination of all joint meetings, the implementation timetable, and providing the minutes from all the meetings. The bank should be responsible for keeping the conversion on schedule since the bank may have represented such conversion timelines during RFP meetings and/or preliminary meetings. Any issues that arise that may jeopardize the stated outcome should be conveyed to the government IPM. The two parties should then review the issues, and set a course of action to correct the deficiencies, which may include an adjustment to the implementation timetable. The key aspect of this entire process is the open and honest communication between the parties. As concerns are identified, they must be communicated quickly to ensure the appropriate corrective measure can be taken.
### Project Plan for Implementing Banking Services (excerpt)

<table>
<thead>
<tr>
<th>Week 1</th>
<th>Week 2</th>
<th>Week 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Govt/Team</strong></td>
<td><strong>Bank Team</strong></td>
<td><strong>Govt/Team</strong></td>
</tr>
<tr>
<td>Sue Jones</td>
<td>Tom Johnson and Data Trans Team</td>
<td>Sue Jones and Data Trans Team</td>
</tr>
<tr>
<td><strong>TIMING</strong></td>
<td><strong>SERVICE AND IMPLEMENTATION</strong></td>
<td><strong>ACCOUNT RECONCILIATION SERVICE – FULL RECON</strong></td>
</tr>
<tr>
<td><em>30 Business Days</em></td>
<td>IMPLEMENT FULL RECONCILIATION (AR)</td>
<td><em>Service implementation must start at the beginning of a new month in addition to the 30-day standard lead time</em></td>
</tr>
<tr>
<td>Establish and test communication links and formats with bank and government, if applicable</td>
<td>Open DDA account(s) associated with full reconciliation</td>
<td></td>
</tr>
</tbody>
</table>

**Bank**

**Govt/Team**
Testing, Training, and Follow-up. As the implementation progresses, extensive testing of the new products and services is required to ensure complete compatibility and accuracy. To check on direct deposit transmissions, for example, a test may be run to process a $0 entry to ensure that the governmental bank account and employee accounts are transmitted properly and completely. During this phase, the government and bank sub-teams will communicate directly regarding the individual products to be reviewed. They will assess electronic file information to verify format and content, test documents, and activate the new systems to ensure the parties have the ability to communicate with one another. The information technology departments for both teams are critical to this process. They will be responsible to ensure all data exchanges and interfaces are compatible and secure. As noted earlier, providing these areas with ample time to complete their work is essential to a successful conversion.

The amount of testing required is driven by the complexity and critical nature of the product or service in question. Testing for an information reporting product may be as simple as accessing the system and inputting a password to ensure accessibility. Testing for a lockbox conversion would be much more extensive and time consuming. In this instance, a complete review of the document's "scan line" (to include position, format, font, and so forth) must occur as well as communication testing to ensure data captured by the bank can be received by the government. This process generally goes through numerous iterations before it is complete.

Once products have been tested and are operational, the bank should provide training. Depending on the physical location of the government and the bank's training department, these sessions may be face-to-face (usually at the government's site) or via conference call. Developments in Web-based applications have provided creative alternatives to this process. Under this scenario, the participants access the training site on the bank's Web page and navigate a tutorial on the particular service they need to master. The sessions may also be interactive in that the computer-based tutorial is tied to a conference call with a leader available to answer the trainee's questions.
Ten Keys for Successful Banking Conversions

The following is based upon a banking conversion that occurred in the City of Santa Rosa, California. The city made a complete conversion from an incumbent to a new bank providing a comprehensive set of depository services. While the recommendations presented were utilized in a mid-size city, the concepts generally apply to other governmental entities.*

1. **Consensus:** Consensus from all players that a bank conversion is a truly worthwhile endeavor is essential. Without buy-in from everyone from the outset, you will increase the likelihood of conflict and delays down the road.

2. **Implementation Team:** Establish an implementation team that includes key staff from all essential departments and divisions. Do not forget areas that utilize banking services in an ancillary manner (for example, remote cash and collection operations). At a minimum, departmental representatives should include: accounting, treasury, investment, payroll, utility billing, and information technology. A designated project manager should be identified in having ultimate responsibility in ensuring proper focus, communication and roles of responsibility are established and maintained.

3. **Timeline:** Establish a reasonable implementation timeline and stick to it. Schedule biweekly meetings with your bank’s implementation team and request that all members of both teams be present at all meetings. Ideally, the bank will assign an implementation manager who is skilled in the conversion process. Ensure that everyone’s role and responsibilities are clear from the beginning. This will mitigate delays and any confusion, frustrations, and other project-inhibiting traits. Allow sufficient time for these meetings for everyone to be clear on expectations and the next tasks and goals.

4. **Terminology:** Early in the process, make sure that everyone is speaking the same language. A huge challenge can be translating product names from the old bank to the new bank. Also, there may be many types of services under one common heading (e.g., ACH – Automated Clearing House), each with a different name between the two banks. An approach to address this confusion is to develop a list of products or services of the old bank, then develop a list of the counterpart product or service name at the new bank.


continued
Ten Keys for Successful Banking Conversions

5. **Business Process Efficiencies:** Throughout the process, continue to look for ways to create efficiencies and improve customer service. Many ideas will have surfaced as a result of the RFP process, but many more are identified as you begin to talk about the details of each product or service.

6. **Change Management:** Early on, notify all departments that will be affected by the decision to change banks. Tell these departments the target implementation date and let them know that the government’s project team and/or the bank will address any questions. Reassure them that it will not adversely impact their workload (or if it will, be sure to disclose and quantify such impact). Schedule department-wide training for all staff preparing deposits or accepting credit cards to be held at least one week before the “go live” date. Invite local and cash vault bank staff to assist with the training; then use this training session to distribute new supplies to all departments and answer questions.

7. **Testing:** Allow sufficient time for file testing for different ACH services. Select information technology staff that are flexible and knowledgeable to work closely with bank technical staff. Submit check stock early for MICR and CD-ROM imaging testing.

8. **External Notification:** Provide early written notification with your new banking information to other agencies (e.g., federal, state, regional) that may fund grants and/or provide other revenue/expenditure transactions directly through your existing banking entity for processing. Requirements differ and sufficient lead-time will prevent payments from being misrouted.

9. **Feedback to Bank:** On an ongoing basis, be candid with the bank’s implementation team about how the process is going. If there are problems, discuss solutions and agree to a strategy for resolution. Remember that the government is in the process of building a relationship with its new bank. The government’s project manager should be talking with the bank’s team leader or implementation manager on a regular basis, at times daily.

10. **Post-Conversion Evaluation:** Once conversion has been fully done, meet again to evaluate what worked and what did not. This is a valuable step for all parties. While it is unlikely that your entity will undertake a banking conversion again soon, many similar processes occur where team members with diverse interests need to work together.

Ultimately, bank conversions are projects, requiring treasurers and cash managers to learn (or obtain staff with) project management skills. Whether your government is a state, county, school, or special district, focusing on these ten keys should tilt the odds in favor of the government and its stakeholders.
Follow-up is a key aspect to the implementation process. After the conversion is complete and all of the products and services are "live," a subsequent meeting should be scheduled to review the status. This will usually occur within the first week after the conversion is completed and transactions are being processed. Any issues will be discussed and plans will be created to correct any deficiencies. Additional meetings should be scheduled on a periodic basis until both parties are completely satisfied with the outcome. Any concerns after this period can be directed to the government’s relationship manager or treasury services officer.

Exhibit 6.10 summarizes important strategies to successfully convert to a new bank, based on the experience of a California municipality.

ENDNOTES

1. See Appendix C for the GFOA Recommended Practice, “Procurement of Banking Services.”

2. For example, one GFOA member government requires that banks indicating an exception to proposed terms in the RFP must list it on a separate exception page; otherwise, it would not be recognized as an exception.

3. See Appendix C for GFOA Recommended Practice, “Procurement of Banking Services.”

4. See Appendix C for GFOA Recommended Practice, “Use and Application of Voluntary Agreements and Guidelines for Cash Management.”

5. Articles 3 and 4 of the Uniform Commercial Code allocate liability for check fraud losses between the account holder (the government issuing the check), the payor bank, the depository bank, and the collecting bank.

6. For example, see “Checking on Checks Moves Online,” Treasury and Risk Management, November 2003, p. 15.

7. One way to engage an out-of-town bank is to simply require the bank to provide courier service for daily deposits, lockbox deliveries, etc.

8. Specific software can be used such as Microsoft Project or spreadsheet software.
This chapter looks at the cost of obtaining banking services, with the goal of ensuring that governments obtain the maximum value from each dollar of banking fees. Whether the cost is $50 to maintain a monthly account, or 50 cents for every check paid, fees are an unavoidable part of doing business with a bank. Fees need to be taken into account both at the time a request for proposals (RFP) is issued as well as during the ongoing oversight of banking activities.

Governments have two methods to compensate banks: the use of compensating balances (indirect compensation) or direct compensation via fee-for-service billing. This chapter describes each method and provides information intended to help officials determine which method (or combination thereof) is most appropriate for their government. In addition, the chapter presents a discussion of optimal account balances, the components of an account analysis statement, and monitoring of costs.

As discussed in this chapter, compensation pertains to core banking services, such as general account maintenance services, depository services, branch teller services, retail lockbox services, automated clearinghouse, and information services (detailed in Chapters 2 through 4). In contrast, ancillary services, such as investment management, use an entirely different method (such as payment based on a percentage of assets under management) that often involves a separate banking division or different bank altogether. Compensation for ancillary services is not covered in this chapter. The discussion in this chapter on compensation complements the Chapter 6 review of RFP preparation, since compensation is a facet of any RFP document.
Direct Fees versus Compensating Balances

Direct fees are an explicit means of presenting banking costs in a government's budget and can therefore aid in providing a clearer, more comprehensive picture of the government's expenses associated with financial management. Compensating balances can be less transparent from a budgetary perspective, since costs can be embedded in the banking relationship and are not necessarily conveyed through the budget. In some ways, however, the compensating balances method can be seen as administratively advantageous.

Compensating Balances

Under the compensating balances method, the government provides indirect compensation by maintaining deposits at specific levels negotiated with the bank, allowing the financial institution to lend the funds to other customers and thereby earn revenues. Typically, a bank provides a government an earnings credit pursuant to a formula developed through the RFP or negotiation. This earnings credit is used to place value on the balances held, and the earnings credit is used to "pay" for banking services (in lieu of direct disbursements to the bank).

These balances may be stated in terms of minimum balances or as a variant of averaged balances. Compensating balances can benefit both parties by making available greater resources for the bank, while reducing the administrative burden on the government. In exchange for being allowed to use the government's cash, the bank credits the government through an earnings formula. If the cash balance is maintained at an agreed upon level, then the earnings credit will theoretically offset the cost of services for a specific period. In practice, it is difficult to hit this target exactly.

Direct Fees

Whereas compensating balances present an indirect payment method, the direct fees method simply requires that the government pay upon receipt of an invoice (for example, billing on a monthly cycle based upon an itemized invoice). The invoice is referred to as an account analysis, and is

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discussed in the following section. Each service transaction during a billing period is recorded and at the end of the period, the transactions are multiplied by the per-item cost and totaled. The bank invoices the fee directly to the government, and in turn, the government makes an electronic payment to cover the expense or issues a check. (Usually, the bank executes the transaction simply by deducting the government’s account.) Per-item fees can be fixed for the duration of the contract.

**Blended Approach**

Many governments use a blended approach that combines the compensating balance and direct fee payment methods. Under this scenario, a government would be invoiced according to a direct fee method but simply uses balances (kept at a minimal level) to cover invoiced fees. The advantage of this approach is the clear identification of fees with the administrative convenience of compensating balances.

Some governments may prefer a blended approach. For example, a government may budget for a certain amount in annual banking expenses. The government would manage the level of balances — by raising or lowering the amount on deposit — to ensure that it hits the budgetary target for banking expenses. The blended approach is clearly preferable in certain situations, such as when the government may not be able to earn investment income on certain deposits (e.g., grants or court bond deposits held in escrow).

The Government Finance Officers Association (GFOA) generally recommends that governments use a direct fees approach or a blended approach. In its Recommended Practice, “Procurement of Banking Services,” GFOA suggests:

Evaluate the relative benefits and costs of paying for services through direct fees, compensating balances, or a combination of the two. Compensating-balance arrangements can offer convenience and seemingly low costs. However…compensating banks through fees or a combination of fees and balances generally is financially advantageous.
Account Analysis

An account analysis is a type of monthly statement that banks provide to their governmental and other institutional customers. Essentially, it is the bank’s monthly invoice for services rendered. The account analysis differs from bank statements for retail customers because it is not a list of paid checks and deposits; rather, it is an expanded list of services provided by the bank (for example, the volume of checks presented and cleared) and their costs. In cases where the provision of an account analysis is not a standard practice, it would need to be requested from the bank as part of the RFP.

The government should request an account analysis statement for each bank account that that the government maintains, accompanied by a summary statement for all accounts. The summary statement is simply a consolidated report of multiple account analysis statements. Compensation to the bank should be based upon the summary statement, as opposed to the individual account analysis statements. The account analysis can be delivered through the bank’s electronic reporting tool, or through the mail.

Exhibit 7.1 illustrates a simplified account analysis. The components of a service analysis include:

- The actual services provided by the bank (first column in Exhibit 7.1);
- Unit count or occurrence of the service provided during the reporting period (second column);
- The unit or per item charge (third column), as stipulated in the RFP or contract; and
- The total charge for the particular service.

For a given service, the monthly charge is simply the number of occurrences of the service multiplied by the charge per service. For example, in Exhibit 7.1 it can be seen that account maintenance occurs once per month at a unit cost of $42 per occurrence, which results in a $42 charge for the month.
Sample Account Analysis (Simplified): Analysis of Service Costs

Account Analysis Statement – January

<table>
<thead>
<tr>
<th>Category / Service</th>
<th>Number of Units</th>
<th>Unit Price</th>
<th>Charge for Service (rounded)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. General account services/ account maintenance</td>
<td>1</td>
<td>$42.00</td>
<td>$42</td>
</tr>
<tr>
<td>2. Depository services/ deposit checks (encoding)</td>
<td>950</td>
<td>0.0950</td>
<td>90</td>
</tr>
<tr>
<td>3. Branch teller services/ credits posted (branch)</td>
<td>44</td>
<td>3.7500</td>
<td>165</td>
</tr>
<tr>
<td>4. Retail lockbox services/ lockbox payments</td>
<td>1,273</td>
<td>0.27</td>
<td>344</td>
</tr>
<tr>
<td>5. ACH/ACH direct items</td>
<td>230</td>
<td>0.20</td>
<td>46</td>
</tr>
<tr>
<td><strong>Total fees</strong></td>
<td></td>
<td></td>
<td><strong>$687</strong></td>
</tr>
</tbody>
</table>

*Note: Figures are illustrative only and do not represent actual government data.*

Exhibit 7.1 shows five service line items in five service categories, whereas an actual statement will have a greater number of service categories with a correspondingly greater number of service line items. In general, the complexity of the account analysis will depend upon (a) the level of detail the governments prefers, in accordance with the RFP instructions it gives, (b) the scope of services the government seeks, and (c) the sophistication of the bank’s system for account analysis.

Variations from one bank to another for service charges exist, depending upon the costing method a bank uses for a particular service. Thus, it is unlikely a government will find a service-pricing proposal to be exactly comparable, line item by line item, from one bank to the next. Some banks will have a greater degree of specificity for a given service. For example, one bank may combine various lockbox service charges into
one general lockbox charge whereas another bank may unbundle them into specific components. A government should view proposals for banking services in aggregate to determine the total operational cost.

To determine the amount of balance required to offset the fees, the balance analysis is performed (see Exhibit 7.2).

Generally, the method used in determining the compensating balance requirement relies on the bank calculating five components. These are contained in the balance analysis as follows:

1. *Average Daily Balance* – This is the amount of cash on hand at the end of each business day, per the bank’s book or ledger balance, and not necessarily the amount available to the government (owing to the reserve requirement and other factors discussed below). Determining the average depends on the method employed by the bank, and generally can be approached in at least two ways: (a) the sum of the beginning and ending balance divided by the number of days within the month, or (b) true average. Calculating the daily balance with the true average (balance determined daily,
summed, then divided by the number of days) takes into account every day within a billing period and thereby generates the most complete portrayal of daily balance.

2. **Average Float** – This refers to funds in transit through the U.S. banking system. The process of funds being made available reflects time required for check clearing and deposit postings (see Chapters 2 and 3 for a discussion of float). Float measurement may differ from bank to bank; therefore, if actual float is not used, the bank should specify so in its proposal. Average float is not usually a major determinant of average investable balance, as indicated in Exhibit 7.2.

3. **Average Collected Balance** – This is equal to the average daily ledger balance less average float.

4. **Reserve Requirement** – Federal Reserve regulations require that a percentage of all deposited funds be held in reserve. Generally this is 10 percent of deposits. (According to the Federal Reserve Bank of San Francisco, the Fed has the authority to alter the percentage of deposits required to be held in reserve in order to implement monetary policy. The Fed rarely alters this percentage.) To offer a more competitive RFP proposal, some banks will waive the 10 percent offset for the purposes of the account analysis.

5. **Average Investable Balance** – The portion of the government’s average daily account balance that is available for investment after subtracting float and reserve balance requirements.

6. **Earnings Credit Allowance** – The income the government’s average investable balance would have earned for one month if it had been invested at the earnings credit rate (ECR). The earnings credit allowance is the amount that is used to essentially pay for banking fees, under a compensating balances or blended method. In Exhibit 7.2, the annual earnings credit rate of 1.5 percent is adjusted to arrive at a monthly figure. Many banks will calculate monthly interest on a daily basis, but this will depend upon RFP instructions.
BANKING SERVICES

Banks may have the greatest discretion in determining the earnings credit allowance. Therefore, the RFP should ideally leave little “wiggle room” for the bank and the government should specifically state its preferred ECR formula. The ECR rate used to calculate the income is generally based upon an established market rate, such as the 91-day U.S. Treasury bill rate or Fed funds rate. Alternatively, a government could index the ECR to the rate offered by a local government investment pool, either at the exact index rate or the rate plus additional basis points. Be wary of a bank that offers an unusually high ECR, since it may be tied to a higher set of service fees.

Maintaining an Optimal Account Balance

Ideally, if a government is using either the compensating balance or blended method to pay for bank services, close oversight would ensure that the level of compensating balances is exactly sufficient – no more and no less than needed – to offset service costs. In practice, no matter how aggressively the government finance officer manages banking activity, ECRs and average available balance amounts are impossible to predict with precision, because the components of the earnings credit calculation and the actual quantity of banking services used varies from month to month. Without gathering information and managing the process, the government can run the risk of paying higher direct fees because of insufficient balances or incurring an opportunity cost from excess idle funds in the account. If it is an important objective, however, the finance officer can come close to offsetting fees by daily tracking of the available balance over the course of the month and adjusting the balances each day to meet the target balance needed to offset the estimated cost of services, based on historical usage.

As Exhibits 7.2 and 7.3 indicate, an average investable balance of $761,583 generates an earnings credit of $970, whereas service charges for the month are only $687. The average investable balance required to generate an earnings allowance equal to the service fee amount is significantly lower. Thus, in this example, the average investable balance that the government maintained during the month exceeds the target of
## Analysis to Determine Optimal Balance

<table>
<thead>
<tr>
<th>January</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average daily balance</td>
<td>$862,743</td>
</tr>
<tr>
<td>Average float balance</td>
<td>$16,539</td>
</tr>
<tr>
<td>Average collected balance</td>
<td>$846,204</td>
</tr>
<tr>
<td>Reserve requirement</td>
<td>$84,620</td>
</tr>
<tr>
<td>Average investable balance</td>
<td>$761,583</td>
</tr>
<tr>
<td>Balance required for service charges</td>
<td>$539,227</td>
</tr>
<tr>
<td>Excess (deficit) balance</td>
<td>$222,357</td>
</tr>
<tr>
<td>Earning credit rate</td>
<td>1.50%</td>
</tr>
</tbody>
</table>

| Term | 11.7742 | Calendar year days divided by number of days in specific month |
| Dolls in balance to offset $1 in service charges | $785 | Term divided by earnings credit rate |
| Balance required for service charges | $539,227 | Term divided by total service charges |
| Term earning rate | 0.127% | Earnings credit rate divided by term |
| ECA | $970 | Investable balance multiplied by term earning rate |

| ECA | $970 | Investable balance multiplied by term earning rate |
| Total service charges | $687 | From account analysis |
| Excess (deficit) earnings | $283 | Earnings allowance less total service charges |
$539,227, and that excess in effect generates nothing for the government while in the checking account. (Some governments roll over any excess balances, however, as discussed in the next paragraph.)

The effort to maintain an optimal balance in a government's bank account should take into account several factors. First, does the government have the ability to roll over any excess balances to future periods? For example, if the government historically has maintained a balance in excess of what is needed for compensating balance in a given month, it may be able to stipulate in the RFP that this average would apply to subsequent periods. Conversely, any shortages in a given month would be applied to subsequent periods as well. At year's end (or some other period defined in the RFP), the bank and the governments would reconcile the excesses and shortages, reflecting all twelve months of activity. (See Exhibit 7.6 for sample language.)

Second, do balances maintained in excess of the minimum level (the amount required to generate a credit large enough to offset service charges) present a material opportunity cost, in the form of lost earnings through other short-term investments? Governments should analyze investment alternatives to see if earnings (net of fees) invested in open market securities will outweigh that received from the ECA. There may be costs associated with executing investment transactions (such as wire transfers) that would diminish any investment income, and these would need to be taken into account.

A third factor is cash flow forecasting. Governments that have the ability to precisely forecast cash flows on a daily basis are well positioned to maximize investment income, and minimize idle funds at the bank (that is, minimize average investable balances). On the other hand, governments that (a) have less experience in this area, (b) have software with limited functionally, or (c) maintain incomplete data to support cash flow forecasting may not be able to maximize investment income. In this case, the governments may need to maintain a higher cash balance at the bank.
Paying for Banking Services

RFP Considerations

In developing an RFP, governments need to specify the format for banks to submit a cost proposal. As an illustration, Chapter 6 offers a four-part format consisting of (a) introduction, (b) scope of banking services, (c) bidding instructions, and (d) proposal evaluation, along with bidding forms as an appendix. Many governments provide competing banks a bidding form or spreadsheet to specify cost proposals that is included as an appendix.

Exhibit 7.4 illustrates an example of a bidding form used to obtain cost proposals from competing banks. The example is taken from a mid-sized city. A more detailed bidding form is included in Exhibit 7.5, taken from a county government. The bidding forms can contain even greater detail, as illustrated in Exhibit B.2 of Appendix B. The level of detail is a function of the (a) complexity of the government’s account structure, (b) scope of cash management services, and (c) government’s preference for detail versus flexibility in RFP responses. Regarding the latter, some governments use the Association for Financial Professionals’ RFP templates that utilize perhaps the most detailed formats available.

Governments constructing an RFP may provide basic instructions that would affect the account analysis. For example, the government should indicate the timeframe in which the government expects the analysis to be delivered. Sample language is included in Exhibit 7.6.

Ongoing Oversight of Banking Fees

Governments should monitor banking costs and activity levels not only to ensure accurate invoicing and contract compliance by the bank, but also to gain insight into the government’s overall cash management program. Monitoring the types of services used and the transaction volumes will provide useful information regarding the government’s cash management processes. A simple spreadsheet can track monthly usage for core services, and show trends over the period.
# Bidding Form for Cost Proposal
(Mid-Sized City)

<table>
<thead>
<tr>
<th>Bank Depository Services</th>
<th>Estimated Annual Volume</th>
<th>Charge Per Item</th>
<th>Annual Service Charges</th>
</tr>
</thead>
<tbody>
<tr>
<td>Account maintenance (11 accounts)</td>
<td>132</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Checks paid</td>
<td>6,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Items deposited (non-lockbox)</td>
<td>72,750</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of deposit slips processed</td>
<td>815</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Returned checks charged to account</td>
<td>100</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stop payments</td>
<td>10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wire transfers:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Incoming</td>
<td>10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Outgoing – PC</td>
<td>30</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ACH transactions:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Incoming</td>
<td>15,600</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Outgoing – direct deposit</td>
<td>1,560</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank transfers between accounts – daily</td>
<td>25</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Daily balance reporting – PC</td>
<td>260</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Returned checks sorted</td>
<td>6,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Securities pledged per $1,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

## Other Services

- PC banking software
- Monthly maintenance
- Other costs (itemize on separate attachment, if necessary)
- Earnings credit balance (information only)

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Proposed</td>
<td>$</td>
</tr>
<tr>
<td>Average Monthly Amount (Total +12)</td>
<td>$</td>
</tr>
<tr>
<td>Balance Required to Support $1.00 of Services</td>
<td>$</td>
</tr>
<tr>
<td>Required Monthly Compensating Balance</td>
<td>$</td>
</tr>
</tbody>
</table>

*Source: Adapted from Village of Carol Stream, Illinois RFP*
### Bidding Form for Cost Proposal (Mid-Sized County)

<table>
<thead>
<tr>
<th>Activity Description</th>
<th>Annual Units</th>
<th>Unit Cost</th>
<th>Annual Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lockbox with OCR scan line per item</td>
<td>180,000</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td><strong>Account Maintenance (monthly):</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depository / concentration</td>
<td>12</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>ZBA checking</td>
<td>12</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>ZBA payroll checking</td>
<td>12</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>ZBA school depository</td>
<td>12</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>Escrow (approximately 250 sub accounts)</td>
<td>12</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>Special welfare checking</td>
<td>12</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td><strong>Night Deposit Service:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Per canvas bag</td>
<td>1,400</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>Per plastic bag (not currently used)</td>
<td>1,400</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td><strong>Deposits:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Per deposit slip</td>
<td>3,300</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>Items deposited, non-encoded</td>
<td>102,000</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>Items deposited, encoded</td>
<td>150,000</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>Imaging deposited items to CD or other agreeable method, per month</td>
<td>12</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>Items deposited per image</td>
<td>252,000</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>Cash processing, teller line (in dollars)</td>
<td>125,000</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>Cash processing, night deposit (in dollars)</td>
<td>1,200,000</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>Debit card processing ability (monthly)</td>
<td>12</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>Debit card processing per item</td>
<td>500</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>Credit card processing ability (monthly)</td>
<td>12</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>Credit card processing per item</td>
<td>2,500</td>
<td>x</td>
<td></td>
</tr>
</tbody>
</table>

continued
### Bidding Form for Cost Proposal (Mid-Sized County)

<table>
<thead>
<tr>
<th>Activity Description</th>
<th>Annual Units</th>
<th>Unit Cost</th>
<th>Annual Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Items Paid:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payroll</td>
<td>27,600</td>
<td>×</td>
<td>=</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>33,600</td>
<td>×</td>
<td>=</td>
</tr>
<tr>
<td>Accounts payable ACH (not currently used)</td>
<td>10,000</td>
<td>×</td>
<td>=</td>
</tr>
<tr>
<td>Positive pay (not currently used)</td>
<td>61,200</td>
<td>×</td>
<td>=</td>
</tr>
<tr>
<td>Payroll direct deposit ACH</td>
<td>57,600</td>
<td>×</td>
<td>=</td>
</tr>
<tr>
<td>Stop payments</td>
<td>130</td>
<td>×</td>
<td>=</td>
</tr>
<tr>
<td>Cleared item inquiry</td>
<td>50</td>
<td>×</td>
<td>=</td>
</tr>
<tr>
<td>Imaging all items paid to CD or other agreeable method, per month</td>
<td>12</td>
<td>×</td>
<td>=</td>
</tr>
<tr>
<td>Items paid per image</td>
<td>61,200</td>
<td>×</td>
<td>=</td>
</tr>
<tr>
<td>Returned, represented items</td>
<td>500</td>
<td>×</td>
<td>=</td>
</tr>
<tr>
<td>Returned items</td>
<td>350</td>
<td>×</td>
<td>=</td>
</tr>
<tr>
<td>Wires – Incoming</td>
<td>200</td>
<td>×</td>
<td>=</td>
</tr>
<tr>
<td>Wire transfer by terminal – Outgoing repetitive</td>
<td>100</td>
<td>×</td>
<td>=</td>
</tr>
<tr>
<td>Wire transfer by terminal – Outgoing non-repetitive</td>
<td>25</td>
<td>×</td>
<td>=</td>
</tr>
<tr>
<td>Online services for account information and reconciliation (per month), balance inquiry, deposit transactions, cleared items, etc</td>
<td>12</td>
<td>×</td>
<td>=</td>
</tr>
<tr>
<td><strong>Courier Services (monthly):</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Return lockbox items processes to treasurer’s office daily (next day)</td>
<td>12</td>
<td>×</td>
<td>=</td>
</tr>
<tr>
<td>Pickup deposits from treasurer’s office daily</td>
<td>12</td>
<td>×</td>
<td>=</td>
</tr>
</tbody>
</table>

continued
<table>
<thead>
<tr>
<th>Activity Description</th>
<th>Annual Units</th>
<th>Unit Cost</th>
<th>Annual Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pickup deposits from other collection points daily (18 schools)</td>
<td>9</td>
<td>×</td>
<td>=</td>
</tr>
<tr>
<td>Daily sweep of excess balances to investment, per month cost</td>
<td>12</td>
<td>×</td>
<td>=</td>
</tr>
<tr>
<td>Change/Currency order services (daily)</td>
<td>260</td>
<td>×</td>
<td>=</td>
</tr>
<tr>
<td><strong>Other (list):</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total estimated annual cost</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Estimated compensating balance required for estimated cost**

**Estimated earnings allowance rate used for compensating balance listed above** (Per RFP, must also provide actual earnings allowance rates per month for 1999 calendar year).

*Source: Adapted from Hanover County, Virginia RFP*

Governments cannot assume that monthly account analyses will be accurate. There are a number of factors that could cause banks to issue an inaccurate account analysis:

1. At the time a new bank relationship is started, the bank’s customer relationship manager fails to share detailed information on the cost provisions to the back-office department responsible for billing;
Sample RFP Language: Cost Proposal and Itemization of Service Fees

The government anticipates that proposed banking services be compensated on a fee for service basis and maintain a balance as close to zero as possible in the account. The total charges shall be billed on a quarterly basis and will be paid within thirty days of receipt of the quarterly bill. However, the government may elect at any time to utilize a combination of fees and compensating balances to pay for banking services provided. Banks must propose a unit charge for each required service, and must extend the unit charge based on the government's estimated monthly volume for each service to obtain a monthly total cost for each service. Any earnings credit occurring in the account will be used to offset fees. Earnings credit on collected balances in excess of those required to pay charges incurred in any month shall be carried forward to offset future bank charges.

2. The bank subsequently changes its overall fee schedule applicable to all clients, which might override any special arrangements between the bank and a particular government;

3. The bank merges with another bank, and the acquiring bank fails to honor previous pricing commitments, or alters the bundle of services/related service descriptions in the account analysis (making a cross-walk between the old bank's fees and new bank's fees difficult);

4. Services not procured or included in the RFP scope are added to the account analysis; or

5. The bank alters its fee calculation methods (for example, counting a particular transaction in a different way that overstates transaction volume).

The government should occasionally review and compare the services used against those that are unused but available from the bank. This process may identify potential areas for improvement or change. For example, if lockbox service costs reveal a trend of an unusually large num-
ber of exception items (payments that are processed manually and cost more per unit), it may require changes in cash management procedures, such as using a high-quality laser printer for generating invoices. Improved cash management techniques such as centralized depository accounts or consolidated deposits may also reduce the cost of bank services by reducing redundancy and units of service.

Moreover, given that government needs and available banking services are sure to change over time, the government can potentially deploy new services that did not exist at the time of the original banking service procurement. For example, newer technologies applied to collection and disbursement may be used to enhance the government's operational efficiency and meet changes in service requirements.

At a conceptual level, most government treasury officials understand that electronic banking services are more efficient than paper-based processes. By monitoring their monthly service costs, these officials can assemble concrete evidence of the relative costs and benefits of paper-based versus electronic methods, which can help build the case for more e-government initiatives. Electronic transaction costs are generally less than paper-based methods and savings are relative based on the size of the government. For example, one mid-sized municipality saved over $15,000 in banking fees by implementing ACH-based payroll disbursements versus traditional payroll checks. Electronic transactions do not require the reconciliation or fraud protection (positive pay) services of the bank, which further reduces costs.
Once a banking relationship is established through the procurement process, government treasury officials must manage the relationship and monitor the delivery of services. It is important that the responsibility for managing banking relations be formally assigned to an appropriate area of the government, usually the finance department or treasury department (if separate). The primary purpose for oversight of the banking relationships is to ensure that (a) the government receives the contracted services at the agreed-upon fees, (b) the providers of these services deliver them throughout the term of the contract/relationship, and (c) the assets on deposit are secure.

This chapter focuses on the tools to ensure that a bank, once selected, remains financially stable, and that the government is adequately protected from potential downgrades in financial condition. The government’s main responsibilities are to both perform due diligence to ensure that the bank is financially sound and implement tools such as collateral and FDIC insurance.

**Background**

Over the years, bank failures have cost governments millions of dollars in losses. Local governments have lost millions of dollars by depositing funds in excess of the Federal Deposit Insurance Corporation (FDIC) limit of $100,000 into banks with financial problems. Many of these losses could have been avoided if local governments had properly collateralized deposits and had instituted proper safekeeping procedures for the securities that were held as collateral for those deposits.
Historical Record on Bank Failures

Before the Depression, bank failures were confined to mostly small, rural banks. Underwriting securities was a major bank activity during this period and a primary cause of many failures. From 1921 through 1929, more than 600 banks failed on average each year. ¹ During the Depression, from the years 1930 through 1933, there were nearly 9,100 bank failures. At the end of 1933, there were fewer than 14,500 banks still in existence, less than half the number of banks in 1921. ²

The gravity of this situation resulted in the greatest reform ever to occur in the banking industry. In 1933, the Glass-Steagall Act ³ was enacted to prohibit paying interest on demand deposits, eliminate investment banking activities, and establish the FDIC. This act, along with the Federal Deposit Insurance Act and the Securities Exchange Act of 1934, were responsible for stabilizing the banking industry.

In the period following the Depression and up until World War II, bank failures averaged 46 annually. During these years, the economy suffered another, although much less severe, depression that continued to flush the excesses from the economy. After World War II but before the 1980s, banking continued to be stable and the number of bank failures greatly declined to a total of 117, or less than 5 per year. ⁴

Bank failures increased dramatically in the 1980s and early 1990s. Between 1980 and 1994, 1,617 banks failed. ⁵ Causes for bank failures during this period were economic, financial, legislative, and regulatory. The most notorious bank failure of this period was the Penn Square Bank of Oklahoma City, which had $517 million in assets. The failure of Penn Square Bank in 1982 caused a run on Continental Illinois Bank, the country’s seventh largest bank at that time, and caused Seattle First National Bank (SeaFirst) to merge with Bank of America. Total losses to uninsured depositors, stockholders, and to other banks amounted to $1.5 billion. This loss exceeded the $1.3 billion in losses to depositors during the Depression (disregarding inflation). ⁶

The late 1980s and early 1990s were a particularly risky time for financial institutions. Since that time, the health of the country’s financial institutions has greatly improved. From 1997 through 2002, only 34 banks failed. The reasons for these failures were attributed to alleged
fraud, poor management, poor internal controls, and economic conditions. Subprime lending (lending to less-than-top-grade borrowers) played a significant role in bank failures since 1997, because banks began concentrating their lending in this area and therefore increasing their exposure to risk. In addition, brokered deposits (interest-rate sensitive deposits or “hot money”) played a role in many of the bank failures during this period.

Today there are fewer banks in existence. The banking industry has consolidated through mergers and acquisitions and has become stronger as a result. Legislative and regulatory changes allowed banks to expand. The Riegle-Neal Interstate Banking and Branching Efficiency Act in 1994 eliminated restrictions on interstate bank mergers. As a result, bank holding companies acquired banks of all sizes. As the chart shows in Exhibit 8.1, there were 7,812 commercial banks in September 2003 compared to 12,343 banks in 1990. A smaller number of banks, however, means that individual banks hold a larger share of insured deposits.

**Why Do Banks Fail?**

Banks fail for a variety of reasons, but most bank failures can be attributed to managerial weaknesses, poor internal routines and controls, fraud, and
economic conditions. Economic conditions are the only factor over which bank management does not have control.

There are warning signs that can signal problems for a bank. These warning signs can be grouped into five broad categories:

- Rapid growth and the use of high-risk business models;
- Lack of corporate governance;
- Distortion of financial records;
- Overpayment for assets or services; and
- Concealment of information.

Local governments must be aware of the factors that can cause problems for banks and stay informed on events that can affect the state of the banking industry.

**Challenge of Evaluating Bank Creditworthiness**

In order to ensure the safety of the government’s deposits, public officials must evaluate the creditworthiness of a bank – both during the procurement process and periodically during the life of the agreement. Trying to determine if a bank has a strong financial condition can be a challenge. In fact, even federal bank examiners find this evaluation challenging.

When bank examiners evaluate a bank’s financial condition they look at five components of a bank’s operation. These components make up the acronym CAMEL, which stands for:

- Capital adequacy;
- Asset quality;
- Management;
- Earnings; and
- Liquidity.
In the late 1990s, a sixth component was added to the CAMEL rating system. This component assesses a bank’s sensitivity to interest-rate or market risk and is referred to as an “S” (hence CAMELS).

Government regulators assign a CAMELS rating on a scale of 1 to 5, with 1 being the highest and 5 the lowest. Ratings of 1 or 2 are assigned to financial institutions in fundamentally sound financial condition. Institutions rated 3 will typically retain that rating from six months to several years before being assigned a higher or lower rating. CAMELS ratings of 4 or 5 indicate that serious problems may exist that, if not resolved, could lead to insolvency. Banks rated 4 typically require immediate remedial actions and intensive monitoring by regulatory officials. Most banks downgraded to 4 or 5 are subject to formal enforcement actions. Institutions with a CAMELS rating of 4 can stay in business for several years before either earning an improved rating, deteriorating to a lower rating, or being declared insolvent by the regulator. A rating of 5 indicates a high probability of failure, usually within the next 12 months.

Bank examiners never release a bank’s CAMELS rating to the public. Because the ratings are kept confidential, many bank-rating service providers try to replicate the CAMELS rating through their own analysis. Public officials have two practical options: they can (1) purchase reports on the banks they use (or are evaluating as part of the procurement process) from the service providers, or (2) evaluate a bank’s financial condition themselves. Performing the latter exercise can be time consuming and can expose the public official to liability if a bank should subsequently fail. Depending upon the cost, purchasing reports may be more cost-effective and provide governments the expertise of financial analysts who specialize in financial analysis of banks. As a matter of practice, a Government Finance Officers Association (GFOA) Public Investor article indicates that governments utilize both internal staff and external bank rating services. These service providers include Fitch Ratings, Sheshunoff Information Services, Duff & Phelps, and others. For example, one provider offers the following type of analysis of bank creditworthiness:
• Evaluations of each bank’s core ratios of financial strength, as well as comprehensive ratios alongside a peer ranking for each ratio, presented over time;

• Bank rates aggregated nationally, regionally, and by peer group (asset size), with national rating guidelines to determine exactly where a bank falls in line with all other banks in the United States; and

• Supporting financial data for the current quarter, the previous year, and four year-end periods, organized by category.

A public official’s due diligence should include an evaluation of both the bank and its holding company, but frequent mergers and acquisitions can make bank evaluation challenging. A strong holding company can help a weak bank through tough times, whereas a weak holding company can drain a solid bank. In addition, if a bank is merged or acquired, analysis on both the newly formed bank and the acquiring holding company should be performed.

Tools for Ensuring Safety of Deposits

Ensuring the safety of public funds is one of the most important objectives of managing public funds. There are two ways a local government can protect its deposited funds in case a bank fails: through FDIC insurance up to $100,000 per depositor and through the use of pledged collateral for amounts greater than $100,000. Experience has shown that collateralization is an effective guarantee for public funds when banks fail.

FDIC Insurance

The FDIC was established by Congress in 1933 to provide stability to the banking industry by (1) insuring bank deposits as well as helping to maintain sound conditions in the banking system and (2) protecting the nation’s money supply in case of financial institution failure.
Bank Creditworthiness

An independent agency of the federal government, the FDIC is funded by premiums paid by banks and thrift institutions for deposit insurance coverage and from earnings on investments in U.S. Treasury securities. The FDIC directly examines and supervises approximately 5,300 charter banks and savings banks.\textsuperscript{11} Banks that are chartered by states rather than by the federal government have the choice of joining the Federal Reserve System. The FDIC is the primary federal regulator of banks that are chartered by the states that do not join the Federal Reserve System. The FDIC is the back-up supervisor for the remaining insured banks and thrifts.

The FDIC cannot declare a bank insolvent and order it closed. Banks generally are closed by their chartering authority—the state regulator, the Office of the Comptroller of the Currency, or the Office of Thrift Supervision. If a bank fails, the FDIC has several options for resolving institution failures. The option used most often is to sell the deposits and loans of the failed bank to another bank. Customers of the failed bank automatically become customers of the assuming bank.

The FDIC insures deposits, such as savings deposits, checking deposits, and certificates of deposit up to $100,000 per depositor. The FDIC offers an insurance guide on its Web site at www.fdic.gov to help depositors calculate the amount of coverage for their various accounts. FDIC-insured deposits are backed by the full faith and credit of the U.S. government. Overall, the FDIC insures more than $3 trillion of deposits in U.S. banks and thrifts.\textsuperscript{12}

Collateral

The purpose of collateralization is to reduce a local government's exposure to its bank's credit risk, by providing a government assets that it can take possession of in the event of bank failure. Properly structured, collateral offers the best insurance for governments dealing with financial institutions, since FDIC coverage is capped well below a typical government's daily deposit levels.\textsuperscript{13} Although collateral provides some peace of mind should a bank fail, it does not remove the anxiety and inconvenience associated with trying to manage financial affairs with a failed bank.\textsuperscript{14} Therefore, to err on the side of safety, a government should
use all of the risk prevention tools that are available to protect public deposits: FDIC insurance, credit evaluation of the bank’s financial condition, and collateral.

State statutes regarding collateralization vary widely. Most states have enacted statutes of some kind that either require or permit depositories to pledge collateral securities to secure public deposits. These protections are necessary to protect public funds in case of a bank failure or an economic crisis, such as a banking panic. Governments must be able to provide the necessary resources to maintain public order and to avoid jeopardizing the health and safety of the population in case of a financial crisis in the banking community.

Most collateralization statutes were enacted during the Depression when thousands of banks failed. As a result of the bank failures in the 1980s and early 1990s, many states reassessed their statutes and amended them to increase protection for public deposits. The merger mania that struck the banking industry in the mid-1990s has helped to strengthen the credit quality of many smaller institutions by making those banks part of a larger, diversified banking corporation.

There are three general types of collateralization statutes. These include:

- **Mandatory statewide collateralization.** States that have statutes establishing uniform collateralization require depositories to collateralize public deposits as a condition of doing business with local governments. These statutes typically outline what types of securities will be eligible as collateral and will often specify a ratio by which the value of the collateral must exceed the deposit.

  This type of statute is the most pervasive and often leaves the responsibility for enforcement and implementation to either the state or the local government. Unfortunately, if not administered properly, public deposits may not be fully protected because the market value of collateral used for pledging purposes may be less than face value. Local governments learned this lesson in 1982 when Penn Square Bank failed. Several municipalities received municipal bonds in lieu of their deposits. The prices of these se-
Bank Creditworthiness

Securities in the open market were considerably less than the amount of the deposits. Municipalities were forced to hold the low-interest, tax-exempt securities until maturity to avoid booking a loss. If the municipalities had been unable to hold these securities to maturity, they would have been forced to realize a true loss.

Some states such as North Carolina have a state office that is responsible for administering and supervising collateralization practices. This type of arrangement takes oversight responsibility from the local government office where there may not be sufficient resources or expertise to monitor the types and amounts of collateral.

- **Statutory permission on a voluntary basis.** Some states do not require collateralization but permit local governments to obtain collateral for their deposits. Under this type of system, local officials are responsible for obtaining and monitoring collateral securities. Lack of state guidance is a disadvantage because local officials must develop their own collateralization policies and procedures and may not fully understand how the process works. For example, local officials may accept inappropriate securities for collateral or may accept securities with a high degree of market risk at a collateralization ratio that fails to cover the market fluctuations of the security. Another disadvantage of this type of collateral system is the increased cost of collateralization. Typically, banks will pay a lower interest rate on deposits when they have to tie up collateral to secure those deposits.

- **Statewide collateral pools.** In some states (such as Florida), a state office is assigned responsibility for administering statewide collateralization. Instead of collateralizing public deposits 100 percent, banks pledge a fractional percentage of the public deposits they hold. For example, in Florida, banks must pledge 50 percent of their public deposits with the State Board of Administration. Typically, the state statute will authorize state officials to assess higher ratios for some banks under certain cir-
cumstances, such as new banks or a bank with a weakening financial condition.

There are two main advantages to a statewide collateral pool. One advantage is that responsibility for administering the program lies with state officials. Local officials can rely on the state's supervision of collateral and the state's legal powers. Another advantage is that by requiring fractional collateral, the bank's cost of collateralization is reduced while local governments still benefit from protection against individual bank failures.

**Collateralization Practices**

Generally, securities such as U.S. Treasury obligations, federal agency securities, government-sponsored enterprise obligations, and municipal bonds are pledged to protect public deposits. While eligible collateral is usually specified by the state statute, as mentioned, a local government may wish to allow only certain instruments in order to assure liquidity and marketability. When considering what type of securities to allow as collateral, a government should ask itself if it would hold that security in its portfolio and only accept collateral securities that it would be comfortable investing in directly. The bottom line is that if a bank fails, the collateral securities will become the property of the local government, and the local government must then sell those securities to be made whole for its deposits.

Because the risks associated with different instruments vary, a collateralization schedule should be incorporated into the local government's agreement with its bank. The schedule would identify the required market value of collateral held by a third party custodian, which would vary according to the type of instrument used as collateral. Many times these schedules are more restrictive than the state statute. GFOA's Committee on Cash Management has developed a schedule of sample collateralization ratios. These ratios are presented in Exhibit 8.2. At least monthly, the market value of collateral securities should be calculated and the collateral should be adjusted as needed. A government should receive a monthly statement from the bank holding the collateral securities
so it will know what collateral is being held and can monitor the market value of those collateral securities. All pledged collateral should be held at an independent third-party bank.

Having proper arrangements and sound written agreements in place will help to protect a local government’s deposits and ensure that the local government has a perfected security interest in the securities collateralizing the deposits in excess of the FDIC insurance. (A perfected security interest refers to an investor’s right to ownership of underlying investment instruments.) A written agreement will also help satisfy the Uniform Commercial Code (UCC) requirements for control. The UCC states that the depositor does not have a perfected interest in a security unless the depositor controls it. Control means swaps, sales, and transfers cannot occur without the depositor’s written approval.

Furthermore, a written agreement will protect the local government if its bank defaults. The local government will be recognized as the owner of the securities and can then liquidate those securities as a way to recover
Collateralization Process

How Collateralization Works

The flowchart below illustrates how collateralization and third-party safekeeping work. The government places deposits with its depository bank and enters into a security agreement that formalizes the public entity’s relationship with the bank. The depository bank transfers securities through the Federal Reserve System to a third-party bank that acts as custodian.

The depository bank and the custodial bank enter into a custodial trust agreement that ensures the securities held by the custodial bank show the government as the owner of those securities. The custodial bank will send the government a monthly statement listing the securities being held as collateral and reporting the market value of those securities.

its deposited funds. A government should periodically review the agreement to ensure that charges in case law or statutes have not weakened the agreement. Exhibit 8.3 illustrates how collateralization and third-party safekeeping work.

GFOA has developed a recommend practice concerning how governments should collateralize deposits. (Refer to Appendix C for the full text.) Among the key recommendations are for governments to:
Bank Creditworthiness

- Establish a written security agreement;
- Hold collateral at an independent third-party custodian; and
- Mark to market the collateral on at least a monthly basis.

The North Arkansas Medical Center Case

When collateralizing public deposits, government officials must follow certain procedures to ensure that they have a perfected security agreement with the depository bank and that the agreement complies with the federal statute, Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), that governs collateral security interests. This need for more protection was highlighted in 1992 in the case, North Arkansas Medical Center v. Barrett, 962 F.2d 780 (8th Cir. 1992). The following section describes the case and explains the FDIC’s position as a result of this case.

The North Arkansas Medical Center had almost $1 million in deposits with Guaranty Savings and Loan Association. Guaranty had pledged collateral to cover the portion of the funds that were in excess of FDIC insurance but subsequently sold the collateral without the knowledge of the medical center. After the fact, Guaranty obtained the medical center’s permission to release the original collateral and pledged substitute collateral which was held by a local third-party custodian.

Soon after, Guaranty was placed in receivership and the FDIC became the receiver. The medical center brought an action to recover its funds based on its collateralized security interest. The District Court dismissed the complaint, and the Court of Appeals for the Eighth Circuit affirmed that decision.

The court based its decision on the provisions in FIRREA, particularly U.S. Code Section 1823 (e), which specifies the requirements that must be satisfied if an asset acquired by the receiver of a failed institution is to be subject to the claims of a depositor based on a security agreement. Namely, a security agreement must meet the following requirements:
It is in writing;

It was executed by the depository institution and the entity making the claim contemporaneously with the acquisition of the asset;

It was approved by the board of directors or loan committee of the institution; and

It has been an official record of the institution continuously from the time of its execution.

The requirement that agreements be executed contemporaneously with the acquisition of collateral caused quite an outcry in the public sector. That requirement was lifted for public deposits by FDIC policy and the passage of the Riegle Community Development and Regulatory Improvement Act of 1994. Even in states that have a mandatory collateralization program administered by a state agency, a government must still execute and "perfect" security agreements with each of its banks.

GFOA's Committee on Cash Management recommends that security agreements:

- Establish funds to be collateralized;
- Specify eligible collateral securities;
- Outline collateralization ratios;
- Require marking collateral securities to market at least monthly;
- Specify safekeeping procedures;
- Address how substitution of collateral should be handled; and
- Require monthly statements from the custodial bank.

As part of the agreement, the bank should warranty that:

- It is the legal owner of the pledged collateral;
- The collateral is free and clear of liens and claims;
Bank Creditworthiness

- No other person has the right, title, or interest in the collateral securities; and
- The collateral has not been pledged or assigned for other purposes.

Without the federally required documentation, the FDIC could choose to challenge the collateralization agreements and the local government’s security interests in case of bank failures.

ENDNOTES

3. The Glass-Steagall Act has since been repealed and replaced by other legislation. A list of important banking legislation can be found on the FDIC’s Web site at www.fdic.gov or in Appendix A of this book.
10. Periodically, Congress debates whether to raise the $100,000 threshold. In the spring of 2003, the FDIC issued recommendations for strengthening the deposit insurance system and adopting a risk-based system for charging insurance premiums. The 108th U.S. House of Representatives passed H.R. 522 to reform the deposit insurance system, namely by increasing deposit insurance from $100,000 to $130,000 and by indexing the insurance limit beginning in 2005. The amount of deposit insurance has not been increased since 1980. In addition, the bill would double coverage for retirement accounts and increase public deposit insurance up to $2 million or to the deposit insurance limit plus 80 percent of the deposited amount—whichever is less. Increasing the amount of federal coverage for public deposits would help local governments and would provide greater flexibility in selecting banks. H.R. 522 would also merge the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) to provide for streamlined administration between banks and savings and
loans. At press time, the Senate had yet to address this measure. In general, the failure to act since 1980 reflects the federal government's interest in limiting its own financial liabilities, which only underscores the importance of collateralization.

13. Even a small government typically has deposits well in excess of $100,000.
14. In addition to inconvenience associated with a bank failure, any government assets on deposit would probably undergo a lengthy process to recover those assets.
The Evolving Structure of the Banking Industry

Clarence Lewis and Sonia Patel

This appendix describes the structure of the banking industry and its evolution over the past two and a half decades. First, legislative history of banking laws and regulations is presented. Second, the impact of mergers and acquisitions on the industrial structure of banking is reviewed. Third, deregulation and occasional addition of new regulations (re-regulation) is discussed. Finally, emerging issues—such as electronic banking services, privacy, and bankruptcy law—are described. Governments will continue to be affected indirectly by these changes that impact the ability of banks to serve their public-sector clients.

Major Legislation Since 1980

Not since the 1930s has there been a time of more legislative and regulatory ferment within the financial services industry than during the 1980s and 1990s. Congress passed several major laws, with regulatory change a byproduct of these newly enacted laws (see Exhibit A.1). The general legislative trends were to liberalize regulation of the banking industry and to meet pressing financial crises. Indeed, the laws passed after 1980 were primarily a reaction to crises in the banking and savings and loan industry, as well as a response to the changes that took place in the prior decades.
### Historical Overview of Banking Legislation

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<tr>
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<td>Community Reinvestment Act</td>
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<td>1980</td>
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<td></td>
<td>Depository Institutions Deregulation and Monetary Control Act</td>
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<td></td>
<td>Garn-St Germain Act</td>
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<td></td>
<td>Competitive Equality Banking Act</td>
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<td>1990</td>
<td>Expedited Funds Availability Act</td>
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<td></td>
<td>Federal Deposit Insurance Corp. Improvement Act</td>
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<tr>
<td></td>
<td>Riegle-Neal Interstate Banking and Branching Efficiency Act</td>
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<tr>
<td>2000</td>
<td>The Gramm-Leach-Bliley Act</td>
</tr>
</tbody>
</table>

*Source: Century of Change, Banking in the 1900s*

**Depositary Institutions Deregulation and Monetary Control Act (DIDMCA), 1980**

The backdrop to DIDMCA was the high and rising inflation of the 1970s, which raised market interest rates above the ceilings established in the 1930s. The DIDMCA phased out the ceiling on interest rates that banks could offer to their depositors, allowing them to be more competitive. This law was meant to deregulate banking and promote greater competition to benefit consumers.
DIDMCA also set out to tighten monetary control by establishing reserve requirements for all eligible financial institutions. (At the time, there was a perception that the Federal Reserve had lost some control over the money supply.) In addition, the Federal Deposit Insurance Corporation (FDIC) ceiling on insured deposits was raised from $40,000 to $100,000.

**Garn-St. Germain Act (GSGA), 1982**

The Garn-St. Germain Act was seen primarily as an attempt to rescue the thrift industry, which was in crisis due to earnings problems. The financial position of savings and loan institutions (also known as thrifts) deteriorated when interest rates rose in 1980, remaining persistently high. Rates did not decrease noticeably until the middle of 1982. As a result, the thrifts faced a damaging asset-liability mismatch, whereby they paid high interest rates to customers while receiving low interest rates from their loan portfolios.

GSGA enhanced the powers of the FDIC to assist troubled banks. Regulators were given authority to (a) grant loans to failing institutions, (b) make deposits in those institutions, (c) purchase their assets, (d) purchase securities they had issued, and (e) assume their liabilities. Another part of the legislation made changes to the rules on lending and borrowing by national lenders. Limits on loans to one borrower were increased from 10 percent of a bank’s capital to 15 percent, for unsecured loans. If additional loans were secured by readily marketable capital, the limit could be increased by another 10 percent. Finally, the Act removed restrictions on real estate lending by national banks. The Office of the Comptroller of the Currency (OCC) viewed these regulations as restricting the capacity of banks to react to changes in the real estate markets.

**Competitive Equality Banking Act (CEBA), 1987**

The purpose of CEBA was to provide aid to the Federal Savings and Loan Insurance Corporation (FSLIC). CEBA gave more than $10 billion towards re-capitalization of the fund and promoted stricter appraisal, re-
serve, accounting, and capital standards for the thrift industry. A one-year moratorium was set on bank power expansion by federal regulators. After that period, the Federal Reserve and OCC could allow banks access into new areas.

The Act also eradicated the future chartering of “nonbank banks” (financial institutions by definition that either accept demand deposits or make commercial loans but do not do both) by closing the loophole that allowed these institutions to escape Federal Reserve regulation. The last provision of CEBA encouraged the recovery of failing or failed banks by allowing them to become eligible for interstate acquisition. The powers of the FDIC were expanded, allowing it to create bridge banks to assist in acquisitions.

Federal Deposit Insurance Corporation Improvement Act (FDICIA), 1991

The passage of FDICIA arose from a climate of savings and loan (S&L) bailouts and the crisis in commercial banking. It was felt that the overall banking system did not act quickly enough to avoid such occurrences. The Act re-capitalized the federal government’s bank insurance fund, increased the amount the FDIC could borrow from the Treasury to cover insurance losses from $5 billion to $30 billion, and allowed the FDIC to borrow funds on a short-term basis for working capital.

Moreover, the regulatory agencies were given more authority to enforce capital standards and requirements were put into place to establish comprehensive standards for all parts of a bank’s business. On-site examinations were conducted on all insured institutions and regulators obtained authority to restrict activities of banks or close them entirely if they remained undercapitalized.

Riegle-Neal Interstate Banking and Branching Efficiency Act (1994)

The major change brought about by the Riegle-Neal Act was authorization of interstate banking and branching. Beginning in 1995, adequately capitalized and managed bank holding companies were allowed to acquire a bank in any state. Interstate mergers were allowed beginning in
1997. These provisions were subject to state laws and deposit concentration limits.

The provisions of this Act stemmed from policymakers' changing sentiments regarding financial concentration. The banking crises of the 1980s and early 1990s seemed to argue for geographic expansion. With expansion, it was believed that geographically diversified banks would not be tied to the economic well-being of a particular geographic region and, therefore, would have protection against regional economic downturns. A great amount of legislative and regulatory reform occurred between 1980 and 1994. The legislation provided new powers for banks while the banking regulatory agencies sought—and won—provisions making capital requirements more uniform. At the start of the 1980s, the dominant theme was deregulation of the financial services industry with passage of DIDMCA and Garn-St. Germain. As the S&L crisis intensified and the banking crisis progressed, however, the theme turned to re-regulation with passage of FDICIA. By 1994, as the banking industry returned to good health the environment for deregulation became more favorable and helped enable the passage of the Riegle-Neal Act.

**Graham-Leach-Bliley Act (GLBA), 1999**

GLBA represented landmark legislation that in some ways culminates the process of deregulation that has occurred over the past quarter-century. Signed into law in November 1999, the bill was born out of the need to repeal the Glass-Steagall Act of 1933 that separated commercial and investment banking, as well as the Bank Holding Company Act of 1956 that prohibited unions between banks and insurance companies. The intent of the Act was to allow banks, insurance companies, securities firms, and other financial institutions to affiliate under common ownership and offer their customers “one-stop shopping” previously prohibited by legislation. The primary objective of the GLBA was to deregulate financial institutions and achieve financial modernization.

To some extent, GLBA reflected the reality that the separations between commercial and investment banking had eroded. Indeed, deregulation was probably inevitable as evidenced by the court approval of the Traveler's (an insurance company) application to purchase Citicorp (a
commercial bank) prior to the passage of GLBA. As depicted by Exhibit A.2, the GLBA allowed bank holding companies (BHCs) and foreign banks to become financial holding companies (FHCs) that could engage in financial activities that include (a) securities underwriting and dealing, (b) insurance agency and underwriting activities, (c) merchant banking activities, and (d) other complementary financial and non-financial activities. The GLBA also authorizes national banks to directly underwrite, purchase, and deal in municipal revenue bonds.

An FHC is a multi-purpose financial institution that must be well capitalized, well managed, and have a Community Reinvestment Act (CRA) rating of satisfactory or better. The GLBA has far-reaching impli-
cations for BHCs and FHCs that are affected by the changes in the existing regulatory structure, CRA provisions, and consumer privacy issues.

The regulatory structure stemming from the passage of GLBA resulted in a compromise between the Fed and the OCC that gives the Fed oversight responsibility to supervise the organizations' consolidated risk management while providing the Treasury Department's Office of the Comptroller of the Currency functional/operational regulatory responsibility. The Securities and Exchange Commission (SEC) will continue to regulate securities activities and state governments will continue to oversee insurance carriers.

For FHCs seeking to expand and achieve certification, the GLBA provides a motivation to achieve at least a satisfactory rating with respect to the CRA. The Community Reinvestment Act of 1977 was enacted to eradicate redlining and to ensure investment in low- and moderate-income communities where banks and non-banks operate. The GLBA modified provisions (sunshine provision on grants and loans greater than $10,000 and $50,000, respectively, as well as required public disclosure of CRA-related expenditures) of the CRA.

Privacy issues were addressed in the GLBA in an effort to protect the consumer. Provisions in the GLBA provide customers of financial institutions an opportunity to opt out of the company selling or sharing personal information with non-affiliated companies. However, the GLBA stops short of preventing large conglomerate financial institutions like Citigroup from sharing information between affiliates. All financial institutions are required to disclose their privacy policies concerning the information-sharing agreements with other institutions, both at the time the customer relationship is established and annually. The GLBA requires financial institutions to notify all customers once a year of their privacy rights. States like California may pass stronger laws to protect the financial privacy of its citizens.

**USA Patriot Act (2001)**

Following the attacks on September 11, 2001, the U.S. government enacted the USA PATRIOT Act, which was signed into law the following month. The acronym means "Uniting and Strengthening America by
Providing Appropriate Tools Required to Intercept and Obstruct Terrorism.” The Act contains new anti-money laundering requirements and amendments to the current requirements of the Bank Secrecy Act. It requires financial institutions to:

- Adopt an effective anti-money laundering (AML) program;
- Effectively identify and verify the identity of customers;
- Exercise enhanced due diligence of international financial institutions; and
- Not conduct business with offshore shell banks.

The Bank Secrecy Act (BSA) was enacted to prevent banks and other financial service providers from being used as intermediaries to hide and/or transfer deposits of money derived from criminal activity. The BSA imposes criminal liability on individuals and institutions that knowingly or by willful blindness assisted or participated in money laundering or other violations of the BSA.

**Check Clearing for the 21st Century Act (Check 21), 2003**

This Act gives banks the opportunity to convert paper-based checks into electronic images of checks, making checking processing easier and faster. Although it will be sure to reduce the amount of float (the time needed for checks to be processed), it remains to be seen whether that will translate into benefits in the form of governments receiving expedited payments from customers. (Conversely, governments could lose disbursement float, meaning less time to earn investment income after a government issues a check.)

Check 21’s major change is to allow banks to use substitute checks to expedite the movement of checks through the U.S. payment system. Substitute checks (or what the Federal Reserve refers to as image replacement documents) allow for the elimination of the physical transport of paper checks. Essentially, a government issuing a paper-based check would have the check converted into an electronic image or digitized.
The electronic information would be transported through the payment process instead of the check document itself, and if necessary, the digital image could be reconstructed into the substitute check. Any government requesting the cashed check back would have to accept the regenerated substitute check. The substitute check would contain the same information as on the front and back of the original check, and would have the magnetic ink character recognition data found at the bottom of a typical check.

Traditionally, paper checks have a made a round trip, as shown in Exhibit A.3, from payor (e.g. the government issuing the check) to payee and back.

The new process will use a similar round trip involving less physical handling and transport, as shown in Exhibit A.4.

According to the Electronic Check Clearing House Organization (ECCHO), a consortium of banks supporting the legislation, by creating a substitute check the law creates a new legal instrument having four attributes:

- Legal equivalent of the original paper check;
- Can be processed exactly as if were the original paper check;
- Banks creating the substitute check must provide warranties and indemnifications to parties involved in the subsequent routing of the check; and
- Parties wanting to receive paper checks cannot refuse substitute checks.

As a result, banks, paying customers, depositing customers, consumers, the Federal Reserve, and others cannot refuse the new instrument.

Government treasurers may want to discuss the potential impact of these changes with their banking relationship managers. Questions to ask might include:

- What percentage of checks will be affected in first and second years of the law?
- What is the reduction in collection float?
- What is the reduction in disbursement float?
- Will it allow the government to push back the daily cut-off time for deposits?
- Can information on bounced checks be obtained sooner?
New Check Settlement Process Under Check 21

- How will substitute checks be reflected in online reporting or monthly statements from banks?
- Will the law support government initiatives to introduce check truncation?

Check 21 takes effect October 2004, one year after being signed into law.
Mergers and Acquisitions since 1980

Coinciding with the wave of legislation during the 1980s and 1990s was a wave of mergers and acquisitions. Roughly 8,000 mergers took place, totaling $2.4 trillion in acquired assets. Along with this merger activity came changes in the U.S. banking structure. Most of this activity was driven by the removal of intrastate and interstate barriers to banks' geographic expansion. This section summarizes a study on bank mergers and banking structure from 1980-1998 conducted by Stephen Rhoades, a Federal Reserve Board Governor.³

Mergers by State and Year

During the 1980-1998 period, the states with the most mergers were Texas (1,086) and Illinois (751). Stated in terms of dollar volume of acquired assets, California was the largest ($424 billion), Illinois was second ($180 billion), and New York was third ($177 billion). On an average annual basis, there were 437 mergers during the 1980s, compared to 403 for the 1990s (up to 1998).

There were 248 large mergers that took place during the 1980-1998 study period, most occurring in the latter years. These mergers involved institutions whereby the target bank and acquiring firm both had at least $1 billion in assets. Of the large mergers, 168 were considered interstate mergers. Exhibit A.5 outlines the number of large mergers that took place from 1980 through 1998.⁴

Mergers by Asset Size

In general, mergers were not limited to particular states or banks of a particular size. During the study period, 49 percent of the targets had assets of less than $50 million and 85 percent had assets of less than $200 million. This contrasts to acquiring firms, of which 50 percent had more than $1 billion in assets. As might be expected, acquired banks were fairly small while the acquiring banks were comparatively large.

However, the percentage of acquired banks with $100 million or less in assets decreased consistently throughout the study period, from 80 percent to roughly 54 percent. The average size of acquired banks
### Recent Merger Trends

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*Source: Federal Reserve Bulletin; Staff Study 174*

jumped five to ten times over this period. This shows the greater incidence of large bank mergers that took place in the 1990s, a situation most likely promoted by greater opportunities for interstate mergers and the anticipation of full nationwide banking.
Mergers by Type of Merger and Market

Horizontal mergers are those that combine banks operating primarily in the same markets. Market expansion mergers combine banks that operate in different geographic markets. Up until 1995, approximately 50 percent of mergers were horizontal mergers. This pattern began to change during 1995-98 when that figure dropped to 33 percent. The prevalence of market expansion mergers was due to the removal of restrictions on interstate banking and the apparent emphasis on expanding the scope of the banking franchise. It appears that once banks expanded the geographic scope of their business, the emphasis was then placed on increasing market share in the local banking markets.

The percent of acquired banks located in metropolitan statistical areas (MSAs) stayed constant at 58 percent over the study period. It seems that MSAs were more appealing to acquiring firms than the rural areas due to the prospect of better opportunities.

Mergers by Type of Acquirer

During 1980-98, roughly 64 percent of bank mergers were made by multi-bank holding companies, 27 percent by one-bank holding companies, and 9 percent by independent banks. These percentages held steady over this time frame. Multi-bank holding companies controlled about 30 percent of all banks and 75 percent of all banking assets.

Structural Effects on the Industry

The effects of mergers on the banking structure can be seen in various facets of the industry. As portrayed in Exhibit A.6, by the end of 1998 there were 8,697 banks, down from 14,381 in the early 1980s. The number of banks declined by about 400 to 500 annually over this time period. The number of banking offices, however, has surprisingly increased from 53,000 offices in 1980 to 71,000 in 1998. This demonstrates the importance of local market representation in maintaining competitiveness within a particular area.

The number of automated teller machines (ATMs) increased from 18,500 in 1980 to 187,000 in 1998. ATM transactions increased from 1 billion to 11.2 billion and the dollar value of such transactions grew from
The Evolving Structure of the Banking Industry

$49 billion to $762 billion over the same time frame. Since the number of offices increased at the same time, it can be said that ATMs were not a replacement for banking offices but more of a convenient tool for obtaining cash (and/or a complement to the local banking offices).

In the 25 largest banking organizations, the concentration of U.S. banking deposits increased over time from 29 percent in 1980 to 51 percent in 1998. The increase in aggregate banking concentration appears to be a competition concern only if the relative size of the biggest banks tends to affect competition in individual markets.

Measures of average local market concentration, based on commercial deposits and 50 percent of thrift deposits, show an increase, particularly for MSAs. (Thrift deposits are used in the calculation since this is the way regulatory decisions are made on bank merger applications.) This will most likely lead to an increasing number of MSA markets in which bank merger proposals could raise competition issues. Concentration increases in MSAs occurred in relatively unconcentrated markets, whereas decreases occurred in relatively highly concentrated markets.

The likelihood of mergers seems to be on course to continue in the future given the liberalization of laws of bank “branching” (holding constant the cycles in the stock market and economy). However, antitrust laws could become a constraint on mergers due to the rise in local market concentrations. Antitrust laws could make use of divestitures as an avenue to counter anticompetitive bank mergers.

The Impact of Deregulation

Since the 1930s, the banking industry has moved through periods of both deregulation and re-regulation, affected greatly by the state of the economy and other external factors unique to the time period observed. Banking regulation remained static from the late 1930s to the middle 1970s but made the biggest change from the 1970s to the 1990s, as seen in Exhibit A.1.

Deregulation in the banking industry has increased efficiency and brought about positive structural changes with respect to intrastate and interstate branching for banks. Subsequent to lifting regulatory con-
straints, customer assets have migrated to the most efficiently run banks. Moreover, deregulation has forced banks, insurance companies, investment banking companies, and other financial intermediaries to compete for business, which has led to a more competitive industry and arguably stronger economic growth. Prior to deregulation, banks were limited or prohibited from establishing branches, which created an oversupply of independent banks. The consolidation and integration across state lines has led to a decline in the market share of smaller banks.

Empirical evidence suggests that financial market development can play an important causal role in driving long-run growth of an economy. For example, an analysis by King and Levine\textsuperscript{5} demonstrated that the size and depth of the economy's financial system is positively correlated with its future growth in per capita real income. Levine, Loayza, and Beck\textsuperscript{6} show that the external component of banking development is positively related to growth performance. More recent theories show a positive correlation between financial market efficiency and economic growth. To
support the view that financial market efficiency can spur faster economic growth, data from 1972 to 1992 was used to show that annual growth rates in per capita state-level personal income accelerated 0.50 percent to 1.00 percent of GDP after deregulation.

Many economists emphasize the importance of financial markets supporting start-ups and young firms as a key channel through which financial firms can affect long-run growth. Deregulation has had a positive effect on entrepreneurs from the standpoint that young firms entering the financial markets are much more dependent on banks to support them financially until they generate enough cash flow to sustain themselves. Healthy competition and increased efficiency derived from deregulation has naturally increased the financial options available to the entrepreneur. If the number of business incorporations is used as a proxy for business formations, both the level and growth of entrepreneurial activity increased following deregulation.

In addition, there is some evidence that supports the theory that deregulation has increased regional stability in the business cycle. Interstate banking was the driving force behind the banking system becoming integrated nationally. Prior to deregulation, the banking system was fragmented into 50 banking systems located in 50 states. After interstate deregulation, multinational banks or holding companies owned 60 percent of a state’s banking assets. The equilibrium rate of investment in the economy depends on the level of bank capital and firm collateral. Shocks to either variable can cause a direct contractionary effect because it leads to a reduction in the availability of capital that can be invested in the firm by the bank and also a reduction in the firm’s investment spending, respectively. After banking industry integration, however, the effect of a bank capital shock is diminished because bank capital can flow from other states that did not experience a shock. (Of course, the effect of a firm collateral squeeze can be amplified because banks in the affected state can shift their lending across state lines to firms with better collateral.)
Issues on the Horizon

In the future, financial institutions will likely become larger and more complex as they create new and innovative products to meet the needs and objectives of the market place. For example, means of executing electronic payments — using smart cards, stored value cards, electronic benefit transfer, and e-billing — are beginning to gain traction. These innovative products are redefining the retail payment infrastructure and changing how consumers transact business and utilize data/stored information. Other issues on the horizon include changes to privacy law and bankruptcy regulation.

It is estimated that in the last four years, over 21 million smart cards have been put into circulation. The smart card technology provides the consumer with a single card that functions via an encrypted chip that can store, program, and access data as well as facilitate chip-based credit/debit, Internet access, e-ticketing, e-couponing, e-signatures, authentication, stored value, secure e-commerce and physical point-of-sale purchases, rewards, and services. The multi-functionality should provide financial institutions with new account acquisition, higher customer retention, and increased usage.

The next trend should be a steady increase in smart card devices at retail and merchant locations that allow consumers to realize the benefits of the smart card technology. Currently there are competing technologies and different platforms for smart cards. The need exists to develop standards that allow the consumer to use one card and card reader for multiple applications and multiple retailers.

The banking industry is by nature fee income driven and consequently e-billing was not initially provided as a free service. Utility, credit card, and retail companies got a head start by offering e-billing services for free or teaming up with third parties. Financial institutions are now looking at e-billing as a customer relationship strategy that leads to customer acquisition and strong customer retention. E-billing represents a huge market opportunity for banks to open new markets and be the natural consolidators of electronic bill presentment and payment (EBPP) for consumers and businesses that are comfortable online and relish the opportunity to save time and money. The ability to offer customers a single,
The Evolving Structure of the Banking Industry

flexible, user-friendly location to pay all of their bills instead of paying bills at multiple Web sites is a distinct advantage to financial institutions that have a captive audience. While the convenience and time-saving advantages to consumers are obvious, the advantages to businesses include automating the reconciliation process, receiving payments sooner, and much quicker receivable turnover.

When it comes to smart cards and e-billing, the implications for the banking industry are tremendous in the areas of reducing float, paper transactions, physical checks, transaction time, and costs. Increased usage has the potential to reduce brick and mortar as well as labor costs associated with the more traditional methodology of banking. The following markets will be key drivers for implementation and application of the technology and infrastructure needed for smart cards: government, Internet commerce, general retail, mobile commerce, transit, and college and business campuses.

Privacy laws will be one of the most complex and difficult issues to deal with in the near future. Financial intermediaries agree that a single national standard is needed for sharing a consumer's financial information. A balance must be struck between preserving the constitutional rights provided by the First Amendment and stronger consumer privacy laws that protect the consumer from the harmful use of their financial information. Consumers are increasingly experiencing millions of dollars of unauthorized charges on bank, credit card, mortgage, and other accounts due, in part, to financial institutions sharing financial data that end up in the wrong hands.

The debate over opt-out versus opt-in rules presents challenges for both the consumer and the financial institutions. Under opt-in, the financial institution must get the consumer's permission to share a consumer's financial information. The financial intermediaries argue that opt-in places an undue burden on the cost of the institution obtaining permission each time a new use for the information arises. Under opt-out, the financial institution may share a consumer's financial information unless he or she opts out. Not surprisingly, bankers prefer opt-out rules, which continue to let banks share data unless the customer forbids it. The challenge looming—whether it be opt-out or opt-in—is
the fact that over 90 percent of consumers who are presented with privacy notices chose neither option. It is clear that communication to the consumer must be more clear, concise, and simple.

Bankruptcy reform is also a top priority. During the early 2000s, personal bankruptcy filings exceeded 1.5 million annually, a historically high figure. At the time of writing, federal legislation proposed to make it more difficult for consumers to discharge debt. The bill would cause debtors to reorganize through Chapter 13 instead of Chapter 7 liquidation if the debtor had sufficient income to repay at least 25 percent of the debt over a five-year period or at least had the median income for his or her state. Clearly, this would direct more debtors into payment plans instead of extinguishing their debt.

Whether bankruptcy reform will reduce the number of bankruptcies is unclear, however. The reform will have its greatest impact on those who file bankruptcy to avoid foreclosure on their home and/or paying unsecured debt and those who are in lower-income brackets or who are victims of crimes. An important question that needs to be asked regarding reform is whether issuers underwriting standards are appropriate for the credit risk taken.

Sources


Early History and Developments of Banks and Branching Regulation.


Lence, Sergio H. "Recent Changes in the Structure of the Banking Industry: Causes, Effects, and Topics for Research." *Dept. of Economics, Iowa State University.*


Smart Cards and the Retail Payments Infrastructure: Status, Drivers, and Directions. A Smart Card Alliance White Paper. [October 2002].


ENDNOTES


2. Money laundering is the process of introducing the proceeds of crime into a legitimate stream of financial commerce by masking its origin. The first phase is placement, which is the process of placing (through deposits, wire transfers, or other means) unlawful cash proceeds into financial institutions. The second phase, layering, is the process of separating the proceeds of criminal activity from their origin through the use of layers of complex financial transactions. The third phase, integration, is the process of using an apparently legitimate transaction to disguise the illicit proceeds, allowing the laundered funds to flow back to the criminal.


4. During the period of the Fed study, the largest merger was the NationsBank - BankAmerica merger in 1998 with the combined firm controlling over 10 percent of domestic U.S. bank assets. The largest bank mergers and consolidations of the 1990s include:
   • Citicorp merges with Travelers;
The Evolving Structure of the Banking Industry

• Chase Manhattan acquires Chemical Bank;
• Chase acquires J.P. Morgan;
• Mellon acquires Dreyfus;
• Nations Bank acquires Bank of America;
• Bank of New York acquires Irving Bank Corp.;
• Fleet Financial Group acquires BankBoston;
• Bank One acquires First USA; and
• Southern National acquires BB&T Financial.


Case Study of Joint Procurement

Perry James

In an environment of constrained resources, governments must take advantage of cost saving opportunities wherever possible. Many governments have banded together to achieve savings, adopting such strategies as merging city and county services, sharing facilities, and combining buying power in joint purchasing bids. There is nothing particularly unique about the cooperative procurement of products such as asphalt, road salt, furniture, office supplies, and vehicles. For years, governments have known that they could obtain better pricing and service from vendors by aggregating volumes.

However, this model has rarely been applied to the procurement of banking services. Many governments assume that the sheer number of providers, the disparate needs of governments, and the nuances of paying for banking services make such a procurement unfeasible. While these factors certainly add a layer of complexity, they are not insurmountable. This case study describes how three North Carolina governments overcame these obstacles and successfully lowered their banking costs by jointly procuring banking services.

The Evolution of an Idea

Sharing many of the same core issues and challenges, as well as the common goal of efficient government, the City of Raleigh, the Town of Cary, and Wake County have long enjoyed a good working relationship. The governments readily share information with one another, and finance personnel regularly discuss ways to collaborate on fiscal matters. Several
years ago, the finance officers noticed that these discussions increasingly turned to the subject of banking services.

As it turned out, all three governments used the same bank (Wachovia Bank). While there were differences in the types of banking services required by each government, many of the needs were the same or very similar. These included the processing of transactions through central checking and payroll accounts, the use of lockbox and purchasing card services, ACH transactions, and the safekeeping of assets. As we delved into the matter in greater detail, we discovered that our respective jurisdictions shared two overriding needs: (1) to moderate ongoing fee increases that were not always consistent with the experiences of the other units and (2) to obtain state-of-the-art technological solutions for our rapidly evolving business needs.

As these discussions evolved, the idea of collaboratively procuring banking services became more and more appealing. All three governments were looking for ways to contain the costs of banking services, and the expansion of e-commerce and e-government were creating new opportunities and challenges in this area. If ever there were a time to alter the nature of municipal banking relationships, this seemed to be it. Still, two fundamental questions remained about the viability of a collaborative banking services agreement. First, would combining service needs and business volume result in better services at lower costs for each unit of government? And if so, how would the governments go about soliciting proposals on a joint basis?

Raleigh, Cary, and Wake County appointed a project team consisting of finance personnel from each unit to study the viability of a collaborative banking services contract. This team soon identified a number of important issues that would need to be resolved before the three governments could begin developing a request for proposals (RFP).

- **What effect**—either positive or negative—**would the different financial characteristics of each government have on a combined contract?** For example, county revenue streams are primarily large-dollar, seasonal tax receipts, whereas cities receive many small-dollar, regular payments for utilities and other services.
Case Study of Joint Procurement

- Would it be beneficial to combine under one RFP the core banking services of each unit, as well as the newer services that can be priced at a premium? There was a concern that banks might adjust the core services fees upward to make newer services more appealing.

- Should the contract combine all of the banking services under one financial institution or would it make sense to have separate contracts with multiple banks for different services?

- Would each of the three participating units be bound by the results of the joint procurement, even if some services were priced higher than the same services under existing agreements?

- Given the differences in service levels among the participating governments, would it be possible to obtain an “apples to apples” pricing comparison?

- Would it be advantageous to share contract savings with other governments in the county?

As with any new initiative, answering these kinds of questions requires much discussion, analysis, and inquiry. The localities benefited tremendously from the expertise of the University of North Carolina’s Institute of Government, which facilitated a series of meetings designed to achieve a common understanding of the issues among the three governments and a consensus on how to proceed. At first, the governments struggled to understand one another’s existing banking agreements. Over time, however, the issues became clearer and the group eventually achieved consensus in terms of its expectations for potential providers.

When the project team first involved banking institutions in its discussions about joint contracting, there were more questions than answers. The banks used different terminologies, packaged and priced their services differently, and offered different services. Nevertheless, one fact was clear—all of the banks were interested in pursuing the combined business of the three units and viewed such an arrangement as an attractive alternative to the status quo. Based on the positive feedback from the
banks and a consensus opinion that a collaborative procurement would indeed result in cost savings and enhanced service, the project team decided to press forward, settling on the following approach to collaborative banking:

- Banking services would be divided into five separate service areas in the RFP—each to be bid separately, with the possibility of selecting a different bank for each service area.
- All three jurisdictions would commit to use the bank selected for each service area; however, each unit would contract with that bank and could choose not to utilize certain services.
- Each of the three governments would adjust the terms of existing banking contracts to concurrently begin a new three-year term, with the possibility of two three-year term renewals.
- Proposing banks would be required to provide the same level of service and pricing to any other local government jurisdiction in the county.

**RFP Development**

The next step in the collaborative procurement effort was to develop and issue an RFP based on the approach outlined above. Each of the participating governments had previous experience procuring banking services for themselves, so they understood the importance of a well-organized, thorough, user-friendly RFP document. To facilitate the drafting of the joint RFP, the project team gathered previous banking services RFPs from each of the three governments and sought sample RFPs from professional associations.

Exhibit B.1 shows the table of contents from the joint RFP document. The final 73-page RFP included three sections: a general section containing important introductory information about the bidding process, an RFP section outlining the five service areas for which separate
Request for Proposals:  
Table of Contents

Individual Request for Proposals (RFP's) have been developed for the five services listed below. Separate responses are required, however institutions are not required to respond to all RFP's.

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proposals were sought, and an attachment section providing the cost form and other important information.

The general section of the RFP included certain mandatory requirements that all proposing banks had to meet in order for their proposals to be considered. Banks were required to be FDIC-insured, registered online with the Federal Reserve for funds and securities, and in compliance with all general and mandatory requirements specified for each RFP on which it bid.
The five service areas in the RFP (core banking services, disbursement processing, wholesale lockbox service, retail lockbox service, and purchasing card services) corresponded with the banking services that the units were already using. The purpose of separating services in this manner was to enable the governments to take advantage of the strengths of individual institutions. While particularly interested in recommending a central banking institution for core services, the project team also wanted to ensure that it obtained the best possible pricing and service for the custom services. As such, the project team spent a great deal of time crafting the language used to describe how these services should operate and what the governments expected of providers. For this purpose, the project team relied on its own understanding, information gained from area banks, and sample RFPs.

One of the most involved pieces of the RFP was the cost schedule that each proposing bank was required to complete based on the expected transaction and volume levels specified by the project team. To facilitate the submission of cost proposals and the evaluation of these proposals, the project team provided a spreadsheet template as Attachment 1 to the RFP (see Exhibit B.2). Proposing banks were required to seal the completed template (both a printed copy and the spreadsheet file on disk) in a separate envelope, which allowed the project team to separate its evaluation of service cost from its evaluation of service quality. The cost proposal template included all five service areas.

The other attachments to the RFP included details on the operations of each unit, a list of the current providers of banking services, a terminology section, technical specifications, and a sample check for disbursement processing. The intent in providing this information was to anticipate what each proposing bank needed to be able to submit a proposal that could be accurately compared to the other proposals.

**Evaluation and Selection**

Given the depth of the proposals anticipated from interested banks, the project team understood the importance of having an organized method of evaluating the proposals before they were due. The project team orga-
## EXHIBIT B.2

### Cost Proposal Template (Excerpt)

Volumes were averaged or estimated from the bank analysis statements. Certain volumes may not be represented since many services are offered in packages. Unlisted or zero volume may not indicate transactions did not occur.

All volumes are monthly except those 1-time implementation & setup fees which are denoted by an "**". Some services will not have volumes.

**VOLUMES ARE SUBJECT TO CHANGE**

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<td>PAID ITEMS-TAPE - PER ITEM</td>
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*continued*
## Cost Proposal Template (Excerpt)

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continued
### Cost Proposal Template (Excerpt)

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**Note:** Encoded checks are those having the dollar amount of the transaction encoded on the MICR line. Banks assess a lower cost for checks that are encoded prior to deposit. "On us" checks involve transaction in which the payee and payor use the same bank.
organized a pre-bid conference to allow banks to ask questions and to explain the objectives of the joint procurement effort. During this conference, the evaluation criteria to be used in selecting providers were communicated to the banks. These criteria included the following:

- Extent to which proposal requirements and conditions are met;
- Level of financial stability;
- Prior experience in similar settings;
- Technological capabilities and plans for continued advancement;
- Ability to be responsive on an ongoing basis;
- Ability to meet each jurisdiction’s goals, objectives, and mandatory service requirements;
- Strength of references;
- Ability to efficiently transition from current service provider, if necessary;
- Cost; and
- Willingness to provide the same level of services and pricing to other units of government within the county.

Ultimately, three national banks with a local presence in the area submitted proposals. For the purpose of evaluation, the proposals were divided among the three participating governments. Project team members representing each government were assigned specific banks and asked to become experts on their core services proposals. Non-core services were split along subject lines and assigned to the three units. For example, Wake County studied all of the issues surrounding disbursement outsourcing. Wake County and the City of Raleigh teamed up to review the lockbox proposals. Once they had finished reviewing their assigned banks and services, the three governments reported back to the full evaluation team.

The most challenging aspect of evaluating banking services proposals is comparing the costs of individual services. This involved a tremendous
amount of research and analysis, including breaking down package pricing into per unit charges. While the project team believed that allowing banks a certain degree of latitude in proposing packages of services would result in more creative and cost-effective solutions, it was still necessary in some cases to break out the detail in order to compare the costs that would be incurred in a collaborative contract.

While cost was certainly the most objective—and perhaps the most important—criterion, it was only one factor in the ultimate decision. All three governments placed great emphasis on the technological capabilities of potential providers. Other factors that received close scrutiny included the ease of integrating the bank’s systems, the cost of changing banks, and past experience.

In the end, Raleigh, Cary, and Wake County reached a consensus decision to select one bank (Wachovia Bank) for core banking services, disbursement outsourcing, and purchasing cards and a second (First Union Bank) for all lockbox services. The governing bodies of the three jurisdictions each approved the three-year contract term, reserving the option of renewing the contract for two additional three-year terms.

**The Impact on Cost and Service**

Under the original agreement, the three jurisdictions anticipated collective savings of $150,000 over the contract term. While the actual savings for each unit of government have varied, all three have experienced equal or lower banking costs on the baseline number of transactions than they had been paying under their individual agreements with Wachovia Bank. The latest projection shows that the governments will not only realize the anticipated savings of $150,000, but they will also see additional gains of approximately $50,000 from higher-than-anticipated service volumes.

Raleigh, Cary, and Wake County recently negotiated a “hold the line” fee level on banking fees with the now merged Wachovia/First Union Bank ("Wachovia") for another three-year period beginning in 2004. In so doing, we also ensured that new initiatives in e-commerce and enhancements to existing banking programs will be made available to us. The countywide school district signed on to the contract for the next
term, further increasing aggregate volumes. With this negotiation, the
governments have assured themselves quality services and lower costs
over what will be a nine-year period of operations.

As the collaborative banking arrangement moves into its second
three-year term, several other Wake County municipalities and the Wake
County School System have signed on. While their primary motivation
was cost savings, they are beginning to see that the benefits of the joint
contract extend to service quality as well. The collective business volume
of the participating governments has increased their strategic importance
to the bank, which has resulted in ready access to banking officials and
new business opportunities. New services include EDI strategies, “no
cost” banking services for government employees, and integrated payable
systems.

**Lessons Learned**

After the bank contracts were approved, the project team took time to re-
fect on the things that had worked and the lessons that had been learned
during the various phases of the joint procurement process. These are
summarized below for the benefit of governments considering ways to
lower their banking services costs.

**Planning and Preparation**

As with any important project, planning and preparation played a vital
role in the success of the collaborative procurement of banking services.
The most critical decision in the planning stage is to choose the right peo-
ple for the project team. Members of the project team should be repre-
sentative of the participating governments, knowledgeable about banking
services, and committed to improvement. Another important consider-
ation is the project timeline. Governments should allocate enough time
to complete required tasks and should meet important milestones, start-
ing with the requests for information from the banking community
through the selection of a provider. Finally, governments should make
use of any existing resources dealing with the procurement of banking
services, such as Government Finance Officers Association publications, sample RFPs, previous proposals, and so forth.

**RFP Development**

Given the complexity of the banking services being sought, it is critical that the responses to the RFP are such that they can be readily compared to one another. To this end, governments should provide specific instructions directing bidders on how respond to both qualitative measures and pricing configurations. A pre-bid conference is a particularly effective forum for clarifying these instructions and for ensuring that all bidders have the same information. Dividing needed services into five categories and allowing banks to bid separately on one or more of these categories optimizes the pool of bidders and facilitates the evaluation process.

**Evaluation**

Looking back, the project team agreed that the decision to divide the proposals among the three units for the purpose of evaluation was a good one. Instead of overwhelming the project team with all of the proposals at once, the members became experts in the proposals assigned to them. The end result was a more thorough analysis and thus a better understanding of each of the proposals. And despite the fact that the project members had focused on specific banks and services, they were able to separate themselves from their analysis and reach consensus on the best provider for each service area.

One particularly nettlesome issue was the cost associated with switching from the existing bank to another provider. The project team realized early on that the cost of change could neither be ignored nor overemphasized. While these costs are certainly relevant to the decision, the team knew that if they were made an overriding factor, they could stifle change and bias the integrity of the selection process. The selection team estimated the cost of changing banks and divided this amount over the three-year contract term to arrive at the differential cost. This did not factor into the ultimate decision, since the proposals of the existing bank-
ing services providers were well below what each government had been getting on their own.

Board Approval

The process did not end with the project team’s selection of providers. The three governments agreed from the project’s inception that the project team’s recommendations would be subject to the approval of each unit’s governing body. Given each government’s unique administrative and legal procedures, the project team found this approval process to be an effective way to move the process into final contract form with minimum difficulty and bureaucracy. It was at this point that the project team communicated its decision to the bidding financial institutions, as well as to the other local governments in the county that could potentially sign on to the agreement.

Conclusion

It is not unusual for two or more governments to combine their buying power in order to obtain volume discounts on a variety of products. However, few governments have considered the application of the cooperative purchasing model to banking services. This appendix describes how three governments in North Carolina overcame the complexities of such a venture and successfully negotiated a joint banking services contract that has resulted in lower costs and better services. In the process, the governments established a working relationship that emphasizes common benefits to area citizens over individual gain.
GFOA Recommended Practice
Acceptance of Credit Cards (1999 and 2002)

**Background.** In the last two decades, credit card acceptance as a payment method via nationally recognized credit cards has become virtually universal within the private sector. Such cards are now accepted at a point of sale (POS) for even the smallest transaction. There are advantages and disadvantages to accepting credit card payments which governmental entities need to weigh when deciding whether to accept payments by credit cards.

**Recommendation.** The Government Finance Officers Association (GFOA) recommends that, subject to state and local law and regulation, governmental entities evaluate whether acceptance of credit cards as a payment option is reasonable and appropriate for the type of charge or fee being paid and the customer service level desired. The evaluation should consider the following:

1. Merchant discount fees. The costs charged by the credit card issuer per transaction typically vary between one and three percent of the value of the transaction. Governmental entities should negotiate the lowest possible fee to minimize the financial impact to the government or to the consumer, whichever party will ultimately pay the fee. When negotiating fees, consolidate all potential users to get the best price. With adequate controls in place, discount fees may be recovered by using a third party to process the payment.

2. Type of payment. Governments should consider whether they want to utilize credit cards for mandatory charges for which citi-
zens must pay (such as taxes, utility bills), or for discretionary charges which citizens elect to pay (such as recreation fees, performing arts admissions). Acceptance of credit cards as a method of payment for mandatory charges may not significantly increase the amount of revenue received by the government, and may actually reduce net expected revenues as a result of paying the merchant discount fee. Acceptance of credit cards as a method of payment for discretionary charges and absorption or payment of the related merchant discount fees may facilitate collection of such charges. The volume of Internet transactions may increase as a result of the acceptance of credit cards.

3. Administrative costs. The costs of equipment and the associated personnel necessary to process credit card transactions.

4. Benefits to government may include:

- Increased certainty of collection;
- Reduced return check processing costs;
- Accelerated payments and the availability of funds;
- Improved audit trail;
- Reduced cashiering costs; and
- Enhanced customer convenience.

5. Government entities should weigh the cost of paying the credit card fee versus the cost of processing cash, checks and checks returned for insufficient funds.

6. Third-party processors, such as commercial automated services capable of processing credit card transactions seven days per week, 24 hours per day, should be considered as part of the evaluation because they may prove to be essential in recovering discount fees. GFOA further recommends that a credit card acceptance agreement be made as a bank services agreement administered by the public official in charge of the treasury function.
References


Approved by the Committee on Cash Management, June 15, 2002.
Approved by the Executive Board, October 25, 2002.

**GFOA Recommended Practice**

**Revenue Policy: Cash Receipts Controls (2003)**

**Background.** To ensure strong financial management practices, the proper controls over revenues are imperative in determining budget, forecasting, reconciliations and general oversight over the various revenues collected. As part of performing governmental services, management must provide for appropriate mechanisms, automated and manual, to collect all funds for services performed and ensure that proper controls exist over all receipts.

**Recommendation.** This recommended practice advocates for the inclusion of cash receipts controls and policy statements as part of a revenue policy. When formulating cash receipts controls and policy statements, it is imperative that such controls abide by authoritative standards and practices as they pertain to Governmental Accounting Standards Board (GASB) pronouncements and state laws, as there may be some variability amongst states in applying parameters for management discretion regarding delinquent penalties and related financial management decision-making. The following factors, as applicable, should be considered in the development of cash receipts controls in a revenue policy:

- Internal Controls: All aspects of cash receipts shall be subject to proper internal controls with standard controls documented and followed by revenue generating departments:
  — Segregation of duties – authorization, recordation, custodian functions, and reconciliation.
— Daily processing – daily cash/collection total reconciled to subsequent deposit.
— Timely depositing of funds received – For those governmental entities that have centralized cash collection points with direct supervision by treasury management, daily processing procedures should be developed and adhered to including daily deposit to financial institutions.
— For those governmental entities that may have decentralized cash collection points (remote sites from the primary treasury function), then appropriate procedures should be established that address the timeliness of when such remote collections are deposited either directly to a financial institution and/or through the centralized treasury management function that would include both a dollar threshold (e.g., point when cash/checks collected exceeds a certain dollar threshold) and/or time threshold (e.g., all collections should be deposited within a certain amount of days from receipt).
— Reconciliation to the general ledger and other supporting accounting ledgers shall be performed in a timely manner.
— Physical security procedures during work hours and non-working hours for all funds received and change drawers maintained.
— Automated system resources should be utilized where practical to provide better processing and reconciliation support as well as providing a more efficient and effective manner to manage receipts.
— Overpayments – Overpayments shall not be accepted when the intention is to provide a cash refund back to the customer. For other instances of overpayments, the standard practice would be to apply such overpayment as a credit to next bill, with any exception to this standard practice noted in departmental procedures.
— Use of lockbox processing will be considered when the benefits of such processing exceed the costs for such services or if
internal controls substantially enhance mitigating potential risks.

- Upon any suspicion of fraud, the departmental supervisor would timely notify the appropriate personnel (e.g., internal audit, law enforcement) for further investigation.

- If there is any suspicion regarding non-compliance of internal control directives, the departmental supervisor will notify the appropriate personnel (e.g., internal audit) for further review.

- Depositing of Received Funds for Services

  - An established treasury management division should serve as the primary recipient of all monetary payments via cash, check, wire transfer and credit card, unless there are established guidelines for a revenue process for which the treasury management division does not serve as the primary recipient.

  - Remote cash and check collection points should be established where appropriate customer service benefits are evident. Documented internal controls need to be established with such collection points. The ultimate remittance or deposit of such collection receipts should be documented and systematically performed by the applicable officials.

  - Non-remote collection site departments are encouraged to direct all receipts to the centralized treasury function and utilize information provided by the cash receipt and general ledger system in determining the propriety and reasonableness of such revenue transactions relative to departmental function.

- Returned Checks – Unless otherwise stated per ordinance or resolution, all checks returned due to insufficient funds in the customer’s account should be processed by the treasury division in conjunction with departmental assistance, as appropriate, and fees shall be charged for the returned check in conjunction with the treasury division established practices. This process should include processing the check at least twice through the entity’s financial institution.
• Billing Practices – Unless otherwise stated per ordinance or resolution, all initiated bills should have established terms (e.g., 30 days from bill date) and all bills should be generated within an established time after initial service provision (e.g., within 45 days).

• Escrowed Funds – For those funds received in advance of revenue recognition criteria or for which such funds are anticipated to be remitted back to payee in relief of meeting performance guarantee, such funds should be deposited into an escrow account or trust fund if held by the entity. Escrowed funds should only accrue interest back to an individual account if explicitly stated in the escrow agreement. Otherwise such escrow funds will accrue interest to General Fund or other applicable fund(s). Upon the government meeting the criteria for revenue recognition, such escrowed funds will be timely transferred and recognized as revenue in the applicable fund. For those performance guarantee escrows, such funds should be returned back to the payee upon compliance or retained in meeting established procedures for use of such funds.

• Budgetary Review Responsibilities – Revenue initiating departments should have oversight in the formulation of budgeting applicable revenues from a forecasting perspective. Such revenue estimates should be supported by variables (base, rate, etc.) that comprise such revenue. Monitoring of revenue budget should be performed in a timely manner throughout the fiscal year and should include an analysis of actual vs. budgeted variances. Continued compliance of revenue with all laws and/or regulations should be primarily the responsibility of the revenue initiating department.

References

• Adoption of Financial Policies, Recommended Practices for State and Local Governments, GFOA.

Approved by the GFOA's Executive Board, October 17, 2003.
GFOA Recommended Practice
Check Fraud Protection (1999 and 2003)

Background. Despite the increase in use of electronic payments, reports of check fraud also are increasing. Technological advances in computer hardware, software, scanners, Magnetic Ink Character Recognition (MICR) equipped printers, and photocopiers make it increasingly possible to produce fraudulent checks. The Uniform Commercial Code shifts liability for fraudulent items from banks to government and corporate account holders, if an entity has not taken reasonable steps to protect against losses.

Recommendation. The Government Finance Officers Association (GFOA) recommends that governments consider the following steps to protect themselves against check fraud.

- Make use of check stock with security features such as watermarks, “void” pantograph (which displays the word “void” when the check is photocopied), microprinting, laid lines and other backgrounds with multiple patterns or colors, special ink that can be read under ultra violet light, and chemical coatings that react to attempts at alteration.

- Test check stock to validate security features.

- Secure check stock daily. Remove continuous forms from printer, lock printer, and secure check stock in a locked environment.

- Ensure that there is appropriate security over signature plates, cards, and software.

- Require two signatures on checks over a specified amount.

- Update signature cards routinely and/or when staff changes.

- Reconcile all bank statements and notify banks of discrepancies on a timely basis.

- Provide for physical security of returned checks and check copies or digital images.
BANKING SERVICES

- Ensure proper segregation of duties among staff initiating, authorizing, preparing, signing, and mailing payments and reconciling bank statements.

- Conduct periodic and surprise audits or reviews of procedures.

- Set dollar limits for individual checks, particularly on smaller accounts.

- Make use of "positive pay" services provided by banks, through which banks pay only those items that match a check issue file provided to the bank.

- Provide written instructions to local banks regarding the honoring or returning of checks.

- Make use of electronic check presentment (ECP) with the disbursement bank, if available.

- Consider outsourcing the payment process.

- Promote use of Electronic Funds Transfer (EFT).

References


Recommended for Approval by the Committee on Cash Management, January 23, 2003.

Approved by the Executive Board, February 28, 2003.

GFOA Recommended Practice


**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 surety bonds by deposi-
tories is an important safeguard for such deposits. State programs pertaining to the collateralization of public deposits have generally proven to be beneficial for both the public sector and its depositories. However, 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 be able to avoid 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) favors the use of pledging requirements as protection for state or local government’s deposits. GFOA further favors and 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 an effective statewide collateralization program, local officials should establish and implement collateralization procedures.

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 statute requires 110 percent), the margin levels should be at least 102 percent, depending on the volatility of the collateral pledged.

• 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. The use of surety bonds and other appropriate types of insurance in lieu of collateral could be reviewed as an alternative to collateralization. If a public entity agrees to the use of surety bonds and other types of insurance in lieu of collateral, only insurers of the highest credit quality as determined by a nationally recognized insurance rating agency should be used.

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 require-
ment 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). Because of this change, the bullet item "was executed by the depository institution and any person claiming an adverse interest, contemporaneously with the acquisition of the asset by the depository institution" that appeared in previous versions of this recommended practice has been removed from this version.

References


GFOA Recommended Practice

Background. State and local governments are responsible for making a wide variety of payments to their employees, program recipients, vendors and other governments. In addition, governments receive revenue and fees from a wide variety of sources. Processing these disbursements and receipts can be time-consuming, resource intensive, and costly. Many governments and private-sector entities are moving towards the electronic movement of funds and information to achieve the following types of benefits:

- Improved customer/employee relations;
- Reduced bank fees;
- Faster deposit and investment of funds;
• Improved cash flow certainty allowing better investment decisions;

• Easier and less expensive bank reconciliations;

• Reduced check production and distribution costs (e.g., supplies, storage, security, printing, signing, bursting, mailing, and handling);

• Reduced check fraud;

• Fewer lost, stolen, and reissued checks; and

• Demonstrate to customers that the organization is customer oriented, technologically capable, and cost conscious.

Recommendation. The Government Finance Officers Association (GFOA) recommends that state and local governments evaluate opportunities to make and receive electronic payments in the following areas:

Disbursements

• Payroll;

• Expense reimbursements;

• Vendor payments;

• Retirement payments;

• Intergovernmental payments;

• Other recurring payments;

Collections

• Internet transactions;

• Grant payments;

• Repetitive collections – such as utility payments;

• Tax payments;

• License payments; and
GFOA Recommended Practices

- Other recurring receipts.

Government entities should establish the appropriate authorizing individual(s) for the implementation of electronic transactions.

In evaluating the costs and benefits of electronic payments, governments should consider at least the following factors:

- Bank fees;
- Experience with fraudulent or returned checks;
- Supply costs;
- Administrative and processing costs;
- Mail fees;
- Impact (either positive or negative) on the availability of funds and interest earnings; and
- Information technology resources and capabilities of the jurisdiction.

To the extent that electronic transactions are used, governments should implement the following safeguards:

- Establishment of adequate computer network security to protect against viruses and unauthorized access to account information;
- Written agreements for electronic transactions with financial institutions in compliance with Uniform Commercial Code Article 4A (UCC4A);
- Dual controls for the authorization of non-repetitive transactions;
- Dual controls for the establishment of repetitive transactions;
- Establishment of dollar limits for authorized personnel;
- Establishment and use of passwords for authorized personnel to initiate transactions;
BANKING SERVICES

• Call-back procedures to verify transactions;

• Confirmations of transactions from financial institutions;

• Establishment and use of adequate controls against unauthorized Automated Clearing House (ACH) debits;

• Use of separate accounts for ACH debit activity where volume and type of payment warrant; and

• Implementation and periodic review of internal controls that address access control, confidentiality of data, integrity of data, and other information security issues as appropriate.

References

• Model Electronic Payments Agreement and Commentary, prepared by the EDI and Information Technology Division Section of Science and Technology, American Bar Association, 1996.


Approved by the Committee on Cash Management, June 15, 2002.
Approved by the Executive Board, October 25, 2002.

GFOA Recommended Practice
Procurement of Banking Services (1997)

Background. State and local governments use a wide variety of banking services for the deposit, disbursement, and safekeeping of public monies. Prudent procurement practices necessitate the reevaluation of banking services on a periodic basis. In addition, recent changes in technology,
cash management practices, and banking industry structure offer public investors opportunities to reevaluate banking services and costs.

**Recommendation.** The Government Finance Officers Association (GFOA) recommends that state and local governments should undertake the following practices to receive effective banking services at a reasonable cost:

1. Periodically initiate competitive-bidding and negotiation processes, in accordance with state and local laws and regulations, for major banking services. The processes should include requests for proposals and should cover services, fees, earnings credit rates, and availability schedules for deposited funds.
2. Have contracts for banking services that specify services, fees, and other components of compensation.
3. Evaluate the relative benefits and costs of paying for services through direct fees, compensating balances, or a combination of the two. Compensating-balance arrangements can offer convenience and seemingly low costs. However, because of uncompetitive earnings credit rates, reserve requirements, and insurance fees on deposits, compensating banks through fees or a combination of fees and balances generally is financially advantageous.
4. Evaluate their needs against the costs and benefits of specific banking services, including but not limited to:
   - Controlled disbursement accounts;
   - Zero-balance accounts;
   - Positive-pay services;
   - Reconciliation services;
   - Lock-box services;
   - Electronic-balance and transaction-reporting services;
   - Electronically placed stop payments;
   - Electronic payments;
Electronically transmitted analysis statements;
Electronic or digitized storage of paid checks;
Overnight sweep accounts;
Safekeeping and custody arrangements;
Credit-card receipt merchant services; and
Procurement cards.

References


**GFOA Recommended Practice**

**Purchasing Card Programs (2003)**

**Background.** The purpose of a purchasing card (also known as a procurement card) program is to provide an efficient, cost-effective method of purchasing and paying for small-dollar as well as high-volume, repetitive purchases. This type of program is designed as an alternative to the traditional purchasing process and can result in a significant reduction in the volume of purchase orders, invoices, and checks processed. Purchasing cards can be used whenever a purchase order, check request, or petty cash would have been processed and with any vendor that accepts credit cards.

There are numerous benefits to a purchasing card program. Benefits to the cardholder include:
GFOA Recommended Practices

- Convenience of purchasing without a purchase order;
- Expedited delivery of goods;
- Expanded list of merchants from whom purchases can be made; and
- Reduced paperwork.

Benefits to the government’s internal departments include:

- Simplified purchasing process;
- Lower overall transaction processing costs per purchase;
- Increased management information on purchasing histories;
- Reduced paperwork; and
- The ability to set and control purchasing dollar limits.

Benefits to the vendor include:

- Expedited payments;
- Reduced paperwork; and
- Lowered risk of nonpayment.

Purchasing cards may be issued in a designated individual’s name and/or the government’s name clearly indicated on the card as the buyer of goods and services. The purchasing card and any transactions made with the card may become a liability of the governmental entity. For this reason, it is important that governments be aware of the risks related to the use of purchasing cards and develop plans to address those risks.

**Recommendation.** The Government Finance Officers Association (GFOA) recommends that governments explore the use of purchasing cards to improve the efficiency of their purchasing procedures. A competitive process should be used to select a purchasing card provider. Consideration should be given to vendors who can provide automated approval and reconciliation software. This software should provide for the ability to integrate to the entity’s accounting records. Purchasing card programs should be designed to be simple and easy to use; however, gov-
ernments need to maintain appropriate controls, in accordance with their purchasing policy, to ensure the ongoing success of a purchasing card program. These controls should include:

- Written agreements with banks, which include fee schedules and processing procedures;
- Written policies and procedures for internal staff;
- Instructions on employee responsibility and written acknowledgments signed by the employee;
- Spending and transaction limits for each cardholder both per transaction and on a monthly basis;
- Written requests for higher spending limits;
- Recordkeeping requirements, including review and approval processes;
- Clear guidelines on the appropriate uses of purchasing cards, including approved and unapproved Merchant Category Codes (MCC);
- Guidelines for making purchases by telephone and fax or over the Internet;
- Periodic audits for card activity and retention of sales receipts and documentation of purchases;
- Procedures for handling disputes and unauthorized purchases;
- Procedures for card issuance and cancellation, lost or stolen cards, and employee termination; and
- Segregation of duties for payment approvals, accounting and reconciliations.

References

GFOA Recommended Practices


Approved by the GFOA’s Executive Board, October 17, 2003.

GFOA Recommended Practice
Use and Application of Voluntary Agreements and Guidelines for Cash Management (2003)

Background. Various participants in the investment process are seeking to clarify the relationship of parties in an investment transaction by undertaking voluntary efforts to develop model agreements and guidelines. Some of these documents contain legal assumptions that might affect the validity of a transaction. Others would require certain statements to be in writing in order to be effective. Although the enforceability of such guidelines is uncertain, state and local government investors should be aware of their existence and the possibility that their counterparties may be operating under these or similar guidelines.

Recommendation. The Government Finance Officers Association (GFOA) recommends that state and local governments consider carefully any agreement or guideline presented for their use because many of these documents affect a public entity’s rights and responsibilities in a given transaction. Furthermore, GFOA recommends that:

• Governmental investors develop written investment policies using the GFOA-developed Sample Investment Policy.

• Governmental investors be aware of the federal, state, and local laws that govern investment contracts and agreements, as well as statutes and regulations affecting suitability obligations of broker/dealers, which require that a broker/dealer should only recommend a product after that broker/dealer has taken steps to determine that it is suitable and legally permissible for the customer.
• Governmental investors protect their existing statutory and regulatory rights by ensuring that such rights are not inadvertently waived through the use of “boilerplate” language in contracts with counterparties.

• Governmental investors should use the GFOA-developed library of sample agreements and guidelines as below.

References

• An Introduction to Treasury Agreements for State and Local Governments, Linda Sheimo, GFOA, 1993.


Approved by the GFOA’s Executive Board, October 17, 2003.

GFOA Library of Sample Agreements in Cash Management

1. Sample Investment Policy
2. Security Agreement (long)
4. Sample Custodial Trust Agreement
5. Mutual Fund Request for Information
6. Sample Request for Proposal for Investment Advisory Firms
7. Sample Investment Advisory Agreement
8. Investment Policy and Procedure Self-Assessment Questionnaire (not developed by Cash Committee)
9. Broker/Dealer Request for Information
10. Sample Agreement for Securities Service
11. Statement of Work
12. Considerations for Government in Developing a Master Repurchase Agreement

Guidance from An Introduction to Treasury Agreements for State and Local Governments

1. Banking Services Agreements
2. Wire Transfer Agreements
GFOA Recommended Practices

3. Lockbox Agreements
4. Trust Account Agreements
5. Escrow Account Agreements

**GFOA Recommended Practice**

**Use of Lockbox Services (2000 and 2003)**

**Background.** Lockbox services are designed to expedite the collection of paper-based payments and provide timely payment information to update accounts receivable records. Lockbox services are usually provided by a third-party processor (usually a bank) that receives, opens, and processes payments for a government entity or business. For most entities, lockbox services should: increase payment and posting accuracy; improve cash flow by reducing processing time between delivery of mail and depositing of payments; and increase staff productivity by freeing personnel from the labor intensive process of manually handling mail and payments. There are two basic types of lockbox services: wholesale (used for high dollar, low volume payments) and retail (used for high volume, low dollar payments such as taxes, utilities, licenses and fees, accompanied by standardized remittance documents). Retail lockbox services generally are of primary interest to government entities.

**Recommendation.** The Government Finance Officers Association (GFOA) recommends that government entities evaluate the benefits and costs of utilizing lockbox services to determine if advantages can be gained in the areas of accuracy, cash flow and efficiency. The evaluation should consider:

1. **Availability of Lockbox Services.** Major metropolitan areas typically have multiple banks and companies competing for lockbox processing accounts while other areas may not be serviced by any local processors. In order for a processor to make the investment in expensive machinery and personnel, there must be a concentration of lockbox clients (both public and private). Governments should consider joining together to encourage local banks to enter the lockbox business or attract a lockbox processor into an area.
that is not serviced. Governments seeking a lockbox processor should investigate how local utilities and cable television firms process their payments.

In areas that are not serviced, governments should evaluate the use of regional lockbox processors. Other than overcoming the public confusion about sending local payments to an out-of-area address, there is normally no technical requirement for lockbox processing to be done locally.

2. *Workflow and Cash Flow.* Any evaluation of lockbox services must include:

- An analysis of the existing workflow from receiving mail to depositing payments and posting receivables;
- Staffing requirements;
- Time necessary to complete;
- Security of the process;
- Employee accuracy; and
- Capital requirements.

Costs associated with these processes can then be evaluated against the costs and benefits of outsourcing to a lockbox processor. Particular attention should be paid to any delays in depositing funds as most lockbox processors guarantee that payments received are deposited into the organization’s bank account the same day they are received.

3. *Technical Requirements.* Automated lockbox processing has certain technical requirements. The process must begin with a remittance document that meets the processor’s specifications. Primary among these specifications is that the document contains an optical character recognition (OCR) scan line that includes identification and payment information. Other document requirements typically include form size, character placement, inclusion of a check digit, ink type, and paper quality. The type of printer used to
produce the remittance document can have an impact on lockbox processing error rates and thus on overall costs. Laser printing is recommended with non-magnetic ink.

Depending on the needs and capabilities of the government entity, the transmission of data from the lockbox processor back to the entity can range in sophistication from the exchange of hard copy records to computer-to-computer data transmission. Computer-to-computer data exchange will usually require changes to existing software. Lockbox processors can also offer data storage services by converting remittances to electronic data.

4. **Staffing Levels and Workload.** Government billings and cash flows are often cyclical, causing problems in cash management operation staffing levels. Shifting payment processing responsibility to a lockbox processor alleviates the dilemma of adequately staffing to meet a limited number of peak periods versus overburdening a small staff during critical periods.

GFOA also recommends that any contract entered into by a governmental entity and lockbox provider at a minimum include the following:

- Treatment of exception (non-standard) items;
- Turnaround time;
- Disposition of documents, including imaging capabilities;
- Funds availability schedule; and
- Error tolerance.

In the event that these services are procured through the use of a request for proposal, the request for proposal and the vendor response should be included as part of the contract.

**References**

BANKING SERVICES


Recommended for Approval by the Committee on Cash Management, January 23, 2003.

Approved by the GFOA’s Executive Committee, February 28, 2003.

GFOA Recommended Practice
Use of Positive Pay Versus Reverse Positive Pay
(2004)

Background. Positive pay is becoming the leading method of check fraud deterrence available today. This process entails a daily reconciliation of an issuer’s checks to checks presented for payment to the issuer’s bank to identify potentially fraudulent checks. For those entities unable to use positive pay, GFOA recommends that such entities use reverse positive pay. However, positive pay is a stronger deterrent to check fraud.

Positive pay allows an issuer and its bank to work together to detect check fraud by identifying items presented for payment that the issuer did not issue. Under positive pay, an issuer prepares a formatted-checks issued data file (including check number, amount, and date, as well as other bank and account information) and transmits this data to its bank. Stop payments, voided checks and manual checks can also be included in the formatted-checks issued file. The bank compares checks received for payment against the record of all issued checks. The bank identifies items that do not match the issue amount and check number. The bank may offer additional services to identify checks that exceed certain dollar amounts and "stale" (dated) checks. The bank presents the rejected items to the issuer for its consideration for payment.

Reverse positive pay is similar to positive pay, but the process is reversed, with the issuer, not the bank, maintaining the list of checks issued. When checks are presented for payment the issuer’s bank prepares a file of the checks, account numbers, serial numbers, and dollar amounts
and sends the file to the issuer. The issuer then compares the information to its internal records. The bank is notified which checks to pay or reject.

**Recommendation.** The GFOA recommends that governmental entities use positive pay as the primary check clearance process in banking services agreements. This service should be included as part of an overall program of check fraud protection, including secure file transmission.

The GFOA further recommends that the issuer have specific knowledge of their exposure to loss with both their insurance carrier, if any, and their banking institution. It is recommended that the government have a clear, written understanding of their depository bank's policy on check fraud and liability for loss. Governments should familiarize themselves with the Uniform Commercial Code with regard to both bank and issuer responsibilities.

**Reference**


Approved by the GFOA's Executive Board on March 26, 2004.
Glossary of Banking Terms

**Account analysis statement** – The bank’s invoice to the government for services, usually provided on a monthly basis. It shows balance information, service activity, and an itemization of service costs.

**American Banking Association (ABA)** – Association representing financial institutions.

**ABA routing number** – A number assigned to each bank, used to route checks. The number can be found on the MICR line.

**Account reconciliation services** – The process of matching issued and paid checks verifying a government’s own record of checks written against the bank statement. Banks can provide this as a service to governments.

**Automated Clearing House (ACH)** – A nationwide network of financial institutions supporting an electronic payment system. ACH entries can be substituted for checks in recurring payments, such as direct deposits. In an ACH debit entry, the originator receives funds; in an ACH credit entry, the originator pays funds.

**Availability schedule** – A bank-provided list determining the time (usually measured in days) when funds deposited by a government can be used. The time will vary according to the type of deposit and location where the deposit is made.

**CAMELS** – A system for rating the creditworthiness of banks; the acronym stands for: capital adequacy, asset quality, management competence, earnings, liquidity, and sensitivity to market or interest rate risk.
Cash concentration – The movement of funds from the various locations receiving deposits on behalf of the government to the government’s central bank account, where the funds can be utilized and managed.

Check 21 – Shorthand for federal legislation known as the Check Clearing for the 21st Century Act. This law gives banks the opportunity to convert paper-based checks into electronic images of checks, making checking processing easier and faster.

Collateral – Securities pledged by a bank to protect the government’s assets on deposit with the bank, in the event of default.

Community Reinvestment Act (CRA) – Federal legislation to encourage financial institutions to help meet the credit needs of the communities in which they operate. Banks receive a CRA score to gauge the extent of service to communities.

Compensating balance – A method for a government to pay a bank for cash management services.

Earnings credit allowance – The earnings generated by a government’s deposits that are applied toward monthly banking service fees. The earnings credit allowance is calculated in the bank’s monthly account analysis.

Earnings credit rate – The rate of interest used in calculating the earnings credit allowance.

Electronic data interchange (EDI) – Computer-to-computer exchange of documents between two parties. With financial EDIs, one party delivers a payment and related information using a standardized format.

Electronic fund transfers (EFTs) – Delivery systems used to transfer funds electronically via ACH-based payments or Fedwires, in lieu of issuing paper checks. The funds are transferred through computers, magnetic tapes, automated teller machines, or telephones.

Fedwire – An electronic means of exchanging funds. It is also referred to as wire transfers or simply wires.

Demand deposit account (DDA) – A checking account with a bank.
Glossary of Banking Terms

**Encoding** – This usually denotes inscribing or imprinting MICR characters on checks, deposits, and other documents, to be processed by a MICR sorter/reader.

**Federal Reserve System** – The Federal Reserve System consists of the Board of Governors in Washington, D.C., twelve regional Federal Reserve Banks, and twenty-five branches. The Federal Reserve System is both a regulator of banks and a provider of cash management services (e.g., Fedwires).

**Float** – A term used to describe the funds in the process of being collected from one party to another party, usually through the originating and depositing financial institutions.

**Interactive voice response (IVR)** – A telephone technology in which someone uses a touch-tone telephone to interact with a database to acquire information from or enter data into the database.

**Lockbox** – Collection and processing service where payments made to a government are received by its bank through the use of a post office box or unique zip code. The checks are deposited directly into the government’s bank account with receivables and/or invoice information provided to the government.

**Magnetic ink character recognition (MICR) line** – Machine-readable magnetic characters encoded at the bottom of checks. The MICR line includes from left to right: bank identification number, account number, check number, and, after encoding, check amount.

**National Automated Clearing House Association (NACHA)** – A national association made up of local automated clearing houses. It sets rules for how ACH payments are executed.

**On-us check** – Any depositor’s check, drawn on and payable at the bank wherein the account is carried, is termed an “on us” check when presented for payment to the drawee bank. The party drafting the check and the party depositing the check both use the same bank.

**Positive pay** – A type of account reconciliation service provided by banks. It allows for governments to compare the bank’s record or list of
checks issued against the government's record prior to funds being released from the account.

**Reserve requirement** – The percent of bank deposits that must be kept on deposit at the Federal Reserve.

**Uniform Commercial Code** – Set of laws governing commercial transactions. UCC Article 4 addresses bank and governmental liability in case of check fraud.
About the Contributors

APPENDIX E

About the Contributors

James Beasley – President of J.F. Beasley & Co., Inc. Mr. Beasley is a former advisor to the GFOA Committee on Cash Management, and past contributor to GFOA publications.

Erik Bush – Director of Finance and Information Services, City of Warrenville, Illinois. Mr. Bush is a member of the GFOA Committee on Cash Management.

Joseph Casey – Director of Finance & Management Services, Hanover County, Virginia. Mr. Casey is the Vice-Chair of the GFOA Committee on Cash Management.

Nicholas Greifer – Manager, Policy Analysis, GFOA Research & Consulting Center. Mr. Greifer is editor of Public Investor, a GFOA newsletter for state and local cash managers and investors, and has written several GFOA books.

Perry James – Finance Director, City of Raleigh, North Carolina. Mr. James is a member of GFOA’s Committee on Accounting, Auditing, and Financial Reporting and has contributed to the GFOA membership magazine, Government Finance Review. In March 2002, the North Carolina State Treasurer’s Office awarded the City of Raleigh, Wake County, and the Town of Cary its annual accounting/financial management award for their joint banking services efforts (described in Appendix B).

Bill Jones – Vice President, Wachovia Bank. Mr. Jones manages Wachovia’s Treasury Services Government team for the Mid-Atlantic region.

Janet Langenderfer – President, Vision Partners, Inc. Ms. Langenderfer is a past contributor to Public Investor and consults with governments and private-sector companies on credit card acceptance.
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