An Introduction to Collateralizing Public Deposits

Second Edition

M. Corinne Larson

GOVERNMENT FINANCE OFFICERS ASSOCIATION
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ISBN 0-89125-282-7

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Foreword

Over the years, the Government Finance Officers Association’s (GFOA) Committee on Cash Management has monitored the banking industry and has adopted policy statements and recommended practices to guide and instruct public officials in the collateralization of public deposits. In 1987, the GFOA published a booklet, Considerations for Governments in Collateralizing Public Deposits, to emphasize the importance of protecting public deposits and to define the steps that public officials should take to ensure that their deposits would be safe in case a financial institution failed. The late 1980s and early 1990s were a particularly risky time for financial institutions, and bank failures were a constant concern for government officials.

Since that time, the health of the country’s financial institutions has greatly improved. In 1996, GFOA published An Introduction to Collateralizing Public Deposits for State and Local Governments, a document that highlighted sample security agreements and a sample custodial trust agreement that the committee had developed. That publication also described key provisions commonly found in security agreements to assist public officials with the review of new or existing agreements. In addition, the 1996 publication presented recommended collateral practices and offered information on other forms of prudent risk control.

Today, consolidation of commercial banks into fewer larger companies has changed the face of the banking industry. Although banks are more diversified and less exposed to regional economic downturns, risk of bank failure remains. Moreover, with fewer banks holding more public dollars, it is more important than ever for governments to ensure that their deposited funds are protected in case of a bank failure. This publication, An Introduction to Collateralization, draws on the two previous publications and presents concrete steps that governmental entities can take to protect their deposits in today’s banking environment.

A special debt of gratitude is owed to M. Corinne Larson, Vice President, MBIA Asset Management Group, who served as the principal author of this publication and the 1996 publication. We gratefully acknowledge Michelle Saddler of the Illinois Metropolitan Investment Fund for her invaluable assistance in reviewing the manuscript and offering suggestions for improvement. Our appreciation also goes to Nicholas Greifer, formerly of the GFOA Research and Consulting Center, who assisted on this publication and performed background research on state statutes.

Jeffrey L. Esser
Executive Director
Government Finance Officers Association
Introduction

The safety of public funds deposited with banks and other depository institutions has been and most likely will always be one of the foremost concerns of government finance officers. Governments typically entrust depositories with millions, and sometimes billions, of dollars in checking accounts, savings accounts, and certificates of deposit. Hundreds of depository institutions failed in the late 1980s and early 1990s. These bank failures highlighted the need to pay careful attention to protecting government deposits beyond the $100,000 limit provided by the Federal Deposit Insurance Corporation (FDIC).

Background Information

In addition to bank failures, legislative and regulatory activities have changed the nature of the banking industry, and, by extension, the risk exposure of governments placing deposits with banks. In 1994, the Interstate Banking and Branching Efficiency Act eliminated restrictions on interstate bank mergers, which allowed banks to expand geographically. The landmark Graham-Leach-Bliley Act (GLBA) of 1999 enabled further consolidation between commercial banks and other types of financial entities, such as insurance companies and investment banks.

These legislative changes helped bring about numerous bank mergers and acquisitions. Multi-bank holding companies acquired banks of all sizes, resulting in large banks operating across state lines. The number of commercial banks has steadily declined from 11,342 in 1984 to 7,691 as of June 30, 2004. Given this industry consolidation, individual banks now hold a larger share of insured deposits.

*North Arkansas Medical Center Case.* The case of *North Arkansas Medical Center v. Barrett*, 962 F.2d 780 (8th Cir. 1992) highlighted the need not only for more protection for deposits over the FDIC insurance limit but also for iron-clad agreements that would be honored by the FDIC in a receivership situation.

The medical center (NAMC) had placed almost $1 million in deposits with Guaranty Savings and Loan Association (Guaranty) over a period of time. Because this amount exceeded coverage under federal deposit insurance, collateral was pledged by Guaranty to secure the uninsured funds. Guaranty subsequently sold the collateral without the knowledge of NAMC. NAMC’s permission to release the collateral was obtained after the fact and substitute collateral was designated by Guaranty. The securities were held by a local third-party custodian.

Soon thereafter Guaranty was placed in receivership and the FDIC ultimately became the receiver. NAMC brought an action to recover its funds based on its collateralized security interest. However, the District Court dismissed NAMC’s complaint, and the Court of Appeals for the Eighth Circuit affirmed that decision.

The court’s decision focused on the provisions in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), particularly U.S. Code Section 1823 (e), which specifies 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. By terms of the statute, a valid security agreement:

1. Is in writing;
2. Was executed by the depository institution and the entity making the claim contemporaneously with the acquisition of the asset;
3. Was approved by the board of directors or loan committee of the institution; and
4. Has been an official record of the institution continuously from the time of its execution.

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3. The Riegle Community Development and Regulatory Improvement Act of 1994 lifted that requirement as noted in the next section.
The court in the North Arkansas case held that the statutory requirements were not met because the pertinent documents were not executed contemporaneously with Guaranty’s acquisition of the asset and there was no evidence that any security agreement regarding these assets was ever approved by Guaranty’s directors or loan committee.

The FDIC’s Position. The FDIC has consistently held that it must be able to determine from its examination of the records of a failed institution what the obligations and assets are. Any agreements that may exist outside the records maintained by that institution would not be considered. Given the existence of an agreement, however, the fact that it may not have been executed at precisely the time an asset was acquired is not of primary concern to the FDIC as long as the other requirements of Section 1823(e) have been met.

In 1993 following the NAMC decision, the FDIC’s Board of Directors issued a policy statement in response to concerns over the enforcement of security interests for public deposits in insured institutions. The statement emphasizes that both statutory and case law require that, to be “legally enforceable,” a perfected security interest must be in compliance with all aspects of the law concerning the FDIC’s conservator rights, including the requirement that acquisition of collateral be contemporaneous with execution of a security agreement. The requirement that agreements be executed “contemporaneously” with the acquisition of the collateral was lifted for public depositors by this FDIC policy and the passage of the Riegle Community Development and Regulatory Improvement Act of 1994.

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 its deposited funds. A government should periodically review the agreement to ensure that changes in case law or statutes have not weakened the agreement.

To help governmental entities comply with these requirements, the GFOA Committee on Cash Management developed sample security agreements for governments that meet FIRREA requirements. These sample agreements are presented in Appendix A.

These events and others have forced public officials to re-examine the creditworthiness of their depositaries and to take positive action to protect funds entrusted to these institutions. Part of this process involves selecting financially strong banks and minimizing bank balances through aggressive cash management practices. Most governments are unable to reduce the size of their deposits in individual depositary institutions to such a level that, without implementing safeguards, a bank failure would not seriously threaten the financial condition of the investing government. In fact, cash management practices encourage the concentration of short-term depositary accounts in order to improve the efficiency of funds management and thus, increase the credit risk exposure of public deposits.

Purpose of this Publication

The purpose of this publication is to provide finance officers with the latest information on collateralizing public deposits and safeguarding public funds. This publication contains three major sections. The first section discusses the collateralization of public deposits and how that can be accomplished. A description of collateralization methods used by governments is presented in this section, along with a discussion of the advantages and disadvantages of each method. The second section offers guidance on implementing GFOA’s Committee on Cash Management recommended collateralization practices. This section discusses alternative methods of collateral safekeeping, various forms of collateral, the need to monitor current market values of pledged securities, and documentation that should be obtained by the depositor.

The final section discusses additional steps that should be taken by public officials who seek to invest and deposit in a prudent manner. These steps
include establishing policies regarding depository credit risk, implementing credit evaluation procedures, and using secured investments as alternatives to unsecured deposits. Appendices presented at the end of the publication include GFOA's sample security agreements along with a sample custodial trust agreement, and model collateralization statute. Also included in the appendices are state pledging requirements for public deposits, eligible collateral by state, and a list of state statute citations. Additionally, GFOA's policy statement on pledged collateral and a recommended practice on collateralizing public deposits are included.
SECTION I

Alternative Collateralization Policies

The purpose of collateralization is to reduce a government's exposure to its bank's credit risk. Most states have enacted statutes that either require or permit depositories to pledge collateral securities to secure public deposits. However, statutes vary widely among states. Some statutes apply uniformly to all political subdivisions whereas others are a patchwork of deposit protection laws applying to various forms of governments.

The rationale for these statutes is that a depository is necessary in order to operate the finances of a government; but the collapse of a bank should not jeopardize the safety of money held in trust for the benefit of taxpayers. Further, in the event of severe economic crisis (such as a banking panic), governments must have rapid access to the resources necessary to ensure the maintenance of public order.

Through the use of collateralization, governments have sought to ensure that in a financial crisis, the failure of banking institutions would not jeopardize the general health and safety of the population.

Most collateralization statutes were enacted or amended during the Great Depression when thousands of banks failed. Since the Depression, additional reforms have been implemented to control the banking industry and protect depositors. Despite regulatory control and improved publication of financial information for depositors and investors, financial institution failures still occur. Further, in small rural jurisdictions, the only depository institution in town may be inadequately capitalized, leaving public officials with the choice of sending their money out of town or accepting credit risks that may not be prudent. The mergers that occurred in the banking industry in the mid-1990s have helped to strengthen the credit quality of many smaller institutions by making those banks part of larger banking corporations. Even so, finance officers must exercise care in choosing financial institutions, monitor their creditworthiness on a regular basis, and take other steps as necessary to protect their deposits.

In general, most states require some form of depository collateralization. Typically, high-quality government securities (such as U.S. Treasury obligations, federal agency securities, and municipal bonds) are pledged to protect public deposits. Finance officers should be aware of various collateralization structures and supervisory responsibilities that exist throughout the United States. These include three methods of supervising and administering collateral. Each method has its advantages and disadvantages as detailed below.

Statewide Collateral Pools

Creation of a statewide collateral pool by legislative action, with a central agency supervising a system of partial collateralization. This method, first introduced in Florida and Washington, and now used in several other states, reduces the cost of collateralization imposed upon depository institutions while still offering important protections against individual failures of banks and thrifts. By requiring only fractional collateral, the bank's cost of collateralization is reduced. Because banks earn modest income on government securities held as collateral, pledging these securities essentially ties up assets that could otherwise be used for loans. As a result, it creates an opportunity cost for the bank compared to the income earned on a bank's loans.

5. See Appendix C for a summary of state statutes.
Because of this potential earnings loss and the transactions costs of maintaining collateral in safekeeping, the depository’s return on collateralized deposits is diminished. These systems therefore seek to provide adequate collateral statewide to reduce costs and protect against any individual depository’s collapse by requiring a collateral “pool” that exceeds total public deposits in the largest institution.

Rather than 100 percent collateralization, a fractional system is used. For example, in Florida, banks and savings institutions must pledge 50 percent of their public deposits with the State Board of Administration. In Washington, the treasurer requires 10 percent of all deposits to be pledged. The statutes also authorize officials to assess higher ratios under certain circumstances, particularly for new banks or when a particular financial institution is exhibiting weakness. Collateralization costs are viewed by all depositories as a condition of doing business with the public sector.

A key advantage of these statewide systems is that local governments need not become involved in the administrative process of protecting their deposits. Typically, a state office is assigned responsibility for administering depository collateralization. Local governments can rely on the state’s supervision of collateral and the state’s legal powers, enforcement authority, and supervision. For special districts and other unique governmental entities, however, some statewide systems do not include all governmental or quasi-governmental agencies.

In 1984, the GFOA Committee on Cash Management drafted a model collateralization statute that was designed to systematize the desirable features of the Florida and Washington pool systems. The provisions of that model legislation appear in Appendix B.

Uniform Statewide Collateralization Requirements

General statewide requirements for full collateralization, as a condition for doing business with governments. By far the most pervasive practice, this model requires uniform statewide collateralization of all public deposits, but may leave the responsibility for enforcement and implementation to either the state or local officials. The forms of collateral and the other mechanical details of these practices vary. Although the percentage of coverage required and eligible forms of collateral differ among the states (see Appendices C and D), the common denominator in these statutes is that they require public deposits to be fully collateralized. One example of this type of legislation is the Texas Public Funds Collateral Act, which requires governments to collateralize their deposits at 100 percent and specifies what types of securities may be pledged as collateral.

Cost is one potential disadvantage of statewide full collateralization practices. As discussed above, the requirement of full collateralization represents an inefficiency. Because of the economic cost to the depository of establishing custodial accounts and foregoing the higher income ordinarily available on loans, full collateralization may be an unnecessarily expensive way to protect public deposits. The advantage of complete collateralization, of course, is that in the event of an economic crisis, it would provide greater protection of all government assets at risk — whereas a fractional collateralization program may prove inadequate. Some analysts note that public investors concerned about such risks should explore the full range of available investment options, such as investing in government securities or local government investment pools (LGIPs), which occasionally yield a higher interest rate than a fully collateralized bank deposit. (Banks may be forced to offer comparatively lower interest rates because collateralization imposes costs, as noted, and because the Federal Reserve imposes bank reserve requirements that act as a drag on bank earnings.)

Another disadvantage is that some of these statutes may not fully protect public deposits because the market value of collateral used for pledging purposes may prove to be less than the deposits. In Oklahoma, the 1982 failure of Penn Square Bank illustrated the fallacy of relying upon face value (the par value of a security), rather than market value (the amount a security can be sold in the open market), of collateral securities. Several municipalities were protected when the bank failed, but ultimately received municipal bonds whose prices in the open market were considerably less than the amount of the deposits. Only by holding these low-interest, tax-exempt securities until maturity could the investing governments avoid booking a loss. Even so, the economic losses resulting from deficient practices were significant.

Fortunately, many governments have learned from this painful lesson and monitor the market
value of their collateral securities. However, many governmental entities accept long-term securities with a limited secondary market as collateral. If the government’s bank fails, the entity may have difficulty finding a buyer for those securities. Some securities (such as a mortgage-backed security) may be relatively illiquid and difficult to sell before maturity.

In some states (e.g., North Carolina and Virginia), a state official administers the statewide collateral program, and local jurisdictions need not assume supervisory responsibility. In other states this is not the case. If responsibility for monitoring depository collateral resides with local officials, the possibility exists that a government could fail to properly administer the statute. Accordingly, government officials must understand the important technical issues associated with collateralization, so that they can implement a collateralization policy and properly discharge their responsibilities.

**Uncoordinated, Autonomous Collateral Pledging**

*Statutory permission to implement depository collateralization on a voluntary basis.* Some states do not require collateralization, but permit public treasurers to obtain collateral. This method of collateral pledging is the “home rule” or permissive approach. Under such systems, local officials bear complete responsibility for their collateralization practices. Typically, this approach results in higher costs of obtaining collateral because of the lack of uniformity in practices and the competitive weakness of governments operating in isolation from each other. In some states, the state does not require that all public deposits be collateralized. Instead, some political subdivisions operating under home rule authority have implemented their own, individualized collateralization programs.

Some public officials argue that this approach is reasonable because those who wish to protect themselves against depository risks are able to do so. However, the disadvantage of this collateralization system is that each local government must fend for itself in the open marketplace. Ununiformity is not established on a statewide basis, so the collateralization practices of different depositories and different political subdivisions vary. Everybody operates in isolation, having to negotiate agreements with prospective banks without a standard template.

Because the cost of collateralization becomes a direct cost to the depositories, public investors frequently are confronted with the choice between (1) an uncollateralized deposit yielding market interest rates and (2) collateralized deposits bearing a lower yield that reflects the bank’s cost of collateralization. Unfortunately, some banks even include a rate penalty designed to discourage the practice of collateralization. A few banks and thrifts operating in these states refuse to collateralize deposits as a general business policy. Thus, public depositors are forced to either forego income on a specific transaction or may be unable to secure collateralization. Ultimately, those governments having the clout, experience, and determination to insist on full protection of deposits are likely to obtain it, but those lacking it may not.

A final disadvantage of this practice relates to the expertise of the investment officer. Because there is no uniform statewide practice, local officials must devise their own collateralization policy and procedures. Without standardization, these individuals typically incur greater risks of error in the design of their safekeeping procedures and the market monitoring process. Accordingly, this publication provides technical assistance to those responsible for prudent implementation of a local collateralization system. Section II identifies key administrative issues.

**Surety Bonds**

In many states, governments are permitted to use a surety bond in lieu of collateral. A surety bond is an agreement issued by an insurance company to guarantee the payment of principal and interest on public deposits. If a bank defaults, the public entity can draw on the surety bond and receive its funds within 24-48 hours. Surety bonds eliminate the need for custodial agreements, security agreements, and valuing collateral securities. The advantage to the entity is that it would not have to wait to take possession of the collateral securities and then liquidate them to be made whole for its deposits.

Because surety bonds are direct obligations of the insurance company that issues them, it is important for finance officials to verify the credit quality of the insurance company and to only accept surety bonds from high credit quality companies. Essentially, the public entity is trading expo-
sure from the bank’s credit risk to the insurance company’s credit risk.

Surety bonds are economical for banks because the bank does not have to tie up securities by pledging collateral. The bank pays a premium to the insurance company. Finance officials should be aware, however, that the agreement is between the bank and the insurance company. The public entity is a named insured but does not participate in negotiating the agreement. To date, this method of securing deposits has not been tested and many if not most governments prefer to collateralize their deposits.

As an example, the State of Maryland permits localities to use a surety bond, with the following statutory provisions:

(i) the bond is irrevocable and absolute;
(ii) the surety bond is issued by an insurance company authorized to do business in the state;
(iii) the issuer of the surety bonds does not provide surety bonds for any one financial institution in an amount that exceeds 10 percent of the surety bond insurer’s policyholders’ surplus and contingency reserve, net of reinsurance; and
(iv) the claims-paying ability of the authorized insurance company is rated, at all relevant times, in the highest category by at least two nationally recognized rating agencies acceptable to the state treasurer.

The advantage of accepting surety bonds in lieu of collateral to governments is that banks do not have to tie up securities for collateral and therefore do not penalize governments for this cost of doing business. A disadvantage of accepting surety bonds in lieu of collateral is that the insurance agreement is between the bank and the insurance company. The government entity has no control over the agreement. If there is a problem with the bank’s agreement with the insurance company, the insurance company may not honor the surety bond if the bank fails and the government entity will have no protection above the FDIC insurance limit.
SECTION II

Implementing Recommended Practices for Collateralization

When a collateralization program is used in conjunction with the other risk-control policies and techniques identified in Section III of this publication, finance officers can significantly improve the safety of their deposits and investments. This section provides a five-step process for establishing a collateralization program for ensuring the safety of public funds.

Step 1: Review State Collateralization Laws

Some state and local government officials are unaware of key provisions of their public depository protection statutes. By obtaining copies of the statutes, investors can become better aware of their rights and responsibilities. Appendix E presents a legal citation index of the various states’ depository collateralization statutes. Finance officials should review their respective state statutes and discuss the law with local legal counsel. A finance officer may also find it useful to compare in-state provisions against provisions from other states (e.g., some state statutes may be more explicit on remedial actions a government should take when a bank default occurs).

In addition, finance officials must make sure that each step outlined in the statute is carefully followed. The state statute should be considered the minimum requirement. Local finance officials may wish to exclude eligible collateral or institute higher collateralization ratios for securities that are long-term, illiquid, or have a lower credit rating.

Step 2: Identify Depository Risk Exposure

Public cash managers must determine the extent to which their deposits are protected. A formal risk analysis should begin with a study of daily and average monthly bank demand deposit levels. Public officials often find that demand deposits are difficult to collateralize because of fluctuations in cash flow. Some governments use “sweep” accounts or other similar vehicles to ensure that funds are automatically invested in repurchase agreements or money market mutual funds on an overnight basis. If a block of collateral securities is used to protect demand deposits, the finance officer should study carefully the maximum risk exposure that occurs during cash flow peaks. Governments whose peak cash balances significantly exceed their collateral levels should enact policies that acknowledge this problem and require their banks to adjust the collateral accordingly.

A second step in the risk analysis is to determine the extent, if any, that existing collateralization practices fail to fully protect public deposits and investments. For example, some states permit depository institutions to pledge securities at face value instead of market value. Thus, the deposit may be under-collateralized if the market value is less than par. During periods of high or rising interest rates, bond prices may decline to less than par, which exposes the entity to market price risk. Finally, inferior quality instruments (e.g., certain industrial development bonds) or illiquid instruments (e.g., individual mortgages) may be used, exposing the public depositor to unacceptable credit risks.

A third factor in assessing risk is the extent to which the portfolio is invested in negotiable certificates of deposit (CDs). A negotiable certificate of deposit is different from a non-negotiable CD in that it is a money market instrument rather than a time deposit of the bank. Banks are unable to collateralize negotiable CDs. For this reason, many governments do not invest in negotiable CDs or limit their investments to large money center banks to reduce their exposure to the bank’s credit risk. Those governments that do invest in negotiable
CDs should restrict the percentage of the portfolio invested in these instruments to 10 percent or less, again to reduce their exposure to the bank’s credit risk.

**Step 3: Establish a Written Depository Collateralization Agreement**

In 1995, the GFOA Committee on Cash Management developed a sample security agreement and custodial trust agreement for governments to use for collateralizing deposits. GFOA encourages governments to develop and enter into depository collateralization agreements even if state law assigns this responsibility to the state. A written agreement helps assure enforcement of collateral protections. GFOA’s sample agreements are presented in Appendix A of this publication.

Such agreements should include the following elements:

**Funds to be Collateralized.** This section should address demand and time deposit accounts and should discuss the overlap or offset of federal deposit insurance.

**Eligible Collateral Instruments.** Sometimes state law dictates this, but in some cases a public entity may wish to allow only certain instruments in order to assure liquidity and marketability. As noted below, certain instruments involve greater risks and should be collateralized at higher levels. If a bank fails, the depositor will receive the collateral securities in lieu of the deposits. A good rule of thumb is to only accept securities as collateral that the entity would be comfortable holding in its own investment portfolio.

**Market Value.** At least monthly, the market value of collateral securities should be recalculated and the collateral adjusted as needed because the face value of securities generally is not the true market value. This practice, known as marking-to-market, may be done as often as daily or weekly.

One of the primary reasons for determining market values is that interest rates, a major determinant of market values, rise and fall continually. In a rising interest rate environment, bank collateral would drop in market value and reduce the government’s protection. Furthermore, certain banks, particularly those that have an internal asset-liability mismatch (mismatch between liabilities to depositors and assets on hand), may encounter severe financial stress when interest rates rise, which could put the government’s funds at risk.

**Collateralization Ratios.** Many states establish a single ratio by which the value of the collateral must exceed the deposit. (Sometimes this is referred to as “haircut,” or “excess margin.”) However, the risks associated with different instruments vary, and a collateralization margin schedule should be inserted in the agreement to reflect those different risks and liquidity characteristics. These are presented in Exhibit 1. Readers should note that these ratios differ significantly from many states’ statutory ratios. Special efforts may be needed to implement these guidelines in states with lower ratios. (Of course, in some states the existing ratios already exceed these minimum guidelines.) However, it is extremely important to specify the collateral ratios for various types of securities because securities with greater credit risk or long maturities should be collateralized at a higher ratio. It is expensive for banks to tie up collateral so they tend to pledge longer-term, less marketable securities.

As defined in Exhibit 1, the collateralization ratios constitute the minimum market value for collateral instruments that are pledged for public deposits (and accumulated interest thereon), under a program in which collateral is revalued and adjusted monthly. The specific collateralization ratio will depend upon a) valuation frequency and b) quality of the security. In general, lower ratios would be appropriate for collateral programs that mark-to-market more frequently, and higher ratios are necessary if collateral is adjusted less often. Similarly, highest quality, fastest-maturing securities have a significantly lower ratio whereas the higher ratios are for longer-date and illiquid securities. This reflects that fact that high quality, fast-maturing securities can be readily converted to cash, with low transactional costs, in the event of a bank failure.

**Safekeeping procedures.** Public deposits are best protected by collateral that is held in safekeeping by an independent third party. To accomplish this, the securities can be held at the following locations:

1. A Federal Reserve Bank or its branch office. Public investors must understand that the “Fed” is the “bankers’ bank.” The Fed’s client is the depository, not the government jurisdiction seeking collateral. However, Federal Reserve safekeeping
Exhibit 1 • Suggested Collateralization Ratios to Be Used in a Monthly Mark-to-Market Program

<table>
<thead>
<tr>
<th>Form of Pledged Collateral</th>
<th>Collateral Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>U.S. Treasury Bills, Notes, and Bonds</strong></td>
<td></td>
</tr>
<tr>
<td>Maturing in less than 1 year</td>
<td>102%</td>
</tr>
<tr>
<td>Maturing in 1-5 years</td>
<td>105%</td>
</tr>
<tr>
<td>Maturing in more than 5 years</td>
<td>110%</td>
</tr>
<tr>
<td>Zero-coupon Treasury securities (STRIPS etc.) with maturities exceeding 10 years</td>
<td>120%</td>
</tr>
</tbody>
</table>

| **Actively Traded U.S. Government Agencies** | |
| Maturing in less than 1 year | 103% |
| Maturing in 1-5 years | 107% |
| Maturing in more than 5 years | 115% |

| **U.S. Government Agency Variable Rate** | 115% |

**GNMA Mortgage Pass-Through Securities**
- Current issues | 115%
- Older issues | 120%
- Issues for which prices are not quoted | 125%

**Other Federal Agency or Mortgage Pass-Through Securities** | 125%

**Collateralized Mortgage Obligations and Real Estate Mortgage Investment Conduit Securities** (*)

**Municipal General Obligation Bonds (**)**
- Maturing in less than 1 year | 102%
- Maturing in 1-5 years | 107%
- Maturing in more than 5 years | 110%

**Municipal Revenue Bonds (***)**
- Maturing in less than 1 year | 105-110%
- Maturing in 1-5 years | 110-120%
- Maturing in more than 5 years | 120-130%

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Notes:

* Mortgage securities, such as CMOs and REMICS, carry a high degree of market risk and the market prices of these securities can be volatile in periods of rising interest rates. For this reason, high collateral ratios such as 125 percent should be considered.

** General obligation bonds refer to bonds issued by an in-state unit of government. Out-of-state municipal bonds may require a higher collateralization ratio unless their credit ratings are in the highest investment grades (e.g., AAA or AA).

*** Lower investment grade revenue bonds (A or BBB) should be collateralized at higher ratios. Industrial development revenue bonds may not be acceptable due to credit quality, unless guaranteed by a third party. High credit ratings should be demanded if such bonds are pledged for collateral.

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Procedures can provide for independent control of collateral, and frequently two signatures are required before assets can be released in an event of default. (Note: Federal agencies and the Government Accounting Standards Board (GASB) have stated that they interpret this form of deposit pledging to be the equivalent of delivery to the investor.)

(2) Third-party collateral safekeeping can be arranged at another custodial facility. Most banks maintain "correspondent" relationships with independent commercial banks that can hold a government’s deposit collateral in safekeeping. A written safekeeping agreement should document this safekeeping relationship. Such third-party safekeeping assures independence and reduces the chance for fraud. However, this arrangement may be more costly than safekeeping at a Federal Reserve Bank. Generally, third-party safekeeping should be held in a trust department through book-entry at the Federal Reserve (unless physical securities are involved).

Exhibit 2 demonstrates how collateralization is conducted, using an independent third-party safekeeping agent. First, the government places deposits with its depository bank and enters into a security agreement that formalizes the public entity’s relationship with the bank. Second, 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. Third, the depository bank transfers securities through the Federal Reserve System to a third-party bank that acts as custodian.

(3) The trust department of a commercial bank can hold the collateral in safekeeping. This procedure is usually cost-effective, but should be substantiated by a written trust agreement as a way to discourage fraud and to ensure the existence of an impenetrable boundary between the bank’s operations and trust departments.

Substitution. If the depository wishes to substitute one form of collateral for another, the agree-
Exhibit 2 • Collateralization Process

Step 4: Establish Effective Safekeeping Procedures

Many finance officers will likely discover that the process of developing a suitable collateralization agreement requires considerable time, legal review, and discussion with interested parties. While the formal drafting process is underway, however, it would be prudent to act immediately to establish effective safekeeping procedures. The three primary methods of safekeeping are discussed above in Step 3, and may require remedial action if current practices are deficient.

Step 5: Prepare for Financial Reporting Disclosures

In March 2003, the GASB issued Statement No. 40, Deposit and Investment Risk Disclosures, an amendment of GASB Statement No. 3.6 GASB Statement No. 40 eliminates many of the cumbersome reporting requirements of Statement No. 3, although governments must still disclose depository risk for deposits that are not insured or properly collateralized. In their annual financial statements, govern-

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6. A summary of the GASB statements can be viewed on the organization's Web site.
ments must report deposits that are uninsured and uncollateralized or if the collateral securities are held by the same financial institution holding the deposits, according to GASB Statement No. 40. Some governments may decide to avoid financial statement disclosures that are difficult to explain and will therefore elect to provide for third-party delivery of deposit collateral. As noted in Step 3, this can be accomplished efficiently through the Federal Reserve System.
SECTION III

Other Forms of Prudent Risk Control

In addition to deposit collateralization, public investors have developed several techniques to control the risks of their cash and investment portfolios. Many of these represent a preventive approach to safeguarding government assets, minimizing the government's risk exposure, and reducing the likelihood that the collateralization "tool" will ever be called upon in a crisis. This section presents a brief list of these techniques.\(^7\)

**Formal Credit Analysis**

Public cash managers are strongly encouraged to study carefully the financial condition of depository institutions. To accomplish this task, several indicators and quantitative tests can be used. Credit rating agencies and many independent bank rating agencies provide ratings of commercial banks and savings and loan institutions.

An alternative form of credit analysis is to compare a bank's financial data with its peer group, using the Uniform Bank Performance Report published by the Federal Financial Institutions Examination Council (FFIEC).\(^8\) The FFIEC uses the information that banks send to regulators to calculate key financial ratios and to compare a particular bank to its peer group. Bank regulators examine several key financial measures, including the so-called "CAMELS" indicators, an acronym referring to:

- Capital adequacy,
- Asset quality,
- Management,
- Earnings,
- Liquidity, and
- Sensitivity to risk.

**Capital Adequacy.** The capital account of a depository offers an important margin of safety. After liabilities are subtracted from assets, the equity balance cushions depositors from operating losses that could otherwise render a bank or savings association insolvent.

Capitalization ratios, which typically compare equity or capital with total assets or total liabilities, should be positive and growing; therefore, a high and increasing ratio is preferred. A declining ratio is a warning signal.

**Asset Quality.** The quality of a depository's asset base can be difficult to determine. The composition of the loan portfolio is seldom disclosed, so the only readily available measures pertain to "bad debts." Generally, those ratios compare loan write-offs (charge-offs) and the loan loss reserve to the total portfolio. In general, a rising level of charge-offs and nonperforming loans is a warning signal. If the loan loss reserve is declining while loss write-offs are rising, credit quality is weakening.

**Management.** To detect possible weaknesses in management, several indicators are usually monitored. The ratio of overhead expenses to total assets provides an insight into the degree to which an institution is leveraged. A low overhead ratio is desirable; a rising ratio suggests problems that could affect profitability. Analysts also use indicators of "hot money" that could be an unreliable source of funding during a banking panic or a period of rising interest rates. These include abnormally high jumbo deposits (over $100,000) and brokered de-

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7. For more detailed information, reference GFOA publications such as *Investing Public Funds*, second edition. A list of publications can be obtained from GFOA's Web site at www.gfoa.org or by calling 312/977-9700.

8. For information on uniform bank performance reports, visit the FDIC Web site at www.fdic.gov.
posits, which suggest that management may be papering over its problems.

**Earnings.** Earnings are an important measure of solvency. A successful depository earns a profit on its portfolio and is less likely to fail as long as it generates income. Net income increases total capital, so safety rises as earnings increase relative to the institution's portfolio and its capital base. Analysts therefore monitor net earnings relative to total assets and shareholder equity. Also used as a reliable indicator of profitability is the net interest margin—the difference between interest earned on loans and investments vs. the interest paid on deposits and borrowed money. All three of these indicators should be positive and stable (or rising) when a depository is successful and solvent.

**Liquidity.** To protect depositors from a “run on the bank,” financial institutions are required to maintain certain minimal standards for liquidity. Liquidity is provided through ownership of short-term marketable investments that can be converted to cash quickly to meet depositors' claims. Historically, banks have maintained higher liquidity ratios than savings institutions due to the nature of their business. In general, the higher the ratio of total assets held in liquid instruments, the better the environment for public investors. Liquid securities offer the best form of depository collateral, which usually is reflected in a willingness of financially strong depositories to offer such securities as deposit collateral.  

**Sensitivity to Risk.** Bank examiners attempt to gauge a bank's sensitivity to interest-rate or market risk. Federal regulators adopted this measure relatively recently during the late 1990s.

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 essentially have two 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 specialists in the financial analysis of banks. As a matter of practice, a GFOA *Public Investor* article indicates that governments utilize both internal staff and external bank rating services.

**Minimizing Demand Deposit Levels**

A second preventative technique that public cash managers can pursue is a program to minimize cash balances. Instead of maintaining compensating bank balances, many state and local governments invest their cash directly in money market instruments, using a sweep account or a zero-balance account program to reduce their demand deposits. Depositories then are paid directly for services.

This approach typically increases the return on cash balances because (a) money market securities usually pay higher interest rates than the banks' comparable "earnings allowance rate" and (b) bank reserve requirements would not apply to funds swept out of the bank, into the money markets. Moreover, the sometimes unheralded side-benefit of such systems is that funds are usually better protected, particularly if they would otherwise be left in an uncollateralized or under-collateralized checking account. When a master repurchase agreement with the depository is used as the investment vehicle, the safety of such cash assets can be enhanced significantly.

**Written Policies for the Investment Program and for Banking Relationships**

A written policy provides a solid understanding between the public, its elected officials, and public cash managers. By themselves, such policies obviously cannot prevent losses, but as part of a prudent, well-designed cash management program, they can provide useful controls. Written investment policies typically address the following topics:

- Governing authority
- Scope
- General objectives
- Standards of care

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• Authorized financial institutions, depositories, and broker/dealers
• Safekeeping and custody
• Suitable and authorized investments
• Investment parameters
• Reporting
• Policy considerations
• Approval of investment policy
• List of attachments
• Other documentation

In the same area of depository relationships, the GFOA adopted a policy statement in 1984 that supports the use of pledging requirements to protect public deposits. The policy statement is presented in Appendix F. The committee developed a companion recommended practice that offers important guidance to state and local government officials seeking to minimize losses and to preserve the public trust. The original recommended practice was subsequently updated and is presented in Appendix G.

**Investing in Fully Secured Instruments**

Many public investors monitor their investment programs to assure the safety of their principal. Although short-term yields may not be quite as attractive, higher quality instruments have recently become the favored vehicles for many public investors. As alternatives to uncollateralized or under-collateralized deposits, public investors may consider:

1. Direct ownership of liquid U.S. Treasury securities. At various points in the business cycle, public investors can obtain yields on Treasury bills and short-term notes that compare favorably with depository instruments. Even with small spreads between the two markets, it may be possible to outperform nonnegotiable bank CDs through active portfolio management.

2. Properly documented repurchase agreements with depository institutions generally are better protected and more liquid than interest-bearing deposits. Financial institutions must hold reserves against deposits, but need not hold reserves against repurchase agreements. This reduces the institution's cost of conducting a repo transaction, and these cost savings can be passed on to the public entity.

Furthermore, a master repurchase agreement with a depository clearly establishes the rights of a public entity in an event of insolvency. In some cases, investors may encounter fewer obstacles to the liquidation of their repo collateral than they would under a deposit collateral program.

The GFOA Committee on Cash Management is unaware of any instance in which a government has been unable to recover its funds under a repurchase agreement with a regulated financial institution. Some analysts believe that with an appropriate master repurchase agreement in force, a public investor would have secured preferential status among a failed depository's creditors. The existence of such a written agreement therefore appears to offer important protections.  

3. Local government investment pools, operated by state officials or under state supervision or by a private investment manager, offer another avenue for prudent investing. With their large and diversified portfolios, these investment pools generally offer excellent liquidity as well as safety.

4. Money market mutual funds whose portfolios consist of full-faith-and-credit U.S. government securities also can be used as a safe, liquid alternative to bank deposits. The Securities and Exchange Commission regulates money market mutual fund practices regarding asset quality, delivery, and maturities.

**Summary**

Deposit collateralization is one of several important risk control procedures that should be used by prudent public cash managers. Although the process of establishing a sound collateral program may be complex, the effort is worthwhile. The public's foremost concern is the safety of principal. Therefore, it may be desirable to have stronger collateralization requirements than those required by the state statute. These issues usually can be addressed in consultation with the entity's legal counsel who can help strengthen the entity's collateral agreement.

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The GFOA is committed to provide assistance in this stewardship function through publications, training, and legislation efforts. However, the most important link in this effort will be the disciplined professional actions of public officials who implement the policies and procedures recommended by their professional associations.
APPENDIX A

GFOA Sample Agreements

Sample Security Agreements
To provide some guidance to public depositors on how to bring their agreements into conformance with federal law, the GFOA Committee on Cash Management collected and reviewed security agreements from both depositors and banks. The committee then developed two sample security agreements that depositors may wish to reference in developing their own agreements. While the committee believes the agreements meet federal requirements, they have not been reviewed or approved by the FDIC. Thus, legal counsel should review the agreements against federal law. Finance officers also should review all the agreements with counsel to ensure that they are consistent with state and local laws and regulations. In addition, counsel should make sure that the agreements are sufficient to create valid, enforceable, and perfected security interests under applicable state law. Perfecting a security interest can be a fairly intricate process and procedures often differ between states.

The “short form” agreement is for depositors in those states with statutorily established collateralization programs. The agreement is aimed at meeting the federal requirements and should reference statutory or regulatory requirements without needing to restate them in detail.

The “long form” agreement is aimed at those depositors that either do not have a state collateralization program to rely upon or who wish to develop separate agreements. The agreement suggests which funds should be collateralized, requirements and procedures for adding and reducing collateral as bank balances and collateral values fluctuate, eligible collateral, collateralization ratios (or haircuts) for different instruments, safekeeping procedures, substitution procedures, and requirements for monthly statements.
SHORT FORM

SECURITY AGREEMENT

This Security Agreement, dated ____________, is between [name of bank] (the "Bank"), a [bank and trust company, national banking association, state banking corporation, savings bank or savings and loan association] having an address at ________________, and [public depositor], having an address at ________________, (the "Public Depositor").

WITNESSETH:

WHEREAS, the Bank is a qualified public depository as defined in [state statute] (the "Act"); and

WHEREAS, Public Depositor from time to time makes deposits, as said term is defined in the Act, in the Bank (its "Public Deposits"), which Public Deposits shall from time to time aggregate in excess of One Hundred Thousand Dollars ($100,000.00); and

WHEREAS, the Public Depositor desires to have its Public Deposits secured by collateral in the amounts required by the Act; and

WHEREAS, the Bank has agreed to secure the Public Depositor’s Public Deposits by granting to the Public Depositor a security interest in certain collateral ("Eligible Collateral") owned by the Bank, which collateral meets the requirements described in the Act, as permitted by 12 U.S.C. § 90 and the Act;

NOW THEREFORE, in consideration of the Public Depositor depositing its Public Deposits as herein described, and for other good and valuable consideration, hereby acknowledged as received, it is hereby agreed between the Public Depositor and the Bank as follows:

1. Pursuant to the Act and in order to secure the Public Depositor’s Public Deposits the Bank hereby pledges, assigns, transfers and grants to the Public Depositor a perfected first priority security interest in (a) such amounts of the Eligible Collateral to meet the collateral ratios and other requirements described in the Act, and (b) the Custody Account (as defined in Section 9 below) and any and all investment property and security entitlements from time to time held in, by, or for the benefit of the Custody Account (including without limitation the Eligible Collateral) and all proceeds thereof (collectively, the "Collateral"). If at any time the ratio of the market value of the Eligible Collateral to the Public Depositor’s Public Deposits, plus accrued interest, is less than required by the Act, the Bank shall immediately, within no more than 24 hours, make such additions to the Eligible Collateral in such amounts such that the ratio of the market value of the Eligible Collateral to the Public Depositor’s Public Deposits, plus accrued interest, shall be at least equal to that required by the Act. Such additions to the Eligible Collateral shall constitute an assignment, transfer, pledge, and grant to the Public Depositor of a security interest in such additional Eligible Collateral pursuant to this Agreement and the Act.

2. The security interest granted herein (as described in Section 1 above) shall secure not only such Public Deposits and accrued interest of the Public Depositor as are held by the Bank at the time of this Agreement, but also any and all subsequent Public Deposits made by the Public Depositor in the Bank regardless of the accounts in which such funds may be held or identified by the Bank.
3. The pledge of Collateral by the Bank shall be in addition to, and shall in no way eliminate or diminish, any insurance coverage to which the Public Depositor may be entitled under the rules and regulations of the Federal Deposit Insurance Corporation or any private insurance carried by the Bank for the purpose of protecting the claims and rights of its depositors.

4. The Public Depositor is under no obligation to maintain its deposits with the Bank and may withdraw them at any time without notice. It is agreed that when the Bank shall have paid out and accounted for all or any portion of the Public Depositor s Public Deposits, any Collateral pledged under this Agreement to secure such paid out Public Deposits shall be released from the security interest created hereunder.

5. The Bank hereby represents that (i) it is a [state banking corporation] duly organized and validly existing under the laws of [state]; (ii) it is a qualified public depository as defined by the Act; (iii) it has, or will have as of the time of delivery of any securities as Collateral under this Agreement, the right, power and authority to grant a security interest therein with priority over any other rights or interests therein; (iv) the execution and delivery of this Agreement and the pledge of securities as Collateral hereunder have been approved by resolution of the Bank's Board of Directors at its meeting of [date], and the approval of the Board of Directors is reflected in the minutes of that meeting, copies of which resolution and relevant portion of the minutes of said meeting are attached hereto as Exhibit A and made a part hereof; (v) the execution and delivery of this Agreement and the pledge of securities as Collateral hereunder will not violate or be in conflict with the Articles of Incorporation or By-laws of the Bank, any agreement or instrument to which the Bank may be a party, any rule, regulation or order of any banking regulator applicable to the Bank, or any internal policy of the Bank adopted by its Board of Directors; and (vi) this Agreement shall be continuously maintained, from the time of its execution, as an official record of the Bank.

6. The Bank warrants that it is the true and legal owner of all Collateral pledged under this Agreement, that the Collateral is free and clear of all liens and claims, that no other person or entity has any right, title or interest therein, and that the Collateral has not been pledged or assigned for any other purpose. Should an adverse claim be placed on any pledged Collateral, the Bank shall immediately substitute unencumbered Collateral of equivalent value that is free and clear of all adverse claims.

7. At any time that the Bank is not in default under this Agreement, the Bank may substitute Eligible Collateral, provided that (a) the total market value of Eligible Collateral held in the Custody Account shall meet the requirements of the Act and this Agreement, and (b) the Public Depositor shall have approved such actual substitution or substitution process and all documentation relating to such substitution before it becomes effective.

8. Any additional pledge of Collateral hereunder, substitution of Collateral, or release of Collateral shall be approved by an officer of the Bank duly authorized by resolution of the Board of Directors to approve such additional pledges, substitutions, or releases of Collateral under this Agreement.

9. The Bank agrees to place the Collateral with a Federal Reserve Bank, a trust department of a commercial bank, or a trust company (the "Custodian"), to hold in a custody account (the "Custody Account") for the benefit of the Public Depositor, as required by the Act. Any such commercial bank or trust company shall be a securities intermediary that in the ordinary course of its
business regularly maintains securities accounts for its customers. The Bank shall execute a custodial trust agreement with the Custodian ("Custodial Trust Agreement") for the custody of the Eligible Collateral consistent with the terms of this Agreement. The Custodial Trust Agreement shall contain the Custodian’s agreement to hold all Collateral in the Custody Account for the benefit of the Public Depositor and subject to the Public Depositor’s direction and control and to comply with entitlement orders originated by the Public Depositor without the Bank’s further consent. The executed Custodial Trust Agreement is attached hereto as Exhibit B. The execution by the Bank of the Custodial Trust Agreement shall in no way relieve it of any of its duties or obligations hereunder or under the Act.

10. Upon the initial transfer of Eligible Collateral under this Agreement and monthly thereafter, the Bank shall cause the Custodian to report to the Public Depositor specifying the type and market value of Eligible Collateral being held in the Custody Account for the benefit of the Public Depositor.

11. The Bank has heretofore or will immediately hereafter deliver to the Custodian for immediate deposit in the Custody Account Eligible Collateral of sufficient value to meet the terms of this Agreement. Said Eligible Collateral or substitute collateral, as herein provided for, shall be retained by the Custodian in the Custody Account so long as the Bank holds deposits of the Public Depositor.

12. In the event the Bank shall (a) fail to pay the Public Depositor any funds which the Public Depositor has on deposit, (b) fail to pay and satisfy when due, any check, draft, or voucher lawfully drawn against any deposit of the Public Depositor, (c) fail or suspend active operations, (d) become insolvent, or (e) fail to maintain adequate Collateral as required by this Agreement, the Bank shall be in default, the Public Depositor’s deposits in such Bank shall become due and payable immediately, the Public Depositor shall have the right to unilaterally direct the Custodian to liquidate the Collateral held in the Custody Account and pay the proceeds thereof to the Public Depositor and to exercise any and all other security entitlements with respect to the Custody Account and the other Collateral, to withdraw the Collateral, or any part thereof, from the Custody Account and deliver such Collateral to the Public Depositor, or to transfer the Collateral or any part thereof into the name of the Public Depositor or into the name of the Public Depositor’s nominee, and ownership of the Collateral shall transfer to the Public Depositor. The Bank authorizes the release, withdrawal and delivery of the Collateral to the Public Depositor upon default by the Bank, and authorizes the Custodian to rely without verification on the written statement of the Public Depositor as to the existence of a default and to comply with entitlement orders originated by the Public Depositor without further consent of the Bank.

13. In the event of default as described in Section 12, the Public Depositor shall also have the right to sell Collateral at any public or private sale at its option without advertising such sale, upon not less than three (3) days notice to the Bank and the Custodian. In the event of such sale, the Public Depositor, after deducting all legal expenses and other costs, including reasonable attorney’s fees, from the proceeds of such sale, shall apply the remainder on any one or more of the liabilities of the Bank to the Public Depositor, including accrued interest, and shall return the surplus, if any, to the Bank, or its receiver or conservator.

14. During the term of this Agreement, the Public Depositor will, through appropriate action of its governing board, designate the officer, or officers, who singly or jointly will be authorized
to represent and act on behalf of the Public Depositor in any and all matters arising under this Agreement.

15. All parties to this Agreement agree to execute any additional documents that may be reasonably required to effectuate the terms, conditions and intent of this Agreement.

16. All of the terms and provisions of this Agreement shall be binding upon and shall inure to the benefit of the parties hereto and their respective successors and assigns.

17. This Agreement may be executed in one or more counterparts, each of which shall be deemed an original and all of which taken together shall constitute one and the same instrument.

18. This Agreement shall be governed by and construed in accordance with the laws of [state], and the laws of the United States, and it supersedes any and all prior agreements, arrangements or understandings with respect to the subject matter hereof. In the event that any conflict of law issue(s) should arise in the interpretation of this Agreement, the parties agree that when [state] law is not preempted by laws of the United States, [state] law shall govern.

19. No provision of this Agreement may be waived except by a writing signed by the party to be bound thereby and any waiver of any nature shall not be construed to act as a waiver of subsequent acts.

20. In the event that any provision or clause of this Agreement conflicts with applicable law, such conflict shall not affect other provisions of this Security Agreement, which shall be given effect without the conflicting provision. To this end the provisions of this Agreement are declared to be severable.

21. Unless applicable law requires a different method, any notice that must be given under this Agreement shall be given in writing and sent by certified mail, return receipt requested or third party overnight priority mail carrier to the address set forth herein or such other place as may be designated by written notice in the same manner from one party to the other.

[public depository bank]

By:
Its:
Date:____________________

[public depositor]

By:
Its:
Date:____________________
LONG FORM

SECURITY AGREEMENT

This Security Agreement, dated ________________, is between [name of bank] (the "Bank"), a [bank and trust company, national banking association, state banking corporation, savings bank or savings and loan association] having an address at ________________, and [public depositor] having an address at ________________ (the "Public Depositor").

WITNESSETH:

WHEREAS, the Bank is a qualified public depository as defined in [state statute], (the "Act"); and

WHEREAS, Public Depositor from time to time makes deposits, as said term is defined in the Act, in the Bank (its "Public Deposits"), which Public Deposits shall from time to time aggregate in excess of One Hundred Thousand Dollars ($100,000.00); and

WHEREAS, the Public Depositor desires to have its Public Deposits secured by collateral; and

WHEREAS, the Bank has agreed to secure the Public Depositor's Public Deposits by granting to the Public Depositor a security interest in certain collateral ("Eligible Collateral") owned by the Bank, as permitted by 12 U.S.C. § 90;

NOW THEREFORE, in consideration of the Public Depositor depositing its Public Deposits as herein described, and for other good and valuable consideration, hereby acknowledged as received, it is hereby agreed between the Public Depositor and the Bank as follows:

1. In order to secure the Public Depositor's Public Deposits the Bank hereby pledges, assigns, transfers and grants to the Public Depositor a perfected first priority security interest in (a) such amounts of the Eligible Collateral to meet the collateral ratios and other requirements described in this Agreement, and (b) the Custody Account (as defined in Section 9 below) and any and all investment property and security entitlements from time to time held in, by, or for the benefit of the Custody Account (including without limitation the Eligible Collateral) and all proceeds thereof (collectively, the "Collateral"). If at any time the ratio of the market value of the Eligible Collateral to the Public Depositor's Public Deposits, plus accrued interest, is less than required by this Agreement, the Bank shall immediately, within no more than 24 hours, make such additions to the Eligible Collateral in such amounts such that the ratio of the market value of the Eligible Collateral to the Public Depositor's Public Deposits, plus accrued interest, shall be at least equal to that required by this Agreement. Such additions to the Eligible Collateral shall constitute an assignment, transfer, pledge, and grant to the Public Depositor of a security interest in such additional Eligible Collateral pursuant to this Agreement and the Act.

2. The security interest granted herein (as described in Section 1 above) shall secure not only such Public Deposits and accrued interest of the Public Depositor as are held by the Bank at the time of this Agreement, but also any and all subsequent Public Deposits made by the Public Depositor in the Bank regardless of the accounts in which such funds may be held or identified by the Bank.

3. The pledge of Collateral by the Bank shall be in addition to, and shall in no way eliminate or diminish, any insurance coverage to which the Public Depositor may be entitled under the rules and regulations
of the Federal Deposit Insurance Corporation (FDIC) or any private insurance carried by the Bank for the purpose of protecting the claims and rights of its depositors.

4. The Public Depositor is under no obligation to maintain its deposits with the Bank and may withdraw them at any time without notice. It is agreed that when the Bank shall have paid out and accounted for all or any portion of the Public Depositor’s Public Deposits, any Collateral pledged under this Agreement to secure such paid out Public Deposits shall be released from the security interest created hereunder.

5. The Bank hereby represents that (i) it is a [state banking corporation] duly organized and validly existing under the laws of the [State of [state]]; (ii) it is a qualified public depository as defined by the Act; (iii) it has, or will have as of the time of delivery of any securities as Collateral under this Agreement, the right, power and authority to grant a security interest therein with priority over any other rights or interests therein; (iv) the execution and delivery of this Agreement and the pledge of securities as Collateral hereunder have been approved by resolution of the Bank’s Board of Directors at its meeting of [date], and the approval of the Board of Directors is reflected in the minutes of that meeting, copies of which resolution and relevant portion of the minutes of said meeting are attached hereto as Exhibit A and made a part hereof; (v) the execution and delivery of this Agreement and the pledge of securities as Collateral hereunder will not violate or be in conflict with the Articles of Incorporation or By-laws of the Bank, any agreement or instrument to which the Bank may be a party, any rule, regulation or order of any banking regulator applicable to the Bank, or any internal policy of the Bank adopted by its Board of Directors; and (vi) this Agreement shall be continuously maintained, from the time of its execution, as an official record of the Bank.

6. The Bank warrants that it is the true and legal owner of all Collateral pledged under this Agreement, that the Collateral is free and clear of all liens and claims, that no other person or entity has any right, title or interest therein, and that the Collateral has not been pledged or assigned for any other purpose. Should an adverse claim be placed on any pledged Collateral, the Bank shall immediately substitute unencumbered Collateral of equivalent value that is free and clear of all adverse claims.

7. At any time that the Bank is not in default under this Agreement, the Bank may substitute Eligible Collateral, provided that (a) the total market value of Eligible Collateral held in the Custody Account shall meet the requirements of this Agreement, and (b) the Public Depositor shall have approved such actual substitution or substitution process and all documentation relating to such substitution before it becomes effective.

8. Any additional pledge of Collateral hereunder, substitution of Collateral, or release of Collateral shall be approved by an officer of the Bank duly authorized by resolution of the Board of Directors to approve such additional pledges, substitutions, or releases of Collateral under this Agreement.

9. The Bank agrees to place the Collateral with a Federal Reserve Bank, a trust department of a commercial bank, or with a trust company (the “Custodian”) to hold in a custody account (the “Custody Account”) for the benefit of the Public Depositor. Any such commercial bank or trust company shall be a securities intermediary that in the ordinary course of its business regularly maintains securities accounts for its customers. The Bank shall execute a custodial trust agreement with the Custodian (“Custodial Trust Agreement”) for the custody of the Eligible Collateral consistent with the terms of this Agreement. The Custodial Trust Agreement shall contain the Custodian’s agreement to hold all Collateral in the Custody Account for the benefit of the Public Depositor and subject to the Public Depositor’s direction and control and to comply with entitlement orders
originated by the Public Depositor without the Bank's further consent. The executed Custodial Trust Agreement is attached hereto as Exhibit B. The execution by the Bank of the Custodial Trust Agreement shall in no way relieve it of any of its duties or obligations hereunder.

10. Upon the initial transfer of Eligible Collateral under this Agreement and monthly thereafter, the Bank shall cause the Custodian to report to the Public Depositor specifying the type and market value of Eligible Collateral being held in the Custody Account for the benefit of the Public Depositor.

11. The Bank shall pledge and transfer to the Custody Account Eligible Collateral having a total market value of at least the total value of the Public Deposits, including accrued interest, of the Public Depositor, less amounts covered by insurance of the FDIC.

12. Eligible Collateral shall include only the following securities and shall have a minimum market value as expressed in the following collateral ratios:

<table>
<thead>
<tr>
<th>FORM OF ELIGIBLE COLLATERAL PLEDGE</th>
<th>COLLATERAL RATIO* (MARKET VALUE DIVIDED BY DEPOSIT PLUS ACCRUED INTEREST)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. United States Treasury bills, notes, and bonds</td>
<td></td>
</tr>
<tr>
<td>i. Maturing in less than one year</td>
<td>102%</td>
</tr>
<tr>
<td>ii. Maturing in one to five years</td>
<td>105%</td>
</tr>
<tr>
<td>iii. Maturing in more than five years</td>
<td>110%</td>
</tr>
<tr>
<td>B. Actively traded United States government agency securities</td>
<td></td>
</tr>
<tr>
<td>i. Maturing in less than one year</td>
<td>103%</td>
</tr>
<tr>
<td>ii. Maturing in one to five years</td>
<td>107%</td>
</tr>
<tr>
<td>iii. Maturing in more than five years</td>
<td>115%</td>
</tr>
<tr>
<td>C. United States government agency variable rate securities</td>
<td></td>
</tr>
<tr>
<td>D. [State] general obligation bonds</td>
<td></td>
</tr>
<tr>
<td>i. Maturing in less than one year</td>
<td>102%</td>
</tr>
<tr>
<td>ii. Maturing in one to five years</td>
<td>107%</td>
</tr>
<tr>
<td>iii. Maturing in more than five years</td>
<td>110%</td>
</tr>
</tbody>
</table>

* The collateral ratios set forth below are merely suggested ratios and should be modified by the Public Depositor to reflect applicable statutory requirements and their investment policies.

13. The Bank shall recalculate the market value of individual securities comprising Eligible Collateral at least monthly.

14. The Bank has heretofore or will immediately hereafter deliver to the Custodian for immediate deposit into the Custody Account Eligible Collateral of sufficient value to meet the terms of this Agreement. Said Eligible Collateral, or substitute collateral, as herein provided for, shall be retained by the Custodian in the Custody Account so long as the Bank holds deposits of the Public Depositor.

15. In the event the Bank shall (a) fail to pay the Public Depositor any funds which the Public Depositor has on deposit, (b) fail to pay and satisfy when due any check, draft, or voucher lawfully drawn against any deposit of the Public Depositor, (c) fail or suspend active operations, (d) become insolvent, or (e) fail to maintain adequate Collateral as required by this Agreement, the Bank shall be in default, the Public
Depositor's deposits in such Bank shall become due and payable immediately. the Public Depositor shall have the right to unilaterally direct the Custodian to liquidate the Collateral held in the Custody Account and pay the proceeds thereof to the Public Depositor and to exercise any and all other security entitlements with respect to the Custody Account and the other Collateral, to withdraw the Collateral, or any part thereof, from the Custody Account and deliver such Collateral to the Public Depositor or to transfer the Collateral or any part thereof into the name of the Public Depositor or into the name of the Public Depositor's nominee, and ownership of the Collateral shall transfer to the Public Depositor. The Bank authorizes the release, withdrawal and delivery of the Collateral to the Public Depositor upon default by the Bank, and authorizes the Custodian to rely without verification on the written statement of the Public Depositor as to the existence of a default and to comply with entitlement orders originated by the Public Depositor without further consent of that Bank.

16. In the event of default as described in Section 15, the Public Depositor shall also have the right to sell Collateral at any public or private sale at its option without advertising such sale, upon not less than three (3) days' notice to the Bank and the Custodian. In the event of such sale, the Public Depositor, after deducting all legal expenses and other costs, including reasonable attorney's fees, from the proceeds of such sale, shall apply the remainder on any one or more of the liabilities of the Bank to the Public Depositor, including accrued interest, and shall return the surplus, if any, to the Bank, or its receiver or conservator.

17. During the term of this Agreement, the Public Depositor will, through appropriate action of its governing board, designate the officer, or officers, who singly or jointly will be authorized to represent and act on behalf of the Public Depositor in any and all matters arising under this Agreement.

18. All parties to this Agreement agree to execute any additional documents that may be reasonably required to effectuate the terms, conditions and intent of this Agreement.

19. All of the terms and provisions of this Agreement shall be binding upon and shall inure to the benefit of the parties hereto and their respective successors and assigns.

20. This Agreement may be executed in one or more counterparts, each of which shall be deemed an original and all of which taken together shall constitute one and the same instrument.

21. This Agreement shall be governed by and construed in accordance with the laws of [state] and the laws of the United States, and it supersedes any and all prior agreements, arrangements or understandings with respect to the subject matter hereof. In the event that any conflict of law issue(s) should arise in the interpretation of this Agreement, the parties agree that when [state] law is not preempted by laws of the United States, [state] law shall govern.

22. No provision of this Agreement may be waived except by a writing signed by the party to be bound thereby and any waiver of any nature shall not be construed to act as a waiver of subsequent acts.

23. In the event that any provision or clause of this Agreement conflicts with applicable law, such conflict shall no affect other provisions of this Security Agreement, which shall be given effect without the conflicting provision. To this end the provisions of this Agreement are declared to be severable.

24. Unless applicable law requires a different method, any notice that must be given under this Agreement shall be given in writing and sent by certified mail, return receipt requested or third-party overnight
priority mail carrier to the address set forth herein or such other place as may be designated by written notice in the same manner from one party to the other.

[public depository bank]
By:
Its:
Date:__________________

[public depositor]
By:
Its:
Date:__________________
Sample Custodial Trust Agreement

The Committee on Cash Management also developed a sample of the type of custody agreement that should be executed between the bank and the custodian of the collateral. The sample custodial trust agreement is aimed at banks that use bank trust departments as their custodians. If a bank were to use a Federal Reserve Bank, the agreement would need proper modification. This agreement can be used in states with or without collateralization laws. If a state does not have a collateralization law, references to the law should be replaced with references to the security agreement between the public depositor and the public depository.

Custodial Trust Agreement

This Custodial Trust Agreement ("Agreement"), dated as of __________, 19_____, between [name of financial institution acting as Custodian (whether or not the institution is the same as the institution acting as public depository)] , a [type of bank - national or state, bank and trust, savings or savings and loan] , as custodian (the "Custodian"), for the [public depositor] , having an address at __________, (the "Public Depositor"). and [name of financial institution acting as public depository], a [type of bank - national or state, bank and trust, savings or savings and loan] (the "Public Depository").

WHEREAS, the Public Depository receives or holds “public deposits,” as said term is defined by [state statute] ("Public Deposits");

WHEREAS, the Public Depository is required by [state statute] to grant a security interest in its public deposits to the Public Depositor for the benefit of public depositors by the segregation of “eligible collateral,” as said term is defined by [state statute]; and

WHEREAS, the Public Depository desires to appoint the Custodian and the Custodian desires to act as custodian for the public depository in the conduct of its duties under [state statute], all upon the terms and conditions and subject to the limitations hereinafter set forth.

NOW THEREFORE, in consideration of the premises and of the mutual covenants herein contained, the Custodian and the Public Depository hereby agree as follows:

1. Transfer of Collateral.

a. Initial Transfer. The Public Depository hereby transfers to the Custodian, on behalf of the Public Depositor, subject to the security interest granted to public depositors under [state statute], the collateral described in Schedule 1 attached hereto (the "Collateral"). The Public Depository certifies that the Collateral is Eligible Collateral, subject to the requirements of the Security Agreement between the Public Depositor and the Public Depository and [if applicable] [state statute] and regulations adopted pursuant thereto (together, the "Public Deposits Act").

b. Additions and Substitutions of Collateral. The Public Depository may, from time to time, transfer to and deposit with the Custodian additional Eligible Collateral or moneys for the purchase of additional Eligible Collateral, to be held by the Custodian pursuant to the terms of this Agreement; provided, however, that if in its sole discretion the Custodian deems the same necessary or convenient, the Public Depository and the Custodian shall first have entered into an amendment to this Agreement describing additional or different terms subject to which the Custodian will receive, hold and dispose of such additional Eligible Collateral. Except as otherwise provided in an amendment to this Agreement, upon transfer or purchase thereof by the Custodian, such additional Eligible Collateral shall be subject in all respects to the terms of this Agreement, and the word "Collateral" as used in this Agreement shall include such additional Eligible Collateral. If Collateral is purchased by the Custodian with moneys provided by the Public Depository, including moneys designated for such purpose pursuant to Section 2 hereof, such
purchase of Collateral shall be at the written direction of the Public Depository, specifically identifying the Collateral to be purchased.

c. **Public Depository’s Transfer Certificate.** Each transfer of Collateral or money for the purchase of Collateral, including the initial transfer of Collateral under this Agreement, shall be accompanied by a certificate of the Public Depository stating, as applicable, the par value or original face amount, current par value, interest rate, CUSIP number, maturity date, market value and security rating of the Collateral transferred or to be purchased. The certificate shall also contain a description of the Collateral and shall state that the Collateral is being transferred to ___[name of financial institution acting as Custodian]__, as Custodian, pursuant to this Agreement.

2. **Sale or Disposition of the Collateral: Recoveries of Moneys With Respect to the Collateral.**

   The Custodian shall not sell or otherwise dispose of the Collateral prior to its maturity. Notwithstanding the foregoing, the Custodian shall, if and as directed in writing by the Public Depository, transfer to the Public Depository, sell or otherwise dispose of any or all of the Collateral. The Custodian shall pay to the Public Depository the proceeds, if any, of any such sale or other disposition of the Collateral. The Custodian shall promptly pay to the Public Depository all other moneys, other than interest (which is to be paid to the Public Depository pursuant to the terms of Section 3 hereof), received by the Custodian with respect to the Collateral. Notwithstanding the foregoing, the Public Depository may provide to the Custodian written instructions to apply all or any part of such proceeds or moneys to the purchase of additional Collateral, provided that such purchase of additional Collateral shall be subject to the terms of Section 1 hereof.

3. **Interest Fund.**

   An Interest Fund (the “Interest Fund”) is hereby established with the Custodian, into which Interest Fund the Custodian shall deposit any interest or other amounts (excluding amounts subject to the terms of Section 2 hereof) received by the Custodian on the Collateral. By the fifteenth day of each month during the term of this Agreement, the Custodian shall pay to the Public Depository any amounts then held in the Interest Fund, subject, however, to the Custodian’s lien or right of set off pursuant to Section 5(d) hereof.

4. **Custodian’s Certificate: Notice of Noncompliance.**

   Prior to or upon execution of this Agreement, the Custodian will deliver to the Public Depository a certificate in substantially the form attached hereto as Schedule 2, stating that the Custodian: (a) is authorized under law to exercise fiduciary powers in the State of ___________; (b) complies with all applicable capital guidelines and requirements as described in the Public Deposits Act; has assets which exceed its liabilities; and that the Custodian’s execution and performance of this Agreement is legal, valid, binding, and enforceable in accordance with the terms of this Agreement; and (c) is either federally insured or has the approval of the state banking commissioner (“Commissioner”) to act as custodian hereunder despite not being federally insured. The Custodian agrees to notify the Public Depositor and the Public Depository immediately in writing if at any time (a), (b), or (c) ceases to be true of the Custodian.

5. **Concerning the Custodian.**

   a. **Custodian’s Duties and Responsibilities.** The Custodian may act upon any instrument or other writing believed by it in good faith to be genuine and to have been signed or presented by the proper person and shall not be liable to any party hereto or to the Public Depositor in connection with the performance of its duties hereunder, except for its own negligence or willful misconduct. The Custodian’s duties shall be determined only with reference to this Agreement and the Public Deposits Act (as it relates specifically to the qualifications or duties of the Custodian) and the Custodian is not charged with knowledge of or any duties or responsibilities in connection with any other document or agreement.
b. **Liability of the Custodian.** The Custodian shall maintain and segregate all Collateral which at any time comes into its possession in accordance with the customary standards in the industry for such possession. The Custodian shall not be liable for any loss resulting from the investment of any moneys held by it hereunder. The Custodian shall in no event be liable for any violation by the Public Depository of, or be responsible to ensure the Public Depository’s compliance with, the Public Deposits Act. In addition, the Custodian makes no representations concerning [state] law as it relates to the Public Depository’s holding and securing of Public Deposits under the requirements of the Public Deposits Act applicable to the Public Depository. The Collateral is subject to the requirements of the Public Deposits Act; provided, however, that the Custodian shall have no liability to ensure the Public Depository’s compliance with such requirements.

c. **Indemnification; Fees and Expenses.** In consideration of the Custodian’s acceptance of its appointment as the Custodian, the Public Depository agrees to indemnify and hold the Custodian harmless as to any liability incurred by the Custodian to any person, firm or corporation, including, without limitation, to the Public Depositor, by reason of its having accepted the same or in carrying out any of the terms hereof, and to reimburse the Custodian for all its expenses, including among other things, counsel fees and court costs, incurred by reason of its position hereunder or actions taken pursuant hereto, except in the event of the gross negligence or willful misconduct of the Custodian. In the event of its failure to exercise ordinary care, the Custodian shall be liable for direct damages. The Custodian shall be deemed to have exercised ordinary care if its actions or failure to act is in conformity with reasonable practice of its banking industry. Notwithstanding any other provision of this Agreement, if it becomes necessary for the Public Depository to obtain court enforcement of its rights against the Custodian and the Public Depositor should prevail, the Custodian shall be liable for the legal fees and costs of the Public Depositor. The Public Depository agrees that the Custodian shall not be liable to it for any actions taken by the Custodian pursuant to the terms hereof. The Public Depository agrees to pay the fees of the Custodian pursuant to the terms of a fee letter delivered by the Custodian to the Public Depository and accepted by the Public Depository. The Public Depository also agrees to pay on demand the Custodian’s costs and expenses, including the fees and expenses of counsel and independent appraisers used by the Custodian, reasonably incurred in connection with its duties hereunder.

d. **Custodian’s Lien.** The Custodian shall have a lien or right of set off on all moneys held in the Interest Fund to pay all fees, expenses and indemnities under this Agreement, and on all moneys being returned to the Public Depository pursuant to Section 2 hereof.

e. **Resignation.** The Custodian shall have the right at any time to resign hereunder by giving written notice of its resignation to the Public Depository at the address set forth herein or at such other address as the Public Depository shall provide, at least thirty (30) business days prior to the date specified for such resignation to take effect (the “Effective Date”) and upon the Effective Date all moneys, Collateral, and proceeds of Collateral then held by the Custodian hereunder shall be delivered by it to the successor custodian designated in writing by the Public Depository. Any such resignation shall not be effective until a successor custodian has been appointed by the Public Depository. As used in this Agreement, the term “business day” means any Monday through Friday, excluding any day on which the Public Depository is authorized or required to be closed under [state] or federal law.

f. **Delivery of Collateral to the Public Depositor.** Promptly upon receipt of written statement of the Public Depositor that the Public Depository is in default, and without need of inquiry as to the validity of such statement, the Custodian shall transfer and surrender to the Public Depositor all or any part of the Collateral, as demanded by the Public Depositor. If the Custodian transfers all of the Collateral held by it hereunder to the Public Depositor, the Custodian shall, concurrently therewith, transfer to the Public Depository all moneys held by it hereunder, subject to the Custodian’s lien pursuant to Section 5(d) hereof, and this Agreement shall thereupon terminate in accordance with the terms of Section 6 hereof.

g. **Insurance.** The Custodian shall, at its own expense, maintain at all times during the existence of this Agreement and keep in full force and effect (a) fidelity insurance, (b) theft of documents insurance, (c) forgery insur-
ance and (d) errors and omissions insurance. All such insurance shall be in amounts, with standard coverage and subject to deductibles, as are customary for insurance typically maintained by banks which act as Custodian in similar transactions. A certificate of the respective insurer as to each such policy shall be furnished to the Public Depository, upon request, containing the insurer’s statement or endorsement that such insurance shall not be materially altered or terminated prior to receipt by the Public Depository, by registered mail, of 10 days notice thereof.

h. **Miscellaneous.** The Custodian may execute any of its powers or responsibilities hereunder and exercise any rights hereunder either directly or by or through its agents or attorneys. Nothing in this Agreement shall be deemed to impose upon the Custodian any duty to qualify to do business or to act as fiduciary or otherwise in any jurisdiction other than in the State of _________. The Custodian shall not be responsible for and shall not be under a duty to examine into or pass upon the validity, binding effect, execution or sufficiency of this Agreement or any agreement amendatory or supplemental hereto with regard to the Public Depository.

6. **Termination.**

This Agreement shall terminate upon the Effective Date of the Custodian’s resignation, or at any time at the option of the Public Depository by written notice to the Custodian terminating this Agreement and instructing the Custodian to transfer all moneys, Collateral, and proceeds of Collateral then held by it hereunder to the Public Depository or to a successor custodian, or upon transfer of all of the Collateral to the Public Depositor and of other moneys to the Public Depository pursuant to Section 5(g) hereof. The provisions of Subsections 5(c) and (d) hereof shall survive termination of this Agreement.

7. **Notices.**

All notices, requests, consents, instructions, demands and other communications required under this Agreement shall be in writing and, unless otherwise specifically provided, may be delivered personally, by telegram, telex, facsimile, or by first class mail, postage prepaid, or by express delivery service, at the addresses set forth below, or such other addresses as may hereafter be furnished to the other parties by like notice. Any such demand, notice or communication hereunder shall be deemed to have been received on the date delivered to or received at the premises of the addressee at:

If to the Custodian:

[address]

If to the Public Depository:

[address]

8. **Amendments.**

No modification or amendment of or supplement to this Agreement shall be valid or effective unless the same is in writing and signed by all the parties hereto.

9. **Governing Law.**

This Agreement shall be governed by and construed in accordance with the laws of the State of _________.

10. **Counterparts.**
This Agreement may be executed in counterparts, each of which shall be deemed an original, but all of which shall constitute but one and the same instrument.

11. **Reports.**

Upon the initial transfer of collateral under this Agreement, and by the fifteenth day of each month during the term of this Agreement, the Custodian shall provide to the Public Depository and Public Depositor a statement: (1) listing the Collateral held by the Custodian; (2) stating the aggregate Value (as defined below) of the Collateral; and (3) itemizing the interest and other amounts received on the Collateral and deposited into the Interest Fund pursuant to Section 3 hereof. The Value of Collateral shall be its market value, if the same is readily determinable. If the market value of Collateral is not readily determinable from sources available to the Custodian in the ordinary course of its corporate trust business, then the Custodian shall have no obligation to determine the value of such Collateral.

12. **Successors and Assigns.**

This Agreement shall be binding upon the parties hereto and their respective heirs, legal representatives, executors, administrators, successors and assigns.

13. **Severability.**

If any of the provisions of this Agreement shall be held invalid, then such provisions shall be deemed severable from the remaining provisions of this Agreement and shall in no way affect the validity or enforceability of the other provisions of this Agreement.

14. **Further Assurances.**

Upon demand, the Public Depository will execute and deliver to the Custodian such instruments and documents as the Custodian may reasonably deem necessary or advisable to confirm the Custodian’s interest in the Collateral or to further define the Custodian’s obligations hereunder.

**IN WITNESS WHEREOF,** this Agreement has been duly executed by the parties hereto as of the date first above written.

[NAME OF FINANCIAL INSTITUTION], as Custodian

By: ____________________________

Name:

Title:

Dated: ____________________________

[NAME OF FINANCIAL INSTITUTION], as Public Depository

By: ____________________________

Name:

Title:

Dated: ____________________________
Attachments to the Agreement

The agreement references schedules 1 and 2 as attachments. Below are examples of schedules that may be used and include a schedule of collateral and a certificate of eligibility of the custodian. These schedules are as follows:

SCHEDULE 1

[DESCRIPTION OF COLLATERAL]

SCHEDULE 2

CUSTODIAN'S CERTIFICATE OF ELIGIBILITY

The undersigned, being a duly authorized officer of [name of financial institution, acting as Custodian], as custodian (in such capacity, the “Custodian”) under the Custodial Trust Agreement (the “Agreement”) dated as of ________________, 20__ between the Custodian and [name of financial institution acting as public depository] (the “Public Depository”) hereby certifies as follows:

1. the Custodian is authorized under the laws of the United States of America to exercise trust and fiduciary powers in the State of __________;

2. the Custodian complies with all applicable capital guidelines and requirements applicable to it, adopted by the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Board of Governors of the Federal Reserve System as from time to time amended;

3. deposits of the Custodian are insured by the Federal Deposit Insurance Corporation;

4. the Custodian has assets that exceed its liabilities; and

5. the Agreement is a legal, valid, and binding obligation of the Custodian, enforceable in accordance with its terms.

The Custodian agrees to notify the Public Depositor and the Public Depository immediately in writing if at any time any of the above conditions ceases to be true and accurate.

Certified this ________ day of ________________, 20__. 

[NAME OF FINANCIAL INSTITUTION ACTING AS CUSTODIAN],
as Custodian

By:__________________________

Name:

Title:
APPENDIX B

GFOA Model Collateralization Statute

MODEL LEGISLATION
Security for Public Deposits
Collateral Pledging)
(But it enacted, etc.)

SECTION 1:

Short Title—This chapter may be cited as the “Security for Public Deposits Act.”

SECTION 2:

Public Deposits to be Secured—All public deposits in banks or savings associations located within this state shall be secured as provided in this act.

SECTION 3:

Required Collateral—The state treasurer shall promulgate regulations requiring that banks and saving associations located within the state deposit collateral securities to secure the deposits of the state and its political subdivisions in each such institution.

Subsection (a)
The amount of collateral securities to be pledged for the security of public deposits shall be established by rules and regulations consistent with the provisions of this act.

Subsection (b)
To secure public deposits, a financial institution must place required collateral securities in a restricted account at a Federal Reserve Bank, a trust department of a commercial bank, or with another financial institution that is not owned or controlled by the same institution or holding company. The depositor shall deliver to the state treasurer a power of attorney authorizing the treasurer to transfer or liquidate these securities in the event of a default, financial failure, or insolvency of a public depository.

Subsection (c)
Minimum Collateral—The state treasurer shall periodically determine a minimum ratio for collateral pledging for each institution that accepts public deposits. The minimum amount of collateral required of financial institutions shall not be less than the percentage of total public deposits held by a single financial institution located within the state. In no event shall the minimum ratio used for collateralization be less than 10 percent of each institution’s public deposits.
Subsection (d)

Additional Collateral—The state treasurer shall adopt rules and regulations to require additional collateral from depositories:
1) Whose deposits exceed the statewide average ratio of public deposits to total deposits;
2) Whose financial condition is weakening;
3) Whose public deposits exceed capitalization; and
4) Which have begun accepting public deposits within the past two years.

Subsection (e)

Valuation—The state treasurer shall adopt rules and regulations to provide for the valuation of collateral, in the event that market value is not readily determinable.

Subsection (f)

The state treasurer shall promulgate rules governing reporting requirements and other administrative procedures necessary to effectively carry out this act.

SECTION 4:

Eligible Collateral—For purposes of securing public deposits the following securities are eligible:
a) Obligations of the U.S. government, its agencies and instrumentalities;
b) Prime banker's acceptances;
c) Obligations of the state or one of its political subdivisions or municipalities;
d) Securities eligible for discount at the Federal Reserve Bank or the Federal Home Loan Bank;
e) Other marketable securities and debt instruments determined by the state treasurer to be satisfactory for purposes of providing liquid assets in the event of a public depository default or insolvency; and

f) Substitution—A financial institution may substitute different forms of collateral from time to time, provided that each meets the requirements of this statute and the rules and regulations of the state treasurer.

SECTION 5:

Procedure for Payment of Losses—In the event of a default or insolvency of a public depository, the state treasurer shall implement the following procedures:

a) In cooperation with the State Department of Banking and other regulatory officials, the state treasurer shall ascertain the amount of public funds on deposit at the defaulting institution and the amount of deposit insurance applicable to such deposits.

b) The potential loss of public depositors shall be calculated by compiling claims from such depositors. Such claims shall be validated. The loss to public depositors shall be satisfied, insofar as possible, first through any applicable deposit insurance and then through the sale of securities pledged by the defaulting depository institution.

c) If the loss to public depositors is not covered by such insurance and the proceeds of the failing depository's assets and pledged collateral, the treasurer shall provide coverage of the remaining loss by assessment against other qualified public depositories' pledged collateral. Such assessment shall be determined by multiplying the total amount of the remaining loss to all public depositors by a percentage that represents the average of public funds deposits held by each depository during the previous 12 months, divided by the average total public deposits held by all depositories during the same 12-month period. Each qualified depository shall pay its assessment to the state treasurer within three business days after it re-
ceives notice of assessment. If a depository fails to pay its assessment when due, the treasurer shall satisfy the assessment by selling securities pledged by that depository.

d) Following collection of the assessments, the state treasurer shall distribute funds to the public depositors of the failed depository according to their validated claims. In the event the assets available are less than the total deposits, the treasurer shall prorate the claims. Entities receiving payment under the provisions of this section shall assign to the state treasurer any interest they may have in funds that subsequently become available to depositors of the defaulting depository.

SECTION 6:

Limits of Liability—When public deposits are made in accordance with this chapter, no public depositor shall be liable for any loss resulting from the default or insolvency of a public depository in the absence of negligence, malfeasance, misfeasance or nonfeasance on the part of the official. The financial liability of public depositories for the failure or default of another financial institution shall not exceed the amount of collateral required at the time of the default. In the event the state treasurer sells an institution’s collateral securities, the institution must deposit additional collateral to meet required collateral levels.
APPENDIX C

State Pledging Requirements for Public Deposits

Percentage of Coverage Required
(Footnotes in Parentheses)

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**Footnotes**

1. For deposits above FDIC coverage, the commissioner of the Department of Revenue determines amount and kind of deposit collateral, if any.
2. State and local units of government can participate in a voluntary collateral pool program. For governments participating in this program, the collateral ratio varies according to the bank’s capitalization.
3. 150 percent if collateral consists of first mortgages and first trust deeds.
4. 10-120 percent base on depository’s risk-based capital ratio.
5. Guidelines vary based on depository’s size, performance ratios, etc. In Kentucky, the State Investment Commission has statutory authority to lower the ratio to 60 percent for certain banks having little or no credit risk.
6. All in-state banks have a mutual responsibility for the protection of public deposits.
7. Cannot deposit out of state. In Colorado, this applies to non-home-rule municipalities.
8. State law permits local governments to use certificates of deposit at 125 percent of the value of the deposit. State law authorizes the state treasurer to establish a pool.
10. Coverage for amount in excess of FDIC coverage for deposits representing over 25 percent of the bank’s capital.
11. 200 percent if collateral consists of real estate mortgages.
12. 5 percent if funds are less than 75 percent of capital accounts and reserves; 100 percent if funds over 75 percent.
13. A collateral pool exists for these local government units.
14. State funds are deposited with the Bank of North Dakota, a state entity.
15. 110 percent when deemed necessary by the State Treasury.
17. Deposits in excess of established allotment must have 110-130 percent coverage.
18. In Virginia, the collateral is pledged with the State Treasurer in a re-insurance pool. Financial institutions must pledge not less than 50 percent of the amount of public deposits in excess of the FDIC coverage. The State Treasurer may require additional collateral.

19. Collateralization is allowed, but not required.

20. For deposits above the FDIC coverage, the bank commissioner’s advisory committee determines amount and kind of collateral.

21. Corporate surety bond executed by a company authorized to do business in the state is allowed instead of collateral.

22. Although coverage is 100 percent or more of deposits, the statute requires “market values” to be adjusted downward for certain types of collateral. This effectively increases the coverage requirements when using those types of collateral.

23. Iowa requires banks to collateralize amounts in excess of: (total public funds on deposit at a given bank) minus (total bank capital).

24. No collateral is required for demand deposits. Collateral requirements apply to time deposits with maturities over 60 days, or if a bank does not meet minimum capital standards.
## APPENDIX D

### Eligible Collateral for Deposit Pledging by State

(Footnotes in Parentheses)

<table>
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<tr>
<th>State</th>
<th>US Gov't Obligations</th>
<th>US Agencies</th>
<th>State Obligations</th>
<th>State Agencies</th>
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**Notes**

1. See listing below.
2. See Appendix C.
3. Other as determined by the Cash Management Policy Board.
4. Other as determined by the bank commissioner.
5. The state government has a greater number of collateral options than localities.
6. In Idaho, the law permits but does not require governments to collateralize deposits. It is silent on types of collateral eligible for pledging.

**Other collateral**

A. African Development Bank
B. Asian Development Bank
C. Bankers acceptances
D. Canadian bonds
E. Certificates of deposit
F. Commercial paper
G. Inter-America Development Bank
H. International Bank of Reconstruction and Development (World Bank)
I. Israeli bonds
J. Merchant Marine bonds
K. Investment trusts registered under the Investment Company Act of 1940
L. Warrants
M. International Finance Corporation
N. Government Development Bank of Puerto Rico
O. Surety bond (although some restrictions may exist, such as limited to a certain percentage of deposits or allowed for state funds but not local funds)
P. Collateralized mortgage obligations (CMOs)
Q. Real estate mortgage investment conduits (REMICs)
R. Specifically states mortgage pass-through or participation certificates or similar securities
S. Municipal revenue bonds
T. Asset-backed securities
U. Irrevocable, nontransferable, unconditional standby letters of credit issued by the Federal Home Loan Bank of Topeka
V. Puerto Rico bond issues
W. Insurance provided by a AAA-rated insurer
X. Share in a government investment pool
Y. Certificates of deferred property taxes
Z. Repurchase agreements
AA. Certificates of Deposit Account Registry Service (CDARS)
# APPENDIX E

## Deposit Pledging Statutes: Citations

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<td>New Mexico</td>
<td>6-10-10, 6-10-15 to -22</td>
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<td>147-69; 159-31</td>
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<td>135.18 and 18.01</td>
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<td>281-72; 309.1</td>
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<td>Texas</td>
<td>Chapter 404.031, Chapter 2256, Chapter 2257</td>
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<td>Wisconsin</td>
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<td>Wyoming</td>
<td>Title 9, Chapter 4, Article 8, 9-4-821</td>
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APPENDIX F

GFOA Policy Statement

In 1984, GFOA’s Committee on Cash Management adopted a policy statement regarding the collateralization of public deposits. The text of the statement follows:

Use and Importance of Pledging Requirements for Public Deposits

The Government Finance Officers Association (GFOA) is aware of the extensive use and major importance of pledging requirements, whereby state and local government deposits in financial institutions must be secured by governmental obligations pledged for that purpose.

Because these requirements protect state and local depositors, the Government Finance Officers Association is in favor of the use of pledging requirements. The Association continues to oppose legislation that would directly or indirectly diminish the use and value of pledging requirements as protection for state and local government deposits. Consistent with the foregoing, the Association further favors and encourages state and local governments to establish adequate and efficient administrative systems to monitor and maintain such pledged collateral, including state or locally administered collateral pledging or collateral pools.
APPENDIX G

GFOA Recommended Practice

In 1987, the committee developed a recommended practice that was last updated in 2000. The recommended practice is as follows:


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 depositories 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 requirement 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.