

New Public Funds Collateralization Law

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In 2002, the Iowa Legislature amended the public funds collateralization law. The law became effective on July 1, 2003. The Treasurer of the State adopted rules to implement the new law on January 30, 2004, to become effective March 30, 2004. Below is a brief summary of the changes to the collateralization of public funds.

Generally, how does the law work?

Under the new law, when a bank accepts a deposit of public funds, the bank agrees to pledge certain collateral in accordance with Iowa Code section 12C.22 to secure the public funds deposited. If collateral must be pledged, the bank is known as a “pledging bank”. If the bank fails to pay a check, draft or warrant of a public officer, if the bank closes, or in other limited circumstances, the Treasurer of the State may liquidate the pledged collateral to pay the claims of the public entity. Now, when the Treasurer of the State pays claims of public entities, the claims will be paid from the following sources in the following order:

1. Any applicable insurance (i.e., first \$100,000 on deposit is insured by the FDIC);
2. Liquidation of any pledged collateral or funds received from a Letter of Credit used by a pledging bank to secure the public funds;
3. Assets of the bank which are liquidated within 30 days of the closing of the bank;
4. Funds in the State Sinking Fund; and
5. Assessments against all remaining banks whose public funds deposits exceed FDIC insurance coverage.

Which banks have to pledge collateral?

Each bank that accepts public funds must determine if it must pledge collateral. A bank must pledge collateral, thus becoming a “pledging bank”, if the *total* amount of public funds (i.e., all deposits by a city, county, school district, municipal utility, etc. must be included) on deposit in the bank exceeds the total capital of the bank. Iowa Code section 12C.22 sets out a specific calculation which each bank must make to determine its total capital.

This means a bank may not be a pledging bank one day but may be a pledging bank the next day, depending on the total capital of the bank and the amount of public funds on deposit *on that particular day*. For example, a public entity maintains an account at Bank X and on approximately October 14 Bank X would not be a pledging bank under

the statute because the total amount of public funds would not exceed the total capital of Bank X. However, when the public entity receives its property tax collections on approximately October 15, Bank X may be a pledging bank because the total amount of public funds on deposit would exceed the total capital of Bank X *on that day*.

Although the Treasurer of the State's web page states that "[b]anks are required to determine if circumstances on any given day require them to pledge securities that day"¹, it may be wise for public entities to verify the to what extent the total amount of public funds deposited exceed the total capital of the bank on the date of any substantial deposit such as state aid payments for school districts, property tax collections, or bond proceeds.

Who holds the pledging bank's collateral?

The pledging bank must pledge collateral which will be held by an "approved custodian". Generally, an approved custodian may not be the pledging bank, an affiliate bank or subsidiary of the pledging bank or any bank in which the approved custodian or any affiliate has direct or indirect control of the pledging bank. The Treasurer of the State will develop a list of criteria which a bank must meet to be an approved custodian.

What type of securities are "eligible collateral"?

Iowa Code section 12C.22(6) lists specific securities and other forms of collateral which are acceptable. This includes cash and, in certain circumstances, a Letter of Credit. A Letter of Credit will be held in the Treasurer of the State's vault, not by an approved custodian.

May a pledging bank withdraw, substitute, or change the collateral?

Yes. The pledging bank must submit a Certificate and Approval for Withdrawal, Substitution, or Addition of Collateral to the approved custodian, along with a calculation that demonstrates once the transaction is complete, there is sufficient collateral pledged. Before completing the transaction or releasing any collateral, the approved custodian must verify that, after the transaction is complete, the total collateral market value is equal to or exceeds the total excess public funds. If the calculation is verified the approved custodian will then notify the Treasurer of the State and the pledging bank of the completion of the transaction.

¹See www.treasurer.state.ia.us.

What are the consequences if a pledging bank violates the law?

If a pledging bank violates any provision of the laws, rules, agreements proscribed by the Treasurer of the State, or fails to fulfill its duties, or applicable FDIC insurance coverage is suspended or terminated, the Treasurer of the State may suspend or terminate the bank's ability to accept uninsured public funds. **The public entity will be notified of the suspension or termination of a bank's ability to accept uninsured public funds by notices included in the monthly rate-setting notice posted on the Treasurer of the State's Web site. If a public entity's funds are on deposit with a suspended or terminated pledging bank, the public entity may have an illegal investment and/or deposit under Iowa law and should consult with their attorney.**

What are the consequences if an approved custodian violates the law?

If an approved custodian violates any provision of the laws, rules, agreements proscribed by the Treasurer of the State, or failed to fulfill its duties, the Treasurer of the State may suspend or terminate the bank's designation as an approved custodian. The Treasurer of the State will notify the pledging bank of the suspension or termination and the pledging bank must immediately secure the services of another approved custodian.

What should public entities do to ensure the safety of their funds?

Although the statute and rules do not require public entities to take any action, it may be prudent for public entities to implement procedures to periodically verify the bank's compliance with the collateralization requirements and when making a substantial deposit. Because this issue will be receiving increasing attention from auditors, state regulators, and banks, it may be wise to review policies and practices and to consult with legal counsel.

The purpose of this column is to identify issues. It does not purport to be exhaustive or to render legal advice. You should consult with qualified counsel or other professionals in developing responses to specific situations.