Overview of Pledging Bank Assets for Uninsured Deposits

NOTE: This article is a description only of Illinois law regarding the ability or requirement for banks to pledge assets to secure funds not insured by the FDIC. It is not a recommendation of any business practice for a state-chartered or national bank in Illinois.

We all know that a bank is authorized to pledge assets to secure uninsured deposits of public agencies. In this article, I will discuss some specifics behind that authority and/or requirement. For example, if a bank opens a deposit account with public funds in the amount of $500,000 without a pledge to secure the uninsured $250,000 when the account is opened, is the bank in violation of Illinois law?

The answer to the question is "It depends." It depends on whether the public agency and the bank have already contracted for the pledge of bank assets. The deposit of funds by a public agency into an account at a bank or savings bank is governed by two Illinois acts: the Public Funds Investment Act ("Investment Act") and the Public Funds Deposit Act ("Deposit Act") While both acts include an *expectation* that uninsured public funds on deposit will be collateralized, Section 6 of the Investment Act states that the public agency "may enter into an agreement with the financial institution" requiring that uninsured funds be protected by a bank pledge; similarly, Section 1 of the Deposit Act states that the public agency's treasurer or custodian of funds ""may require" the depository institution to collateralize uninsured public deposits. Technically, therefore, the financial institution is statutorily obligated to pledge to secure the uninsured public funds on demand from the public agency only after the bank and public agency have reached a pledging agreement. As a matter of practice, I suspect that the treasurer or custodian of the public funds would negotiate and execute the pledge agreement before making a deposit of funds over the $250,000 FDIC coverage.

Section 6(a) of the Investment Act requires that a bank, to be a depository of public funds, must provide to the public agency its two most recent "sworn statements of assets and liabilities which the bank is required to furnish to the (Illinois Division of Banking) or to the Comptroller of the Currency;" the bank must continue submitting such documents in future years to the public agency for the duration of the bank's status as a depository of funds of that public agency.

In 2014, CBAI collaborated with Promontory Financial Corporation ("Promontory") and successfully initiated legislation to create an alternative to the pledging requirement pertaining to uninsured public deposits. The addition of Section 6.5 of the Investment Act codified Promontory's Certificate of Deposit Account Registry Service ("CDARS") as a legal option that would not involve the pledging of bank assets

for public funds; of course, the bank cannot ***compel*** a public agency to select CDARS over a conventional pledging demand, but it is an option that provides no risk to the public funds.

CDARS works as an alternative to pledging because there are never any "uninsured" public funds that need to be secured. Much like, on the loan side, a bank could participate out to a correspondent, affiliate, or other bank a portion of a loan to avoid a lending limit violation, CDARS is a network of banks willing to "participate" in public deposits in a manner that would at all times fully cover the public deposits with FDIC insurance. For example, when a public agency wants to deposit $500,000, the original bank of deposit could keep $250,000 under its own FDIC limit and "participate out" the other $250,000 to one or more other CDARS banks, resulting in no uninsured funds of that particular public agency. Only the original bank of deposit, and not the "participants," would be required to provide its two most recent statements of assets and liabilities to the public agency consistent with Section 6(a) of the Investment Act.

Two conflicting Interpretive Letters have been published over the years by the predecessor agencies of what is today the Division of Banking within the Illinois Department of Financial & Professional Regulation ("State Agency"). In 1998, Interpretive Letter #98-12 claimed that state-chartered banks could pledge to secure private deposits; whether intentionally or not, the State Agency did not rescind Interpretive Letter 91-1, which concludes that a state-chartered bank is only authorized to pledge against uninsured ***public*** deposits.

As between those two Interpretive Letters, in my opinion the more recent, permissive one is likely of no use, because there is a problematic condition attached to its conclusion that a bank can pledge to secure private deposits: the condition that the bank would have to apply for, and receive, permission from the FDIC. That application/approval requirement is necessary because of a federal regulation (Part 362 of the FDIC'S regulations) limiting the investments and activities of state-chartered banks to those that are allowed for national banks. I have confirmed with the Office of the Comptroller of the Currency's Central District office (Chicago) that national banks are not authorized to pledge to collateralize uninsured private deposits. It is not realistic to think that the FDIC would approve a Part 362 application allowing state-chartered banks to pledge assets against uninsured private deposits, because in its receivership and liquidation role when a bank fails it is in the FDIC's interest to assemble all of the failed bank's assets that the FDIC can reach.