Indiana Board for Depositories

Semi-Annual Report to the State Budget Committee

12/14/2010

In the 2010 legislative session, the Indiana General Assembly passed HEA 1336 that gives the Indiana Board for Depositories (IBFD) the tools to be more strategic in the safekeeping and prompt payment of public funds held in Indiana depositories. Until this time, the primary tool in fulfilling this mission was the maintenance and operation of the Public Deposit Insurance Fund (PDIF) which could be drawn upon to pay claims of those public funds held by a failed depository that were not covered by a federal deposit insurance program. Included in this legislation was the requirement for the IBFD to prepare a report each June and December on its activities and the status of the PDIF, and for the IBFD chairperson or designee to present the report to the budget committee at a public hearing. The report is to focus on the previous six months' activities but since this is the first report additional historical information has been provided for greater context relating to these activities.

A Brief History

The IBFD was created by the Depository Act of 1935 and became truly operational pursuant to the Depository Act of 1937. The first assessment was set at 1% of the public funds on deposit but was reduced to ½% after the first six months. For the next 48 years, the IBFD reduced the rate to as low as ¼%, periodically suspended assessments, periodically granted assessment refunds, and reinstated assessments on selected deposit account types. Assessments were last levied in 1985. The PDIF has been drawn upon three times to pay claims due to the closure of Indiana depositories in the late 1980's and early 1990's. Initial payouts ranged from $59,000 to $2.3 million with favorable recovery rates following the FDIC disposition of assets.

The number of depositories eligible to hold Indiana public funds has fallen from over 500 in the 1940's to 190 today. A table of public funds on deposit at Indiana financial institutions, the largest amount held by a single institution and the PDIF reserve fund at certain points in time is presented below.

		Millions		
Year	No. of Depositories	Public Funds on Deposit	Largest Balance Held by Single Depository	PDIF Reserve
1950	500+	$291	unavailable	$5
1985	400+	$3,500(a)	$280	$131
2010	190	$12,364	$1,354	$250

(a) estimated from available records

The amount of public funds on deposit reported by Indiana depositories exceeded $12.3 billion as of September 30, 2010. The average balance of public funds held is $65 million but the median of $15 million reveals the concentration of public funds in an industry where the number of depositories has fallen dramatically in the last 25 years. A dozen depositories hold public funds in excess of the PDIF reserve.

Operational Background

A financial institution, once designated as an eligible depository, must maintain capital equal to or above the minimum required by its regulator. Compliance has been self-reported and as long as that is maintained, the depository can hold and accept additional public funds. Collateralization was permitted prior to the enactment of HEA 1336 but its application was an "all or none" proposition. If the IBFD deemed the assets of the PDIF to be insufficient to meet liabilities or to insure the safekeeping and prompt payment of public funds in the event of a closure, it could impose collateralization only on all depositories at 100% of the public funds held. This did not permit a structure to address the depositories that presented greater risk to the system.

In light of the changes in the public funds markets and the turmoil in the global financial markets in the fall of 2008, the IBFD began a more deliberate review of its tools to fulfill its mission. It was becoming evident that other factors, such as asset quality and liquidity, could significantly impact financial stability prior to those challenges being reflected in the capital of the institution. In fact, the PDIF survived a critical situation in 2009 where the PDIF had insufficient resources to pay the full amount of potential claims for public funds held by a struggling institution. That institution maintained its minimum capital requirements up until regulatory resolution.

Since both statutory options to improve the effectiveness of the PDIF (the universal 100% collateralization and/or uniform assessments to all eligible depositories) were not deemed viable in light of the circumstances, a legislative effort was pursued to permit collateralization that reflected the risk profile presented by the depository. HEA 1336-2010 provided that flexibility.

Recent Activities

A working group was formed following passage of the legislation and has been meeting at least weekly. Research of other states' programs to protect public deposits was conducted along with outreach efforts with the Indiana Bankers Association which included surveys, presentations at its annual convention, and other communication. Using the information gathered from those efforts, a rule for the collateralization of public funds was adopted by the IBFD at its September meeting and was further refined at its December board meeting. The rule can be found at www.in.gov/tos/deposit/2552.htm.

The program is expected to be operational in February 2011. Eligible collateral (marketable government securities and letters of credit from the Federal Home Loan Bank) will be required on a graduated basis depending on the depository's risk profile. Rating services, specific to the banking industry, will be the primary basis for establishing the risk profile. The goal is to use the rating service as a "leading indicator" so that a depository begins collateralizing as its ratings decline to more risky levels. The services researched and selected for use have a commendable track record of predicting troubled institutions. If that risk grows to critical levels, collateralization at 100% could occur. The IBFD will contract with a custodian to hold in separate accounts the securities for those institutions required to pledge and deliver collateral. HEA 1336 allows a depository to voluntarily collateralize at 100% to be exempt from any future assessments. Approximately 40% of the depositories are expected to be required to collateralize at some level. At this time, approximately 40% of the public funds will be

subject to collateralization. Each quarter, public funds will be reported by the depositories and updated ratings will be received and used to reset the collateralization levels based on that data.

Local government finance and investment officials should see no difference in their day-to-day banking relationships as this activity will be centralized at the IBFD. Questions regarding eligibility can be directed to the IBFD who will confirm eligibility and compliance with the rule.

All information related to the collateral requirement of a depository is strictly confidential to protect the institution from undue or abnormal activity.