

CDARS: AN ALTERNATIVE FOR LOCAL GOVERNMENTS

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As many California governmental agencies struggle with decisions on how to invest their surplus funds in this challenging economic environment, a relatively new tool has emerged as an increasingly attractive option. A service called the Certificate of Deposit Account Registry Service, or CDARS, allows customers the opportunity to deposit up to \$50 million through one bank and still maintain full FDIC insurance coverage on the entire deposit amount.

Virtually all states, including California, have enacted statutes that require public deposits in excess of the FDIC's insurance limit (currently \$250,000 through December 31, 2009) to be secured by pledged collateral securities from depository institutions. However, effective January 1, 2007 and sunseting on January 1, 2012, AB 2011 added Government Code Sections 53601.8 and 53635.8, which expanded local governments' permitted investments to include the use of private CD placement services, such as CDARS. Rather than potentially dealing with a very large number of different banks, for larger deposits, in order to ensure full FDIC insurance coverage on the amount deposited, the enabling legislation provides a means for a local agency to work with only one bank for non-negotiable CD investments.

CDARS is a deposit-placement service designed to allow FDIC-insured depository institutions the ability to accept deposits of more than \$100,000 and obtain full coverage for the depositor by spreading the funds among as many separate FDIC-insured institutions as necessary so that no institution holds more than \$100,000 (principal plus interest) for each depositor. While the basic FDIC insurance limit was raised from \$100,000 to \$250,000 last October, the increase is temporary and is scheduled to expire at the end of 2009. Currently, CDARS CDs are offered in 4-week, 13-week, 26-week, 52-week, 104-week (2 years), and 156-weeks (3 years) maturities. The Bank of New York Mellon, which serves as the program's master custodian, tracks all depositors, monitors member institutions and administers deposits electronically among the participating network of banks with minimal paperwork. In the event of a bank failure of one of the participating institutions, the Bank of New York Mellon, along with Promontory Interfinancial Network, would provide the electronic records and file the necessary claim with the FDIC in order to retrieve the customer's funds. Depositors using CDARS are not charged fees to open accounts, instead participating banks pay a fee to join CDARS and pay transaction fees to Promontory depending on the size of the deposit. Like most CD deposits there are penalties for early withdrawals, and the penalties for early withdrawals from CDARS CDs can be substantial, sometimes as much as all of the interest earned on the deposit.

An example of how the program works is as follows; suppose a city needs to invest \$5 million. The city would enter into negotiations with one or more local banks that are members of the Promontory Interfinancial Network that participate in the CDARS program. In order for a bank to participate in the CDARS program it must be "well capitalized" (the highest rating) and "well managed" as defined by FDIC guidelines. Once a "gateway bank" has been selected, and an interest rate and term of the deposit, have been agreed, the original deposit amount would be divided into amounts that fall within the FDIC insurance limits (currently less than \$250,000 if the CD matures prior to the end of 2009 or less than \$100,000 if the CD matures in 2010 or later). These deposit amounts would then be placed throughout the CDARS network in CDs issued by between 21 and 53 other member institutions (depending upon the term of the CD that was negotiated with the gateway bank) where they would enjoy full FDIC insurance coverage for the principal and interest. The city would receive regular consolidated interest payments and statements from the gateway bank showing the account activity for each CD held in its name.

In addition, the gateway bank receives funds from other banks within the CDARS networks totaling the amount deposited. In other words, the amount of money a bank places using the CDARS service returns to that bank in the form of customer money from other network members. These reciprocal deposits are usually qualify funds using CDARS as "local." This may often be a requirement of many government investment policies. This policy of reciprocal deposits should encourage the greater use of smaller local and community banks by government agencies, which have previously been excluded from accepting large deposits because the law required them to collateralize all deposits in excess of the FDIC insurance limits. Most small banks do not have the financial flexibility to collateralize large deposits, however, because CD deposits placed using CDARS are eligible for full FDIC insurance coverage, governments investing through CDARS are not required to track collateralized assets and constantly mark-to-market the prices of Treasury bills and other pledged assets. For government officials responsible for investing public funds this means not having to deal with multiple banks, rate negotiations and collateral monitoring. At the end of the day, the gateway bank has the deposit on its books that can be used for community lending purposes, which could potentially stimulate economic activity at the local level.

In conclusion, CDARS increases the number of potential banks that local agencies might be able to work with in managing their funds, by allowing local governments the opportunity to manage large deposits in non-negotiable CDs with less administration than if it invested in separate financial institutions on its own. It allows local agencies to obtain full FDIC insurance coverage on up to \$50 million, as well as the opportunity to invest its funds "locally," which could promote greater community lending and potentially stimulate economic activity at the local level. However, any agency contemplating investing through CDARS should first review their investment policies to ensure that this type of investment is permitted. Second, they should carefully research the opportunity to determine if the investment meets its cash flow and liquidity needs to avoid having to break the CD and incur early withdrawal penalties. Third, the local agency should monitor where any current bank deposits are being held to make sure that there is no overlap with potential CDARS-placed deposits that might negate the FDIC insurance coverage at that institution. Finally, if a local agency is contemplating investing proceeds of a municipal bond issue they should consult with their financial advisor, bond counsel and tax counsel to ensure that the investment is appropriate. In relation to municipal bond proceeds, certain issues including which party holds funds under the indenture or trust agreement may make investing bond proceeds through CDARS not a viable option. ♦