

State of North Carolina

Department of State Treasurer

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Memorandum No. 1109

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TO: Local Government Officials and Certified Public Accountants

**FROM: Sharon Edmundson, Director
Fiscal Management Section**

**SUBJECT: Current Issues in Deposits and Investments for North Carolina Local
Governments**

In light of recent issues and events in the financial markets, we thought it appropriate to review the regulation of banks in North Carolina, the collateralization process and follow up procedures, and overall investment policies. In addition, we also will address concerns regarding the soundness of holding or purchasing investments in the senior debt of Fannie Mae and Freddie Mac.

Regulation of our banks comes from two different sources – 1) the North Carolina Banking Commission, and 2) the Office of the Comptroller of the Currency within the US Treasury Department. The NC Banking Commission regulates and monitors all North Carolina state-chartered financial institutions. The Banking Commission examiners review closely the regulatory and lending practices of North Carolina banks, and are quick to act if a bank experiences difficulties. Their close monitoring of banking activities strongly contributes to the fact that there has been only one state-chartered bank to fail in North Carolina since 1944.

The Office of the Comptroller of the Currency is charged with executing the laws and regulations of the nationally chartered banks, and supervises the bank examiners who monitor their activities. In addition, the Federal Deposit Insurance Corporation (FDIC) provides insurance on deposits at every member bank. As of October 3, 2008, the FDIC insures demand deposits at \$250,000 (previously \$100,000) and time deposits are insured for an additional \$250,000 (previously \$100,000) for a total possible coverage of \$500,000 (previously \$200,000) at a given financial institution. In order for public depositors to receive the maximum \$500,000 benefit, all funds must be on deposit with a bank that is in the same state as the depositor. (The account must have been opened at a branch office located in North Carolina). If funds are on deposit with a bank that is in a different state, the maximum combined insurance is \$250,000 (previously \$100,000). (Individual public schools are only covered at the \$250,000 amount for both account types.) These new insurance limits expire as of December 31, 2009 as the law currently stands. It is important to note that since the FDIC's inception in 1933, no insured deposits have been lost. The FDIC website (www.fdic.gov) provides financial indicators on all

federal and state-chartered banks, and local governments are encouraged to inquire at any time if they are concerned about the financial health of a given bank.

Local governments are required by G.S. 159-31 to collateralize any deposits beyond the FDIC insured amount. These deposits must be secured, and the NC General Statutes allow the use of surety bonds, letters of credit, or collateral to be pledged for this purpose. The vast majority of banks use collateral to secure public deposits, although there are a few who use one of the other methods. The NC Administrative Code (20 NCAC 07) specifies what securities are eligible to be used for collateral in Section .0200. These securities include Treasuries, agencies, State bonds, local government bonds, GO bonds of other states, prime quality commercial paper bearing the highest rating, and various other securities. The pledging of collateral can be managed under two different methods, as allowed by 20 NCAC 07. The pooling method allows the bank to pool all public deposits and pledge the security to the State Treasurer on the local government's behalf. The State Banking Operations Section of the NC Department of State Treasurer monitors this process, approving all banks that participate in this method, monitoring each bank's financial health, and monitoring each bank's quarterly and/or monthly reporting of collateral to the State Treasurer. Collateral for the pooling method is pledged at 110% of the average balances in excess of FDIC coverage provided. The dedicated method requires that the bank pledge the collateral to the local government. The local government's finance officer must monitor the collateral to verify that amounts are adequate and that the collateral is the proper type of instrument. These deposits must be collateralized at 100% of the value in excess of the FDIC coverage.

Assuming that adequate collateral has been pledged under either method, a local government would be made whole in the event of a bank default. Procedures are in place with the Financial Operations Division of the Department of State Treasurer to provide for settlement of funds, although this process can take some time. For further clarification and explanation on collateralization, we encourage you to review ***Collateralization of Public Deposits in North Carolina***, a publication made available by the Financial Operations Division. It clarifies the federal regulations on FDIC coverage and discusses in detail the two types of collateralization. It also includes the relevant sections of the NC Administrative Code. You may find this document at www.nctreasurer.com under Financial Operations Publications, or under State and Local Government Finance, Auditing and Reporting Resources, Deposit and Investment Information.

Local governments can assist the State Treasurer in the monitoring of adequate collateral for public deposits held in banks using the pooling method by submitting their INV-91s on a timely basis. The NC Administrative Code as documented in the publication mentioned above (20 NCAC 07.0103) requires that local governments file an INV-91 with the State Treasurer annually as of June 30th for each financial institution used as a depository. Current procedures require that the INV-91 forms be prepared in duplicate with one copy going to the financial institution and the other coming to the Local Government Commission (LGC) when the LGC 203 report is filed, typically in July. The INV-91 forms are forwarded to the State Banking Operations Section where they are matched to the reports filed by the banks (INV-97). Properly filing the INV-91 serves two functions: 1) it identifies to the bank that the accounts listed are "public deposits" that must be collateralized; and 2) it serves as an audit document for Banking Operations to verify the collateral for those accounts. It appears from the data supplied by the Banking Operations section that a number of units have not yet submitted their INV-91s for June 30, 2008. It is imperative that each local government prepare and send their INV-91s to their

respective banks and to the State Treasurer. Forms can be sent to the LGC and will be forwarded to Banking Operations. Completion and filing of the INV-91 is not only a matter of compliance but a matter of safety. Collateral can only protect local government funds if the accounts are marked as "public deposits" and the collateral pledged is adequate.

There has also been much discussion in both the national and local news media about Fannie Mae and Freddie Mac. In September, the Treasury Department and the Federal Housing Finance Agency transferred control of both agencies to a conservatorship. In this plan, the Treasury Department and FHFA will purchase mortgage-backed securities guaranteed by Fannie Mae and Freddie Mac and inject capital to bolster the mortgage company's abilities to attract investors and continue funding mortgages. North Carolina local governments, which are subject to G.S. 159-30, are not authorized to purchase stock except for a very few governments that have special legislation. G.S. 159-30 does allow local governments to purchase senior debt in these two agencies when it is a direct obligation of either agency. Many of you currently hold these securities and they are still being publicly traded. The securities still carry an "implicit" guarantee from the Federal government and are being closely monitored by the U.S. Treasury. Institutional money managers are continuing to buy and hold the senior debt as a staple in their portfolios. Considering current market conditions, the State Treasurer feels comfortable at this time with local governments holding to maturity their senior debt in Fannie Mae and Freddie Mac. If your governing boards feel otherwise, then it is certainly your prerogative to take other measures.

Many of you have funds invested in the North Carolina Capital Management Trust (NCCMT), the authorized mutual fund as permitted by G.S. 159-30(c)(8). The staff of the LGC confers regularly with Capital Management of the Carolinas to review the status of the NCCMT and has been pleased with both the nature and timeliness of their responses to us. We also follow up with Fidelity Investments, the fund's management firm, on the quality and liquidity of the portfolio and are pleased with the nature and timeliness of their responses as well. The NCCMT cash portfolio is an SEC registered 2a-7 mutual fund and has opted in to participate in the new US Treasury Temporary Guarantee Program for Money Market Funds, which guarantees the principal balances in the fund at September 19, 2008.

If you have questions or we can be of assistance please call Sara Shippee at 919-807-2356 or sara.shippee@nctreasurer.com or Ken Wease at 919-807-2391 or ken.wease@nctreasurer.com.