

issue brief

California Debt and Investment Advisory Commission

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Investing with a Certificate of Deposit Placement Service

Introduction

With Federal Deposit Insurance Corporation (FDIC) insurance limited to \$100,000 in deposits per owner at a single insured bank, investing a larger sum of money in non-negotiable certificates of deposits (CDs) has always meant opening accounts at multiple banks, ensuring the issuing bank meets collateral requirements or assuming the risk of not being fully insured.

Effective January 1, 2007, AB 2011 (Chapter 459, Statutes of 2006) authorizes local agencies to invest their surplus funds in non-negotiable CDs with a depository institution (e.g., a commercial bank, savings bank, savings and loan association or credit union) that is a participant in a private CD placement service. The CD placement service splits the invested funds into less than \$100,000 increments and trades deposits with other participating institutions across the nation. This ensures that the depositor will have no more than \$100,000 at any one bank; thereby, all deposits would be protected by FDIC insurance.

Currently, the only placement service of this type is the Certificate of Deposit Account Registry Service (CDARS) operated since 2001 by Promontory Interfinancial Network, LLC (Promontory) in Arlington, Virginia.

This issue brief will cover the provisions of the authorizing legislation, provide a description of the CDARS program, and present issues that a local agency may wish to consider before investing with a CD placement service.¹

The Authorizing Legislation

Effective January 1, 2007 and sunseting on January 1, 2012, AB 2011 added Government Code Sections 53601.8 and 53635.8, which expand local agencies' permissible investments to include the use of private CD placement services. AB 2011 provides local agencies with an investment tool that minimizes monitoring and administration of their surplus cash investments while allowing smaller local banks to accept deposits that they currently are unable to because of collateralization requirements. Rather than dealing potentially with multiple banks to ensure full FDIC insurance coverage for deposits, AB 2011 provides a means for a local agency to work with one bank for non-negotiable CD investments. The statute limits total portfolio investment in CDs to 30 percent of combined negotiable CDs [authorized under Government Code Section 53601(h)] and CDARS deposits.

¹ This issue brief is written with the recognition that Promontory is currently the sole provider of this service and is not an endorsement of their products or services.

As stated above, the legislation encourages deposits in smaller local banks that have previously been excluded from accepting large deposits because current law requires them to collateralize all deposits in excess of \$100,000. Most small banks do not have the financial flexibility to collateralize large deposits. In turn, investment in small community banks may stimulate economic activity at the local level.

AB 2011 specifically states that it is not the legislature's intent to restrict competition among providers of CD placement services. However, as of this writing, Promontory is the only provider of this service. A local agency considering large CD deposits with an alternate provider (should a provider other than Promontory become available) should thoroughly understand the services that are available and how they may differ, if at all, from those described in this issue brief.

Certificate of Deposit Account Registry Service (CDARS)

There are currently over 1,600 member banking institutions participating in CDARS with members in every state, including 109 member banking institutions in California.² Currently, statutes in 36 states enable local governments to make CDARS investments.

To offer CDARS to its depositors, a bank must be a member of the network. In order to be a member, the banking institutions are required to be "well capitalized" (the highest rating) and "well managed" as defined by FDIC guidelines. The FDIC has stated that "deposits placed through the CDARS system would be insured on a pass-through basis under the FDIC's rules on the insurance coverage of agency or custodial accounts."

CDARS is not a CD broker. CDARS is an order allocation service that facilitates the

placement of deposits with insured financial institutions. In arranging for the placement of deposits in CDs, the banking institutions act as deposit brokers and agents for their customers.

CDARS' software matching system allows The Bank of New York, the master custodian that handles the CD transactions for all the banks in the CDARS network, to track depositors. The Bank of New York is the only institution, other than the depositor's own bank, that sees confidential information from depositors. The system administers deposits electronically among the participating network of banks with minimal paperwork.

How it Works

- » A local agency interested in purchasing non-negotiable CDs through CDARS first selects a bank that participates in the CD placement service.
- » The local agency signs an agreement with the participating bank that specifies the amount of investment, interest rate and maturity. The maximum investment amount per depositor currently is \$50 million. CDs are offered in 4-week, 13-week, 26-week, 52-week, 104-week (2 years), and 156-week (3 years) maturities. However, each participating bank has the option to select which maturities to offer its depositors.
- » The participating bank places an order with CDARS to have the deposit divided into less than \$100,000 increments (principal plus interest). Each individual \$100,000 deposit is FDIC-insured.
- » CDARS wire transfers deposits among the network of member banks on a dollar-for-dollar basis. These exchanges bring the full amount of the original deposit back to each originating bank.

² The list of California member institutions can be found at <http://www.cdars.com/find-cdars-state.php?s=CA>.

- » When the CDs are issued, the depositor receives a notification of deposit from its bank.
- » The depositor periodically will receive one consolidated statement from their banking institution for all of its deposits. A typical statement will specify the issuing banking institutions, interest rates, maturities, interest paid and balances.
- » Local agencies may specify banking institutions in which they do NOT want their deposits placed.
- » A transaction fee is paid by the banking institution to CDARS in the form of basis points per transaction on a sliding scale from 2.25 basis points for a 4-week CD up to 24 basis points for a 156-week CD. While CDARS specifically prohibits this transaction fee from being passed on to the depositor, the banking institution may cover these fees in the interest rates offered for their CDs (see CONSIDERATIONS below).
- » When the CD matures, CDARS provides an electronic notice to the depositor's bank. The depositor's bank notifies the depositor.
- » In the event of a bank failure, the Bank of New York as master custodian provides the electronic records to the FDIC for insurance coverage.
- » maturity, accrued-interest penalties are imposed: 100 percent of accrued interest for 4-week and 13-week maturities, and 50 percent of accrued interest for longer maturities.
- » The local agency should review CDs held in the CDARS program against CDs in which it invests to ensure multiple CDs are not held from the same bank. Multiple CDs held by the same bank or subsidiary are only insured by the FDIC for up to \$100,000, even through they may be held in separate accounts. When investing through CDARS, the local agency should specify which banks should not receive their deposits to avoid this potential problem.
- » Since each CD has its own issuing banking institution and may have varying maturities, interest rates, and amounts, it is advised that the local agency's periodic investment portfolio report list each CD separately.
- » CDARS prohibits member banks from passing the transaction fees on to the depositor. A random sampling of California's CDARS member institutions revealed a wide range of approaches to cover these fees. The responses included: absorbing the costs as a cost of doing business, evaluating the market weekly and setting CDARS rates to a brokered CD level, and offering a lower interest rate.³
- » Although CDARS rates could be lower than the rate received if the local agency invested directly with the banking institution, the local agency would be responsible for managing its deposits to ensure FDIC coverage. If the local agency decides to invest through CDARS, it should determine which bank offers the best rates for the services provided.

Considerations

The following are some issues that local agencies should consider before investing through CDARS:

- » CDs placed with CDARS are non-negotiable, that is, there is not an active secondary market to buy and sell these investments. If the local agency needs to liquidate this investment prior to

³ One bank evaluates on a case-by-case basis and offers a combination of absorbing the costs and lowered interest rates.

» At this time, credit unions are not participating in CD placement services. AB 2011 specifies that no credit union may act as a selected depository institution unless the credit union has received written guidance or other written communication from National Credit Union Administration (NCUA) authorizing participation of federally-insured credit unions in CD placement services and affirming that the moneys held by those credit unions while participating in a CD placement service will at all times be insured by the federal government. As of this writing, NCUA has not provided written guidance or communication to any credit unions.

In closing, CDARS can provide a local agency with a means of managing large deposits in non-negotiable CDs with less administration than if it invested in separate financial institutions on its own, which would involve monitoring to ensure FDIC coverage. The local agency, however, should be aware of the various issues discussed above before investing through CDARS to ensure the service is appropriate for their investment needs. Above all, a local agency that is considering using CDARS as part of its portfolio investments should continue to ensure that the agency's liquidity needs are met and should monitor where its funds are invested if it is investing in other non-negotiable CDs to ensure that FDIC coverage is maintained.

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