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The Impact of New FDIC Limits on Towns

By Rebecca Otto, State Auditor

In response to this fall's financial crisis, Congress temporarily increased the amount of Federal Deposit Insurance Corporation (FDIC) protection for bank deposits. The new limit is $250,000 per bank depositor, which includes government entities. All of the other FDIC rules regarding public depositors will still apply. The new coverage limit has a "sunset provision", however, and will only be in effect through December 31, 2009.

This increase in FDIC protection comes at a time of increased bank failures. According to the FDIC, only eleven banks failed in the United States between October 1, 2000 and December 31, 2007: since January 1, 2008, thirty-five banks have failed. Although the increased FDIC coverage does provide increased protection to bank depositors, it is only temporary, which could create some problems for town investments. This article will lay out potential issues that could arise from the new limits, and how careful planning and monitoring can help towns avoid them.

How A Town's Investments Could Be Affected

The new limits offer increased protection for a town's bank deposits, but they also create new challenges for towns that purchase certificates of deposit (CDs).

If your town purchases CDs, you will now be able to purchase them in amounts insured up to $250,000. The FDIC will cover the value of the CD and any interest that has accrued up to $250,000.

Keeping this in mind, if you were to purchase a CD, make sure that it is an amount that will allow the FDIC coverage to insure the principal <u>and</u> any accrued interest. For instance, your town buys a CD in the amount of $250,000 at 5% interest paid quarterly, but the issuing bank fails the day before interest is posted (or credited) to the CD. In such a case the FDIC will only cover $250,000, the value of the CD, and the town will not collect the interest that had accrued over three months -- at 5%, over $3,000. If, however, the town had purchased a CD in the amount of $246,000 and the issuing bank failed the day before interest was posted, the FDIC would cover your CD and the accrued interest up to $250,000.

Protecting CDs That Mature After December 31, 2009

A CD with a value over $100,000 that matures after December 31, 2009 -- the sunset date for the higher protection limits -- could present a different set of challenges in the face of a bank failure. In this case, the amount of the CD over $100,000 would be uninsured, unbonded and uncollateralized. Caution should be used in purchasing any CD with a value in excess of $100,000 that would be due to mature after December 31, 2009.

Options for protecting your investment would depend on the type of CD you purchase. There are two types of CDs: negotiable and deposit. A negotiable CD, frequently purchased from an out-of-state bank, is transferable, and the issuing bank has no record as to who holds the CDs it has issued. A deposit CD is frequently purchased from a local bank, which identifies your town as the account holder. There is usually a penalty for early withdrawal of this type of CD.

If your town holds a negotiable CD in excess of the FDIC limit from a bank outside the state of Minnesota, your only option will probably be to sell the CD. This presents a situation where you may lose money on the CD. Its value at the time of sale will be a function of its interest rate and maturity date. The fact that the CD is now partially uninsured may also affect its salability. The CD could be worth less at the time than the principal owed, in which case the town may have a loss.

If your town holds a deposit CD in excess of the FDIC limit, you would either need to sell the CD or obtain pledged collateral. If the depository that issues the CD declines to pledge collateral, the town will have to cash in the CD -- and pay the penalty of early withdrawal. To avoid this situation, your township can try to either negotiate with the depository bank to take the early withdrawal provision out of the CD or to provide a waiver in writing. Alternatively, it may be possible for the depository bank to agree in writing to collateralize the CD should it ever become partially uninsured.

CDs That are Pledged as Collateral

Care should also be taken with CDs that are pledged as collateral for the protection of the town deposits. If CDs are pledged as collateral and they are no longer completely insured by the FDIC on January 1, 2010, other collateral will have to be obtained by the town to protect its bank deposits.

There is the possibility that the temporary FDIC limits of $250,000 will be extended by Congress past the December 31, 2009 sunset date. However, if the FDIC coverage limit returns to $100,000 on that date, towns will need to monitor both the CDs they own and those CDs pledged to protect town deposits. The temporary increase in FDIC coverage means that towns will need to be extra vigilant, especially in these uncertain financial times.