



**REPORT OF
THE
STATE AUDITOR**

**DIVISION OF BANKING
PUBLIC DEPOSIT PROTECTION ACT**

**Performance Audit
March 2000**

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March 20, 2000

Members of the Legislative Audit Committee:

This report contains the results of a performance audit of the Public Deposit Protection Act (PDPA) program within the Division of Banking at the Department of Regulatory Agencies. The audit was conducted pursuant to Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct audits of all departments, institutions, and agencies of state government. The report presents our findings and recommendations, and the responses of the Division of Banking.

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J. DAVID BARBA, CPA
State Auditor

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Authority, Purpose, and Scope

This performance audit was conducted under the authority of Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct audits of all departments, institutions, and agencies of state government. The audit was conducted in accordance with generally accepted governmental auditing standards. Our audit procedures included reviewing documentation, interviewing Division of Banking staff, interviewing staff from other state agencies, analyzing data, and surveying other states' banking oversight entities. The purpose of the audit was to review the Division of Banking's administration of the Public Deposit Protection Act (PDPA or the Act).

We gratefully acknowledge the assistance and cooperation of the management and staff at the Division of Banking. We also would like to thank staff at the Offices of the State Controller and the State Treasurer for their help. The following summary provides highlights of the comments, recommendations, and agency responses contained in the report.

Background

The Colorado General Assembly passed the Public Deposit Protection Act in 1975. The purpose of the PDPA is protect all public funds held on deposit in financial institutions. In the event eligible banks or savings and loan institutions default, statutes provide for the expedited repayment of public deposits not covered by the Federal Deposit Insurance Corporation (FDIC). The PDPA eligible financial institutions are to repay public funds through a form of collateralization--the set-aside of marketable instruments for each public deposit held. The Division of Banking (the Division), within the Department of Regulatory Agencies (DORA), administers PDPA for public deposits held in banking institutions. The Division of Financial Services, also within DORA, administers a parallel law to protect public deposits held in savings and loan associations.

For further information on this report, contact the Office of the State Auditor at (303) 866-2051.

In Fiscal Year 1999, the Division of Banking oversaw approximately \$1.6 billion in public deposits. Of this amount, \$200 million was deposited by state government entities. The remaining \$1.4 billion was deposited by local government entities. Our audit focused on the Division's administration of the PDPA as it relates to state government deposits. We did not conduct a detailed review of local government deposits or of public deposits made to savings and loan institutions. Because our audit work concentrated on state government entities' banking activities, our recommendations apply to state agency deposits of public funds. We believe, however, that similar findings and recommendations may be applicable to local government deposits. We have noted some of these areas in the audit report.

Improved Oversight of PDPA is Needed

The Division of Banking is responsible for ensuring that public funds are properly identified and sufficiently collateralized. The Division has implemented procedures and systems to ensure that proper collateral exists after public funds are deposited. However, the Division does not have fundamental systems or procedures in place to ensure that all public deposits are properly identified and reported as such. Therefore, there is a risk that public funds may be unprotected in the event of a bank failure.

We found more than \$21 million in discrepancies related to accounts not properly identified as containing state agency deposited public funds. In total, we were unable to conclude on the appropriateness of PDPA coverage for almost 800 state agency bank accounts. The discrepancies we found are significant for two reasons. First, when accounts are reported to the State Controller's Office but are not properly reported to the Division of Banking, there is a risk that the accounts will not be protected by PDPA in the event of default. Second, although accounts reported by the banks to the Division are likely protected through the banks' PDPA activities, there could be inaccuracies in the State Controller's data. This could result in misreported amounts in the Statewide Financial Statements. In addition, this may diminish both the State Controller's and the State Treasurer's abilities to ensure the risks associated with state funds are minimized.

Prior to our audit, the Division of Banking had not reconciled the reports submitted by banks to those available from other public entities. Reconciling reports is important to ensure that all public entity accounts are appropriately insured or collateralized. The Division of Banking is currently working with the State Controller and State Treasurer to resolve the problems identified. In addition, we are recommending that **the Division strengthen its oversight of PDPA by increasing targeted PDPA examinations in banks with high concentrations of public deposits and by sharing essential account information with other public entities.** Also, there is a general lack of knowledge about PDPA among state agencies and banks involved with the program. Therefore, **the Division should improve its efforts to inform and educate participants in the PDPA program by routinely disseminating information and updates and by providing periodic training to banks and public entities.**

FDIC Coverage Has Been Overstated

The Division of Banking is not ensuring that banks and public agencies are correctly applying Federal Deposit Insurance Corporation (FDIC) guidelines for the coverage of public deposits. Specifically, we found that the number of public depositors operating under the assumption that they are separately covered by FDIC insurance is incorrect. Consequently, there were potentially \$13 million of unprotected public funds being held in Colorado banks at June 30, 1999. There is legal support for separate FDIC coverage of only 17 subdivisions of State government. However, there are currently as many as 300 state entities assumed to be separately covered by FDIC. To correct this situation, **we recommend that the Division apply existing regulations and legal opinions regarding the determination and application of FDIC coverage and require banks to adjust FDIC insurance estimates and PDPA collateralization accordingly. If the Division believes that additional clarification is needed, then it should obtain the appropriate legal guidance. Also, the Division should reevaluate the existing PDPA numbering system to determine its effectiveness as a control over FDIC and PDPA coverage.**

The Division of Banking has agreed or partially agreed to all of our recommendations. A summary of responses can be found in the Recommendation Locator.

RECOMMENDATION LOCATOR
Agency Addressed: Division of Banking

Rec. No.	Page No.	Recommendation Summary	Agency Response	Implementation Date
1	13	Strengthen oversight by reconciling public deposits reported by bank with amounts reported by public entities, increasing targeted PDPA examinations, and sharing essential account information with public entities.	Partially Agree	June 30, 2000
2	15	Improve efforts to educate public depositors and financial institutions about their PDPA responsibilities through the Division's website, newsletter, and periodic training.	Agree	Ongoing
3	16	Enhance monitoring activities by supplementing the existing detail reporting requirements by annually requiring an additional report to be submitted by banks as of June 30.	Partially Agree	June 30, 2000
4	22	Apply existing regulations and legal opinions regarding FDIC coverage and require banks to adjust FDIC insurance estimates and PDPA collateralization accordingly. Obtain additional legal guidance as needed.	Partially Agree	July 31, 2000
5	26	Reevaluate the effectiveness of the PDPA numbering system and: <ul style="list-style-type: none"> a. Adjust the current system or implement a new system to support legal opinions on FDIC coverage. b. Notify depositors, banks, and oversight entities of changes made. c. Recommend legislative changes, as appropriate. 	Agree	December 31, 2000

Oversight of the Public Deposit Protection Act

Chapter 1

Background and Description

The Colorado General Assembly passed the Public Deposit Protection Act (PDPA or the Act) in 1975. The purpose of the PDPA is “to serve the taxpayers and the citizens of Colorado by establishing standards and procedures to ensure the preservation and protection of all public funds held on deposit” in financial institutions. In the event eligible banks or savings and loan institutions default, statutes provide for the expedited repayment of public deposits not covered by the Federal Deposit Insurance Corporation (FDIC). The PDPA eligible financial institutions are to repay these public funds through a form of collateralization--the set-aside of marketable instruments for each public deposit held. At a minimum, banks must pledge collateral with a market value equal to 102 percent of the aggregate amount of uninsured public deposits. Savings and loans must set aside similar levels of collateral based on average daily uninsured public deposits.

Administration of PDPA

The Division of Banking, within the Department of Regulatory Agencies (DORA), administers PDPA for public deposits held in banking institutions. The Division of Financial Services, also within DORA, administers a parallel law enacted to protect public deposits held in savings and loan associations. The Division of Banking’s mission is to “protect the public interest by regulating the business of state chartered and/or licensed institutions under its supervision”. By statute, the Commissioner of Banking is the administrative head of the Division and shall set administrative policy and be responsible for internal administration including records, reports, systems, and procedures for all aspects of the Division’s operations, including PDPA. In addition, statutes prescribe that the Commissioner “is responsible for all examination and enforcement functions of the Division of Banking subject to the policy making and rulemaking authority of the Banking Board.”

The Division has a total of 38 FTE. Two of these FTE administer the daily activities of the PDPA program. In addition, as part of their regular bank examinations, the

Division's 24 bank examiners review some aspects of PDPA. The Division is cash funded through bank fee assessments, specialty examination charges, and application and licensing fees. Administration of the PDPA program is funded through a special assessment designed to cover the program's costs. The assessment rates and fee structure are reviewed and approved by the Banking Board. The Division's approved budget for Fiscal Year 1999 was about \$3 million of which about \$138,000, or about 5 percent, was appropriated for PDPA.

The Colorado State Banking Board is the policy and rule making authority for the Division. By statute, the eight-member Banking Board has the authority to implement any provisions of the PDPA by order or by rule and regulation. In addition, the Board is statutorily authorized to obtain restraining orders and injunctions to prevent violations or to enforce compliance with PDPA provisions.

Public Deposits and PDPA Institutions

As of June 30, 1999, Colorado governmental entities had on deposit, in financial institutions, more than \$1.6 billion. The majority of these deposits--approximately \$1.4 billion--were made by local government entities. The remaining \$200 million or about 12 percent of the total \$1.6 billion was on deposit from state government entities in 1,493 accounts. At the time of our audit, there were 188 commercial banks in Colorado. Of this total, 180, or about 96 percent, had been determined by the Division of Banking to be PDPA eligible. This means that these institutions were authorized to accept deposits of public funds and were to comply with PDPA regulations regarding collateralization and other requirements. As of June 30, 1999, the PDPA-eligible institutions had collateral of slightly more than \$162 million for the state government portion of total public deposits.

Scope of Audit

Our audit focused primarily on the administration of the Public Deposit Protection Act as it relates to state government deposits of public funds in banking institutions. That is, we concentrated on the approximately \$200 million of public deposits originating from state government entities. We did not review, in detail, activities as they pertain to the \$1.4 billion in local government deposits. In addition, we focused our efforts on bank deposits rather than deposits in savings and loan associations. We did this because most state government entities deposit their funds in banks rather than in savings and loan associations. As of June 30, 1999, for example, only about 2 percent of state agency deposits were located in eligible savings and loans. For the total \$1.6 billion of all public entity deposits (state and local governments), only about 4 percent or \$66 million was on deposit in savings and loans. Furthermore, there are

only 14 PDPA-eligible savings and loan associations compared with the 180 eligible banks.

Because our audit work focused primarily on state government entities' banking activities, our recommendations apply only to state agency deposits of public funds. However, we believe that similar findings and recommendations for improvement may be applicable to local government deposits. We have noted some of these areas in the audit report.

Improved Oversight Would Strengthen the Protection of Public Funds

The Division of Banking has adopted procedures and developed systems to ensure that reported deposits are properly collateralized. For example, the Division has implemented an automated system to calculate the amount of collateral banks must provide to protect the public funds they reportedly hold. If the collateral is insufficient, the Division is automatically notified by the system. The current system addresses the adequacy of collateralization of reported public deposits. However, the Division does not have fundamental systems or procedures in place to ensure that all public deposits are reported or reported correctly. Therefore, there is a risk that public funds may be unprotected.

To verify whether public funds are being properly identified, reported, and collateralized, we compared Division of Banking data with data maintained by the State Controller's Office. We found that public deposit information reported to the Division and corresponding information reported to the State Controller's Office do not agree. As a result, it is difficult to locate public accounts in bank records and determine if they are properly protected. In addition, accurate calculations of the dollar value of potentially unprotected public funds are difficult to establish. In this chapter, we describe the weaknesses we identified in the oversight of PDPA and make recommendations for improvement.

Discrepancies Exist in Essential Public Account Data

We identified at least \$21 million in discrepancies between the bank account data maintained by the Division of Banking and the bank account data maintained by the State Controller's Office. The Division of Banking receives reports from Colorado banks with PDPA accounts. The State Controller's Office maintains a list of state agency bank accounts reported by the agencies. The Controller's list was developed

in compliance with statutory requirements for both the Controller and the Treasurer to approve all outside bank accounts.

When we compared the Division's bank reports to the State Controller's reports, we found that in some cases, public accounts reported by banks to the Division were not reported by depositors to the State Controller's Office. The reverse situation existed in other cases. We found that account information was either not reported or was reported differently to the Controller's Office than it was reported to the Division. Identification numbers were a problem in a number of cases. In other cases, accounts were classified in one report as investments and in another as deposits. (Investments are not required to be collateralized under the law.) In addition, we found accounts that appeared to be inappropriately classified as public funds. In total, we were unable to conclude on the appropriateness of PDPA coverage for almost 800 state agency bank accounts. These discrepancies are significant because:

- When accounts are reported to the State Controller's Office but are not properly reported to the Division of Banking, there is a risk that the accounts will not be protected by PDPA in the event of default.
- Although accounts reported by the banks to the Division are likely protected through the banks' PDPA collateralization, there could be inaccuracies in the State Controller's data. This could result in misreported amounts in the Statewide Financial Statements. In addition, this could compromise both the State Controller's and the State Treasurer's abilities to ensure the risks associated with state funds are minimized.

Prior to our audit, the Division of Banking had not reconciled the reports submitted by banks to those available from other public entities. Reconciling reports is important to ensure that all public entity accounts are appropriately insured or collateralized. The Division of Banking is currently working with the State Controller and State Treasurer to resolve the problems identified.

The Division needs to establish procedures to sample public entity accounts on a regular basis and compare them with accounts reported by banks. We understand that there are thousands of public entities in Colorado, many of which may have numerous bank accounts. The Division does not have the resources to compare all public entity bank accounts with those reported by banks, nor do we think this is necessary. However, we believe the Division can develop cost beneficial procedures to periodically compare a sample of public entity reports to bank reports. Sampling will help the Division not only to identify and correct problems with collateral, but also to develop training for banks and public entities. (We discuss training later in this chapter.)

Improved Information Sharing Is Essential To Achieve Goals

Improved information sharing is needed between the Division and other public entities. Division staff told us that, in the past, they have interpreted the statutes to mean that they cannot share information about collateralization of public deposits with public entities such as the State Controller's and State Treasurer's Offices. Specifically, staff are concerned about Section 11-2-111.5, C.R.S., which states:

The banking board, the bank commissioner, and all deputies and employees of the division shall not divulge any information acquired by them in the discharge of their duties *except insofar as the same may be rendered necessary by law* (emphasis added).

We believe the Division needs to share information with public entities if it is to carry out its statutory mandates regarding public deposit protection. The Division is currently working with the Attorney General's Office to resolve this and other statutory interpretation issues described later in this report.

Improved information sharing would facilitate the identification and resolution of errors and inconsistencies by all concerned. Further, if the State Controller's Office and the State Treasurer's Office were better informed about PDPA they could assist the Division in educating new state agency staff about PDPA, as part of their bank account approval functions.

Enhancements Are Needed in the Division's Reviews for the Completeness of PDPA Coverage

The Division needs to enhance its reviews over the accuracy and completeness of bank reports and other PDPA related data. Currently, the Division relies solely on its bank examinations (both regular and some targeted examinations) to determine whether public funds are properly identified or properly deposited. Our audit work shows that the existing bank examination process does not provide the necessary assurances about the security of public accounts.

We believe the Division needs to increase targeted PDPA examinations. The Division uses a risk-based approach to conduct its regular bank examinations. This approach is used across the nation by both federal and state examiners. It is based on a nationally established composite score that rates banks on their risk for failure. More than three-quarters or 84 percent of state agency accounts in Colorado are located in low risk banks. Accounts in low risk banks are subject to the Division's regular

examinations, which include PDPA compliance, once every three years. We believe that the Division could enhance its examination procedures by increasing the frequency of targeted PDPA reviews in banks with high concentrations of public funds, even if they are classified as low-risk institutions. This would help reduce the exposure of public dollars in the event of a failure.

A recent, targeted examination conducted by the Division appears to support our recommendation to increase the frequency PDPA reviews. In September 1999, the Division conducted an expanded scope PDPA examination of a large, lower risk bank. The Division identified 113 accounts with over \$22 million in unreported public funds. Targeted examinations should be done regularly at all banks with high concentrations of public funds.

The Division Should Be More Proactive in Educating Financial Institutions and Public Entities About PDPA

We found a lack of adequate knowledge about PDPA among state agency as well as bank personnel. Typically the only contact the Division has with state agencies occurs when agency personnel apply for a PDPA number. If agency personnel are unaware of the requirements of PDPA, they cannot be expected to apply for a number and they may be unaware of the penalties they may be subject to for noncompliance. Public depositors also need to be alerted about ineligible depository institutions and the associated risks. Similarly, bank personnel indicated to us that the only time written PDPA materials have been provided to them by the Division was when the bank first became an eligible depository. In many cases, this occurred more than ten years ago. All subsequent PDPA "training" has occurred on an ad hoc basis, when bank personnel contacted the Division for assistance with a particular problem. The bank personnel we spoke with indicated that the assistance they received on these occasions was helpful.

There are a number of steps the Division could take to better inform and educate agency and bank personnel. For example, we suggest:

- Routinely disseminating an informative document designed to alert public depositors and eligible banks to their responsibilities with regard to PDPA and the penalties for failure to comply.
- Developing training materials which could be made available to a wide audience through the Division's Internet web-site.

- Using its newsletter to banks to alert new tellers about PDPA and the information available on the web-site.

The PDPA statutes provide penalties for noncompliance. The statutes indicate that public depositors and bank personnel can only be punished if they knowingly violate the statutes. There should be little need for criminal sanctions if the Division makes a good faith effort to inform and educate. However, in the event the statutes are violated, the Division and the Banking Board will have better grounds for enforcement.

Recommendation No. 1:

The Division of Banking should strengthen its oversight of PDPA by:

- a. Reconciling public entity deposit reports submitted by banks to those available from public entities.
- b. Sharing essential account information with other public entities.
- c. Increasing targeted PDPA examinations in banks with high concentrations of public deposits.

Division of Banking Response:

Partially agree.

- (a) The Division disagrees with the auditors' conclusion that fundamental systems or procedures are not in place to ensure that public deposits are reported to the Division. The auditors' conclusion is based in large part on a comparison of bank public deposit reports and State Controller records. The audit report calls into question the deposit protection of almost 800 state agency bank accounts. However, the vast majority (600) of the discrepancies were public accounts that were properly reported and collateralized by the banks, but that were not listed on the State Controller's records of State bank accounts. The omission of these accounts from the State Controller's records did not jeopardize the safety of those public funds. The Division's reconciliation of the majority of the remaining exceptions did not disclose the existence of unprotected funds. The fact that the banks' reports to the Division were found to be accurate indicates that fundamental systems and procedures are in place to ensure that public deposits are reported to the Division.

The Division's PDPA efforts have historically been focused almost exclusively on the institutions under its regulatory authority. Division management believes it can most efficiently ensure accurate public deposit reporting through its on-site bank examinations for PDPA compliance and review of the annual PDPA compliance audit reports conducted by independent parties. The Division does not have the resources nor, it believes, the statutory authority to police the investment practices of public entities, nor to ensure the accuracy of public entity records. Nevertheless, it acknowledges the reporting discrepancies between the State Controllers' records and the bank reports, and recognizes the overarching benefits to the State of accurate financial reporting by public entities.

Although Division management does not agree with the conclusions drawn in the Report, internal review procedures will be expanded to include a periodic reconciliation of bank PDPA reports and the State Controller reports. The Division will research the type and availability of local public entity reports. Within resource constraints and subject to a cost-effectiveness standard, the Division will conduct periodic reconciliations based on sampling. The findings will be reported to the Banking Board.

- (b) The Division routinely shares non-confidential information with the State Treasurer's office and many other public entities. Indeed, a senior-level management representative of the State Treasurer's Office serves on the Division's PDPA task force.

The Division will increase efforts to coordinate PDPA oversight activities with the State Controller's office and other public entities. However, it must be noted that Section 11-2-111.5, C.R.S. and federal regulatory interagency agreements preclude the Division from disclosing bank specific CAMELS ratings and/or examination findings.

Division management will seek clarification from the Office of Attorney General regarding the ability to share information contained in public deposit reports with other state agencies and local government units.

- (c) The audit report recommends that the Division strengthen PDPA examinations by expanding the scope of PDPA examinations in low-risk institutions. Currently the Division conducts expanded exam reviews at high-risk banks, and reviews a sampling of deposit accounts at low-risk banks. If significant numbers of unreported public accounts are found during the sampling of deposit accounts, it is the Division's practice to

schedule a second, more comprehensive examination targeting public deposit reporting. In addition to bank examinations, the Division's risk-based approach is supplemented by the annual independent PDPA compliance review required pursuant to Section 11-10.5-109, C.R.S.

The Division will address the concentration of public funds in low-risk institutions by recommending to the Banking Board that the PDPA examination frequency mandate be revised to include more frequent examinations at those banks that hold a level of deposits in excess of ten percent of aggregate public deposits held by Colorado banks. The issue was discussed with the Banking Board on February 17, 2000, and the Board was receptive to the recommendation.

Auditor's Addendum

Prior to our audit, the Division was unaware of the discrepancies, inconsistencies, and inaccuracies related to almost 800 public agency bank accounts that we identified in our audit. The Division does not have the basic procedures in place to identify and reconcile discrepancies or to ensure the completeness of public bank account reporting. Had the Division routinely shared information with other state agencies, for example, it could have identified reporting issues in a timely fashion. For the Division to fulfill its statutory responsibility for the PDPA, it must have accurate, complete, and current information about public agency bank accounts. Otherwise, a risk does exist that accounts will be unreported or misreported, and that public funds may not be adequately protected.

Recommendation No. 2:

The Division of Banking should improve its efforts to inform and educate public depositors and financial institutions regarding their responsibilities related to PDPA by:

- a. Routinely disseminating information and updates to public entities and banks through its website and newsletter.
- b. Providing periodic training to banks and public entities.

Division of Banking Response:

Agree. The Division maintains PDPA information on its web site and will continue to enhance PDPA training of both public officials and bank staff via

the Division's web site, newsletter, informational memos, telephone training, and public speaking engagements. PDPA training goals and activities will be incorporated into the Divisions budget planning and monitoring process.

Synchronizing Report Dates Will Enhance the Division's Ability To Monitor Accounts

Public entities generally report financial information as of the end of each month. Because deposit balances fluctuate throughout any given period, it is important that the timing of financial reporting be consistent to enable accurate verification and comparison among various financial information sources. Currently, the Division requires banks to submit two monthly reports. One is used to ensure proper collateralization and is therefore necessary. The second is a detailed listing of public deposits by depositor and by account, which supports the first report. We believe that the Division should supplement the existing detail report requirements by annually requiring an additional detail report to be submitted as of June 30 when the State Controller's Office requires state agencies to confirm bank deposit balances. The agencies reconcile any differences between the amounts confirmed by banks and their own accounting records. A June 30 comparison of amounts reported by banks to the Division and amounts recorded by state agencies would be valuable because agency amounts have been reviewed by the depositors for accuracy.

Recommendation No. 3:

The Division of Banking should enhance its monitoring activities by supplementing the existing detail report requirements by annually requiring an additional report to be submitted as of June 30.

Division of Banking Response:

Partially agree. The Division currently requires banks to report public account information as of the one day during the previous month that the bank held its highest aggregate amount of uninsured public deposits. This is the most conservative reporting date as it allows the Division to internally verify that the reporting bank is maintaining sufficient collateral to cover peak levels of uninsured public deposits. Implementation of the recommendation will

impose an additional reporting requirement on the industry. The purported benefit of June 30th reporting is to allow easier reconciliation to external public entity reports. However, with the exception of the State Controller's list of state agency deposits, external reports from the nearly 4,000 public entities are not readily available.

The proposal was presented to the Banking Board on February 17, 2000, and the Board was generally receptive. The Division will initiate formal rulemaking to adjust the current reporting rules to incorporate an annual June 30 reporting requirement.

Collateralization and FDIC Determination

Chapter 2

Background

As previously stated, Colorado's PDPA laws provide for the protection of public funds that are not covered by the Federal Deposit Insurance Corporation (FDIC) or the Federal Savings and Loan Insurance Corporation. The amount of PDPA collateralization required is the difference between the maximum FDIC insurance coverage of \$100,000 per bank and the total amount of the public deposit. For example:

Public Deposit		FDIC Insurance		PDPA Collateral
\$150,000	-	\$100,000	=	\$51,000*

* PDPA collateral is equal to 102 percent of the aggregate amount of the uninsured deposit.

During our audit we found that the Division of Banking is not ensuring that banks and public agencies are correctly applying FDIC guidelines for the coverage of public deposits. Specifically, we found that the number of public depositors operating under the assumption that they are separately covered by FDIC insurance is incorrect. Consequently, there were potentially \$13 million of unprotected public funds being held in Colorado banks at June 30, 1999. Our review shows that there is legal support for separate FDIC coverage of only 17 subdivisions of State government. However, there are as many as 300 state entities assumed to be separately covered.

Federal Deposit Insurance Corporation Regulations

Although the FDIC provides a general outline and structure for establishing coverage for public depositors, the actual application of FDIC regulations is left to the financial institutions and to the Division of Banking. In the event of a financial institution's failure, however, the FDIC makes the final determination regarding which depositors are eligible for separate coverage. Therefore, it is critical that the Division ensure accuracy in its application of FDIC rules. Over-estimates of FDIC coverage could

result in a gap between what the FDIC will actually cover, and the amount needed by financial institutions through PDPA collateralization. The portion of public deposits not insured by the FDIC and not protected by PDPA, would be lost in the event a financial institution fails.

Although banks are generally healthy now, there have been failures in the past, both in Colorado and in other states. From 1980 through 1994, 59 Colorado banks or 12 percent of the state's total, failed. Colorado ranked sixth in the nation for bank failures during this period, surpassed only by Texas, Oklahoma, California, Louisiana, and Kansas. Collectively, these six states accounted for about 62 percent of total bank failures in the nation. Since that time, only one bank has failed in Colorado. This occurred in 1998, and according to Division management, no public funds were lost. According to a 1998 study conducted by the California State Treasurer's Office, 42 states, including Colorado, have adopted some form of additional protection for their public funds beyond what is offered through the FDIC. Of these states, 31 use a collateralization system similar to Colorado.

Only 17 State Funds are Eligible for Separate FDIC Coverage

There are specific provisions of FDIC regulations regarding public deposits. Over the years, FDIC legal staff have provided interpretations of these regulations at the request of the State of Colorado. In addition, the Colorado Attorney General has provided legal opinions on this topic. These legal opinions define FDIC coverage in terms of the "official custodian" and of "public units." Also, both have determined that there are only 17 state funds eligible for separate FDIC insurance. Only these 17 are eligible because only they meet the FDIC definitions of a public unit\political subdivision and of an official custodian. By definition, a political subdivision must have all of the following characteristics. It must:

- Be authorized by law.
- Have functions delegated to it by law.
- Be empowered to exercise exclusive control over the funds for its exclusive use.

The third characteristic shown above--exclusive control--is the pivotal point for separate FDIC coverage. In 1992 when the Colorado Attorney General last reviewed this issue, there were 17 state funds that had all of the preceding characteristics. These 17 funds are:

State Departments and Other Subdivisions:

1. Colorado Compensation Insurance Authority (now Pinnacle Insurance)
2. Department of Education, Public School Income Fund
3. Department of Labor and Employment, Unemployment Insurance Benefit Account
4. Department of Labor and Employment, Unemployment Insurance Clearing Account
5. Department of Local Affairs, Mineral Leasing Fund
6. Department of Natural Resources, Oil and Gas Reclamation Deposits
7. Department of Natural Resources, Water Conservation Board
8. Department of Transportation, Highway Fund
9. Department of Treasury, Pooled Cash and Outside Bank Accounts
10. Judicial Department, Court Custodial Accounts
11. Water Resources and Power Authority

Higher Education

12. Colorado School of Mines, Board of Trustees
13. Community Colleges and Occupational Education, State Board
14. State Board of Agriculture (CSU, USC, and Ft. Lewis)
15. State Colleges in Colorado, Trustees (Adams, Metro, Mesa, and Western State)
16. University of Colorado, Board of Regents
17. University of Northern Colorado, Board of Trustees

The State Treasurer is the Official Custodian of State Government Funds

Under FDIC regulations, an official custodian must have “exclusive control” over funds deposited in outside bank accounts. This control includes the ability to establish bank accounts and make deposits, withdrawals, and disbursements. According to both the State Attorney General’s Office and the FDIC, in Colorado, the State Treasurer is the official custodian for all pooled cash, based on Section 24-36-103, C.R.S. This statute requires all state government entities to remit cash collections to the State Treasurer who then has exclusive control over those funds.

Federal Deposit Insurance Corporation regulations also state that if the exercise of authority or control over funds requires action by or the consent of two or more officers, employees, or agents of a public unit, then they will be treated as **one official custodian** (emphasis added) for the purposes of FDIC determination. Colorado statutes specify that the opening of any outside bank accounts be approved in writing

by both the State Controller and the State Treasurer. Therefore, according to the FDIC, (and with the exception of some of the 16 other funds already described) because the control over state agency funds in Colorado requires the consent of two outside parties, the only official custodian is the State Treasurer who has exclusive control over approximately 1,000 outside bank accounts.

Public Deposits Are Not Adequately Protected

As of June 1999, financial institutions in Colorado reported \$13 million more in FDIC insurance for public funds than could be supported by FDIC regulations and State Attorney General legal opinions. Similarly, state agencies reported excessive amounts of FDIC insurance to the State Controller's Office in conjunction with year-end financial reporting. Consequently, State funds were potentially under-protected by \$13 million at June 30, 1999.

We believe that FDIC regulations and State Attorney General opinions are clear on this issue. There are only 17 state funds eligible for separate FDIC coverage. It is incumbent upon the Division to ensure public funds are adequately protected through the accurate determination of FDIC coverage and, correspondingly, PDPA collateralization. Federal Deposit Insurance coverage for public funds should be adjusted according to existing law. This means that all state funds, with the exception of the 17 separate funds described above, should be aggregated in each financial institution. Then, the \$100,000 maximum FDIC insurance, per bank, should be applied to the total state deposits held within each financial institution. The remainder of the state funds, not covered by FDIC insurance, should be collateralized in accordance with PDPA requirements.

Recommendation No. 4:

The Division of Banking should apply existing regulations and legal opinions regarding the determination and application of FDIC coverage and require PDPA eligible banks to adjust FDIC insurance estimates and PDPA collateralization accordingly. If the Division believes that additional clarification is needed, then it should obtain the appropriate legal guidance.

Division of Banking Response:

Partially agree. The Division is applying separate FDIC insurance coverage to the 17 State funds and political subdivisions in accordance with previous Attorney General opinions referenced above. However, it is the Division's

understanding that the referenced Attorney General opinions did not state that *only* those state funds and subdivisions are separately insured. Rather, the Attorney General's opinions were responses to requests to review insurance coverage for only those specific 17 funds and subdivisions.

The Division calculates FDIC insurance for public deposits based on Attorney General opinions, advice from the FDIC's Legal Department, with whom the Division is in frequent contact, and upon materials and advice from the private law firm that researched the FDIC regulations and created the official custodian numbering system. In addition, approximately 11 years ago, the Deputy State Treasurer worked with the Attorney General's office to informally determine FDIC insurance coverage for other State subdivisions, and determined that there are more State subdivisions than the 17 referenced above to which the FDIC would allocate separate insurance coverage. The Division has apportioned separate FDIC insurance to those additional subdivisions in accordance with the State Treasurer and Attorney General's informal determinations, which are supported by the FDIC's Legal Department. The FDIC will not issue its own written opinions on all of the State's funds, because they are too numerous.

The Division will seek Attorney General opinions for additional support for its FDIC insurance allocation practices. The Division will adjust FDIC insurance allocation calculations, PDPA numbering system, and procedures as necessary based on these opinions.

Auditor's Addendum

Our conclusions regarding the eligibility of public deposits for separate FDIC coverage are based on formal, written opinions and determinations by the FDIC and the Colorado Attorney General's Office. The Division must be able to support its position on FDIC qualifying deposits in the event of a bank failure.

Basic Controls Over PDPA Reporting Need to Be Established

In 1989, the General Assembly made some significant changes to the original PDPA legislation. One purpose of these changes was to provide greater assurance that public funds were protected by strengthening controls over the proper identification of such funds. Consequently, the Division of Banking is now statutorily charged with developing a numbering system so that "the amount of funds subject to federal deposit

insurance...may be readily and accurately determined at all times.” During our audit, we found numerous problems with the design and use of the existing numbering system as a means of internal control.

Most importantly, we found that in the absence of a clear and accurate application of FDIC regulations, as described in the preceding section, the Division, the banks, and the state agencies have become reliant on the PDPA numbering system as the means of establishing eligibility for separate FDIC coverage. As a result, there are currently as many as 300 state entities assigned a PDPA number and thereby, erroneously assumed to be separately covered by FDIC insurance. Some of the other problems we found with the existing control system are:

- **It is out of date.** The numbering system has not been updated or reviewed for accuracy since it was developed in 1990. We found that some executive branch Departments created since 1990 are not on the system. In other cases, departments no longer in existence still have assigned numbers. For example, the Department of Human Services does not have a PDPA number. Rather, numbers are still assigned to the former Departments of Institutions and Social Services. The control numbers for these “non-existent” departments are still being used by some divisions in the Department of Human Services.
- **FDIC verification is based on the numbering system.** Division of Banking staff review bank reports to determine compliance with FDIC insurance application. This review is meaningless however, because it is based on the existing numbering system. As stated previously, the numbering system incorrectly reflects eligibility for separate FDIC coverage.
- **Other financial oversight entities rely on the system.** Both the State Controller’s and the State Treasurer’s Offices have been using a list of state agency PDPA numbers prepared in 1991. Up to date and accurate information is critical for these agencies to carry out various functions. For example, for the Controller’s Office to accurately report the risk associated with state cash as is required by generally accepted accounting principles, FDIC and PDPA coverage information must be accurate. Additionally, the State Controller and the State Treasurer need up-to-date, accurate data to assess the riskiness of public deposits and to oversee public funds. The same is true for all local governments.

The Goal Should Be a System of Effective Internal Control

The PDPA numbering system was prescribed in statute as a tool for alerting banks to which public depositors were eligible for separate coverage so that necessary collateral amounts could be computed. It is one means of internal control. Because the Division does not correctly apply FDIC insurance eligibility, the numbering system is inaccurate and therefore, ineffectual as an internal control for identifying public funds. As a consequence, the statutory requirement that the numbering system allow for the timely and accurate determination of federal deposit insurance cannot be met. Our analysis found, that with the exception of oil and gas reclamation and court custodial deposits, there should be only 15 separate PDPA numbers assigned to State government accounts. Instead, as previously noted, as many as 300 separate state entities have been assigned PDPA numbers.

In conjunction with its efforts to implement Recommendation No.4, the Division needs to reevaluate the PDPA numbering system. If the Division believes it is an adequate method of providing internal control, then the system should be corrected to reflect separate numbers only for those funds or account groups eligible for FDIC coverage. All other state agency subdivisions should use the State Treasurer's PDPA number, unless they are otherwise directed by legal opinion. If the Division determines that another system would be more appropriate and effective, then it should take the necessary steps to recommend legislative change and, implement new procedures and practices, as needed.

In addition, the Division needs to provide timely and meaningful training in the use of the numbering or any other internal control system. Staff from several banks told us that training is typically limited to an initial written description given at the time of application. Most bank staff reported that their only contact with the PDPA staff occurs when specific problems arise. Training is also needed for state agency personnel. Our interviews with State Controller's Office personnel and other state agencies' staffs revealed that many agency personnel are not sufficiently knowledgeable about their responsibilities with regard to PDPA, including the numbering system. For example, during a recent inventory of outside bank accounts by the Controller's Office, many state agency personnel reported that they did not know their PDPA number or how to use it.

Recommendation No. 5:

The Division of Banking should reevaluate the existing numbering system to determine its effectiveness as a control over FDIC and PDPA coverage. This could include:

- a. Making adjustments to the current numbering system or implementing a new system to support existing FDIC and State Attorney General opinions on FDIC insurance coverage.
- b. Notifying depositors, banks, and oversight entities of the changes made and providing oversight entities with accurate information.
- c. Recommending legislative changes, as appropriate.

Division of Banking Response:

Agree. The Division will:

- a. Automate the official custodian number data and begin providing quarterly automated reports of State assigned numbers to the State Controller and State Treasurer by December 31, 2000.
 - b. Notify official custodians, banks, and oversight entities of any changes made to assigned numbers as deemed necessary based on new Attorney General or FDIC opinions concerning public deposit insurance coverage.
 - c. If deemed appropriate, the Division will recommend legislative changes to the numbering system.
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