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## Legislation Expands Use of CDARS for Investment Risk Management

By Mark Jacobsen

An increasing number of gov-  
ernments now have a means  
of protecting deposits in  
excess of the \$100,000 FDIC  
limit—without collateralizing those  
deposits or using a portfolio of  
depositories. During the first eight  
months of 2004, several states have  
opened the door for local govern-  
ments by passing enabling legisla-  
tion and adopting legal clarifications.

Through a new service called the  
Certificate of Deposit Account  
Registry Service®, or CDARS® (pro-  
nounced “cedars”), banks can offer  
their customers up to \$5 million in  
federal deposit insurance coverage  
on deposits placed through one  
bank. For government finance offi-  
cers, CDARS offers the safety of  
FDIC insurance with the conveni-  
ence of one rate, one regular  
statement, and one banking relation-  
ship. Equally important, in most  
states, FDIC-insured deposits do  
not require collateralization.

CDARS can be used for CDs with  
4-, 26-, 52-, 104- and 156-week  
maturities. CDARS would not apply  
to overnight investments.

**How CDARS Works.** Members  
of Promontory Interfinancial  
Network—a network of FDIC-  
insured institutions—allocate a cus-  
tomer’s deposit (in the form of  
CDs) among several network banks  
so that all funds are eligible to be  
insured by the full faith and backing  
of the federal government.  
(Technically, deposits placed  
through CDARS meet the pass-  
through insurance coverage guide-  
lines established by the FDIC.)

For example, suppose a city needs  
to invest \$1 million. The city uses a  
competitive bidding process to  
obtain rates from several local  
banks. Because the winning bidder  
is a member of the CDARS net-  
work, the city is able to deposit the  
entire amount with full FDIC insur-  
ance coverage through the winning  
bank. The money is divided into  
amounts less than \$100,000 and  
placed in CDs issued by other net-  
work members through CDARS.  
The city receives regular consolida-  
ted interest payments and statements  
from the bank showing the account  
activity for each CD held in its  
name. In addition, the bank receives  
funds from other network members’  
customers totaling the amount  
deposited by the city.

The 550-plus banks that comprise  
the CDARS network exchange  
deposits on a dollar-for-dollar basis.  
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 among  
banks usually qualify funds placed  
using CDARS as “local,” a require-  
ment of many government invest-  
ment policies. At the end of the day,  
the bank has the deposit on its  
books that can be used for commu-  
nity lending purposes.

Depositors do not pay to use the  
CDARS service; the rate of CDs  
placed through CDARS is negotiat-  
ed like any other CD.

**CDARS Benefits.** Almost all  
states have enacted statutes that  
require public deposits in excess of  
the FDIC’s \$100,000 limit to be  
secured by pledged collateral securi-  
ties from depository institutions.

Before CDARS, the drawback of  
obtaining FDIC insurance for

*continued on page 5*

**Investments** — *continued from page 1*

finance officers was the limit of \$100,000 per depositor, per institution. Even so, many governments choose to spread their deposits among dozens of banks rather than deal with the inconveniences of monitoring and managing collateral.

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, which makes investing easier and less time-consuming. For government cash managers, this means not having to deal with multiple banks, rate renegotiations, and collateral monitoring.

Because statutory requirements for the investment of public funds vary from state to state, governments must make sure that CDARS qualifies as an appropriate investment tool. Some may need to update their investment policies to permit the use of this service.

**Legislative Status.** Last month, Illinois became the fifth state in 2004 to enact legislation to enable finance officers to invest through the CDARS service. The legislation in Illinois was an initiative of the Community Bankers Association of Illinois. Missouri, Colorado, Nebraska, and South Dakota enacted similar legislation earlier in the year, and bankers in other states worked for passage of legislation, as well. Under these 2004 enactments, government finance officers may invest public funds through CDARS only by placing the funds through a CDARS-participating bank located within the state.

Also during this year, Kansas, New Hampshire, and Hawaii through legal interpretation enabled governments to use CDARS.

Finance officers in Alaska, Connecticut, Georgia, Kentucky,

Maine, Minnesota, Nevada, Oklahoma, Pennsylvania, South Carolina, Tennessee, Vermont, and possibly a few other states have been able to use CDARS for investment of public money under existing authority. No legislation was required in these states for local governments to use the CDARS service.

Efforts led by bankers and their associations are underway to obtain legislative or interpretative clarifications in virtually all of the remaining states. (The network has members in all 50 states, the District of Columbia, and Puerto Rico).

Deposits from public units accounted for 25 percent of Promontory's transaction volume, based on recent statistics.

**Conclusion.** For local finance officers, collateralization of deposits has proven to be a generally effective protection against bank failures, but collateralization imposes a significant administrative burden on them. CDARS offers a convenient alternative to collateralization by expanding access to Federal deposit insurance to up to \$5 million of coverage. 2004 legislation will significantly expand this alternative to more localities across the United States. ❧

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