

SPECIAL BULLETIN

State Controller May Issue Registered Warrants June 26, 2009 Update

On June 24, 2009, the State Controller's Office posted a notice that California would begin issuing registered warrants and may do so as soon as July 2, 2009. Previously, the Controller had reported that July 28 was the earliest date the state would issue these warrants. The warrants are "IOUs" issued by the State of California, and they will be paid by the state when they mature or are called. The Controller's release states that these warrants will have a maturity date of October 1, 2009. While there is a bill under consideration in Sacramento that would allow for a higher interest rate, as of now the highest rate that could be set by the state is 5%. The actual rate (5% or lower) is going to be set at a meeting on July 2, 2009 of the state agency responsible for this – the Pooled Money Investment Board. Our understanding is that the Controller's Office will recommend an interest rate of 3.4% to 3.5%.

In case the State Controller decides it will actually issue warrants, it would make sense for all financial institutions to make some top-level decisions quickly. The first one is whether or not the institution will accept registered warrants from its customers. The second decision to be made is how the institution will communicate its decision (to accept or not accept warrants) to its customers. We emphasize that the decision on whether to accept registered warrants is one to be made by each individual financial institution for itself (in consultation with its advisors and counselors).

As a matter of general law, a depository institution in California is not obligated to accept warrants for deposit. However, there is always a question of whether the institution is contractually obligated to accept warrants, and thus it is advisable to review the institution's deposit account agreement. To assist our clients in notifying customers, attached is a draft of a possible notice. However, financial institutions should be very careful before simply posting this draft in its lobby or sending it to customers. There are major contractual, policy and business issues at stake. It is recommended that the financial institution speak with our attorneys, or other experienced legal counsel, before using the attached or any modified version.

The following are some additional issues that financial institutions will want to consider in deciding whether to accept warrants for deposit. We will seek to provide added information as and when it becomes available, likely through supplemental e-mails to our clients.

A. Our understanding is that registered warrants, if issued, will have an October 1, 2009 maturity date. If sufficient cash is not available by the October 1 maturity date, registered warrants may be issued to cover those previously issued registered warrants. The newly issued registered warrants would include the face value plus the interest accrued from issuance to the October 1, 2009 redemption date.

B. In 1992, the IRS opined that the interest on the warrants California issued at that time would have a tax treatment similar to that of similar state obligations. (IRS Announcement 92-111, “*Tax-exempt Status of Interest and Broker Reporting Requirements on Registered Warrants Issued by California.*”) For both the IRS and California’s Franchise Tax Board, the treatment this time around is worth revisiting. Since we are not in a position to advise on whether the interest is or is not subject to federal or state income tax or information reporting, we suggest that you consult with your tax advisors. We can provide the institution with copies of the older IRS ruling, and will of course forward anything new as and when we receive it.

C. Older (again 1992) opinions from the federal and state bank supervisory agencies provided guidance on the treatment of registered warrants. In a June 30, 1992 release (“*Interagency Position on California Registered Warrants*”), the OCC, Federal Reserve Board, FDIC and OTS concluded that: “these warrants should be considered as having the same regulatory requirements as general obligation bonds issued by a state. Thus, there is no regulatory limit on a bank’s or thrift’s investment in such warrants. Additionally, the warrants will receive the same risk-based capital treatment as general obligation bonds.”

D. In a Banking Issuance issued August 10, 1992, the OCC provided further guidance on the June 30, 1992 Interagency Statement. (EB 92-5, “*California Registered Warrants*”.) In the Issuance, the OCC made several important observations and conclusions and should be reviewed carefully. As a general matter, the OCC concluded that the warrants were not subject to lending limits, but were subject to safety and soundness considerations as investments. The Banking Issuance also provided guidance on appropriate accounting for the warrants for regulatory reporting purposes. In particular, note the OCC’s position that:

1. Registered warrants drawn against unexhausted appropriations and otherwise issued in accordance with California law are extensions of credit to the state that constitute state general obligations;

2. The term general obligation means “an obligation supported by the full faith and credit of an obligor possessing general powers of taxation, including property taxation.” (In the 1992 release, the OCC cites to 12 CFR 1.2(g) for this definition. It has since been moved without change to 12 CFR 1.2(b)(1).) The OCC’s regulations (at 12 CFR 1.3(a)) provide that national banks may purchase state general obligation securities for their own account without limitation, subject to prudent banking judgment.

3. As a matter of prudence, banks should consider obtaining appropriate legal opinions that any registered warrants purchased represent valid and enforceable general obligations of the state. In 1992, this legal opinion was issued by the California Attorney General’s Office. The current Attorney General has been asked to reaffirm the

1992 opinion. Even in 1992, the OCC advised that banks should determine the extent to which they should rely on opinions of the California Attorney General, on counsel retained by other banks, or their own counsel, depending upon their particular situations.

4. Assuming that banks have satisfied themselves that the warrants represent valid state general obligations, for regulatory reporting purposes, banks should account for them as “General obligations” on Schedule RC-B, under the category “Securities issued by states and political subdivisions in the U.S.” In 1992, California state obligations were rated “Aa” by Moody’s and “A+” by Standard & Poor’s. Obviously, this has changed, but it is not clear how or if this will affect Call Report reporting obligations.

5. The change in rating may affect credit evaluation. In 1992, the OCC felt that, while the warrants were not rated and were subordinate to the state’s general obligation bonds, the existence of general obligation debt ratings for the state simplified credit evaluation. At that time, examiners were instructed to review the warrants in accordance with Banking Circular 127, which defines sub-investment quality securities as those rated below “Ba” and “BB” (Moody’s and Standard & Poor’s, respectively). Currently, California’s credit ratings on state obligations may be below these levels. Further credit downgrades are also possible, as they were in 1992, if the budget problem is not resolved shortly.

6. In 1992, the OCC instructed examiners to pay particular attention to potential liquidity and credit concentration ramifications, in the event of a prolonged budget stalemate. Examiners were also told to urge banks to adopt procedures to protect against the purchase of unauthorized or fictitious warrants. This may include close consultation with appropriate state officials.

7. Finally, because the timing of payments on the warrants was uncertain, in 1992 national banks were told to have plans to address any undesired reduction in asset liquidity which might occur due to accumulation of the warrants. Banks were told to have systems in place that accurately measure all accumulated credit exposure to the State of California, including other California state general obligation holdings. And banks were told that they should consider preparing appropriate disclosure statements clarifying customer rights and liabilities with respect to the warrants (*e.g.*, distribution of accrued interest income, hold policies, late returns, etc.).

The OCC’s conclusions in 1992 have not been revalidated, although the California Bankers Association has asked the OCC and the other federal agencies to provide updated guidance. Thus, it is not completely clear that a bank or other financial institution should or may rely on these previous positions of the OCC (or as found in the Interagency Statement released by the OCC, Federal Reserve Board, OTS and FDIC). Finally, we note that the OCC’s conclusions are in part based on an opinion from the California Attorney General that registered warrants were payable from the state’s general fund. The Attorney General’s opinion was issued June 24, 1992, and the California Bankers Association has also asked that office to revalidate the 1992 opinion or provide updated guidance.

The Department of Financial Institutions dealt with registered warrants as part of the Weekly Bulletin dated July 3, 1992. In it, DFI concluded that Financial Code Section 1221, which limits the amount of obligations of any one person that may be owing to a bank at any one time (that is, “lending limits”), are not applicable to registered warrants. DFI also concluded that then-Financial Code 1336 (now found at Section 1330, and limiting the amount a bank may invest in securities of a single person) were not applicable to registered warrants. DFI has also been asked to revalidate these prior positions.

We can forward copies of these older rulings, but offer a word of caution since they were issued over a decade ago. We will forward anything new as and when we receive it and we would be happy to advise on an individual basis as to the lending limit issue.

We note that a financial institution will be responsible for safety and soundness matters. Even if not subject to lending limits, a depository institution will want to avoid a concentration that is in excess of its risk parameters.

E. Our understanding is that major correspondent banks (including Federal Reserve Banks) will not accept registered warrants. This should, of course, be confirmed by individual respondent banks with their correspondent banks, since it may materially affect sorting and processing. It would also mean that a depository institution will need to store the paper items if it accepts them for deposit or collection.

F. We have been informed that the Controller’s Office has obtained a unique ABA routing number that will only be used in connection with the registered warrants and has also obtained special check stock for use in that regard. The ABA number for **registered** warrants will be 121145077. (The ABA number for regular warrants is 121113423.) The check stock is in a green color and will have the caption “This REGISTERED WARRANT will be honored on or after 10-1-2009.”

This should assist in outsourcing registered warrants from standard warrants. Recall that the state will continue to issue a large number of standard warrants for those entitled to receive priority, and consequently, immediate payment. Priority payments include payment categories protected by the California Constitution, federal law and court decisions. These payees will receive regular payments in July and thereafter all other general fund payments will be paid with IOUs, including payments to local governments for social services, private contractors, state vendors, income and corporate tax refunds, and payments for state operations including legislative per diem.

G. A key issue for those who do not wish to accept registered warrants for deposit will be how to deal with automated processing and other systems. In other words, how will an institution prevent acceptance of the warrants through systems such as remote capture, courier, cash management and other large volume or remote programs? Items that are processed may be outsourced based on the routing number (see above), and provisional credit reversed. However, there will still remain notice and return concerns. For those who offer remote deposit capture, it will be important to educate customers not to destroy the instruments, since the customer will need the instrument for presentation when matured or called.

H. If a warrant is returned after it has been handled by a financial institution, in appropriate cases, the institution will want to consider removing the financial institution's endorsement (if any) on the item.

I. If the warrants are accepted, institutions will need to decide how to account for them and report them for Call Report purposes, in light of the guidance given in 1992 and as updated by the federal and state banking authorities. Consultation with the institution's CPAs is advised in this regard. If treated as investments, one should ask whether (or under what conditions) they would need to be marked to market.

J. If the warrants are accepted for deposit, they are not considered "checks" subject to Regulation CC unless they are matured or have been called. Thus, if a customer deposits a warrant in July, with a maturity date of October 1, 2009, it is not a "check" under Regulation CC (technically, because it is not a demand instrument). An institution may "hold" funds on these non-Regulation CC warrants without regard to Regulation CC funds availability schedules. It is recommended that the institution provide notice to the customer, either as part of the general educational effort or on a transactional basis. However, if the warrant is deposited on or after October 1, 2009 (assuming the Controller uses that as a maturity date, per the Controller's announcement today), or if deposited otherwise after maturity or being called, then it is a demand instrument and it is a "check" under Regulation CC. An institution may "hold" funds on these Regulation CC-covered warrants only in accordance with Regulation CC and the institution's funds availability policy. Thus, the difference in the warrant (whether it has or has not matured or been called) affects compliance responsibilities, such as hold disclosures notices and the hold period itself.

K. The state has said that it will verify the warrant number on individual warrants. So if a warrant is received, the financial institution will have an opportunity to inquire whether the number associated with a received warrant is within the range of the valid warrants issued by the Controller. This would occur as a fraud control mechanism at the time the warrant is accepted by the financial institution. If the inquiry results in a negative response, the warrant would be charged back. If a positive response is received, the financial institution would hold the warrant until its maturity or until the warrant is called for redemption. Note, however, that the state will still have an opportunity to pay or return the warrant upon presentment to the state. That is, the verification of the warrant number is nothing more than assurance that the warrant has a number that is in the range of those used by the state on outstanding warrants. The verification is not a promise to pay, since the state may still reject upon presentment for a number of reasons. These would include, for example, counterfeit or altered items. A counterfeit item could thus be verified at the time of receipt by the financial institution (because the warrant number is valid) but rejected by the state when the financial institution presents it to the state at the time the warrant matures or is called. Thus, there could be some fairly lengthy period of time between receipt of a counterfeit warrant and discovery of the fraud.

L. In addition, there is a potential problem with stop payments. Historically, the state has been willing to reissue warrants if the payee certifies that the warrant has been lost, stolen or destroyed. Upon reissuance, a stop payment is placed by the state to prevent payment of the original warrant. The concern would be that a financial institution would receive a

warrant, seek and obtain verification that the warrant has a valid number, hold the warrant, and then find out that the payee/customer had falsely claimed that the warrant was lost or destroyed. If this occurred, and the state stopped payment on the original “lost” warrant, then a loss could arise when the “lost” warrant is presented and rejected. The state has repeatedly said that it will initiate a program under which the state will not reissue warrants that are reported lost or stolen if the warrant has already been verified by a financial institution, but to date the state has not implemented or described how this program will work. Accordingly, in our view, it remains a risk.

Sample Notice to Customers Regarding Registered Warrants

(Note: Choose alternative bracketed language to match policy of accepting or not accepting registered warrants.)

Beginning on or about July 2, 2009, California may begin to issue registered warrants for certain debts. Registered warrants issued by California, or similar instruments from other states (“registered warrants” or “warrants”), are subject to special rules. These instruments are state IOUs and will not be paid by the state until they mature or are called for redemption (in California, by the State Treasurer). We are not required to accept registered warrants from you, whether for encashment, deposit or otherwise. [[Alternative #1: OUR CURRENT POLICY IS NOT TO ACCEPT REGISTERED WARRANTS.]] [[Alternative #2: Nevertheless, in most instances we will provide you with immediate credit for the face amount of the registered warrant, upon deposit to us.]] If we do accept warrants from you, we may accept some or a portion of your registered warrants; and may at any time stop accepting warrants, with or without cause or prior notice. We may change our practices at any time and at our discretion, even if we have previously accepted registered warrants from you. If we refuse to accept a registered warrant, we may return to you either the original registered warrant or a paper image of the original registered warrant conforming to the technical requirements applicable to a substitute check in lieu of the original registered warrant.

If we accept warrants, we may provide you with provisional credit. However, you understand that registered warrants are not subject to our funds availability policy, unless they have matured or have been called for redemption. If you present a warrant that has not matured or been called, you agree that we may place a hold on the warrants, including on funds in other accounts of yours, that extends longer than our normal availability policy. The hold may be for all or a portion of the amount of warrants you have provided to us.

You agree that we may keep any interest paid to us on the warrants from the date of their issuance, regardless of the time you may have held the registered warrant prior to its transfer to us. You assign to us all your rights in the warrant and agree to execute any instrument or writing reasonably requested by us to further payment to us. If the State Treasurer honors the redemption of a registered warrant by issuing a new registered warrant to us as holder, we may similarly keep any interest paid to us by the State Treasurer for the new registered warrant.

We may delay presentment (or representment) of warrants for payment until they are called (for example, the State Treasurer publishes a notice of redemption or authorizing payment) or mature, and may hold the warrants until that time, even though preliminary verification efforts may have occurred. You waive notice of dishonor or presentment, and we may provide you with notice of nonpayment at any time after dishonor. Prior to notice of redemption or any maturity date, we may validate (or seek to validate) with the State any registered warrant we have received from you. We may charge the amount of any warrant back to your account at any time if we are unable to validate it or payment to us is refused by any person and for any reason. If we are unable to validate a registered warrant, or if we are unable to obtain payment on it, we may return to you the original registered warrant or a paper image of the original registered

warrant conforming to the technical requirements applicable to a substitute check in lieu of the original registered warrant.

Except as may be otherwise specifically agreed to by us in writing, you agree not to present registered warrants to us via remote deposit or other remote banking services. You understand that registered warrants normally should not be destroyed and must be delivered to us directly. You agree not to present warrants to us on which you are not the original payee. You agree to all obligations of an endorser on the warrant, even if your endorsement is not on the instrument.

We reserve the right to charge the amount of any dishonored registered warrant back against your deposit account, regardless of the reason for dishonor, and you agree to pay us that amount. If you have insufficient funds to cover the amount of the chargeback, we may overdraw your account and you agree to pay back this overdraft obligation and related costs and expenses in accordance with the applicable account agreement.

You agree to indemnify, defend, and hold us harmless from and against any and all losses, damages, claims, costs or expenses (including attorneys' fees and costs) incurred by us as a result of our handling a warrant or purported warrant from you.

This notice supplements the terms and conditions of the applicable account agreement. If there is conflict between this notice and the account agreement, then this notice will govern.