



Collateralization of Public Fund Deposits

Presented by:
Office of the State Treasurer
October 7, 2008



A Sampling of Events in 2008

- Nationalization of Fannie Mae and Freddie Mac
- Downgrade of muni bonds' credit ratings due to bond insurance companies' woes
- Kansas Bankers Surety Co. announces discontinuation of bank deposit insurance
- Bank Closures
 - Missouri: Douglass National Bank and Hume Bank
 - National: IndyMac, WaMu, Wachovia.....
- US legislation raising FDIC insurance limits

Separating Fact from Fiction

- Deposits with Missouri banks remain one of the highest returning & safest asset classes available to governments if proper collateralization procedures are followed
- The vast majority of banks in Missouri continue to show strong balance sheets and remain “well capitalized”
- Collateralization acts as your second line of defense when investing – something you do not have with commercial paper, for example

Definition of Collateral

- An asset, such as a bond, which is pledged to a lender in the event that a loan payment can not be met. The collateral may be appropriated from the borrower and sold in order to fulfill financial obligations.

Purpose of Collateralization

- Collateralization is necessary in order to recover your investment in a CD or deposit accounts in the event of a bank default
- Two conditions must be satisfied to be properly collateralized:
 1. Must have a perfected interest in collateral securities
 2. Must be able to sell collateral in the open market at a price sufficient to recoup your investment (*does not apply to surety bonds or FHLB LOC*)

Statutory References

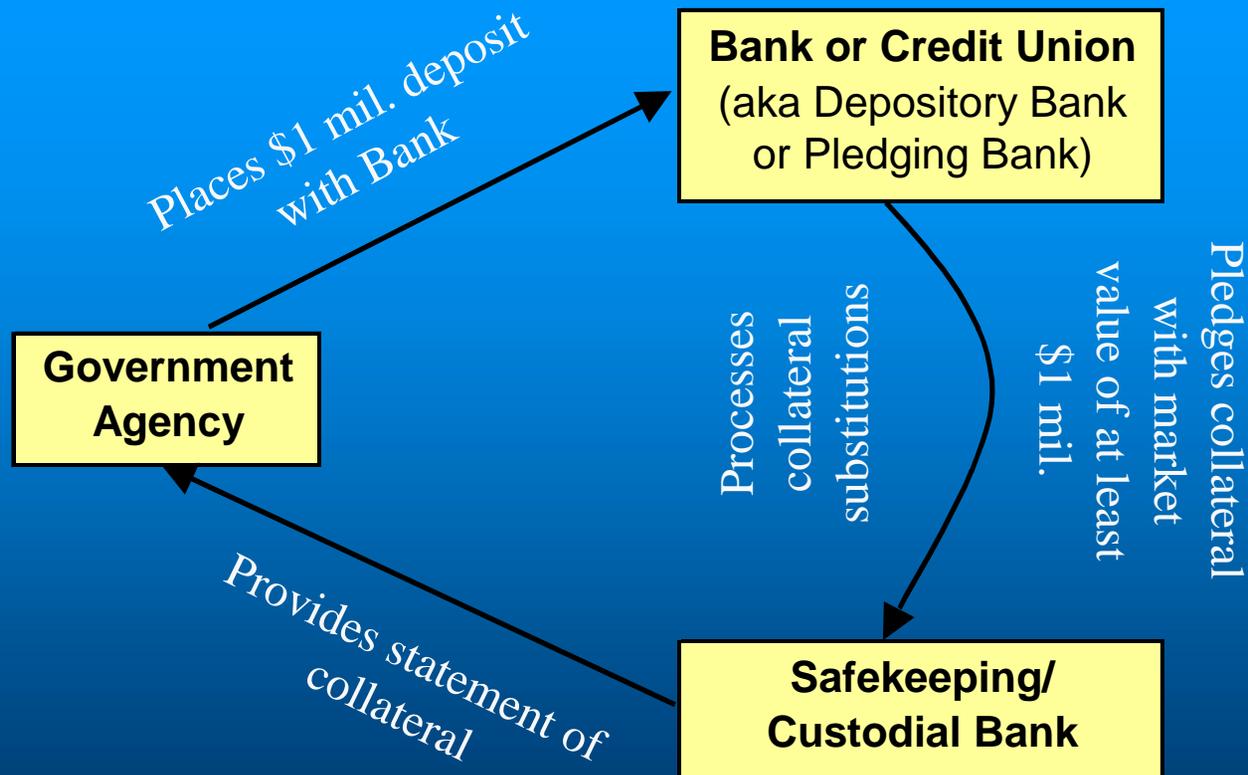
- Section 110.010, RSMo
 - Requires all Deposits of Public Funds to be Collateralized
 - Refers to Chapter 30.270, RSMo., which lists Acceptable Collateral
 - Delivery of Collateral to:
 - Fiscal Officer or Governing Body of Agency OR
 - Another banking institution or safe depository bank satisfactory to both parties
- Section 110.020, RSMo. requires that Market Value of Collateral Shall be at Least 100% of Amount on Deposit (Less FDIC Insurance)

Overview of Collateralization Principles

- State law requires that all public funds deposits with banks/credit unions be collateralized at least 100% and with only certain assets classes
- Each agency should have a pledge agreement and depository contract with each bank enumerating rights and responsibilities
- An agency should have a system in place to ensure that deposits are adequately collateralized



Diagram of Collateralization



Acceptable Collateral

(Section 30.270 - Acceptable Collateral)

- Treasuries
- U.S. Govt. Agencies
- State of Missouri Bonds
- State Agency Bonds, Including Revenue Bonds
- FHLB Letters of Credit*
- Surety Bonds*
- Bonds issued by:
 - Missouri Cities with Population > 2,000
 - Missouri Counties
 - School Districts
 - Special Road Districts
 - Other States
- Tax Anticipation Notes*
- AAA-rated out-of-state muni bonds*

* See Section 30.270 for more specifics on restrictions

Pledge Agreements

- Each agency should have a *depository contract and pledge agreement* with each pledging bank
- Agreement should comply with the Financial Institutions, Reform, Recovery, and Enforcement Act of 1989 (FIRREA).
- Ensures that your security interest in collateral pledged is enforceable against the receiver of a failed financial institution.

Collateral Rights/Obligations*

- You should have the right to determine the eligibility of collateral (or veto rights)
- Final approval of releases and transfers of securities
- Proceeds of called securities and other cash redemptions should remain in collateral account until other securities are pledged
- Board of depository bank must approve a resolution authorizing execution of pledge agreement (FIRREA)

* May be contained in an agency's custodial agreement



Collateralization Formula

- Market value of collateral \geq (Face value of deposit + accrued interest to date – FDIC insurance*) x Collateralization Margin
- Example:
 - \$1,000,000 deposit with Bank X @ 3% yield
 - At 6 months, with no “haircut”, the market value of pledged securities should equal:
$$\$1,000,000 + \$15,000 \text{ (accrued interest)} - \$250,000 = \$765,000$$
 - With a collateral requirement of 110%, the required market value of securities would be:
$$\$765,000 \times 110\% = \$841,500$$

* FDIC insurance applies to all of an agency’s deposits with a bank. In this example, the agency has just one deposit with Bank X.

Collateralization Example

SUMMARY OF DEPOSITS WITH BANK X

Time Deposits

<u>Maturity</u>	<u>Face Amount</u>	<u>Accrued Interest</u>	<u>Total</u>
5/15/09	\$ 10,000,000	\$ 81,250	\$ 10,081,250
12/15/08	\$ 9,000,000	\$ 140,625	\$ 9,140,625
TOTAL	\$ 19,000,000	\$ 221,875	\$ 19,221,875

Collateral Securities

<u>CUSIP</u>	<u>Face Amount</u>	<u>Description</u>	<u>Mkt Price</u>	<u>Mkt Value</u>
31398AKN1	\$ 10,000,000	FNMA 4.55% 1/4/2013 Callable	101.2728	\$ 10,127,276
31371K2M2	\$ 3,038,451	FN 4.50% 4/1/2010 MBS	97.67188	\$ 2,967,712
3133XC6Y4	\$ 7,515,000	FHLB 4.50% 6/22/2010 Bullet	102.2521	\$ 7,684,242
TOTAL MARKET VALUE				\$ 20,779,230
PLUS FDIC INSURANCE				\$ 250,000
TOTAL MARKET VALUE + INSURANCE				\$ 21,029,230
COLLATERALIZATION LEVEL				109.4%

Collateralization Formula

- Market value should be determined/verified by an independent third party on a periodic basis
- Collateral Margin (“Haircut”) should be sufficient to account for fluctuations in price and bid/ask spread required by brokers
 - “Haircut” is a buffer to cover any price depreciation between the date you “marked-to-market” and the date you sell securities
 - “Haircut” is dependent on asset class and market conditions
 - FHLB LOC’s and surety bonds do not require a “haircut”

Collateralization Issues

- Price depreciation of certain asset classes
- Callable securities have been called (redeemed) but still appear on schedule of pledged securities. Result is that you are non-collateralized.
- Formerly AAA-rated out-of-state muni's have been downgraded to "A" or "AA" status

FDIC Insurance

- All "time and savings deposits" owned by a public unit and held by the same official custodian in an insured in-state bank are added together and insured up to \$250,000. *
- Separately, all "demand deposits" owned by a public unit and held by the same official custodian in an insured in-state bank are added together and insured up to \$250,000.*
- \$250,000 applies to the face amount + accrued interest*
- Covers money market demand accounts (MMDA's) but does not cover money-market mutual funds or securities held by bank

* Federal legislation was passed the week of Sep. 29, 2008 temporarily raising the previous FDIC insurance limits from \$100,000 to \$250,000. These revised limits are scheduled to sunset on 12/31/09.

FDIC Insurance (Cont'd)

- A depositor cannot increase insurance coverage by placing deposits at different branches of the same insured bank or by dividing deposits into several different accounts at the same insured bank
- Federal deposit insurance is not determined on a per-account basis
- When a bank fails, FDIC either transfers the insured depositor's account to another FDIC insured bank, or gives the insured depositor a check equal to their account balance.

Other Questions Regarding Deposits

- Does your agency bid time deposits or solely invest in CD's of just one bank?
- Do you have a sense of the creditworthiness of your depository institution(s)?
 - See free ratings at www.bankrate.com
- Do you know if the rates (yields) quoted by your bank are competitive with other banks?

In Summary

- You cannot put your collateralization process on “auto pilot”
- Proper collateralization, along with diversification of your portfolio, is your best protection in a worse case scenario
- Economy is not out of the woods yet
- Continue to “play it safe”
- Ask yourself - are you prepared for the worse case scenario?

Additional Information

- State Treasurer's Office
 - Sample Depository Contract
 - Pricing of Securities
 - Questions
 - Mark.Mathers@treasurer.mo.gov
 - (573) 751-8530
- GFOA
- Credit Ratings
 - www.bankrate.com
(www.bankrate.com/brm/safesound/ss_home.asp)