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 cannot 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

Government Agency

Places $1 mil. deposit with Bank

Bank or Credit Union
(aka Depository Bank or Pledging Bank)

Processes collateral substitutions

Pledges collateral with market value of at least $1 mil.

Safekeeping/Custodial Bank

Provides statement of collateral
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 *depositary 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 ≥ (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 (accrued interest) - $250,000 = $765,000
  – With a collateral requirement of 110%, the required market value of securities would be:
    $765,000 x 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

<table>
<thead>
<tr>
<th>Time Deposits</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Maturity</td>
<td>Face Amount</td>
<td>Accrued Interest</td>
<td>Total</td>
</tr>
<tr>
<td>5/15/09</td>
<td>$10,000,000</td>
<td>$81,250</td>
<td>$10,081,250</td>
</tr>
<tr>
<td>12/15/08</td>
<td>$9,000,000</td>
<td>$140,625</td>
<td>$9,140,625</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$19,000,000</td>
<td>$221,875</td>
<td>$19,221,875</td>
</tr>
</tbody>
</table>

### Collateral Securities

<table>
<thead>
<tr>
<th>Collateral Securities</th>
<th>Description</th>
<th>Mkt Price</th>
<th>Mkt Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>CUSIP</td>
<td>Face Amount</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31398AKN1</td>
<td>$10,000,000</td>
<td>FNMA 4.55% 1/4/2013 Callable</td>
<td>$101.2728</td>
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<tr>
<td>31371K2M2</td>
<td>$3,038,451</td>
<td>FN 4.50% 4/1/2010 MBS</td>
<td>$97.67188</td>
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<tr>
<td>3133XC6Y4</td>
<td>$7,515,000</td>
<td>FHLB 4.50% 6/22/2010 Bullet</td>
<td>$102.2521</td>
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<tr>
<td>TOTAL MARKET VALUE</td>
<td></td>
<td>$20,779,230</td>
<td></td>
</tr>
<tr>
<td>PLUS FDIC INSURANCE</td>
<td></td>
<td>$250,000</td>
<td></td>
</tr>
<tr>
<td>TOTAL MARKET VALUE + INSURANCE</td>
<td></td>
<td>$21,029,230</td>
<td></td>
</tr>
</tbody>
</table>

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](http://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)