



Collateralization of Public Fund Deposits

National Association of County
Collectors, Treasurers and Finance Officers

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A Sampling of Events in 2008-2009

- Nationalization of Fannie Mae and Freddie Mac
- Downgrade of muni bonds' credit ratings due to bond insurance companies' woes
- Fall of Bear Stearns and Lehman Brothers and the stand-alone investment bank model.
- FDIC insurance limits raised from \$100,000 to \$250,000 (expires 1/1/14).
- An alphabet soup of new government programs were implemented to reassure markets



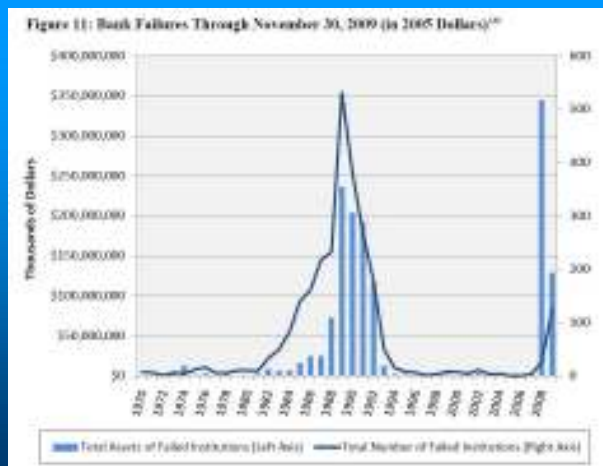
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Banking Industry

- In 2008, larger banks like IndyMac, WaMu, Wachovia and Citibank either failed or had to be rescued
- In 2009, the spotlight and risks have shifted to smaller banks (< \$10 billion) that have greater exposure to CMBS.
- Bank Failures
 - 2008: 25
 - 2009: 140
 - 2010: 22 to date

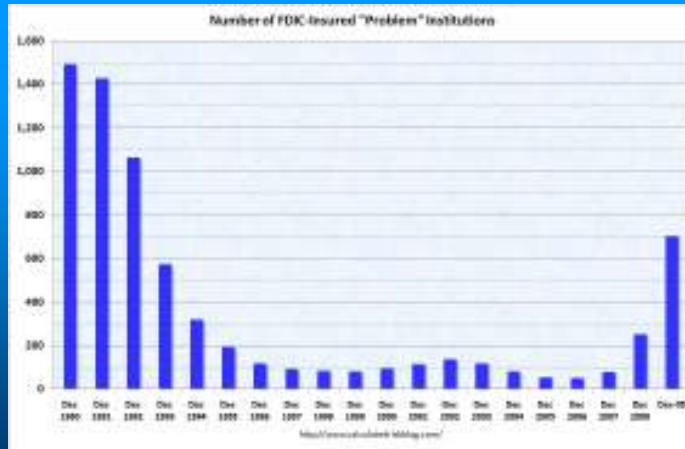
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Banking Industry

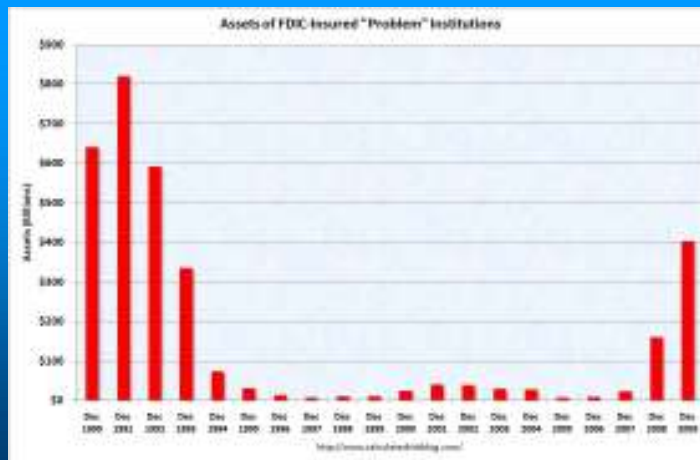


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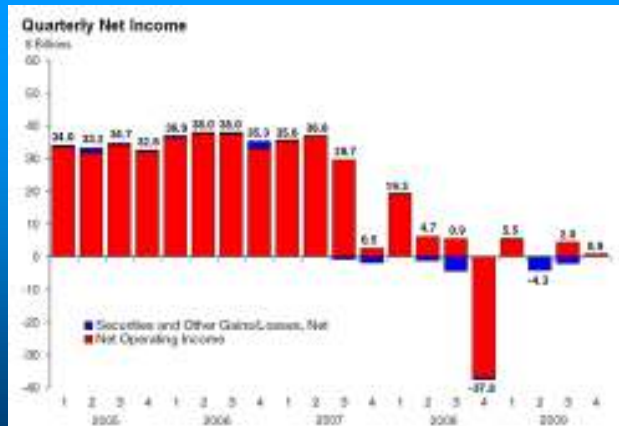
Banking Industry



Banking Industry



Banking Industry



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Are Bank CD's Safe?

- Despite the banking industry's issues, most community banks continue to be well managed and will weather through the current financial crisis.
- Deposits with banks remain one of the highest returning & safest asset classes available to governments **if** proper collateralization procedures are followed
- Collateralization acts as your second line of defense when investing – something you do not have with commercial paper, for example

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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*)

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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.

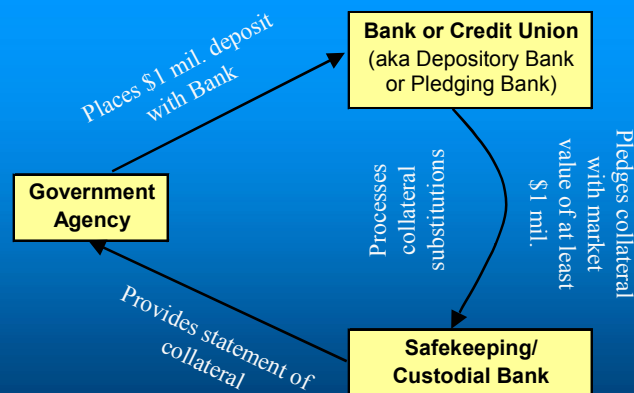
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Four Basic Collateralization Principles

1. Each agency should have a pledge agreement and depository contract with each bank enumerating rights and responsibilities
2. Deposits with banks/credit unions should be collateralized at least 100% and with only certain assets classes
3. Delivery of collateral should be made to a separate safekeeping bank
4. An agency should have a system in place to ensure that deposits are adequately collateralized

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Diagram of Collateralization



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Principle #1: Pledge Agreements

- Each agency should have a *depository contract and pledge agreement* with each safekeeping 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.

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Principle #1: Pledge Agreements

FIRREA Requirements

1. Agreement must be in writing.
 - If your agreement is with a bank that has been acquired or merged, it's time to get a new agreement.
2. Board of depository bank must approve a resolution authorizing execution of pledge agreement
 - Attach a copy of the executed resolution with a seal of the board's secretary to your agreement

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Principle #1: Pledge Agreements

FIRREA Requirements (Cont'd.)

3. Agreement must be in official records of the bank.
4. Pledging of collateral must be contemporaneous or simultaneous with agreement
 - Don't list specific collateral to be pledged
 - Include a term that any collateral pledged must comply with the terms of the agreement (asset class, term, margin, etc.)

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Principle #1: Pledge Agreements

Other Requirements (UCC)

1. You should have the right to determine the eligibility of collateral (or veto rights)
 2. You should have final written approval of releases and transfers of securities
- * Also: Proceeds of called securities and other cash redemptions should remain in collateral account until other securities are pledged

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Principle #2: Collateral

Commonly Accepted Forms of Collateral

- US Treasuries
- U.S. Government Agencies/GSE's
 - GSEs: Fannie Mae, Freddie Mac, Federal Home Loan Bank, Federal Farm Credit Bank
- State Bonds
- Local Government Bonds (“muni’s”)
- FHLB Letters of Credit
- Surety Bonds (issued by insurance companies with a top rating)

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Principle #2: Collateral

- Collateral Margin: The ratio of the market value of pledged securities to the face value and accrued interest of the deposit
- Many states have laws requiring a minimum level of collateralization, which is the collateral margin or “haircut”.
- A minimum “haircut” for any type of collateral should be 102% to reflect price volatility.
- Margins of 110% up to 125% are common, however.

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Principle #2: Collateral

- Agencies can and probably should consider different “haircuts” for different asset classes or sub-classes. The margin for a CMO should be higher than a US Treasury due to the Treasury bond’s greater price transparency and liquidity.
- An agency should always have the right to reject a specific bond to be pledged by the bank.
- An agency should consider the allowable term, or maturity, of pledged collateral.

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Principle #3: Third-Party Bank

- Collateral should always be pledged to an independent, third-party institution (bank or trust department) rather than being held at the pledging bank.
- There should be a custodial or safekeeping agreement with the third-party bank or alternatively, a tri-party agreement between the agency, pledging bank and safekeeping bank.
- See previous UCC requirements for terms to include in the agreement.

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Principle #3: Third-Party Bank

- The key requirement in the agreement is that the agency has the irrevocable right to access and sell the pledged collateral in the event of a default by the pledging bank.
- The pledging bank should pay the third party bank's fees.

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Principle #4: Collateral Monitoring

- The market value of collateral will fluctuate, so it should be determined on a periodic basis, no less than monthly.
- Collateral reports should be received from the safekeeping bank, NOT the pledging bank.
- The market value should be determined by an independent third party, NOT the pledging bank.
- The listing of collateral should be compared to the previous period and checked to ensure that no unauthorized substitutions or releases were made.

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Principle #4 (Cont'd.) 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:
 $\$1,000,000 + \$15,000 \text{ (accrued interest)} - \$100,000 = \$915,000$
 - With a collateral requirement of 110%, the required market value of securities would be:
 $\$915,000 \times 110\% = \$1,006,500$

* 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.

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Principle #4 (Cont'd.) Collateralization Example

SUMMARY OF DEPOSITS WITH BANK X

Time Deposits

Maturity	Face Amount	Accrued Interest	Total
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

CUSIP	Face Amount	Description	Mkt Price	Mkt Value
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				\$ 100,000
TOTAL MARKET VALUE + INSURANCE				\$ 20,879,230
COLLATERALIZATION LEVEL				108.6%

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Principle #4 (Cont'd.) 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”

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Principle #4 (Cont'd.) 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

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FDIC Insurance

- FDIC insurance limits raised from \$100,000 to \$250,000 (expires 1/1/14).
- Transaction Account Guarantee Program
 - Created in late 2008
 - Provides unlimited deposit insurance for non interest-bearing accounts and NOW accounts earning less than 0.50%.
 - Extended through 6/30/10

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FDIC Insurance (Cont'd.)

- "Public unit" includes a state, county, municipality, or "political subdivision" thereof. Under section 330.15, the "official custodian" of the funds belonging to the public unit – rather than the public unit itself – is insured as the depositor.
- 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

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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.

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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?

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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?

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Additional Information

- GFOA (www.gfoa.org)
 - Best Practice for “Collateralization of Public Deposits”
- Credit Ratings
 - www.bankrate.com
 - www.bankrater.com
 - Other fee-based service providers
- State Treasurer of Missouri (www.treasurer.mo.gov)
 - Sample depository and safekeeping agreements

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