CPIM Academy

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CPIM

Center For Public Investment Management

A PROGRAM BROUGHT TO YOU BY:

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CASH 237:

Collateralization of Public Deposits

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Course Learning Objectives

- Understanding how to protect public deposits through collateralization
- Industry and regulatory changes impacting public funds
- Understanding oversight responsibility
- Collateral management practices
- Best practices
- Deposit and investment alternatives
- Reference materials

Purpose of Collateralization

- Collateralization is necessary to protect public funds and recover its ownership in certificate of deposits or deposit accounts in the event of a bank failure.
- Conditions that must be satisfied to be properly collateralized include:
  - Written, signed Collateral Agreement by both parties.
  - Must be in compliance with ORC and UCC Law.
  - Must have a perfected interest in collateral securities.
  - Must be able to sell collateral in the open market at a price to recoup your investment (does not apply to surety bonds or FHLB LOC).

Protecting Public Deposits

ORC Requirements – 135.18

- If a public depository elects to provide security pursuant to division (A)(1) of this section, the public depository shall pledge to the public depositor, as security for the repayment of all public moneys deposited in the public depository . . . eligible securities of aggregate market value at all times equal to at least one hundred five percent of the total amount of the public depositor's uninsured public deposits.

Protecting Public Deposits

ORC Requirements – 135.182

- Not later than July 1, 2017, the treasurer of state shall create the Ohio pooled collateral program. Under this program, each institution designated as a public depository that selects the pledging method prescribed in division (A)(2) of section 135.18 or division (A)(2) of section 135.37 of the Revised Code shall pledge to the treasurer of state a single pool of eligible securities for the benefit of all public depositors at the public depository to secure the repayment of all uninsured public deposits at the public depository, provided that at all times the total market value of the securities so pledged is at least equal to either of the following:
  - (a) One hundred two per cent of the total amount of all uninsured public deposits; or
  - (b) An amount determined by rules adopted by the treasurer of state . . .

Protecting Public Deposits

ORC Requirements – 135.32

- No bank shall receive or have on deposit at any one time public moneys, including public moneys as defined in section 135.01 of the Revised Code, in an aggregate amount in excess of **thirty percent** of its total assets. . . .

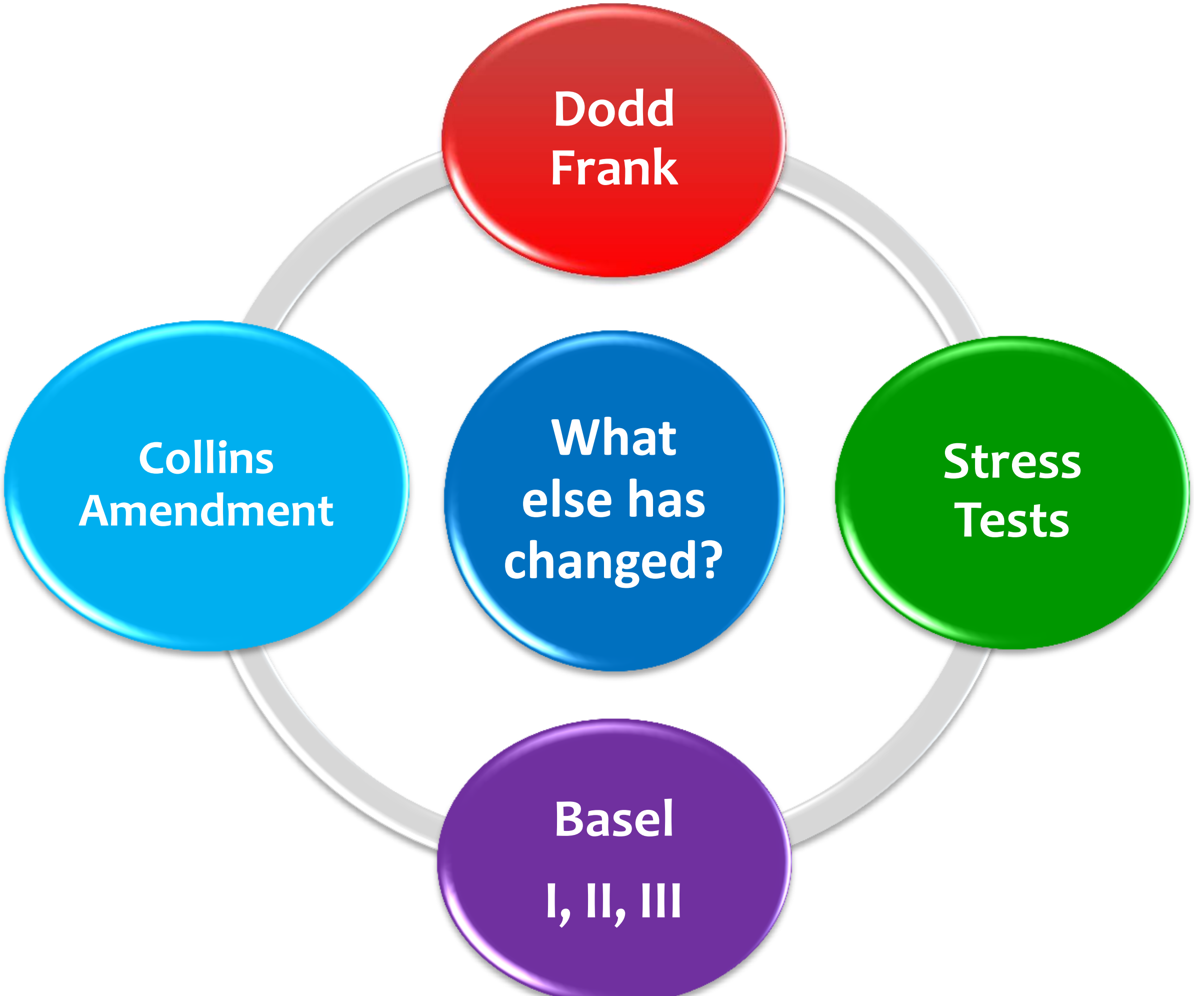
Ohio Bank Failures

- **Who** – Ohio has had few true Bank failures

Bank Name	City	ST	CERT #	Acquiring Institution	Closing Date	Updated Date
AmTrust Bank	Cleveland	OH	29776	New York Community Bank	4-Dec-09	5-Nov-12
Peoples Community Bank	West Chester	OH	32288	First Financial Bank, N.A.	31-Jul-09	20-Aug-12
Miami Valley Bank	Lakeview	OH	16848	The Citizens Banking Company	4-Oct-07	28-Aug-12
Oakwood Deposit Bank Co.	Oakwood	OH	8966	The State Bank & Trust Company	1-Feb-02	25-Oct-12
Malta National Bank	Malta	OH	6629	North Valley Bank	3-May-01	18-Nov-02

- **When** – In the recent history
- **What** – Fraud failures caused losses to political subdivisions; Losses on non-transferred “CDARS” accounts (though covered by FDIC)
- **Why** – Failure to take oversight responsibility

Industry & Regulatory Changes



Industry & Regulatory Changes

Dodd Frank

- Is a United States federal law that places regulation of the financial industry in the hands of the government.
- The legislation, enacted in July 2010, aims to prevent another significant financial crisis by creating new financial regulatory processes that enforce transparency and accountability while implementing rules for consumer protection.

Basel III

- Basel III is a comprehensive set of reform measures designed to improve the regulation, supervision and risk management within the banking sector. Largely in response to the credit crisis, banks are required to maintain proper leverage ratios and meet certain capital requirements.
- It builds on the Basel I and Basel II documents, and seeks to improve the banking sector's ability to deal with financial and economic stress, improve risk management and strengthen the banks' transparency.

Industry & Regulatory Changes

- Why would my bank **NOT** want my deposits?
  - Higher bank capital and liquidity requirements
  - Lack of eligible assets to be used as collateral
  - Significantly higher cost given low return on assets
  - Too deposit heavy with insufficient ability to lend given tightened lending regulations and policies

FDIC Insurance

- Federal deposit insurance is NOT determined on a per-account basis.
- All " time and savings deposits" and all "demand deposits" owned by a public entity in an insured in-state bank are added up together and insured up to $250,000.
- $250,000 applies to the face amount + accrued interest.

FDIC

FDIC Insurance

- Covers money market demand accounts (MMAs) but does not cover money-market mutual funds or securities held by bank.
- A depositor cannot increase insurance coverage by placing deposits at different branches of the same bank or by dividing deposits into several different accounts at the same insured bank.
- 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 after settlement through receivership.

3 Methods of Collateralization

1. Specific Securities – Direct Pledge or Pooled
2. Letter of Credit – Direct Pledge or Pooled
3. Surety Bond
   - Licensed by the State of Ohio and authorized to issue in the State of Ohio
     (https://secured.insurance.ohio.gov/company/authlist.asp)
   - Qualified to provide surety bonds to the Federal Government
     (http://www.fms.treas.gov/c570/c570.html)

Pooled Collateral – ORC 135.181(B)

- In lieu of the pledging requirements prescribed in sections 135.18 and 135.37 of the Revised Code, an institution designated as a public depository ***at its option*** may **pledge a single pool of eligible securities to secure the repayment of all public moneys deposited** in the institution and not otherwise secured pursuant to law, provided that at all times the total market value of the securities so pledged is **at least equal to 105% of the total amount of all public deposits to be secured** by the pooled securities that are not covered by any federal deposit insurance. Each institution shall carry in its accounting records at all times a general ledger or other appropriate account of the total amount of all public deposits to be secured by the pool, as determined at the opening of business each day, and the total market value of securities pledged to secure such deposits.

Pooled Collateral – ORC 135.181(B

- The state and each subdivision shall have an ***undivided security interest*** in the pool of securities pledged by a public depository in the proportion that the total amount of the state's and/or subdivision's public moneys secured by the pool bears to the total amount of public deposits so secured.

Collateral Safekeeping

Who Holds Collateral?

- An institution designated as a public depository shall **designate a qualified trustee and deposit** with the trustee for safekeeping the eligible securities pledged pursuant to division (B) of this section. The institution shall give written notice of the qualified trustee to any treasurer or treasurers depositing public moneys for which such securities are pledged. The treasurer shall accept the written receipt of the trustee describing the pool of securities so deposited by the depository, a copy of which also shall be delivered to the depository.

Collateral Safekeeping – Perfecting a Security Interest

Should I perfect my security interest in securities pledged as collateral?*

- Yes. "Perfecting a security interest" in securities pledged as collateral is important because it elevates a subdivision from a general, unsecured creditor to a ***secured party*** in the event of a failure of a public depository.
- A security interest must be perfected in pledged securities whether the collateral is pledged through a direct pledge or a pool.

(*)This should not be construed as legal advice. Please consult with legal counsel for any issue relating to the perfection of a security interest.

Collateral Safekeeping – Perfecting a Security Interest

How Do I Perfect My Security Interest in Securities Pledged as Collateral?*

- Best practice for perfecting a security interest is to execute: (1) a written depository agreement, (2) a written security agreement , and (3) a written trustee agreement.
- The security agreement must state that the subdivision has a security interest in the pool of securities pledged by the public depository.
- It is your job to ensure that the these agreements are approved by, and recorded in the minutes of, the meeting of the board of directors or loan committee of the public depository.

(*)This information should not be construed as legal advice. Please consult with legal counsel for any issued relating to the perfection of a security interest.

Collateral Safekeeping – Perfecting a Security Interest

*How Else Do I Perfect My Security Interest in Securities Pledged as Collateral?**

- A security interest in securities pledged as collateral is not perfected unless the subdivision has "control" over the securities pledged.
- "Control" is easier to demonstrate for securities pledged as a single pledge than it is for securities pledged to a pool.
- The Ohio Attorney General (Opinion No. 2009-036) has stated that it cannot give a definitive guidance on whether the FDIC and/or a court of law would recognize a perfected security interest in a pool of securities pledged as collateral.

(*)This should not be construed as legal advice. Please consult with legal counsel for any Issue relating to the perfection of a security interest.

Types of Eligible Collateral – ORC 135.18 (B)

The following securities shall be eligible for the purposes of this section:

- (1) **Bonds, notes, or other obligations of the United States**
- (2) **Bonds, notes, debentures, LETTERS OF CREDIT, or other obligations or securities issued by any federal government agency or instrumentality**, or the export-import bank of Washington;
- (3) **Obligations of or fully insured or fully guaranteed by the United States or any federal government agency or instrumentality**;
- (4) Obligations **partially insured or partially guaranteed by any federal agency or instrumentality**;
- (5) **Obligations of or fully guaranteed by the federal national mortgage association, federal home loan mortgage corporation, federal farm credit bank, or** student **loan marketing association**;
- (6) **Bonds and other obligations of this state**;
- (7) **Bonds and other obligations of any county, township, school district, municipal corporation, or other legally constituted taxing subdivision of this state**;
- (8) **Bonds of other states of the United States which have not during the ten years** immediately preceding the time of such deposit **defaulted in payments** of either interest or principal on any of their bonds;
- (9) Shares of **no-load money market mutual funds consisting exclusively of obligations described in division (B)(1) or** (2) of this section and **repurchase agreements secured by such obligations**;
- (10) A **surety bond issued by a corporate surety licensed by the state and authorized to issue surety bonds in this state** pursuant to Chapter 3929. of the Revised Code, and qualified to provide surety bonds to the federal government pursuant to 96 Stat. 1047 (1982), 31 U.S.C.A. 9304;
- (11) Bonds or other obligations of any county, municipal corporation, or other legally constituted taxing subdivision of another state of the United States, or of any instrumentality of such county, municipal corporation, or other taxing subdivision, for which the full faith and credit of the issuer is pledged and, at the time of purchase of the bonds or other obligations, rated in one of the two highest categories by at least one nationally recognized standard rating service.

Collateralization Issues

- Price depreciation of certain asset classes.
- Callable securities have been called (redeemed) but still appear on schedule of pledges securities. Result is you are ***non-collateralized***.
- Formerly AA-rated muni's have been downgraded to "A" or "AA" status.
- Financial Institutions value pooled collateral deposits and pledged securities at the opening of each day – FDIC closes banks at the end of the day leaving potential shortfall.

Collateral Reporting

- Content of Collateral Reports
  - **Sample Collateral Reports from Banks**
    - Include total deposits, securities listing, market value
  - **Sample 3rd Party Trustee Reports**
- Frequency of Reporting to Public Depository
  - Minimum required quarterly, should be monthly
  - Whenever you want to make a special request
- Frequency of Calculations & Pledging
  - Continuous pledging
  - Market value $\geq$ (Public Fund Deposits + Accrued Interest) * 105%
  - Daily mark to market of the assets
  - 24 business hours to cover collateral shortfalls

Image courtesy of sheelamohan/FreeDigitalPhotos.net

Required Depository Agreements

Frequency of Agreements

- State: 2 years
- County: 4 years
- All Other Subdivisions: 5 years

Sample Depository Agreements

- There is no "true" standard.
- Original was prescribed by *The Bureau of Inspection & Supervision of Public Offices*: Prescribed Form No. 350 (7-69) and Prescribed Form No. 353 (Rev 7/93)

How many eligible depositories are allowed?
As many as you want – keep your options open.

Who Is Responsible for What?

- What state oversight/support is provided?
  - It is the requirement of the treasurer to ensure collateral sufficiency and proper monitoring at all times.
  - Questions can be directed to the State Auditor or Treasurer.
- What are the public funds manager's oversight requirements?
  - It is the requirement of the treasurer and the depository to ensure collateral sufficiency at all times.
  - It is the requirement of the treasurer to ensure proper prudent risk control monitoring program is in place.

How Do I Collect Collateral?

- If a bank failure occurs, how do I collect collateral if I have…

Collection of
Pooled Assets

Collection of
Specific Securities

Collection of
Letter of Credit

Summary

- You cannot put your collateralization process on "auto pilot", you must monitor it.
- Proper collateralization, along with diversification of your portfolio, is your best protection in a worse case scenario.
- Allow for multiple depository agreements.
- Continue to "play it safe".
- Ask yourself – are you prepared for the worse case scenario?

References & Samples

- Please see the last page of your hand-out for resources on:
  - Eligible Depository Institutions
  - FDIC – Is my Bank insured?
  - FDIC Bank Info Site
  - Federal Reserve Bank (of Boston, Cleveland) Details
  - FHLB Ratings
  - GFOA Best Practices
  - Ohio Revised Code Online
- …as well as for where to obtain sample agreements

Conclusion

Questions?

Thank You

Resources

CASH 237: Helpful Resources for Managing Collateral for Public Deposits

Eligible Depository Institutions

http://www.tos.ohio.gov/depositorybanks

FDIC – Is My Bank Insured?

https://www2.fdic.gov/drrip/afi/index.asp

FDIC Bank Information Site

http://www.fdic.gov/bank/statistical

Federal Reserve Bank (Boston/Cleveland) Details

http://www.federalreserve.gov/bankinforeg/default.htm

FHLB Ratings

http://www.fhlbanks.com/contacts_mpi_cincinnati.htm

GFOA Best Practices for Collateral Management

http://www.gfoa.org/index.php?option=com_content&task=view&id=1634

http://www.gfoa.org/index.php?option=com_content&task=view&id=331

Ohio Revised Code Website Link

http://codes.ohio.gov/orc/1