Collateralization and Political Subdivisions
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Historically, political subdivisions have been a good source of funding for financial institutions. Comprised of municipalities and schools, libraries, water and park districts, they are typically large depositors from within the community. Political subdivisions are funded through county sales and property taxes, user fees and state and federal sources. Political subdivisions receive funding throughout the year and then invest it to meet obligations. Funding is repeated on an annual basis, making political subdivisions reliable and consistent sources of deposits.

There are two main challenges with political subdivision deposits. Their balances are cyclical in nature and usually require some form of collateralization.

Exhibit A: Sample School District Cash
Total Funds Balance (excluding Capital Projects)

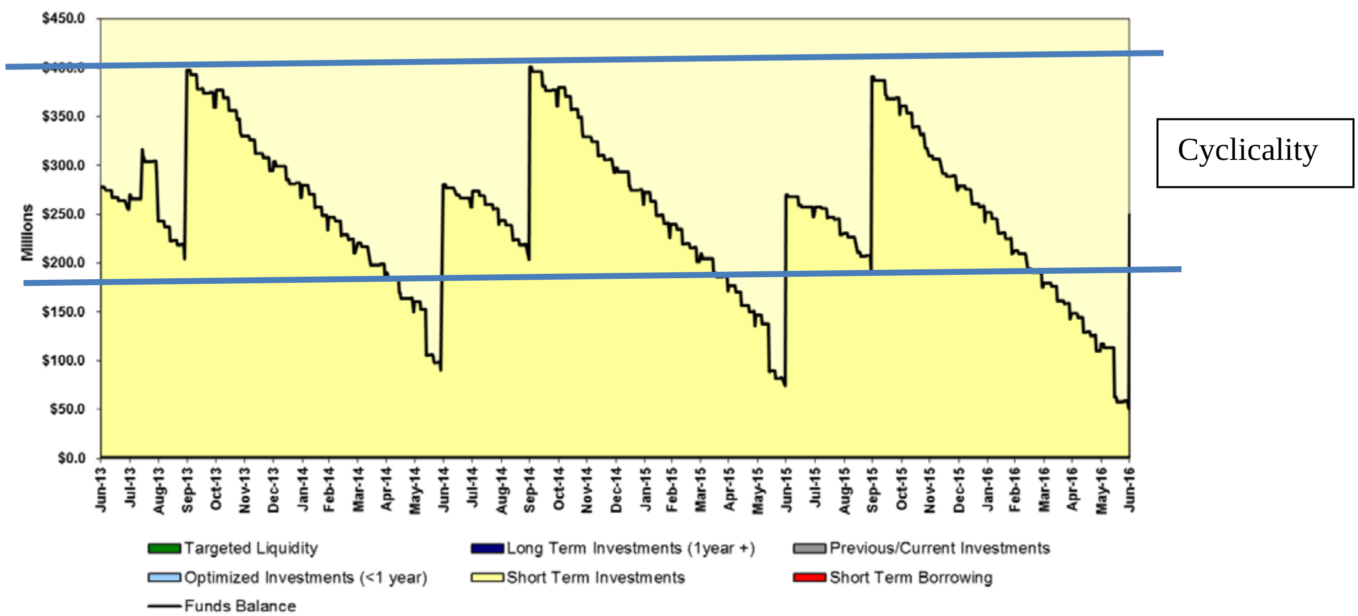
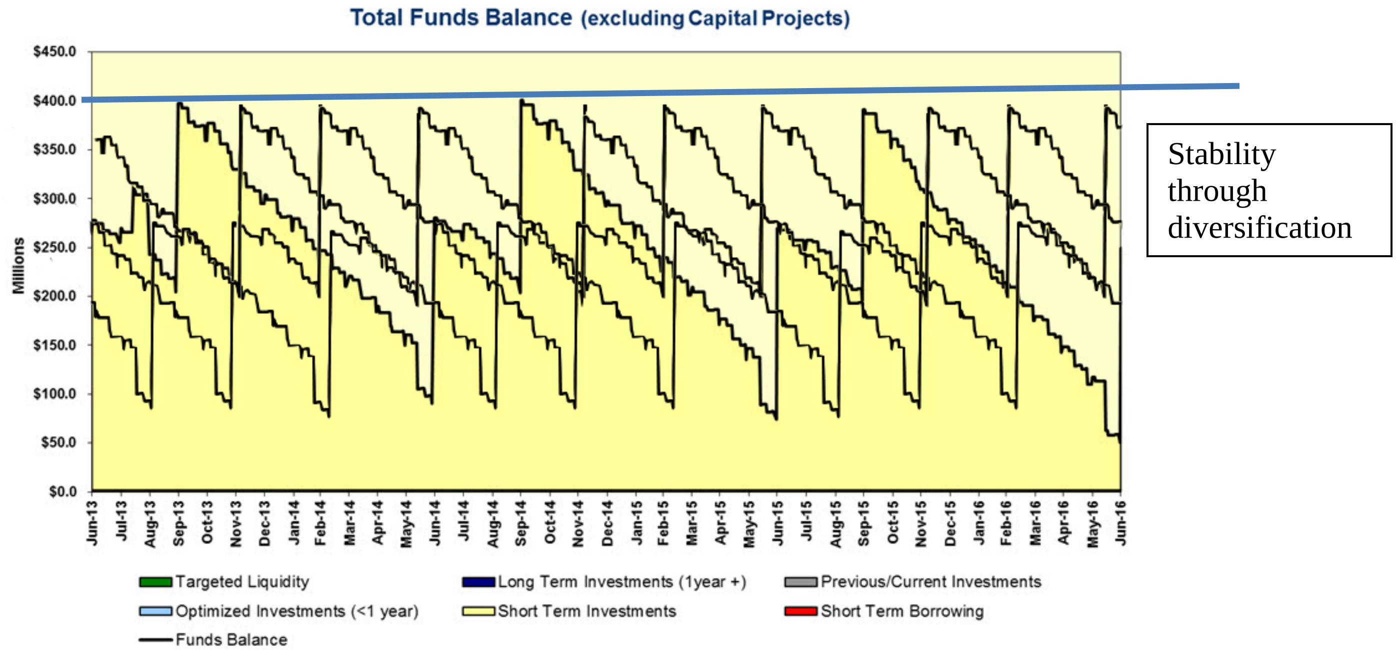


Exhibit B: Sample Multiple School District Cash Flow



Cyclicality can be mitigated by pursuing funding diversification among political subdivision depositor entities (see exhibit B). Funding with a broader base of political subdivisions on different revenue cycles (in and outside of footprint) reduces the potential for volatility. The other challenge is collateralization. Under new regulatory pressure, financial institutions are moving away from encumbering securities as a form of collateralization. However, this does not have to prohibit financial institutions from participating in public funds. By broadening collateral offerings, a financial institution is able to free up more liquid securities for regulatory purposes. There are a variety of collateral options in addition to pledging highly liquid securities and collateral techniques that can simplify the process and reduce cost.

PLEDGING OF SECURITIES

Traditional securities collateralization through a third party custodian is still very prevalent, but we are seeing financial institutions and political subdivisions expand the types of securities being pledged. There is a shift away from US Treasury and Agency Securities towards municipal bonds or other forms of collateral. Each state and individual political subdivision may have restrictions on the type of bond that may be used as collateral, but these restrictions are manageable. Pledging securities requires monthly reporting, monitoring of value, and release of securities collateral.

FEDERAL HOME LOAN BANK LETTER OF CREDIT

A Federal Home Loan Bank (FHLB) Public Unit Deposit Letter of Credit (PUD LOC) is an attractive alternative to the traditional method of pledging highly liquid securities(1). The FHLB allows for the pledging of a variety of loans and in return issues a direct pay PUD LOC for the benefit of the public depositor. The Government Finance Officers Association Best Practices lists Letters of Credit (LOCs) from a government sponsored entity as an important safeguard on public unit deposits. The FHLB PUD LOC is easy to issue (typically within 24 hours) and is operationally efficient. The FHLB PUD LOC does not require monthly reporting, monitoring of value, or release of securities collateral. In addition, some FHLBs offer a PUD LOC that can be established using a fluctuating balance feature so that fees are paid based on actual deposit levels only. In addition, evergreen language can be incorporated so that a single PUD LOC can be issued to capture all activity of an individual depositor, including both fixed term and liquid balance. Many FHLBs are willing to work with depositors to customize the language to fit their needs.

PRIVATE DEPOSIT INSURANCE

Private deposit insurance was a solid alternative to other collateralization options prior to the Great Recession of 2008. There were a variety of insurers that provided deposit insurance to both rated and non-rated institutions at price levels competitive to other collateral options. Since the crisis, private deposit insurance has all but evaporated. Periodically the concept will resurface but among termination clauses, pricing, limited coverage, and/or rating requirements it has remained, for the most part, a nonviable option.

CDARS® RECIPROCAL PROGRAM

Promontory Interfinancial states, "Promontory Interfinancial Network offers two services that allow a financial institution to attract political subdivision deposits without having to pledge collateral. Both the CDARS® ReciprocalSM and ICS® service help your bank to attract large-dollar relationships and reduce collateralization burdens by offering customers access to multi-million-dollar FDIC insurance on funds placed in demand deposit accounts and/or money market deposit accounts through ICS, and in CDs through CDARS. With each service, deposits are exchanged with other Network members on a dollar-for-dollar basis, bringing the full amount of the original deposit back to the originating bank for use in lending or other activities. By providing access to FDIC insurance, CDARS and ICS can help a political subdivision comply with investment policy mandates. And, by offering access to FDIC insurance, banks can improve margins and asset liquidity by reducing collateral-tracking costs and by reallocating repo sweeps and letters of credit into higher-earning assets"(2).

As a financial institution, it is critical to have a variety of collateral options available to utilize in securing and maintaining political subdivision deposits. The key is to implement and periodically test each form of collateralization to ensure availability and gain operational efficiency. In addition, take the time to educate political subdivision depositors about the various forms of collateralization, so they are comfortable with the process while remaining compliant with their investment policies. The more flexibility a financial institution has in utilizing various forms of collateral, the more competitive a financial institution can be in working with political subdivisions.

(1) FHLB CHICAGO: http://www.fhlbc.com/Pages/default.aspx
(2) PROMONTORY INTERFINANCIAL NETWORK: http://www.promnetwork.com/

About D. James Lutter

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