



Understanding Political Subdivision Depositors in a Changing Regulatory Environment

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Over the years, financial institutions have played a significant role in the investment process of political subdivisions. Political subdivisions look to their local financial institutions for the investment of revenue dollars, purchasing of bonds, banking services and general support. At times, political subdivisions utilize financial advisors in conjunction with their local financial institutions due to the complexity of their budgets and limited tools and resources.

As a result of low interest rates, regulatory changes, and continued economic uncertainty, it is challenging for political subdivisions to find financial institutions to participate in the investment process. The common theme among financial institutions is that they are flush with low cost non collateralized deposits which are crowding out political subdivisions as potential depositors. State statutes and political subdivision investment policies usually require some form of collateralization and/or contingent liability associated with deposits in excess of the FDIC insurance limits. When securities are utilized for collateral to support political subdivision deposits, they are considered encumbered and are no longer available as a liquid investment. Under new regulatory requirements, these types of deposits may be viewed as less preferred.

Collateral has become a deterrent in the deposit process. The more limitations political subdivisions place on types of collateral, the greater the difficulty in finding institutions to participate and, at times, the lower the yield offered on the investment. The result is political subdivisions are challenged in generating return on investments and are even being turned away as potential depositors.

The struggle amplifies when a political subdivision utilizes a financial advisor in the investment process because of the impact a third party has on how the deposit is categorized. Types of deposits include core deposits (placed without a third party) and various types of wholesale deposits such as brokered deposits (placed with a third party). A financial advisor's primary purpose may not be a deposit placement; its purpose may primarily be providing cash flow analysis and financial planning to the political subdivision. However, simply utilizing a financial advisor may cause the deposit to be classified similar to other types of brokered deposits. Given regulatory focus on higher percentages of brokered deposits at financial institutions, categorizing deposits placed through a financial advisor with all other forms of brokered deposits works to the detriment of the political subdivisions already under stress to find secure investments generating any type of return.

The concern with wholesale funding/brokered deposits, which was observed during the recent crisis, has been their ability to fuel rapid loan growth and in times of stress create liquidity risk.

In a recent letter from the Federal Home Loan Bank of San Francisco, Phillip Strahan discusses liquidity risk. “In the traditional framework, liquidity risk stemmed from the possibility of bank runs. These are episodes in which depositors lose faith in their bank and withdraw their money, either because of concerns about the bank’s financial condition or because they worry that others might stage runs. Such runs could make banks insolvent by initiating a chain reaction that forced a fire sale of illiquid loans. In the past, such instability was partly checked by reserve requirements tied to deposits, deposit insurance, and the availability of liquidity from central banks, the lenders of last resort.

More recently, liquidity risk has come less from deposit outflows and more from exposure to a range of lending and interbank financial arrangements. These include undrawn loan commitments, obligations to repurchase securitized assets, margin calls in the derivatives markets, and withdrawal of funds from wholesale short-term financing arrangements.”¹

Regulation enacted through Dodd-Frank and Basel III was designed to prevent future liquidity crises and strengthen capital requirements. Two major components of the regulation attempting to reduce risk of inadequate liquidity are standards for the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR). The LCR is the amount of high quality liquid assets banks must maintain to cover cash demands over a 30-day period under conditions of market stress.²

Typically, political subdivisions require high quality assets as forms of collateral. Those securities utilized as collateral for political subdivision depositors would no longer be considered a liquid asset and thus not be utilized in the LCR calculation. In addition, municipal securities, which have traditionally been an acceptable form of collateral for political subdivisions are not considered liquid assets under Dodd-Frank.

The NSFR sets liquidity standards for a longer term than LCR and focuses on a bank’s ability to finance illiquid assets, such as loans, with stable sources of debt finance, like traditional deposits. Depending on duration and placement method, a political subdivision deposit could be classified in one of the following categories: stable, less stable, or wholesale, all of which are weighed differently (0-100%) for purposes of calculating Available Stable Funding Factors in the NSFR calculation.

In addition, Congress mandated in Section 1506 of Dodd-Frank that the FDIC conduct a study on core and brokered deposits. The goal of the study was to address concerns arising in connection with the definitions of core deposits and brokered deposits, including insurance premium pricing, differences and impact on economy, effects by redefining definitions and competitive parity between large banks and community banks that could result with modified definition.³

The study’s take away was that brokered deposits should not be viewed in a negative light when utilized prudently by well capitalized financial institutions.

Political subdivisions face challenges investing as a result of the low rate environment and increased regulation on financial institutions. They often utilize financial advisors to aid in the development and implementation of an investment plan. Financial institutions are a critical component of the investment plan and provide key services to the political subdivisions. The

relationship between a financial institution and political subdivision needs to be well defined (whether through a financial advisor or direct) in order to be successful in developing and maintaining an investment relationship. There are several ways in which a financial institution can productively maintain a deposit relationship with political subdivisions under the new regulatory environment.

Once a political subdivision has established its cash flow plan, the financial institution should be brought into conversations early on to align investment opportunities with the financial institution's liability plan. Financial institutions should also diversify the deposit base among several political subdivisions to minimize concentration and create stability. Under a diversified plan, balances of individual political subdivisions may vary within a range, but an aggregate balance can be maintained and identified as a stable funding source. Financial institutions should explain the need for a broader relationship from a capacity (funding and collateral) standpoint. The stronger the overall relationship, the more stable the relationship appears to regulators and the more inclined the financial institution is to extend funding and collateral.

Also, political subdivisions may increase investment opportunities by creating investment policies to match state statute without additional restrictions regarding collateral. The political subdivision can make investment decisions that are more restrictive than its investment policy, but if opportunities arise to invest requiring flexibility, less restrictions allow it to quickly respond without having to amend its investment policy. With proper understanding, political subdivisions can be a valuable source of stable funding both on a primary and contingency basis.

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¹ FRBSF Economic Letter: 2012-15 May 14, 2012, Liquidity Risk and Credit in the Financial Crisis by Philip E. Strahan.

² Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools: January 2013, Basel Committee on Banking Supervision

³ Study on Core Deposits and Brokered Deposits, July 8, 2011, Federal Deposit Insurance Corporation