Collateral Pooling
A New Alternative for Texas Public Funds
Statute Effective September 1, 2009

This past legislative session, the Texas Legislature approved a new alternative – *and challenge* – regarding collateral pledged to public funds' time and demand deposits in Texas financial institutions.

SB 638 amended Chapter 2257 of the Government Code known as the Public Funds Collateral Act (PFCA) to create an alternative to existing collateral requirements. The program will allow any financial institution to create a "pool of pledged securities" for all the public entities willing to participate in the program. The basic structure means that:

> each financial institution would individually create one statewide pool held by an independent custodian into which it would place pledged securities to collateralize all of their public entity deposits. Each bank would have one pool to hold collateral for all their clients.

Participation in the bank's pool by the public entity is totally voluntary. No public entity would have specific collateral securities pledged to them. The bank's pool of securities would be maintained at 102% of the total assets of all the public entities participating in this bank's pool. This alternative will apply to all types of public entities *except* counties.

Some key points to the program involve (a) what entity establishes the program and what entity monitors the program to assure that adequate collateral is maintained, (b) what contracts and guarantees would be in place with individual public entities, (c) what are public entities rights under the "pool", and (d) what controls will be in place.

Who Establishes this Program?

The details of the pool program are to be initially established, and the operation monitored by, the state Comptroller.

- The Comptroller will establish the program by rule [2257.102(a)].
- The Comptroller will approve or provide the controlling *collateral security agreement* to be used by each public entity. [2257.103(3)]
- The Comptroller must approve the specific bank's participation in the program. [2257.103(2)]
- The Comptroller will monitor the program for all public entities. [2257.102(a)]
- The Comptroller will receive and evaluate reporting on the collateral pools from the banks and take action if reporting and margins are not provided. [2257.103(b)]
- The Comptroller will assess fees for violations from the financial institutions to pay for administration of the program. [2257.106]

Each individual bank (bank holding company) will establish its own "pool" with the Comptroller's approval. The pool of securities will be held by an independent *custodian* (custodial trustee). Within the pool, each public entity collateralized by the pool will have equal rights and equal rights to the collateral.

- The pool will collateralize deposits to 102%. This eliminates the previous 100% and 110% for school districts with mortgage backed securities found in 2257.022 which still apply to those not using the voluntary pooling program. (The law does not distinguish ledger from collected balances.)
- The custodian must fulfill the current requirements for a custodian which means that the custodian can be:
    - A state or national bank

        - Designated by the state Comptroller
        - With main office or branches in Texas
        - With capital or surplus stock exceeding $5million.
    - Texas Treasury Safekeeping Trust Company (TX State Comptroller)
    - A Federal Reserve Bank
    - A Federal Home Loan Bank
    - An institution designated as a custodian by the Comptroller in 404.031(e)
    - A banker's bank[1] as limited by the Finance Code

What contracts would be in place with individual public entities? What are our rights?
The bank and the public entity will execute a *collateral security agreement* (i.e. depository collateral agreement supplementing your banking services agreement). The agreement form is to be approved by the Comptroller. We could assume that each bank will have a standard form approved beforehand by the Comptroller. This is the only documentation between the public entity and the bank.

The rights of the public entities are limited by what is included in the agreements. One could expect that the rights under the PFCA generally would be included especially regarding events of default as opposed to bankruptcies.

Who Monitors the Collateral?
The simple answer is the financial institution and the Comptroller. Financial institutions offering a collateral pool to public entities will report only to the Comptroller and not to the public entity being collateralized. No public entity will have further dialogue on pledged securities or substitutions with the financial institution on collateral beyond the original *collateral security agreement*.

To monitor the collateral the Comptroller is to receive and certify receipt of:
- daily reports of ledger balances by public entity
- a weekly report of collateral market value
- a monthly report listing the securities and their "value"[2] in the pool
- the financial institution's annual financial statement

The Comptroller will post the reports received on the state website daily.

Penalties for not providing the required reports *may*[3] be imposed by the Comptroller. Collateral compliance or Comptroller rule violations *may* also draw penalties from the Comptroller. The financial institution would first be given three business days, after being notified, to cure the problem. The penalty fee will be determined by the Comptroller and must be between $100 and $1,000 per day based on specific criteria such as the number of prior violations and amount of deposits. The Comptroller, through the OAG, *may* ultimately sue the institution to collect.

A Practical Side of the Change
Obviously this "pooling" concept is extremely cost efficient for the financial institutions. Banks will not need to negotiate, coordinate nor communicate with individual public entities as they now do on original pledges, substitutions, annual reports to auditors, etc. (There will be reporting to auditors on the pool as a whole.) The public entity will not be able to restrict collateral to particular types of collateral dependent upon its own risk continuum.

[1] Section 34.105 Finance Code is unclear here but appears to limit the financial institution's ownership of the banker's bank to 5%.
[2] The law does not specify book or market value. It is assumed that market value would be required.
[3] The statute leaves these penalty and legal action conditions to the Comptroller/

The financial institutions must be the source of information that recognizes public deposits accurately and reports *all* deposits accurately to the Comptroller.

The 102% margin will assure that if accounts are correctly categorized the margin will provide an additional level of security against market price volatility from the original PFCA requirement of only 100%. Collateral is reported weekly to the Comptroller. The statute does not require that the financial institution actually mark-to-market (i.e., price securities) on a daily basis. It requires only that the public funds deposits be reported daily.

Since there is no definitive source of information outside the financial institutions that is available to positively ascertain the total amount of public funds, the banks must ensure that all public funds are accurately categorized. It is incumbent on the public entity to assure that all its accounts are correctly identified. The daily posting of the specific entity's daily balance could be checked by the public entity and reconciled against their own records to assure that all funds are captured correctly. Of course, this will be an "after the fact" verification.

If all public funds are not categorized and collateralized correctly, a failure of the bank could result in a loss for each public entity in the pool, not just any one specific public entity. Adequate collateralization It is dependent upon correct designation/identification by the bank and reporting. For example, if a bank holding company reports total deposits of $500 million for ten public entities in the pool it would collateralize with $507,450,000 recognizing the FDIC insurance for each entity.

($500mm) – (FDIC coverage of 10X$250,000) @102%

Therefore, if the categorization of the deposits were actually 2% higher (in this case $510 million) than recognized, then every participant in the pool would share the "loss" on a default (in this case $50,000/10 or $5,000). Pooling spreads the risk. On the other hand, the fluctuations in balances, especially during tax collection periods, add to this risk. It will be necessary during these periods for the financial institutions to substantially increase margins above 102% and continuously monitor the 2% rule.

The second body that the public entities must rely on is the Comptroller. The Comptroller must identify the correct amount of public funds and assure that adequate margins are maintained. The difficulty is that the Comptroller has no source of information for verifying this data other than the banks themselves.

Although the focus for collateral is on bank defaults, collateral agreements also address a separate situation in which collateral would play a major role. An "event of default" occurs when the bank does not fulfill serious contractual obligations such as withholding collected funds or not honoring checks. Normally, in this case, there are a number of formal notification steps requiring correction of the event. If the event is not cured then the public entity has access to the collateral which can be sold in the market. The statute does not address this situation in a pooled environment. It is assumed that the wronged public entity would claim against the pool. The public entity's agreement must address such a situation for equitable treatment for all pooled public entities when only one has an event of default.

In situations of a "event of default" or a bankruptcy there is normally a contractual condition which allows the public entity to receive not only 100% of the funds on deposit (plus accrued), but also a provision for collection of additional expenses incurred in collection of the collateral. This could be problematic in a pool and the agreement should also address such situations although pool amounts may not be sufficient to meet every participants' expenses worst case. Timing of the return of funds to the pool participants is another unanswered question which

should be addressed so that additional losses are not incurred through the process which could include short term loans to cover expenses.

So should I use the bank pooled collateral?

Your decision as to whether to use pooled collateral or not must be based on several elements. Foremost would be consideration of the various points detailed above which should be analyzed and included in any collateral security agreement to assure adequate protection for the public entity. After that, the decision translates directly to your risk tolerance level.

If the public entity uses its bank for all funds deposits and investments i.e., keeps all its funds in this bank, there is risk of access to or loss of funds. Funds will be collateralized at 102% and no further action will be required which makes life easy. It is safe if no defaults occur. Paperwork regarding collateral is eliminated - but there are risk exposures. The public entity may incur principal losses if the pool is not fully funded and a default occurs - even if all the entity's accounts are duly identified. A public entity has two options in this case: recognize and accept this risk or move some funds out of the bank and into other alternatives such as CDs, pools or other securities to reduce exposure. (Your target balance is going to always be covered under the bank's pool in this case.)

If your bank is offering measurably better rates, then the decision is going to weigh on if the additional earnings will make up for potential loss. If for example, your bank is currently offering 2% for all deposits and the other reasonable option for you is a pool at 0.50%:

$2,000,000 annual earnings at 2% = $40,000 or 300% more than in pools
$2,000,000 annual earnings at 0.50% = $10,000

In this case the risk might be worthwhile dependent on your risk tolerance. If the bank offered only equal or slightly higher rates, the risk becomes more apparent and real.

For all entities, a secondary point to consider for any funds maintained in a bank starting October 2009 will be the increased FDIC fees charged against your deposits. FDIC fees are increasing significantly in October 2009 and reflect an additional cost to balances. Even if you have "*free banking"* or "*pay no fees"* you do pay. A bank has to make money. You pay costs through reduced interest rates. With increased FDIC fees imposed on the banks higher balances will cost you more in lost interest income.[4]

If a public entity maintains only limited balances in the bank and uses pools/funds or specific securities for alternate investment then the risk is reduced. Diversification is paramount in all financial aspects. By reducing the amount held at the bank you add diversification to your portfolio and also add safety. The higher the balances you maintain the more bank collateral risk you assume. One way to retain bank balances, but minimize risk, would be to utilize the bank's sweep into a outside money market fund. This takes the need for collateral away because you are invested in an actual security (the fund). Sweeping to the bank's specially designated account does not carry the same protection. If such a sweep is not available, the public entity would have to reduce balances at the bank. Again the earnings and risk tolerance levels will control your decision.

The choice will have to be made. Review your average collected balances to see what level of risk is being assumed. Also, review your Investment Policy to make any necessary changes to accommodate pooling. Retaining the option to move into or out of pooling will give the public entity maximum control.

[4] Current FDIC fees for most public entities range from 10-12 bps. (0.0010-0.0012)