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Legislative Changes to PFIA and PFCA

There were three bills which directly changed the Public Funds Investment Act and the Public Funds Collateral Act from the last session. The bills did not make large sweeping changes but every public entity should be aware of them to act accordingly - and to be wary of certain "deals" which are offered to them.

The first change from SB 19 has little effect on the entities. In the PFIA, Section 2256.022 was modified as regards the audit of the state auditor in reviewing proposed changes to the Act. The change requires that the review by the state auditor is subject to the legislative committee's approval of the review in the audit plan.

The second change to the PFIA comes from SB 1318. "Securities lending" was added as an authorized investment (new Section 2256.0115). Under the Act, entities already had the ability to do security lending but in a safer form as a reverse repurchase agreement. In a repo the entity actually "OWNS" the collateral because it is a buy-sell transaction. The repo is almost always done with the primary dealers (in the Act it could be primaries or banks). The banks are not fond of reverse repo because they can rarely compete on price/profit to the entity. The banks would rather take the securities on "loan", give the entity collateral which is "PLEDGED" to them and pay the entity a set percentage of the profits. Interesting and dangerous in this new section is that it was added that not only can securities be pledged to the entity but a "pledged irrevocable letter of credit issued by a bank". A pledged irrevocable letter of credit can be backed by any type of security including those not authorized by the PFIA or PFCA. Also, in this bill the collateral must ONLY equal 100% not the 102% which is industry standard under a reverse repo agreement. This bill is clearly to benefit the banks wanting to do lending. In 2001, the PFIA was very changed by the banks belonging to the FHLB who wanted to pledge a letter of credit which was backed by securities NOT approved under the Act to entities. Entities should be very wary of the terms and conditions as well as the ultimate results of this program!

The third change was made with HB3459 to the PFCA itself. It is directed to school districts only. It modifies Section 2257.022 to impose a higher collateral limit on mortgage backed securities (i.e. securities with a declining principal balance). If securities with a declining principal balance are pledged to a school district then they must be in an amount not less than 110% and the banks have to report the value to the school at least once a month. There is no question that - especially in times of rising interest rates - mortgage backed securities may extend in maturity and decline in value quite quickly and should be monitored closely. However, the rate of a 110% margin will add considerably to the cost

of providing that collateral by the banks and therefore add to your cost of banking. It is important instead to remember three basic controls to assure your collateral is viable and will be there to serve you.

1. Have the collateral (depository) agreement and your bank bids require at least 102% collateral at all times.
2. Write into your banking agreements that the bank (not you) will monitor and maintain the collateral and the collateral margin of 102% at all times.
3. Approve only marketable securities as eligible collateral.

The redlined versions of the Public Funds Investment Act and the Public Funds Collateral Act with changes from the 2003 Legislative session are available on our website at www.patterson.net.

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