Objectives:

• Review Collateralization Rules and Regulations
• Outline Collateral Documentation
• Consider Collateral Management Issues
• Highlight Security Settlement Procedures
How About Those Collateral Rules?

- Public Funds Investment Act – Ch. 2256 (PFIA)
- Public Funds Collateral Act – Ch. 2257 (PFCA)
- Financial Institution Reform Recovery and Enforcement Act (FIRREA)
The Investment Stuff - PFIA 2256.009

Authorized Investments:

- (a) (4) …obligations fully guaranteed or insured by the FDIC….
- (a) (7) …fully guaranteed or insured by the FDIC and NCUSIF….
- (a) (8) …fully guaranteed or insured by the FDIC and NCUSIF through a …
  - (A) (i) Broker – main or branch office
  - (A) (ii) Depository – main or branch office
  - (B) Spreads to insured depositories
  - (C) Fully insured
  - (D) Appoints Custodian
PFIA 2256.010 Authorized Investments:

- (a) Certificates of Deposit
  - (1) Insured
  - (2) Collateralized
  - (3) Follows PFCA
- (b) (1) Additional Certificates of Deposit
  - (A) Broker – main or branch office
  - (B) Depository – main or branch office
- (b) (2) Spreads to insured depositories
- (b) (3) Fully insured
- (b) (4) Appoints Custodian
The Collateral Stuff - PFCA 2257

- 2257.0025 High-Risk Mortgage Security
- 2257.021 Collateral Required
- 2257.022 Amount of Collateral
  - (a) (1) …not less than P&I less FDIC….
  - (b) Education Code 45.201 (4) (D) – 110%
  - (d) Market Value
PFCA 2257

- 2257.023 Collateral Policy
  - Institution “Security”
  - Substitution or Release
  - Collateral Market Value
- 2257.024 Contract for Securing
  - Possession
  - Substitution or Release
  - Ownership
  - Collateral Market Value
PFCA 2257

- 2257.041 Custodian
  - (1) State or National Bank
    - (B) Main or Branch Office
  - (2) Texas Treasury Safekeeping Trust Company
  - (3) Federal Reserve Bank
  - (4) FHLB
  - (5) Comptroller Designated
- Record Keeping, Perfected Security Interest, Inspection
- Subchapter F - Pooled Collateral
Financial Institution Reform Recovery and Enforcement Act (FIRREA)

“Agreements Against Interests of Corporation”

a) Written Agreement
b) Contemporaneous with Acquisition
c) Approved by Bank Board or Committee
d) Continuous Part of Record

Codified to 12 U.S.C. 1823(e)
www.fdic.gov/regulations/laws/rules/1000-1500.html
Third Party Custodian – A Must!

- Public Entity
- Custodial Bank
- Depository Bank

- Monthly Statement
- Custodial Agreement
- Depository Agreement

- Transfer Securities
Custodial Issues

- Two Party or Three Party Agreement
  - Federal Reserve/FHLB
  - Frost/TIB/BNYM
- Collateral Substitution
  - Written Permission
  - Parameter-based
- Collateral Release
  - Written Permission
  - Depository Bank Discretion
Collateral Issues

- FDIC – Principal & Interest
  - Non-Interest Bearing
  - Interest-Bearing
  - Each Bondholder
- Market (Fair) Value
  - 100%
  - 102%
  - 110%
- Who Determines Value?
  - Depository Bank
  - Custodian
  - Independent Assessment
How About Those “Other Units?”

- FDIC – Principal & Interest
- Collateral-Eligible Public Unit?
- Who Controls?
- Who Handles Cash?
  - Consolidated/Commingled Account
  - Bifurcated Collateral
  - Managed Balances with LGIP
Collateral Market Valuation

Price Volatility

Price Change

Time to Maturity
10 Year Treasury Note Value Reduction

Coupon Rate: 3.00%  Maturity Date: 5/2028
Par Amount:  $10,000,000

Yield Change: 4.00%
Fair Value: +/-$9,180,000 (8.2%)

Yield Change: 5.00%
Fair Value: $8,440,000 (15.6%)
# Valuation Cycle Matters!

## Next Day Collateral Valuation

<table>
<thead>
<tr>
<th>Day</th>
<th>Balance</th>
<th>Required Collateral @ 102%</th>
<th>Actual Collateral</th>
<th>Over/(Under)</th>
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<tr>
<td>One</td>
<td>$9,000,000</td>
<td>$9,180,000</td>
<td>$9,180,000</td>
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<tr>
<td>Two</td>
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<td>$10,200,000</td>
<td>$9,180,000</td>
<td>($1,020,000)</td>
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<td>$10,200,000</td>
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<td>Four</td>
<td>$11,000,000</td>
<td>$11,220,000</td>
<td>$8,160,000</td>
<td>($3,060,000)</td>
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<tr>
<td>Five</td>
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<td>$2,040,000</td>
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<tr>
<td>Average</td>
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<td>$0</td>
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</table>
Letters of Credit as Collateral

• Issued by an Agency or Instrumentality (FHLB)
• Monitor Amount vs. Deposit
• Maintain Extra Business Days on Expiration
• Read the LOC!!
Collateral – Required Documents

• Depository Agreement
• LOC or Custodial Agreement
• Collateral Receipt
• Bank Board or Committee Minutes
• Check Investment Policy Collateral Language
Management Strategies

- <$250k – FDIC Only
- Pledged Securities
  - Fixed/Managed Value
  - “Floating” Value
- LOC
  - Fixed
  - Layered
- Bank Sweep Investments
  - Repo/MMF
  - Watch “Settlement”
Safekeeping Services:
“Settling Trades and Parking Your Securities”
“Security”

CUSIP – Committee on Uniform Securities Identification Procedures

“Uniquely identify a company or issuer and the type of financial instrument”
Buying Securities – Need Broker/Dealer

• Initially and Annually Approved
• Primary or Secondary?
• Selected by:
  • Subjective Process?
  • Objective Process?
• How Many?
Settling Security Transactions

- Delivery Versus Payment @ Third Party - DVP
  - Safest Way
  - Required by PFIA
  - Check Independence
Delivery Versus Payment

Public Entity

Safekeeping Agreement

Safekeeping Bank

Commit to Transaction

Securities Transfer – Federal Reserve or Depository Trust Company

Broker/Dealer

Clearing Agreement

Clearing Bank

Funds Released On Acceptance
Security Clearance and Safekeeping Providers

- Primary Depository Bank
- “Third-Party” Providers
  - Several Texas Banks
  - Review Documentation
  - Funds Transfers – In & Out
  - Collateral? Sweeps?
- Fees
Brokered CDs and MMAs

- Appoint Provider “Custodian”
- “Sub-Custodian” Accounts
  - Who Communicates w/Custodian?
  - Where Does $$ Flow?
  - Who Sends Statements?
  - Who Controls?
- Can’t Buy T-Bill Same Way
- Pre-PFIA History
- SEC Enforcement Actions
Securities Investors Protection Corporation (SIPC)

- $500,000 Total Coverage
- Cash Limit = $250,000
- “…SIPC is not the securities world equivalent of the FDIC…..”
The “Risk” (Excerpts from Sec Filings)

• “…scheme to access the brokerage accounts of more than 100 unwitting victims….”

• “Account takeovers are an increasingly significant threat to retail investors….”

• “…among other things, issuing phony customer account statements and making other material misrepresentations about the value of the accounts.”
Objectives:

- Review Collateralization Rules and Regulations
- Outline Collateral Documentation
- Consider Collateral Management Issues
- Highlight Security Settlement Procedures
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