Government entities are confronted with significant financial challenges. Unemployment is high and revenues are depressed, while market rates remain at all-time lows and regulatory changes are impacting how banks value collateralized deposits. As a result, the public sector faces a perfect storm of tight budgets and limited liquidity returns.

With the aim of enhancing returns while ensuring that the security of public deposits remains paramount, government treasurers are considering new ways to maximize the value of deposits. This paper looks at many options, including identifying optimal account structures for operating funds, sourcing flexible investment options that make it possible to go further along the yield curve and reassessing deposit collateral requirements.
GOVERNMENT ENTITIES UNDER PRESSURE

U.S. government entities face unprecedented budget deficits. The financial crisis and the fragile economic recovery have decreased tax revenues while federal funding and support for nationally mandated programs has been cut. With high fixed costs, these revenue declines are difficult to accommodate.

High unemployment—the national rate in April 2012 was 8.1%—has increased social benefit costs. In addition, costs have risen due to the adoption of GASB 45, which requires states to recognize future funding for non-pension retiree benefit programs. States are also under pressure to close their pension funding gap.

HISTORICALLY LOW RETURNS

While government entities are facing an unprecedented squeeze on their budgets, the returns they can expect to receive on their deposits and investments are at historic lows.

The Federal Reserve Fund Target Rate is expected to remain at 0 to 0.25 percent until late 2014. In addition, the ongoing European debt crisis has caused a flight to quality that has driven yields on U.S. bank and government securities to all-time lows. This drop in rates has negatively impacted public deposit balance earnings and public investment returns. Consequently, government entities face fee deficits and have often had to redeploy cash or obtain approval for special line item budget increases to pay for service fees.

Additionally, regulatory changes designed to enhance the stability of the financial system were introduced in the wake of the financial crisis. Among these changes are increases in deposit insurance fees along with the need to replenish the FDIC Deposit Insurance Fund.

Furthermore, banks are required to hold higher liquidity levels, including high quality securities, which were routinely used as collateral for public deposits.

As a result, some banks have limited the availability of certain product options, lowered yields on other product options and, in some instances, have been unable to accommodate large collateralized deposits.
MAXIMIZING THE VALUE OF PUBLIC DEPOSITS

The combination of public sector budgetary challenges, low market rates and narrowing investment options due to bank-related regulatory change may seem like a perfect storm. However, there are a number of options available to maximize the value of public deposits, including:

- Optimizing operating fund account structures, including eliminating expensive paper processing in favor of electronic options
- Updating investment policies
- Considering a new collateral approach

OPTIMIZING OPERATING FUND ACCOUNT STRUCTURES

To maximize the value of operating funds, government entities need to continuously analyze their service charges in the context of the earnings credit received on their funds. They need to determine—taking state requirements into consideration—whether it is advantageous to pay directly for services or through compensating balances.

Currently, most banks pay higher rates on public analyzed demand checking accounts (via an earnings credit fee offset) than on comparable fully liquid, interest-bearing alternatives. By maintaining optimal checking account deposit levels, government entities will benefit from these higher rates. They can determine their optimal balance levels by weighing their monthly fees against their Earnings Credit (multiple of collected balances and the earnings credit rate “ECR”) on compensating balances. Some banks offer models to help their clients calculate required balances. For budgeting and monitoring purposes, this task should be conducted on a monthly basis. Otherwise, unanticipated deficits may further exacerbate current budget challenges.

Finally, public sector entities should always look for opportunities to improve efficiency and lower transaction costs by switching from paper to electronic processing.

UPDATING INVESTMENT POLICIES

Investment policies should be reviewed and revised to reflect changes in available investment opportunities and market conditions. For example, if large balances are being maintained throughout the year, investment policies could be revised to use excess cash to optimize yields by moving funds into higher-yielding alternatives.
One possible investment opportunity in a normal positively sloped yield curve environment (where short-term rates are lower than longer-term rates)—and assuming predictable cash flows—is a staggered-term investment strategy, which can enhance yield by using the curve.

By designing a portfolio to meet future cash-flow needs, a potential hedge against interest rate swings is achieved using “time-released liquidity.” If rates increase, money is maturing regularly to reinvest at higher rates. If rates fall, higher rates have been locked in by investing in longer maturities. Using a disciplined approach, reinvesting at the longer end of the ladder consistently captures higher yields.

Government entities should also consider the range of investments in their portfolio. Depending on state restrictions—and following consultation with their bank—it may be possible to access a wider range of opportunities (see box).

CONSIDER A NEW COLLATERAL APPROACH

Public deposits typically require protection (collateralization) in the form of FDIC insurance, surety bonds, investment securities or letters of credit. However, from a depository perspective, some forms of collateral may be more expensive to provide or difficult to source. In fact, deposits requiring more restrictive coverage may be limited by collateral availability at some banks and/or possibly subject to lower yields. While collateralization is usually essential, it may be possible to make changes that would be advantageous in terms of costs or returns. However, it is important to work with your bank to assess the potential return and pricing benefit, while also taking state requirements (and possible legislative amendments) into account. Ensuring public funds are protected is paramount.

Possible changes include:

• Reducing margin requirements: Excessive margin coverage requirements can limit yield opportunities and may result in excess collateral expense charges.

• Optimizing structures for “dedicated” collateral balances: Broadening the range of eligible securities can improve pricing.

• Switching to pooled collateral coverage: Banks may consider this more attractive and in turn offer enhanced deposit yields.

• Securing deposits with a Federal Home Loan Bank Letter of Credit (FHLB L/C). Again, this lower-cost option may result in enhanced deposit yields.
POOLED COLLATERAL

Pooled collateral, which is now used by more than 50 percent of states, has many benefits which could in turn result in enhanced deposit yields for government entities.

In pooling, securities are usually placed with a third-party custodian bank pledged to the pool administrator for the benefit of the public agency depositors. The state pool administrator has responsibility for ensuring that banks meet state requirements and usually allocates collateral management administration costs to member banks in the pool.

Collateral agreements between the pool administrator and the bank must be executed before collateral is pledged. The agreements ensure compliance with the Financial Institutions Reform Recovery Act (FIRREA). Some states require a document from public fund agencies indicating agreement with collateral pool participation.

The bank regularly determines the net collateral adjustments needed to cover the combined balances in the pool. Banks typically pledge some excess collateral to eliminate the need for frequent collateral changes. The state pool administrator is responsible for ensuring that banks meet state requirements and allocating administrative costs to pool member banks.

Pooled collateral is an efficient, cost-effective and safe method for collateralizing public funds. Visibility is enhanced because the state pool administrator monitors and manages all collateral for public deposits. Pooling eliminates the need to establish a custodial agreement to hold collateral. It also reduces administrative costs, and information from the pool administrator can aid audits. It may even result in favorable pricing from banks.

USING FHLB L/Cs AS COLLATERAL

For government entities with sizeable deposits (or for smaller public depositors in pooled collateral states), Federal Home Loan Bank (FHLB) letters of credit (L/Cs) can be attractive collateral for deposits and are accepted by most public entities as an efficient, flexible alternative to pledging securities, thus protecting public deposits against a potential loss.

To use FHLB L/Cs as collateral, an entity’s bank must be willing to work with its member FHLB. The bank pledges assets to its member FHLB to obtain an L/C. In return, the FHLB gives the government entity a letter of credit for a specified amount and term. This document serves as evidence that the bank has the L/C in place.

Possible Investment Opportunities

- Government securities; bills, notes, bonds and mortgages.
- Certificates of deposit and other evidences of deposit at federally insured depository institutions.
- Tier 1 commercial paper
- Municipal bonds issued within the entity's state.
- Money market mutual funds (Treasury, government or prime).
Using FHLB L/Cs as collateral is attractive because they offer flexible terms and conditions; in addition, most FHLBs are AAA-rated, and there exists no risk of cancellation without beneficiary approval. Additionally, this option may result in favorable pricing on core deposits or related services.

HOW BANKS CAN HELP

The challenges facing the public sector are sizeable. The backdrop of low rates, higher deposit insurance costs and regulatory requirements covering collateralized deposits demands vigilance. In today’s environment, sourcing the best possible option to enhance rates and yields, in the context of safety, is arguably one of the most important actions that governments undertake.

By updating investment policies, working with banks to optimize operating fund account structures and/or modifying collateralization requirements, government entities have an opportunity to offset these challenges. Not all of these options are suitable for all public sector depositors, but through careful analysis of needs and state requirements, the value of deposits can be optimized while the safety of taxpayers’ money is maintained.