The Letter of Credit Opportunity

September 2023

AGENDA

Letter of Credit (LOC) Overview

Liquidity Trends

Public Funds LOCs

Other LOC Applications:

- Performance Guarantees
- Bond Issuance

The Mechanics

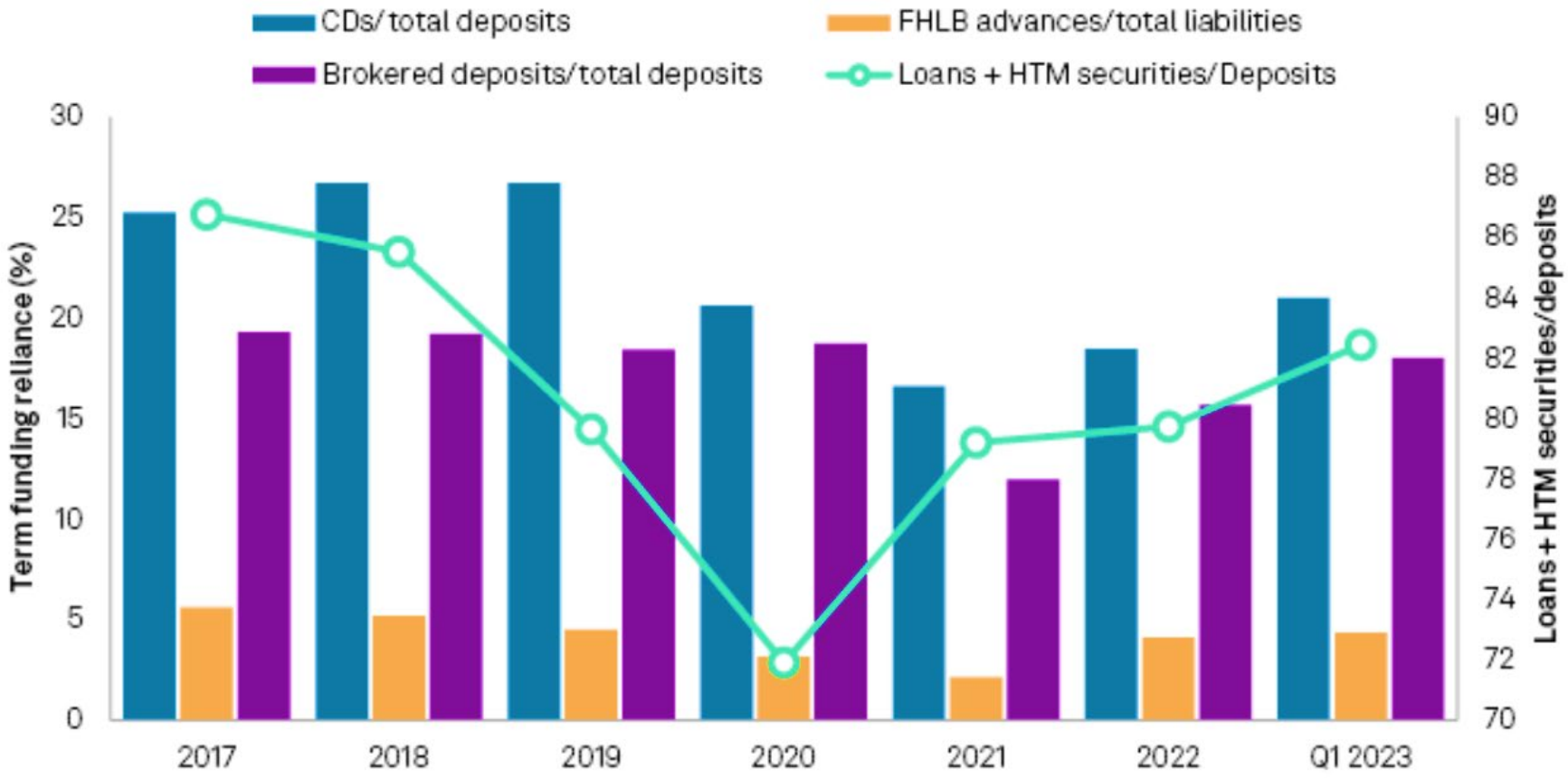
LIQUIDITY TRENDS

LIQUIDITY TRENDS

LIQUIDITY TRENDS

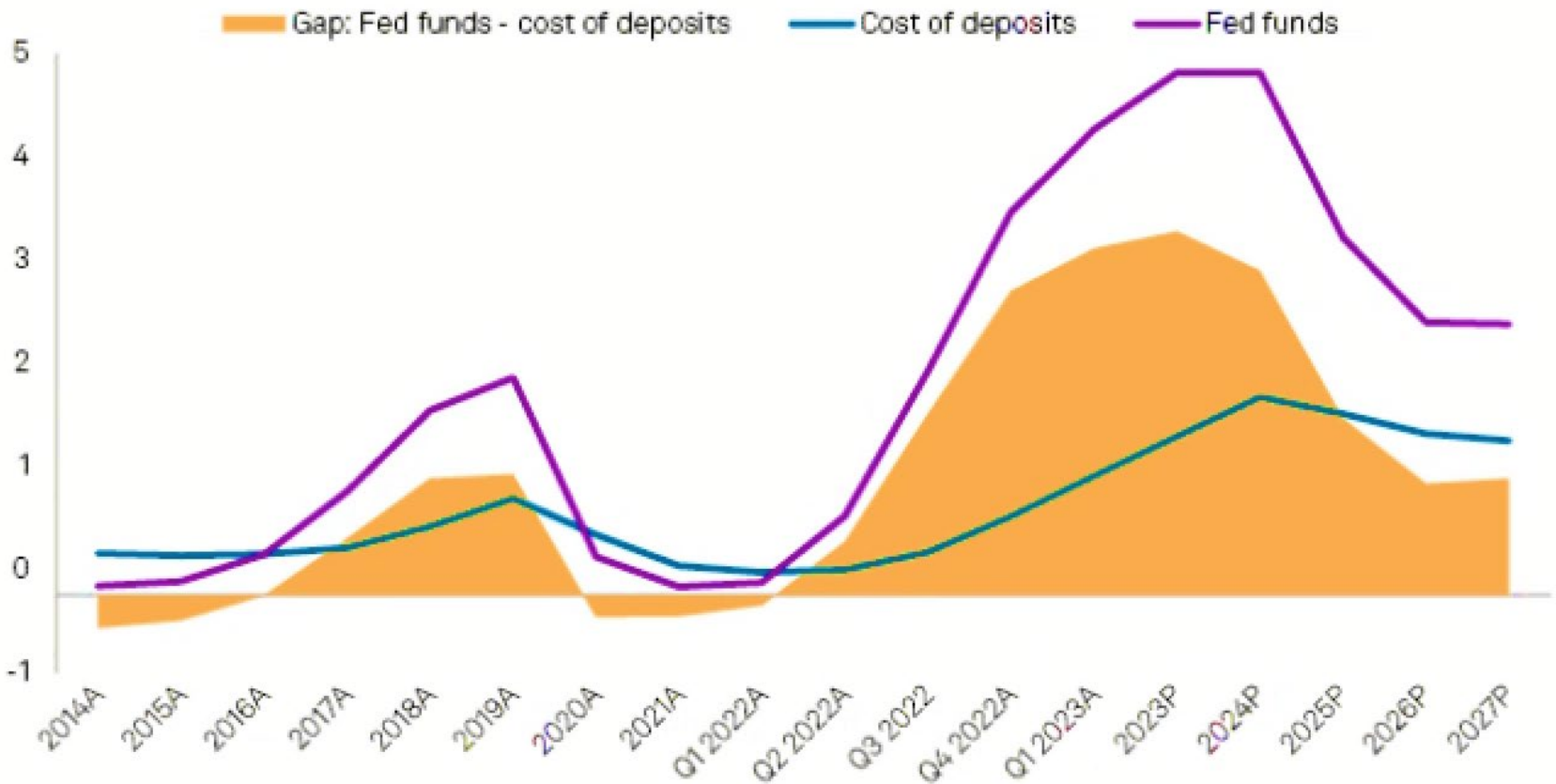
LIQUIDITY TRENDS

Community banks increasing their reliance on CDs, wholesale funding (%)

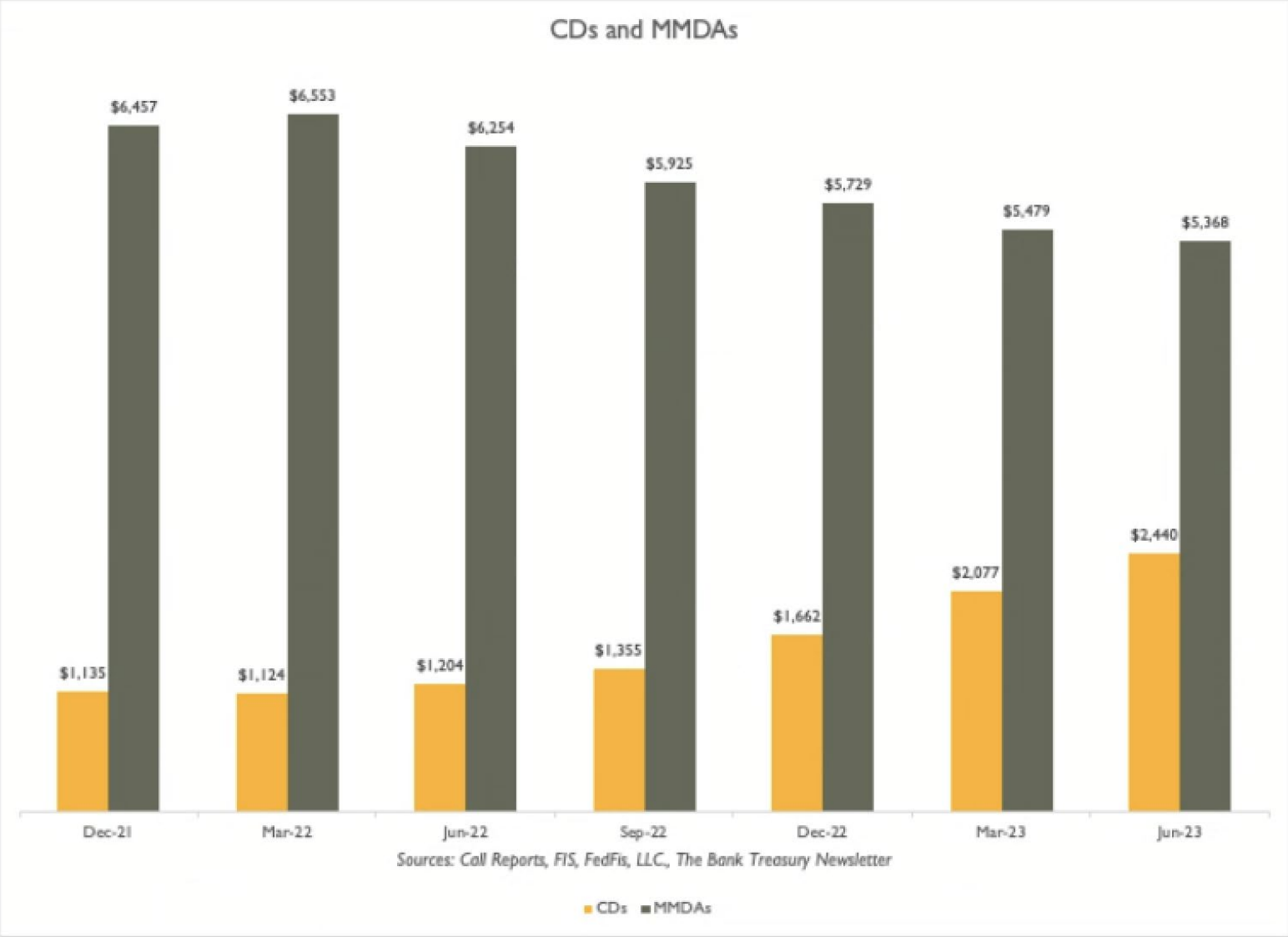


LIQUIDITY TRENDS

Spread between community bank deposit costs and fed funds spurs deposit outflows (%)

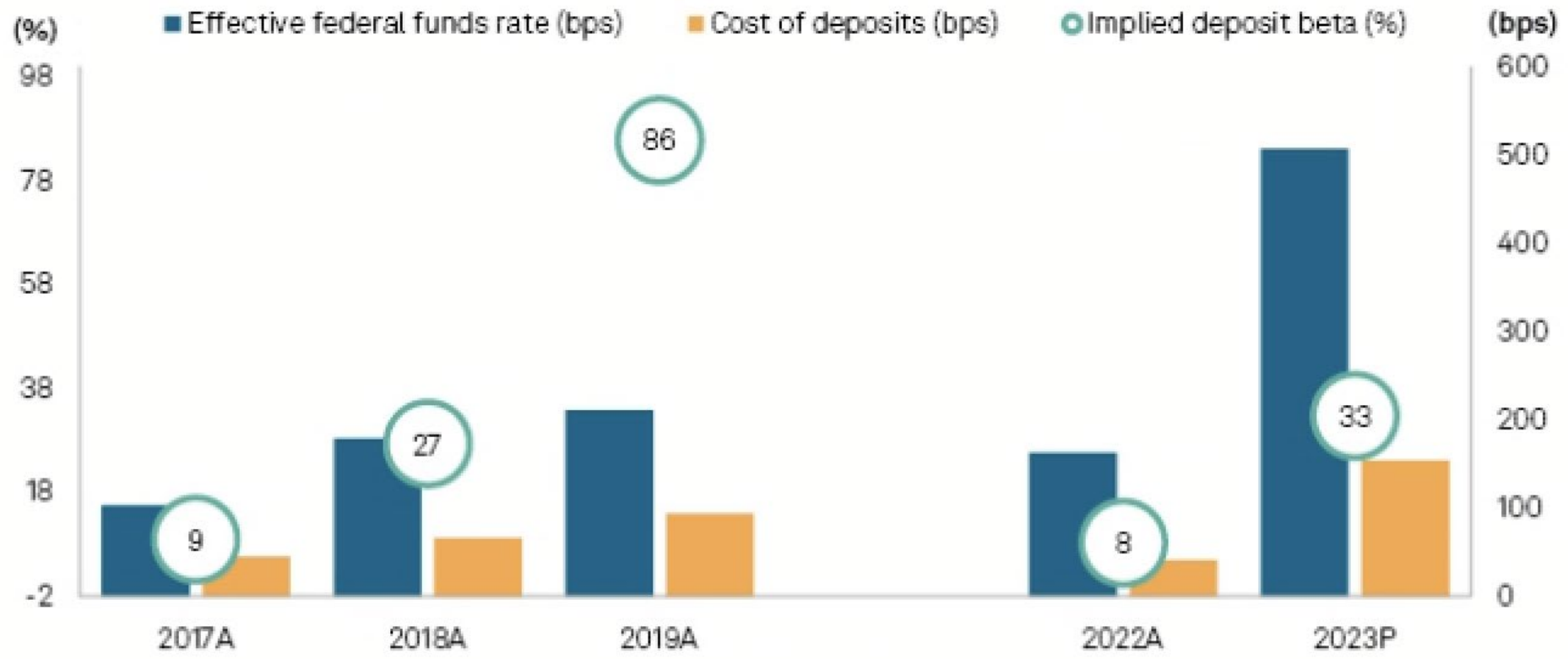


LIQUIDITY TRENDS



LIQUIDITY TRENDS

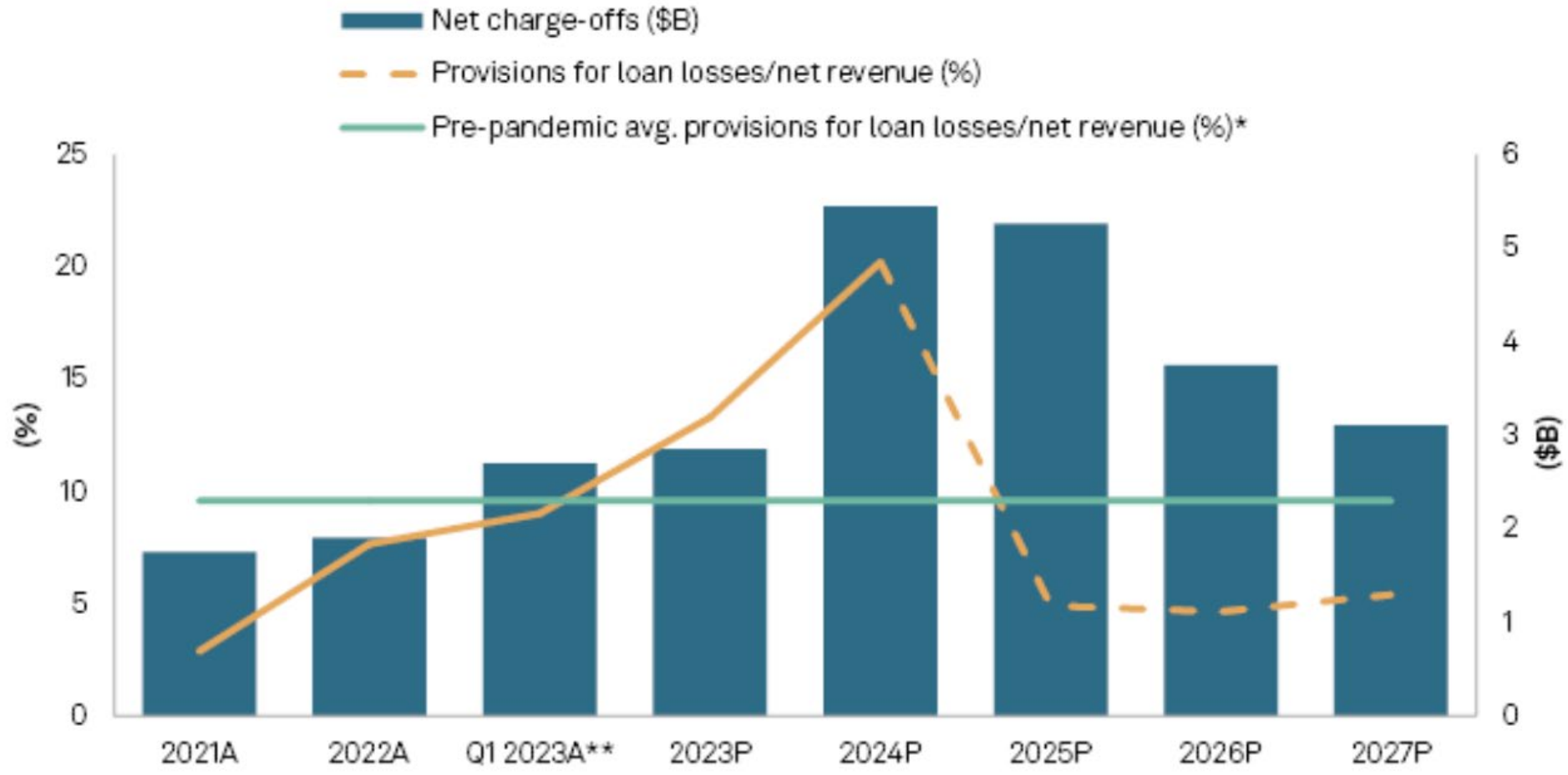
Community bank deposit betas will jump in 2023



S&P Global Market Intelligence – 7/26/23

LIQUIDITY TRENDS

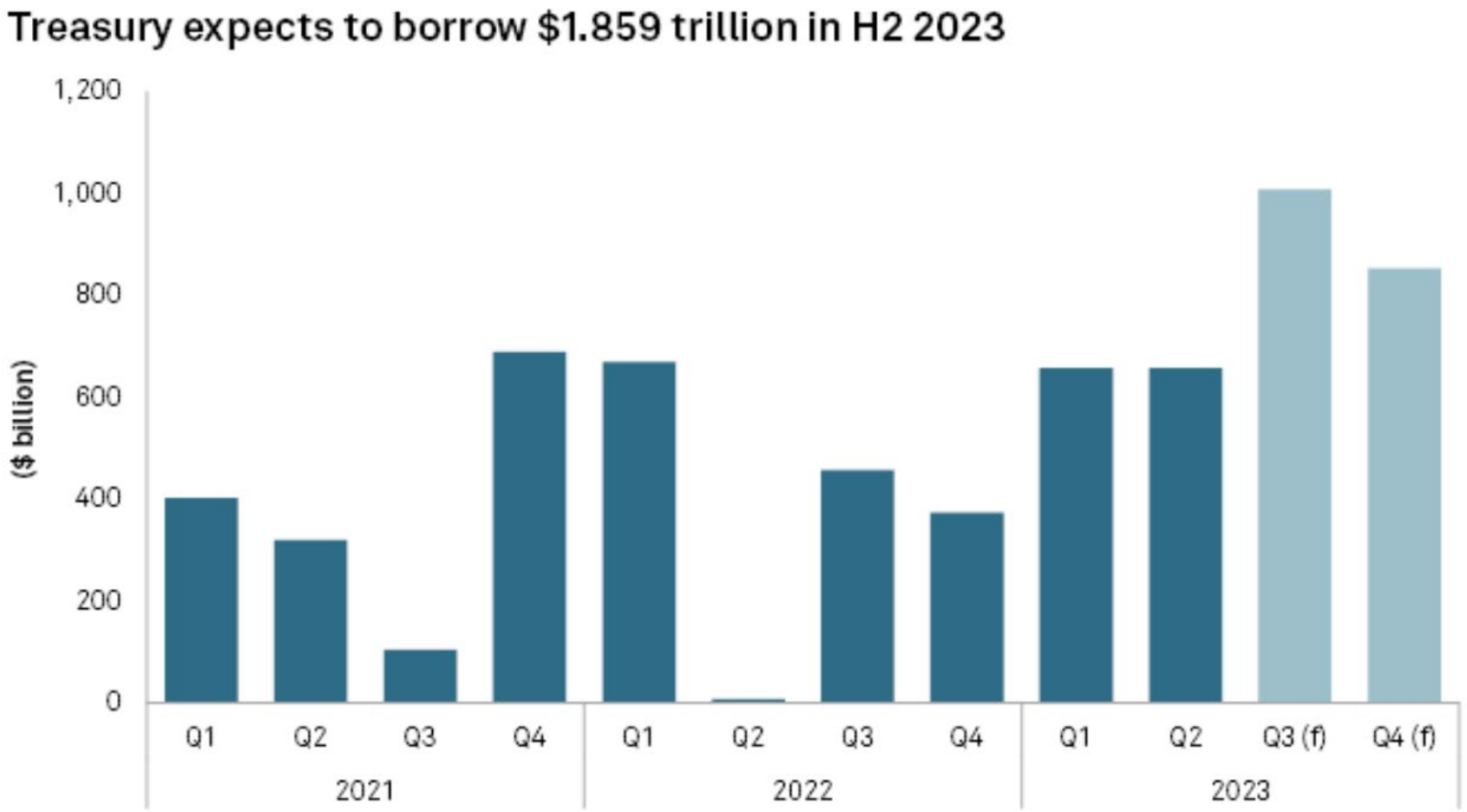
Community banks credit cost to rise in 2023, climb further in 2024



S&P Global Market Intelligence – 7/26/23

LIQUIDITY TRENDS

LIQUIDITY TRENDS



Data as of July 31, 2023.
(f) = forecast.
Source: US Department of the Treasury.
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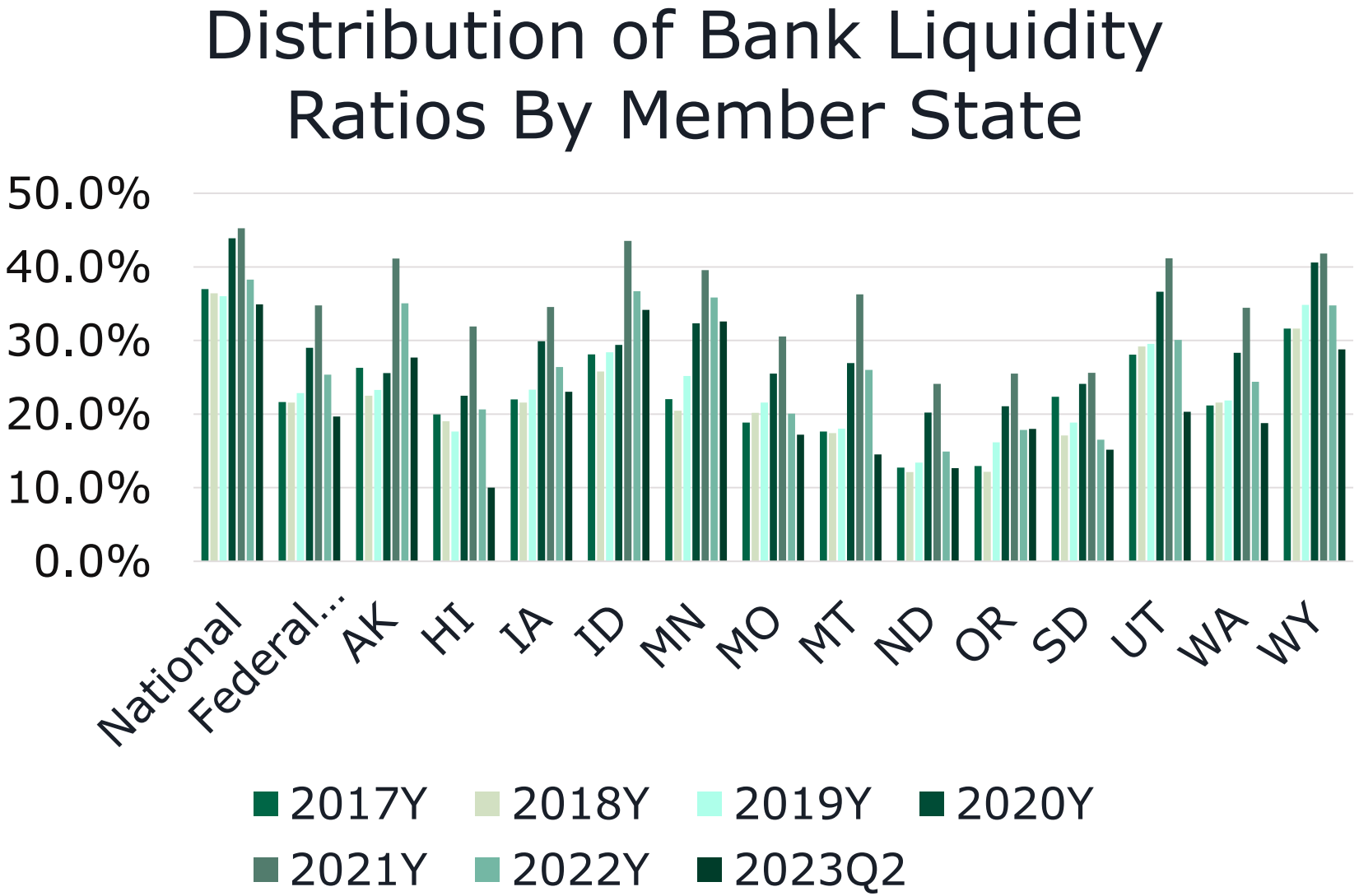
LIQUIDITY TRENDS



LIQUIDITY TRENDS

PUBLIC FUNDS LOCs

PUBLIC FUNDS LOCs

"PUD's" are demand, NOW, MMA or time deposits controlled by a municipality or political subdivision

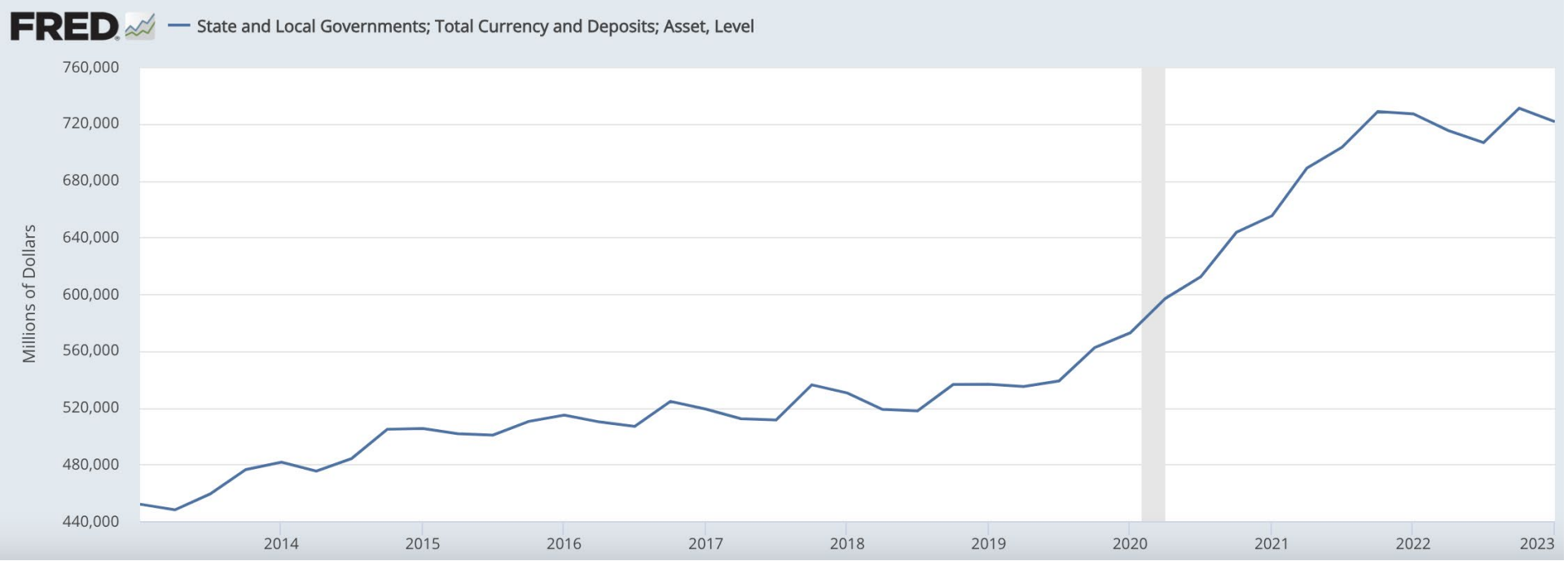
EXAMPLES

- school districts
- bridge and port authorities
- sanitation
- utility and fire districts
- any municipal entity that is authorized to hold exclusive use and control of funds

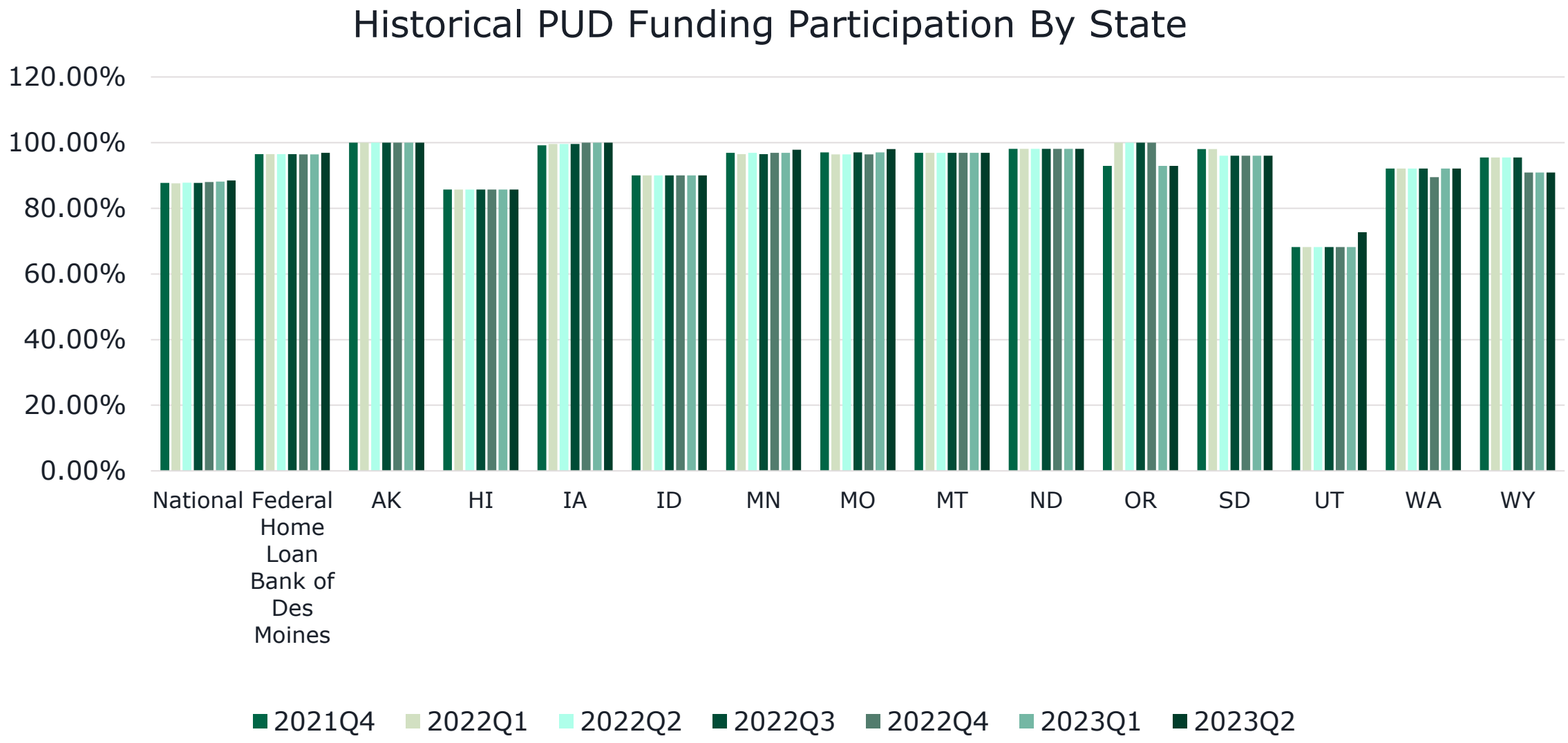
CHARACTERISTICS

- Often seasonal activity around tax and revenue dates
- Most concerned with safety and soundness of depository
  - Maximizing yield is secondary in priority

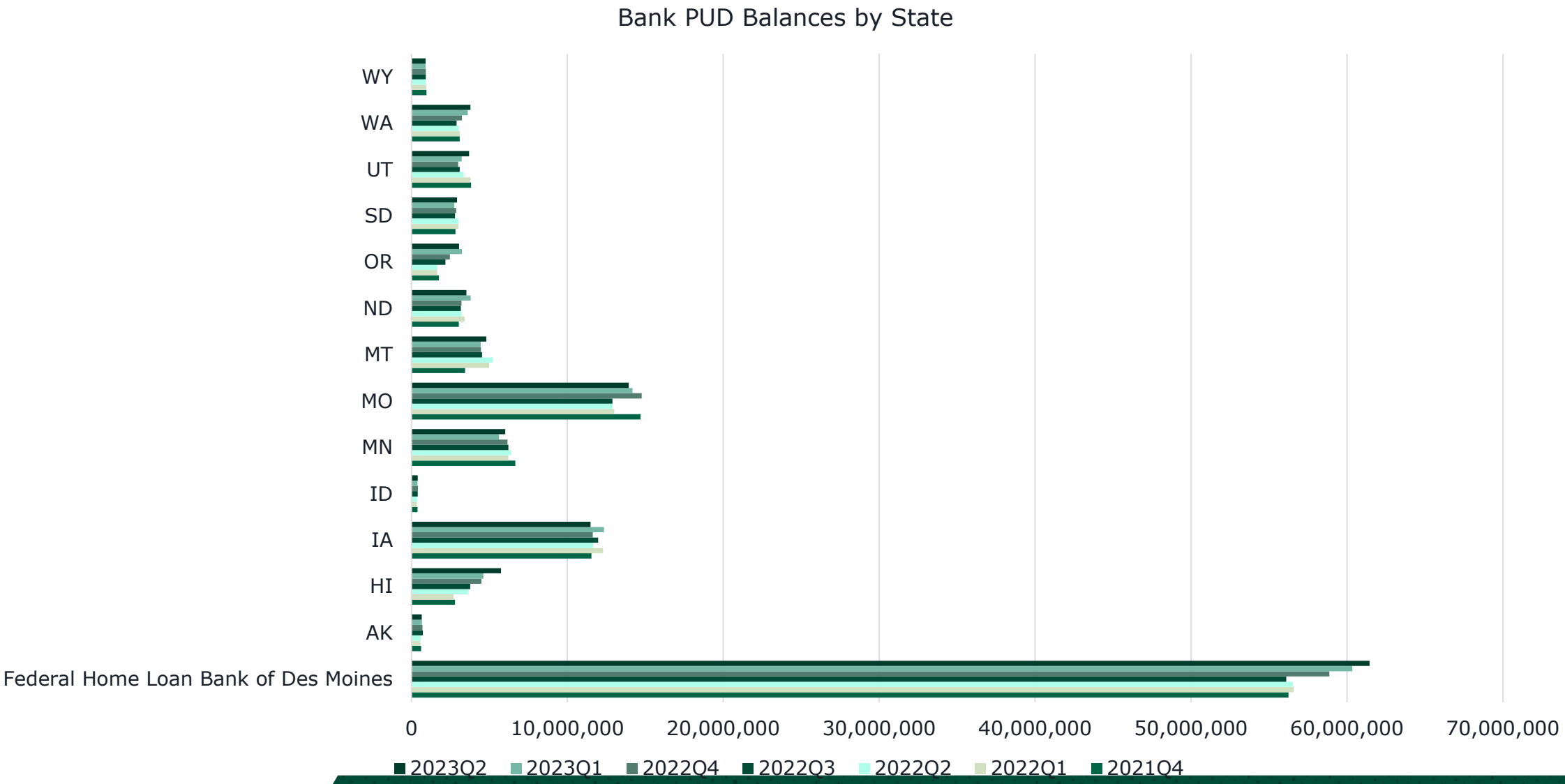
PUBLIC FUNDS LOCs



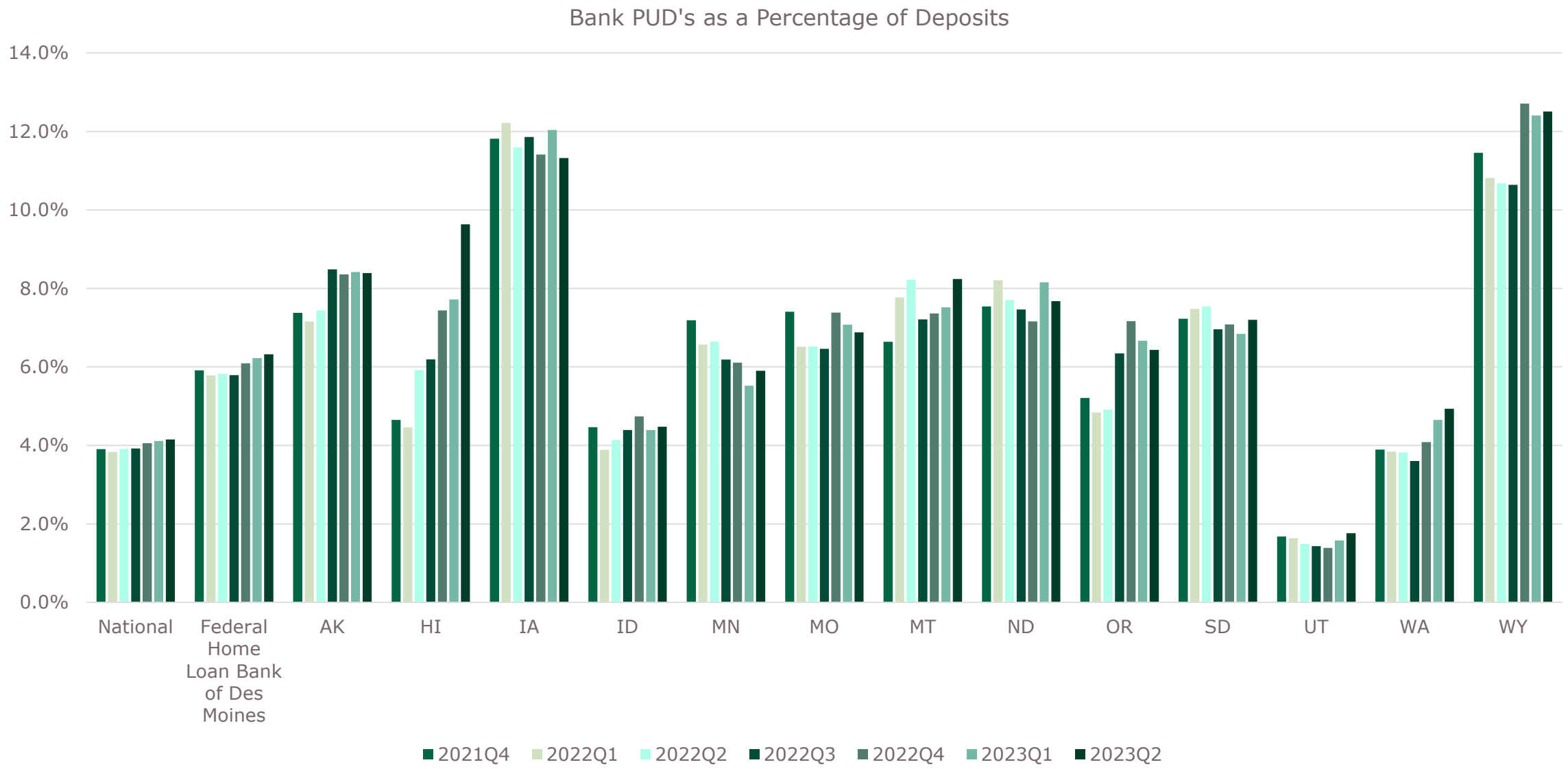
PUBLIC FUNDS LOCs



PUBLIC FUNDS LOC’S



PUBLIC FUNDS LOC'S



PUBLIC FUNDS LOC'S

Email: staci.ashe@tre.wa.gov

Surplus Funds Certificate of Deposit Program

(Formerly known as Time Certificate of Deposit Program)

The Surplus Funds Certificate of Deposit Program was established in 1973 to provide an opportunity for public depositaries in the State of Washington to receive a portion of surplus funds to benefit the local economy.

The Office of the State Treasurer (OST) accomplishes this through investments in Certificates of Deposit.

- Funds are offered semi-annually (January and July) to every qualified Public Depositary in the State of Washington.
- Allocation of funds based on financial institutions' net worth provided by the PDPC.
- All certificates are issued for approximately 181 days on a 365-day basis with simple interest paid at maturity.
- The rate will be set by OST using a spread, currently 15 basis points, over the auction yield of the 26-week Treasury Bill as determined at the first auction of the month in which the CD is issued.
- All Information about proposed CDs is available on the OST web site two to three business days prior to rollover date. Public Depositaries must respond by phone or email with any changes by 11:00 am two working days prior to the rollover date or the certificate will automatically renew at maturity.
- All money transactions are done via Automated Clearing House (ACH); executed by OST.
- All Certificates of Deposit will be in safekeeping at the participating bank.

New participants will need to contact OST with pertinent information, e.g., money transfer instructions.

If you are an existing participant and have not notified OST of any changes, your certificate will renew automatically at the rate posted. Interest on the maturing CD will be taken through ACH.

PUBLIC FUNDS LOC'S

OREGON STATE TREASURY

Depositories

All depositories are required to submit reports to Treasury, providing information including public funds balances in excess of insurance limits, total public funds on deposit, depository net worth, and capitalization information. Depositories are categorized as well capitalized, adequately capitalized, or undercapitalized, and those categories help determine the thresholds for collateral and the required frequency of reporting.

Local Governments

Public officials are required to verify that deposit accounts in excess of deposit insurance limits are maintained at only those financial institutions included on the list of qualified depositories .

Public officials also are required to report at least annually, or within three days of a change, the depositories they do business with, and provide current contact information. Click here to learn how to report changes in depositories.

PUBLIC FUNDS LOCs

TYPICAL COLLATERALIZATION ARRANGEMENTS FOR LOCAL PUBLIC UNIT DEPOSITS

- Above $250,000 FDIC insurance limit, Treasury, Agency and other high-quality securities are pledged as collateral for public unit deposits by a member
- Pledged securities held by trustee as required by the public unit
- Trustee provides frequent collateral reports to the public unit
- Securities market values, substitutions and maturity dates require constant monitoring – high administrative burden
- Should depository member default, public unit may exercise the right to pledged securities collateral

PUBLIC FUNDS LOCs

BENEFITS

- “AAA/AA+” credit rating
- Leverage less-liquid collateral that may already be pledged to FHLB Des Moines
- Relieves the administrative burden
- Customizable: Individual, Pooled, Fixed, Evergreen, Finite

PUBLIC FUNDS LOCs

THE FDIC ON DEPOSIT INSURANCE FOR ACCOUNTS HELD BY GOVERNMENT DEPOSITORS

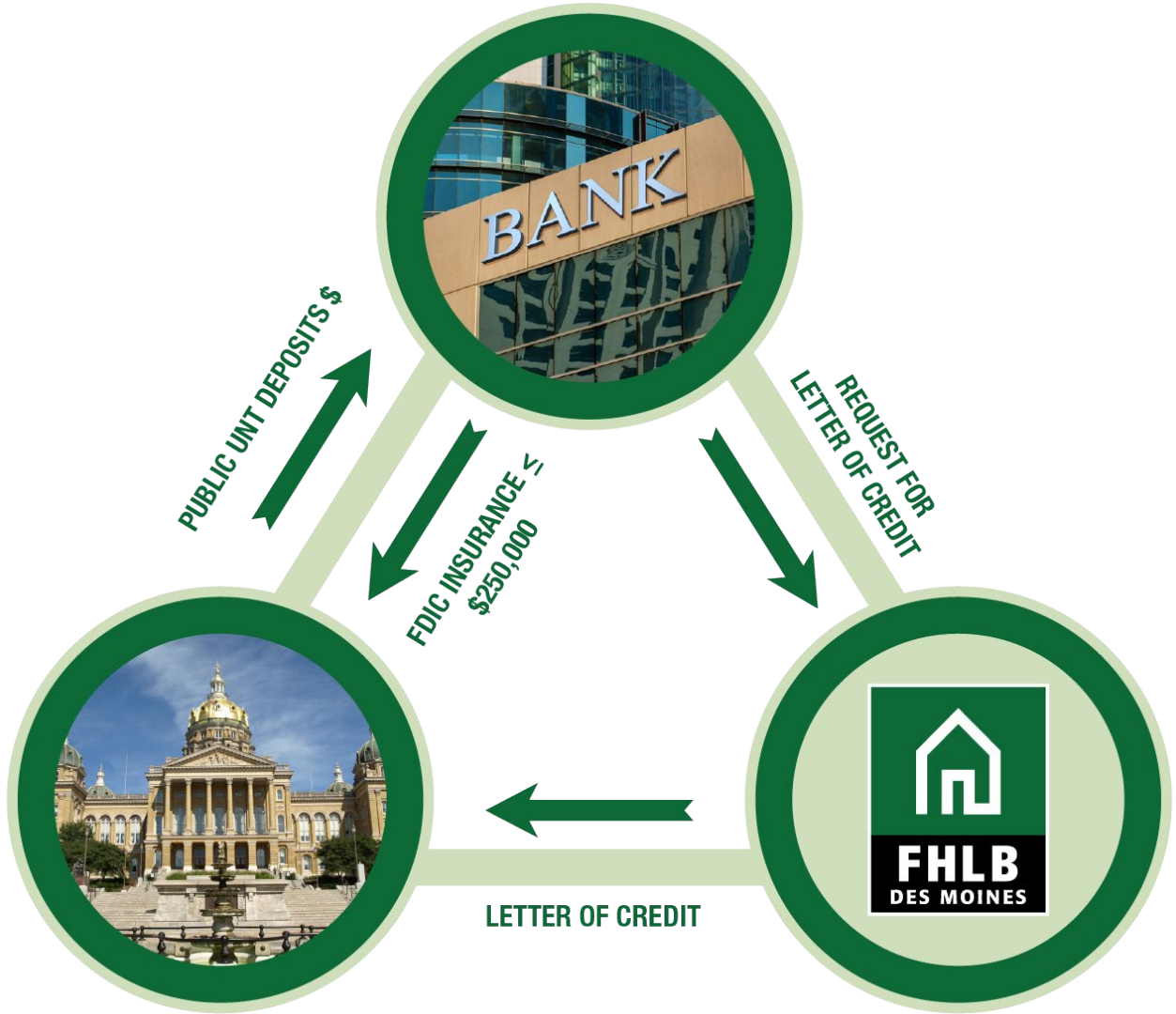
"All time and savings deposits owned by a public unit and held by the public unit's official custodian in an insured depository institution within the State in which the public unit is located are added together and insured up to $250,000. Separately, all demand deposits owned by a public unit and held by the public unit's official custodian in an insured depository institution within the State in which the public unit is located are added together and insured up to $250,000."

"Collateralization of Public Unit Deposits …

Depending on applicable state or federal law, public unit deposits may be secured by collateral or assets of the bank. In the event of the failure of the bank, the FDIC will honor the collateralization agreement if the agreement is valid and enforceable under applicable law. **The FDIC does not guarantee, however, that the collateral will be sufficient to cover the amount of the uninsured funds.** As such, although it does not increase the insurance coverage of the public unit deposits, **collateralization provides an avenue of recovery in the unlikely event of the failure of an insured bank**."

330.15 of the FDIC's regulations (12 CFR 330.15)
January, 2013

PUBLIC FUNDS LOCs



PUBLIC FUNDS LOCs

SUMMARY OF STATUTORY TREATMENT OF LOCs FOR PUDs

State	Public Deposit Statute	FHLB LOC Accepted by Statute	Credit Rating Requirement
Alaska	Investment Policies and Procedures, Department of Treasury, "Collateralized State Deposits"	Yes	
Hawaii	Hawaii Revised Statutes Annotated 38-3	Yes	
Idaho	Idaho Code Annotated 57-128	Implied; has accepted LOC's from FHLBDM	
Iowa	Iowa Annotated 12C.16	Yes. Accepts direct obligations of an instrumentality of the U.S. (by case law interpreted to include FHLB). Has accepted FHLB LOC's.	
Minnesota	Minnesota Statutes Annotated 118A.03	Yes	Minimum FHLB Public Debt of 'AA' from Moody's or S&P
Missouri	Missouri Revised Statutes 30.270	Yes	
Montana	Montana Code Annotated 17-6-103	Yes	
North Dakota	North Dakota Century Code 21-04-09	Yes	Minimum Rating of 'AA' rating or better from Moody's or S&P
Oregon	Oregon Statutes 295-004	Yes	
South Dakota	South Dakota Codified Laws title 4, Chapter 06A, 4-6A-1	Yes	Minimum Rating of 'AA' rating or better from Moody's or S&P
Utah	Utah Code Annotated 51-7-18.1	Limited Requirements	
Washington	Revised Code of Washington Annotated 39.58.050	Yes	
Wyoming	Wyoming Statutes Annotated 9-4-805. Deposit of state money in approved depositories; other acceptable security	Yes	

PUBLIC FUNDS LOCs

CASE ONE: THE FORGOTTEN SECURITY CALL

Challenge

- Member currently using a callable security to collateralize a public unit deposit. The member receives notification that the bond is going to be called at the next call date, which is in five days.

Options

- Pledge another security or purchase a replacement security.
  Member subsequently receives the proceeds from the called security and forgets to replace another security that is needed to fully collateralize the deposit. The security takes at least one day to settle.

OR

- Collateralize the deposit until a replacement security is pledged or purchased using an LOC.
  The LOC can be written for any suitable amount and timeframe that the member selects.

PUBLIC FUNDS LOCs

CASE TWO: DIMINISHING SECURITIES ELIGIBILITY

Challenge

- A member's investment portfolio has historically contained a high percentage of mortgage-backed and callable Agency securities. Rates have dropped and many of these securities have been called. With MBS prepayments accelerating, the member would like to purchase municipal securities (which are not PUD-eligible for securing deposits in their operating area).

Options

- Refrain from purchasing municipal securities and continue to sub-optimally pledge other securities.

OR

- Shift to municipal security purchases and pursue investment objectives by deploying an FHLB Des Moines LOC to collateralize the deposit program at a negligible cost.

PUBLIC FUNDS LOCs

CASE THREE: DIMINISHING SECURITIES AVAILABILITY

Challenge

- A member is experiencing sluggish deposit growth and has been selling securities to fund loan growth. Unfortunately, a sizeable percentage of securities have been pledged to school districts in order to collateralize deposits.

Options

- Continue securities pledging program and suppress loan growth due to liquidity constraints.

OR

- Secure an FHLB Des Moines LOC to collateralize the deposits. Pledge the additional loans, if eligible, as collateral. Continue to fund loan growth.

PUBLIC FUNDS LOCs

CASE FOUR: STRATEGIC REVIEW OF LIQUIDITY AND MARGIN

Challenge

- Liquidity pressures are mounting due to: shrinking monetary policy; competition with money market funds, Treasuries and retail deposit rate competition. Securities liquidity has been impacted by AOCI. Low-yielding securities are contributing to margin pressure as interest rate risk heads in the direction of liability-sensitivity caused by shortening deposit duration assumptions.

Options

- Sustain a diminished ability to fund asset growth with securities sales.

OR

- Assist balance sheet growth strategies by deploying an FHLB Des Moines LOC to collateralize the municipal deposit program at a negligible cost.

PUBLIC FUNDS LOCs

INCREMENTAL IMPACT OF LOC PROGRAM ON LIQUIDITY AND OPPORTUNITY INCOME

(in thousands)

Letter of Credit Amount: $250,000			
Data as of 6/30/2023			
	Before LOC	After LOC	Ratio Improvement
Liquidity Ratio:	12.00%	15.02%	3.02%
Pledged Securities Ratio:	45.10%	26.41%	18.69%
Total PUDs:	$300,000		
Total Uninsured PUDs (Prior EOY):	$250,000		
Total FHLB Des Moines LOCs:	$0	$250,000	
Total Securities Pledged (Call Report):	$620,000	$370,000	
Total Securities (Call Report):	$1,400,000		
Total Credit Availability:	$5,000,000		
Total Collateral Availability:	$4,000,000		
FHLB Indebtedness	$1,000,000	$1,250,000	
Remaining Borrowing Capacity:	$3,000,000	$2,750,000	

Max Earnings			
	Before LOC	After LOC	Earnings/ NIM Change
Reduction in Securities Collateralizing PUD:	$620,000	$370,000	
Yield on Securities:	3.50%	3.50%	
	$21,700	$12,950	($8,750)
	$0	$250,000	
Reinvestment in Higher Yield Loans:	4.75%	4.75%	
Yield on Loans:	$0	$11,875	$11,875
LOC Cost (0.115%):		$287.50	($287.50)
Net Additional Income Earned Per Year:			$2,837.50
Change in NIM:	2.18%	2.21%	0.03%

SNL DATA | CALCULATED | FHLB DATA

PUBLIC FUNDS LOCs

DISAVANTAGES OF OTHER FORMS OF COLLATERALIZATION

- Reciprocal Deposits:
  - Expensive,
  - Considered brokered deposits
  - Capacity and settlement limitations not coinciding with PUD cash flow
  - Operationally intensive
  - PUD faces overnight exposure
- Pledged Securities:
  - Encumbers highly liquid assets
  - Capacity limited to available collateral
  - Securities release is cumbersome with calls and maturities of deposits
- Surety Bonds:
  - More expensive than LOCs, callable by underwriter
  - Monthly reporting required on daily deposits
  - Capacity limitations

PUBLIC FUNDS LOCs

ADVANTAGES OF FHLB DES MOINES LOCs AS PLEDGING ALTERNATIVE

- Minimal cost to the member. No cost to the public unit.

- Operationally efficient for the member as well as the public unit:
  - Does not restrict securities portfolio
  - Helps redirect capital from low-yielding investments to higher-yielding assets
  - Direct and straightforward obligation
  - Compared with pledging securities, relieves the administrative burdens

OTHER LOC APPLICATIONS: PERFORMANCE GUARANTEES, BOND ISSUANCE

OTHER LOC APPLICATIONS

PERFORMANCE GUARANTEE LOCs

- Address counterparty requirements
  - Examples include rating confirmation requirements of swap and other counterparties

- Provides select liquidity, community lending, housing, and other requirements involving your institution and your customers (e.g. captive and other forms of insurance)

OTHER LOC APPLICATIONS

THE CONFIRMING LOC

Member issues its direct pay LOC that is confirmed by the FHLB Des Moines LOC

- FHLB Des Moines confirms member's LOC and improves credit rating of transaction
- FHLB Des Moines LOC stands behind the member's LOC
- FHLB Des Moines LOC is drawn on for member insolvency/ non-performance for principal and interest payments, as well as other transactional charges

OTHER LOC APPLICATIONS

PERFORMANCE OBLIGATION LOC EXAMPLE #1

Self-insured general liability program for a fleet operator

- First-dollar claims exposure retained, larger potential losses contracted out
- FHLB Des Moines confirms member's LOC and "Aaa/AA+ rating supported beneficiary's guarantee requirements
- FHLB Des Moines LOC stands behind the member's LOC

RESULT: lower premiums, stronger deposit and loan balances

OTHER LOC APPLICATIONS

PERFORMANCE OBLIGATION LOC EXAMPLE #2

- Member originated a construction loan
- Takeout ultimately via a Freddie Mac permanent loan
- Freddie Mac required a Confirming LOC as security until rental rolls established and confirmed
- Structured as a one-year Confirming LOC

OTHER LOC APPLICATIONS

PERFORMANCE OBLIGATION LOC EXAMPLE #3

- Member's customer purchasing crude oil contracts forward
- Customer counterparty requires securities or highly-rated LOC issuer
- Member issues Direct Pay LOC in favor of its customer's counterparty
- FHLB Des Moines issues Confirming LOC, combining the member LOC and providing the customer's counterparty with an ultimate "Aaa/AA+" performance guarantee

OTHER LOC APPLICATIONS

PERFORMANCE OBLIGATION LOC EXAMPLE #4

Challenge:

Loans that support shared senior liens are not eligible for pledging with FHLB Des Moines due to associated perfection issues. Most commonly occurs with loans that support "back-to-back" interest rate swaps for the purpose of providing a member's borrower an all-in fixed rate.

Options:

1. Forego loans that contain potential double-lien structures as pledged collateral with FHLB Des Moines.
2. FHLB Des Moines issues a Standby LOC on behalf of the member, in favor of the member's interest rate swap counterparty. In return for the LOC issuance, the swap counterparty agrees to either subordinate or relinquish its senior lien position.

OTHER LOC APPLICATIONS

PERFORMANCE OBLIGATION LOC EXAMPLE #4

Summary Terms:

LOC: Issued by FHLB Des Moines on behalf of ABC Member (“Member”), in favor of Member Swap Counterparty (“MSB”)

Purpose:

MSB is the swap counterparty on various loans made by the member. MSB has an attached lien on the swapped loans. Member would like to have these swapped loans available for general pledging eligibility with FHLB. As a means of allowing these swapped loans to become eligible for pledging, member would like FHLB to issue a LOC in favor of MSB in exchange for MSB subordinating or relinquishing its senior position in the swapped loans to FHLB.

OTHER LOC APPLICATIONS

PERFORMANCE OBLIGATION LOC EXAMPLE #4

Amount of LOC:

TBD. Amount will represent the mark-to-market value of the interest rate swaps that are attached to designated loans, rather than the full notional value of the swap.

Required Documentation:

1. Subordination agreement between MSB and FHLB Des Moines
2. Standby LOC issued by FHLB Des Moines in favor of MSB

Implementation Status:

Beta testing with WA-based member

OTHER LOC APPLICATIONS

Benefits of Using FHLB Des Moines Letters of Credit for Supporting Performance Obligations

Timely issuance

No need to unnecessarily pledge and monitor securities

Fee income opportunities for the member

Ability to enhance your customer relationships

OTHER LOC APPLICATIONS

What Types of Debt Issuances Can FHLB Enhance?

- FHLB Des Moines has historically issued its LOCs on behalf of its member institutions to enhance the financing of residential and community lending-related projects.

- Enhancements typically cover:
  - Non-Housing, Taxable Issues
  - Housing, Taxable Issues
  - Housing, Non-Taxable Issues

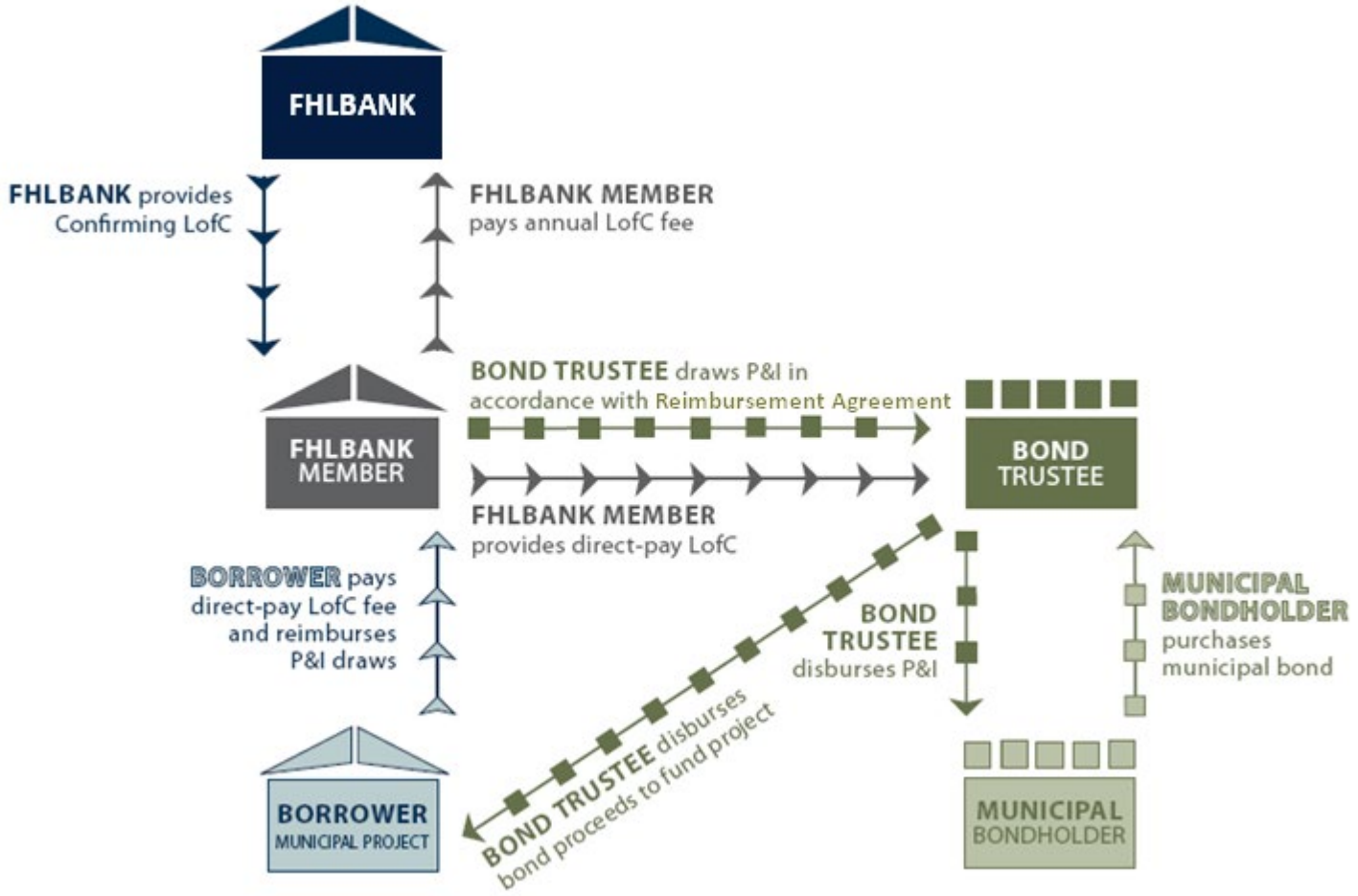
OTHER LOC APPLICATIONS

How Confirming LOCs Are Structured for Debt Enhancement

- LOC from the member with a Confirming LOC issued by FHLB Des Moines
- FHLB Des Moines credit enhanced bonds are in high demand
- Enables access to the private placement, public and/or variable-rate demand (“low floaters”) market
- Capital markets look to the credit rating of the CLOC provider (the FHLB Des Moines rating, in this case is “Aaa/AA+”)
- Interest and principal can be paid from a pledge of specific and definable revenues

OTHER LOC APPLICATIONS

How Confirming LOCs Are Structured for Debt Enhancement



OTHER LOC APPLICATIONS

Why use FHLB Des Moines Confirming LOCs vs. lend directly?

- Provides opportunity for members to issue LOCs (off-balance sheet) that they could not issue directly their own – fee income
- Enables members to offer highest rated credit to customers
- Offers a unique and timely structural alternative vs. commodity loan pricing
- Retains and grows local business relationships
- Can provide lower interest rate for projects
- Low cost of confirmation

THE MECHANICS

THE MECHANICS

LOC REQUIREMENTS

Collateral:
LOCs are subject to the same collateral requirements as FHLB advances.

Activity Stock:
Currently, members are required to purchase Activity Stock that is equivalent to 10 basis bps of the notional LOC amount.

Application:
Public Unit Deposit purposes (e.g., state and county treasurers, school districts, cities and townships)

Non-Public Unit Deposit purposes (e.g., to facilitate residential housing finance, community lending or for asset/liability management)

Completed applications should be emailed to moneydesk@fhlbdm.com by 3:00 PM (CT) for same day processing. You may also fax the application to 515.699.1250.

THE MECHANICS

LOC PRICING

Standard Billing for LOC

Upon issuance of an LOC, FHLB charges a non-refundable fee which is calculated using the following formula:

{Face Amount * FEE * (Term in Days/360)}.

The FEE used in the above formula is based upon the Face Amount of the SLOC. The current fee is 11.5 basis points.

Minimum charge for any LOC is $250.

“When trust was in the room, whatever room that was – the family room, the schoolroom, the coach’s room, the office room, the government room or the military room – good things happened. When trust was not in the room, good things did not happen. Everything else is details.”

- George P. Shultz

STAY IN TOUCH WITH US

Headquarters

909 Locust Street
Des Moines, IA 50309

Phone

(800) 544-3452

Website

www.fhlbdm.com