FHLB
DES MOINES

# Improve Your Liquidity, Income and Efficiency with Federal Home Loan Bank of Des Moines Public Unit Deposit Letter of Credit Opportunity

members.fhlbdm.com

## Public Unit Deposits as a Source of Financial Institution Funding

Many member financial institutions of FHLB Des Moines gain funding access via NOW, MMDA or time deposits from municipalities or political subdivisions. Examples include: school districts, bridge and port authorities; or sanitation, utility and fire districts. Deposit requirements often vary in magnitude in concert with seasonal revenue collections and/or collection of bond proceeds. Public unit depositors are principally concerned with the creditworthiness, safety and soundness of the depository. As a result, public units are frequently bound by statutes and/or investment policies to require collateralization of deposits in excess of Federal Deposit Insurance Corporation (FDIC)/National Credit Union Administration (NCUA) limits of $250,000. Per the FDIC, "Collateralization provides an avenue of recovery in the unlikely event of the failure of an insured bank."*

*FDIC 12C C.F.R. §330.15, January 2013

## Seeking Optimal Forms of Public Unit Deposit Collateralization

Collateralization options vary (depending upon statutes and investment policy), and may include: FHLB Des Moines or Federal Reserve Letters of Credit, surety bonds or pledging of a depository's eligible securities. Although pledged securities as a form of collateralization has historically been the most widely used method, especially during times of excess liquidity, this form of collateralization encumbers highly liquid assets. Pledged securities are typically held by a trustee or custodian and require generation of frequent collateral reports that detail market values, substitutions and other information to the public unit depositor. Also, pledged securities often need to be closely monitored for replacement caused by calls and maturities.

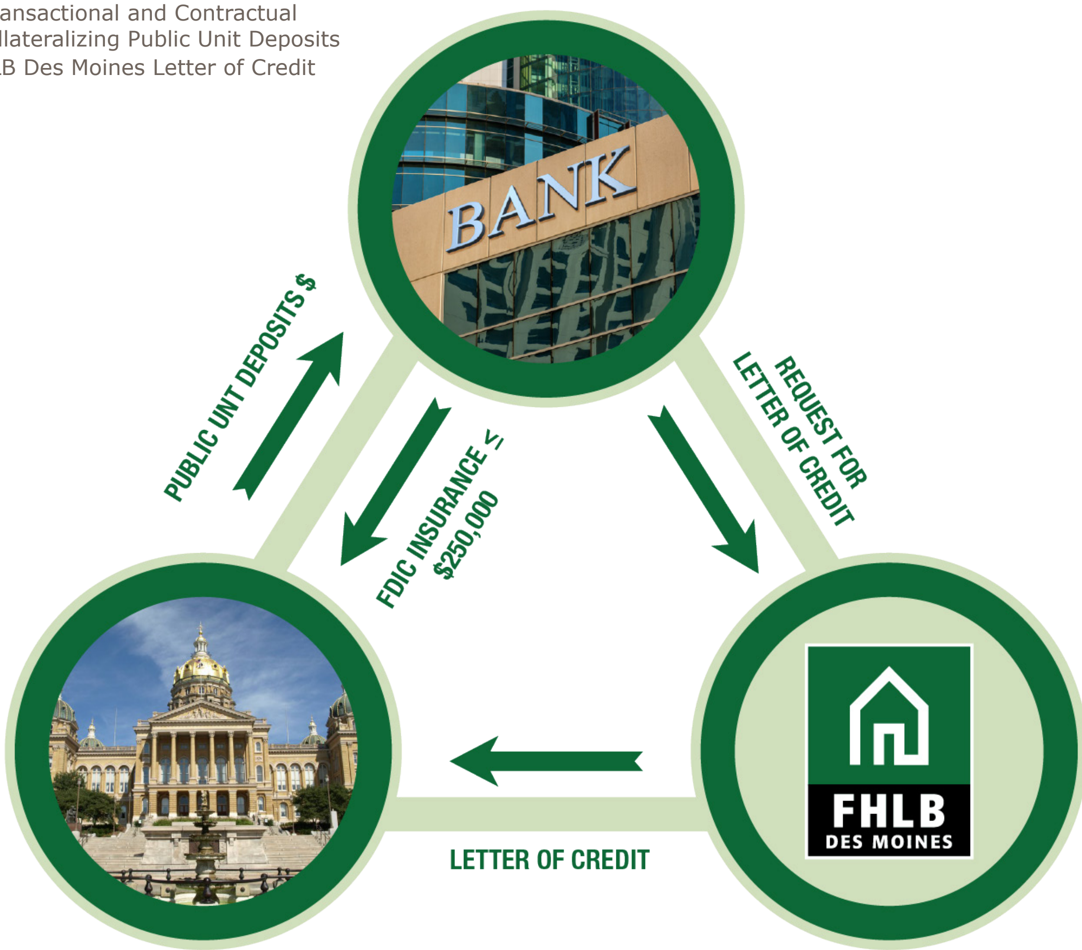
As alternatives, surety bonds that are commissioned by financial institutions for public deposit collateralization can be expensive and subject to calls by the underwriter, monthly reporting on daily deposit levels and may be subject to changing capacity limitations. Finally, reciprocal deposits are sometimes viewed as a means of directing public unit deposits; although capacity and settlement limitations may not coincide with public unit deposit cash flow, may be operationally intensive, and may subject the municipal depositor to overnight settlement risk.

As a solution, public units and depositories are increasingly seeing the benefits of covering deposits via procurement of a FHLB Des Moines Standby, irrevocable Letter of Credit. Such a letter of credit may be written in favor of a public unit depositor in the event a depository fails. Under such an event, the public unit would have the ability to immediately draw upon the letter of credit. The amount of any such letter of credit is incorporated within a member financial institution's collateral and credit lines at FHLB Des Moines. No additional activity stock is required to be purchased.

## More on the Public Unit Deposit Letter of Credit Alternative

As illustrated in Figure 1, there are several contractual and transactional flows associated with public unit deposits that are backed by FHLB Des Moines Standby Letters of Credit. An FHLB Des Moines member institution requests a letter of credit via an application. Next, a letter of credit is generated in favor of a public unit. Once the letter of credit is in place, the member financial institution is set to generate funding from the public unit, now that the institution's deposits in excess of the FDIC insurance

Figure 1: Transactional and Contractual Flows of Collateralizing Public Unit Deposits with an FHLB Des Moines Letter of Credit




limit of $250,000 are adequately covered. The costs associated with issuing an FHLB Des Moines Letter of Credit are minimal from the perspective of a member. There is no cost borne by the public unit depositor. Relative to pledging securities, letter of credit issuance is more operationally efficient and does not encumber a securities portfolio. Moreover, a case can be built that by reducing the amount of pledged securities, a member may be encouraged to redirect capital from low-yielding investments to higher yielding assets such as loans. Currently, public unit deposit-related letter of credit activity is conducted by FHLB Des Moines within the vast majority of jurisdictions. There are several states outside the district that will also accept FHLB Des Moines Letters of Credit. Many states have specific public deposit statutes that reference the ability of their public units to accept FHLB Des Moines Letters of Credit. Many municipalities recognize the benefits of the "Aaa"/"AA+" rating and see letters of credit as easier to monitor than securities. Public unit depositors, which, again, are extremely safety conscious, recognize that in the event of default, exercising the right to security collateral may be more time consuming than simply drawing on a letter of credit.

**Public Unit Deposit Case Studies**

To illustrate issues and options that are typically faced by FHLB Des Moines members, here are a few examples:

Case One - The Forgotten Security Call:

Historically, a financial institution has collateralized a public unit deposit with a pledge of callable agency securities. A member subsequently receives notification that the callable bond will be called in five days, the next scheduled call date.

The options: A) Hurriedly pledge an alternative security (or occasionally run the risk of forgetting to replace the collateral, given settle times and monitoring requirements). B) Consider collateralizing that deposit until a replacement security is found, with a letter of credit. The letter of credit may be customized by amount and timeframe. Also, consider replacing part or all of the securities pledging program with a letter of credit program.

Case Two – Diminishing Securities Availability for Collateralization

With a recovering economy, a member is sustaining strong loan growth and has been decreasing its securities portfolio in order to fund a portion of that growth. An increasing percentage of the securities position has already been pledged to multiple public unit depositors.

The options: A) Continue to pledge securities and suppress further loan growth due to liquidity constraints. B) Procure a letter of credit and pledge the growing amount of loans, if eligible, as collateral with FHLB Des Moines. Continue to fund the loan growth.

Case Three – Decreasing Securities Eligibility

A financial institution has historically supported a portfolio with a high percentage of agency mortgage-backed and callable agency securities. Interest rates have dropped and many of these securities have paid down quickly or have been called. As an alternative investment option, the institution would like to purchase municipal securities (which are not typically accepted by public units as a form of collateralization).

The options: A) Refrain from purchasing municipal securities and continue running the risk of further securities pay-downs. B) Shift to municipal securities purchases and pursue revised investment objectives by deploying a letter of credit program.

Case Four – A Strategic Review of Liquidity Coverage and Income

In the wake of declining margins and a regulatory discussion, a financial institution's management team would like to review means of improving liquidity and income. An increasing portion of public unit deposits is being pledged via securities.

The options: A) Continue to deploy capital toward lower-yielding securities and pressure pledged securities and liquidity ratios. B) Examine the positive implications associated with using low-cost letters of credit. Assess the impact of substituting pledged securities with letters of credit on liquidity ratios and alternatively deploying capital to making loans versus holding securities.

## The Impact of Public Unit Deposit Letters of Credit on Liquidity Ratios and Income

It is valuable for public unit depositories to consider the benefits of diversifying their methods of collateralization. Customized sensitivity analysis involving direction of collateralization away from securities and pledging in favor of letters of credit can yield positive results. Liquidity metrics, including pledged securities and liquidity ratios, can be optimized by reducing the amount of securities that are pledged. In addition to the liquidity benefits of using letters of credit, there is a case to build that repatriation of pledged securities can encourage a financial institution to alternatively deploy capital to higher-yielding loans or other assets.

Figure 2 details a financial institution that currently funds itself with $55 million in public unit deposits. Per its call report, it owns $300 million in marketable securities. 20% of its securities, or $60 million, are pledged. Assumedly, all of its $50 million in uninsured public unit deposits are backed by pledged securities.

This particular institution is also assumed to have a 35% credit line against its $1.286 billion in assets, or $450 million. Available remaining eligible collateral capacity is $150 million.

The member would like to assess the impact of securing a portion of outstanding public unit deposits with a FHLB Des Moines Standby, irrevocable Letter of Credit that would be written in favor of the public unit, in the event the member financial institution failed to perform. Above the FDIC $250,000 insurance limit, the member has historically pledged high-quality treasury and agency securities, in this case assumed to carry a yield of 2.00%, generating an annual income of $1.20 million.

The member would like to consider pledging $25 million of the security requirement in lieu of pledging securities. As such, the member would have the opportunity to redeploy capital to higher-yielding assets such as mortgages, or C&I or commercial real estate loans. In Figure 2 we'll assume that a proxy for an alternative, higher-yielding asset (perhaps SFR mortgages) at 4.25%.

We would next compare the existing securities-generated income with the income from the higher-yielding asset. The $25 million transfer from pledged securities to letters of credit would encourage the institution to generate an additional $534,000 in income.

(SEE PAGE 5 FOR FIGURE 2)

Figure 2: Case Study: The Impact on Select Balance Sheet Ratios and Incremental Income of Securing Public Unit Deposits with Letters of Credit vs. Pledging Securities

**RATIO IMPROVEMENTS OF USING FHLB LOCs**

| | Account Name | | |
|---|---|---|---|
| Member #1234 | Member ABC | Replacing Pledged Sec with FHLB LOCs | Ratio Improvement |
| Reported in '000s | Current | | |
| Financial data as of: | 12/31/2017 | | |
| Liquidity Ratio | 30.00 | 31.23 | 1.23 |
| Pledged Securities Ratio | 20.00 | 11.67 | 8.33 |
| Total PUDs | 55,000 | | |
| Total Uninsured PUDs (Year End Data) | 50,000 | | |
| LOCs Pledged for at FHLB DM | - | 25,000 | |
| Total Securities Pledged (Call Report) | 60,000 | 35,000 | |
| Total Securities Owned (Call Report) | 300,000 | | |
| Total Credit Availability | 450,000 | | |
| Total Collateral Availability | 250,000 | | |
| Total Collateral Exposure | 100,000 | 125,000 | |
| Remaining Borrowing Capacity* | 150,000 | 125,000 | |

*Lower of credit/collateral available

| | |
|---|---|
| Enter $ Amount of FHLB DM LOC Increase/Pledged Securities Decrease | 25,000 |

**NET INCOME IMPROVEMENTS OF USING FHLB LOCs BEFORE USING LOC**

| | |
|---|---|
| Securities collateralizing PUD | $60,000 |
| Yielding Rate | 2.00% |
| Income Earned per Year | $1,200 |

**BEFORE USING LOC**

| | |
|---|---|
| Securities Collateralizing PUD | $35,000 |
| Yielding Rate | 2.00% |
| Income Earned per Year | $700 |
| Reinvestment in higher yielding loans | $25,000 |
| Yielding Rate* | 4.25% |
| Income Earned | $1,063 |
| Amount of LOC | $25,000 |
| LOC Fee | 0.1150% |
| LOC Cost | $29 |
| Net additional income earned | $534 |

**LEGEND**

| |
|---|
| SNL Data |
| FHLB Data |
| Excel Calc |
| Self Input |

## Public Unit Deposit Collateralization: Multiple Benefits to the FHLB Des Moines Member and to the Public Unit Depositor

Standby Letters of Credit issued on behalf of FHLB Des Moines members and in favor of their public unit depositors can: i) help diversify collateralization methods, ii) relieve the administrative complexities of substituting securities, iii) improve member liquidity metrics and iv) encourage members to redirect capital to core, higher-yielding assets. FHLB Des Moines is a widely accepted collateralization counterparty by public units. Feel free to contact your Relationship Manager about the specific impact that FHLB Des Moines public unit deposit Letters of Credit can have on your institution.