

National Association of State Treasurers

Collateralization

May 14, 2009

**Guidelines for Creating and Enforcing
Collateralization Agreements and Gaining
Control of Collateral**

Collateral Agent or Deposit Holder

- Bank insured by FDIC
- Broker insured by SIPC
- Other agent that is not insured

Type of Collateral Held – Investments and Uninvested Funds

- In a custodian failure, uninvested funds may not be available – role of insurance.
- Bank accounts - obligations of the bank to repay funds, such as demand deposits, savings accounts, certificates of deposit, money market deposit accounts.
- Deposit Insurance Limits
 - Bank deposits are currently insured by the FDIC up to \$250,000 per depositor.
 - The limit applies per depositor per bank, and independent government agencies may be treated as separate depositors for insurance purposes.

Type of Collateral Held – Investments and Uninvested Funds

- The insurance limit was increased from \$100,000 to \$250,000 on a temporary basis, originally scheduled to expire on January 1, 2010, at which time the insurance limit will revert to \$100,000 except for certain retirement accounts, unless pending legislation to make the higher limit permanent is passed.
- Non-interest bearing demand deposits, and certain low interest rate deposits at banks participating in the Federal Transaction Account Guarantee Program are fully insured until December 31, 2009, but many banks have opted out of this program.
- Insurance limit may be doubled for government accounts held by certain custodians

Type of Collateral Held – Investments and Uninvested Funds

- SIPC Insured accounts are currently insured up to \$500,000, including up to \$100,000 of uninvested funds.
- Some accounts may be insured by state funds, administered like FDIC insurance but covering excess amounts over FDIC Insurance.
- Whatever the deposit limits are, however, government deposits frequently involve amounts substantially in excess of the applicable FDIC or SIPC insurance limits.

Type of Collateral Held – Investments and Uninvested Funds

- Collateralized Deposits
 - In many jurisdictions, governmental funds are permitted to be or are required to be secured by collateral.
 - Statutes vary from state to state as to the mechanics of collateralization.
 - Rights to collateral are determined by statute and by procedures set forth in the collateral holding arrangements. Typical collateral is Federal treasury obligations, or agency obligations guaranteed by the federal government.
 - Collateral limits must include some margin to account for delays that may occur if the depository institution fails and is taken over by a receiver like the FDIC.

Type of Collateral Held – Investments and Uninvested Funds

- Invested Funds
 - Deposits or other obligations of the agent.
 - Other investments managed by the agent, such as affiliated money market funds.
 - Investments by issuers unrelated to the agent, including treasury securities and other bonds.

Collateral Arrangements Through Control Agreements (Three Party Agreements)

- Investments or accounts held by an independent custodian or agent for the benefit of a depositor, in the form of a three-party agreement: the obligor who owes some performance, the beneficiary who is entitled to that performance, and the independent custodian who holds the collateral to secure the obligations.
- Custodians may provide investment services to invest and reinvest the assets.
- Custodians will invest as directed in permitted investments as specified in the agreement.
- Funds should be invested at all times in order to avoid uninsured balances exceeding the applicable insurance limits.

Collateral Arrangements Through Control Agreements (Three Party Agreements)

- The agreement should allow the beneficiary to restrict the categories of investments, if changes in the market make certain investments less liquid or more risky.
- The agreement should allow the beneficiary to change the collateral agent, possibly based on credit ratings or other objective tests, or in the sole discretion of the beneficiary.

Return of Collateral

- As long as the investments are in the account, their value is determined by the market. Treasury obligations are entitled to the full faith and credit of the United States government. Any investments, including stocks and bonds of all kinds, are treated in the same fashion.
- The value of the investments is not insured, even if the investments are held at an FDIC insured bank or SIPC insured brokerage firm.
- Timing for return of deposits may be affected by the liquidation transition. The agreement should specify notice and procedures for delivery or liquidation of collateral.

Return of Collateral

- If through error or defalcation the investments are in fact not in the account, the depositor may have only claim subject to applicable insurance limits. If the account is at a SIPC-insured brokerage firm, SIPC insurance covers up to \$500,000 of investments, including up to \$100,000 of cash. An FDIC-insured bank, such claims are treated as uninsured except to the extent the claim relates to an insured deposit account (such as cash proceeds held at the time the bank failed).