New bank regulations impact collateralized deposits

Bank capital and liquidity adequacy regulations established in the wake of the global financial crisis are making liquidity management even more challenging for government entities.

“As with all investors, the first challenge for government financial officers, in terms of liquidity management, is today’s historically low interest rate environment,” says Kim Brustuen, Vice President, Corporate Treasury Division – Money Center, at U.S. Bank. “Many government agencies are further hindered by limited investment policies and collateral requirements, particularly in light of Basel III and emerging U.S. rules regulating bank liquidity levels.”

**Basel III ramifications**
Basel III and related regulations are requiring banks to carry more liquidity so that if there is a stress event that produces deposit run-off, the banks have sufficient cash available to meet the needs of their customers. Banks meet these requirements by holding cash at the Federal Reserve Bank, as well as U.S. Treasury securities and some agency securities.

Treasuries and agencies are the same type of securities that banks have traditionally pledged as collateral to back public deposits in accounts that exceed the Federal Deposit Insurance Corporation’s $250,000 coverage level, as required by many states. When a bank pledges bonds as collateral for a government entity’s deposit, for instance, and the bank fails, the entity can take possession of the bonds and sell them to avoid taking a loss, thus protecting taxpayer funds.

“The new bank liquidity standards leave fewer bonds available to be used as collateral for government deposits,” Brustuen explains.

The scarcity of available bonds to be used as collateral limits government financial officers’ access to some bank deposit products and may lower yields on others. “It’s a matter of supply and demand,” she says.

**Addressing the collateral challenge**
Brustuen suggests government financial officers take the following steps to respond to the growing challenge of scarce bank collateral for public deposits:

- Know what your state allows, including the type and amount of collateral required for your respective entity as well as the types of non-collateralized investments allowed. These sometimes include money market mutual funds, bonds, bankers’ acceptances and commercial paper.
- Review your own investment policy to determine if it is more restrictive than what the state statute allows.
- Consider revising your investment policy to ensure your entity has options should collateral availability limit your use of certain vehicles, or to earn a higher yield than collateralized deposit options afford.
- Be selective about which short-term investment vehicles you are using at any given time. Just because a particular investment vehicle is designated as allowable by your policy doesn’t mean you must always be invested in that instrument.

To learn more about how you can respond to the growing challenge presented by bank-deposit collateral requirements or learn more about alternative investments, talk to your U.S. Bank relationship manager or one of our Money Center representatives.
Government financial officers whose agencies accept card payments have a couple decisions to make based on recent card network developments:

- Is it time to invest in the equipment to accept chip-based payment cards?
- Does it make sense to start assessing surcharges on credit card payments?

Let’s look at the card network developments that are prompting the need for these decisions.

**Chip card acceptance**

Chip-based payment cards are also known as “smart cards” or “EMV-enabled” cards. EMV is a global standard for credit and debit cards based on chip card technology.

Chip-based cards provide stronger protection against card counterfeiting than magnetic stripe cards and are growing in use worldwide.

Yet, in the United States, magnetic stripe cards remain the norm. That’s because neither card issuers nor merchants in the United States have been persuaded to pay for EMV technology. Indeed, issuers would have to pay more to produce chip cards and merchants would need to acquire chip-enabled card terminals.

However, the major card networks are beginning to offer incentives to boost adoption of EMV technology. For instance, since last fall (2012), Visa and MasterCard have waived annual validation with the Payment Card Industry Data Security Standard (PCI-DSS) for merchants with at least 75% of their card transactions processed on EMV terminals.

Additionally, beginning in October 2015, Visa, MasterCard and American Express are increasing fraud protection for merchants and issuers adopting EMV technology. With this “liability shift” incentive, generally the party that has the most secure EMV option will be protected from financial liability for card-present fraud losses. For example, if a merchant is chip-enabled but the issuer’s card is not, then the issuer generally will be liable for the fraud.

**Credit card surcharging**

As a result of a recent settlement of litigation brought by merchants against the major card networks, merchants in the U.S. and U.S. territories, starting earlier this year, have been allowed to add a surcharge to certain credit card transactions (but not debit card or prepaid card purchases). The surcharge cannot exceed the merchant discount rate for the applicable credit card surcharged, and can never exceed 4%.

Merchants that choose to surcharge must follow consumer disclosure and other requirements agreed to as part of the settlement. For instance, merchants that plan to assess surcharges on Visa credit card payments must notify Visa and their acquirer at least 30 days before beginning to do so, according to the Visa website. Additionally, merchants must alert consumers to surcharging at the point of sale, both in store and online, and on every receipt.

Despite the settlement, surcharging may not be possible in some states. Ten have laws limiting surcharging: California, Colorado, Connecticut, Florida, Kansas, Maine, Massachusetts, New York, Oklahoma and Texas.

For guidance and assistance in deciding whether to invest in equipment to accept EMV-enabled cards and whether to assess surcharges on credit card payments, contact your U.S. Bank relationship manager.

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**TESTIMONIAL**

On behalf of the Jackson Energy Authority and myself, I want to express our appreciation to U.S. Bank and your staff. Due to issues with an unrelated implementation, we’ve waited over a year for this day to arrive. So, as of May, all of our cashiers are switched over to the Virtual Merchant website for credit card processing and all of our mail is now going through the U.S. Bank Online Electronic Deposit (OED) function. I can’t tell you how relieved and excited I am to finally have this behind us. I wanted to thank you for working so hard and remaining patient as we went through our internal ups and downs and I look forward to a great business relationship. It’s nice to have a partner like U.S. Bank and the wonderful employees we have worked with. Thank you so much!

— Matthew McKenzie
Cashiering Supervisor
Jackson Energy Authority
Jackson, TN

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Past performance is no guarantee of future results. Investing in fixed income securities are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications, and other factors. Investment in debt securities typically decrease in value when interest rates rise. The risk is usually greater for longer term debt securities. Investments in lower rated and non rated securities present a greater risk of loss to principal and interest than higher rated securities. The municipal bond market is volatile and can be significantly affected by adverse tax, legislative or political changes and the financial condition of the issuers of municipal securities. Interest rate increases can cause the price of a bond to decrease. Income on municipal bonds is free from federal taxes but may be subject to the federal alternative minimum tax (AMT), state and local taxes.
Variable Rate Borrowing in a Rising Interest Rate Environment

It has generally become an acceptable industry practice for highly rated entities of size and/or sophistication to maintain a 10% - 20% variable vs. fixed rate debt mix. Over the last few years, however, municipal entities have borrowed more fixed vs. variable rate debt for new money projects, taking advantage of the flat yield curve and long-term fixed rates hovering around all-time lows. This has helped lower the aggregate variable vs. fixed rate debt mix for certain entities.

The volatile interest rate environment over the last few months, however, seems to indicate that we are in the midst of a fundamental shift away from the flat yield curve municipal market participants had come to accept as the new “normal”. Interest rates on intermediate and long-term US treasury and municipal obligations continue to fluctuate with an upward bias due to uncertainty over Federal Reserve policy actions and the strength of the nation’s economy. This has resulted in a steepening of the yield curve, where long-term fixed rates have increased significantly from their lows while short-term variable rates remain stable and hover at their lows. In such a rising rate environment, it is more important than ever for municipal entities to weigh the risks and benefits of financing their projects on a variable rate vs. fixed rate basis.

Municipal entities typically use the following three structures to take advantage of short-term variable rates:

- Variable Rate Demand Bonds (VRDBs) provide market depth and have a proven track record through turbulent market conditions provided that a strong and stable bank counterparty is supplying credit support / liquidity through a letter of credit (LOC) or a standby bond purchase agreement (SBPA). While VRDBs may have a long-term final maturity, the Bank LOC or SBPA providing credit support / liquidity will typically be subject to renewal every 1-7 years and the bonds are subject to daily / weekly / monthly puts by the investor. Underlying credit ratings are required for VRDBs backed by a Bank SBPA but may not be required for VRDBs backed by a Bank LOC. The index on VRDBs is usually SIFMA and typical investors are Money Market Funds.

- Direct Purchases (DPs) have become increasingly popular in recent years and provide municipal issuers with a structure very similar to that of VRDBs with some key differences. With DPs, municipal issuers 1) do not require bank credit support / liquidity (but do use / require bank credit capacity) and thus are not exposed to credit counterparty risk, 2) do not face purchaser puts until the end of the initial DP period (1-7 years), and 3) do not face index spread volatility risk as the bonds will always price at the index + spread during the initial DP period. Underlying credit ratings may not be required for DPs. The index on DPs is usually percentage of LIBOR or SIFMA and typical counterparties are domestic banks. DPs are offered by U.S. Bank.

- Floating Rate Notes (FRNs) have also become increasingly popular in recent years and seek to provide municipal issuers with a structure similar to that of VRDBs with some key differences. With FRNs, municipal issuers normally: 1) do not require credit support / liquidity and thus are not exposed to credit counterparty risk, 2) do not face investor puts until the end of the initial FRN period (1-7 years), and 3) do not face index spread volatility risk as the bonds will always price at the index + spread during the initial FRN period. Underlying credit ratings are required for FRNs and at a minimum need to be in the “A+” and higher category. The Index on FRNs is usually SIFMA and typical investors are Money Market Funds and or Short Duration Funds. FRNs are offered by U.S. Bancorp Investments.

U.S. Bancorp can assist municipal issuers in further assessment and execution of these structures as part of an overall plan as they seek to manage / diversify their capital structure. U.S. Bancorp can offer municipal issuers a full complement of products and services to help evaluate and execute one of these structures.

* Source: Thomson Reuters (based on data available 9/9/13)

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2013 Conference Schedule
Government Banking

Tennessee Government Finance Officers Association 16–18
Wisconsin County Treasurers Association 16–18
Bond Buyers California Public Finance Conference 17–19
Oregon Municipal Finance Officer Association — NW Institute (NWOMFOA) 27–30
The Bond Buyer’s 4th Annual 501(c)3 Super Conference 27–29

OCT
Florida School Finance Officers 6–8
Bond Buyer Transportation Finance/P3 Conference 11–13
Idaho Association of Highway Districts (IAHD) 12–15

NOV
Colorado GFOA 19–21
County Treasurers Association of Ohio 19–21
California State Association of Counties (CSAC) 19–22
Washington State Association of Counties (WSAC) 20–21

DEC
National Association of State Treasurers (NAST) 3–5
Association of California Water Agencies (ACWA) 3–6
Wisconsin GFOA 5–6
Association of Minnesota Counties (AMC) 9–10
Iowa Association of School Boards 20–21

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