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Highlights of the New Ohio Pooled Collateral Program for Public Funds

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AUTHORED ARTICLE | Fall 2016

Published in the Fall 2016 issue of *The Bankers' Statement*

Background

The landscape of collateral requirements for public fund deposits by state and local public entities is changing. Under recent revisions to the Ohio Depository Act (the Act), the Ohio Treasurer is required to develop a new program for the pledging of pooled collateral for public deposits by July 1, 2017, referred to as the Ohio Pooled Collateral Program (the Program). Under current law (in effect until July 1, 2017), depository institutions accepting deposits of public funds (referred to as public depositories) may collateralize such deposits through a pledge of securities for the specific deposit OR a pledge of pooled securities to secure **all** public deposits. Although the pooled collateral system has served to streamline the procedures for collateralization of public deposits, the lack of a centralized collateral monitoring or oversight process requires public entities to manage separate relationships with each public depository. This branched program has also required public depositories pledging pooled collateral to monitor the adequacy of such collateral and has led in some instances to inconsistencies in collateralization of public deposits. The new Program is thus an attempt by the Ohio legislature to "streamline and modernize" the public deposit collateral system in Ohio by allowing public depositories to collateralize all public deposits of state and local public entities, by pledging a pool of collateral to the **state treasurer**, rather than the individual public entities. The state treasurer then, in turn, would contract with the public depositor and public depositories to monitor and hold the collateral on their behalf.

While the Program will be utilized for **all** public deposits of the State of Ohio, political subdivisions may choose not to participate in the Program by accepting only individually pledged collateral for their public deposits. **However, as noted, public depositories seeking to use pooled collateral must participate in the Program.** If the public depository chooses not to "opt into" the Program, it can only accept the deposits of public entities that will allow for individualized collateral. Importantly, the Program does not change the ability of financial

institutions to seek and obtain public deposits in Ohio under the Act. Rather, it provides a centralized mechanism for pooled collateral for all public deposits in Ohio.

The Program will also provide safeguards against fraud and afford local government entities administrative benefits, such as the ability to shift the burden of managing and processing pledged collateral to the state, while maintaining control over their relationships with depository institutions and their choice of collateral. These benefits are among the many reasons that other states, including Tennessee, North Carolina, and Arizona, have adopted statewide pooled collateral programs of their own. While the Act already affords parties the ability to pool collateral against state and local deposits of public funds, the establishment of the Program in 2017 may bring about significant changes to the administrative and regulatory landscape.

Impending Regulatory Changes

Lower Minimum Collateral Requirements for Use of the Program

As stated above, the current regulatory scheme for pooled collateral (arising from Ohio Rev. Code § 135.181) will be replaced with the Ohio Pooled Collateral Program (as mandated by Ohio Rev. Code § 135.182) by July of 2017. Under both statutory provisions, a public depository can elect to pledge a single pool of eligible securities to the benefit of each public depositor to secure the repayment of all such depositor's uninsured public deposits. However, the new Program will require that all such pooled securities be pledged to the Treasurer of State for all state and local public deposits. Qualified trustees holding such pools of collateral must be approved by the Ohio treasurer and must hold the eligible securities in an account indicating the treasurer's security interest. In turn, the Ohio treasurer will hold and monitor the pooled collateral on behalf of the individual public entities.

The minimum market value of such pooled securities will also be lowered from 105% of the total amount of public deposits to be secured to either (1) 102% or (2) an alternative amount as determined by the treasurer. Presumably, the lower collateral minimum stems from the treasurer's ability to more effectively monitor the risk of a statewide collateral pool. In his testimony before the House Finance Committee, Deputy State Treasurer Seth Metcalf emphasized that such an alternative collateral requirement will be a floor, not a ceiling, which local governments may raise if they so desire. In turn, any alternative amount prescribed by the treasurer will be determined by a multi-factor analysis taking into account prudent capital and liquidity management, as well as financial safety and soundness as determined by a third party rating organization.

Enhanced Regulatory Oversight

While, under current law, each public depository is granted an undivided security interest in the collateral pledged by a public depository, such a system lacks a provision for regulatory oversight by the State. The Ohio Attorney General Richard Cordray expressed concern over this deficiency in his 2009 opinion to the state auditor by stating that "when a pool of securities is pledged to secure the repayment of all public moneys deposited with a public depository, it is advisable that a party other than the public depository itself be charged with monitoring the adequacy of the pledged collateral." In response, the Program places responsibility for monitoring the eligibility, market value, and face value of the pooled securities pledged by all public depositories in the hands of the treasurer. A public depository will only be able to substitute, exchange, or release eligible securities deposited with its qualified trustee pursuant to the written authorization of the Ohio treasurer.

Priority of Interests in FDIC Receivership

The current regulatory scheme offers little guidance as to the protection afforded by the Federal Deposit Insurance Corporation (FDIC) to a public depositor that has funds on deposit with a financial institution that is placed in receivership. When a public depositor has a security interest in a pool of securities pledged by a public depository to secure the repayment of all public deposits not otherwise secured by law, the depositor may present a claim for securities in the pool when the FDIC, as receiver, is liquidating or winding up the depository, provided that the depositor's security interest in the securities is: (1) legally enforceable and perfected; and (2) is set forth in a written agreement. However, questions pertaining to enforceability under state law and perfection of security interests are complex and subject to varying interpretations. This lack of clarity has made it difficult to predict with any certainty what conclusion the FDIC or a court of law would reach if they were required to determine, as a matter of federal law, the legitimacy of a depositor's security interest.

The Program seeks to fill this gap by requiring those trustees holding the pooled securities pledged as collateral to enter into custodial agreements with the state treasurer and the respective public depository in which the trustee agrees to comply with "entitlement orders" originated by the treasurer without further consent by the depository. In the event a public depository fails to pay over any portion of the public funds deposited, the Ohio treasurer will be able to demand (on behalf of the public depositor) that the trustee transfer to the treasurer pooled securities equal to the amount requested. Thus, by making it easier for a public depositor to establish "control" over a pool of securities, the Program will provide more protection for public deposits by allowing depositors to more effectively demonstrate to the FDIC or a court of law the legal enforceability and perfection of its security interest in the pooled securities.

Impact of the Program

While the Program has yet to be fully developed, at this time it appears as though the Program will primarily impact those public depositories using pooled collateral for public deposits and the qualified trustees holding such pooled collateral. Because individually pledged collateral is not included in the Program, any political subdivisions and public depositories using this pledging method will be unaffected by these new developments. While substantial changes to the mechanics of pooled collateral are not anticipated at this time, the treasurer's oversight of this process may result in standardization of the criteria for pledged collateral (as noted above) and an increase in the reporting obligations of public depositories and their qualified trustees. Qualified trustees will also need to be approved by the treasurer prior to holding pooled securities pursuant to the Program. However, the implications of this requirement are not yet clear. Despite any general ideas regarding the impact of the treasurer's program, the actual effects of this Program will not be ascertainable until July 2017.

Conclusion

Representative Kirk Schuring stated in his sponsor testimony to the House Finance Committee that the impending Pooled Collateral Program will "eliminate uncertainty as to whether public entities have a fully protected interest in the collateral pledged against their deposits." Indeed, the new Program seeks to modernize the management and protection of public funds by establishing the Ohio treasurer as the sole administrator of all pooled collateral within the state. Rulemaking for the Program is underway in the

treasurer's office. The Program will impose lower collateral requirements for pooled securities, establish enhanced regulatory oversight, and provide public depositors with added means of demonstrating legal enforceability and perfection in the event a public depository is taken into receivership. As a result, institutions accepting public deposits or serving as trustees for pooled securities pledged as collateral for public deposits should be ready to address the requirements of the Program when it is uncovered in 2017.

