

COLLATERALIZATION REQUIREMENTS FOR STATE DEPOSITS

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FOREWORD

This report on the State's collateralization requirements for public deposits is submitted to the Legislature pursuant to House Resolution No. 246 which was adopted during the Regular Session of 1988.

This effort would not have been possible without the assistance of the many individuals who contributed their expertise to this report. The Bureau wishes to acknowledge the valuable assistance provided by the Finance Division of the State Department of Budget and Finance and the Treasury Division of the City and County of Honolulu Department of Finance. The Bureau also wishes to acknowledge the assistance of the many banks and savings and loan associations that contributed their time and knowledge to this report.

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Chapter 1

INTRODUCTION

House Resolution No. 246 (Appendix A) was adopted by the House of Representatives during the 1988 Regular Session of the Legislature in response to the controversy which arose over the introduction and eventual passage of Senate Bill No. 3175, entitled: "A Bill for an Act Relating to the Deposit and Investment of State Funds." Senate Bill No. 3175, was offered at the request of the State Administration as the result of a 1987 survey conducted by the Department of Budget and Finance which found that among the eleven western states participating in the survey, the State of Hawaii received the lowest rate of interest on public funds placed in time certificates of deposit (CD) with financial institutions authorized to conduct business within that state. According to the survey, the average annual interest earned by the State on investments placed in CDs during 1987 was 5.75 percent while the average interest earned by other state treasuries on comparable investments during the same period was approximately 7.27 percent.

The purpose of S.B. No. 3175 was to provide the Director of Finance with "greater flexibility" in the banking of public funds and to "improve on the rate of return thereon consistent with the safety of such deposits".¹ In essence, the bill provided the Director of Finance with the authority to deposit state funds in out-of-state depositories by removing the restriction that all such funds should be deposited with financial institutions authorized to conduct business in the State of Hawaii. The intent of the measure was to provide the director with the opportunity to invest state funds in depositories that may be offering higher yields and to perhaps encourage those in-state institutions receiving deposits of the State to offer rates of interest more comparable to those being offered on the mainland marketplace.

The members of Hawaii's banking and savings and loan associations collectively opposed the passage of the measure citing the economic benefits which, they contended, would be forfeited by the State in its pursuit of the outwardly attractive yields being offered by other banks.² Critics of the measure warned the Legislature of the possible disruption of the "multiplier effect" which purportedly internalizes the benefits of an in-state deposit to the economic network of that particular state by providing local depositories with the capacity to increase their lending of mortgages and consumer loans to the community which, in turn, would result in the expansion of the taxable base of that state and its counties. The banking industry cautioned that this policy would result in the exportation of public funds along with the economic advantages associated with the investment of such funds locally.

In addition to the preceding argument, representatives of the local banking industry also expressed their concern over the State's deposit collateralization policies--claiming that the "stringent practices" of the State constituted a primary factor in the banking industry's inability to offer better rates of interest on state deposits.³ Bank association representatives claimed that the State's practice of accepting only those securities exhibiting the highest degrees of security and liquidity (usually direct or indirect obligations of the federal, state, and local governments) as collateral against

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the State's deposit, played a major role in the local industry's growing difficulty and unwillingness to readily accept such deposits. The bank association testified that the State maintains "a very restrictive collateralization requirement" and that deposit security is achieved only at a "cost in the earning power" of the public deposit.⁴

Bank representatives testified that "other states do not have such stringent collateralization policies" and therefore "earn more but at a cost of greater risk" to the public deposit.⁵ A suggestion was submitted to the House Committee on Finance to study the collateralization policies of the State to enhance its investment earnings.

Despite the controversy which followed the measure throughout its legislative review, S.B. No. 3175, S.D.1, H.D.1, was approved by the Legislature and was signed into law by the Governor as Act 78, Session Laws of Hawaii, Regular Session of 1988.

House Resolution No. 246 was adopted to address the issues and concerns brought to light during the 1988 session of the Legislature regarding public deposit collateralization in Hawaii. House Resolution No. 246 requests the Legislative Reference Bureau to:

- (1) Study and review the State's collateralization requirements for the deposit of public funds;
- (2) Determine whether higher investment yields could be obtained on public deposits through the adoption of less stringent collateral standards without compromising fiscal prudence;
- (3) Examine whether greater flexibility in the acceptance of various other types of securities enumerated in section 38-3, Hawaii Revised Statutes, would allow financial institutions which are not currently depositories of state funds to receive such deposits; and
- (4) Examine the actual programs and collateral requirements of other states.

This report has been divided into seven chapters. Chapter 1 is the introduction. Chapter 2 reviews the basic theories and rationale behind public deposit protection programs and briefly analyzes the problems generally encountered by depositories in collateralizing public deposits. Chapter 3 presents an historical overview of the State's statutory requirements relating to deposit collateralization and examines the cash management program of the state Department of Budget and Finance. Chapter 4 examines the problems and difficulties of local depositories in collateralizing the State's deposits and outlines the proposals and alternatives submitted by several public depositories for consideration in this report. Chapter 5 reviews several deposit protection programs currently maintained in other jurisdictions. Chapter 6 examines the background of section 38-3(9), Hawaii Revised Statutes, and discusses the function and purposes of the Federal Reserve System on which the provision has been based. Chapter 6 also evaluates the alternatives submitted by local depositories (which were outlined in Chapter 4). Chapter 7 summarizes this report and presents its recommendations.

Chapter 2

INVESTMENT OF PUBLIC FUNDS

While the focus of public finance has typically centered on issues such as taxation, debt management, and budgeting, the investment function of the public sector plays a critical role in the fiscal performance of government, constituting an important source of non-tax earnings to state and local governments. With the steady growth of public sector revenues throughout the middle decades of this century, the trend among most state and local governments has been to broaden their reliance on the investment, management, and custodial services of the banking industry. State and local governmental investments currently held in time and demand deposits and other investment securities nationwide have been estimated to exceed \$1 trillion.¹

Banks, savings and loan associations (S&Ls), and other thrift institutions² make up the variety of financial institutions typically entrusted by governments to manage and safeguard their balances of "idle funds"--cash reserves which may be in excess of the governmental entity's immediate budgetary needs and can either be put to work earning the highest interest possible or be allowed to remain idle and unproductive.³ Interest earnings on state and local treasury investments nationwide in 1985 were estimated to have exceeded \$33.2 billion.⁴ Moreover, while the advantages to public entities are clearly evident, such investments are also viewed as beneficial to the economy as a whole. Public, as well as private sector benefits which are theoretically re-injected and "multiplied" throughout the network of a local economy are believed to occur with the investment of public funds in local area institutions. Financial institutions have become an essential component of the fiscal administration of government as well as the economy.

State and local governments can no longer afford to function without the involvement and assistance of the banking and thrift sectors. However, the collapse of a financial institution should under no circumstances be allowed to jeopardize the safety and liquidity of funds held in trust for the benefit of the public. The recent failures of banks and S&Ls in certain areas of the country have brought about a new awareness of the importance of proper cash management and deposit protection among government finance officials and decision-makers. Banks and S&Ls have failed in numbers unparalleled since the Great Depression; the Federal Savings and Loan Insurance Corporation (FSLIC) faces serious financial problems; and troubled banks and S&Ls continue to operate despite the threat they may pose to the stability of solvent competitors, the federal deposit insurance funds, and the banking and thrift industry as a whole.⁵ The Federal Deposit Insurance Corporation (FDIC) reports that in 1986, 138 banks failed, and in 1987, 184 banks failed.⁶ Currently there are approximately 1,600 insolvent or nearly insolvent banks on the FDIC's problem bank list--200 banks were expected to close their doors to business by the end of 1988.⁷ Moreover, the Federal Reserve System reports that since many institutions' book values exceed their market values, current book value accounting practices will probably understate the number of institutions that are insolvent on a market value basis.⁸

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The nation's financial crisis extends even further within the S&L industry. The Federal Home Loan Bank Board (FHLBB) estimates that about one in six of the country's more than 3,100 S&Ls is technically bankrupt and that nearly one-third of the industry is losing money.⁹ At the end of 1986, the S&L industry had a net worth of \$17.4 billion; by June 30, 1988, it was down to \$5 billion.¹⁰ Estimates of the cost of the banking industry's "bailout" by the FDIC in 1988 range from \$3 billion to \$9 billion while FHLBB estimates placed the price of eliminating 217 insolvent S&Ls in 1988 at \$38 billion.¹¹

Collateralization of Public Deposits

Public deposit security, which in the past has often been taken for granted, has presently become an issue of considerable concern for treasury managers at all levels of government. To ensure the safety and liquidity status of public deposits, 43 states have enacted public deposit collateralization statutes that require depositories to pledge marketable securities against the deposits of the public investor.¹² These actions appear consistent with section 5153 of the National Banking Act which requires banks to "give security for the safe-keeping and prompt payment of money so deposited of the same kind as is authorized by law of the state in which such association is located."¹³ A literal translation of this provision places the responsibility of deposit collateralization solely on the discretion of the state.

Most public deposit collateralization requirements were enacted during the 1930s when the failure of the economy led to the nation's greatest banking disaster. During the four-year period from 1930 through 1933, there were nearly 9,100 failures of financial institutions in the United States.¹⁴ The situation led to the greatest reform ever to occur in the banking industry. In 1933 the Glass-Steagall Act was enacted by Congress prohibiting interest payments on demand deposits, eliminating investment banking activities and establishing the Federal Deposit Insurance Corporation. The rationale of government in developing regulatory safeguards such as these was based on the conviction that the deposits of government as well as the public deserve protection. Moreover, the lessons learned over the course of the banking crash of 1929 led Congress and the states to recognize the importance of governmental stability during severe economic situations such as a banking panic to ensure the maintenance of public order. Properly secured deposits may provide governmental entities and the public with the assurance that their investments are not jeopardized. Rather than contributing to collapse of a nearly insolvent institution by withdrawing its unprotected accounts, government investors may utilize properly secured deposits to work toward the institution's as well as their own advantage in providing institutional stability and deposit security.

A second concern pervasive among depositors maintaining large accounts of public funds is the limited extent to which their deposits are protected under existing federal deposit protection insurance programs. Virtually all governmental units take advantage of the deposit insurance protections provided by the federal government. However, while the federal insurance guarantee of \$100,000 per deposit may seem more than adequate to serve the needs of most private account holders, this guarantee protects but a miniscule percentage of the deposits of most public entities whose accounts often range

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in the billions of dollars. With few exceptions, FDIC and FSLIC insurance coverage extends to only a single \$100,000 deposit at any given depository.¹⁵ For example, assume that a treasury invests \$110,000 in a certificate of deposit with a depository where it maintains \$90,000 in a demand account. Under present FDIC coverage, the demand account of \$90,000 would be protected but only \$10,000 of the certificate of deposit would be insured. Should the depository fail, the unprotected \$100,000 may prove to be a monetary loss. Obviously, for investors with larger amounts deposited, the losses would be more substantial. Collateralization provisions provide deposit balances in excess of the FDIC and FSLIC limits with the requisite level of deposit security and liquidity.

Apart from the considerations of deposit security and liquidity, local governments, in the past, often viewed collateralization requirements as an indirect incentive toward the bank and thrift industries to pledge municipal debt as their instruments of collateral. Several proposals to provide 100 percent federal deposit insurance coverage for public deposits have been considered by Congress.¹⁶ However, in 1974, when Congress was considering such a proposal, state and local officials asserted that their borrowing costs would be increased because the banks in many states would no longer be required or inclined to purchase municipal securities for public deposits.¹⁷ Congress held off on the enactment of full deposit insurance for public deposits at least partially because of the lack of substantive information it had regarding the effect such actions would have on the home mortgage industry and the issuance of state and municipal obligations.¹⁸

Although research suggests municipal borrowing costs have indeed been reduced as a result of collateralization requirements, recent federal tax law amendments have eliminated many of the advantages formerly associated with the municipal bond market. Prior to the amendments, income from municipal bonds had been exempt from federal income taxes, so investors in high-income brackets found this type of bond to be an attractive investment. Among tax reform's negative effects for municipal issuers is the thinning-out of some groups of buyers such as banks and corporations. Banks, for instance, lost almost all the tax advantages they had for investing in tax-exempt bonds and have gone from being holders of 35.1 percent of all outstanding tax-exempt bonds in 1985 to holders of 25 percent in mid-1987.¹⁹

Cash managers operating in the public sector deposit funds for short-term purposes; their primary objectives are security and liquidity. Yield considerations, although often discussed, have been subordinated by the priority to protect capital. Typically, "risk-free" government securities such as United States Treasury obligations, federal agency issues, and state and municipal obligations which have an active "secondary market" are required to be placed in escrow with the treasury or an independent trustee such as a federal reserve bank.

Contingent on factors such as credit quality, marketability, maturity, and the extent to which the security may be directly or indirectly guaranteed by government or any other entity, collateral valuation ratios based on the market value of the pledged security in consideration with the dollar amount deposited may range from 100 to in excess of 200 percent. This sliding scale concept ensures compensation toward the depositor for the time, expense and risk involved in liquidating inferior or less marketable securities. The

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valuation formula establishes the amount of assets in the form of collateral securities required to be pledged by the depository in proportion to the balance of deposits held in the public account. This relationship is converted into a pledging ratio which is simply the dollar amount of the security needed to fully collateralize one dollar of the public deposit. The pledging ratios for government-insured, performance-tested investment securities such as United States Treasury bills, notes and bonds are generally based on or nearly at the par value of the security (i.e., approximately a dollar-for-dollar basis--about 100 to 102 percent), while the pledging ratios of securities issued by lesser governmental units may range from 100 to 125 percent--meaning that a minimum of \$125 in municipal bonds may be needed to secure \$100 of the public deposit.²⁰ Experimental, untested, or uninsured instruments of, for example, private corporations may be assessed pledging requirements of 200 percent or more.²¹ In the event of a bank failure, the public depositors can liquidate the collateral in the marketplace--hopefully in a timely manner, and on a dollar-for-dollar basis.

Collateral pledging transactions range from the traditional arrangement in which a depository transfers custody of its collateral instruments to the public depositor or a trustee in exchange for the deposit, to the somewhat more specialized "repurchase agreement". A repurchase agreement consists of two simultaneous transactions. The first is the purchase of securities used as collateral by an investor from a dealer (which can be a bank). The second is an agreement by the dealer to repurchase the securities (at a predetermined date) structured so that the investor receives a known return. The transaction is viewed as a simultaneous sale and purchase of collateral securities. A repurchase agreement is thus a short-term loan from the investor to the dealer. Open repurchase agreements are an excellent investment vehicle as a replacement for bank time certificates of deposit in that it allows the investor to tailor the time period to meet investment needs at a known rate of interest. These agreements do not have a fixed maturity and collateral can be pledged since it is either a buy and sell agreement or a collateralized loan depending on the legal interpretation.²²

The collateralization programs of the various states and municipalities vary in accordance with the overall guidance provided under their respective state laws. In general, collateralization programs can be grouped into three broad categories: (1) those states requiring no collateralization programs; (2) those programs requiring partial deposit collateralization; and (3) those programs requiring full deposit collateralization. Programs requiring full deposit collateralization are the most pervasive while the states of Florida, Washington, and Connecticut maintain partial or "collateral pool" arrangements with their depositories.²³ The collateral pool alternative is based on the presumption that financial institutions located within a given state should collectively pledge at least enough collateral securities to provide adequate protection against default by the institution maintaining the largest deposits of the state or municipal investor. Thus, if the largest bank in a state were to hold 25 percent of all public deposits, the appropriate ratio of collateral pledging would be 25 percent per institution. This shared risk approach results in an arrangement that protects against any individual depository's collapse by requiring a collateral pool that exceeds the total public deposits in the largest financial institution.

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Obviously, in situations where a state requires no collateral, placing funds in certificates of deposit with local institutions would amount to an "unsecured loan" to local depositories. Given these circumstances, the only alternative would be to secure the best bank evaluation service available and follow its recommendations as to the creditworthiness of local institutions.

The Cost of Deposit Collateralization

Despite government's conviction that collateral requirements perform an essential function in securing the property of the public, arguments have been raised in regard to the apparent privileged status afforded to public deposits. One argument regarding public deposit protection programs is that they impose excessive costs upon financial institutions seeking to conduct business with public entities. The Government Finance Officer's Association (GFOA) found in 1984 that many financial institutions charged their public clients from 25 to 200 basis points (.25 percent to 2.00 percent) in diminished yield for the administrative costs of providing collateral securities to secure public deposits. Typically, the cost is passed on to the depositor through a reduction in the interest rates offered by the institution.²⁴

The rate of interest is also affected by the profit margin of the institution. Any institution that accepts a public deposit does so in order to make a reasonable profit. It should be understood that an institution's earnings on investment securities (i.e., U.S. Treasury notes, bonds or bills) used as collateral is often less than the return the institution may receive on its loans.²⁵ Given their strong preference for lending over investing in securities, commercial banks may have little "left over capacity", if any, to add to its investment portfolios beyond secondary reserve requirements particularly during periods of strong loan demand or restrictive monetary conditions. Due to these factors and the costs of maintaining collateral in safekeeping, the depository's return on collateralized deposits may be diminished.²⁶

Deposit collateralization policies may place even greater constraints on smaller institutions which tend to be more aggressive than larger banks in their loan programs and may have even smaller secondary reserves. Collateralization requirements may restrict the lending potential of the institution to the extent that the bank may be required to use its deposits to buy securities to pledge as collateral for the public deposits.²⁷ The result may be that smaller banks may find that the "loanability" of public deposits, especially during periods when loan demands are high, may be very limited.

The Congressional Advisory Committee on Intergovernmental Relations observed in 1979 that the effects of collateral pledging on the banking system may include the following:²⁸

1. The ability of banks to lend may be affected.
2. Banks may be prohibited from achieving their desired portfolio composition. State programs that require collateral pledges equal to 100 to 110 percent of their deposits are costly to banks and may negatively impact their portfolio composition and liquidity.

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3. Liquidity of the financial institution may be weakened. When a pledged security is sold, it must be replaced with another eligible security. This time consuming process may unduly affect the yield of the investments, especially in smaller banks or those with substantial public deposits.
4. Collateral requirements tend to lower the rates banks are willing to pay for public deposits.
5. The effect on bank earnings, while unmeasured in total, is recognized to be negative.

Conflicts over the issue of public deposit collateralization between government and the banking industry occur nationwide. Indeed, the difficulties experienced by the banking establishment in Hawaii have been experienced by depositories accepting public funds in other areas of the country. However, there is no indication that state and local collateralization programs throughout the country are relaxing their collateral requirements. Instead, the current trend in the nation is toward more diligent collateral monitoring and valuation routines and stricter collateral evaluation standards. Government's obligation toward safeguarding the resources of the public and the evident instability of much of the nation's banks and thrifts have served to foster a more conservative approach in the management, investment, and protection of public deposits.

Chapter 3

DEPOSIT COLLATERALIZATION IN HAWAII

Historical Development of Section 38-3, Hawaii Revised Statutes

Hawaii's statutory requirements for public deposit collateralization were enacted in 1909 by the Territorial Legislature and later codified as section 133-3, Revised Laws of Hawaii. While the original requirements for deposit collateralization have been expanded and amended substantially over the years, the basic objective and intent of the original law has remained intact--to ensure the safety and liquidity of public deposits.

As it appears in the Revised Laws of Hawaii, 1955, section 133-3 required depositories accepting deposits of public funds to place in the custody of the treasury, bonds or warrants of the Territory, the United States, or any city of the United States in amounts at least equal to the par or market value of the security in the amount of funds deposited, contingent on the class of security accepted as collateral. The law further authorized the acceptance of industrial bonds approved by the courts of the Territory in an amount at least 25 percent in excess of the deposit placed in any bank. It is important to note that while the classes of securities eligible to be pledged as collateral were identified under the law, the ultimate determination as to the acceptability of such securities as part of the treasury's portfolio was left to the judgment of the treasurer.

In 1968, the Legislature reformatted chapter 133, Revised Laws of Hawaii, and recodified it as chapter 38, Hawaii Revised Statutes. Securities acceptable by the director of finance as collateral were now assembled into nine categories of eligible instruments including bonds, bills, notes, debentures, warrants, other evidences of indebtedness and other safe bonds approved by the governor issued by: the State, its counties, its agencies and any improvement district or frontage improvement of the State; the federal government and its agencies; and, other states and their counties.

Recognizing the potential benefits public deposits may have on the promotion of mortgage lending by banks and savings and loans into the community, the Legislature, in 1970, expanded the State's collateralization standards to include residential mortgages guaranteed by the federal government. To ensure security, however, the amendment also provided that in the acceptance of such securities as collateral, the director of finance "shall require mortgage loans representing no less than \$120 of the unpaid principal for each \$100 of deposit". Senate Standing Committee Report No. 505-70 predicted that the bill would "help relieve the housing shortage and reduce interest rates on home mortgages to the taxpayer". The committee report further qualified, however, that since the provisions were not mandatory, state and county treasurers would be allowed to "use their discretion" in developing their portfolios. The measure also incorporated a provision taken from California law which permitted the director to forego the need to collateralize that portion of a deposit that was already insured under deposit insurance programs of the federal government.

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In 1978, the issue of public deposit collateralization was reviewed by the Committee on Taxation and Finance of the Constitutional Convention. The primary focus of the committee was the inequitable distribution of public funds between commercial banks and local savings and loan associations. Resolution No. 26 noted that 99.7 percent of the State's deposits were placed in local banks, while a total of only 0.3 percent was deposited with S&Ls.

Standing Committee Report No. 102 contended that "public funds should be distributed among financial institutions on a more equitable basis." The committee observed that the situation at that time appeared to stem from "a concern that federally insured home loan mortgages do not constitute sufficiently secure or liquid collateral." The committee felt that the acceptance of such instruments as collateral would permit the local S&L industry to participate in the public funds market to a greater degree. The committee noted that larger deposits of public funds in local S&Ls would assist these institutions in the financing of more home mortgage loans and that such deposits would have a favorable effect on Hawaii's economy.

Although it felt that a constitutional amendment to address the problem was inappropriate, the committee resolved that a more equitable distribution of the State's deposits among all institutions was desirable and that S&Ls should receive a larger share of the State's public funds.

A significant amendment to Hawaii's collateralization requirements occurred during the Regular Session of 1984. House Bill No. 2527-84, as originally drafted, proposed to reduce the percentage of collateral required to be pledged on the amount of a public deposit from 100 to 50 percent. Testimony presented before the House Committee on Finance by local banking representatives pointed to several factors which, they argued, made the policy change necessary:¹

- (1) The highly volatile rates of interest during the early 1980's caused by the change in the Federal Reserve System's economic policy in 1979 from one which focused on controlling the economy's interest rates to one which focused on controlling the money supply;
- (2) The relative increase in the amount of public funds placed in local depositories (requiring collateralization) during that period of time; and
- (3) The decline in investment securities held by local depositories as a percentage of their total assets.

Faced with continuing demands for consumer loans, bank representatives testified that local depositories were confronted with a situation in which the acceptance of public deposits represented a reduction in, rather than a source of, lendable dollars by a bank. Supporters of the measure held that a reduction in the deposit collateral requirement from 100 to 50 percent would afford more flexibility to the banking industry in meeting the public's demand for loans.²

The state administration opposed the measure as originally introduced, stating that the proposed amendment would result in the exposure of that

portion of the State's deposits not subject to collateral protection to potential loss.³ In response to this concern, the House Committee on Finance amended the measure with an alternate amendment offered by the banking industry. House Standing Committee Report No. 435-84 reported that the compromise would not only "provide much of the additional flexibility required by the banks" but that it would also ensure "the necessary protection against risk of loss by continuing the State's requirement for full collateralization".

Although the amendment that was finally incorporated into the bill bore no resemblance to that which was proposed in the original draft, members of the banking industry held that the measure would facilitate the achievement of the same result. Rather than limiting the extent to which the treasury could collateralize its deposits, the bill, as amended, provided the director with the discretion to consider a wider variety of investment security alternatives as eligible for collateral pledging. In effect, the new amendments to section 38-3 authorized depositors of public funds to consider other assets on the books of a depository "which are eligible to secure advances from the Federal Reserve Banks under the regulations of the Federal Reserve Board" as eligible collateral, provided that no more than 50 percent of the public deposits held by a depository could be secured by assets of that class.

In essence, section 38-3(9) became a "catch-all" clause, constituting the broadest, most all-inclusive category of eligible collateral securities in the section. Conceivably, because of its broad applicability over the entire section, paragraph (9) possessed the capacity to stand alone as a single all-encompassing category. However, due of the fact that the paragraph also enabled the acceptance of collateral securities which fell beyond the former scope of the section, paragraph (9) requires special analysis (see Chapter 6).

The most recent amendments to chapter 38, Hawaii Revised Statutes, occurred during the Regular Session of 1988 as the result of the passage of S.B. No. 3175, S.D. 1, H.D. 1. While the amendments effected upon section 38-3 were completely nonsubstantive, the State's policies regarding public deposit collateralization were brought to the forefront of the discussion. House Resolution No. 246, which calls for this study, was a direct result of the introduction and passage of the administration measure.

Senate Bill No. 3175, was introduced in response to the state administration's concern over the relatively low returns that were being earned on state funds placed in time certificates of deposit (CD) in local depositories. According to a November 1987 survey of eleven western states performed by the Department of Budget and Finance (Exhibit 3-1), the State of Hawaii earned the lowest return on public funds placed in such investments. As the survey indicates, the average annual yield earned by the State on CDs during 1987 was 5.75 percent while the average interest rate earned by other state treasuries on comparable investments during the same period was 7.27 percent. Concern over the State's declining earnings during fiscal years 1986 and 1987 was also an important factor in the department's decision to support the bill.

Exhibit 3-2 presents the State's general fund investments and interest earnings over the past four fiscal years. Note that the illustration contrasts the annual earnings of the general fund with the yearly investments of the State at the average rate of interest received for each fiscal year. While the

Exhibit 3-1

SURVEY OF YIELDS ON INVESTMENTS ON TIME CERTIFICATES OF DEPOSIT BY STATE TREASURIES IN THE WESTERN REGION OF THE UNITED STATES AS OF NOVEMBER, 1987

Name of State ⁽¹⁾	Total Amount of Funds Managed (In Millions)	Amount of Total Invested in Time Cert. (In Millions)	Approximate Annual Yield on Time Cert.	Average Length of Invest. in Time Cert. (in # of Days)	Collateralization Required - Percent	Current Rates Payable on 90 day Time Cert.
Arizona (out-of-state)	\$2,600	\$150	8.00%	20	yes - 100%	not available
California	18,279	687	6.98%	54	yes - 110%	7.75%
Colorado	600	232	7.18%	not available	yes - 100%	not available
Hawaii	1,090	1,082	5.75%	90	yes - 100%	5.50%
Idaho	310	22	7.18%	272	no	not available
Montana (in-state)	545	13	7.25%	180	yes - 50%	6.85%
(out-of-state)		530	7.18%	30	no	6.85%
Nevada	600	70	7.00%	90	yes - 100%	7.00%
New Mexico	7,000	1,000	7.32%	471	yes - 100%	not available
Oregon	3,000	15	8.95%	60	yes - 25%	8.95%
Utah (in-state)	1,028	44	7.29%	55	no ⁽²⁾	6.50%
(out-of-state)		493	7.44%	101	no	7.50%
Washington	952	86	6.02%	91	yes - 10%	6.02%
Wyoming	2,700 ⁽³⁾	350	6.80%	340	yes - 100%	not available

Footnotes:

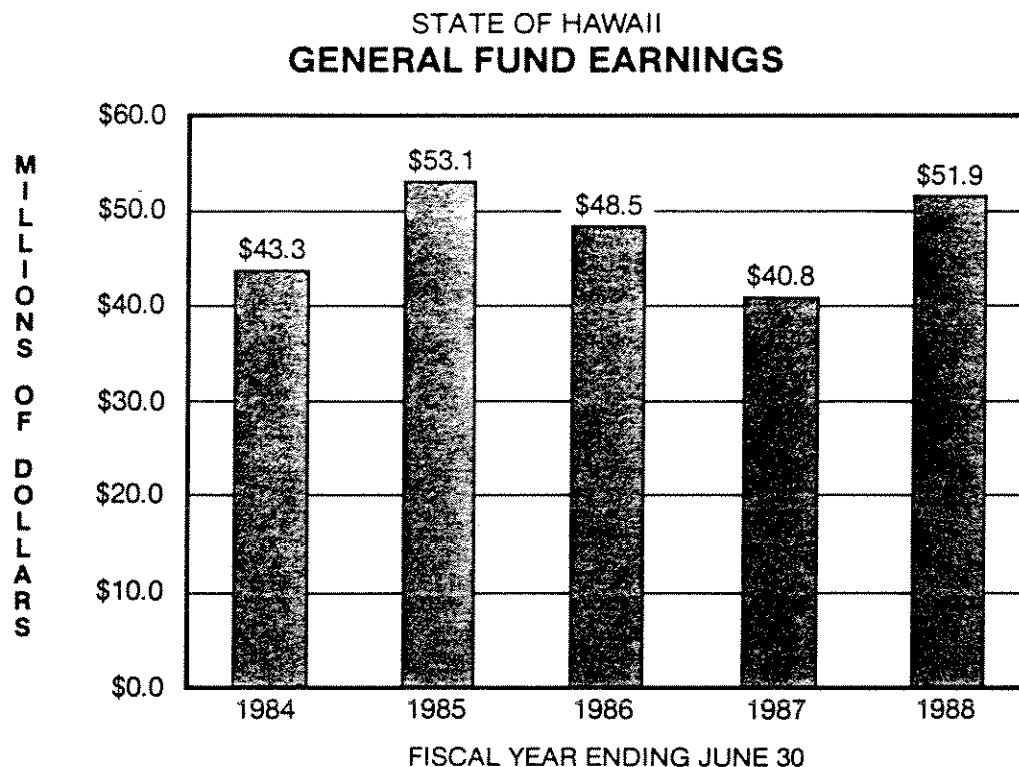
(1) Investments are in-state only, unless otherwise noted.

(2) Utah law does not require collateralization of public deposits. With respect to in-state institutions, an allotment is established based on the ratio of adjusted capital to assets. With respect to out-of-state institutions, the Money Management Council has established quality criteria and maximum deposit limits.

(3) Investments in the State of Wyoming are in contract form, instead of a certificate of deposit.

Source: Department of Budget and Finance, *Report on Survey on Rates of Return on Time Certificates of Deposit as State Investments*, 1987, p. 1.

Exhibit 3-2



Average State General Fund Investments with
Financial Institutions in the State of Hawaii

1984	\$496,344,000
1985	575,366,000
1986	666,632,000
1987	737,297,000
1988	910,526,000

Source: State of Hawaii "Annual Report of Deposits and Investments of State of Hawaii Fiscal Year Ending June 30", 1988, p. 9.

COLLATERALIZATION REQUIREMENTS FOR STATE DEPOSITS

yearly investments of the State steadily increased throughout the period, the earnings of the general fund exhibited actual declines during fiscal years 1986 and 1987. The apparent reason behind the diminishing earnings of the State during this period was the declining rates of interest earned on state deposits for those fiscal years.

The purpose of S.B. No. 3175 was to provide the Department with "greater flexibility in the banking of public funds" and to "improve on the rate of return thereon consistent with the safety of such deposits".⁴ In essence, the bill provided the Director of Finance with the authority to deposit state funds in out-of-state depositories by removing the restriction that all such funds should be deposited in financial institutions authorized to conduct business in the State. The intent of the measure was to provide the Director of Finance with the opportunity to invest state funds in out-of-state depositories offering higher yields and to perhaps encourage those in-state institutions receiving deposits of the State to offer rates of interest more comparable to those being offered by depositories on the mainland.

The members of Hawaii's local banking and savings and loan associations collectively opposed the passage of the measure citing the economic benefits which, they contended, would be forfeited by the State in its pursuit of the outwardly attractive yields being offered elsewhere by other banks.⁵ Critics of the measure warned the Legislature of the possible disruption of the "multiplier effect" which purportedly internalizes the benefits of an in-state investment to the economic network of that particular state by providing depositories with the capacity to increase their lending of mortgages and consumer loans to the community which, in turn, would result in the expansion of the taxable base of that state and its counties. Bankers cautioned this policy would amount to the exportation of public funds along with the economic advantages associated with the investment of such funds locally.

In addition to the previous argument, representatives of the local bank association also expressed their concern over the State's deposit collateralization policies--claiming that the "stringent practices" of the State constituted a primary factor in the banking industry's inability to offer better rates of interest on state deposits.⁶ Bank association representatives testified that the State's policy of accepting only those securities exhibiting the highest levels security and liquidity, played a major role in the local banking industry's growing difficulty and unwillingness to readily accept such deposits. The bank association testified that the State maintains "a very restrictive collateralization requirement" and that deposit security is achieved "only at a cost in the earning power" of the deposit. Bank representatives testified that "other states do not have such stringent collateralization policies" and therefore "earn more but at a cost of greater risk" to the public deposit.⁷

Despite the controversy which followed the measure throughout its review, S.B. No. 3175, S.D. 1, H.D. 1, was approved by the Legislature and was signed into law by the Governor as Act 78, Session Laws of Hawaii 1988. Exhibit 3-3 is a reproduction of section 38-3, Hawaii Revised Statutes, as amended by Act 78, Session Laws of Hawaii 1988.

Exhibit 3-3

§38-3 Securities for protection of funds deposited. For the protection of funds deposited by the director under this chapter, the following securities shall be deposited with the director, or with banks in the continental United States, or with financial institutions with trust powers authorized to do business in the State, as the director may select, to be held therein for safekeeping subject to the order of the director, any other provisions of the laws of the State to the contrary notwithstanding:

- (1) Bonds, notes, debentures, or other evidences of indebtedness of the State or of any county of the State, for which the payment of the interest and principal is a direct obligation of the State or the county, as the case may be, in an amount at least equal in their par value to the amount of the deposit with the depository;
- (2) Bonds, notes, debentures, or other evidences of indebtedness of agencies of the State or of agencies of any county of the State, for which the payment of the interest and principal is from the revenues of the issuing agency, in an amount at least equal in their market value, but not to exceed their par value, to the amount of the deposit with the depository;
- (3) Bonds, notes, debentures, or other evidences of indebtedness of any improvement district or frontage improvement of any county of the State, for which the payment of the interest and principal is from the assessments made for the improvement, in an amount at least equal in their market value, but not to exceed their par value, to the amount of the deposit with the depository;
- (4) Bonds, notes, bills, or certificates of indebtedness of the United States or of agencies of the United States, for which the payment of the interest and principal is a direct obligation of the United States, in an amount at least equal in their market value, but not to exceed their par value, to the amount of the deposit with the depository;
- (5) Bonds, notes, or debentures of agencies of the United States, in an amount at least equal to ninety-five per cent of their market value, but not to exceed their par value, to the amount of the deposit with the depository;
- (6) Warrants or warrant notes of the State in an amount at least equal in their face value to the amount of the deposit with the depository;
- (7) Bonds, notes, debentures, or other evidences of indebtedness of any other state of the United States, for which the payment of the interest and principal is a direct obligation of such state, in an amount at least equal in their market value, but not to exceed their par value, to the amount of the deposit with the depository;
- (8) Bonds, notes, debentures, or other evidences of indebtedness of any city or of any county in the continental United States, for which the payment of the interest and principal is a direct obligation of the city or county, as the case may be, in an amount at least equal in their market value, but not to exceed their par value, to the amount of the deposit with the depository; or
- (9) Other assets on the books of the depository which are eligible to secure advances from the Federal Reserve Banks under regulations of the Federal Reserve Board, in an amount at least equal in their market value, but not to exceed their par value, to the amount of the deposit with the depository; provided that not more than fifty per cent of the deposits held by a depository may be secured by assets of this class.

Security shall not be required for that portion of any deposit that is insured under any law of the United States.

Securities deposited under this section may be withdrawn from time to time; provided that the required amount of securities shall at all times be kept on deposit. The director at any time may require additional securities to be deposited under this section.

In the event that the depository shall fail to pay such deposits, or any part thereof, upon presentation of a check or a certificate of deposit, then the director shall forthwith convert the securities deposited under this section into money for and on behalf of the State; provided that no such securities shall be sold except at public auction, after giving at least ten days' notice by publication in a newspaper of general circulation in the State. [L 1970, c 51, pt of §1; am L 1980, c 229, §2; am L 1982, c 30, §1; am L 1984, c 148, §1; am L 1988, c 78, §4]

The State's Cash Management Program

The State's Cash Management Program is a function of the Finance Division of the Department of Budget and Finance. The Finance Division is responsible for the deposit, safekeeping, investment, and disbursement of state funds. The selection of depositories, the allocation of deposits, and the investment of funds are made in accordance with applicable provisions of law and the policies and objectives of the State's cash management program. The cash management system of the Finance Division provides for the segregation of deposits into four fund classes: general, special, trust, and bond. Exhibit 3-4 details the investments of the State with financial institutions by the four fund classes.

The primary objective of the State's cash management system is to control and allocate the treasury's cash in order to minimize the level of cash in demand accounts and to meet expenditure obligations when they become due while investing the remaining idle cash to secure the maximum amount of interest possible.⁸ A significant change in the State's cash management program which had a positive effect on the earnings of the State's deposits occurred as a result of the 1982 changes to federal banking law which allowed the State to convert most of its non-interest bearing demand accounts to interest bearing checking accounts.⁹ These interest bearing checking accounts are especially important in that they maintain and ensure the State's liquidity position while earning interest at the same time.

The general fund investments of the State are primarily placed in time certificates of deposit (CDs), United States Treasury bills and securities held under repurchase agreements--preferably in denominations greater than or equal to \$100,000 to obtain the higher rates of interest offered on these larger investments. The average length of investment in general fund CDs is ninety days. Treasury bills are purchased in average denominations of \$10 million at maturities of ninety days. Repurchase agreements are purchased at maturities which range between two to seven days. Special, trust, and bond fund investments range from thirty days to five years, with the majority of CDs maturing at ninety days.¹⁰ Exhibit 3-5 displays the general fund interest income on investments during the past five years by the type of investment.

The investment objectives of the State's Cash Management Program are, in order of priority:¹¹

- (1) Safety--To safeguard state funds by securing cash, personnel and facilities and by requiring full collateralization of state deposits.
- (2) Liquidity--To ensure the availability of funds to meet state expenditures by the timely forecasting of cash requirements and the selection of securities that can be converted into cash within a minimum risk of loss of principal.
- (3) Yield--To maximize interest earnings on state investments by investing idle funds to the maximum extent possible.

Section 38-2(a), Hawaii Revised Statutes, provides that in selecting a depository "the class of security being offered shall be considered as the

Exhibit 3-4

STATE OF HAWAII TIME CERTIFICATES OF DEPOSIT WITH FINANCIAL INSTITUTIONS AS OF JUNE 30, 1988

Fund / Agency	Bk of Hawaii	First Havn	First Int Bk of Haw	Cen Pac	City Bk	Haw Natl	Lib Bk	Bk of Hon	Sav & Ln Assn	TOTAL
General										
S/H	\$ 219,100,000	\$ 255,600,000	\$ 6,150,000	\$ 12,200,000	\$ --	\$ --	\$ 2,250,000	\$ 1,200,000	\$ 79,100,000	\$ 575,600,000
Fund Total	219,100,000	255,600,000	6,150,000	12,200,000	--	--	2,250,000	1,200,000	79,100,000	575,600,000
Special										
S/H	158,905,000	122,200,000	595,000	100,000	--	1,000,000	100,000	250,000	--	283,150,000
Agr	4,025,000	--	--	--	--	250,000	--	1,100,000	--	5,375,000
Airports	105,231,809	18,724,000	9,865,000	6,050,000	560,000	2,100,000	3,774,000	4,100,000	--	150,394,809
DAGS off Park	4,435,000	585,000	--	1,000,000	--	--	--	1,190,000	--	7,210,000
DBED Various	7,350,450	5,598,000	1,800,000	1,450,000	--	6,002,000	1,400,000	2,069,969	--	25,670,419
DCCA Various	--	1,105,000	--	--	--	--	--	--	--	1,105,000
DUR Various	2,876,325	25,000	--	--	--	200,000	200,000	125,000	--	3,426,325
DOT-Admn	--	225,000	100,000	245,000	--	--	--	--	--	570,000
Foreign Trade	105,000	580,000	--	--	--	200,000	630,000	--	--	1,515,000
Harbors	12,666,684	2,034,245	1,027,515	1,350,000	--	975,733	726,666	1,172,916	--	19,953,759
Haw'n Home Various	7,620,500	6,958,948	920,000	259,000	323,000	835,500	1,516,000	858,000	--	19,290,948
HI Com Dev Auth	--	3,618,110	--	--	--	--	--	--	--	3,618,110
Health PHC	--	1,730,000	--	--	--	--	--	--	--	1,730,000
HHA Various	36,890,500	6,488,500	500,000	--	--	5,256,000	4,122,500	804,000	--	54,061,500
Highway	11,450,000	4,000,000	200,000	--	--	1,250,000	300,000	2,000,000	--	19,200,000
Labor Workers Comp	1,800,000	2,200,000	200,000	200,000	--	--	1,000,000	--	--	5,400,000
L & NR Various	1,150,000	--	--	--	--	1,050,000	2,025,000	--	--	4,225,000
TDI	--	4,000,000	--	--	--	--	--	--	--	4,000,000
UH Various	3,044,850	1,310,000	--	--	--	--	--	200,000	--	4,554,850
UI	--	119,000	--	--	--	146,000	430,000	--	--	695,000
Fund Total	357,551,118	181,500,803	15,207,515	10,654,000	873,000	19,265,233	16,224,166	13,869,885	--	615,145,720
Trust										
S/H Lit Claim	1,430,000	--	--	--	--	--	--	--	--	1,430,000
Airports	600,000	--	--	--	--	--	--	--	--	600,000
B & F Health Fund	510,000	710,000	--	--	--	--	--	--	--	1,220,000
DCCA Various	27,232,000	19,278,900	100,000	--	--	160,000	2,683,000	375,000	--	49,828,900
DOE Gifts - Libr	--	1,537	--	--	--	160,000	--	--	--	161,537
DOH - Admn	163,000	--	--	--	--	--	--	--	--	163,000
DOT - Highways	1,700,000	--	--	--	--	--	--	--	--	1,700,000
Shippers Wharf	606,200	--	--	--	--	--	--	--	--	606,200
Fund Total	32,241,200	19,990,437	100,000	--	--	320,000	2,683,000	375,000	--	55,709,637
Bond										
S/H	55,003,298	4,400,000	--	--	--	--	--	--	--	59,403,298
Airports	42,884,956	21,982,951	9,921,500	8,752,000	650,000	133,000	3,747,000	3,810,000	--	93,081,407
Harbors	6,650,000	2,910,000	200,000	--	200,000	2,050,000	2,290,000	500,000	--	14,800,000
HI Com Dev Auth	--	--	--	1,300,000	--	--	--	345,000	--	1,645,000
UH - DAGS	--	--	--	345,000	--	--	--	--	--	345,000
Fund Total	104,538,254	29,292,951	10,121,500	10,397,000	850,000	3,383,000	6,037,000	4,655,000	--	169,274,705
Total Time Certificates of Deposit										
Deposit	\$ 713,430,572	\$ 486,394,191	\$ 31,579,015	\$ 33,251,000	\$ 1,723,000	\$ 22,968,233	\$ 27,194,166	\$ 20,699,885	\$ 79,100,000	\$ 1,415,730,062

Source: State of Hawaii, Department of Budget and Finance, *Annual Report of Deposits and Investments of the State of Hawaii*, fiscal year ending June 30, 1988, p. 11.

Exhibit 3-5

STATE OF HAWAII GENERAL FUND INTEREST INCOME ON INVESTMENTS FISCAL YEAR ENDING JUNE 30, 1984-88

Fiscal Years Ending June 30	Time Certificates of Deposits	Securities Held Under Repurchase Agreement	Treasury Bills	Total General Fund Earnings
1984	\$ 42,857,944	\$ 344,513	\$ 49,494	\$ 43,251,951
1985	52,069,416	506,366	518,510	53,094,292
1986	46,925,406	458,111	1,105,822	48,489,339
1987	34,161,546	426,001	6,184,979	40,772,526
1988	46,892,121	511,447	4,482,589	51,886,157

Source: State of Hawaii, Department of Budget and Finance, *Annual Report of Deposits and Investments of the State of Hawaii*, fiscal year ending June 30, 1988, p. 9.

basis of selection and due regard shall be given to a depository doing business in the State". Section 38-2(b) further provides that no more than 40 percent of the aggregate funds deposited and available for deposit by the state treasury may be placed in depositories outside of the State. Despite the passage of Act 78, Session Laws of Hawaii 1988, the Department has thus far not elected to exercise its authority to invest public funds out-of-state.

Section 38-2(d) further provides that the beneficial effects of using depositories operating in the State as well as "the safety and liquidity of the sums to be deposited in the depository and the yield offered by the depository" should be considered by the director prior to the selection of a depository. An institution's ability and willingness to accept state general fund investments in light of the State's requirement for deposit collateralization are also factors of deposit distribution. As Exhibit 3-6 indicates, the State's deposits are relatively concentrated in terms of both their distribution among the individual institutions and their distribution between banks and S&Ls. During 1986 and 1987, 86 percent of the State's deposits were placed within the two largest banks operating in Hawaii: Bank of Hawaii and First Hawaiian Bank.¹² In addition, Hawaii's banks have traditionally taken on the larger share of the State's deposits. During 1986 and 1987, 95 percent of the State's deposits were placed in Hawaii's banks while only 5 percent was deposited in Hawaii's S&Ls. In addition, several S&Ls chose to limit their acceptance of state funds to the FSLIC insurance limit of \$100,000, which requires no collateralization under the law.¹³

Exhibit 3-6

STATE OF HAWAII SUMMARY STATEMENT OF DEPOSITS AND INVESTMENTS IN THE STATE TREASURY AS OF JUNE 30, 1988 AND 1987

	1987 DEPOSITS				1988 DEPOSITS			
	Demand Deposit	Time Certificates	Total		Demand Deposit	Time Certificates	Total	
Banks								
Bank of Hawaii	\$ 7,207,228	1.00%	\$ 713,430,572	98.00%	\$ 7,207,228	1.00%	\$ 713,430,572	98.00%
First Hawaiian Bank	5,068,784	1.05	480,654,191	98.95	5,068,784	1.05	480,654,191	98.95
First Interstate Bank								
of Hawaii	289,814	0.91	31,579,015	99.09	289,814	0.91	31,579,015	99.09
Central Pacific Bank	277,344	0.83	33,251,000	99.17	277,344	0.83	33,251,000	99.17
City Bank	50,737	2.86	1,723,000	97.14	50,737	2.86	1,723,000	97.14
Hawaii National Bank	212,101	0.92	22,959,233	99.08	212,101	0.92	22,959,233	99.08
Liberty Bank	221,475	0.81	27,194,168	99.19	221,475	0.81	27,194,168	99.19
Bank of Honolulu	149,415	0.74	20,099,885	99.26	149,415	0.74	20,099,885	99.26
Sub-Total	\$13,496,986	1.00	\$1,330,900,062	99.00	\$13,496,986	1.00	\$1,330,900,062	99.00
Specific Accounts	3,340,488	36.83	5,730,000	63.17	3,340,488	36.83	5,730,000	63.17
Total Banks	\$16,837,474	1.24	\$1,336,630,062	98.78	\$16,837,474	1.24	\$1,336,630,062	98.78
Savings and Loan								
American Savings & Loan Assn.	\$ -	-	\$ 100,000	100.00%	\$ -	-	\$ 100,000	100.00%
First Federal Savings & Loan	153,191	1.25	12,150,000	98.75	153,191	1.25	12,150,000	98.75
Honolulu Federal Savings & Loan	141,731	0.55	25,850,000	99.45	141,731	0.55	25,850,000	99.45
International Savings & Loan	154,832	0.77	19,900,000	99.23	154,832	0.77	19,900,000	99.23
New People's Savings & Loan	-	-	-	-	-	-	-	-
Pioneer Federal Savings & Loan	-	-	-	-	-	-	-	-
Teritorial Savings & Loan	151,798	0.72	21,000,000	99.28	151,798	0.72	21,000,000	99.28
Total Savings & Loan	\$ 601,552	0.75	\$ 79,100,000	99.25	\$ 601,552	0.75	\$ 79,100,000	99.25
Total for Banks and Savings & Loan	\$ 17,439,026	1.22	\$ 1,415,730,062	98.78	\$ 17,439,026	1.22	\$ 1,415,730,062	98.78
Other Investments								
Repurchase Agreements	-	-	6,000,000	100.00	-	-	6,000,000	100.00
U.S. Treasury Sec.	-	-	189,443,473	100.00	-	-	189,443,473	100.00
Total other Investments	-	-	\$ 195,443,473	100.00	-	-	\$ 195,443,473	100.00
Grand Total	\$17,439,026	1.07	\$1,611,173,535	98.93	\$17,439,026	1.07	\$1,611,173,535	98.93

Source: State of Hawaii, Department of Budget and Finance, *Annual Report of Deposits and Investments of the State of Hawaii*, fiscal year ending June 30, 1988, p. 10.

The State's Collateral Portfolio

In addition to the foregoing requirements, section 38-3 provides that depositories accepting deposits of public funds must maintain sufficient collateral securities with the treasury to ensure the protection of such deposits. The section further provides that in the event a depository fails to transact payment upon the presentation of a check or a certificate of deposit, the director shall at that time "convert the securities deposited under this section into money" on behalf of the State.

In accordance with the State's objectives of maintaining the highest level of security and liquidity over its investments, the Department has maintained a firm policy of permitting only those securities which, in its opinion, conform to these objectives to be pledged as collateral. While security and liquidity objectives are often implicated as the primary impediments toward the fulfillment of the third objective (i.e., yield), this trade-off is clearly understood. Simply stated, the relationships which occur between these objectives are:

- The higher the investor's priority for safety and liquidity, the lower the investor's expectations must be in the area of yield.
- The higher the investor's priority for maximizing yield, the lower the standards and requirements must be for either safety or liquidity, or both.

The highest levels of investment security and liquidity are generally associated with collateral portfolios consisting of securities which perform well on the secondary (resale) market and are secured directly or indirectly by the federal, state, or local governments or their agencies. Exhibit 3-7 displays the aggregate values of the securities held as collateral as of September 30, 1988, assembled in accordance with paragraphs (1) to (9) of section 38-3, Hawaii Revised Statutes.

As the exhibit indicates, United States Treasury bills, bonds, and notes constitute the largest segment of the State's collateral portfolio. The combined aggregate values of collateral securities eligible under section 38-3(7) and (8)--bonds of other states and counties--make up the second largest segment followed by bonds and other obligations of the various federal agencies.

Long- and short-term debt securities of the United States government and its agencies are generally regarded throughout the investment world as the safest, most risk free, securities in the marketplace. The need for capital by the ever-expanding federal government has provided investors with an ample supply of quality securities in which to invest funds. Federal debt has kept pace with the expansion of government activities. In December of 1982, the total gross public debt of the United States Treasury was estimated at nearly \$1.2 trillion.¹⁴ In spite of the large and increasing debt, the United States enjoys an excellent credit position with domestic and foreign lenders. The enormous market of United States Treasury issues guarantees that investors can generally secure as much as is necessary without undue competition in the marketplace. The secondary market for Treasury securities is broad, deep, and resilient and opportunities for quick resale at relatively

Exhibit 3-7

SUMMARY OF STATE DEPOSIT COLLATERAL SECURITIES

Listing by Paragraph Code--Section 38-3, Hawaii Revised Statutes
As of September 30, 1988

§38-3(1)

Bonds, notes, debentures and other evidences of
indebtedness of the State or counties of the State of
Hawaii:

State General Obligation Bonds
Honolulu City and County GO Bonds
Maui County GO Bonds
Hawaii County GO Bonds

\$14,245,000.00

§38-3(2)

Bonds, notes, debentures and other evidences of
indebtedness of any state or county agency:

State Airport Revenue Bonds
State Harbor Revenue Bonds
Hawaii Housing Authority Revenue Bonds
Hawaii Department of Budget and Finance
Special Purpose Revenue Bonds

30,512,942.76

§38-3(3)

Bonds, notes, debentures and other evidences of
indebtedness of any improvement district or frontage
improvement of any county of the State:

Hawaii Community Development Authority

435,000.00

§38-3(4)

Bonds, notes, bills or certificates of indebtedness of
the United States or agencies of the United States:

U.S. Treasury Notes
U.S. Treasury Bills
U.S. Treasury Bonds

677,315,000.00

§38-3(5)

Bonds, notes or debentures of any agency of the United States:

Federal Home Loan Banks
Federal National Mortgage Association (FNMA)
Federal Farm Credit System
Federal Home Loan Mortgage Corporation (FHLMC)
Student Loan Marketing Association
Government National Mortgage Association (GNMA)
Farmers Home Administration

379,921,489.08

§38-3(6)

Warrants or warrant notes of the State:

0.00

§38-3(7) and 38-3(8)

Bonds, notes, debentures and other evidences of indebtedness of any state, city or county of the United States:

Various obligations of states, cities and counties of the United States

397,918,369.00

§38-3(9)

Other assets on the books of a depository which are eligible to secure advances from the Federal Reserve Banks:

Puerto Rico Bond

500,000.00

TOTAL

\$1,500,847,800.92

Source: Department of Budget and Finance

stable prices can usually be anticipated with confidence. The general consensus among most investors in the marketplace is that United States Treasury securities are less risky than federal agency issues and municipal obligations.¹⁵ The quality of commercial and foreign securities is generally considered to be below that of government securities in terms of risk and stability.¹⁶ Another principle is that short-term securities are less of a risk than long-term securities. Bond rating agencies such as Moody's Investors Service and Standard and Poor's Corporation give government securities their highest ratings. The advantages of government issued securities include the quality and security they afford to the investor, the stability of income they provide, and the superior level of marketability these instruments maintain in the marketplace.¹⁷

Marketable securities of the federal government are divided into short-term, intermediate-term, and long-term issues. Treasury bills are short-term securities carrying maturity dates of 91 days to a year sold by the United States Treasury as a direct obligation. The bills are issued in bearer form in denominations ranging from a minimum of \$10,000 to \$1,000,000, in \$5,000 increments.¹⁸

Treasury notes are term loans of the Treasury and are typically issued for periods of three to five years. Once the securities are issued, they can be bought and sold freely in the marketplace. These notes have historically offered higher rates than long-term government bonds but have also experienced higher variability of yields and should therefore be considered more risky than other government securities.¹⁹

Treasury bonds are long-term interest bearing debts of the United States that represent the largest portion of publicly held marketable debt. The maturities range from six months to 35 years. An increased degree of rate variability is assumed when long-term issues are purchased because of potential losses through fluctuations in the money rate.²⁰

Federal government corporations and agencies offer a variety of bonds with maturities to fit the portfolio requirements of most investors. These bonds are obligations of the issuing agency and are not guaranteed by the United States government. Agencies and corporations issuing debt through these securities include the Federal Land Bank, the Federal Intermediate Credit Bank, the twelve district Banks for Cooperatives, the Federal Home Loan Banks, the Federal National Mortgage Association (Fannie Mae) and the Government National Mortgage Association (Ginnie Mae) of the U.S. Department of Housing and Urban Development, the International Bank for Reconstruction and Development (the World Bank), the Inter-American Development Bank, and the United States Postal Service.²¹

State and municipal bonds have traditionally maintained a good record of stability and security and have experienced relatively few defaults over the history of state and local debt. The total amount of state and local debt is significantly smaller than the total federal debt. The outstanding debt of state and local government issuers at the end of 1982 stood at approximately \$9.5 billion.²² Approximately 75 percent of the aggregate state and municipal debt outstanding has been issued by local governmental units which includes counties, municipalities, townships, towns, school districts, and special districts.²³ The need for all types of public utilities and facilities continually

COLLATERALIZATION REQUIREMENTS FOR STATE DEPOSITS

expands, necessitating the generation of capital through the sale of debt securities.

State and municipal bonds are usually debenture contracts (long-term promissory notes to pay) that do not have a pledge of either real or personal property. Their credit rating rests upon their ability to pay principal and interest solely from tax revenues or from the operating revenues of a special authority or both. The general classifications of state and municipal bonds include:²⁴

- (1) General obligation (GO) bonds which are supported through the tax revenues of the government;
- (2) Revenue bonds whose debt service is paid directly out of the revenues of a special project;
- (3) Special assessment bonds which are repaid through funds received from the person or property assessed; and
- (4) Combination bonds which are hybrids of GO bonds and revenue bonds.

It is extremely difficult for an individual to independently determine the legality and financial position of a particular bond issue. To estimate this, the economic and financial position of the governmental unit issuing the debt must be analyzed. Moody's and Standard and Poor's regularly evaluate the bond issues of the states, counties, and other political jurisdictions of the United States.

Given the reliability of most government-issued debt securities, the Department of Budget and Finance has maintained a heavy preference toward the use of those securities eligible under paragraphs (1) through (8) of section 38-3, Hawaii Revised Statutes. The Department's acceptance of securities classified under paragraph (9) has, thus far, been strictly limited. The Department maintains the belief that the State's present portfolio mix affords the highest level of security and liquidity attainable under the provisions of the law.

Chapter 4

DEPOSIT COLLATERALIZATION: THE PERSPECTIVE OF DEPOSITORIES IN HAWAII

Deposit collateralization programs provide public depositors with a mechanism that ensures deposit security and liquidity, but not without costs to both the depositor and the institution. While these costs are generally passed on to the depositor in the form of lower interest earnings, deposit collateralization programs have also been criticized for the constraints these mechanisms may place on the effective use of public funds by the institution and the economy.

The negative effects these programs tend to have on the earnings of the depositor are generally recognized and accepted as a consequence of deposit security. As stated earlier in this report, financial institutions often charge their public clients from 25 to 200 basis points (0.25 percent to 2.00 percent) in diminished yield for the costs of pledging collateral securities and maintaining a third-party custody arrangement with an independent trustee.

Also discussed earlier were the constraints these requirements may impose on the yield and liquidity objectives of the institutions themselves. Institutions wishing to conduct business with public entities are often forced to alter their investment practices or reserve characteristics to accommodate the security requirements of public funds. Occasionally, these actions may not be in accord with the priorities and objectives of the institution. The productive capacity of public funds requiring full deposit collateralization may be diminished considerably for depositories maintaining such funds. Any institution that accepts a public deposit does so in order to make a reasonable profit--lower earnings for the institution translates into lower earnings for the depositor.

The purpose of this chapter is to review the various problems, concerns, and arguments of public depositories in Hawaii and to examine the important regulatory and economic conditions which may have contributed to the difficulties experienced by these institutions. This chapter will also outline the proposals submitted by several depositories in the interest of providing the local industry with greater flexibility in meeting the State's requirements for deposit collateralization.

Collateralization and Public Depositories in Hawaii

Exhibit 3-6 displays the heavy reliance the Department of Budget and Finance typically maintains on Hawaii's commercial banks--as opposed to Hawaii's savings and loan associations (S&Ls)--to manage and safeguard the deposits of the State. Also evident is the heavy reliance placed on Hawaii's two largest commercial banks. While the allocation of State deposits among Hawaii's various depositories is a function and responsibility of the department, an institution's willingness to accept such deposits also influences the distribution of public funds throughout the financial community of the State. Deposits are allocated among eight local commercial banks and six S&L associations based on their asset size, interest rates, and their ability to

fully collateralize deposits. Despite the passage of Act 78, Session Laws of Hawaii 1988, the department has thus far not elected to exercise its authority to invest public funds out-of-state.¹

Contingent upon factors such as the size and composition of an institution's secondary reserves, certain institutions may find it difficult to accept deposits of public funds. Local institutions have, on occasion, refused or placed limitations on the amount of State and county deposits they were willing to accept due to their reluctance or inability to collateralize these deposits to the satisfaction of the depositor.²

While it is conceivable that deposit collateralization has never been a very popular method of deposit protection from the perspective of the financial industry, various economic and regulatory factors during the past decade have made this mechanism an even less attractive alternative for the industry as a whole. In recent years, Hawaii's public depositories have reported various concerns and difficulties in meeting the collateralization requirements of the State.

An important factor in any depository's ability to satisfy the collateralization requirements of a public depositor, in a manner which would also be consistent with the interests of the institution, is the asset structure or reserve capacity of the depository. To conform with applicable state and federal regulatory minimum reserve requirements, most institutions are required to maintain a balance between the amount of assets they hold in cash, the size or magnitude of their liabilities (i.e., time and demand deposits), and the reserve needs that apply to them. Managing the asset position of an institution implies not only the continual monitoring of the institution's loans, deposits, and reserve balances, it also involves the forecasting of cash needs to meet the withdrawal demands of their depositors.³ Since the primary intent of maintaining a portion of a bank's assets in the form of liquid reserves is to prepare for the possibility that a situation may arise wherein the bank may be forced to convert these assets into cash to meet unexpected cash drains and other obligations, the securities held in these reserves generally consist of readily marketable, short-term, and highly liquid instruments.⁴ Quality and marketability in a security assures the bearer that the issuers will pay them off at maturity and that the possibility of default is nonexistent or, at worst, extremely slight.

The gross income of a commercial bank is determined by the performance of its loans and investments, the fees and charges it imposes for the performance of services, and the size and composition of its assets. Interest earnings on loans and investments of institutions nationwide have been estimated to be nearly 90 percent of a bank's income.⁵ As noted earlier, however, the return a bank receives on its loans is often significantly higher than the return it receives on its investment securities. Although interest on securities historically has been the second most important source of income for banks, earnings through this source have declined as a percentage of total income in recent years as banks have opted to change their asset balances in an effort to attain higher earnings.⁶

Hawaii bankers report that in the 1970s, the typical practice for local banks was to hold 20 to 30 percent of their total assets in the form of investment securities.⁷ In contrast, the State's S&L industry, whose primary

focus is on the single-family residential mortgage market, held only 10 percent of their assets in securities, fixed assets, and other assets in 1978.⁸ Traditionally, S&Ls have accepted short-term deposits and have originated, serviced, and held long-term mortgages. An S&L's income is based primarily on financing mortgages at rates which exceed their cost of funds.⁹

The typical practice among Hawaii banks in the past was to maintain a loan to asset ratio of not more than 70 percent, while mortgage loans represented nearly 90 percent of the assets on the books of local S&Ls.¹⁰ Given the asset mix and capacity of the local banking industry in the 1970s, most banks possessed an adequate reserve of securities which could be pledged as collateral for public deposits. Under these circumstances, collateral pledging was simply a matter of segregating the requisite amount of securities on hand and pledging these securities to the depositor.¹¹ With excess collateral there was no immediate change in the volume of securities, only an allocation. The bank's loan to deposit ratio was therefore decreased with the acceptance of a public deposit, thereby increasing the bank's capacity to make additional loans.

Exhibit 4-1 profiles the wide range of investment assets held by Hawaii's state-chartered banks.¹² The reserve capacity and asset positions of each institution may provide an insight into the extent to which any given depository may be willing or capable of pledging its securities in the amounts necessary to collateralize the deposits of the depositor. While it is fairly obvious that loans represent the major use of assets among all state-chartered banks, the quantity and variety of the securities on reserve with each institution differs significantly. For example, while the investment portfolio of Hawaii's largest banking institution, Bank of Hawaii, was heavily concentrated in United States Treasury obligations, the investment preferences of Hawaii's second largest bank, First Hawaiian Bank, were somewhat more diversified--having greater emphasis on municipal obligations and "other" securities.

Whereas in the past, the incoming volume of public deposits requiring collateralization was relatively manageable for most banks, the increased level of State deposits in recent years has imposed strains on several depositories' ability to collateralize these deposits through their existing reserves. Hawaii bankers reported in 1984 that during the two and one-half year period beginning in 1981 and ending in mid-1983, public deposits increased at a rate of 36 percent while private sector deposits grew at a rate of 27 percent.¹³ Obviously, for institutions accepting greater shares of public funds, larger pledges of securities were required to collateralize the growing balances of the depositor.

Given the advantages of loaning over investing in securities, and faced with an expanding market for loans in Hawaii, local banks found little reason to maintain large portions of their assets in the form of investment securities. Hawaii banks began reducing the percentage of total assets allocated to investment securities and concurrently began expanding their lending activities.¹⁴ As a result, securities on reserve which would otherwise have been eligible as collateral for pledging against a public deposit began to decline. Thus, Hawaii bankers reported that most banks soon reached a position where each new deposit of public funds no longer resulted in available funds for loans. This situation occurred as the deposit of every

Exhibit 4-1

State of Hawaii Honolulu, Hawaii		COMPARATIVE STATEMENT OF CONDITION OF STATE-CHARTERED BANKS As at the Close of Business JUNE 30, 1988, DECEMBER 31, 1987, and JUNE 30, 1987 (000 Omitted)							Department of Commerce & Consumer Affairs Division of Financial Institutions 8/88		
		Fed Funds Sold and Loans & Discounts*	SECURITIES				Premises, Furniture, Fixtures & Equipment	Other Real Estate Owned	Other Assets	Cash and Due From Banks	Total Assets
			U.S. Treasury	U.S. Govt. Agy. & Corp.	State & Municipal	All Others					
ASSETS											
Bank of Hawaii	\$3,469,844	\$821,407	\$15,825	\$179,982	\$55,039	\$79,747	\$154	\$171,621	\$902,501	\$5,696,120	
Bank of Honolulu	43,246		26,177	4,281	4,085	1,390		1,288	3,756	84,223	
Central Pacific Bank	439,235	8,974	105,679	32,507	8,416	10,217		18,262	81,696	704,986	
City Bank	258,309		77,252	7,057	8,537	5,645	696	12,293	28,888	398,677	
First Hawaiian Bank	1,819,692	119,880	247,455	342,326	275,428	67,554	2,780	64,252	769,015	3,708,382	
First Interstate Bank of Hawaii.....	471,525	24,999	60,509	27,871	634	14,555	1,641	11,729	39,071	652,534	
Liberty Bank	170,643	17,986	26,010	8,640		2,140	14	5,883	29,671	260,987	
TOTALS JUNE 30, 1988	\$6,672,494	\$993,246	\$558,907	\$602,664	\$352,139	\$181,248	\$5,285	\$285,328	\$1,854,598	\$11,505,909	
TOTALS DEC. 31, 1987	\$6,512,598	\$762,908	\$532,283	\$660,910	\$95,748	\$183,204	\$6,992	\$352,759	\$2,198,020	\$11,305,422	
TOTALS JUNE 30, 1987	\$5,948,127	\$791,560	\$368,400	\$706,447	\$99,454	\$185,940	\$8,675	\$309,700	\$2,075,795	\$10,494,098	

Source: State of Hawaii, Department of Commerce and Consumer Affairs, Comparative Statement of Condition of State-chartered Banks, 1988, p. 1.

\$100 in public funds meant the purchase of \$110 in new collateral, because of the lack of "excess" securities available for pledging.¹⁵

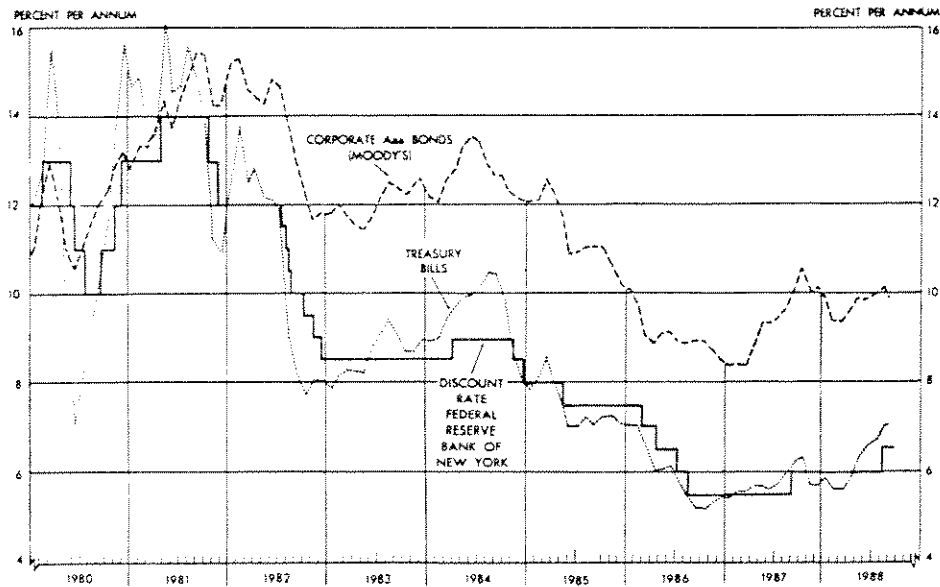
An event which compounded the impact of the growth of public deposits and the restructuring of bank balance sheets in Hawaii, was the change in the Federal Reserve System's (Fed) economic policy in 1979 from one which focused on stabilizing interest rates to one which focused on the control of the money supply. Faced with the slumping dollar and high level inflation in the latter period of the 1970s, the Fed undertook an unprecedented approach toward regaining stability in the nation's economy.¹⁶ The basic premise of the Fed in 1979 was that inflation would not persist without continued and excessive monetary growth and that appropriately restrained growth of money and credit over the long run would be critical to achieving the ultimate objective of reasonably stable prices and sustainable economic growth. The key to stemming the inflationary tide of the 1970s was to alter the economy's perception regarding the monetary policies of the Fed, particularly with respect to the level and stability of interest rates. In October of 1979, the Federal Open Market Committee decided to try to discipline money growth from the supply side by directly controlling reserves rather than from the demand side by controlling the federal funds rate.¹⁷ In this way, attention was diverted toward monetary growth and away from the Fed's influence on rising interest rates. This was a drastic departure from the Fed's former philosophy where the primary focus was directed toward the federal funds rate and a political alarm was set off each time interest rates inched upward even by as little as one-eighth of a percentage point. The key element in the plan was that sharp increases in interest rates would eventually dampen consumer speculation and business borrowing in the United States.¹⁸ While the Fed's actions successfully contained inflation and helped to strengthen the U.S. dollar, interest rate volatility increased dramatically.¹⁹ Exhibit 4-2 displays the degree of volatility among several important economic indicators following 1979.

Prior to 1979, the practice among most Hawaii banks was to place their assets in long-term securities at yields higher than the rate paid to the public depositor. Typically, banks invested in securities of five to fifteen years maturity, even though the underlying public deposits matured at average intervals of 90 days.²⁰ This strategy was not particularly risky, in that the Federal Reserve System was committed to a policy of controlling interest rates and intervened to control rapid shifts in market rates.²¹ With the policy change of 1979, however, local bankers reportedly began losing money in large amounts.²² This occurred because older securities were yielding between four to seven percent less than the rate paid to the depositor. Understandably, the negative margin was further aggravated by the increased flow of incoming public deposits.

The immediate response of the banking industry was to lower the interest rates paid on public deposits and to reduce the maturities of securities pledged on such deposits.²³ To continue to purchase longer-term securities would have exposed banks to continued risks due to interest volatility. The prudent alternative was to purchase collateral securities which had maturities similar to that of each new time certificate purchased in the name of the public depositor.²⁴ If a six-month deposit was accepted by a bank, the general course of action was to purchase a six-month security as collateral. While the risk of exposure to interest volatility was reduced

Exhibit 4-2

INTEREST RATES AND BOND YIELDS



Source: Board of Governors of the Federal Reserve.

somewhat, the profitability of maintaining public deposits under such terms was also reduced. Predictably, the earnings of the public depositor were also reduced.

In 1985, Bank of Hawaii, the State's largest depository claimed that due to the State's requirements for public deposit collateralization, a situation had evolved in the local economy wherein:²⁵

- (1) The community gets no direct benefit from the local deposit of public moneys.
- (2) The yield on public deposits has been below that realizable on uncollateralized deposits.
- (3) The risk to local banks, while reduced, is still significant.

While the costs associated with deposit collateralization are aspects of the public funds market that institutions throughout the nation often find problematic, most local depositories acknowledge the importance of maintaining an effective public deposit protection program in Hawaii. Although efforts have been made in the past to alter the State's statutory requirements for deposit collateralization, the current effort on the part of the industry is to work within what is already allowed under the law and to deal administratively

with the Department of Budget and Finance to develop a solution to their concerns.

Alternatives and Proposals for Deposit Collateralization

To properly ascertain the views and concerns of local depositories in regard to the State's collateralization requirements, suggestions were solicited from several institutions accepting deposits of the State. The alternatives and proposals presented in this section were submitted by depositories in an effort to expand their options in meeting the State's requirements for deposit collateralization. According to local depositories, the higher earning power of the securities and assets to be reviewed in the following section would compensate depositories for the risks and poor yield spreads often associated with the use of government securities as collateral. As a result, depositories contend, the productivity of public deposits in the community and the economy would be increased, and the State would realize an improved return on its deposits.

While any effort at reducing or removing the State's statutory requirements for deposit collateralization would require the involvement and approval of the Legislature, the alternatives submitted to this study for consideration propose no actions of that nature. Instead, the alternatives submitted for review would more than likely qualify under an existing provision of the law. As noted earlier in this report, section 38-3(9), Hawaii Revised Statutes, provides the department with the authority to accept other assets on the books of a depository which are eligible to secure advances from a federal reserve bank under the regulations of the Federal Reserve Board as collateral for State deposits. Given the flexibility of the Federal Reserve System in accepting a broad array of securities or assets for loans to commercial banks, the class of securities and assets presented in this section would most probably fall within the scope of section 38-3(9), Hawaii Revised Statutes.

The classes of securities and assets submitted by local depositories for consideration include:

- (1) Asset-backed securities, including, Certificates for Automobile Receivables (CARS) and Credit Card Asset Backed Securities (CARDS);
- (2) Mortgage-backed securities, including, Real Estate Mortgage Investment Conduit Pass-Through Certificates (REMICs) and Floating Rate Collateralized Mortgage Obligations (CMOs); and
- (3) A proposed deposit protection program based on the pledging of a depository's commercial loans as collateral against the deposits of the State.

(1) Asset-backed Securities as Collateral for State Deposits

• Certificates for Automobile Receivables (CARS)

Asset-backed securities entered the investment securities market three years ago with the introduction of CARS. The first offering of CARS in 1985 sparked an immediate trend in the securities industry toward backing securities with a broad range of consumer and commercial loans or receivables.²⁶ While CARS securities still dominate the asset-backed securities market, 1987 marked the first public offerings of credit card asset-backed securities (CARDS) and other securities backed by heavy-duty truck loans, automobile leases, airplane leases, "junk" bonds, and consumer loans.²⁷ Republic Bank, Delaware offered the first credit card-backed financing in January 1987. Volvo brought automobile leases to the private market in 1987, while Volkswagen issued the first public auto lease securities in October of the same year.²⁸ Imperial Savings Bank of California broke new ground in September 1987 with the issuance of securities collateralized by junk bonds, and Household Finance Company offered the first issue collateralized by pools of unsecured closed-end consumer loans in November of the same year.²⁹

The capital markets, continually devising new products, began to note that receivables, including mortgages, have both market value and borrowing value. Thus receivable-backed securities could be structured on the basis of the borrowing value of identified mortgages or other receivables determined, in principle, without regard to the creditworthiness of the borrowers, and could be rated with the nationally recognized rating agencies' standard corporate debt rating definitions.³⁰ Many billions of dollars worth of receivables outstanding--such as corporate and consumer loans and credit card billings--carry rates much higher than prevailing market interest rates, making them a very profitable commodity to package and sell.³¹ Securitization provides liquidity or the ability to convert illiquid assets into cash more easily. Asset-backed securities are particularly attractive to issuers because they take the loans off of their books, saving them the cost of capital necessary to support the loans.³² By securitizing assets and relending the proceeds in high quality loans, institutions can improve asset quality while effectively managing interest rate risk and diversifying the use of funding markets. The transference of interest rate risk from the originator to the investor is a key motivating factor behind securitization, particularly in mortgage financing. Few thrifts would still offer 30-year fixed-rate mortgages if they could not sell them through securitization. Interest rate risk is fully passed on in most sales transactions.³³

Securitization enables firms to achieve the benefits of lower financing costs. Investors are willing to pay more for securities than they are for the assets themselves and are willing to require less of a yield when they are collateralized by pooled assets or receivables.³⁴ Securitization also reduces the exposure of firms to interest rate risk. The assets held by the firms can be sold more easily and exposure to increases in interest rates which revalue the assets can be reduced if they are securitized.³⁵ Credit risk can be diminished through securitization where assets are sold to reduce a firm's total credit exposure to another firm which is able to undertake greater credit risks. Thus, the risks associated with typical balance sheet lending can be decreased.³⁶

A particular segment of the nation's economy where asset-backed securitization may provide direct assistance is the automobile industry. In the past decade, the nation's auto industry has come under increasing pressure from foreign competition. While financial techniques cannot directly improve the quality of their products, it can provide an additional source of funding for the auto industry at a lower cost and on the most flexible terms. Low-cost automobile financing has proved to be one method for automobile companies to preserve their market share against foreign competition.³⁷

For investment banks, the picture is even brighter. At present, about 50 percent of all debt raised in the national economy is done through securities; if that figure is raised to 80 percent over the next decade, the profit potential for the investment banks leading the securitization process (First Boston, Salomon Brothers, Goldman Sachs, Merrill Lynch and Drexel Burnham and Lambert, Inc.) is enormous. This is particularly true since the new instruments, to date, appear to have larger profit margins for underwriting and trading than do conventional securities.³⁸

Most CARS issues are backed by loans made to individuals to finance purchases of new automobiles and light trucks. Automobile loans are characteristically self-amortizing with monthly payments at fixed rates of interest with two to five year maturities. Loans on automobile purchases constitute the major component of consumer installment credit. As of September 30, 1986, auto loans--at \$237 billion--accounted for 40 percent of the \$585 billion of consumer installment debt.³⁹

Typically, the securitization process is structured as follows. The bank extends credit to customers in the form of loans (i.e., automobile, credit card loans, etc.). The bank segregates the loans into a subsidiary or separate trust to get them off of its books. Alternatively, the bank may sell the loans to a packager who will convey them to a separate trust--usually a grantor trust. Proceeds from the loan "sales" go to the originator. The face value of the loans in the pool is determined and documents evidencing the loans are placed in the custody of the trust. The loans removed from the books of the originator become assets of the trust which thereby becomes the legal vehicle upon which the securitization process is structured. In accordance with the terms of the indenture agreement governing the trust, the trustee is obligated to act in the best interest of the security holders. The packager, in conjunction with an underwriter, structures the security in terms of maturity, coupon rate, payment schedules, and so on.⁴⁰

The underwriter then distributes or sells the securities to investors and advises the packager on the securitization terms and the terms of the trust indenture. Investors receive documentation giving them pro-rata ownership rights to loans in the pool. Investors receive payments from the cash flow generated by the underlying assets.⁴¹

Securitized bank loans usually require some form of credit enhancement to make them attractive to investors. Overcollateralization is a common credit enhancement strategy in mortgage-backed securities sales. The majority of asset securitization programs involving consumer and commercial loans provides some type of a limited guarantee by the selling bank or by a third party in order to insulate the investors from losses on the assets sold. Rating services require credit enhancement--usually in the form of an

acceptable "letter of credit"--for a higher rating on most non-real estate deals. Letters of credit (LOC) are the most common type of credit support for CARS and CARDS. Some asset-backed securities have LOCs that provide coverage up to a fixed percentage of the pool balance; that is, the LOC amount decreases as the pool pays down. For other issues the LOC coverage equals a fixed percentage of the original principal amount. In these cases, the percentage loss coverage increases as principal is retired. The amount of credit support generally provides coverage five or more times the historical "worst case" loss experience of the lender's portfolio.⁴²

Securities collateralized by automobile receivables currently dominate the expanding asset-backed securities market. Since the first sale of \$23 million of CARS securities by Marine Midland Bank to Salomon Brothers, Inc.--which resold them to institutional investors--in February 1985, the asset-backed securities market has grown substantially.⁴³ Although subsequent CARS offerings may be structured differently, the initial issuance of CARS by Marine Midland represented ownership of a pool of car loans collected by Marine Midland, which continued to service the loans. Cash flows from the loans were awarded to the investors. Marine Midland collected a servicing fee and Salomon Brothers derived its profits from the difference between the purchase and the sale price of the certificates.⁴⁴

As of October 1986, more than 17 CARS issues totalling \$9.1 billion had been offered publicly. The predominant issuers of most CARS securities have been the automobile companies' captive finance subsidiaries, but the potential exists for issues of significant size to be made by commercial banks and thrifts. The General Motors Acceptance Corporation (GMAC) has been by far the largest issuer, directly or indirectly accounting for nearly 90 percent of CARS issued by the end of 1986. Other recent issuers include the Nissan Motors Acceptance Corporation and the Chrysler Financial Corporation.⁴⁵

Generally, CARS have monthly or quarterly payment schedules and stated final maturities of three to five years. Most CARS have been structured either as grantor trust "pass-throughs", "pay-through" notes or "fixed-payment" securities.⁴⁶ CARS with a pass-through format represent ownership interests in a fixed pool of receivables. CARS pass-through securities are structured after the mortgage pass-through formats of FNMA and GNMA. In this type of transaction, auto receivables are sold to a grantor trust, which sells pass-through certificates representing undivided interests in auto loan assets. To date, the grantor-trust format has been the most common format for securitizing auto loans.⁴⁷

CARS structured as pay-through notes are debt instruments supported by cash flows from the underlying assets. Pay-through CARS--analogous to those cash flow bonds or CMOs of the mortgage securities market--are the latest development in the CARS market. In general, pay-through CARS are backed by cash flows rather than the par or market value of the collateral. The principal amount of CARS issued is determined so that the debt service can be supported by scheduled principal and interest payments on the loans. For this issue, a specified portion of the cash received is allocated first to pay interest on the obligations and then to retire principal.⁴⁸

CARS also include securities with "fixed-payment" schedules--these instruments resemble corporate bonds with sinking funds because their cash

flows do not depend on prepayments. In general, these issues are based on structures assuming no prepayments. A guaranteed investment contract is used to ensure that the fixed debt service schedule can be maintained regardless of prepayments. Fixed-payment CARS are more attractive to investors than issues with uncertain prepayment rates. Fixed payment CARS configurations account for almost as large a percentage of the market as the grantor trust pass-through.⁴⁹

CARS are currently the mainstay of the asset-backed securities market. While the CARS market is judged to be "reasonably liquid", it is predicted that it will become even more so through additional issuance and with the emergence of large issuers other than GMAC and Chrysler Financial. Thus far, CARS have offered attractive yield spreads relative to corporate bond alternatives.⁵⁰ The cash flows of CARS securities are reportedly much more stable than those of CMOs or other mortgage-backed securities. Unlike mortgages, the prepayment rates on auto loans vary little with interest rates and play a less important role in the value of a CARS security. According to First Boston Corporation, the difference is that borrowers seldom pre-pay auto loans when interest rates drop.⁵¹ That gives CARS a much more regular cash flow than mortgage-backed securities such as CMOs.

• Credit Card Asset-Backed Securities (CARDS)

CARDS, an acronym representing "certificates for amortizing revolving debts", represent participations in a fixed pool of credit card accounts. While the structure of CARDS was modelled in the tradition of its predecessors, credit card receivables differ significantly from the fixed-installment debt found in other asset-backed securities. Because of the revolving nature of the assets, CARDS pay interest only for a specified period, typically 18 months.⁵² The CARDS balance remains constant during this period, while any cardholder repayments or new borrowings flow to the issuer's participation. Once the principal amortization phase begins, the balance declines with paydowns on the underlying portfolio.⁵³

From the time of their establishment in the 1950s, credit cards have become a major consumer payment mechanism as well as a major form of consumer borrowing. Credit cards now account for an estimated 61.9 percent of all retail store purchases and 23.4 percent of non-mortgage consumer debt.⁵⁴

In spite of the enormous size of the credit card asset base, the development of CARDS has been constrained by the great complexity of credit card receivables--relative to automobile loans--and because even a sold portfolio of credit card receivables is affected by the condition of the issuer and the industry. Credit card loans are much more complex to securitize when compared to a mortgage-backed security, but bank issuers have not found this complexity to be a deterrent.

In January 1987, RepublicBank Delaware issued the first CARDS pay-through notes. These notes represented a general obligation of the bank secured by a pool of receivables arising from selected credit card accounts. Bank of America, with the second largest credit card portfolio in the country after Citibank's, has been one of the most enthusiastic issuers of CARDS.

Bank of America has completed two public issues so far at a combined total of \$700 million and a private issue that it placed through its own merchant banking arm. In March, 1987, Bank of America established "California Credit Card Trust 1987-A" and issued the first certificates of ownership in a pool of credit card receivables. The transfer of credit card receivables from the bank to the trust was structured as a sale for regulatory and financial reporting purposes.⁵⁵

Two forms of credit card-backed securities were introduced to the public markets during 1987: (1) a sale using certificates of ownership of the credit card receivables; and (2) a borrowing using notes collateralized by receivables.

While the structure of CARDS technology has yet to be fully standardized, a typical CARDS issue may be structured as follows. The issuers initially sell a set of customer credit card balances, frozen as of a certain date. The accounts remain with the bank, and customers are naturally free to continue paying down or running up their balances. The balances are sold to an "owner's trust", which divides them into two portions: the investors' interest, which is sold to bond holders, and the sellers interest, anywhere from 15 to 40 percent of the investors' portion, which remains with the trust.⁵⁶

The life of a CARDS issue is ordinarily between two and three years, of which the first eighteen months is an "interest only" period during which the balances remain fixed. The seller's interest acts as a buffer to keep the investors' balances fixed; it fluctuates to compensate for any changes as customers pay down or run up their balances.⁵⁷

To date, most CARS and CARDS have received high ("AAA", "AA") ratings based on the quality of collateral, the integrity of the payment structure, and the amount and the quality of the credit support.⁵⁸

(2) Mortgage-backed Securities

• Collateralized Mortgage Obligations (CMO)

The CMO first appeared in June 1983, when the Federal Home Loan Mortgage Corporation (FHLMC) introduced a \$1 billion security offering on the capital market. By the end of February 1986, 160 CMO issues had been offered with an aggregate principal amount totalling over \$36 billion.⁵⁹

For all existing CMOs, the cash inflows are derived from pools of residential mortgages. CMOs may be collateralized by conventional mortgages, FHA/VA mortgages, mortgage pass-through securities, or any combination thereof. About two-thirds of CMO issues have been backed by GNMA issues. Most CMOs have very low default rates because they are backed by GNMA, FNMA, and FHLMC.⁶⁰ This does not mean that the cash flows are riskless. Their timing is uncertain because the mortgage borrower has the privilege of prepaying the loan at any time. There is the risk that the borrower will choose to prepay at an inopportune time, when interest rates for reinvestment are relatively low.⁶¹

The CMO issuer divides the issue into two or more classes or "tranches" and sells the securities in each specified tranche. Most of the existing issues have four tranches (A,B,C...Z). Each tranche is entitled to a specific portion of the cash flows received from mortgage collateral. In a typical issue, the first tranche (or the A tranche) receives a stated bond coupon, and to the extent that the underlying mortgage prepays, the A tranche also receives additional payments which serve to retire the outstanding principal amount. The total payments to each tranche is determined by a formula that the CMO trustee is obligated to follow.⁶²

All principal payments from the mortgage pool are passed through to the first tranche until it is retired. Cash flow from the collateral is used first to pay interest and then to retire each tranche sequentially. All regularly scheduled principal payments and all prepayments of principal are paid first to the shortest maturity tranche. When the A tranche is paid off, principal payments are then directed to the "next shortest maturity" tranche--the B tranche. This process continues until all tranches are paid off.⁶³

The shortest maturity tranche is typically structured to have a three to ten year contractual maturity based on no prepayment of principal. But because of prepayments, the A tranche typically has an average life of one to three years. Investors in A tranches are generally liquidity buyers such as banks.⁶⁴

The B and C tranches usually have projected lives of three to seven and five to ten years, respectively. Investors in B and C tranches will be cushioned from prepayment risk to some extent because early prepayments are directed to the A tranche. Investors in these tranches will have a period when they receive interest only--depending upon the rate of principal prepayment on the underlying collateral. Investors in B and C tranches are usually intermediate term investors such as pension funds and trust accounts.⁶⁵

Z tranches combine characteristics of zero-coupon bonds and mortgage-backed securities pass-throughs.⁶⁶ While A, B, and C tranches are being paid down, the interest earned on the Z tranche is accrued or added to the principal. The balance of the Z tranche grows at the coupon rate. After all the earlier tranches are paid off, the Z tranche accrual period ends and interest and principal payments commence. Z tranche investors are usually long term bond investors who have predictable cash flow needs and are willing to sacrifice cash flow, interest payments, and liquidity for higher yields.⁶⁷

• Real Estate Mortgage Investment Conduit (REMIC)

The Tax Reform Act of 1986 created a new tax entity called the real estate mortgage investment conduit or REMICs. REMICs are pass-through vehicles designed for multiclass mortgage pools and offer flexibility and protection from double taxation--a problem CMOs avoid through legal technicalities.⁶⁸ Under the new tax rules, any financing done through a REMIC will be treated as a sale of assets for tax purposes, regardless of the legal form or the financial accounting treatment of the transaction. As a result, an issuer may elect to structure a REMIC offering as either a sale of

assets or as collateralized debt. Interests in a REMIC will be issued in the form of one or more tranches of regular interests--similar to the debt obligations of a CMO.⁶⁹ For purposes of this report, REMIC securities will be considered equivalent to CMOs. The advent of REMICs is expected to result in a proliferation of mortgage-backed securities with widely varying risk/return characteristics.

(3) Consumer Loans as Collateral For State Deposits

Following the adoption of section 38-3(9), Hawaii Revised Statutes, by the Legislature in 1984, Bank of Hawaii (BOH) developed and submitted a proposed pledging program to the Department of Budget and Finance for consideration. While the initial proposal was rejected by the department in 1985, BOH has once again submitted its prospectus for consideration in this report. The following is a brief summary of the 1985 BOH prospectus relating to the use of commercial loans as collateral for State deposits.

The basic intent of the BOH prospectus is to establish a pledging program that would collateralize up to 50 percent of the State's deposits through the use of a pool of the bank's commercial loans as collateral.⁷⁰ The remaining 50 percent of the State's deposits would be collateralized by United States Treasury, federal agency, and municipal securities. The prospectus commits the BOH to paying interest rates on the State's CDs at a rate at least equal to 103 percent of the prevailing coupon equivalent yield of Treasury bills of comparable maturities (see Chapter 6).⁷¹ As an average, public depositors have in the past received a rate close to but normally less than the treasury bill equivalent.⁷² According to the prospectus, the benefits to the State in accepting this program would include "greater yield on deposits, reduced total risk and improved liquidity."⁷³ The prospectus further states that the program would "provide a source of funds for local lending, which should result in increased local economic activity and improved tax revenues."⁷⁴

The pledged loans will consist of: (1) a "core" of loans which are either floating rate loans with maturities of less than five years or fixed rate loans with maturities of not more than a year; and (2) "other" loans which are pledgable at the Federal Reserve Discount Window but which "do not meet the liquidity standards of the 'core' collateral".⁷⁵ The prospectus states the BOH will agree to maintain "a portion" of the pool in "highly liquid qualifying loans". The loans will be pledged at par and valued for collateral purposes at 90 percent of their par value. At that value, the bank commits to pledging total loans in an amount at least equal to 150 percent of the State's collateral requirements.⁷⁶

BOH guarantees that no loans classified as substandard by the FDIC or whose payments are delinquent for more than ninety days will be pledged for collateral purposes and that the totals of such loans will be netted out of the collateral total. BOH reports that the default experience for loans in this category has been extremely low, averaging less than one-half of one percent. The bank also states that the 150 percent excess collateralization allowance will off-set the credit risk associated with loan defaults in the pool.⁷⁷

THE PERSPECTIVE OF DEPOSITORIES IN HAWAII

As the loans mature, the bank will remove the appropriate promissory note from the collateral pool. Paid loans will be formally deleted from the pool quarterly. Physical custody of the loan pool will be the responsibility of Hawaiian Trust Company.⁷⁸

Chapter 5

DEPOSIT PROTECTION PROGRAMS IN OTHER JURISDICTIONS

As noted earlier in this report, the state Department of Budget and Finance conducted an eleven state survey (Exhibit 3-1) of state treasury *investment yields on time certificates of deposit (CD)* during 1987. The survey disclosed that among the eleven states responding to the questionnaire, the State of Hawaii apparently received the lowest return on its investments placed in CDs during that period of time. The Department pointed to the lack of competitive forces in the public funds market in Hawaii due to the statutory restriction that existed at the time prohibiting the investment of funds out-of-state. Hawaii's banking industry argued that factors such as the State's collateralization policy and the short-term maturities of the State's CD investments were the primary reasons behind the State's lower return.

While there exists no reason or cause to challenge the validity of the foregoing arguments, analysis of those arguments in light of the results of the survey may lead to contradictory findings. For example, it is generally believed that collateralization requirements will negatively impact the yield an investor should expect to receive on investments secured under such terms. As the survey indicates, however, the State of Washington, which maintains a pooled collateralization program that limits collateral coverage to only 10 percent of a public deposit, received a return only 27 basis points above that of State of Hawaii which requires deposit coverage at 110 percent. Additionally, the State of Arizona, which requires full deposit collateralization received a return almost 200 basis points above that of the State of Washington.

Another factor which may affect the return an investor may receive on CDs is the length of their maturity. It is generally understood that longer maturities yield higher returns. Once again, however, the survey reveals situations which may appear to be contradictory. For example, the State of Oregon received an average return of 8.95 percent on its deposits held in CDs with average maturities of 60 days, while the State of Idaho (which requires no collateralization) received a return approximately 175 basis points below that of Oregon's on CDs with average maturities of 272 days. Clearly, strict reliance upon either the results of the survey or the aforementioned factors may lead to erroneous conclusions. Many factors of cash management contribute to the determination of an investor's yield. It may be inaccurate to assume that any one factor could in fact be responsible for either the superior or poor performance of an investment.

While the investment and cash management alternatives available to the public investor to enhance yield merit review and analysis, the focus of this chapter is confined to the subject of deposit collateralization and its implications upon deposit safety and liquidity as set forth in H.R. No. 246. Based on the premise that more information would be needed to reliably evaluate both the deposit protection practices of other states and the collateralization alternatives proposed by local depositories for consideration in

this study, a follow-up survey of the eleven original states in the 1987 study was conducted.

Deposit Protection Programs in Other Jurisdictions

The public deposit protection requirements of the various states and municipalities of the United States are generally set forth in the statutes of each state. However, a review of any given state's statutory requirements for deposit collateralization will often be uninformative. Generally, most deposit collateralization statutes are purposefully broad in setting forth the options and alternatives available to the deposit protection program administrator. Typically, programmatic details and other issues that require analysis on a case-by-case basis are either left to the discretion of the program's administrator or are clarified in the program's administrative guidelines. For example while most states statutorily define the parameters of acceptable collateral, the final decision as to the prudence of incorporating any particular security into the program's portfolio is left to the judgment of the administrator. Therefore, while any given class of security may appear to be legally acceptable under the statutory language of a particular state, that particular class of security may not meet the program's administrative standards. One exception to this observation is the State of Colorado where the State Divisions of Banking and Savings and Loan are obligated to accept all securities identified by the Legislature as permissible in that state. Such exceptions notwithstanding, the general purpose of most deposit collateralization statutory provisions is to establish the basic powers and duties of the program and to set forth the administrator's obligation to safeguard the public treasury. Exhibit 5-1 presents the collateral instruments eligible for pledging among the fifty states.

As noted earlier in this report, 43 states have enacted deposit protection statutes of some kind that require depositories to pledge collateral to secure public deposits. In addition to state level deposit protection, 38 states presently require their political subdivisions to collateralize their public deposits. Exhibit 5-2 presents a national overview of the deposit coverage requirements of state and local governments.

For the purposes of this chapter, three deposit protection program variations will be reviewed in detail: (1) the program of the State of Utah where there are no requirements for deposit collateralization; (2) the program of the State of Washington where the Public Deposit Protection Commission maintains a pooled collateral program; and (3) the program of the City and County of Honolulu where full deposit collateralization is required pursuant to section 38-3, Hawaii Revised Statutes, but where a higher return yield can be negotiated with certain depositories due to the acceptance of the class of securities eligible under section 38-3(9). Exhibit 5-3 presents a summary of the follow-up study conducted on the deposit protection programs of the eleven states originally surveyed by the Department of Budget and Finance. The following is a detailed study of the programs of Utah, Washington, and the City and County of Honolulu.

Exhibit 5-1

ELIGIBLE COLLATERAL FOR DEPOSIT PLEDGING

State	U.S. Government obligations	U.S. agencies obligations	State obligations	State agencies	General obligations	Corporates	First real estate mortgages	Other ¹
Alabama	Yes	Yes	Yes	Yes	Some	No	No	L
Alaska ²	—	—	—	—	—	—	—	—
Arizona	Yes	Yes	Yes	No	Yes	No	Some	L
Arkansas	Yes	Yes	Yes	Yes	Yes	No	No	L
California	Yes	Yes	Yes	Some	Yes	No	Yes (@150%)	A,B,G,H,L
Colorado	Yes	Yes	Yes	Yes	Yes	No	Some	No
Connecticut ²	Yes	Yes	Yes	Yes	Yes	Yes	Yes	—
Delaware	Yes	Yes	Yes	No	Some	No	No	No
Florida	Yes	Yes	Yes	Some	Yes	Some	No	H,L
Georgia	Yes (No Strps)	Yes	Yes	No	Yes	No	No	H,J,L
Hawaii	Yes	Yes	Yes	Yes	Yes	No	No	L
Idaho ²	—	—	—	—	—	—	—	—
Illinois	Yes	Yes	Yes	Some	Yes (@115%)	No	Some	No
Indiana ²	—	—	—	—	—	—	—	—
Iowa	Yes	Yes	Yes	No	Yes	Some	No	No
Kansas	Yes	Yes	Yes	Yes	Some	—	No	L
Kentucky	Yes	Yes	Yes	Yes	Yes	No	No	No
Louisiana	Yes	Yes	Yes	Yes	Yes	No	No	No
Maine	Yes	Yes	Yes ³	Yes ³	Yes	Some	No	D,G,H
Maryland	Yes	Yes	Yes	Yes	Yes	No	No	G,H
Massachusetts	—	—	—	—	—	—	—	—
Michigan	Yes	Yes	Yes	Yes	Yes	No	No	No
Minnesota	Yes	Yes	Yes	Yes	Some	No	Yes	C,F,K
Mississippi	Yes	Yes	Yes ³	Yes ³	Yes	No	No	No
Missouri	Yes	Yes	Yes	Yes	Some	No	No	No
Montana	Yes	Yes	Yes	Yes	Yes	No	Yes	L
Nebraska	Yes	Yes	Yes	No	Yes	No	No	C,E
Nevada	Yes	Yes	Yes	No	Yes	No	Yes (@200%)	No
New Hampshire ²	—	—	—	—	—	—	—	—
New Jersey	Yes	Yes	Yes	Yes	Some	No	No	No
New Mexico	Yes	Yes	Yes	Yes	Yes	No	No	No
New York	Yes	Yes	Yes	Yes	Yes	No	No	No
North Carolina	Yes	Yes	Yes	Yes	Some	No	No	No
North Dakota	Yes	Yes	Yes	Yes	Yes	No	No	No
Ohio	Yes	Yes	Yes	Yes	Yes	No	No	No
Oklahoma	Yes (No Strps)	Yes	Yes	Yes	Some	No	No	No
Oregon	Yes	Yes	Yes	Yes	Yes	No	No	No
Pennsylvania	Yes	Yes	Yes	Yes	Yes	No	No	Yes
Rhode Island	—	—	—	—	—	—	—	—
South Carolina	Yes	Some	Yes	Some	Some	No	No	E
South Dakota	Yes	Yes	Yes	Yes	Yes	No	Yes	No
Tennessee	Yes	Yes	Some	Yes	Some	No	No	B,C,F,G,H
Texas	Yes	Yes	Yes	Yes	Yes	No	No	No
Utah ²	—	—	—	—	—	—	—	—
Vermont ²	—	—	—	—	—	—	—	—
Virginia	Yes	Yes	Yes	Yes	Some	Some	No	B,C,F,G,H
Washington	Yes	Yes	Yes	Yes	Yes	No	No	?
West Virginia	Yes	Yes	Yes	Some	Some	No	No	No
Wisconsin ²	—	—	—	—	—	—	—	—
Wyoming	Yes	Yes	Yes	Yes	Yes	Some	Yes	E,J,L

¹See Appendix A

²Out-of-state obligations are accepted with restrictions.

³See listing below

Other collateral:

A—African Development Bank

B—Asian Development Bank

C—Bankers' acceptances

D—Canadian bonds

E—Certificates of deposit

F—Commercial paper

G—Inter-America Development Bank

H—World Bank

I—Israeli bonds

J—Merchant Marine bonds

K—Shares of an investment company

L—Warrants

Source: Matthew Petri, Fidelity Investments, *Government Finance Review*, Vol. 3, No. 5, October 1987, p. 25.

Exhibit 5-2

**PLEDGING REQUIREMENTS FOR THE PROTECTION
OF DEPOSITS OF PUBLIC FUNDS:
PERCENTAGE OF COVERAGE REQUIRED**

State	State Funds	Subdivision Funds
Alabama	100%	None
Alaska		None
Arizona	100	100
Arkansas		
California	110	110
Colorado	100	100
Connecticut		
Delaware	102	102
Florida	50	50
Georgia	110	110
Hawaii	100	100
Idaho	None	None
Illinois	110	None
Indiana	None	None
Iowa	110	110
Kansas	100	100
Kentucky	100	100
Louisiana	100	100
Maine	100	100
Maryland	102	102
Massachusetts	None	None
Michigan	100	None
Minnesota	110	110
Mississippi	75	75
Missouri	100	100
Montana	50	50
Nebraska	110	110
Nevada	100	100
New Hampshire	None	None
New Jersey	120	
New Mexico	100	100
New York	100	100
North Carolina	100	100
North Dakota		110
Ohio	100+	100
Oklahoma	110	100
Oregon	25	25
Pennsylvania	120	
Rhode Island	?	None
South Carolina	100	100
South Dakota	110	110
Tennessee	100	110
Texas	100	100
Utah	None	None
Vermont	None	None
Virginia		
Washington	10	10
West Virginia	102	102
Wisconsin		
Wyoming	100	100

Source: Matthew Petri, Fidelity Investments, Government Finance Officers Association, *Collateralizing Public Deposits*, May 1987, p. 15.

Exhibit 5-3

SURVEY OF ACCEPTABLE COLLATERAL FOR PUBLIC DEPOSITS IN ELEVEN WESTERN STATES

<u>NAME OF STATE</u>	<u>DEPOSIT PROTECTION REQUIREMENT</u>	<u>ACCEPTABLE COLLATERAL FOR DEPOSITS OF PUBLIC FUNDS</u>	<u>POLICY ON THE ACCEPTANCE OF: CREDIT CARD ASSET-BACKED SECURITIES (CARDS); CERTIFICATES FOR AUTOMOBILE RECEIVABLES (CARS); COLLATERALIZED MORTGAGE OBLIGATIONS (CMOs); AND COMMERCIAL LOANS</u>	<u>COMMENTS</u>
Arizona	ICDs and repurchase agreements at 102%	U.S. Government and Agency Obligations at 102%; Municipal Obligations; GNMA Pass-Through Certificates; Whole Loan Mortgage Collateral at 200%	Not accepted--Depositories have never proposed these securities	Whole Loan Commercial Mortgage Collateral must be marked to market monthly and recorded in the name of the state treasury. Presumably, due to this added expense, and the 200% market value ratio, banks and S&Ls have thus far declined to pledge these securities
4 California	ICDs at 110%	U.S. Government and Agency Obligations; GNMA and FNMA; state and local obligations; also mortgage notes and deeds of trust at 150%	Not accepted--Depositories have never proposed these securities	Most ICDs are with S&Ls and require 110% coverage; negotiable ICDs with banks require no collateral
Colorado	ICDs and repurchase agreements at 102% S&Ls not meeting the minimum capital requirements or exhibiting signs of failure may be required to collateralize deposits up to 300%	U.S. Government and Agency Obligations; state and municipal obligations; commercial paper; banker's acceptances; negotiable CDs Deposit protection for banks and S&Ls are dealt with separately by the Division of Banking and the Division of S&Ls. Division of S&Ls accepts GNMA, FHLMC, FNMA, first mortgage loans at approximately 130%. The Colorado legislature mandates the types of securities that are eligible to be pledged as collateral. The Divisions of Banking and S&Ls are obligated to accept securities approved by the legislature.	CMOs will be allowed next year--the valuation ratio is presently being determined. CARS, CARDS and Commercial Loans have NOT BEEN AUTHORIZED by the legislature.	A state task force is currently in the process of developing recommendations to strengthen Colorado's deposit protection laws. Colorado has experienced several bank failures in recent years. Due to improper collateral monitoring and inadequate coverage, a bank failure in southern Colorado resulted in public fund losses. Several counties have filed suits against the state for inadequate protection of their deposits and for the recovery of their funds. The task force will submit a revision package to the legislature which is expected to result in the major restructuring and strengthening of the bank deposit protection law.

NAME OF STATE	DEPOSIT PROTECTION REQUIREMENT	ACCEPTABLE COLLATERAL FOR DEPOSITS OF PUBLIC FUNDS	POLICY ON THE ACCEPTANCE OF CREDIT CARD ASSET-BACKED SECURITIES (CARBS); CERTIFICATES FOR AUTOMOBILE RECEIVABLES (CARs); COLLATERALIZED MORTGAGE OBLIGATIONS (CMOs); AND COMMERCIAL LOANS	COMMENTS
Idaho	No collateral requirement FDIC and FSLIC coverage only	Not applicable	Not applicable	Idaho permits TCD investment with in-state deposits only. The state invests principal and interest up to the \$100,000 FDIC, FSLIC limit.
Montana	State law requires a minimum of 50%. The Board of Investments investigates the condition of the institution and can assess a higher ratio	U.S. Government and Agency Obligations; state and municipal obligations; commercial paper; bankers' acceptances	Not accepted--Basically prefers to work with securities that are marketable and have readily determinable prices. The spread between bid and offer in the marketplace may be substantial for such instruments--an aspect they wish to avoid. Price fluctuation may be a problem.	Montana has experienced several bank failures in recent years. During one incident which nearly resulted in a failure, the state utilized a strategy to avert the loss of funds and help provide stability to the bank. Rather than withdrawing its deposits, the state segregated its deposits into separate denominations of \$100,000. CDS were pledged in the name of each separate special fund account. The FDIC recognized each fund as individual and therefore guaranteed \$100,000 coverage per special fund account. The state has never sustained any monetary losses.
Nevada	100% of the uninsured portion of the deposit	U.S. Government and Agency Obligations; state, county, municipal, or school district bonds; also GNMA and FNMA mortgages at 200%	Not accepted--Some institutions have suggested several of these items, but the State has thus far declined to accept such proposals	Each bank in Nevada receives a token \$100,000 deposit.
Utah	No collateral requirement. FDIC and FSLIC coverage only; the State Money Management Council rates banks and develops a list of qualified banks	Not acceptable	Not applicable--The State has evaluated several of these items in terms of their investment potential. However, they felt that due to their preference for short-term (30 to 60 days) money market investments to coincide with their expenditure schedules and the problems they felt they would encounter with liquidity, the state has chosen not to include these securities in its investment portfolio	See text for full review

NAME OF STATE	DEPOSIT PROTECTION REQUIREMENT	ACCEPTABLE COLLATERAL FOR DEPOSITS OF PUBLIC FUNDS	POLICY ON THE ACCEPTANCE OF: CREDIT CARD ASSET-BACKED SECURITIES (CARDS); RECEIVABLES FOR AUTOMOBILE RECEIVABLES (CARS); COLLATERALIZED MORTGAGE OBLIGATIONS (CMOs); AND COMMERCIAL LOANS	COMMENTS
Oregon	Each depository must post collateral at a minimum of 25%. The state may assess a higher requirement up to 100% based on the financial status of the depository	U.S. Government and Agency obligations; state and municipal obligations; insured FHA and VA mortgages. The Oregon Treasury is in the process of eliminating one class of mortgage security (one to four family mortgage loan notes) from its list of eligible instruments due to the treasury's judgment that it fails to meet their performance standards	Not accepted--Prefers to deal with instruments that exhibit high levels of liquidity and less price fluctuation in the market	The State of Oregon maintains a highly competitive system of TCD bidding. The state utilizes the federal composite TCD rates published by the Federal Reserve Bank of New York to establish the minimum acceptable bid. These rates are national rates established by the large rate setting banks that tend to be more competitive than smaller banks. Consequently, the TCD bids accepted by Oregon are competitive on the national level.
Washington	10% pool for banks 10% pool for S&Ls	U.S. Government and Agency obligations; state and municipal issues	Not accepted--This class of security may be "difficult to unload" in the marketplace	See text for full review.
New Mexico	New Mexico conducts a risk-assessment analysis on their depositories. Banks rated in good condition are required 50% deposit coverage; banks in fair condition are required to post 75%; and banks in poor condition are required 100% deposit coverage. If a bank maintains unsatisfactory status for more than two quarters, public funds are withdrawn.	U.S. Government and Agency obligations; state and municipal obligations	Securities such as these have been proposed several times, however, the legislature has consistently rejected each bid to authorize such instruments	
Wyoming	100% coverage required for the uninsured portion of the deposit	U.S. Government and Agency Bills, Notes, and Bonds; municipal issues; in-state mortgages at 150%; 90% guaranteed portion of SBA loans	CMOs have been accepted recently, CARS, CARPS; and commercial loans are not accepted	Wyoming has experienced several bank failures in recent years. However, with the assistance of the FDIC, the State has never sustained any monetary losses.

The State Money Management Act of Utah

The State of Utah does not require collateralization of its public deposits. Public deposit protection in Utah is accomplished through the use of a bank ranking system and the deposit insurance guarantees of the FDIC and FSLIC.¹

To protect its public deposits, the State Financial Commission of Utah develops a list of banks which are considered qualified to receive deposits of public funds. With respect to in-state institutions, an allotment is established by the State Money Management Council based on a formula of adjusted bank capital to assets.² This ratio establishes guidelines for determining the maximum amount of public funds allowed per public treasurer which can be held at a qualified depository in order to protect public treasurers from the risk of loss. These criteria along with an institution's willingness to provide interest at the market rate contribute to the state's decision to allow public funds to be deposited in any in-state institution.

To assess the financial condition of any potential out-of-state depository, the State Financial Commission utilizes the evaluative criteria of the firm of Keefe, Bruyette, and Woods. To qualify as a depository under the rules of Utah, an out-of-state depository must maintain a rating of "BC" or better (on a scale of A to D) and must possess \$5 billion in assets. Any out-of-state depository whose rating drops below the minimum standards established by the Commission must be eliminated from the list of qualified depository institutions.³

Due to Utah's stringent system of bank ranking and the understandable priority it places on receiving a fair market yield, many in-state banks are limited to deposits not exceeding the \$100,000 federal insurance protection ceiling. In 1987 the Utah Treasury reported \$44 million in CDs invested in depositories within the State of Utah and \$493 million in CDs invested in depositories located out-of-state.

In the event of the collapse of either an in-state or an out-of-state depository, public treasurers in Utah are guaranteed deposit recoveries only up to the federally insured limits of \$100,000 for banks and thrift institutions.⁴ Deposits of principal and interest earnings in excess of this limit may be lost. The investment officer of the Utah State Treasury stated that the treasury has thus far been fortunate in that the State's funds have never been placed in any institution that eventually became insolvent.⁵

The State Public Deposit Protection Act of Washington

Prior to the enactment of the Public Deposit Protection Act (PDPA) in 1969 by the Washington State Legislature, each public treasurer (including treasurers of 265 cities and towns, and 39 counties) was required to execute a collateral agreement with every bank in which an account was held.⁶ To guarantee against loss, the bank, after allowance for FDIC insurance, was required to place in escrow, securities having a value equal to 110 percent of each public treasurer's bank balance.⁷

COLLATERALIZATION REQUIREMENTS FOR STATE DEPOSITS

With the establishment of the Public Deposit Protection Commission (PDPC), a new concept was adopted based on mutual responsibility of all banks for the failure of a single bank. The PDPC was charged with the responsibility of arranging for collateral for all public deposits under the jurisdiction of state and local public fund custodians. This procedure provided the assurance that in the event of default of any participating bank, the other member banks in the State of Washington would collectively assure that no loss of funds would occur to any custodian of public funds.⁸

Each bank's collateral requirement of pledged securities was initially reduced from 110 percent of a deposit to only 5 percent of the aggregate public treasurer's bank account balances. In 1977 the Legislature increased the collateral requirement from 5 percent to 10 percent. In the event of a bank default, the PDPC would determine the extent of the public fund loss and assess each participating bank for its proportionate share, based on the ratio that its public deposits bore to the statewide total.⁹

In 1983, the Washington Legislature expanded the Public Deposit Protection Act by allowing thrift institutions (mutual savings banks and savings and loan associations) to become eligible as public depositories. This amendment created a collateral pool for savings and loan associations separate from that of commercial banks. Although the collateral pools are separate, the procedures for each are identical.¹⁰

In 1984, the Washington Legislature amended the PDPA by limiting the total public deposits in each public depository to 300 percent of its net worth or 30 percent of total public deposits statewide, whichever amount was less. A depository could exceed these limits only by pledging 100 percent collateral to cover the excess deposits.¹¹ In 1986, the limit was lowered to 150 percent of an institution's net worth or 30 percent of total deposits statewide, whichever amount was less. Again, a depository would be permitted to exceed this limit only by pledging full collateral coverage for the excess deposits.¹²

In 1985, the Westside Federal Savings and Loan Association of Seattle collapsed--constituting the first failure of a public depository since the inception of the collateral pool concept in the State of Washington. In cooperation with the FSLIC, the PDPC instituted procedures to protect all public deposits.¹³ Due to the protective actions of the PDPC, all public funds on deposit with the institution at the time of its collapse were properly collateralized. All public treasurers received both principal and interest payments due.¹⁴

The collateral pool program of the State of Washington provides public treasurers with wide flexibility while providing adequate protection of public deposits.¹⁵ Presumably, due to the lower ratio of collateral coverage required per institution, a larger segment of Washington's financial community is able to participate in the public funds market. The total interest earnings on \$1.9 billion of investments by the Washington Treasury during fiscal year 1987 was \$70.4 million.¹⁶

The Program of the City and County of Honolulu

The deposit and investment of City and County of Honolulu funds are governed by chapter 38, Hawaii Revised Statutes, and section 46-50, respectively. Section 46-48 extends the rights, powers, duties, and obligations of chapter 38 as they apply to the deposit and investment of state funds with respect to county funds. Section 46-50 sets forth the specific items of investment in which the Director of Finance, with the approval of the City Council, may invest city funds which are in excess of the amounts necessary for meeting immediate requirements when such action will not impede or hamper the necessary financial operation of the City.

Through the adoption of Council Resolution No. 238, on March 24, 1974, the Honolulu City Council has vested blanket authority in the director of finance to invest, at the director's discretion, City funds deemed to be in excess of immediate operating requirements, provided that prior approval of the City Council is necessary before investing in bank savings accounts or time certificates of deposit if such investments are intended for out-of-state deposit. Despite the passage of Act 78, Session Laws of Hawaii 1988, which authorized the out-of-state deposit of public funds, Council Resolution No. 238 maintains the in-state deposit restriction on City funds. In its 1985 audit of the cash management program of the City and County of Honolulu, the firm of Arthur Young and Company recommended the repeal of Council Resolution No. 238.¹⁷ The report contended that maintaining the flexibility to deposit funds out-of-state, "may enhance negotiating with local institutions and ensure a competitively healthy environment for providing the City's banking services."¹⁸ The report continues that "out-of-state financial relationships will enable the City to be aware of and/or take advantage of attractive investment opportunities that may be available elsewhere from time to time."¹⁹ The City is presently in the process of preparing a motion to consider the repeal of Council Resolution No. 238.²⁰

In conducting its investment program, the City has maintained the position that while interest earnings are significant, the safety of public funds is of paramount consideration and has adhered to the following principles of investment:²¹

Safety: Regardless of any other consideration, the preservation of capital and the protection of principal are the main objectives.

Liquidity: When money is needed, the maturing investments must be immediately available for prompt convertability into cash to meet projected operating requirements.

Yield: If the first two considerations are met, the rate of return then becomes a major consideration for investing, but within the limits prescribed by law.

Section 6-204 of the Revised Charter of Honolulu 1973 (1984 edition) provides that the Director of Finance, along with a designee of the Council shall jointly, at least once every three months, verify the amount of money in the treasury and make a certified report showing the amount of money that ought to be in the treasury, and the amount and kind of money actually therein.

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With the adoption of section 38-3(9), Hawaii Revised Statutes, by the Legislature in 1984, public depositors were authorized to accept any assets on the books of a depository that was acceptable by the Federal Reserve System to secure advances made to member banks. In 1986, Bank of Hawaii submitted a prospectus to the City (identical to the proposal submitted to the State described in Chapter 4) proposing a pledging program based on the acceptance of commercial loans as collateral for City deposits.²² In May 1986, the City and County of Honolulu authorized the first pledging of commercial loans as collateral for its deposits with Bank of Hawaii.²³ Currently, Bank of Hawaii and First Hawaiian Bank are the only two institutions participating in the consumer loan pledging program with the City.

As proposed in the prospectus submitted to the State, 50 percent of the City's deposits are secured by a pool of consumer loans held by the institution. The remaining balance of the City's funds is collateralized by government securities eligible under section 38-3(1) to (8), Hawaii Revised Statutes.²⁴ The higher earnings of the City have been attributed to their participation in the consumer loan pledging program and the longer maturity periods of the City's certificates of deposit.

Currently, the City and County of Honolulu is the only public entity in Hawaii allowing its deposits to be collateralized under such terms. As the only participant in the program, the consumer loans constituting the City's collateral pools are thought to be the highest quality and best performing loans within the loan portfolios of the respective depositories. Given the size and magnitude of the respective loan pools, the City's deposits are, at present, substantially over-collateralized.²⁵ The State's participation in this program may place restrictions on the amount of quality loans that can be allocated to the collateral pools of both the State and the City.²⁶

Chapter 6

EVALUATION OF THE STATE'S COLLATERALIZATION ALTERNATIVES

The deposit protection programs of public depositors throughout the United States vary widely in terms of structure as well as methodology. Unfortunately, case studies or examples relating to most of the alternatives proposed by local depositories for this report were non-existent among the states surveyed. The risks relating to these alternatives are difficult to determine until they are actually implemented and put to the test of deposit protection. Realistically, however, such an evaluative approach should be unacceptable. Any level of risk or uncertainty surrounding any particular approach should be explored before the alternatives are implemented. The protection of public funds should be the primary objective of any administrative or legislative decision-maker; deposit security is not an issue that should be left to chance. Decision-makers are obligated to carefully scrutinize any proposed amendment in statutory or administrative policy to anticipate the risks associated with the change in policy.

The purpose of this chapter is to evaluate the programs and alternatives discussed earlier in this report and to assess the suitability of each alternative in light of the goals and objectives of Hawaii's deposit protection program. This chapter will also provide an in-depth analysis of the role of the Federal Reserve System as it relates to public deposit collateralization in Hawaii.

Alternate Deposit Protection Programs

While the programs reviewed in this report vary considerably in terms of their approach toward deposit protection, it is evident that regardless of the strategy utilized, deposit safety is an issue that is never intentionally compromised in the pursuit of other objectives. For example, although it may appear that other states may have "less stringent" collateralization requirements than the State of Hawaii, deposit security is attained through other safeguards which often result in unwanted, yet unavoidable trade-offs.

In the case of Utah, where the state requires no deposit collateralization, a stringent system of bank credit evaluation is utilized. Although depositories are not subject to the requirement of pledging collateral, less qualified institutions receive less of a share of the state's public funds. Given the risks involved in requiring no collateral coverage on deposit balances exceeding the federal insurance limits, the State of Utah places a high priority on earning the highest yield possible.¹ Due to this and other factors such as the asset size and the credit ratings of banks and other institutions in the state, the great majority of Utah's deposits are placed with highly rated institutions outside of the state.

While it is not the intent of this illustration to question the worthiness of any institution currently receiving deposits of public funds in Hawaii, a program based on the asset size and credit ratings of a depository would obviously favor Hawaii's larger banks. The current distribution of public deposits--based on the ability of the institution to adequately collateralize

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public deposits--would, perhaps, be further concentrated, contingent upon the ratings smaller institutions may receive in relation to Hawaii's larger and outwardly more secure banks. A second possibility may be the flow of public funds out-of-state to mainland banks possessing higher credit ratings. In either case, such a program would surely result in the development of negative effects, at least for certain segments of the banking industry in Hawaii.

The collateral pool system of the states of Connecticut, Florida, and Washington is an approach of proven effectiveness. This system, however, may also suffer several drawbacks when applied to the public funds market in Hawaii. The collateral pool system implies a program of "shared risk" among institutions participating in the public funds market. Inherently, therefore, such a system requires, or would perhaps be most suited for, a state or a region supporting banks and thrifts of relatively equal size and credit positions.² The pooled system allows for wide participation in the public funds market. Smaller institutions formerly incapable of meeting the deposit coverage requirements of a full deposit collateralization program may be capable of posting the reduced percentage of collateral required in a pooled program. While this may seem equitable, larger institutions may be concerned that this redistribution may result in a smaller share of the public funds market for their institutions. Conceivably in a state such as Hawaii, where as much as 86 percent of the State's deposits are held by the two largest banking institutions, a system facilitating a more equal distribution of public funds may generate considerable controversy. Moreover, the "shared risk" approach may be perceived as unfair by larger or more stable institutions in that all institutions participating in the pool must support the credit and cover the defaults of the weaker or less secure institutions.³

Aside from the foregoing considerations, the systems utilized in Utah and Washington would, in all probability, require the establishment of an upgraded system of bank monitoring. In a full deposit collateralization program, deposits are theoretically protected despite the financial status of the depository. In a scenario where no collateralization is required, however, deposit security is directly contingent upon the condition and stability of the bank. To ascertain this, the depositor must develop and maintain an up-to-date and highly sophisticated system of bank credit examination and monitoring. While this may be a prudent objective for the State's cash management program to aspire toward in any case, a partial deposit collateralization program may necessitate more vigorous depository evaluation and the expansion of the Department of Budget and Finance's capacity to monitor the condition of local depositories.

The Discount Function of the Federal Reserve System as it Relates to Public Deposit Collateralization in Hawaii

As indicated earlier in this report, the Department of Budget and Finance has maintained a preference toward working with those securities enumerated under paragraphs (1) through (8) of section 38-3, Hawaii Revised Statutes. With the addition of paragraph (9) by the Legislature in 1984, however, a much broader range of securities became eligible for consideration under the scope of the section. Thus far, however, the Department's acceptance of securities under this paragraph has been strictly limited.

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Paragraph (9) permits the acceptance of "other assets on the books of the depository which are eligible to secure advances from the Federal Reserve Banks under the regulations of the Federal Reserve Board". The intent of the provision was obviously to adapt the collateralization standards utilized by the Federal Reserve System (Fed) to those of the State. Hawaii bankers testified in 1984 that:⁴

By allowing for the pledging of the types of collateral which are acceptable for securing borrowings from the Federal Reserve Bank, it will not be necessary for the Governor and the Director to under go (sic) exhaustive investigations of each new financial instrument as it is created. That investigation will have been done by the Federal Reserve Bank.

As noted previously, most of the alternatives submitted for review and consideration in this study would more than likely fall within the scope of section 38-3(9). In this regard, section 38-3(9) deserves special analysis. This section of this chapter reviews the intent of the Federal Reserve System's policy on discounts and advances to member banks and examines this policy in light of the intent and purpose of section 38-3, Hawaii Revised Statutes.

To understand the underlying rationale of the Federal Reserve Act's broad and open-ended policy on the collateralization of federal reserve credit, the basic role of the Fed must be examined. One of the principal reasons for the establishment of the Fed in 1913 was to provide member banks of the Fed system with a new source of funds to augment their reserves.⁵ While the Act originally restricted federal reserve credit to member banks of the system, the Monetary Control Act of 1980 directed the Fed to open the discount window to nonmember institutions requiring assistance, subject to certain provisions.⁶ Essentially, therefore, nonmembership in the system no longer precludes the borrowing of credit through the discount window.

When a Federal Reserve Bank (reserve bank) grants a loan to a commercial bank, the transaction may either be a "discount" or an "advance". A discount is a loan made to a commercial bank on promissory notes, drafts and other instruments on which the bank itself has granted loans to its customers, provided that these instruments satisfy the eligibility standards enumerated in the Federal Reserve Act.⁷ In effect, the bank borrows on other peoples' obligations to pay. On the other hand, an advance of a reserve bank to a commercial bank is a loan whose repayment is solely the obligation of the bank. On advances, the member bank must pledge securities that are eligible collateral--United States Treasury obligations, securities of federal agencies, or any other assets the reserve bank is willing to accept.⁸

Most commercial bank borrowing is in the form of advances--against notes with government securities as collateral. According to the Legal Division of the Board of Governors of the Federal Reserve System, almost all of the collateral currently held by the Fed on discount window loans is in the form of U.S. Treasury and federal agency obligations.⁹ This form of borrowing is more convenient and saves time for the bank because the collateral is theoretically free of credit risk, is readily appraisable as to its

value, and can be readily supplied in large amounts conforming to the borrowing needs of individual banks. Member banks of the Fed system often leave government securities with their regional federal reserve banks for safekeeping. This arrangement also makes it easier to pledge such securities as collateral when the need to borrow arises.

Federal Reserve credit is generally extended on a short-term basis to a commercial bank to enable it to adjust its asset position when necessary due to developments such as a sudden withdrawal of deposits or seasonal requirements for credit beyond those which can reasonably be met by use of the bank's own resources. Federal reserve credit is also available for longer periods when necessary to assist banks in coping with unusual situations, such as national, regional, or local economic difficulties or exceptional circumstances involving particular banks.¹⁰ Under ordinary conditions, the continuous use of federal reserve credit by a bank over a considerable period of time is regarded as inappropriate. The discount window has the absolute right to refuse credit to banks based on its overall assessment of the economy and the legitimacy of the bank's request for credit accommodation.¹¹ Federal reserve banks will authorize credit advances only on the assurance that the bank has exhausted all other avenues of borrowing. Banks usually consider borrowing at the discount window as the "last resort".¹² In considering a request for credit accommodation, each reserve bank gives due regard to the purpose of the credit and to its probable effect upon the maintenance of sound credit conditions, both as to the individual institution and the economy in general.

Although the majority of the loans granted by the Fed to any bank are in the form of advances secured through pledges of U.S. Treasury or federal agency securities, the broadest lending authority that any federal reserve bank appears to have is enumerated in 12 U.S.C., section 347b, entitled: "Advances of individual member banks on time or demand notes." While Congress clearly intended to support the use of federally issued debt obligations during the lending of credit by the Fed, the Federal Reserve Act also provides for the acceptance of a broader array of assets identified only in terms of an extremely nebulous standard. The section permits advances to member banks "on its time or demand notes" provided that the advance is "secured to the satisfaction of the Federal Reserve Bank". In the past, this provision has been interpreted to include items such as property and equipment.¹³ There is a restriction, however, which specifies that federal reserve banks may charge interest at a rate at least one-half of one percentage point above the highest discount rate in effect at the reserve bank on advances authorized under section 347b.¹⁴

The "penalty rate" was originally intended to hold section 347b advances in reserve for financial crises and emergencies. When section 347b along with the so-called penalty rate was added to the Federal Reserve Act in 1935, Congress appears clearly to have been thinking about financial emergencies. The idea was that, as long as member banks had U.S. Treasury obligations and other eligible securities on which to borrow, it would be highly unlikely that banks would apply for section 347b advances on which a higher rate of interest would be assessed.¹⁵ However, in times of crises when holdings of federal agency and U.S. Treasury obligations may be insufficient, member banks surely would not refuse to pay a slightly higher rate in order to protect solvency, and the Fed as the "lender of last resort" would not deny

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the approval of loans on securities such as municipal obligations, consumer loans, real-estate mortgage notes, and other kinds of assets not otherwise "eligible".¹⁶

The issue in question is the primary role of the Fed in the national banking system. As the nation's central bank, one of the major functions of the Fed is to assist commercial banks to cope with the problems and difficulties they may encounter. These situations may include problems involving simple liquidity adjustment as well as crisis situations wherein the Fed's assistance is essential in order to avert an institution's collapse. Under normal circumstances, advances are allowed on the basis of securities issued by the federal government pledged as collateral. Under justifiable circumstances, however, a federal reserve bank is empowered to accommodate a broader class of paper--including consumer and commercial loans, as collateral. Having exhausted all other avenues of borrowing, most institutions approach the discount window as a "last resort." It would, therefore, be contrary to the basic purpose of the Fed to refuse credit assistance to an institution on the basis of the type of collateral it is capable or not capable of pledging. Banks approaching the discount window in a weakened position may often have limited reserves of securities or assets on which to offer as collateral. Assets and securities accepted by the Fed as collateral are often accepted out of necessity. The Fed may have no alternative but to accept the types of securities or assets a failing institution may be holding in reserve. As a practice, however, the acceptance of assets such as commercial, mortgage, and consumer loans by the discount window is viewed as a "last resort." Given the risks of extending credit to failing institutions, the Fed has been known to require loan coverage as high as 200 percent, even in cases where U.S. Treasury securities--marked-to-market twice daily--are pledged as collateral.¹⁷

The Fed's acceptance of any security or asset on the books of a bank at the discount window by no means ensures the quality of these instruments as collateral. It is questionable as to whether or not the deposit protection program of the State should subscribe to a standard that was developed by the Fed as a standby option to assist banks in cash deficient situations. Indeed, the financial condition of banks receiving deposits of the State should, hopefully, be just the opposite. Clearly, the mere acceptance of any given security or bank asset by the Fed at the discount window does not preclude the need to perform the so-called "exhaustive investigations" normally required of the Department of Budget and Finance when considering the acceptance of any asset or newly developed instrument eligible under section 38-3(9), Hawaii Revised Statutes.

According to Harry Jorgenson, senior attorney with the Board of Governors of the Federal Reserve System, while the discretion provided under section 38-3(9) may be "useful to have" if managed properly, "I'm not sure you're going to be too safe in accepting everything allowable under that language."¹⁸

Consumer Loans as Collateral for State Deposits

As Exhibit 5-3 indicates, the acceptance of consumer loans as collateral for state deposits would be unprecedented among the eleven state treasuries

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surveyed in this study. Most state treasuries are required to utilize registered securities when collateralizing public deposits. In Hawaii, however, section 38-3(9), Hawaii Revised Statutes, permits the acceptance of consumer and commercial loans as collateral. During the course of this study, the only program found to be authorizing consumer and commercial loans as collateral for public deposits was that of the City and County of Honolulu.¹⁹

As noted in Chapter 5, the proposal offered by the Bank of Hawaii (BOH) was rejected by the Department of Budget and Finance during its first submittal in 1985.²⁰ In light of its administrative policy regarding deposit security and liquidity, the Department found that the acceptance of consumer loans as collateral against its deposits would be inconsistent with its obligation to protect public funds. Despite the higher rate of interest promised in the prospectus, the Department felt that a possibility existed for deposit security to be compromised.²¹

The BOH prospectus contends that the benefits to the State in accepting the bank's proposal would "include greater yield on deposits, reduced total risk and improved liquidity".²² According to the prospectus, the rate paid to the State on public certificates of deposit would be at least equivalent to 103 percent of the prevailing coupon equivalent yield on U.S. Treasury bills of like maturity.²³ In essence, a minimum floor based on the market rates of Treasury bills on the secondary market would be established for state CDs of comparable maturities. To estimate the approximate yield the State would have earned given the guarantee of a minimum floor, the proposed 103 percent adjustment rate for state CDs was calculated for fiscal years 1983 through 1988.

Exhibit 6-1 displays: (1) the actual rates of interest received on state deposits during fiscal years 1983 through 1988; (2) the average secondary market rate for *three month Treasury bills* calculated to correspond with the State's fiscal cycle (July 1 to June 30); (3) the minimum floor based on the 90-day CD/Treasury bill adjustment formula; and (4) the positive or negative differential between the minimum rate guaranteed by BOH and the actual rate of interest (overall average) earned by the State during the same fiscal period.

As the data indicate, the minimum floor guaranteed by BOH exceeded the actual rate of interest received by the State during four out of the six fiscal years reviewed in the exhibit. During 1983 and 1986, however, the minimum guaranteed rate fell below the overall average rate actually earned by the State during those fiscal years. While a higher rate of interest could have been offered by BOH during those fiscal years, this is not guaranteed, as the minimum floor only guarantees that the rate will not fall below the CD/Treasury bill adjustment rate.

By definition, the 103 percent adjustment rate is tied to the prevailing market rate of Treasury bills on the secondary market. During fiscal year 1984, when the rates for Treasury bills were relatively high, the interest spread between the *minimum floor* and the actual rate of interest received by the State was substantial. However, during periods such as fiscal years 1983 and 1986 when the average CD rates exceeded that of Treasury bills by a

Exhibit 6-1

COMPARISON BETWEEN BANK OF HAWAII'S PROPOSED INTEREST ADJUSTMENT RATE AND INTEREST ACTUALLY EARNED BY THE STATE 1983-1988

	Fiscal Year 1983	Fiscal Year 1984	Fiscal Year 1985	Fiscal Year 1986	Fiscal Year 1987	Fiscal Year 1988
Return on investment ¹	9.04%	8.71%	9.09%	7.27%	5.53%	5.70%
Average treasury bill rate (July to June) ²	8.43%	9.23%	8.69%	6.83%	5.54%	6.01%
Bank of Hawaii 103% CD equivalent adjustment rate estimate ³	8.90%	9.73%	9.15%	7.16%	5.79%	6.28%
Differential between actual earnings and proposed rate	- .14	+1.02	+ .06	- .11	+ .26	+ .58

1. Annual Report of Deposits and Investments of the State of Hawaii, 1983 to 1988.
2. Federal Reserve Statistical Release--Selected Interest Rates, Federal Reserve System 1983 to 1988.
3. BOH CD equivalent adjustment formula:

$$\frac{360 \text{ days} \times \text{T. Bill rate}}{360 \text{ days} - (\text{T. Bill rate} \times 90 \text{ days})} \times 103\%$$

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relatively large margin, the minimum floor fell short of being outwardly beneficial.

Although the promise of higher yields is an obvious incentive, it is difficult to determine the extent to which additional risks should be assumed in order to earn additional profits. Obviously, the better the offer, the greater the temptation. However, in light of the fact that the interest rate advantage of the proposed program during the four fiscal periods in which there was any measurable advantage at all, was approximately 48 basis points--about one-half of one percent--the benefit of taking on the additional risks of consumer or commercial loans as collateral is questionable. Indeed, the estimated BOH minimum floor that would have been offered to the State in fiscal year 1987 (at 5.79 percent) would have fallen far short of the average 7.27 percent earned by the eleven western state treasuries, utilizing relatively conventional instruments as collateral (Exhibit 3-1).

A second major concern of the Department in evaluating any potential asset or security as collateral is the liquidity of the instrument. As noted earlier, the marketability of a security on the secondary market is of prime concern to any public depositor. High liquidity ensures that security can be sold immediately without substantial losses in value and that the security can be readily converted into cash.

Unsecuritized consumer or commercial loans are not registered securities. Securities are liquid and tradeable while most loans are not. The BOH prospectus itself concedes that: "There is no active secondary market for commercial loans."²⁴ The prospectus continues: "The ability of public depositors to liquidate this collateral is based on the character of those loans (short maturity, high quality, floating rate)."²⁵ Regardless of the quality of the loans, the presence of an established market consisting of willing buyers is essential to the sale of these assets. Without a market for assets of this nature, the State may become the owner of the loans, having to collect payments on their outstanding balances until they mature--a situation the Department would wish to avoid.

Given the fact that as much as 50 percent of the State's deposits with BOH would be subject to collateralization by assets of this nature, the State's portfolio may consist of loans in amounts exceeding \$300 million.²⁶ In the event of a default, the chances of the Department immediately locating a buyer that would conveniently purchase assets of this size off the books of the State is questionable.

The third major concern of the Department is the use of Hawaiian Trust Company as the custodian of collateral pledged to the State. A cardinal rule among all public depositors requiring deposit collateralization is that securities pledged as collateral should be segregated and physically placed in the custody of an independent third party for safekeeping. The rationale behind this practice is to ensure that the collateral is independently controlled, and that if the need to liquidate the securities arises, problems relating to title or ownership would be avoided. Currently, collateral securities pledged to the State by local depositories are placed in the custody of banks or trustees located on the mainland.²⁷ The problem perceived by the Department under the BOH arrangement is that Hawaiian Trust Company is a subsidiary of the Bank of Hawaii. Although Hawaiian Trust Company would be obligated to

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function in a capacity as an independent trustee in any default proceeding of the BOH, the Department feels that this close relationship may present an unnecessary conflict.²⁸

Other concerns may include the additional work hours that would be required on the part of the Department to evaluate and monitor the pool of pledged loans. Unlike conventional bonds or bills of the government which appreciate in value as they mature, consumer loans are constantly being paid off. While it would be the bank's responsibility to maintain the proper collateral balance and eliminate loans as they default or mature, the diminishing value of these assets (including securitized assets such as CARS, CARDS, and CMOs) complicates the public depositor's ability to independently verify the actual value of the pool of assets pledged as collateral. Without a direct access computerized system of collateral monitoring, it may be difficult for the Department to determine the actual status of the collateral pool (and therefore the actual value of the collateral itself) at any given point in time.²⁹

CARS and CARDS as Collateral for State Deposits

Asset-backed securitization is an emerging industry. It is not surprising, therefore, that state treasurers currently remain skeptical or undecided as to the appropriateness of accepting these instruments as collateral. A second concern may be that such securities may not be legally acceptable as collateral unless authorized by the legislature of the state. Among the states surveyed in this study, only one state--New Mexico--noted that these instruments were being seriously considered as collateral for state deposits. As indicated in the survey, however, the New Mexico State Legislature has thus far rejected each bid to authorize these securities as collateral.³⁰ The use of CARS and CARDS as collateral for State deposits in Hawaii would be unprecedented among the states contacted in this study. While the market outlook for receivable-related securities may seem promising, the industry is still in its infancy, and without a record to evaluate the performance of these securities as instruments of collateral for public deposits, it is difficult to develop a determination as to the reliability of these instruments. Without a record of performance as legitimate instruments of collateral in the public sector, the only alternative is to evaluate these securities in terms of the risks they pose to investors. National securities rating services such as Moody's Investment Services, Inc. and Standard and Poor's Corporation (S&P) play an important role in developing the market's perception regarding any particular investment vehicle. The structure of asset-backed securities, which are backed by pools of loans with little or no reliance on the issuer's own credit, is so complex that investors rely heavily on the rating firms' scrutiny.

As noted earlier, the yield spread of receivable-related securities for investors is often a principal factor behind their decision to select these investment vehicles over conventional government securities. Without the "full faith and credit" assurance of the government, however, securities such as corporate bonds and receivable-related securities rely heavily on good ratings issued by Moody's and S&P to define the market outlook for these securities. A high rating is often essential to the success of the issue, while a low rating by either S&P or Moody's may spell trouble for the security in

the market.³¹ While rating firms have not always been invited to rate and examine certain issues of asset-backed securities, firms such as Moody's have chosen to rate these securities without the issuer's cooperation. Moody's contends that several points of view may be necessary to judge accurately the quality of a firm's offerings.³²

Although there are very few "AAA" rated banks in the United States, asset-backed securities often achieve "AAA" ratings by tacking on a whole web of third-party credit enhancements³³--often through foreign banks and insurance companies--such as the Union Bank of Switzerland's \$60 million letter of credit guarantee to enhance Bank of America's 1986 credit card-backed offering.³⁴ Asset-backed securities need third-party support because most investors find it difficult to determine the reliability of the pool of credit card billings or auto loans held by individuals supporting the security.³⁵ As noted earlier, these credit guarantees can come in the form of insurance policies, over collateralization, or, most commonly, "letters of credit" (LOC) which generally cost half the price of an insurance policy.³⁶

While credit enhancement of securities through LOCs and insurance policies are legitimate means of protecting the investor's interests, caution has been advised on relying entirely upon the ratings awarded to these securities and the guarantors themselves. Both the Wall Street Journal³⁷ and Owen Carney, director of the Comptroller of Currency's Investment Securities Division in the United States Treasury³⁸ warned that an LOC guarantee is only as stable as the party issuing the guarantee. In many cases, according to Moody's, the security's rating is "strongly" dependent on the rating of the guarantor.³⁹ According to Mr. Carney, "if the guarantor fails, so does the guarantee". Indeed, a firm in jeopardy will often find it difficult to live up to its promise to fully support the security.⁴⁰

Such was the case in August of 1988, when Moody's placed almost \$14 billion of asset- and mortgage-backed securities on watch because the guarantor's condition was in jeopardy.⁴¹ When the rating of the third party guarantor is in jeopardy, the securities' ratings are also in danger. Moody's decision to reconsider the ratings of securities guaranteed by certain banks was brought on by their growing concern over the heavy "third-world" debt loads threatening the stability of the particular institutions.⁴²

Clearly, although asset-backed securities are generally rated highly, caution should be exercised in judging the full quality of any particular issue. Unlike government securities, the structures of these instruments are extremely complex, and any failure within the network of the structure can cause its collapse. According to Moody's, the complexity of asset-backed technology has resulted in a situation wherein "investors are exposed to risk from areas they may not expect".⁴³ The Wall Street Journal further warns that "investors who fail to understand the subtle risks of the new securities could suffer unexpected losses, as happened with mortgage-backed notes when rates fell and homeowners repaid much faster than expected."

A concern that is often expressed with regard to most asset-backed security issues is the uniqueness of each issue and the limited geographic or economic base of the individual issue's credit card or auto loan pool. A disadvantage of investing in asset-backed securities as well as whole mortgages is that they are not homogenous commodities, and are, therefore,

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less marketable than conventional government securities. Due to the uniqueness of the terms of each pool of assets and the complexity of the assets securing it, asset-backed issues are often not uniform. These securities are regulated essentially by state and local laws that vary considerably and are parochial--an isolated downturn in a local area's economy may affect them sharply.⁴⁵ The natural tendency of a bank securitizing a pool of receivables is to use its own receivables as the assets of the pool. According to Mr. Carney of the Office of the United States Comptroller of Currency, a major default experience in the originating state of an issue may seriously affect the quality of the issue. If an economic catastrophe in a local area leads to loan payment defaults in excess of the "worst-case default scenario" guaranteed under the LOC, the investor's interests may be threatened.⁴⁶ Mr. Carney contended that perhaps the only CARS issues having a national base of auto loans within its pools are the securities offered by GMAC.⁴⁷ Regulators contend that this exposure is necessary to compensate for regional or local disasters in the economy.

In terms of the overall investment picture for asset-backed securities, the future remains promising. As reviewed in the previous chapter, substantial benefits may be realized by certain sectors of the economy. However, due to the likelihood of possible repercussions to the economy in bringing about such a tremendous restructuring of the current system of bank lending and credit securitization, government, as well as investors and rating agencies, have been keeping a close watch on the emerging industry. The Internal Revenue Service, the Federal Reserve System, and the Securities and Exchange Commission have expressed the need to address certain aspects of the industry.

Additionally, while rating agencies such as Standard and Poor's have issued high ratings on certain issues of CARS and CARDS, they also have expressed their concerns. S&P noted in March of 1988, that although the auto-backed securities industry's net losses in relation to "average outstandings" (i.e., the average amount of that type of security which is on the market at any given time) have been under 0.5 percent for the last five years, several factors could cause losses to be significantly greater in a securitized pool of auto assets. S&P warned that:⁴⁸

- Actual losses may be understated since many portfolios have grown rapidly in the last few years. The average outstandings would therefore be higher than appropriate.
- Recent economic performance has been relatively good, but S&P expects significantly greater frequency of default if a recession occurs within the next few years.
- Incentive financing programs by captive finance companies and manufacturers' rebates to sell cars have caused used car prices to decline. This trend may continue and will affect the resale value of vehicles whose owners default on their loans or leases.
- Rapid growth may test the resources and controls of many servicers, resulting in less effective collection efforts and increased losses.

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- The industry has become very competitive so underwriters of auto loans and leases may be pressured to accept marginal credit in order to maintain or increase market share.

A final concern regarding the asset-backed securities industry is the fact that these instruments are very new. In an interview with The Bankers Magazine, in March 1988, Lowell Bryan of McKinsey & Company, a major proponent of the asset-backed securities industry and the publisher of several articles on the issue stated that: "The (asset-backed) technology is very new, and we're missing a lot of what we need. It might take a decade to establish the standards and infrastructure that will be necessary to operate under this new technology."⁴⁹ Mr. Bryan continued:⁵⁰

Given the newness of the instruments, neither regulators nor rating agencies nor potential guarantors are exactly sure which rules should be followed. There are also legal and regulatory constraints. Congress and regulators have to take some proactive steps to create an environment that will shape the development of securitized credit into a sounder system. For instance, the kind of regulation that is needed to make the securitized credit system work is regulation to ensure that participants make, and are provided with, full disclosure of information; that only competent players participate; that contracts are effective; that reserves and capital are adequate for the risk taken; that there is no fraud; and that the information disclosed is accurate.

While the market for asset-backed securities has expanded dramatically in recent years, the need to address, regulate, and standardize the industry is evident. Senate Bill 2017 (S. 2017) entitled: "The Receivable-Related Securities Market Improvement Act" was introduced in the United States Senate in 1988 by Senator Richard Shelby to address this concern. Although the measure failed to receive a hearing in the 1988 session of Congress, the effort toward the federal regulation of the industry has been initiated. In the opinion of some observers, without several modifications, the chances of S. 2017 passing are remote.⁵¹ According to the office of Senator Shelby, the measure will be reintroduced during the 1989 session of Congress for further consideration.⁵²

In brief, S. 2017, as introduced, would:

- (1) Waive certain registration requirements under the Securities Act of 1933 for sales of securities backed by receivables, loans, or other assets to sophisticated institutional investors;
- (2) Exempt asset-backed securities from Federal Reserve Board margin requirements that restrict the ability of broker-dealers to extend credit to customers to purchase such securities;
- (3) Exempt asset-backed securities from state blue sky securities registration laws when an issuer has already listed securities of a comparable nature on a major securities exchange;

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- (4) Allow asset-backed pass-through securities to qualify, as mortgage-backed pass-through securities now qualify, for shelf registration under the Securities and Exchange Commission's Rule 415 whereby issuers can minimize the red tape when they want to sell a series of securities offerings or sell them quickly when market conditions are favorable without having to undergo the lengthy registration process again and again;
- (5) Allow commercial banks greater certainty as to when they can sell off loans with recourse back to the bank to cover potential losses on loans in such securities to institutional investors or securities firms for resale without having to incur excessive reserve requirements against such potential liabilities; and
- (6) Preempt state legal investment statutes to allow asset-backed securities to qualify as legal investments for state-chartered savings institutions, commercial banks, pension funds, and insurance companies.

Of particular importance is the concern stated in item (6). Due in part to the fact that the receivables-related industry has just recently emerged, state investment statutes presently fail to address the issue of the asset-backed securities market. The Congressional Record of the United States Senate dated February 1, 1988, outlines this issue as follows:⁵³

Receivable-related securities receive less favorable treatment than corporate bonds and mortgage-backed securities under so-called state legal investment statutes which restrict the types of investments which state regulated or state chartered entities such as banks, savings and loan associations, trust funds, employee pension systems and insurance companies may make. As a result the market for receivable-related securities is limited.

State legal investment statutes usually authorize state regulated or chartered entities to invest in interest bearing obligations of corporations such as corporate bonds, provided certain conditions are met. While these conditions differ from state to state they typically require the obligor on the bonds to be a corporation chartered under the laws of the United States or one of the states and that either: (a) the obligor on the bonds meet certain financial standards such as an earnings test; or (b) the bonds be rated in one of the four highest investment grades by a nationally recognized rating organization such as Standard and Poors.

Such legal investment statutes with few exceptions do not specifically authorize investment in receivable-related securities. Receivable-related securities often do not qualify as corporate debt obligations because the obligors on the receivables are individuals (such as would be the case with automobile loan receivables) rather than corporations (such as with trade receivables) and because the real issuer of the securities is a trust which is neither an obligor nor a corporation and the nominal issuer of the securities is not an obligor thereon. In other cases special purpose financing

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corporations set up to issue the securities have no earnings history and, thus, do not meet the earnings test.

Authority to invest in receivable-related securities must be found if at all in provisions authorizing investments in receivables themselves.

As a result of this disparate treatment there are many instances where a state regulated or state chartered entity such as an insurance company may invest in corporate bonds or receivables themselves but may not invest in receivable-related securities having an equal or significantly better investment grade rating.

The bill would preempt state legal investment laws so that certain receivable-related securities rated investment grade could be purchased by state regulated entities to the same extent as if they were federal government securities. Any state could enact a statute within seven years after enactment prohibiting or limiting this authority. This legislation would allow a state regulated or chartered entity to invest through a receivable related security in a receivable not permitted under state law for the entity to invest in.

While the applicability of the aforementioned problem to any particular state is obviously contingent upon the regulatory and discretionary capacities of the state-chartered entity regulators of the jurisdiction, concern apparently exists in Congress with regard to the national outlook of the receivables-related industry. As stated earlier, most state investment statutes currently are silent on the issue of whether or not asset-backed securities fall within the scope of eligible investments currently permissible for state-chartered institutions. Although investment in asset-backed securities may not be specifically prohibited, provisions specifically permitting such investments are also generally absent. National legislation clarifying this matter may eliminate the ambiguity that presently exists among the states.

While receivable-related securities are not presently addressed in the State's statutes outlining the legal investment options of state-chartered institutions in Hawaii, section 403-47.1, Hawaii Revised Statutes, of the Hawaii Bank Act of 1931, provides "wild card" authority to any state-chartered bank to function as a national bank. The section provides that:

With the consent of the commissioner (of financial institutions), every bank organized under the laws of the State shall have the power to and may engage in any activity or business and acquire, hold and dispose of any property or interest as and to the same extent it would, at the time, be so authorized by federal legislation or regulation if it were a national bank. (Parenthetical material added.)

Based on the fact that receivable-related securities such as CARS and CARDS are included in the portfolios of national banks, Hawaii's state-

chartered banks contend that these instruments fall within the scope of Hawaii's law. Although the State's so-called "wild card" provision may indeed provide Hawaii's state-chartered banks with the authority and flexibility to invest in this class of securities, a problem may exist in other states where such authority may not exist. While this is arguably a simple technicality in the language of the laws of each state, the issue, as stated in the Congressional Record, is that "the market for receivable-related securities is limited".⁵⁴ Given the fact that a major consideration of the State in determining the quality of any particular instrument as collateral is the marketability of the security, and that banks and other state-chartered institutions in other states may be an important outlet for the liquidation of such securities, the presence of this ambiguity in other states should be a cause for concern. While the market for CARS and CARDS is admittedly large and expanding, the question as to whether or not state-chartered institutions in other areas of the country are legally permitted, under their statutes, to invest in these instruments should be addressed prior to the acceptance of these securities as collateral. In estimating or judging the liquidity of any particular instrument as collateral, the broadest possible market should be an obvious precondition. The elimination of this ambiguity (i.e., passage of a national exemption) may elevate the status and liquidity of CARS and CARDS securities to a point beyond its current position in the marketplace.

CMOs and REMICs as Collateral for State Deposits

As noted in the follow-up survey of the eleven western state treasuries, two states currently permit depository institutions to pledge CMOs as collateral for public deposits. REMICs, a hybrid of CMOs, currently are not accepted in the states surveyed.

Although CMOs have been on the market since 1983, examples of their acceptance as collateral for public deposits are still limited. A general lack of familiarity with the complex structure of the instrument by treasury managers and their overwhelming preference for the use of government securities as collateral has restricted its use in this area. Further, national organizations such as the Government Finance Officer's Association (GFOA) remain skeptical as to the suitability of these instruments as collateral.

Exhibit 6-2 shows the GFOA's suggested collateralization ratios for securities accepted as collateral. As noted in the table, CMOs and REMICs are currently considered "experimental" in terms of its use as collateral for public deposits. The valuation ratio suggested for each instrument is relative to the degree of risk estimated by the GFOA. According to Girard Miller, former director of the Technical Services Division of the GFOA and the principal author of the article from which these data were obtained, the valuation ratios of securities considered "experimental" (including CARS and CARDS) should begin at 200 percent.⁵⁵ Clearly, while CMOs may be gaining some measure of acceptance among state treasuries, experts agree that caution should be exercised in dealing with these instruments.

By virtue of the underlying guarantees of the federal government (i.e., FNMA, GNMA, FHLMC), CMOs are not viewed as particularly risky. Federal agency issued CMOs are collateralized by mortgages with the agency's

Exhibit 6-2

Suggested Collateralization Ratios To Be Used in a Monthly Mark-to-Market Program

The following percentages constitute the minimum market value for collateral instruments that are pledged for public deposits (and accumulated interest thereon), under a program in which collateral is revalued and adjusted monthly.

Lower ratios would be appropriate for collateral systems that mark-to-market more frequently, and higher ratios are necessary if collateral is adjusted less frequently.

Form of Collateral Pledged	Collateral Ratio (market value divided by deposit plus accrued interest)	Form of Collateral Pledged	Collateral Ratio (market value divided by deposit plus accrued interest)
1. U.S. Treasury Bills and Treasury Notes/Bonds		5. Other federal agency or mortgage pass-through securities	125%
a. maturing within one year	102%	6. Local mortgage pools (1)	150%
b. maturing in 1-5 years	105%	7. Collateralized Mortgage Obligations (CMOs) and Real Estate Mortgage Investment Conduit Securities (REMICS)	Experimental (2)
c. maturing in more than 5 years	110%	8. Municipal bonds	
d. zero-coupon Treasury securities (STRIPS, etc.) with maturities exceeding 10 years	120%	a. General obligation bonds issued in same state (3)	
2. Actively traded U.S. Government Agency securities		(1) maturing in less than 1 year	102%
a. maturing in less than 1 year	103%	(2) maturing in 1-5 years	107%
b. maturing in 1-5 years	107%	(3) maturing in more than 5 years	110%
c. maturing in more than 5 years	115%	b. Revenue Bonds (4)	
3. U.S. Agency variable-rate securities	103%	(1) maturing in less than 1 year	105-110%
4. GNMA mortgage pass-through securities		(2) maturing in 1-5 years	110-120%
a. current issues	115%	(3) maturing in more than 5 years	120-130%
b. older issues	120%		
c. issues for which prices are not quotes	125%		

NOTES:

(1) Local mortgages or mortgage pools could prove to be completely illiquid and should be used sparingly as collateral for public deposits needed to fund basic operating expenditures. Market values may be difficult, if not impossible, to establish. Book value, not face value, should be studied as well as market value of comparable mortgages or mortgage pools.

(2) Mortgage securities such as CMOs and REMICS may not possess the high credit quality desired by public depositors. If these relatively untested instruments are used for deposit pledging, high collateral ratios are recommended, depending on factors such as marketability and the extent of federal government and agency guarantees.

(3) General obligation bonds issued in other states might be collateralized at higher levels unless their credit ratings are the highest grades (AAA or AA).

(4) Lower rated revenue bonds (A or BBB) should be collateralized at the higher ratios. Industrial development revenue bonds, unless guaranteed by a third party, may not be acceptable due to credit quality. High credit ratings should be demanded if such IDBs are pledged for collateral.

Source: Government Finance Officers Association, *Collateralizing Public Deposits*, May 1987, p. 10.

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guarantee. Most privately issued CMOs are collateralized by pass-through securities rather than conventional mortgages.⁵⁶ In those situations where CMOs are collateralized by conventional mortgages rather than federal agency guaranteed mortgage-backed securities, the conventional mortgages are supported by private insurance policies that guarantee timely payments of principal and interest in the pool and provide for a limited guarantee on individual mortgages with loan to value ratios above a specified limit.⁵⁷ Regardless of the type of collateral, virtually all CMOs are overcollateralized.

Most CMOs that trade actively are rated "AAA". The rating is usually predicated on the quality of the collateral, the structure of the security, the originator's credit underwriting standards, and the servicer's ability to service the assets.

One of the credit risk factors CMO investors should be aware of is the performance of the trustee. The competence of the trustee is of major importance to investors. The trustee must allocate payments to the right investors; when a major error occurs in the structure it will be important to have a trustee with "deep pockets".⁵⁸

Liquidity risk is also a major consideration of CMO investors. Generally, CMOs issued by federal agencies enjoy the widest secondary markets--GNMA guaranteed CMOs are the most liquid. "AAA" rated private issues have a wide market, however, private issues are often proprietary products issued by trusts set up by securities firms. It is unlikely that Salomon Brothers, for example, will bid very enthusiastically on a CMO originated by a rival firm such as First Boston Corp.⁵⁹

As noted earlier, a major concern of investors in CMOs is the prepayment risk associated with the underlying mortgages. Although the structure of CMOs may cushion prepayment risk, it does not eliminate risk entirely.⁶⁰ During periods of rapidly falling rates, the collateral underlying the CMO will prepay more rapidly. During periods of high interest rates, principal payments will slow.⁶¹ Projections concerning average life are, at best, educated guesses. Like mortgage-backed pass-through securities, CMOs will prepay when an investor does not want prepayments and they will not prepay at the time most investors want the prepayment.⁶²

Similar to the concern stated in the previous section relating to CARS and CARDS, investors may accumulate risks by purchasing unusually large holdings of CMOs originating in the same geographic area.⁶³ Localized economic conditions can adversely affect the quality of the CMO and the local rates of prepayment. In addition to concentrations associated with an issuer's name, the risks associated with CMOs serviced or guaranteed by a bank or other entity that is known to be having problems should be recognized. If the trustee of a number of CMO issues is known to be failing, institutional investors will certainly be leery of purchasing CMOs guaranteed by that particular trustee.⁶⁴

Unlike the asset-backed securities industry, the mortgage-backed securities industry is recognized by Congress. In 1984, Congress enacted the Secondary Mortgage Market Enhancement Act.⁶⁵ The Act authorized banks to purchase mortgage-related securities in unlimited amounts provided that the security meets the Act's eligibility requirements. However, while

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banks are authorized to purchase unlimited amounts of CMOs, the Office of the United States Comptroller of Currency advises particular caution in this practice with CMOs. Like CARS and CARDS, investments in CMOs should be diversified to compensate for local or regional risks.

In conclusion, due to the complexity of CARS, CARDS, CMOs, and REMICs, investors as well as government treasurers remain hesitant to rely on these instruments as reliable instruments of collateral. The more complex these securities become, the more things need to go right to ensure that an investor is protected. The more things that need to go right at the same time, the greater the likelihood that something unforeseen will go wrong.

Given the fact that consumer or commercial loans may prove to be impossible to value and that they may be completely illiquid on the secondary market, the acceptance of these assets as "security" for public deposits would seem contrary to the intent and purpose of requiring collateral securities.

Chapter 7

CONCLUSION

"I'm not as concerned with the return on my principal
as I am with the return of my principal."
(Will Rogers)¹

House Resolution No. 246 requested the Legislative Reference Bureau to study and review the State's deposit collateralization requirements and to determine whether higher interest rates could be obtained on public deposits through the adoption of less stringent collateral standards without compromising deposit security. H.R. No. 246 was adopted by the House of Representatives in response to the controversy which arose over a 1987 survey conducted by the Department of Budget and Finance which found that among the eleven states participating in the study, the State of Hawaii received the lowest rate of interest on public deposits placed in time certificates of deposit within in-state financial institutions. The Department contended that the lack of competition in the public funds market in Hawaii was the major factor responsible for the low yields. The banking industry contended that the State's "stringent" collateralization requirements were to blame.

The current crisis of the nation's banks and savings and loans in certain areas of the country has brought about a new awareness of the importance of proper deposit protection in the public sector. Banks and S&Ls have failed in numbers unparalleled since the Great Depression. Deposit security, which has often been taken for granted in the past, has become an issue of the utmost concern for cash managers at all levels of government.

Deposit collateralization programs ensure that public deposits are properly protected in the event of the collapse or default of a depository institution. Collateralization requirements generally require institutions accepting deposits of public funds to pledge marketable securities to the public depositor to ensure the full return of the funds deposited. In the event of a bank failure or default, the depositor can liquidate the collateral in the marketplace--hopefully in a timely manner and on a dollar-for-dollar basis. Public depositors generally prefer to work with performance-tested, highly liquid investment securities with proven records of reliability and stability in the marketplace. According to cash managers in the public sector and most investors in general, debt obligations issued by the U.S. Treasury and the various agencies of the federal government are considered to be the safest, the most marketable, and the most risk-free investments in the investment marketplace. A widely held belief among investors is that higher yielding securities usually pose greater risks. Conversely, higher levels of security usually mean lower earnings. While federal securities as collateral provide higher levels of security for the depositor, these securities often result in lower yields for the depository institution. Although higher yields could be realized on the acceptance of other types of investment securities as collateral, most cash managers prefer to work with conventional government securities.

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From the perspective of the banking industry, therefore, collateralization requirements are often problematic. Government securities required as collateral often earn less than the depository receives on its loans and other investments. Additionally, the reserve position and liquidity of the institution may be affected and its capacity to loan may be diminished.

Conflicts over the issue of deposit collateralization occur throughout the nation. However, in light of government's obligation to safeguard the funds of the public, deposit collateralization programs have become the standard methodology for deposit protection on all levels of government. On February 23, 1987, the Government Finance Officer's Association (GFOA) Committee on Cash Management adopted a policy statement regarding collateralization requirements for public deposits. The statement was subsequently approved by the association's Executive Board. Section 1 of the policy statement reads as follows:²

Safety of public funds should be the foremost objective in managing public funds. Collateralization of public deposits through pledging of appropriate securities is the only way to fully guarantee the safety of such deposits.

Additionally, public entities should implement programs of prudent risk control. Such programs could include a formal depository risk policy, credit analysis and use of fully secured investments.

Statewide collateralization programs have generally proven to be cost effective and beneficial for both the public sector and its depositories. In the absence of an effective statewide collateral program, local officials should establish and implement collateralization procedures.

The GFOA notes that general statewide programs requiring 100 percent deposit collateralization for public deposits are by far the most pervasive collateralization strategy among the states. There seems to be no recent evidence that "many mainland jurisdictions have decided to relax their collateral requirements" or that "some jurisdictions have removed the collateral requirement entirely".³ Instead, in light of the alarming increases in bank and thrift failures in certain areas of the nation, Girard Miller, formally of the GFOA, noted that cash managers throughout the country are evolving toward "a more conservative approach" in the areas of deposit investment and protection. Typically, this involves the development of more stringent depository credit evaluation standards, the mechanization of collateral information and monitoring systems, and the adoption of strict investment and collateral securities selection criteria.

While it may seem that other states have "less stringent" collateralization requirements than the State of Hawaii, partial collateral pledging ratios (i.e., 10 percent, 50 percent, etc.) often result in unwanted, yet unavoidable tradeoffs. For example, in Utah, where the state requires no deposit collateralization, a strict system of bank credit evaluation is utilized. As a result, many institutions may not be qualified to receive deposits over and

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above the FSLIC and FDIC limits. Consequently, most of Utah's deposits are invested out-of-state.

In Washington, where the state maintains a pooled collateralization program, the collateral pledging ratio has been reduced to 10 percent of the deposit with the largest depository institution. This "shared risk" approach ensures that in the event of a failure, each depository participating in the pool would contribute its share of collateral to cover the losses experienced by the depositor as a result of the default. The pooled system allows greater participation in the public funds market--smaller, less secure institutions formerly incapable of meeting full collateral pledging requirements may be able to meet the lesser ratios required under a pooled system. In states such as Hawaii, however, where as much as 86 percent of the State's deposits are concentrated within the two largest banking institutions, a pooled program may meet with opposition from institutions seeking to protect their present market share. Moreover, the "shared risk" approach may be perceived as unfair by larger, more secure institutions in that all institutions participating in the pool must support the credit and cover for the defaults of the weaker, less secure institutions.

During the course of this study, numerous comments and recommendations were received from local depositories regarding their views on the State's deposit program. The major concern with most depositories was the issue of flexibility in the institution's options in pledging deposit collateral. Although attempts have been made in the past to reduce the State's statutory requirements for collateralization, the recommendations submitted for this study propose no actions of that nature. Instead, the proposals submitted would more than likely qualify under a provision already established by the Legislature in 1984. Paragraph (9) of section 38-3, Hawaii Revised Statutes, authorizes the Department of Budget and Finance to consider a broad range of investment securities as eligible collateral. According to local depositories, the classes of assets and securities recommended would increase their earning power, reduce their risks, and provide them with greater flexibility in meeting the State's requirements for deposit collateralization. In turn, this flexibility would allow depositories to pay a higher rate to the State on its deposits. Among the alternatives suggested by depositories for consideration were:

- (1) Asset-backed securities including: Credit Card Asset-backed Securities (CARDS) and Certificates for Automobile Receivables (CARS);
- (2) Mortgage-backed securities including: Real Estate Mortgage Investment Conduit Securities (REMICs) and Floating Rate Collateralized Mortgage Obligations (CMOs); and,
- (3) A proposed collateralization program based on the pledging of an institution's consumer loans as security for public deposits.

While the Bureau is fully cognizant of the fact that the capital market is perpetually evolving, and that new securities and investment opportunities for banks, thrifts, and other investors are continually being created, it should be noted that the principal obligation of cash managers in the public sector--the protection of public deposits--remains the same. Newly created

COLLATERALIZATION REQUIREMENTS FOR STATE DEPOSITS

instruments or securities in the marketplace, while attractive to investors because of their higher yields, may not meet the levels of security required to safeguard the funds of the public. To ascertain the extent to which these securities are currently being utilized as collateral in other state programs, the Bureau conducted a survey of eleven state treasuries in the western region of the United States. Aside from the acceptance of CMOs in two states, the survey found that most states have not yet considered these securities as vehicles of collateral. Most states expressed reservations regarding the liquidity of these securities on the secondary market. Because of the limited market for these securities--in contrast to the enormous market for United States Treasury bills and notes--cash managers were often concerned with the marketability of mortgage- and asset-backed securities.

Acceptance of the class of securities (CARS, CARDS, consumer loans, and REMICs) proposed by several local depositories in Hawaii would be unprecedented among the states surveyed in this study. Factors such as the complexity of the asset- and mortgage-backed securitization technologies, the ambiguity that currently exists in the regulatory framework of the asset-backed industry, and the risks associated with investing in asset-backed securities, have contributed to the development of an atmosphere of caution among state treasurers responsible for assessing the potential of these newly established investment instruments as eligible collateral. Given the choice between working with securities backed by the "full faith and credit" of the federal government and securities backed by credit cards, auto loans, and mortgage pools, state treasurers overwhelmingly preferred the conventional alternative. When asked to contrast the levels of risk associated with securities issued by the federal government and securities such as CARS, CARDS and CMOs, Harry Jorgenson of the Board of Governors of the Federal Reserve System, stated that there is "absolutely no comparison" between the levels of security provided by the two investment classes.⁴ Debt obligations of the U.S. Treasury are widely considered to be the safest, most risk-free securities in the capital markets.

Pools of consumer loans are not registered securities. The risks associated with the acceptance of consumer loans as collateral are extensive. A major concern in this proposal is the marketability of the loans. Without a market for these loans, the State may become the owner of the loan pool--collecting payments until the loans mature--a situation the State wishes to avoid.

Findings and Recommendations

Based on the foregoing analysis the Legislative Reference Bureau finds that Hawaii's system of deposit collateralization is not unduly unfair. Although the issue of "fairness" to in-state depositories is a legitimate concern, the Bureau finds that the definition of fairness differs markedly among institutions. One institution's idea of fairness may be perceived by another as an attempt to capture a greater share of the public funds market. Accepting certain classes of securities as collateral from one institution holding a large portfolio of such securities (i.e., CARS, CARDS, etc.) may be viewed as unfair by others not maintaining large amounts in their reserves. Similarly, allowing only certain institutions to pledge their consumer loans as collateral may be perceived as unfair by smaller institutions

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not able to meet the credit standards of the larger depositories. As noted earlier, deposit protection programs based on the asset size and creditworthiness of each depository will often be viewed as unfair by the smaller, less stable institutions. Clearly, a simple solution which would satisfy the needs and desires of every depository accepting deposits of the State is difficult to develop. In this regard, full deposit collateralization programs allowing voluntary participation in the public funds market have become the most widespread practice of state and local deposit protection programs.

Although the Bureau is aware that deposit collateralization requirements reduce the productivity of public funds for depository institutions, it should be noted that the conditions which led to profit losses in the early 1980s are no longer present in the economy. During the course of this study, no reports of bank losses or bank earnings as a result of the State's requirements were received. While depositories contend that certain risks continue to exist, the interest volatility of the early 1980s that led to bank losses of profit have long since stabilized.

Although the promise of higher returns to the public depositor may be attractive, reductions in deposit security should not be an acceptable method of generating new income for the State, unless a conscious decision is made by the Legislature that as a matter of policy, the reduction of security is a price worth paying. Based on the opinions of state treasurers, federal government regulators and organizations such as the GFOA, the acceptance of securities such as CARS, CARDS, CMOs, and REMICs by the State would presently seem contrary to the Department of Budget and Finance's objective of ensuring security and liquidity for public deposits. Similarly, the acceptance of consumer loans as collateral may jeopardize the State's security and liquidity in the event of a banking default.

While local bankers have argued that "the community derives no direct benefits through the local deposit of public funds" as a result of the State's collateralization requirements, the Bureau is of the opinion that the greatest benefit the State can deliver to the taxpayers is through the responsible protection of their tax dollars.

Recommendation 1

The Legislative Reference Bureau recommends that the Department of Budget and Finance maintain its current standards of deposit collateralization. While the Bureau does not recommend the acceptance of any of the proposals reviewed in this report at the present time, the Department should continue to monitor their acceptance and performance as collateral in other states. Until the reliability of these instruments can be verified empirically through market performance and until a reliable "track record" has been established, these securities should remain unacceptable as collateral for public funds. The Bureau finds that it would be inadvisable for the State to be among the pioneers in testing the reliability of CARs, CARDS, CMOs, REMICs, and consumer loans as collateral for deposits of public funds.

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Recommendation 2

While cash management alternatives such as extending the average maturities of the State's time certificates of deposit are beyond the scope of this report, the Bureau recommends that the Department of Budget and Finance consider extending the life of its investments in local depositories. Contingent on the current cash flow needs of the State, a certain share of the treasury's idle deposits can be placed in longer-term CDs. As advised by Arthur Young and Company in its 1977 audit of the State's cash management program, lengthening deposit maturities may result in higher earnings to the State and reduced risks to institutions collateralizing such investments.

Footnotes

CHAPTER 1

1. Testimony presented by Yukio Takemoto, Director, Department of Budget and Finance before the House Committee on Finance regarding H.B. No. 3502, February 16, 1988, p. 1 (H.B. No. 3502, as introduced, was the companion measure to S.B. No. 3175).
2. Testimony presented by Clarence Taba, Executive Vice-President, Hawaii Bankers Association before the House Committee on Finance, February 16, 1988, p. 2; and testimony presented by Berg Fujimoto, Chairman, Legislative Committee, Hawaii League of Savings Institutions, before the House Committee on Finance, March 17, 1988, p. 1.
3. Testimony presented by the Hawaii Bankers Association before the House Committee on Finance, February 16, 1988, p. 1.
4. Ibid.
5. Ibid.

CHAPTER 2

1. Girard Miller, Public Budgeting and Finance, "Investment of Public Funds: A Research Agenda", Autumn 1987, vol. 7, no. 3, p. 47.
2. For example, mutual savings banks, trust institutions, finance companies, and credit unions.
3. John A. Jones, S. Kenneth Howard, Investment of Idle Funds by Local Governments (Municipal Finance Officers Association), 1973, p. 5.
4. Facts & Figures on Government Finance, 1988-1989 edition (1988 Tax Foundation, Incorporated), p. 195.
5. Federal Reserve Bank of San Francisco, "Troubled Banks and Thrifts", FRBSF Weekly Letter, January 29, 1988, p. 1.
6. Honolulu Star Bulletin, "184 Banks Failed in 1987", January 6, 1988, p. D-4.
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8. Ibid.
9. Honolulu Star-Bulletin and Advertiser, "Healthy S&Ls are dumping their sick relatives on Uncle's doorstep", November 11, 1988, p. B-4.
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17. Ibid., p. 5.
18. Ibid., p. 6.
19. Penelope Lemov, "The Municipal Bond Market After Tax Reform: It's A New Way of Doing Business", Governing, March 1988, p. 44.
20. Miller, supra note 12, p. 10.
21. Ibid.
22. U.S., Congressional Research Service Library of Congress for the Committee on Banking, Finance and Urban Affairs House of Representatives, A Reference Guide to Banking and Finance (Washington: U.S. Government Printing Office, March 1983), p. 42.
23. Miller, supra note 12, p. 5.
24. Girard Miller and others, Model Investment Legislation for State and Local Governments (Chicago: Government Finance Officers Association, June 1984), p. 5.

25. Girard Miller and Michelle Saddler, "Collateralization: Protecting Public Deposits", Government Finance Review, October 1987, p. 23.
26. Miller, supra note 24, p. 5.
27. Testimony of the Hawaii Bankers Association regarding H.B. No. 2527-84 before the House Committee on Finance, March 6, 1984, p. 3.
28. Bolt, supra not 15, p. 25.

CHAPTER 3

1. Testimony presented by Takao Sato, President of the Hawaii Bankers Association before the House Committee on Finance on March 6, 1984, regarding H.B. No. 2527-84, p. 3.
2. Ibid., p. 4.
3. Testimony presented by Jensen S. L. Hee, Director, Department of Budget and Finance before the Senate Committee on Ways and Means on March 7, 1984, regarding S.B. No. 2093-84, p. 1 (as introduced S.B. No. 2093-84 was the companion measure to H.B. No. 2527-84).
4. Testimony presented by Yukio Takemoto, Director, Department of Budget and Finance before the House Committee on Finance regarding H.B. No. 3502 on February 16, 1988, p. 1 (as introduced, H.B. No. 3205 was the companion measure to S.B. No. 3175).
5. Testimony presented by Clarence Taba, Executive Vice-President, Hawaii Bankers Association before the House Committee on Finance, February 16, 1988, regarding H.B. No. 3205, p. 2, and testimony presented by Berg Fujimoto, Chairman, Legislative Committee, Hawaii League of Savings Institutions before the House Committee on Finance on March 17, 1988, regarding S.B. No. 3175, p. 1.
6. Ibid.
7. Ibid.
8. Annual Report of Deposits and Investments of the State of Hawaii, Fiscal Year Ending June 30, 1988, Department of Budget and Finance, State of Hawaii (Honolulu: 1988), p. 8.
9. Annual Report of Deposits and Investments of the State of Hawaii, Fiscal Year Ending June 30, 1983, Department of Budget and Finance, State of Hawaii (Honolulu: 1983), p. 2.

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Appendix A

HOUSE OF REPRESENTATIVES
FOURTEENTH LEGISLATURE, 1988
STATE OF HAWAII

H.R. NO. 246

HOUSE RESOLUTION

REQUESTING A STUDY ON COLLATERALIZATION REQUIREMENTS FOR DEPOSITS
OF PUBLIC FUNDS.

WHEREAS, the safe investment of state monies in federally insured banks and savings and loan associations is of paramount concern; and

WHEREAS, it is important that the State adopt a safe and prudent investment strategy that yields a high rate of interest without sacrificing safety and liquidity objectives; and

WHEREAS, the State has adopted stringent collateralization requirements which require banks to purchase acceptable collateral, usually United States government bonds, notes, or debentures, to back public deposits in order to ensure the safety of public funds; and

WHEREAS, approximately eighty-six per cent of all state funds are deposited in the major banks located in Hawaii, based primarily upon the bank's ability to collateralize the deposits; and

WHEREAS, for the fiscal year ended June 30, 1987, interest income from investments credited to the state general fund amounted to \$40.8 million or a yield on investment of 5.53 per cent; and

WHEREAS, a recent survey conducted by the Department of Budget and Finance showed that the yield earned on comparable investments by other states was approximately 7 per cent on the average; and

WHEREAS, the Hawaii Bankers Association claims there is a direct and unquestioned link between the collateral requirements and interest earned; and

WHEREAS, the Hawaii Bankers Association also claims that other states have been able to enhance their yield strategy and investment flexibility due to less restrictive collateralization requirements; and

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WHEREAS, it is in the best interest of the State for public officials and financial institutions to develop an approach which will keep public funds in local financial institutions while still paying a competitive rate of interest; and

WHEREAS, this rate of interest may be seriously affected by collateralization requirements and administrative rules and objectives; now, therefore,

BE IT RESOLVED by the House of Representatives of the Fourteenth Legislature of the State of Hawaii, Regular Session of 1988, that the Legislative Reference Bureau is requested to conduct a study on collateralization requirements and other restrictions applicable to deposits of public funds; and

BE IT FURTHER RESOLVED that the Legislative Reference Bureau review existing state collateralization requirements and restrictions on out-of-state deposits, and actual practices of other states, to determine whether higher yields can be obtained on state fund deposits, without sacrifice of fiscal prudence, through the adoption of less stringent requirements; and

BE IT FURTHER RESOLVED that the Legislative Reference Bureau examine whether greater flexibility in the acceptance by the Director of Finance of the various types of collateral or security enumerated in section 38-3, Hawaii Revised Statutes, could allow financial institutions which are not currently depositories of state funds to receive deposits of state funds; and

BE IT FURTHER RESOLVED that the Legislative Reference Bureau submit findings and recommendations to the Legislature prior to the convening of the Regular Session of 1989; and

BE IT FURTHER RESOLVED that a certified copy of this Resolution be transmitted to the Director of the Legislative Reference Bureau.

OFFERED BY:

Roland M. Kotani

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