<u>Understanding the True Cost of Collateral</u>

Banks accepting public deposits must collateralize those deposits with acceptable securities, treasuries, or agency bonds. Letters of Credit issued by government agencies and CDARS also provide sufficient coverage to meet the mandate. CDARS, (certificate of deposit account registry service) and the Promontory Network also have gained market acceptance in the past 20 years. This form of collateral uses the FDIC $250,000 USD insurance to meet the requirement.

All forms of collateral have a cost. Identifying the variables of cost within the financial institution varies from bank to bank. While the price for the various forms of collateral remain a constant for most institutions, how they recognize cost can be a challenge. The primary form of collateral is the use of excess securities, (agency bonds, treasury bonds, and municipal bonds) on balance sheet when unencumbered. In a rising interest rate environment the bank may be forced to pledge additional securities to maintain the designated collateral requirement set in state statutes. Most states require 100-110% of the face value of the deposit. As rates rise the value of the pledged securities may be negatively impacted therefore requiring an additional pledge to remain in compliance.

The use of the FHLB letter of credit program requires an equity investment to become a member bank. The 12 bank system offers Letters of Credit to back deposits from the Public Sector. The product is priced competitively versus other options. Once written, usually for a one year term, the face value and duration are set. By comparison, Surety Bonds require no equity investment to gain access and Surety can be increased or decreased as deposits enter or leave the bank.

CDARS, a part of the Promontory Network, uses the FDIC insurance designation of the client tax ID to gain the required collateral position limited to $250,000 per deposit, per bank. The reciprocal nature of this product depends on a software program to track placement, rate and return of capital. This form of collateral is highly efficient for smaller deposits. Deposits above $20MM are impacted by the number of participating banks with a profile of reciprocity. Banks participating in the network have noticed an increase in the cost of cyber insurance premiums.

The opportunity cost of pledging excess securities on balance sheet will vary, however in comparison, a Surety Bond is a credit instrument once pledged does not impact alternate profitable commitments. By state statue, Surety Bonds are a one to one commitment not requiring excess pledge of balances to remain in compliance. In addition a Surety bond may offer an enhanced credit rating to the client once introduced.