

HOUSE OF REPRESENTATIVES STAFF ANALYSIS

BILL #: HB 145 Letters of Credit Issued by a Federal Home Loan Bank

SPONSOR(S): Santiago

TIED BILLS: **IDEN./SIM. BILLS:** SB 558

REFERENCE	ACTION	ANALYST	STAFF DIRECTOR or BUDGET/POLICY CHIEF
1) Insurance & Banking Subcommittee	12 Y, 0 N	Bauer	Cooper
2) Government Operations Subcommittee	12 Y, 0 N	Harrington	Williamson
3) Regulatory Affairs Committee	13 Y, 0 N	Bauer	Hamon

SUMMARY ANALYSIS

Chapter 280, Florida Statutes, is the Florida Security for Public Deposits Act (act), which authorizes state and local governments to deposit public deposits with qualified public depositories (QPDs). Public deposits are funds in excess of amounts required to meet disbursement needs or expenses, and QPDs are banks, savings banks, or savings associations that meet specific criteria under the act. Qualified public depositories must secure public deposits in accordance with the act and the collateral requirements and pledging levels as set for by rule of the Chief Financial Officer (CFO). Qualified public depositories may meet this collateral requirement by pledging, depositing, or issuing eligible collateral to the CFO, or to a CFO's designee in some instances. The Department of Financial Services, as headed by the CFO, administers a collateral management program which ensures compliance with the act.

The act's collateral requirements protect public deposits against loss in the event of a QPD's insolvency or default. Losses are satisfied first through the standard maximum federal deposit insurance of \$250,000, and then through the CFO's demand for payment under letters of credit or the sale of collateral pledged or deposited by the defaulting QPD. Any shortfall would then be covered by the CFO's authority to impose assessments against the other QPDs.

Qualified public depositories are permitted to use Federal Home Loan Bank (FHLB) letters of credit to meet collateral requirements if certain requirements are met under the act. One such condition is that obligations issued by the FHLB remain triple-A rated (the highest credit rating available) by a nationally recognized source. The three major credit rating agencies are Standard & Poor's (S&P), Fitch Ratings, and Moody's.

On August 5, 2011, S&P downgraded the credit rating of the United States' long-term sovereign debt from triple-A to AA+. Standard & Poor's also downgraded the credit rating of FHLB obligations from triple-A to AA+. While Fitch Ratings and Moody's have maintained their triple-A ratings of both U.S. sovereign debt and FHLB obligations, they have given negative outlooks in light of the current debate and uncertainty regarding U.S. fiscal and economic policy. In the event these two agencies also downgrade their credit ratings for FHLB obligations, QPDs could no longer use FHLB letters of credit as eligible collateral under current law. This would require QPDs to use other assets as replacement collateral, which in turn could affect their liquidity and lending ability.

The bill allows QPDs to continue securing and retaining FHLB letters of credit as eligible collateral in the event the other major credit agencies downgrade their ratings of FHLB obligations below triple-A. The bill permits QPDs to use FHLB letters of credit, if no longer triple-A rated, if FHLB obligations are rated by a nationally recognized source at not lower than its rating of the long-term sovereign credit of the U.S.

The bill does not have an impact on the private sector, and it is not likely that the bill will have a fiscal impact on state or local government.

The bill provides an effective date of July 1, 2013.

This document does not reflect the intent or official position of the bill sponsor or House of Representatives.

STORAGE NAME: h0145e.RAC

DATE: 3/14/2013

FULL ANALYSIS

I. SUBSTANTIVE ANALYSIS

A. EFFECT OF PROPOSED CHANGES:

Present Situation

Chapter 280, Florida Statutes, is the Florida Security for Public Deposits Act (act), which authorizes state and local governments to deposit funds in excess of amounts required to meet disbursement needs or expenses in a qualified public depository (QPD), which is a bank, savings bank, or savings association that meets specific criteria. Qualified public depositories must secure public deposits in accordance with the act and the collateral requirements and pledging levels as set forth by rule of the Chief Financial Officer (CFO).¹ Qualified public depositories may meet this collateral requirement by pledging, depositing, or issuing eligible collateral to the CFO, or to a CFO's designee in some instances. Eligible collateral consists of securities, Federal Home Loan Bank (FHLB) letters of credit, and cash, as designated by the act.² The Department of Financial Services, as headed by the CFO, administers a collateral management program which ensures compliance with the act.³

The act's collateral requirements protect public deposits against loss in the event of certain triggering events, most notably, a QPD's insolvency or default.⁴ Losses are satisfied first through the standard maximum federal deposit insurance of \$250,000, and then through the CFO's demand for payment under letters of credit or the sale of collateral pledged or deposited by the defaulting QPD.⁵ Any remaining shortfall would then be covered by the CFO's authority to impose assessments against the other QPDs.⁶

Qualified public depositories are permitted to use Federal Home Loan Bank (FHLB) letters of credit as a collateral option, if certain requirements are met.⁷ Unlike the other eligible collateral types, FHLB letters of credit do not involve a custodial arrangement and instead name the CFO as a beneficiary.⁸ According to the Florida Bankers Association, FHLB letters of credit are stable, irrevocable, and cost-efficient. Additionally, the use of FHLB letters of credit provide operational efficiencies to the CFO who can directly make a demand on the FHLB letters of credit in the event of a QPD's default, without having to sell and transfer pledged securities.⁹ As of October 29, 2012, 17 QPDs have pledged a total of \$1.88 billion in FHLB letters of credit as collateral.¹⁰

One prerequisite for QPDs to use FHLB letters of credit is that obligations issued by the FHLB remain triple-A rated by a nationally recognized source.¹¹ Currently, FHLB letters of credit are the only eligible collateral type that the act imposes a credit rating requirement, even though other eligible collateral forms, such as Treasury bonds and other federal agency obligations, receive credit ratings.

According to Standard & Poor's (S&P), a nationally recognized source and one of the "Big Three" credit rating agencies (the other two being Moody's and Fitch Ratings):

¹ See chapter 280, F.S., and chapter 69C-2, F.A.C.

² Sections 280.02(12) and 280.13, F.S.

³ More information about the Bureau of Collateral Management can be found at: https://apps8.fldfs.com/cap_web/, last accessed February 26, 2013.

⁴ Section 280.041(6), F.S.

⁵ Section 280.08(3)(a), F.S.

⁶ Section 280.08(3)(b), F.S.

⁷ Section 280.13(5), F.S.

⁸ Section 280.13(5)(b)4., F.S.

⁹ Florida Bankers Association's analysis of HB 145, on file with the Insurance & Banking Subcommittee.

¹⁰ Policy & Research Memorandum from the Department of Financial Services, on file with the Insurance & Banking Subcommittee.

¹¹ Section 280.13(5)(c), F.S.

Credit ratings are forward-looking opinions about credit risk...[and] the ability and willingness of an issuer...to meet its financial obligations in full and on time. Credit ratings can also speak to the credit quality of an individual debt issue...and the relative likelihood that the issue may default...Each agency applies its own methodology in measuring creditworthiness and using a specific rating scale to publish its ratings opinions. Typically, ratings are expressed as letter grades that range, for example, from 'AAA' to "D" to communicate the agency's opinion of relative level of credit risk.¹²

On August 5, 2011, S&P issued an unprecedented downgrade of the U.S.'s sovereign long-term credit rating from triple-A (the highest credit rating available) to AA+ (very strong capacity to meet financial commitments). Standard & Poor's attributed its downgrade to its negative outlook of the current debate and uncertainty surrounding U.S. fiscal and economic policy.¹³ Due to the FHLB System's status as a government-sponsored enterprise, its credit ratings are integrally tied to those of the U.S. Accordingly, S&P similarly lowered its credit ratings on 10 of 12 FHLBs from triple-A to AA+:

The downgrades reflect the interplay between the sovereign rating and the entities' stand-alone credit profiles. The ratings continue to reflect our opinion that there is a very high likelihood the U.S. government would provide timely and sufficient extraordinary support to these entities in the event of financial distress.¹⁴

However, Moody's gave its highest ratings to long-term debt (Aaa) and short-term debt (Prime-1) issued by the FHLBs,¹⁵ and Fitch Ratings affirmed its triple-A rating of several FHLBs.¹⁶ In addition, both Moody's and Fitch Ratings have maintained their triple-A ratings of U.S. long-term sovereign debt, although subject to a negative outlook based on concerns over the federal deficit.¹⁷

In the event all nationally recognized sources downgrade their ratings of FHLB obligations below triple-A, current law would not permit QPDs to use FHLB letters of credit as eligible collateral. Consequently, QPDs would have to turn to other assets (such as Treasury notes and Fannie Mae securities) as replacement collateral, which could affect their liquidity and lending ability.

Effect of the Bill

This bill enables QPDs to continue using FHLB letters of credit as eligible collateral, in the event the other major credit agencies downgrade their ratings of FHLB obligations below triple-A. The bill permits the use of FHLB letters of credit, if no longer triple-A rated, if FHLB obligations are rated by a nationally recognized source at not lower than its rating of the long-term sovereign credit of the U.S. The bill provides an effective date of July 1, 2013.

B. SECTION DIRECTORY:

¹² Standard & Poor's Credit Ratings Definitions & FAQs, at <http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us>, last accessed February 26, 2013.

¹³ *United States of America Long-Term Rating Lowered to 'AA+' Due to Political Risks, Rising Debt Burden; Outlook Negative*, S&P's press release, August 5, 2011, <http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245316529563>, last accessed February 26, 2013.

¹⁴ *Credit Matters: Special Report on the U.S. Rating Downgrade and Its Global Effects*, Standard & Poor's CreditWeek, Vol. 31, No. 31, Page 19 (August 17, 2011). A copy of the article is available online at: www.standardandpoors.com/spf/swf/creditweek/data/document.pdf

¹⁵ Federal Home Loan Banks, Office of Finance: Credit Ratings: http://www.fhlp-of.com/ofweb_userWeb/pageBuilder/credit-ratings-31, last accessed February 26, 2013.

¹⁶ "Fitch Affirms Several Federal Home Loan Banks' 'AAA' Rating and Stable Outlook," at <http://www.reuters.com/article/2011/08/16/idUS209276+16-Aug-2011+BW20110816>, last accessed February 26, 2013.

¹⁷ "Fitch Backs Away from Downgrade of U.S. Credit Rating," at <http://www.reuters.com/article/2013/01/28/us-usa-rating-fitch-idUSBRE90R0WS20130128>, last accessed February 26, 2013.

Section 1 amends s. 280.13, F.S., revising circumstances under which letters of credit issued by a Federal Home Loan Bank are eligible as collateral.

Section 2 provides an effective date of July 1, 2013.

II. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT

A. FISCAL IMPACT ON STATE GOVERNMENT:

1. Revenues:

A fiscal impact to state government revenues is not likely.

2. Expenditures:

A fiscal impact to state government expenditures is not likely.

B. FISCAL IMPACT ON LOCAL GOVERNMENTS:

1. Revenues:

A fiscal impact on local government revenues is not likely.

2. Expenditures:

A fiscal impact on local government expenditures is not likely.

C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR:

None.

D. FISCAL COMMENTS:

The ability to continue using FHLB letters of credit as eligible collateral may be beneficial to QPDs, as FHLB letters of credit are stable, irrevocable, and cost-efficient. Additionally, there are operational efficiencies to the CFO who can directly make a demand on the FHLB letters of credit in the event of a QPD's default without having to sell and transfer pledged securities.

The Department of Financial Services does not anticipate that the bill will have a fiscal impact.

III. COMMENTS

A. CONSTITUTIONAL ISSUES:

1. Applicability of Municipality/County Mandates Provision:

Not applicable. This bill does not appear to require counties or municipalities to spend funds or take an action requiring the expenditure of funds; reduce the authority that counties or municipalities have to raise revenues in the aggregate; or reduce the percentage of a state tax shared with counties or municipalities.

2. Other:

None.

B. RULE-MAKING AUTHORITY:

Current law authorizes the Chief Financial Officer to adopt rules to determine collateral requirements and procedures by rule, which have been set forth in chapter 69C-2, F.A.C.¹⁸ However, it is not anticipated that the bill will require amendments to current rules.

¹⁸ See ss. 280.04(1) and (9), F.S.

C. DRAFTING ISSUES OR OTHER COMMENTS:

None.

IV. AMENDMENTS/ COMMITTEE SUBSTITUTE CHANGES

None.