Protecting Public Funds

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Best Practices

As recommended by the Office of the New York State Comptroller
The Importance of Diversification

An important consideration for public funds

Diversification is a crucial risk management strategy for protecting public funds. By spreading investments across a range of financial instruments and institutions, diversification helps reduce the overall risk to, and ensure the safety of government funds.
Authorizing Official Depositories Every Year

- NYS General Municipal Law Section 10 requires that the governing board of each municipality designate one or more banks or trust companies as official depositories of its public funds. By engaging in this practice annually, County Governments realize several advantages:

  • **Financial Transparency and Accountability**
    - Regularly designating official depositories helps ensure that public funds are managed transparently and responsibly. It provides an opportunity for local governments to review the financial institutions’ performance, stability, and trustworthiness, thereby minimizing the risk of mismanagement, fraud, or theft of public funds.

  • **Ensuring Liquidity and Accessibility**
    - Regularly designating official depositories ensures that public funds remain liquid and easily accessible. It allows local governments to maintain a steady cash flow to meet operations needs, pay salaries, and cover expenses for various public services.

  • **Building Relationships**
    - By evaluating and designating official depositories annually, local governments can establish and maintain relationships with reputable financial institutions. These relationships can prove beneficial in terms of access to financial advice, credit facilities, and other banking services that may be needed to support operations and projects.
Written Investment Policy

- **NYS General Municipal Law Section 39**
  - Establishes legal requirement for local governments to adopt a written investment policy
- **Limits liabilities**
  - Protects local governments from potential losses
  - Ensures prudent and responsible investment practices
- **Defines the rules**
  - Outlines investment objectives, guidelines, and procedures
  - Addresses permitted investments, diversification, and maturity limits
- **Defends your actions**
  - Provides a framework for decision-making and accountability
  - Supports legal defense in case of disputes or challenges
Elements of an Investment Policy

• Overall Statement of Intent
  • Purpose of the policy and its guiding principles

• Clearly Stated Objectives
  • Legality: Compliance with laws and regulations
  • Safety: Preservation of Capital
  • Liquidity: Availability of funds when needed
  • Yield: Earning a reasonable return

• Delegation of Authority
  • Identifying responsible officials for investment decisions

• Eligible Investments
  • Types: Permitted investment instruments
  • Maturities: Maximum maturity limits
  • Limits: Restrictions on amounts or percentages within the portfolio

• Statement of Prudence
  • Adherence to the “prudent person” standard in managing investments

• Eligible transactions
  • Authorized types of investment transactions

• Diversification
  • Spreading investments across various instruments to reduce overall portfolio risk

• Liquidity
  • Ensuring availability of funds to meet cash flow needs

• Approved List of Financial Institutions
  • Authorized banks, brokers, and dealers for investment transactions

• Indemnification of Cash Management Personnel
  • Protection for officials responsible for investment decisions and actions

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1. It is important to consult with legal and financial advisors when creating or modifying your investment policy statement to ensure that it is comprehensive and complies with all applicable laws and regulations.

2. This standard, also known as the “prudent investor rule”, requires fiduciaries to act with the same care, skill, and diligence that a prudent person would exercise under similar circumstances when investing on behalf of others.
Permissible Investments

- **Demand deposit accounts in a bank or trust company located and authorized to do business in New York State**
  - Demand deposit accounts with interest
  - Money market deposit accounts

- **Certificates of deposit**
  - CDs are used by many governments because of their familiarity and flexible maturities.
  - CDs are purchased for specific periods of time that may be as short as seven days or as long as a year or more.

- **Obligations**
  - Local governments may also invest in obligations such as bonds, notes or other forms of indebtedness issued by specific entities
  - Generally, obligations of the United States (Treasury Bills, Treasury Bonds and Notes), the State of New York, and, in certain cases, New York State Local Governments are permissible investments

- **Authorized Investment Pools**
  - Authorized investment pools can be used by local governments for investing moneys not required for immediate expenditure
  - In order to be authorized to invest public funds, pools may invest only in securities that are legal for public funds investment in the State of New York
FDIC Insurance Coverage

As applicable to public deposits
FDIC Insurance Coverage

- **FDIC Insurance**
  - Protects depositors’ funds in case of bank failure
  - Covers: Demand Deposit Accounts (DDAs), Time Deposits, Certificates of Deposit (CDs), Money Market Deposit Accounts (MMDAs)
  - Limit: Up to $250K in DDAs + Up to $250K in Time Deposits for a total of up to $500k per insured bank for deposits owned by a “Public Unit” and held by the Public Unit’s “Official Custodian”

- **Investment Options Not FDIC**
  - Authorized investment pools and directly purchased securities are not guaranteed and may lose value due to no fault of the financial institution, as such they are not covered by FDIC Insurance

- **Key Considerations**
  - Ensure adequate collateral to make up for balances above the amounts covered by FDIC insurance
  - Diversify between FDIC-insured deposits and uncovered investments to balance risk and return characteristics

The information related to FDIC insurance has been compiled from FDIC deposit insurance reference materials found at FDIC websites [www.fdic.gov/deposit](http://www.fdic.gov/deposit) and [https://www.fdic.gov/deposit/deposits/factsheet.html](https://www.fdic.gov/deposit/deposits/factsheet.html) and is not meant to replace the advice of your own financial, tax, accounting or legal advisors. For questions about the insurance coverage of Government Accounts, contact the FDIC at [www.fdic.gov](http://www.fdic.gov), toll free at 1-877-ASK-FDIC (1-877-275-3342); TTY Toll-free number 1-800-877-8339; or by email at Part370@FDIC.gov
Deposit Insurance for Accounts Held by Government Depositors

Section 320.15 of the FDIC's regulations (12 C.F.R. 320.15) governs the insurance coverage of public unit accounts. For deposit insurance purposes, the term "public unit" includes a state, county, municipality, or any "political subdivision" of the public unit. Under section 330.16, the "official custodian" of the funds belonging to the public unit - rather than the public unit itself - is insured as the depositor.

**Permanent Rule**

The insurance coverage of public unit accounts depends upon the type of deposit and the location of the insured depository institution. All time and savings deposits owned by a public unit and held by the public unit's official custodian in an insured depository institution within the state in which the public unit is located are added together and insured up to $250,000. Separately, all demand deposits owned by a public unit and held by the public unit's official custodian in an insured depository institution within the state in which the public unit is located are added together and insured up to $250,000. For the purpose of these rules, the term "time and savings deposits" includes NOW accounts and money market deposit accounts but does not include interest-bearing demand deposit accounts (which were permitted after July 21, 2011). The term "demand deposits" means both interest-bearing and noninterest-bearing deposits that are payable on demand and for which the depository institution does not reserve the right to require advance notice of an intended withdrawal. The insurance coverage of accounts held by government depositories is different if the depository institution is located outside the state in which the public unit is located. In that case, all deposits, both time and savings deposits and demand deposits, owned by the public unit and held by the public unit's official custodian are added together and insured up to $250,000. Time and savings deposits are not insured separately from demand deposits.

As mentioned above, a political subdivision (through its official custodian) is entitled to its own insurance coverage. The term "political subdivision" is defined to include drainage, irrigation, navigation, improvement, levee, sanitary, school or power districts, and bridge or port authorities and other special districts created by state statute or compacts between the states. The term "political subdivision" also includes any subdivision or principal department of a public unit (state, county, or municipality) if the subdivision or department meets the following tests:

- The creation of the subdivision or department has been expressly authorized by the law of such public unit;
- Some functions of government have been delegated to the subdivision or department by such law; and
- The subdivision or department is empowered to exercise exclusive control over funds for its exclusive use.

The term "political subdivision" does not include subdivided or non-autonomous divisions, agencies, or boards within subdivisions or principal departments.

Again, a public unit (including a political subdivision) is insured through its official custodian. If the same individual is an official custodian for more than one public unit, he or she is separately insured for the deposits belonging to each public unit. On the other hand, two or more individuals are treated as one official custodian if action or consent by any of these individuals is required for the exercise of control over the funds of a single public unit.

An official custodian is an officer, employee, or agent of a public unit having official custody of public funds and lawfully depositing the funds in an insured institution. In order to qualify as an official custodian, a person must have plenary authority - including control - over the funds. Control of public funds includes possession as well as the authority to establish accounts in insured depository institutions and to make deposits, withdrawals, and disbursements.

Deposit insurance coverage cannot be increased by dividing funds among several official custodians who lack plenary authority over such funds. Likewise, coverage cannot be increased by dividing funds among several accounts controlled by the same official custodian for the same public unit.

**Collateralization of Public Unit Deposits**

Depending on applicable state or federal law, public unit deposits may be secured by collateral or assets of the bank. In the event of the failure of the bank, the FDIC will honor the collateralization agreement if the agreement is valid and enforceable under applicable law. The FDIC does not guarantee, however, that the collateral will be sufficient to cover the amount of the uninsured funds. As such, although it does not increase the insurance coverage of the public unit deposits, collateralization provides an avenue of recovery in the unlikely event of the failure of an insured bank.

**Special Rule for Public Bonds**

A special rule applies to funds held by an officer, agent, or employee of a public unit under a law or bond indenture that requires the funds to be set aside to discharge a debt owed to the holders of notes or bonds issued by the public unit. A deposit of such funds in an insured depository institution is insured up to $250,000 for the beneficial interest of each bondholder. This coverage is separate from the coverage for other deposits owned by the public unit at the same institution. In order to obtain this special coverage, however, the deposit account must satisfy certain disclosure requirements applicable to deposits held by agents or fiduciaries. Specifically, the deposit account must be a special account that is separate from other deposit accounts of the insured depository institution. The account must disclose the existence of the fiduciary relationship or the fiduciary nature of the deposit. In addition, the details of the fiduciary relationship and the interests of the bondholders must be ascertainable from the records of the depository institution or the records of the depository institution maintained in good faith and in the regular course of business.

The relevant section of the FDIC's deposit insurance regulations can be found at 12 C.F.R. 320.15.

If you have questions or comments about the insurance coverage of public unit accounts, contact the Federal Deposit Insurance Corporation by telephone at 1-877-ASK-FDIC or by mail at 550 17th Street, NW, Washington, DC 20429.
Full FDIC via Reciprocal Deposits

A provision allowing banks to provide full FDIC insurance coverage through reciprocal deposit arrangements

- Reciprocal deposits are arrangements between two or more FDIC-insured banks that agree to swap a specific amount of deposits, increasing each bank’s deposit base and offering additional insurance coverage to clients.

- The 2012 amendment allowing reciprocal deposits aimed to reduce banks’ reliance on risker brokered deposits and promote stability in the banking system.

- Benefits include increased deposit base for banks, meeting regulatory capital requirements, and providing higher protection for client deposits.

- Despite being considered brokered deposits, reciprocal deposits receive different regulatory treatment by the FDIC, such as in calculating deposit insurance assessment rates.

- The 2012 amendment helped to promote financial stability in the banking system by encouraging community banks to engage in reciprocal deposit arrangements, which in turn helped these banks to better manage liquidity risks and support their local economies.
Collateralizing Public Deposits
Protecting Public Funds in Excess of FDIC Coverage
General Municipal Law Section 10: Deposits of Public Money

• **Objective**
  - Ensure the security of public funds deposited by local governments in New York

• **Definition of a Bank**
  - Defined by banking law or a national banking association
  - Located and authorized to do business in New York
  - Must be a commercial bank

• **Requirement for Collateral**
  - Banks receiving deposits of public funds must provide eligible collateral
  - Collateral must have a market value equal to or greater than the deposited amount

• **Types of Allowable Collateral**
  - Defined by GML Section 10
  - Details provided further into presentation materials

• **Definition of Custodian**
  - An institution holding the collateral on behalf of the local government
  - The custodian can be the same bank that is holding the deposits or a third party
  - Responsible for safeguarding the collateral and ensuring its availability in the case of a bank default
Collateral Agreement

- Regardless of the chosen collateralization method, local governments must enter into written agreements with the financial institution holding the deposits.
- The agreements should detail the rights and responsibilities of each party, the collateralization requirements, and the procedures for valuing and monitoring collateral.
- State Comptroller has a model agreement that most banks use.
- It is the responsibility of each municipality to ensure that each bank at which they hold deposits has an updated agreement on file and that the agreement matches their investment policy.
Collateral Statements & Reconciliation

• **Bank Collateral Statements**
  • Summary of collateral pledged by banks to secure public deposits
  • Ensures safety of local government funds beyond FDIC coverage limits

• **Reconciliation Process**
  • Compare collateral statements with financial records
  • Verify the adequacy and accuracy of collateral held by banks
  • Monitor changes in collateral value due to market fluctuations

• **Why Reconciliation is Important**
  • Risk Management: Ensures funds are properly secured, reducing the potential for loss
  • Compliance: Ensures adherence to regulatory requirements and local government policies
  • Transparency: Provides clear record of collateral, enabling regular reviews and audits

• **Best Practices**
  • Regular Reconciliation: Perform reconciliation of bank collateral statements regularly and frequently, at a minimum at month end
  • Documentation: Maintain accurate records for audit purposes and future reference
Collateralizing Public Deposits

In New York State, local governments are required to secure their deposits with collateral to protect public funds. There are several options available to local governments for collateralization of their deposits:

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<td>Local governments can require that their deposits be collateralized with eligible securities, which include obligations issued by the United States, New York State, and certain municipalities and agencies.</td>
<td>An irrevocable letter of credit issued by a Federal Home Loan bank can be used as collateral for deposits.</td>
<td>An irrevocable letter of credit is a binding financial instrument issued by a qualified bank, guaranteeing payment from a buyer to a seller. It cannot be altered or canceled without consent from all involved parties.</td>
<td>Local governments can accept surety bonds issued by insurance companies authorized to do business with NYS as collateral for deposits.</td>
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Securities

- Local Governments can specify the types of Eligible Securities that are used by Financial Institutions to collateralize their deposits
- Eligible securities and the methodology used to determine their market value can be found in the NYS Comptroller’s Local Government Management Guide – Investing and Protecting Public Funds: Appendix B Schedule A
FHLB Letter of Credit

• Federal Home Loan Bank (FHLB) System:
  • A network of 11 regional banks providing funding and services to member financial institutions
  • Supports housing finance and community investment

• FHLB Letters of Credit
  • Issued by FHLBs to member financial institutions
  • Serve as collateral for local government deposits

• Advantages of FHLB LOCs:
  • Reliable and secure alternative to traditional collateral
  • Backed by strength and creditworthiness of the FHLB system
  • Enables local government to maintain liquidity and safety of funds

• Key Considerations:
  • Confirm the bank is a member of the FHLB system
  • Ensure the LOC is irrevocable and issued for the specific purpose of collateralizing local government deposits
  • Monitor the LOC’s amount and expiration date and renew or adjust as needed
Irrevocable Letter of Credit Issued by a Qualified Bank

- **Irrevocable Letter of Credit (LOC)**
  - Financial instrument issued by a qualified bank
  - Guarantees payment from one party to another
  - Cannot be altered or canceled without consent from all involved parties
  - Must be issued for 140% of the aggregate balance of public deposits and investments for a term not to exceed 90 days
  - Bank LOCs are rarely used as collateral by Local Governments in NYS

- **Qualified Bank**
  - Meet specific regulatory requirements
  - Deemed creditworthy to issued LOCs

- **Advantages of Irrevocable LOCs**
  - Provides security for both sides of a transaction
  - Ensures stability and confidence in the financial arrangement
  - Backed by the creditworthiness of the issuing bank

- **Key Considerations**
  - Verify the bank’s qualifications and creditworthiness
  - Ensure the LOC is irrevocable and issued for the specific purpose of collateralizing local government deposits
  - Monitor the LOC’s amount and expiration date and renew or adjust as needed
Surety Bonds

• **Surety Bonds**
  • A contract between three parties: the principal (bank), the obligee (local government), and the surety (insurance company)
  • Ensures the bank’s performance of its obligations to the local government
  • **Surety bonds are rarely used as collateral by NYS municipalities**

• **Role of Surety Bonds**
  • Provide an alternative form of collateral for securing local government deposits
  • Guarantee the bank’s compliance with regulatory requirements and local government policies

• **Advantages of Surety Bonds**
  • Backed by the financial strength and creditworthiness of the surety company
  • Reduces counterparty risk to provide an additional layer of financial protection

• **Key Considerations**
  • Evaluate the creditworthiness and financial strength of the surety company
  • Ensure the surety bond covers the specific purpose of collateralizing local government deposits
  • Monitor the bond’s expiration date and renew as needed
Recovering Collateralized Deposits

What would happen in the event of a default?
What may happen in the event of default?

In the event of a default by a financial institution holding local government deposits in NYS, the collateral securing those deposits will be used to cover the losses. The process may vary depending on the type of collateral used. Here’s an overview of what may happen for each type of collateral:

**Eligible Securities**
- If the financial institution defaults, the local government can take possession of the pledged securities. These securities can then be liquidated, either by selling them in the open market or though a more structured sale process. The proceeds would be used to cover the local governments deposits and accrued interest not covered by FDIC insurance.

**Letters of Credit**
- In the case of a default, the local government can draw on the irrevocable letter of credit issued by the Federal Home Loan Bank or Qualified Financial Institution. The drawn amount should cover the deposits and any accrued interest not covered by the FDIC. The Federal Home Loan Bank or Qualified Financial Institution that issued the Letter of Credit would then have a claim against the defaulting financial institution.

**Surety Bonds**
- If the financial institution defaults, the local government can make a claim against the surety bond issued by the insurance company. The insurance company would be required to pay the local government an amount equal to the deposits and any accrued interest not covered by the FDIC. The insurance company may then pursue recovery from defaulting financial institution.

When a financial institution is closed, the FDIC is appointed as receiver and the closed financial institution is placed into receivership. In the event of the failure of a bank, the FDIC will honor the collateralization agreement if the agreement is valid and enforceable under applicable law. The facts and circumstances surrounding a bank failure can vary dramatically and the FDIC will control the deposit recovery process, including how and when a local government may claim the collateral pledged to secure their public deposits.