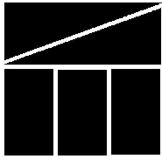

Virginia Department of Planning and Budget
Economic Impact Analysis

1 VAC 75-20 Virginia Security for Public Deposits Act Regulations
Department of the Treasury
Town Hall Action/Stage: 5663 / 9376
December 27, 2021

The Department of Planning and Budget (DPB) has analyzed the economic impact of this proposed regulation in accordance with § 2.2-4007.04 of the Code of Virginia (Code) and Executive Order 14 (as amended, July 16, 2018). The analysis presented below represents DPB's best estimate of these economic impacts.[1]

Summary of the Proposed Amendments to Regulation

As the result of a 2018 periodic review,[2] the Treasury Board (Board) proposes to: 1) update the regulation to reflect legislative changes that occurred in 2009 and 2010, 2) increase the amount of collateral required for municipal securities in the pooled collateralization method, 3) exclude corporate notes from eligible collateral types in the pooled method, 4) add a requirement for public depositors to periodically verify their account balances through the Department of Treasury's (Treasury) website, and 5) formalize in the regulation minimum qualifications to become a Qualified Public Depository (QPD) and an escrow agent and update compliance requirements for continued eligibility.

Background

The Virginia Security for Public Deposits Act (Act), Code of Virginia §§ 2.2-4400 et seq, establishes a single body of law applicable to the pledge of collateral for public deposits in

[1] Code § 2.2-4007.04 requires that such economic impact analyses determine the public benefits and costs of the proposed amendments. Further the analysis should include but not be limited to: (1) the projected number of businesses or other entities to whom the proposed regulatory action would apply, (2) the identity of any localities and types of businesses or other entities particularly affected, (3) the projected number of persons and employment positions to be affected, (4) the projected costs to affected businesses or entities to implement or comply with the regulation, and (5) the impact on the use and value of private property.
[2] https://townhall.virginia.gov/L/ViewPReview.cfm?PRid=1757

financial institutions. Consequently, the Treasury requires collateral that QPDs must pledge in order to secure public deposit balances in excess of the insurance coverage provided by the Federal Deposit Insurance Corporation. The purpose of collateral is to safeguard the financial stability of the Commonwealth by ensuring that public deposits of the Commonwealth and its counties, cities, towns, and other public entities are adequately protected against the economic consequences of a failure of a financial institution holding public funds.

According to the Treasury, significant changes were made to the Act in 2009 and 2010. These changes include Chapter 64 of the 2009 Acts of Assembly and Chapters 640 and 674 (identical) of the 2010 Acts of Assembly.[3] However, the regulation has not been amended to reflect these changes. This action largely involves updating the regulatory text to reflect the legislative changes that took place in practice more than a decade ago. However, several proposed changes would depart from current practices as discussed below.

Estimated Benefits and Costs

The Treasury may require that certain securities (those that are difficult-to-value, subject to rapid declines in value, or otherwise represent a risk of decrease in value) be valued for collateral purposes at a rate that is less than 100 percent of their market value. This valuation approach is intended to minimize the risk that any securities used as collateral will diminish in value and thus no longer serve as adequate protection against financial loss. The percentage difference between an asset's market value and the amount that can be used as collateral is commonly referred to as the “haircut” in the context of this regulation. For example, if the Treasury counts only 80 percent of an asset’s value as collateral, that translates to a 20 percent haircut on that security. Currently, there is a 20 percent haircut on mortgage-backed pass-through securities pledged as collateral by both dedicated and pooled QPDs,[4] and a 10 percent and a 20 percent haircut on Virginia municipal securities and non-Virginia municipal securities respectively that are pledged by dedicated QPDs.

[3] https://leg1.state.va.us/cgi-bin/legp504.exe?ses=091&typ=bil&val=ch64
https://leg1.state.va.us/cgi-bin/legp504.exe?ses=101&typ=bil&val=ch640
https://leg1.state.va.us/cgi-bin/legp504.exe?ses=101&typ=bil&val=ch644

[4] Under the dedicated method, a depository collateralizes deposits made by a public depositor individually without contingent liability. Under the pooling method, however, the depositories secure all of their public deposits collectively by establishing a pool of collateral with contingent liability.

The Board proposes to introduce a 10 percent and a 20 percent haircut respectively for Virginia based and non-Virginia based municipal securities pledged by pooled QPDs. According to the Treasury, this change would provide consistency with the dedicated method and better protect public deposits at pooled QPDs by requiring them to either increase their pledged collateral, or pledge different security types that are more easily valued and liquidated in the event of a QPD failure. Using balances as of June 30, 2021, three pooled QPDs would either need to pledge approximately $45 million in additional securities combined (individually $35 million, $8 million, and $2 million), or substitute other security types with lower or no haircuts for municipal securities, in order to maintain sufficient collateral and improve protection of public funds.[5]

Similarly, the Board proposes to exclude corporate notes from eligible collateral types for pooled QPDs in order to achieve consistency with the collateral types accepted for dedicated QPDs. A corporate note is a short term loan agreement between a lending source and a company and as such is riskier relative to some other types of collateral. According to the Treasury, there is currently only one QPD that pledges two corporate notes with a combined market value of $1.9 million. However, that bank is currently over-collateralized by $13.6 million and would still be over-collateralized by $11.7 million without the corporate notes under this change. Thus, this change would not have an immediate impact. In the long-term, if the bank wants to maintain its deposit capacity at the current level it would have to replace its corporate notes with other types of collateral. This change would provide consistency between the pooled and dedicated methods as well as reduce public funds' exposure to risk in the long-term.

The Board also proposes to add a requirement for public depositors to verify their fund account balances after the end of each quarter, using the search feature presented on the Treasury's website for that purpose, to ensure their accounts are being properly reported to the Board by the QPDs. This requirement would help reveal any public fund accounts that were not reported or reported inaccurately so corrections can be made. According to the Treasury, many public depositors are already doing this voluntarily. Thus, the administrative cost to QPDs is expected to be modest.

[5] Using balances three months earlier, March 31, 2021, there was a fourth QPD under-collateralized by $71,826.

Finally, the Board proposes to formalize in the regulation minimum qualifications to become a QPD and an escrow agent as well as update compliance requirements for continued eligibility. The Board would also make numerous changes to conform the regulatory language to the Code of Virginia. According to the Treasury, these changes are primarily housekeeping measures to reflect in the regulation the current standards that are already followed in practice. Thus, no significant economic impact is expected from these changes other than improving the accuracy of the regulatory text.

Businesses and Other Entities Affected

This regulation applies to 83 banks that hold public deposits. Of these, 57 are collateralized using the pooled method and 26 using the dedicated method.

The Code of Virginia requires DPB to assess whether an adverse impact may result from the proposed regulation.[6] An adverse impact is indicated if there is any increase in net cost or reduction in net revenue for any entity, even if the benefits exceed the costs for all entities combined. As noted above, three pooled QPDs would be affected by the increased haircut requirements for municipal securities and would therefore be required to pledge additional collateral or pledge different collateral with lower or no haircuts. One pooled QPD would be affected by the exclusion of corporate notes from use as collateral and would therefore be required to pledge additional collateral if it wishes to maintain its current deposit capacity. Thus, an adverse impact is indicated on the four banks.

Small Businesses[7] Affected:[8]

The proposed amendments appear to adversely affect banks that are small businesses.

[6] Pursuant to Code § 2.2-4007.04(D): In the event this economic impact analysis reveals that the proposed regulation would have an adverse economic impact on businesses or would impose a significant adverse economic impact on a locality, business, or entity particularly affected, the Department of Planning and Budget shall advise the Joint Commission on Administrative Rules, the House Committee on Appropriations, and the Senate Committee on Finance. Statute does not define "adverse impact," state whether only Virginia entities should be considered, nor indicate whether an adverse impact results from regulatory requirements mandated by legislation.

[7] Pursuant to § 2.2-4007.04 of the Code of Virginia, small business is defined as "a business entity, including its affiliates, that (i) is independently owned and operated and (ii) employs fewer than 500 full-time employees or has gross annual sales of less than $6 million."

[8] If the proposed regulatory action may have an adverse effect on small businesses, Code § 2.2-4007.04 requires that such economic impact analyses include: (1) an identification and estimate of the number of small businesses subject to the proposed regulation, (2) the projected reporting, recordkeeping, and other administrative costs required for small businesses to comply with the proposed regulation, including the type of professional skills necessary for preparing required reports and other documents, (3) a statement of the probable effect of the proposed regulation on affected small businesses, and (4) a description of any less intrusive or less costly alternative methods of achieving

Types and Estimated Number of Small Businesses Affected

The Treasury reports that two of the three banks affected by the increased haircut to municipal securities appear to be small businesses (employ fewer than 500 full-time employees) and thus an adverse impact on small businesses is indicated. More generally, of the current total of 57 pooled QPDs, approximately 20-25 appear to fit the criteria for a small business and could potentially be impacted at some time in the future.

Costs and Other Effects

The proposed amendments would require affected small banks to increase the amount of collateral provided to continue as QPDs or pledge different collateral with lower or no haircuts. Thus, an adverse economic impact on them is indicated.

Alternative Method that Minimizes Adverse Impact

There does not appear to be a clear alternative method that both reduce adverse impact and meet the intended policy goals. The affected banks could potentially decide to no longer hold public funds if the costs of doing so because of this regulation exceed the benefits. The Treasury notes, however, that this outcome would be unlikely.

Localities[9] Affected[10]

The proposed amendments primarily affect banks that hold deposits of public entities including towns, cities, and counties. However, the proposed changes do not appear to introduce costs for local governments and no localities appear to be disproportionately affected.

Projected Impact on Employment

The proposed amendments do not appear to directly affect total employment.

Effects on the Use and Value of Private Property

Having to provide additional collateral or pledge different collateral with lower or no haircuts may negatively affect the profitability and hence the asset values of banks using the pooled method. Otherwise, the proposed amendments do not appear to affect the use and value of private property or the real estate development costs.

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the purpose of the proposed regulation. Additionally, pursuant to Code § 2.2-4007.1, if there is a finding that a proposed regulation may have an adverse impact on small business, the Joint Commission on Administrative Rules shall be notified.

[9] "Locality" can refer to either local governments or the locations in the Commonwealth where the activities relevant to the regulatory change are most likely to occur.

[10] § 2.2-4007.04 defines "particularly affected" as bearing disproportionate material impact.