



TEXAS COMPTROLLER OF PUBLIC ACCOUNTS

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OPINION COMMITTEE

RQ-0295-GA

November 17, 2004

The Honorable Greg Abbott
Attorney General of Texas
P.O. Box 12548
Austin, Texas 78711-2548

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OPEN RECORDS DIVISION

FILE # MC-44026-04

I.D. # 044026

Re: Whether statutory amendments are required to enable the Texas Treasury Safekeeping Trust Company to enter into repurchase investment contracts that contemplate the possibility of cash as the collateral

Dear Attorney General Abbott:

On behalf of the Texas Comptroller of Public Accounts, I respectfully request your opinion concerning whether subchapters C and D of chapter 404 and chapter 2257 of the Government Code, which generally require that any deposit of public funds be secured by eligible investment securities, are required to be amended to authorize the use of cash as collateral on an overnight basis under repurchase agreements when other eligible securities are insufficient or unavailable.

As you know, the Texas Treasury Safekeeping Trust Company ("TTSTC") is a special-purpose trust company organized under subchapter G of chapter 404 of the Government Code. Its sole shareholder and director is the Texas Comptroller of Public Accounts (the "Comptroller"). TTSTC manages and invests state funds under the Comptroller's control. TTSTC also manages and invests funds in the Texas Local Government Investment Pool ("TexPool"), which consists generally of funds belonging to or under the control of political subdivisions or entities created by political subdivisions (hereinafter referred to as "local funds"). In these capacities, TTSTC periodically enters into investment contracts commonly referred to as repurchase agreements or direct security repurchase agreements.

Under a repurchase agreement, when the Comptroller or TexPool has funds that are not immediately needed for disbursement or investment in other securities, TTSTC uses these funds to purchase specified securities, subject to a binding commitment from the seller of those securities to buy back, or "repurchase," the securities at a future date at a price equivalent to a AAA rated money market yield. These are typically short-term arrangements, and in many cases, the repurchase obligation matures the next day. The investment goal and, usually, the effect is to obtain a better overnight yield on the excess funds by investing in a security instead of depositing the money into a bank account. Furthermore, since most bank deposits are only insured up to \$100,000 and the securities typically used on repurchase agreements are AAA rated, government guaranteed U.S. Treasury bills or notes, much larger amounts can be invested overnight or on a short-term basis, with minimal administrative burden and risk-free or virtually

risk-free. Frequently, several hundred million or even a billion dollars might be placed in overnight or short-term repurchase agreements. Maintaining such amounts in deposit accounts subject to federal insurance would be fiscally imprudent. The importance of repurchase agreements to sound fiscal management is clear. The state's ability to protect that investment by accepting cash as short-term collateral is the issue that is the subject of this opinion request.

With respect to state funds under the Comptroller's control, section 404.024 of the Government Code expressly authorizes investment in repurchase agreements (referring to them as "direct security repurchase agreements"). With respect to funds in TexPool, section 2256.011 of the Government Code provides express authorization for investing local funds in repurchase agreements.

Both as security for the obligations of the parties under the repurchase agreements and for the purpose of operational efficiencies, the securities that are bought and sold under repurchase agreements are kept at a custodian bank, usually a large money-center bank located in New York City. This custodian is separately owned from the investment bank or entity that serves as the repurchase agreement counterparty. The counterparty might be another large money-center bank that does business in this state or a primary government securities dealer. In many cases, the repurchase agreement counterparty will keep billions of dollars in securities at the custodian, and TTSTC will be one of many public or private entities investing in such agreements with the counterparty. The counterparty will provide the custodian, normally by mid-day, with a list of all repurchase agreements that will be in place that night. The custodian – acting upon the instructions of the repurchase counterparty (the seller) and in accordance with the previously executed tri-party custody agreement among the repurchase buyer (here TTSTC), repurchase seller, and the custodian – will allocate on its books the securities to all of the repurchase buyers from that repurchase seller for the night. In the event the repurchase seller were to default on its obligations to repurchase the securities at the time when the various repurchase agreements terminate, the buyers would hold the AAA-rated securities, which should be liquid in the marketplace, thus preventing catastrophic loss.

However, in some cases, there are insufficient securities held in the name of the seller at the custodian to satisfy all of the seller's repurchase agreements for a particular evening. Usually, this is determined only very late in the day and occurs because a large number of orders may be placed by repurchase buyers at or near the deadline. When this occurs, the seller may not have time to either purchase more securities or to move securities it is holding at another location to the relevant custodian. Accepting cash as a security obligation under such circumstances is customary in the banking industry; and the state's reluctance to accept cash severely limits the number of entities willing to act as custodians. In such circumstances, the seller needs to be able to pledge cash held at the custodian to one or more of the buyers to satisfy its security obligations. Typically, this circumstance would most likely occur with a term repurchase agreement, *i.e.*, an agreement that is for a period of time longer than overnight. With respect to the term repurchase agreement, the repurchase agreement buyer will deliver cash to the custodian and execute an agreement with the seller to purchase securities and have them held for the

benefit of the buyer at the custodian for periods of time ranging from several days to up to 90 days. Typically, the longer the term of the repurchase agreement, the higher the yield to the repurchase agreement buyer. The repurchase agreements typically used by most primary government securities dealers provide that despite the "term" nature of the arrangement, the actual securities held by the buyer are determined or allocated on a nightly basis. If all the securities are U.S. Government obligations, have a value greater than the repurchase obligation of the seller, are AAA rated, and have maturities of 270 days or less, then TTSTC is indifferent to the actual securities held by the custodian in its name because the yield is based strictly upon the repurchase agreements' terms, and not the yield on the underlying security. Consequently, the securities are allocated to the buyers of repurchase agreements each night, rather than holding a specific security for the entire term of the agreement.

The issue here is two-fold: (1) if the custodian holds cash for the benefit of the buyer (because U.S. Treasury securities or agency securities are not available), whether it is necessary for such cash to be secured by collateral, and (2) whether the repurchase agreement may contemplate the possibility that cash could be one of the eligible securities allocated to the repurchase agreement.

The provisions of subchapters C and D of chapter 404 of the Government Code with respect to state funds, and the Public Funds Collateral Act, chapter 2257 of the Government Code with respect to local funds, give rise to the first issue. Section 404.031 of the Government Code permits the Comptroller to "deposit state funds with a depository only if the depository has pledged with the comptroller eligible investment securities acceptable to the comptroller in amount not less than the amount of deposits to be secured." TEX. GOV'T CODE ANN. § 404.031 (Vernon Supp. 2004). Section 2257.021, which generally applies to local funds, directs that "a deposit of public funds shall be secured by eligible security to the extent and in the manner required by this chapter." *Id.* § 2257.021 (Vernon 2000). In light of these provisions, if the custodian were to use cash as part of the designated securities for the repurchase agreement obligations of the seller, the question is whether the provisions of subchapters C and D of chapter 404 or the Public Funds Collateral Act would be implicated, so as to require the custodian to post security for any cash held (given the amounts held would, in almost every circumstance, exceed the limits of federal deposit insurance). Most custodians refuse to agree to this requirement, since the presence of cash in the repurchase agreement context would only be known late in the day, typically too late to arrange for collateral to be deposited with TTSTC.

We specifically inquire whether under a term repurchase agreement cash may become the designated security. An argument may be made that when cash is temporarily the collateral, such event does not constitute a "deposit" for the purposes of the above statutes, requiring eligible investment securities as collateral. While the term "deposit" is not specifically defined, in the context of subchapters C and D of chapter 404 dealing with collateralization of state funds, it clearly refers to time and demand deposits. *See, e.g., id.* §404.001(2), (7) (Vernon 1998); *id.* § 404.024 (Vernon Supp. 2004). A "demand deposit" is "a deposit that is payable on demand." *Id.* § 404.001(2). A "time deposit" is a deposit subject to "a contract providing that . . . the deposit

may [not] be withdrawn . . . before the expiration of the period of notice that must be given in writing.” *Id.* §404.001(7). Similarly, the term “deposit of public funds” is defined in section 2257.002 of the Government Code as funds that “(B) are held as a demand or time deposit by a depository institution . . .” No further attempt is made in the Public Funds Collateral Act to define deposit.

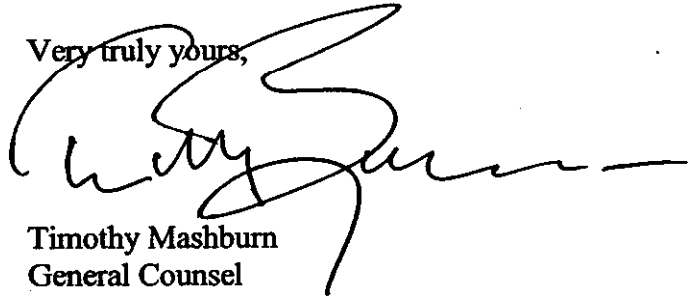
Further, the jurisprudence over the last fifteen years in banking law reflects that money held under a custody arrangement or otherwise in safekeeping is not a demand or time deposit. It is considered to be a special deposit, akin to trust funds or a bailment, and does not become property of the bank, so that if the custodian were to fail, the assets held by it in the context of the repurchase agreement, whether cash or securities, would remain the property of TTSTC, and not be subject to being seized by the receiver of the bank. *See, e.g., Hodge v. Northern Trust Bank*, 54 S.W.3d 518, 522 (Tex. App. – Eastland 2001, *writ denied*) (noting that a special deposit of money with a bank creates a bailor-bailee relationship and the bank receives no title to the money deposited); *Kaufman v. First Nat’l Bank*, 493 F.2d 1070, 1072 (5th Cir. 1974) (holding that a bank has no right of offset against funds deposited for a special purpose known to bank). In a recent case applying New York law (the law that almost invariably applies to the substantive rights of the parties under the custody arrangements used in repurchase agreements), U.S. District Court of the District of Columbia held that (a) state law (in this case New York) would determine if a deposit were a general deposit versus a special deposit, (b) the determinative factor was the express agreement between the parties as to whether the bank had to segregate the funds or hold the funds for a specific purpose, and (c) when a special deposit was found to exist, the result was a quasi-bailment situation whereby the beneficiary of the fund would be entitled to its return ahead of all of the creditors of the bank, including the FDIC, in receivership because such special deposit never becomes the property of the bank. *Merrill Lynch Mortg. Cap., Inc. v. FDIC*, 293 F. Supp. 2d 98, 103 – 107 (D.C. 2003). Accordingly, the use of cash as an “eligible security” under a repurchase agreement arguably is not to be construed as a “deposit” in the usual sense, and may not implicate subchapters C and D of chapter 404 of the Government Code or the Public Funds Collateral Act.

The second issue, whether the repurchase agreement may contemplate the possibility that cash could be one of the eligible securities allocated to the repurchase agreement, arises because section 404.024 of the Government Code (with respect to state funds) and section 2256.011 of the Government Code (with respect to local funds) do not expressly include cash as an eligible security for a repurchase agreement. We do not believe this omission was intended to prohibit using cash as security under the circumstances. On its face, the purpose of listing the securities was to limit the universe of eligible securities to risk-free and highly liquid securities. Cash is not a security in the usual sense, but in the case of repurchase agreements is deemed to be an eligible security. Because cash has immediate value to purchase goods, it is not an investment, per se. It has no expectancy of increasing in value, nor is there any risk associated with holding it (other than purchasing power lost if it is not earning a yield). Therefore, for the statute to omit cash as an eligible security for a repurchase agreement is not surprising, nor necessarily is it an indication of legislative intent that cash could not serve as an eligible investment security for a

repurchase agreement. We respectfully ask whether you agree, or whether amendment of the pertinent provisions is required to provide for cash specifically as an eligible security.

We emphasize that our inquiry concerns only a repurchase agreement that permits cash to be a substituted eligible security if (a) the use of cash is only when other eligible securities are not available, and (b) there is no diminution of yield as a result of such substitution.

Very truly yours,

A handwritten signature in black ink, appearing to read 'Timothy Mashburn', written over a horizontal line.

Timothy Mashburn
General Counsel

cc: Paul Ballard, TTSTC
Chip Rainey, Locke Liddell & Sapp LLP
Leslie K. Ross, Reed Smith LLP