Report to the
Minnesota Legislature: Local Bank Deposit Pilot

February 1, 2013

MINNESOTA
Management & Budget

Background

Minnesota Laws of 2010, Chapter 364, Section 33 established a two year pilot project which allowed postsecondary institutions within Minnesota State Colleges and Universities (MnSCU) to transfer some of their reserve deposits to a community financial institution. The intent of this legislation was to increase the use of community financial institutions and to provide wider distribution of the economic benefit of postsecondary reserves. See copy of the legislation in Exhibit A.

Participating colleges and universities were selected by application by the Board of Trustees of MnSCU. The applicants were required to designate one or more community financial institutions with which they would enter into a General Banking Agreement if selected for participation in the pilot program. A community financial institution meant "federally insured bank or credit union, chartered as a bank or credit union by the state of Minnesota or the United States, that is headquartered in Minnesota and that has no more than $2.5 billion in assets". By December 1, 2010, the MnSCU Board of Trustees was required to notify the commissioner of Management and Budget (MMB) of the participating colleges and universities, the deposit amount for each institution and the associated community financial institutions. The pilot project provided for the transfer of reserves from the period of January 2, 2011 through December 31, 2012.

On December 1, 2010, MMB was provided with a list of the colleges and universities that were selected by the MnSCU Board of Trustees to participate in the pilot program along with the amounts of the reserve funds that could be deposited. See Exhibit B. Although the legislation allowed for up to eight institutions to participate, MnSCU only received interest from seven institutions, five colleges and two universities.

A request for proposal (RFP) was prepared by staff of the Office of the Chancellor of MnSCU with input from participating postsecondary institutions. The RFP required that the financial institutions response include:

1. Rate of return (terms and time frames)
2. Description of the evaluation and reports that they would provide regarding the effectiveness of this local deposit pilot project.
3. Provision of evidence of financial strength.
4. Provision of all requirements set forth in the RFP.

The seven postsecondary institutions that were included in the RFP were:

INSTITUTION	**DEPOSIT AMOUNT**
Minnesota West Community and Technical College (Candy, Granite Falls, Pipestone, Worthington, and Jackson)	$2,100,000
Hibbing Community College (Hibbing)	$1,000,000
Ridgewater College (Willmar and Hutchinson)	$2,100,000
Northwest Technical College (Bemidji)	$600,000
South Central College (Faribault and North Mankato)	$500,000
Winona State University (Winona)	$2,200,000
Bemidji State University (Bemidji)	$1,600,000
Total Deposits Available	$10,100,000

Individuals representing the financial institutions were notified once the RFP was posted. The participating colleges and universities also contacted their local financial institutions to notify them of the posting.

Four (4) proposals were received to serve three colleges and one university. MnSCU rejected two of the responses; one, because the interest rate of return was lower than what was currently being earned, and the other, because the proposer did not provide the information as requested in the RFP. The following colleges and university negotiated agreements with the following financial institutions:

INSTITUTION	**FINANCIAL INSTITUTION/ DEPOSIT AMOUNT**
Minnesota West Community and Technical College (Candy, Granite Falls, Pipestone, Worthington, and Jackson)	First State Bank/$2,100,000
Northwest Technical College (Bemidji)	Security State Bank/$600,000
Bemidji State University (Bemidji)	Security State Bank/$1,600,000
Total	$4,300,000

EVALUATION

Minnesota Laws of 2010, Chapter 364, Section 33, subd. 4 required:

> The commissioner of management and budget and the board of trustees shall independently evaluate the effectiveness or harm of the local deposit pilot project in increasing the use of community financial institutions and providing wider distribution of the economic benefits of the deposit of postsecondary reserves. Each evaluation must include the participating colleges, universities and community financial institutions. The commissioner of management and budget and the board shall report on the pilot project evaluation to the appropriate committees of the legislature by February 1, 2013, with recommendations on the future implementation of the pilot project.

In the summer of 2012, staff at MMB worked collaboratively with staff from MnSCU to develop surveys for the colleges and the university and the financial institutions that were participating in the pilot program. This method was chosen for two reasons. One, this prevented the colleges, the university, and financial institutions from having to complete two similar surveys. Two, the financial institutions would only be able to answer questions from the postsecondary institutions with which they had banking relationships. Staff of the Office of the Chancellor of MnSCU provided the financial institutions and the colleges and universities with their respective survey questions. The survey results compiled by MnSCU were shared with MMB for purposes of this evaluation and are attached as Exhibit C.

RESULTS

As stated in the beginning of this report, the intent of this legislation was to increase the use of community financial institutions and to provide wider distribution of the economic benefit of postsecondary reserve balances.

The MnSCU institutions that participated in the pilot program benefited from this program by being able to earn higher interest rates than those they were earning from the balances held in the state treasury. For two postsecondary institutions, the personal banking relationship was conducive to conducting business and getting questions answered. The perception from two of the postsecondary institutions indicated a lack of trust between the MnSCU institutions and the financial institution due to the unbalanced nature of the agreement, particularly in the area of the termination terms as well as the interest rates. All three of the postsecondary institutions indicated that the legislation was well-received by the financial institutions, and one of the postsecondary institutions expressed interested in continuing and expanding the program. In general, this pilot program did increase the use of community financial institutions.

The financial institutions had a total of $4.3 million of MnSCU reserves on deposit. Because of these additional deposits, both financial institutions were able to assist in economic development in their respective communities. In northwest Minnesota, the bank was able to finance the expansion of a local cooperative grocery store and an independent manufacturing firm. In southwest Minnesota, the financial institution assisted in the start-up of a number of new business and employment opportunities. Both financial institutions mentioned that the volume of paper work was large and complex requiring explanations. In general, the financial institutions were able to finance economic benefit to the communities as a result of the reserve balances of the MnSCU institutions. According to the financial institutions, they had increased deposits to spend on local economic investments.

RECOMMENDATIONS AND FUTURE CONSIDERATIONS

Given the initial success of meeting the legislative intent with a limited number of partners, MMB would recommend continuing the pilot program with MnSCU and its local financial institutions for another two years with additional reporting requirements to better track the economic development benefits. The documentation, including the request for proposal and the agreement between the colleges and universities and the financial institution, is already in place.

Continuing with this program does require future considerations:

- Given current market conditions, i.e. very low interest/investment rates, as the MnSCU institutions experienced through its RFP process, there could be limited interest rate benefits.
- Financial institutions are experiencing increased banking regulations under the Dodd–Frank Wall Street Reform and Consumer Protection Act signed into law in 2010. For community banks, there are a number of new regulatory initiatives arising from the Act. The most critical initiatives will be those concerning capital requirements and consumer lending. In addition, strengthened capital requirements and introduced liquidity requirements are going to be implemented under Basel III. Basel III is a new set of banking rules developed by the Basel Committee on Banking Supervision of BIS (Banks of International Settlement). Dodd-Frank and Basel III could result in more expensive costs of banking and/or fewer financial institutions wanting to participate.
- As mentioned by one of the financial institutions, the state's banking partner, as well as a state agency that works with community banks to encourage economic development, there are healthy banks in the state that have the available cash but there are fewer opportunities to lend the money due to new regulations, capital reserve requirements, and lower demand for capital.
- In order to establish stronger relationship with the financial institution, MnSCU may want to consider allowing more balance in the termination terms. The state agreement for depository services allows for either party to terminate with or without cause by giving sixty (60) day notice. Under the negotiated MnSCU agreements, MnSCU was required to give only 31-day notice and the financial institution was required to give 181-day notice.
- Both MnSCU and MMB should explore what some of the complexities were in making the balance transfer from the state treasury to the local financial institutions so processes can continue to improve.

SUMMARY

Minnesota Laws of 2010, Chapter 364, Section 33 established a two year pilot project which allowed postsecondary institutions within MnSCU to transfer some of their reserve deposits to a community financial institution. The intent of this legislation was to increase the use of community financial institutions and to provide wider distribution of the economic benefit of postsecondary reserves.

Postsecondary institutions were selected by application to the MnSCU Board of Trustees and the financial institutions were selected through a request for proposal process.

The postsecondary institutions that participated in the pilot were able to increase the use of the community financial institutions and benefited from higher interest rates than they would have otherwise earned. One postsecondary institution was interested in continuing and expanding the program. With the increased deposits, the financial institutions were able to assist in economic development projects in their respective communities.

It is the recommendation of MMB that the pilot continue for another two years with additional reporting requirements to better track the economic development benefits.

EXHIBIT A

Minnesota Laws of 2010, Chapter 364, Section 33

Sec. 33. PILOT PROJECT; LOCAL DEPOSIT OF RESERVES OF MINNESOTA STATE COLLEGES AND UNIVERSITIES.

Subdivision 1. **Establishment.** To increase the distribution of potential economic benefit of deposits of reserve funds of the institutions of Minnesota State Colleges and Universities, a pilot project is established to transfer certain reserve deposits of selected institutions from the state treasury to a community financial institution. Notwithstanding Minnesota Statutes, section 16A.27, by January 2, 2011, the commissioner of management and budget shall transfer the specified amount of board-required reserve funds of colleges and universities selected by the board of trustees under subdivision 2, to a community financial institution designated for each of the participating colleges and universities.

Subd. 2. **Participating colleges and universities.** By August 15, 2010, colleges and universities may apply to the Board of Trustees of Minnesota State Colleges and Universities for participation in the pilot project. Each applicant must designate one or more community financial institutions for the deposit of a specified amount of board-required reserves, with the terms of the deposit for each designated community financial institution. The designated community financial institution must be located in the geographic area of a participating campus. From the applicants, the board shall select up to eight postsecondary institutions to participate in the local deposit pilot project. In making its selection, the board must consider the size of the institution's reserves and the terms offered by the designated community financial institutions. Unless there are not sufficient applicants, two-year and four-year institutions must be selected to participate in the pilot project and the majority of the selected institutions must be located in greater Minnesota. By December 1, 2010, the board must notify the commissioner of management and budget of the participating colleges and universities, the deposit amount for each institution and the associated community financial institutions. The pilot project shall provide for the transfer of deposits for no more than the period January 2, 2011, to December 31, 2012.

Subd. 3. **Community financial institution.** As used in this section, "community financial institution" means a federally insured bank or credit union, chartered as a bank or credit union by the state of Minnesota or the United States, that is headquartered in Minnesota and that has no more than $2,500,000,000 in assets.

Subd. 4. **Evaluation and report.** The commissioner of management and budget and the board of trustees shall independently evaluate the effectiveness or harm of the local deposit pilot project in increasing the use of community financial institutions and providing wider distribution of the economic benefit of the deposit of postsecondary reserves. Each evaluation must include the participating colleges, universities, and community financial institutions. The commissioner of management and budget and the board shall report on the pilot project evaluation to the appropriate committees of the legislature by February 1, 2013, with recommendations on the future implementation of the pilot project.

Minnesota
STATE COLLEGES
& UNIVERSITIES

OFFICE OF THE CHANCELLOR
FINANCE DIVISION

WELLS FARGO PLACE
30 7TH ST. E., SUITE 350
ST. PAUL, MN 55101-7804

ph 651.296.8012
fx 651.297.5550
www.mnscu.edu

MEMORANDUM

Date: November 29, 2010

To: Tom Hanson, Commissioner

From: Laura M. King
Vice Chancellor – Chief Financial Officer

Subject: Notification of Local Bank Deposit Pilot Institutions

Minnesota Laws of 2010, Chapter 364, Section 33 provides that the Minnesota State Colleges and Universities will conduct a pilot for up to eight institutions for the deposit of reserve funds with community financial institutions to increase the distribution of potential economic benefits throughout the state. Per law, this letter is to inform you of the participating colleges and university, the deposit amount for each institution, and the associated community financial institutions.

Currently the following three institutions are finalizing agreements with their local community financial institutions and will be ready to transfer funds from the state treasury to the local banks as required in the law on January 2, 2011:

Bemidji State University with Security Bank - $1,600,000
Northwest Technical College-Bemidji with Security Bank - $600,000
Minnesota West Community and Technical College with First State Bank Southwest - $2,100,000.

Please see the attached report presented in September to our Board of Trustees for further details on the process used. If you have further questions please contact myself or Judy Borgen, Associate Vice Chancellor Budget.

Attachment
c: Kerstin Larson

Banking Pilot Evaluation Survey
October 2012

EXHIBIT C

Question:	Security Bank USA (BSU)	Security Bank USA (NWTC)	First State Bank SW (MnWest)
1. What was the average daily balance(s) in the account(s)?	$1,630,879.88	$611,579.94	$2,118,900
2. What were the collateral requirements for the college/university deposits, and what collateral did your institution provide to meet these requirements?	100% coverage of the balances on deposit. Security Bank USA used letters of credit through Federal Home Loan Bank as collateral.	100% coverage of the balances on deposit. Security Bank USA used letters of credit through Federal Home Loan Bank as collateral.	The collateral requirements were to provide collateral on the deposit that is in excess of the FDIC coverage. Some of the bank's investment securities are used as collateral.
3. How were the funds deposited in your bank used? Were they compensating balances or were they invested in the community? If invested in the community, please provide details.	Due to the economic conditions, the bank has experienced higher deposit levels and lower loan demand during the period of this pilot program. However, we did invest a portion of the dollars in the community. Please refer to the response to item #4.	Due to the economic conditions, the bank has experienced higher deposit levels and lower loan demand during the period of this pilot program. However, we did invest a portion of the dollars in the community. Please refer to the response to item #4.	First State Bank Southwest invested the funds from MN West Community and Technical College into the communities resulting in a number of new business startups and employment opportunities. Fortunately and totally unplanned, these projects were in Worthington and Pipestone, who happen to both have MNSCU campuses. One of our Worthington Projects was a $632,000.00 new start up adult daycare service to the Southwest MN region. We were able to collaborate with the City of Worthington, Southwest Initiative Foundation, and SBA to make this project possible. The Pipestone project was a $400,000.00 commercial building purchase and remodel project for a young entrepreneur to create new shared offices for an Abstracting business, his Real Estate Company and Insurance Agency. These are just a few examples of ways we invested the MNSCU deposits.
4. Did the college/university deposits enable your bank to accomplish a wider distribution of local economic benefit? If so, how much and in what way? Please describe and quantify specific local economic benefit.	The college/university deposits helped enable us to finance a local cooperative grocery store's large expansion and an independent manufacturing firm's expansion in our community.	The college/university deposits helped enable us to finance a local cooperative grocery store's large expansion and an independent manufacturing firm's expansion in our community.	Yes, First State Bank Southwest did provide additional economic development benefit to the area with these funds. In the Worthington example above, the project complete provided 2 full time and 5 part time jobs with an estimated annual payroll of approximately $320,000.00. Local contractors did all the work providing a stimulus to the local economy. The new construction will provide an increased tax revenue to the local city, county and school district of over $30,000.00.

Question:	Security Bank USA (BSU)	Security Bank USA (NWTC)	First State Bank SW (MnWest)
5. How would you categorize your experience with the program from an administrative and regulatory perspective? Was it easy or difficult? How so?	The general banking agreement that we signed, was large and needed explanations. Bill Maki, VP for Finance and Administration helped work through that process, however consideration for a more simplified form would be helpful.	The general banking agreement that we signed, was large and needed explanations. Bill Maki, VP for Finance and Administration helped work through that process, however consideration for a more simplified form would be helpful.	It was overall on the easy side. The process went well after all the paper work needed on the state side was completed.
6. Would you recommend any changes to the program? Please provide details.	We would recommend a shorter time between the bid and closing of the agreement and a less cumbersome general banking agreement.	We would recommend a shorter time between the bid and closing of the agreement and a less cumbersome general banking agreement.	No, unless there could be less requirements or agreements needed on the state college part of the transaction.
7. Are there other things you would like to share about your experience with this pilot program?			

Banking Pilot Evaluation Survey
October 2012

EXHIBIT C

RESPONSES FROM COLLEGES/UNIVERSITIES

Question:	Bemidji State University (Security Bank USA)	Northwest Technical College (Security Bank USA)	MnWest (First State Bank SW)
1. What were the terms of this pilot relationship with your local bank (length, negotiated rate, etc)?	In January 2011, $800,000 was invested for 2 years at 1.7% and $800,000 was invested for 1 year at 1.4%. The one year funds were renewed for and additional one year term at 1.05% in January 2012.	In January 2011, $300,000 was invested for 2 years at 1.7% and $300,000 was invested for 1 year at 1.4%. The one year funds were renewed for and additional one year term at 1.05% in January 2012.	2 years – January 2, 2011 through December 31, 2012 with an option to renew; rate was set at 0.90% for 2 years
2. How much was your initial deposit and what was the average daily balance?	$1.6m was deposited in January 2011. Average daily balance due to compounded interest was $1.615m through 6/30/12.	$600,000 was deposited in January 2011. Average daily balance due to compounded interest was $607,000 through 6/30/12.	$2.1 million; interest not added until end of first year (18,900), no additional interest added until the end of year two
3. How were the funds secured? What were the collateral requirements and how did your local bank meet them?	The bank covered the entire balance of the deposits with a FHLB letter of credit and the coverage has remained intact during the term of the certificates of deposit.	The bank covered the entire balance of the deposits with a FHLB letter of credit and the coverage has remained intact during the term of the certificates of deposit.	The bank pledged collateral – FHLMC and FNMA. The agreement was to have 110% at all times. At one time during the term, they attempted to use FDIC coverage which caused an undercollaterization issue; they subsequently resolved this and have maintained the balance in excess since then.
4. How did this pilot impact the college/ university from a financial perspective? Could your institution have secured a higher return on investments by using another financial institution? What was the opportunity cost, if any, by using local financial institutions?	The University secured the highest rate available based on the responses to the RFP. With the declining interest rate environment, earnings exceeded the cash return rate of the State Treasury funds by 2-3 times the State Treasury average during that time.	The University secured the highest rate available based on the responses to the RFP. With the declining interest rate environment, earnings exceeded the cash return rate of the State Treasury funds by 2-3 times the State Treasury average during that time.	The college invested local funds at rates that varied from 1.5% in March 2011 (the high) to the 0.28% in May 2012 (the low). The most recent rate we secured for a CD was 0.65% for 6 months on $100,000. The rate obtained from this investment of state treasury funds was more than competitive in the long run. State treasury returns averaged .542 for the 15 months from July of 2011 through September of 2012. The locally obtained rate of 0.90% provided the college with $15,360 of additional investment income for the two year period (based on the treasury's average return for 15 months of that 24 month period). (0.90% - 0.542% X 2.1M X 2 years)

Question:	Bemidji State University (Security Bank USA)	Northwest Technical College (Security Bank USA)	MnWest (First State Bank SW)
5. How easy or difficult was the program to administer in comparison to the standard processes? Please explain.	The personal banking relationship with Security Bank USA was very conducive to conducting business. Discussions relating to the status of the letter of credit as well as balance inquiries as needed for accruing interest were easily handled.	The personal banking relationship with Security Bank USA was very conducive to conducting business. Discussions relating to the status of the letter of credit as well as balance inquiries as needed for accruing interest were easily handled.	The college worked through the RFP process. As with all new processes, it compelled more human resources the first time than it would in repeat efforts. The process will now be ready for other System institutions as well. The college doesn't currently use an RFP process for local investments.
6. a. Do you believe the deposits allowed for wider distribution of economic benefit? If so, how much and in what way? Please describe and quantify specific local economic benefit. b. Did the financial institution communicate such information with your college/university?	We are not sure as there was no direct communication from the financial institution that that was the case. I believe the financial institution had concern that we might withdraw the funds unexpectedly based on the way the contract was written. Our termination notice for the agreement was 30 days' notice while theirs was 181 days' notice.	We are not sure as there was no direct communication from the financial institution that that was the case. I believe the financial institution had concern that we might withdraw the funds unexpectedly based on the way the contract was written. Our termination notice for the agreement was 30 days' notice while theirs was 181 days' notice.	a. Yes, the funds invested in a banking institution provided access to residents and businesses in this region. The bank awarded is located in Worthington, MN, which is noted for its minority population and minority business ownership. The funds made available locally were then accessible to these groups of local citizens. b. The agreement with the financial institution provides for communication of this information at the close of the pilot.
7. Would you recommend changes to the program? Please provide details.	Yes, I think the contract should be more balanced and not so much in MnSCU's favor. My perception was this imbalance created a reduced sense of trust with the financial institution.	Yes, I think the contract should be more balanced and not so much in MnSCU's favor. My perception was this imbalance created a reduced sense of trust with the financial institution	No.

Question:	Bemidji State University (Security Bank USA)	Northwest Technical College (Security Bank USA)	MnWest (First State Bank SW)
8. Are there other things you would like to share about your experience with this pilot program?	I think both the institution and the financial institution underestimated the complexity of the process and the contract to move the funds from the state treasury to the local bank. Overall, the initial legislation was well-received as the local bank did appreciate the opportunity to be able to keep more university funds in a local financial institution. The environment of interest rates since the pilot program was initiated was not favorable to the bank, but was to our institution. I think this external factor made it less of a win/win situation.	I think both the institution and the financial institution underestimated the complexity of the process and the contract to move the funds from the state treasury to the local bank. Overall, the initial legislation was well-received as the local bank did appreciate the opportunity to be able to keep more university funds in a local financial institution. The environment of interest rates since the pilot program was initiated was not favorable to the bank, but was to our institution. I think this external factor made it less of a win/win situation.	We were pleased to be a part of this pilot and hope that it will continue and expand in the future to provide the same opportunities across the state.