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Analysis of CD Placement Programs

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Key Points

- To ensure the product is appropriate for their defined risk and liquidity tolerance, we believe investors and their boards should be fully aware prior to investing of the various issues CD programs can present, including liquidity risk, low transparency to bank failure, high penalties for early withdrawal which may cause loss of principal and other factors.
- Investment policies should be carefully reviewed to ensure CD placement program compatibility.
- Investors should continue to monitor that there is no liquidity need for the CD-invested cash. Transparency into the underlying bank being invested in is essential to ensure that the \$250K maximum is not exceeded.
- In the event of a bank failure, the FDIC does not pay the deposit insurance directly to the investor in the CD, but rather is paid to the agent who opened the CD on behalf of the investor. We therefore recommend appropriate due diligence conducted on the selling agent.
- It remains unclear to know exactly how soon depositors will receive their money back. For CDARS deposit coverage to be available, the recordkeeping and certain FDIC procedures would have to be followed, which may take time due to involvement of multiple parties (the relationship bank, the issuing bank, the subcustodian). From our observations, money invested in the CDs of the 100+ banks that have failed this year has been returned to investors in timeframes typically ranging from two days to two weeks.

Benefits for Investors

With CDARS, the investor can access full FDIC insurance coverage on its investments while earning CD-level returns. Currently depending on the member banks, the yield for 52-week CDs range from 75 bps to 150 basis points. The investor will only need to enter one deposit placement agreement with a member bank, earn one rate for the entire investment and will be receiving regular, consolidated account statements summarizing all CDs holdings from his bank. A typical statement will specify the issuing banking institutions, interest rates, maturities, interest paid and balances. Investors may also specify banking institutions in which they do NOT want their deposits placed.

With CDARS, the client no longer has to spend time managing multiple bank relationships, administering various interest rates, organizing interest disbursements from various sources or manually consolidating monthly statements. This helps reduce the administrative burden.

Considerations for Investors

Liquidity risk

CDs placed with CDARS are non-negotiable and are not Depository Trust Company (DTC) eligible. Currently, no active secondary market exists to buy and sell these investments, should the client need immediate liquidity.

High penalty rate for early withdrawals

Early withdrawals are available, but include a penalty of 50 percent or 100 percent of the interest earned over the term of the CD, based on maturity. The interest penalty owed may be unearned at the time of withdrawal, causing loss of principal.

Transparency issue

Many of the bank participants are primarily community and regional banks with no direct access to capital markets. These banks have come under tremendous pressure during the current crisis. They have higher cost of funds, and a greater need to raise funds locally. As we move through the crisis conditions, the credit weakness has expanded rapidly into the commercial real estate sector, negatively impacting regional and small community banks, which typically have a large concentration in commercial real estate lending and construction development loans. An integral part of the treasury department's responsibility is reporting on the company's investment holdings to senior management, board, accounting staff and auditors. Due to lack of public disclosure, it is typically hard to assess the underlying creditworthiness of these banks. This lack of data may be an unacceptable condition for larger firms with well-defined credit parameters for their allowable investments.

Many investment policies do not accommodate CD placement vehicles

Most corporate investment policies will state specifically the minimum credit ratings, liquidity requirements and issue size required for the investment vehicles they allow. Since most banks in CD placement networks are either not rated by the rating agencies or do not have an investment grade

rating, an exception for the presence of FDIC insurance of these otherwise disallowed investments is usually required by board. The inability to resell these securities in the open market, the presence of a potential penalty if liquidated prior to maturity and the generally small issue size of these investments compared to typical investment grade issue sizes create other investment policy compliance violation scenarios, each of which may need to be reviewed by corporations and their boards prior to investment. In addition, despite the government insurance, these investments may need to be classified as financial sector investments. This will need to be considered under the sector diversification parameters of a firm's investment policy.

FDIC payment to depositors when a bank fails

The FDIC has stated that investor deposits placed through the CDARS system would be insured on a pass-through basis under the FDIC's rules on the insurance coverage of agency or custodial accounts.

Although the FDIC will provide pass-through deposit insurance coverage to the actual owner(s), the FDIC does not pay the deposit insurance directly to the owners or customers. Rather, the FDIC will pay the deposit insurance coverage to the agent (relationship bank) who opened the CD account at an insured bank on behalf of their client(s). In turn, the agent will be responsible for distributing the deposit insurance payments to their client(s). However, in order to determine the deposit insurance coverage for such deposits, the FDIC will typically need to obtain from the agent supplemental information, such as a list of the owner or owners of each deposit and the dollar interest of each owner in the deposit account. As soon as the agent provides the needed information, the FDIC will pay insurance as prescribed on the FDIC procedure for depositor payment. The FDIC does not attempt to supervise the relationships between agent and clients or the distribution of funds from agent to clients. Depositors are urged to contact their agents regarding the status of their investment funds, as the FDIC depends on those parties to supply the necessary information to determine

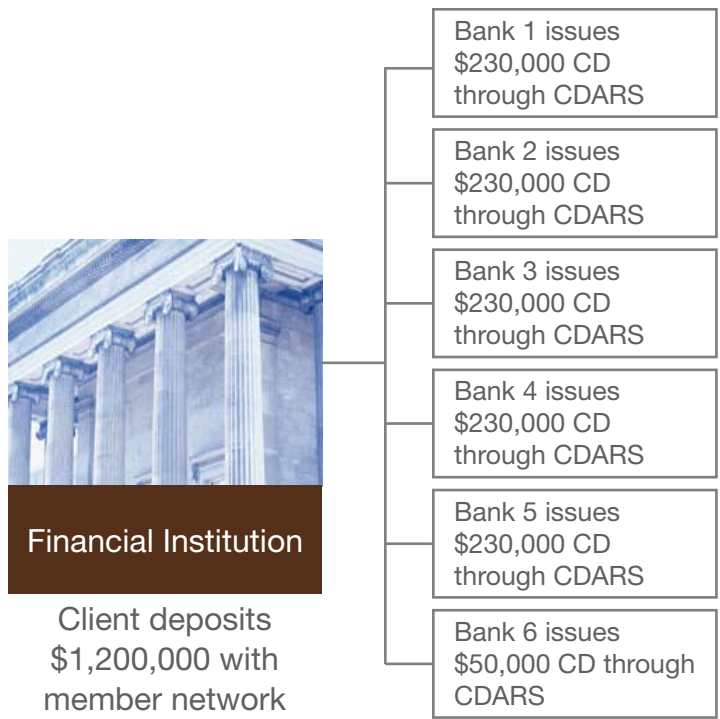
insurance coverage. Thus, it remains unclear to know exactly how soon will depositors receive their money back. From our observations, money invested in the CDs of the 100+ banks that have failed this year has been returned to investors in timeframes typically ranging from two days to two weeks.

It's important to ensure that CDs invested in the same bank or subsidiary do not exceed the FDIC insurance limit

The depositor should review the CDs held in CDARS programs against any CDs they invest in directly to ensure multiple CDs are not held from the same bank. Multiple CDs held by the same bank or subsidiary in the same ownership capacity are only insured by the FDIC for up to \$250,000, even though they may be held in separate accounts.

How They Work

CDs are issued by different banks in amounts under \$250,000 so that principal and interest are eligible for full FDIC insurance.



Description

CDARS is a deposit placement services offered by nearly 3,000 financial institutions are members of the CDARS network. The service allows investors to access full FDIC insurance for deposits of up to \$50 million.

Firms that sell CDARS to their clients become members of an institution called Promontory Interfinancial Network. When a client places a large deposit with a network member, the member can place the funds into certificates of deposit under \$250,000 issued by banks in the network so that both principal and interest are eligible for complete FDIC insurance.

The standard FDIC insurance amount of \$250,000 per depositor is in effect through December 31, 2013. On January 1, 2014, the standard insurance amount will return to \$100,000 per depositor for all account categories except IRAs and other certain retirement accounts, which will remain at \$250,000 per depositor.

Depositors can choose from an array of maturities: 4-week, 13-week, 26-week, 52-week, 2-year, 3-year and 5-year. However, each participating bank has the option to select which maturities to offer its depositors.

The bank that places deposits retains complete ownership of the customer relationship.

The CDARS rates will often be lower than the rate received if the investor invested directly with the bank due to transaction fees. While CDARS specifically prohibited this transaction fee from being passed on to the depositors, the bank may cover these fees in the interest rates offered for their CDs.

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