SOUTH DAKOTA INVESTMENT COUNCIL

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MEMORANDUM

TO: Matthew L. Clark

FROM: Sherry Z. Nelson

DATE: August 8, 2019

RE: Certificate of Deposit (CD) Program Review Update

The South Dakota Investment Council CD program is a modest program designed to benefit economic development in South Dakota by making funds available to local financial institutions for loans. Below is a discussion of the CD Program including information on the purpose of the program, the pros and cons of the program and return comparisons.

1. Purpose of the CD program:

    - Provide funds to South Dakota financial institutions for loans within the state.
    - Provide the South Dakota Cash Flow Fund with a market rate of return.

2. Pros and Cons of the CD Program

    A. Pros
    - Provides a safe and predictable one-year return based on the Treasury note plus a risk premium for liquidity and collateral risk.
    - Safety provided by 100% governmental security collateralization above FDIC insurance of up to $250,000 at each participating financial institution.
    - Standardized low labor-intensive process to administer program.
    - Provides capital to South Dakota institutions for potential loans within the state which can help the state economy.

    B. Cons
    - CD program investments may be giving up return if the appropriate return comparison is not the one-year Treasury note plus an assigned risk premium.
    - CD program investments provide less liquidity than T-note or agency securities.
    - Cost of administering the program.

3. Return Comparisons

    - CD program provides return identical to the one-year Treasury note return with a floor of 0% plus a risk premium for liquidity and collateral risk, while providing slightly more credit risk and much less liquidity than Treasury notes.

    - CD Program investments can be compared to one-year government-sponsored agency investments. CDs offer a comparable risk profile and less liquidity than agency investments.

One-year agencies offer a good comparison for the one-year South Dakota Investment Council CDs. Prior to 2010, the CD Program investments provided, on average, a return of 20 basis points less than investments in government-sponsored agency securities with like maturity dates. Thereafter, the rate-setting methodology changed to incorporate a risk premium. With the risk premium added to the base one-year Treasury note yield, there continues to be no expected yield give-up versus agency securities. Initially the risk premium was set at .50%, .25 % for illiquidity and .25% for collateral risk, for CDs maturing 9/30/11 and 9/30/12. To reflect the narrowing of Agency-versus-Treasury spreads and market pricing of liquidity, it was reduced to .25%, .15% to compensate for illiquidity and an additional .10% to compensate for collateral risk. We propose that the risk premium remain at .25% for the one-year CDs to mature 9/30/20.

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