SOUTH DAKOTA INVESTMENT COUNCIL

4009 West 49th Street, Suite 300
Sioux Falls, SD 57106-3784 USA
605-362-2820 – https://sdic.sd.gov

MEMORANDUM

TO: Matthew L. Clark

FROM: Sherry Z. Nelson

DATE: August 15, 2021

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 to account for illiquidity and collateral risk. With the risk premium added to the base one-year Treasury note yield, there will be a small expected yield pick-up versus agency securities. Given that the current yield of agencies and treasury bills is approximately the same and there has been a significant decline in participation, we recommend lowering the total risk premium from 25 basis points to 10 points, thus eliminating the 10 basic point premium for collateral risk and lowering the 15 basis point liquidity premium to 10 basis points for the CDs maturing 9/30/22. The level of risk premium will be reevaluated each year.

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