Investment of California's Short-Term Funds
The Pooled Money Investment Account

Kenneth W. Umbach, Ph.D.
Rosa M. Moller, Ph.D.

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www.umbachconsulting.com

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The original version of this report was written in response to Section 3 of AB 2805 (Chapter 913, Statues of 2000). It also includes what was to have been the first in a series of annual reports under Section 2 of AB 2805, providing data and analysis regarding the placement of surplus state funds for investment. It focuses primarily on the Pooled Money Investment Account (PMIA) and was intended to respond to several questions posed by the Legislature regarding placement of those funds. The paper was never published. This is a shortened version of what had been prepared for consideration by the California Research Bureau. *[Note (May 2004): a few months ago, a truncated, condescending, and misleading version of the paper was published by the Bureau, with the bibliography accidentally omitted. That version lacked my name as author by my request.]*

The original report was jointly prepared by Dr. Moller and Dr. Umbach. Dr. Umbach has edited this version* down significantly from the original, omitting some sections and all but one appendix. The data have not been updated. Section IV was primarily the work of Dr. Moller. Much of the rest was prepared by Dr. Umbach, although both authors collaborated on the entire original version. Dr. Moller's approval of the document in its present form should not be inferred. Nor does the document have authorization from the California Research Bureau.

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* Posted at www.umbachconsulting.com/discussion/CAShortTerm.pdf.

Introduction

The assignments made in Assembly Bill 2805 (Chapter 913, Statues of 2000), to which the original version of this paper was intended to respond, encompass complex ideas and terms. As a result, this report touches on many facets of investment and related policy questions, not all of them clearly related to one another.*

Section 3 required a report on:

> The geographic and socioeconomic distribution of California's invested state funds. (We read this to refer to short term investments of surplus cash.)
>
> How state agencies ensure the funds receive the best rates while satisfying other socially important goals and maintain a significant portion of publicly invested funds in California financial institutions.
>
> Additional efforts that can be made to keep California funds working for Californians while practicing prudent investment policies.
>
> The feasibility and social benefits of the following:
>
> 1. Requiring the state to follow guidelines similar to the federal Community Reinvestment Act in its investment policies.
> 2. Allocating funds for specific investment purposes.
> 3. Mandating that a set percentage of California's public funds be used in California.
> 4. Identifying impediments, if any, to community banks' receipt of public moneys, such as those from pooled money investment accounts.
> 5. Creating a separate program for pooling deposits in California's community financial institutions to ensure that more public funds are used at the local level.

We understand this assignment to refer to the manner in which California's surplus cash is invested, with a specific view to funds placed in community financial institutions or otherwise placed in short-term investments related to California and its localities. We also understand the assignment to require consideration of the manner in which the

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* The original report, of which this is a condensation and adaptation, was never published. The reader should be aware that the content of even this briefer version suffers from the attempt to cope with the contorted requirements of the law. *[Note (May 2004): a few months ago, a truncated, condescending, and misleading version of the paper was published by the Bureau, with the bibliography accidentally omitted. That version lacked my name as author by my request.]*

placement of those funds promotes, or could promote, the kinds of financial institution lending and investment activities described in the federal Community Investment Act and its regulations.[1]

Section 2 required an annual report, the first of which was to have been encompassed in the present report as Section IV, "Geographic and Socioeconomic Distribution of Funds," and through material incorporated by reference. This material addresses:

- The placement of all state short-term investment funds.
- The names of financial institutions receiving state funds, and at what rates, with specific care being given to the location and disposition of the funds.
- The geographic location and use of the funds.
- The percentage of funds remaining in California and the percentage of funds invested out of state and out of the country.

Much of the information required to address the request in Section 2 is available in Pooled Money Investment Board reports published by the California State Treasurer. We do not repeat that information here, but instead refer the reader to printed reports available from the Treasurer's Office:

- Monthly reports of the Pooled Money Investment Board, issued after the end of each month
- Annual reports of the Pooled Money Investment Board, issued following close of each fiscal year[2]

The monthly reports provide bank-by-bank lists of time deposits, and day-by-day reports of other investment activity. The annual reports provide summary information and program descriptions. Here we summarize, organize, identify (to the extent that is possible), and analyze key information that relates state investments to California communities, rather than reproducing the detailed data published by the Treasurer's Office.

I. The Community Reinvestment Act

AB 2805 highlights the federal Community Reinvestment Act (CRA) as a potential model for California investment practices. AB 2805 also seeks data on the distribution of California's funds available for investment in communities in California, a CRA-related issue.

This section summarizes CRA, its origin and purposes, implementation, and impacts. Potential for emulating CRA in California's investment practices is addressed in Section V, "Feasibility and Social Benefits of Selected Initiatives."

CRA IN BRIEF

The Community Reinvestment Act requires regulated banks and thrifts to meet the credit needs of their communities.

In its statement of purpose for the Community Reinvestment Act, Congress found that:

> (1) regulated financial institutions are required by law to demonstrate that their deposit facilities serve the convenience and needs of the communities in which they are chartered to do business;
>
> (2) the convenience and needs of communities include the need for credit services as well as deposit services; and
>
> (3) regulated financial institutions have continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered.
>
> . . . It is the purpose of this chapter to require each appropriate Federal financial supervisory agency to use its authority when examining financial institutions, to encourage such institutions to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions.[3]

CRA, Chapter 30 of Title 12, U.S.C., is implemented through detailed regulations, but the core remains the brief statement of purpose above.[4]

Regulators periodically review the record of banking institutions and provide a rating on CRA performance. CRA performance is considered as part of the review of applications for mergers and acquisitions involving banking institutions, and is therefore taken seriously by most banks. Many banks have found sound and profitable opportunities in meeting the needs described in the act, including the needs of low and moderate income individuals and communities.

NEW EMPHASIS ON PERFORMANCE RATHER THAN PROCEDURES

CRA as originally designed and carried out was criticized as being too heavily oriented toward procedures and toward promises of future performance, and too little toward

demonstrated results. As a result, in 1995 regulations implementing the act were significantly revised in order to focus CRA evaluations on performance and in order to differentiate between different categories of institution.[5]

For each type of institution and for each applicable test, the focus is explicitly on "helping to meet the credit needs of [the institution's] assessment area(s)."[6]

The major categories of examination are:

- Lending test
- Investment test
- Service test
- Community development test for wholesale or limited purpose banks
- Small bank performance standards

In every case, the focus is on *meeting the credit needs of the community or communities served by the institution*, with special emphasis on meeting needs of low and moderate income individuals and areas.

It is important to recognize that "lending" is different from "investment" in CRA terms, and that even the investment test is intended with reference to the underlying goal of meeting credit needs of communities.

The lending test is the most important criterion for most banks and thrifts. An institution that achieves an "outstanding" rating on that test is virtually assured of at least an overall rating of "satisfactory." Loans considered under that test include both those originated by the institution and those purchased or participated in by the institution.[7]

The investment test excludes activities already weighed under the lending test, but may encompass activity of affiliates and in-kind as well as cash investments. In general, "The investment test evaluates a bank's record of helping to meet the credit needs of its assessment area(s) through qualified investments that benefit its assessment area(s) or a broader statewide or regional area that includes the bank's assessment area(s)." Like everything else about CRA, the rules are involved, encompassing such factors as "innovativeness or complexity of qualified investments."

Small banks (essentially those with under $250 million in assets as of the previous year's end) have simpler requirements than large banks; wholesale and special purpose banks have requirements tailored to their types of activities.

CRA's Impact

Although there is a substantial literature about the CRA and its estimated impacts, there appears to be no general agreement regarding those impacts.[8] Limitations of data and conflicts in assumptions and interpretations lead to widely differing views.

It does seem fair to conclude that since the enactment of CRA credit availability to low and moderate income areas and individuals has increased, regulated depository institutions are more aware of opportunities in those areas and among those individuals, and institutions covered by CRA are aware of the importance of achieving at least a satisfactory rating. This summary is consistent with the most thorough recent analyses.[9] Further, it appears fair to conclude that the emphasis of CRA regulations has effectively moved from procedure and promises to documented performance

A further reasonable interpretation (our conclusion from reviewing the literature) is that the underlying assumption of risk regarding financial services to low and moderate income areas and individuals has shifted over the quarter century since CRA was enacted. Before CRA the risk of providing credit in such areas and to such individuals was perceived as the greater concern, but now the risk of failing to address those credit needs is perceived as the greater concern. That is, regulated institutions that fail to meet CRA requirements at least satisfactorily risk inability to engage in mergers, acquisitions, or changes in branches, and risk unfavorable public perceptions that may harm the interests of the institutions.[10] In a time of rapid evolution and highly competitive environment in the financial services industry and of numerous mergers and acquisitions in financial services, the loss of flexibility that would result from less than satisfactory CRA ratings must be taken seriously by institutions.

A possible explanation for the failure to achieve a CRA rating of at least "satisfactory" by some institutions might be that they lack management sophistication in serving the entire community or have an unusually specific institutional focus or clientele. Either could make those institutions unsuitable as a recipient of public deposits. If so, it is only appropriate to exclude those few institutions with ratings of "needs to improve" or "substantial noncompliance" as candidates to hold deposits of state funds. Thus, it is not surprising that, as it will be discussed in a later section of this paper, these institutions do not participate in the time deposit program managed by the California Treasurer's Office. After such exclusion, 99 percent of depository institutions remain eligible to participate under the satisfactory-CRA-performance requirement, including credit unions, which are not subject to CRA review.

II. The Pooled Money Investment Account

OVERVIEW

With some exceptions reflecting specific authorizing statutes, California state agencies do not invest their own funds. Funds are handled by the State Treasurer and invested via the Pooled Money account.[11] Even where agencies are authorized to invest separately, in most cases they may petition the Pooled Money Investment Board to invest via the Surplus Money Investment Fund, in turn encompassed in the Pooled Money Investment Account. Other states have different patterns regarding where investment authority falls.

California law does not authorize agencies to earmark funds for any specific use or allocation among investments within the pool. Funds go into the pool (with the Controller keeping track of what belongs to which agencies and special funds) and the pooled funds are invested by the staff of the Treasurer's Office.

WHAT THE PMIA DOES

The PMIA holds and invests the state's surplus funds.[12] The Investment Division of the State Treasurer's Office also manages the Local Agency Investment Fund (LAIF) as part of PMIA. Staff also assists various state agencies with separate investment authority for escrow and reserve accounts.

The PMIA must be managed in a way that (a) allows acceptance of incoming funds and placement in authorized types of short-term investments and (b) enables prompt return of funds to the state and to participating local agencies on request. In California, portfolio guidelines are set by statute and the "prudent person" rule. Other states have administrative stipulations in addition to statute and the prudent person rule. For example, Michigan has different portfolio objectives for each of its various funds. California, like most states, pursues the objectives of safety, liquidity, and high rates of return consistent with safety and liquidity.

Below we discuss the PMIA investment rules and practices and then look more closely at the portfolio composition of this fund.

INVESTMENT PRACTICES FOR CALIFORNIA'S POOLED FUNDS

Practices for investment of the Pooled Money Investment Account are governed by state law, by policies adopted by the Pooled Money Investment Board (PMIB), and by accepted norms for prudent fiduciary management of investments.[13]

The governing concepts are established in Government Code Section 16480.2:

> It is the intent of this article [Article 4.5, Treasury Pooled Money Investments] that money available for investment or deposit be invested in securities or depos-

> ited in banks and savings and loan associations in such a way as to realize the maximum return consistent with safe and prudent treasury management.

The most essential criterion for investment of the pooled funds is *liquidity*, as funds move in and out quickly to reflect transient surpluses and needs of the many participants. Closely related to liquidity is the concept of *safety*.[14] Rate of return must be viewed in the context of safety and liquidity, as a nominally high rate of return cannot compensate for illiquidity of an investment or for the chance that principal value might fall when the investment is sold on short notice.

California Pooled Money Investment Board Policies

The Pooled Money Investment Board oversees funds available for temporary investment:

> The Pooled Money Investment Board (PMIB) is [composed] of the State Treasurer as chairperson, the State Controller, and the Director of the Department of Finance. The main duties of the Board are:
>
> - To design an effective cash management and investment program to realize maximum return through safe and prudent investments of the state's idle money and
> - To designate the amount of money temporarily available for investment.[15]

The PMIB publishes annual and monthly reports. The monthly reports provide specific information on daily investment activities (purchases and redemptions) and a list of time deposits in effect as of the end of the month, as well as monthly summary information. The annual reports give an overview for the reported year.

The rate of interest earned on the Pooled Money Investment Account serves as a benchmark for setting interest rates in several provisions of state law. For that reason, changes in practices for the PMIA could indirectly affect other programs.[16]

A portion of PMIA funds provide interim financing for state buildings and other facilities.

Liquidity and Safety are Key Elements of PMIA Strategy

PMIA participants expect their funds to be safe, available when needed, and invested at the best rate of interest consistent with safety and liquidity. (An unusually high rate of return on an investment signals unusually high risk. Investments of comparable type with comparable risk typically have roughly comparable rates of return.) Risk tolerance for the PMIA funds is minimal and the time frame is short, virtually day-to-day for many participants, as they use the LAIF as a safe haven for short term cash. Thus, management must weigh those needs when making investment decisions.

Liquidity is significant at three key levels:

1. Public agencies (state and local)
2. The Pooled Money Investment Account itself, as agent of the public agencies
3. Financial institutions holding funds deposited by the PMIA

Agencies (the state itself, as well as local governments) need to pay their expenses as well as to have a safe and interest-bearing place for temporary cash. The PMIA must have immediate access to sufficient cash to meet the needs of its participants. And finally banks, savings and loans, and credit unions in which time deposits are made must have the liquidity to return funds at maturity of deposits. Renewal of deposits, although typical practice, cannot be assured.

In short, the managers of the PMIA must keep an eye on the liquidity of institutions in which the PMIA deposits funds in order to assure liquidity of the PMIA itself.

Authorized Investments

State funds and funds held in trust by the Treasurer are predominantly invested as authorized in Government Code Section 16430. Funds not so invested are deposited in eligible banks, savings and loans, and credit unions. Some funds may, under specified circumstances, be deposited in out-of-state banks that are not otherwise "eligible banks." Investments and deposits not authorized under law are prohibited.[17]

California Government Code Section 16430 specifies these types of eligible investments for the pooled money account:

- Bonds or interest-bearing notes or obligations of the United States, or those for which the faith and credit of the United States are pledged for the payment of principal and interest, and comparable bonds issued by federal agencies.
- Comparably guaranteed bonds and notes of the State of California.
- Various other specified types of bonds and notes and similar types of instrument issued by municipalities and districts within California.
- Certain other types of bonds, notes, and so on issued by federally authorized land banks and other lending agencies.
- Prime commercial paper (short term obligations issued by top-rated corporations meeting specified requirements), within several specified limits and conditions.
- Bankers acceptances meeting certain requirements.
- Negotiable certificates of deposit meeting certain requirements.
- Certain other types of federally guaranteed loans and obligations.
- Certain international obligations, with specified types of guarantees.

Section 16480.1 also allows for deposits in banks and savings and loan associations, as well as loans to the General Fund. Other provisions of law permit loans to special funds.[18] Other sections expand the list of institutions that may receive deposits of state funds and of funds held in trust by the Treasurer to encompass eligible credit unions.[19] That is, funds may be placed in "time deposits" in qualified banks, savings and loans, and credit unions, within certain limits.

Rules Regarding Deposits in Banks, Savings and Loans, and Credit Unions

The Treasurer's Office may deposit public funds only according to California law. Rules encompass the definition of eligible institutions, the types of collateral acceptable for deposits, and limits on the amount of money that may be deposited in any single institution, limits that pertain to such issues as equity capital.

Types of institutions eligible to receive Treasurer's Office time deposits are banks, savings and loans, and credit unions. Conditions for eligibility are stated in California Government Code sections 16500 and 16600. Those conditions include:

- A rating of not less than "satisfactory" under the federal Community Reinvestment Act, which requires covered institutions to meet the credit needs of their communities, including low and moderate income persons and neighborhoods.
- Furnishing of specified types of security (collateral) for deposited funds.

What Limits apply to Deposits?

The California Government Code, at Sections 16505 and 16604, limits deposits in banks and savings and loans to not more than the total of the bank's or savings and loan's "net worth." That phrase replaced the prior wording of "paid in capital and surplus." For purposes of this paper, "net worth" is taken to mean "paid in capital and surplus," and equated with "equity capital" as reported in FDIC data, which is the figure used by Treasurer's office staff in interpreting "net worth."[20] Equity capital is in most cases a small fraction of deposits, and a smaller fraction of assets, typically 6-11 percent, but not uncommonly up to 18 percent (a few slightly below 6, some from 18 to 30 percent, and a handful over that). The limit on deposits and the requirements for security are important precautions: "[E]ven well capitalized banks are thinly capitalized, and it does not take much in terms of unexpected losses to undermine a bank."[21]

A key impact of the limitation of deposits to not more than equity capital is that deposits can rarely exceed a small fraction of the assets or of the deposits of an institution. The maximum allowable deposit is further reduced by the need to keep a margin for safety, as equity capital may vary significantly for smaller institutions over relatively short periods. That thin layer of equity capital stands behind a much deeper layer of assets and liabilities. One or two large bad loans can make a significant dent in equity capital, and might even lead to intervention by bank regulators.

What Security (Collateral) is Required for Time Deposits?

Time deposits and demand deposits must be secured by some form of collateral, as specified in the Government Code.[22] The rules for bank time deposits are summarized below, but the reader is referred to the law itself for details. (Banks are authorized to provide certain types of collateral for which savings and loans and credit unions are not eligible, but otherwise the lists are the same.)

Portions of deposits insured by the federal government, currently up to $100,000 per account, do not require collateral. For amounts over that limit, security equal to 110 percent of the amounts in question, must be provided through any of several types of collateral. (A higher percentage applies in some cases.) Many of those types are similar to instruments in which the Treasurer may directly invest Pooled Money Investment Account funds:

Authorized types of security for time deposits include:

- Bonds, notes, and other federally guaranteed obligations.
- Certain types of state and municipal bonds and other obligations.
- Certain promissory notes, secured by first mortgages and first trust deeds upon residential real property located in California (requires a 50 percent excess over value of time deposit secured by the notes).
- Bonds issued by the State of Israel.
- Certain guaranteed obligations issued by international organizations.
- A letter of credit, meeting certain conditions, issued by the Federal Home Loan Bank of San Francisco. (This provision is new as of January 1, 2001.)
- A bond provided by an admitted surety insurance company that is also certified by the U.S. Treasury.

A few points regarding collateral are worth noting.

Collateral may take many forms, ranging from a wide array of "hard" assets such as Treasury bonds, to letters of credit from the FHLB of San Francisco (a new option as of 2001), and bonds from admitted surety insurers.

The provision of collateral, whether in the form of hard assets or otherwise acceptable forms of guarantee, enables the Treasurer's Office to accept a market rate of interest, pegged to comparably dated Treasuries plus a very small spread (additional basis points). Without adequate security, the added risk would require a higher spread.

The financial institution gains some confidence in the use of the deposited funds because the Treasurer's Office holds collateral against the funds plus the added protection against fluctuation in market value of the 10 percent additional margin of collateral over deposit. A deposit made with sound collateral is one that has a high probability of remaining in

place and therefore potentially of funding long-term assets. A deposit made without collateral would be a deposit that would have to be withdrawn or not renewed in the event of any perceived credit risk, and therefore would be a very insecure source of funds and a potential contributor to instability.

Although it protects the invested funds, the requirement of collateral imposes some relatively modest costs on the Treasurer's Office, as that office must manage the collateral and mark-to-market (determine current market value) regularly to assure that the collateral remains sufficient. The state gains additional security, but it has additional work to do in connection with the collateral. The tradeoffs between costs and benefits may vary with changing economic conditions.

Girard Miller, in a report on public fund investment published by the Government Finance Officers Association, summarized impact of and experience with collateralization this way:

> Several studies have determined the effect of collateral pledging on public deposits and even the municipal bond market. This text acknowledges that collateral practices vary widely among the states and that collateral protection has worked in the past, with the notable exception of the Penn Square Bank in Oklahoma City [a notorious 1982 bank failure]. Oklahoma's collateralization laws did not require that collateral be marked-to-market to compensate for price discounts, so several municipalities found themselves holding collateral securities whose market value fell short of their deposits and accrued interest. Several jurisdictions reportedly accepted long-term bonds that were under water, and were forced to await their maturity to avoid a loss.
>
> In states where collateralization is provided as a statewide condition of doing business with the public sector [California is such a state], the investor's cost of collateralization seems to be the lowest. Where collateralization is optional or otherwise not uniformly required, entities that seek to obtain collateral for their uninsured deposits report that a significant interest penalty is involved. These general tendencies reflect the depositories' cost of providing collateral as a matter of portfolio inefficiency and the administrative costs of collateralization. The intriguing question is, "Who pays."[23]

There is an alternative to pure collateralization (that is, to segregated collateral) used by some states. That alternative is *collateral pooling*. There are two basic types of collateral pooling. One (shared pooling) creates a statewide pool, as each institution that receives public deposits contributes a percentage into the pool. That pool is then drawn upon in the event of a default on any public deposit. The other type (bank collateral pooling) calls for each institution that receives public funds to create a collateral pool covering all such deposits.[24]

PMIA PORTFOLIO COMPOSITION

Resources in the Pooled Money Investment Account averaged $44.5 billion per day during the fiscal year 2000/2001, with a portfolio of $43.8 billion and demand accounts of

$736 million. These totals encompass both state funds and Local Agency Investment Fund (LAIF) deposits made by local governments and agencies, a voluntary program that began in 1977.[25]

LAIF allows participating agencies, cities, counties, and special districts to pool resources in a major portfolio using the investment expertise of the Treasurer's Office Investment staff at no additional cost to the taxpayer. California is not the only state that operates local government investment pools. Thirty states have similar programs, but in only 23 of them does the state treasurer administer the fund. Michigan, New York, and Minnesota, for example, do not have this type of program.[26]

As of June 30, 2001, the LAIF had $14.4 billion under management and around 2,800 participating agencies, geographically diverse and of all sizes. The fund has increased substantially from 1977, when the LAIF had $468 million and only 293 participating agencies. The current composition of LAIF participants includes 54 counties, 468 cities, 1,896 special districts, and 286 trustees. In August 2001, LAIF deposits totaled $1.84 billion and withdrawals totaled $1.61 billion. Month-end balance for August 2001 was $18.19 billion.[27]

Because the state funds are not separated from the local agency funds managed within the same pool, this report considers the entire fund and its geographic and socioeconomic aspects. Once deposited into the fund, all of the money is commingled and managed as a whole, not earmarked for any particular type or location of investment.

Investments of the PMIA are made from funds flowing through the Treasurer's demand accounts (non-interest bearing). The Treasurer's Office traditionally has maintained these accounts in large banks. In 2000/2001 fiscal year, demand accounts were about 1.7 percent of the total PMIA funds. This was lower than the 2.2 percent of the previous three years. In 1995 these balances averaged less than 0.6 percent. The vast majority of these funds – some 99 percent – were placed in banks with assets in excess of five billion dollars.

Although the fund is called a "pool," it would be more accurate to describe it as a "stream," because money constantly flows into and out of it, not just recirculating within, but entering and leaving. Turnover is large and rapid, and therefore not suited to static investment. Rather, the Pooled Money Investment Account serves as a large, active cash management vehicle – essentially a money market fund – simultaneously serving the state and its numerous special funds and participating cities, counties, districts, and other local government entities. Many agencies that participate in LAIF have a zero balance at any given time, as they use the LAIF as a place to put money temporarily and safely while earning interest on it.[28]

Performance is measured by safety and availability of funds and by rate of return measured month to month. This is in contrast to a long-term investment account, in which short-term fluctuations are unimportant and funds do not quickly flow in and out, but rather are, on balance, added to and allowed to grow year after year.

In California there are no specific limits for most approved investments. However, commercial paper holdings may not exceed 30 percent of the total portfolio and the state cannot own more than 10 percent of any one issuer's outstanding paper. In other states the policies are different and portfolio requirements are fixed by investment guidelines. Kentucky, for example, has maximum percentage in each security except Treasuries by total portfolio, and Michigan does not have limits.

Generally, California invests in the same types of investments as other states. Most states invest their cash balances in negotiable CDs, time deposits, banker's acceptances, commercial paper, corporate notes and bonds, state and local government obligations, U.S. Treasury obligations, U.S. agency obligations, repurchase agreements, and mortgage-backed securities. Some states, such as New York, New Hampshire, and New Mexico, invest only in negotiable CDs issued within the state, and not in CDs issued by banks in other states. California invests in both out-of-state and within-state CDs.[29]

Holdings of the Pooled Money Investment Account for various fiscal years are shown in Table II-1. Over time there has been a significant decrease of Treasuries in the portfolio, a significant increase in time deposits, and a decline in the proportion of mortgages. The average yield of the portfolio has been fairly steady and slightly increasing.

Table II-1

POOLED MONEY INVESTMENT ACCOUNT PORTFOLIO COMPOSITION

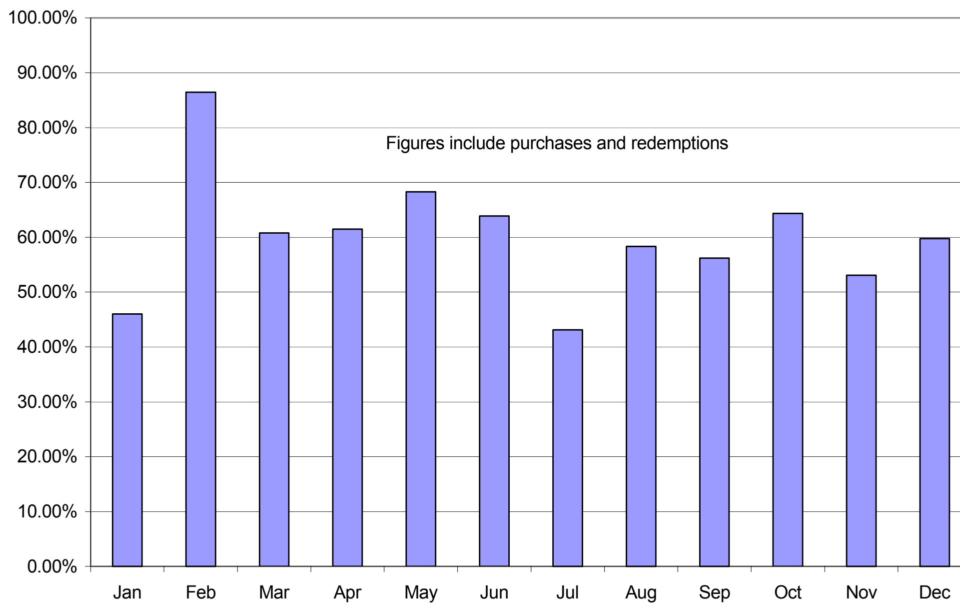
Type of Instrument	1994/1995 Avg. Daily Portfolio	% of Portfolio	Eff. Yield for Year	1997/1998 Avg. Daily Portfolio	% of Portfolio	Eff. Yield for Year	1999/2000 Avg. Daily Portfolio	% of Portfolio	Eff. Yield for Year	2000/2001 Avg. Daily Portfolio	% of Portfolio	Eff. Yield for Year
US Treasury Bills/Strips	$ 3,736,571,873	13.94%	5.20	$ 1,938,670,027	6.61%	5.63	$ 1,778,142,958	5.09%	5.18	$ 2,646,954,548	6.04%	6.01
US Treasury Bonds and Notes	$ 6,538,492,411	24.40%	5.37	$ 5,434,581,766	18.52%	5.53	$ 2,606,607,214	7.46%	5.35	$ 3,056,497,078	6.97%	5.77
Federal Agency Coupon Securities	$ 1,070,168,683	3.99%	5.65	$ 1,817,706,835	6.19%	5.89	$ 3,356,025,630	9.61%	5.52	$ 3,282,193,454	7.49%	6.21
Federal Agency Discount Notes	$ 164,642,142	0.61%	5.31	$ 804,086,802	2.74%	5.69	$ 4,627,362,742	13.25%	5.79	$ 9,011,738,061	20.56%	6.37
GNMA	$ 16,075,341	0.06%	8.16	$ 2,624,793	0.01%	12.01	$ 1,512,775	0.00%	11.86	$ 1,166,433	0.00%	11.83
FHLMC	$ 47,575,438	0.18%	9.64	$ 25,615,646	0.09%	9.63	$ 14,486,502	0.04%	9.66	$ 11,353,297	0.03%	9.64
Negotiable Certificates of Deposit	$ 6,682,813,378	24.93%	5.61	$ 7,826,928,357	26.67%	5.74	$ 7,506,612,991	21.49%	5.83	$ 8,184,759,498	18.67%	6.13
Time Deposits	$ 217,522,247	0.81%	5.62	$ 1,076,267,781	3.67%	5.34	$ 2,820,735,683	8.08%	5.40	$ 4,317,935,890	9.85%	5.82
Bankers Acceptances	$ 1,261,898,919	4.71%	5.62	$ 413,851,403	1.41%	5.77	$ 6,574,807	0.02%	6.60	$ 11,464,798	0.03%	6.59
Commercial Paper	$ 6,183,517,314	23.07%	5.62	$ 6,541,833,773	22.29%	5.72	$ 8,344,655,602	23.89%	5.91	$ 9,273,506,834	21.15%	5.92
Corporate Bonds	$ 1,286,302,875	4.80%	5.99	$ 1,760,774,832	6.00%	5.94	$ 2,658,056,464	7.61%	5.87	$ 2,304,913,906	5.26%	6.27
Repurchase Agreements	$ 312,859,959	1.17%	5.28	$ 37,798,921	0.13%	5.62	$ 8,865,984	0.03%	5.44	$ 5,808,219	0.01%	5.71
Reverse Repurchase Agreements	$ (1,057,642,319)	-3.95%	-5.07	$ (376,042,913)	-1.28%	5.25	$ (836,246,642)	-2.39%	5.11	$ (857,535,461)	-1.96%	5.81
AB55 Loans	$ 225,243,711	0.84%	5.24	$ 1,805,762,786	6.15%	5.66	$ 2,005,213,439	5.74%	5.41	$ 2,589,664,164	5.91%	6.34
General Funds Loans	$ 116,081,096	0.43%	4.60	$ 234,051,507	0.80%	5.69	$ 30,427,869	0.09%	5.49	$ -	0.00%	0
Total Portfolio	$ 26,802,123,068	100.00%	5.53	$ 29,344,512,316	100.00%	5.70	$ 34,929,034,018	100.00%	5.71	$ 43,840,420,720		6.104

Source: California Office of the State Treasurer

INVESTMENT ACTIVITY

Every day the Treasurer's Office must invest incoming funds and must close out investments in order to meet cash requests by participants. For that reason, much of the portfolio must be in highly liquid investments that may be sold at any time and some must be in very short-term investments, as short as one day. California law lists many acceptable investment vehicles for the PMIA, which were discussed earlier in this section.

Chart II-1



Monthly investment activity as a percentage of total portfolio value is substantial, for example ranging from 43 to 86 percent during calendar year 2000. It is of course also substantial in dollar terms.

This activity reflects purchases and redemptions and encompasses trades made to accommodate inflow and outflow to the fund as well as adjustments from one specific investment to another within the portfolio as investments mature or other needs and opportunities dictate.[30]

As liquidity needs grow, average maturity must shrink. For example, as of May 2001, average maturity was 170 days, according to the PMIB monthly report. In contrast, it was 187 days in May 2000, and 223 days in July 1999. The reduction helped to assure liquidity while the state coped with costs of power and impending bond sales. Average maturity may be expected to increase again when demands ease. The variation is substantial, as the low (170) is just over 76 percent of the high (223). Such variation in aver-

age maturity (life) can be managed through use of a variety of investment vehicles, some (specifically, some commercial paper investments) with a life of as little one day.

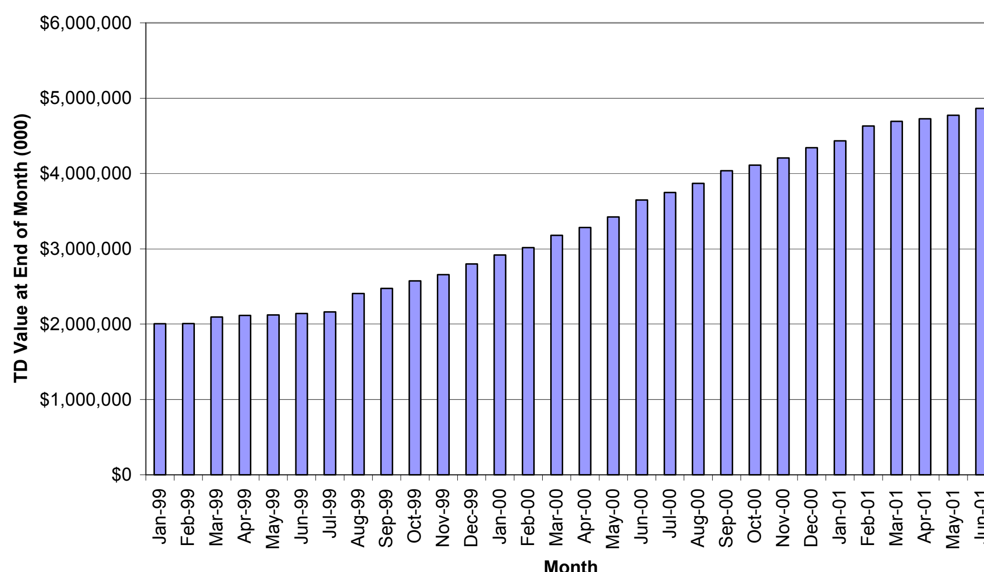
TIME DEPOSITS AS PART OF THE PORTFOLIO

California is one of ten states that use time deposits in their investment strategies. Although twenty-seven states authorize time deposits, only ten used them, according to a recent report on state treasurers' activities.[31] In California, interest rates on time deposits are set 2 to 15 basis points over a Treasury of comparable maturity. Lower rated institutions would be expected to pay rates at the upper end of this range, while higher rated institutions would be at the lower end.

In other states rates are set as federal funds plus 25 basis points, or either set at a rate not less than the bond equivalent yield on direct obligations of the U.S. Treasury with similar maturity, or an average of the rates paid on U.S. Treasuries. Institutions holding state time deposits must not be rated less than "satisfactory" under the Community Reinvestment Act.

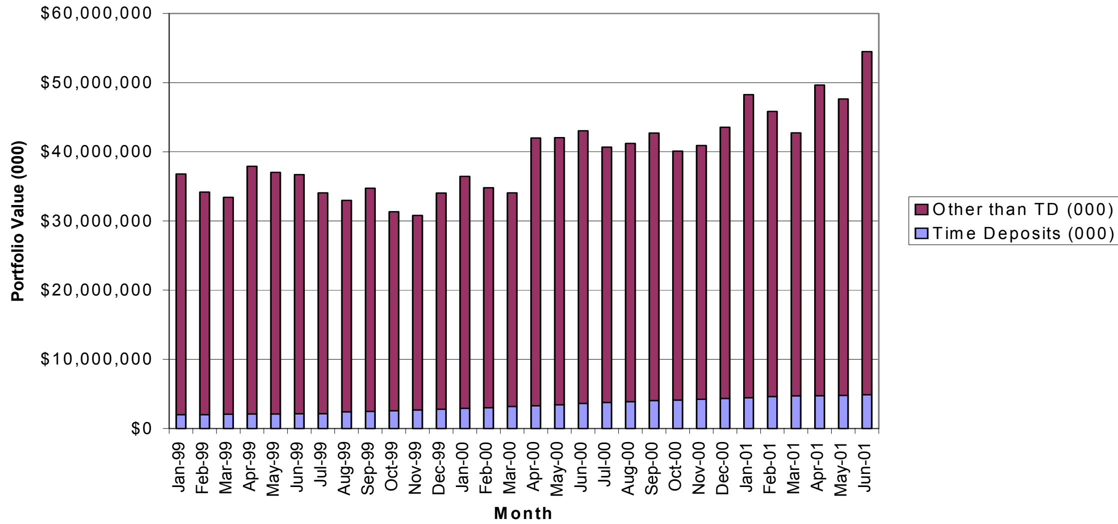
Time deposits in the PMIA have grown steadily in dollar terms in recent years. This growth reflects Treasurer's Office investment staff efforts to encourage participation in the time deposit program and a willingness to "roll over" deposits at maturity.[32] From January 1999 through April 2001, time deposits grew from $2 billion to over $4.7 billion, an increase of over 230 percent, rising each month of the period.[33]

Chart II-2



Time deposits have also grown on average as a proportion of the portfolio over the same period, although with more month-to-month volatility resulting from variations in total portfolio value from month to month. (Money moves in and out in response to the participants' cash inflows and outflows.)

Chart II-3



Time deposits have been the most consistent element of the overall portfolio, not moving up and down with fluctuations in the entire portfolio, but instead sloping upward month after month from January 1999 to June 2001.

A longer term perspective (Chart II-4) shows a more pronounced increase in the TD proportion.

The patterns in the data substantiate Treasurer's Office investment staff's descriptions of ongoing efforts to encourage participation in the time deposit program, willingness to roll over deposits upon maturity (as long as criteria for an institution's participation are still met), and practice of working with institutions to meet particular needs. The latter may include length of maturity and precise maturity dates. In short, the amount of money placed in time deposits is in large measure in the hands of banks, savings and loans, and credit unions, at least until the proportion of the portfolio in time deposits reaches a strategic limit.

Chart II-4 shows the increase in the proportion of PMIA investments held in time deposits for the last 11 years. Since the fiscal year 1996/97 the proportion has increased significantly.

Chart II-4

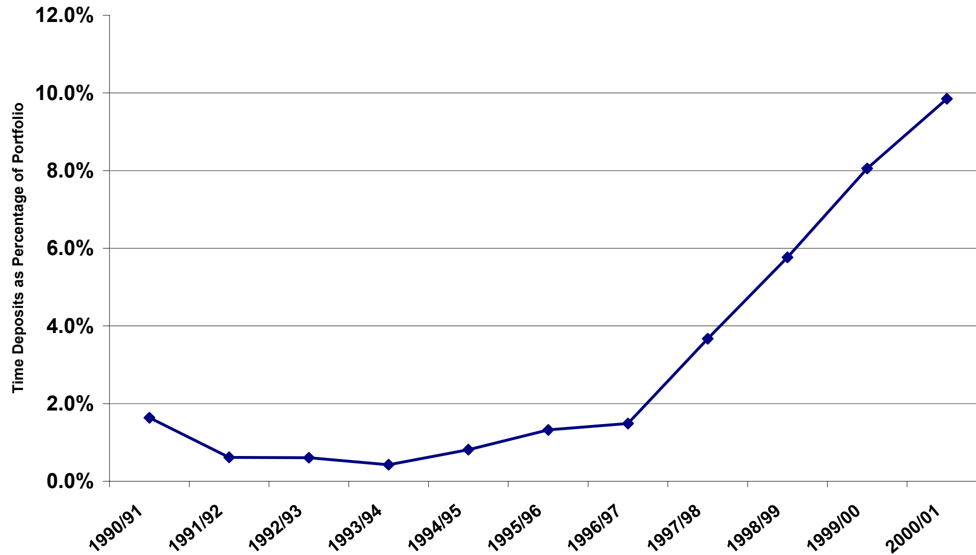


Table II-2 shows trends in time deposits invested by the PMIA as of June 30, for four years, by type of depository institutions. The number of institutions holding time deposits increased from 70 banks in 2000 to 94 in 2001. The increase was proportionally larger for credit unions and savings institutions. There were deposits in 17 credit unions and 14 saving institutions in 2001, compared to 4 and 11, respectively, in 2000.

Table II-2

Pooled Money Investment Account Time Deposits, Selected Years

	1995		1998		2000		2001	
	Amount In Thousands	Percentage	Amount In Thousands	Percentage	Amount In Thousands	Percentage	Amount In Thousands	Percentage
Banks	$147,290	54.1%	$1,418,890	91.8%	$3,157,090	86.5%	$3,799,295	78.1%
Savings and Loans	$125,000	45.9%	$126,000	8.2%	$411,350	11.3%	$627,350	12.9%
Credit Unions	$0	0.0%	$0	0.0%	$80,000	2.2%	$438,500	9.0%
TOTAL	$272,290	100.0%	$1,544,890	100.0%	$3,648,440	100.0%	$4,865,145	100.0%

Source: California Office of the State Treasurer

The proportion of time deposits held by credit unions and savings institutions has increased significantly in comparison to those held in banks over the last two years.

According to small bank and community bank representatives, one way in which the Treasurer's Office could support local communities is by making deposits in community banks, as smaller banks tend to use the money from their deposits for local lending and investing. The relationship of small banks and community investment is suggested by the definition of a community financial institution in the Gramm-Leach-Bliley Act of 1999.

A community financial institution is one with less than $500 million in assets by the G-L-B definition, although other definitions put the figure at $100 to $300 million.

Because of the strong link between local community investment and smaller banks, it is interesting to look at the distribution of the Treasurer's Office investments in time deposits by size of the banks.

A look at PMIA time deposits shows whether, over time, PMIA the time deposit distribution has become more concentrated in smaller banks.

The Link Between Small Banks and Local Communities

Before looking at the distributions it is important to note that the traditional link between small banks and local community lending has been blurred by changing technology and consolidation of the banking system that has taken place during the last decade.

Until recently, research showed that smaller banks (or bank branches) located in the borrowers' communities have been an important provider of credit for small businesses, as well as important in mortgage lending for lower-income and minority individuals:

> The data show that small banks do a lot of small business lending, especially when compared to their overall presence in the industry: Banks with assets of under $1 billion hold 24 percent of the industry's assets but do almost half of the small business lending. The pattern is the same for even smaller banks: the nearly 9,100 banks with less than $300 million in assets do 35 percent of small commercial lending, even though they account for only 15 percent of total U.S. banking assets.[34]

This suggests that supporting the capacity of small banks to lend also indirectly supports small business lending in the areas served by those banks, and in that way contributes to local economies.

The small bank role can result from several factors, including lack of funds to make large loans suited to large businesses and difficulty in competing for large loans, and the need to diversify and not over-concentrate risk. More interesting for our purposes is this:

> Smaller banks' heavier focus on small business lending could also be due to comparative advantage. Small banks might be better able to serve small businesses because they can more efficiently collect the detailed local information needed for credit analysis on such loans, or because they can provide a superior level of customer service. The idiosyncrasies of some small borrowers, such as new businesses or those with unusual credit histories, might require a flexibility in loan underwriting standards that larger banks cannot afford to allow within their organizations. Berger and Udell (1996) have presented evidence that small banks tend to serve borrowers that are less "generic" than those who borrow from large banks.[35]

In other words, because of the variety of small business situations, small banks may be better able to meet customer demands, especially those that are less typical. Large banks with automated and centralized loan approval processes may not provide a great deal of flexibility. (Evidence on this point is mixed. See the discussion of credit scoring in section III and the notes to that material.) It may also be important that real estate agents, homebuilders, community organizations, and nonprofit groups can develop working relationships with individual officers of smaller financial institutions, facilitating the lending process.

All this argues for a focus on depositing public funds in California community banks to the extent that fund management considerations permit and banks choose to participate, as an indirect means of supporting small business lending in California.[36]

However, the process of bank consolidation of the last decades (the acquisition of smaller banks by larger banks and institutions operating in various regions across the country) has challenged the view that it is mostly small banks that provide credit for small business and poorer communities. Contrary to many analysts' predictions, the availability of credit in the localities where small banks were closed as a result of consolidation did not decrease significantly. Recent research has found that the negative effects from small bank closures have been offset by economies of scale and new technologies that reduce lending costs by large banks.

Today, large banks may be able to meet the needs of small or poor communities as well as smaller banks. With the growing reach of banking organizations, banks are no longer constrained to lend in specific communities. For example, a study by the Federal Reserve System staff indicates that bank consolidation appears to have little relationship to changes in home purchase lending to minorities and low-income groups, and that more than half of mortgage lending is originated by financial institutions located outside the borrowers' communities.[37]

With increased consolidation in the financial system, the marketing of home and business loans has changed dramatically. The inclusion of loans from different geographic areas and types of customers helps to diversify portfolios, and in that way strengthens the financial condition of banks. CRA has influenced banks to extend their services and look for opportunities in previously neglected markets, and to provide financial products to areas and individuals of low and moderate income.

Large banks have created partnerships with community-based organizations to look for ways to satisfy their CRA obligations and fill the gap that the closure of small banks may have created. For example, large banks have either (1) created partnerships with community based organizations that have knowledge and experience in distressed communities or localities where these institutions do not have offices, or (2) outsourced products and services that they cannot provide efficiently or profitably.

Thus, the strong link between small business loans and smaller banks has weakened with the increased participation of large banks in community reinvestment projects, as a result of globalization and the existence of new technologies.

Distribution of PMIA Time Deposits by Bank Size

Table II-3 shows the distribution of California time deposits and the Treasurer's Office's time deposits by bank size for 1995, 1998, 2000, and 2001.[38]

Table II-3

	Percentage of PMIA Time Deposits for Year			
Asset size category of bank	**1995**	**1998**	**2000**	**2001**
More than $1 Billion	84.87%	85.03%	81.26%	56.54%
More than $500 million to $1 Billion	0.00%	5.29%	7.46%	11.49%
More than $300 million to $500 million	0.00%	5.64%	3.42%	8.89%
$100 million to $300 million	14.19%	3.49%	6.18%	19.00%
Less than $100 million	0.95%	0.55%	1.68%	4.07%
TOTAL	100.00%	100.00%	100.00%	100.00%

Source: FDIC and Calif. Treasurer's Office Data; CRB calculations.
This table includes only data for banks, not S&Ls or credit unions.

As of **June 1995**, the PMIA invested $272.3 million in time deposits. (Data are for June 30 of the corresponding year.) Of that total, nearly half ($125 million, excluded in the table above), was on deposit at one large savings association. Most of the bank deposits were held in large banks (more than $1 billion in assets). Only 17 percent of the bank deposits were in institutions with $300 million assets or less.

As of **June 1998**, time deposits were more than five times as high as in 1995. Most of these deposits were held in 33 banks. Only 8.2 percent of time deposits were held in three savings institutions. More than 87 percent of the deposits in saving institutions were held in one large institution (assets above $5 billion). Only slightly above 4 percent of the time deposits were held in banks of $300 million or less in assets.

As of **June 2000**, time deposits were almost 2.4 times as high as in 1998. The proportion of deposits in smaller banks increased significantly, and deposits were less concentrated in larger banks. The number of institutions holding time deposits increased from 33 banks in 1998 to 70 banks in 2000. There were deposits in four credit unions and 11 savings institutions.

As of **June 2001**, time deposits were more than three times as high as in 1998, and 33 percent higher than in 2000.

In considering potential for PMIA deposits, figures must be viewed with caution, as the absolute legal limit on PMIA deposits in any bank is determined by that bank's equity capital, not by its assets or deposits, and ratios of equity capital to deposits and to assets vary widely. Without detailed examination of equity capital levels and of any risk factors that might determine the appropriate percentage of risk capital that should serve as limit on PMIA time deposits in each specific bank, no conclusion can be drawn as to what is feasible or prudent.

In general, it appears that PMIA time deposits in small banks represent a much higher percentage of equity capital than do PMIA time deposits in large banks.

Here is a quick summary of selected statistics, excluding credit unions and omitting the two banks that had recently changed ownership. This is based on March 2001 PMIA deposits and December 2000 FDIC asset data. (The mismatched dates do not substantially change the picture.)

The data show 47 participants in the time deposit program with less than a quarter billion dollars in assets each, 14 from a quarter to a half billion dollars, 14 from half to one billion dollars, and 29 over one billion dollars. A higher proportion of the larger banks participate than of small banks. This may indicate that such time deposits fit better into the asset and liability management strategy and capacity of larger banks, or may reflect the larger number of branches owned by larger banks, or both. Still it is an inclusive array, as about 22% of the banks with under $250 million in assets participated as of March 2001.

The smallest participant has assets about equal to 1.6% of the assets of the largest participant. The PMIA deposit in the smallest participating bank is about 6 percent of assets and 32 percent of equity, vs. deposits equaling about 0.1 percent of assets and 1.7 percent of equity for the largest participant. Considering that the smallest participant (Asiana Bank) had under $25 million in assets, it seems clear in the monthly list that SMALL is welcome as long as the criteria are met.

SPECIAL TOPICS

This section discusses some issues of general financial interest that affect management of pooled funds.

Securitization of Loans

Few developments have as fundamentally altered the financial landscape as securitization of loan pools.[39] This development has both enlarged the ultimate sources of funding for loans and helped to spread risk widely. Most important, it is now common for mortgage loans to be gathered together in a pool, usually with various kinds of enhancements and guarantees, and sold off into the market as tradable securities. Other types of loans are can also be securitized.

Significant for purposes of this paper:

- Securitization has enlarged the opportunities for and liquidity of CRA types of mortgage lending
- PMIA funds may be invested in securitized mortgages (mortgage backed securities) specifically reflecting California CRA-eligible mortgages
- Securitization, by packaging, selling, and reselling diverse loans, has made it even more difficult to state "where" any particular investment dollars reside

Mortgage-backed securities may be tailored to particular investor preferences. For example, a mortgage-backed security might be based on a pool of CRA-eligible California mortgages.

Prominent issuers of mortgage backed securities are well-known "government sponsored enterprises" (GSEs), Fannie Mae and Freddie Mac. (Fannie Mae was known as the Federal National Mortgage Association, and Freddie Mac was known as the Federal Home Loan Mortgage Corporation.[40])

Securitization allows banks and other mortgage originators to sell the mortgages and then invest the cash received in new loans or in other opportunities. The large and active market for mortgage backed securities and the growing skill and sophistication of the process has greatly expanded available of mortgage funding.[41]

Other types of loans, such as SBA small business loans, may be securitized (and PMIA has held such securities), but the process is best established and most common for mortgages.

One summary of securitization sums up its impact this way:

> Securitization owes its success primarily to the fact that it has lowered the cost of moving funds from investors to borrowers. . . . Securitization . . . tends to increase the number of specialized participants competing at various states of the lending and funding process and encourages new entrants and price and product competition.
>
> On the investor side, securitization's major contribution has been to convert non-rated, relatively illiquid loans into rated, highly liquid, tradable securities at attractive market prices. . . . Linking local debt markets to the national capital markets, it eliminates the regional pockets of monopoly power that marked bank and thrift markets for decades. Today, home loan interest rates and terms are essentially national, varying relatively little from one section of the country to another, or from big towns to small.[42]

Banks, and other mortgage originators, can of course simply sell whole mortgages, or can retain them for the life of the loan. There is no requirement that mortgages be packaged into mortgage-backed securities. Because the originator might sell the mortgage, but retain servicing rights, the borrower might never know that his or her mortgage has been sold.

Issues in Asset and Liability Management

Banks and other depository financial institutions must manage their assets and liabilities in order to meet several objectives and regulatory requirements. Most important, depository institutions must manage the risks entailed in their mix of long and short term liabilities (including deposits) and long and short term assets (including loans and investments).

It is essential to bear in mind that a deposit is not an *asset*, but rather is a *liability*. That is, once the bank (or other depository institution) has accepted a deposit, it then is liable for the return of that deposit, and often for payment of interest on the deposit.

The received funds do of course constitute an asset, but one that must be put to use in some way that covers the costs of the liability – interest, operational expenses, and overhead. For example, a bank might take in a $1,000,000 deposit on which it pays a 5 percent rate of interest, and lend out the same $1,000,000 at 8 percent. The bank might lend or otherwise invest the funds in a manner that generates both interest and fees. However, when the depositor wishes to withdraw the funds, the bank must repay the deposit with accrued interest. Only as long as the depositor wishes to leave the funds on deposit can bank can use those funds for lending or other purposes.

For that reason, banks want deposits that are likely to remain for a long time, and especially deposits that are relatively indifferent to the interest rate environment or to potential concerns about the soundness of the bank. Deposits meeting that definition are "core deposits," generally made up of insured savings deposits, time deposits under $100,000, and demand deposits (checking accounts and the like).[43] Likewise, regulators prefer a high proportion of a banks' deposits to be in the form of core deposits, as those are the most stable source of funds.

Writing for the Division of Bank Supervision and Structure, Federal Reserve Bank of Kansas City, Forest E. Myers outlined issues of stability of liabilities this way:

> An important issue in using the liability side of the balance sheet as a liquidity management tool is the stability of a bank's liabilities. [Note: recall that deposits are liabilities for the bank.] Often, fed funds, large CDs, and brokered/listed deposits (referred to as "hot money" or "noncore deposits") are available only as long as a bank is willing and able to pay for their use. A bank may not be able to obtain these funds if it becomes uncreditworthy, is restricted by law due to a weakened capital position, or is otherwise unable to pay above-market rates. Because of this, banks that rely on hot money or noncore deposits may be particularly vulnerable to liquidity pressure in times of trouble.[44]

California law regulating time deposits of the Pooled Money Investment Account limits such deposits to not more than equity capital.[45] Thus those deposits are within the meaning of the phrase above, "restricted by law due to a weakened capital position" if equity capital declines enough to approach or fall below the amount of PMIA time deposits. This, in turn, means that acceptance of such deposits (whether from PMIA or any other source) is subject to constant watchfulness on the part of bank management and potential concern to bank regulators in the event of difficulties affecting bank capital.[46] Because PMIA time deposits tend to be a larger proportion of equity capital in small banks, this is an especially pertinent issue for them. This is not to suggest that the time deposits are a bad thing (plainly that is not the case), but only that such deposits require special attentiveness to capital ratios and regulatory standards.

Changing Investment Environments

Any evaluation of investment policies and outcomes must bear in mind that investment opportunities, risks, and rewards vary from one period to another. Such changes may affect distribution of funds among investment alternatives in the PMIA just as they do in other types of investment account.[47]

With respect to the participation of banks, savings and loans, and credit unions in the time deposit program, changing environmental factors may work from both sides of the relationship: the Treasurer's Office investment staff view of suitable placement and distribution of funds among investment alternatives *and* institutions' receptiveness to large time deposits and ability to invest the funds suitably.[48]

Just as the managers of the PMIA may see better opportunities outside of time deposits, so might banks see advantage in not seeking large time deposits at some times, or not have suitable destinations for such funds at a given time.

III. Overview of California's Financial Institutions

PMIA funds may be placed with banks, with savings and loans, and with credit unions. Currently, PMIA funds are placed with all three types of financial institution. Here we summarize some important changes in the world of banking in recent years, and give an overview of the three major types of financial institution in California.[49]

The Changing World of Banking

What was once a largely local business has, through changes in law and in technology, become increasingly regional, national, and even international. An overview is essential in order to put the notion of "distribution" of funds into context.[50]

New Technologies

The Internet. By way of the Internet, supplemented by toll-free telephone numbers, banks may now operate across the nation, in some cases with no physical branches at all. For example, ING Direct offers savings accounts, CDs, loans, and fixed and variable-rate mortgages and home equity loans via its Web site.[51] In this way, every local bank, savings and loan, and credit union is in competition not only with other local institutions but with a national institution free from the requirement to build and staff local offices, and offering rates that might be difficult for local institutions to match. Such available-everywhere banks provide a reference point for comparison of rates on deposits and on loans, and an alternative to local institutions.

Credit Scoring. Automated software systems can evaluate loan applications on the basis of set criteria, both speeding the process of making decisions and removing the individual discretion (and potential for discrimination) that local lending officers may have.

The Federal Trade Commission summarizes:

> Credit scoring is a system creditors use to help determine whether to give you credit. Information about you and your credit experiences, such as your bill-paying history, the number and type of accounts you have, late payments, collection actions, outstanding debt, and the age of your accounts, is collected from your credit application and your credit report. Using a statistical program, creditors compare this information to the credit performance of consumers with similar profiles. A credit scoring system awards points for each factor that helps predict who is most likely to repay a debt. A total number of points -- a credit score -- helps predict how creditworthy you are, that is, how likely it is that you will repay a loan and make the payments when due.[52]

FTC describes the key reasons for using credit scoring:

> Credit scoring is based on real data and statistics, so it usually is more reliable than subjective or judgmental methods. It treats all applicants objectively. Judg-

mental methods typically rely on criteria that are not systematically tested and can vary when applied by different individuals.[53]

Some critics have expressed concerns that automated credit scoring systems can have (unintended) discriminatory effects, while some researchers have found positive impacts for low-income areas. The issue is unresolved at this time.[54] What is clear is that automated systems can expedite decisions, make loan decision making less costly, and enable decisions to be centralized even within an institution that has widely scattered offices. The impact might be greater equity in access.

From Branch Banking to Financial Holding Companies

It was once common for banks to be limited to a single location – no branches allowed. California has long allowed branch banking, and over the years most restrictions on in-state branch banking have been eliminated in most other states. More recently, limits on interstate branch banking have been all but eliminated (Texas being the notable exception). In California, banks may operate in a single location serving a single community, or may have two or more branches serving the same or nearby communities, or may span areas as large as the entire state, with numerous branch locations up and down California.

Historical Perspective

"The chief method by which the concentration of banking resources is effected is the consolidation of existing banking institutions. Such consolidation may have as its purpose the building up of a branch banking system. An illustration of this is the Bank of Italy (California) which, in March 1927, absorbed the Liberty Bank of America and the Commercial National Bank of Los Angeles, and in the same month converted to a national bank under the provisions of the McFadden Act. This consolidation gave the Bank of Italy 178 added branches and increased its deposits by $172,260,087.25. Other mergers, Chiefly in California, had the same end in view." (Frederick A. Bradford, *Banking* [NY: Longmans, Green and Co., 1932], 424-5.)

The Bank of Italy became the Bank of America in 1928. Recently (approval came in 1998), Bank of America merged with North Carolina-based NationsBank. The resulting corporation, headquartered in North Carolina, is one of the nation's largest banks.

All manner of mergers and acquisitions, as well as internal expansions, have contributed to the widening reach of banks, savings and loans, and credit unions. Many are headquartered in California and serve only California communities, while others, headquartered in California or in another state, serve communities in many states. Banks are often held in a holding company structure. Some holding companies have a single bank, and some have two or more.[55]

Beyond the growth of branch banking and expansion of the use of bank holding companies that extend the reach of institutions, large-scale developments now include the authorization under federal law of financial holding companies, FHCs. The Gramm-Leach-

Bliley Act of 1999, removed restrictions dating back to the Glass-Steagel Act, enacted during the Great Depression:

> The Gramm-Leach-Bliley Act now permits banks, insurance companies, securities firms and other financial institutions to affiliate under common ownership and offer their customers a complete range of financial services. This Act places certain conditions on these new activities, one of which is that all of a holding company's insured depository institution subsidiaries have at least a satisfactory Community Reinvestment Act (CRA) rating.[56]

The long-term implications of these changes in laws governing financial institutions are not yet known. However, it does appear that "large complex banking organizations" will tend to concentrate resources on major metropolitan areas, develop standardized CRA products and services, work with other organizations to facilitate meeting CRA obligations, and focus efficiently in order to manage "specialized and complicated CRA projects."[57]

These developments may suggest that special attention is appropriate to assure that the needs of rural areas are addressed, recognizing that those areas are more likely to depend on services of community banks.

Local Banks as Service Agents

The following, from the FY 2000 annual report (10K) of Community West Bancshares, parent of Goleta National Bank, shows one way in which the mortgage market has changed and how what one sees on the surface of a transaction does not necessarily represent the underlying reality:

> During 1994, the Company established a Mortgage Loan Processing Center. The Mortgage Loan Processing Center takes residential real estate loan applications for lenders located throughout the nation and processes them for a fee. At any point in time, the Company processes loans for 50-70 such lenders. Due to the volume of loans generated by these lenders, the Company has the ability to offer significantly more loan programs than normally offered by any single institution . . . .[58]

This is a type of relationship that can work both ways, as institutions elsewhere in the state or nation might handle applications for a local lender in California. In other words, it is difficult to determine just where a transaction is taking place on the basis of who is doing the front-end paperwork. The borrower might not even know what institution, where, has provided funding if the local bank provides not only application processing but also loan servicing.

Competition from Non-Financial Institutions and the Market

Lending is no longer the exclusive preserve of banks, savings and loans, and credit unions, nor is finance even dependent on traditional borrowing as it once was. Countless other participants, including such large institutions as GE Capital, have gained a growing

role, and securitized debt is now traded in the markets. According to Martin Mayer, "Indeed, the working capital of large corporations that once borrowed from banks comes predominantly from the sale of commercial paper directly to investors. Only one-fifth of the nation's commercial and industrial financing now comes from the banks . . . proprietors of the 'new economy' don't borrow at all; they raise their money from venture capitalists and initial public offerings of common stock."[59]

Home buyers of course cannot float their own paper, but they can obtain mortgages from American Express or any of countless mortgage originators as well as from local or distant banks.

The shift of loan sources to non-bank entities has affected banks' revenue strategies:

> After steadily losing shares of the loan market to less-regulated competitors, banks now rely more heavily than ever on deposit-account fees, asset-management revenues and other sources of income unrelated to traditional lending. Unsurprisingly, customer service charges have soared.[60]

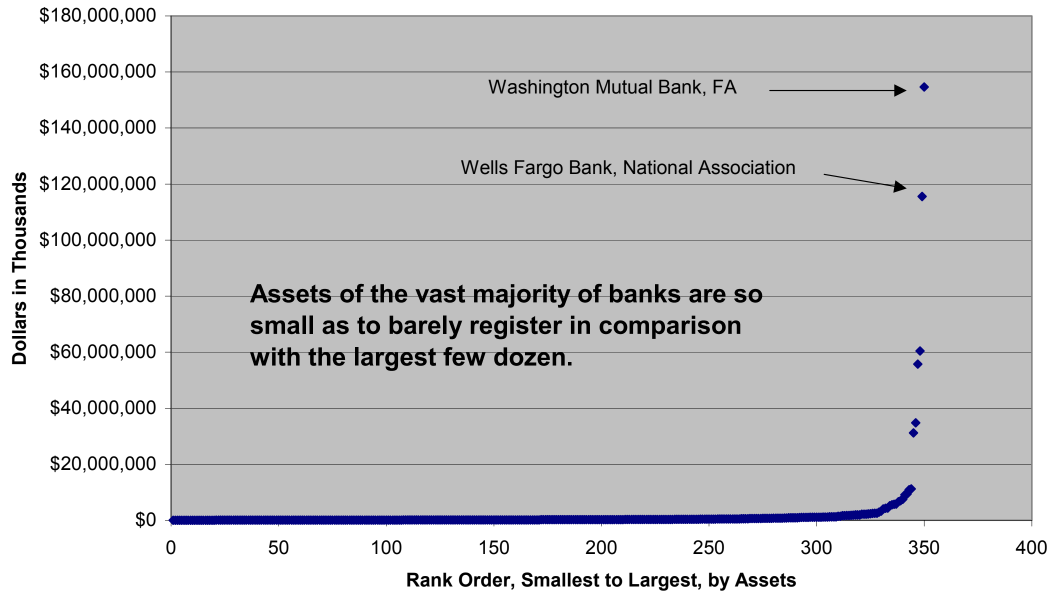
Exploration of this topic is beyond the scope of this paper except to note that it illustrates the many-sided nature of banking today and the adjustment of products, services, and fees in the changing financial services environment. Community banks may have a relatively close relationship to their communities, depositors, and borrowers, but they still face competition.

BANKS AND SAVINGS INSTITUTIONS

A March 2001 search at the Federal Deposit Insurance Corporation Web site found 355 FDIC-insured listed California banks and savings institutions, with assets ranging from about $2.5 million (JCB, National Association), to about $155 billion (Washington Mutual Bank, Federal Association). For brevity, we will call them all "banks" in this overview. This list excludes some institutions, such as credit unions, that can receive state funds, but still illustrates the range found within the state. Although details change over time, the general picture shown below will remain correct.

The smallest 336 banks on the list (calculated on the basis of assets) have total assets approximately equal to the single largest (not accounting for a few for which asset total was missing from the FDIC data). The 130 smallest have assets approximately equal to the assets of the tenth largest; the 81 smallest have total assets approximately equal to the twentieth largest on the list. Note that these comments reflect total assets, not deposits in California branches of these banks. Given the mixture of purely California banks and interstate banks, the comparisons may be somewhat misleading, as the disparity in sizes is even more important when viewed in the light of equity capital rather than assets or deposits.

Chart III-1



In short, the assets of a relative handful of very large banks overwhelm the combined assets of the large majority of smaller institutions. This fact has a bearing on any analysis of how state funds might be allocated among institutions. What is a drop in the bucket for behemoth Washington Mutual or Wells Fargo Bank National Association (the second largest, at $115 billion in assets) would completely dominate even a combination of dozens of small banks. Two hundred thirteen banks on the FDIC list fall below the cutoff of $250 million in assets to be considered a small bank by some definitions.[61] The total assets of those 213 banks add up to $23.46 billion, or about 15 percent of the assets of Washington Mutual alone.

These figures raise many questions, including what kind of impact state funds might have on small banks and what would be the management costs of distributing state funds across many small institutions. Answers to these questions will be affected by investment rules and principles discussed elsewhere in this paper. Key among those are limits on the funds that may be deposited in any single institution and considerations of safety, liquidity, and rate of return.

Banks vary widely in their focuses. Most pertinent here: "Large banking organizations tend to lend to medium and large business borrowers, whereas small banking organizations more often specialize in lending to small businesses."[62] The rules, however, are far from inflexible, especially in a time of rapid change in the financial services sector. That small banks may specialize in lending to small businesses does not mean that large banks perform little or no such lending.[63]

Over the past several years, the number of banking institutions has fallen sharply, and the number with assets under $100 million (small according to federal definition) has fallen very sharply, while assets per institution have grown. Total assets (from FDIC data, reflecting FDIC-insured institutions in California) rose between 1995 and 1998, and then fell somewhat by 2001.

Table III-1

Number of California Banks and Savings Institutions

	June 1995	June 1998	June 2001
Banks	394	336	300
Savings institutions	82	54	45
Total	476	390	345

Assets of California Banks and Savings Institutions (millions)

	June 1995	June 1998	June 2001
Banks	$358,687	$481,493	$334,620
Savings institutions	$251,367	$279,165	$391,845
Total	$610,054	$760,658	$726,465

Average (Per Institution) Assets of California Banks and Savings Institutions (millions)

	June 1995	June 1998	June 2001
Banks	$910	$1,433	$1,115
Savings institutions	$3,065	$5,170	$8,708
Combined	$1,282	$1,950	$2,106

Source: FDIC data for California banks and savings institutions.

Chart III-2

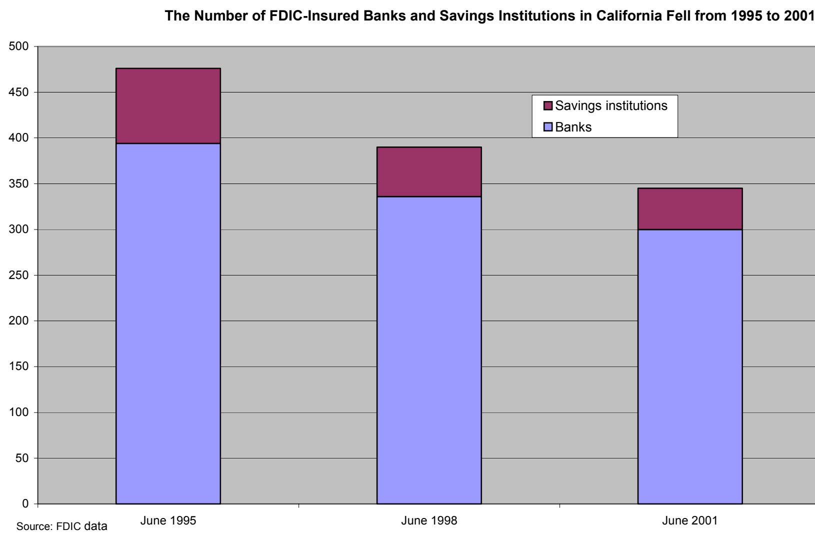
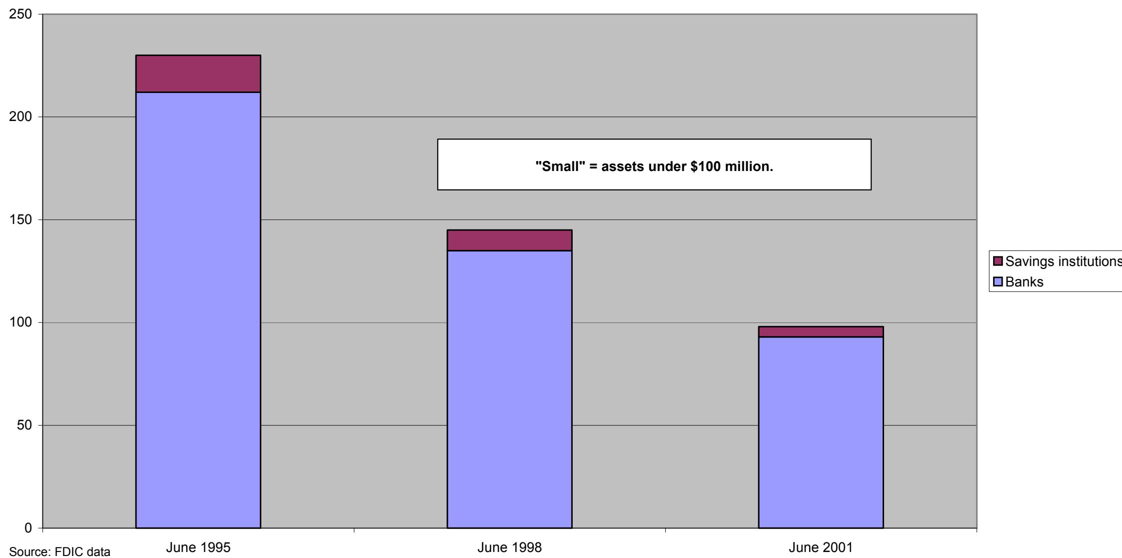


Chart III-3



Savings and loan associations generally focus on taking deposits and on making mortgage loans, although their functions are of course more wide ranging than that. As with banks, some are federally chartered and some are state chartered.

Differences between banks and savings and loan associations are unimportant for our purposes. Both are supervised, regulated, reviewed under CRA, examined, and file detailed reports of condition at regular intervals. Both take deposits and lend for various purposes. And both can range in size from small and local to large and geographically widespread.

Banks and savings institutions have enough similarities that an FDIC staff study in 1997 explored the potential for "A Unified Federal Charter for Banks and Savings Associations."[64] That study summarized the "Major Differences Between Federal Savings Associations and National Banks" as follows (in part):

> Federally chartered depository institutions insured by the Federal Deposit Insurance Corporation (FDIC) consist of federal savings associations,[65] which are regulated by the Office of Thrift Supervision (OTS), and national banks, which are regulated by the Office of the Comptroller of the Currency (OCC). Their respective holding companies are savings-and-loan holding companies, which are under the jurisdiction of the OTS, and bank holding companies, which are regulated by the Federal Reserve Board (FRB).
>
> Federal savings associations have historically enjoyed four distinct advantages not accorded national banks. These advantages were: (1) preferential taxation; (2) the

> most liberal branching rights of all federal depository institutions; (3) expanded subsidiary powers; and (4) virtually unlimited holding company activities. However, the magnitude of these thrift advantages has dissipated over time, and with enactment of the Small Business Job Protection Act on August 20, 1996, the preferential tax treatment for thrifts has been eliminated.
>
> Balanced against the historical benefits accruing to federal savings associations, national banks have enjoyed the ability to engage in a much wider range of lending activities. National banks were subject neither to an enforced orientation toward a particular area, such as real-estate financing, nor to specific asset-type lending constraints. National banks may focus on a particular area of lending and investment if they desire, but they are not forced to.

The most important difference between banks and S & Ls may be that banks have had "the ability to engage in a much wider range of lending activities" than savings and loans.

Credit Unions

Credit unions are membership organizations. Criteria for determining eligibility for membership have been greatly broadened in recent years. Credit unions take deposits from and make loans to their members. The National Credit Union Association (NCUA) summarizes what credit unions are this way:

> A federal credit union is a nonprofit, cooperative financial institution owned and run by its members. Organized to serve, democratically controlled credit unions provide their members with a safe place to save and borrow at reasonable rates. Members pool their funds to make loans to one another. The volunteer board that runs each credit union is elected by the members. *Not for profit, not for charity, but for service* is a credit union motto.[66]

A September 2001 search at the National Credit Union Association Web site found 643 credit unions listed in California, of which 431 were federally chartered, 192 state chartered, and 20 "Non-Federally-Insured State."[67] The number of federally chartered credit unions has been shrinking for many years. Data in the 2000 edition of the *California Statistical Abstract* (Table L-5) show the number declining from 1,249 in 1970 to 474 in 1999. The more recent data indicate that the decline is continuing. The number of state-chartered credit unions has also been in decline, from 478 in 1980 to 213 in 1999, according to the *California Statistical Abstract*, and to 192 as of September 2001, according to NCIA data.

Credit union deposits are insured by the National Credit Union Share Insurance Fund, up to a current $100,000 limit, the same as that for FDIC insured banks and thrifts.

IV. Geographic and Socioeconomic Distribution of Funds

This chapter addresses requirements of Section 2 of AB 2805 (Chapter 913, Statues of 2000). It was developed as part of the first report in a series of annual reports required under that section.* Bank-by-bank lists of time deposits, and day-by-day reports of other investment activity are available in the monthly and annual reports of the Pooled Money Investment Board, available from the Treasurer's Office. Here we provide information and analysis of the socioeconomic and geographic distribution of those investments that can be linked to the specific areas or socioeconomic groups that these assets benefit.

Today, with financial globalization and burgeoning branch bank systems and affiliate relationships, the assignment of particular invested dollars to a particular geographic location is highly problematic at best. Picture trying to trace a particular gallon of water after it is poured into Lake Tahoe. It diffuses throughout the whole.

If deposits in First National Bank fund mortgage loans across a metropolitan area, those mortgages are then pooled with other loans in other areas and securitized, with the resulting package sold in many pieces to investors across the country, where might one say those deposits are? The liabilities represented by the deposits remain with First National Bank, but the assets initially funded by those deposits have been transferred to other owners, while First National Bank might retain little or connection to the loans. Meanwhile, interest payments (or accruals) flow to the depositors, who may reside anywhere.

Nonetheless, some investment instruments in the Pooled Money Investment Account can reasonably be identified as being within California. For example, one can view time deposits held by institutions as most likely being invested in the communities where the institutions are located.

PMIA of course cannot force any particular bank, savings and loan, or credit union to accept a time deposit from the pool. Some financial institutions might not find large-denomination time deposits to fit their strategies for management of assets and liabilities at a given time. Institutions that meet the requirements for participation and that find the deposits to be suited to their needs at the time are free to participate. That combination of meeting requirements and of choice to participate, together with limits imposed by equity capital and by assets, determines the geographic distribution of the deposits.

California-Specific PMIA Investments

The Office of the Treasurer places some PMIA funds in investments it can identify as specific to California. Investment Division staff provided us with a list of identified in-

* The Bureau chose not to publish it, and a response to the law is still pending as of December 2002.

vestments specifically within California and presumed to benefit California communities. Those investments are summarized in Table IV-1.

Table IV-1

Summary of California-Specific PMIA Investments

	As of June 1995	Pct.	As of June 1998	Pct.	As of June 2000	Pct.	As of June 2001	Pct.
California Small Business Loans	$70,077,519	2.7%	$236,668,668	4.0%	$323,908,032	4.5%	$305,789,970	4.1%
California First Time Homebuyers	$375,371,855	14.2%	$118,567,445	2.0%	$420,293,691	5.9%	$529,607,202	7.2%
Misc. California Investments	$1,924,987,239	72.8%	$4,062,293,401	68.1%	$2,775,027,513	38.7%	$1,690,000,000	22.9%
Time Deposits (California)	$272,290,000	10.3%	$1,544,890,000	25.9%	$3,648,440,000	50.9%	$4,865,145,000	65.8%
Total	$2,642,726,613	100.0%	$5,962,419,514	100.0%	$7,167,669,236	100.0%	$7,390,542,173	100.0%

Source: California Treasurer's Office and authors' calculations.

"California only small business loans" are Small Business Administration-issued securities backed by small business loans made by California banks to businesses in CRA-eligible census tracts in California. (That is: securitized small business loans.) By selling loans into the market, lenders such as community banks in Yorba Linda and El Dorado can invest the proceeds of those transactions in new loans. Nearly all the small business loans that are successfully securitized have SBA guarantees. The Treasurer's Office buys only the guaranteed portion of SBA loans.

Included in "California only first time homebuyers" investments (second category of the table) are mortgage pools that the Treasurer's Office buys through a major investment bank such as Bear Sterns and mortgage-backed securities issued by the Federal Home Loan Banks and by government-sponsored enterprises (GSEs), such as Fannie Mae. These types of investments are predominantly CRA-eligible loans.

The third category, "miscellaneous California only investments," includes corporate bonds, notes, and commercial paper from institutions that are clearly identifiable as California institutions. For example: Union Bank corporate bonds or notes, Union Bank commercial paper, or Wells Fargo medium term notes.

The fourth category is "time deposits," PMIA deposits held in bank branches throughout California.

The table shows that California small business loans in the portfolio more than quadrupled since 1995 and increased by 29 percent since 1998. Mortgages for first-time homebuyers increased by more than 12 percent between 1998 and 2000. Time Deposits in California banks have increased by almost 18 times since 1995 and more than tripled between 1998 and 2001.

GEOGRAPHIC DISTRIBUTION OF TIME DEPOSITS

This section shows the distribution of time deposits invested by the Treasurer's Office by location of the financial institutions where these deposits are held.[68] While this information may be of interest, it has to be taken with caution, as changes in the banking industry and in communications technologies have made the geographic location of depository institutions less important than it used to be.

Table III-2

County	Total Deposits for County	County Population, 2001	Average deposit per Capita
Alameda	$15,000,000	1,479,100	$10
Alpine	$0	1,220	$0
Amador	$0	35,400	$0
Butte	$47,500,000	205,800	$231
Calaveras	$0	41,100	$0
Colusa	$0	19,200	$0
Contra Costa	$83,500,000	972,100	$86
Del Norte	$0	28,100	$0
El Dorado	$40,000,000	159,700	$250
Fresno	$30,000,000	823,900	$36
Glenn	$0	26,800	$0
Humboldt	$0	127,800	$0
Imperial	$27,500,000	150,900	$182
Inyo	$0	18,150	$0
Kern	$0	685,800	$0
Kings	$0	136,100	$0
Lake	$2,000,000	59,300	$34
Lassen	$0	35,900	$0
Los Angeles	$1,663,295,000	9,802,800	$170
Madera	$0	129,400	$0
Marin	$201,800,000	250,400	$806
Mariposa	$0	17,200	$0
Mendocino	$0	87,300	$0
Merced	$20,000,000	216,700	$92
Modoc	$0	9,600	$0
Mono	$0	13,350	$0
Monterey	$10,000,000	410,800	$24
Napa	$0	126,200	$0
Nevada	$0	94,000	$0
Orange	$86,800,000	2,925,700	$30
Placer	$0	257,500	$0
Plumas	$4,000,000	21,100	$190
Riverside	$0	1,609,400	$0
Sacramento	$633,500,000	1,258,600	$503
San Benito	$0	55,200	$0
San Bernardino	$140,000,000	1,764,300	$79
San Diego	$154,000,000	2,883,600	$53
San Francisco	$856,300,000	793,700	$1,079
San Joaquin	$245,000,000	583,700	$420
San Luis Obispo	$50,950,000	252,100	$202
San Mateo	$244,500,000	720,100	$340
Santa Barbara	$132,000,000	408,900	$323
Santa Clara	$51,500,000	1,723,700	$30
Santa Cruz	$16,000,000	259,800	$62
Shasta	$3,000,000	165,700	$18
Sierra	$0	3,560	$0
Siskiyou	$0	44,300	$0
Solano	$40,000,000	403,400	$99
Sonoma	$32,000,000	468,800	$68
Stanislaus	$6,000,000	459,900	$13
Sutter	$0	80,900	$0
Tehama	$9,000,000	56,800	$158
Trinity	$0	13,050	$0
Tulare	$12,000,000	377,500	$32
Tuolomne	$1,000,000	55,200	$18
Ventura	$7,000,000	773,500	$9
Yolo	$0	173,500	$0
Yuba	$0	60,800	$0
Total	**$4,865,145,000**	**34,818,430**	**$140**

Sources: *Pooled Money Investment Board Report*, June 2001; DOF Population Estimate for 1-1-01.

Furthermore, deposit transactions between the Treasurer's Office and banks are increasingly being carried out through bank holding company representatives rather than by individual branches. For example, Greater Bay Bancorp (a bank holding company)

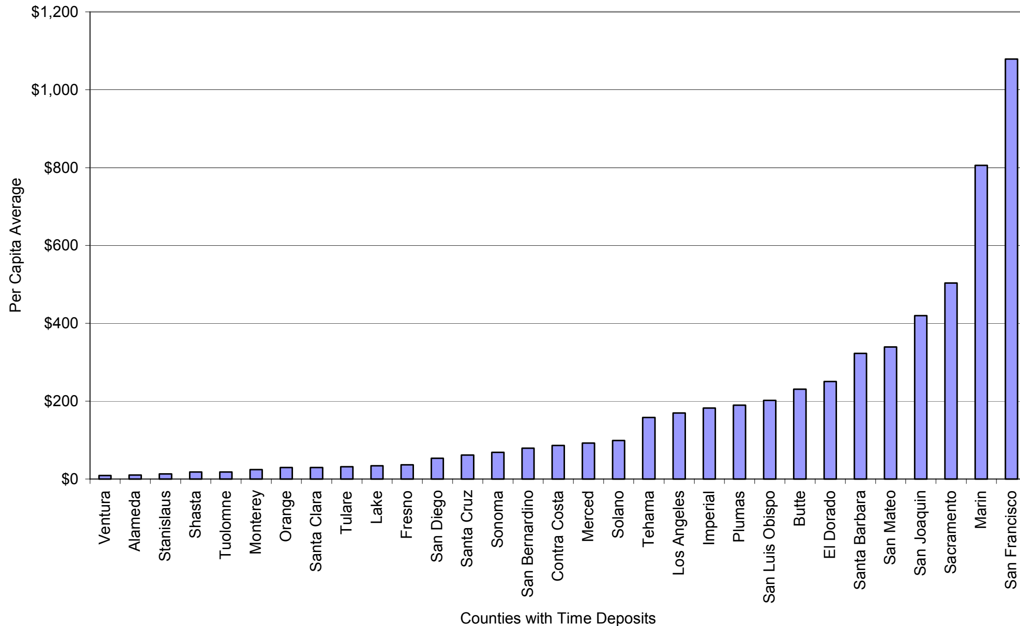
designates an individual to receive deposits on behalf of the Bank of Petaluma, Bank of Santa Clara, Bay Area Bank, Bay Bank of Commerce, Coast Commercial Bank, Cupertino National Bank, Golden Gate Bank, Mid-Peninsula Bank, and Peninsula Bank of Commerce. All of those banks are under the same holding company. Therefore, it is increasingly difficult to trace which communities are actually receiving the Treasurer's Office deposits. In the past, deposits were handled by each of these banks individually.

This suggests that with consolidation and changes in the financial institutions system, it will be impossible in the future to assess where deposited funds go and which communities may benefit from the funds.

Table IV-2 shows the distribution of all PMIA time deposits as of June 2001, by county in which depository branch is located, with population and per capita deposit data for comparison. Populous Los Angeles County holds the largest dollar figure of deposits, while financial center San Francisco County has the largest amount in terms of per capita average. Many small counties, unlikely to have branches of qualifying institutions, have none. Because this is a voluntary program, in which institutions may choose to participate or may decline to participate, and in view of the tendency of major financial institutions to cluster in major metropolitan areas, especially in financial districts, we are unable to determine the reasons for the distribution outlined in the table.

Chart IV-1 shows the per capita figures for those counties that had bank, S&L, or credit union branches with PMIA time deposits as of June 2001.

Chart IV-1



SOCIOECONOMIC DISTRIBUTION OF TIME DEPOSITS

It is impossible to look at the socioeconomic conditions of areas served by such investments as commercial paper, securitized loans, and negotiable CDs, as the funds cannot be connected to specific locations. Time deposits, however, are placed in specific branches of specific financial institutions.

This section provides tables illustrating the distribution of time deposits by the socioeconomic conditions of the areas in which the branches of financial institutions holding these deposits are located.[69] This analysis assumes that, generally, there is a relationship between where a deposit is made and where the money is used. This is an uncertain assumption today, but taken as an approximation.[70]

For purposes of this discussion, we view "socioeconomic distribution" as referring to the social (predominantly racial and Hispanic/non-Hispanic) and economic characteristics of the vicinity of the branches in which funds have been deposited. This is a very imperfect measure, as multi-branch financial institutions may serve widely varied areas, and as borrowers may do business with institutions that have no branch in their immediate vicinity – indeed even some that have no physical branch locations at all.

Tables IV-3 and IV-4, on the following two pages, summarize distribution (in terms of branches holding deposits) of the time deposit funds by socioeconomic indicators. Bank-by-bank deposit information is provided in the published monthly reports issued by the Pooled Money Investment Board.

The figures must be viewed with care. Populations of ZIP code areas differ substantially, and may or may not correspond with service areas of banks or bank branches ("assessment areas" in CRA terms[71]) or the lending patterns of banks or branches. Further, a ZIP code analysis, like any other geographical view, cannot consider the extent to which people live in one ZIP code area but work in another and therefore may benefit from lending or investment made in the area where jobs are located. Nor can the analysis weigh the extent to which deposits in one branch affect lending or investment capacities or choices of another branch of the same bank or investments made by one financial institution in another in the same or different geographical area.

Table IV-3

AVERAGE DEPOSITS BY ZIP CODES BY SOCIOECONOMIC CONDITION

		1998	2001	1998	2001
Effective Buying Income		**No of Zip Codes**	**No of Zip Codes**	**Avg. Deposit by Zip Code (000)**	**Avg. Deposit by Zip Code (000)**
A	High Income (more than $75,000 EBI)	1	1	$100,000	$150,000
B	Higher Middle Income (More than $50,000 to $75,000 EBI)	5	15	$60,505	$66,820
C	Middle Income (More than $25,000 to $50,000 EBI)	19	42	$27,147	$27,907
D	Low Income ($15,000 to $25,000 EBI)	4	15	$106,375	$86,327
E	Very Low Income (Less than $15,000 EBI)	1	2	$75,000	$90,000
	Total Average	30	75	$47,294	$50,657
Percentage of Households under $25,000 EBI					
A	More than 75%	2	2	$50,000	$90,000
B	More than 50% to 75%	3	15	$53,333	$86,327
C	More than 25% to 50%	16	34	$59,600	$21,597
D	Less than 25%	9	24	$22,810	$66,254
	Total Average	30	75	$47,296	$50,657
% of Minorities					
A	More than 75% of the Population	6	17	$46,183	$47,635
B	More than 50% to 75%	7	20	$21,186	$40,340
C	More than 25% to 50%	10	20	$64,390	$58,605
D	25% and Less	7	18	$49,943	$56,144
	Total Average	30	75	$47,296	$50,657
% Hispanics					
A	More than 75% Hispanics	1	2	$50,000	$100,500
B	More than 50% to 75% Hispanics	2	8	$15,500	$31,438
C	More than 25% to 50% Hispanics	8	20	$46,549	$42,595
D	More than 10% to 25% Hispanics	11	29	$56,063	$50,124
E	10% or Less Hispanics	8	16	$43,600	$65,081
	Total Average	30	75	$47,296	$50,657
% Blacks					
B	More than 25% to 50% Blacks	2	5	$52,500	$80,400
C	More than 10% to 25% Blacks	3	9	$135,000	$102,100
D	More than 5% to 10% Blacks	5	12	$16,360	$29,358
E	2% to 5% Blacks	5	16	$43,860	$44,006
F	Less than 2% Blacks	15	33	$40,519	$43,091
	Total Average	30	75	$47,296	$50,657

Sources: Effective Buying Income (EBI) and Percentage of Households with EBI under $25,000 by Zip Code was obtained from *Demographics USA – ZIP Edition* , a publication of TradeDimensions.
Data on Percentages of Minorities, Hispanics, and Blacks obtained from the Census 2000.

Table IV-4

DISTRIBUTION OF TIME DEPOSITS BY SOCIOECONOMIC CONDITIONS OF THE ZIP CODES WHERE THE DEPOSITS ARE HELD

Dollar figures below in thousands.

	Effective Buying Income	**1998**		**2001**	
A	High Income (more than $75,000 EBI)	$100,000	7.0%	$150,000	3.9%
B	Higher Middle Income (More than $50,000 to $75,000 EBI)	$302,525	21.3%	$1,002,300	26.4%
C	Middle Income (More than $25,000 to $50,000 EBI)	$515,795	36.4%	$1,172,095	30.9%
D	Low Income ($15,000 to $25,000 EBI)	$425,500	30.0%	$1,294,900	34.1%
E	Very Low Income (Less than $15,000 EBI)	$75,000	5.3%	$180,000	4.7%
	TOTAL DEPOSITS	$1,418,820	100.0%	$3,799,295	100.0%
	Percentage of Households under $25,000 EBI	**1998**		**2001**	
A	More than 75%	$100,000	7.0%	$180,000	4.7%
B	More than 50% to 75%	$160,000	11.3%	$1,294,900	34.1%
C	More than 25% to 50%	$953,600	67.2%	$734,295	19.3%
D	Less than 25%	$205,290	14.5%	$1,590,100	41.9%
	TOTAL DEPOSITS	$1,418,890	100.0%	$3,799,295	100.0%
	% of Minorities	**1998**		**2001**	
A	More than 75% of the Population	$277,095	19.5%	$809,795	21.3%
B	More than 50% to 75%	$148,300	10.5%	$806,800	21.2%
C	More than 25% to 50%	$643,895	45.4%	$1,172,100	30.9%
D	25% and Less	$349,600	24.6%	$1,010,600	26.6%
	TOTAL DEPOSITS	$1,418,890	100.0%	$3,799,295	100.0%
	% Hispanics	**1998**		**2001**	
A	More than 75% Hispanics	$50,000	3.5%	$201,000	5.3%
B	More than 50% to 75% Hispanics	$31,000	2.2%	$251,500	6.6%
C	More than 25% to 50% Hispanics	$372,395	26.2%	$851,895	22.4%
D	More than 10% to 25% Hispanics	$616,695	43.5%	$1,453,600	38.3%
E	10% or Less Hispanics	$348,800	24.6%	$1,041,300	27.4%
	TOTAL DEPOSITS	$1,418,890	100.0%	$3,799,295	100.0%
	% Blacks	**1998**		**2001**	
B	More than 25% to 50% Blacks	$105,000	7.4%	$402,000	10.6%
C	More than 10% to 25% Blacks	$405,000	28.5%	$918,900	24.2%
D	More than 5% to 10% Blacks	$81,800	5.8%	$352,300	9.3%
E	2% to 5% Blacks	$219,300	15.5%	$704,100	18.5%
F	Less than 2% Blacks	$607,790	42.8%	$1,421,995	37.4%
	TOTAL DEPOSITS	$1,418,890	100.0%	$3,799,295	100.0%

Sources: Effective Buying Income (EBI) and Percentage of Households with EBI under $25,000 by Zip Code was obtained from *Demographics USA -- ZIP Edition,* a publication of TradeDimensions.
Data on Percentages of Minorities, Hispanics, and Blacks obtained from the Census 2000.

V. Other States' Short-Term Investment Practices

This section looks at selected other states' policies to see whether they explicitly allocate funds to community development projects or CRA types of investments. Policies of Oregon, Texas, New York, Michigan, and Florida are summarized. This section reflects a combination of documents provided by and conversations with investment officers managing state excess funds in the cited states, as well as review of some state statutes.

In these and any state-to-state comparisons, it is important to note that state laws differ considerably in the investment scope and responsibilities accorded to the state treasurer or other officials and in the rules governing investment of surplus state funds. With this caution, it appears that California tends to focus more on investing in or with an eye on community development than is typical of many other states, and that the California State Treasurer has authority over a larger proportion of the relevant funds than treasurers in some states, although less than in many.[72]

NEW YORK

In New York, cash balances not required for immediate use are invested either through a short term investment pool (STIP) administered by the State Comptroller or by the fund custodian. Investments are made in accordance with the State Finance Law. Cash is primarily invested in repurchase agreements involving U.S. Treasury obligations and remaining funds are invested in U.S. treasury bills and commercial paper. Cash deposits not held in the state treasury and controlled by various other state officials are generally held in interest bearing accounts. Time deposits are authorized but not used. New York does not have a local government investment pool program.

FLORIDA

Florida has a different policy than California, and a strong time deposit program. However, Florida's treasurer has jurisdiction over only 9 percent of state funds available for investment, in contrast to 75 percent in California, and a total budget less than half that of California.[73]

By law, first priority for investment of the pertinent excess funds in Florida must be given to requests for certificates of deposit (including time deposits) from Florida banks and savings association.[74] Excess funds are placed in qualified public depositories (banks and savings and loans) that will pay rates established by the Treasurer at levels not less than the prevailing rate for United States Treasury securities with a corresponding maturity. Publicity about the deposit program must be provided to all qualified public depositories in Florida.

If the available money is not requested for interest-bearing time deposits or savings accounts by qualified public depositories (for example these institutions are unwilling to accept these funds and pay the rates established) then funds can be invested in other instruments. Instruments of investment can be U.S. Treasuries, obligations of federal agen-

cies, asset-backed securities, commercial paper, banker's acceptances, corporate obligations, convertible bonds, and commingled[75] and mutual funds. Treasury deposits should not exceed 10 percent of the assets of any qualified public depository. Certificate of deposit placements are limited by the capacity of qualified public depositories and by the desire of qualified public depositories to hold state funds.

OREGON

In Oregon, the state treasury operates the Oregon Short Term Fund (OSTF) which as in California, is a fund that invests surplus state and local government funds. The pool offers a time deposit program for Oregon depositories. Portfolio rules do not directly address the issue of investing in local communities; however, indirectly, the time deposit policy was designed to help communities. Time deposits are 1.2 percent of portfolio (a much lower proportion than in California, currently around 10 percent). All investments are made in four types of assets: commercial paper, banker's acceptances, U.S. agencies, and time deposits.

MICHIGAN

Michigan's pooled money account, called the "Common Cash" account, only handles state funds. Michigan does not have any investment vehicle for local governments to invest their cash with the state. However, Michigan has a program to use surplus funds to make loans to Michigan governments, collateralized by future revenues to be paid by the state to that local government unit. The common cash account managers, by statute, may also invest surplus funds under the state treasurer's control (up to $210 million) in certificates of deposit or other instruments of a financial institution qualified under the law to receive deposits or investments of surplus funds in order to make agricultural loans. The financial institution must provide ample security and must identify the qualified agricultural loans and terms of conditions of those loans. If a financial institution has not made qualified agricultural loans within 90 days, the rate of interest will be increased.

The state treasurer must prepare separate reports to the legislature regarding the disposition of money invested for purposes of qualified agricultural loans. The report should include the total number of farmers and the total number of agricultural businesses who have received such a loan, and by counties. Similar programs allow (1) the investment of surplus funds to facilitate marina dredging loans (up to $20 million), and (2) the investment of surplus funds in loans to Michigan municipal bond authorities to use bond proceeds to promote solid waste management.

In Michigan, time deposits are less than one percent of the $5.4 billion fund, a slightly higher proportion than emergency municipal loans. Most of the portfolio is invested in commercial paper.

TEXAS

In Texas, all banks, savings and loans, and credit unions doing business in the state are notified of the time deposit program and invited to apply to participate. To participate, an

institution must not have a CRA rating below "satisfactory." Institutions must apply to participate, must furnish documentation of condition, and must make their books open for inspection by the comptroller. Selection as a depository lasts two years, and may be re-newed if applicable requirements are met. The comptroller may determine and designate the amount of state funds to be deposited in time deposits in state depositories. Under Texas law, the "percentage of state funds to be deposited in state depositories shall be based on the interest rates available in competing investments, the demand for funds from Texas banks, and the state's liquidity requirements." Funds beyond those placed in time deposits are to be invested in a specified list of approved investment types.[76]

VI. Feasibility and Social Benefits of Specified Initiatives

This section addresses AB 2805's request for an examination of the feasibility and social benefit of several specified potential initiatives.

"Requiring the State to Follow Guidelines Similar to the Federal Community Reinvestment Act in its Investment Policies"

At about the time AB 2805 was passed and signed, another bill (AB 2708, Wesson) created a role for Community Reinvestment Act ratings in placement of state funds in banks and savings and loans.[77] That bill became Chapter 1036, Statutes of 2000, amending Section 16500 et seq. of the Government Code.

By the action of AB 2805, in placing money into financial institutions the Treasurer is now indirectly following CRA guidelines. That is, the invested funds flow to institutions that at least satisfactorily conform to the requirements of CRA. (The specific wording does not exclude credit unions, which are not reviewed or rated under CRA.)

It should also be noted that the Treasurer's Office does make other specific efforts that are in the spirit of CRA. Some are made via the Pooled Money Investment Account and others via other activities unrelated to PMIA.

The nature of the Treasurer's investment activities, not to mention sources of funds, differs fundamentally from the nature of the lending and investment activities of financial institutions. Likewise, the rules and even fundamental concepts under which the PMIA operates on the one hand and financial institutions operate on the other differ radically. Financial institutions, especially banks that are members of the Federal Reserve or that have correspondent relationships with other institutions, have access to liquidity that PMIA does not. Banks can borrow, lend to corporations and individuals, sell or securitize the loans they have originated, and can syndicate participation in large loans or participate in such syndicated loans. The PMIA can do none of these things. PMIA's sole charge is to invest funds belonging to the state and participating local agencies with a view to safety, liquidity, and rate of return, and it can invest only under conditions specified in California law and in investments authorized in California law.

However, the Treasurer's investment staff is now, as noted above, permitted by California law to make time deposits *only* in institutions that do not have a less than "satisfactory" CRA rating. PMIA funds may also be invested in pools of loans (securitized in accordance with normal practices) comprising CRA-eligible California-based loans.

Many months are required to assemble, underwrite, and issue mortgage-backed securities and similar types of securities. At any given time, the number and distribution of eligible loans may be limited. For those reasons, it is not clear that any specific requirement, whether by percentage or dollar amount, for such securities as part of PMIA would be

feasible. The need to limit maturities and to weigh changing interest rate environments and risk profiles further restrains the potential to establish guidelines for such securities as a part of the pool.

Social benefits of increasing emphasis on CRA standards are not quantifiable as a result of the complexity and indirectness of relationships between PMIA funds and eventual application in communities, the embedding of such funds in a far larger financial market, and the sale and resale of assets by all participants.

At the same time, involvement of the PMIA in the market for CRA-aware investments, such as securitized pools of CRA-eligible mortgages, improves liquidity in that market. Therefore, such investments tend to make such lending more attractive to lenders and more available to borrowers. In short, participation in that market, within prudent investment standards, is socially preferable to refraining from participation and, if appropriately managed, imposes no significant cost on the PMIA or its participants.[78]

"Allocating Funds for Specific Investment Purposes"

California's investment purposes for the funds under discussion in this paper are encompassed in three words: safety, liquidity, and return. Investment choices must contribute to achievement of these three key purposes. Investments are not typically made with a view to how the funds will be used by the receiving institution. The exception involves occasional investments in mortgage pools composed of CRA-eligible California mortgage loans or in other pooled CRA-eligible loans, such as small business loans, if available. Those pools reflect standard underwriting practices and can also be viewed as reflecting diversification of investments. Such investments are sought under current PMIA policy and practice.

The PMIA does not invest in equities, excluding mortgage-backed or other loan-backed securities, which trade like somewhat like equities but bear interest. PMIA investments are short term, with average life of approximately six to eight months, in contrast to equity investments (stock) that in a different type of investment pool might be held for years. For these reasons, the type of sector diversification that might apply to a retirement account is not a model for the PMIA. That is, allocation among such sectors as technology, basic materials, retail, automotive, and health care, a familiar sort of approach for broad-based equity investment, does not apply to the PMIA.

A method that might accomplish a result similar to purpose-designated investments could be a tied deposit program, under which time deposits are placed with agreement that the funds will be used in specific ways. This concept is discussed in the Policy Options section, below.

"Mandating that a Set Percentage of California's Public Funds be Used in California"

Although measuring the impact on the economy of the state of placement of short-term funds in California financial institutions is difficult and uncertain, some analysts believe

that the impact is important to bear in mind in investing state cash balances and in assessing comparative yields. A 1975 report published by the Council of State Governments addressed this point specifically, but could reach no clear conclusion one way or the other.[79]

In an important sense, all of the funds under discussion in this paper *are* "used in California," as they are earning interest for the benefit of the state and of the 2,800 local agencies that participate in the fund pool. That interest helps to support the work of local governments and of state agencies, and the availability of the PMIA as a safe investment vehicle helps the state and local governments to manage their fiscal affairs.

Defining what portion of funds are "used in California" in a second sense of that phrase is more difficult. Time deposits are placed exclusively in California branches of banks and other institutions. But other investments are made in agency obligations (national), treasury bills (national government instruments), commercial paper (large corporations of national or international scope, often with significant California presence), negotiable certificates of deposit and bank notes (not necessarily California-based banks), and bonds of major corporations, plus a small amount in other instruments and a modest percentage on loan to entities within state government.

Diversification of funds is a key component of assuring safety, liquidity, and return, and suggests both that some portion of the funds will be placed with California institutions and that a large proportion will not, so that a statewide economic problem cannot place the pooled funds at undue risk.[80] Placement of a proportion of funds within the state has the dual benefit of playing a role in diversification and increasing lending potential within the state, even if the increase cannot be quantified. We are, however, unaware of any guidelines as to an optimal proportion. The Legislature might wish to consider a directive to the Treasurer's Office to seek to place the highest proportion of funds into in-state deposits consistent with appropriate levels of diversification, interest expressed by qualified financial institutions, and the need for liquidity to respond to flows of funds.

"Identifying Impediments, If Any, to Community Banks' Receipt of Public Moneys, Such as Those from Pooled Money Investment Accounts"

The major impediments are of two types. The first reflects legislatively enacted precautions to assure sound collateral and not over-concentrate funds in any particular institution. That is, the receiving institution must provide acceptable collateral, which is reevaluated periodically to assure that it remains sufficient. That collateral is then unavailable to serve other purposes within the institution; that is, it cannot be used simultaneously as collateral for another deposit, nor can it be sold or exchanged by the institution, while held as collateral by the Treasurer's Office.[81] (It should be noted that with approval of the Treasurer's office, the collateral provided for a specific time deposit may be exchanged. For example, a bank might provide qualifying municipal bonds in exchange for Treasuries that had been held as collateral.) Further, as also required in California law, time deposits may not exceed the institution's equity capital. Equity capi-

tal in a community bank might be only a few million dollars, in contrast to billions of dollars in a large institution.

The second type of impediment reflects how financial institutions must manage their own liquidity requirements, interest rate risk, and mix of assets and liabilities. Large wholesale time deposits – or additional such deposits – do not necessarily fit well within the strategy and funding needs of *every* financial institution at all times. For some institutions at a given time, such deposits may provide no benefit that outweighs the costs, and hence not be sought. For some, such deposits might pose unwanted challenges to manage, at least at that time, and not be desirable. For others, large wholesale time deposits may fit well into the strategy and facilitate additional local lending, and hence be actively sought and received. Only the management of any institution is in a position to determine where it falls on this spectrum.

From a regulator's perspective, management of liabilities is important. Federal Reserve Board Chairman Alan Greenspan commented on this point in a June 2001 report to Congress on the condition of the U.S. banking system. In part, from the appendix to the testimony:

> For banks to remain in sound condition, they must not only pay attention to the quality of their assets, but also to the nature and quality of their funding. In recent years, large and small banks alike have come to rely increasingly on large wholesale deposits and nontraditional sources of funds . . . banks have also made the calculated decision to pay relatively low interest rates on some types of retail accounts and rely on higher-priced jumbo deposits or wholesale borrowing to fund incremental asset growth.
>
> . . . .
>
> While community banks have experienced moderate erosion in the share of core deposits funding assets, when that trend is coupled with rapid loan growth, pressures on bank liquidity have intensified.[82]

This concern suggests that some caution is in order in any effort to encourage unlimited growth in large-denomination time deposits of PMIA funds.

One potential impediment is simply a lack of familiarity with the time deposit program on the part of banks, savings and loans, and credit unions. To address this potential impediment, California might emulate the Texas approach, under which every pertinent financial institution is formally notified every other year, and invited to apply for participation. Although impacts of such a policy cannot be clearly identified, as participation is voluntary, it would serve to assure that all institutions do receive periodic and formal notification.

"CREATING A SEPARATE PROGRAM FOR POOLING DEPOSITS IN CALIFORNIA'S COMMUNITY FINANCIAL INSTITUTIONS TO ENSURE THAT MORE PUBLIC FUNDS ARE USED AT THE LOCAL LEVEL"

We have read this provision as suggesting the need for a method of earmarking funds for placement in time deposits in small banks, savings and loans, and credit unions. The meaning of the phrase "to ensure that more public funds are used at the local level" is taken to mean "are placed in time deposits in small banks, savings and loans, and credit unions," with the expectation that those funds will be available for local lending.

The most direct way of accomplishing the goal of assuring priority for time deposits would be to place in law the policy and practice currently followed by the Treasurer's Office. That policy is, within limits required to assure adequate liquidity and prudent management, to give first call on PMIA funds to time deposits in institutions that meet applicable requirements of law.[83] The law could be made even more specific to give priority to time deposits in eligible community banks, savings and loan associations, and credit unions. This approach would be consistent with current practice and consistent with other provisions of California law regarding investment of pooled funds. This alternative does not establish a separate program, but it does appear to meet the intent of the law on this point and to do so within the existing operational framework.

The Policy Options section outlines specific changes in law that could be considered to implement this alternative.

Another theoretically possible means could be a second pool specifically directed toward time deposits in community institutions. This, however, appears to be an impractical alternative. A second pool would create new administrative demands, as funds received by the Treasurer for investment would have to be earmarked for one or the other pool. Not only would the Treasurer's Office have to manage two pools, but also the state and the participating local agencies would have to specify which pool was to receive their funds. This would complicate record keeping and reduce flexibility in funds management both when funds are placed into the pool(s) and when they are withdrawn.

An alternative to a separate pool for time deposits in community institutions might be a *shared collateral pool* for small financial institutions. See the Policy Options section for a brief discussion of that concept.

POTENTIAL ADDITIONAL EFFORTS IN CALIFORNIA

Additional efforts to put available state funds in California-specific investments would be within the purview of the Treasurer's Office in its management of pooled funds. Such efforts would of course have to conform to state law either as it currently stands or as it might be amended to allow new options. Some potential options are explored in the Policy Options section of this paper.

In general, readily feasible additional efforts could be of a few basic types:

1. Further placement of funds in current types of investment, including time deposits in community banks and in purchase of mortgage-backed securities targeted to California communities.

   This is largely a matter of the availability of such investments in the context of the universe of authorized investments and the key goals of safety and liquidity plus competitive market return. The continuous growth in time deposits of PMIA funds, especially in the last few years, suggests success in pursuit of such deposits, although it is not possible to determine what specific impacts those deposits have had on local or statewide economies.

2. Investment in bonds or commercial paper, or both, with a view to selecting corporations with a significant presence in California, and especially those with a significant presence in or other contribution to low and moderate income areas.

   This could be accomplished (or current level of accomplishment expanded) through ongoing analysis of investment opportunities with a view to a California focus. However, this focus must be balanced with the overriding requirement for safety and liquidity, plus competitive market return, in turn requiring appropriate diversification by geography, investment type, and economic sector.

3. Expanded efforts to purchase securities backed by California small business loans, but meeting established criteria for safety and liquidity.

   This could be pursued within existing law and guidelines to the extent that the market makes such options available, but securitization of small business loans has lagged securitization of mortgages, a market issue on which state investment officials have little impact. Some securitized SBA-guaranteed California small business loans have already been included in the PMIA portfolio.

4. Programmatic options entirely separate from the investment of pooled funds discussed in this paper, such as loan guarantees or credit enhancements provided through or with the support of budgeted funds.

   This option is of a different type than the preceding ones, and not within the scope of this paper, but might benefit from the investment expertise of the Treasurer's Office.

VII. Policy Options

In this section we present some potential policy options related to directing state funds to California communities. The design of policies to channel funds to these communities or to increase deposits in community banks only makes sense when there are significant barriers to the flow of funds in financial markets. Thus, policy makers should evaluate the prevailing conditions of the financial markets and particular communities before discussing potential policies. Furthermore, there are also two important considerations to assess:

- First, whether this type of policy reduces the return on investments, decreasing the availability of money to spend on other state and local projects.
- Second whether support to community banks assures that overall lending will increase in local communities, since it is possible that more lending by a community bank leads to less lending by other banks in the same community.

Once these issues are addressed, a variety of potential policies could be evaluated. With those considerations in mind, the following options might be considered in the light of the background and analysis offered in this paper. Listing of an option should not be taken to imply endorsement or recommendation.

LEGISLATIVE PRIORITY TO TIME DEPOSITS IN COMMUNITY FINANCIAL INSTITUTIONS

The Legislature could amend the law to formalize what is current policy and practice with regard to time deposits: give them first priority within limits imposed by the need for liquidity. To be more specific, the Legislature could consider giving first priority to time deposits in eligible community banks, savings and loans associations, and credit unions, with the next priority to time deposits in larger financial institutions, and other funds then to be invested in other instruments authorized in law.

This option would require no change in current investment options for pooled funds and no change in security (collateral) requirements. It would require a brief statement of the policy that might, for example, take the following form of a new Section 16430.1 in the Government Code:

> *§ 16430.1. The following priorities are established for investment of surplus monies under this chapter, provided that all time deposits of surplus funds and all other investments of surplus monies shall conform to all other requirements established in law:*
>
> *(1) To the maximum extent consistent with liquidity requirements and prudent management of surplus moneys, time deposits in eligible community banks, eligible community savings and loan associations, and eligible community credit un-*

> *ions, as defined in Section 16600, shall be given first priority for investment of surplus moneys.*
>
> *(2) Funds not placed as specified in Section 1 shall, to the maximum extent consistent with liquidity requirements and prudent management of surplus moneys, have priority to be placed in time deposits in other eligible banks, eligible savings and loan associations, and eligible credit unions, as defined in Section 16600.*
>
> *(3) Surplus monies not placed in time deposits shall be invested in eligible securities authorized in Section 16430 or as otherwise authorized in law.*

This provision would: specify priority for time deposits, first in community financial institutions and second in larger financial institutions; provide that all such institutions must meet the definitions of eligible institutions; and provide for investment decisions to be made with a view to the need for liquidity and prudent management of surplus funds.

LONGER MATURITIES FOR DEPOSITS IN SMALL FINANCIAL INSTITUTIONS

Maturity schedules reflect the needs of the portfolio as well as preferences of the receiving institutions. Dan Dowell, Assistant Director, Investment Division, State Treasurer's Office, commented on this issue:

> By and large, the length of the maturity is determined by the financial institution. As one would suspect, in a falling interest rate environment, shorter maturities are generally preferred. The opposite is generally preferred in a rising interest rate environment.
>
> We have previously discussed the lag time between placing a deposit and the availability of current financial data – often close to six months. This lag time would be a negative factor in considering maturities greater than the current one year maximum. It should be noted that only a minute percentage of our participants have ever listed maturity limitations as a drawback in participating in the Treasurer's Time Deposit Program. . . . Therefore, the risks [of a policy of longer maturities] outweigh the rewards, in our opinion. [84]

To some extent, maturities could be extended, especially for the smaller deposits, with no material effect on liquidity or safety, and little on net yield of the portfolio, but with some increase in risk resulting from the unavoidable delay in availability of data on bank condition. However: interest rates change over time; such changes affect both the PMIA and the banks, S&Ls and credit unions taking deposits; and deposits typically are rolled over (at revised interest rate) at maturity. For those reasons there is no obvious benefit to any participant to establish arbitrarily longer maturities, and there may be increased risk in a volatile interest rate environment, and an especially profound risk to community banks when (as during 2001) interest rates drop quickly.[85]

WORK WITH NEW COMMUNITY FINANCIAL INSTITUTIONS FOR POTENTIAL FUTURE PARTICIPATION IN THE TIME DEPOSIT PROGRAM

New banks and other financial institutions are unlikely to meet requirements immediately for receipt of PMIA time deposits. However, some have met the criteria within about two years. It might be appropriate to develop a system to formally advise new financial institutions about the time deposit program and about specific milestones that would enable them to participate.

LINKED DEPOSIT PROGRAM FOR TIME DEPOSITS IN COMMUNITY BANKS

The Legislature could consider authorizing a "linked deposit" (also known as "tied deposit") program, whereby a specific time deposit is contingent on the receiving institution, a community bank, for example, using the funds for a specific purpose. For example, the bank might accept the funds with the specific agreement to lend an equivalent amount to local small businesses, in addition to existing levels of such lending.

This concept is not new, but is also not extremely common. The idea was described in a 1990 publication of the Government Finance Research Center of the Government Finance Officers Association, which summarized such programs this way:[86]

> Linked deposits are an easy-to-administer mechanism for bank-government partnerships aimed at expanding local business opportunities, improving neighborhood housing[,] or assisting farmers. The 'link' which gives the concept its name connects government funds deposited in a bank with the bank's promise to lend money to members of targeted groups." (From the Foreword, p. v.)

The scope, nature, and design of a tied deposit program would require careful analysis, and there is no assurance that such a program would be found suited to California's needs or to promise significant benefits.[87] Any consideration of such a program would also call for evaluation of the investment returns achieved in states or localities that have used such a program, as tied deposit programs may involve interest rate preferences that reduce returns on invested state and local dollars.

ALTERNATIVE METHODS OF PROVIDING SECURITY FOR TIME DEPOSITS

Current law offers a wide range of acceptable types of collateral to provide security for time deposits. Allowed collateral includes such assets as bonds and promissory notes and, as of 2001, a letter of credit from the Federal Home Loan Bank of San Francisco. In addition, security for a time deposit may be provided through a bond issued by an admitted surety insurer. In each case, security must be to equal at least 110% of the value of the time deposit. With approval of the Treasurer's Office, collateral for a specific time deposit may be exchanged for other acceptable collateral even before a time deposit has matured.[88] The new collateral must, of course, also meet the requirements set forth in law.

Some states allow alternatives to the types of collateral authorized by California law. A report prepared by the National Association of State Treasurers indicates that (at least for demand deposits), collateral is not required by Alaska, Delaware, Idaho, Indiana, Maine, New Hampshire, North Dakota, Utah, and Wisconsin.[89] For states with collateral requirements, the percentage required ranges from 25% to 110% (California's is 110%).

Some states allow a "collateral pool program." Pool programs are of two types. Under a *shared collateral pool* program, each participating financial institution places a percentage of its public deposits in a pool that is drawn upon in the event of a default by any one of them. In this way, no single institution must provide full collateral for the deposits placed with it, but the pooled collateral fund serves to mitigate risk for the depositors (state or local agency). Under a *bank collateral pooling* program, a financial institution may pledge acceptable collateral (securities, bonds, or other approved instruments) "equal to the aggregate value of that institution's public deposits."[90]

The Legislature might wish to consider allowing a shared collateral pool program specifically and exclusively for small banks, savings and loans, and credit unions as a step to expand the flexibility available to community institutions in PMIA time deposit participation. This is not a simple issue, as it does raise the possible concern that, in so participating, each institution assumes some degree of risk (however modest) for the condition and circumstances of every other participating institution. That risk might be less or greater than the benefits accruing from not having to provide full collateral for each time deposit. The trade-offs would require careful consideration both at the level of design of such an option and at the level of individual institutions' analysis of the desirability of participating.

The Government Finance Officers Association of the U.S. and Canada stated in 1993, that it:

> . . . continues to urge state and local government depositors to take action necessary to protect collateralized deposits. GFOA has long endorsed statutes that require financial institutions to collateralize public deposits exceeding the $100,000 federal insurance limits. State statutes governing collateral agreements should be followed closely.[91]

A relatively simple change to current law suggested by some bank representatives with whom we spoke would be to permit use of highly rated corporate bonds as collateral for time deposits. Corporate bonds are subject to certain risks to which Treasuries, for example, are not, although they are authorized for direct investment of PMIA funds and therefore reasonable as collateral under appropriate circumstances. Those circumstances might include an extra degree of over collateralization and regular marking to market to protect against fluctuations in principal value.[92]

Also suggested as additional option for collateral is out-of-state municipal bonds. While this option, reflecting an investment not permitted directly to the PMIA, would expand the current list, it would raise questions of (1) valuing the bonds, especially any that are

thinly traded, and (2) whether that option might tend to divert investment away from California municipalities.

Any alternative to the current requirements regarding collateralization of PMIA deposits will require careful consideration in order to evaluate impacts on the PMIA/LAIF and its members and on participating financial institutions.

Selection of Depositories through Competitive Bidding

Some states select depositories for public funds through competitive bidding. We do not have detailed information at this time on the methods used, nor on costs or benefits. However, in general, the basis on which bids might be solicited could include rates paid, term of deposit, type and amount of collateral, and (especially for demand deposits) services to be provided and related fees.

To be feasible, competitive bidding would have to be based on specific, objective, measurable criteria. For time deposits, the simplest would be rate to be paid, or spread in comparison to some specified benchmark. Others could include commitments with respect to application of the deposited funds, including, for example, earmarking for CRA lending or local investment. The latter, however, would be similar to a tied deposit program (described above), which could be accomplished through non-competitive means based on established criteria open to participation by all qualified depositories.

A State-Owned Bank

This alternative is the most far-reaching that might be considered, but does have a precedent in the United States. The State of North Dakota (alone among the states) owns the Bank of North Dakota, a profitable bank that emphasizes lending to in-state borrowers.[93]

A state-owned bank could serve as a default depository for the time deposit portion of PMIA funds and could serve as a benchmark against with to measure performance in lending and investment within California and with respect to CRA standards.

Creation of a California state bank would require the most careful analysis and consideration, although, as the case of North Dakota shows, it is technically feasible. North Dakota, however, is a thinly populated and largely agricultural state with a very different history, culture, and economic environment that California, and established its bank in a very different era, just after World War I. Analysis of the potential for a state-owned bank in California would, if nothing else, throw light on the operations and functions of banks and comparable financial institutions in connection with the goal of keeping surplus state and local funds available for lending within California.

Formal, Periodic System for Notifying and Soliciting Potential Depositories for PMIA Funds

Texas has a formal system for notifying potential depository institutions every other year and for documenting receptiveness to participation in the time deposit program.

California could consider a similar formal, periodic system, with results to be made available publicly, in order to document that access to receipt of deposits is statewide, impartial, and fully communicated to all eligible institutions.

Comments Received

As part of the research for this paper, we conducted interviews with representatives (chief financial officers) of the banking industry. Twenty-four banks, members of the Community Bankers of California, were contacted, resulting in 14 interviews. A few other interviews were conducted with officials of banks not members of that organization. Interviews were conducted with the understanding that comments would not be quoted directly or attributed to specific individuals or institutions.

These interviews do not comprise a random sample, and may be taken only as suggestive of some issues and concerns.

Most of the interviewees agreed that the Treasurer's Office time deposit program was good for the banks and for their communities

Most interviewees considered the operation of the program efficient and did not suggest any change that could be implemented to improve the operation of the program. Most considered that it was very easy to participate in the program. They found the officers of the Treasurer's Office extremely professional and easy going. They could obtain funds at a very convenient rate. Some bankers pointed out that in recent years the program has reached out to banks, a different situation from the past, when only large banks could participate.

Most people agreed with the collateral requirements established in law for the program. However, a few bankers argued that the range of types of collateral accepted by the program could be expanded. They suggested out-of-state municipal bonds, as well as highly rated corporate bonds as alternatives to be considered. (This would require a change in the law.) One of the bankers contacted considered the required collateral extremely expensive, making very difficult for that bank to participate. Another bank said that the minimum requirements to participate in the program were too strict in view of the collateral requirements.

Some expressed that they were not interested at all in participating in the program, while many considered that because of current economic conditions, this was the time to try to expand their deposits by attracting public deposits.

Some of the bankers had only recently heard about the program. Many heard about the program from other bankers rather than being directly contacted by the State. A majority of those contacted had participated in the program for some time. One banker stated that early on, he would receive an occasional reminder call about the program, but that now (as of last spring) he would contact the Treasurer's Office regarding participation. He indicated a preference for longer maturity dates, and indicated importance of rolling over deposits during poorer economic times to better enable support of loan customers with difficulties.

One banker in a metropolitan area indicated that, on the basis of talks with local bankers, he did not see a strong feeling of need for State funds to go to community banks in that area.

A banker with a relatively new community financial institution indicated that his institution had gone to the Treasurer's Office to initiate participation. He indicated that his institution's request would be that no collateral be required for first $100,000 of time deposit. (However, the first $100,000 is already exempted by law. Possibly this point was not communicated in this particular case, or was overlooked by the banker.)

Glossary

This section defines selected specialized terms used in this paper or likely to be found in related reading and important to understanding key issues.

Certificate of deposit (CD). Receipt from a bank, savings and loan, or credit union, for deposit of funds at a fixed rate, for a fixed period. There are various types, including negotiable CDs, issued in bearer form, that may be resold in the market.

Commercial paper. Short term obligations of corporations, with maturities ranging from one day to nine months.

Community bank. For purposes of this report, a bank, savings and loan, or credit union with assets not over $300,000,000. This encompasses "small banks" as defined in California law, plus some slightly larger institutions. The term "community bank" is not defined in California law. However, "The Gramm-Leach-Bliley Act of 1999 defined a 'community financial institution' as a bank with less than $500 million in assets."[94]

Community Reinvestment Act. Federal law enacted in 1977 and occasionally revised since that requires banks and thrifts to meet the credit needs of their communities, with special emphasis on low and moderate income areas, consistent with safe and sound banking practices.

Core deposits. Summarizing from an OCC publication and a Federal Reserve Board of San Francisco glossary, core deposits are the sum of transaction balances (the amounts in checking accounts and similar accounts used to make payments) plus savings deposits and small (under $100,000) time deposits. Another definition is: "The checking and savings accounts that stay in the bank despite changing economic conditions."[95] These are complementary ways of saying the same thing. "Core deposits" are not the same as a bank's "core assets."

Demand account. An account that holds funds payable "on demand." Most commonly, this is a standard checking account, although there are other types of account with different names and features but that function similarly.

Depository institution. Bank or thrift institution that accepts deposits.

Disintermediation. "Withdrawal of funds from a financial institution in order to invest them directly."[96] This means that banks and savings and loans have lost some of their role as receiver of deposits that they then invest in mortgages and loans, as depositors instead turn to other means of investment, no longer putting banks and S&Ls in the middle of (acting as intermediary in) the transaction.

Equity investment. An equity investment, of which stock in a corporation is the best known example, represents partial ownership of the company, but does not entitle the investor to interest or dividends nor does it assure that the value of the investment will remain stable or rise. Investors benefit as a company grows, as its net income is retained, reinvested in the company, paid out in dividends, or some combination of those. The value of such an investment in the market depends on buyers and sellers and on market sentiment. Dividends, if offered, are not guaranteed, and may be reduced, eliminated, or increased at the discretion of management. (Compare to "fixed income investment.")

Fiduciary responsibility. Obligation to act on behalf of and for the benefit of another.[97]

Fixed income investment. A fixed income investment does not encompass ownership in a company, or in other entity offering the investment. Such investments include corporate bonds, Treasury bills, certificates of deposit, and others. The investor receives payment of interest and is

entitled to repayment of principal at maturity. If the investment is not held to maturity, but resold into the market, the principal value may be less or more than the investor paid, depending on such factors as the interest rate environment, confidence in the issuer of the investment, and ability of the issuer to pay interest and to repay principal. (Compare to "equity investment.")

Fractional reserve system. System under which transaction deposits (checking accounts, savings accounts) are backed by a fraction of the total deposits. That is, to back (for example) $1,000,000 in deposits a bank might be required to have $100,000 in a combination of vault cash, deposits with Federal Reserve Bank, and other authorized types of reserves. In this way, nearly all of a deposit may be loaned out, and the funds may likewise generate further lending by an institution into which the borrowed funds are then deposited, and so on. Under normal conditions, the reserve is sufficient to meet daily demands for cash. Under current Federal Reserve rules, only transaction deposits require a reserve.[98] Also see "Reserve requirements."

Fungibility. Interchangeability of one unit of something (bushel of wheat, barrel of oil, ten-dollar bill) for another. Cash deposited in a piggy bank is fungible – one dollar bill drawn out is the equivalent to any other, without regard to when deposited or by whom. Likewise, deposits in a financial institution are fungible and not associated with any specific asset, as money is fungible.

GSE. Government sponsored enterprise. Term used for Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac), publicly traded corporations whose obligations are often incorrectly assumed to have government guarantees comparable to the "full faith and credit" that stands behind Treasury issues.[99]

Hedge. Any method to protect against loss in an investment position. Methods of hedging are varied, and the choice of appropriate method or methods depends on the type of investment and on the acceptable cost of the protection.

Interest rate risk. Risk posed by holding assets and liabilities while market interest rates change. Fixed rate assets become less attractive (and lose value) as rates rise, and it may become necessary to offer higher rates to depositors than will be covered by interest paid on fixed-rate assets. When rates are falling, loans at higher than market rates will tend to be pre-paid, removing the asset from the books. This is one of several types of risk that regulators watch and that bank management must plan for.

Investment. From an economist's point of view, investment is the purchase of an asset that is expected to produce future revenue, as, for example, a warehouse, printing press, fleet of delivery trucks, or, of a less tangible sort, education to prepare for a career. Closely related is the purchase of interest-bearing instruments, such as bonds, or dividend-paying stocks. More distantly related is purchase of an asset that does not itself produce income, such as a non-dividend-paying stock or a rare coin or stamp, with expectation of resale later at a higher price. Some call the latter "speculation" and exclude it from the category of "investment."

Local Agency Investment Fund. That portion of the Pooled Money Investment Account belonging to participating local agencies, currently numbering over 2,800.

Money market fund. "A mutual fund that sells shares of ownership and uses the proceeds to purchase short-term, high-quality securities such as Treasury bills, negotiable certificates of deposit, and commercial paper."[100] "To be called a money market fund, a mutual fund must operate within strict federal rules. Designed to help maintain a stable $1.00 share price, these rules limit money funds to particular types of securities and strategies. Some of the rules [limit individual] securities [to] remaining maturities of no more than 397 days. The dollar-weighted average maturity . . . cannot exceed 90 days. All securities must be in the top two credit grades for short-term securities and be denominated in U.S. Dollars."[101] The TIAA-CREF money market fund

indicates in its prospectus that its investments will primarily be in commercial paper, obligations of commercial banks (including time deposits and bankers acceptances, among other forms), securities guaranteed by the U.S. government, certain loan participations, certain asset-backed securities, and a few others.[102] "The Fund seeks to provide current income and preserve investors' principal . . . ."[103] **Note:** compare these rules to those governing the Pooled Money Investment Account, especially at Government Code Section 16430. Although PMIA is not a mutual fund, its investments follow comparable guidelines to those governing money market mutual funds and its purposes are similar.

Moral hazard. Willingness to take otherwise unacceptable risks or incur otherwise unacceptable expenses because another party would suffer the loss or make the risk-taker whole. The term is usually used in connection with insurance, but applies wherever there is a guarantee against loss that weakens incentive to avoid or mitigate risk.

Negotiable certificate of deposit. A large denomination CD ($100,000 and up) that may be traded in the secondary market. The value of the CD rises and falls in a direction opposite the movement of market interest rates.

Opportunity cost. Difference between actual investment results and best potential investment results from an alternative use of the funds.

Pooled Money Investment Account (PMIA). State and local agency funds managed by the Treasurer's Office and invested in a range of instruments. The term is used in California law, but never explicitly defined. Money moves in and out of the pool on short notice, and may be loaned to the General Fund (that is relatively rare, and the period is very brief when it happens) or, for up to a year, to special funds of the State (these are so-called "AB55 loans," or "Pooled Loans").

"Prudent person" rule. Requirement that a fiduciary will invest on behalf of the client with the same care a prudent person would use in investing his or her own funds:

> Investments shall be made with judgment and care, under circumstances then prevailing, which persons of prudence, discretion and intelligence exercise in the management of their own affairs, not for speculation, by for investment, considering the probable safety of their capital as well as the probable income to be derived.[104]

Reserve requirements. Depository institutions (those accepting deposits of funds) must maintain reserves in accordance with Federal Reserve rules. Reserves "must be held in the form of deposits with Federal Reserve Banks or vault cash. Nonmember institutions may maintain reserve balances with a Federal Reserve Bank indirectly, on a pass-through basis, with certain approved institutions." Currently, net transaction accounts up to $42.8 million have a reserve requirement of 3 percent of deposits. Net transaction accounts above $42.8 million have a reserve requirement of 10 percent. Nonpersonal time deposits have a zero percent reserve requirement, as do Eurocurrency liabilities. For further information, see "Reserve Requirements of Depository Institutions," http://woodrow.mpls.frb.fed.us/info/policy/res-req.html. Also see "Fractional reserve system."

Securitization. The packaging of mortgages, business loans, receivables, or other types of obligation as tradable securities. Types and mechanisms of securitization are varied and complex. A more formal definition is: "Securitization [is] a process of packaging individual loans and other debt instruments, converting the package into a security or securities, and enhancing their credit status or rating to further their sale to third-party investors. The process converts illiquid individual loans or debt instruments, which cannot be sold readily to third-party investors, into liquid, marketable securities. These new debt instruments are often called 'asset-backed securities' because each pool is backed by specific collateral rather than by the general obligation of the issuing corporation or instrumentality."[105]

Small bank. Defined in California law as a bank with less than $250 million in assets.[106] But also see "Community bank."

Speculation. Purchase of an asset with the expectation that it may be resold at a higher price. In general, speculations do not generate interest or dividends and have little assurance as to maintenance of value. Distinguished from "investment," although some assets, such as equities, may have elements of both investment and speculation.

Thrift. "A financial institution that derives its funds primarily from consumer savings accounts."[107] The term, often used in reference to savings and loans and to credit unions, has become less meaningful over the years, as savings deposits now form a much smaller portion of the assets of such institutions and as banks have been allowed to offer types of accounts formerly permitted only to thrifts, and vice versa.

Time deposit. A deposit in a bank or other financial institution that bears a specific interest rate and extends to a specific date. Time deposits may have maturities of, for example, three months, six months, one year, two years, and may be renewed by agreement at an interest rate current at time of renewal.

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U.S. Office of Thrift Supervision, http://www.ots.treas.gov. CRA information: http://www.ots.treas.gov/. See above, under Federal Deposit Insurance Corporation, for link to thrift financial reports.

Woodstock Institute, http://www.woodstockinst.org. Policy research on CRA, fair lending issues, and community development.

Interviews

We have talked with officers of selected financial institutions, local government treasurers or others responsible for funds placed with PMIA, officials of selected other states with roles similar to the Treasurer's staff, and people concerned with local investment. To preserve confidentiality and encourage sharing of views, information gathered from interviews has been incorporated into the discussion in this paper but not cited with specific reference to interviewee or institution except where permission was granted to quote by name. Our thanks go to all who shared time and insights with us.

Other Sources

We have also consulted data available from federal bank and thrift regulatory agencies, including call reports, thrift financial reports, and CRA evaluations, and have also consulted some annual and quarterly reports filed with the SEC by financial institutions.

Acknowledgements

The authors wish to acknowledge the time and cooperation of staff of the Investment Division of the Office of the State Treasurer, who provided detailed information and talked with us on several occasions and explained operations of the Pooled Money Investment Account. Their contribution of time and information and their comments on a draft of the paper were valuable and appreciated, although the conclusions in this paper (and any remaining errors) are ours and do not necessarily reflect the views of the Treasurer's Office

or its staff. The present version of this paper, it should be noted, differs greatly from that reviewed and commented on by Treasurer's Office staff and others.

We also wish to thank bank officials and others who spoke with us and who reviewed a draft of this paper. Here again, our conclusions are our own and do not necessarily reflect the views of the persons we interviewed

Appendix: Interest Rate Environment

The interest rate environment consists of (1) current rates on various maturities and types of instrument and (2) the direction or anticipated direction of movement in those rates. A discussion of the implications of movements and expectations is beyond the scope of this paper except to note that, for example, when rates are falling, homeowners tend to refinance, thus paying off existing mortgages early, and fixed-rate investments lose principal value in the market. When rates are rising, homeowners will keep existing mortgages and fixed-rate investments rise in principal value. The magnitude of change in principal value depends on the remaining maturity. Long maturities are affected more than short maturities.

An investment policy that seeks current market rates and that favors relatively short maturities will see rate of return rise and fall with interest rates, with some lag. Staggering of maturities will tend to reduce short term fluctuations in the overall rate of return on a portfolio, but over a period of months rates will tend to reflect the environment.

Chart A-3-1 shows Freddie Mac 30-year fixed rate mortgage rates for about a ten-year span.

Chart A-3-1

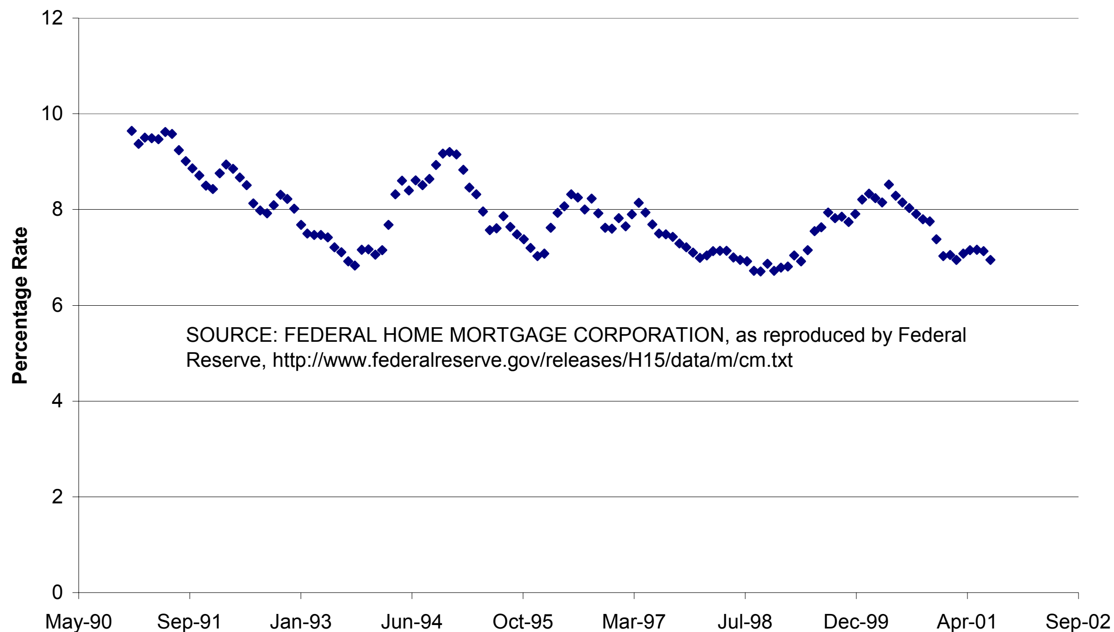
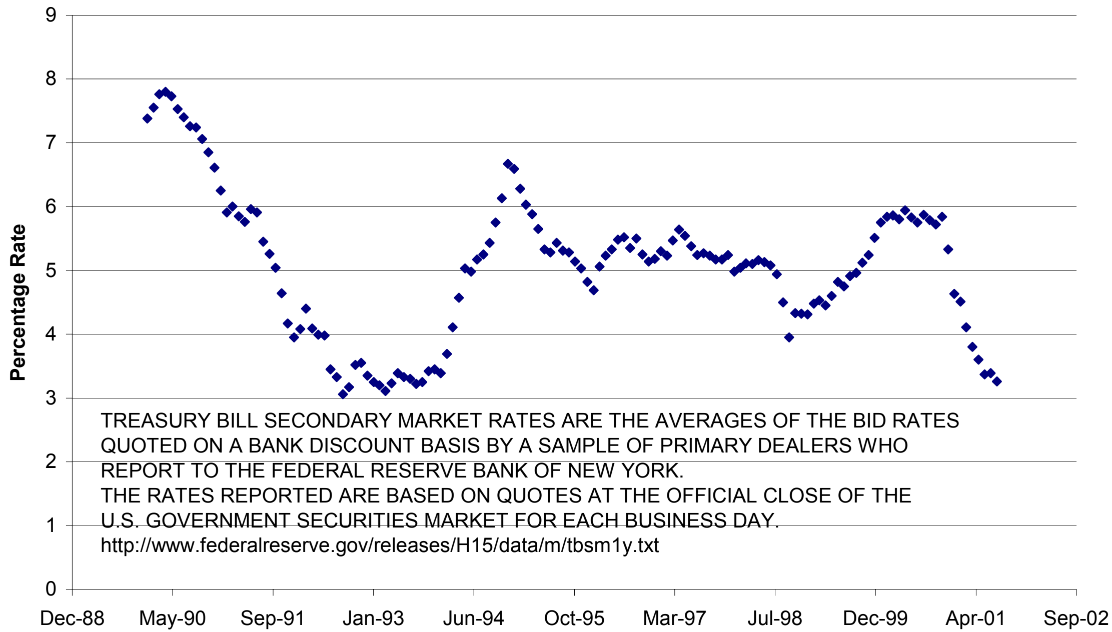


Chart A-3-2 shows one-year Treasury rates in the secondary market. (Note: rates fell significantly following the period graphed in the chart, as the Federal Reserve cut rates another 150 basis points in three 50-BP moves as of November 6, 2001.)

Chart A-3-2



The one-year rates vary much more sharply than the 30-year rates shown for mortgages. However, the comparison is more complex than rates alone can suggest. What is clear from these charts is that rates of return on the Pooled Money Investment Account, despite including a wide range of interest-bearing investments and a range of maturities (all relatively short term), necessarily vary considerably over time.

Notes

[1] Although the study was completed by December 2001, publication was delayed for subsequent editing and formatting of the report, and has now aparently been shelved permanently. [Note: (May 2004): a truncated version was finally published by the Bureau early in 2004.] This version includes some minor edits done as late as December 2002, but no updates to the data or analysis.

[2] These reports are printed and made available by the Treasurer's Office. Beginning with the January 2002 issue, recent reports are posted on the Treasurer's Web site, http://www.treasurer.ca.gov.

[3] Section 2901 of Title 12 of the U.S. Code.

[4] CRA may be found via http://uscode.house.gov/usc.htm. See the bibliography to this paper for sources of detailed discussion of CRA and its administration and impacts.

[5] The regulations are to be considered for possible revision in 2002.

[6] CRA reviews are carried out by several agencies: Federal Reserve Board, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and Office of Comptroller of the Currency. Each has its own regulations. Links to proposed revisions of the regulations were made available via the Federal Financial Institutions Examination Council (FFIEC) Web site, http://www.ffiec.gov/cra/regulation.htm. Readers who need more current and detailed information are referred to that site. See especially *A Guide to CRA Data Collection and Reporting*, http://www.ffiec.gov/cra/pdf/cra_guide.pdf, and Federal Reserve Bank of Dallas, *A Banker's Quick Reference Guide to CRA,* http://www.ffiec.gov/cra/pdf/quickref.pdf, and "A Guide to Small Bank Public Performance Evaluations under the Community Reinvestment Act," *Perspectives*, Second Quarter 1997, http://www.ffiec.gov/cra/pdf/smallbnk.pdf.

[7] Purchase of loans poses some difficulties for analysis: "[B]ecause the lending test for large, retail institutions considers both originations and purchases of loans, institutions have an incentive to purchase loans in order to hit the numbers they believe are necessary to achieve a good lending test rating. This incentive can lead to the purchase and sale of the same loans over and over again among institutions covered by the CRA. Such activity does not lead to more dollars in the communities where credit is needed, however." Ellen Seidman, "Challenges to Measuring CRA Performance," remarks to Fair Lending and CRA Colloquium, Newport, Rhode Island, June 17, 1999, http://www.ots.treas.gov/docs/87066.html.

[8] Studies, reports, and articles specific to the Community Reinvestment Act have been listed in their own section within the bibliography to this paper. The list is selective, but we believe is both representative of a range of views and offers access to much more of the literature through notes and bibliographies within the selected items. It also includes selected guides for regulators and bankers.

[9] See especially the papers by Susan White Haag and by Robert Litan and others, listed in the CRA section of the bibliography to this paper.

[10] For a view of large commercial banking organizations and CRA, see Fred Mendez, "The Big Bank World of CRA," *Community Investments [Newsletter]* (Federal Reserve Bank of San Francisco), April 2001.

[11] Various State agencies and accounts hold securities for purposes of escrow and reserve and in compliance with both federal and state law. Those funds, which would not necessarily be available for time deposits, depending on governing statutes, regulations, and agreements, and which are circumscribed by laws or other requirements that do not affect the PMIA, are not encompassed in the scope of this report. A summary of these funds, providing dollar totals but not specific investment information, appears in the report of the California State Auditor 2001-008, *State of California: Statement of Securities Accountability of the State Treasurer's Office, December 31, 2000*, June 2001. Of agencies with separate investment authority, the State Compensation Insurance Fund, regulated by the California Department of Insurance, is the largest, with $6,473,826,000 in bonds, $209,663,000 in money market funds, and $94,932,000 cash on hand as of December 31, 2000 (http://www.scif.com/newscif2/scif/2000Ann_Rpt/admitted_assets.htm). For details of holdings, see notes to annual report, http://www.scif.com/newscif2/scif/2000Ann_Rpt/fin_notes2.htm. The second largest is the State Lottery, with nearly $4 billion as of December 31, 2000, according the to the State Auditor report 2001-008. Those funds, whose purpose is to pay lottery winners, are in zero coupon bonds.

[12] Another term for what the PMIA represents is "cash balance," or "idle cash balance." See Merlin Hackbart and Robert Stafford Johnson, *State Cash Balance Management Policy* (Lexington, Kentucky: Council of State Governments, 1975). The key point, whatever they are called, is that these funds are not long-term savings and are not long-term investment.

[13] The day-to-day Pooled Money Investment Account management is the responsibility of the Investment Division, whose investment authority is found in California Government Code Sections 16430 and 16480.4.

[14] The two concepts are related, but not the same. An investment might be safe, offering guaranteed return of principal and payment of interest at a specified future date, but illiquid – not readily sold or not salable at face value on short notice. To some extent, there is a tradeoff, as liquidity of some investments may be achieved at the cost of uncertainty about price that will be received. Stocks of large-capitalization U.S. corporations are highly liquid – a market always exists – but the value can change significantly, even over short periods, and large sales or purchases can affect price. A balance of safety and liquidity may be achieved across a portfolio of different investment instruments with different maturities, especially those with guarantees of principal and interest, whereas no single instrument and no single maturity period can offer both liquidity and safety, especially where a high rate of return (or at least a competitive market rate) is also important.

[15] State Administrative Manual (SAM) Section 7350, "Organization for Fiscal Management, Pooled Money Investment Board" (Revised and Renumbered from 7360 12/95).

[16] See, for example, Public Resources Code Section 14591.4 and Streets and Highways Code Section 2701.17.

[17] Section 16609 of the Government Code states: "Any state officer or employee who deposits any money belonging to or in the custody of the state in any manner other than as prescribed in this chapter or Chapter 4 (commencing with Section 16500) is subject to forfeiture of his office or employment."

[18] The loans to special funds and to anticipate bond revenues are referred to as "Pooled Loans" in the monthly report of the Pooled Money Investment Board, and referred to as "AB 55 loans" by

investment staff. Those loans are authorized by §16312 of the Government Code. We will not dwell on the General Fund or AB 55 loans in this paper, but will only note that the occasional need for such loans is a consideration in the management of pooled money investments.

[19] See especially Government Code Sections 16502 and 16601.

[20] Discussion with Treasurer's Office investment staff, May 31, 2001.

[21] Benton E. Gup, *The Bank Director's Handbook* (Chicago: Irwin, 1996), 136. Gup's brief, simplified example on pp. 135-6 is helpful, showing how a few million dollars in bad loans in an $80 million loan portfolio of a bank with $110 million in assets could turn the bank to undercapitalized status and receivership.

[22] Bank collateral options are listed in California Government Code Section 16522. Options for savings and loans and for credit unions are listed in Section 16612. For a general review of collateral and public deposits, see M. Corinne Larson, *An Introduction to Collateralizing Public Deposits for State and Local Governments* (Chicago: Government Finance Officers Association, 1996).

[23] Girard Miller, with M. Corrine Larson and W. Paul Zorn, *Investing Public Funds*, second edition (Chicago: Government Finance Officers Association, 1998), 157.

[24] Miller, Larson, and Zorn, *Investing Public Funds*, 157-8; also see Peter Smith, "Keeping Municipal Deposits Safe," *American City & County* 106, no. 10 (October 1991), 6.

[25] LAIF background and information may be found at http://www.treasurer.ca.gov/laif/laif.htm.

[26] See Allen, DeSimone, and Tyson, *State Treasury Activities*.

[27] August 2001 *LAIF News*, http://www.treasurer.ca.gov/laif/newsletters/082001.pdf.

[28] Per conversation with Eilene Park, a staff member of the Investment Division of the Treasurer's Office, May 8, 2001. A list of "active participants" provided in May 2001 included 2,513 cities, counties, and various agencies and districts.

[29] Tables in *State Treasury Activities & Functions 2000-2001*, published by the National Association of State Treasurers, appear to suggest that some states invest such funds in other types of instrument. See tables in Chapter 4. (The volume was edited by Chris Allen, Dan DeSimone, and Kathy Tyson, and published by NAST in 2001.) The questions used in developing the tables, however, leave much uncertainty about precisely what types of funds were encompassed in the responses from each state, and whether each state was responding in the same way. For a Government Finance Officers Association policy statement regarding appropriate short-term investment vehicles, and related discussion, see Girard Miller, *Investing Public Funds*, second edition (Chicago: Government Finance Officers Association, 1998), Chapter 6.

[30] One city treasurer's office official advised one of the authors (Umbach) that his city's funds in the pool varied between $5 million and $30 million. This may not be typical, but indicates the kind of inflow and outflow that can take place as funds and needs for the funds ebb and flow.

[31] Chris Allen, Dan DeSimone, and Kathy Tyson, eds., National Association of State Treasurers, *State Treasury Activities & Functions*, 2000-2001 edition (Lexington, Kentucky: NAST, 2001).

[32] Commitment to rolling over or renewing deposits cannot be unconditional, as a guarantee of renewal under any circumstances could invoke a form of moral hazard and place PMIA deposits

at unnecessary risk. Rolling over time deposits must be contingent on the institution's continuing to meet applicable requirements.

[33] For purposes of comparison, the average sum of time and savings deposits in insured commercial banks headquartered in California for 1992-94 was approximately $192 billion, and the average of savings deposits in savings and loans for the same period was approximately $172 billion. Share deposits in California state chartered credit unions rose sharply during the same period, reaching over $24 billion in 1999, but averaging approximately $14 billion over those years. The average in federally chartered credit unions in California over the period 1992-99 was approximately $27 billion. The sum of these averages is approximately $405 billion. (The figures are based on data in the California Department of Finance's *California Statistical Abstract, 2000*, Section L.) The current total of PMIA time deposits (mid-2001) is less than $5 billion, and the figure was substantially less during the 1992-99 period. In short: PMIA time deposits are a very small portion (about one percent) of the sum of savings and time deposits in California banks and thrifts.

[34] Mark Levonian and Jennifer Soller, "Small Banks, Small Loans, Small Business," *FRBSF Weekly Letter* 96-02 (January 12, 1996).

[35] Levonian and Soller, "Small Banks, Small Loans, Small Business."

[36] Although small banks (community banks) have a stronger tendency to lend to small businesses, the mergers and acquisitions of recent years that have subsumed many small banks in larger ones do not necessarily equate to less small business lending. For an exploration of evidence, see Allen N. Berger, Anthony Saunders, Joseph M. Scalise, and Gregory F. Udell, "The Effects of Bank Mergers and Acquisitions on Small Business Lending," draft paper (version reviewed for this paper dated May 1997). Those authors look predominantly at market responses, not developments within particular banks, noting for example that "other lenders step forward" to fill in gaps. They also note that "Contrary to popular belief, acquisitions by out-of-state banking organizations do not appear to be associated with a reduction in small business lending by the participating banks." (Page 34.) Further complicating an already complicated picture, the authors point out that changes in public perceptions and in law and regulatory requirements might change responses of banks: "For example, Wells Fargo pledged to make $25 billion in small business loans in the ten years following its consolidation with First Interstate." (Pages 34-35.) For further discussion of the topic, see also David W. Blackwell and Drew B. Winters, "Local Lending Markets: What a Small Business Owner/Manager Needs to Know," *Quarterly Journal of Business and Economics* 39, no 2 (Spring 2000). Blackwell and Winters observe that even after bank mergers small business lending may be available (possibly even more so), "but at what cost?" That is, the issue may not be so much availability of lending, but terms on which loans are provided.

[37] Robert B. Avery, Raphael W. Bostic, Paul S. Calem, and Glenn B. Canner, "Trends in Home Purchase Lending: Consolidation and the Community Reinvestment Act," *Federal Reserve Bulletin* 85 no. 2 (Feb. 1999), 81-82.

[38] Note that the comparison in table II-4 is not strictly valid because the figures for bank time deposits include *all* time deposits, not just large time deposits. PMIA time deposits fall into the latter category, large time deposits, and are excluded from banks' "core deposits." Comparisons from year to year for EITHER "all CA bank branches" OR "PMIA TDs" *are* valid, but comparisons between "all branches" and "PMIA TDs" are not valid (whether within or between years) because different types of deposit are included in the two sets of figures.

[39] Also important is syndication of large loans, whereby a large bank might originate a large loan (to a major corporation, for example), but parcel out participation to many financial institutions and other participants, such as retirement funds, each taking a portion. Syndication is less pertinent to the issues discussed in this paper than securitization, as the PMIA participates in the latter, but not the former, and securitization contributes to availability of funds for mortgage loans, the type most prominently securitized.

[40] For more information on Freddie Mac, see http://www.freddiemac.com/ , and for more information on Fannie Mae, see http://www.fanniemae.com. Freddie Mac and Fannie Mae differ from Ginnie Mae, the Government National Mortgage Association. Quoting from the Freddie Mac frequently asked questions page, "Ginnie Mae is a government agency within HUD created by Congress to ensure adequate funds exclusively for government loans insured by the Federal Housing Administration (FHA) and guaranteed by the Department of Veterans Affairs (VA) and Veterans Administration" (http://www.freddiemac.com/corporate/about/twlvquest.html#BM9_).

[41] For discussions and explanations of securitization, see Frank J. Fabozzi, ed., *Issuer Perspectives on Securitization* (New Hope, Pennsylvania: Frank J. Fabozzi Associates, 1998), and Leon T. Kendall and Michael J. Fishman, eds. *A Primer on Securitization* (Cambridge, Massachusetts: MIT Press, 1996.

[42] Leon T. Kendall, "Securitization: A New Era in American Finance," in Kendall and Fishman, eds., *A Primer on Securitization*, 11, 13.

[43] Although demand deposits will be drawn upon during monthly or quarterly periods, they will also be replenished, and different depositors use such funds on different schedules. On average, therefore, the total in demand deposit accounts is relatively stable. Where no interest is paid on such accounts, the depositors are indifferent to fluctuations in the interest rate environment.

[44] Forest E. Myers, *Basics for Bank Directors* (Kansas City: Federal Reserve Bank of Kansas City, 1998), 67-68. Myers offers excellent coverage of a wide range of issues facing banks in managing assets and liabilities. The book is available online at the FRBKC Web site.

[45] California Government Code Sections 16505 and 16604.

[46] See Robert E. Litan with Jonathan Rauch, *American Finance for the 21st Century* (Washington, D.C.: Brookings Institution, 1998), 48, regarding impact of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) on regulators' watchfulness.

[47] Because PMIA does not invest in equities (stocks), the variation in its strategy and allocation among types of asset will vary less dramatically than would a typical full-range investment fund with the freedom to invest in stocks, bonds, money market, Treasuries, and derivatives. PMIA does not invest for capital growth, but always for interest. Other types of funds (especially those not having safety and liquidity as top priority) might ignore interest-bearing investments in favor of those offering capital growth opportunity, dividends, or both.

[48] For a discussion of the impact of interest rate declines on bank profits, with some emphasis on circumstances in the Sacramento area, see Mark Anderson, "Interest Rate Cuts to Hammer Bank Profits," *Sacramento Business Journal*, September 28, 2001, 1, 55.

[49] The California Department of Financial Institutions provides a brief overview of the different types of financial institution, and who regulates which, at

http://www.dfi.ca.gov/consumer/REGINFO.htm. There are other types of deposit-taking and lending institutions, but those are not of interest here, and are ineligible for PMIA deposits.

[50] A full discussion of these changes would take far more space than available in this report. For one overview, see Robert E. Litan with Jonathan Rauch, *American Finance for the 21st Century* (Washington, D.C.: Brookings Institution Press, 1998). Also of interest: Martin Mayer, *The Bankers: The Next Generation* (N.Y.: Truman Talley Books/Dutton, 1997. And on the development of securitization, see, for example, Leon T. Kendall and Michael J. Fishman, eds., *A Primer on Securitization* (Cambridge, Massachusetts: The MIT Press, 1996 [paperback edition 2000]). For a look at banking several generations ago, see, for example: William A. Scott, *Banking* (Chicago: A. C. McClurg & Co., 1914); Major B. Foster, *Banking* (N.Y.: Alexander Hamilton Institute, 1918); Walter Leaf, *Banking* (N.Y.: Henry Holt and Company, 1927); and Frederick A. Bradford, *Banking* (N.Y.: Longmans, Green and Co., 1932).

[51] See http://home.ingdirect.com/products/products.html.

[52] FTC, "Credit Scoring," http://www.ftc.gov/bcp/conline/pubs/credit/scoring.htm.

[53] FTC, "Credit Scoring."

[54] For example, see *Federal Register*: October 31, 2000 (Volume 65, Number 211), "HUD's Regulation of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac)," http://198.17.75.65/fril/2000/20001031/00-10311.txt: "However, because of the enhanced roles of credit scoring and automated underwriting in the mortgage origination process, it is unclear to what degree the reduced rigidity in industry standards will benefit borrowers who have been adversely impacted by the traditional guidelines. Some industry observers have expressed a concern that the greater flexibility in the industry's written underwriting guidelines may not be reflected in the numerical credit and mortgage scores which play a major role in the automated underwriting systems that the GSEs and others have developed. Thus lower-income and minority loan applicants, who often have lower credit scores than other applicants, may be dependent on the willingness of lenders to take the time to look beyond such credit scores and consider any appropriate 'mitigating factors,' such as the timely payment of their bills, in the underwriting process." Research done for the Federal Reserve Bank of Atlanta was summarized as follows: "Recent research by Michael Padhi, Lynn Woosley and Aruna Srinivasan of the Federal Reserve Bank of Atlanta suggests, however, that credit scoring applied to small business lending not only does not increase discrimination against business in LMI neighborhoods, but it also seems to increase the level of small business funding available in these areas. The research by Padhi, Woosley and Srinivasan may have serious implications for banks as they endeavor to comply with the Community Reinvestment Act (CRA)." (http://www.frbatlanta.org/publica/econ_south/1999/q3/es_v1n3_3.html.) More recent work supports this finding: W. Scott Frame, Machael Padhi, and Lynn Woosley, "The Effect of Credit Scoring on Small Business Lending in Low- and Moderate-Income Areas," Federal Reserve Bank of Atlanta, Working Paper Series, Working Paper 20001-6, April 2001. The authors' conclusion: "Our analysis suggests that credit scoring is increasing small business lending by reducing asymmetric information problems between borrowers and lenders. This effect appears to be particularly pronounced for LMI [low and moderate income] areas, which historically have had difficulty attracting capital. Overall, these results suggest that low-income areas do benefit from technological enhancements – and that sometimes these benefits are greater than those experienced in higher income areas." (P. 17.)

[55] Consolidations and acquisitions need not mean loss of net branches: "[W]hile the number of banks declined substantially over the period [1980-93], the surge in the number of branches meant that the number of banking offices – banks plus branches – actually increased by over twenty percent." Daniel E. Nolle, "Banking Industry Consolidation: Past Changes and Implications for the Future," Working Paper No. 111, April 1994, presented at "The Financial System in the Decade Ahead: What Should Banks Do," A Conference of The Jerome Levy Economics Institute. (See bibliography above for link to paper online.)

[56] Fred Mendez, "The Big Bank World of CRA," *Community Investments Newsletter* (Federal Reserve Bank of San Francisco), April 2001, p. 15.

[57] Mendez, "Big Bank World," 18.

[58] Like mortgage lending, "payday lending" is developing into a national business. For example, Goleta National Bank participates in the payday lending business by issuing loans offered under the name of institutions elsewhere. Paul Beckett, "Exploiting a Loophole, Banks Skirt State Laws on High Interest Rates," *Wall Street Journal*, May 25, 2001.

[59] Martin Mayer, *The Fed: The Inside Story of How the World's Most Powerful Financial Institution Drives the Markets* (N.Y.: The Free Press, 2001), xi.

[60] *Federal Reserve Research Roundup* (publication of the Financial Markets Center), 1st Quarter 2001.

[61] The Federal Reserve Board describes commercial banks with consolidated assets of $100 million or more as "large commercial banks." See http://www.federalreserve.gov/releases/lbr.

[62] Allen N. Berger, Anil K. Kashyap, and Joseph M. Scalise, "The Transformation of the U.S. Banking Industry: What a Long, Strange Trip It's Been," *Brookings Papers on Economic Activity* 2 (1995), 57.

[63] Research for the Board of Governors of the Federal Reserve System suggests that adoption of credit scoring technologies has led to an increase in small business lending by large banks. More specifically, that report cites a Federal Reserve Bank of San Francisco study indicating such an increase "by the largest banks in the [San Francisco] District," despite "only slight increases in such lending among smaller institutions which typically did not employ scoring technologies . . . ." Federal Reserve System Board of Governors. *Report to the Congress on the Availability of Credit to Small Business* (undated, but apparently 1997 or 1998), 34. That report in turn cites M[ark E.] Levonian, "Changes in Small Business Lending in the West," Federal Reserve Bank of San Francisco, *Economic Letter*, 97-02 (1997). Quoting directly from Levonian's article, "The strong growth in the smallest loans [under $100,000] at the largest banks is consistent with an emphasis on automated loan application and evaluation. As a result of this growth, the largest banks as a group increased their share of these small commercial loans by about 5 percentage points during the year, to 58% of the District total." Levonian's conclusion is more complicated: "The push by big banks into small business lending has been more than just cheap talk. The top banks in the District have strongly increased their commercial loans of less than $100,000 and have taken market share from smaller banks. However, they appear to have retreated from small business loans that are slightly larger and therefore not good candidates for new automated lending processes. Smaller banks have moved into this gap left by the big banks, but have not kept small business loan growth at Twelfth District banks from lagging the rest of the country."

[64] The study, published in *Banking Review*, may be found at http://www.fdic.gov/bank/analytical/banking/1997summ/unified.html.

[65] The following note appeared in the FDIC staff study at this point: "Technically, there are two distinct federal thrift charters, a federal savings-and-loan association charter and a federal savings bank charter. With the very limited exception of mutual state-chartered savings banks that convert to a federal savings bank charter, the two have identical powers and are referred to collectively in this paper as savings associations."

[66] See http://www.ncua.gov/ncua_faq.html#14.

[67] See http://www.ncua.gov/data/cudataexpanded.html for access to lists.

[68] More specifically, the location of the branch (office) of the institution. Deposits are recorded and reported by office (see http://www3.fdic.gov/idasp/ for access to this information), but the deposits become liabilities of the institution as a whole. *Assets*, such as loans, are not reported on an office-by-office basis. For this reason, a summary of deposits in terms of office where the deposits are recorded is not the same as a summary of deposits by location of the financial institutions, as most financial institutions have multiple branches, sometimes hundreds statewide.

[69] Note that a deposit may be booked in a branch in, say, Sacramento County, although the institution might have branches in dozens of counties. *Branches* do not independently have assets or equity capital – only the institution as a whole does. Regulators consider ratios (say, of core deposits to all deposits, or of loans to deposits) for the institution as a whole, not for specific branches.

[70] For related discussion, see John Rutledge, "A Credit Crunch Imperils the Economy," *The Wall Street Journal*, November 2, 2001, A26. This is an opinion piece. Rutledge outlines the impact that bank regulators (specifically the Treasury Department's Office of Comptroller of the Currency) have had in restricting business lending over the past year, despite ample liquidity and a falling interest rate environment.

[71] For a discussion of assessment areas, see Ellen Seidman, "Challenges to Measuring CRA Performance." She points out: "It is not unusual now for an institution to use mail, telephone, loan production offices, agent relationships, affinity relationships, and the Internet to market and deliver banking services. The reach of these systems transcends the [CRA] regulation's focus on assessment areas in evaluating CRA performance." This, from a New Jersey Division of Banking statement, is also of interest: "To this end, the basic requirement on institutions for CRA compliance is that they ascertain and meet the financial services needs of their assessment areas. Although institutions have considerable latitude in defining their assessment areas, they must include all areas in which they have offices and they may not arbitrarily exclude low and moderate income census tracts. If an institution is not generating satisfactory numbers, it must take affirmative steps to reach out into the community and provide the services. In short, it is not enough for such an institution to stay within its own walls, even if it is meticulously careful about not discriminating against those who walk through its doors." From document titled "Community Reinvestment Act," last updated September 14, 1999, available via http://www.naic.org/nj/bcra.htm. Institutions that "reach out into the community" are likely to cross ZIP code lines, so there may be little correlation between ZIP codes for a branch location and ZIP codes within which is provided a significant portion of CRA-related lending and investment. More authoritatively, from the Federal Reserve Bank of San Francisco: "The guiding principle under the new CRA is that

assessment areas must 'consist generally of one or more MSAs (metropolitan statistical areas) or one or more contiguous political subdivisions, such as counties, cities, or towns.' Although the regulation states that banks may adjust their boundaries to include 'only the portion of a political subdivision that it reasonably can be expected to serve,' caution is advised. The regulation goes on to say that an assessment area 'must consist only of whole geographies.'" *Community Investments* 8, No. 4 (Fall 1996), http://www.frbsf.org/publications/community/investments/cra96-4/census.html. For a very recent commentary anticipating a review of CRA rules in 2002, see Edward M. Gramlich, At the CRA and Fair Lending Colloquium, Boston, Massachusetts October 23, 2001. Among other topics, Gramlich comments specifically on assessment areas. See http://www.federalreserve.gov/boarddocs/speeches/2001/200110232/default.htm.

[72] According to a report published by the National Association of State Treasurers, the California State Treasurer has authority over 75% of state funds, while the figure in other states ranges from as little as "none" (Kansas and Kentucky, for example; five states total) to as much as 100% (Arizona and Colorado, for example; 24 states total). The figure for New York is "less than 1%," according to the report. Chris Allen, Dan DeSimone, and Kathy Tyson, eds., *State Treasury Activities & Functions 2000-2001* (Lexington, Kentucky: National Association of State Treasurers, 2001), p. 42 and Table 24 (pp. 50-51).

[73] Allen, DeSimone, and Tyson, *State Treasury*, pp. 50-51. It is not clear that the figures provided there are fully comparable ("apples to apples") from state to state. Florida's 2001-02 budget is around $47 billion, compared to around $104 billion for California. (The numbers for both states are approximate and subject to change.)

[74] California *law* does not specify a similar priority for time deposits. However, according to Treasurer's Office staff, the current *practice* of the Treasurer's Office is to seek first to place PMIA funds in time deposits and to place remaining funds (currently a substantial majority of the funds) in other authorized investments.

[75] For a discussion of "commingled funds," a type of pooled asset fund, see Karen Lee, "401(k) plans take on an institutional look and feel," *Employee Benefit News*, 14, No. 13 (November 1, 2000), http://www.benefitnews.com/subscriber/00_11/retire2.htm.

[76] For pertinent Texas law, see http://www.capitol.state.tx.us/statutes/go/go040400.html#go010.404.024.

[77] Credit unions are not reviewed under CRA, and a similar requirement was not created for them. However, the nature and purposes of credit unions may make such a requirement for them moot in any event.

[78] It is important to note that CRA is specific to *banks and similar regulated financial institutions* (and by extension to certain of their associates), and applies to nothing else. It is a mandate that regulated financial institutions meet the credit needs of their service areas, a mandate originally intended to overcome the impacts of "redlining," which prevented equal access in poorer communities even though such communities placed deposits in financial institutions. The business of banks is banking, and it is conducted within a framework of law and with many benefits and protections provided by government, including deposit insurance. In contrast, governments conduct a wide range of activities, from law enforcement to road building, and from agricultural inspection to education, and do so under the direction of elected legislatures and executive officials. One must be cautious in attempting to apply CRA standards, designed and intended exclusively

for financial institutions (themselves chartered and regulated by federal and state governments), to governments, or in attempting to extend CRA standards to the management of cash and other financial reserves of governments, the function of which is to help support and facilitate the ongoing functioning of the entire range of governmental activities in all communities in the jurisdiction and in relation to every inhabitant of the jurisdiction. Determination of whether a government is serving the convenience and necessity of its citizens is made on grounds quite different from a review of the meeting of credit needs applied to banks under CRA. Governments are not banks; they are subject to review by voters, not by bank regulators, and on a vast range of issues and performance factors.

[79] Merlin Hackbart and Robert Stafford Johnson, *State Cash Balance Management Policy* (Lexington, Kentucky: Council of State Governments, 1975), 15-17.

[80] The disaster that struck New York City on September 11, 2001, dramatically illustrates the importance of geographic diversification, although its impacts appear to be spreading through the economy.

[81] As discussed elsewhere in this paper, the use of collateral also provides benefits to receiving institutions. Please see that discussion in the subsection "What Security is Required for Deposits?"

[82] Alan Greenspan, Appendix to testimony on condition of the U.S. banking system, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, June 20, 2001. The quoted passages are from page 5 of 9 of the document (in the section headed "Funding") as printed from the transcript available at http://www.federalreserve.gov.

[83] This observation reflects conversations with Treasurer's Office investment staff and examination of monthly reports of PMIA activities covering several years.

[84] Undated memo to the authors, received November 2, 2001.

[85] See Mark Anderson, "Interest Rate Cuts to Hammer Bank Profits," *Sacramento Business Journal*, September 28, 2001, pp. 1, 55. Note especially: "[B]anks fund their loans through deposits. While they pay little interest for ordinary savings accounts, they must pay competitive rates for the larger certificates of deposit. And certificates of deposit are essentially contracts guaranteeing an interest rate for anywhere from 30 days to 10 years. When interest rates drop, banks are stuck paying higher rates for certificates of deposit while their interest income dwindles." The situation especially affects community banks: "Community banks make up to 90 percent of their profits on the spread [difference between rate paid for deposits and rate received on loaned funds] . . . . By comparison, the large national and regional 'money center' banks make about half their profit on the spread. They use bank fees and other profit centers for the rest." (Page 55.)

[86] Andrew L. Zehner and George A. Valais, *Linked Deposits: Leveraging for Economic Development* (Chicago: Government Finance Research Center of the Government Finance Officers Association, 1990), p. v.

[87] Treasurer's Office staff indicated that such a program had been suggested in the past (estimated around 1991), but rejected by the Legislature. Going back farther, in 1968, a clause was amended out of AB 1777 that would have added to the criteria for investment in Government Code Section 16480.2 that the investment or deposits "result in the greatest benefit to the economy of the state." According to an Attorney General's opinion, quoted by Treasurer's Office staff in its comments

on a draft of this paper, "The . . . clause was amended out of the bill on July 30, 1968. The inference to be drawn from the deletion of this clause is that the Legislature did not intend to vest in the Treasurer or the Pooled Money Investment Board broad discretionary power in the area of economic policy." The cited source is Richard D. Martland, Deputy Attorney General, Opinion Request No CV 76/153 IL., September 28, 1976. Any consideration of a tied deposit program would need to consider legislative history in this area.

[88] This point is implicit in Government Code Sections 16522 and 16611 ("shall deposit . . . securities . . . approved by the Treasurer"), and is made explicit in practice.

[89] National Association of State Treasurers, *State Treasury Activities & Functions*, 2000-2001 edition (Lexington, Kentucky: NAST, 2001), Table 55 (page 109). See also Appendix, p. 218. Table 55 appears to pertain to demand deposits, but we are unable to determine from the information provided whether the collateral requirements (or lack thereof) also pertain to time deposit programs. For a comparable table, see M. Corinne Larson, *An Introduction to Collateralizing Public Deposits for State and Local Governments* (Chicago: Government Finance Officers Association, 1996), Appendix A (pp. 21-22). Our examination of policies and practices in several states indicated to have no collateral requirement suggest that some of the "no-collateral" states do in fact have collateral requirements for deposits in excess of federal deposit insurance. Some make deposits only after competitive bidding. At least one (Idaho) requires annual reports to state and local investment authorities regarding capital and surplus. Some of the "no collateral" states have little or no funds in time deposits.

Maine law provides for collateral for public funds deposits under certain conditions. See Title 5, Administrative Procedures and Services, § 135, "Deposit of state funds; limitations." Quoting in part: "No sum exceeding an amount equal to 25% of the capital, surplus and undivided profits of any trust company or national bank or a sum exceeding an amount equal to 25% of the reserve fund and undivided profit account of a mutual savings bank or state or federal savings and loan associations shall be on deposit therein at any one time. The restriction shall not apply to deposits subject to immediate withdrawal available to meet the payment of any bonded debts or interest or to pay current bills or expenses of the State. The restriction shall not apply to deposits which are secured by the pledge of certain securities as collateral, nor to deposits fully covered by insurance."

North Dakota law also provides for collateral for public deposits, under terms different from California practices, in lieu of an otherwise mandatory security bond for deposits. An exception is made for the state owned Bank of North Dakota, the only state owned bank in the nation (see http://www.banknd.com for information). *State* funds *must* be deposited in the Bank of North Dakota, and BND is a preferred destination for local agency funds, but not mandatory.

[90] Peter Smith, "Keeping Municipal Deposits Safe," *American City & County* 106, no. 10 (October 1991).

[91] Betsy Dotson, "Collateralization of Public Deposits," *Government Finance Review* 9, no. 3 (June 1993). This position was reiterated and expanded in M. Corinne Larson, *An Introduction to Collateralizing Public Deposits for State and Local Governments* (Chicago: Government Finance Officers Association, 1996). Also see Girard Miller, *Investing Public Funds* (Chicago: Government Finance Officers Association, 1998), 157-158, and the GFOA recommended practice regarding collateralization of public deposits, reproduced on page 375 of *Investing Public Funds*.

[92] The value of corporate bonds can change quickly and sharply when business conditions or company circumstances change. *Security Analysis*, the classic book on investing by Benjamin Graham and David Dodd, published in 1934, was explicit about the risks of bonds, and numerous examples could be cited bonds recently trading at a fraction of par value, even those of "blue chip" corporations. Aside from price fluctuations, corporate bond pricing is difficult, in part because of differing features and risks, even for bonds of the same company. See Craig Carmin, "Price Issues Cloud Corporate-Bond Investing," *Wall Street Journal*, October 18, 2001, C1, C11.

[93] The bank's home page is http://www.banknd.com, and 2000 annual report may be found at http://www.banknd.com/pdf/BND_ANNUAL_REPORT_2000.pdf. The home page summarizes, "Bank of North Dakota, located in Bismarck, ND, is the only state-owned bank in the nation. Its mission, established by legislative action in 1919, is to encourage and promote agriculture, commerce and industry in North Dakota. In this role, the Bank acts as a funding resource in partnership with other financial institutions, economic development groups and guarantee agencies."

[94] Dusan Stojanovic; Mark D. Vaughan; and Timothy J. Yeager, "Is Federal Home Loan Bank Funding A Risky Business for the FDIC?" *The Regional Economist* (Federal Reserve Bank of St. Louis), October 2000, http://www.stls.frb.org/publications/re/2000/d/pages/lead-article.html.

[95] Definition quoted from Stojanovic, Vaughan, and Yeager, "Is Federal Home Loan Bank Funding A Risky Business for the FDIC?"

[96] Yahoo Financial Glossary, http://biz.yahoo.com/f/g/dd.html.

[97] Adapted from *Black's Law Dictionary*, Revised Fourth Edition.

[98] See Kenneth Spong, *Banking Regulation: Its Purposes, Implementation, and Effects*, Fifth Edition (Kansas City: Federal Reserve Bank of Kansas City, 2000), 105-107.

[99] See Nicholas Kulish and Jacob M. Schlesinger, "How Fannie Mae Beat Effort by Adversaries to Rein it In," *Wall Street Journal*, July 5, 2001, A1, A14. Also see CBO testimony and study listed in the Sources section of this paper.

[100] David L. Scott, *Wall Street Words*, revised edition (Boston: Houghton Mifflin, 1998), p. 236.

[101] Summit Mutual Funds prospectus, February 1, 2001, p. 16.

[102] TIAA-CREF Mutual Funds prospectus, April 1, 2001, p. 33.

[103] Vanguard Admiral Treasury Money Market Fund prospectus, May 31, 2001, p. 1.

[104] Quoted by M. Corinne Larson in *An Elected Official's Guide to Investing* (Chicago: Government Finance Officers Association, 1996), 3.

[105] Leon T. Kendall, "Securitization: A New Era in American Finance," in Leon T. Kendall and Michael J. Fishman, eds., *A Primer on Securitization* (Cambridge, Massachusetts: The MIT Press, 2000), 1-2.

[106] Financial Code, Section 146.1:

"'Small bank'" means a bank that, as of December 31 of either of the prior two calendar years, had total assets of less than two hundred fifty million dollars ($250,000,000) and was independent.

"This section shall become inoperative on November 30, 2004, and as of January 1, 2005, is repealed, unless a later enacted statute, that is enacted before January 1, 2005, deletes or extends the dates on which it becomes inoperative and is repealed."

[107] David L. Scott, *Wall Street Words*, revised edition (Boston: Houghton Mifflin, 1997), 388.