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Investment of California's Short-Term Funds

By Rosa M. Moller, Ph.D.

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R E S E A R C H B U R E A U

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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. Our thanks go to all who shared time and gave insights to this project.

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EXECUTIVE SUMMARY

WHY THIS REPORT?

Some Californians feel that the State should put its investment money to work more aggressively for its own citizens. The most obvious way to do this would be to deposit more state money in local banks. The local banks, the logic goes, turn around and use more state money to make more loans to businesses and individuals in their neighborhoods. It sounds simple, but well-intentioned policies must work in a complex 2003 financial landscape. The state has to keep public money safe and earning high interest rates in a global marketplace where banks have diversified.

However, policy makers in California might be able to revise its laws and policies in small ways that would funnel more money, by way of community banks, to local communities, especially financially-stressed communities, without jeopardizing the safety of public funds or losing interest. That's what this report is about. This report responds to a mandate of the legislature directing the California Research Bureau to study this issue. (AB 2805, Assembly Member Papan, 2000).

The State Treasurer's Office has the responsibility of investing the money we talk about in this report, the State of California's surplus cash. So, in AB 2805, the Legislature really asks if *the Treasurer's Office* could do more to "keep public funds working for Californians, and ensure that a significant portion of publicly invested funds reach California's local communities."

The present State Treasurer *already* believes that the state's surplus cash should help California's communities, and our analysis of the Treasurer's Office investment policies indicates that more funds have been allocated to California communities. A notion like the legislature's was on Treasurer Angelides' mind in May 2000 when he published *The Double Bottom Line: Investing in California's Emerging Markets*. Angelides argued in 2000 that both public and private investors were ignoring good investment opportunities in poorer California communities and often making much higher risk investments in other countries. The state keeps its idle cash balances in the Pooled Money Investment Account (PMIA). The state also allows local governments to park their money in this account. PMIA investment data are consistent with Angelides optimistic view for California, with a few qualifications.

Time deposits in banks and other depository institutions have increased steadily from January 1999 through July 2003, from around \$2 billion to around \$5.7 billion. The share of the PMIA's total assets placed in these time deposits also increased from less than one percent in 1994/95 to more than 10 percent in 2002/03. For many, this is the form of PMIA investment that most directly puts funds in the hands of California banks. They can then use these to make loans to local businesses (although they may also do a number of other things with it, including making out-of-state loans).

As of June 2003, the distribution of PMIA bank time deposits closely follows the distribution of time deposits in all California banks, with a slight shift towards smaller banks. Around 82 percent of the PMIA's assets in time deposits are placed with a small number of very large banks (with assets over \$1 billion). That is down from 85 percent in 1998. Time deposits in large banks (assets from \$500 million to \$1 billion) increased from 5.3 to 11.5 percent during this five-year period. The share of the PMIA's time deposits in smaller banks (assets of \$300 million or less) increased from 4 percent to 4.8 percent during the five years. But the share of deposits in smaller banks is significantly less than in the year 2000, when the share of PMIA's time deposits in smaller banks was almost 8 percent. The decrease of the share of PMIA's time deposits in smaller banks is partly explained by recent bank consolidation, which decreased the number of small independent banks. As these banks became branches of larger banks, PMIA deposits in those banks now appear as deposits in larger banks. On the other hand, the number of institutions participating in the time deposit program has increased significantly over time. In the year 2003, PMIA time deposits were held by 91 banks, 18 savings and loans and 13 credit unions, while in 1998, only 33 banks and three savings institutions held these deposits.

PMIA time deposits with banks are not evenly distributed around the state. In June 2001, PMIA time deposits per person were \$364 in the seven counties around Sacramento, \$271 per person in the 10 counties around San Francisco, and only \$117 per person in the five counties around Los Angeles and \$61 per person in the combined area of San Diego and Imperial Counties. Although uneven, this distribution is more even than the one in 1995, when time deposits were much more concentrated in the Sacramento and San Francisco areas.

The PMIA holds diverse investments, as it should. Many, such as federal notes and bonds, are not focused on California by their nature. The PMIA does, however, invest in certain California-specific securities. These include packages of California-only small business loans backed by Small Business Administration guarantees. The Treasurer has also pioneered development of packages of California mortgages, emphasizing those from lower income neighborhoods. The Treasurer has substantially increased PMIA investment in both of these kinds of securities over the last five years.

This report looks at the following questions:

- What are the current investment practices of the Treasurer's Office?
- Can those policies be improved so that California's surplus cash can better help California's economically stressed communities?
- Can California learn from the best practices of other states?
- Could the Treasurer's Office investment process be modified to put more money in those small banks that the federal government has given passing investment and lending grades under the Community Reinvestment Act (CRA)?

INTRODUCTION

The legislature directed the California Research Bureau to study how California invests its funds, focusing on the degree to which these investments support California's economy (through AB 2805, Assembly Member Papan, 2000). This report responds to that request.

The legislation and this report focus on the State of California's idle cash balances (called surplus funds). These are monies, such as tax collections, that are not yet needed to pay current expenses.

The state is no different than anyone else in trying to best figure out how to manage its cash. Households typically keep their idle cash balances in a checking account or a money market account. The state keeps its idle cash balances not in a checking account but in the Pooled Money Investment Account (PMIA). The state also allows local governments to park their money in the PMIA. In 2002/2003, this state/local account had an average balance of \$52.6 billion. Interest earnings on this money amounted to more than \$1.1 billion, serious money even by state government standards.

The Treasurer's office is vested with the significant responsibility of managing the PMIA. The Pooled Money Investment Board (PMIB) oversees the PMIA and how the Treasurer's Office invests the PMIA funds.

California needs these mind-boggling sums to work hard for the people of California, but it has to be cautious. Although the state wants PMIA to earn high returns, the state simultaneously needs to ensure the invested money's safety (Orange County's bankruptcy of a few years ago was caused by the catastrophic failure of investments in the county's self-run version of the PMIA). The state would like to stimulate its economy but also needs the money to be accessible and thus, cannot lend the money for extended periods of time.

It is widely thought that PMIA time deposits in branches of California banks and savings and loans are particularly likely to stimulate California's economy, since these institutions are reasonably likely to use the funds to lend to local businesses or homebuyers. So it is encouraging that time deposits make up a large and growing part of the monthly investment activity in the PMIA portfolio. During 2002/2003 they comprised more than 10 percent of PMIA holdings and grew about 261 percent from June 1998 through June 2003. That's from \$1.5 billion to over \$ 5.5 billion.

How do these time deposits help the economy? Here's a best-case scenario:

A small bank in a California community might use funds the state deposited at the bank to make loans to local businesses. The businesses would grow, and hence create local jobs and local income. And if the locally-invested funds help low-income people have better jobs, and minority entrepreneurs get started, so much the better. This best scenario requires the state make these investments without

having to accept a lower rate of return than the ones offered by other alternative forms of investment.

Assembly Bill 2805 (Chapter 913, Statutes of 2000)

In this bill, the California Legislature asked the California Research Bureau to examine where California's surplus cash goes, how it gets there, and if the surplus cash is invested in ways that help California's communities. The legislature specifically asked about the "feasibility and social benefits" of California investing along the "guidelines" of the CRA. The Community Reinvestment Act (CRA) is a federal act that requires banks to meet the credit needs of their communities. The federal government fine-tuned the act in 1995, and the CRA now tests and rates the small, large, and special-purpose banks on how successfully banks help to meet these needs. The California legislature wanted to know if and how we can implement such policies within the state Treasurer's Office.

The law also requests information about the geographic and socioeconomic distribution of funds. This phrase means the physical place where the investments are put to work: who lives there; and what is the economic health of that place. This task was partially accomplished because it is almost impossible to find where the investments in tradable securities and deposited money are actually used. So we focused on where banks that receive state funds in the form of time deposits are. To show the reader these features, we include tables that summarize the locations of branches into which the state has placed deposits and the characteristics of those branches' areas or neighborhoods.

The Legislature had specific suggestions in AB 2805. These included:

Requiring the Treasurer's Office to follow guidelines similar to CRA.

Allocating funds for specific investment purposes.

Mandating that a set percentage of California's public funds be used in California.

Identifying impediments, if any, to community banks' receipt of public money, such as money from the Pooled Money Investment Account.

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 discuss these options and suggest some potential policy actions that the legislature may want to consider.

I. THE COMMUNITY REINVESTMENT ACT (CRA)

Since AB 2805 specifically asks if federal CRA standards and tests might be appropriate for California investment practices, we will start with a short discussion of the federal law. The CRA requires regulated banks and savings and loans to meet the credit needs of their communities. Regulators periodically review the record of banking institutions and provide a rating on CRA investments.

Since CRA testing and rating of banks began, analysts have found that available credit to low- and moderate-income areas and individuals has increased, and regulated banks have learned they can profit from lending to this group.¹ CRA-qualified investments include those designed for revitalizing or stabilizing low- or moderate-income areas, or providing affordable housing for or community services to low- to moderate-income persons.

If a regulated bank fails CRA tests, it risks being unable to gain the approval of regulators for mergers, acquisitions, or changes in branches. It also looks bad in the neighborhood² and no one wants to look bad in the dog-eat-dog world of the financial services industry.

CRA'S RELEVANCE TO THE TREASURER'S OFFICE

Although CRA guidelines only apply to private banks and savings and loans, rather than public organizations or any other type of business, policy makers have proposed requiring that public investments, such as those made by the PMIA, also follow CRA guidelines. AB 2805 asks if a CRA-like rating with CRA-like criteria (community-based investing) applied to the Treasurer's Office and its investment policy might increase community-based investing. It's a hard comparison to make, as we'll see, because banks are retail businesses and the Treasurer's Office is a wholesale lender.

TREASURER'S OFFICE COMMITMENT TO CRA TYPE OF INVESTMENTS

By happy coincidence, the State Treasurer, Phillip Angelides, *already* believes that the state's surplus cash should help California's communities. A notion like the legislature's was on Angelides' mind in May 2000 when he published *The Double Bottom Line: Investing in California's Emerging Markets*. Angelides argued in 2000 that both public and private investors were ignoring good investment opportunities in poorer California communities and often making much higher risk investments in other countries. Angelides also proposed increasing Pooled Money Investment Account investments in California communities.

Angelides notes in *The Double Bottom Line*³ that his office invests in the spirit of the CRA, with California's "underserved communities" in mind. He also wrote that "the State Treasurer is sponsoring legislation to link state and local government deposit policies to performance under the CRA to spur lending to California's underserved communities."⁴ The legislation passed, and now financial institutions need a

“satisfactory” CRA rating before they can receive time deposits from the state’s enormous account.*

In a sense, the legislature’s request in AB 2805 asks whether the Treasurer is practicing what he preached in *Double Bottom Line*. The answer is “yes.” In contrast to comparable agencies in other states, the California Treasurer’s Office invests state funds in ways consistent with CRA purposes.

* AB 2708, Chapter 1036, Statutes of 2000, Section 16500 et seq of the Government Code.

II. CALIFORNIA'S FUNDS FOR INVESTMENT

INVESTMENT CRITERIA

When the Treasurer makes investment decisions for the state's surplus cash, the Treasurer is much like any other investment manager. The State looks for investments that yield high return rates, but subject to at least two qualifications (1) being able to access surplus money fast, in case it is needed (in other words, maintaining a certain level of *liquidity*), and (2) keeping the money in safe investments. As most investors know, there is a trade-off between high returns and safety since, in general, the higher the risk the greater the return. Investment managers earn their stripes by maximizing the return on their clients' money while maintaining the level of liquidity and safety the clients demand.

PMIA funds belong to the State of California and to the state's local governments. Once local funds, the money in the Local Agency Investment Fund (LAIF) account, are deposited into the greater, PMIA fund, the Treasurer's Office manages the local and state money as a whole. Because of this commingling, we don't break out the local, LAIF, funds in this report.

The Treasurer is constrained compared to most investment managers. Although the individual investor has a choice about whether or not to take a gamble on the equities market, or speculative long-term investments, it is against the law for the Treasurer's Office to take such risks with public money. The Investment Division of the State Treasurer's Office manages PMIA in a way that balances (a) liquidity (b) safety, (c) access, and (d) high return rates; investment criteria that adhere to California law dictating where PMIA money should go.⁵ The Treasurer's investment staff is directed by the Pooled Money Investment Board (PMIB), composed of the State Treasurer, the State Controller, and the Director of the Department of Finance, to follow these principles.

In step with these rules, PMIA 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.

WHAT CALIFORNIA LAW ALLOWS THE PMIA TO BUY

In accordance with California Government Code Section 16430, the Treasurer's Office can only buy the following investment instruments for the PMIA:

- 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 instruments 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.

Generally, the law allows California to invest in the same instruments as other states. However, some states, such as New York, New Hampshire, and New Mexico, invest only in negotiable CDs issued by banks within the state, while California invests in both out of state and within state CDs.⁶

DEFINING TERMS: DIFFERENT KINDS OF DEPOSITS AND THE PMIA

Since AB 2805 requires this study to look at investments that directly benefit California, most of our analysis focuses on time deposits, because these investments can be linked more easily to California communities than other forms of investment. For example, due to active trading, it is difficult to link investments in commercial paper or bonds to the localities where these securities originated.* In this section we define some terms as a background to the analysis that is developed in later sections.

There are two key kinds of deposits that the Treasurer’s Office makes via the Pooled Money Investment Account (PMIA) in financial institutions around the state. They are demand deposits and time deposits. To understand the distinction between these two types of deposits, let’s think of our household accounts again.

When you want to access, to *demand*, your cash quickly, without penalty, you put it in your checking account – you have made a demand deposit. In this *demand account* your money doesn’t earn much interest but you are deliberately bypassing profit to be able to access your money quickly. The State of California also needs to get to its surplus cash quickly. Tax payments are concentrated at certain times of the year and are deposited into the PMIA. The state needs access to some of the collections very soon to pay for government’s expenses. So the Treasurer’s Office places chunks of PMIA money in *demand accounts* in banks statewide.

If, however, you can afford to put aside money that you know you will not need for a specific time period, you can put your money in a *time* deposit, which most people will think of as a type of savings account. You decide that for a concrete time period, six months, a year, and so on, you will not need that cash. The institution gives you a higher interest rate for your money than it did for the demand deposit and you agree that it can

* Extensive research supports the notion that money from deposits in local banks and other depository institutions tends to support investment activities in the communities where these institutions are located.

penalize (charge) you if you withdraw your money before the allotted time. Your money earns more interest in a *time deposit*, but you have forfeited access to your money unless you want to pay a penalty. One familiar type of *time deposit* is the widely advertised Certificate of Deposit or CD.

The Treasurer's Office, we'll see, has a high and growing percentage of PMIA money in *time deposits*. Time deposits' life spans are short compared to bonds and other safe investment instruments, but they do offer a higher return than demand deposits. Like any longer-term investment, time deposits require accurate financial forecasting.

WHERE THE PMIA DEPOSITS CAN GO: BANKS, SAVINGS AND LOANS, AND CREDIT UNIONS

California law also limits where the Treasurer's Office may deposit public funds and how much the Treasurer's Office can deposit in any single institution. Banks, savings and loans, and credit unions are normally the only institutions eligible to receive PMIA funds.

- California law says an institution must meet these criteria before receiving investments of public funds:⁷
- A "satisfactory" Community Reinvestment Act rating.
- Collateral for most deposited public funds.

HOW THE PMIA DEPOSITS IN ELIGIBLE INSTITUTIONS

Limits Established for Deposits

The Government Code limits deposits in banks and savings and loans to not more than the institution's "net worth."⁸ The Treasurer's office staff obtains information on net worth from regular reports by banking regulators, who use the term "equity capital."⁹ Equity capital is usually a very small fraction of assets. This means that public deposits can rarely exceed a very small fraction of the assets or of the deposits of an institution, an important practice to enhance the safety of the state's funds.

To further improve the security of the investment, the Government Code also specifies that some form of collateral secure the state's time deposits and demand deposits. The security is required when the state deposits exceed the \$100,000 federal deposit insurance, which it almost always does. There are many authorized forms of security:

- 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.

The security must equal 110 percent of the deposit.* This extra percentage protects the state, but also allows the financial institution to gain some confidence that the state won't summarily withdraw the deposit if modest fluctuations in markets affect the collateral's value. Investors tend to withdraw non-collateralized non-insured deposits in the event of any perceived credit risk, making large time deposits an insecure source of funds. The collateral requirement increases the chances of the state maintaining funds with the institution, an action that helps financial stability.

Collateral requirements can be too restrictive for some institutions. AB 2805 included a new type of collateral that has made it easier for smaller banks to participate in the Treasurer's time deposit program.

Interest Rates on Time Deposits

In California, banks pay interest rates on time deposits of 0.02 to 0.15 percent in interest over a treasury note of comparable maturity.† Lower-rated institutions would pay rates at the higher end of this range, while higher-rated institutions would be at the lower end.

ISSUES IN ASSET AND LIABILITY MANAGEMENT

A bank's *assets* are instruments like loans; the bank is the creditor. Its *liabilities* are instruments like time deposits; the depositor is loaning the bank money; the bank is liable for the return of that deposit, and the interest on the deposit.

The bank's job is to use the deposit profitably, to make that liability work while the bank is responsible for it. For example, a bank might take in a \$1,000,000 deposit and pay a five percent rate of interest to the depositor. The bank then would turn around and lend out the same \$1,000,000 at eight percent.

So, banks enjoy an advantage with deposits of long maturity so that they have more time to make money 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).¹⁰ Likewise, regulators prefer a high proportion of banks' deposits to be in the form of core deposits, as those are the most stable source of funds.

* A higher percentage applies in some cases.

† That is two to 15 basis points over a treasury of comparable maturity. By definition, 100 basis points is one percentage point. For example, 25 basis points means one-quarter of a percent in interest.

California law regulating time deposits of the Pooled Money Investment Account limits such deposits to not more than equity capital of the depository institution.¹¹ The state must reduce its deposit if the equity capital of a bank, for example, 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.¹² Because PMIA time deposits tend to be a larger proportion of equity capital for 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.

III. CURRENT PMIA INVESTMENTS

The Pooled Money Investment Account (PMIA) was worth about \$55.4 billion as of June 30, 2003.

PMIA *demand accounts* (analogous to checking accounts) are but a small portion of the total fund. As of June of 2003, demand accounts held about 2.8 percent of the total PMIA funds, a higher proportion than in previous years. In 1995, these balances averaged less than 0.6 percent.

Table 1 shows the distribution of these accounts by the bank asset size for fiscal years 1995 through 2003.

Table 1						
Pooled Money Investment Account (PMIA)						
Demand Accounts Balances as of June 30 (In thousands)						
Bank Size Assets	1995	1998	2000	2001	2002	2003
Greater than \$5 Billion	\$164,396	\$669,760	\$770,281	\$730,651	\$937,609	\$1,544,376
Up to \$5 Billion		\$48	\$3,115	\$4,988	\$12,026	\$32,691
Total	\$164,396	\$669,808	\$773,395	\$735,639	\$949,635	\$1,577,067
Source: California Office of the State Treasurer						

Table 2 shows the distribution of all PMIA funds for various fiscal years from 1995 through 2003. We notice over time a significant decrease of treasury obligations in the portfolio, although the relative proportion of holdings of U.S. Treasury Bonds and Notes increased significantly in 2002/2003. We also see a significant increase in time deposits. GNMA and FHLMC are long-term investments held for about 20 years. Once these investments mature, they will be replaced by shorter-term securities. The current policy is to invest in securities with maturities no longer than five years. The average yield of the portfolio was fairly steady until the fiscal year 2000/2001, but yields have decreased significantly during the last two fiscal years, mainly due to the current financial market conditions and prevailing low interest rates.

Shortages in the state General Fund do not radically affect PMIA investments, for several reasons. First, a significant portion of the PMIA is made up of local funds. Second, if the General Fund borrows money to meet its obligations, this money is invested in the PMIA until it is spent, adding to cash balances. However, when the State budget is tight, the average life of PMIA investments shortens to meet increased cash demands.

Table 2

POOLED MONEY INVESTMENT ACCOUNT PORTFOLIO COMPOSITION (Selected Years)

	1994/1995	Percent	Effective	1997/1998	Percent	Effective	2002/2003	Percent	Effective
	Average Daily	of	Yield for	Average Daily	of	Yield for	Average Daily	of	Yield for
	Portfolio	Portfolio	Year	Portfolio	Portfolio	Year	Portfolio	Portfolio	Year
U.S. Treasury Bills/Strips	\$3,736,571,873	13.94%	5.20%	\$1,938,670,027	6.61%	5.63%	\$839,032,383	1.59%	1.53%
U.S. Treasury Bonds and Notes	\$6,538,492,411	24.40%	5.37%	\$5,434,581,766	18.52%	5.53%	\$6,436,185,173	12.23%	3.37%
Federal Agency Coupon Securities	\$1,070,168,683	3.99%	5.65%	\$1,817,706,835	6.19%	5.89%	\$4,177,431,296	7.94%	3.93%
Federal Agency Discount Notes	\$164,642,142	0.61%	5.31%	\$804,086,802	2.74%	5.69%	\$7,676,817,371	14.58%	1.50%
GNMA	\$16,075,341	0.06%	8.16%	\$2,624,793	0.01%	12.01%	\$674,908	0.00%	11.90%
FHLMC	\$47,575,438	0.18%	9.64%	\$25,615,646	0.09%	9.63%	\$6,046,915	0.01%	9.64%
Negotiable Certificates of Deposit	\$6,682,813,378	24.93%	5.61%	\$7,826,928,357	26.67%	5.74%	\$8,994,926,405	17.09%	1.55%
Time Deposits	\$217,522,247	0.81%	5.62%	\$1,076,267,781	3.67%	5.34%	\$5,313,014,712	10.09%	1.59%
Bankers Acceptances	\$1,261,898,919	4.71%	5.62%	\$413,851,403	1.41%	5.77%	\$0	0.00%	0.00%
Commercial Paper	\$6,183,517,314	23.07%	5.62%	\$6,541,833,773	22.29%	5.72%	\$11,433,556,267	21.72%	1.61%
Corporate Bonds	\$1,286,302,875	4.80%	5.99%	\$1,760,774,832	6.00%	5.94%	\$2,193,113,396	4.17%	3.93%
Repurchase Agreements	\$312,859,959	1.17%	5.28%	\$37,798,921	0.13%	5.62%	\$18,947,945	0.04%	1.43%
Reverse Repurchase Agreements	-\$1,057,642,319	-3.95%	-5.07%	-\$376,042,913	-1.28%	5.25%	-\$50,564,033	-0.10%	1.54%
AB55 Loans	\$225,243,711	0.84%	5.24%	\$1,805,762,786	6.15%	5.66%	\$3,918,799,247	7.45%	2.42%
General Funds Loans	\$116,081,096	0.43%	4.60%	\$234,051,507	0.80%	5.69%	\$1,678,665,918	3.19%	2.11%
Total Portfolio	\$26,802,123,068	100%	5.53%	\$29,344,512,316	100%	5.70%	\$52,636,647,903	100.00%	2.15%

Source: California Office of the State Treasurer

POOLED MONEY INVESTMENT ACCOUNT PORTFOLIO COMPOSITION (2001-2003)

	2000/2001	Percent	Effective	2001/2002	Percent	Effective	2002/2003	Percent	Effective
	Average Daily	of	Yield for	Average Daily	of	Yield for	Average Daily	of	Yield for
	Portfolio	Portfolio	Year	Portfolio	Portfolio	Year	Portfolio	Portfolio	Year
U.S. Treasury Bills/Strips	\$2,646,954,548	6.04%	6.01%	\$1,355,272,871	2.72%	3.59%	\$839,032,383	1.59%	1.53%
U.S. Treasury Bonds and Notes	\$3,056,497,078	6.97%	5.77%	\$4,709,440,928	9.45%	4.76%	\$6,436,185,173	12.23%	3.37%
Federal Agency Coupon Securities	\$3,282,193,454	7.49%	6.21%	\$4,780,029,269	9.59%	4.61%	\$4,177,431,296	7.94%	3.93%
Federal Agency Discount Notes	\$9,011,738,061	20.56%	6.37%	\$10,552,162,814	21.18%	3.29%	\$7,676,817,371	14.58%	1.50%
GNMA	\$1,166,433	0.00%	11.83%	\$860,326	0.00%	11.88%	\$674,908	0.00%	11.90%
FHLMC	\$11,353,297	0.03%	9.64%	\$8,585,735	0.02%	9.64%	\$6,046,915	0.01%	9.64%
Negotiable Certificates of Deposit	\$8,184,759,498	18.67%	6.13%	\$8,564,155,942	17.19%	2.86%	\$8,994,926,405	17.09%	1.55%
Time Deposits	\$4,317,935,890	9.85%	5.82%	\$5,031,746,918	10.10%	2.86%	\$5,313,014,712	10.09%	1.59%
Bankers Acceptances	\$11,464,798	0.03%	6.59%	\$8,473,313	0.02%	1.94%	\$0	0.00%	0.00%
Commercial Paper	\$9,273,506,834	21.15%	5.92%	\$10,312,154,515	20.70%	2.69%	\$11,433,556,267	21.72%	1.61%
Corporate Bonds	\$2,304,913,906	5.26%	6.27%	\$1,846,073,528	3.70%	4.64%	\$2,193,113,396	4.17%	3.93%
Repurchase Agreements	\$5,808,219	0.01%	5.71%	\$19,361,644	0.04%	1.86%	\$18,947,945	0.04%	1.43%
Reverse Repurchase Agreements	-\$857,535,461	-1.96%	5.81%	-\$424,825,385	-0.85%	1.64%	-\$50,564,033	-0.10%	1.54%
AB55 Loans	\$2,589,664,164	5.91%	6.34%	\$2,735,413,668	5.49%	4.41%	\$3,918,799,247	7.45%	2.42%
General Funds Loans	\$0	0.00%	0.00%	\$328,170,685	0.66%	2.77%	\$1,678,665,918	3.19%	2.11%
Total Portfolio	\$43,840,420,720	100.00%	6.10%	\$49,827,076,771	100%	3.45%	\$52,636,647,903	100.00%	2.15%

Source: California Office of the State Treasurer

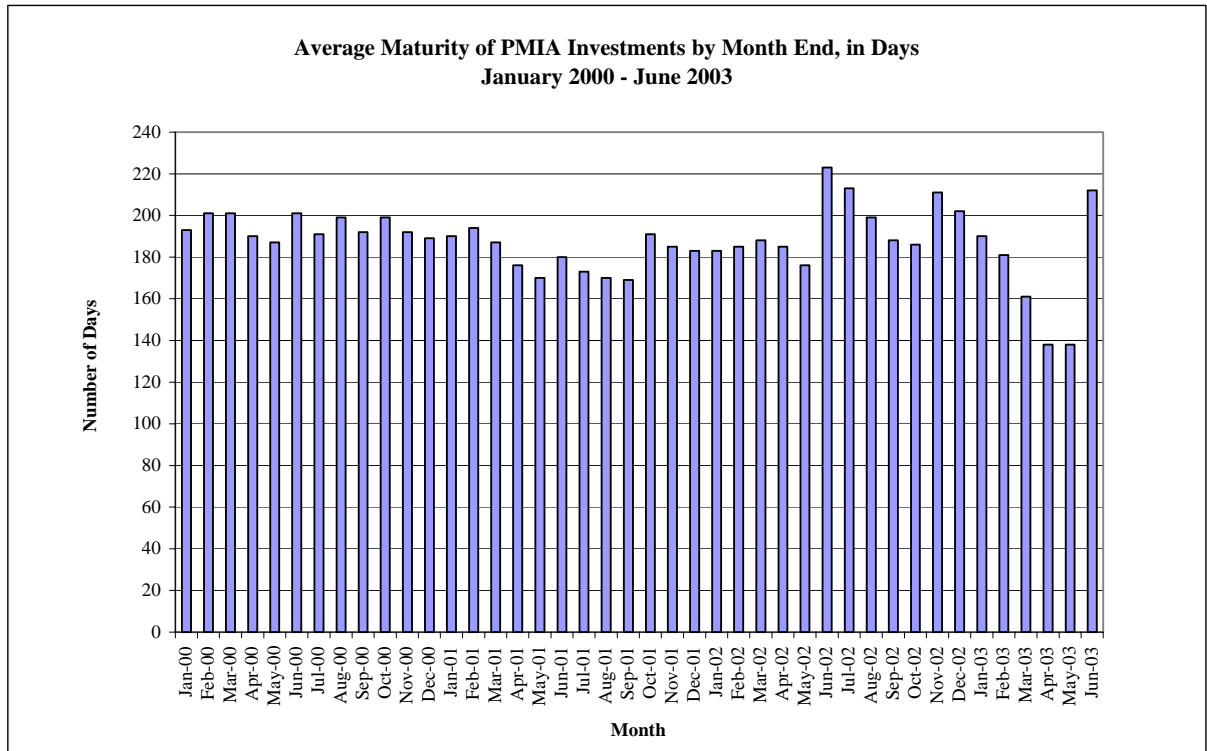
Investment Activity

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. The Treasurer's Office makes investment decisions on a daily basis. Monthly investment activity as a percentage of total portfolio value is substantial. For example, during the calendar year 2000, the lowest monthly investment turnover was 43 percent of the portfolio (in July) while the largest monthly proportion of the portfolio invested was 86 percent (in February).

The average maturity of PMIA investments varies over time. Average maturity shrinks as liquidity needs of the state and local governments grow. For example, when large repayments are due, the portfolio managers must be sure that enough instruments will matured at the same date, to be sure to cover expected outflows. This decreases the overall average life of the fund investments. If interest rates are low, it is not worth taking the risk of running a cash shortage, so a higher proportion of the PMIA funds will be held in cash.

During the last couple of years, the energy crisis and budget problems have increased the liquidity needs of the PMIA. Significant Revenue Anticipation Warrants and Revenue Anticipation Notes have been issued to purchase power during the energy crisis of 2001, for example. PMIA managers had to be sure that they would have enough cash when it was needed to repay those borrowings. This is the reason for the sharp swings in average maturity shown in Chart 1 in 2002 and 2003. If interest rates continue to be low and there are no major changes in tax collections, chances are that at the end of the fiscal year 2003/2004 there will a significant drop in the average maturity of the PMIA investments.

Chart 1



California-Specific Investments in the PMIA

AB 2805 requires this study to look at investments that benefit California. If this means an examination of all investments made with PMIA funds, it is an exercise in judgment, at best. Most securities have only a loose attachment to any particular geographical place. Commercial paper issued by a large corporation might be used to pay for a plant expansion in Los Angeles, or in New Jersey, or in Bangalore, even if the corporation is headquartered in San Francisco.

The Office of the Treasurer provided us with a list of investments which they felt clearly help California communities, such as securitized low-income home mortgages and securitized small business loans. Furthermore, research has shown that money from deposits in local banks and other depository institutions tends to support investment activities in the communities where these institutions are located.

Table 3 shows investments that the Treasurer’s Office identifies as California-only investments. These include securities that are backed by small business loans made by California banks to businesses in CRA-eligible census tracts in California. 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.

The second category includes “California-only first time homebuyers” mortgage pools or mortgage-backed securities. The Treasurer’s Office buys these through major investment banks or from the Federal Home Loan Banks and 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 identifiable as California institutions, either because they primarily operate in California or because they are headquartered in California. For example: Union Bank corporate bonds or notes, Union Bank commercial paper, or Wells Fargo medium-term notes. The degree to which investments in this category benefit California is not completely clear. Wells Fargo notes might be used to fund construction of a new branch office in almost any state in the country, or even in Latin America, for example. Nevertheless, Wells Fargo is recognizable as a California firm.

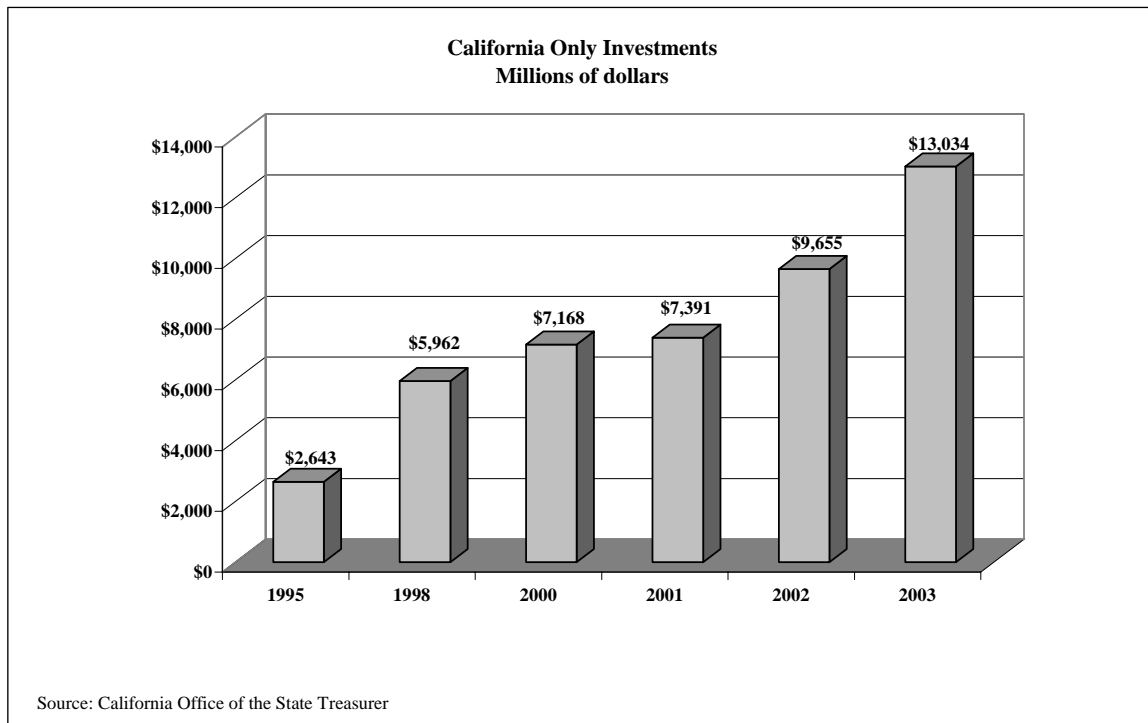
The fourth category is “time deposits,” PMIA deposits held in bank branches throughout California.

Table 3

Summary of California-Only Investments as of June 30, as Identified by the California Treasurer's Office``										
Type of Investment	As of June 1995	% of CA Only Inv.	As of June 1998	% of CA Only Inv.	As of June 2001	% of CA Only Inv.	As of June 2002	% of CA Only Inv.	As of June 2003	% of CA Only Inv.
California Only Small Business Loans	\$70,077,519	2.7%	\$236,668,668	4.0%	\$305,789,970	4.1%	\$260,367,998	2.7%	\$418,306,691	3.2%
California - Only First Time Homebuyers	\$375,371,855	14.2%	\$118,567,445	2.0%	\$529,607,202	7.2%	\$645,656,422	6.7%	\$545,989,262	4.2%
California - Only Misc. Investments	\$1,924,987,239	72.8%	\$4,062,293,401	68.1%	\$1,690,000,000	22.9%	\$3,570,969,381	37.0%	\$6,494,388,588	49.8%
Time Deposits	\$272,290,000	10.3%	\$1,544,890,000	25.9%	\$4865,145,000	65.8%	\$5,177,695,000	53.6%	\$5,575,095,000	42.8%
Total California - Only Investments	\$2,642,726,613	100%	\$5,962,419,514	100.0%	\$7,390,542,172	100%	\$9,654,688,801	100%	\$13,033,779,541	100.0%
Source: California Office of the State Treasurer										

Chart 2 shows the share of California-Specific PMIA Investments, as identified by the Treasurer’s Office. These investments have more than doubled since 1995. As a proportion of the PMIA portfolio, California-specific investments, as identified by the Treasurer’s Office, increased from about 10 percent of PMIA investments in 1995, to 25 percent in the year 2003. The chart is a little less impressive if the comparatively ambiguous category of “California Only Miscellaneous Investments” is taken out, but the overall trend of increasing California investment of PMIA money remains.

Chart 2



TIME DEPOSITS AS PART OF THE PORTFOLIO

California is one of ten states that use time deposits in their investment strategies. Time deposits in the PMIA have grown steadily in dollar terms in recent years: doubling from \$2.9 billion in January 2000 to more than \$5.6 billion in June 2003. As shown earlier, time deposits increased more than three times from June 30, 1998 to June 30, 2003, and by almost 15 percent between the fiscal year 2001 and 2003. (Chart 3)

Chart 3

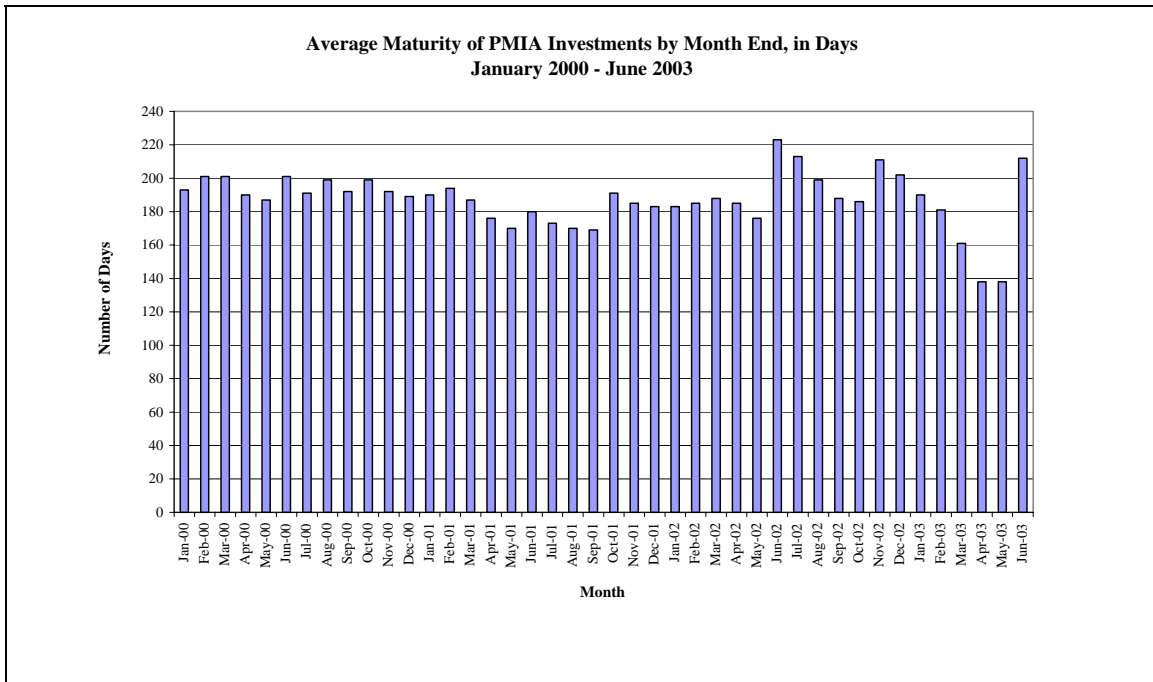
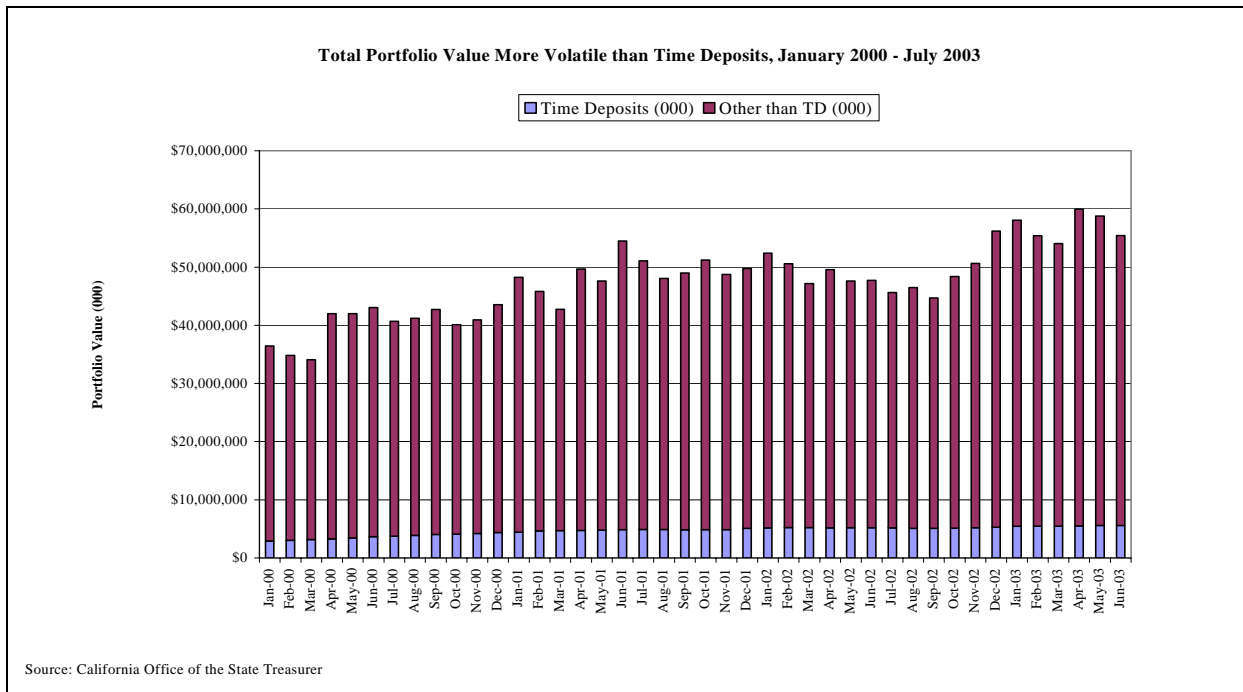


Chart 4

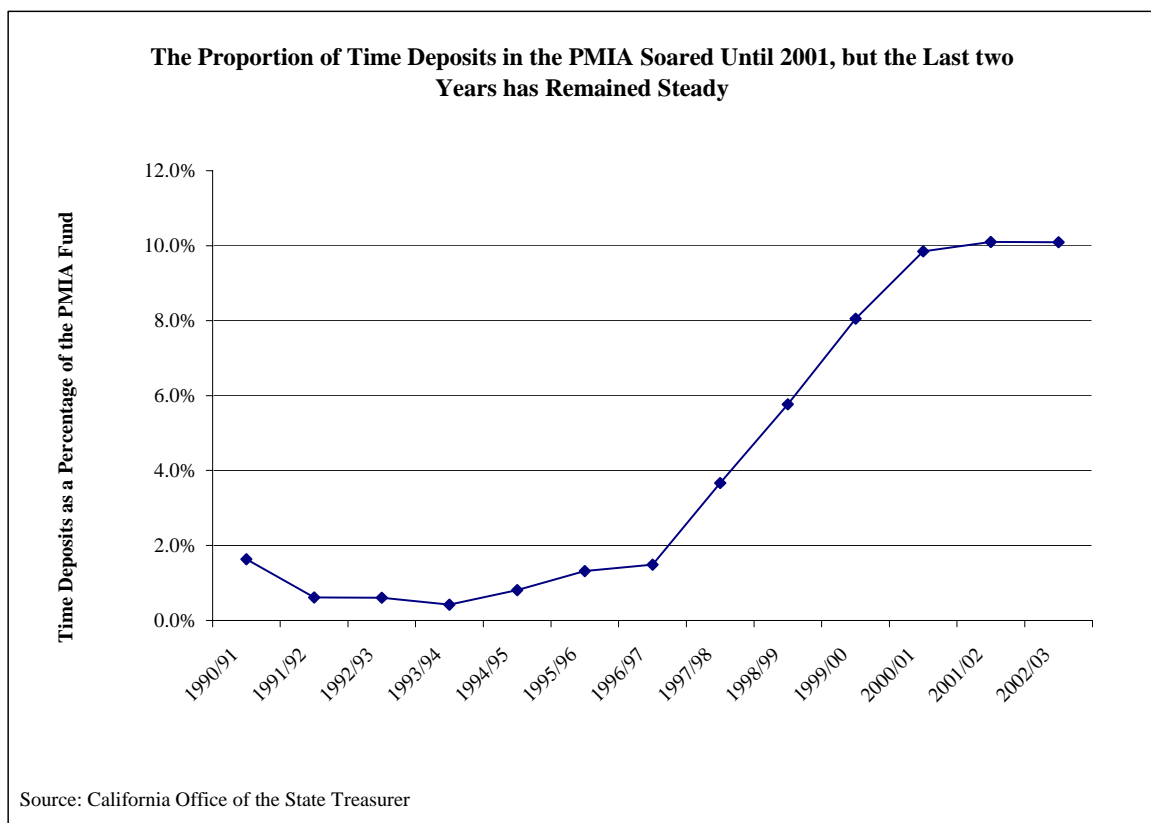


On a monthly basis, the share of time deposits in PMIA investments has fluctuated less than the share of other investments, and generally has increased steadily month after month since January 1999. This may reflect the efforts of the Treasurer’s Office to keep expanding their time-deposit

program, or it may be because of increases in banks' demand for public deposits for market reasons. (Chart 4)

A chart looking back 12 years (Chart 5) shows that the proportion of time deposits in the PMIA account increased significantly from the fiscal year 1996/97 through the fiscal year 2000/01, and has remained fairly stable since then. The trend of these three years may reflect 1) the number of new banks participating in the time-deposit program decreased as the program is already known by most banks that are likely to participate in this type of program, and 2) a large supply of credit in an environment of very low interest rates.

Chart 5



The number of depository institutions holding PMIA time deposits has also grown significantly. Table 4 shows trends in time deposits invested by the California's Treasurer's Office as of June 30, for five selected years, by type of depository institutions. Since the year 2000, the proportion of time deposits held by savings institutions and credit unions has increased substantially relatively to those held in banks.

Table 4

Pooled Money Investment Account (PMIA) Time Deposits (Selected Years)										
	1998		2000		2001		2002		2003	
	Amount In Thousands	Percentage	Amount In Thousands	Percentage	Amount In Thousands	Percentage	Amount In Thousands	Percentage	Amount In Thousands	Percentage
Bank Time Deposits	\$1,418,890	91.8%	\$3,157,090	86.5%	\$3,799,295	78.1%	\$4,015,095	77.5%	\$4,281,595	76.8%
Savings Institutions	\$126,000	8.2%	\$411,350	11.3%	\$627,350	12.9%	\$822,850	15.9%	\$1,049,500	18.8%
Credit Unions		0.0%	\$80,000	2.2%	\$438,500	9.0%	\$339,750	6.6%	\$244,000	4.4%
TOTAL	\$1,544,890	100.0%	\$3,648,440	100.0%	\$4,865,145	100.0%	\$5,177,695	100.0%	\$5,575,095	100.0%

Source: California Office of the State Treasurer

The Distribution of PMIA Time Deposits by Bank Size

According to small bank and community bank representatives, one way in which the Treasurer’s Office could increase support for 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.* Small banks, we know, tend to use time deposits to make loans in their neighborhoods, whereas larger banks focus on larger markets. In a larger bank, California’s surplus cash might go to Nebraska or Argentina. Small banks may be more flexible in loaning money in their neighborhood than larger banks with centralized (distant) loan approval processes.¹³

Extensive research shows that smaller banks (or bank branches) located in borrower’s communities have historically provided much of the credit for small businesses in those communities, and for mortgage lending for lower-income and minority individuals. For example, analysis by Levonian and Soller (1996) concluded that:

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.¹⁴

These small banks’ tendency to devote a larger share of their funds to small business lending resulted from several factors. One is the limit on the size of the loans a small bank can make. If loans are too big relative to the bank’s total assets, risks increase, as the bank is not adequately diversified. Diversification is achieved by making many smaller loans rather than a few large ones.

* A community financial institution is one with less than \$500 million in assets by the Gramm-Leach-Bliley Act of 1999 (G-L-B). Although other definitions put the figure at \$100 to \$300 million.

Furthermore, small banks can arguably meet the needs of their customers more efficiently than larger banks. Large banks with automated and centralized loan approval processes may not provide a great deal of flexibility.

Banks located within the community are likely to have better information about economic conditions or risk factors that are specific to their community. Their increased knowledge grants them flexibility in making credit decisions. For example, real estate agents, homebuilders, other community organizations and nonprofit groups often develop working relationships with individual officers of the financial institutions, to facilitate the lending process.

However, recently the notion that small banks can meet the needs of their communities more efficiently than larger banks has been challenged. 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 changed this picture. 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.

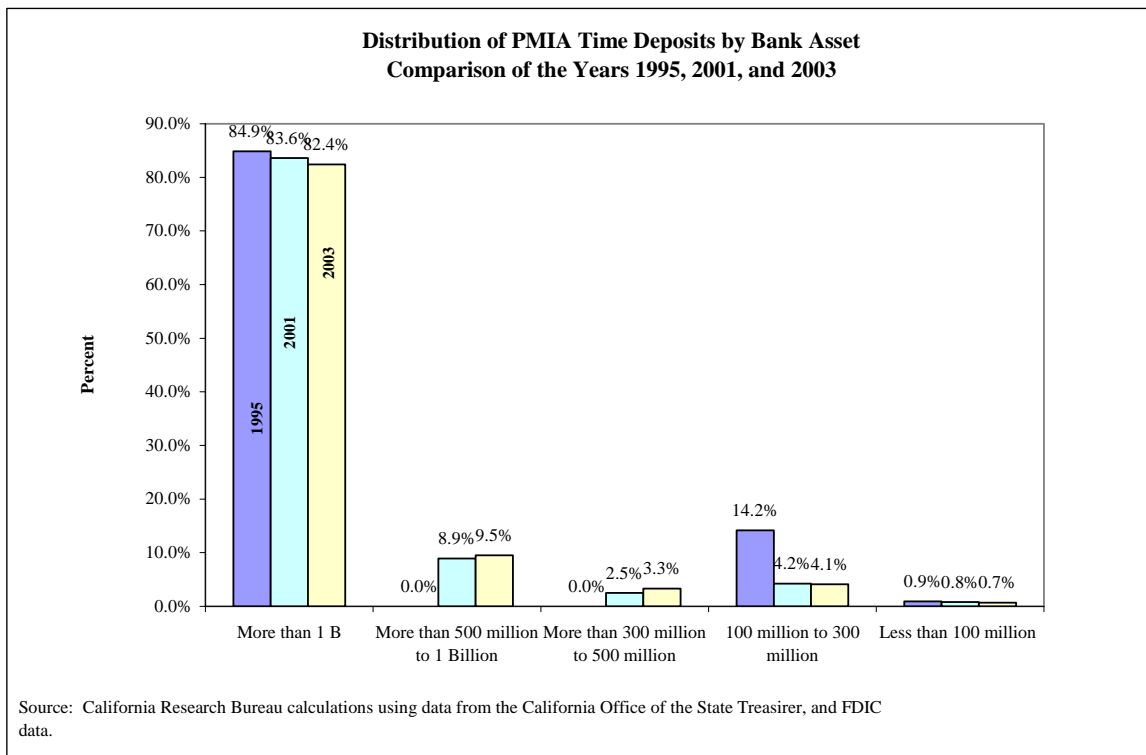
Thanks to new technologies, the ability of large banks to serve smaller areas has increased somewhat. Recent research indicates that some large banks may be able to meet the needs of small or poor communities as well as smaller banks.¹⁵ For example, a Federal Reserve study¹⁶ indicates that bank consolidation appears to have little relationship to changes in home purchasing lending to minorities and low-income groups, and that more than half of mortgage lending is provided by financial institutions located outside the borrowers' communities.

With increased consolidation in the financial system, the marketing of home and business loans has changed dramatically. A bank's financial condition strengthens with portfolio diversification brought by the inclusion of loans from different geographic areas and types of customers. The Community Reinvestment Act (CRA) has also influenced banks to extend their services and look for opportunities in previously neglected markets, motivating them to provide financial products to low- and moderate-income geographies. In addition, 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 (1) either 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.

Although these developments suggest that the strong link between small business loans and smaller banks has weakened, small banks remain important credit providers to small businesses and local residents close to the bank. So it is still useful to analyze the proportion of PMIA funds invested in smaller banks versus larger banks, as a way to assess whether PMIA investments are actually supporting California communities.

The following chart shows how much of PMIA time deposits are *actually going* to small banks, and how the Treasurer’s Office historically distributed time deposits by size of bank. Our chart shows only a modest shift of PMIA deposits from larger to mid-sized banks over time, and no shift at all to the smallest banks. However, increases in the amount of PMIA deposits in the smallest banks could be masked by increased consolidation in the banking system. For example, a given PMIA deposit in a small bank, say Bank X, may appear in the year 2001 in the bank asset category of \$100-\$300 million, but in 2003 could appear in the more than \$1 billion category, if the small Bank X was acquired by a large bank. After 2001 we have observed a significant number of consolidations in the banking industry that have affected smaller institutions that were participating in the time deposit program.

Chart 6



Comparing the Distribution of California Bank Time Deposits and the State Time Deposits by Bank Size

Because of the link between local community investment and smaller banks, it is interesting to look at the distribution of PMIA investments in time deposits by size of the banks, compared to the distribution of all time deposits in California by size of the banks.

The purpose of this comparison is to answer two key questions:

- Is the Treasurer's Office distribution of time deposits less or more concentrated in smaller banks than the distribution of all Californians' time deposits?
- Over time, has the Treasurer's Office time deposit distribution become more concentrated in smaller banks, once we take into account the geographic distribution and size structure of the banking system in California?

If the Treasurer's Office has a higher proportion in smaller banks than the share held by all Californians, and particularly if that proportion increases over time, we can conclude that the Treasurer has made a significant effort to put more PMIA funds in local banks.

Table 5 shows the distribution of California time deposits and PMIA time deposits in banks (as opposed to savings and loans and other institutions) by bank size. While there has been increased concentration of all deposits in California in larger banks, the PMIA time deposits tended to move to mid-sized banks. Deposits in the smallest categories of banks declined, increased, and then declined again over the years covered by the table. These figures, however, must be taken with caution, since they are affected by mergers and acquisitions, formation and dissolution of institutions, and movement of institutions from one asset category to another (usually a larger one as institutions grow). The table shows that the percent of all California deposits in the smallest two categories of banks declined markedly from 1995 to 2003, which may explain why the percent of PMIA deposits in these categories also declined.

Table 5

Comparison of the Distribution Time Deposits Held by California's Bank & Treasurer's Office										
	1995	1998		2000		2001		2002		2003
	California Branches	Treasurer's Office Inv.	California Branches	Treasurer's Office Inv.	California Branches	Treasurer's Office Inv.	Treasurer's Office Inv.	California Branches	Treasurer's Office Inv.	Treasurer's Office Inv.
More than 1 B	72.4%	84.9%	77.8%	85.0%	81.8%	81.3%	83.6%	82.8%	82.6%	82.4%
More than 500 Million to 1 Billion	5.9%	0.0%	6.7%	5.3%	6.6%	7.5%	8.9%	7.1%	8.8%	9.5%
More than 300 Million to 500 Million	4.9%	0.0%	3.9%	5.6%	3.0%	3.4%	2.5%	3.2%	3.4%	3.3%
100 Million to 300 Million	10.8%	14.2%	8.4%	3.5%	6.6%	6.2%	4.2%	5.2%	4.2%	4.1%
Less than 100 Million	6.0%	0.9%	3.2%	0.5%	2.0%	1.7%	0.8%	1.7%	1.0%	0.7%
TOTAL	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: FDIC, California State Banking Department, and Treasurer's Office Data

Over Time, PMIA Deposits Have Been Placed in a Larger Number of Banks

As of June 1995, the Treasurer's Office invested \$272.3 million in time deposits. Of that total, nearly half (\$125 million) was on deposit at one large savings association. Most 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 only three savings institutions, and 87 percent of those deposits were held in one large institution (assets above \$5 billion). Only four 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.

As of June 2003, time deposits were 3.6 times higher than in 1998. After the fiscal year 2000/2001, the growth of time deposits has slowed down compared to previous years. Between 2001 and 2003 time deposits increased by less than 15 percent. As of June 30, 2003, 91 banks, 18 savings and loans, and 13 credit unions held public deposits. All these figures reflect both the Treasurer's interest in directing more investments to support California local communities, and

the demand of public deposits by depository institutions, resulting from the financial market conditions of the time.*

* The Treasurer's office emphasizes the percentage of eligible deposits to bank equity. For example, even when the Treasurer's Office deposits smaller amounts in small banks, the ratio of these deposits to equity is significantly larger than the one for larger banks. On this basis, small banks have a higher degree of participation in the time deposit program.

IV. GEOGRAPHIC AND SOCIOECONOMIC DISTRIBUTION OF FUNDS

This section looks at the socioeconomic and geographic distribution of PMIA investments to see to what extent these investments benefit specific areas or socioeconomic groups. We focus on the distribution of time deposits in this section since the geographic and socioeconomic distribution of other investments is very hard to trace.

GEOGRAPHIC DISTRIBUTION OF TIME DEPOSITS

Table 6 and Chart 7 show the distribution of time deposits invested by the Treasurer's Office by location of the financial institution where these deposits were held. 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 6 shows the distribution of all PMIA time deposits as of June 2003, by the county in which the depository branch is located, with population and per capita deposit data for comparison. Populous Los Angeles County holds the largest dollar amount of deposits, while financial center San Francisco County has the largest amount per capita. Many small counties, unlikely to have branches of qualifying institutions, have none. There are some factors behind this distribution that are important to consider. First, this is a voluntary program, in which institutions may choose to or may decline to participate, and 2) financial institutions tend to concentrate in major metropolitan areas.

Table 6

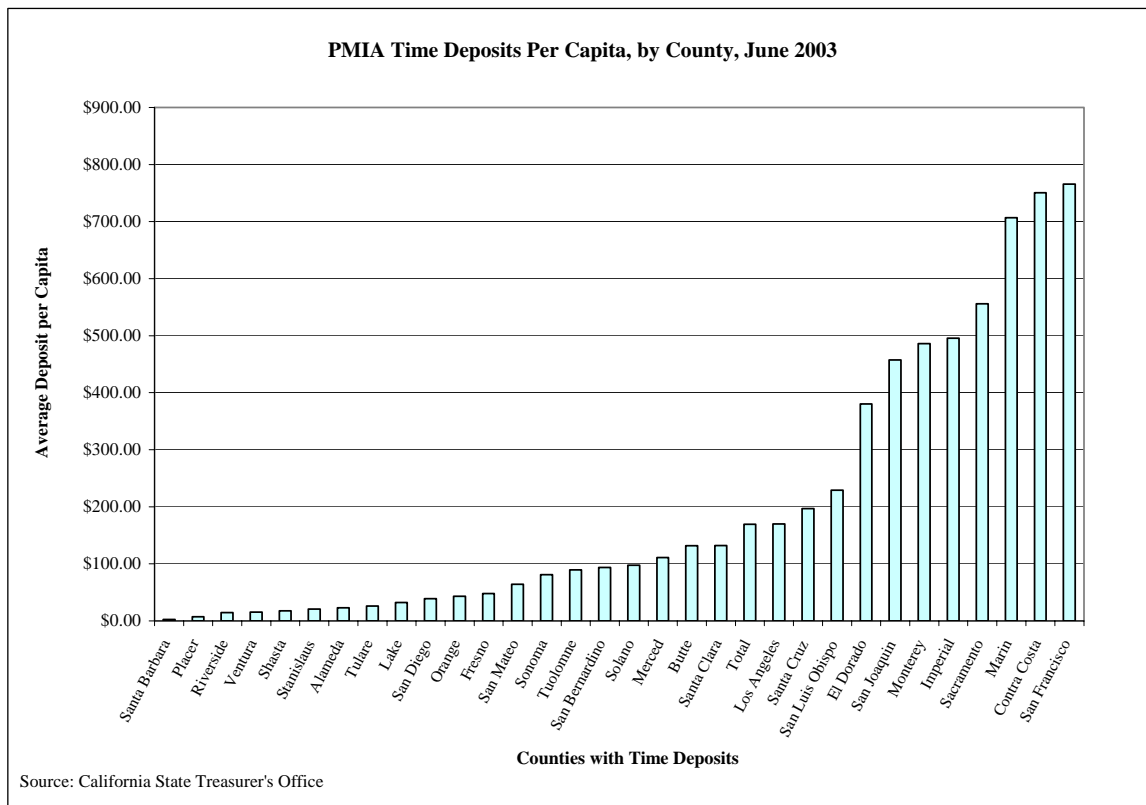
Geographic Distribution of PMIA Time Deposits by County, June 2003

County	Total Deposits for County (In Thousands)	County Population, 2002	Average Deposit per Capita
Alameda	\$34,000	1,472,310	\$23.09
Alpine	\$0	1,200	\$0.00
Amador	\$0	36,657	\$0.00
Butte	\$27,500	209,203	\$131.45
Calaveras	\$0	42,978	\$0.00
Colusa	\$0	19,312	\$0.00
Contra Costa	\$744,500	992,358	\$750.23
Del Norte	\$0	27,482	\$0.00
El Dorado	\$63,000	165,744	\$380.10
Fresno	\$40,000	834,632	\$47.93
Glenn	\$0	26,623	\$0.00
Humboldt	\$0	127,159	\$0.00
Imperial	\$72,500	146,248	\$495.73
Inyo	\$0	18,214	\$0.00
Kern	\$0	694,059	\$0.00
Kings	\$0	135,043	\$0.00
Lake	\$2,000	61,970	\$32.27
Lassen	\$0	34,007	\$0.00
Los Angeles	\$1,668,295	9,806,577	\$170.12
Madera	\$0	130,265	\$0.00
Marin	\$175,000	247,581	\$706.84
Mariposa	\$0	17,195	\$0.00
Mendocino	\$0	87,240	\$0.00
Merced	\$25,000	225,398	\$110.91
Modoc	\$0	9,289	\$0.00
Mono	\$0	13,117	\$0.00
Monterey	\$201,000	413,408	\$486.20
Napa	\$0	130,268	\$0.00
Nevada	\$0	95,047	\$0.00
Orange	\$126,800	2,938,507	\$43.15
Placer	\$2,000	278,509	\$7.18
Plumas	\$0	20,890	\$0.00
Riverside	\$25,000	1,699,112	\$14.71
Sacramento	\$725,500	1,305,082	\$555.90
San Benito	\$0	55,938	\$0.00
San Bernardino	\$170,000	1,816,072	\$93.61
San Diego	\$113,000	2,906,660	\$38.88
San Francisco	\$585,000	764,049	\$765.66
San Joaquin	\$281,000	614,302	\$457.43
San Luis Obispo	\$58,000	253,408	\$228.88
San Mateo	\$45,000	703,202	\$63.99
Santa Barbara	\$1,000	403,084	\$2.48
Santa Clara	\$222,000	1,683,505	\$131.87
Santa Cruz	\$50,000	253,814	\$196.99
Shasta	\$3,000	171,799	\$17.46
Sierra	\$0	3,552	\$0.00
Siskiyou	\$0	44,103	\$0.00
Solano	\$40,000	411,072	\$97.31
Sonoma	\$38,000	468,386	\$81.13
Stanislaus	\$10,000	482,440	\$20.73
Sutter	\$0	82,580	\$0.00
Tehama	\$0	57,472	\$0.00
Trinity	\$0	13,174	\$0.00
Tulare	\$10,000	381,772	\$26.19
Tuolumne	\$5,000	55,850	\$89.53
Ventura	\$12,000	783,920	\$15.31
Yolo	\$0	180,856	\$0.00
Yuba	\$0	62,339	\$0.00
Total	\$5,575,095	35,116,033	\$158.76

Source: Data From the State Treasurer's Office, BLS Population Estimates for 07-01-02

Chart 7 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 7



Los Angeles, Orange, and San Diego seem to have very low averages compared to San Francisco.

SOCIOECONOMIC DISTRIBUTION OF TIME DEPOSITS

Because the Treasurer's Office places time deposits in specific branches of specific financial institutions, it is easier to connect them to a geographic area compared to other short-term investments like securitized California small business loans or bonds and notes.* This section provides tables and maps 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.¹⁷ For purposes of this discussion, "socioeconomic" means the ethnic and economic make-up of the vicinity of the branches, which have PMIA time deposits.

Despite all the changes in the banking industry, it does seem clear that the geographic location of the financial institution will have some effects. If the money is placed exclusively in branches in

* The concept of securitization is explained in Appendix 1.

wealthy and predominantly white areas, that is likely to have a different impact from placement across the entire spectrum of neighborhoods, including those outside of major urban centers, areas of low and moderate income, and predominantly African American, Hispanic, or Asian neighborhoods.

Table 7

Average Size of Time Deposits by Zip Codes by Socioeconomic Condition

	1998	2003	1998	2003
	No. of Zip Codes	No. of Zip Codes	Average Deposit/Zip Code	Average Deposit/Zip Code
Effective Buying Income				
High Income (more than \$75,000 EBI)	1	11	\$100,000	\$39,273
Higher Middle Income (More than \$50,000 to \$75,000 EBI)	5	19	\$60,505	\$81,000
Middle Income (More than \$25,000 to \$50,000 EBI)	20	58	\$26,780	\$40,645
Low Income (\$15,000 to \$25,000 EBI)	4	10	\$106,375	\$121,120
Very Low Income (Less than \$15,000 EBI)	1	1	\$75,000	\$35,500
Total Deposits	30	99	\$47,294	\$56,314
Percentage of Households under \$25,000 EBI				
More than 75%	2	1	\$50,000	\$35,500
More than 50% to 75%	3	10	\$53,333	\$121,120
More than 25% to 50%	18	36	\$54,078	\$40,183
Less than 25%	9	52	\$22,810	\$55,419
Total Deposits	30	99	\$47,296	\$56,314
% of Minorities				
More than 75% of the Population	6	9	\$46,183	\$86,044
More than 50% to 75%	8	25	\$21,013	\$57,316
More than 25% to 50%	10	34	\$64,390	\$59,935
25% and Less	7	31	\$49,943	\$42,903
Total Deposits	30	99	\$47,296	\$56,314
% Hispanics				
More than 75% Hispanics	1	6	\$50,000	\$18,883
More than 50% to 75% Hispanics	3	11	\$13,333	\$59,955
More than 25% to 50% Hispanics	8	22	\$46,549	\$60,877
More than 10% to 25% Hispanics	11	37	\$57,045	\$57,527
10% of Less Hispanics	8	23	\$43,600	\$58,022
Total Deposits	30	99	\$47,296	\$56,314
% African American				
More than 25% to 50% African American	2	4	\$52,500	\$108,125
More than 10% to 25% African American	3	17	\$135,000	\$90,200
More than 5% to 10% African American	5	12	\$16,360	\$57,958
2% to 5% African American	6	26	\$38,050	\$35,504
Less than 2% African American	15	40	\$40,639	\$49,765
Total Deposits	30	99	\$47,296	\$56,314

Sources: Treasurer's Office data and 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 African American obtained from the Census 2000.

Table 7 compares the average number of zip codes with institutions receiving state time deposits for the years 1998 and 2003, as well as the size of the average deposit by zip code, according to the socioeconomic conditions of these zip codes. We see that the number of zip codes receiving state time deposits (regardless of the level of income of the people located in the area) has increased significantly.

Dollar amounts per area have increased more significantly in the middle-income and higher-income areas, as defined by the median disposable (EBI) income of the zip code.

There has been a definite increase in the average deposit in those zip codes containing households half or more of which have income under \$25,000. But this increase has been relatively lower than the increase in zip codes with less poor households.

The table also shows that the average deposit per zip code increased substantially in those areas with a high level of minorities, particularly Hispanics.

Table 8 shows the proportion of State deposits by the socioeconomic conditions of the zip codes where the deposits are held. The proportion of deposits in institutions located in higher-income zip codes increased, as did the proportion of deposits in institutions located in low-income neighborhoods. However, the proportion of deposits in very low-income zip codes decreased. In terms of the amount of deposits, deposits in institutions located in higher income areas increased more significantly than deposits in institutions located in lower income areas.

Table 8 also reports the proportion of deposits according to the location of banks in areas with a high proportion of minorities, singling out Hispanics, and African Americans. There was some increase in the proportion of funds deposited in institutions located in zip codes with a high proportion of minorities, especially Hispanics. In dollar amounts, these increases have been fairly significant.

Table 8

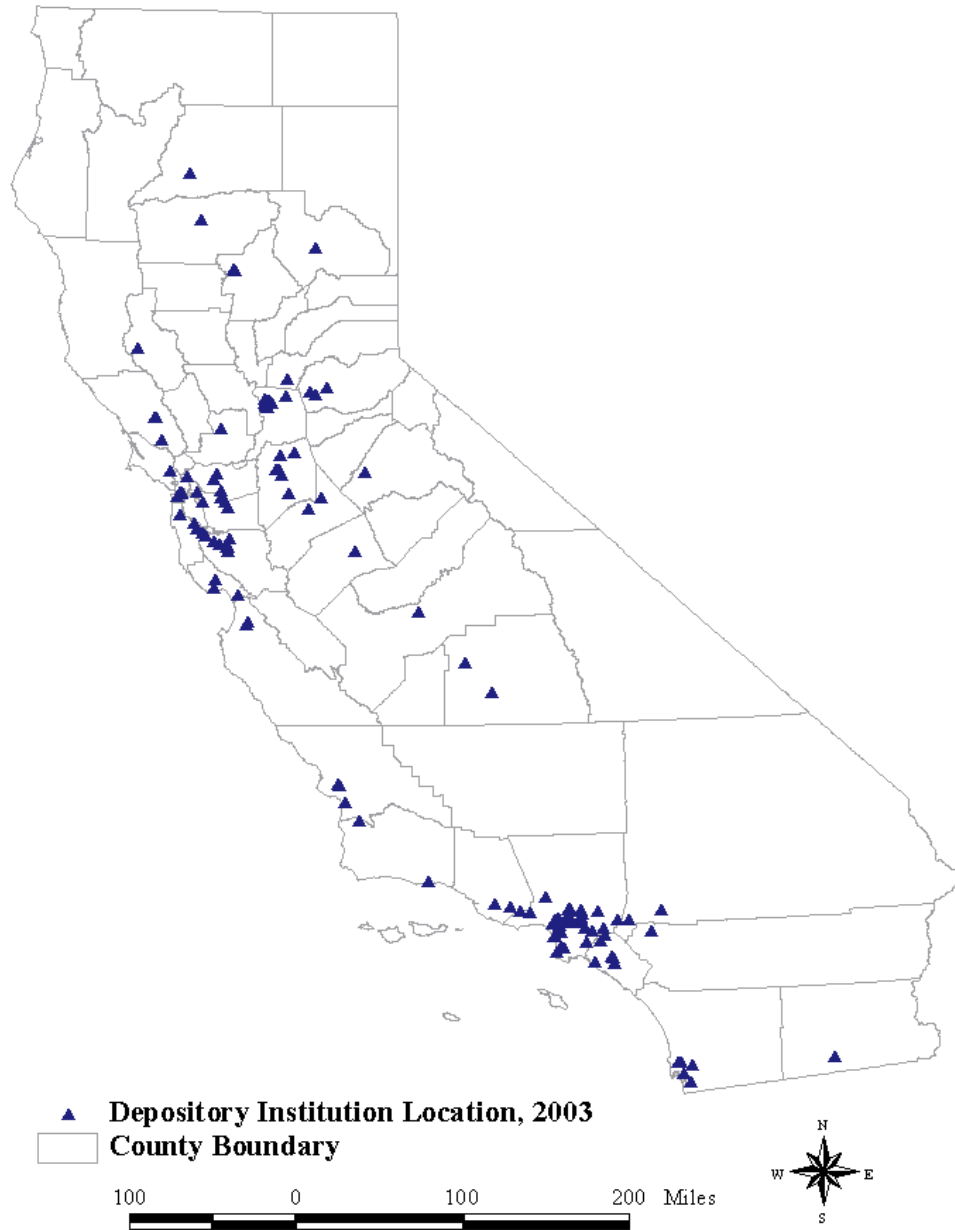
Average Size of Time Deposits by Zip Codes by Socioeconomic Condition					
	1998		2003		% Growth (1998-2003)
	Total	Percent	Total	Percent	
Effective Buying Income					
High Income (more than \$75,000 EBI)	\$100,000	7.0%	\$432,000	3.9%	332.0%
Higher Middle Income (More than \$50,000 to \$75,000 EBI)	\$302,525	21.3%	\$1,539,000	36.4%	408.7%
Middle Income (More than \$25,000 to \$50,000 EBI)	\$515,795	36.4%	\$2,357,395	30.9%	357.0%
Low Income (\$15,000 to \$25,000 EBI)	\$425,500	30.0%	\$1,211,200	34.1%	184.7%
Very Low Income (Less than \$15,000 EBI)	\$75,000	5.3%	\$35,500	4.7%	-52.7%
Total Deposits	\$1,418,820	100.0%	\$5,575,095	100.0%	292.9%
Percentage of Households under \$25,000 EBI					
More than 75%	\$100,000	7.0%	\$35,500	0.6%	-64.5%
More than 50% to 75%	\$160,000	11.3%	\$1,211,200	21.7%	657.0%
More than 25% to 50%	\$953,600	67.2%	\$1,446,595	25.9%	51.7%
Less than 25%	\$205,290	14.5%	\$2,881,800	51.7%	1303.8%
Total Deposits	\$1,418,890	100.0%	\$5,575,095	100.0%	292.9%
% of Minorities					
More than 75% of the Population	\$277,095	19.5%	\$774,400	13.9%	179.5%
More than 50% to 75%	\$148,300	10.5%	\$1,432,895	25.7%	866.2%
More than 25% to 50%	\$643,895	45.4%	\$2,037,800	36.6%	216.5%
25% and Less	\$349,600	24.6%	\$1,330,000	23.9%	280.4%
Total Deposits	\$1,418,890	100.0%	\$5,575,095	100.0%	292.9%
% Hispanics					
More than 75% Hispanics	\$50,000	3.5%	\$113,300	2.0%	126.6%
More than 50% to 75% Hispanics	\$31,000	2.2%	\$659,500	11.8%	2027.4%
More than 25% to 50% Hispanics	\$372,395	26.2%	\$1,339,295	24.0%	259.6%
More than 10% to 25% Hispanics	\$616,695	43.5%	\$2,128,500	38.2%	245.1%
10% of Less Hispanics	\$348,800	24.6%	\$1,334,500	23.9%	282.6%
Total Deposits	\$1,418,890	100.0%	\$5,575,095	100.0%	292.9%
% African American					
More than 25% to 50% African American	\$105,000	7.4%	\$432,500	7.8%	311.9%
More than 10% to 25% African American \$75,000 EBI)	\$405,000	28.5%	\$1,533,400	27.5%	278.6%
More than 5% to 10% African American	\$81,800	5.8%	\$695,500	12.5%	750.2%
2% to 5% African American	\$219,300	15.5%	\$923,100	16.6%	320.9%
Less than 2% African American	\$607,790	42.8%	\$1,990,595	35.7%	227.5%
Total Deposits	\$1,418,890	100.0%	\$5,575,095	100.0%	292.9%

Sources: Treasurer's Office data and 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 African American obtained from the Census 2000.

Following are maps describing the geographic distribution of PMIA time deposits in California for the year 2003. Due to the small scale of the maps, some overlapping has occurred, hiding a few observations

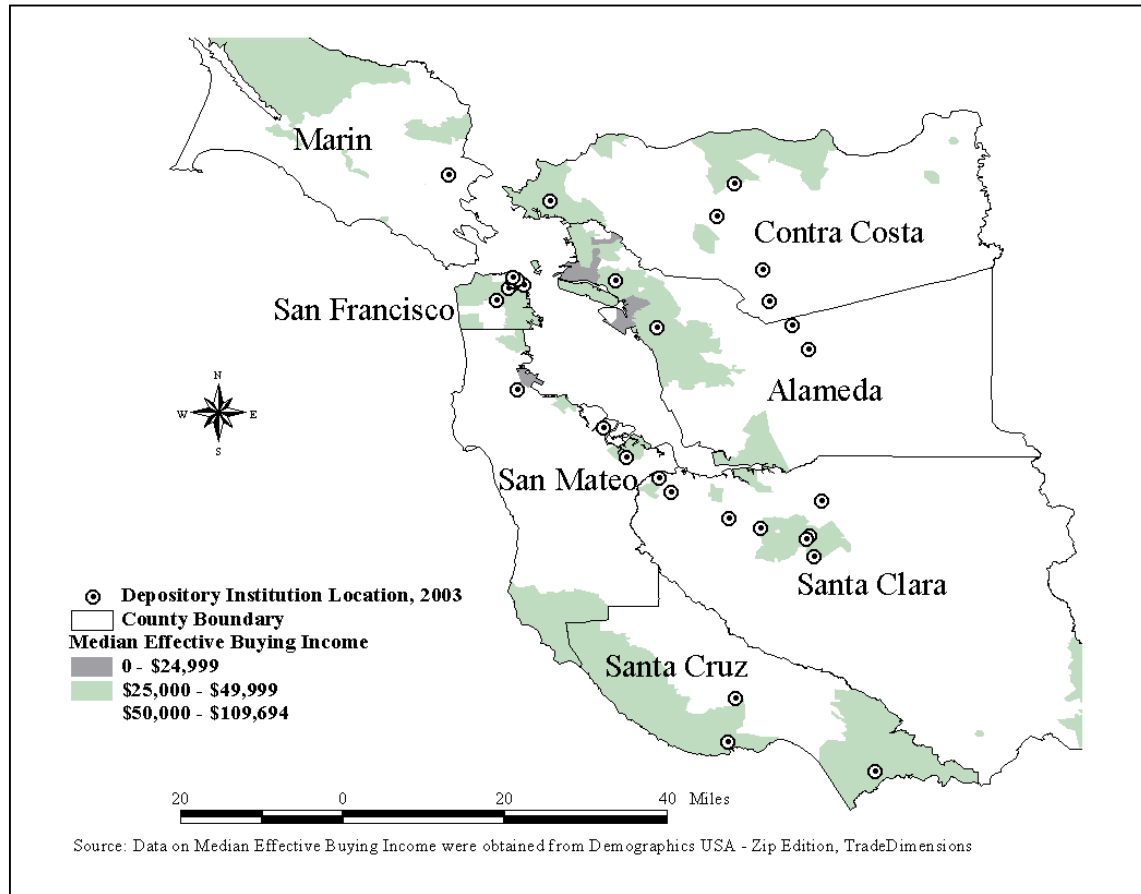
Map 1

Location of PMIA's 2003 Time Deposits in California

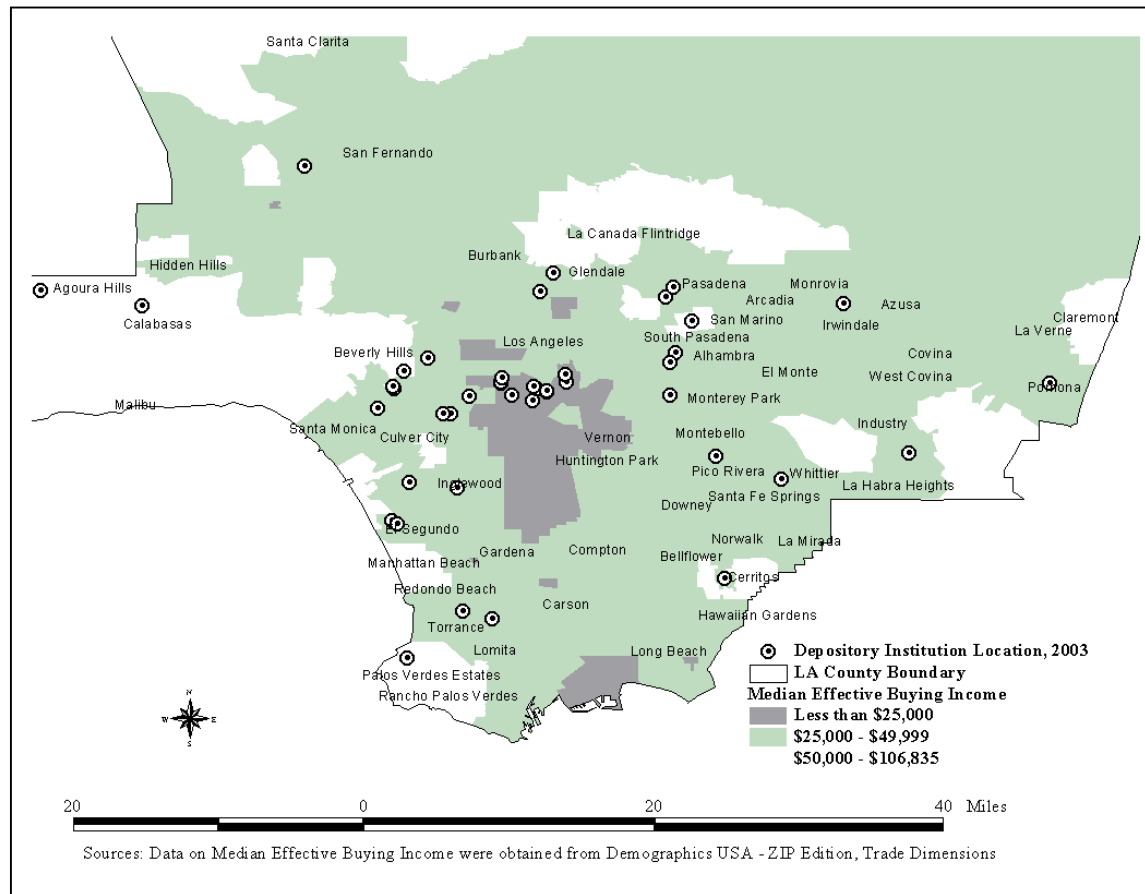


Map 2

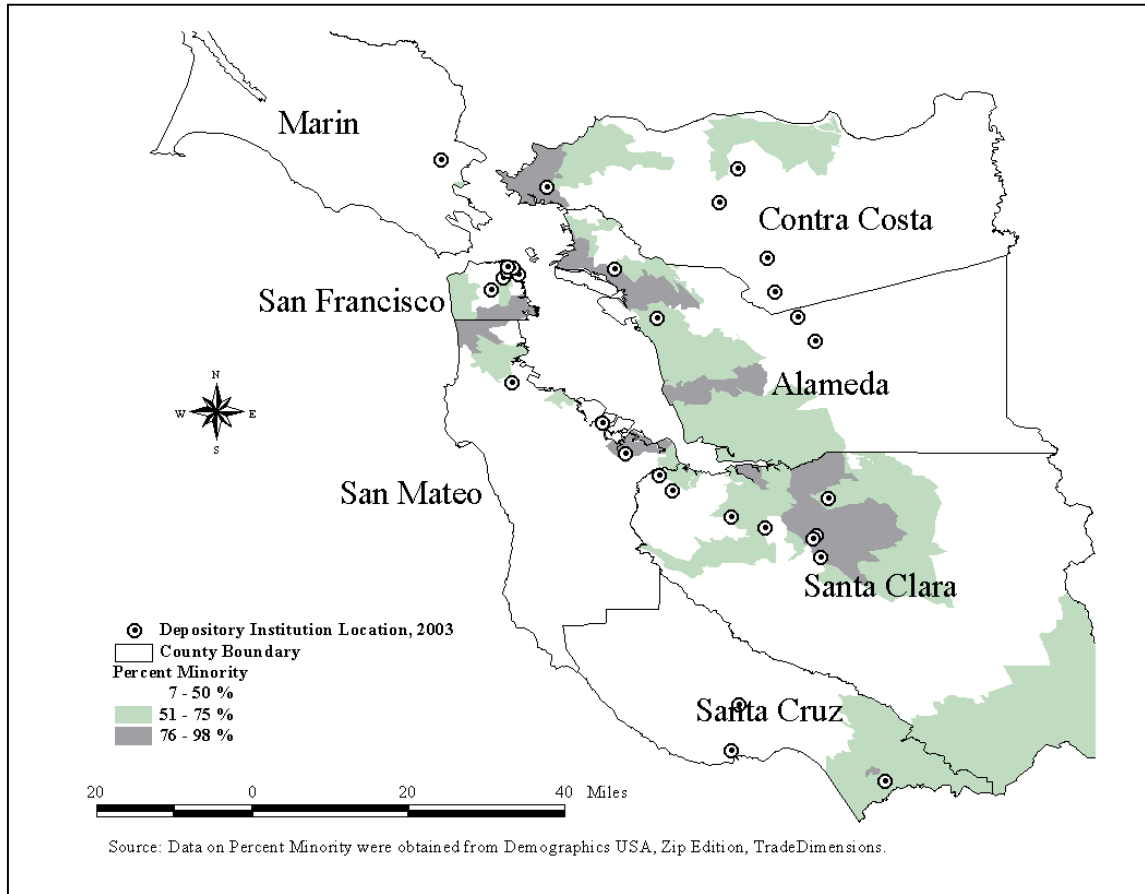
Location of PMIA's 2003 Time Deposits San Francisco Bay Area by Median Income



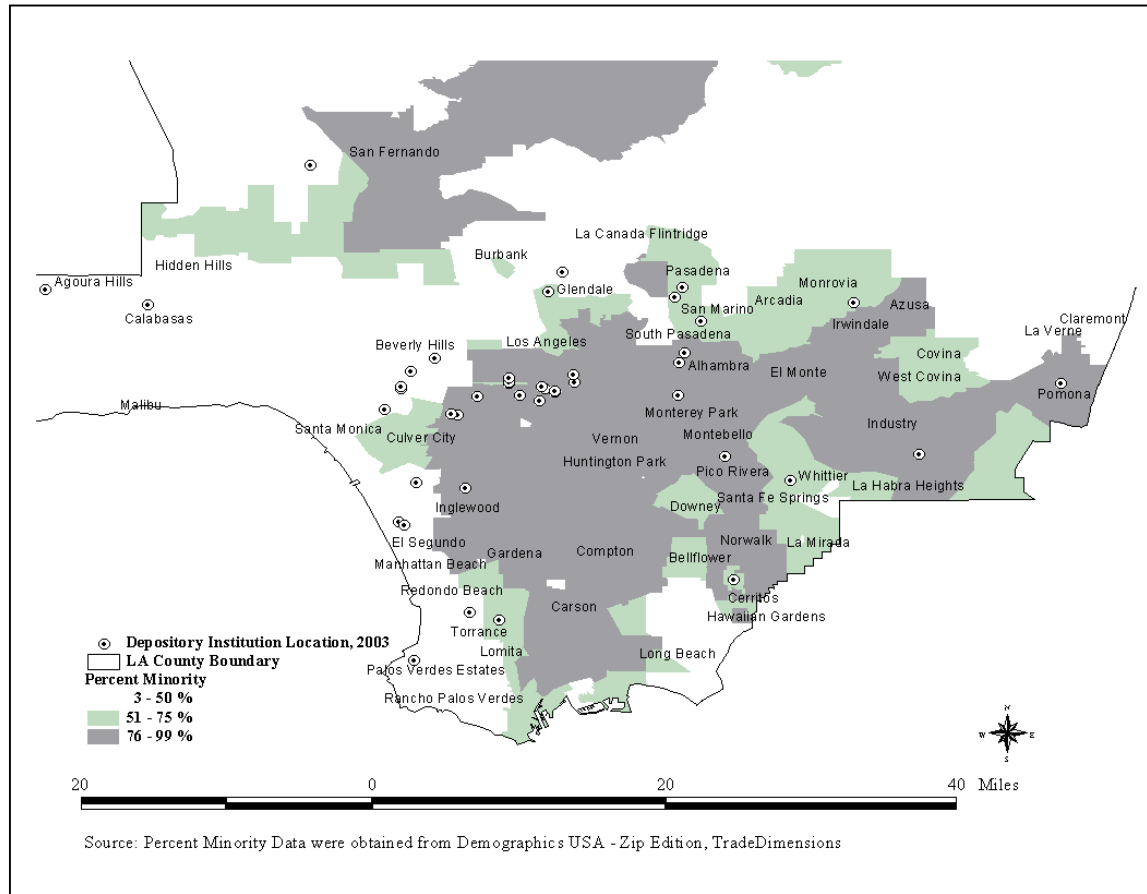
Map 3 Location of PMIA's 2003 Time Deposits Southern Los Angeles County by Median Income



Map 4 Location of PMIA's 2003 Time Deposits San Francisco Bay Area by Percent Minorities



Map 5 Location of PMIA's 2003 Time Deposits Southern Los Angeles County by Percent Minorities



V. OTHER STATES' EFFORTS TO INVEST EXCESS FUNDS IN THEIR COMMUNITIES

In this section we explore selected other states' policies (Oregon, Texas, New York, Michigan, and Florida) to see whether they explicitly allocate funds to support community development. 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.¹⁸

We learn in looking at other states' policies that California invests with an eye on community development more than other states, and that the California State Treasurer has authority over a larger proportion of the relevant funds than treasurers in some states.¹⁹

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. The STIP consists of the State's General Fund and various other funds. 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, local jurisdictions (cities, counties, etc.) are not authorized to participate in the STIP.

FLORIDA

Florida's treasurer has jurisdiction over only nine percent of state funds available for investment, in contrast to 75 percent in California, and a total budget less than half that of California.²⁰ Florida does have a strong time deposit program. By law, first priority for investment of the pertinent excess funds must be given to requests for certificates of deposit from Florida banks and savings association.²¹ Excess funds are placed in qualified 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 agencies, asset-backed securities, commercial paper, banker's acceptances, corporate obligations, convertible bonds, and commingled²² and mutual funds. Treasury deposits should not exceed 10 percent of the assets of any qualified public depository.

OREGON

In Oregon, the state treasury operates the Oregon Short Term Fund (OSTF), which 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 the portfolio (a much lower proportion than in California, currently around 10 percent). All investments are made in four types of assets: commercial paper, bankers' acceptances, U.S. agencies securities, and time deposits.

MICHIGAN

Michigan's pooled money account, called the "Common Cash" account, only handles state funds. However, Michigan uses surplus funds to make loans to Michigan local governments, collateralized by future revenues to be paid by the state to those local government units. 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 and 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 promote solid waste management. In Michigan, time deposits are less than one percent of the \$5.4 billion fund. 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 (See Appendix 3 for Texas law on this point). To participate, an institution must not have a CRA rating below "satisfactory." Institutions must apply to participate, must furnish documentation about their financial condition, and must make their books open for inspection by the comptroller. Selection as a depository lasts two years, and may be renewed 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.²³

VI. THE LEGISLATURE'S IDEAS: FEASIBILITY AND SOCIAL BENEFITS OF SELECTED INITIATIVES

In this section we address the “feasibility and social benefits” of the legislature’s (AB 2805’s) ideas for increasing PMIA dollars in California’s communities.

SUGGESTION ONE: REQUIRING THE STATE TO FOLLOW GUIDELINES SIMILAR TO THE FEDERAL COMMUNITY REINVESTMENT ACT IN ITS INVESTMENT POLICIES

The CRA requires that banks and savings and loans make significant loans to businesses in low and moderate-income areas and in low and moderate-income housing. Since banks and savings and loans are in the business of making loans to businesses and homebuyers, these requirements have a straightforward meaning. The Treasurer, however, does not make direct loans in communities. He can approach the CRA goal of increasing investment in low and moderate income communities only indirectly; by parking surplus state funds in banks and S&Ls that are likely to serve those areas, or by buying certain securities that represent investments in those areas.

Current state law requires that pooled funds be invested “in such a way as to realize the maximum return consistent with safe and prudent treasury management (Gov 16480.2).” It also says pooled funds should be invested with “due regard to assisting ... specific programs of the state designed to support the economy of economically disadvantaged areas. (Gov 16480.35)” If funds are invested in banks and S&Ls, those institutions must have satisfactory CRA ratings (Gov 16500 and Gov 16600).

One interpretation of this suggestion is: Could this legislative direction be changed to goad the current Treasurer into investing pooled state funds in a more CRA-like manner? Probably not, since the Treasurer is an admirer of this policy and has moved state investment practice a considerable distance in this direction since assuming office.

A second interpretation is: Could this legislative direction be changed to give clearer guidance to a future Treasurer who might have less innate interest in this policy direction? Current law says pooled funds should be invested with safety and return as primary considerations, but also “with due regard” for supporting disadvantaged areas, as cited above. This language is from 1968 and focuses on a program called the California Job Development Corporation Law. It might be of some value to bring the section into line with current legislative direction and current pooled money investment practice.

SUGGESTION TWO: ALLOCATING FUNDS FOR SPECIFIC INVESTMENT PURPOSES

One way for the Treasurer to more closely approach the CRA goals of increasing investment in low and moderate areas and housing would be to require that banks and S&Ls make additional investments in those areas in return for getting deposits of state pooled funds. Nothing in current law authorizes the Treasurer to impose conditions of

this sort on the deposits and investments that he makes. So the question is whether current law should be amended to allow conditional or tied deposits.

Other states have tied deposit programs. Illinois was the first, beginning in 1967. By 1991, 17 states had linked deposit programs.²⁴ In Ohio, under the Small Business Linked Deposit Program, the Treasurer may approve a time deposit in a financial institution at up to three percent below the market interest rate if the financial institution agrees to lend to small businesses at three percent below their present lending rate.* The interest rate on these loans is fixed for a term of two years, with the possibility of a two-year extension at a reduced rate (the rate is negotiated again at 3 percent below the market rate.) Ohio sets aside 12 percent of the state's investment portfolio for this program. Ohio's program has special requirements for a small business to qualify for a linked deposit loan. Businesses must be headquartered and transact business in Ohio, employ fewer than 150 persons, must be organized for profit, and must create a certain number of jobs.

At least some evaluations of other states' tied deposit programs have been critical. Complaints include:

- Lenders do not always pass on the full interest rate reduction to business borrowers.
- It is difficult to determine if the interest savings is enough to cause a business that would otherwise go somewhere else to locate in a target community.
- The program has considerable cost to the state, since the state receives a lower interest rate for the money that it deposits through the linkage program, and also because it gives up the ability to reclaim that money if it needs cash, at least for a period of time. If the state needs the cash sooner, it would have to borrow at market interest rates while lending its own money at below market rates.

California might envision two variations of a tied deposit proposal. One might be like Ohio's, where the state agreed to accept a lower interest rate for its deposited funds if the recipient bank made additional loans in targeted communities, and also to leave the funds with the bank for a set and fairly lengthy amount of time. That would involve a direct loss of state revenue roughly equivalent to appropriating an equivalent amount of money and spending it on programs to benefit those same communities, and an additional cost if the state needed to borrow an equivalent amount of money to meet its cash needs. The state has a number of programs that attempt to stimulate job growth in distressed communities, such as our enterprise zone laws, our industrial development bond program, our small business loan guarantee program, our export lending financing program, and also our job training and infrastructure funding programs. If the state has additional money to spend on stimulating economic development in targeted areas, it ought to at least weigh whether the benefits from increasing funding for one or more of these existing programs might not be larger than the rather indirect path of making subsidized loans to banks.

* Currently banks pay 1.75 percent of interest on surplus funds, and lend this money at the market rate minus 3 percent.

A variation would be to authorize the Treasurer to require that banks make additional loans in targeted communities as a condition for deposit of state funds, but without any reduction in interest rates or guarantee that the funds would remain with the bank for a period of time that bore some relation to the length of the new loans the bank was making. These new conditions would significantly decrease the attractiveness of state fund deposits for banks that would be subject to the conditions. It might have the perverse effect of actually decreasing the amount of state funding deposited in low and moderate-income communities, and the amount of bank and S&L capital available for lending there.

The unstated premise of the tied deposit idea is that state fund deposits are a significant plum for the lucky recipient bank. That view almost certainly overstates the advantage that these funds give banks. The bank has to pay market rate interest for them, has to put up collateral exceeding the amount of the deposit, and has the money with certainty only for a limited amount of time. If the bank has a lending opportunity at a higher interest rate with roughly similar characteristics, and does not have funds to make the loan, then the state money is attractive. Otherwise, the bank is not likely to be interested. That is why Ohio added a subsidized interest rate and a longer term as sweeteners.

SUGGESTION THREE: MANDATING THAT A SET PERCENTAGE OF CALIFORNIA'S PUBLIC FUNDS BE USED IN CALIFORNIA

This report has documented the rather dramatic increase in the proportion of California's pooled funds that are invested in a manner that makes it likely that they will be used in California. The legislature could amend the law regulating the investment of surplus funds to require that a specified percentage of those funds be invested in this manner. The point would be to prevent the present Treasurer from backsliding, should he have a sudden change of heart, or to prevent a future Treasurer from drifting away from this policy direction.

A fixed percentage requirement could be costly to the State of California under some circumstances:

- The relative rates of return to various investments suitable for the surplus funds pool change over time. There will be times when the rate of return to time deposits in California banks will be significantly less than for alternative investments, for example. It is possible that the extra economic stimulation that California gets from increased investment resulting from deposits in California institutions is enough to offset this difference up to a point. But after that point, a fixed percentage requirement would result in lower pool earnings. That would mean lower revenues for California state governmental purposes, and it would also mean that local governments that park their surplus funds in the pool would be likely to reevaluate whether there was not something more lucrative that they could do with their money.
- Many of the options for making investments that would be likely to directly benefit California involve tying up the invested funds for a set period of time. If

the state encounters circumstances where it needs cash immediately, such as at present, it may be best to keep what cash does come its way for short periods in more liquid assets. In that case, the state could meet a “fixed percentage” requirement only with difficulty and at considerable cost.

- One of the most direct ways of investing state pool funds so they are likely to be used for private investment in California is by depositing them with banks and S&Ls, especially smaller ones located in low and moderate income areas in California. But these banks have to pay market interest rates for the money, provide collateral, and meet other requirements. State fund deposits are attractive to these institutions only sometimes, and only in amounts that are limited by their own lending opportunities. The amount of funds that these institutions want may swing considerably over time. A fixed percentage deposit requirement does not seem well suited to this volatility.

SUGGESTION FOUR: IDENTIFYING IMPEDIMENTS, IF ANY, TO COMMUNITY BANKS’ RECEIPT OF PUBLIC MONEYS, SUCH AS THOSE FROM POOLED MONEY INVESTMENT ACCOUNTS

There are impediments that reduce community banks’ ability to receive deposits of state surplus funds, although there are mostly good reasons for those impediments. They are not merely spiteful bureaucratic hurdles.

A first category of impediment reflects legislatively enacted precautions requiring substantial collateral for deposits and prohibiting over-concentration of funds in any particular institution. The depository institution must provide acceptable collateral with value that exceeds the amount of the deposit by ten percent, and which is reevaluated periodically to assure that it remains sufficient. Once a security becomes collateral and is held by the Treasurer’s Office, it cannot be used simultaneously as collateral for another deposit, nor can it be sold or exchanged by the depository institution.²⁵ (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, California law also requires that time deposits do not exceed the institution’s equity capital. Equity capital in a community bank might be only a few million dollars, in contrast to billions of dollars in a large institution.

The point of the collateral requirement is to be sure, very sure, that California gets back the money that it has deposited. California is on the conservative end of the range of possibilities here. Some nine states make deposits with no collateral requirements at all.²⁶ Others require collateral running from 25 percent of the amount deposited to 110 percent, which is what California requires. Lowering the collateral requirement would presumably make it easier for smaller community banks to participate in the pooled money deposit program. But it would also increase the state’s risk.

Another approach to easing the collateral requirement would be to allow banks to participate in a collateral pool. For example, participating banks might be required to put

collateral equaling 50 percent of the amount deposited with them into a collateral pool. If any bank failed to repay its deposited amount, the state could draw from the pool to recover all of its loss. All the banks participating in the pool would lose a proportionate share of the collateral they had deposited in the pool. Or the defaulting bank would lose all of the collateral it had contributed to the pool, and the other half would come from the pool. This arrangement would have the advantage of giving the state complete collateral coverage for its deposits (at least, in the absence of very widespread bank failures that might exhaust the entire pool). It would allow the participating banks to tie up only half as much collateral as now for a given deposit. But it would expose those banks to the risk that they might lose part of their collateral because of the failure of some other bank.

A second impediment is that the state's deposits are for a limited amount of time. Although the state may roll a time deposit over into a second and third time period, the bank cannot count on it. So the bank must use the money in ways that ensure that it will have sufficient cash to repay the state at the end of the time period. This condition limits the ways that banks can use state deposits.

The obvious reason for the time limits on deposits is that the pooled money fund is intended to be a place for cash that is not immediately needed, but that might be needed on short notice. It is a cash management account. Local government depositors are allowed to withdraw their deposits with 24 hours notice.

It might be possible ease this impediment a little by consciously arranging fund investments so that deposits in banks in particularly virtuous communities could be rolled over long enough to fit the terms of loans that those banks could most usefully make, at least until the state was really low on cash. But a policy of this sort would rely on sound practical financial judgment, and is not the sort of thing that could be legislatively mandated.

A third impediment may be simply a lack of familiarity with the time deposit program on the part of banks, savings and loans, and credit unions. The obvious thing to do is to notify banks and other institutions about their potential eligibility for state deposits, and to spread the word at conferences, seminars, and special training programs. The Treasurer's office says they do all these things already. Since future Treasurers might be less enthusiastic about this program, the Legislature might consider requiring at least that the eligible institutions be notified every year or two. Texas has a requirement along these lines (see Appendix 3).

SUGGESTION FIVE: 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

California's present program for investing pooled funds locally also attempts to maintain a high rate of return, conservative liquidity, safety, and to keep voluntary local government participants happy. In general, there are more opportunities for balancing those conflicting objectives if the pool is large. For example, you can make longer term

deposits with local banks, or roll them over more nearly predictably, if the pool is large enough that you seldom need to scrape the pool's bottom. Likewise, a portfolio will have some relatively high yield but perhaps riskier or less liquid assets and some bank deposits. If you somehow arrive at the correct ratio between the two, then the dollar amount available for bank deposits will be larger if the pool as a whole is larger. From this point of view, creating a sub-pool to make local deposits seems like a move in the wrong direction.

However, if the state were to take a more aggressive approach to investing pooled assets locally, then a separate pool for this purpose might make sense. For example, a more aggressive pool might:

- Allow local banks to pay the state a below market interest rate if they, in turn, made below market loans to local businesses.
- Allow banks to maintain less collateral, or to pool collateral, for state deposits.
- Allow banks to keep money for longer terms before repaying it to the state, either with or without periodically adjusting the interest rate.

In this case, the state might want to make only a part of the state's cash balances subject to these conditions, as a way of limiting its exposure and controlling the expense of the program. Also, it would allow local governments to leave their funds in the traditionally run pool (most would probably do that), or to put some or all of their funds in the more aggressively localized program (which they might be more likely to do if they thought they would especially benefit from it).

APPENDIX 1

SECURITIZATION OF LOANS

Few developments have as fundamentally altered the financial landscape as securitization of loan pools.²⁷ 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 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).²⁸

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 availability of mortgage funding.²⁹

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 nonrated, 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.³⁰

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.

APPENDIX 2

RATIO OF TIME DEPOSITS TO TOTAL DEPOSITS IN CALIFORNIA BANKS

The table shows the ratio of time deposits to total deposit by bank size used in the calculation of California time deposits. The FDIC reports these ratios in their summary tables. Since the Treasurer's Office places funds in time deposits, while deposits in the California banking system include Negotiated Order of Withdrawal (NOW accounts) and other interest-bearing accounts, the amount of time deposits had to be estimated.

Banks by Size of Assets	Total Deposits in California Banks	% of Total Deposits	Ratio of Time Deposits to Total Deposits	Total Time Deposits in California Banks	% of Total Time Deposits
1995					
Greater than 5 Billion	\$155,769,306	68.0%	24.6%	\$38,258,376	61.5%
More than 1 B-5 B	\$27,654,152	12.1%	24.6%	\$6,792,114	10.9%
More than 500 million to 1 Billion	\$9,955,069	4.3%	36.8%	\$3,659,857	5.9%
More than 300 million to 500 milli	\$8,149,268	3.6%	37.2%	\$3,030,578	4.9%
100 million to 300 million	\$18,140,911	7.9%	36.9%	\$6,696,857	10.8%
Less than 100 million	\$9,561,616	4.2%	39.3%	\$3,754,100	6.0%
TOTAL	\$229,230,322	100.0%	27.1%	\$62,191,882	100.0%
1998					
Greater than 5 Billion	\$196,813,566	72.4%	25.8%	\$50,732,630	66.9%
More than 1 B-5 B	\$32,114,719	11.8%	25.8%	\$8,278,211	10.9%
More than 500 million to 1 Billion	\$13,354,775	4.9%	38.3%	\$5,109,206	6.7%
More than 300 million to 500 milli	\$7,956,147	2.9%	37.1%	\$2,954,023	3.9%
100 million to 300 million	\$16,108,586	5.9%	39.5%	\$6,361,953	8.4%
Less than 100 million	\$5,562,361	2.0%	44.0%	\$2,446,327	3.2%
TOTAL	\$271,910,154	100.0%		\$75,882,349	100.0%
2000					
Greater than 5 Billion	\$234,038,666	72.5%	30.9%	\$72,274,422	68.9%
More than 1 B-5 B	\$43,561,268	13.5%	30.9%	\$13,452,330	12.8%
More than 500 million to 1 Billion	\$14,905,516	4.6%	46.5%	\$6,928,424	6.6%
More than 300 million to 500 milli	\$8,541,975	2.6%	37.2%	\$3,181,828	3.0%
100 million to 300 million	\$16,972,581	5.3%	40.7%	\$6,912,783	6.6%
Less than 100 million	\$4,709,041	1.5%	44.8%	\$2,110,161	2.0%
TOTAL	\$322,729,047	100.0%		\$104,859,949	100.0%
2003 (as of June 2002)					
Greater than 5 Billion	\$272,891,843	72.6%	26.1%	\$71,088,325	68.3%
More than 1 B-5 B	\$57,594,025	15.3%	26.1%	\$15,003,244	14.4%
More than 500 million to 1 Billion	\$17,179,127	4.6%	42.9%	\$7,371,947	7.1%
More than 300 million to 500 milli	\$9,751,168	2.6%	34.7%	\$3,379,348	3.2%
100 million to 300 million	\$13,955,936	3.7%	38.8%	\$5,417,951	5.2%
Less than 100 million	\$4,414,664	1.2%	40.1%	\$1,768,800	1.7%
TOTAL	\$375,786,763	100.0%		\$104,029,615	100.0%
Source: California Office of the Treasurer, and FDIC (Summary of Deposits in all bank branches located in California), and California State Banking Department (for data on State-only chartered banks).					

APPENDIX 3

TEXAS PROCEDURES FOR NOTIFYING AND APPROVING DEPOSITORIES

Texas has a more formal and documented method for notifying potential depositories than does California. This extract from Texas law describes the procedures.

Texas Government Code § 404.022. Applications

- (a) The comptroller, not later than the first business day in June of each odd-numbered year, shall mail to each eligible institution a letter stating the conditions with which applicants for designation as a state depository must comply. The comptroller shall keep on file in the comptroller's office and make available for inspection by any person a list of institutions to which letters have been sent.
- (b) The application for designation as a state depository must include a statement:
 - (1) of the amount of the applicant's paid capital stock and permanent surplus, if any;
 - (2) of the maximum amount of state time deposits the applicant will accept;
 - (3) of the applicant's condition according to the most recent financial statement on the date the application is submitted; and
 - (4) that the books and accounts of the institution, if it is designated as a state depository, will be open at all times for inspection by the comptroller or a representative of the comptroller.
- (c) An application shall be mailed to the comptroller at Austin and must be received before noon on the first business day of August of the year in which the letter is sent. An application received after that time may be considered at the option of the comptroller. The comptroller may charge a processing fee of \$25 for each application and shall deposit the fees to the credit of the general revenue fund.
- (d) On receipt of an application under this section, the comptroller shall endorse on the application the date of its receipt. The comptroller shall prepare a list of the names of the applicants and the amount for which each has applied.
- (e) The comptroller may approve those applicants that are acceptable and may reject those whose management or condition, in the opinion of the comptroller, does not warrant the placing of state funds in their possession.
- (f) The designation as a state depository is effective for a period of not more than two years.
- (g) As soon as practicable after the comptroller has made its designations, the comptroller shall inform applicants whether they have been designated as state depositories.
- (h) The comptroller may execute a simplified version of a depository agreement with an eligible institution desiring to hold \$98,000 or less in state deposits that are fully

insured by the Federal Deposit Insurance Corporation (FDIC) or the National Credit Union Share Insurance Fund.

ENDNOTES

¹ 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.

² 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.

³ Published by the State Treasurer's Office, May 2000, <http://www.treasurer.ca.gov/publications/doublebottomline/DBL.htm>.

⁴ *Double Bottom Line*, 25.

⁵ 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.

⁶ 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.

⁷ [California Government Code sections 16500 and 16600].

⁸ Sections 16505 and 16604.

⁹ Discussion with Treasurer's Office investment staff, May 31, 2001.

¹⁰ 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.

¹¹ California Government Code Sections 16505 and 16604.

¹² 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.

¹³ 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, as terms on which loans are provided.

¹⁴ Mark Levonian and Jennifer Soller, "Small Banks, Small Loans, Small Business," *FRBSF Weekly Letter* 96-02 (January 12, 1996).

¹⁵ For example, Robert B. Avery, Raphael W. Bostic, Paul S. Calem, Glenn B. Canner, Kelly A. Bryant, and John E. Matson, "Trends in Home Purchase Lending: Consolidation and the Community Reinvestment Act," *Federal Reserve Bulletin* 85 no. 2 (Feb. 1999), p. 81.

¹⁶ Robert B. Avery, Raphael W. Bostic, Paul S. Calem, Glenn B. Canner, Kelly A. Bryant, and John E. Matson, "Trends in Home Purchase Lending: Consolidation and the Community Reinvestment Act," *Federal Reserve Bulletin* 85, no. 2 (Feb. 1999), p. 81.

¹⁷ 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.

¹⁸ 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).

¹⁹ According to a report published by the National Association of State Treasurers, the California State Treasurer has authority over 75 percent 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 percent (Arizona and Colorado, for example: 24 states total). The figure for New York is "less than 1 percent," 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).

²⁰ 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).

²¹ 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.

²² 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.

²³ For pertinent Texas law, see <http://www.capitol.state.tx.us/statutes/go/go040400.html#go010.404.024>.

²⁴ Management Audit Committee Wyoming State Legislature, "Program Evaluation: Linked Deposit Program," February 1991.

²⁵ 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?"

²⁶ 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. For states with collateral requirements, the percentage required ranges from 25 percent to 110 percent (California's is 110 percent).

²⁷ 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.

²⁸ For more information on Freddie Mac, see <http://www.freddie.mac.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.freddie.mac.com/corporate/about/twlvquest.html#BM9>).

²⁹ 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).

³⁰ Leon T. Kendall, “Securitization: A New Era in American Finance,” in Kendall and Fishman, eds., *A Primer on Securitization*, 11, 13.

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WEB SITES

The following list is provided both as documentation and as an aid to further research on the part of readers of this paper.

Banks on the Internet, http://www.thecommunitybanker.com/bank_links/index.htm.
California banks on the Internet,
http://www.thecommunitybanker.com/bank_links/usa_california.htm.

California Bankers Association, <http://www.calbankers.com>. The membership of this organization overlaps but is not identical to that of the California Independent Bankers.

California Code of Regulations, <http://ccr.oal.ca.gov>. Banking-related regulations, under the purview of the Department of Financial Institutions, appear in Title 10.

California Department of Financial Institutions, <http://www.dfi.ca.gov>. Financial Statistics, <http://www.dfi.ca.gov/IndustryServices.htm>. Banking-Related Sites <http://www.dfi.ca.gov/RelatedWeb.htm>.

California Independent Bankers (sponsors of AB 2805), <http://www.cib.org>. CIB is an affiliate of Independent Community Bankers of America (ICBA). Links to regulatory and other federal banking-related agencies are provided at a related page, http://www.cib.org/leg_reg.html.

California Public Employees Retirement System (CalPERS), <http://www.calpers.ca.gov>.

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Federal Deposit Insurance Corporation (FDIC), <http://www.fdic.gov>. Bank Data: Individual Banks, <http://www.fdic.gov/bank/individual/index.html>. Institution Directory, <http://www2.fdic.gov/idasp/index.asp>. CRA ratings: <http://www.fdic.gov/regulations/community/index.html>. Quarterly Banking Profile: <http://www2.fdic.gov/qbp/qbpSelect.asp?menuItem=QBP>. Reports of Condition and Income (Call Reports) and Thrift Financial Reports (TFRs), http://WWW2.FDIC.GOV/call_tfr_rpts. Quarterly Banking Profile, published approximately 75 days after the end of each quarter, <http://www2.fdic.gov/qbp/qbpSelect.asp?menuItem=QBP>. Regional Outlook, <http://www.fdic.gov/bank/analytical/regional>. Also see <http://www.fdic.gov/bank/analytical> for additional links to FDIC data and publications.

Federal Home Loan Bank System, <http://www.fhlbanks.com>.

Federal Financial Institutions Examination Council (FFIEC), <http://www.ffiec.gov>. FFIEC Interagency CRA Rating Search, <http://www.ots.treas.gov/> – purportedly searches all under all four supervisory agencies, Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision. This should be the easiest site to use if you are not sure which is the applicable oversight agency, but it appears to be very incomplete or to have problems that result in not finding information for some or many institutions. HMDA Aggregate Reports (lists mortgage lenders with home or branch office by MSA), http://www.ffiec.gov/hmda_rpt_agg_1999.htm. The site also offers a vast array of detailed information down to the census tract level (latest available data for 1999, as of June 2001).

Federal Reserve Bank of San Francisco, <http://www.frbsf.org>. Index to *FRBSF Weekly Letter*: <http://www.frbsf.org/publications/economics/letter/index.html>.

Federal Reserve Board of Governors, <http://www.federalreserve.gov>. CRA ratings, <http://www.federalreserve.gov/DCCA/CRA/crarate.cfm>. The Twelve Federal Reserve Districts, <http://www.federalreserve.gov/otherfrb.htm>. The various districts offer many publications and data sources. Note especially the San Francisco and Kansas City regions. Statistical releases and historical data: <http://www.federalreserve.gov/Releases>. Beige Book information (compilations and observations from the districts) is available online. For 2001, see <http://www.federalreserve.gov/FOMC/BeigeBook/2001>.

Financial Markets Center, <http://www.fmcenter.org>. Quoting its own description, “The Financial Markets Center is an independent, nonprofit institute that provides research and education resources to grassroots groups, unions, policymakers and journalists interested in the Federal Reserve System and financial markets. Through its work, the Center seeks to promote democratic values, accountable public institutions and improved living standards for ordinary citizens.” Publications and resources posted at FMC encompass banking as well as many other topics.

National Credit Union Administration, <http://www.ncua.gov/indexdata.html>. Individual credit union information: <http://www.ncua.gov/data/cudataexpanded.html>.

U.S. Comptroller of the Currency, <http://www.occ.treas.gov>. CRA information: <http://www.occ.treas.gov/crainfo.htm>. Comptroller's Handbook – Safety and Soundness: <http://www.occ.treas.gov/handbook/S&S.htm>. Comptroller's Handbook, Compliance: <http://www.occ.treas.gov/handbook/compliance.htm>.

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.