Date of Hearing: April 16, 2012

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Mike Eng, Chair
AB 1617 (Dickinson) – As Amended: April 9, 2012

SUBJECT: State treasury: community banks.

SUMMARY: Provides that under certain circumstances, the Treasurer shall invest an average of 30% of surplus moneys that are in the Pooled Money Investment Account (PMIA) in time deposits in community banks or credit unions. Specifically, this bill:

1) Specifies that, under certain conditions, the Treasurer shall invest an average of 30%, as averaged over a twelve month period, of surplus PMIA moneys, into community banks and credit unions.

2) Requires the Treasurer, when choosing which community banks and credit unions to use for investment, to take into consideration the following:

   a) The extent to which institution serves a community with an unemployment rate that exceeds the statewide average;

   b) Whether the institution services a low or moderate income community;

   c) Whether the institution offers small business loans in the communities they serve;

   d) Whether the institution is an "eligible bank" as defined under current requirements regarding state investments; and

   e) Whether the institution is headquartered in this state.

3) Defines "community bank" as a bank or savings institution in California with aggregate assets of less than ten-billion dollars.

4) Defines that for purposes of investments as required under this section that "surplus moneys" means those funds in the PMIA exclusive of money from the Local Agency Investment Fund and Money allocated for internal state borrowing.

EXISTING LAW

1) Provides that eligible securities for the investment of state surplus moneys include any of the following:

   a) 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;

   b) Bonds or interest-bearing notes on obligations that are guaranteed as to principal and interest by a federal agency of the United States;

c) Bonds and notes of this state, or those for which the faith and credit of this state are pledged for the payment of principal and interest;

d) Bonds or warrants, including, but not limited to, revenue warrants, of any county, city, metropolitan water district, California water district, California water storage district, irrigation district in the state, municipal utility district, or school district of this state;

e) Bonds, consolidated bonds, collateral trust debentures, consolidated debentures, or other obligations issued by federal land banks or federal intermediate credit banks established under the Federal Farm Loan Act, as amended, in debentures and consolidated debentures issued by the Central Bank for Cooperatives and banks for cooperatives established under the Farm Credit Act of 1933, as amended, in bonds or debentures of the Federal Home Loan Bank Board established under the Federal Home Loan Bank Act, in stock, bonds, debentures and other obligations of the Federal National Mortgage Association established under the National Housing Act as amended, and in the bonds of any federal home loan bank established under that act, obligations of the Federal Home Loan Mortgage Corporation, in bonds, notes, and other obligations issued by the Tennessee Valley Authority under the Tennessee Valley Authority Act as amended, and bonds, notes, and other obligations guaranteed by the Commodity Credit Corporation for the export of California agricultural products under the Commodity Credit Corporation Charter Act as amended;

f) Commercial paper of "prime" quality as defined by a nationally recognized organization that rates these securities;

g) Bills of exchange or time drafts drawn on and accepted by a commercial bank, otherwise known as bankers acceptances, which are eligible for purchase by the Federal Reserve System;

h) Negotiable certificates of deposits issued by a federally or state-chartered bank or savings and loan association, a state-licensed branch of a foreign bank, or a federally or state-chartered credit union;

i) The portion of bank loans and obligations guaranteed by the United States Small Business Administration or the United States Farmers Home Administration. Bank loans and obligations guaranteed by the Export-Import Bank of the United States;

j) Student loan notes insured under the Guaranteed Student Loan Program established pursuant to the Higher Education Act of 1965, as amended (20 U.S.C. Sec. 1001 and following) and eligible for resale to the Student Loan Marketing Association established pursuant to Section 133 of the Education Amendments of 1972, as amended (20 U.S.C. Sec. 1087-2); and,

k) Obligations issued, assumed, or guaranteed by the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the International Finance Corporation, or the Government Development Bank of Puerto Rico; or, Bonds, debentures, and notes issued by corporations organized and operating within the United States. Securities eligible for investment under this subdivision shall be within the top three ratings of a nationally recognized rating service. (Government Code, Section 16430. All further references are to the Government Code).

2) For purposes of bank deposits by the Treasurer defines "eligible bank" as a state or national bank located in this state, selected by the Treasurer for the safekeeping of money belonging to or in the custody of the state, that has received an overall rating of not less than "satisfactory" in its most recent evaluation by the appropriate federal financial supervisory agency of the bank's record of meeting the credit needs of the state's communities, including low- and moderate-income neighborhoods, pursuant to Section 2906 of Title 12 of the United States Code. (Section 16500).

3) Allows the Treasurer with approval of the Director of Finance to deposit money in banks outside the state when the banks are fiscal agents of the state or custodians of securities owned by the state. (Section 16501).

4) Allows the Treasurer to determine what amounts of money shall be deposited in banks as time deposits and demand deposits. (Section 16503).

5) Provides that deposits in any bank shall exceed the total of its net worth. (Section 16505).

FISCAL EFFECT: Unknown impact to PMIA.

COMMENTS:

According to information provided by the author's office, the need for this bill is stated as the following:

Under current law, the State Treasurer invests temporarily idle state and local funds from the Pooled Money Investment Account (PMIA) into a variety of investments and products, including time deposits, offered by financial institutions that meet certain statutory requirements concerning safety and soundness. According to information on the Treasurer's website, there are 13 large domestic banks certified to receive PMIA funds. B of A, Wells Fargo, Chase and Citibank are among the large domestic banks certified to receive PMIA deposits.

Unfortunately, many, if not all of the certified domestic banks have participated in the type of highly leveraged activities that brought the national and state economies to the brink of disaster. Further, many of these same institutions became so financially unstable as a result of their own extremely risky financial activity, the federal government had to bail them out using taxpayer funds. Many of these institutions have also been responsible for residential lending practices that led to the housing meltdown, which resulted in families losing their homes, growing joblessness and even homelessness. Finally, in the midst of all the economic upheaval caused by these banks, these very same institutions have severely restricted the availability of credit to individuals and small businesses, thus retarding any economic recovery from what has become known as the Great Recession.

Smaller, community banks, however, which did not participate in the unsound, risky financial transactions of the last decade, have remained relatively stable, and have continued to offer financial services and credit to individuals and small businesses in the local communities in *which they are located and operate. However, the Treasurer deposits a relatively small share of state surplus funds in community banks, when compared to deposits in the large national banks. In January 2012, time deposits, which are the typical community bank/credit union investment, amounted to only 6.3% of the $66 billion in the PMIA at that time. This circumstance is problematic in a couple of ways. First, community banks have less access to capital that is derived from taxpayer funds. These are California dollars that could otherwise be put to good work in underserved California communities, helping to create jobs and stimulate economic growth in areas of high unemployment in this state. Second, the current situation of investing most state resources in large national banks, perversely rewards the very institutions that have hurt so many California taxpayers who themselves cannot access credit or services from these same big banks.*

As stated in the Banking Committee's analysis of AB 1156 from 2009, an article appearing in The Washington Monthly, Too Small to Fail (December 2008), detailed the stability and soundness of the community bank model. The findings concluded that small banks are holding steady through much of the current economic crisis. For example, the failure rate among big banks (those with $1 billion or more) is seven times greater than among smaller banks. The article goes on to say, "One reason community banks are doing so well right now is simply that they never became too clever for their own good." Additionally, because most community banks did not sell off large portions of their lending portfolios to investors, and in such, retained the risk, they were more likely to have made the determination that customers could actually repay the loans that had been given to them. Finally, "When savers, borrowers, and lenders all live in the same community, lenders don't write loans that amount to financial crack. They know their business depends on their good reputation."

Understandably, the Treasurer is focused on obtaining the highest rate of return on the investment of state funds for the taxpayer. However, by investing a proportionately larger share of state surplus money in community banks and credit unions the state could assist in generating other economic benefits for taxpayers, especially in distressed California communities, that are equal to or greater than a strict maximization of monetary return, while still, adhering to safe and soundness standards.

The Treasurer is also concerned about the liquidity of the state's investments, particularly to honor potential withdrawal demands of local agencies investing in the Local Agency Investment Fund, and to be able to make and repay internal state loans. AB 1617 recognizes these needs and excludes LAIF and internal borrowing from the calculation of surplus moneys that the bill requires to be invested in community banks and credit unions.

Background.

The PMIA, governed by the Pooled Money Investment Board (PMIB) has three primary sources of funds: State general fund, special funds held by state agencies, and moneys deposited by local jurisdictions in the Local Agency Investment Fund (LAIF). Moneys in the PMIA can only be invested in U.S. government securities, securities of federally-sponsored agencies, domestic corporate bonds, interest bearing time deposits in California banks, savings and loan associations and credit unions, prime-rated commercial paper, repurchase and reverse repurchase agreements, security loans, banker's acceptances, negotiable certificates of deposit and loans to various bond funds.

Currently the Treasurer invests some moneys under the PMIA into banks and credit unions via the time deposit program (TDP). The TDP often provides a greater return than the yield from Treasury bills and makes money available to banks at better rates than they can get from other sources. Deposits in the TDP must be collateralized by at least 110% of the funds on deposit.

The Pooled Money Investment Board Report (PMIBR) for February 2012 provides data on the various investments and cash management strategies conducted by the Treasurer. Under the existing TDP, for February 2012, $4,233,640,000 (Representing 6.53% of PMIA portfolio) was in time deposits in approximately 65 institutions located across the state. A review of the institutions in the report reveals a broad range of small, medium and large sized banks and credit unions that take part in the TDP. However, a review of the report does not reveal which banks would be considered community banks under the criteria in this bill.

This bill seeks to require that over a 12 month period the PMIA, with some exceptions, should have a 30% investment average in community banks and credit unions. In making these investments the Treasurer should consider certain factors such as whether the institution serves a moderate to low income community.

<u>Questions.</u>

1) Is it appropriate to require a strict percentage of PMIA investments into one type of investment? California's Government code provides boundaries on those investments that are appropriate for investment of state and local funds. Statute typically provides investment standards that require investments in quality assets and restrictions in over investment in one particular type of investment. Statute typically does not mandate minimum amounts that should be invested in one vehicle versus the other. Much of the state's investment strategy that is not in statute is outlined in non-statutory investment policies. For example, the State Treasurer maintains an Investment Policy: Pooled Money Investment Account, July 20, 2011. The key areas of the PMIA invest policy is below:

   The pool will be managed to insure the safety of the portfolio by investing in high quality securities and by maintaining a mix of securities that will provide reasonable assurance that no single investment or class of investments will have a disproportionate impact on the total portfolio…

   In addition to the safety provided by investing in high quality securities, the safety of the portfolio is enhanced three ways by maintaining a prudent mix (i.e., diversity) of investments: 1) Spreading investments over different investment types minimizes the impact any one industry/investment class can have on the portfolio; 2) Spreading investments over multiple credits/issuers within an investment type minimizes the credit exposure of the portfolio to any single firm/institution; and 3) Spreading investments over various maturities minimizes the risk of portfolio depreciation due to a rise in interest rates. An unforeseen liquidity need allows no options if ***"all your eggs are in one basket."***

   …The portfolio shall contain a sufficient number and diversity of marketable securities so that a reasonable portion of the portfolio can be readily converted to cash without causing a material change in the value of the portfolio. Limitation and eligibility as to specific investments are to be determined by the Pooled Money Investment Board in the

case of Commercial Paper, the Treasurer's Office Investment Committee in cases of new dealer authorizations and approval of new corporate investments, and the Treasury Investment Division in all other matters.

The pool will be managed to ensure that normal cash needs, as well as scheduled extraordinary cash needs can be met. Further, adequate liquidity shall be maintained to ensure the unforeseen cash needs, whether ordinary or extraordinary.

The pool will maintain a "cash flow generated" portfolio balance sufficient to cover specifically the one-month prepared cash forecast, as well as generally the six month prepared cash forecast. Further, sufficient marketable treasuries will be maintained to cover unforeseen withdrawals or delayed deposits.2 July 20, 2011

First priority is given to maintaining specific calendar liquidity, as dictated by the most recent cash forecast. Second priority is the maintenance of Treasury Bill positions adequate to meet unscheduled needs. Final consideration would be given to "other" investments deemed appropriate to portfolio maintenance, enhancement, or restructuring.

2) Are there community banks and credit unions that wish to receive deposits from the PMIA and that meet investment criteria not getting a fair chance to participate?

3) In making investments in community banks and credit unions the bill provides that the Treasurer "shall consider" various criteria relating to the communities served by the institutions. While it is a requirement to "consider" these factors it is unclear on how each factor would be weighted in making investments.

Suggested amendments:

1) In order to specifically target the TDP, committee staff recommends that the bill should be amended to avoid placing an investment threshold in the PMIA and instead provide for a threshold within the TDP. For example, it may be more appropriate to provide that 30% of investments in time deposits should go to community banks and credit unions. Committee staff is supportive of further changing the 30% threshold, but first would encourage stakeholders to provide information and justification for a greater percentage if it's deemed necessary.

2) In order to provide more clarity, staff recommends language that would provide that the Treasurer delineate in the PMIA Board Reports which banks are community banks.

3) In regards to factors that must be considered prior to investing in community banks and credit unions, staff recommends that the consideration of these factors should be permissive in nature, instead of mandatory.

Previous Legislation.

AB 1156 (Nava) of 2009 would have prioritized the investment of surplus moneys in community banks and credit unions. Held in Assembly Appropriations.

REGISTERED SUPPORT / OPPOSITION:

Support

California Credit Union League
California Independent Bankers

Opposition

California State Treasurer

Analysis Prepared by: Mark Farouk / B. & F. / (916) 319-3081