OFFICE OF THE AUDITOR GENERAL

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REPORT ON INVESTMENT POLICIES OF THE POOLED MONEY INVESTMENT BOARD AND PROCEDURES OF THE STATE TREASURER

SEPTEMBER 1974

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September 13, 1974

The Honorable Speaker of the Assembly
The Honorable President of the Senate
The Honorable Members of the Senate and the
Assembly of the Legislature of California

Members:

Transmitted herewith is the Auditor General's report pertaining to the investment and bank deposit policies of the Pooled Money Investment Board and the related procedures of the State Treasurer, who is responsible for the administration of the board's policies.

The Pooled Money Investment Board consists of the State Controller, the State Treasurer, and the State Director of Finance. In fiscal year 1973-74, the board members, assisted by the presence of historically high interest rates and the largest amount of state funds ever available, are to be commended for earning interest income of $231.2 million, the highest amount of interest income in the state's history.

However, the board members must accept responsibility for the fact that as a result of their policies and procedures and failure to obtain broader investment authority, additional interest income which should have been earned, conservatively estimated at $11.2 million annually, has been lost by the state.

Further, the Treasurer must accept responsibility for not having requested authorization from the Legislature since 1970 to issue lower interest rate general obligation refunding bonds to replace high interest rate state bonds. Unless such authorization is obtained for bonds issued in fiscal year 1974-75, approximately $18.7 million of unnecessary bond interest costs will be incurred by the state over the average life of the bonds for each 1/2 of one percent decrease in interest rates.

The major audit findings are as follows:

As a result of a policy established by the Pooled Money Investment Board in 1956, and reaffirmed by the board in 1968 and 1972, $250 million of state funds are deposited in certain interest bearing bank accounts on a daily basis at all times despite the fact that higher interest rates are available from other authorized bank deposits and investments. This board policy, which is clearly not in the best interests of the state, has resulted in an annual loss to the state of approximately $1.7 million in interest income.

In accordance with the Pooled Money Investment Board's policy established in 1956, excessive state funds averaging $15.5 million daily in fiscal year 1973-74 have been maintained in non-interest bearing checking accounts in ten banks, resulting in an annual loss of interest income to the state of approximately $930,000. The ten banks are Bank of America, Bank of California, Central Bank, Crocker National Bank, First Western Bank & Trust Company, Merchants National Bank, Security Pacific National Bank, Union Bank, United California Bank, and Wells Fargo Bank.

Based on the board's policy established in 1968, state investments in commercial paper have been concentrated in nation-wide finance companies and in California banks and corporations, rather than in nation-wide prime industrial corporations and major bank holding companies. The interest rate offered on commercial paper of the finance companies and California banks and corporations is generally 1/4 of one percent less than the rate offered on commercial paper of prime industrial corporations and bank holding companies. As a result of the board's policy, an estimated $500,000 in interest income is lost annually by the state.

Interest income of approximately $4 million is lost annually by the state as a result of the Treasurer not seeking legislative authorization and the Legislature not granting authorization which would permit prudent investment of state funds in negotiable certificates of deposits. Further, interest income of approximately $1 million is lost annually by the state as a result of the Treasurer not seeking legislative authorization and the Legislature not granting authorization to invest in commercial paper with maturity dates of up to 270 days and to invest in commercial paper up to 30 percent of state funds available for investment. Present state legal restrictions of 90 days and 15 percent are in effect.

For the first eight months of fiscal year 1973-74, the Treasurer invested in commercial paper only 9.6 percent of the state funds available for investment. The Treasurer's procedure of not investing in selected commercial paper to the maximum of 15 percent as is already authorized by law, has resulted in an estimated annual loss of interest income of $350,000 to the state.

The Treasurer's procedures permit 60 to 75 percent of the dividends and interest income on the state retirement systems' investments in stocks and bonds to be received by the Treasurer's Office an average of at least three days after these monies are due to the state. As a result, approximately $260,000 of interest income is lost by the state annually.

Reports and records of the State Treasurer relating to the state's deposit and investment activities do not provide full disclosure to the public, do not document that competitive procedures have been utilized, are not summarized in a manner to evaluate performance and make sound policy decisions, and are untimely.

These reports are deficient despite the fact that in fiscal year 1973-74, the state had average daily total investments and bank deposits of approximately $2.6 billion, and that a total of approximately $73.9 billion of securities was purchased and sold by the Treasurer's Office.

As a result of procedures by the State Controller for disbursing an average of approximately $170 million monthly for the support of public schools, prior to the time such funds are required to be disbursed, the state is losing an estimated $2 million of interest income annually.

The Auditor General has made 21 recommendations to correct the findings contained in the report. Among others, he has recommended that (1) the Pooled Money Investment Board discontinue its requirement to maintain $250 million in certain interest bearing bank accounts in order that the state can obtain the highest available interest income from other authorized bank deposits and investments, consistent with safe and prudent treasury management and consistent with state law; (2) the board reduce the excessive state funds maintained in non-interest bearing checking accounts deposited in ten banks; (3) the Treasurer request the Legislature to authorize the investment of state funds in negotiable certificates of deposit and request the Legislature for broader authority to invest in commercial paper; and (4) the Controller discontinue the disbursing of state funds prior to the time that such funds are required to be disbursed.

The Auditor General has stated that proper implementation of the 21 recommendations will result in increased interest income to the state conservatively estimated at $11.2 million annually and could result in reduced bond interest costs to the state of approximately $18.7 million.

Detailed working papers, evidencing the facts obtained and supporting the conclusions and recommendations of the Auditor General, are available for review and inspection by all interested parties.

Respectfully submitted,

Vincent Thomas

VINCENT THOMAS, Chairman
Joint Legislative Audit Committee

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INTRODUCTION

In response to a legislative request, we have reviewed the policies and procedures for the investment and the deposit of state funds used by the Pooled Money Investment Board and the State Treasurer. We also examined certain related procedures of the State Controller for the disbursing of state funds and fee policies of the State Insurance Commissioner in connection with safekeeping services provided to workmen's compensation insurance companies by the Treasurer.

The Pooled Money Investment Board was created by the Legislature, effective July 7, 1955. It is the stated intent of the law that all available money be invested in securities or deposited in bank accounts in such a way as to realize the maximum return consistent with safe and prudent treasury management.

The Pooled Money Investment Board consists of the Controller, Treasurer, and the Director of Finance. The board, by majority vote, designates banking and investment guidelines and the amount of state funds to be invested and deposited. The day-to-day administration of the Pooled Money Investment Board's investment and deposit program is the responsibility of the State Treasurer, who is charged with the following:

- Investing temporarily idle state monies

- Providing a centralized state banking system for the deposit of state receipts and the payment of warrants drawn by the Controller and various state agencies

- Administering the sale, redemption and payment of interest on state bonds

- Maintaining custody of all money and securities belonging to or held in trust by the state

- Reviewing the financial soundness of local water district construction financing proposals.

In general, the Treasurer's Office has developed and employed sophisticated and effective principles and concepts to manage the state's investment and banking activities.

Further, as a result of the policies of the Pooled Money Investment Board and the administration of such policies by the Treasurer, together with the presence of historically high interest rates and the largest amount of state funds ever available for investments and deposits, in fiscal year 1973-74, the state earned the highest amount of interest income in its history. In total the state earned $231.2 million, and received the highest rate of return, 8.97 percent on its average daily investments and deposits of $2.58 billion.

While the Pooled Money Investment Board members are to be commended for this achievement, they must also accept responsibility for the fact that as a result of their policies and procedures and failure to obtain broader investment authority, additional interest income of approximately $11.2 million has been lost annually by the state. Further, the Treasurer must accept responsibility for not having requested authorization from the Legislature since 1970 to issue low interest rate general obligation refunding bonds to replace high interest rate state bonds. Unless such authorization is obtained for bonds issued in fiscal year 1974-75, approximately $18.7 million of unnecessary bond interest costs will be incurred by the state over the average life of bonds scheduled for sale by the Treasurer during fiscal year 1974-75 for each 1/2 of one percent decrease in interest rates.

As of June 30, 1973, the State of California, exclusive of the University of California, had total investments and deposits for all funds of approximately $11.5 billion. The state's investments and deposits were made by the following:

Investment Authority	Amount	Percent
State Treasurer (Pooled Money Investment Board)	$ 2,646,771,876	23.0%
Public Employees' Retirement Board	5,436,392,393	47.3
State Teachers' Retirement Board	2,696,407,746	23.4
Other separate investment authorities	717,770,179	6.3
Total	$11,497,342,194	100.0%

The Pooled Money Investment Account consists of temporarily unused monies of all state funds, outstanding state warrants, and investments for approximately 188 separate state funds, which are commonly deposited in bank accounts and invested in securities until needed for state operations. Interest income earned from bank accounts and investments of the Pooled Money Investment Account is distributed proportionately to the general fund and the 188 separate funds semi-annually based on resources provided to the Pooled Money Investment Account.

Unless otherwise identified, the term "state funds", as it appears in this report, refers to the funds in the Pooled Money Investment Account.

During the fiscal year ended June 30, 1974, the Treasurer completed approximately 6,900 investment transactions amounting to approximately $73.9 billion. The average amount of state funds invested each day during fiscal year 1973-74 was $2.58 billion.

In estimating future savings which could be achieved by proper implementation of the recommendations contained in this report, an estimated six percent annual earnings rate was used. This is slightly less than the average rate earned by the state on its investments during the last three years. Therefore, savings amounts have been conservatively estimated. As of July 1, 1974, monies deposited in interest bearing bank accounts by the Treasurer earned as much as 11 percent interest. The total investments made by the Treasurer, representing a divergent group of bank deposits and securities purchased at different times, were earning a 10.35 percent annual return on June 30, 1974. Historically, these are unusually high earning rates.

Detailed working papers evidencing the facts obtained and supporting the conclusions and recommendations of the Auditor General are available for review and inspection by all interested parties.

FINDINGS

INTEREST INCOME OF APPROXIMATELY $3.2 MILLION IS LOST ANNUALLY BY THE STATE AS A RESULT OF POLICIES ESTABLISHED BY THE POOLED MONEY INVESTMENT BOARD.

Policies established by the Pooled Money Investment Board, relating to the deposit of state funds in both non-interest bearing and interest bearing bank accounts and the investment of state funds in eligible securities, result in the loss of an estimated $3.2 million annually of interest income. Details of these policies and their related deficiencies are described in the following sections.

Excessive Balances Averaging $15.5 Million Daily Have Been Maintained In Non-Interest Bearing Checking Accounts in Ten Banks Resulting In An Annual Loss to the State Of $930,000 of Interest Income.

In accordance with the policy established by the Pooled Money Investment Board in 1956, the Treasurer maintains in ten banks non-interest bearing checking accounts which, in total, averaged $58.6 million per day during the three months ending June 30, 1974. These ten accounts had excessive balances averaging $15.5 million per day during fiscal year 1973-74, resulting in the loss of interest income to the state of an estimated $930,000 annually.

The balances maintained by the state in these non-interest bearing checking accounts are intended to compensate the banks for providing normal bank functions for the state, such as receipt of state deposits and the cashing of state warrants for state employees.

As of June 30, 1974, the non-interest bearing checking account balances for the ten California banks providing checking account services for the State of California were as follows:

Bank	Account Balance
Bank of America NT&SA	$44,084,000
Security Pacific National Bank	6,850,000
Wells Fargo Bank NA	3,301,000
United California Bank	2,220,000
Crocker National Bank	1,045,000
Union Bank	425,000
First Western Bank & Trust Co.	318,000
Bank of California NA	302,000
Central Bank NA	45,000
Merchants National Bank	10,000
Total	$58,600,000

The amounts to be maintained in the accounts are determined by the Pooled Money Investment Board's policy of using a formula developed over a period of years through negotiation with the banks. However, the banks have been provided with the excess funds, which otherwise could have earned interest income for the state, because of the following factors:

1. The average time allowed for bank collection of state deposits is too long, thereby reducing the interest income the state can earn from such deposits;

2. Bank earnings from the use of state monies deposited in checking accounts are calculated at less than the prime rate even though the banks earn interest from these monies at the prime rate or greater; and

3. No value has been obtained for amounts deposited by the state for federal income tax withheld from state employees' salaries and used by the banks in their operations.

Average Time Allowed for Bank
Collection of State Deposits
Is Too Long.

Included in the formula for determining the average daily balances to be maintained in non-interest bearing checking accounts is an amount which is estimated to compensate the ten banks for the time required to make collection on state deposits, thereby guaranteeing the banks that on an annual basis, the state is only spending collected funds.

Checks which are deposited by the state in a bank other than the one on which they are drawn must then be presented for payment to the bank on which drawn. Since 1968, the Pooled Money Investment Board has authorized the use of one business day as the average time required for the depository banks to make collection on state deposits. Prior to that time, longer periods of time were allowed.

In October 1973, the Department of Finance reported to the Pooled Money Investment Board that it had found that the average time required by the ten banks to collect payment on state deposits was .7948 of a business day. This Department of Finance report was based on a detailed, quantitative, scientific study using statistical sampling methods approved in advance by the banks. Nevertheless, the Pooled Money Investment Board directed that one full business day continue to be used for the 1973-74 fiscal year.

The reason given by the board for not reducing the time for fiscal year 1973-74 from one day to .7948 of a day to collect payment on state deposits was that the state planned to change its methods of making deposits in fiscal year 1974-75. The state would pre-sort the checks to be deposited by three major state agencies and deposit most of them directly with the bank on which they were drawn which would result in substantially reduced collection time for those deposits.

However, the board concluded that the remaining checks deposited by these three state agencies, as well as other state agencies, would require more than .7948 of a day to collect payment and therefore concluded that, overall, the continuation of the one day policy was sound. The pre-sort procedure began to be implemented by one state agency in July 1974, but there is no statistical data yet to show the effect this has had on average collection time.

The Board's conclusions for fiscal year 1973-74 are in error. By not reducing the time factor from one business day to .7948 of a business day during fiscal year 1973-74, the banks have been provided with the use of state monies in non-interest bearing checking accounts amounting to an average of $8.7 million daily in excess of what was required to fairly compensate the banks for normal checking account services they provided to the state.

Bank Earnings From the Use of State Monies Deposited in Checking Accounts Are Calculated At Less Than the Prime Rate.

In the formula for determining the average daily balances to be maintained in non-interest bearing checking accounts to compensate the ten banks for services provided to the state, the earning value of the state's checking account balances is assumed by the banks and the Pooled Money Investment Board to be only seven-eighths of the prime rate. The prime rate is the lowest rate at which the banks loan money to their largest and most credit-worthy customers. During fiscal year 1973-74, the prime rate of major California banks fluctuated from 7-1/2 percent to 11-3/4 percent.

Since banks charge their most preferred borrowers the prime rate, and less preferred borrowers even higher rates, in our judgment, the earning value of state funds available for use by the banks in their operations should be at least the prime rate.

The Pooled Money Investment Board's decision to calculate bank earnings at seven-eighths of the prime rate provided the banks in fiscal year 1973-74 with the use of state monies in non-interest bearing checking accounts amounting to an average of at least $1.5 million daily in excess of what was required to fairly compensate the banks for normal checking account services they provided to the state.

No Value Has Been Obtained for Amounts Deposited by the State for Federal Income Tax Withheld from State Employees' Salaries And Used by the Banks in Their Operations.

The formula used by the Pooled Money Investment Board since 1956 for determining the average daily balances to be maintained in non-interest bearing checking accounts to compensate the ten banks for services provided to the state did not give consideration to the amounts deposited monthly by the state with three of the ten banks for federal income tax withheld from state employees' salaries and used by the banks in their operations.

In calendar year 1973, the state deposited in these banks a total of $253.4 million for federal income tax withheld for employees' salaries, as follows:

Bank	Total Amount Deposited in 1973 (In Millions)
Crocker National Bank	$147.8
Wells Fargo Bank NA	50.4
Security Pacific National Bank	55.2
Total	$253.4

These deposits of $253.4 million remained with the three banks an average of 7.7 days for calendar year 1973 before they were withdrawn by the United States Treasury. This was equivalent to having an additional $5.3

million per day for use in the banks' operations. However, the state obtained no value from these three banks for placing such deposits with them.

Since 1917, the U. S. Treasury has allowed these deposits to be left in banks until they are needed, to provide stability to the financial markets and to compensate the banks for services they provide, such as collection of the taxes withheld. However, it has been recently reported that the U. S. Treasury is now reviewing their historical position on this matter because of the unusually high interest rates which allow the banks to earn more than the value of the services provided.

Following our discussions with the State Controller's and State Treasurer's Offices regarding the value obtained from the three banks for such deposits, and prior to the reports of the U. S. Treasury reviewing its policy on these deposits, the State Treasurer solicited bids to award a contract to make collection on pre-sorted state checks. As an added incentive, the bank submitting the best bid would also receive all state deposits of federal income tax withheld. The bidders were not required to separately identify value given to obtain all state deposits of federal income tax withheld.

As of July 1, 1974, the Treasurer began operating under a three-year agreement with Security Pacific National Bank to make collection on pre-sorted state checks. This agreement was also intended to obtain value from the bank for the deposit by the state of all amounts withheld from employees for federal income taxes. This contract is still subject to approval by the State Department of General Services. Therefore, we have not evaluated the reasonableness of the terms of this agreement.

Under the Pooled Money Investment Board's policy of not obtaining value for deposits of federal income tax withheld for employees' salaries in fiscal year 1973-74, banks had the use of state monies in non-interest bearing accounts amounting to an average of $5.3 million daily in excess of what was required to fairly compensate the banks for nornal checking account services they provided to the state.

While we recognize that for the three months ending September 30, 1974, the average daily balance in the ten non-interest bearing checking accounts was reduced by $8 million from the balances maintained for the three months ending June 30, 1974, there is no evidence that this reduction results from deficiencies noted in this report which have caused excessive average daily balances in non-interest bearing checking accounts of $15.5 million.

As previonsly noted, these excess balances result in a loss of interest income to the state estimated at $930,000 annually.

Highest Available Interest Rates Are Not Being Obtained As a Result of a Requirement to Deposit $250 Million in Certain Interest Bearing Bank Accounts On A Daily Basis at All Times Without Regard to The Higher Interest Rates Available from Other Authorized Investments and Bank Deposits and Because of Policies Pertaining to Commercial Paper and Other Investments. This Has Resulted in an Annual Loss to the State of $2.3 Million of Interest Income.

The state is losing $2.3 million of interest income annually because of policies established by the Pooled Money Investment Board which have prevented the deposit and investment of state funds so as to provide maximum interest income.

Specified Amounts Required to Be Deposited in Banks Regardless of Higher Rates of Interest on Other Authorized Investments and Bank Deposits.

Pooled Money Investment Board policy requires that $250 million of state funds be deposited in certain interest bearing bank accounts at all times regardless of the higher rates of interest income available from other authorized investments and bank deposits. Of this amount, since 1968, $225 million has been allocated daily to banks generally based in proportion to the amounts of their total capital and surplus.

The board's policy requiring that a specified amount of state funds currently set at $225 million be kept in banks based on the total amount of the banks' capital and surplus rather than considering all rates of interest income available to the state was established in 1956 when $196 million was so designated. This was prior to the time when legal approval was given in 1968 and 1971 for investment of state funds in specified securities which generally yield more than bank deposits.

With regard to state funds available for daily deposit and investment other than the $225 million, in June 1970 the Pooled Money Investment Board adopted a policy to deposit state funds in interest bearing bank accounts in order to obtain maximum return of those state funds. This policy was enacted following a temporary suspension in federal regulations intended to make interest bearing bank accounts competitive with other money market instruments. This temporary suspension is still in effect.

However, the Pooled Money Investment Board also retained its 1956 policy which eventually required that the $225 million of state funds be deposited in certain bank accounts daily, generally based in proportion to the amounts of the banks' total capital and surplus without regard to the higher interest rates available from other authorized investments and bank deposits.

In fiscal year 1972-73, the $225 million designated to be deposited at all times in interest bearing bank accounts without regard to higher interest rates paid to the state together with another so designated $25 million as explained on the next page provided a return of 5.398 percent. However, additional state funds in fiscal year 1972-73 averaging $660 million per day were deposited during the same period in interest bearing bank accounts based on the highest interest rates available, and such funds provided a return of 5.460 percent. For the first eight months of fiscal year 1973-74, the $250 million provided a return of 7.965 percent, while additional state funds, averaging $521 million per day which were placed in bank accounts to obtain maximum return, provided a return of 8.520 percent. Based on the two fiscal years ended June 30, 1974, the failure to secure the higher rates of return from the $250 million in bank deposits resulted in an annual loss of approximately $750,000 in interest income.

Similarly, the failure to invest the $250 million to obtain higher available interest rates from selected eligible investments such as bankers' acceptances, which are currently being purchased by the State Treasurer with other available funds, resulted in a loss of approximately $1.7 million annually in additional interest income. This $1.7 million was used in the computation of the total losses to the state as shown in this report.

Since July 1972, in addition to the $225 million, $25 million has been on deposit in banks that comprise the California Job Creation Corporation without regard to higher available interest rates paid to the state. Such deposits as of March 31, 1974 are as follows:

Bank	Amounts Deposited As of March 31, 1974
Bank of America, NT&SA	$ 7,750,000
Bank of California, NA	1,800,000
City National Bank	400,000
Crocker National Bank	3,300,000
First Western Bank & Trust Company	750,000
San Diego Trust & Savings Bank	350,000
Southern California First National Bank	875,000
Union Bank	725,000
United California Bank	2,175,000
Wells Fargo Bank NA	6,875,000
Total	$25,000,000

With regard to this corporation, the intent of the Legislature, as stated in the California Government Code, is that "...the Pooled Money Investment Board, in administering its investment program, shall give due regard to assisting such specific programs of the state designed to support the economy of economically disadvantaged areas as the California Job Corporation Law."

However, such expressed intent does not require that a specified amount be perpetually invested in those banks comprising what is now called the California Job Creation Corporation. Further, the intent does not preclude the state from attempting to obtain the highest interest rates available.

We conclude that the policy of the Pooled Money Investment Board requiring that $250 million of state funds be deposited in interest bearing bank accounts on a daily basis at all times, regardless of the rate of interest income paid to the state, is clearly a policy which is not in the best interests of the state.

Approval of State Investments In Commercial Paper Has Been Concentrated In Issuers Other Than Those Which Generally Offer the Highest Interest Income.

Under the Pooled Money Investment Board's policy established in 1968, the board has concentrated approval of commercial paper issuers in nation-wide direct issuer finance companies and California banks and corporations rather than in nation-wide prime industrial corporations and major bank holding companies. The interest rate offered on commerical paper of nation-wide direct issuer finance companies and California banks and corporations is generally 1/4 of one percent less than that of nation-wide prime industrial corporations and major bank holding companies.

As a result of the board's policy, $500,000 annually in interest income is lost to the state.

Commercial paper is an unsecured promissory note issued by a corporation in order for the corporation to obtain working capital for a maximum period of 270 days. Corporations referred to as direct issuers of commercial paper are those, including many California banks, whose borrowing needs are large and routine. Therefore, they find it economical to personally contact investors to sell commercial paper. Prime industrial corporations are leading industrial companies whose borrowing needs may only be seasonal or occasional. Therefore, they retain investment bankers to sell their commercial paper.

Authority for the state to invest funds in commercial paper was established in 1968, with a qualification that the Pooled Money Investment Board approve the issuers. The initial list of commercial paper issuers approved by the board consisted of 19 corporations, of which three are nation-wide finance companies and 16 are major nation-wide direct issuer finance companies.

The finance companies are:

- Beneficial Corp.
- Household Finance Corporation
- International Harvester Credit Corporation.

The major direct issuer finance companies are:

- Associates Corp. of North America
- American Investment Company
- Avco Financial Services, Inc.
- Chrysler Financial Corp.
- C.I.T. Financial Corporation
- Commercial Credit Company
- Ford Motor Credit Co.
- General Acceptance Corporation
- General Electric Credit Corporation
- General Motors Acceptance Corporation
- Walter E. Heller & Company
- Montgomery Ward Credit Corp.
- J. C. Penney Financial Corp.

- Sears Roebuck Acceptance Corporation
- James Talcott Incorporated
- Transamerica Financial Corporation.

Since the initial approval of commercial paper issuers, only nine additional corporations have been approved. These approvals have shown a concentration in California banks and corporations as shown below:

- BankAmerica Corp.
- Crocker National Corp.
- Unionamerica Inc.
- Western Bancorporation Credit Corporation (a subsidiary of the holding company of United California Bank)
- Wells Fargo & Company
- Pacific Gas & Electric Company
- Pacific Lighting Corporation
- Subsidiaries of American Telephone & Telegraph Company
- Westinghouse Credit Corp.

The subsidiaries of American Telephone & Telegraph Company were given conditional approval only. The State Controller, as a member of the Pooled Money Investment Board, requested that American Telephone & Telegraph Company guarantee its subsidiaries' commercial paper before the state invests its funds in such commercial paper. The staff of the State Treasurer does not believe it is possible to obtain such a guarantee, however.

Over a period of years prior to 1972, the State Treasurer's Investment Officer unsuccessfully sought Pooled Money Investment Board approval to expand the list of eligible commercial paper issuers to include prime industrial corporations. Although no such approval has been sought since 1972, the Investment Officer stated that he still believes that commercial paper of selected prime industrial corporations would offer greater return on the investment of state funds consistent with safe and prudent treasury management than those commercial paper issuers (direct issuer finance companies and California banks and corporations) currently approved.

We concur with the Investment Officer. Further, commercial paper of selected nation-wide bank holding companies would offer greater return on the investment of state funds consistent with safe and prudent treasury management than those commercial paper issuers currently approved.

In the first eight months of fiscal year 1973-74, 20 selected prime industrial corporations could have supplied 25 percent of the commercial paper purchased by the state. Interest income on those investments would have been 1/4 of one percent, or $116,000 greater than on the investments actually made by the state during that period. Four investment bankers we contacted sell commercial paper for 203 additional prime industrial corporations which meet the requirements of the commercial paper law for state investments.

We conclude that 50 percent of the commercial paper eligible to be purchased by the state could be purchased from selected nation-wide prime industrial corporations and major bank holding companies consistent with safe and prudent treasury management.

Additional interest income of an estimated $500,000 annually could be realized by the state if the Pooled Money Investment Board authorized investment of state funds in commercial paper of those selected nation-wide prime industrial corporations and bank holding companies which meet desired credit standards of the board and offer maximum return consistent with safe and prudent treasury management.

Based on Policy of the Pooled Money Investment Board, Investments Made By The State Treasurer are Generally Not Sold Prior to Their Maturity Date Even When Interest Earnings To the State Could Be Improved.

It is the policy of the Pooled Money Investment Board to generally not sell investments purchased by the state prior to the maturity date of such investments. Therefore, the state does not benefit from occurrences in the marketplace which allow investors to routinely make sales and purchases of investments to improve interest earnings.

Occurrences in the marketplace which provide opportunities for an investor such as the state, to routinely sell or purchase securities to improve interest earnings include:

- Sales of large blocks of securities by institutional investors at discounted prices, to obtain cash required in a short period of time

- Sales of large blocks of new securities by the United States Treasury and other federal agencies, creating short-lived excesses of the supply over the demand for such investments, thereby creating lower market prices

- Economic policies or events

- Anticipation by investors of interest rate changes.

The State Treasurer generally does not sell fixed income securities before maturity because in periods of rising interest rates, prices of such securities decline, resulting in accounting losses. However, in actuality, increased returns may be attained over the term of the investment because of a simultaneous sale of securities held by the state and purchase of alternative securities bearing higher interest rates.

In the first eight months of fiscal year 1973-74, the state had invested an average of $260 million per day in three to five year fixed income securities which provide average interest earnings of 7.03 percent on the purchase price.

Securities dealers assert that annually at least 20 percent of the fixed income securities held by institutions such as the State of California could be sold and alternative securities purchased simultaneously to improve interest earnings by at least one fourth of one percent and recover accounting losses. If a policy requiring such action by the Treasurer were established, an estimated $130,000 additional interest income could be earned annually on the state's fixed income investments.

RECOMMENDATIONS

We recommend that the Pooled Money Investment Board immediately:

- Reduce the excessive non-interest bearing checking account balances maintained at the Bank of America NT&SA, Security Pacific National Bank, Wells Fargo Bank NA, United California Bank, Crocker National Bank, Union Bank, First Western Bank & Trust Company, Bank of California NA, Central Bank NA, and Merchants National Bank, for fiscal year 1974-75 to an amount sufficient only to compensate the banks for the services they provide. Such a reduction would have amounted to approximately $15.5 million for fiscal year 1973-74.

- Discontinue its requirement to maintain $250 million in certain interest bearing bank accounts on a daily basis at all times without regard to the higher interest rates available from other authorized investments and bank deposits, and establish policies which require that all available state funds be invested in those specified securities such as bankers' acceptances or bank deposits offering the highest available interest income consistent with safe and prudent treasury management.

- Approve commercial paper issued by selected nation-wide prime industrial corporations and bank holding companies which meet the desired credit standards of the board so that the Treasurer may make investments in this commercial paper.

- Establish policies required for the sale of state investments prior to their maturity date and the simultaneous purchase of higher interest bearing investments when such opportunities arise to maximize the state's interest earnings.

SAVINGS

Proper implementation of these recommendations will result in increased interest income to the state of approximately $3.2 million annually.

INTEREST INCOME OF APPROXIMATELY $5.9 MILLION IS LOST ANNUALLY BY THE STATE AS A RESULT OF THE STATE TREASURER NOT SEEKING LEGISLATIVE AUTHORIZATION, AND THE LEGISLATURE NOT GRANTING AUTHORIZATION, WHICH WOULD PERMIT THE MAXIMIZING OF SUCH INCOME CONSISTENT WITH SAFE AND PRUDENT TREASURY MANAGEMENT AND AS A RESULT OF PROCEDURES USED BY THE STATE TREASURER RELATING TO THE INVESTMENT AND DEPOSIT OF STATE FUNDS. FURTHER, REPORTS AND RECORDS OF THE STATE TREASURER RELATING TO DEPOSIT AND INVESTMENT ACTIVITIES ARE DEFICIENT.

Because the State Treasurer, who is responsible for the day-to-day management for the investment of state funds, had not requested legislative authorization, and the Legislature has not granted authorization, which would permit maximizing investment income consistent with safe and prudent treasury management, and because the Treasurer has used some investment procedures which are not in the state's best interests, the state is losing approximately $5.9 million of interest income annually. Also, reports and records prepared and maintained by the Treasurer are deficient. These matters are described below.

Investment of State Funds in Negotiable Certificates Of Deposit, Which Are Not Authorized by Statute, Would Provide Interest Income of $4 Million More Annually Than Similar Interest Bearing Bank Accounts Which are Specifically Authorized.

Present law provides for deposit of state funds in interest bearing accounts of eligible state or national banks located in California, and does not authorize investment of state funds in negotiable certificates of deposit.

California banks, in which the state maintains deposits in interest bearing accounts, are required to pledge securities as collateral equal to 110 percent of the state's deposits. These interest bearing bank accounts which have no marketability are referred to as "inactive public deposits".

Similar interest bearing certificates are issued by the same California banks, but are not eligible for investment of state funds. These investments are referred to as "negotiable certificates of deposit".

Banks are not required to pledge securities as collateral for monies invested in negotiable certificates of deposit. However, negotiable certificates of deposit offer marketability to the portfolio and provide greater rates of annual interest income than the inactive public deposits.

There are no published indexes regarding the return offered by California banks on inactive public deposits. However, a comparison of the rate of interest earned on state funds in the inactive public deposits to a nationally recognized index of interest rates for negotiable certificates of deposit reveals that the negotiable certificates of deposit would have earned the state an estimated $12 million more interest income for the three-year period ending June 30, 1974. This is equal to $4 million annually, or one-half of one percent of the average daily investment of state funds in inactive public deposits.

Negotiable certificates of deposit are considered to be a prudent investment and are purchased by other state governments, the University of California and even other banks themselves. Further, these investments are as safe and prudent as investments such as bankers' acceptances, commercial paper, and short-term federal agency securities which are current investments of the State Treasurer.

As a result of the State Treasurer not having requested legislative authority, and the Legislature not having granted authority, to place state funds in negotiable certificates of deposit, interest income of $4 million annually has been lost by the state.

If the State of California were specifically authorized to invest funds in negotiable certificates of deposit, the Treasurer might have to hire or engage the services of an investment analyst to assist in the investment decisions within broad policy guidelines to be established by the Pooled Money Investment Board. However, the cost for the services of an investment analyst would be a mere fraction of the additional interest income the state could earn from investment in negotiable certificates of deposit.

Investment of State Funds in Commerical Paper for Longer Periods of Time and In Greater Amounts Than Presently Authorized By Statute Would Provide Increased Interest Income of $1 Million Annually.

Present law specifies that state funds may not be invested in commerical paper with a maturity date of more than 90 days, or in total amounts in excess of 15 percent of the Pooled Money Investment Account resources. No other type of investment of state funds is restricted by statute to a maximum maturity period or to a limit on the total amount which may be invested.

In practice, commerical paper is limited to a maximum term of 270 days from issue to redemption. Eighty-eight percent of the state's investments during the three-year period ending June 1974, or $1.8 billion per day, was invested in various types of securities for terms of 270 days or less. Thus, since investments for periods of up to 270 days are in demand by the state, if legal authorization were obtained, greater amounts of state funds could be invested in commercial paper which provides higher interest rates than other comparable investments.

During the three-year period ending June 1974, the state invested an estimated 30 percent or more of its total assets available for investment in each of two types of investments: 37 percent, or $777 million per day, in inactive public deposits (interest bearing bank accounts); and 30 percent, or $630 million per day in repurchase agreements which are investments usually with banks secured by U. S. Treasury and federal agency securities. Thus, precedent is established for having up to 30 percent or more of the state's total assets available for investment in a single type of investment.

Selected commercial paper is considered a prudent investment of public funds and, on the average, yields at least 1/4 of one percent greater interest income than other comparable investments, such as inactive public deposits, repurchase agreements, U. S. Treasury bills, and short term federal agency securities. Further, commercial paper is issued for periods of time that meet 88 percent of the state's investment needs.

If the state were given broader legal authority to invest in commercial paper with maturity dates of up to 270 days, and to invest up to 30 percent of its total assets available for investment in such commercial paper, an estimated $1 million more interest income could be earned annually than under the present legal restrictions on investments in commercial paper.

As a result of the State Treasurer not having requested legislative authority, and the Legislature not having granted authority (1) to invest in commercial paper with maturity dates of up to 270 days, and (2) to invest in commercial paper up to 30 percent of the state funds available for investment, interest income of $1 million has been lost by the state.

Procedures Used by the State Treasurer Relating to the Investment and Deposit Of State Funds Prevent the Obtaining Of Maximum Interest Income and Have Resulted in an Annual Loss of $892,000 In Interest Income to the State.

The State Treasurer's procedures regarding investment and deposit of state funds result in an annual loss of $892,000 of interest income to the state, as described below.

Commercial Paper Is Not Purchased To The Extent Presently Authorized By Law And Is Required To Be Delivered To Sacramento.

As presently noted, the state by statute has been authorized since 1968 to invest in commercial paper up to 15 percent of the resources of the Pooled Money Investment Account. Investments in selected commercial paper generally yield, on the average, at least 1/4 of one percent greater interest income than other comparable authorized investments.

In prior years, the Pooled Money Investment Board established a policy limiting the investment of state funds in commercial paper to $225 million, or 15 percent of investment resources, whichever was smaller. This policy was finally rescinded, but not until May 1973. Therefore, as a result of the board's policy in fiscal year 1972-73, and as a result of the Treasurer's procedures, investments of state funds in commercial paper totaled only $202 million, or $128 million less than could have been invested under the 15 percent legal limitation.

For the first eight months of fiscal year 1973-74, investment of state funds in commercial paper averaged $247.1 million, or only 9.6 percent of the funds of the Pooled Money Investment Account. The Treasurer's staff stated that the reason they do not invest additional amounts in commercial paper up to their 15 percent authorization is that the total resources in the Pooled Money Investment Account fluctuate daily. In our judgment, the only basis on which the 15 percent limitation can be reasonable is that it applies at the time commercial paper is purchased. It is therefore our judgment that the Treasurer possesses the authority to purchase commercial paper up to 15 percent of the total resources in the Pooled Money Investment Account at the time of purchase.

The Treasurer requires that commercial paper purchased by the state be delivered to Sacramento. However, the Treasurer has established an account at a New York bank where all other investments purchased may be delivered. The Treasurer's requirement of Sacramento delivery for commercial paper results in excessive costs to issuing corporations. The corporations must develop new banking relationships and make other special arrangements to deliver commercial paper in Sacramento.

We contacted four investment brokers who stated that of 47 states with which they do business, 28 have authority to purchase commercial paper.

Only six of the 28 states require local delivery of commercial paper. Twenty-two states have arranged for delivery of commercial paper to New York banks. At least 37 commercial paper issuers will not deliver commercial paper to Sacramento because of additional costs.

The Treasurer's requirement that commercial paper be delivered to Sacramento restricts the ability of commercial paper to provide maximum interest income to the state. The adverse dollar effect of this restriction cannot be estimated.

The Treasurer's procedure of not investing in selected commercial paper to the full extent authorized by law, which is 15 percent of the state funds in the Pooled Money Investment Account, results in an estimated annual loss of interest income of $350,000 to the state.

The Responsibilities for the Deposits Of State Monies Are Separated From The Responsibilities of Investments Of State Monies.

Within the Treasurer's Office, either the Deputy Treasurer or the Trust Officer deposits monies in bank accounts, while the investment department invests monies in securities. The coordinating procedures for making deposits and investments, which have been established within the Treasurer's Office, have resulted in a loss of interest income to the state of an estimated $115,000 annually. This loss resulted because it was not known by those personnel, while purchasing specific securities on specific dates, that higher interest rates were available from interest bearing bank accounts. Due to the responsibilities being separated, there are inadequate controls to prevent such losses.

If authority to make deposits and investments were combined, as is common in the management of financial institutions, the highest interest rates available should always be obtained.

The State Treasurer Commits the State to Purchase from Broker-Dealers Federal Securities Bearing a Specified Interest Rate Before Such Interest Rates Are Officially Established.

Before new issues of U. S. Government and federal agency securities are initially sold to investors, information relating to these securities is disseminated to investors. One purpose for this public dissemination is to determine potential investor interest in order to arrive at an interest rate. If the interest rate established is not satisfactory to the potentially interested investor, he may withdraw his commitment or intent to purchase the issue. If the interest rate is satisfactory to the investor, he is assured the opportunity to purchase the security.

However, the Treasurer's staff has advised us that certain broker-dealers require the State Treasurer to unconditionally commit the state to purchase federal bonds at a specific rate of return before the interest rate is officially established. If the Treasurer does not unconditionally commit the state to a specified interest rate, some broker-dealers will not assure the state the opportunity to purchase the securities.

On five occasions between July 1971 and January 1974, the State Treasurer committed the state to purchase federal bonds several days before interest rates were established. On one of these occasions, July 1973, the Treasurer made a commitment to purchase federal bonds with a par value of $54.5 million and an average life of three years. The interest rate which was established three days later was not competitive with other types of investments available. The Treasurer's commitment required him to purchase the bonds at the non-competitive interest rate, however. The same bonds could have been purchased in the open market on the day the interest rate was established at a price which would have provided the state with $190,000 more income over the life of the bonds.

While such situations do not occur frequently, the Treasurer should institute a procedure with broker-dealers which would insure that the state does not commit itself to purchase federal securities until the interest rates on such securities are officially established. In this manner, the Treasurer will be assured that maximum return is obtained on state investments.

As a result of the Treasurer not having established such a procedure, an estimated $60,000 in interest income has been lost to the state annually.

Inadequate Procedures for Collecting And Depositing Interest Income and Federal Monies Results in Loss of Interest Income to the State.

Procedures established by the Treasurer's Office do not assure prompt collection and deposit of interest income monies received by the state from (1) bank deposits and investments, and (2) from monies obtained from the federal government for the support of state operations. Since these monies are not available immediately to earn interest for the state, an estimated annual loss of $367,000 of interest income results.

With regard to investments made by the state's various retirement systems, approximately 75 percent of interest due on the state's investment in bonds and 60 percent of the dividends on the state's investment in stock are received by the Treasurer's Office an average of at least three days after the monies are due to the state. This occurs because the state permits these amounts to be delivered through the United States mails, and most of the paying agents on these investments are banks located in New York. The state could make arrangements for a bank, in close proximity to the paying agents, to receive payments on the state's investments in stocks and bonds, and then wire them directly to the Treasurer's account in a California bank.

We estimate that such arrangements would enable the state to earn an additional $260,000 of interest income annually, after paying the banks for the services provided.

The Treasurer has established the first calendar day of the month as the maturity date for interest bearing bank deposits of $225 million of state funds which are continuously reinvested for periods up to one year. However, for approximately 30 percent of the time, the first day of the month is a non-banking day. When this occurs, the state does not have the amounts of interest earned on these deposits available for other investment until at least the first business day of the month. Further, in some instances the amount of principal to be returned to the state, and frequently the amount of interest earned, is sent by the banks to the Treasurer by mail rather than by wire.

If the Treasurer were to establish a procedure to insure (1) that all interest bearing bank deposits mature on business days, and (2) that all principal and interest payments be wired to the state on the date payable, the state could invest such amounts promptly and earn an estimated $12,000 additional interest income annually.

Various state agencies prepare vouchers to obtain previously agreed upon amounts from the federal government for the support of state operations. These vouchers are then deposited by the Treasurer's Office in a checking account with the Bank of America, which must then present the vouchers for payment to the Federal Reserve Bank in San Francisco. In some instances the Bank of America does not credit the state's checking account the same day the deposit is made. The Treasurer could require the Bank of America to credit the state's checking account the same day the deposit is made, or could deposit the state vouchers directly with the Federal Reserve Bank for immediate credit to any bank in which the state maintains a checking account.

If the amounts were credited to a state checking account the same day deposited, the funds would be available for immediate investment and the state could earn an estimated $90,000 additional interest income annually.

The state vouchers for federal funds during the last three fiscal years have ranged from a few thousand dollars to $71 million. In many instances, the officials of the state agencies which prepared the vouchers signed them with an incorrect signature, and the Federal Reserve Bank refused to honor the voucher. This resulted in unnecessary delays in the state receiving credit for the funds and having them available for investment. Such delays could be avoided if the Treasurer's Office maintained a file of photostatic copies of authorized signatures and compared them to the vouchers before the vouchers were deposited in a bank.

An estimated $5,000 additional interest income could be earned annually by the state if such procedures were adopted by the Treasurer.

Reports and Records of the State Treasurer Relating to the State's Deposit and Investment Activities Do Not Provide Full Disclosure to The Public, Do Not Document That Competitive Procedures Have Been Utilized, Are Not Summarized in a Manner To Evaluate Performance and Make Sound Policy Decisions, and Are Untimely.

The state had a daily average of $2.58 billion in investments and bank deposits during fiscal year 1973-74. During the same period, a total of about $73.9 billion of securities were bought and sold by the Treasurer's Office in approximately 6,900 transactions. Earnings received by various banks and brokerage houses for their services on such transactions totaled an estimated $46 million. The records and reports maintained and prepared by the Treasurer's Office are inadequate for effective management and control of the state's investments and deposits, and do not provide full disclosure to the public.

No permanent records are maintained by the Treasurer's Office to show what procedures were followed or to what extent competition was obtained when purchasing securities and placing deposits in bank accounts. Investment personnel of most other financial institutions keep a telephone log of their activity and competitive prices which were available from various sources. Although the Treasurer's Office maintains that they do follow competitive procedures when investing in securities and making deposits in bank accounts, they have no permanent records to support and document that they did so or which could be used to evaluate the investment decisions made.

Also, the Treasurer's Office has not developed a means to summarize data relevant to its huge investment operations. Such a summary is necessary to evaluate the overall performance of the investment portfolio and to provide a basis for making sound investment and policy decisions. Such information should include the percentage of the portfolio's resources by type of investment, the average life, or term of investments, and the rate of earnings by type of investment, etc.

To evaluate the Treasurer's investment operations, we developed a computer program to analyze the investment portfolio of the Treasurer's Office for the 31-month period ending January 31, 1974. This analysis and comparisons to nationally recognized indexes of rates of return on various types of investments led us to the data which is developed and presented in other sections of this report. If such analytical data had been developed and maintained by the Treasurer's Office and had been available to the Pooled Money Investment Board, they would have been in a position to correct many of the deficiencies noted in this report, to evaluate on a continuing basis prior earnings performance and current investment position, and to develop future investment policy consistent with changing market conditions.

We examined all investment transactions made by the Treasurer's Office during the 31-month period, except bankers' acceptances and repurchase agreements. While we found that according to closing prices of independent market sources competitive prices were obtained for the type of security purchased or sold, and investments were made in a manner which did not show favoritism to any particular dealer, records have not been maintained to show the various competitive prices at the actual time of purchase or sale.

All treasury bills acquired by the State Treasurer from the Federal Reserve amounting to $250 million were acquired through tenders placed by the Bank of America, but as a result, no value or earnings were received by the Bank of America.

The Government Code requires the Treasurer to place on file for public inspection at the offices of the Controller, Treasurer, and Director of Finance a report of investment and bank account transactions during each month and related information the Pooled Money Investment Board deems should be included. The report is to be filed no later than 30 days after the close of each month.

As of September 3, 1974, the last report that had been published by the Treasurer is the report for April 1974. Therefore, at that time, the report for May was 65 days late, and 95 days after the last transactions were made. To save postage, the Treasurer mails the monthly report to interested parties, other than the Pooled Money Investment Board, only after reports for two months are prepared.

The late preparation and dissemination of the reports diminish their usefulness to the Pooled Money Investment Board and interested citizens. Approximately one-half of the investments made by the Treasurer's Office in the first eight months of fiscal year 1973-74 had a maturity of less than 95 days. Therefore, the investment dealers are provided little opportunity to improve the state's investment portfolio.

However, more significantly, the monthly report is not designed to include certain significant data. Therefore, the reports are of little use to the Pooled Money Investment Board for management information and control, and do not provide information necessary for full disclosure to the public of the state's investment activities.

The major omissions in the monthly reports are as follows:

- No information is provided to indicate the banks or brokerage houses which handle investment transactions of the Treasurer's Office.

- No information is provided on the deposit date, maturity date or interest rate for interest bearing bank deposits. The bank's name is also omitted on those bank deposits made under the policy to realize maximum return.

- No information is provided as to the maturity date or the organizations from which purchases of investment securities referred to as "repurchase agreements" were made.

- The name of the corporation providing the underlying credit for investment in "commercial paper" and "bankers acceptances" is omitted.

- Investment transactions between state funds are designated as "market" purchases and sales appearing to have been executed with outside broker-dealers in lieu of being designated as state inter-fund transactions.

- Accrued interest income on securities purchased is not separately identified.

RECOMMENDATIONS

We recommend that the State Treasurer immediately:

- Request the Legislature to authorize the investment of state funds in negotiable certificates of deposit.
- Request the Legislature (1) for authority to invest in commercial paper with maturity dates of up to 270 days, and (2) to increase the authorized maximum amount which can be invested in commercial paper from 15 percent to 30 percent of the state funds in the Pooled Money Investment Account.
- Pending implementation of the above recommendation, establish procedures which require that investments in commercial paper be made in amounts up to the present authorized maximum of 15 percent of the state funds available for investment under the Pooled Money Investment Account.
- Combine the responsibilities for the deposit of state funds with the responsibilities for the investment of state funds.
- Establish a procedure with broker-dealers to insure that the state does not commit itself to purchase federal securities until the interest rates on such securities have been officially established.

- Establish procedures for a bank to receive payments on the investments in stocks and bonds made by the state's various retirement systems and to wire such payments directly to the Treasurer's account in a California bank.

- Establish a procedure to insure that all interest bearing bank deposits mature on business days and that the principal and interest payments from such deposits be wired in lieu of mailed to the state.

- Establish a procedure to insure that state vouchers, claiming reimbursement of federal funds, are deposited with a bank which will obtain immediate credit of the federal funds for state use.

- Obtain a photostatic copy of signatures authorized to sign state vouchers claiming reimbursement of federal funds and compare such signatures to the vouchers before such vouchers are deposited in a bank.

- Prepare reports and maintain records relating to deposit and investment activities which (1) provide full disclosure to the public of all pertinent data, (2) document that competitive procedures have been utilized, (3) summarize information in a manner permitting the evaluation of performance and the making of sound policy decisions, and (4) are distributed in a timely manner.

SAVINGS AND BENEFITS

Proper implementation of these recommendations will result in increased interest income to the state of approximately $5.9 million annually as well as to provide for preparing and maintaining proper records and reports.

INTEREST INCOME OF $2.1 MILLION IS LOST ANNUALLY BY THE STATE AS A RESULT OF PROCEDURES BY THE CONTROLLER FOR DISBURSING STATE FUNDS TO COUNTIES PRIOR TO THE TIME SUCH FUNDS ARE REQUIRED.

Because the Controller has disbursed state funds to counties for support of public schools and social welfare benefits sooner than required by law, such funds are not otherwise available for investment and the state is losing an estimated $2.1 million of interest income annually.

Disbursements for the Support of Public Schools Are Made Sooner Than Required, Resulting in an Annual Loss of $2 Million Of Interest Income to the State.

The Education Code requires payments to counties each month for support of public schools. The code does not require the payment of such funds on any specified date within the month. These payments, which average approximately $170 million per month, provide approximately one-third of the funds to support a typical school district. The Controller's procedure is to disburse these funds as soon after the 20th of each month as possible.

If the Controller were to establish a procedure of wiring the funds for support of public schools to the counties on the last working day of the month, allowing the funds to be invested by the Treasurer until that date, an estimated $2 million additional interest income could be earned by the state annually.

Disbursements for the Support of Welfare Benefits Financed by Federal Funds are Made Before County Warrants for Such Benefits Are Payable, Resulting in an Annual Loss of $100,000 of Interest Income to the State.

The various counties make payments of certain social welfare benefits to recipients each month. The Welfare and Institutions Code requires that the warrants for payments for Aid to Families With Dependent Children be placed in the mail by the counties in time for warrants to be received by the recipients not later than the first calender day of the month or, if this is not a working day, the last postal delivery day of each month.

These benefit payments are reimbursed by the federal government through a single payment to the state for all counties. However, the federal reimbursement is not received by the state until the first working day of the month. To assure that the counties have the necessary funds available for payment of the welfare benefits, the Governor has proclaimed periods of welfare emergency during which the state is authorized to advance general fund monies to the counties prior to receiving the federal reimbursements. However, the Controller has advanced these monies to the counties before the warrants for welfare benefits are payable.

If the Controller were to establish a procedure of wiring the advanced funds to the counties on the same day the warrants for welfare benefits are payable, allowing such funds to be invested by the Treasurer until that date, an estimated $100,000 additional income could be earned by the state annually. This procedure would not delay benefit payments to welfare recipients.

RECOMMENDATIONS

We recommend that the Controller discontinue the disbursement of state funds prior to the time such funds are required to be disbursed by establishing procedures to:

- Wire funds for support of public schools to the counties on the last working day of each month.

- Wire advances of funds for welfare benefits to the counties on the same day the county warrants for such benefits are payable to the recipients.

SAVINGS

Proper implementation of these recommendations will result in increased interest income to the state of $2.1 million annually.

FEES VALUED AT $80,000 ANNUALLY ARE LOST BY THE STATE AS A RESULT OF A NO-FEE POLICY OF THE STATE INSURANCE COMMISSIONER RELATING TO SAFEKEEPING SERVICES PROVIDED FOR WORKMEN'S COMPENSATION INSURANCE COMPANIES.

The State Insurance Commissioner has not established policies to charge workmen's compensation insurance companies specific fees for safekeeping services provided the companies by the Treasurer, and has not established rules and regulations for alternative means by which the companies could obtain such services. As a result, the state is receiving no specific fees for the safekeeping services, valued at $80,000 annually, which are provided by the Treasurer for 218 workmen's compensation insurance companies.

Workmen's compensation insurance companies in California are required to pledge to the state securities for the benefit of policy holders in case of bankruptcy of the companies. Under provisions of the Insurance Code, which became effective in 1968, the insurance companies have the option of depositing such securities with either the Treasurer or with an approved depository bank under rules to be established by the Insurance Commissioner. To date, the Insurance Commissioner has not issued rules and regulations under which these securities may be deposited in depository banks because, in his opinion, no workmen's compensation insurance companies would deposit securities in approved banks because it would increase insurance company costs and offer no major advantages.

In the absence of such rules and direct charges by the state, all workmen's compensation insurance companies have elected to deposit the required securities with the Treasurer, rather than with approved banks which charge fees for safekeeping services. The safekeeping services provided by the

Treasurer would cost the 218 workmen's compensation insurance companies at least $80,000 annually if they were obtained from banks. While the State Insurance Commissioner pays the State Treasurer approximately $16,000 annually for the safekeeping services, specific reimbursement from the insurance companies is not obtained.

The securities deposited with the Treasurer by the workmen's compensation insurance companies occupy about 25 percent of the space in the Treasurer's vault, and many are small denominational coupon bonds which require excessive handling and record keeping by vault personnel.

If the Insurance Commissioner were to establish a policy of charging workmen's compensation insurance companies specific fees for the market value of safekeeping services provided them by the Treasurer, and establish rules and regulations under which the insurance companies could alternatively deposit in approved banks the securities pledged to the state, the state would receive additional fee income of $80,000 annually, or would not have to provide such services to the insurance companies.

RECOMMENDATION

> We recommend that the State Insurance Commissioner immediately institute the charging of specific fees, equal to the market value of the services provided, to those 218 workmen's compensation insurance companies which are provided with free safekeeping services by the Treasurer, and establish rules and regulations under which the insurance companies could alternatively deposit pledged securities in commercial banks in lieu of depositing such securities in the Treasurer's vault.

SAVINGS

Implementation of this recommendation will result in increased fee income to the state of $80,000 annually, or will eliminate the need for and the cost of the Treasurer providing safe-keeping services for workmen's compensation insurance companies.

AUTHORIZATION FROM THE LEGISLATURE TO ISSUE LOWER INTEREST RATE STATE REFUNDING BONDS, IN LIEU OF OUTSTANDING HIGH INTEREST RATE STATE BONDS HAS NOT BEEN REQUESTED BY THE STATE TREASURER SINCE 1970. UNLESS SUCH AUTHORIZATION IS OBTAINED FOR STATE BONDS SCHEDULED TO BE SOLD IN FISCAL YEAR 1974-75, UNNECESSARY BOND INTEREST COSTS OF APPROXIMATELY $18.7 MILLION WILL BE INCURRED BY THE STATE FOR EACH 1/2 OF ONE PERCENT DECREASE IN INTEREST RATES.

Although Section 53550 et seq. of the Government Code, added by the Legislature in 1971, provides statutory authority for local governments to issue refunding bonds under certain conditions, as a potential means of reducing interest costs, the issuance of refunding bonds to replace previously issued state general obligation bonds requires a vote of the electorate. In 1970, through the Treasurer's efforts, a constitutional amendment was introduced in the Assembly that would have added to the State Constitution provisions to issue refunding bonds to replace state general obligation bonds. However, this amendment was never submitted by the Legislature for voter approval. The Treasurer did not subsequently request the Legislature for authority to issue refunding bonds.

The state's bond interest costs for fiscal year ended June 30, 1973 were approximately $23 million for outstanding state revenue bonds and $215 million for outstanding state general obligation bonds.

A primary goal of the State Treasurer's Office is to minimize the state's interest costs through a planned bond marketing program. This is attempted through administration of the sale of state bonds, and their related redemption and interest payments. The issuance of refunding bonds is another potential means which could be used to minimize interest costs if authorized by the Legislature and the voters.

The use of refunding bonds has become feasible in recent years because of the volatile municipal bond interest rates of the 1960's and 1970's. Refunding bonds are issued when it is possible to assure a reduction of total interest costs of outstanding bonds in future years by replacing high interest rate state bonds with lower interest rate state bonds. The decision regarding when to issue refunding bonds is a financial decision similar to the decision made by the Treasuer's Office when other bonds are sold.

Revenue bonds issued by certain state agencies may be refunded under existing statutory authority, but there is no similar authority for refunding general obligation bonds. While there are currently comparatively few revenue bonds outstanding, there is no central state agency which monitors revenue bonds outstanding to arrange for replacing them with bonds of lower interest costs when favorable opportunities present themselves.

Although municipal bond interest rates in June 1974 were comparatively high at 6.01 percent on the Municipal Bond Buyers Index, opportunity did exist to refund certain state revenue bonds. An example would be the Series "D" Housing System Revenue Bonds issued in 1970 by the Trustees of the California State University and Colleges when the Bond Buyers Index was 6.45 percent. Although these revenue bonds are not callable until 1980, we estimated that $750,000, or 25 percent of the interest costs currently scheduled to be paid between the years 1980 and 2000 could have been saved if refunding bonds had been issued in June 1974. June 1974,was not the most ideal time to issue refunding bonds, however; in calendar years 1971, 1972 and 1973 the Municipal Bond Buyers Index dipped below 5.00 percent, which would have yielded far greater interest savings if the bonds had been refunded then.

The Legislature could include a provision authorizing refunding bonds in each general obligation bond issue submitted to the voters for approval. This procedure would not require an amendment to the State Constitution. Neither would this procedure affect bonds already approved by the voters, but not yet issued. However, despite the availability of this procedure, none of the bond issues submitted to the voters for approval in the elections of 1970, 1972 or 1974 had refunding provisions.

In fiscal year 1974-75, the State of California plans to issue $250 million in revenue bonds and $500 million in general obligation bonds which have previously been approved by the voters. On August 29, 1974, the Municipal Bond Buyers Index of interest rates on selected governmental bonds was 6.91 percent. In contrast, the average interest rate for fiscal year 1972-73 on outstanding state bonds was only 4.06 percent.

If, in future years, the state is constitutionally able to issue refunding bonds at less than current interest rates, substantial interest costs could be saved. To illustrate, if the Treasurer pays the current 6.91 percent interest rate for the $750 million of state bonds to be issued in fiscal year 1974-75, and if refunding bonds could be issued at a 1/2 of one percent lower interest rate to replace the 1974-75 bonds for a period of only five years of their total life, the savings over the average life of the bonds would be $18.7 million. However, if state interest rates decline from the present 6.91 percent to the state's historic average of 4.06 percent, interest cost on these bonds could be reduced $107 million by issuing refunding bonds for the five-year period. In addition to securing approval of the voters for refunding bond issues, the bonds issued must be refundable or callable so they can be redeemed at a time when interest rates are to the state's advantage.

We recognize that a higher rate of interest might have to be paid by the state on the original issue of these bonds in 1974-75 if a provision making them callable is included, than if such provision were not included. However, the extent of such difference in interest rates cannot be determined at this time. We also recognize that interest rates might not decline sufficiently to justify issuance of the refunding bonds, although the potential benefits, based on historic interest rates, indicates that the issuance of refunding bonds would result in substantially reduced bond interest costs to the state.

We conclude that opportunities for refunding state bonds are potentially lucrative, especially in this period of historically high interest rates, and should be sought systematically. Accordingly, the State Treasurer should request the Legislature to seek voter authorization for a refunding bond program, set forth guidelines for implementation of the program, and should include refunding or call provisions, in bonds already authorized but not yet issued, in order to redeem such bonds early.

RECOMMENDATIONS

We recommend that the State Treasurer:

- Request the Legislature to authorize a planned refunding program for state bonds.

- Request the Legislature to include refunding provisions in future general obligation bond proposals submitted to the voters when interest costs are comparatively high.

- Monitor all future state general obligation and state revenue bonds outstanding to arrange for replacing them with bonds of lower interest costs to the state when favorable opportunities avail.

- Include refunding or call provisions in the contracts for state general obligation bonds to be sold in fiscal year 1974-75 in order to provide the Treasurer with the option of replacing such bonds with lower interest rate refunding bonds, subject to voter approval of the issuance of such refunding bonds.

SAVINGS

Implementation of these recommendations will assure the state of the opportunity to reduce its bond interest costs by an amount estimated to be $18.7 million over the average life of state bonds scheduled to be sold in fiscal year 1974-75 for each 1/2 of one percent decrease in interest rates.

SUMMARY OF COMMENTS OF THE STAFFS
OF THE POOLED MONEY INVESTMENT BOARD
AND THE STATE TREASURER

1. It is unfair to label as a "loss" future estimated additional interest income which might result from the implementation of the Auditor General's recommendations. The "losses" should more properly be referred to as "potential savings".

2. With regard to the factors used by the Pooled Money Investment Board for determining average daily balances to be maintained in non-interest bearing checking accounts, the banks, as well as the state, should have their say in the determination of these factors. The Pooled Money Investment Board does not dictate terms to the banks.

3. Among the board's reasons for maintaining $250 million in interest bearing bank accounts at all times, despite the fact that higher interest rates might be available, are that (1) the California banks are strong supporters in the purchase of state bonds, and (2) the banks provide various services to state employees. $50 million was recently withdrawn from the Bank of America. This was as a result of a misunderstanding and such funds will be redeposited with the Bank of America.

4. With regard to investing state funds outside of California, it should be remembered that monies flowing to the State Treasury are monies received from California taxpayers. Therefore, all things being equal, the Treasurer should invest such monies in California. Further, there are numerous requests of the Treasurer from brokers, bankers, and others

to maintain state investments in California. However, because the amount of state funds available for investment is so great, all such funds cannot be invested in California.

5. The state should invest in negotiable certificates of deposits. However, it would be difficult to obtain legislative authorization to make such investments since the banks issuing negotiable certificates of deposit would not be required to submit collateral to the state. Likewise, it would be difficult to obtain legislative authorization to increase the Treasurer's investment authority in commercial paper from 15 to 30 percent since it was difficult in the first place to get the authorization to invest 15 percent of the state's funds in commercial paper.

6. It is not always prudent for the Treasurer to take maximum advantage of the present 15 percent authorization on commercial paper investments because flexibility is needed.

7. Corrective procedures, to insure that all interest bearing bank deposits mature on business days, were implemented as of September 1, 1974.

8. One reason that the Treasurer's reports do not disclose all information pertaining to the investment activities of the Treasurer is to preserve the confidentiality of data that the Treasurer's staff considers necessary to secure advantageous interest rates.

9. With regard to the Controller's disbursement procedures, an analysis would be necessary to determine if school district cash flow problems and investment procedures would be adversely affected if state funds to support the districts were not disbursed until the last working day of each month. Further, there may be a serious reluctance by some county auditors to release welfare warrants before the money is in the county treasury and therefore, benefit payments to some welfare recipients may be delayed.

Harvey M. Rose
Harvey M. Rose
Auditor General

Date: September 6, 1974

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