REPORT OF THE
JOINT SUBCOMMITTEE STUDYING

The Feasibility Of The Creation Of An Agricultural Linked Deposit Program

TO THE GOVERNOR AND
THE GENERAL ASSEMBLY OF VIRGINIA

HOUSE DOCUMENT NO. 37

COMMONWEALTH OF VIRGINIA
RICHMOND
1990

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REPORT OF THE
JOINT SUBCOMMITTEE STUDYING THE
FEASIBILITY OF THE CREATION OF AN AGRICULTURAL
LINKED DEPOSIT PROGRAM

TO

THE GOVERNOR AND THE GENERAL ASSEMBLY OF VIRGINIA
RICHMOND, VIRGINIA
NOVEMBER, 1989

TO: The Honorable Gerald L. Baliles, Governor
and
The General Assembly of Virginia

I. AUTHORITY FOR STUDY

House Joint Resolution No. 381 established a joint subcommittee to examine the feasibility of creating an agricultural linked deposit program targeted to agricultural diversification in Virginia. The subcommittee was directed to (i) review the state of the agricultural industry in Virginia and the reasons behind the need for agricultural diversification, (ii) analyze the current agricultural credit situation in Virginia and its effect on farmers' willingness to diversify, and (iii) consider the creation of an agricultural linked deposit program to encourage diversification. The subcommittee was composed of six members: J. Paul Councill, Jr., Glenn B. McClanan, and Mitchell Van Yahres, from the House Committee on Agriculture; Frank W. Nolen, and William A. Truban from the Senate Committee on Agriculture, Conservation and Natural Resources; and S. Mason Carbaugh, Commissioner of the Department of Agriculture and Consumer Services.

II. BACKGROUND

A. Need for Diversification

During most of this decade, traditional U.S. staple crops, such as corn, soybeans, and wheat, have experienced shrinking markets internationally and, as a result, deflating prices. Many farmers have been forced to diversify their operations and cultivate new crops or face bankruptcy. While the Midwest has been the hardest hit region, Virginia has not been immune from the need to diversify its agricultural industry. Of the $1.8 billion in total cash receipts for Virginia's agricultural industry in 1988, $1.7 billion, or about 89 percent, was generated by 13 commodities. In fact, Virginia farmers were forced to begin diversifying their crops earlier than those in other states because Virginia's wheat and corn producers had to compete with their counterparts in the Midwest who can produce these crops more cheaply. This is due in part to the region's rich soils which require minimal attention. Throughout the first half of the 1980s, Virginia's agricultural community has had to look for new markets and to find the crops to fill them.

B. Diversification Efforts

In 1986 the General Assembly created the Virginia Farmers' Market System with an objective of increasing the opportunity for marketing alternative crops. A year later, the concept of diversification was given further endorsement by Virginia Polytechnic Institute and State University's Agriculture Futures Study which recommended developing a process for identifying those alternative crops that can be produced profitably in Virginia and marketed successfully in the eastern United States. During its 1988 Session, the General Assembly established the Virginia Department of Housing and Community Development's Community for Opportunity (CFO) Program in order to promote economic development in Southwest Virginia. As part of the program, the General Assembly approved $100,000 for the 1988-90 biennium to fund an agricultural diversification element of the CFO program. The Department of Agriculture and Consumer Services (VDACS) was given lead responsibility for the diversification program which provides grants to selected diversification projects within Planning Districts 1-4. To qualify, projects must show the potential for long-term growth, profitability, and utilization of natural resources found in Southwest Virginia. The program funded five projects in 1988-89 for a total of $50,000.

In addition to these programs, the VDACS also oversees two ongoing diversification initiatives: the promotion of aquaculture and Belgian endive. In 1988, in an effort to encourage farmers to take advantage of markets for fish, the VDACS permitted four commercial facilities for hybrid striped bass production. In the first four months of 1989, three new producers have been permitted, and nine others are awaiting approval. During the past year, the number of catfish producers has increased from 20 to almost 50, and the total pounds of harvested catfish is expected to rise from 10,000 pounds last year to more than 50,000 by the fall of 1989. Martinsville's Blue Ridge Fisheries, which will be the largest closed-system, indoor, recirculating aquaculture system in the world, is expected to harvest its first crop of catfish by January 1990. Funding for the 1988-90 biennium includes: $1.1 million to

Virginia State University for aquaculture research, $225,000 to the VDACS for use in contracting with Virginia State University for fish farming demonstration projects, and an additional $600,000 to Virginia Polytechnic and State University for closed-system aquaculture research.

The Commonwealth's Belgian endive project is entering its third year of research. U.S. demand for Belgian endive has increased 400 percent during the 1980s and accounts for about $6 million in wholesale sales; however, as much as 90 percent continues to be imported from Belgium. Hoping to take advantage of this growing demand, VDACS officials originally applied for and received a $45,000 grant from the United States Department of Agriculture (USDA) for research into Belgian endive production. The Commonwealth has since indirectly contributed about $100,000 to the research. The VDACS recently hired a private consultant from New York to help direct the Commonwealth's research and development projects for the crop. Three test sites across the Commonwealth will each be planted with a different type of Belgian endive during 1989. VDACS officials say the results of this year's research will determine the feasibility of commercial production in Virginia.

C. Current Agricultural Financing

1. Sources of Agricultural Credit

Currently, a farmer considering diversification can take advantage of three primary sources of credit in Virginia: commercial banking institutions, the Farm Credit System, and the Farmers Home Administration. Of the banks in Virginia, only three -- Sovran, Dominion and Central Fidelity -- have specialized agricultural finance units. They offer standard consumer, commercial, and term loans at prime rate or higher based on a borrower's calculated risk. These commercial institutions compose the most selective source of credit.

The Farm Credit System is a national cooperative credit system which includes 33 agricultural credit associations (ACAs). The ACAs offer general agricultural loans at competitive rates, usually at about prime plus one percent in Virginia. Unlike commercial institutions, which base their loans on their deposits, the Farm Credit System prices its loans on the cost of funds obtained through the sale of consolidated bonds on the money market plus estimated operating costs of the association. In order to qualify for loans, a borrower must purchase stock in the ACA totaling either two percent of the amount of the loan or $1,000, whichever is less. Depending upon the bylaws of the individual ACA, the stock can be returned after the loan is repaid; it can be applied to the last payment of the loan; or it can be held by the borrower, allowing the stockholder to maintain voting privileges in the ACA. At the discretion of its board of directors, an ACA may pay a small dividend to its stockholders, but this expense may be passed on to the borrowers through higher loan rates.

The Farmers Home Administration (FmHA) provides loans only to those farmers who do not qualify for loans from other lenders. Usually, a borrower must provide a statement from a commercial bank showing that his loan application was declined. Although the FmHA continues to offer operating and farm ownership loans (the February 1989 rates for these loans were 9.5 percent and 9.75 percent, respectively), Congress has been cutting the funding for these programs since the early 1980s and instead, redirecting the focus of the

FmHA toward loan guaranteeing. If a commercial institution rejects an application, the FmHA will guarantee 90 percent of the bank's loss on a loan, leaving only 10 percent exposure for the lender. These guaranteed loans made up about 40 percent of the total FmHA assistance provided in 1988.

The FmHA also administers two specialized loan programs: Limited Resource Loans and Disaster-Emergency Loans. Limited Resource Loans are of two types, Limited Resource Operating Loans and Limited Resource Ownership Loans. These limited low-interest loans are given to those farmers with particularly difficult cash flow problems, especially young borrowers just getting started in farming. The FmHA made about 41 Limited Resource Operating Loans in 1988 for a total of $6,778,820. The February 1989 rate for these loans was 6.5 percent. Thirteen Limited Resource Farm Ownership Loans were made in 1988, for a total of $5,440,800. The interest rate on these loans was 5 percent in February 1989. In order to be eligible for the Disaster-Emergency Loans, a farmer must reside in a county declared eligible by the Secretary of Agriculture. In 1988, 36 Disaster-Emergency Loans were made for a total of $1,590,000.

2. State Financing Mechanism

Two mechanisms of agricultural financing are found in Title 3.1 of the Code of Virginia. The Virginia Farm Loan Revolving Account, Chapter 5, is administered by the VDACS. The account is a trust fund made up of assets from the former Virginia Rural Rehabilitation Corporation which was dissolved in 1946. The fund's current assets total about $3.25 million. Of that balance, $1 million has been committed to financial assistance in the operation of Virginia's farmers' market system, and another $1 million is available for a limited number of farm real estate loans to those farmers who cannot acquire credit. The VDACS will loan up to 50 percent of the cost of a farm. The remainder of the loan and all loan servicing is provided by the FmHA. Rates for these loans currently average 8 percent. At this time, approximately $500,000 of the account is yet unrepaid.

The Virginia Agricultural Development Authority, created by Chapter 5.1, is an independent political subdivision created by the Virginia General Assembly in 1981. The Authority was to provide loans to farmers for long-term real estate purchases and depreciable agricultural property through funds generated by the sale of private purpose, tax-exempt agricultural development bonds; however, federal authority to sell these bonds expired December 31, 1986.

III. AGRICULTURAL LINKED DEPOSIT PROGRAMS

In a linked deposit program, the state makes a deposit with a commercial lender at below the market interest rate and in turn, the lender provides below market rate loans to certain qualified borrowers. In most states, a borrower approaches an approved commercial lender -- usually those institutions eligible to be a depository of state funds -- for the loan, and, if the loan is approved, the bank turns to the state for approval. If the state's chief financial officer approves the loan, the state deposits the amount of the loan in the form of CDs. Therefore, a specific low-yielding deposit is "linked" to a specific low-interest loan. While a linked deposit program would require no direct appropriation of funds, the state would be foregoing some interest earnings on its investments by providing an interest rate subsidy.

Programs differ in the amount of state funds deposited. Some programs limit deposits to a certain percentage of the state's total investment portfolio; others set a specific monetary amount. Although most states require the lenders to approach the state with individual loans and then the state deposits the amount of the loan, in some instances lenders make several loans during a set period of time and the state purchases a CD for the block of loans.

Interest rate formulas differ from program to program. Most states set a maximum interest rate that can be charged above the interest rate of the certificate. For example, if the state receives 5 percent on its investment, it may require the bank to charge the borrower no more than 3 percent above that, or 8 percent. Some states agree to accept a specific rate on their deposits less than the U.S. Treasury bill of comparable maturity and require lenders to subtract the same percentage points off the loan they offer to borrowers. The states may accept 2 percent less than the current rate of a Treasury bill and require the lender to subtract 2 percent from its usual loan rate. Other states use a sliding percentage formula which corresponds to changes in U.S. Treasury bill rates. Attached as Appendix A is a special report by the National Association of State Treasurers briefly describing each state's program.

IV. SUBCOMMITTEE DELIBERATIONS

In its study of the feasibility of an agricultural linked deposit program, the subcommittee sought to assess (i) the current investment practices of the Commonwealth, (ii) the perspective of the private sector and (iii) the genesis and success of another state's program.

A. Current Investment Practices of the Commonwealth

Greg Schnitzler, Director of Cash Management and Investments, Department of the Treasury, testified as to the current investment practices of the Commonwealth. Presently, the state treasury manages $2.5 billion: 50 percent of that amount represents funds in the general account (Appendix B) and the other 50 percent is distributed through certain trust funds. Mr. Schnitzler limited his remarks to the moneys in the general account, from which funds for a linked deposit program would be withdrawn. At the present time less than 1 percent (approximately $11.5 million) of the general account, is invested in time deposits such as CDs.

Deposits of state funds in time deposits and CDs are authorized by § 2.1-329 of the <u>Code</u>, the primary prohibition being that no deposit be made for any one period in excess of five years. The Virginia Security for Public Deposits Act, § 2.1-359 <u>et seq.</u>, requires that "public deposits," as defined, also have collateral securities of the character authorized as legal investments under the <u>Code</u>. In addition, there are certain collateral requirements mandated for state investments. The Security for Public Deposits Act requires that banks collateralize all public deposits with security "over and above" the $100,000 federally insured limit. Banks must collateralize 50 percent of the excess over $100,000. For example, if the Commonwealth deposits $1 million, the first $100,000 is federally insured leaving $900,000 uninsured. The bank then must post $450,000 in securities to be pledged in case the bank "runs into difficulty." In the case of a savings and loan institution, the amount of security is 100 percent over and above the federally insured $100,000. In the case of a $1 million deposit, the first $100,000 is federally insured and the savings and loan posts $900,000 in security. Any linked deposit program would be subject to the requirements of § 2.1-329 and the Act, unless legislation authorizing the creation of such a program exempts the linked deposits from these requirements.

The State Treasurer had several concerns about a linked deposit program. Such a program would be the first in which nonfinancial criteria are used in determining investments and investment policies. The State Treasurer's office is required to deposit the Commonwealth's idle funds in the highest quality investments. Opponents of linked deposit programs say that if the state wishes to provide some type of subsidy, there are more cost-efficient ways to provide assistance. For example, the money lost in foregone interest could be minimized if the state's money were left in current investments and, instead, the amount of estimated savings to the borrowers were directly appropriated to a grant program. Such suggestions also follow the theory that consumers prefer rebates to low-interest rate financing. The issue as to whether the cost to the state is justified by the savings to the farmer was also raised. For example, if the Commonwealth's initial commitment is $15 million, the interest lost on a 3 percent discount would be approximately $450,000. On a $50,000 loan to a farmer, the farmer's savings would be $1,500. Opponents also pose the question of whether other special interest groups would want similar programs and if such a program is, in fact, the best way to assist Virginia's farmers. It appeared that the financial benefits of any such program in Virginia would not be as great as the cost to the Commonwealth in foregone interest income. The State Treasurer's written comments are attached as Appendix C.

B. The Perspective of the Private Sector

The subcommittee received testimony from James Johnson, executive vice-president of Colonial Farm Credit, who discussed the concept of an agricultural linked deposit program and its impact on his institution. Likely participants would probably have sound credit records, proven profitability, and would be likely to succeed in their projects. However those members currently have adequate credit resources. Many of the association's members have undertaken diversification initiatives in areas such as lumber export, further processing, expanded vegetable farming, and catfish farming.

Another speaker from the banking industry was Daniel Payne of Dominion Farm Loan Corporation. Mr. Payne pointed out that because such undertakings are inherently risky and bank administrative costs are higher, Dominion will "require a higher spread" between the CD interest rate and the loan interest rate. The state has been averaging 8.3 percent on its investments; a 2 percent discount would make the interest rate 6.3 percent. The discount to farmers would, in reality, be approximately 0.5 percent to 0.75 percent. It is questionable whether the funds "will really be used by farmers," considering the relatively small discount.

Low participation rates among commercial lenders in states where linked deposit programs already are in place are often cited as an index of the potential success of such a program in Virginia. From a bank's perspective, the costs of carrying out such a program make the savings on interest payments to the state negligible. The banks must train their staffs for the programs and, if few loans are made, the expense in staff education and additional paperwork is not easily justified. Also, given the risk involved with some of the loans, banks face the possibility of diluting the quality of their own portfolios.

Critics of linked deposit programs raise the issue of whether the state should subsidize a specific sector of the economy. They also point out the possibility of substitution -- that the qualifying borrowers could have obtained the same loans at regular rates. Proponents argue that because the banks are responsible for the loans, that, naturally they will lend to those borrowers with a sound credit record. They also point out that while those farmers who participate in linked deposit programs may qualify for standard commercial loans, these same farmers may not have been willing to undertake a diversification project at going rates. They maintain that these entrepreneurs will take more of a risk because, under a linked deposit program, the state is fixing the amount of interest charged. Moreover, some supporters of the programs believe that it is important for the commercial institutions initially to lend to those individuals who have shown profitability and who are more likely to succeed in their projects. They believe an early success rate among those participating in a linked deposit program will serve not only to encourage borderline farmers to seek loans but also to convince more banks to take part in the program.

The reason given for most instances of substitution in farm programs -- a lack of clear targeting -- is also related to another concern of opponents of the program: that farmers will use the loans to refinance their existing debts. VDACS officials point out that because the program can be targeted to agricultural diversification and uses for the loans can be specifically defined, problems with refinancing existing debt can be alleviated, if not eliminated. They also point out that Virginia farmers are more financially sound than many of their counterparts across the country. VDACS estimates that 50 percent of Virginia's farmers are debt-free. Furthermore, a study released in August 1989 by the Federal Reserve Bank of Richmond reported that the value of Virginia farmland has increased and a majority of bankers, 58.3 percent, were actively seeking to make agricultural loans.

C. Iowa's Agricultural Linked Deposit Program

Wishing to receive information about another state's agricultural linked deposit program, the subcommittee heard testimony from Michael Tramontina, Deputy State Treasurer of Iowa. Mr. Tramontina explained that Iowa's linked deposit program had its genesis in the farm crisis of the 1980s. Traditionally, Iowa has depended on corn, wheat, rye, oats, hogs, and cattle for its agricultural products. Because the market for traditional crops has suffered from oversupply and low market prices in recent years, Iowa developed the Linked Deposit Program for Horticulture and Alternative Crops to assist farmers who produce alternative cash crops and products. In 1989, the statute was re-enacted as the Iowa Linked Deposit Program Act.

Iowa actually has three programs: one for horticulture, one for businesses owned by women and minorities, and one for the restoration of historic buildings. All three programs utilize the same application process and operate under the same framework.

Iowa's program is similar to many other states' programs in that the state deposits one-year certificates with participating banks and savings institutions and links the certificate to a specific loan. The certificates earn an interest rate 3 percentage points lower than the one year Treasury bill and may be renewed with the interest rate recalculated at each renewal. The lending institutions are allowed to charge up to 4 percent above the certificate rate. The state does not guarantee the bank's payment of the principal or interest on the loans, and the bank is required to use usual and customary lending standards. Aside from verifying that the project relates to horticulture or alternative crops, the state does not evaluate the loan or review the borrower's credit worthiness.

The maximum loan allowed is $250,000 for a production project and $500,000 for a processing or marketing project. From the program's inception through the period ending September 30, 1989, 210 loans have been made through 65 financial institutions. From June 5, 1986, through September 30, 1989, $6,711,656.61 was disbursed in loans. One hundred loans have been repaid totaling $2,735,899.83. However, there has been no research to supply data indicating whether the program was the incentive to diversify or that diversification was a result of the program.

V. FINDINGS AND RECOMMENDATION

Agricultural diversification, which can be used to describe not only the production of new crops but also the further processing or direct marketing of existing crops, benefits farmers in four basic ways. First, it serves as a way for producers to remove their dependence on staple crops whose production has become unprofitable. Secondly, diversification would allow Virginia farmers to take advantage of the growing markets for fresh fruits and vegetables. Thirdly, it allows a farmer to become more fully employed and to more efficiently use his time. And finally, by adding an additional crop or enterprise, a farmer can spread out his financial risk, helping to insure against the possibility of economic ruin due to adverse weather conditions or other unforeseen disasters. For these reasons, the subcommittee finds that encouraging diversification is a long-term goal for Virginia's agricultural industry and is convinced of the positive, widespread effects of agricultural diversification.

The subcommittee is not convinced of the impact of an agricultural linked deposit program on actual diversification efforts. The subcommittee finds that a linked deposit program may not be the mechanism best suited to stimulate diversification, given current conditions in Virginia. When Iowa undertook its program, farmland, because of its deflated value, was inadequate collateral for loans. Based on figures released in August 1989 by the Federal Reserve Bank in Richmond, the value of Virginia farmland in the second quarter of 1989 was up from $1,277 per acre in the first quarter to $1,313 per acre. Unlike Iowa at the inception of its program, there is currently plenty of credit available to Virginia farmers.

The subcommittee also recognizes that such an agricultural linked deposit program would be the first program where nonfinancial criteria would be introduced in the process of investing state funds. Presently, the State Treasurer follows the "prudent person" rule in investing moneys and uses financial criteria exclusively. Because of those nonfinancial criteria in determining investments, only a certain segment of the population would directly benefit from the linked deposit program.

The subcommittee also finds that there may be less costly initiatives than linked deposits to stimulate agricultural diversification. Testimony from Alice W. Handy, Virginia State Treasurer, indicated that it would cost the Commonwealth 4 percent to give farmers a 2.5 percent discount on a loan. Many other methods would earn a better return on money invested for both the Commonwealth and the farmers.

Recommendation: The Commonwealth should continue to develop strategies for diversification and assess obstacles to such efforts.

Respectfully submitted,

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GENERAL ASSEMBLY OF VIRGINIA -- 1989 SESSION

HOUSE JOINT RESOLUTION NO. 381

Establishing a joint subcommittee to examine the feasibility of the creation of an agricultural linked deposit program.

Agreed to by the House of Delegates, February 6, 1989
Agreed to by the Senate, February 23, 1989

WHEREAS, the industry of agriculture is recognized as the largest single industry in the Commonwealth; and

WHEREAS, is it in the public interest for the Commonwealth to help provide an economic climate conducive to maintaining and improving the health and vitality of agriculture; and

WHEREAS, the Virginia Farmers Market System has been created to provide an agricultural marketing system with the capacity to market many nontraditional food commodities; and

WHEREAS, agricultural producers need to diversify their production to include alternative commodities for which a demand has been identified; and

WHEREAS, the production of new commodities in which some farmers have little or r production or marketing experience can improve profitability and cash flow, and perha reduce overall risks of farming; and

WHEREAS, the Commonwealth encourages agricultural diversification recognizing production of new commodities by an individual farmer presents more than normal financial risks because of production and marketing inexperience; and

WHEREAS, a new source of reduced interest rate money to compensate for the additional production and marketing risks may be an incentive to diversify production; and

WHEREAS, twenty states have created agricultural linked deposit programs since 1985 to provide low interest rate loan programs to farmers through customary private and public agricultural lenders; and

WHEREAS, in 1985 the Board of Agriculture and Consumer Services recommended to the Governor the creation of an agricultural linked deposit program; and

WHEREAS, the Governor's Agricultural Credit Committee in 1988 recommended the creation of an agricultural linked deposit program, specifically targeted to stimulate agricultural diversification; now, therefore, be it

RESOLVED by the House of Delegates, the Senate concurring, That a joint subcommittee be established to examine the feasibility of creating an agricultural linked deposit program targeted to agricultural diversification in Virginia.

The joint subcommittee shall consist of six members as follows: three members of the House Committee on Agriculture, to be appointed by the Speaker of the House; two members of the Senate Committee on Agriculture, Conservation and Natural Resources, to be appointed by the Senate Committee on Privileges and Elections; and the Commissioner of the Department of Agriculture and Consumer Services.

The joint subcommittee shall complete its work in time to submit its findings and recommendations to the Governor and the 1990 Session of the General Assembly as provided in the procedures of the Division of Legislative Automated Systems for processing legislative documents.

The indirect costs of this study are estimated to be $11,070; the direct costs of t' study shall not exceed $4,320.

PROGRAM OPERATION

There are five general components in a linked deposit program: (1) program funding, (2) eligibility requirements, (3) reinvestment criteria, (4) interest subsidies, and (5) monitoring. In a typical linked deposit program, the state treasurer purchases certificates of deposit from eligible banks using state funds designated by the legislature. The financial institution, in turn, lends those funds to borrowers who meet eligibility criteria. In exchange for a lowered rate of return of the state's deposit, the bank agrees to charge a lower interest rate on linked depositloans to borrowers. This spread is usually around 3% - 4% below prevailing market rates.

Program funds are limited by law. This limit may either take the form of a percentage limit on the portfolio investments by the state treasurer, or, in some cases, monetary caps. For instance, Ohio limits investment to 12% of their investment portfolio, while Iowa limits treasury investments to 10% of the state's investment portfolio. Wyoming and Missouri establish monetary limits on investment.

Eligibility criteria are used to channel the loan monies. Typically, participating lenders must: (1) be eligible to make commercial loans, (2) be designated as a depository of state funds, and (3) be able to collateralize deposits in excess of federally insured amounts. To be eligible to borrow, a small business must demonstrate that: (1) the business is headquartered in the state, (2) the business employs fewer than "x" employees (to qualify as a "small" business), (3) jobs will be saved or created, (4) other positive effects will result due to the reduction in capital costs, (5) the borrowed money will be used in accordance with program guidelines, (6) the business is located in a distressed area, and (7), the business is organized for profit.

For farmers, eligibility standards stipulate that a set percentage of income must be obtained from agriculture. In addition, some states require debt-to-worth or debt-to-assets ratios to be met in order to qualify for agricultural loans.

Application procedures for linked deposit loans are relatively simple. In most cases linked deposits are made in response to requests from banks for monies to make a particular loan. In some cases, states deposit funds in advance for the bank to use at its discretion. The difference is one of control: How involved does the state want to be in the actual selection of borrowers? Usually funds are apportioned to banks based on the number of jobs created. A rule of thumb often used is at least one full time job created or saved for every $15,000 - $25,000 deposited with the bank.

Reinvestment criteria are used to gauge the suitability of certain banks for deposits. For example, many states require banks to pledge or meet certain standards. In some cases consistent lending to groups that the state desires to aid such as small business and farmers will increase that bank's chances for future deposits.

Interest subsidy requirements spell out the interest rate the state will receive on its deposit. This rate of interest is often 3% below current market rates. Louisiana and Ohio stipulate that the rate of return on deposits will be 3% below market for business (Ohio's return on agricultural deposits is not legislatively set. It is 4%). Iowa, however, accepts a rate of 2% below market while allowing the bank to charge its customers within 4% of the rate that the institution pays the state. The state treasurer usually must report on current loan arrangements with participating banks. Careful monitoring will avoid misuse of state deposits and identify potential problems.

STATE PROGRAM PROFILES

ALABAMA

THE WALLACE PLAN FOR LINKED DEPOSITS

PROGRAM FUNDING: A total of $60 million is available for investment. Of that total, $10 million is available for agriculture and $50 million is available for small business.

BANK ELIGIBILITY: Any bank or savings and loan association that is a state depository and wishes to participate.

REINVESTMENT CRITERIA: The lending institution makes the credit decision, completes the forms, and sends them to the Treasurer's office. Examples of uses of loans include feed, seed and fertilizer; veterinary, legal, and accounting fees; energy costs and crop insurance; equipment and harvesting expenses; and land, labor, livestock, and repair costs. Business loans may be for land, buildings, equipment; repairs, renovations; rent, utilities, insurance, taxes; legal, accounting fees; and wages and inventory.

INTEREST SUBSIDY: The State Treasurer will place a deposit with a local bank and accept 3% less than market interest rate on that deposit. The bank will agree to make a loan to eligible borrowers at an interest rate of 3% less than the normal rate for that borrower.

REPORTING/MONITORING: The treasurer must prepare an Annual Report to the Legislature, not later than the 10th legislative day of each regular session, outlining the activities, results (in terms of benefits), and findings based on the monitoring of the plan.

ILLINOIS

ILLINOIS STATE TREASURER'S LINKED DEPOSIT PROGRAM

PROGRAM FUNDING: Typical loan size ranges from $400,000 - $2,500,000, and are from 1-3 years in length, with annual renegotiation provisions. Bank deposits must also be limited to 8% of the total assets of that bank.

BANK ELIGIBILITY: Under regulations for the Community Services Program, deposits must be awarded according to the bank's past loan performance in several loan categories.

REINVESTMENT CRITERIA: Participating institutions may not arbitrarily reject mortgage loans. In addition, the bank may receive deposits for loans that assist local communities to recover from natural disasters.

INTEREST SUBSIDY: The interest subsidy is negotiated on an individual basis with the bank. For example, the Treasury made $50 million available for drought relief in 1988 with the understanding that state deposits would receive 6.5% interest with bank loans to farmers at no more than 9.5%.

REPORTING/MONITORING: The State Treasurer maintains a public record of institutions participating in the program.

INDIANA

THE TREASURER'S FARM PROGRAM

PROGRAM FUNDING: Indiana has committed $62 million to the program, $50 million for Indiana banks and financial institutions and $12 million for the Production Credit Association's service centers throughout the state. In addition, the state is limited to $1.5 million deposited per bank, provided that the figure does not exceed 50% of the institution's net worth.

BANK ELIGIBILITY: Banks and financial institutions receiving TFP funds must be previously-approved state depositories and have statutory authority to receive the deposit.

REINVESTMENT CRITERIA: The application must be submitted to the Treasurer of the State for approval on the financial institution's own forms; and copies of 1040 and Schedule F must be submitted. The program is targeted toward young, lower net worth farmers. Signatures of the Chief Executive Officer and the borrower are required on a state-provided form certifying that each loan conforms to the intent of the program. Funds under the program may be expended for the following: feed, seed, fertilizer, chemicals, crop insurance, feeder stock, production-related energy, labor, veterinarian fees, and cash rent for farm land.

INTEREST SUBSIDY: Funds are deposited in the form of a Certificate of Deposit. The initial rate of deposit is 5%, but may be changed by the Treasurer during the program. The financial institution may charge up to 2.5% more than the deposit rate.

REPORTING/MONITORING: The Treasurer of State maintains updated records by institution of Certificates of Deposit placed specifically for the TFP. Financial institutions must submit a quarterly report of the outstanding TFP loans by the 15th of the following month. Participating institutions must also submit a report by January 25, 1990 detailing all loans funded, the date paid, and the balance of loans even if the CD has reached maturity.

IOWA

IOWA'S LINKED DEPOSIT PROGRAM FOR HORTICULTURE AND ALTERNATIVE CROPS AND TARGETED SMALL BUSINESS

PROGRAM FUNDING: For agricultural loans the total amount the Treasurer may invest is 10% of the state's idle funds; this equals approximately $40 million. The Targeted Small Business program will make up to $30 million available for investment.

BANK ELIGIBILITY: All Iowa Banks, Savings and Loans, and Credit Unions that are eligible to make commercial loans are eligible to be a depository of state funds. Participating institutions must meet the terms of the deposit program.

REINVESTMENT CRITERIA: The participating banking institution forwards the appropriate forms to the Treasurer for approval based on funds availability. Agricultural loans must be for non-traditional crops and horticultural enterprises. Examples are: fruit, vegetables, cut flowers, turf, and nuts. Targeted Small Business loans, when extended, must be for businesses that are certified as a Targeted Small Business by the Iowa Department of Economic Development. To qualify, the business must be located in Iowa, be for profit, have fewer than 20 employees or annual gross income of less than $20 million, and be 51% owned or actively managed by one person, or by women or minorities.

INTEREST SUBSIDY: The lender must make a loan at not more than 4% above the interest rate of the Certificate of Deposit. The state's interest return of the CD will be at 2% below the market rate for a U.S. Treasury Bill of comparable maturity.

REPORTING/MONITORING: The Treasurer reports to the Governor, the Speaker of the House of Representatives, and the President of the Senate on the linked deposit program for the preceding year. The report sets forth the linked deposits made by the state treasurer, under the program during the year and includes information regarding the nature, terms, and amounts of the loans upon which the linked deposits were based and the eligible borrowers to which the loans were made. (Iowa Linked Deposits Act; 86 Acts, ch 1096, $12.38).

KANSAS

THE KANSAS LINKED DEPOSIT PROGRAM FOR AGRICULTURE AND SMALL BUSINESS

PROGRAM FUNDING: The Kansas linked deposit program is funded through idle highway funds. These funds vary from year to year. A hedge of one-half of available funds is invested in U.S. Government securities.

ELIGIBLE BANKS: Any chartered Kansas bank is eligible to receive funds under the program.

REINVESTMENT CRITERIA: Banks request money from the State Treasurer to lend under the program. Farmers and Small Businesses must meet the definition of "family farmer" and "small business" in order to qualify.

INTEREST SUBSIDY: The most recent interest rate on state deposits is 4%. Banks are allowed to charge no more than 3% more for handling, profit, and risk.

REPORTING/MONITORING: Kansas banks report to the Treasury. A legislative post-audit is conducted.

LOUISIANA

LINKED DEPOSIT PROGRAM FOR AGRICULTURAL LOANS

PROGRAM FUNDING: Up to $10 million is available for linked deposits with a $50,000 limit per loan.

BANK ELIGIBILITY: All banks that are state depositories are eligible for linked deposits.

REINVESTMENT CRITERIA: The loan may be used for most farming related activities and for refinancing a loan.

INTEREST SUBSIDY: The state deposits funds at 3% below market rate interest. The interest rate extended to the farmer must also be 3% below market rate.

REPORTING/MONITORING: The State Treasurer reports annually on all linked deposit business transactions.

MAINE

LINKED INVESTMENT PROGRAM FOR AGRICULTURE AND SMALL BUSINESS

PROGRAM FUNDING: Under authorization of the Maine Legislature, the State Treasurer may invest no more than $4,000,000 of state funds into both the agricultural and the commercial programs, with each participating lending institution not to exceed $1,000,000 of state investment. The Finance Authority of Maine (FAME) assists the State Treasurer in the administration of the program.

BANK ELIGIBILITY: To become a participating lender, chartered financial institutions may enter into an agreement with the State Treasurer.

REINVESTMENT CRITERIA: To obtain an agricultural loan, applicants must have: (1) obtained an FmHA operating loan within the past year, or (2) accrued, for the most recent fiscal year, interest expense in excess of 13% on agriculture related loans. Further, the agriculture loan may not be used for purposes other than the purchase of: seed, feed, fertilizer, chemicals, veterinary services, labor, production-related energy and other production inputs.

To obtain a commercial loan, the business applicant must not have agriculture production as its principal source of revenue, nor may it be a for-profit business located in the state. The business applicant must have 20 or fewer employees OR annual sales of less than $2,500,000. Additionally, business applicant must: (1) Make at least 70% of it sales out of state; OR (2) Be a manufacturer defined as a commerical enterprise. Further criteria are that the business applicant must be at least 50% owned and operated by Maine residents, the business must create or retain at least one job for each $20,000 of deposited funds, and it must use the loan proceeds only for acquisition of or improvements to real property or fixed assets, research and development or working capital. The Treasurer may approve others on a case by case basis.

INTEREST SUBSIDY

The State will deposit funds for eligible loans at a rate which may not be less than 2% below the one year CD rate of depository institutions as of the date of the transaction. The lender shall make each borrower aware of the interest rate for their loans in the absence of state funds. Taking into account all applicable criteria, the linked deposit loan shall fully reflect the discount to the lender on the state's investment.

REPORTING/MONITORING

The State Treasurer maintains a public record of institutions and borrowers participating in the program.

MASSACHUSETTS

LINKED DEPOSITS

PROGRAM FUNDING: Linked deposit amounts vary according to monies available in the general fund float.

ELIGIBLE BANKS: Banks must meet the Community Reinvestment Act criteria to qualify for state deposits. The state treasurer solicits bids twice each year. Depositories in Massachusetts are divided into two categories, or leagues. League 1 incorporates all commercial banks. League 1 is further divided into three sizes: 1(a), banks which have assets in excess of $1 billion, 1(b), banks with deposits of $500 million to $1 billion, and 1(c), banks with deposits under $500 million. League 2 includes thrifts, cooperatives, and savings and loans. League 2 includes thrifts, co-operatives, and savings and loans. League 2(a) includes institutions with assets up to $100 million.

REINVESTMENT CRITERIA: Several loan categories are used to determine an institution's eligibility for linked deposit loans. These categories include investment in small businesses, student HELP loans and home mortgage and home improvement loans in low-income areas.

INTEREST SUBSIDY: Interest rates are determined by Wall Street money rates for CDs.

MONITORING: Participating institutions must maintain and update their basis point calculation twice each year.

MICHIGAN

INVESTMENT OF SURPLUS FUNDS

PROGRAM FUNDING: Currently, $174 million is on deposit with Michigan banks. $200 million is allocated for the program.

ELIGIBLE BANKS: Michigan banks and Production Credit Associations.

REINVESTMENT CRITERIA: There were two programs. Under the first program, which expired June 30, 1988, a farmer could borrow money if the farmer was having difficulty making debt payments (limited to

$100,000 of debt including linked deposit loans), or the farmer had suffered a 25% to 50% production loss within Michigan in any one crop (commonly referred to as a "stress test"). Under the second plan, now in operation, money is loaned to borrowers at 0% interest. In addition the "stress" test has been dropped. This program is directed at flood victims. However, the stress test will be reintroduced following the expiration of a three year "emergency period".

INTEREST SUBSIDY: The interest on a linked deposit cannot be more than the interest on a linked agricultural loan. The current interest rate on linked deposits to flood victims is 0%.

REPORTING/MONITORING: Quarterly reports from the lending institution on all loans and outstanding debts.

MISSOURI

MO BUCKS LINKED DEPOSIT PROGRAM

PROGRAM FUNDING: The total MO BUCKS Fund is $300 million with $150 million allocated for farm loans, $50 million in small business loans, and $100 million for job creation loans. The funds are available through December, 1990.

ELIGIBLE BANKS: Potential borrowers apply to Missouri banks, savings and loans, credit unions, and farm credit banks that are eligible for deposits under the program.

REINVESTMENT CRITERIA: The purpose of the program is to assist those small farmers and business owners with less than 10 employees, where a reduced loan rate will make a significant contribution to their continued operation, and to assist larger companies with 10 or more employees to create or sustain at least one job for each $25,000 borrowed.

INTEREST SUBSIDY: The Missouri Treasurer's Office places deposits of state funds with participating lenders at three percent below the usual Treasury bill rate when those lenders agree to pass the interest savings on to the borrower. The lending rate to farmers and small business owners since the beginning of the program has averaged 7.9%.

REPORTING/MONITORING: The Missouri Treasurer's Office makes field audits and uses computer checks to monitor the programs.

MONTANA

PREFERENCE TO IN-STATE INVESTMENT FIRMS

PROGRAM FUNDING: The State Board of Investment oversees all investments.

ELIGIBLE BANKS: In-state depositories are eligible for linked deposits.

REINVESTMENT CRITERIA: Special consideration is given to investments that benefits smaller communities.

OHIO

THE WITHROW PLAN AND AGRI-LINK PROGRAM

PROGRAM FUNDING: The Treasurer may invest up to 12% of the state's investment portfolio, of which $100 million will be used for agriculture. Under state law, deposit totals may not exceed $100 million for small business and $100 million for agriculture loans.

ELIGIBLE BANKS: Any bank that is a state depository is eligible for deposits under the Withrow Plan. A state depository is defined as any bank that collateralizes deposits, accepts no public funds in excess of 30% of the bank assets, and agrees to participate in the student loan program. In addition, Ohio Production Credit Associations are eligible for state deposits under the Agri-Link program.

REINVESTMENT CRITERIA: Small businesses must pledge to use borrowed money to create or retain jobs. Lenders must give priority to applications based on area economic needs and the jobs created or saved. Agri-Link borrowers must meet standards under a formula which takes into account such factors as debt-equity ratios, full-time farmer status, and percentage of operating cost which goes directly to pay interest.

REPORTING/MONITORING: The treasurer must report annually on all program activities.

In addition, an extensive bank and business monitoring system is in effect that utilizes follow-up questionnaires and bank and business visits to assess the effectiveness of the institutions in reaching program goals.

INTEREST SUBSIDY: Deposits are placed at up to 3% below market rate interest under the small business program. Loans are made at 3% below market rates for that particular borrower in the Withrow Plan for small business, and up to a 4% reduction in market rates for agriculture loans.

OKLAHOMA

AG-LINK PROGRAM

PROGRAM FUNDING: The state treasurer may invest up to 15% of total investable funds. Total funding for Linked deposit program is approximately 150 million dollars.

ELIGIBLE BANKS: All banks that are state depositories are eligible for deposits.

REINVESTMENT CRITERIA: Oklahoma's agricultural program is divided into two areas eligible for linked deposits: (1) alternative agricultural products, or crops "new to the area", and (2) the "distressed farmers" portion designed primarily to aid the family farmer. Oklahoma's linked deposit program for business is intended for small business with the purpose of creating or preserving jobs in Oklahoma.

INTEREST SUBSIDY: Loan rates have been between 6%-9% to farmers. Linked deposits for business will be extended beginning the week of October 9, 1988.

REPORTING/MONITORING: The Oklahoma State Treasury spot checks bank records.

APPENDIX B

DEPARTMENT OF THE TREASURY
GENERAL ACCOUNT
Monthly Average Investment
Amounts and Yields
(millions of dollars)

FISCAL YEAR 1990	REPURCHASE AGREEMENTS Max. Authorized 35%			U.S. GOVERNMENT and AGENCY SECURITIES Max. Authorized 100%			MONEY MARKET SECURITIES Max. Authorized 75%			TIME DEPOSITS Max. Authorized 25%			COMPOSITE	
	Amount	Percent	Yield	Amount	Percent	Yield	Amount	Percent	Yield	Amount	Percent	Yield	Amount	Yield
July	$ 66.3	5.4%	9.12%	$ 742.8	60.2%	9.01%	$ 413.9	33.5%	9.66%	$ 11.5	.9%	9.21%	$1,234.5	9.23%
August														
September														
October														
November														
December														
January														
February														
March														
April														
May														
June														

PENNSYLVANIA

THE PENNSYLVANIA TREASURY DEPARTMENT'S LINKED DEPOSIT PROGRAM

PROGRAM FUNDING: The treasury department made up to $200 million available in 1988.

ELIGIBLE BANKS: Any bank or savings and loan that is approved for state deposits.

REINVESTMENT CRITERIA: The state responds to requests from banks for linked deposit loans. The treasury evaluates the application and, if approved, purchases CD's from the bank. To be eligible for loans the business must be organized for profit, must employ fewer than 150 people, and must submit documentation that jobs will be created or retained.

INTEREST SUBSIDY: The discount on the bank's loan to borrowers will be equal to the reduction in interest on the state's CD's.

TEXAS

THE TEXAS LINKED DEPOSIT LOAN PROGRAM

PROGRAM FUNDING: The legislature in House Bill 49 and the voters of Texas approved in November of 1987 a total of $5 million in a revolving fund to be allocated for deposit in eligible state lending institutions for Linked Deposit Loan funds to help diversify Texas' second largest industry, agriculture. The Program became active on June 20, 1988.

ELIGIBLE BANKS: Banks and savings and loans are eligible that: are state depositories, agree to participate in the program, agree to provide collateral equal to the amount of the deposit, and agree to loan an equal amount and pass along the lower interest rate to the borrower.

REINVESTMENT CRITERIA: Loans will be considered for alternative crop production up to $100,000, for processing of agricultural products up to $250,000, and for direct marketing initiatives for agriculture products up to $250,000.

To participate, borrowers fill out the lending institution's standard application forms and the Linked Deposit Application. The lender sends these materials to the Texas Department of Agriculture (TDA) for review and approval by both TDA and the Texas Treasury within a ten day period. Once approved and the Treasury has sufficient collateral, a Linked Deposit rate commitment is requested from the Treasury within the week the loan is to be funded. The borrower then delivers a written confirmation to the TDA that their loan has been funded. The TDA then advises the Treasury to fund the Linked Deposit to the lender within a 24 hour period.

INTEREST SUBSIDY: The Linked Deposit rate is calculated by subtracting 2% points from the U.S. Treasury Bill or Note yield rate of comparable maturity to the loan. The lender must make the Linked Deposit Loan rate at no more than 4% points above the current market rate of the U.S. Treasury or Note yield rate of comparable maturity, not to exceed the fiscal biennium of the state. To date, rates charged by Lenders have ranged from 2.5 to 4% points above the Linked Deposit rate.

REPORTING/MONITORING: The Texas Department of Agriculture's Administrator of the Texas Agriculture Diversification Program monitors the program for compliance and is directed to inform the State Treasurer of noncompliance on the part of eligible borrowers and lending institutions. Annual reports are made to the state legislative committees reviewing the Program's activities.

WEST VIRGINIA

THE TREASURER'S ECONOMIC DEPOSITS DEVELOPMENT INCENTIVE PROGRAM

PROGRAM FUNDING: $225 has been allocated for TEDDI linked deposits.

BANK ELIGIBILITY: Lenders must be West Virginia financial institutions to receive TEDDI deposits.

REINVESTMENT CRITERIA: The company must be headquartered in West Virginia, must employ 200 or fewer employees, or must have gross receipts of less than 4 million dollars annually. The company must retain or create jobs with the money borrowed. Each business must be in good standing with all other agencies of the state government to qualify, including the Department of Employment Security, Workers' Compensation Fund, and Tax.

INTEREST SUBSIDY: The state accepts an interest rate of 3% less than the most current rate for the two year U.S. Treasury bills on its deposits. The bank must pass this discount on to its customers.

REPORTING/MONITORING: Field audits of 5% - 10% of all bank loans. The state also audits business papers for compliance with the TEDDI program and submits a quarterly report to the Governor and Legislature detailing every loan executed.

WYOMING

LINKED DEPOSITS AND INVESTMENTS

PROGRAM FUNDING: The treasurer is authorized to deposit up to $100 million in state funds. Another $50 million was allocated during the last session of the Wyoming legislature with the proviso that no link deposit monies could be lent to a business if an unfair advantage over a competing business was created.

REINVESTMENT CRITERIA: The state responds to linked deposit requests from lending institutions. Commercial or agricultural jobs must be created or maintained in Wyoming.

INTEREST SUBSIDY: The borrower's rate of interest must be the same rate of interest that the state earns on its investment.

REPORTING/MONITORING: The state treasurer reports annually by financial institution the name of the borrower, amount, and purpose of the loan.

APPENDIX C

COMMONWEALTH of VIRGINIA

Department of the Treasury

ALICE W. HANDY
TREASURER OF VIRGINIA

P. O. BOX 6-H
RICHMOND, VIRGINIA 23215
(804) 225-2142

October 17, 1989

MEMORANDUM

TO: Deanna S. Byrne, Staff Attorney

FROM: G.A. Schnitzler

SUBJECT: Linked Deposit Study

Over the past several weeks, the office of the State Treasurer has been requested to offer its view regarding a proposed program which would link deposits made by the State treasurer in Virginia Financial institutions with below market loans made to the agricultural community for the purpose of crop diversification.

The State treasurer has offered a number of concerns to the members of a joint subcommittee which has been tasked with the responsibility of studying the feasibility of such a program.

- The introduction of this program would be the first time that nonfinancial criteria would be introduced in the process of investing public funds.

- The program might set a precedent for other special interest groups that may desire similar type of programs.

- As presented by the representative of Iowa, it appears that the financial benefits to the beneficiaries of any such program in Virginia would not be as great as the cost to the State Treasury in foregone interest income.

Notwithstanding these concerns, the State Treasurer has pledged to support this program in the event it was enacted into law.

Please let me know if we can be of any further assistance in this matter.

cc: Alice W. Handy

GAS/lds