Local Government Investment Pools and the Financial Crisis

Lessons Learned

BY JEFF PANTAGES

Just a few years ago, everyone was grabbing for yield, and complacency reigned. In early 2007, government cash managers were being asked why they were not using the cool, sophisticated instruments the other guys were using — why they were sticking with SLY (the basics: safety, liquidity, and yield) when other funds were using SIVs (structured investment vehicles). It was a world where brokers were saving their clients a few basis points by having them issue auction rate securities and swapping it to fixed instead of issuing traditional fixed rate debt.

Government investment and finance professionals were thought to be old fashioned. Of course, within months, the tables had turned. Exotic instruments were out and plain vanilla was back in style as the greatest financial crisis since the Great Depression got underway. Local government investment pools (LGIPs) did pretty well — with a few notable exceptions — and learned some lessons in the process.

HOW LGIPS WORK

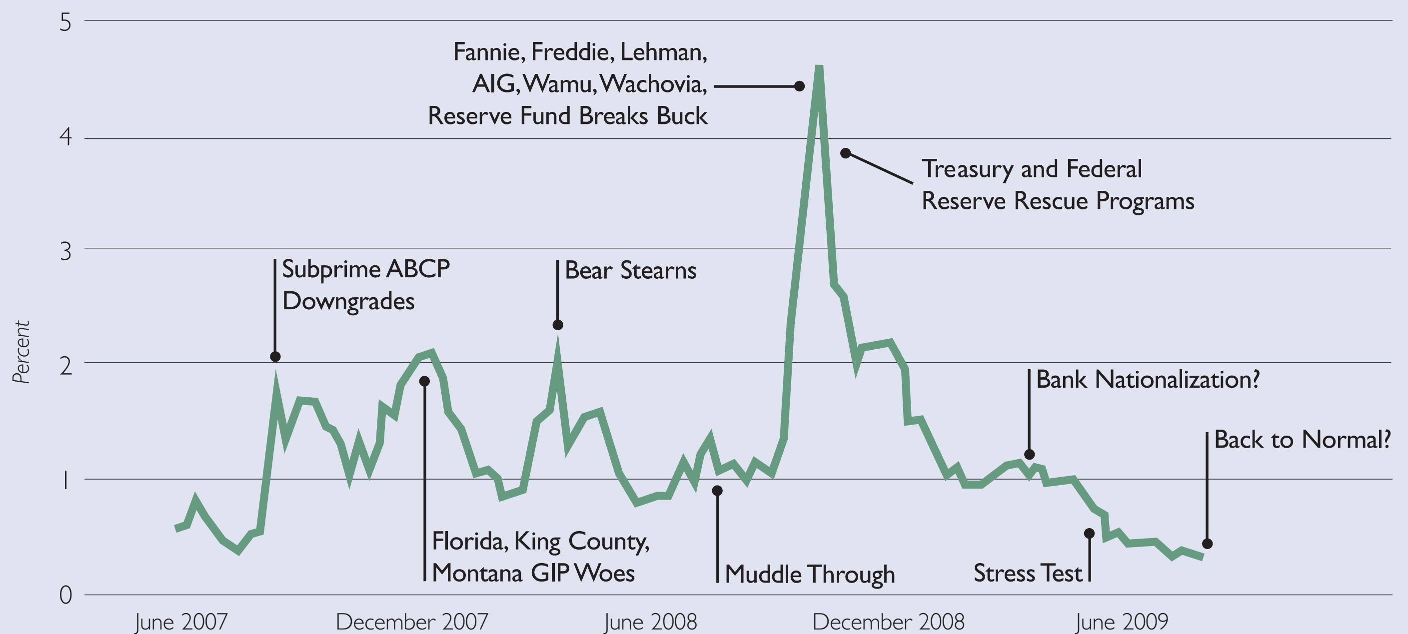
LGIPs are state- or county-operated short-term investment pools that are available to cities, school districts, and other governmental entities. Authorizing statutes and enabling legislation provide structure and investment restrictions. The idea is that local governments will invest in a pool to take advantage of the economies of scale, professional management, and liquidity features that they would have difficulty achieving on their own. Participation is mandatory for some governmental entities in some states.

Standard & Poor's estimates that there are more than 125 LGIPs. According to iMoneyNet, 45 states have LGIPs with assets totaling more than $250 billion. About two thirds of these funds hire independent money managers, and the rest are managed internally by government employees. Most operate like money market funds with a stable $1 net asset value (the NAV is the fund's per-share value, calculated by dividing the total value of all the securities in its investment portfolio by the number of fund shares outstanding) and a dollar-in, dollar-out policy. Some are ultrashort bond funds that stretch for more yield, have investment horizons from one to three years, and have fluctuating NAVs.

Importantly, LGIPs are not registered with the Securities and Exchange Commission (SEC) and are not required to register

Exhibit 1: The TED Spread

The TED Spread compares the difference between three-month interbank loans (LIBOR) and the U.S. Treasury's three-month lending costs. The measure is an indicator of perceived credit risk in the overall economy because T-bills are considered risk-free, while the interbank loan rate reflects the credit risk of lending to commercial banks.



Data: Bloomberg

under the Investment Company Act of 1940 and meet Rule 2a-7 safety requirements like most money market funds. While many LGIPs say they are considered "2a-7-like", they generally do not meet all of the Rule 2a-7 guidelines, an exemption that allows a pool greater flexibility but also reduces investor protection.[1]

THE GATHERING STORM (2007)

The timeline of the financial crisis, shown in Exhibit 1, maps out key events against what's called the TED spread. This is the money markets' "fear gauge." It takes the London Interbank Offered Rate (LIBOR), at which banks trade unsecured funds among themselves, and subtracts the yield on risk-free U.S. Treasury bills to get a risk premium. This risk premium is normally around 50 basis points. It widened out to a record 463 basis points in October 2008, reflecting the unprecedented stress and panic in the money markets.

The financial crisis began in early 2007, when problems in subprime mortgage loans surfaced. A shadow banking system had developed, allowing banks to securitize these loans (and others) and pass them on to off-balance sheet SIVs (a type of structured credit product that borrowed money by issuing short-term securities at low interest and then lent that money at higher interest) and other investors in the United States and abroad. The problem was that this was an "originate to distribute" model, not an "originate to hold" model. There was little incentive to do good underwriting. The rating agencies slapped AAA ratings on much of this paper, relying on historical data and flawed mathematical modeling instead of common sense.

Local government investment pools seem to have emerged from the financial crisis relatively unscathed.

Funding for the shadow banking system came from the money markets, including money market funds and LGIPs that relied largely on the A1/P1 short-term issuer ratings from rating agencies. As the subprime crisis worsened and concerns mounted, many SIVs and issuers of asset-backed commercial paper couldn't roll over their short-term debt, leading to forced sales of the underlying assets at distressed prices. Parent banks came to the rescue in some cases, but a number of issuers defaulted.

While no 2a-7 money market fund "broke the buck" (that happened later), the SEC observed in its proposed rule for money market reform (published in the Federal Register in July 2009) that "we know of at least 44 money market funds that were supported by affiliates because of SIV investments." Money market funds also benefited from positive cash flow resulting from the fact that investors began to shun risky assets in general. According to the SEC, "During the period from July 2007 to August 2008, more than $800 billion in new cash was invested in money market funds, increasing aggregate fund assets by one-third."

The Florida Government Investment Pool. Several LGIPs were at the center of the storm. The Florida Government Investment Pool was the country's largest LGIP ($31 billion), and also one of the highest yielding. News that nearly $2.1 billion of its holdings were in default or troubled led to a panic and a classic "run on the bank." In mid- to late November of 2007, $14 billion left the pool before the State Board of Administration (SBA) suspended withdrawals.

A week later, the pool reopened with an interim manager. The SBA decided to split the pool into Fund A (good assets) and Fund B (bad assets). Withdrawals from Fund A were allowed subject to a withdrawal penalty set at 2 percent. This formula was based on the determination that a complete liquidation of Fund A would result in a 2 percent shortfall. Apparently, on a mark-to-market basis, the NAV of Fund A was in fact 98 cents and not $1. Standard & Poor's issued an AAAm principal stability fund rating on the newly created Fund A. The rating indicated a strong capacity to maintain principal value, and while this no doubt provided some comfort to pool participants, Fund A has continued to shrink and now has assets of $6 billion.

Withdrawals from the $2.1 billion Fund B were frozen. Funds are being transferred to participants as maturities, sales proceeds, and income become available. At the end of July 2009, participants had received $1.4 billion. The remaining securities have a $700 million book value and market value of $277 million. Loyal investors that stayed the course over the last few years will have received about 97 cents on their original investment.

A Participant Advisory Committee report was critical of the SBA.[2] It indicated that a lack of oversight by the three-member governing board (composed of the state's chief financial offi-

cer, governor, and attorney general) coupled with weak risk and control safeguards contributed to the debacle. The pool seems to have stretched for yield and paid a high price.

King County, Washington. King County's $4.5 billion investment pool also made headlines. It had four SIVs totaling $207 million that defaulted. Unlike Florida, King County did not bifurcate its pool owing to operational complexity. Participant losses are estimated at about $100 million, which works out to a loss of about 2 or 3 cents for every dollar invested in the pool.

Standard & Poor's suspended the fund's AAAf rating on the pool in January 2008. The "f" refers to the fact that the King County pool was being rated as a variable NAV investment pool. This is an important distinction. AAAm is a rating for stable $1 NAV money market funds. AAAf is a different rating and means the fund has high credit quality but because it invests in longer securities, it can have a fluctuating NAV. (Pool participant buyers need to beware, as it is understood that some LGIPs choose an AAAf rating after first seeking a AAAm rating as the AAAf standards are easier to achieve.)

In an eye-opening and comprehensive report, the King County Investment Pool Advisory Panel said, "These impaired investments presented the investment pool with unprecedented decisions and raised questions about whether the investment pool's current policies, structure, and systems were sufficiently robust given today's challenging market conditions."[3] The panel's report is a must read and offers insight into best practices for all LGIP money managers.

The King County Pool is an unusual hybrid fund. It offers share daily liquidity at a NAV of $1, yet it invests in longer securities and does not mark the portfolio to market like short bond funds. Effectively, longer-term investors are subsidizing the investors who move in and out of the fund at $1 per share as their liquidity needs wax and wane. As one might expect, the advisory panel recommended that the pool be split into two funds.

Connecticut, Maine, Orange County, and Montana. A February 2009 special report from iMoneyNet, which provides money market news and analysis, reviewed other LGIPs caught up in the SIV storm.[4] Connecticut, Maine, Orange County, and Montana were named. Bloomberg estimates that LGIPs held close to $1 billion in defaulted SIV and ABCP short-term debt.[5] Recoveries are all over the map, but about 60 cents on the dollar is a reasonable estimate.

THE CRISIS CONTINUES (2008)

The financial markets muddled along through 2008 until September, when a sequence of financial failures (Lehman Brothers, AIG, and others) culminated in the Reserve Primary Fund "breaking the buck" and re-pricing the fund at 97 cents per share instead of a dollar. Within a week, the fund had suspended redemptions and began an "orderly" liquidation.

Investors panicked and fled prime money market funds in favor of government funds and Treasury bills. Stocks plunged, and trading in the bond and money markets froze with a virtual shutdown in primary issuance and secondary market trading. Credit risk premiums soared to Great Depression levels. Trust and confidence evaporated, and our highly interconnected financial system seized up.

It is hard to overstate the level of panic. In mid-September, policymakers intervened to stabilize and provide liquidity to the markets. In addition to the Troubled Asset Relief Program (TARP), the Treasury announced a Temporary Guarantee Program (expiring in September 2009) for money market funds that essentially guaranteed a $1 NAV for all 2a-7 funds that elected to participate and purchase the insurance. (LGIPs were not eligible.) The Federal Reserve offered up an alphabet soup of lending facilities, many targeted at the money markets, while eventually pushing the federal funds rate to zero.

Despite these actions, over the next four weeks, prime institutional money market funds lost 30 percent of their assets ($418 billion) because of withdrawals. In its proposed rule on money market reform, the SEC noted in the Federal Register that "No other money market fund other than the Reserve Primary Fund broke the buck, although money market fund sponsors or their affiliated persons in many cases committed extraordinary amounts of capital to support the net asset value per share."

LGIPs seem to have emerged from this debacle relatively unscathed. Perhaps LGIPs had found religion as a result of their experience just a year earlier with SIVs, helping them avoid the fallout from Lehman and the credit crisis in the fall of 2008. The managers for some pools, including the Alaska Municipal League Investment Pool, became quite risk averse beginning in August 2007 all the way through June 2009. These funds chose to sacrifice yield for safety and liquidity.

Another factor has to do with "hot money." Investors in institutional money market funds are often not long-term investors. Instead, they transfer funds for a few extra basis points and abandon ship at the hint of trouble. This is not the way LGIP participants work, and therefore, the money in these pools is "stickier."

San Mateo County Pool. Still, there were a few hiccups. There are several examples of pools that had exposure to Lehman Brothers.[6] For example, the $2.6 billion San Mateo County Pool in California had 5.9 percent of its assets in Lehman paper. Losses are estimated at $155 million. A consultant brought in after the fact reviewed the San Mateo investment policy and holdings. One glaring concern was that the maximum issuer holding limit of 10 percent for most sectors made it possible to have 40 percent of assets in one investment, so long as that investment was aggregated across several sectors (CDs, commercial paper, corporate notes, etc).[7] In fact, San Mateo owned positions exceeding 10 percent of assets in Deutch Bank, General Electric, Lehman Brothers, Morgan Stanley, Union Bank of California, and Wells Fargo during 2008. Another consulting firm stated that such concentration was inconsistent with industry best practices and arguably in conflict with the Prudent Investor rule.[8] They also noted that the Board of Supervisors oversight was "not being conducted by anyone with portfolio management experience."

Colorado Diversified Trust. The Colorado Diversified Trust shut down as a result of its holdings in bankrupt Lehman paper. Assets were transferred at 98 cents on the dollar to the AAAm-rated Colorado Local Government Liquid Asset Trust.

AFTERMATH OF THE CRISIS

Without the extraordinary efforts on the part of the U.S. Government and money market fund sponsors, many investors would have lost money, and money market funds would have lost all credibility. Peter Crane, a pioneer in the money fund business, estimates that perhaps a third of all money market funds received support from their parent organizations during the crisis.

Several policy groups have weighed in and are recommending changes to money market funds as a result of the crisis, wanting to make them more resilient to short-term market disruptions and provide greater protection for investors. These discussions are about 2a-7 money market funds, but LGIPs should pay attention.

The Group of Thirty (G30, a non-profit group composed of senior representatives of the private and public sectors and academia) issued a report called *Financial Reform: A Framework for Financial Stability*. The project was led by Paul Volcker, and one conclusion was that money market funds represent a systemic risk and should be put under the auspices of banks and receive Federal Deposit Insurance Corporation (FDIC) insurance and access to the lender of last resort — the Federal Reserve. Otherwise, amortized cost accounting should not be permitted, and these funds would have a variable NAV.

The Investment Company Institute (ICI), the trade group for money market funds, disagrees, seeing the G30 solution as the death of money market funds as we know them and a boon to the banks. The group defends amortized cost accounting and wants to maintain the one dollar stable NAV for all money market funds. The ICI offered up 26 recommendations in March to make money market funds stronger. They include:

- No second-tier or illiquid securities
- New liquidity mandates of 5 percent cash for retail funds and 10 percent daily cash for institutional funds
- Maximum weighted average maturity of 60 days for less volatility
- Regular stress tests (rate shocks and withdrawals)

- Know your customer (large participants) — know when large withdrawals and contributions are coming

In July, the SEC proposed changes to Rule 2a-7 that closely follow the ICI recommendations. The agency is asking for comments on the variable NAV question as well. Their report in the Federal Register is fascinating reading. Really.

PLAY IT SMART

It is hard to get a handle on the total losses LGIPs suffered during the economic crisis. Lehman commercial paper is trading around 15 cents on the dollar, and various defaulted SIVs are in the neighborhood of 60 cents. The few LGIPs that got hit may have suffered losses of about 2 or 3 cents on the dollar. Not bad, under the circumstances.

Delegate, But Don't Abdicate. It's clear that boards and oversight panels need to take ownership and be engaged. Delegation is one thing, but we cannot abdicate responsibility. A government panel of disinterested politicians based on rank will not work. Financial expertise is important.

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Let The Sun Shine In. Some managers might have provided unwarranted assurances to pool participants, thinking that full disclosure would lead to a stampede out of the pool during difficult markets. Some participants might have been misled into thinking their LGIP was a 2a-7-like money market fund when in fact it was more like "cash on steroids," or in fact a variable NAV short bond fund. But, at the same time, perhaps participants have not asked enough questions, or the right questions.

If It Sounds Too Good To Be True It Probably Is. One reason LGIPs should have avoided SIV/ABCP paper in the summer of 2007 was that the spreads were so narrow versus traditional paper — it was not worth the risk. Now, however, budgets are tight, and it might be more tempting to stretch for yield to make up for lost revenue elsewhere. Don't do it.

SIVs yielded more than traditional commercial paper for a reason. These investments were complicated and not transparent. Similarly, issuing straightforward long-term debt is different than entering into some Rube Goldberg maze of auction rate securities and swapping the cash flows with a counterparty to create "synthetic" debt. Don't do it — especially to save a few basis points. Keep in mind that Wall Street firms are not charitable organizations. They exist to make money. The job of a salesman is to be your friend so that things will get done because of the "relationship." At a minimum, trust but verify.

Diversify. Diversify. Diversify. Diversification is about the only way to protect portfolios in difficult times. While most investment policy guidelines (and Rule 2a-7) limit exposure to the securities of any individual entity to 5 percent, many managers limit individual credit exposure to 1-2 percent. Investments should be diversified across sectors and industries as well.

Keeping Score. Get a fund rating from one of the ratings firms. It provides another layer of oversight and monitoring of investments. Naysayers claim that it's just checkers, checking the checkers, but in this case, safety is paramount. Engineers will tell you that to prevent catastrophic failure, you should build in redundancies.

If you keep the score, you'll know the score, and the score will improve. Standard performance metrics are important, and total investment return is best. At a minimum, make sure to look at portfolio returns versus the benchmark and peer managers on a consistent basis. Do not cherry pick the data and time horizons. A good starting point would be for all LGIPs to agree to quote yield consistent with SEC requirements for money market funds.

CONCLUSIONS

Like everything else, LGIPs took their lumps during the crisis. For the most part, they did well, but some LGIPs need to strengthen their governance and investment policies to protect pool participants against future turbulence. Now that the worst is behind us, the time for reflection is at hand. We will vow to never, ever, make the same mistakes again. Well, at least for a few years! After all, as Mark Twain noted, the past may not repeat itself, but it often rhymes.

Notes

1. Sophia Anastopoulos, *An Elected Officials Guide to Investing* (Chicago: Government Finance Officer's Association) 2007.
2. Florida SBA Local Government Investment Pool (LGIP) Participant Advisory Committee Statement of Position, June 2009, http://www.Sbafla.com.

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3. The King County Investment Pool Advisory Panel, *Report on the King County Investment Pool*, May 2008.

4. *Government Investment Pools: Investment Strategies, Facts, Figures, and Trends*, iMoneyNet, February 2009.

5. David Evans, "The Subprime in the Schoolhouse," Bloomberg Markets, January 2008.

6. iMoneyNet.

7. Nancy Jones and Ken Schiebel, PFM Asset Management LLC, *Report on Risk Analysis of the Treasurer's Investment Pool: County of San Mateo Working Group*, February 27, 2009.

8. Alan Biller and Associates, *Country of San Mateo Investment Pool: Investment Consultant's Report*, June 17, 2009.

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For More Information

- The GFOA has a best practice on LGIPs, *Use of Local Government Investment Pools*, available on its Web site at http://www.gfoa.org/downloads/cashlgip.pdf.
- The Florida Government Investment Pool adopted best practice guidelines in July 2009; they are available at http://www.sbafla.com/fsb/LinkClick.aspx?fileticket=FLNtt7JAI4U%3D&tabid=611.
- The Florida State Board of Investment, after its initial stumble, has stepped up its communication and has an excellent Web site (http://www.sbafla.com/fsb/).
- *Money Market Fund Reform; Proposed Rule*, July 2009, Federal Register, available at http://www.sec.gov/rules/proposed/2009/ic-28807fr.pdf.
- *Report of the Money Market Working Group*, March 2009, The Investment Company Institute, available at http://www.ici.org/pdf/ppr_09_mmwg.pdf.
- *The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace*, January 2009, The Group of Thirty, available at http://www.group30.org/pubs/recommendations.pdf.