HOUSE OF REPRESENTATIVES STAFF ANALYSIS

BILL #: PCB GEAC 08-31 Local Government Investment Pool Trust Fund
SPONSOR(S): Government Efficiency & Accountability Council
TIED BILLS: **IDEN./SIM. BILLS:**

REFERENCE	ACTION	ANALYST	STAFF DIRECTOR
Orig. Comm.: Government Efficiency & Accountability Council	9 Y, 0 N	Kruse/Dykes	Cooper
1)			
2)			
3)			
4)			
5)			

SUMMARY ANALYSIS

At the direction of Speaker Rubio, the House recently undertook an investigation of the Local Government Investment Pool (LGIP) managed by the State Board of Administration. In the fall of 2007, the LGIP went through a series of tumultuous events related to the subprime mortgage meltdown leading to a freeze of the LGIP and subsequent formation of a Pool A and Pool B. Pool A is subject to certain withdrawal limitations and Pool B remains frozen. The team hired for the investigation issued its report on March 24, 2008, and listed 16 recommendations. Speaker Rubio further directed the House to consider legislation that could effectively provide control measures and ensure accountability and return investor trust in the Pool.

This proposed bill creates the Fund B Surplus Funds Trust Fund, provides for the funds for deposit to be transferred from Fund B of the Local Government Surplus Funds Trust Fund, provides for the yearly carryover of the funds, and provides for its termination upon self-liquidation.

The bill does not have a fiscal impact.

The bill is effective upon becoming law.

FULL ANALYSIS

I. SUBSTANTIVE ANALYSIS

A. HOUSE PRINCIPLES ANALYSIS:

Lower taxes: A successfully administered investment pool for local governments may mean a higher rate of return and more revenue available for local governments, diminishing the need for increased revenue from taxes.

B. EFFECT OF PROPOSED CHANGES:

<u>Current Situation</u>

State Board of Administration

The State Board of Administration of Florida (the "SBA" or the "Board") is an agency of Florida state government that provides a variety of investment services to various governmental entities. These include managing the assets of the Florida Retirement System (FRS) Pension Plan (i.e., defined benefit plan) and Investment Plan (i.e., defined contribution plan), the Lawton Chiles Endowment Fund, the Local Government Surplus Funds Trust Fund (also known as the "Local Government Investment Pool" or "LGIP"), the Hurricane Catastrophe Fund, the Lottery Fund and a variety of smaller funds. Total assets under management as of June 30, 2007 were approximately $184 billion.

The SBA's Trustees are the Governor who serves as Chairman, the CFO who serves as Treasurer and the Attorney General who serves as Secretary. The Trustees delegate authority to the Executive Director, who serves at the discretion of the Trustees and is responsible for managing and directing all administrative, personnel, budgeting, investment policy and investment functions. The Executive Director manages 162 professional and administrative support staff. The Board of Trustees appoints six members to serve on the Investment Advisory Council. The Investment Advisory Council provides independent oversight of SBA's funds and major investment responsibilities. The Council meets on an ongoing basis to discuss general investment policies and broad topics related to the general economic outlook.

History of the Pool

The Local Government Investment Pool (Pool) was established "to provide local governments a low cost, low risk, fully transparent investment option for their surplus funds".[1] The Pool is open to all units of local government in Florida and has been operated by the SBA since January 1982. As of June 30, 2007, the SBA managed approximately $31 billion in assets in the Pool serving almost 1000 participants.

Confidence in the Fund began to erode as a result of the Pool's July and August 2007 purchase of four securities, Ottimo, KKR Pacific, KKR Atlantic and Axon (the "Securities"), with a par value at time of purchase of $947.8 million. These Securities were downgraded in late summer and early fall 2007 below the Pool's investment guidelines. Knowledge of these downgrades, primarily from financial news accounts and rumors that in July and August one or more of the Securities had defaulted, all against the backdrop of the national sub-prime mortgage crisis, prompted participants into withdrawing $14 billion from the Pool in mid- to late- November 2007.

As a result of this run, on November 29, 2007, the SBA Trustees suspended withdrawals from the Pool and on December 4, 2007, split the Pool into two funds, Fund A and Fund B. The four downgraded Securities with a then-par value of approximately $867 million together with additional securities with a par value of approximately $1.2 billion deemed by an investment manager hired by the SBA,

[1] http://sbafla.com/fund_pool.aspx

BlackRock, to have an unacceptable level of risk, were placed in Fund B and frozen. Additionally, the Trustees transferred to Fund B the Pool's entire $22 million in accumulated, unspecified reserves and $96 million representing the Pool's interest earned in November 2007 by all participants in the Pool. The $96 million was transferred to Fund B in the form of $82 million in cash and $14 million in securities.

The Pool's remaining securities were placed in Fund A and rated by Standard and Poor's as AAA. When Fund A was reopened, the SBA established withdrawal limitations based upon the Fund's liquidity and imposed a 2% fee on participants which elected to withdraw more than they were allowed under the liquidity restrictions on redemptions. The 2% fee was based upon an assessment by the SBA staff that a complete liquidation of Fund A would result in a 2% shortfall. On January 18, 2008, the SBA released the greater of 22% or $2 million in additional liquidity.

On February 12, 2008, the SBA chose Federated Investors Inc. to take over management of the Pool. Federated reported on March 14, 2008, the following investment management guidelines and practices:

- LGIP Fund A managed in compliance with investment guidelines and Standard & Poor's (S&P) AAA rating criteria
- Dollar-weighted average maturity not greater than 60 days
- Final maturity of an individual security not greater than 397 days
- 5% individual issuer limit
- 10% limit on illiquid securities/"limited liquidity securities"
- At least 50% of the LGIP's securities must be rated A1+; remainder invested in at A1 only
- Weekly reporting to Standard & Poor's

LGIP B

- Daily assessment of liquidity
- Daily assessment of market value of all securities
- All cash invested in overnight securities only
- Countrywide maturity: $200 million will move to LGIP A 3/17/08
- Ongoing assessment of impaired assets

LGIP B Securities

By July 31, 2007, the Pool had invested in 28 collateralized debt obligations and structured investment vehicles and seven extendable asset-backed commercial paper (ABCP) issued by seven ABCP programs that chose to extend. The Pool's investment guidelines effective July 1, 2006, to October 31, 2007, permitted the purchase of first-tier securities, which are, as defined by SEC Rule 2a-7, those receiving the highest short term rating for debt obligations from two of the nationally recognized statistical rating organizations. If only one service rated the security, only one was required.

The first tier rating for the three major agencies are:

- Standard and Poor's A-1+ and A-1
- Moody's P-1
- Fitch F1+ and F1

KKR Pacific and KKR Atlantic, sponsored by KKR Financial Holdings, and Ottimo, sponsored by Aladdin Capital Management, three ABCP issues, extended their maturities and chose to negotiate with their investors to meet a mutually agreed-upon liquidation plan for the assets collateralizing the securities. Axon, a SIV sponsored by Axon Financial Funding, is also in restructuring. All of these Securities were first-tier rated.

The following table sets forth the history and status of the rating of these four Securities with their original par value totaling $947.8 million.

SECURITIES	PAR ($MM)	SELLER	PURCHASE DATE	RATING AT PURCHASE	DOWNGRADE DATE & RATING
Ottimo	52.8	Lehman	7/3/2007	A-1+/P-1	8/30/2007 A-2 (S&P)
Ottimo	100	Lehman	7/9/2007	A-1+/P-1	8/30/2007 A-2 (S&P)
KKR Pacific	125.1	Lehman	7/26/2007	A-1+/P-1/F1+	10/29/2007 Fitch B
KKR Pacific	200	Lehman	7/27/2007	A-1+/P-1/F1+	10/29/2007 NP (Moody)
Ottimo	30.7	JP Morgan	7/27/2007	A-1+/P-1	NA
Axon	175	JP Morgan	7/27/2007	A-1/P-1/F1+	10/29/2007 F3 (Fitch)
KKR Pacific	64.3	Lehman	8/1/2007	A-1/P-1/F1+	8/15/2007 B (Fitch)
KKR Pacific	200	Lehman	8/1/2007	A-1/P-1/F1+	10/24/2007 A-2 (S&P)

The SBA is currently undergoing a search, through an executive placement company, for a new executive director.

An unofficial LGIP Participant Advisory Committee was created at the outset of the situation and currently consists of 17 members with various affiliations.

At the direction of Speaker Rubio, the House undertook an investigation of the Pool. The team hired for this role issued its report on March 24, 2008, and listed 16 recommendations. Speaker Rubio further directed the House to consider legislation that could effectively provide control measures and ensure accountability and return investor trust in the Pool.

Advantages and Disadvantages of Pools to Local Governments

Local government investment pools ("pools") have existed for more than 100 years. Today, 45 of the fifty states have such pools and the funds run by these pools exceed $200 billion.[2] There are significant tangible and intangible public service benefits related to these pools. Tangible benefits typically are lower fees, diversification and access to professional management. Fees paid by participants to the Fund averaged a very favorable 1.5 basis points from the Pool's inception in 1982 through June, 2007, a savings of over 73% relative to the average fees paid. Intangible benefits include the ability of a State's Auditor General and other oversight and control functions to perform reviews of a single entity, the Pool, to enhance protection of participants, rather than reviews of numerous entities.

Local Government Investment Pools "are not registered with the Securities and Exchange Commission (SEC) and are exempt from SEC regulatory requirements because they fall under a governmental exclusion clause. While this exemption allows pools greater flexibility, it also reduces investor protection. Investments in these pools are not insured or guaranteed and substantial losses have occurred in the past. Some rating agencies rate LGIPs using the same criteria as money market mutual funds. These ratings are based on safety of principal and ability to maintain a NAV of $1. Pool ratings can provide an additional method of due diligence."[3]

Effect of Proposed Changes

[2] Source: iMoneyNet, "Government Investment Pools: 2007 Update of Investment Strategies, Facts, Figures and Trends".

[3] GFOA Use of Local Government Investment Pools (LGIPs) (2007) (CASH), located at http://www.gfoa.org/downloads/cashlgip.pdf, last viewed March 24, 2008.

The bill creates the Fund B Surplus Funds Trust Fund. Funds are credited to it by a transfer of the investments, interest earned, except for the November 2007 interest, and reserves in Fund B of the Local Government Surplus Funds Trust Fund. The bill provides that the funds are carried forward each year. The trust fund terminates upon self-liquidation.

C. SECTION DIRECTORY:

Section 1: Creates the Fund B Surplus Funds Trust Fund.

Section 2: Provides that the bill is effective upon becoming law.

II. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT

A. FISCAL IMPACT ON STATE GOVERNMENT:

1. Revenues:

   None.

2. Expenditures:

   None.

B. FISCAL IMPACT ON LOCAL GOVERNMENTS:

1. Revenues:

   None.

2. Expenditures:

   None.

C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR:

None.

D. FISCAL COMMENTS:

E. Although the bill creates a new trust fund, the funds come from the Fund B of the Local Government Surplus Funds Trust Fund already being managed by Federated Investors Inc.

III. COMMENTS

A. CONSTITUTIONAL ISSUES:

1. Applicability of Municipality/County Mandates Provision:

   Not applicable because this bill does not appear to: require cities or counties to spend funds or take an action requiring expenditure of funds; reduce the authority that cities or counties have to raise revenues in the aggregate; or reduce the percentage of a state tax shared with cities or counties.

2. Other:

   None.

B. RULE-MAKING AUTHORITY:

None.

C. DRAFTING ISSUES OR OTHER COMMENTS:

None.

D. STATEMENT OF THE SPONSOR

Not applicable.

IV. AMENDMENTS/COUNCIL SUBSTITUTE CHANGES

None.