January 14: Industry Risk – Fitch Comments on US State Operating Investments

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Author: **Cindy Stoller**
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Fitch Ratings began surveying U.S. state governments regarding their practices for short-term investment of operating funds, whether in state-only investment portfolios or in combined state and local pools. Fitch's goal in the survey has been to identify any exposure that states may have to impaired investments and any possible risks to liquidity and credit quality, both for the state itself and for local participants in combined state-local pools. To date, Fitch's survey of state investments, including combined state-local pools, has identified limited direct exposure to troubled instruments; for those with some exposure, it appears manageable. However, given the rapidly evolving nature of the credit market crisis, Fitch will continue to monitor state investment holdings and practices. The survey excluded the five states for which Fitch does not carry a tax-supported rating. Some states with notable holdings of troubled investments are discussed later in this release.

In recent months, several investment pools operated by state and local government entities have disclosed exposure to the troubled U.S. subprime mortgage market through investment in assets secured by pooled mortgage payments. Many of these securities experienced credit deterioration, even as the investment pools themselves became vulnerable to the broader liquidity deterioration in the short-term investment market.

Specifically surveyed by Fitch are the positions that states hold in asset-backed commercial paper (ABCP) and ABCP issued by structured investment vehicles (SIVs), as well as direct investments in short-term tranches of mortgage-backed securities (MBS) backed by home equity collateral and collateralized debt obligations (CDOs).

Fitch also is separately evaluating local government investment pools (LGIPs), including those Fitch does not rate, to gain a better idea of the breadth of investments in these non-performing or distressed securities, and how that might affect participants that Fitch rates. LGIPs sponsored by a state government but that contain no state operating resources are part of the separate evaluation.

Most states invest cash that is not essential for immediate operations in instruments with relatively short durations, with the goal of maintaining liquidity and principal value while generating a small return. As a service to local governments, many states allow local governments to pool their operating cash with larger state balances. Typically state investment portfolios maintain a large portion of their balances in high quality money market instruments and government securities in order to accommodate state agencies' and any participating local government's cash flow needs.

In recent years, with broader market acceptance of MBS and ABS securities, these state pools increasingly have invested in money market instruments directly and indirectly exposed to the subprime market. Since the summer of 2007, a number of these investments have experienced credit deterioration as U.S. subprime mortgage default rates have exceeded the assumed and tolerable rates for a given rating level. While most of these investments have continued to perform, several have defaulted, leading to delayed payment, and others have experienced credit rating downgrades, in some cases to levels below the statutory or policy thresholds allowed under state investment guidelines. Moreover, the broader liquidity deterioration in the short-term market has raised the possibility of losses to principal, particularly in situations requiring the sale of distressed assets. Also, the market's current overall discomfort with structured securities had resulted in structures backed by performing assets becoming illiquid, although liquidity has improved recently.

Fitch's survey of state investments has sought to identify exposure to credit-impaired and illiquid assets, and the consequent risks to investment principal should such investments fail to perform. To date, Fitch's review suggests that exposure to risky investments is relatively confined. Most states have investment statutes or policies in place preventing investment in riskier instruments, and the vast majority of states have not invested in such instruments. Others hold small positions in ABCP conduits with no exposure to the subprime market and the positions are supported by bank-provided liquidity lines. However, a few states have exposure to troubled investments. Fitch's review also finds that most states with ABCP investments are reducing their exposure to ABCP as it matures and are reinvesting in government and government agency paper.

To the extent state operating funds are invested in credit-impaired and illiquid instruments, these states face the risk of delayed access to principal, if not losses of such principal. However, operating risk is mitigated to the extent that the state has sufficient holdings of other short-term investments that are liquid. In the case of state investment pools that allow local participation, liquidity risk may be heightened by the possibility that unplanned, rapid withdrawals by concerned local participants may force a sale of pool assets on unfavorable terms, or require limits or a freeze on local withdrawals. Concerns over a 'run' on a combined state-local pool are less in cases where the state owns a sizable majority of pool assets.

A few state investment portfolios that have received broader media attention for holding troubled investments are detailed below:

Florida: Although it contains no state operating funds, Florida's LGIP experienced a run in November 2007, bringing its balance to approximately $14 billion, from $26 billion. After freezing withdrawals on Nov. 29, the riskiest investments--about 14% of the total--were sequestered in a separate pool. Withdrawals from the pool holding the remaining 86 percent of assets were allowed to resume on Dec. 6 but only up to the greater of 15 percent of a participants' deposits or $2 million, without paying a newly-implemented, two percent redemption fee. Participants' access to deposits is expected to increase next week to 40 percent without paying a redemption fee. Florida is rated 'AA+' by Fitch; Outlook Stable.

Montana: The Montana Board of Investments operates the $2.2 billion Short Term Investment Pool (STIP) for state and local governments. At present, approximately 24 percent of deposits in the pool are from Montana local governments. As of Jan. 7, 2008 the STIP had high exposure to commercial paper and medium-term notes issued by SIVs, totaling approximately $470 million, or about 21 percent of pool assets. A $90 million investment in paper issued by the SIV Axon defaulted and is now rated 'D' by Fitch, while several other SIV-issued securities have deteriorated in credit quality. The fund's management increased its liquid holdings in August 2007; nonetheless, the state reported that as of Jan. 7, local governments had made net withdrawals of $371 million. Withdrawals have slowed since mid-December, and the state reports that there has been no difficulty maintaining liquidity. Montana's STIP benefits from state deposits constituting the bulk of fund assets, at 76 percent following recent withdrawals. Also, Montana (rated 'AA' by Fitch; Outlook Stable) has had strong fiscal performance in recent years, enabling it to build large general fund and trust fund balances, which further aid liquidity and financial position.

Connecticut: As of Sept. 30, 2007, the state's Short Term Investment Fund (STIF) had assets of $5.8 billion, 30 percent of which were deposits of local government funds. The STIF has exposure to structured credits, including $400 million in medium term notes issued by SIVs, about 6.9 percent of pool assets; one such investment, a $100 million holding issued by Cheyne, has defaulted. The remaining $300 million are invested in AAA-rated Citibank-sponsored SIVs, but that are currently under review for possible downgrade. There is a high probability of full ultimate repayment of principal as a result of Citigroup's announcement last month that the firm would back the senior notes and take them onto its balance sheet. The timing of, and ultimate loss from, disposition of Cheyne paper remains unclear at present. However the STIF has a $52 million loss reserve cushion, and broader liquidity risks to state and local government participants appear to be limited at present. The STIF's managers in the State Treasurer's office have taken steps to increase liquidity in the fund. Also, the state's large holdings in the fund, at approximately 70 percent of fund assets, limit the risk of a 'run' by local government participants. Connecticut itself (rated 'AA' by Fitch; Outlook Stable) has maintained a very strong cash position in recent years, and has built a budget reserve fund balance of $1.4 billion, equal to 8.5 percent of general fund appropriations.

Maine: Maine (rated 'AA' by Fitch; Outlook Stable) manages a cash pool which totaled $688 million as of Nov. 30, 2007, virtually all of which is state funds. The state made a $20 million investment in ABCP issued by the Mainsail II SIV in August 2007, accounting now for only about three percent of the cash pool; although rated highly at the time of purchase, the SIV was backed mainly by U.S. residential mortgages and CDOs. Failure of capital adequacy tests late in August 2007 led to a freezing of the SIVs assets and its downgrade to below investment grade. Since then, the SIV has been placed in receivership; although the timing and ultimate outcome of the fund's restructuring is not clear, the state currently expects full reimbursement. The wider impact on Maine's finances is expected to be limited; the cash pool's average daily balance is high, at $675 million during fiscal 2007, and the state expects no difficulty in meeting daily cash needs. In response, Maine also has ceased investing in commercial paper, and is reviewing how it selects and manages short term investments.
