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Credit FAQ:

U.S. State And Local Government Investments And Recent Market Disruption

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Standard & Poor's Ratings Services has received many inquiries about government investments as the structured finance and asset-backed markets have recently demonstrated greater interest-rate spread and price volatility than ever before. While increased spreads ostensibly reflect investor concerns about increasing mortgage delinquencies there is a generalized and market-wide repricing of risk underway which is affecting structured financings secured by all manner of assets, not just mortgage-backed securities. Because many of these assets are held in the portfolios of asset-backed commercial paper (ABCP) programs and structured investment vehicles (SIVs), investor concerns in early summer about the underlying mortgage-backed assets began to appear in the market for short-term investment instruments.

Unfortunately, what began as a price dislocation of the subprime mortgage sector—largely not held by structured investment vehicles (SIVs)—has now affected the assets held in SIVs that represent every sector of the U.S. and global economies. As a result, by summer's end SIVs had gradually lost their ability to roll CP and refinance themselves. After stabilizing somewhat in October, market liquidity was again very tight in November and remains so in December.

Market reticence notwithstanding, it is important to note that the credit quality of the underlying assets under management in the SIVs remains strong with only 0.6% of assets under management having been downgraded. Specifically, out of a universe of 7,800 tranches held by SIVs, only 36 RMBS tranches and 10 CDO of ABS tranches have either been downgraded or placed on CreditWatch with negative implications. However, falling market prices for the assets under management and the general drying up of funding options for SIVs renders a diminished outlook for the sector that may not be resolved anytime soon. (For background, see "The Global Liquidity Squeeze Has SIVs In A Tight Spot—But Solutions For Some Emerge," Dec. 7, 2007.)

Some local government investment pools (LGIP) are holding structured investments and we have received numerous inquiries from various municipal market participants about what the exposure is for state and local governments. We try here to address many of the inquiries from governments, municipal market participants, and the media regarding state and local government investments. Although this article focuses on pools, it is also possible that governments are holding these investments in their own accounts. If so, credit and liquidity issues are the same.

Standard & Poor's today also published "Credit FAQ: Local Government Investment Pools."

Frequently Asked Questions

How many government pools are operating and are they factored into state and local credit ratings?

Currently, 45 of 50 states offer some type of local government investment pool. There are at least 125 state and local government investment pools operating today with an estimated $200 billion of assets. These pools have been an important investment vehicle for governments over time. None of the investment pools offers a state or local government guaranty and none is considered to be an obligation or liability of a government. As such, these pools have not been a factor in state and local credit ratings. There might be circumstances where a government will offer a limited level of support to pool participants, which was the case temporarily with King County, Wash. (see "King County, WA 'AAA' Debt Rating Unaffected By Investment Pool Rating Action," Oct. 23, 2007). If financial commitments were made, they would be evaluated on a case-by-case basis to determine if there were credit implications.

Are government investment policies part of S&P's state and local government credit review?

Government investment policies and practices have long been part of the criteria that we utilize to evaluate state and local government ratings, and liquidity can be an important factor in timely debt service payments. The types of investments, security credit profile (including any security interests), and uses of investment income are important considerations in the credit review process. In addition, Standard & Poor's Financial Management Assessment (FMA) was introduced in June 2006 to provide greater transparency on government financial management practices. Investment management policies and frequency of reporting investment results and investment portfolios to elected officials are included in the assessment.

What are state and local government investment alternatives and what guidelines do they follow?

State statutes broadly outline eligible investments for state and local governments. State and local governments will often have formal policies that further fine-tune investment policies and practices. In response to the Orange County, Calif. bankruptcy filing in 1994, many governments across the country adopted or revised policies and reporting requirements relating to investments.

Do local governments utilize investment pools exclusively?

Investment pools are one vehicle that a government can use but many will have other investment vehicles that are part of their total portfolio. There are exceptions. A small local government may rely more heavily on investment pools due to a lack of staff or expertise to manage investments. Some local governments, often larger ones with deeper staffing levels, will tend to invest funds and manage their portfolios independently. In states such as California, participation in the county investment pool is mandatory for school districts and voluntary for cities and other special districts.

How has the recent disruption in the credit markets impacted government investment holdings?

Many local government investment pools permit money market instruments, including bank certificates of deposit, banker's acceptance, CP and ABCP. Since ABCP (some of it issued by SIVs) represents nearly half of the outstanding CP market, whenever the investment policy of a pool permits money market instruments, the pool could have some exposure to paper with strained liquidity. Many ABCP programs are also covered by third party liquidity. Some government investment pools permit government-only investments, such as Treasury and Agency securities; these pools should be unaffected.

The recent disruption in the global capital markets, including sharply curtailed liquidity of fixed-income assets, has resulted in depressed market values of these assets and corresponding ratings on investments falling below purchase credit guidelines. The amount of holdings in various government investment portfolios is unknown. Actual losses have been limited so far and many of the distressed securities are expected to have some level of recovery. The ability of a government to hold the assets during the period of disruption will determine if a loss will be realized, and how large it will be.

How widespread is the exposure for state and local governments?

We do not know whether state and local government investments may have additional exposure to subprime, ABCP, SIV, or CDO fixed income assets. Based on current information which includes a review of the 75 government pools we have ratings on and a survey completed in October 2007 on California investment pools (which included rated and unrated pools), the exposure appears to be limited. As of early December, 15 rated LGIPs have exposures to ABCP and/or SIVs, The average ABCP exposure was 12.3% and the average SIV exposure 1.3% (see government pool FAQ). We will be conducting a broader survey of state investment pools.

As of Oct. 12, 2007 only eight of 34 responding counties in California invested—through their liquidity pools—in SIVs or ABCP directly and in no case was total exposure greater than 2%. Through its variable asset value (extended fund) pool, Orange County has greater exposure--20% or $460 million--in SIVs. King County, Wash., whose fund (AAAf/S1) was placed on CreditWatch with negative implications in November, holds ABCP issued by three SIVs totaling $151 million, or 3.1% of its $4.87 billion in assets. In that the pool has stopped making such investments, as existing CP holdings mature this asset type represents a declining portion of the King County pool's overall allocation—having declined to less than 8% of the portfolio in November from 25% in August.

Based on current information about the breadth of LGIP investment exposure to SIVs or ABCP, we believe that, where there is exposure, it tends to be limited, particularly for liquidity or money market 2a-7 like funds.

If a pool incurs losses, what might be the impact on governmental credit quality and liquidity?

As noted above, because the assets under management of most SIVs remain of sound credit quality, to the extent a LGIP does not experience cumulatively large withdrawals of assets by participating local governments, the actual impact on credit and governmental liquidity could be limited. However, if participant concerns about pool holdings of distressed assets were to lead to a surge of withdrawals, the pool would be forced to sell holdings at low net asset values to meet demands for funds, and would incur real losses. Net asset values represent the residual value of the capital notes—issued by the SIV—if the asset portfolio were to be liquidated at current market value. In some cases it is likely that ultimate recovery on the holding would occur once market value returns to levels that are more in line with prior market sentiment for the type of asset. This assumes that the instrument would not be liquidated under current market conditions. If loses were to occur, distributing realized losses on a pro-rata basis among remaining participants in the pool potentially exacerbates the situation by accelerating withdrawals to the detriment of the pool as a whole.

As in the recent situation in Florida (see "Bulletin: Florida Local Govt Investment Pool Suspends Withdrawals," Nov. 29, 2007) faced with this situation the pool could respond by freezing its assets, halting all withdrawals. Obviously, this could impair local government credit quality and liquidity if debt service or operational obligations came due while assets were frozen. In addition, severe realized losses could impair a government's ability to meet debt service or operational obligations. At present, Standard & Poor's has not received information that suggests that the fundamental credit of governments has deteriorated as a result of the potential for losses in investments. To date, liquidity concerns have been addressed by either ongoing revenue flows or bank loans.

Are there any examples of rapid withdrawals from a LGIP actually occurring?

The Florida local government investment pool, managed by the State Board of Administration, has experienced these difficulties. The disclosure of holdings in distressed securities caused widespread withdrawals. While no losses have occurred up to this point, the pool was reduced from $27 billion at Sept. 30 to $14 billion on Nov. 29 when withdrawals were suspended. The number of participants declined from 995 to about 820 during this period. The participants that withdrew funds will not share in any losses that may occur on the assets that are still in the pool. While the pool has been reopened, withdrawals are limited. The diminished liquidity of the participants will need to be reviewed on a case-by-case basis to assess their ability to fund operations and debt service.

Will the recent capital market disruptions cause S&P to reassess how investments are treated in the credit review process in US Public Finance?

Recent market disruption relates to constrained market liquidity more than underlying credit quality. To the extent market events impact credit quality of obligors we rate, our analysis will consider it.

What is the risk if a pool or fund holds ABCP or SIVs that are not currently distressed or have very limited exposure to distressed assets?

Although the outlook for the ABCP and SIV sector is presently negative due to limited liquidity, some SIVs continue to actively fund their assets, are restructuring toward more conservative liability-asset alignments, or are implementing strategic asset sales. These SIVs retain their original ratings. The risk is that this situation could change or investor psychology (as discussed above) could cause rapid asset withdrawals from pools despite limited exposure to distressed assets (see "The Global Liquidity Squeeze Has SIVs In A Tight Spot-But Solutions For Some Emerge").

