The Florida Senate

BILL ANALYSIS AND FISCAL IMPACT STATEMENT

(This document is based on the provisions contained in the legislation as of the latest date listed below.)

Prepared By: The Professional Staff of the General Government Appropriations Committee

BILL:	CS/SB 2422
INTRODUCER:	Governmental Operations Committee and Senator Alexander
SUBJECT:	Local Government Finance
DATE:	April 15, 2008 REVISED:

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	Wilson	Wilson	GO	**Fav/CS**
2.	Pigott	DeLoach	GA	**Fav/1 amendment**
3.				
4.				
5.				
6.				

Please see Section VIII. for Additional Information:

A. COMMITTEE SUBSTITUTE..... [X] Statement of Substantial Changes
B. AMENDMENTS........................ [ ] Technical amendments were recommended
[X] Amendments were recommended
[ ] Significant amendments were recommended

I. Summary:

The bill amends the provisions governing the operation of the Local Government Investment Pool,[1] a short term cash management fund administered by the State Board of Administration on behalf of participating local governments.

This bill amends the following sections of the Florida Statutes: 218.401, 218.403, 218.405, 218.407and 218.409.

II. Present Situation:

The State Board of Administration is the investment manager for nearly three dozen fiduciary accounts for specific state and local government financial programs. Its largest single investment holding is the Florida Retirement System and its two component defined benefit and defined contribution plans. The board also manages separate investment accounts for pre-paid college contracts, the Florida Lottery prizes, and the Hurricane Catastrophe Fund. The board is composed of the Governor, the Chief Financial Officer, and the Attorney General.

[1] Officially named the Local Government Surplus Funds Trust Fund in s. 218.405, F.S.

The Local Government Investment Pool is a money market-like fund that invests in securities with short-term maturities to provide its local government participants with highly rated investments that produce rapid liquidity, that is, the ability of converting an asset into cash. The Pool is created in s. 218.405, F.S., to act as a repository of local government funds not needed for immediate expenditure. Investments are purchased jointly on behalf of all fund participants who share in their gains and losses in apportionment to their shares in the fund.
The fund has a seasonality to its balances since the local government fiscal year lags that of state agencies by three months. Depletion of the fund occurs in the fourth fiscal quarter with replenishment in the first and second quarters due to the receipt of state funds and the proceeds of *ad valorem* property tax collections.

Beginning in early 2007, domestic financial markets began to experience a contraction in investments that were heavily concentrated in securities known as collateralized debt obligations (CDOs) and collateralized mortgage obligations (CMOs). These financial instruments aggregate separate revenue streams from commercial debt and first or second residential mortgages, respectively, and repackage them into separate securities with an expected cash flow. Each of the strips is rated separately and an investor can choose among highly rated, lower yielding ones, or lesser rated, higher yielding ones. Investments with the highest rated risk have the lowest priority if the securities do not perform. This occurs, for example, if larger numbers of residential mortgages move to a non-performing status in which payments are missed or are in arrears. Mathematical models predict the incidence of such behavior on the basis of past practice, credit scores, and other factors. When the models have to contend with unexpected behavior, such as that which began to occur about one year ago, the risk of default increases, and there are increased calls by the investors for additional liquidity. When there is a flight to liquidity the ability to convert assets into cash to satisfy capital calls becomes impaired and the consequences move through the financial markets. As securities are downgraded, fiduciaries must dispose of them if they lose investment grade status, and both public and private investors have to contend with severed income streams that underpin their own current obligations. The largest single contraction has been experienced by the Swiss bank UBS which saw its total market capitalization fall by one half in the last nine months as it recorded losses in excess of $37 billion on sub-prime investments principally located in the United States.

The State Board of Administration was not immune to this behavior since, like many money market-like funds, it had some investments in securities believed to be investment grade but not ordinarily subject to massive redemption calls. The board reported four investment vehicles which had liquidity difficulties although they were only a small proportion of its total investment holdings. In late November 2007, faced with an unprecedented series of redemption requests by its participants, the board suspended activity in the fund for several days ending in early December 2007. In rapid order the fund declined from $30 billion to about $9 billion. In two days alone, the fund lost 26 percent of its assets through participant redemptions. When the pool was reopened there were withdrawal limits and redemption fees imposed on the participants until the board could develop an orderly method of stabilizing the fund without further jeopardy. The securities were partitioned in a Fund A and a Fund B, the latter comprising the non-performing investments.

The board hired an outside fund manager, BlackRock, to replace its internal managers and is now in its second successive external manager, Federated Investors. The board began to assemble a longer term plan to stabilize the fund and, in response to specific commentary by its fund participants, assembled an ad hoc external investors committee to augment its internal staff functioning in that capacity. That successor committee, in turn, made its own recommendations to the board on future courses of action, some of which are embodied in this bill.

In February 2008, the State Board of Administration published a compilation of events on the disruption in the pool.[2] The chronology indicated that there were four separate securities that had been downgrade by ratings services into categories no longer suitable for investment, as follows:

Ottimo Funding	$ 183,407,000
Axon Financial Funding	$ 175,000,000
KKR Atlantic Funding	$ 200,000,000
KKR Pacific Funding	$ 389,381,000
Total	$ 947,788,000

As of January 31, 2008, three of the four issuers are in performing status due to a restructuring of the portfolios with extended maturity dates. Regular principal and interest payments are being received. One issuer, Axon, is in default pending a controlled liquidation.

In March 2008, a special report commissioned by the Florida House of Representatives made sixteen recommendations for changes in this trust account, some of which are embodied in the bill.[3]

III. Effect of Proposed Changes:

The bill states that the purpose of this fund is to assure the safety of the principal and the maintenance of liquidity.

The bill requires that the board, as trustees, annually certify to the Joint Legislative Auditing Committee that the fund is operated in compliance with the provisions of the amended Part IV of ch. 218, F.S. Many of the rules promulgated by the board are reformatted as statutory amendments to Part IV of ch. 218, F.S., resulting in statutory provisions calling for more disclosure and transparency in communications.

The bill requires a monthly accounting of each participant’s contributions and investment earnings. The bill provides for the development of regular and frequent notification of changes in the ratings and performance of the securities themselves.

A separate Pool Participant Advisory Council is created, similar in scope to the agency-wide Investment Advisory Council in s. 215.444, F.S.

[2] State Board of Administration, "Florida Local Government Investment Pool, Significant Events Timeline," February 6, 2008. Tallahassee, FL: 18 pp.
[3] Florida House of Representatives, "Due Diligence Review, Local Government Investment Pool," Tallahassee, FL: March 17, 2008, 26 pp.

When a major disruption in market activity produces impaired liquidity or a variation in the ratio of fund market value to amortized cost below .995 or above 1.005 for two consecutive business days, the board is directed to take specific actions to mitigate this disruption. These actions include: limiting contributions or withdrawals; the imposition of early redemption fees; and the creation of a separate liquidating account within the fund.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

Current law contemplates the ability of the board to restrict fund access which it executed on November 29, 2007. The bill does not change that status but places more of the rule-based procedures into statute.

V. Fiscal Impact Statement:

A. Tax/Fee Issues:

None.

B. Private Sector Impact:

There has been a significant retrenchment in world financial markets in reaction to the liquidity issues affecting CDOs and CMOs. This has had a ripple effect upon financial institutions, brokerage houses, institutional investors, and the housing and labor markets. As Florida is particularly exposed to economic disruptions in housing and the credit markets, there has been a noticeable decline in new construction and financing, retrenchment on the granting of credit on favorable terms to thinly capitalized buyers, and labor disruptions in the construction-affected workforces. Returning structural stability to this trust fund will not have a direct influence on these market reactions but it may restore the ability of the participating local governments to rejoin the pool or recoup some of the opportunity costs of the money withdrawn as interest rates stabilize.

C. Government Sector Impact:

The restructuring of this pool has cost local governments lost interest earnings and caused them, in some cases, to resort to short-term loans to meet operational expenses. While some of these governmental units have indicated their desire to be made whole, none has yet converted this desire into a demand.

VI. Technical Deficiencies:

None.

VII. Related Issues:

None.

VIII. Additional Information:

A. Committee Substitute – Statement of Substantial Changes:

(Summarizing differences between the Committee Substitute and the prior version of the bill.)

CS by Governmental Operations on April 3, 2008:

The committee substitute changes the direction of the bill from an energy performance contract bill into one which provides procedural changes to the management of a local government investment fund pool.

B. Amendments:

Barcode 702786 by General Government Appropriations on April 10, 2008:

- Amends current law to include the confirmation of the Senate when appointing the executive director of the State Board of Administration.
- Expands the quarterly reporting requirements of the executive director to the Board of Trustees.