

HB

199



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February 1991

Alaska Municipal League
Investment Pool Legislation and Program Justification

The Alaska Municipal League (AML) urges the passage of legislation to authorize the formation of investment pools under Title 29. The AML wishes to form an investment pool to improve the efficiency and effectiveness of municipalities and other local public entities statewide in the investment of their short-term, "idle," public funds. The objectives of the pool's investments, in order of priority, will be 1) security, 2) liquidity, and 3) return. In the absence of an Alaska "joint powers act," the AML is seeking legislation to authorize a public entity or a nonprofit corporation to form and enter into agreements for the purpose of investing funds.

Many AML member municipalities and school districts do not have banks in their communities much less investment options. In certain cases, municipalities lost funds when several banks folded in the 1980's because their funds were not collateralized. As federal and state financial assistance to municipalities have declined, making the most of local funds through interest revenues continues to be important.

The AML membership of over 125 municipalities passed a resolution in November 1989 directing the AML Board of Directors to investigate the feasibility of a municipal investment pool. The AML formed a committee of municipal officials to investigate the need and feasibility of a pool. The committee surveyed municipalities and school districts in June 1990 to gather information on local investment practices and interest in participating in a pool. Over 50 responses were received indicating:

- o Idle funds may be sufficient to form a pool
- o A significant number of respondents do not have written investment policies
- o Few municipalities and school districts employ investment professionals
- o Few do not collateralize their investments
- o Most respondents invest in a broad variety of investment instruments
- o Some respondents indicated that they had investments of over 2 years in terms which may not be prudent for these public funds
- o An investment pool would broaden the investment options available to even the most sophisticated, investor municipalities/school districts
- o The less sophisticated municipalities/school districts would benefit from safekeeping, yield of a pool, and professional advice.

AML Investment Pool
February 1991
Page 2

The committee reviewed investment pools operating in 13 states. These pools are operated within the state treasurer's office or a independent non-profit corporations. The committee is leaning toward using a money market fund limited to very secure types of investments. The return on investments would be improved by increasing volume and term through pooling rather than on increasing risk.

In September 1990, the AML Board authorized the committee to proceed with establishing an investment pool by introducing legislation and distributing a request for proposal for a firm(s) to assist the AML with managing pool and investing the funds on behalf of entities who choose to participate in the pool.

A request for proposal from firms wishing to bid on providing administration, custodial and investment services has been finalized and will be distributed in March. AML is also working with a law firm to develop the necessary legal documents. If the legislation passes this session as planned, it is the intent of the AML to establish the pool and accept funds as of July 1, 1991.

The legislation would have a zero fiscal note and would not affect the State of Alaska. Participation in the pool by eligible public entities would be optional. The AML Board of Directors urges the Legislature to pass the investment pool legislation in the First Session of the 17th Alaska State Legislature to enable the AML to immediately begin to improve the efficiency and effectiveness of participants in the investments of their public funds.

sab2:investwhy

FISCAL NOTE

STATE OF ALASKA
1991 LEGISLATIVE SESSION

BILL NO. CS HB 199

Revision Date: _____
Title: "An Act relating to investment
pools for public entities.."
Sponsor: House C&RA Committee
Requestor: _____

Department Affected: Community & Regional Affairs
BRU: _____
Component: _____

COMPONENT SERIAL NO.

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Expenditures/Revenues: (Thousands of Dollars)

OPERATING	FY 92	FY 93	FY 94	FY 95	FY 96	FY 97
PERSONAL SERVICES						
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	-0-	-0-	-0-	-0-	-0-	-0-

CAPITAL						
---------	--	--	--	--	--	--

REVENUE						
---------	--	--	--	--	--	--

FUNDING: (Thousands of Dollars)

GENERAL FUND	-0-	-0-	-0-	-0-	-0-	-0-
FEDERAL FUNDS						
OTHER						
TOTAL	-0-	-0-	-0-	-0-	-0-	-0-

POSITIONS:

FULL-TIME	-0-	-0-	-0-	-0-	-0-	-0-
PART-TIME						
TEMPORARY						

Estimate of current year impact: _____

ANALYSIS: (Attach a separate page if necessary.)

Prepared By: Remond Henderson, Director Phone: 465-4708

Division: Administrative Services Date: 4/2/91

Approved by Commissioner: Edgar Blatchford *Ed. Blatchford*

Agency: Community & Regional Affairs Date: 4/2/91

Distribution (by preparer): Legislative Finance, Legislative Sponsor, Requestor, OMB, & Impacted Agency(ies).

STATE OF ALASKA

DEPT. OF COMMUNITY & REGIONAL AFFAIRS

OFFICE OF THE COMMISSIONER

WALTER J. HICKEL, GOVERNOR

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April 2, 1991

POSITION PAPER

RE: CS for House Bill 199

SPONSOR: House Community and Regional Affairs Committee

Departmental Position: Support

Program Effects

The bill would provide for certain public entities to form and operate investment pools for public funds which might otherwise lie idle.

Comments

This concept would provide a much needed tool for public entities to use in maximizing available revenues to offset the cost of services provided within their boundaries. In these times of declining state revenues, it is extremely important that we focus on discovering new sources of revenues for local jurisdictions, and methods whereby existing fiscal activities at the local level can be enhanced to maximize their efficiency. Committee Substitute for House Bill 199 directly addresses that concept, and the Department strongly supports its passage.

Ed. Blatchford

Edgar Blatchford, Commissioner



STATE OF ALASKA
OFFICE OF THE GOVERNOR
BILL ANALYSIS

DEPARTMENT Revenue	DIVISION Treasury	BILL NUMBER HB 199	SPONSOR House Community & Regional Aff
SHORT TITLE OF BILL Investment Pools for Public Entities			
DEPARTMENT POSITION See amendments proposed.			
PREPARED BY Brian C. Andrews	<i>CBT</i>	DATE 4/2/91	COMMISSIONER'S SIGNATURE <i>[Signature]</i>
			DATE 4-3-91

SUMMARY

OTHER AGENCIES AFFECTED BY BILL None known	CONSTITUENT GROUP(S) AFFECTED BY BILL
ORGANIZATIONAL SUPPORT FOR BILL Municipalities and other public entites.	ORGANIZATIONAL OPPOSITION TO BILL None known

FISCAL IMPACT: NONE FISCAL NOTE ATTACHED

BACKGROUND/LEGISLATIVE INTENT
To allow for the creation of a nonprofit corporation for the purpose of establishing and operating an investment pool of securities for public entities.

ANALYSIS OF BILL/PROGRAM EFFECTS
Through a cooperative effort, public entities would establish a privatized money market mutual fund which may provide for increased investment returns and lower investment risk.

AMENDMENTS PROPOSED
Please see attached.

PLEASE ATTACH A SEPARATE SHEET FOR ADDITIONAL COMMENTS OR ANALYSIS.

**STATE OF ALASKA
OFFICE OF THE GOVERNOR
BILL ANALYSIS**

HB 199

Amendments proposed:

Section 37.25.050 (b) of CS SB 182 and HB 199 should be modified to include within the definition of "public entity" the State of Alaska as well as a subdivision of the State, including a municipality, school district, regional educational attendance area or service area within the unorganized borough; or an organization composed of public entities. The expanded definitions would allow the General Investment Fund of the State to be a participant in the investment pool.

The Department of Revenue believes that the formation of an investment pool for money market securities within the Division of Treasury would offer the following benefits.

1. Use of Treasury's expertise in investment and cash management matters.
2. Treasury's existing arrangements for custodial services can accommodate a participant investment pool.
3. Treasury has already established cash concentration procedures within banks located in Alaska which could be used by public entities to transfer funds to the investment pool.
4. Use of Treasury's existing ACH electronic funds transfer capabilities which accommodates movement of deposits and withdrawals to and from the bank accounts of the participants.
5. Inclusion of the General Investment Fund as a participant would assure the investment pool's objectives of enhanced yields, liquidity and preservation and safety of capital.
6. Probable overall lower cost benefits to all participants.

Treasury would anticipate the following annual costs if it was charged with the responsibility of establishing and managing an investment pool of an assumed size of \$500 million.

Personal:	1 FTP cash management position	\$ 50,000
	1/2 FTP Investment officer	40,000
	1 FTP Accountant	50,000
Contractual:	Custodial fees @ 5 bps ¹	250,000
	External audit	25,000

¹"bps", or "basis points", is the standard of measurements of less than one per cent. One bps equals one percent of one percent.

Equipment/Communications, computer supplies
software and equipment enhancements 75,000

TOTAL \$490,000

\$490,000 represents a cost of 0.00098 (9.8 bps) of the \$500 million pool total. For example, an 8.0 per cent gross investment return will net to 7.9 per cent after Treasury's total expenses. The only variable cost is custodial fees which would increase slightly by additional asset amounts to the investment pool. Because of scales of economy, the impact of Treasury's expenses on gross earnings would be reduced further by investment pools greater than \$500 million.

FISCAL NOTE

BILL NO. IEB 199

STATE OF ALASKA
1991 LEGISLATIVE SESSION

Revision Date: April 2, 1991

Department Affected: Revenue

Title: Investment pools for public entities

BRIU: Treasury

Component: _____

Sponsor: Senate Community & Regional Affairs

Component Serial No.

Requestor: _____

	1	2	1
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Expenditures/Revenues: (Thousands of Dollars)

OPERATING	FY 92	FY 93	FY 94	FY 95	FY 96	FY 97
PERSONAL SERVICES						
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	0	0	0	0	0	0

CAPITAL						
---------	--	--	--	--	--	--

REVENUE						
---------	--	--	--	--	--	--

FUNDING: (Thousands of Dollars)

GENERAL FUND						
FEDERAL FUNDS						
OTHER						
TOTAL	0	0	0	0	0	0

POSITIONS:

FULL-TIME						
PART-TIME						
TEMPORARY						

Estimate of current year impact: _____

ANALYSIS: See attached.

Prepared by: Brian C. Andrews *CSA*

Phone: 465-2350

Division: Treasury

Date: April 2, 1991

Approved by Commissioner: _____ *[Signature]*

Agency: Revenue

Distribution (by preparer): Legislative Finance, Legislative Sponsor, Requestor, OMB, & Impacted Agency(ies).

INVESTMENT EXCHANGE

FIDELITY INVESTMENTS NEWS AND ANALYSIS FOR PUBLIC FINANCE PROFESSIONALS

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APR 03 1989

ALASKA MUNICIPAL LEAGUE

Local Government Investment Pools

By Girard Miller and David Maynard

Editor's Note: The recent widely publicized collapse of the State of West Virginia's LGIP and ensuing questions raised by readers has prompted the following article.

Local governments are a major source of capital to the money markets. Public cash managers earn attractive market rates of return by investing their short-term funds. When interest rates are relatively high, as they are now, a community's cash management and investment program is an important contributor to local revenues.

Most local governments invest a segment of their short-term funds

LGIPs are now operating in 26 states and usually offer the benefits of daily liquidity, money market rates of return and portfolio diversification.

directly in government securities, bank CDs and other money market instruments. Local officials also have learned to take advantage of the liquidity and services offered by their state's local government investment pool (LGIP). LGIPs are now operating in 26 states

and usually offer the benefits of daily liquidity, money market rates of return and portfolio diversification. Generally, pools operate like SEC-registered money market mutual funds. They combine the cash of local governments to invest in a diversified portfolio of money market securities with earnings paid to participants in proportion to their total investment. Not all pools are alike, however.

Types of LGIPs

When measured in terms of asset size and participation, the largest local government investment pools are those overseen by state treasurers or other state administrative boards. Presently, 22 states sponsor and operate an investment pool for the benefit of their local governments. In some state pools, local funds are commingled with the

state's liquid assets. In others a completely separate fund for localities is maintained.

Generally, LGIP investment and recordkeeping functions are performed by state officials, although several states have contracted with private firms for investment and administrative services. In some states, an advisory board of local government officials provides consultation and input regarding LGIP policies and practices.

In addition to the state-sponsored pools, local governments in a few states have jointly organized and operate LGIPs pursuant to "joint powers" or "intergovernmental cooperation" agreements. Typically, these non-state-sponsored intergovernmental pools are operated by a private money manage-

Continued on next page

Treasury Finalizes Arbitrage Regulations

The U.S. Treasury Department will soon release preliminary arbitrage regulations governing the calculation of arbitrage rebates. Some highlights:

- Rebates will be based on a "future value," calculated every five years.
- No calculation is required if qualified investments earn less than the issuer's bond yield.
- A \$1,000 computational credit against the rebate will be allowed to help issuers defray expenses.
- Mutual funds are acceptable investments and are used as an example in the regulations.

The next issue of INVESTMENT EXCHANGE will discuss the new arbitrage rebate regulations in detail.

mutual funds (Rule 2a-7) are unlikely to suffer market price shocks: this is done by maintaining the pool's average maturity below 120 days and by holding individual securities with maturities of less than one year.

Diversification and Credit Research Pays Off

A major advantage of most state-sponsored LGIPs is their size. Economies of scale are generally realized

When investing in an LGIP, local officials should first study the investment policies and practices of the pool, and obtain information regarding the portfolio's average maturity.

through better prices on individual securities and defrayal of administrative expenses such as third-party custodial fees. Also, many LGIPs are able to purchase diversified portfolios of higher-yielding money market securities such as commercial paper. Frequently, individual municipalities are unable to perform thorough credit analysis or to diversify their investment portfolios adequately on their own. However, LGIPs can be managed to accomplish these functions on behalf of their participants.

The Problem With Bond Proceeds

Some LGIP officials are anxiously awaiting U.S. Treasury Department regulations concerning arbitrage investments of bond proceeds. Presently, some statewide LGIPs have instructed local governments to avoid using their pool for investments of bond proceeds subject to federal arbitrage restriction. Pools which maintain longer average dollar weighted portfolio maturities (in excess of 90 days) and are not valued to market regularly may not meet the Treasury's so called "market price rule" and therefore could be inappro-

Increasing Interest in Deferred-Compensation Plans

Deferred-compensation plans allow employees to save portions of their incomes untaxed until retirement. Upon retirement, the employee will likely be in a lower personal income-tax bracket, and will be taxed less.

Congress authorized Section 457, public-sector deferred compensation plans in the Revenue Act of 1978, enabling government workers to save for retirement and emergencies. Under Section 457 of the Internal Revenue Code, a public-sector employee may defer up to \$7,500 of income annually.

Typically, deferred-compensation plans allow the employee to choose to have contributions placed in one of several investment options, and to periodically transfer the assets between investment vehicles.

The choices range from straight savings options, which are the most conservative investments, to mutual funds, which are riskier but have the potential for higher yields.

Many deferred-compensation investments are in fixed-rate annuities or in guaranteed investment contracts

Deferred-compensation plans are meant to supplement, rather than replace, other retirement plans. At retirement, a plan member has the

option of withdrawing deferred funds in a single lump sum, in monthly installments or on a schedule based on life expectancy.

The Tax Reform Act of 1986 heightened interest in deferred-compensation plans by placing considerable restrictions on the tax deferral for employee contributions to individual retirement accounts. ■



Illustration by William Canty.

appropriate as a vehicle for the investment of bond proceeds. The Treasury's second set of arbitrage regulations, to be issued later this year, will probably address the issue of allocating investment income received from such pools.

The Money Market Mutual Fund Alternative

In states that lack an LGIP, money market mutual funds can be considered as a viable alternative for local government liquidity investments, provided mutual funds are an authorized investment under state statute. Some institutional money market funds provide subaccounting and arbitrage

recordkeeping services specifically designed for governments, which are not provided by most LGIPs.

GFOA Guidance

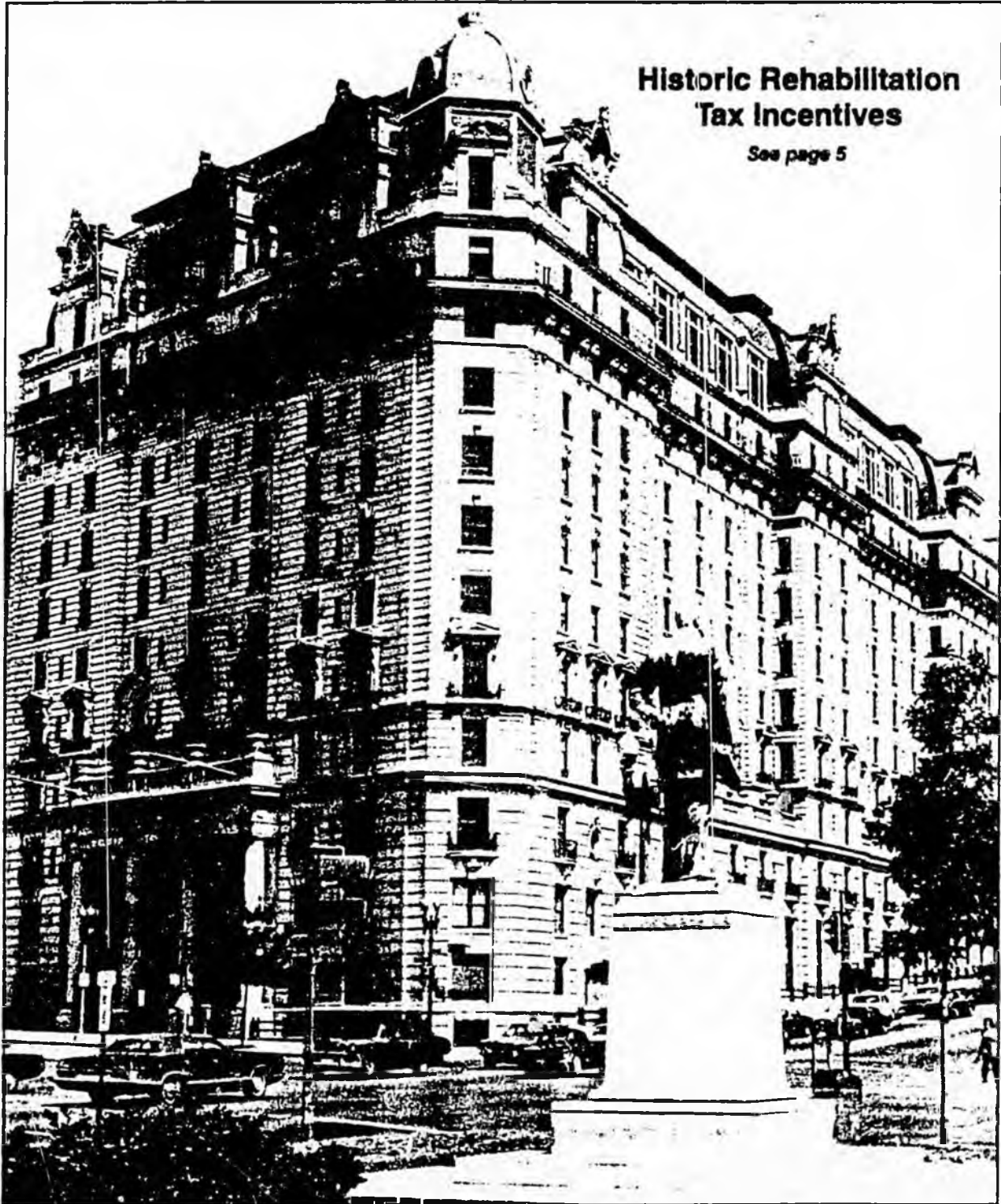
The Government Finance Officers Association's Standing Committee on Cash Management has previously endorsed local government use of LGIPs and is now studying the various issues associated with proper administration and use of LGIPs. Guidelines for LGIPs will be issued by the National Association of State Treasurers (NAST) later this year. *Investment Exchange* will provide further information on this topic as it becomes available. ■

GOVERNMENT FINANCE REVIEW

Government Finance Officers Association

Volume 2, Number 1

February 1986



**Historic Rehabilitation
Tax Incentives**

See page 5

At the Crossroads: Private Sector Perspectives on Public Sector Investing

Local government investment officers are faced with the challenge of achieving high yields without sacrificing safety and liquidity. While pressures on public finance officials to enhance earnings from investments will not go away, there are several options for the prudent investment of public funds at market yields.

By David E. Maynard and Priscilla M. Wheatley

"A federal bankruptcy judge approved a settlement that would give 34 municipalities and school districts nationwide about \$29 million of the \$40.8 million they claimed was lost when Lion Capital Group sought protection under federal bankruptcy law [in 1984]. . . . The settlement means claimants will receive about 73 cents on the dollar. . . . [A]n attorney for the school districts said the benefits of the settlement 'are extraordinary.' At a hearing in bankruptcy court, he called the settlement 'almost a total victory for the school districts and municipalities.'"¹

Seventy-three cents on the dollar, a victory?

Despite the exposure, publicity and education since the demise of Drysdale Securities in 1982, and the lessons to be learned from Lion and other failed dealers, public sector investors lost again in 1985. Lion Capital was one of three small government securities dealers to go under as a result of multiple pledging of collateral; the other two were E.S.M. Government Securities Inc. and Beville, Bressler & Shulman Inc. E.S.M.'s trustee anticipates that settlements could pay municipalities in the vicinity of 75 cents on the dollar.

Could it happen again? Why have some public finance officials altered their traditionally conservative investment practices? Has "safety, liquidity and yield" become "yield, liquidity and safety" in the minds of many public finance officials?

Are realistic options currently available that will help the public sector maximize its return while ensuring the safety of invested funds? This article examines the sources of some of the pressures on public finance officials, explores several options for prudent investment of public funds at market yields and suggests some initiatives to be taken over the long term to strengthen the public finance profession.

Investing Public Funds—A Fiduciary Responsibility. For most of the 20th century, investment of public funds has been appropriately considered a fiduciary function: that is, the conservation of principal is the primary responsibility, even if income is to be earned from investments. Because of this, most state legislatures have controlled the investment of public funds by enacting restrictive statutes which narrowly define allowable investments. In fact, many of those statutes bear striking similarity to statutes that govern the investment of trust funds, and some incorporate the "prudent person rule."

Until the escalation of inflation and interest rates during the 1970s and early 1980s, there was little pressure on most public officials to invest revenues. Rates of return were generally so low that there was little benefit to be gained. The rapid rise in interest rates that began in the late 70s was concurrent with taxpayer revolts that led to passage of tax-cutting measures

such as Propositions 13 in California and 2½ in Massachusetts (see Figure 1). The need to find sources of additional income led most local finance officers to step up short-term investing. Some treasurers were so successful that investment earnings became the second or third largest source of revenues for their communities.

In the heyday of double-digit rates, local treasurers were often reporting annualized rates of return in excess of 15 percent, and many were justly proud of hitting the top of the yield curve, purchasing one- to six-month certificates of deposit with annualized yields of 18 percent to 20 percent. Even recently elected treasurers without specific investment training were able to report exceptional earnings. The attractiveness of above-market yields became even more apparent on the downside, when rates on short-term money market instruments slid back into single digits from their historic highs. Some public sector investors had become so accustomed to double-digit returns that, in their quest to maintain high rates of return, they invested funds in short-term instruments such as repurchase agreements and certificates of deposit (CDs) at 25 to 200 basis points higher than was available in their local markets. Some substantial investments were made without considering the risk factors that might have at least partially explained the higher yields.

Everyone agrees that safety of principal is still the fundamental goal of public

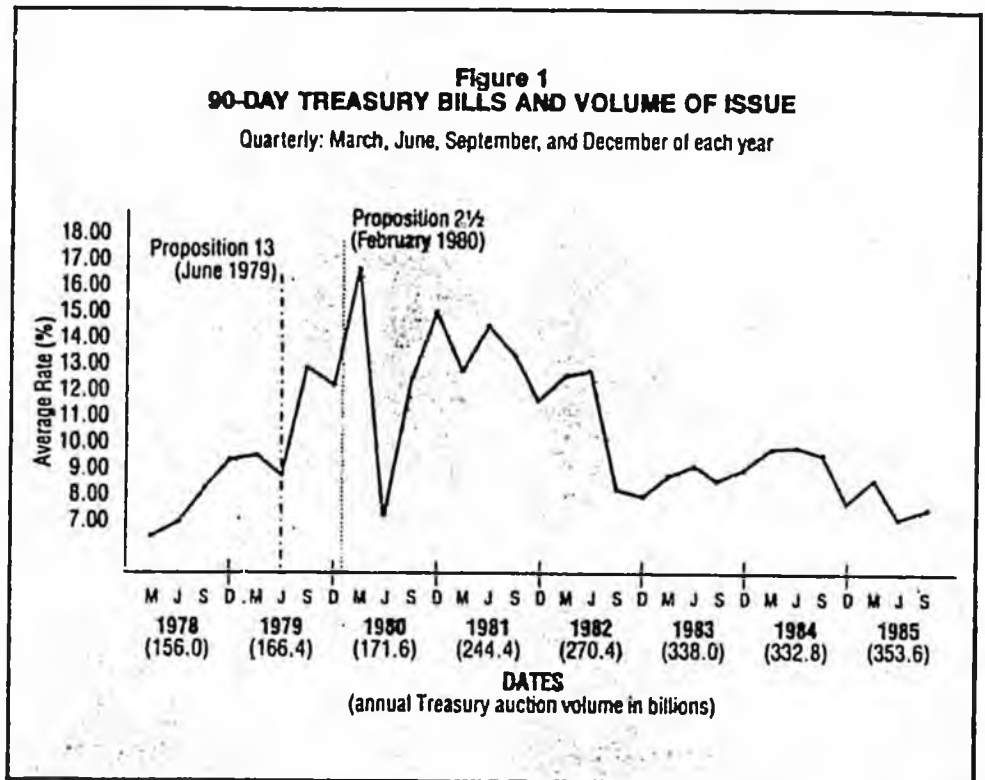
sector investment. However, while chasing yields in response to pressures to continue generating income, some public sector investors appear to have temporarily lost sight of the different types of investment risk. A U.S. Treasury security is a risk-free investment, but only from a credit standpoint. If it is purchased through a broker/dealer or bank, either as a direct investment or part of a repurchase agreement, the dealer is subject to credit risk, and the value of the security will fluctuate with changing interest rates. An in-state bank CD may be legal, insured and collateralized, but that doesn't preclude the fact that the solvency of the issuing institution is critical—no local treasurer wants to stand in line waiting for the FDIC to settle a claim.

Some Practical Options. One thing is certain: pressure on local government finance officers to enhance earnings from investments will not go away. Expectations of both the electorate and local officials were raised by several years of double-digit interest rates and the success of many finance officers in managing their investments. In many cases interest earnings have become a major component of local government revenues. As austerity in state and local government continues, the focus will be on continuing to produce significant investment earnings, notwithstanding a general decline in rates. Given this scenario, how can local units achieve high yields without sacrificing safety and liquidity?

Repurchase agreements. Because some public sector investors have experienced major losses of principal, the use of repurchase agreements (repos) has received a great deal of publicity. The repo market is huge—\$160 billion in average daily activity—and generally quite efficient, but safe use of repos hinges on proper perfection of the underlying collateral (see "A Few Thoughts About Repos" on page 18). Three cardinal rules for their use have been suggested over and over:

- know your counterparty,
- take physical possession or independent book entry of the collateral, and
- establish and monitor a margin to protect the market value of the collateral from interest rate movements.

The call for proper perfection by the Governmental Accounting Standards Board, the Federal Reserve and other



regulators is long overdue, but it has created a stumbling block for the public sector. Most municipalities still execute "trust me" repurchase agreements; that is, they do not take delivery of the repo collateral through an independent third party, but rather rely on a safekeeping receipt from the dealer or its agent, which is usually *not* sufficient to establish legal control over the securities. In some states, investments in repos without taking delivery of collateral may be illegal. Collateral should be delivered to an independent custodian under the unit's (not the dealer's) control, and there should be written agreements between the unit and the custodian. A unit might also choose to use a custodian which the two repo parties agree upon, but again, there should be separate written agreements between each of the parties to protect the unit's interest. Local units that have collateral delivery mechanisms have found that the costs tend to reduce net yields below those available from other equally liquid and safe investments. In any case, lack of perfected delivery results in an ownership problem in the truest sense, and is not unlike buying a house without having the deed properly recorded.

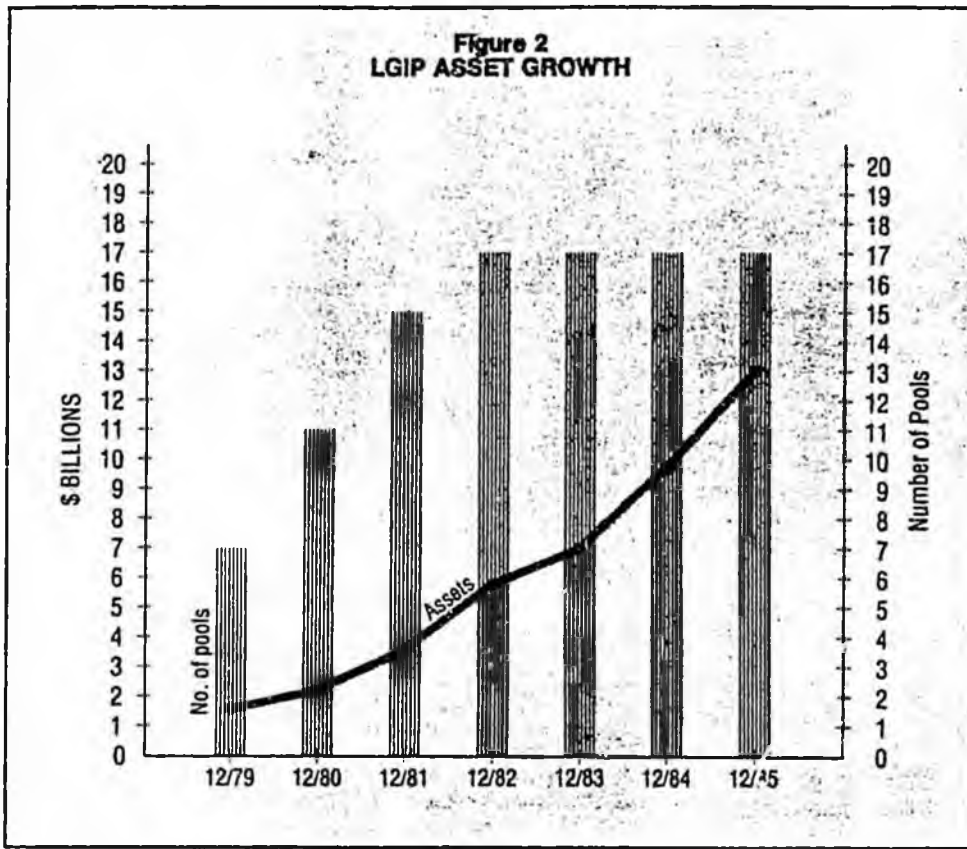
If an efficient, low-cost mechanism for

delivery is not available to a local unit, repos should not be considered an appropriate investment, especially when other liquid investments are available at competitive or higher yields.

Direct investments. Some units have successfully used direct purchases of U.S. Treasury and government agency obligations in lieu of repurchase agreements. When coupled with federally insured time deposits at banks, this type of investment program is perhaps the safest in terms of credit risk, but may be burdensome to manage in order to maintain sufficient daily liquidity. Unless the unit is able to structure maturities to match its cash flow requirements, the portfolio must be actively managed and traded.

As with any investment program, there are other trade-offs that must be considered. First, active management of the portfolio usually means a substantial investment of time in order to ensure that maturities match cash flows, and effective use of swaps and hedges may require a significant level of expertise. Second, unless securities are purchased directly from the Federal Reserve and held to maturity, commissions and custodial costs will tend to reduce net yields below those of other appropriate alternatives. Finally,

**Figure 2
LGIP ASSET GROWTH**



in order to benefit from economies of scale, the portfolio must be sizable, thus limiting the effectiveness of this option to larger public units.

Local government investment pools. In the investment area, one of the best examples of interlocal cooperation and capacity sharing is the local government investment pool (LGIP). LGIPs increase the efficiency and earnings of local government investment programs by providing a safe, professionally managed, diversified portfolio. LGIPs are, in effect, a financial intermediary—a "middle man" between local governments and the securities purchased by the pool on behalf of its participants. LGIPs are tailored to meet the needs of and specialize solely in serving local governments.

When a local government invests in an LGIP it purchases "shares" or "units" of the pool. Monies from each participating entity are combined for purposes of investment, but principal and earnings are accounted for separately; therefore, each participant's funds maintain their own identity. Pools are the public sector version of money market mutual funds, which give individual investors convenient access to high-yielding money market

instruments.

LGIPs are usually created by states for the benefit of their local units. In most, but not all cases, the pool is managed by the state treasurer, and it may include some state money. The programs vary from state to state, but most allow deposits and withdrawals at any time, usually in any amount, and pay interest on a daily basis, net of pool expenses. Participation in LGIPs is voluntary, and once an account is established, transactions may be executed as often as desired. Yields are usually comparable to rates on large-denomination money market instruments of \$1 million and more and, thus, are normally in excess of what most units can earn on their own.

By providing daily liquidity and permitting participants to select virtually any denomination for their investment, LGIPs alleviate many of the limitations of direct investment in money market securities. Most money market instruments are available only in select denominations with fixed maturities. Although larger government units do some buying and selling in the secondary markets and pay commissions, most local units purchase short-term securities from the original

issuer and hold them to maturity. The costs of premature liquidation can be prohibitive. For example, a six-month CD for less than \$1 million issued by a nonmoney center bank usually pays a below-market rate and is not readily marketable to another investor. The issuing bank may refuse to redeem the certificate, or it may assess penalties in addition to those required by federal regulations.

A significant feature of LGIPs that is often overlooked is that they require "delivery versus payment" for all securities purchases, including repurchase agreements. In other words, the pool's custodian will not release funds to the seller until delivery is made. Thus, the pool's investments are "perfected" because the custodian has possession of and control over the securities on behalf of the pool. This should provide comfort not only to current participants, but also to those units that may be considering the use of an LGIP in lieu of repos.

State treasurers in the following states sponsor an LGIP which is currently operating or is being established under recently passed enabling legislation (year of creation in parentheses):

California (1977)	North Carolina (1981)
Connecticut (1973)	Ohio (1985)
Florida (1977)	Oregon (1974)
Georgia (1981)	Tennessee (1979)
Illinois (1974)	Utah (1974)
Maryland (1981)	Virginia (1981)
Massachusetts (1977)	West Virginia (1978)
Montana (1973)	Wisconsin (1977)
New Jersey (1978)	

Private sector firms have established, or are trying to start, pools which are independent of state sponsorship in several other states, including Colorado, New York, Pennsylvania and Rhode Island. In addition, school districts in Illinois, Minnesota and Pennsylvania may use pools formed by their respective state school boards with assistance from the National School Board Association. All of these programs were established and operate under so-called "joint powers statutes."

A recent review of operating pools indicates that acceptance and usage of LGIPs has grown rapidly². Total LGIP assets have risen five-fold, from \$2.1 billion at the end of 1981 to \$13.0 billion in September 1985. During the same period, participating units have increased from about 2,300 in 11 pools to 6,600 in 17 pools (see Figure 2). Some states have seen the percentage of eligible units increase to more than 50 percent; the

highest participation rate, 75 percent, is in Massachusetts.

I.GIPs enable local units to pool their resources to obtain professional investment management, and, over the past decade have proven themselves an efficient and economical alternative because they provide:

- portfolio diversification,
- stringent credit analysis,
- competitive rates of return,
- daily liquidity,
- economies of scale and
- low overhead.

These features and advantages create a persuasive case for using existing I.GIPs instead of repos, and for the creation of similar vehicles in those states where such an alternative is not currently available.

Money market mutual funds. A few states, such as Michigan, Minnesota and Tennessee, allow their local units to purchase shares of money market mutual funds (MMFs) whose authorized investments meet the state's legal list for localities. Money market funds are registered with and regulated by the Securities and Exchange Commission, and their operations are outside the direct control of the states. States which allow use of MMFs have recognized the benefits of pooling which were discussed above, and manifest the intent of the Model Investment Legislation for State and Local Governments developed by GFOA's Committee on Cash Management in June 1984. The committee's report included sample investment statute language which places MMFs on the legal list of investments, and sample enabling legislation for establishing I.GIPs. (Editor's note: Copies of the Model Investment Legislation are available from the committee staff. Contact Girard Miller at the Chicago office of the GFOA.)

Allowing the use of an existing money market fund is a sound alternative to creating an I.GIP, particularly in those states where local government cash flows are not sufficient to support an independent pool. The approach can be refined to ensure that local units reap the maximum benefits from management of pooled funds by private sector organizations.

To the layman, most MMFs appear similar. There are, however, 350 distinct funds¹ which have varying investment disciplines, maturity ranges and service features. Funds run the gamut from those which invest solely in U.S. Treasury obligations to international portfolios with

A FEW THOUGHTS ABOUT REPOS

Is it wise to purchase a car without a title? What about a house without a recorded deed? Probably not—when it comes time to sell that asset, legal proof of ownership is essential.

Buying a repurchase agreement is the equivalent of purchasing any other asset. The purpose of the underlying securities—the so-called collateral—is to assure the buyer that there is something of value to sell off in the event the seller fails to meet his obligations at maturity. "Perfected delivery" establishes the repo buyer's legal control of the securities because the buyer pays for the securities only after they have been delivered to the buyer's agent.

There is no problem with the credit-worthiness of the U.S. Treasury and government agency securities pledged by the E.S.M.s and Lion Capitals of the industry. The real problem is one of mechanics—establishing the legal right to sell repo collateral as quickly as possible, if necessary. Four common problems have led to public sector losses:

1. *Failure to take delivery versus payment.* Funds should be released only upon delivery of the securities. A safekeeping receipt from the seller or its agent is not enough to establish legal control. Also, the Federal Reserve has not stated categorically whether safekeeping by the trust department of the transacting bank is perfected delivery.

2. *Lack of credit analysis of repo dealers.* Inability to foresee an impending insolvency is usually due to lack of credit analysis. Securities dealers that are slow to respond or refuse to provide audited financial statements may be trying to hide their deteriorating financial position. Some may not be licensed to do business in the state. Also, small dealers that have grown substantially in a short period of time and have a small capital base, or those with numerous affiliates and substantial intercompany transactions also may be on the brink of insolvency.

Purchasers should insist that their dealers comply with the capital adequacy standards of the New York Federal Reserve Bank.

3. *Lack of written trading agreements.* Written master trading agreements between the unit and its dealers (including banks with which it executes repos) are strongly recommended. These documents delineate the conditions to which all parties have agreed, and their respective obligations and responsibilities. Established dealers or banks should be able to provide drafts of these documents for review and revision by the unit.

4. *Fraud on the part of dealer.* Fraud is almost impossible to detect, even by the most sophisticated and experienced credit analyst. Even so, losses due to fraud shouldn't occur if the first three problems are scrupulously avoided.

varying levels of credit risk. The diversity in types of funds and their varying service levels is why some states are developing parameters to select and approve the use of existing MMFs. This approach recognizes the desirability of a state role in exerting some control to ensure high-quality management and a selection of features and services that benefit participating local units.

Once enabling legislation is passed to allow use of existing MMFs, the mechanics of setting up a program are relatively straightforward. Investment restrictions, features, services and reporting requirements can be established to limit the universe of eligible funds, and a request for proposals issued, delineating criteria for approval of funds. To provide maximum benefits to local units, a MMF

should offer:

1) Same-day (as opposed to next-day) portfolio pricing and interest stream. Public units, like all other institutional investors, expect and require interest earnings on each dollar invested for an exact number of days.

2) No minimum investment period or dollar value of investment. Units should be allowed to invest or redeem any amount on any business day, without penalty. This feature is especially important for smaller local units, which may be less certain of their cash flow requirements.

3) Unlimited wire transfer and check-writing access. While the wire system is used primarily by larger participants for transfers to and from the fund, check-writing can be used by large and small

**Figure 3
GOVERNMENT SECURITIES DEALER FAILURES
PUBLIC FUNDS AT RISK**

Dealer Name	Year Failed	Public Units Affected	How Much at Risk	Settlement Reached
Lombard-Wall, Inc.	1982	New York State Dormitory Authority & other gov't. units	\$52 million	66 cents on the dollar
Lion Capital	1984	34 municipalities & school districts	\$40.8 million	73 cents on the dollar
RTD Securities	1984	NY municipalities & school districts	\$40+ million	
E.S.M. Government Securities Inc.	1985	12 municipalities	\$100+ million	Proposed settlement 23 cents on the dollar
Bevill, Bressler & Shulman Inc.	1985	No municipalities, but with E.S.M. precipitated Ohio and Maryland thrift crises. Municipalities indirectly affected.		

TOTAL PUBLIC FUNDS AT RISK: \$232.8+ million

units alike when they wish to capture additional earnings from float.

4) Complementary participant services and education. This important but generally overlooked area encourages units to use the fund and can ensure quality and continuity of participant services provided by the manager. Among services that can be requested are:

- dedicated participant service personnel;
- toll-free telephone lines;
- prompt daily, monthly and year-to-date confirmation statements of accounts and transactions;
- unlimited transfers between fund accounts of identical registration;
- regular reporting to the state treasurer or other supervisory authority on fund performance, marketing activities and local unit participation;
- educational assistance, special publications and a monthly newsletter for all eligible participants.

Other criteria which can be used to screen funds are availability of special services, such as terminal-based sub-accounting systems, automatic daily sweeps of excess balances in noninterest bearing accounts, and direct deposit of state and federal transfer payments by automated clearing house. An advisory board of local officials, which serves as a liaison between the fund and its users, is an effective tool not only for monitoring

the fund's activities, but also for enhancing services and creating new features.

The North Carolina approach. North Carolina provides an example of the trend toward state-controlled use of MMFs. Because of the volume of local government cash flows, North Carolina had the option of requiring the establishment of a new SEC-registered mutual fund, uniquely tailored to meet the needs of North Carolina local units.

In 1981, the state legislature amended the local government investment statute to make "participating shares in money market mutual funds [legal] for local government investment if the investments of the fund are limited to those qualifying for investment by the State, and if said fund is certified by the Local Government Commission." Through use of a competitive bid process, the state made it possible for the private sector to assist local units. Despite the fact that the fund is a legally independent entity regulated by the SEC, the state oversees its operations through the Local Government Commission, which exercises "the authority to issue rules and regulations concerning the establishment and qualifications of any mutual fund for local government investment." This approach acknowledges that the private sector can and will provide services when there is opportunity for

reasonable profit. But the state retains the ability to exercise a firm level of review and control to protect the best interests of its local units.

In its three years of operation, North Carolina's fund has grown to more than \$300 million with more than one-third of eligible units actively using the fund. Its success is an indication of the acceptance by local units of this approach and the unique alliance between the public and private sectors.

Externalizing the Investment Management Function. LGIPs and MMFs are ways of externalizing part of a local unit's investment function; the purest form of externalization, however, is the individually managed account through an investment management firm.

The external management of public funds by the private sector occurs most frequently with public pensions. These systems have recognized that investment advisors offer economies of scale and generally superior investment returns because they have the resources, staff and expertise that most public units usually are not in a position to duplicate. The concept of using an outside advisor for managing short-term, fixed-income securities, on the other hand, has not been considered necessary or justified. This is because the investment techniques of this discipline are believed to be relatively uncomplicated. Two factors, one dramatic and the other more subtle, have begun to change that perception.

The drama was seen over the past several years when more than \$200 million in public funds were at risk as a result of investment in repurchase agreements with collapsing securities dealers (see Figure 3). In the words of one public finance official, "Two hundred million dollars would pay for a lot of management fees."

More subtle, but no less important, is the trend of innovation in the securities markets and the marked increase in investment vehicles and strategies that are used in managing short-term, fixed-income portfolios. The use of zero-coupon securities, options, futures and various hedging strategies was fostered within the private sector to increase yield or safety. Some of these new vehicles and techniques can be used successfully by municipalities to enhance yield without sacrificing safety or liquidity, but others are nothing short of speculative yield-chasing and have no place in a public sector investment

GFOA'S CASH MANAGEMENT COMMITTEE NEEDS YOUR HELP

As an aid to researchers, GFOA's Committee on Cash Management is compiling resource materials on authorized investment vehicles by state. The committee will use the data to determine which vehicles are used universally, as well as how the statutes differ between the states. It would be most appreciated if readers would forward a copy of their state's investment statutes, as well as any interpretive releases which also may be pertinent to:

Technical Services Center, Government Finance Officers Association, 180 N. Michigan Ave., Suite 800, Chicago, IL 60601. Fidelity Investments will receive copies of these documents and will assist the committee in its efforts. Copies of the listing will be available to interested readers upon completion.

program with its fiduciary orientation.

Because of the fiduciary nature of public funds investment, state statutes have generally been structured toward narrowing alternatives, rather than recognizing prudent innovation. This statutory structure and the accompanying political environment have not encouraged most local officials to keep up with the rapid changes and increasing sophistication of the financial markets. As a result, new securities and strategies that are appropriate for the public sector go unused or may be misused because of lack of adequate training.

Although most existing state laws would have to be changed to allow the externalization of short-term funds management, localities that now operate under prudent person or home-rule provisions could take advantage of this strategy immediately. Among the benefits to be realized are reduction of staff and overhead expense, full-time professional portfolio management and credit analysis, and greater portfolio diversification. External managers also can provide regular market valuation, more and better management reporting, and economical procedures for delivering, paying for and safekeeping securities, all at a relatively low cost. If finance officers are elected, external management can provide continuity of investment management through transition periods, and free the new official to focus on other aspects of

the unit's financial operations. Finally, by virtue of the fact that they are full-time investment professionals, outside advisors are in a position to pursue more esoteric strategies with the unit's concurrence.

Working with an external manager allows a local unit to develop fundamental investment guidelines within the prudent person rule, to which the manager must adhere, with periodic review and revision by the unit. In many localities, some private institutions traditionally have had a vested interest in the fact that the municipalities are restricted in their investment alternatives. A contract which is awarded to a qualified investment manager based on sealed bids, with periodic rebidding of the agreement, could substantially mitigate this situation.

Where Do We Go From Here? In a political and imperfect world one will not find a universal accepted "best" approach for the safe investment of public funds, especially when local finance officers are under political pressure to maximize returns within the constraints of safety and liquidity. Recent experience has shown that the "lowest common denominator" approach of state legal lists for local units, coupled with collateral pledging requirements, has not been sufficient to insure the safety of all public funds. Nor is it expected that the development of investment guidelines or the externalization of the investment function will in the future insure against losses due to fraud or malfeasance.

What longer-term initiatives can be undertaken by local units to safely incorporate innovation and new technology in their investment strategy?

Recodification of state investment laws. GFOA's Committee on Cash Management has created model legislation for this purpose. It speaks to the need to expand the investment options available to local units, and to improve their ability to externalize investment management through the use of LGIPs and MMFs. It also suggests the widespread adoption of collateral pools to reduce costs and increase the safety of collateralized deposits. This three-pronged approach can go a long way toward assisting most local units.

Increased training. The issue is not what to teach to investment officers, but rather how to reach the thousands of finance officers in the United States with an effective program. State college and

university systems could house the effort, with a central body such as the GFOA orchestrating the development of curriculum. Interested private sector individuals and organizations that have been active in this area would be encouraged to continue their involvement. Funds to defray the costs could come from a number of sources including the states, the private sector and, of course, the benefiting officials and jurisdictions.

Better salaries. Public finance is a profession. Historically, however, it has had a low profile and many localities, not recognizing its importance, continue to pay salaries that are not substantial enough to attract and keep talented individuals. This false economy will probably persist until the public sector recognizes the finance officer's responsibility within the community and the potential benefits of paying salaries that encourage competence and continuity in these positions.

Minimum competency. Establishing minimum competency standards for any profession is fraught with problems, but in light of recent losses to public treasuries perhaps the time has come to take a closer look at this controversial issue. Some state associations of finance officers have begun to implement certification programs, which complement training programs and encourage a high level of competence on the part of both appointed and elected finance officials. New programs in Texas and North Carolina were described in the December 1985 issue of *Government Finance Review*. In New Jersey, Oregon and Ontario such programs have been in place for a few years. There is, however, little specific training in cash management skills in any of the above programs. Training and certification programs also would serve to provide a level of comfort to both the electorate and public executives.

Conclusion. This article was prompted in part by the recent article by J. Dwight Hadley in the September 1985 *Government Finance Review*, which discussed New York state's response to the repo crisis faced by some of its units. By combining the ideas discussed in that article and this one, several approaches begin to emerge.

It is impossible to totally eliminate the risk in any investment program—fraud, abuse and greed are almost impossible to detect, and always will be around. The

goal of the public sector should be to create an environment which fosters the development of investment professionals who are qualified and capable of minimizing investment risk and probability of loss. Short-term reactive approaches which seek to place even greater limitations on public investment officers may prove to be very damaging to the achievement of this goal. Over the long term, practical solutions must be designed to attract additional talented individuals, provide them with appropriate professional training and encourage them to remain in the profession. The public should be able to assure itself that its funds have been entrusted to investment professionals, whether they are appointed or elected individuals, or outside managers.

Public sector investing is at the crossroads. The vehicles are there—it's up to finance officials to choose the best route. □

Fidelity Investments

Fidelity Distributors Corporation
(General Distribution Agent)

NOTES

¹ *Wall Street Journal*, September 6, 1985.

² Telephone survey of operating LGIPs by Fidelity Investments, November 1985.

³ *Donoghue's Money Fund Report*, October 25, 1985.

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