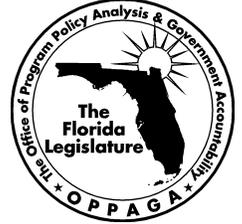




The Florida Legislature

OFFICE OF PROGRAM POLICY ANALYSIS AND GOVERNMENT ACCOUNTABILITY



RESEARCH MEMORANDUM

The SBA Is Correcting Problems Related to Its Oversight of the Local Government Investment Pool

March 31, 2009

Summary

As requested, this memorandum provides a summary on the events leading up to the near liquidation of the Local Government Investment Surplus Funds Trust Fund (commonly known as the Local Government Investment Pool). The State Board of Administration provides oversight of this fund and charges local governments a fee for its management services. This memorandum addresses two questions about the pool.

1. What did the Legislature do in response to the run on the Local Government Investment Pool?
2. What did consultants recommend and what actions did the SBA take to improve its management of the Local Government Investment Pool?

After the near liquidation of the pool, the Legislature hired a consulting firm to provide recommendations for helping to restore investor confidence and to offer guidance on how state law could be amended to support best investment practices. Upon receipt of these recommendations, the Legislature required board managers to provide pool participants with monthly reports disclosing any material events affecting the fund and required local officials to sign statements saying they understood the risks involved in placing their money in the pool. The Legislature also established the Participant Advisory Council and charged the council with regularly reviewing the administration of the pool.

The State Board of Administration has taken several actions to address consultant recommendations, particularly in the area of stakeholder communication and accountability. The board has hired a director of communications to help ensure timely communication with stakeholders and it has expanded its website with additional disclosure and pool performance. The board also has hired a national investment firm to provide oversight and investment management of the pool.

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Background

The State Board of Administration manages the Local Government Investment Pool. The State Board of Administration (SBA) is primarily an asset management organization charged by Article XII, Section 9 of the Florida Constitution and state law with investing on behalf of a variety of state and local government entities. The Local Government Investment Pool, one of the 35 funds managed by the SBA, was established in 1982 to help local governments maximize earnings on surplus funds. It is open to all units of local Florida governments, including counties, cities, school districts, special districts, sheriffs, property appraisers, and tax collectors. As of December 31, 2008, 813 local governments participated in the investment pool and it was, at one time, the largest of its kind in the nation. The pool is intended to operate like a highly liquid, low-risk money market fund, with securities like certificates of deposit, cash, U.S. treasury bills, and bonds issued by other U.S. government agencies comprising the fund.

The SBA charges local governments fees for investing in the pool. These fees have historically been in the mid-range when compared to other states; among the states we surveyed, five had lower fees and five had higher fees (see Exhibit 1). Additionally, many states, including California, Delaware, Georgia, New York, Texas, and Washington, outsource the management of similar funds. On March 3, 2008, Florida also began contracting for this service, and it raised management fees from 0.015% to 0.0368% of assets invested.

Exhibit 1

As a Percentage of Assets, Florida's Fees for Managing Local Government Non-Retirement Funds Fall in the Midrange When Compared to Other States¹

States¹	Fees Charged as a Percentage of Assets
North Carolina—Short-Term Investment Fund	.0039%
California—Local Agency Investment Fund	.0095%
Wisconsin—State Investment Fund	.0300%
Georgia—Georgia Fund	.0330%
Washington—Local Government Investment Pool	.0350%
Florida—Local Government Investment Pool	.0368%
Texas—Local Government Investment Pool	.0485%
Tennessee—Local Government Investment Pool	.0500%
Oregon—Short-Term Fund	.0522%
Delaware—Local Government Investment Pool	.0650%
New York—Liquid Asset Fund	.0750%

¹ Comparison states were chosen based on the following factors: the asset value of the state's retirement portfolio was comparable to Florida—California and New York; the portfolio was fully funded with assets exceeding liabilities—Delaware, North Carolina, Oregon, and Wisconsin; states were in the southeastern region—Georgia and Tennessee; and states the Legislature specifically requested we review—Texas and Washington.

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With the exception of the one-year and three-year periods ending December 31, 2008, the board has exceeded its investment goals for the pool. These goals are based on a market index for institutional short-term funds and, as shown in Exhibit 2, the board has exceeded its 1-, 3-, 5-, and 10-year target investment goals for the past three fiscal years. However, for the 12-month period ending December 31, 2008, the board clearly missed its one-year goal, narrowly missed its 3-year goal, and exceeded its 5- and 10-year goals. The current economic decline greatly reduced the 1-year rate of return from June 30 to December 31, 2008, dropping from 4.35% to 2.55%. The declining economy also served to deflate the 3-year return. The economic downturn has not yet affected 5- and 10-year investment results.

**Exhibit 2
Board Investment Performance Generally Exceeded Target Returns for the Local Government Investment Pool**

Local Government Investment Pool	Fiscal Year			December 31, 2008 ¹
	2005-06	2006-07	2007-08	
1-Year Return	4.28%	5.52%	4.35%	2.55%
1-Year Target	4.04%	5.45%	4.26%	2.77%
Exceed target?	Yes	Yes	Yes	No
3-Year Return	2.59%	4.03%	4.69%	4.38%
3-Year Target	2.27%	3.95%	4.66%	4.40%
Exceed target?	Yes	Yes	Yes	No
5-Year Return	2.40%	3.01%	3.51%	3.57%
5-Year Target	2.10%	2.90%	3.44%	3.56%
Exceed target?	Yes	Yes	Yes	Yes
10-Year Return	4.02%	4.05%	3.87%	3.69%
10-Year Target	3.77%	4.00%	3.84%	3.68%
Exceed target?	Yes	Yes	Yes	Yes

¹ Reported returns are for the 1-, 3-, 5-, and 10-year periods ending December 31, 2008.

Source: SBA Investment Reports from Fiscal Years 2005-06 through 2007-08, interviews with SBA managers, and OPPAGA analysis.

Because of market fears, local governments rapidly withdrew funds from the Local Government Investment Pool in 2007. In July and August 2007, SBA managers purchased four mortgage-backed securities, valued at \$948 million that were rated as being of superior financial strength and contained no subprime mortgages.¹ Less than three months after their purchase, rating agencies downgraded these securities and \$8.8 million of the mortgages backing the securities were identified as subprime. These securities no longer conformed to the low-risk highly liquid securities that were supposed to be in the pool, which comprised 3% of the pool, as of October 31, 2007. The SBA informed local governments of these assets in its October 31, 2007 newsletter. An additional review of all the securities held in the pool revealed that another \$1.2 billion failed to conform to the pool's low risk profile.

Shortly thereafter, in mid-November, the national media reported on this issue, headlining with the statement that the board held \$2.2 billion in bad debt. With these headlines, and against the backdrop of the national subprime mortgage crisis, local government officials reacted swiftly to these reports and began withdrawing their funds. In one month, fund investors withdrew \$14

¹ Subprime mortgages are those issued by companies to borrowers with flawed credit ratings; frequently these securities have the potential for high returns as a trade-off for the higher risk they pose to the purchaser—in this case the SBA.

billion, depleting the pool by nearly 50%. SBA managers could not meet the total demand for all withdrawals because some pool securities were illiquid and the penalties for early withdrawal would have resulted in investors losing their principal.

To address this problem, the board prohibited withdrawals by freezing the fund from November 29 to December 6, 2007. Based on input from an independent financial advisor, SBA trustees divided the pool in two, segregating the downgraded securities from the rest of the pool. Participants were only allowed to withdraw funds from the pool that did not contain the downgraded securities, and only in specific amounts relative to the size of their accounts. Participants who needed withdrawals beyond amounts authorized were required to pay a 2% withdrawal fee until December 29, when the policy was rescinded.

These restrictions created significant financial difficulties for some local governments, which historically had had unrestricted access to pool funds. For example, when it was unable to withdraw any of the \$46 million it had in the pool, the Leon County School Board had to borrow \$10 million from other lenders to pay its 4,600 teachers and staff and incurred \$13,000 in interest on the borrowed money. A \$155 million public works project was effectively halted in Port St. Lucie, and the city lost an additional \$1.5 million in interest when the board froze the pool. Similarly, the town manager of Oakland missed the deadline for accessing the pool by 15 minutes, resulting in her town's failure to make payments on an \$800,000 school bond and a \$300,000 road project. As of early February 2009, approximately \$580 million of investor principal, or 2% of the total pool, remained frozen and is not expected to return to fair market prices for another seven to nine years—at which time remaining investor principal will be returned.

Questions and Answers

What did the Legislature do in response to the run on the Local Government Investment Pool?

In response to the near liquidation of the Local Government Investment Pool, the Speaker of the House hired consultants to determine how investor confidence in the pool could be restored and to provide guidance on legislation that would support best investment practices. Although the consultants found no fault with the board's initial investments themselves, they faulted the board's lack of transparency in operating the fund and its communication with stakeholders.

Specifically, the consultants reported that

- problems with the pool were readily identifiable as early as August 2007, but SBA managers did not timely disclose these problems to stakeholders;²
- there was a “serious disconnect” between the SBA’s public description of the fund and the actual rules regarding the fund, with no transparency on how investment income distributed to participants was calculated;

² Although SBA documents show the executive director and senior management met informally on this matter, the board's inspector general faulted SBA managers for not formally notifying the board's investment oversight committee—an internal committee established to address such issues—within 24 hours as required by policies, but instead waiting as long as 35 days for formal notification.

- information about the pool, including fees, assorted charges, investment returns, and risk, were not readily disclosed to potential pool participants and fund materials were difficult to understand, and did not disclose that the pool was not registered with the Securities and Exchange Commission;
- inconsistent investment returns were reported to trustees and participants, with trustee information not reflecting all market losses; and
- SBA managers had not briefed its investment advisory council on the pool in six years prior to the crisis.

Upon learning of these problems, the Legislature passed Senate Bill 2422 charging SBA managers with ensuring that participants received monthly reports disclosing any material events affecting the fund.³ The legislation also established a six-member Participant Local Government Advisory Council and charged the council with regularly reviewing the administration of the pool and for making recommendations to the board's trustees, i.e., the state's Chief Financial Officer, Attorney General, and Governor. In addition, the Legislature charged the Auditor General with conducting an annual financial audit of the pool, ensuring the pool is in compliance with its investment policy. Lastly, the Legislature required the Participant Local Government Advisory Council and the SBA's Investment Advisory Council to approve the investing practices and guidelines for the pool each year.

What did consultants recommend and what actions did the SBA take to improve its management of the Local Government Investment Pool?

The consultants commissioned by the Legislature to review the State Board of Administration's oversight of the Local Government Investment Pool made recommendations to the board, predominantly in the areas of accounting, internal controls, and stakeholder communication and accountability. As shown in Exhibit 3, the consultants recommended that the board

- disclose all material information to stakeholders immediately;
- improve its transparency so that information is easily understood;
- disclose the board's relevant SEC exemptions; and
- inform stakeholders that participating in the pool poses investment risks.

In addition, consultants recommended that the board provide additional training to staff members as a reminder of their fiduciary duty to stakeholders. Moreover, the consultants recommended to the board trustees that the staffing and budget devoted to pool oversight be sufficient such that staff can meet their fiduciary obligations to stakeholders.

As also shown in Exhibit 3, the Auditor General and OPPAGA both determined that the board has taken actions to address consultant recommendations. In a separate report, the Auditor General found that the SBA has made appropriate changes relevant to meeting Securities and Exchange Commission disclosure and security purchasing requirements, but had not implemented a risk-based monitoring program, which would comprehensively evaluate all areas of the board's operation, management, and internal control to help ensure compliance with

³ The enacted law is Chapter 2008-59, *Laws of Florida*.

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board policies and procedures.⁴ We determined that the board had taken corrective action in all but three areas related to stakeholder communication and accountability. For example, to address concerns about its communication with pool participants, the board hired a director of communications who will review, edit, and ensure that all information provided to stakeholders is accurate, timely, and useful. In addition, pool participants now receive a monthly report that lists all pool transactions for the month, realized gains and losses, changes in pool liquidity, and overall performance. New disclosure information provided to pool participants now states that the pool is not registered with or regulated by the Securities and Exchange Commission and that pool participants may lose money. Lastly, the pool's website was expanded to disclose information on pool performance, holdings, fees, investment guidelines, and oversight procedures.

However, the SBA did not take action on three recommendations and deferred a fourth to the trustees and the Legislature. The House consultant recommended that the SBA appoint a chief executive officer of the fund, but the board asserted that its executive director was already the *de facto* chief executive officer of the pool. The House consultant also recommended that the board resume management control of the pool when its contract with external investment managers expires because the SBA's lower management fees would translate into more earnings for participants. The board responded that the participants were better served by outsourcing the fund to external managers who had the resources, efficiencies, and economies of scale to provide better day-to-day oversight and management of the fund. Additionally, the consultants recommended that the board address communication challenges stemming from Florida's public records law, which creates obstacles for investment advisory council members to discuss proprietary and confidential investment information. The SBA managers took no action, stating they are bound by state law. Lastly, the consultants recommended that the board add more trustees to the board, noting that other states had considerably more trustees with direct investment experience. SBA managers deferred this recommendation to the Legislature and the board trustees, but noted that the Investment Advisory Council members provided an additional level of expertise to the board, thus diminishing the need for additional trustees.

⁴ *Financial Audit of the State Board of Administration Local Government Surplus Funds Trust Fund*, Auditor General, [Report No. 2009-124](#), February 2009.

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Exhibit 3

The SBA Has Taken Steps to Address Many Recommendations Made by Consultants

Recommendations ¹	SBA Actions	Date Implemented
Communication		
Require escalation and exception reporting that addresses any material events affecting the pool; ensure immediate disclosure of material information.	Hired a director of communications to maintain and implement the SBA's communication policy, ensure publications and information released to the media and the public are accurate, and distribute useful information in a timely manner to plan beneficiaries and other stakeholders. Engaged a local government client coordinator whose job is to prepare formal disclosure reports for stakeholders of all material events.	May 2008 August 2008
Educate participants in the pool about the risks of securities within the pool and the board's SEC exemptions.	Expanded the pool's Investment Policy Guidelines to enhance disclosures to potential and current participants that the pool is not registered or regulated by the SEC and that there is potential for the pool to lose money, as with any investment.	July 2008
Improve transparency and communication so that account information is current, easily understood, and discloses all information material to the pool.	Expanded the pool's website to disclose information on fund performance, holdings, fees, investment guidelines, and oversight practices. Implemented statutorily mandated changes to the pool, such as providing potential participants with a complete fund profile with basic information about the investment management, the historical performance, recent financial statements, and fees and penalties.	Fall 2007
Ensure consistent information so that identical investment performance data are reported to trustees and stakeholders.	Began distribution of a monthly report that lists the value of each investment in the fund, each security transaction, realized gains and losses, changes in the pool's liquidity, performance of the fund, progress in restoring pool participants' principal from the fund holding the downgraded assets, and material compliance actions.	June 2008
Address communication challenges presented when the advisory council needs to bring up confidential financial information in a public meeting.	No action taken—Florida's Sunshine Law applies to the SBA and its advisory boards. While this may present certain communication challenges, the SBA intends to abide by the state statute.	—
Accountability		
Create a new pool and allow the current pool to self-liquidate.	Legislation was passed in 2008 that substantially modified the pool's structure, making the recommendation inapplicable. Specifically, the legislation kept the original pool and allowed the board to contract with a professional money management firm to manage the pool. The legislation also created a separate pool containing the downgraded assets, which will be returned to pool participants as this pool's liquidity increases.	May 2008
Ensure ongoing oversight of the pool	Hired a private investment management firm that had the resources, efficiencies, and economies of scale to make, manage, and monitor investments and exercise better day-to-day oversight more efficiently than the SBA could with its current staffing and budget allocation. The result has been that the pool has now obtained a superior rating from credit rating agency, which required more stringent investment guidelines, revised compliance procedures, and weekly monitoring of the pool's compliance to guidelines by the rating agency. Additionally, began distribution of a monthly report to the Trustees and Investment Advisory Council that discloses changes in pool liquidity, progress in restoring the principal from the downgraded securities, value of securities held, all investment transactions for the pool, and compliance to pool guidelines.	March 2008 June 2008
Address "step-child" status of the pool by adding a Chief Executive Officer (CEO) to the pool and review SBA compensation practices	Rejected the addition of a CEO for the pool, stating that the SBA executive director was already the <i>de facto</i> CEO of the pool. Requested an increase for Fiscal Year 2008-09 of 11 employees and 13% increase in budget spending to address staffing retention and recruitment, compensation, and other organizational needs.	— May 2008

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Recommendations ¹	SBA Actions	Date Implemented
Accountability (continued)		
Train SBA staff by implementing an ongoing training program for new and existing employees regarding their understanding of their fiduciary responsibilities to pool participants.	Requested an increase in budget spending for Fiscal Year 2008-09 for a training manager and education programs on compliance issues and fiduciary responsibilities.	May 2008
Return pool to SBA internal management	No action taken – board officials assert that the pool participants are better served by outsourcing the fund to external managers who have the resources, efficiencies, and economies of scale to provide better day-to-day oversight and management of the pool.	—
Expand the number of trustees for the SBA to include two who are substantial stakeholders in SBA mandates and two who are experienced financial professionals.	No action taken—SBA managers deferred this recommendation to the Legislature and the board trustees, but noted that the Investment Advisory Council and the pool's Participant Advisory Council members provided additional levels of experience and expertise to the board.	—
Accounting and Control		
Conduct an independent financial and operational audit of the SBA and update risk and control standards.	The Office of the Auditor General conducted a financial and operational audit noting that the SBA had made appropriate changes relevant to meeting Securities and Exchange Commission disclosure and security purchasing requirements, but had not implemented a risk-based monitoring program, which would comprehensively evaluate all areas of board's operation, management, and internal control to help ensure compliance with board policies and procedures.	February 2009
	In addition, SBA is currently undergoing an operational audit to enhance its compliance and related risk management processes.	January 2009

¹ Where appropriate, we have combined similar recommendations.

Source: *Due Diligence Review* Submitted to Speaker Marco Rubio, March 17, 2008; *State of Florida, State Board of Administration, Local Government Surplus Funds Trust Fund, Financial Audit For The Year Ended June, 30, 2008*, Audit General Report No. 2009-124, February 2009; OPPAGA review of State Board of Administration documents and interviews of SBA officials.