

A Review of

The State Treasury's Management of TexPool



Office of the State Auditor

Lawrence F. Alwin, CPA

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Key Points Of Report

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Overall Conclusions

Due to corrective action by the Texas Legislature, TexPool is now required to observe stringent safety requirements. TexPool currently maintains a AAAm rating by Standard & Poor's Managed Funds Group.

These additional requirements were necessary because, in the past, TexPool was not operated safely. Questionable management decisions by TexPool administrators contributed to TexPool's liquidity crisis, which ultimately cost the State at least \$97 million.

Key Facts And Findings

- From April until December of 1994, TexPool operated outside safety margins established for regulated money market funds. By failing to take action to stabilize the net asset value of TexPool while simultaneously allowing participants to withdraw their original investments in full, TexPool administrators took inappropriate risks for a fund premised upon principles of safety and liquidity.
- The Attorney General has determined that the Treasury's use of state funds to purchase TexPool's securities for a price above market value was not authorized by law.

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This review was conducted in accordance with Government Code, §§ 321.0131 and .0132.



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Executive Summary

The State Treasury administers TexPool, which is a pooled investment fund for local governments in Texas. TexPool is established as a separate and distinct trust fund held outside the Treasury, and the State Treasurer serves as trustee of the fund.

In December 1994, in response to a "run" on TexPool, the Treasury purchased approximately \$2.2 billion in securities from TexPool's portfolio. To generate cash needed to buy TexPool's securities, the Treasury sold securities from its own portfolio at a loss of \$22.2 million. The Treasury then bought TexPool's securities for a price that was \$74.7 million more than they were worth on the open market. The total cost to the State of the TexPool bailout was at least \$97 million.

The Treasury accurately reported that the TexPool bailout resulted in realized losses of approximately \$55 million. However, this significantly understates the actual cost of the bailout because it does not include an additional \$42 million in costs resulting from purchasing TexPool's securities for a price above market value. A more detailed calculation of the cost of the TexPool bailout is included in the body of this report.

The Attorney General has determined that the Treasury's use of state funds to purchase TexPool's securities for a price above market value was not authorized by law. (A copy of the Attorney General's opinion is included as Appendix 2 of this report.)

The run on TexPool and the State's bailout of the fund have been blamed on various factors, ranging from multiple interest rate hikes to alleged irresponsible reporting by the *Wall Street Journal*. Although external events contributed to TexPool's problems, our review indicates that the actions, and in some cases inaction, of TexPool administrators were contributing factors as well. Had TexPool administrators taken timely action to stabilize

the net asset value of the fund, the run on TexPool and the loss of state funds could have been averted.

Although no single decision or event precipitated the run on TexPool, the following management decisions by TexPool administrators contributed in varying degrees to TexPool's problems:

- Raising the ceiling on weighted average maturity of TexPool's portfolio from 120 days to 180 days (January 1993)
- Failing to take action to stabilize the value of the fund after the net asset value per share declined, while continuing to allow participants to withdraw shares at full value (February - December 1994)
- Raising the ceiling on weighted average maturity of TexPool's portfolio from 180 days to 270 days (June 1994)

Due to its emphasis on safety, liquidity, and immediate access to account balances, TexPool was established to function in the same manner as a money market fund. Although public funds investment pools such as TexPool are not subject to federal regulation, the regulations provide important guidelines for the safe operation of money market funds.

Once the net asset value (market value ÷ book value) of TexPool declined, TexPool administrators did not follow safety guidelines established for regulated money market funds. They took no action to stabilize the value of TexPool while simultaneously allowing participants to withdraw their original investments in full. These management decisions involved an inappropriate degree of risk for a short-term investment fund premised on principles of safety and liquidity.

Executive Summary

Rising interest rates caused the longer-term securities in TexPool's portfolio to drop in value. TexPool administrators decided not to sell the devalued securities at a loss. Instead, they retained the devalued securities in the portfolio in the belief that they could be held until maturity, and TexPool could avoid taking losses.

Retaining the devalued securities in the portfolio depressed TexPool's yield, which created an incentive for participants to leave TexPool for more favorable investment opportunities elsewhere. Permitting participants to withdraw their original investments in full despite the decline in the fund's net asset value shifted the potential losses to participants remaining in the fund, which created further incentive to leave TexPool before the losses might be realized.

The risks associated with these management decisions should have been apparent to TexPool administrators as soon as the net asset value of the fund started to decline. These risks grew progressively more acute throughout 1994 as TexPool's balance fell sharply.

Corrective Action by the Legislature

The 74th Texas Legislature took corrective action by amending the Public Funds

Investment Act to strengthen controls over public funds investment pools and to expressly prohibit the Treasury from purchasing securities for a price above market value. The Treasury is implementing the controls mandated by the Legislature.

Management's Response

The State Treasury disagrees with many of the findings and conclusions in this report. The Treasury's response is included in Appendix 3.

The State Auditor's Office believes that the Treasury's response contains numerous inaccuracies. Therefore, the State Auditor's Office has included follow-up comments in Appendix 4.

The Attorney General's Office has been afforded the opportunity to comment on the Treasury's response. The comments of the Attorney General's Office are included in Appendix 5.

This report and all of the appendices should be read in their entirety in order to obtain a complete perspective of the events in question.

What is TexPool?

In 1989, the Texas State Treasurer established TexPool, an investment pool which currently includes over 1,400 units of local government in Texas. TexPool is established as a separate and distinct trust fund held outside the State Treasury, and the State Treasurer serves as trustee for the fund. The TexPool Participation Agreement provides that all earnings and losses on investments shall be allocated on a *pro rata* basis among TexPool participants.

The objective of TexPool is to provide a safe environment for the short term investment of public funds. Safety is the prime responsibility of every public investment officer.

- TexPool Information Statement
September 1989

Under law, TexPool's investment objectives in order of priority are:

- (1) safety of principal
- (2) liquidity
- (3) yield

Due to its emphasis on safety, liquidity, and immediate access to account balances, TexPool was established to

function in the same manner as a money market fund. TexPool functions as a "constant dollar objective" fund, meaning that participants deposit and withdraw money at \$1.00 per share. In order for such a fund to operate safely, it is essential to maintain a stable net asset value (market value ÷ book value) of \$1.00 per share. Corrective action must be taken to stabilize the net asset value of the fund if it deviates beyond a narrow range from the \$1.00 per share valuation.

Public funds investment pools such as TexPool are not subject to the federal regulations which govern private money market funds. However, the federal regulations contain important guidelines for the safe operation of money market funds and provide a frame of reference by which to evaluate the management decisions of TexPool administrators.

Events Leading to the Run on TexPool

In December 1994, in response to a "run" on TexPool, the Treasury purchased approximately \$2.2 billion of TexPool's securities so that TexPool would have the cash needed to meet withdrawal demands. These transactions cost the Treasury at least \$97 million.

The run on TexPool and the State's bailout of the fund have been blamed on various factors, ranging from multiple interest rate hikes to alleged irresponsible reporting by the *Wall Street Journal*. Although external events contributed to TexPool's problems, our review indicates that the actions, and in some cases inaction, of TexPool administrators were contributing factors as well. Had TexPool administrators taken timely action to stabilize the net asset value of the fund, the run on TexPool and the loss of state funds could have been averted.

The circumstances giving rise to the run on TexPool are best understood in the context of earlier events and management decisions which influenced the condition of the fund. In order to understand how TexPool's condition changed over time, these events will be discussed in chronological order.

Raising the Ceiling on Weighted Average Maturity from 120 Days to 180 Days

The chain of events leading to the run on TexPool began in January 1993, when TexPool administrators raised the ceiling on weighted average maturity of TexPool's portfolio from 120 days to 180 days. This was a significant change in TexPool's investment policy because it permitted TexPool to invest more of its portfolio in longer-term securities. Although longer-term securities are generally associated with higher yields, they have a correspondingly higher market risk because they are more susceptible to a decline in value if interest rates rise.

Because of the higher market risk associated with longer-term investments, regulated money market funds are not permitted to have a weighted average maturity of more than 90 days. Although TexPool is not subject to this requirement, the federal regulations illustrate that a lower ceiling on weighted average maturity is an important control for ensuring the safety and liquidity of a money market fund.

While safety is the primary goal of TexPool, liquidity is a simultaneous objective. After meeting the first two objectives, TexPool seeks to provide a competitive yield for the invested funds.

TexPool is designed to be highly liquid to give participants immediate access to their account balance. Therefore, the weighted average maturity of TexPool will not exceed 120 days.

*- TexPool Information Statement
September 1989*

TexPool's primary objectives were to provide safety and liquidity for short-term investments. A secondary objective was to seek competitive yields, but this objective was to be pursued only after the primary objectives were satisfied. As initially established, TexPool's ceiling on weighted average maturity was 120 days. This was somewhat higher than the ceiling permitted for regulated money market funds. Therefore, from its inception, TexPool had a somewhat higher market risk than a regulated money market fund. Presumably, TexPool administrators considered this to be a manageable risk, given that local government investment pools are inherently more stable because the cash needs of local governments are more predictable than those of investors in a private money market fund.

However, when TexPool administrators raised the ceiling on weighted average maturity to 180 days, TexPool tilted away from its primary objectives of safety and liquidity and toward its secondary objective of competitive yields. With a 180-day ceiling on weighted average maturity, TexPool assumed a hybrid character. On one hand, TexPool continued to represent itself as a short-term investment fund emphasizing safety, liquidity, and immediate access to cash balances. On the other hand, TexPool was aggressively seeking higher yields by investing more of its portfolio in longer-term securities, which involved greater market risk and resulted in a less liquid portfolio.

From January 1993 until early 1994, this investment strategy worked to TexPool's advantage. The higher ceiling on weighted average maturity of the portfolio allowed TexPool to invest in longer-term securities and generate higher yields. The higher yields coupled with its lower administrative fees allowed TexPool to outperform other short-term investment funds, which attracted more participants and larger investments to TexPool.

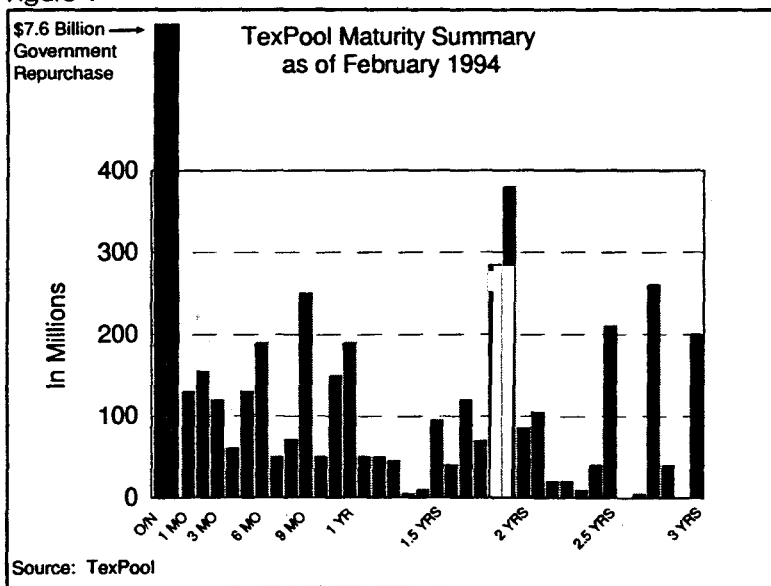
As long as interest rates were either stable or declining, TexPool's investment strategy was highly successful. However, TexPool's investment strategy had a downside risk. Due to the longer maturities of its securities, TexPool's portfolio was more interest-rate sensitive than a regulated money market fund and more susceptible to a decline in net asset value should interest rates rise.

Given its higher market risk, TexPool's portfolio required a vigilant and active management strategy. This should have included continuous monitoring of interest rate indicators and a quick response to any decline in the net asset value of the fund caused by rising interest rates.

Under these circumstances, it appears that TexPool administrators should have been especially alert to indications prevailing in late 1993 that interest rates might rise and should have adopted a more cautious investment strategy in response to that possibility. However, as late as January and early February of 1994, TexPool continued to purchase a substantial number of securities with longer maturities. These securities suffered a significant decline in market value as interest rates rose during 1994.

Failing to Take Action to Stabilize the Value of the Fund While Continuing to Allow Participants to Withdraw Shares at Book Value

Figure 1



With the first interest rate hike on February 4, 1994, the market value of TexPool's longer-term securities dropped. Consequently, TexPool's net asset value per share (market value ÷ book value) declined.

Rather than selling the devalued securities at a loss, TexPool administrators decided to retain the securities in the portfolio until maturity, and the loss in market value of the securities remained an "unrealized loss." TexPool administrators made this decision based on the assumption that TexPool's balance would follow

historical patterns, and TexPool would be able to maintain sufficient cash and short-term investments in the portfolio to meet projected liquidity needs.

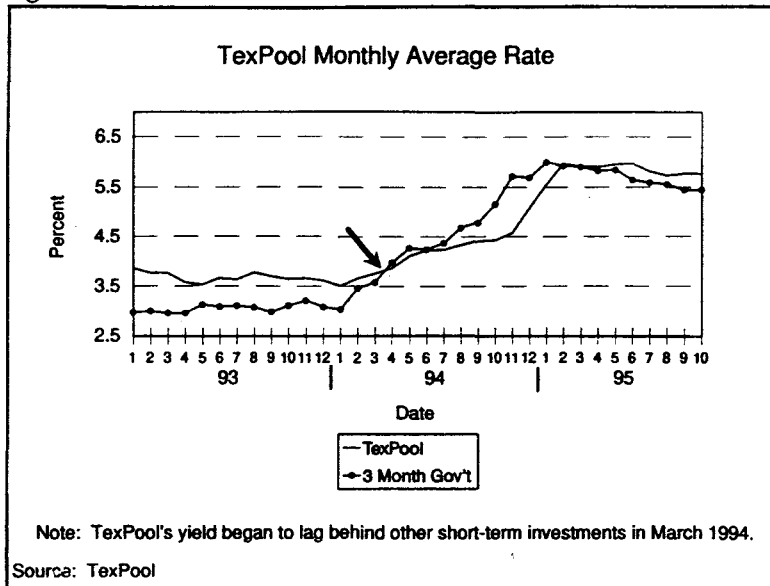
In February 1994, TexPool's balance was over \$10 billion, of which about \$2 billion consisted of securities with remaining maturities of 18 months or longer. The bulk of the portfolio was invested in overnight and other short-term securities, so TexPool did not face an immediate liquidity problem. (See Figure 1 on the preceding page.)

However, the decision to hold the longer-term securities to maturity locked approximately \$2 billion of TexPool's balance into securities that were earning relatively low yields and did not free up cash to purchase new investments at the

higher yields that became available in the market once interest rates started to rise. As a result, TexPool's yield started to lag behind other short-term investments (see Figure 2), and participants originally attracted by TexPool's higher yields began leaving TexPool for more favorable investment opportunities.

In April 1994, due to the devaluation of the longer-term securities, TexPool's net asset value per share dropped below \$0.995. This is a critical margin of safety for a regulated money market fund. When a "constant dollar objective" fund drops below this level, it is known as "busting the buck." Regulated money market funds are required to have

Figure 2

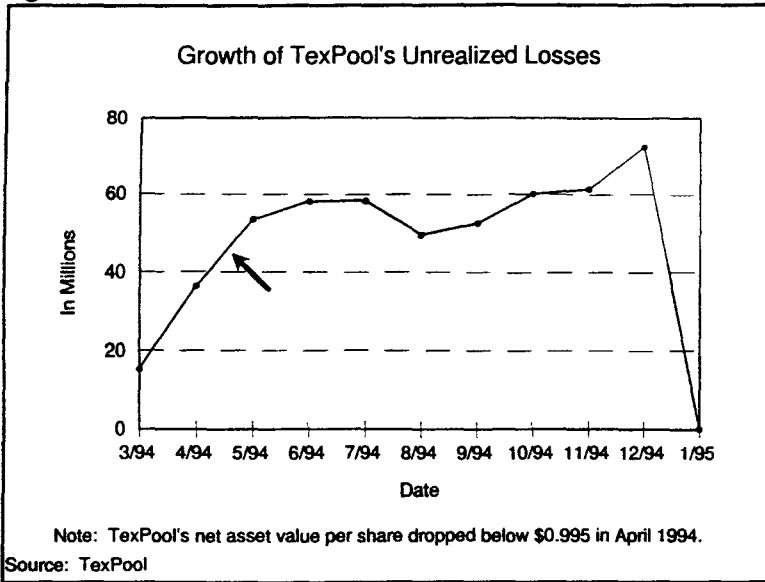


written policies describing the corrective action to be taken when this threshold is reached. TexPool was not subject to these regulations and did not implement a corrective action plan to stabilize the value of the fund.

No later than April 1994 when TexPool's net asset value per share dropped below \$0.995, TexPool administrators should have taken corrective action to stabilize the value of the fund. Examples of appropriate corrective action include:

- Selling as many of the devalued securities as necessary to restore the fund's net asset value per share to \$1.00, and prorating resulting losses among participants
- Establishing a reserve fund out of interest earnings or implementing another appropriate contingency plan to equitably prorate losses among participants in the event it subsequently became necessary to sell the devalued securities at a loss to meet cash obligations

Figure 3

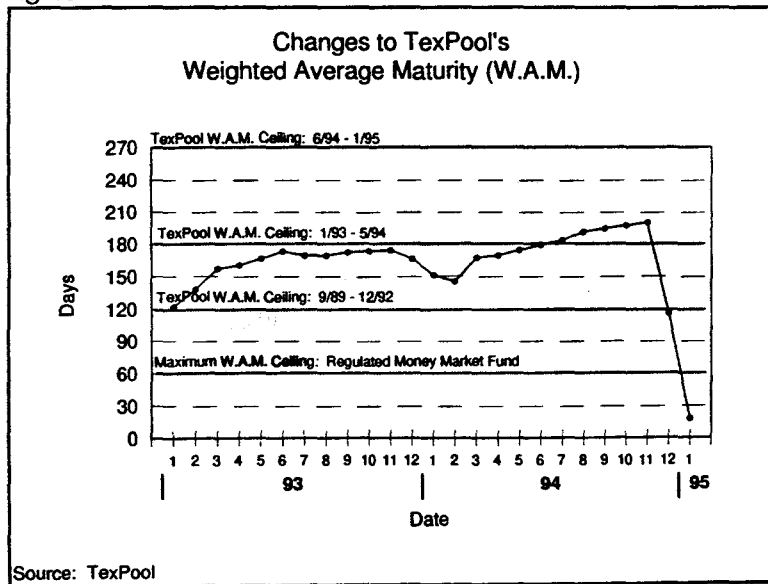


Either of these options would have ensured the safety and stability of TexPool and would have resulted in an equitable distribution of losses as required by the Participation Agreement. If TexPool administrators had taken corrective action to restore the fund's net asset value per share to \$1.00 when TexPool "busted the buck" in April 1994, the losses distributed to participants would have been approximately \$46 million. (See Figure 3.)

Raising the Ceiling on Weighted Average Maturity from 180 Days to 270 Days

Due to further interest rate hikes and continuing withdrawals, by June 1994, TexPool had experienced a \$58 million decline in the market value of its portfolio, and its net asset value per share had dropped to \$0.992. TexPool continued to retain the longer-term securities in its portfolio, while at the same time its short-term investments were being depleted to satisfy participant withdrawals. As TexPool's fund balance declined, the relative percentage of longer-term securities in the portfolio continued to increase, which caused a corresponding rise in the weighted average maturity of TexPool's portfolio. As a result, during May 1994, TexPool's weighted average maturity exceeded the 180-day ceiling established by the Participation Agreement.

Figure 4

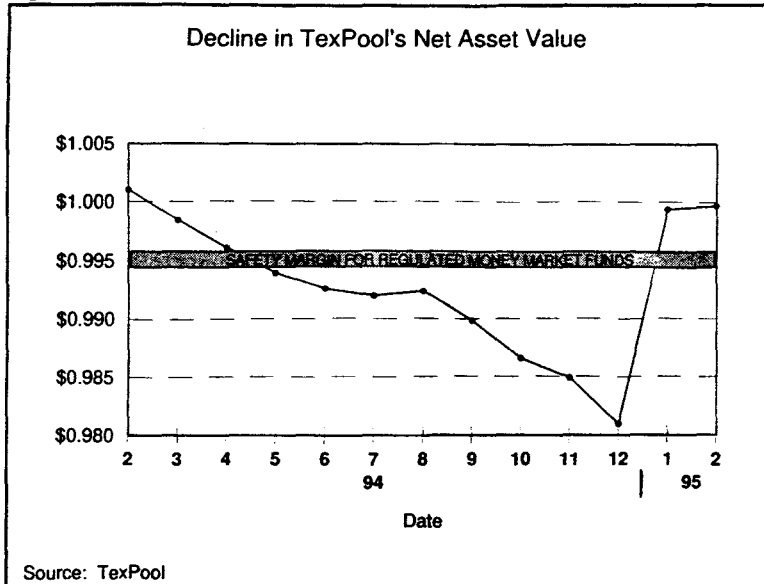


Instead of selling enough longer-term securities to stay under the 180-day ceiling on weighted average maturity, TexPool administrators raised the ceiling from 180 days to 270 days. (See Figure 4.)

As noted above, the ceiling on weighted average maturity is an important control to ensure that a money market fund operates safely and maintains sufficient liquidity to meet its obligations. Raising the ceiling to 270 days, which is three times higher than that permitted for a regulated money market fund, further weakened this safety feature and

allowed TexPool administrators to further postpone taking corrective action to stabilize the value of the fund.

Figure 5



TexPool continued to allow participants to withdraw their investments at \$1.00 per share, even though the net asset value of the fund was continuing to decline. (See Figure 5.) This had the effect of shifting the potential loss to participants remaining in TexPool. Because participants could withdraw their full investment without taking any loss and could immediately reinvest elsewhere at more favorable yields, there was no economic incentive to remain in TexPool. In fact, because the fund was not guaranteed, it was apparent that if TexPool's balance continued to decline and it became necessary to sell the devalued securities at a loss,

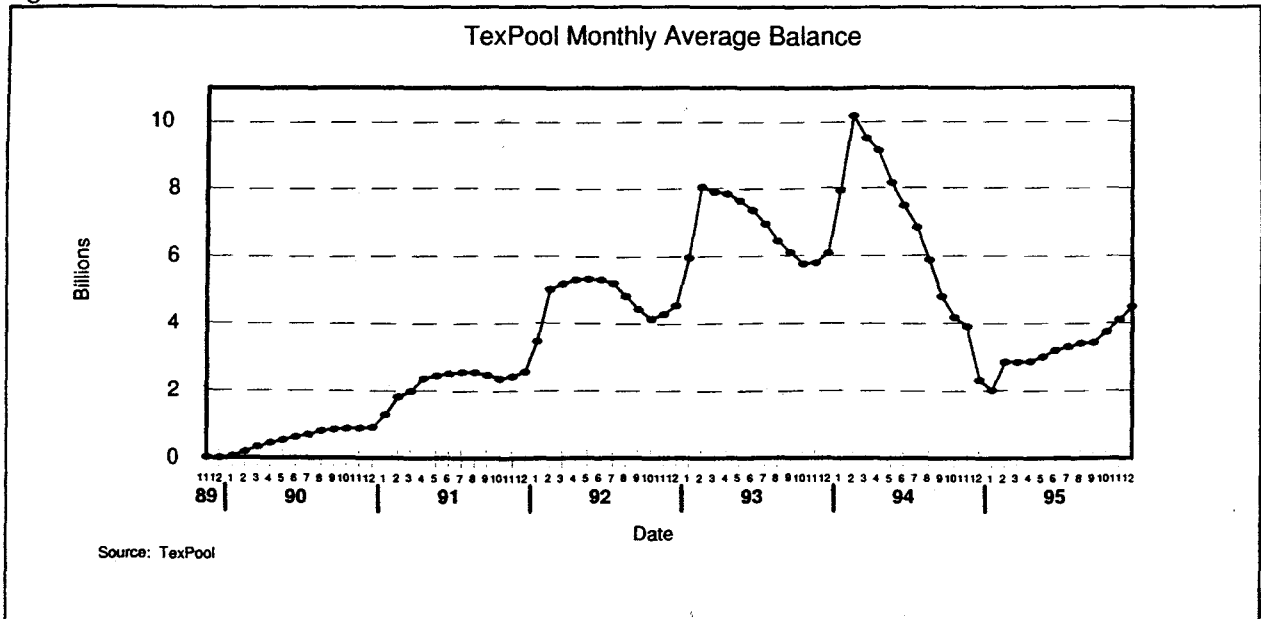
those participants remaining in TexPool risked having to absorb a disproportionate share of the loss.

By not taking action to stabilize the value of the fund while continuing to allow participants to withdraw their investments at \$1.00 per share, TexPool administrators created a powerful incentive for participants to withdraw their funds from TexPool. In this way, the management decisions of TexPool administrators contributed to TexPool's growing liquidity problem.

The Run on Texpool

Throughout the summer and fall of 1994, TexPool's balance continued to decline sharply. Although TexPool historically experienced regular and predictable declines in its balance over the calendar year as local governments spent their tax revenues, the decline in 1994 was much steeper than the historical pattern. This should have alerted TexPool administrators that the attempt to hold the devalued securities to maturity was becoming increasingly risky and that a liquidity crisis was a growing possibility. (See Figure 6.)

Figure 6

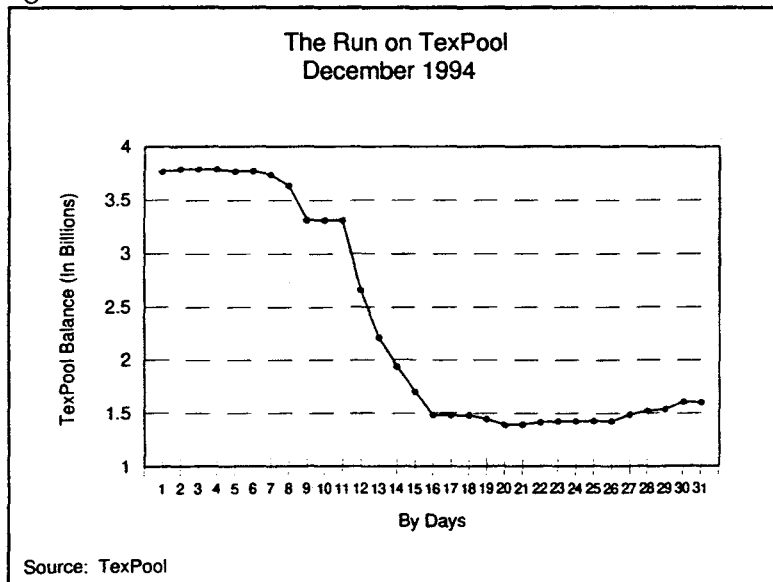


By December 1, 1994, TexPool had experienced a \$72.4 million decline in the market value of its portfolio, its net asset value per share had dropped to \$0.981, and its balance had fallen to \$3.7 billion. Of this amount, over \$2 billion consisted of devalued securities that could only be sold at a loss. At this point, the composition of TexPool's portfolio no longer bore any resemblance to a short-term liquidity fund.

On December 9, 1994, the *Wall Street Journal* published an article stating that TexPool was running some of the same types of risks as Orange County, California.

The article was not accurate insofar as it implied that TexPool's problems were comparable to those of Orange County. TexPool's portfolio consisted of government securities and only two percent of the portfolio was invested in derivatives. Furthermore, TexPool was not engaged in the high-risk leveraging techniques employed by Orange County. However, the article accurately described TexPool's unrealized losses and potential liquidity problems. Given TexPool's precarious condition, the article served as the catalyst for a "run" on TexPool. (See Figure 7.)

Figure 7



Although investor nervousness over the Orange County debacle and the *Wall Street Journal* article contributed to TexPool's problems, the management decisions of TexPool administrators were contributing factors as well. From April through December 1994, TexPool operated outside of safety margins established for regulated money market funds. By not taking timely corrective action to stabilize the value of the fund while simultaneously allowing participants to withdraw their original investments in full, TexPool administrators took inappropriate risks for a fund premised upon principles of safety and liquidity.

TexPool administrators stated that, except for the *Wall Street Journal* article, TexPool would have avoided a liquidity crisis and the condition of the fund would have significantly improved during the first quarter of 1995, which is the period of the year when local governments historically deposit a substantial amount of tax revenues in TexPool.

However, TexPool's balance had not followed historical patterns since early 1994, when TexPool's yield began to lag behind other short-term investments. Historically, TexPool's balance would begin to trend upward in November of each year, but that did not occur in 1994. (See Figure 6.) Further, it is questionable whether local governments would have returned substantial amounts of cash to TexPool as long as TexPool was offering below-market yields. TexPool could not offer competitive yields until the devalued securities that were depressing the fund's net asset value were out of its portfolio either by sale or maturation. TexPool's yield did not become competitive again until the Treasury purchased virtually all of TexPool's devalued securities.

Using State Funds to Purchase TexPool's Securities at Book Value Rather than Market Value

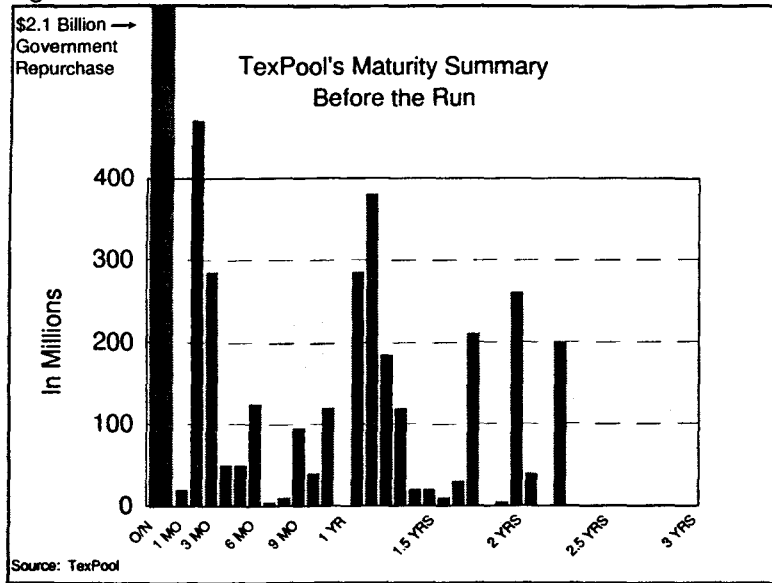
On the day the *Wall Street Journal* article appeared, the State Treasurer tried to reassure TexPool participants by issuing a press release containing the following statement:

"I want to assure our investors, our TexPool participants, which are really the people of this state, that TexPool will be open on Monday morning doing business. Their money is entirely safe. Every dollar invested will be returned to them should they choose to withdraw it. TexPool will abide by the letter and spirit of its agreement with its participants.

This can be accomplished by the Treasury purchasing securities from TexPool thereby providing cash for TexPool."

TexPool administrators stated they initially believed the announcement that the Treasury would stand behind TexPool would be sufficient, in and of itself, to calm nervous investors and forestall a run on the fund. However, this did not prove to be the case.

Figure 8



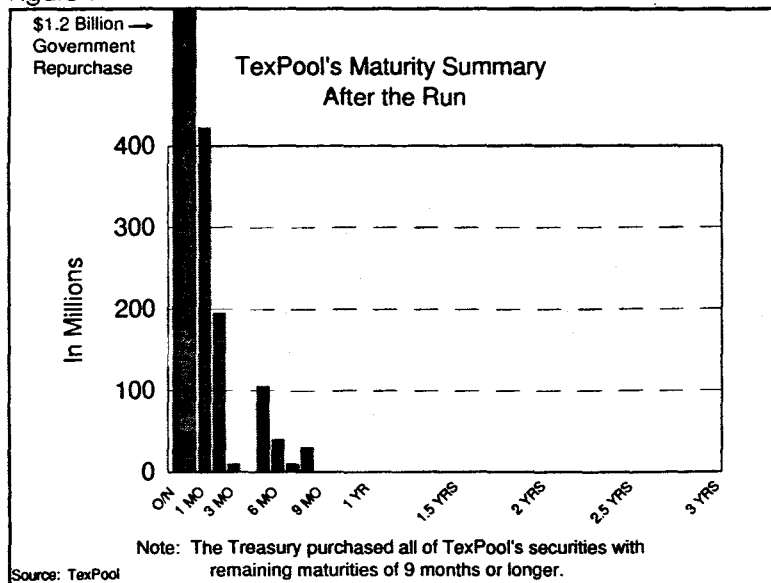
Between December 9 and December 16, 1994, participants withdrew approximately \$2.2 billion from TexPool. In order for TexPool to obtain the cash it needed to meet withdrawal demands, the Treasury purchased approximately \$2.2 billion of TexPool's devalued securities at book value rather than market value. (Figures 8 and 9 show the composition of TexPool's portfolio before and after the State's intervention.)

The Treasury's purchase of TexPool's securities involved the following sequence of transactions:

- (1) The Treasury initially generated cash to purchase TexPool's securities by selling approximately \$1.1 billion of securities from its own portfolio. Because the market value of these securities was lower than the book value, the Treasury lost \$22.2 million on these transactions. The Treasury used the \$1.1 billion in cash to purchase TexPool's devalued securities at book value rather than market value.

- (2) As the run progressed, TexPool needed more cash to meet withdrawal demands. To provide TexPool with additional cash, the Treasury purchased more of TexPool's devalued securities at book value rather than market value. The Treasury generated cash to purchase the additional TexPool securities by selling approximately \$1.26 billion of securities that it had just purchased from TexPool. Although the Treasury purchased these securities from TexPool at book value, they were immediately sold at market value for a loss of \$32.9 million.

Figure 9



The Treasury bought TexPool's devalued securities at book value for \$2,252,846,953, although the market value of the securities was \$2,178,176,700. Thus, the Treasury paid TexPool \$74.7 million more than its securities were worth. In this manner, TexPool's losses were transferred to the Treasury.

The TexPool Bailout Contravened the Terms of the Participation Agreement

The TexPool Participation Agreement specifically provides that all losses on investments shall be allocated on a *pro rata* basis among TexPool participants and that neither the Treasurer nor the Texas Treasury Safekeeping Trust Company shall be liable for losses on TexPool's investments.

In the press release of December 9, 1994, the Treasurer stated that "TexPool will abide by the letter and spirit of its agreement with its participants." Obviously, this did not occur. The bailout of TexPool directly contravened the provisions of the Participation Agreement.

Every investment carries the risk of loss. Generally speaking, a higher rate of return on investments carries a higher risk of loss. Until interest rates began to rise, TexPool participants benefited from the higher rates of return associated with TexPool's aggressive investment strategy. TexPool participants were able to reap above-market yields when the fund was strong, yet were able to leave for more favorable investment opportunities without having to absorb any of the losses resulting from TexPool's investment strategy. TexPool became, in effect, a risk-free investment for participants because the Treasury absorbed the losses on their behalf and thus constructively guaranteed TexPool.

It is also noteworthy that, despite substantial unrealized losses in the portfolio, TexPool continued to make full interest payments to participants. From the time TexPool's net asset value per share fell below \$0.995 in April 1994 until the commencement of the run in December 1994, TexPool paid out over \$168 million in interest payments to participants.

Even as late as December 9, 1994, TexPool administrators had options available which, while problematical, could have averted a state bailout of the fund. For example, if TexPool participants had been presented with the option of either taking a loss on their investments or leaving their funds in TexPool, it is possible that a substantial number of participants would have decided to remain in the fund.

However, even in a "worst-case scenario" where all remaining participants withdrew their funds from TexPool at a loss, each would have received almost 98 cents for every dollar invested, plus interest payments previously received. In addition, at the time of the run, most TexPool participants were entering the peak period for the collection of tax revenues and should not have been facing any immediate cash shortfall. Therefore,

concerns voiced by Treasury officials that local governments would have experienced major disruptions in schools, police and fire protection, and debt service unless the State intervened appear exaggerated.

Calculating the Cost to the State of the TexPool Bailout

Shortly after the TexPool bailout, the Treasury estimated the loss to the State resulting from the purchase of TexPool's securities to be approximately \$55 million. This estimate included the \$22.2 million in losses realized when the Treasury's securities were sold at a loss in order to generate cash to purchase TexPool's securities, and another \$32.9 million in losses realized when the Treasury immediately sold \$1.26 billion of the securities purchased from TexPool in order to generate cash to purchase additional TexPool securities.

The \$55 million in realized losses resulting from the sale of securities understates the actual cost to the State of the TexPool bailout. Based on our review, we calculate that the bailout of TexPool actually cost the State at least \$97 million.

As noted earlier, from December 9 through December 16, 1994, the Treasury spent \$2.253 billion to purchase TexPool's securities. To generate part of the cash needed to purchase the securities, the Treasury sold \$1.1 billion of securities from its own portfolio at a loss of \$22.2 million. We include this amount in our calculation of the cost to the State.

The \$2.253 billion was spent by the Treasury to purchase TexPool's securities at book value. These exact same securities could have been purchased on the open market for \$2.178 billion. Thus, the Treasury paid \$74.7 million more for TexPool's securities than they were worth. Part of this amount immediately became a realized loss when the Treasury sold \$1.26 billion of the securities purchased from TexPool at a loss of \$32.9 million. However, the full \$74.7 million should be considered as an actual cost to the State.

When the \$74.7 million is added to the \$22.2 million in realized losses resulting from the sale of the State's investments, we calculate that the bailout of TexPool actually cost the State approximately \$97 million, plus interest that could have been earned on this amount.

Put in the simplest terms, if the bailout of TexPool had not taken place, there would be at least \$97 million more in the Treasury.

Under current governmental accounting standards, the full cost of the TexPool bailout will never appear on a ledger sheet. Current standards only require gains or losses to be recorded when securities are *sold*, and do not address a situation where securities are *purchased* for a price above market value. It appears that the standards do not include an accounting mechanism for such a transaction because it is assumed that no governmental entity would intentionally purchase securities for a price above market value. In light of what occurred in this case, we will be forwarding this report to the

Governmental Accounting Standards Board in order that they may consider whether revisions to the accounting standards are warranted.

Legal Issues Relating to the Transactions

The Attorney General has determined that the Treasury's use of state funds to purchase TexPool's securities for a price above market value was not authorized by law. (See Appendix 2.)

Corrective Action by the Legislature

The 74th Texas Legislature amended the Public Funds Investment Act to strengthen controls over public funds investment pools, including TexPool. As amended, the law now requires that:

- TexPool must sell securities to stabilize the value of the fund if the net asset value per share drops below \$0.995.
- TexPool must maintain a rating no lower than AAA or AAAM, or an equivalent rating, by a nationally recognized rating service. In order to maintain this rating, Standard & Poor's Managed Funds Group currently requires a ceiling on weighted average maturity that does not exceed 60 days.
- The TexPool Advisory Board must be composed equally of TexPool participants and other persons who do not have a business relationship with TexPool. A board member must also be qualified to advise TexPool.

These amendments now require TexPool to observe safety guidelines that are as stringent as those required for a regulated money market fund.

The Legislature also amended the Public Funds Investment Act to expressly prohibit the Treasury from purchasing securities for a price above market value.

The Treasury is implementing the controls mandated by the Legislature.

Objectives, Scope, and Methodology

Objectives

The objectives of this review are as specified by Texas Government Code, § 321.0132, which directs the State Auditor to determine:

whether the audited entity has obligated, expended, received, and used state funds in accordance with the purpose for which those funds have been appropriated or otherwise authorized by law;

and,

whether money or negotiable securities or similar assets handled by the audited entity on behalf of the state or received from the state and held in trust by the audited entity have been properly and legally administered.

Scope

The scope of this review included:

- Analyzing the circumstances leading to TexPool's liquidity crisis and the State's bailout of the fund
- Seeking resolution of legal questions concerning the Treasury's use of state funds to purchase TexPool's securities for a price above market value

Scope Limitation

The scope of our review was limited by the following:

Treasury officials did not cooperate with our efforts to seek resolution of the legal questions presented by the TexPool bailout. Requested documents were not provided and the Treasury asserted the attorney-client privilege to preclude discussion of the legal issues raised by these transactions with the Attorney General's Office.

The Treasury's lack of cooperation significantly hampered our efforts to obtain relevant information concerning the TexPool bailout.

Methodology

Information reviewed to accomplish our objectives included the following:

- State laws relating to the powers and duties of the State Treasurer
- Authorizing legislation for TexPool and various documents relating to the establishment of TexPool, including disclosure instruments and Participation Agreements
- TexPool portfolio asset summaries and other performance information
- TexPool Advisory Board minutes
- Federal laws pertaining to regulated money market funds

In addition, we conducted interviews with current and former TexPool administrators and other state officials. We also reviewed literature and audit reports relating to the operation of TexPool and other public funds investment pools.

Opinion of the Attorney General



COPY

Office of the Attorney General State of Texas

DAN MORALES
ATTORNEY GENERAL

February 20, 1996

Ms. Rita Horwitz
Executive Director
State Pension Review Board
P.O. Box 13498
Austin, Texas 78711-3498

Letter Opinion No. 96-013

Re: Whether the state treasury is prohibited by statute or constitutional provision from purchasing any security priced above market value and whether the state is prohibited from guaranteeing the investments of other governmental subdivisions (ID# 30971)

Dear Ms. Horwitz:

You ask whether "the state Treasury is prohibited by statute or constitutional provision from . . . [purchasing] any security priced above market value" and whether "there is any legal provision that enjoins the state from guaranteeing the investments of other governmental subdivisions." The state auditor has also expressed an interest in these questions.¹

Your questions arise from events involving the Texas Local Government Investment Pool ("TexPool") in December 1994, and our answers will be limited to the state treasurer's actions with respect to TexPool securities at that time. TexPool is a public funds investment pool for local governments established by the Texas Treasury Safekeeping Trust Company (the "trust company"). The state treasurer is authorized to establish the trust company by chapter 404, subchapter G of the Government Code² "to obtain direct access to services provided by the Federal Reserve System and to enable the treasurer to manage, disburse, transfer, safekeep, and invest funds and securities more efficiently and economically." Gov't Code § 404.102(a). Although the trust company may not engage in commercial banking activity, *see id.* § 404.102(b), the trust company may

receive, transfer, and disburse money and securities as provided by statute or belonging to the state, agencies and local political subdivisions of the state, and nonprofit corporations, foundations, and other charitable organizations created on behalf of the state or an

¹This office has requested the state treasurer to provide a brief regarding the legal issues raised by this request. To date, we have not received a brief from the state treasurer.

²All references to the Government Code are to provisions in effect in December 1994.

Ms. Rita Horwitz - Page 2 (LO96-013)

agency or local political subdivision of the state in a manner that qualifies the trust company for federal reserve services.

Id. § 404.103(a); *see also id.* § 404.106(b) (investment of trust company funds). The state treasurer is the sole officer, director, and shareholder of the trust company; the state treasury manages the trust company. *Id.* § 404.104(a). TexPool is a distinct trust fund held outside the state treasury. TexPool Participation Agreement art. II, § 2.02. The state treasurer serves as a trustee of the fund. *Id.*

In December 1994, there was concern nationwide regarding the integrity of public investments as a result of investment losses in a pooled fund managed by Orange County, California. A number of TexPool participants withdrew their funds in what was referred to as a "run" on the pool. In response, the state treasurer used funds in the state treasury to purchase securities in TexPool's portfolio at a price above market value. We understand that in order to generate cash to do so, the state treasurer sold securities from the state treasury's portfolio at a loss.

With respect to your first question, it has been suggested that the state treasurer's use of funds in the state treasury to purchase TexPool securities at a price above market value was improper for the following reasons: first, that it was inconsistent with the state treasurer's duty to invest funds held in the state treasury; and second, that the state treasurer's actions constituted an unauthorized withdrawal from the state treasury contrary to the Texas Constitution. We examine these two contentions in turn.

The state treasurer's authority with respect to funds in the state treasury is governed by chapter 404 of the Government Code. The state treasurer is the trustee of funds in the state treasury. Gov't Code § 404.041. Generally, subchapter C of chapter 404, sections 404.021 through 404.027, authorizes the state treasurer to deposit or invest funds in the state treasury. Section 404.024 provides that state funds not deposited in state depositories shall be invested by the state treasurer in certain statutorily authorized investments. *See id.* § 404.024(b); *see also id.* § 404.0245 (authorizing investment of state funds in certain futures contracts).³

Chapter 404 of the Government Code does not define the terms "invest" and "investment." We construe them according to their common meaning. *Id.* § 311.011(a) (rule of code construction). To "invest" means to loan or place money "so that it may produce revenue or income"; an "investment" is the "placing of capital . . . in a way intended to secure income or profit from its employment." BLACK'S LAW DICTIONARY

³Other provisions of chapter 404 of the Government Code authorize the state treasurer to engage in other transactions for limited purposes and are not applicable here. *See, e.g.,* Gov't Code §§ 404.024(k) (now Gov't Code § 404.024(i)) (authorizing state treasurer to purchase commercial paper in certain circumstances), .027 (providing that state treasurer may enter into certain credit agreements), .121 - .126 (providing for issuance of tax and revenue notes in case of cash shortfall).

960 (rev. 4th ed. 1968). Section 404.024(b) authorizes the state treasurer to invest funds in the state treasury in certain securities. Ordinarily, the purchase of authorized securities would constitute an investment. The state treasurer's use of funds in the state treasury to purchase TexPool securities at a price above market value under these circumstances, however, does not appear to have been undertaken for investment purposes, but for the purpose of preventing losses to TexPool. We have not been able to locate a statute which permits the state treasurer to use unappropriated funds in the state treasury for a purpose other than those delineated in chapter 404. We conclude that the state treasurer's decision to use funds in the state treasury to purchase TexPool securities at a price above market value was inconsistent with the state treasurer's authority with respect to funds held in the state treasury.

We next consider whether the use of funds in the state treasury to purchase TexPool's securities at above market value constituted the withdrawal of funds from the state treasury in the absence of a legislative appropriation. Article VIII, section 6 of the Texas Constitution provides in part: "No money shall be drawn from the Treasury but in pursuance of specific appropriations made by law"

When the state treasury bought TexPool securities at a premium above market value for the purpose of preventing losses to TexPool, there was a transfer of state funds to TexPool in the amount of the premium. As we have already stated, TexPool is held outside of the state treasury. Pursuant to article VIII, section 6 of the Texas Constitution, funds may be drawn from the state treasury only pursuant to an appropriation enacted by the legislature.⁴ Even in a situation in which funds were erroneously deposited in the state treasury, the funds could not then be withdrawn from the state treasury in the absence of a legislative appropriation. *Manion v. Lockhart*, 114 S.W.2d 216, 219 (Tex. 1938); Attorney General Opinions C-742 (1966), O-44 (1939). We conclude that the transfer of funds to TexPool in excess of the market price of the securities constituted the withdrawal of funds from the state treasury without an appropriation, in violation of article VIII, section 6 of the Texas Constitution.

Moreover, we question whether the legislature would have had authority to appropriate funds to TexPool for the purpose of preventing losses to its investors. Article III, section 44 of the Texas Constitution provides that the legislature shall not "grant, by appropriation or otherwise, any amount of money out of the Treasury of the State, to any individual, on a claim, real or pretended, when the same shall not have been provided for by pre-existing law." See *Austin Nat'l Bank v. Sheppard*, 71 S.W.2d 242 (Tex. 1934); Attorney General Opinion JM-1181 (1990). As we will discuss below in connection with section 404.103(b) of the Government Code and the TexPool Participation Agreement, the state had not guaranteed the trust company's obligations to TexPool. Accordingly, we

⁴A constitutional provision may of course appropriate funds. See Tex. Const. art. VII, § 17.

find no pre-existing law that would have supported a legislative appropriation to cover losses to TexPool investors.

You also ask whether any law prevented the state from guaranteeing the investments of political subdivisions in TexPool. Section 404.103(b) of the Government Code, which authorizes the trust company to enter into contracts and trust agreements with the state treasurer, the Federal Reserve System, and other third parties, provides as follows:

The trust company shall be liable under those contracts in accordance with the terms contained in the contracts. Notwithstanding any other statute to the contrary, to the extent permitted by the Texas Constitution and the contracts, trust agreements, or other fiduciary instruments between the trust company and the Federal Reserve System, the trust company's obligations shall be guaranteed by the state [Emphasis added.]

Thus, the terms of the contracts control the liability of the trust company to other parties. The TexPool Participation Agreement provides that all earnings and losses on investments shall be allocated on a pro rata basis among TexPool participants. TexPool Participation Agreement art. IV, § 4.03; *see also id.* art. VII, § 7.02 (“[N]either the Treasurer nor the Trust Company shall be liable for any losses from investments and transfers made in accordance with the procedures set forth in this Participation Agreement.”). Accordingly, pursuant to the TexPool Participation Agreement in effect in December, 1994, the trust company's obligations to TexPool participants were not guaranteed by the state. Thus, we conclude that section 404.103(b) of the Government Code together with the TexPool Participation Agreement prevented the state from guaranteeing the investments of political subdivisions in TexPool.

Finally, we close with the following observations in order to provide a framework for these conclusions. First, the office of the state treasurer will cease to exist effective September 1, 1996. Moreover, when the legislature met in January 1995, it was fully aware of the actions taken by the state treasurer in December 1994 with respect to TexPool and the context in which those actions were taken. The legislature responded by passing House Bill 2459, which significantly changed and restricted the way in which public funds in Texas may be invested. *See* Act of May 18, 1995, 74th Leg., R.S., ch. 402, § 1, 1995 Tex. Sess. Law Serv. 2958, 2958-69 (amending Public Funds Investment Act) (effective September 1, 1995).

Ms. Rita Horwitz - Page 5

(LO96-013)

S U M M A R Y

The state treasurer's use of funds in the state treasury in December 1994 to purchase TexPool funds at a price above market value was not authorized by law.

Yours very truly,



Susan L. Garrison
Assistant Attorney General
Opinion Committee

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Management's Responses from the Office of the State Treasurer



A RESPONSE TO THE STATE AUDITOR'S REPORT REGARDING THE MANAGEMENT OF TEXPOOL

MARCH 1996

Currently, over 1,400 local government entities enjoy the safety, liquidity and competitive yield of the TexPool program. As of February 13, 1996, the balance in TexPool was \$7.121 billion.

While the Treasury appreciates the opportunity to comment on this report, we feel strongly that the report is misleading and replete with inaccuracies and incorrect assumptions. We disagree with the report for several reasons.

KEY AREAS OF DISAGREEMENT

- As we have contended consistently since December 1994, the realized loss to the State of Texas was \$55 million, not the inflated figure of \$97 million. Any other number put forward is merely a "guesstimate."
- When it was created by the Texas Legislature, TexPool was not intended to operate as a money market fund. It is misleading to compare TexPool to a money market fund. The assumptions underlying the entire Auditor's report are incorrect.
- The auditor's ability to play Monday morning quarterback far exceeds the Treasury's ability to play fortune teller to predict the future. The Federal Reserve raised interest rates 6 times in 1994, a phenomenon most analysts, economists, and portfolio managers in the country could not have predicted.
- Given the nature of the crisis, the policy decision to protect schools, cities, and counties from financial straits was a sound one.
- The crisis of December 1994 was unique. However, based on the information we had at the time, including the legal advice of the Attorney General, we would have taken the same actions today to protect local governments.
- The Attorney General's opinion is legally incorrect and suspiciously tardy.

CONTACT:
Michael D. Doyle,
Deputy Treasurer
Texas State Treasury
200 E. 10th Street
Austin, TX 78701-2436

CALCULATING THE LOSS

The statement that the cost was "at least \$97 million" is inaccurate and misleading for several reasons.

The most notable is that it contradicts the findings of earlier work performed by the State Auditor's Office relating to the same issue which concluded that the total loss of revenue was less than \$57 million. The report recognizes, as we have always stated, that the actual realized loss is \$55 million.

Clearly, the report purposely confuses the difference between the actual "loss" and the auditor's unsubstantiated "guesstimate" at quantifying the "cost." The difference in the actual loss and the cost now estimated by the auditor is the unrealized or paper loss assumed by the Treasury when it purchased TexPool securities at the price that TexPool paid for them.

The intention was, and still is, to hold those securities to maturity, meaning they will never become realized losses. In fact, of those securities purchased, the Treasury has regained \$40 million of the auditor's estimated "cost" and earned \$50 million in interest for the State of Texas.

The actual recorded loss to the State of Texas is \$55 million and is correctly shown on the accounting records of the State, as substantiated by the State Auditor's report. Furthermore, the State Auditor recognizes that the only recordable loss under the current Governmental Accounting Standards is \$55 million. The auditor identifies no additional losses in his report.

When the "run" on TexPool occurred in December 1994, the Treasury purchased and held \$1.1 billion of securities from TexPool. The Treasury purchased these securities at the price that TexPool paid for the securities. We recognize that additional interest income could have been earned had we purchased other securities. Some of these securities have matured at full value, a few have been sold at a gain to the state while others remain as Treasury investments.

The TexPool securities still held by the Treasury will be allowed to mature at full value or may be sold at gains if market conditions warrant.

For example, the Treasury purchased a U.S. Treasury Note from TexPool on December 13, 1994 and paid TexPool \$19,975,188 for the security. On January 31, 1996 the Note matured and the State received \$20,000,000 which was \$24,812 more than the cost to the Treasury. In addition, the Treasury received interest on the Note. Using the State Auditor's methodology, they would claim that the Treasury lost \$687,688 on this security because at the time the Treasury purchased the security from TexPool the market value of the security was \$19,287,500. This type of logic is faulty and misleading because the market value of securities changes each day as interest rates fluctuate. The financial industry clearly recognizes these day-to-day fluctuations in the prices of securities as unrealized gains or losses (or commonly called paper gains and losses). It is industry practice to recognize gains and losses when securities are sold and not before. It's analogous to the daily increases and decreases in the prices of individual stocks.

Either the auditor does not understand the securities market or the report attempts to mislead the reader.

TEXPOOL NOT ESTABLISHED AS MONEY MARKET FUND

We vehemently disagree with the conclusion on page one that:

“ . . . TexPool was established to function in the same manner as a money market fund.”

When the Texas Legislature authorized the creation of TexPool in 1989, it had a weighted average maturity (WAM) of 120 days and a maximum maturity on security purchases of three years. Both exceed money market requirements of 90 days and thirteen months, respectively. The State Auditor's Office is required by law to audit the Texas Treasury Safekeeping Trust Company which includes TexPool. If the State Auditor's Office was concerned with the pool, then, in their audits on the Trust Company, those concerns could have been addressed at any point after 1989. The State Auditor's Office cannot deny that they were aware of the pool guidelines.

TexPool is compared to a regulated money market account throughout the report. Statements like the one on page nine: *“At this point, TexPool's portfolio was so illiquid that it no longer bore any resemblance to a short-term liquidity fund”* — essentially compare apples to oranges. Actually the auditor's report is contradictory in that it concedes on page three that: *“public funds investment pools such as TexPool are not subject to federal regulation which govern private money market funds.”*

Clearly, the Securities and Exchange Commission recognizes that TexPool is not a money market fund and their rules and regulations do not apply to TexPool. It was not created as a money market fund; it was created as an investment pool and still is an investment pool.

The management decisions of the TexPool administrators regarding the changes in the WAM of the pool or the decision not to sell securities when the net asset value dropped below 99.5 did not violate any investment policy, statute or law, or the Public Funds Investment Act. To suggest this is the case is misleading.

As participants began to withdraw funds in the Spring of 1994, the maximum WAM was extended from six months to nine months by the TexPool Advisory Board. The reason for extending the WAM was not to purchase longer maturity investments, but to stay in the range allowed by the investment policy.

PLAYING "MONDAY MORNING QUARTERBACK"

Admittedly, the auditor's ability to play Monday morning quarterback far exceeds the Treasury's ability to play fortune teller to predict the future.

It's like the old saying, "If only I knew then, what I know now . . ." If we had known how the markets would perform in 1994, we might have planned our strategy differently. Unfortunately, our crystal ball was as murky as everyone else's in the country.

Since 1927, the United States has not seen the kind of interest rate surge we saw in 1994. It proved to be the worst year on record for the bond market. TexPool, like all other short term fixed income portfolios, suffered market (unrealized) losses as a result of the rapid rise in interest rates. Experts estimate that worldwide unrealized losses in fixed income portfolios could have run as high as \$1.5 trillion.

The auditor criticizes the Treasury's decision not to sell securities at losses during the summer of 1994, instead holding them to maturity. If we knew then what we know now, arguably we could have sold the securities and taken the losses during that summer. However, we believed the losses could have been avoided altogether by holding the securities. That was a reasonable and prudent decision based on the best information we had at the time.

- ★ "The *Wall Street Journal* is behaving like a journalist who causes an accident, writes about it, then requests a raise for having beaten the competition to the story. The *Journal*, having sparked the panic, now settles back to cover the story. It's not a proud moment for American's leading financial daily."
— Dallas Morning News
(12/19/94)
- ★ "Treasurer Whitehead is right to protect investors."
— Dallas Morning News
(12/19/94)
- ★ "But what scared Texas' local government officials was an irresponsible Dec. 9 story in the *Wall Street Journal*..."
— Houston Post
(12/21/94)
- ★ "Comparisons to Orange County's investment failures are ridiculous."
— Wichita Falls Times-Record
(12/14/94)

BUY AND HOLD STRATEGY

Our decision to hold these securities was based on the assumption that TexPool's balance would follow historical patterns and TexPool would be able to maintain sufficient cash and short term investments in the portfolio to meet projected liquidity needs. A year and a half later, because of the events subsequent to December 9, 1994, we know that this was not the case. **However, based on the information at the time, the State Auditor's Office agreed with our position.** In a quote given to *The Bond Buyer* in the December 9, 1994 edition, First Assistant Auditor Sharon Cobb agreed with our policy to hold our investments until maturity (see box at right).

TexPool maintained over \$647 million in cash before the *Wall Street Journal* articles appeared in December 1994. The balance in the fund was beginning to increase as it always does at that point in the cycle. Contrary to the auditor's report, TexPool endured withdrawals and had begun to grow again as the pool had in previous years (see chart below). The report states that: "It is questionable whether local governments would have returned substantial amounts of cash to TexPool as long as TexPool was offering below market yields." This is a hypothesis for which we will never know the answer.

However, the balance today in TexPool is \$7.1 billion, up from the low of \$1.3 billion in December 1994.

Page six of the report states that some securities should have been sold in April at a loss, effectively turning unrealized losses into actual losses. This conclusion, however, appears easy to reach, knowing that the Federal Reserve raised interest rates five more times. At the time, TexPool maintained over \$6 billion in cash and no one predicted how the federal government would react to an uncertain market. The market could have rebounded and the absorption of losses would have been an unnecessary mistake.

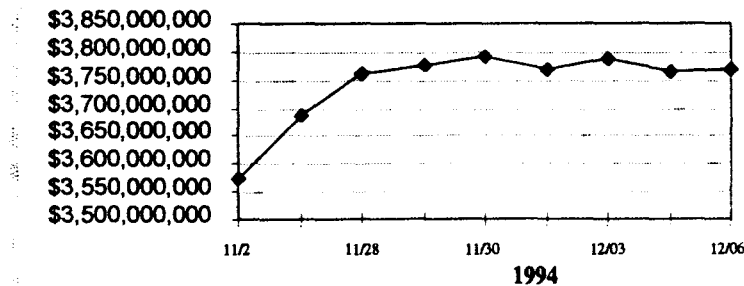
"There is a paper loss, but they haven't sold them and they won't have to." Cobb said. *"There is a difference between Orange County and Odessa where they had to do some selling and you have actual losses."*

Cobb said that she didn't have specific figures on the losses but she believes the fund has enough liquidity.

"We think we have enough liquidity to weather the current market," she said.

— Sharon Cobb, First Assistant Auditor, as quoted in *The Bond Buyer*, 12/9/94

TEXPOOL DAILY BALANCE



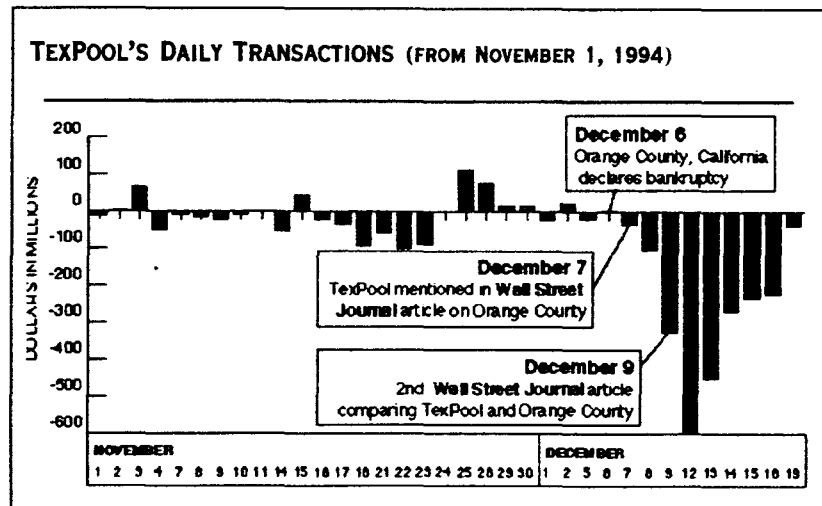
In fact, an article in the February 12, 1996 issue of *Forbes* magazine is right on point:

"It's been about a year since Orange County declared bankruptcy and tossed out Treasurer Robert Citron. The good guys stepped in to dump Orange County's highly leveraged \$21 billion portfolio-at a loss of \$1.7 billion. Derivatives became a dirty word. Well, guess what? If Orange County had held on to it's [sic] portfolio, derivatives and all, Orange County taxpayers wouldn't have lost a dime; the portfolio would have recovered its full \$21 billion value plus \$300 million in interest. Taxpayers would have been made whole and then some. Orange County closed out at the worst of times, just as savings and loans were forced to do with junk bonds in 1989 and 1990."

Even though TexPool in no way resembled Orange County, the result would have been the same had we not acted.

The report also offers the opinion as to the effect the "run" would have had on local governments had we simply sold all of the TexPool securities at a loss and distributed those losses to the participants. This is merely conjecture. However, if the calls we received were any indication, we were correct in our conclusion. A lot of mutual funds in the country that held Texas local government bonds called us ready to dump them into the market. They wanted to know what the exposure was. Dumping them would have essentially turned them into "junk bonds." Those entities in TexPool would have faced an increased cost in the market to issue debt, as well as an inability to meet existing debt service and possible ratings downgrades.

Selling these securities at a loss would have resulted in losses to Texas school districts at a time the State was striving both in the courts and in the legislature to adequately fund



Management's Responses from the Office of the State Treasurer, continued

those very school districts. The financial integrity of Texas school districts and their outstanding bonds would have been undermined at the very beginning of the 1995 legislative session that ultimately made additional money available to Texas school districts.

Also, we must not underestimate the negative impact on the market had we tried to sell \$3 billion in TexPool securities in one day. The unrealized losses on that day were approximately \$75 million. A "fire sale" could have resulted in much larger losses because the market would be flooded by overvalued paper.

We are convinced, as evidenced by the "TexPool Daily Transaction" graph (on preceding page), that our buy and hold strategy would have prevailed and that the state would have suffered no losses had it not been for the irresponsible article published by the *Wall Street Journal*.



DECISION NOT MADE IN VACUUM

The implication throughout this report is that the Treasury operated in a vacuum during this period. The State Auditor's Office knows this is not the case.

On December 9, 1994, after publication of an inaccurate and incomplete article in the *Wall Street Journal*, we met with the staffs representing the Governor, Governor-Elect, Lt. Governor, Speaker of the House, Legislative Budget Board, Attorney General, Comptroller, and others. The State Auditor and his first assistant attended the meeting. We informed everyone of the possible run at this meeting and possible options for meeting the impending crisis. Upon leaving the meeting, it was our belief, and still is, that the general consensus of the group was that the local governments should not bear any losses and, if there were to be any losses, they should be borne by the General Revenue Fund. Neither the State Auditor nor his first assistant advised us not to take this course of action at the time. At that time, we all hoped there would be no losses. The opinion of the group was that, if the participants knew that the state would make good on its obligation to them, their fears would be calmed and the "run" would not occur. Within the parameters of the consensus, the leadership left it up to the Treasury to act.

"While a local government may fall from fiscal grace, the perceived wisdom is that the state will step in to clean up the mess. In almost all cases involving general units of government and tax-supported debt, that has been the case. New York City, Cleveland, Philadelphia, Bridgeport, even little Chelsea in Massachusetts, were thrown a lifeline by the state. Their respective states swam through the often shark-infested waters of politics to effect a rescue. Not since the default of Detroit in the 30's had a state failed to aid one of its troubled municipalities."

— *Governing Magazine*, Nov. 1995

In addition, it was clear to the Treasury after consultation with lawyers, including representatives from the Attorney General's office, what the best course of action should be. The purchase of TexPool securities was believed to be lawful and not in violation of the Texas Constitution. Furthermore, a previous administration took similar action. In 1992, TexPool securities were purchased by the Treasury at a price other than market value, thereby setting a precedent.

Again, based on our own research and the advice we were given, we had every reason to believe these transactions were permissible. We would not have held the subsequent press conference upon leaving the meeting or taken the actions we did had we not felt our course of action was permissible. We continue to believe that these transactions were permissible and have filed an initial brief with the Attorney General challenging the basis of his opinion.

The final course of action was taken in consideration of the best interest of all Texans.

TEXPOOL PARTICIPATION AGREEMENT

The auditor asserts that the Treasury violated the TexPool Participant's Agreement by not allocating the losses on a pro-rata basis. Given the action taken by the Treasury, this assumption is simply untrue. By the Auditor's own definition of a loss in his report, there were no losses to be distributed pro-rata. No securities were sold at a loss by TexPool, therefore, there were no gains or losses to be allocated pro-rata among participants. Further, the Treasurer's statement, cited on page 11, is taken out of context in this regard — the statement meant that participants would receive dollar for dollar on their investment.

CONCLUSION

The Auditor's report is misleading, inaccurate, incomplete and contradictory in its portrayal of the actions taken by the State Treasury to secure the TexPool fund. We are particularly disturbed by the failure of the report to acknowledge the ongoing role of the Auditor's office in the decisions made in connection with the TexPool fund and the totally false suggestion that the Treasury has withheld any information. There were obvious ramifications to local governments, as evidenced by Orange County, had the Treasury not acted accordingly.

We feel it is important to point to the fact that, not only did we support the action of the 74th Legislature, but we also worked with them in drafting tighter regulations on all local government investment pools in Texas. In fact, the TexPool Advisory Board took action to tighten the TexPool Participation Agreement in January of 1995 prior to any legislation being drafted.

Finally, one must question the purpose of the auditor's report. This news is old news; all these events took place in the full light of day. The events have been well chronicled and acted upon by the legislature. It is interesting to note that this auditor in his report has made no recommendations because none are warranted.

We appreciate the opportunity to comment on the draft review of the State Treasury's Management of TexPool. We take strong exception to the report's accusation that the Treasury did not cooperate in this effort. The State Auditor's recent statement in a letter to the Treasurer dated February 16, 1996 (see box), directly contradicts the report's assertions.

"Your staff has worked cooperatively with us in furnishing information about the financial aspects of the TexPool bailout, and we appreciate this." — Larry Alwin, State Auditor

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State Auditor's Follow-Up Comments

We obviously disagree with most of the State Treasury's response. We will direct our follow-up comments to the key areas of disagreement identified by the Treasury.

Treasury's Assertion:

As we have contended consistently since December 1994, the realized loss to the State of Texas was \$55 million, not the inflated figure of \$97 million. Any other number put forward is merely a "guesstimate."

State Auditor's Follow-Up Comment:

The Treasury's assertion is inaccurate. Although the Treasury may not wish to acknowledge that the bailout of TexPool cost the State at least \$97 million, this is in fact the case.

As noted in this report, to generate part of the cash needed to buy TexPool's securities, the Treasury sold securities from its own portfolio at a loss of \$22.2 million. The Treasury then bought TexPool's securities for a price that was \$74.7 million more than they were worth on the open market.

Contrary to the Treasury's assertions, the Treasury has not "regained" \$40 million of this amount. The \$22.2 million lost on the sale of the State's securities can never be "regained," nor can the \$74.7 million overpayment for TexPool's securities ever be "regained."

The cost to the State of paying more for TexPool's securities than they were worth is clearly illustrated by the example included in the Treasury's response found on page 24 of this report:

[T]he Treasury purchased a U.S. Treasury Note from TexPool on December 13, 1994 and paid TexPool \$19,975,188 for the security. On January 31, 1996 the Note matured and the State received \$20,000,000, which was \$24,812 more than the cost to the Treasury. In addition, the Treasury received interest on the Note [A]t the time the Treasury purchased the security from TexPool the market value of the security was \$19,287,500.

Of course, if the Treasury had paid market value rather than book value for this security, when the security matured on January 31, 1996, the State would have received **\$712,500** more than the cost to the Treasury. In addition, the Treasury would have received the same interest on the note.

When securities are purchased for a price above market value, this is not merely a "paper loss" as suggested by the Treasury. These are real dollars that leave the Treasury and can never be recouped through earnings on the securities.

Finally, the Treasury fails to note in its example that the Treasury sold securities from its own portfolio at a loss in order to generate cash to purchase TexPool's securities. Thus, the Treasury had already lost money on these transactions even before TexPool's securities were purchased at above-market value prices. Since it was apparent at the time of the purchase of TexPool's securities that the Treasury would lose money on these transactions, we do not believe that the purchase of TexPool's securities can be considered as an investment of state funds, as asserted by the Treasury.

Treasury's Assertion:

When it was created by the Texas Legislature, TexPool was not intended to operate as a money market fund. It is misleading to compare TexPool to a money market fund. The assumptions underlying the entire Auditor's report are incorrect.

State Auditor's Follow-Up Comment:

The Treasury's assertion is inaccurate in several respects. We would first note that the Texas Legislature did not create TexPool, but passed legislation authorizing its creation. The State Treasurer, acting through the Texas Treasury Safekeeping Trust Company, created TexPool.

Although the Treasury may not wish to acknowledge that TexPool was established to function in the same manner as a money market fund, this is in fact the case. Since its inception, TexPool has been intended to provide a safe environment for the short term investment of public funds and has been premised on the following investment objectives:

- safety and preservation of principal
- liquidity
- immediate access to account balances
- maintenance of a "constant dollar objective"

In all these respects, the investment objectives of TexPool are identical to those of a money market fund.

This report clearly acknowledges that TexPool is not subject to the federal regulations which govern private money market funds. However, TexPool administrators still have a fiduciary responsibility to operate the fund in a safe and prudent manner. The safety guidelines applicable to regulated money market funds provide a frame of reference by which to evaluate the management decisions of TexPool administrators.

The State Auditor's Office is not alone in comparing TexPool to a money market fund. For example, the following legislation passed by the 74th Texas Legislature indicates that the Legislature regards TexPool as having been created to function as a money market fund:

Portfolio of Certain Investment Pools

A public funds investment pool *created to function as a money market mutual fund* must mark its portfolio to market daily and, to the extent reasonably possible, stabilize at a \$1 net asset value. If the ratio of the market value of the portfolio divided by the book value of the portfolio is less than .995 or greater than 1.005, portfolio holdings shall be sold as necessary to maintain the ratio between .995 and 1.005. (Texas Government Code, § 2256.017)

Finally, Standard & Poor's Managed Funds Group has been rating local government investment pools since 1990, and over that period has consistently used its money market fund criteria to evaluate investment pools like TexPool. In a recent publication, Standard & Poor's describes its rating approach as follows:

Local Government Investment Pools (LGIPs) are supposed to provide a safe and liquid means to invest public monies while offering an attractive yield for state and local governments. Standard & Poor's rating approach for LGIPs is based on the pool's investment objectives and participants' expectations. Investment pools seeking to preserve absolute principal stability with daily liquidity should invest in very short-term, high-credit quality "low-risk" securities while maintaining an actively priced portfolio. In evaluating LGIPs that seek to provide a constant net asset value, Standard & Poor's applies its money-market fund criteria.

Treasury's Assertion:

The auditor's ability to play Monday morning quarterback far exceeds the Treasury's ability to play fortune teller to predict the future. The Federal Reserve raised interest rates 6 times in 1994, a phenomenon most analysts, economists, and portfolio managers in the country could not have predicted.

State Auditor's Follow-Up Comment:

The Treasury's assertion is inaccurate. This report does not suggest that TexPool administrators could have predicted the multiple interest rate hikes in 1994. However, TexPool administrators had a fiduciary responsibility to take corrective action in response to this or any other circumstance which destabilized the net asset value of the fund.

TexPool functioned as a "constant dollar objective" fund premised upon principles of safety, liquidity, and immediate access to account balances. This type of fund *must* maintain a stable net asset value and take corrective action when the net asset value deviates beyond a narrow range from the \$1.00 per share valuation.

The Treasury describes TexPool's investment strategy as "buy and hold," but in fact this was not the case. Prior to the decline in net asset value in February 1994, TexPool's portfolio was actively traded when gains could be realized on the sale of investments. A more accurate description of TexPool's investment strategy was an unwillingness to sell securities at a loss.

Principles of prudent management dictate that securities must be sold at a loss if necessary to ensure the stability of the fund and provide for the equitable treatment of participants. Selling securities at a loss is never an easy decision. However, a short-term investment fund premised upon principles of safety, liquidity, and immediate access to account balances cannot afford to gamble that devalued securities will rebound in value or that it will not become necessary at some point to sell the devalued securities at a loss in order to meet cash obligations. This is why the federal regulations establish safety parameters to prevent regulated money market funds from deviating too far from the \$1.00 per share valuation. Safety must always be the paramount consideration. The risks associated with the failure to take timely corrective action are amply demonstrated by what occurred in this case.

The Treasury extracts certain information out of context to suggest that TexPool's balance was recovering in November 1994. Although there were fluctuations in TexPool's daily balance as participants deposited and withdrew funds, the overall trend continued downward in November 1994, as illustrated by the chart included in the Treasury's response (on page 28) and by Figure 6 (on page 9) in this report.

The Treasury believes that TexPool's balance would have recovered in the first quarter of 1995, if not for the *Wall Street Journal* article. However, the Treasury still fails to recognize that even if TexPool had managed to scrape through without a liquidity crisis, this would not have justified their management decisions. TexPool administrators took inappropriate risks for a short-term investment fund premised upon principles of safety and liquidity.

Finally, while TexPool administrators may not have foreseen the potential adverse consequences of their management decisions, these consequences were clearly evident to outside observers. Between the initial decline in the fund's net asset value in February 1994 and the run on TexPool which occurred 10 months later, many outside observers, including the Treasurer's political opponent, the *Quorum Report*, the County Treasurer of Comal County, and finally the *Wall Street Journal*, publicly pointed out the risk TexPool was taking by failing to stabilize the net asset value of the fund and simultaneously permitting participants to withdraw their shares at full value. TexPool administrators dismissed warnings about the safety of the fund as "false charges" and "politically motivated nonsense."

Treasury's Assertion:

Given the nature of the crisis, the policy decision to protect schools, cities, and counties from financial straits was a sound one.

State Auditor's Follow-Up Comment:

The Treasury's assertion is questionable for several reasons.

TexPool participants were attracted to the fund by above-market yields and then began to depart when TexPool's yield lagged behind other short-term investments. When TexPool continued to allow participants to withdraw their investments in full after the decline in the fund's net asset value, most participants naturally took advantage of this opportunity. Therefore, it is quite possible that the Treasury's decision to allow participants to withdraw their full investments actually fueled, rather than stemmed, the run on TexPool. Conversely, it is also possible that the run would have slowed or stopped had TexPool participants been required to take losses as specified by the Participation Agreement.

Finally, there are no facts to support the Treasury's predictions of a "fire sale" of TexPool's securities or dire economic consequences for participants. TexPool participants had consistently acted in their own economic best interests, and there is no reason to believe they would not have continued to do so.

Treasury's Assertion:

The crisis of December 1994 was unique. However, based on the information we had at the time, including the legal advice of the Attorney General, we would have taken the same actions today to protect local governments.

State Auditor's Follow-Up Comment:

As noted in this report, questionable management decisions by TexPool administrators contributed to TexPool's liquidity crisis. Although TexPool's liquidity problems had been looming for months, the Treasury waited until a crisis actually broke on December 9, 1994, to brief the State's leadership.

Contrary to the Treasury's assertions, our review indicates that nothing approaching a consensus was achieved concerning a proposed course of action at the briefing session on December 9, 1994. Although there was discussion that the Treasury was prepared to buy and hold some of TexPool's securities until maturity if necessary to provide liquidity for TexPool, few details were provided concerning the specifics of the transactions. Attendees at the briefing session recall no discussion that the Treasury would have to sell its own securities at a loss in order to generate cash to purchase

TexPool's securities. In fact, it was represented that if it did become necessary for the Treasury to purchase any of TexPool's securities, they would be held to maturity and the State would suffer no loss of revenue.

Based on our review, the only consensus reached at the briefing session appears to have been that the Treasury was charged with responsibility for administering TexPool, and the Treasury should decide on an appropriate course of action to address the problem. Implicit in this consensus was the understanding that whatever action the Treasury decided to take, it must be legally permissible.

The Treasury's characterization of an ". . . *ongoing role of the Auditor's office in the decisions made in connection with the TexPool fund . . .*" is completely untrue. TexPool is audited by a private CPA firm, not by the State Auditor. The "ongoing role" of the State Auditor's Office consisted of the following:

- In early December 1994, after the Orange County scandal broke, a reporter from *The Bond Buyer* contacted First Assistant State Auditor Sharon Cobb and asked questions about *derivative investments* held by various state agencies and by TexPool. Ms. Cobb's remarks to the reporter related solely to these derivatives. It should be noted that only two percent of TexPool's portfolio was invested in derivatives.
- On December 9, 1994, representatives of the State Auditor's Office were asked to attend the briefing session on TexPool. As discussed above, no consensus was reached concerning a proposed course of action at the briefing session.

Treasury's Assertion:

The Attorney General's opinion is legally incorrect and suspiciously tardy.

State Auditor's Follow-Up Comment:

The Attorney General's Office has been afforded the opportunity to respond to the Treasury's assertions concerning their involvement in this matter. (Please refer to Appendix 5: Attorney General's Follow-Up Comments.)

State Auditor's Concluding Remarks

There are several remaining points to be addressed.

- The Treasury asserts that there were no losses to prorate among TexPool participants because "no securities were sold at a loss by TexPool." The only reason TexPool had no losses to prorate is that \$74.7 million in unrealized losses were transferred from TexPool's portfolio to the Treasury's portfolio as a result of the Treasury's purchase of TexPool's securities for a price above market value.
- The Treasury questions the lack of recommendations in this report. As the Treasury is aware, recommendations were included in the original draft of this report. However, most of these recommendations related to the legal issues that were recently addressed by the Attorney General.

We remain concerned that the Treasury lacks adequate written policies to prevent improper transactions between the separate trusts administered by the Treasurer, and we will be formally recommending that the Treasury adopt such policies. We will also communicate these concerns to the Office of the Comptroller, which will be assuming responsibility for the Treasury's functions in September 1996.

- The Treasury closes its response with a quote from the State Auditor's letter of February 16, 1996, to the State Treasurer:

Your staff has worked cooperatively with us in furnishing information about the financial aspects of the TexPool bailout, and we appreciate this. . . .

The Treasury's use of this quote illustrates the difficulty we have encountered in obtaining the complete truth about the TexPool bailout. The Treasury lifts the first sentence from the State Auditor's letter, but omits the sentence immediately following which puts the State Auditor's remarks in an entirely different perspective:

. . . . However, it must be evident to you at this point how little cooperation we have received from the Treasury in our attempts to see that the legal questions raised by the TexPool bailout are properly addressed.

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Attorney General's Follow-Up Comments



Office of the Attorney General State of Texas

DAN MORALES
ATTORNEY GENERAL

March 5, 1996

Mr. Lawrence F. Alwin
State Auditor
State Auditor's Office
206 E. Ninth Street, Suite 1900
Austin, Texas 78701

RE: TexPool Audit

Dear Mr. Alwin:

We have reviewed your report and the State Treasurer's management response to your report concerning the bailout of TexPool. Based upon our review, we believe your report to be a true and accurate characterization of the events and circumstances examined.

We have two areas of disagreement with the State Treasurer's management response, which contains factually incorrect and/or misleading statements. We offer the following information to correct these misstatements.

First, on December 9, 1994, attorneys from our office met with the State Treasurer to advise her that the Texas Constitution did not permit her to guarantee the participants' investments in TexPool. We gave her this advice because she had previously called our office soliciting our legal judgment on that specific point. Any action to address the TexPool crisis had to conform to this constitutional mandate. In fact, our attorneys specifically advised her to adhere to the terms of the Participation Agreement, which provided that participants wishing to withdraw from the Plan would be paid their pro rata share of the market value of the fund.

Moreover, on December 13, 1994, we sent the State Treasurer a letter that once again advised her that the Constitution prohibited her from guaranteeing the participants' investments in TexPool. A copy of that letter is attached to this letter as Exhibit 1.

Given our clear and unambiguous advice to the Treasurer, we are at a loss to understand her assertion that guaranteeing the investments in TexPool "was ... lawful and not in violation

Mr. Alwin
March 5, 1996
Page 2

of the Texas Constitution." Moreover, we note with interest her statement that a previous State Treasurer had taken a similar action. The Treasurer's Office never informed us during any of the relevant times in December 1994 that TexPool securities were purchased by the Treasury at a price other than market value in 1992. Had we been informed of this fact, our advice would not have changed: a prior violation of the Constitution can not justify a current violation of the Constitution.

Second, the State Treasurer states that "the Attorney General's opinion is legally incorrect and suspiciously tardy."

As to the opinion being "suspiciously tardy," this office properly waited first for the legislature to consider corrective legislation in 1995 in order to determine whether there would be a need for the opinion after the legislature acted. After the legislation was passed and the need for the opinion had not dissipated, this office accorded the State Treasurer every courtesy by granting her ample time to submit a brief, which she said would be forthcoming, detailing the legal justification of her actions. A timely receipt of the Treasurer's brief would have resulted in an earlier issuance date of the opinion. Even after repeated requests from our office for submission of the promised brief, no brief was submitted. In fact, we did not receive her brief until after the opinion was issued.

As to the legal correctness of the opinion, we have seen nothing that would persuade us to question its legal validity or soundness and, accordingly, our office stands by the opinion as written.

We appreciate the opportunity you have given us to correct the record on this matter. We commend you for the very fine work you and your staff have done in this difficult situation.

Sincerely,



Jorge Vega
First Assistant Attorney General



COPY

Office of the Attorney General
State of Texas

DAN MORALES
ATTORNEY GENERAL

December 13, 1994

Ms. Martha Whitehead
Texas State Treasurer
P.O. Box 12608
Austin, Texas 78711

Confidential Attorney-Client Privilege

Dear Ms. Whitehead:

I am concerned about characterizations by the media of our office's involvement with respect to the current TexPool issue. On Friday morning, December 9, 1994, you asked our office whether the State of Texas could guarantee the investments made through TexPool. After researching that issue we advised you that the State of Texas, or you on its behalf, could not make any such guarantee because neither the Participation Agreements nor the Texas Constitution allows it.

In an effort to assist you regarding this legal issue in your preparation for your press conference, our attorneys suggested that you state only that you would adhere to the terms of the Participation Agreement. Moreover, we suggested that you not be specific about the actual mechanism you would use to fund the pool because we had concerns about the legality of any approach you would ultimately decide to pursue. In short, we did not want to make it appear that we approved the legality of a funding mechanism of which we did not know the details nor had the opportunity to perform legal research to determine its legality.

This is obviously an important issue for the State and its taxpayers, and it is critical that all Texas Constitutional, statutory, and contractual provisions are complied with by all concerned. If you need further legal advice, please let me know.

Sincerely,

A handwritten signature in dark ink, appearing to read "Jorge Vega".

Jorge Vega
First Assistant Attorney General

EXHIBIT 1

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Copies of this report have been distributed to the following:

Legislative Audit Committee

Honorable James E. "Pete" Laney, Speaker of the House, Chair
Honorable Bob Bullock, Lieutenant Governor, Vice Chair
Senator John Montford, Chair, Senate Finance Committee
Senator Kenneth Armbrister, Chair, Senate State Affairs Committee
Representative Robert Junell, Chair, House Appropriations Committee
Representative Tom Craddick, Chair, House Ways and Means Committee

Governor of Texas

Honorable George W. Bush

Legislative Budget Board

Sunset Advisory Commission

Texas State Treasury

Honorable Martha Whitehead, State Treasurer
Mr. Michael D. Doyle, Deputy Treasurer of Operations
Mr. Jim Howell, General Counsel
Ms. Cindy Coats, Director of Internal Audit

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