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State temporarily loses access to \$1B

Money's tied up in market for auction-rate securities, which remains frozen

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More than a third of the state government's investment portfolio is stuck in illiquid auction-rate securities because markets for the investments remain frozen.

The state Department of Budget and Finance said \$975 million of the state's \$2.6 billion portfolio, or about 37 percent, is tied up in the investments. But it said having the money trapped in auction-rate securities isn't a problem now.

"The best thing for us to do now is hold it until it matures," said state Finance Director Georgina Kawamura, explaining the state would probably take a \$200 million loss if it sold the investments now.

"I can't in good conscience sell it off and take an actual loss."

She added that if the state did sell, it could not reinvest the money at the same rate it is earning now with the auction-rate securities.

The disclosure was made as the Senate Ways and Means Committee and the House Finance Committee held a joint informational hearing into the state's use of auction-rate securities and whether the department followed investment policy in buying so much of the supposedly safe securities.

Sen. Donna Mercado Kim, head of the Ways and Means Committee, said she was curious about why the department exceeded a guideline saying no more than 20 percent of the state's investments could be in auction-rate securities.

She also questioned whether the state should have dabbled in the investments, since they were derived from student loan packages that weren't short-term in nature, and maturities extending more than three decades, in some cases.

"I'm wondering why we had that big of an amount (invested) and if that was a reasonable amount during that time," said Kim, explaining her investigation had turned up the state more than doubling use of auction-rate securities from 2006 to 2008.

She said it appeared the state increased its holdings in student loan auction-rate securities from \$452 million to more than \$1 billion.

Markets dried up

The investments had been popular with money managers until the market collapsed in February 2008 as credit markets dried up and bond insurance worries swept Wall Street.

The investment is a complex one, but it allows investors to get returns that are higher than can be obtained in bank accounts or certificates of deposits.

Investors could move in and out of the securities every seven to 35 days in auctions, and big investment houses marketing the securities backed up their sale with a pledge to repurchase the securities themselves should the auctions fail.

But that guarantee fell by the wayside when auctions failed to attract bidders, trapping an estimated \$330 billion that had been invested in the market. The Hawai'i state government had about \$1.07 billion invested in auction-rate securities while Hawai'i county governments had more than \$40 million at the time the market froze.

Kawamura said the shutdown caught many people by surprise, including many professional investors.

State to hold on

The legislators were told the state is prepared to hold on to the investments until they mature, and that for now, the state is earning an average of 1.85 percent on the investments, or more than they would in comparable 30-day, one-year and two-year investments.

Scott Kami, administrator of the Financial Services Division, said the investments are held by the state treasury and meet covenants and assurances on bonds. He said such money would never be used for the day-to-day spending of the state. As such, it would be available to help the state with its present budget crisis.

Kawamura and Kami were also asked by legislators about whether risk assessments were done, how the 20 percent limit was eclipsed and how much in commission was paid to Morgan Stanley Smith Barney, which sold the state the auction-rate securities.

The amount has come down slightly from the \$1.07 billion invested when markets froze as some student loans were repaid early, resulting in principal being paid back to security holders.

The probing prompted Rep. Gene Ward, R-17th (Kalama Valley, Queen's Gate, Hawaii Kai) to criticize Kim, D-14th (Hālawa, Moanalua, Kamehameha Heights), about the nature of her questioning. Ward said Kawamura and Kami had been trying to manage the state's money prudently when they got caught in the auction-rate market failure, along with many investors worldwide.

"You're playing the blame game," said Ward. "It's an information hearing, not a 'gotcha' hearing."

Kim responded that she was trying to find out how the state got into the situation and whether laws were adhered to.

"If we had followed investment policies perhaps we wouldn't have as much tied up."

Tomorrow key date

Kami said the state is closely following what will happen in coming days as brokers approach a Dec. 31 deadline for making "best efforts" to repay large investors.

Brokers made that agreement with the U.S. Securities and Exchange Commission, and the state wants to see if the SEC will take further action, Kami said. Other states have sued brokers, and Kami said Hawai'i is keeping its options open.

Kawamura said the state has not lost any money on the investments yet, though it was forced to write down the carrying value on its accounting records by \$114 million.

But "we have not incurred any actual loss," said Kawamura, saying the state has not been forced to liquidate or sell any of the securities.

"I don't think anyone could have known what would happen in February 2008."
