GIOA Update

Summer 2012

NEWS *from the* GOVERNMENT INVESTMENT OFFICERS ASSOCIATION

President's Message

BY LAURA GLENN

Many state and local governments place overnight cash in repurchase agreements ("repo") with highly rated banks as their counterparties. Repo seemed like a simple form of short-term borrowing until it brought down the likes of Lehman Brothers and MF Global. As Fed Chairman Ben Bernanke observed, "Until recently, short-term repos had always been regarded as virtually risk-free instruments and thus largely immune to the type of rollover or withdrawal risks associated with short-term unsecured obligations. In March (2008), rapidly unfolding events demonstrated that even repo markets could be severely disrupted when investors believe they might need to sell the underlying collateral in illiquid markets." As Standard & Poor's states in their principal stability fund rating criteria, "The credit quality of the counterparty determines the credit quality of a repo because the timing and ownership of collateral is uncertain. A default by a repo counterparty results in a fund taking possession of the underlying collateral and could create both liquidity and market risks."

> "Until recently, short-term repos had always been regarded as virtually risk-free instruments and thus largely immune to the type of rollover or withdrawal risks associated with short-term unsecured obligations..."

Overnight repurchase agreements make up over 50% of most taxable money market funds. Thus, the investment community's focus has turned to evaluating its repo counterparties -- not simply relying on a rating from a nationally recognized rating agency or taking comfort in the fact that the overnight investment is collateralized. Keeping an eye on market indicators such as a bank's 5-year credit default swap (CDS) or it's 5-year bond yield, as well as performing a fundamental analysis, will allow cash investors the opportunity to be proactive on minimizing counterparty risk.

Continued on page 2

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GIOA 9th Annual Conference
Las Vegas, Nevada — March 13-15, 2013

GIOA 9th Annual Conference
Market Madness
Las Vegas • March 13-15, 2013

Online Registration Visit our website at **www.GIOA.us** to register for the **low registration rate of $100 for government attendees.** To become acquainted with what the GIOA Conference has to offer, we invite you to visit the "Events" page and view last year's conference agenda, as well as download the posted presentations. Also available is the 2013 preliminary schedule of events, which includes a Pre-Conference Workshop for government members on Wednesday, a welcome reception for all attendees that evening, and a "NCAA Basketball" party on Thursday evening.

Hotel Reservations Visit **www.montecarlo.com** or call **1.800.311.8999** to make your reservation. There's a limited block of rooms and a deadline of February 12, 2013, so please book early and be sure to mention the group code XGIOA2013 for a room rate of $65, plus a mandatory $15 resort fee. Don't miss out on a great deal for this premier property adjacent to Aria and City Center.

GIOA
Government Investment Officers Association

President's Message | Continued from page 1

At our 2012 conference we discussed the important topic of counterparty analysis as well as several others including the proposed SEC reforms affecting the U.S. money market fund industry. The $2.7 trillion U.S. money market fund industry is being targeted for regulatory reforms designed to make it more transparent and less risky. The proposed SEC reforms include requiring funds to float their NAV rather than maintain a stable $1 NAV and/or maintain a capital buffer. To date, the SEC has not resolved these issues.

Our 2012 presenters also introduced us to the story of the supranationals, the health of the public pensions and the state of the U.S. and global economy. These topics will continue to play an important role in the way state and local government investment officers invest their cash.

Most of the 2012 presentations can be found on our website at www.gioa.us/events. For those of you that couldn't join us in Las Vegas, we hope you will take a peek as to what you missed.

More importantly, we hope you will join us for the 2013 conference as we once again make sense of the market madness. I hope to see you in Las Vegas on March 13th!

Using Social Media

BY SUSAN MUNSON

For most, the words "Social Media" immediately brings Facebook, Twitter, and LinkedIn to mind. "Everybody" must be using them, although how and why in our world is still a bit of a blur. But with nearly 1 billion people on Facebook and 48 hours of video being uploaded every minute to YouTube, it is obvious that "it" is not going away. To quote a line from Erik Qualman's fabulous website, www.socialnomics.com, "Social Media isn't a fad, it's a fundamental shift in the way we communicate."

Yet how does this phenomenon impact public agencies, particularly treasury and finance professionals? What steps need to be taken before we empower staff to "tweet away!"? Industries that are highly regulated, such as brokerage and banking, face more challenges than unregulated industries. Companies need to be concerned with supervision and archiving and making sure the wayward employee doesn't implode one's image. For public agencies, throw in the Public Record and Information Acts and it is easy to understand why far more agencies disallow than allow the use of Social Media in their organizations.

If you are wondering why on earth you would want the headache, let's go back to Erik's quote. We have shifted the way we communicate and if we don't use the tools of the day it will be difficult to build relationships and trust with anyone. I don't know for sure, but it's possible that what we are experiencing today is similar to the transition from telegraph to telephone. And like the telephone, today's technology can be enormously beneficial if used properly.

> "Social Media isn't a fad, it's a fundamental shift in the way we communicate."

Through research and more than a little trial and error, I found that it is best for organizations to commit time upfront to first develop a comprehensive social media policy and plan. It is critical to identify what systems and tools can and should be implemented and maintained to advance that organization's objectives. Very often, websites and platforms are built without realistic expectations as to the amount of resources required to keep up those platforms. While missteps can occur even with a strategic plan, I believe the number of costly delays can be greatly reduced.

The primary goal of my presentation at the conference was to provide a step by step action plan for developing a policy. I also provided links to examples of policies

Continued on page 4

developed by several public agencies and if you didn't grab the links at the conference, send me an email and I'll forward them to you.

The six recommended steps for policy development are:

1 Build Your Team: Include individuals from multiple generations and business units and don't forget customer service, legal and compliance.

2 Research Regulations: FINRA provides good guidelines; Public Information Acts may vary by state and organizations may interpret differently. If you are developing a policy for a department, check to see if one already exists at the organization level.

3 Measure Goals: Define goals and objectives first then plan the technology around the goals instead of planning the goals around the technology. Measure outcomes!

4 Develop Guidelines: Refer to other agencies' guidelines, but customize them based on your goals. Keep in mind: copyright, security, review process, rules of conduct, confidentiality, and retention requirements.

5 Research Tools: Match the tools you want to use with the needs of your audience and use the ones that will accomplish the goals of your organization. Only incorporate the ones you will have the resources to sustain.

6 Review, Revise, Repeat: As with all good plans, include the process of staying abreast of trends, making sure content is fresh and relevant, and measuring the process. Implementing systems for review and measurement of results will enable you to adjust as needed to stay ahead of the curve.

There is more to talk about. Hundreds of websites are dedicated to just keeping up on the latest and greatest technology and next big social network. But once the map is drawn, we will have a guide for those conversations so we can identify which tools are going to help us get to where we want to go.

Stay tuned!

Susan Munson is the Founder and CEO of Fixed Income Academy. To learn more about financial education and Bond School visit www.fixedincomeacademy.com or email Susan at smunson@fixedincomeacademy.com or call 800-243-5097.

The Washington Supras

A high-quality investment opportunity for US government investors

GEORGE RICHARDSON, HEAD OF CAPITAL MARKETS, WORLD BANK

More US government investors are asking to learn more about triple-A rated supranational issuers as a possible alternative investment to GSEs who are issuing smaller and smaller volumes of debt. Supranationals headquartered in Washington, DC (sometimes referred to as the "the Washington Supras") seem to be especially interesting due to their triple-A credit, the fact that the US is their largest shareholder, and because they issue similar products to those issued by GSEs, like benchmark bonds, callables and short-term discount notes. These supranationals -- the International Bank for Reconstruction and Development (IBRD, or "World Bank"), the International Finance Corporation (IFC), and the Inter-American Development Bank (IADB) -- likewise find the US government investor base particularly interesting because US government investors share similar conservative investment strategies and return objectives as other investor groups who are core to supranational bond issues, such as central banks.

The World Bank, IFC, and IADB, together with other supranationals,[1] are also referred to as multilateral development banks, or MDBs because of the shared development goal to improve standards of living in their member countries. Each one works in development financing in different ways (see "The Washington Supras" box for a more detailed overview):

The World Bank and IFC are both part of the World Bank Group[2], but each is charged with different development mandates. The World Bank provides loans to governments of borrowing countries, whereas IFC focuses on private sector investments. IADB is a regional development bank that primarily funds loans to governments in Latin America and the Caribbean, with a small portion of its loan portfolio dedicated to the private sector.

The World Bank, IFC, and IADB issue securities in a variety

Continued on page 5

of currencies, and their funding program is demand driven – often reverse inquiry-based and can be customized. What seems to resonate well with US investors are the characteristics of their debt issuance that are shared with the US agency paper investors are accustomed to. For example, each Washington Supra benefits from certain exemptions in a similar way to Fannie and Freddie, and provides investors with similar types of bonds, including large liquid USD benchmarks, discount notes and callables, offered through many US dealers.

As the largest shareholder in each of the three supranationals, the US is also the only country that essentially holds veto power to decisions such as amending the articles of agreements which first established these institutions. Because of their balance sheet strength and conservative financial policies, the downgrade of the US as a major shareholder by S&P in August 2011 did not affect the ratings of the World Bank, IFC, and IADB. Like other supranationals, they have maintained their triple-A credit ratings.

Unlike other issuers, for example GSEs who depend on government ownership for the credit rating of their debt issuances, supranationals like IBRD, IFC, and IADB rely on a variety of factors behind their triple-A credit.

First of all, the development cooperative structure of each of the supranationals supports the high quality loan portfolio. Member countries are represented on the board of the World Bank, IFC, and IADB – they are shareholders as well as clients and borrowers. Borrowers prioritize repayments of loans made by the supranationals and honor their so-called 'preferred creditor status', even in times when they have defaulted to private creditors. Shareholder support for the supranationals is thus proven through the record of debt repayment as well as the capital backing they provide, should this be needed.

Also, supranationals are similar to government entities in their conservative investment strategies, favoring very high quality credit investments for the funds raised in the capital markets. These conservative financial policies have also enabled each of the supranationals to build up significant reserves to support lending and support to their clients, while protecting the credit quality of their bonds to investors.

As sovereign lenders, the World Bank and IADB's capital structure includes two types of capital: paid-in and callable. Callable capital provides an extra level of comfort

Continued on page 6

The Washington Supras

Issuer	World Bank (IBRD) www.worldbank.org/debt-securities	International Finance Corporation (IFC) www.ifc.org	Inter-American Development Bank (IADB) www.iadb.org
Issuer Rating	Aaa/AAA	Aaa/AAA	Aaa/AAA
Development purpose	Global source of funding to member governments	Global source of finance for private enterprise in developing countries.	Regional source of development finance for Latin America and the Caribbean.
Membership	Global – 188 members	Global - 184	Regional (Latin America and the Caribbean) - 48
Largest shareholder	United States – 16.5%	United States – 24%	United States – 30%
Annual Funding Program	USD 25-35 billion	USD 10 billion	USD 15 billion
Funding Program in USD	Yes – 50% to 60%	Yes – 60% to 70%	Yes – 75%
SEC exemption per Securities Act of 1933 and Securities Exchange Act of 1934	Yes	Yes	Yes, but still required to file certain information with SEC under SEC Regulation IA
Act of Congress Authorizing US membership	Bretton Woods Act 22 USC 286 et. seq.	International Finance Corporation Act 22 USC 282 et. seq.	Inter-American Development Act 22 USC 283 et. seq.

for bond holders, but is to only be called for debt repayment to bond holders in extraordinary situations. No call has ever been made on callable capital for any supranational and when determining capital adequacy and other prudent risk management policies include only actually paid-in capital and reserves, not the callable capital.

Each of the Washington Supras set statutory lending limits so that lending does not exceed total capital plus reserves. The World Bank and IFC also set country-specific limits depending on a country's debt repayment capacity to mitigate overexposure to any single borrower. As a matter of policy, these supras minimize currency exchange and interest rate risks – both sides of the balance sheet are managed on a USD Libor basis; swaps are used for hedging purposes and collateral helps manage counterparty risks.

As highlighted earlier, the Washington Supras operate like cooperatives - shareholders are also clients. The World Bank, IFC, and IADB were all created by federal statutes similarly drawn up as those which created Fannie and Freddie. The US has given these organizations immunities and privileges which can be considered consistent with an instrumentality of the US – as well as an instrumentality of each of the other shareholders.

More and more US investors are showing an interest in learning about the Washington Supras – including how they fit with their investment guidelines. The World Bank, IFC, and IADB look forward to continuing to provide support to US government investment officers so that they may consider supranationals when looking for safe investments.

Key credit drivers behind the AAA rating

	Asset Quality	Equity Capital	Risk Management	Govenrment Ownership / Guarantee
GSE's				✔
Covered Bonds	✔			
USAID Guaranteed Bonds				✔
KfW / EDC				✔
Supranationals	✔	✔	✔	✔

1 Other multilateral development banks that issue debt in the international capital markets include the Asian Development Bank (ADB) and the African Development Bank (AfDB), and although their mandates are somewhat different, also the European Bank for Reconstruction and Development (EBRD) and the European Investment Bank (EIB).

2 The World Bank Group is made up of five agencies: International Bank for Reconstruction and Development (IBRD, also known as the "World Bank"), International Development Association (IDA), International Finance Corporation (IFC), Multilateral Investment Guarantee Agency (MIGA), and International Centre for Settlement of Investment Disputes (ICSID). IBRD and IFC are the only two agencies that issue bonds in the capital markets.

Washington and the Year Ahead

GIOA 2012 Conference Presentation Synopsis

JOANNE MEDERO, MANAGING DIRECTOR, BLACKROCK

Financial regulatory reform presents significant challenges for investors. As a fiduciary for our clients, BlackRock supports the creation of a regulatory regime that increases transparency, protects investors, and facilitates responsible growth of capital markets, while preserving consumer choice and assessing benefits versus costs. During her presentation at the 2012 GIOA Conference, Joanne focused on changes in markets as a result of Dodd-Frank, including of particular interest to GIOA members, structural reform of money market funds (MMFs).

Since the historic "breaking of the buck" by the Reserve Primary Fund in 2008, MMFs have been a subject of debate. This event cast scrutiny upon an industry that for the prior 40 years had successfully provided liquidity to markets and yield to investors without government intervention. Reaction to the "breaking of the buck" resulted in the imple-

Continued on page 7

mentation of reforms to Rule 2a-7 in May 2010 that tightened standards and enhanced protections for MMF investors. Many in the industry believe that these reforms are sufficient. However, policymakers continue to explore ways to strengthen the regulatory structure of MMFs.

SEC Chairman Schapiro has publicly reinforced her commitment to pursuing additional reforms and has signaled that the SEC will release a proposal for comment in the near future. While many ideas have been floated and each continues to evolve, the model expected to be proposed for comment would give providers the choice between a stable value MMF that incorporates capital buffers and redemption restrictions or a MMF with a floating net asset value (NAV).

BlackRock believes that the redemption restriction structure that has been described will not work for three reasons: i) clients will not invest in MMFs with these restrictions; ii) may increase the likelihood of a run; and iii) enormous operational challenges in implementation. Alternative redemption rules may mitigate these issues.

The floating NAV idea has also met consistent industry opposition. The chief opposing argument is that the proposal would result in MMFs losing their constant NAV, which is highly valued by investors. However, regulators continue to return to this as a viable solution. Several have argued that a floating NAV reflects a fund's true market value, allowing investors to see regular fluctuations in their investment and provide a market-based assessment of the risks associated with a MMF. Proponents believe that floating the NAV reduces the likelihood of a run on a fund because all investors receive the true value of their shares, regardless of when they redeem.

It appears that more change is imminent for the MMF industry. Faced with this, it is important that all interested parties — policymakers, fund sponsors, industry organizations, and corporate and municipal issuers of commercial paper — are part of the discussions to ensure the best outcome. Ultimately, when contemplating change, it is critical to ensure that reforms, both those implemented and those proposed, achieve the objective of protecting MMFs and the shareholders who invest in them without inadvertently destabilizing financial markets or increasing systemic risk.

For more information, please refer to BlackRock's March 2012 ViewPoint entitled "Money Market Funds: The Debate Continues.", which can be found at the following web address:

http://www2.blackrock.com/global/home/PublicPolicy/ViewPoints/index.htm

The opinions expressed are as of March 2012 and may change as subsequent conditions vary. The information and opinions contained in this material are derived from proprietary and non- proprietary

FUN FACT$

- The United States actually has a $100,000 bill. It has a picture of Woodrow Wilson on it, and was used to transfer funds around the government or between banks before the days of electronic exchange. So if you stole one you might be rich, but only on paper because you couldn't spend it.
- Two of the highest risk groups for bankruptcy are former professional athletes and Lottery winners.

WHO KNEW?

Counterparty Risk—An Overview

HAMPTON SMITH, CFA
MANAGING DIRECTOR - BNP PARIBAS

Counterparty risk assessment, analysis, and mitigation are critical activities when conducting business in today's global credit environment. There are essentially two main types of counterparty risk:

Credit Risk - the risk of non-performance in a legal financial transaction. This risk can be measured, and to a certain degree, hedged.

Reputational Risk - the risk of being associated with a transaction(s) of a dubious legal or ethical nature, usually resulting in reputational harm. Unfortunately, this risk can only be monitored and rarely hedged.

This article will focus on describing, quantifying, and mitigating counterparty credit risk from the perspective of an investment bank's securities and derivatives dealership.

Credit Risk is generally bilateral in nature, as each party bears some risk of non-performance to the other. The contributors of this bilateral risk typically include the type, tenor, and currency of the transaction (or portfolio of transactions) that the counterparties engage in. Furthermore, it is important to consider if the transaction portfolio is secured or unsecured.

However, not all credit risks are bilateral, a major asymmetric risk exists in that rarely are two counterparties to a transaction the same credit rating. The probability of default, and the associated recovery rate, typically differ. This asymmetric risk can be mitigated to some degree with additional transaction credit terms that we will cover in the latter half of this article.

Measuring Counterparty Credit Risk

First, however, one must measure the amount of counterparty credit risk that they are taking on. Let's use a 30-year fixed / floating interest rate swap in a notional amount of $100 million as our example. In this type of transaction, one counterparty commits to paying a fixed rate of interest on a fixed notional principal amount, while the other agrees to pay a periodically resetting floating rate of interest on the same notional amount with a pre-defined reset frequency. At inception, such a transaction has a zero present value to both counterparties. Inevitably, however, market swap rates move, therefore presenting a positive PV for one side of the transaction and a mirror image negative PV to the other.

As a derivative dealer, BNP Paribas uses a Value-at-Risk Monte Carlo simulation process to arrive at an unsecured exposure profile through the life of the swap transaction (Chart 1). To generate this profile, we assume that the transaction moves distinctly in the favor of BNP Paribas, is not collateralized, and the counterparty defaults. As a dealer, we are only concerned with the deterioration of our counterparty's credit quality when the transaction is in our favor, therefore we utilize a one-tailed test at either a 90 or 99% confidence interval. This test only considers the combination of adverse interest rate paths coupled with our counterparty's default probability and expected recovery rate.

Chart 1

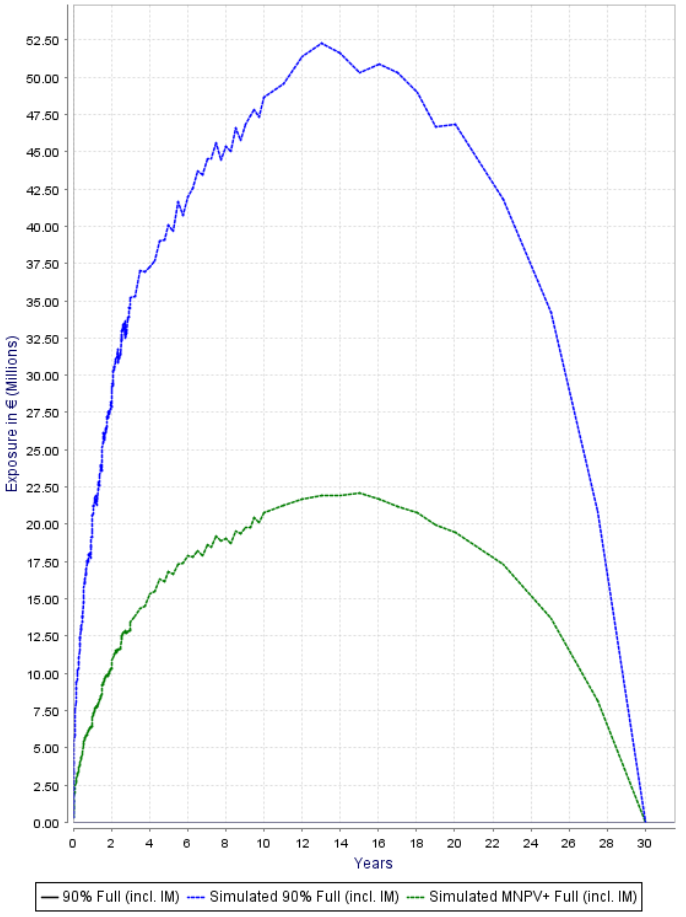


Chart 1 indicates considerable credit exposure for this unsecured transaction. Since credit appetite to any particular counterparty is typically expressed as a fixed

Continued on page 9

amount of VAR exposure, it is easy to see that without credit mitigation, long tenor transactions can consume significant credit capacity. For this reason, it has become commonplace to employ credit risk mitigants in the regular course of business.

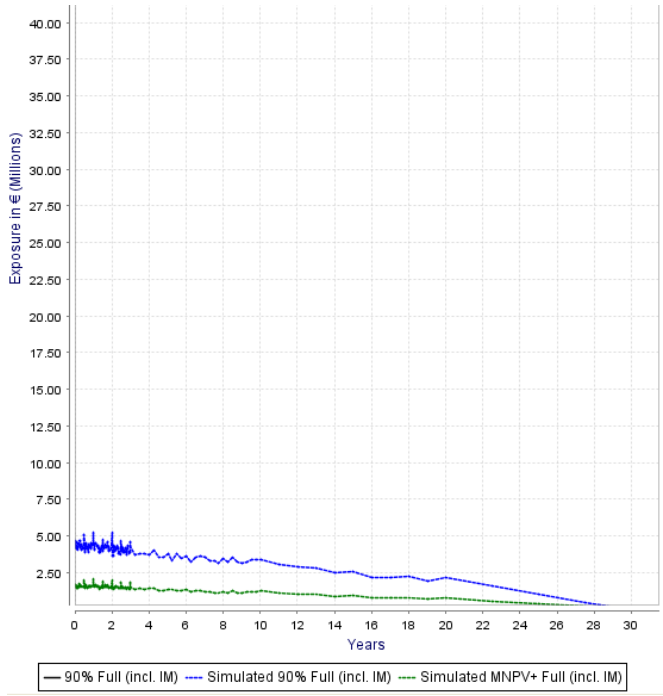
Mitigating Counterparty Credit Risk

The most powerful mitigant of asymmetric credit risk is collateralization. Much like exchange traded products, over the counter transactions can be collateralized with both initial and maintenance margin which can include cash, government securities, and even corporate securities in certain circumstances.

Chart 2 demonstrates the effect on the VAR simulation when employing collateralization as discussed above. Specifically, in this example we assume the following:

- Bilateral, zero threshold collateral posting requirement.
- Daily collateral exchanges.

Chart 2



Clearly, collateralization permits significantly more volume to be transacted given a certain amount of overall credit appetite. At the 2012 GIOA conference, for example, a large derivative customer of BNP Paribas indicated that their total notional portfolio exceeded $100 billion, but due to the effect of collateral and netting, their VAR exposure totaled only $13 million.

It is important to note that even with full collateralization, there remains residual counterparty exposure. This risk stems mainly from assumptions surrounding the mechanics of liquidating collateral in a counterparty default scenario.

Finally, there exist legal mitigants to counterparty credit risk. Credit terms can be included in the legal documentation that require termination upon ratings downgrade, netting of offsetting transactions, and third party custodians for collateral safekeeping.

Post 2008, counterparty credit risk is at the forefront of most financial risk manager's responsibilities. Fortunately, with improvements in the technology of measuring this risk, coupled with more robust mechanical and legal mitigants, counterparty credit risk can be largely managed.

We would like to thank our sponsors for their participation at our 2012 annual conference in Las Vegas, Nevada.

8th Annual GIOA Conference

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