

# MONTANA BOARD OF INVESTMENTS

Department of Commerce

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June 1, 2010

Financial Crisis Inquiry Commission  
1717 Pennsylvania NW, Suite 800  
Washington, DC 20006

Re: Rating agency impact on Montana Public Funds

As you requested, I am sending you the Montana Board of Investments experience with its reliance on the rating agencies.

**The Board's Legal Mission** – Pursuant to state law, the Board invests all state funds; including state/local pension funds, trust funds, insurance funds, state agency cash; and local government funds at their discretion. The Board currently invests \$12.4 billion. Historically, all fixed-income investments have been managed by Board staff. Board policy requires that the securities be investment grade when purchased and consequently staff has been extraordinarily dependent upon rating agencies to accurately gauge the risk of fixed income investments.

**The Rating Agencies Failed When We Needed Them** - While the rating agencies have many years of experience rating plain vanilla securities, when they began rating the complex securities created by Wall Street, they got it wrong. The Board is still living with the lingering effects of the “Structured Investment Vehicles” (Vehicles) that were given the highest possible ratings by the agencies. For the creators of these securities, the concept was simple - sell short term securities and use the cash to invest in long term securities. The interest rate “spread” between short term rates and long term rates would provide the profits - and the long-term debt would serve as collateral for the short term debt. The agencies rated the long-term debt purchased within the Vehicles as well as the short-term debt that funded them; a process much more complex than that for a corporate bond.

First, many of the long term securities in the Vehicles were complex, such as Collateralized Debt Obligations, Collateralized Loan Obligations, and Collateralized Bank Obligations. Second, the default risk of the short term debt was magnified because it included not only the default risk of the long term debt (collateral) but the risk that no one would purchase the short term debt when it matured. (The short term debt was simply intended to be “rolled over” until all the long-term debt matured or was sold.) The “rolling over process” fell apart during the financial markets meltdown. Investors were no longer willing to purchase the Vehicles and unless the sponsoring

bank/investment manager had the financial resources to pay off the short-term debt when due, the Vehicles defaulted.

**The Board's Reliance on the Rating Agencies** - The Board was detrimentally impacted by the rating agencies failure to properly rate these investments and is still holding two Vehicles that defaulted just months after they were purchased with a triple-A rating from both Moody's and S&P. The table below shows the Vehicles held in the Board's Short Term Investment Pool (a money market type fund) as of November 15, 2007 and their ratings at the date of purchase.

<u>Purchase Date</u>	<u>Issue</u>	<u>Ratings</u>		<u>Par</u>	<u>Maturity</u>
		<u>Moody's</u>	<u>S&amp;P</u>		
12/22/06	Premier Asset	Aaa	AAA	30,000,000	12/21/07
12/11/06	Cullinan Finance	Aaa	AAA	25,000,000	01/04/08
01/12/07	Theta	Aaa	AAA	15,000,000	01/14/08
02/08/07	Theta	Aaa	AAA	40,000,000	02/08/08
01/16/07	Orion	Aaa	AAA	25,000,000	01/16/08
04/20/07	Orion	Aaa	AAA	25,000,000	04/21/08
01/30/07	Sigma	Aaa	AAA	30,000,000	02/04/08
02/28/07	Parkland	Aaa	AAA	25,000,000	02/28/08
05/25/07	Parkland	Aaa	AAA	25,000,000	05/27/08
03/13/07	Courtland	Aaa	AAA	50,000,000	03/13/08
04/30/07	Courtland	Aaa	AAA	25,000,000	04/15/08
04/12/07	Axon	Aaa	AAA	40,000,000	04/14/08
04/16/07	Axon	Aaa	AAA	50,000,000	04/15/08
05/29/07	Harrier	Aaa	AAA	40,000,000	05/29/08
06/06/07	Harrier	Aaa	AAA	40,000,000	06/06/08
06/20/07	Vetra	Aaa	AAA	40,000,000	06/20/08
07/22/07	Hudson Thames	Aaa	AAA	25,000,000	07/22/08
<b>Total SIV's</b>				<b>550,000,000</b>	
<b>Total Portfolio</b>				<b>2,427,958,264</b>	
<b>SIV's Percentage</b>				<b>22.65%</b>	

The Board would not have purchased these Vehicles without the over-inflated ratings published by the rating agencies. On its face, it seems preposterous for the rating agencies to have suggested that these complex, exotic creations were as risk-free as US Government Bonds. But, at that time the Board still had confidence in the rating agencies and assumed the Vehicles had been thoroughly vetted and that default risks were low. When the financial markets melted down, several of these Vehicles were bailed out by the banks that created them. But, for those Vehicles created by entities without deep pockets, the worst possible scenario unfolded. Axon defaulted in November 2007 and Orion defaulted in January 2008 and the Board still holds them in its money market pool. These short term securities rated on par with US Government Bonds became long-term, defaulted securities, entangled in complicated work-outs, with no assurance of recovery.

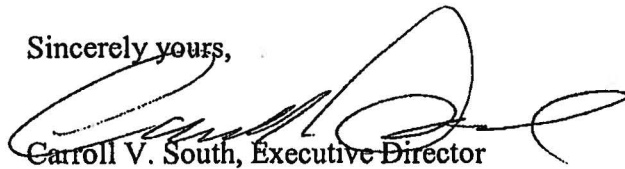
Additionally, the Axon default precipitated a "run on the pool" by local governments. In less than two weeks after the default, local governments withdrew \$359 million, or 40.0 percent of

their pool investments. It was only because of the stability provided by state funds in the pool, that a major crisis was averted.

**Conclusion** –The Board has lost confidence in the ability or willingness of the rating agencies to protect the interests of investors. Fixed-income investors are totally at the mercy of the agencies because most investment policies require that a bond be rated prior to purchase. The rating agencies are the only source of that information. Because issuers pay agencies to rate their bonds, the agencies may be tempted to act in the best interest of the issuer rather than the investors who purchase the bonds. As more complex, exotic investments have been created and sold to investors, the rating agencies “got it wrong”, either because their vetting was superficial or they were unduly influenced by the creators of the investments and needed to “get the deal done.” When the rating agencies chose to rate complex and market-sensitive investments, such as Structured Investment Vehicles, as risk free as US Government Bonds, they failed the investors who were depending upon their independent, thorough analysis. The Board and other public fund investors are still living with the impacts of that failure.

If most issuers cannot sell bonds without a rating and most investors cannot buy bonds without a rating, the rating agencies have a collective monopoly that may require some type of oversight by an independent entity to ensure a level playing field for issuers as well as investors. The inherent conflict of the “issuer pay” model of the ratings industry should be addressed by some innovative method of paying for these services. Otherwise the industry will continue to be compromised in its ostensible goal of protecting investor interests.

Sincerely yours,



Carroll V. South, Executive Director  
Montana Board of Investments