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Local Government Investment Pools (LGIPs) Maintain Conservative Practices As Markets Recover From The Pandemic

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Sector	**Coronavirus, Credit Analysis, Fund Ratings**
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Key Takeaways

- Local government investment pools (LGIPs) remained resilient during the pandemic, and credit metrics continue to meet our expectations for the ratings.
- Rated LGIPs have gained assets, while managing seasonal flows.
- As yields remain at historic lows, LGIPs continue to focus on high credit quality assets, defensive maturity positions, and conservative asset allocations to help maintain principal stability.

During the height of the COVID-19-related market stress, local government investment pools (LGIPs) that we rate remained resilient and pertinent metrics were within our expectations for the ratings. As a result, we did not take any negative rating actions during that time (see "**Monitoring The Effect Of Market Volatility On Local Government Investment Pool Ratings**," May 19, 2020). One year on, we maintain this view as rated LGIPs continue to demonstrate conservative management and investment practices.

S&P Global Ratings has evaluated LGIPs since 1992, analyzing numerous pools and their respective investment practices, investment objectives, and policies to determine whether public funds are managed consistent with our fund rating criteria. LGIPs are typically organized as cost-effective investment options for municipalities and public entities to pool their idle cash and operating balances to attain economies of scale, via diversified investments, and to earn an incremental rate of return. Pools generally follow investment objectives that focus primarily on the safety of invested principal, followed by liquidity, and lastly yield.

There are traditionally two types of LGIPs that state and local governments and counties offer: constant NAV pools and variable NAV pools. Constant net asset value (CNAV) LGIPs have maintained exposures to high-quality assets, defensive maturity positions, and conservative asset allocations, all of which have supported NAV (net asset value per share) stability. CNAV pools generally seek to maintain a stable NAV of $1.00 (similar to a money market fund), whereas a variable NAV (VNAV) pool's investment objective generally weights the investment strategy to achieve a higher return (similar to a short-term fixed-income bond fund). We typically rate CNAV pools under our principal stability fund rating (PSFR) methodology and VNAV pools under our fund credit quality rating and fund volatility rating (FCQR/FVR) methodologies.

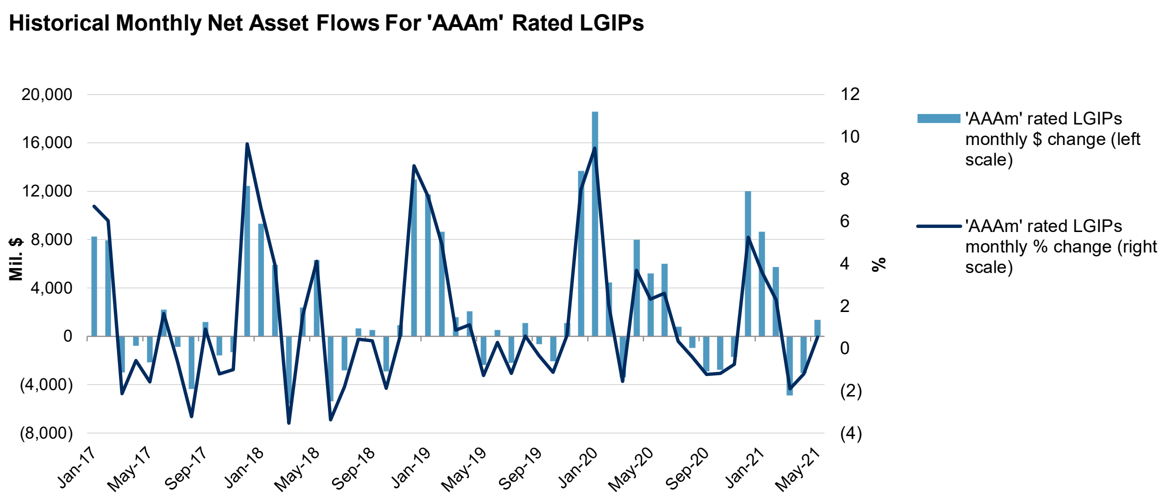
Asset Flows Remain Cyclical

LGIP shareholders, also known as pool participants, are typically state and local governments, cities, counties, school districts, and other public entities whose cash flow patterns are generally tied to recurring events like tax payments and receipts, debt service, and payrolls (see chart 1). In the past year, LGIPs have exhibited cyclical flow patterns as well as modest growth in net assets (see chart 2). Rated pool assets totaled $390 billion as of May 31, 2021, compared with $330 billion a year earlier, an 18% increase. When looking at the past 18 months, total rated pool assets are up 30%. Of the rated LGIP assets, 62% we rate under our PSFR methodology and the remainder under our FCQR/FVR methodology, which largely is consistent year over year, with the allocation of ratings distributed between the two methodologies

Rated LGIP sponsors and investment managers have spent significant time discussing with their underlying pool participants to understand liquidity needs and potential flow patterns during the pandemic. Based on our dialogue with these parties, we understand that flow patterns for

LGIPs continue as normal, but to some extent LGIPs have also received contributions via added bond proceed capital amid strong refinancing activities at the state and local government level. Federal stimulus deposits into pools have also been key to growth, but growth may likely be temporary as LGIP participants spend the stimulus balances in the near term.

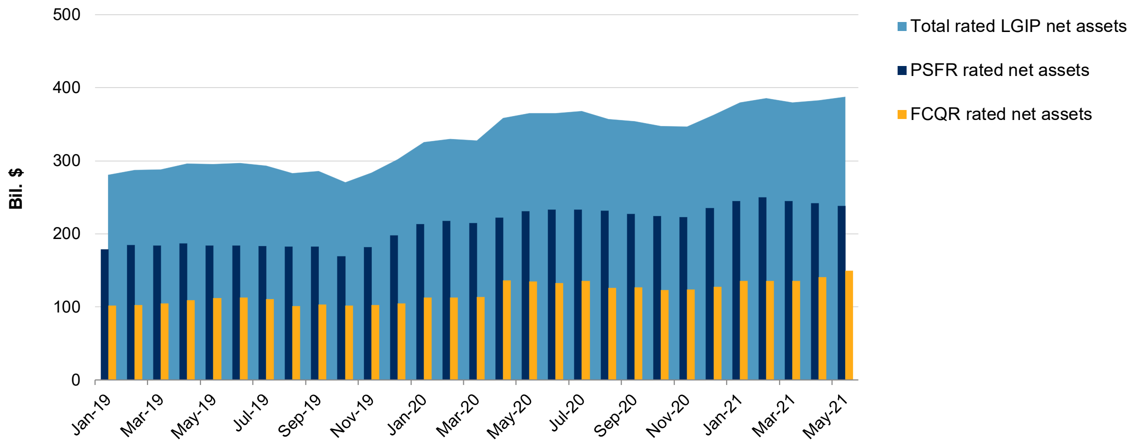
Chart 1



LGIPs--Local government investment pools. Source: S&P Global Ratings.

Chart 2

Total S&P Global Ratings LGIP Net Assets



LGIP--Local government investment pool. PSFR--Principal stability fund rating. FCQR--Fund credit quality rating. Source: S&P Global Ratings.

Even As Market Liquidity Levels Return To Normal, Pool Managers Are Remaining Cautious

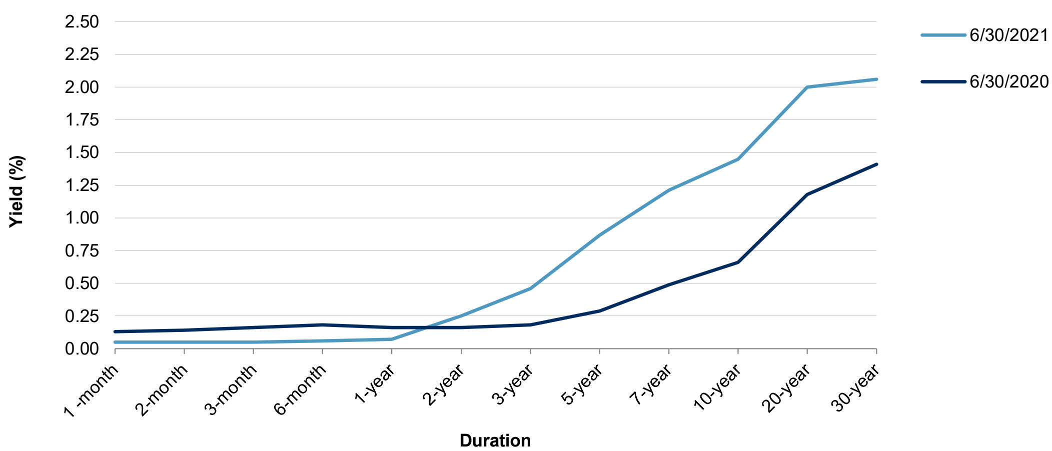
LGIPs historically have competed with SEC-registered money market funds (MMFs) and bank deposits as alternatives for state and local governments' idle cash. LGIPs generally have provided a slight pickup in yield (net of fees and expenses) over MMFs and, thus, have been a favorable option for municipalities. With the flattening of the U.S. Treasury yield curve on the front end (one year or less), the key challenge pools face under current market conditions is maintaining competitive yields while rates are near zero.

In our discussions, rated pool managers have generally indicated a calm but cautious mindset as it relates to current market conditions. Market liquidity has returned to relatively normal levels, but pool managers have highlighted the risk-return trade-off for materially extending maturities or taking excess credit risk remains impractical. Based on these factors, we have observed pool managers adopting a defensive stance--maintaining ample liquidity to mitigate the effects of potential future market disruptions.

We note LGIPs are not registered with the SEC under the Investment Company Act of 1940 and, therefore, can differ in their level of risk taking, internal oversight, shareholder transparency, and external reporting. Rated pools, on the other hand, have generally held steady with their conservative approach rather than reaching for yield.

Chart 3

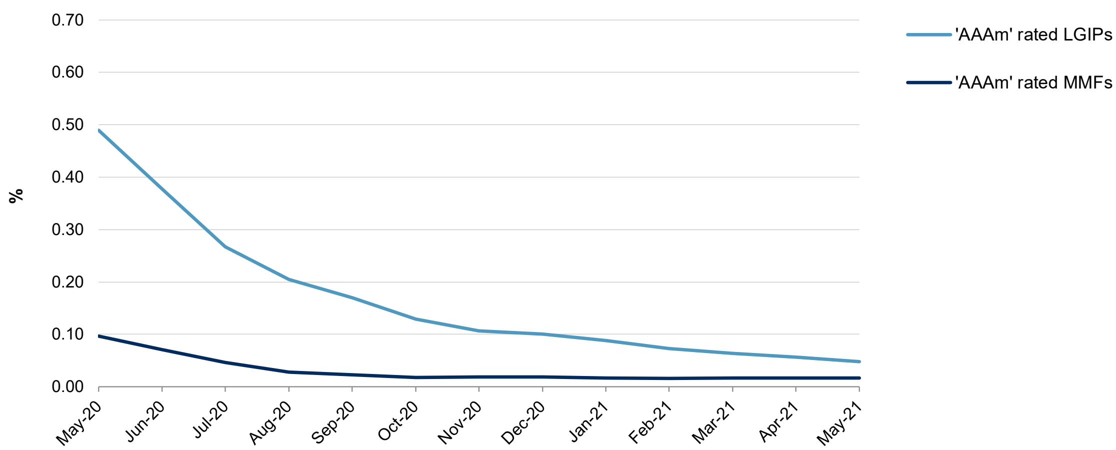
U.S Treasury Yield Curve Rates



Source: U.S. Department of the Treasury.

Chart 4

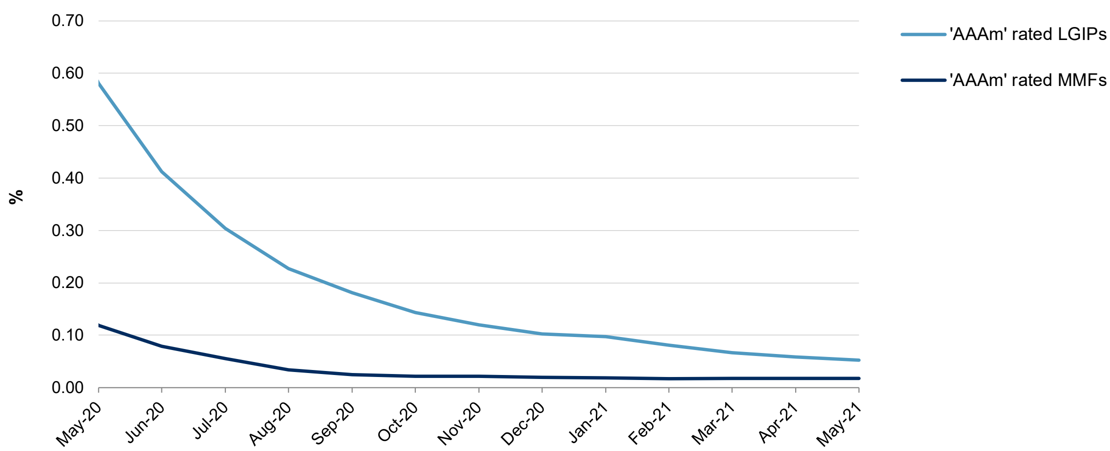
'AAAm' U.S. Dollar Funds' Seven-Day Net Yields



LGIPs--Local government investment pools. MMFs--Money market funds. Sources: S&P Global Ratings and Crane Data.

Chart 5

'AAAm' U.S. Dollar Funds' 30-Day Net Yields



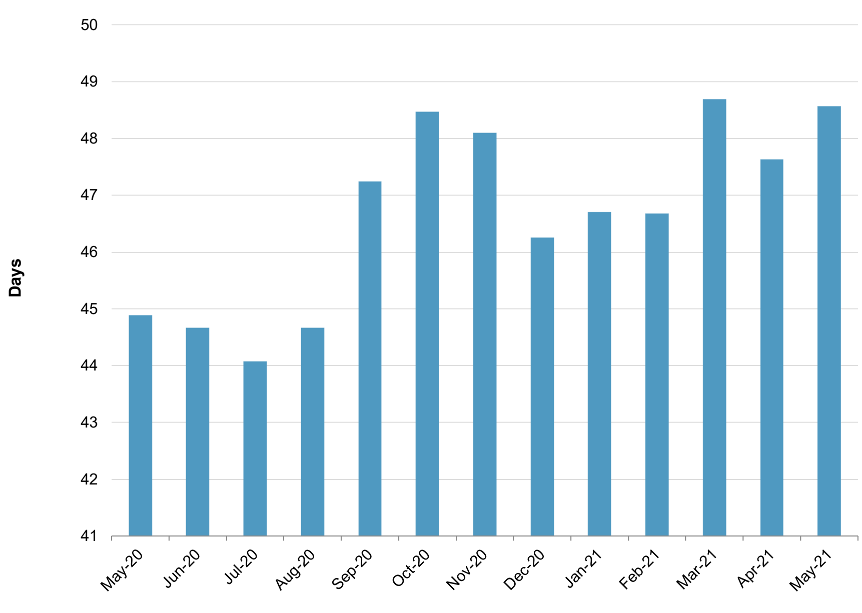
LGIPs--Local government investment pools. MMFs--Money market funds. Sources: S&P Global Ratings and Crane Data.

Some LGIPs Are Extending Maturities But Overall Are Remaining Conservative

In our view, a portfolio's weighted-average maturity (WAM) is a key measure of a fund's tolerance and sensitivity to changes in interest rates. Based on recent directives from the Fed, rates are expected to remain low until at least 2023. That said, pools have remained conservative both from a WAM and weighted-average life (WAL) standpoint. In the past year, pools have been cautious in their approach to investment allocation, but they have also taken opportunities to extend maturities where practical. As such, rated pools have positioned WAMs slightly higher than this time last year, but only by a couple days and remained less than 50 days on average. WAMs of 60 days or less and WALs ranging from 90 days to 120 days (depending on the composition of floating-rate notes) are consistent with funds rated 'AAAm'. WAMs ranged from 44 days to 49 days, while the WAL has remained between 78 days and 85 days (see charts 6 and 7).

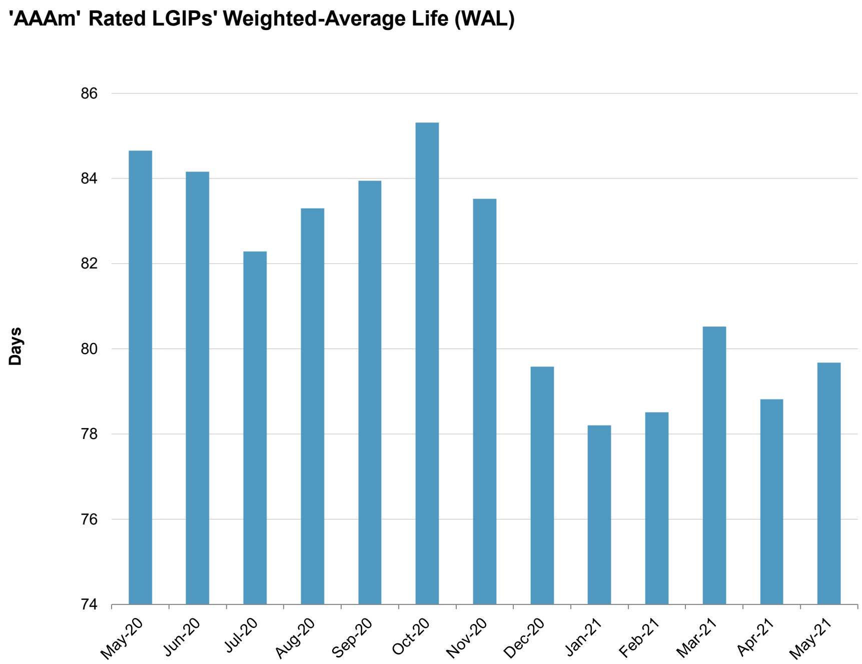
Chart 6

'AAAm' Rated LGIPs' Weighted-Average Maturity (WAM)



LGIPs--Local government investment pools. Source: S&P Global Ratings.

Chart 7

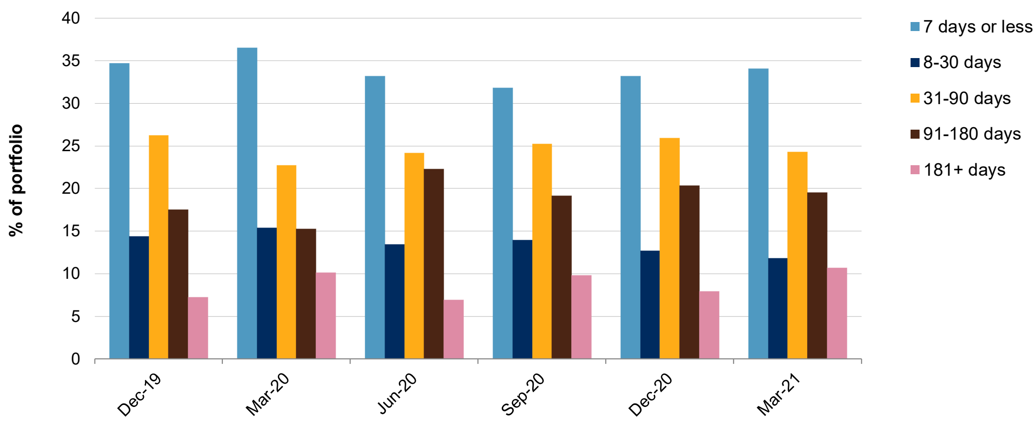


LGIPs--Local government investment pools. Source: S&P Global Ratings.

When looking at LGIP final maturities (see chart 8), we see pools have primarily focused on positioning assets maturing within one week, generally 32%-37% of total portfolio assets. Much of this strategy is likely because guidelines issued under Governmental Accounting Standards Board (GASB) Statement 79, allow LGIPs to price their portfolios using amortized cost if certain underlying conditions are met. One of these conditions requires pools hold a minimum 10% of assets with daily liquidity and 30% of assets with weekly liquidity. Outside of fulfilling their weekly liquidity mandates, pools have generally positioned maturities in the three-to-six-month part of the curve, which typically represented 40%-45% of portfolio assets on average.

Chart 8

'AAAm' Rated LGIP Maturity Composition



LGIP--Local government investment pool. Source: S&P Global Ratings.

We are of the opinion that an essential factor in managing liquidity is the investment manager's assessment of the underlying shareholder base and its process and philosophy in determining appropriate liquidity levels in the event unexpected redemptions occur. As discussed earlier, LGIPs have maintained their normal cyclical flow patterns. This predictable nature of flows benefits LGIP investment managers when determining a pool's maturity structure and securing appropriate liquidity to meet expected and unexpected flows. With foreseeable flow information, investment managers of certain rated LGIPs gain insights about where potential opportunities may arise when allocating assets.

Rated Pools' Asset Allocations Remain Consistent Over Time, With Some Having Concentrations in LOC-Backed Deposits

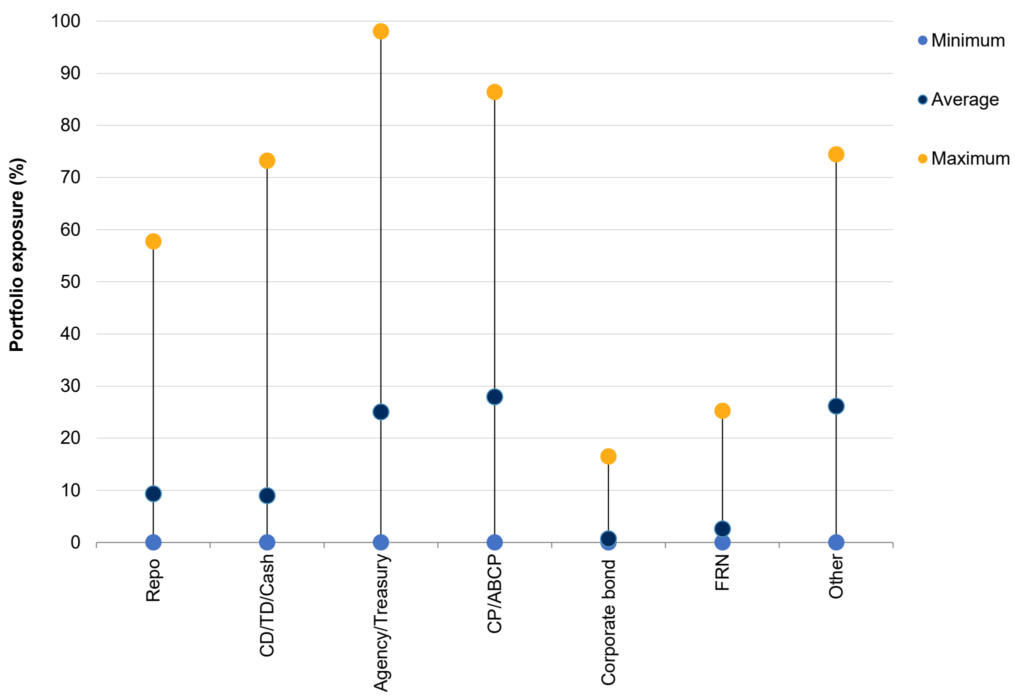
Pool managers generally consider the shape of the yield curve, direction of rates, investment policies, and market conditions when determining the allocation of investments within a portfolio. As part of our monitoring of LGIPs, we have observed strategic allocations across rated pools have largely been consistent year over year. The asset mix generally remains "plain vanilla," with diversified exposures to short-term money market securities, including repurchase agreements, bank deposits, U.S. Treasury bills, U.S. government agencies, commercial paper, and floating-rate notes (see chart 9 for the allocations as of May 2021).

In addition, certain pools have sought opportunities via deposits that are either rated below 'A-1+' or 'A-1' short-term rating or, in some cases, unrated, at face value. Mitigating factors for these deposits include credit substitution features with highly rated guarantors or that benefit from a Federal Deposit Insurance Corp. (FDIC) guarantee. Deposits with credit enhancements are usually backed by a letter of credit (LOC) issued by a U.S. agency (such as a Federal Home Loan Bank). If determined consistent with criteria, we view the credit substitution as equivalent to the credit enhancer, (i.e., FHLB) for credit quality and diversification purposes. We have seen large concentration to these LOC-backed deposits at times, primarily because the fund's ultimate exposure is to a U.S. agency. Deposits that are subject to an FDIC guarantee are typically invested through a pooled deposit program, where invested assets are distributed across a network of participating banks with deposit size amounts below the current FDIC limit of $250,000. (For more information, see "
Guidance: Principal Stability Fund And Fund Credit Quality Ratings Methodology
," Oct. 27, 2020).

For these types of investments, we independently review each transaction and determine consistency with our relevant credit enhancement criteria. In general, we view the presence of FHLB LOC credit enhancements or FDIC insurance for U.S. bank deposits, including those deposited at unrated banks, as supportive of money fund NAV stability (see the "Liquidity" section of the PSFR methodology). In addition, we generally include the benefit of credit substitution as supportive for PSFRs because it relates to money fund NAV stability and for the determination of a rating input within the FCQR methodology (see the "Credit Quality" section of the PSFR methodology and the "Ratings Inputs" section of the FCQR methodology).

Chart 9

'AAAm' LGIP Portfolio Composition As Of May 2021



LGIP--Local government investment pool. CD--Certificates of deposit. TD--Time deposits. CP--Commercial paper. ABCP--Asset-backed commercial paper. FRN--Floating-rate notes. Other--Letter of credit (LOC)-backed deposits and those with Federal Deposit Insurance Corp. (FDIC) exposure via pooled deposit programs. Source: S&P Global Ratings.

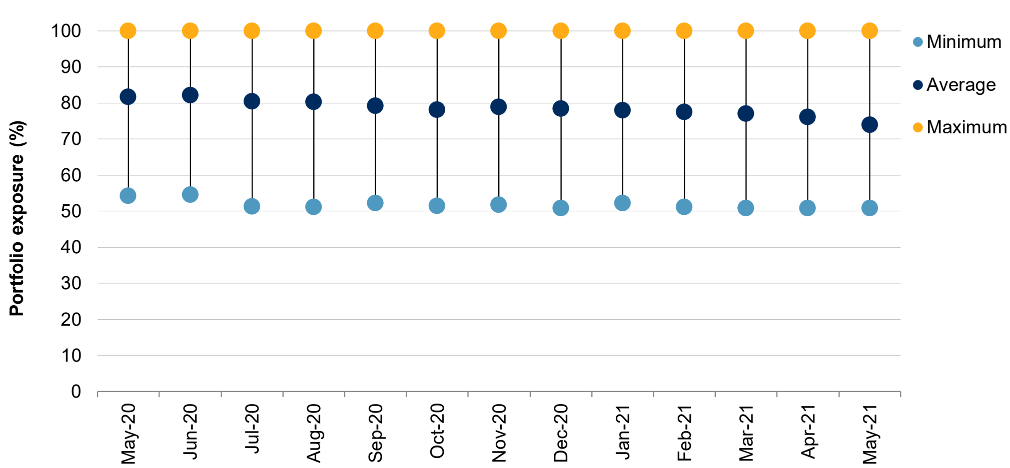
Credit Quality Has Held Up In The Past Year

We consider credit quality to play a key role in NAV stability and view higher-rated assets as indicating higher price stability. Our PSFR criteria call for pools rated 'AAAm' to manage a minimum of 50% of total fund assets in securities rated 'A-1+'.

In the past 12 months, no LGIP has dropped below this 50% threshold at any point, reflecting LGIP managers' diligence in maintaining high credit quality and a relatively stable list of underlying government, corporate, and bank investments. On average, the 'A-1+' allocation across rated pools has been 74%-82% over the past year (see chart 10). In instances where a 'AAAm' rated fund has breached the minimum 50% exposure of 'A-1+' rated securities, a 10-business-day cure period applies providing the fund's marked-to-market NAV remains consistent with the 'AAAm' NAV minimum of .9975.

Chart 10

'A-1+' Rated Exposure Within 'AAAm' Rated LGIPs



LGIPs--Local government investment pools. Source: S&P Global Ratings.

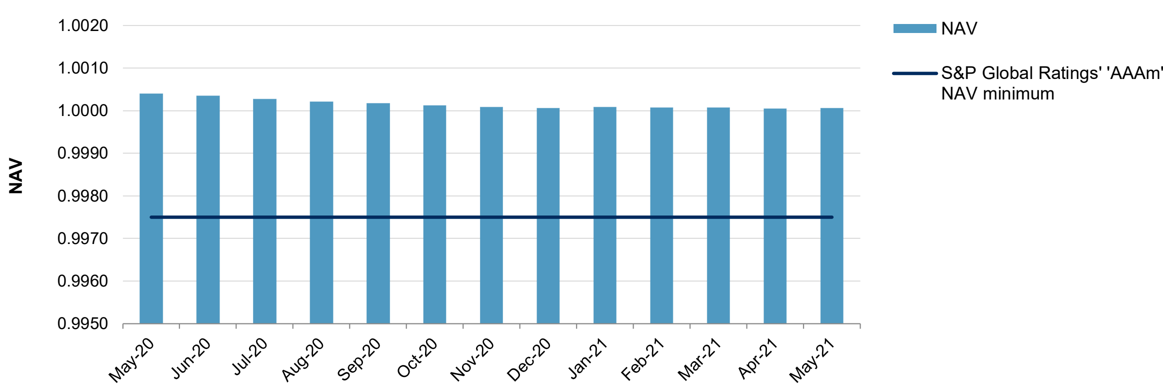
Rated Pool Managers Are Focusing On Managing Liquidity And Preserving Principal Value

Accurate portfolio valuation is essential to determine a pool's NAV. Valuation methods for certain pools and their underlying investments are often based on amortized cost for reporting purposes instead of mark-to-market calculations. Since we began rating LGIPs, we have maintained our view that accurate pricing is particularly important when interest rates are rising--especially when participant withdrawals increase to seek higher-yielding options. As part of our monitoring of rated pools, we ask that pools provide weekly mark-to-market pricing for LGIPs rated under our PSFR methodology. We also seek to understand pricing policies and their respective pricing verification processes.

Based on our weekly surveillance of data and our interactions with pool providers, all of the LGIPs we rate have exhibited mark-to-market NAVs above 0.9975, the lowest deviation point for the 'AAAm' rating. In fact, rated pools have remained well above 0.9999 on average. Out of the 65 pools rated under our PSFR criteria, the highest mark-to-market NAV observed during the past 12 months was 1.00078, and the lowest was 0.999935 (see chart 11). Given the conservative strategies and management practices during this time, and the low yield, rated pool managers have clearly kept their sights on managing liquidity and preserving principal value.

Chart 11

Average Net Asset Values (NAVs) Of 'AAAm' Rated LGIPs



LGIPs--Local government investment pools. Source: S&P Global Ratings.

Related Criteria

- **Fund Credit Quality Ratings Methodology**, June 26, 2017
- **Principal Stability Fund Rating Methodology**, June 23, 2016

Related Research

- **Guidance: Principal Stability Fund And Fund Credit Quality Ratings Methodology**
  , Oct. 27, 2020
- **Monitoring The Effect Of Market Volatility On Local Government Investment Pool Ratings**
  , May 19, 2020
- **How Liquidity Risk Factors Into Money Market Fund Ratings**, June 21, 2016

This report does not constitute a rating action.

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