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$1B in Hawaii state investments tied up

- **Lapses noted in fiscal reporting**
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Hawai'i bought its auction-rate securities through Salomon Smith Barney, a unit of Citigroup Inc., which has agreed to re-buy $7.5 billion of auction-rate securities from small investors.

Bloomberg News Service

For the past 18 months the state has been unable to use $1 billion it sank into supposedly highly liquid, short-term investments because of a collapse in trading of the securities.

No one knows for certain when the state will get its money out of so-called auction-rate securities, and an auditor recently required the state to revalue its holdings at $114 million less than what it paid for the investments.

"It is disturbing that we have that much money tied up in something like that," said Rep. Karl Rhoads, D-28th (Palama, Downtown, Lower Makiki), who learned of the frozen assets from a constituent. "We knew or should have known it could have become illiquid."

Even with the frozen assets, the state has more than enough in other money to pay its bills and fund projects, said Scott Kami, administrator of the state's Financial Services Division. But he acknowledges no efficient, real market for the auction-rate securities exist at this time.

"We were always able to meet all of our liquidity requirements," Kami said.

"The investments (auction-rate securities) continue to pay a very good rate of return and we don't see any actual losses because of this."

The situation can be traced to a rise in the popularity of auction-rate securities as "near cash equivalents" or investments that can be easily and quickly converted into cash, and problems experienced on Wall Street early last year.

The rate of return on auction-rate securities is typically higher than comparable investments with interest rates or yields being set in auctions taking place on a weekly or monthly basis. For borrowers, the auction-rate market was a way to get short-term borrowing rates on long-term obligations.

The market for auction rates was pitched as an alternative to lower-yielding money market mutual funds or certificates of deposit along with promises from brokers to buy back the investments should the securities fail to attract bids at auction.

As a result, the market grew from nothing in 1984 to at least $325 billion of the securities when the auctions began failing last year as dealers hamstrung by subprime losses pulled back from purchase guarantees and credit markets started to tighten.

MORIBUND MARKET

For most of that quarter-century, auction-rate securities were a prudent way for financial officers to park money and get a higher rate of return. No auctions failed and the state of Hawai'i only invested in student-loan auction-rate securities, known as SLARS, that were issued with bond insurance.

The state of Hawai'i is just one of many large investors holding auction-rate securities — among corporations alone, 400 companies ranging from Google Inc. to Starbucks Corp. bought them, resulting in $4.8 billion of write-downs, according to Bloomberg News.

But while other markets have rebounded from the worst credit crisis since the Great Depression, the auction-rate market remains moribund. Bloomberg said SecondMarket Inc., a New York brokerage firm, has estimated $160 billion of auction-rate securities await refinancing.

At the state Department of Budget and Finance, the investment in auction rates totaled $1.1 billion of the $4.5 billion in total investments at the time the market failed.

The purchase of student loan auction rate securities was allowed by state law as long as the investments were deemed AAA by financial rating agencies.

State Auditor Marion Higa questions whether it was good to have had a quarter of the state's investments in auction-rate securities.

"It was a surprise to me to learn we were this heavily invested in student-rate loans," Higa said.

"It is something that the public needs to know — that so much of our cash is illiquid."

The situation caught the eye of Deloitte & Touche LLP auditors that are annually brought in to look over the state's books.

The examiners insisted the state was wrong in how it valued the SLARS and that accounting standards demanded they be assessed at their fair market value. The state had told the auditors it didn't think it needed to write down the value since it had the capability to hold the SLARS until they matured in eight to 38 years.

Auditors also noted the investments were now in violation of policies that short-term investments be less than five years in duration and that three of the SLARS purchased for $54.3 million had fallen below the AAA-rating standard.

The state eventually wrote down the $1.1 billion by $114 million, heeding the auditor's recommendations. Some firms that have needed to get at the money tied up in auction-rate securities have sought sales through specialty brokers such as SecondMarket for 60 cents to 80 cents on the dollar.

'WE NEED THE MONEY'

Rhoads said he was concerned about the state's reluctance to write down the investments and wonders if the state should be more aggressive in seeking redress.

"If we've lost $114 million, how come we're not suing to get some of that back because Lord knows, we need the money right now," Rhoads said.

For now the state is reserving its right to sue investment banks that sold the SLARS. New York Attorney General Andrew Cuomo sued Charles Schwab Corp. this month claiming the broker had misrepresented auction-rate securities as liquid investments.

While the state of Hawai'i says it could hold the securities until their maturity, it is hoping the banks will make good on an agreement they struck with the U.S. Securities and Exchange Commission on the auction-rate problem.

Kami said the state bought its SLARS through Salomon Smith Barney, a unit of giant investment firm Citigroup Inc., which last year agreed with the SEC to repurchase $7.5 billion of auction-rate securities from small investors with less than $10 million in holdings. It must "use its best efforts" by the end of 2009 to make good on $12 billion sold to larger investors.

"We believe if they don't make a good faith effort it does provide grounds for the SEC and other regulatory entities to take action against these firms," Kami said.

For now the state is in an OK position and able to weather the loss of liquidity while collecting interest off the investments. "We've adjusted the rest of our investment portfolio to provide us with that short-term liquidity now," Kami said.

"We believe either through the SEC settlement or the markets coming back eventually there will be an efficient market to liquidate these investments without any loss."

Bloomberg News Service contributed to this report.