

Date of Hearing: April 11, 2018

ASSEMBLY COMMITTEE ON LOCAL GOVERNMENT

Cecilia Aguiar-Curry, Chair

AB 1770 (Steinorth) – As Introduced January 4, 2018

SUBJECT: Local government: investments.

SUMMARY: Updates and clarifies the preconditions required for asset-backed securities (ABS) and other pass-through securities in which local agencies may invest. Specifically, **this bill:**

- 1) Removes a rating requirement on issuers of mortgage passthrough securities, collateralized mortgage obligations, mortgage-backed or other pay-through bonds, equipment lease-backed certificates, consumer receivable passthrough certificates, or consumer receivable-backed bonds.
- 2) Clarifies that all of the investment vehicles in 1), above, must have a maximum remaining maturity of five years or less.

EXISTING LAW:

- 1) Allows the legislative body of a local agency to invest funds not immediately needed by the agency in a variety of specified financial instruments.
- 2) Allows local agencies to invest in a mortgage passthrough security, collateralized mortgage obligation, mortgage-backed or other pay-through bond, equipment lease-backed certificate, consumer receivable passthrough certificate, or consumer receivable-backed bond of a maximum of five years' maturity.
- 3) Requires securities eligible for investment pursuant to 2), above, to be issued by an issuer rated in a rating category of "A" or its equivalent or better for the issuer's debt as provided by a nationally recognized statistical rating organization (NRSRO) and rated in a rating category of "AA" or its equivalent or better by an NRSRO.

FISCAL EFFECT: None

COMMENTS:

- 1) **Bill Summary.** This bill updates and clarifies the preconditions required for specified asset-backed securities and other pass-through securities in which local agencies are allowed to invest. Specifically, this bill removes a requirement that mortgage passthrough securities, collateralized mortgage obligations, mortgage-backed or other pay-through bonds, equipment lease-backed certificates, consumer receivable passthrough certificates, or consumer receivable-backed bonds be issued by an issuer rated in a rating category of "A" or its equivalent or better for the issuer's debt as provided by an NRSRO. This bill also clarifies that all of these types of investments must have a maximum remaining maturity of five years or less.

This bill is sponsored by the California Association of County Treasurers and Tax Collectors.

- 2) **Author's Statement.** According to the author, "Local agencies' opportunities for investment in highly-rated ABS have been unnecessarily limited by requiring an *issuer* rating of "A" or better. As the statute is currently written, many "AA-AAA" rated ABS and pass through securities are ineligible for purchase due to the ambiguity surrounding the definition of what constitutes the *issuer* in an ABS transaction.

"The ABS market has experienced significant changes since (this requirement was enacted in) 1992, including the creation of registered securitized trusts, which purchase the assets from the issuer/sponsor and issue ABS in the marketplace. Most of these securitized trusts are not individually rated by the NRSROs, while ABS issued by the trusts may be rated "AA-AAA." Therefore, as currently written in the statute, the required "A" *issuer* rating prevents counties from investing in highly-rated ABS because of this ratings ambiguity.

"For example, the registered *asset-backed security* Ford Credit Auto Owner Trust 2017-B A3 (tranche) 1.69% 11/15/21 CUSIP# 34531HAD1 is rated "AAA" by S&P & Moody's, but is ineligible for purchase because Ford Motor Credit Co., LLC is rated Baa2/BBB/BBB. Ford Credit Auto Owner Trust 2017-B (not rated) is a separate legal entity from Ford Motor Credit Co., LLC. The ratings of Ford Motor Co. or Ford Motor Credit Co., LLC have no bearing on the trust because there is no support or guarantee to the asset-backed trust.

"Furthermore, the placement of commas and phrasing makes the application of the 'maximum of five years' maturity' tenor limit unclear. Given that all securities under the statute are understood to be non-government insured or backed (vs. government insured or backed agency pass through securities...), the language should be clear that all investment types in this section are limited to a maximum of five years' final maturity. The current language could be read to imply that only consumer receivable-backed bonds are limited to a maximum of five years' maturity."

- 3) **Background on Securitized Investment/Securities.** Since 1913, state law has authorized local officials to invest a portion of their temporarily idle funds in a variety of financial instruments. AB 3576 (Umberg), Chapter 173, Statutes of 1992, added certain types of collateralized medium term notes, or ABS, to the list of instruments eligible for local agency investment. Under the terms of AB 3576, local agencies were permitted to purchase mortgage pass-through securities, collateralized mortgage obligations, equipment lease-backed certificates, consumer receivable pass-through certificates, or consumer receivable-backed bonds of a maximum of five years maturity, provided all of the following conditions were met:
- a) The securities were rated "AA" or better by a NRSO;
 - b) The issuer of the securities had an "A" or higher rating for its debt as provided by a NRSO;
 - c) Such securities compromised no more than 20% of the agency's funds eligible for investment.

In 1992, the minimum "A" rating for an issuer was considered necessary due to the fact that the ABS market was still in its infancy. As noted above in the author's statement, the ABS market has experienced significant changes since the early 90's, including the creation of registered securitized trusts that purchase the assets from the issuer/sponsor and issue ABS in

the marketplace. Some issuers of ABS now in the market are not rated, precluding local agencies from investing in the securities they issue. By eliminating the requirement that issuers be rated, this bill will increase the securities in which local agencies are allowed to invest. Agencies will still be limited to purchasing highly-rated securities, maintaining the safety of the agencies' portfolios.

This bill will also clarify any uncertainty regarding which investment vehicles are subject to the five-year tenor limit by clarifying that all investment types in this category are limited to a maximum maturity limit of five years or less.

- 4) **Arguments in Support.** The California Association of County Treasurers and Tax Collectors, sponsor of this measure, states, "(Existing law requiring issuers to be rated) restricts counties and other agencies from purchasing many 'AA-AAA' rated ABS when their associated issuers do not meet the required rating...Additionally, the language (in existing law) is ambiguous with regard to the maximum maturity (tenor) limit of five years...Both of these outdated provisions create limitations that have caused counties that either purchase ABS or have outside advisors that manage their assets to lose important investment opportunities...AB 1770 will allow counties to purchase a broader range of 'AA-AAA' rated securities that are of very high quality, while also clearing up any ambiguity over the application of the five-year tenor limit. Both of these changes will allow counties to diversify their portfolios which will in turn increase portfolio safety, liquidity, and yield..."
- 5) **Arguments in Opposition.** None on file.

REGISTERED SUPPORT / OPPOSITION:

Support

California Association of County Treasurers and Tax Collectors
California Municipal Treasurers Association

Opposition

None on file

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