

Public Cash Management and the Subprime Loan Crisis: Be Aware of Financial Investment Risks

Posted by Michel Lazare

Effective cash management is one of the basic pillars of sound public financial management. The essence of effective cash management is conservation of cash. This includes minimizing idle cash balances by: (a) keeping on the government's account only the working cash balances needed to face day-to-day routine expenditures and the cash needed to face immediate financial obligations; (b) investing the remaining cash on liquid and interest-earning financial assets.

So far, so good. But, like any other financial investment, investing cash may present risks. A January 1, 2008, article in the New York Times provides a good illustration of the potential risks involved: municipalities in Florida have become victims of the subprime loan crisis.

In some US States, municipalities have the possibility of depositing their cash in investment pools: instead of investing their available cash themselves, municipalities can deposit it in a financial entity (the investment pool) which in turn invests the pooled cash. Because the investment pool is able of investing larger sums of money, it is in principle capable of earning a somewhat higher interest income and of passing these gains on to the municipality. At the same time, the investment pool avoids the need for a municipality, especially a small one, to gather the information and knowledge needed for investing its available cash. So, investment pools, which largely operate like money-market mutual funds (without technically being federally-regulated mutual funds), have a clear economic and financial logic and potentially provide valuable financial services to municipalities.

But this is only true to the extent that investment pools remain financially sound, do not invest in too risky financial assets, and remain liquid.

This is not exactly what happened in Florida, where the state-run investment pool invested \$2 billion out of its initial \$32 billion in financial assets based on subprime housing loans. In the financial crisis that erupted in Summer 2007, mostly in the US and Europe following the collapse of the subprime housing loan market, the financial assets held by the Florida investment pool lost a substantial part of their value. This in turn triggered a run on the investment pool (depositors quickly withdrawing their deposits) and the pool decided to freeze the municipalities' deposits. As the New York Times' article indicates, Florida municipalities are, for the moment at least, unable to withdraw their deposit from the investment pool and have to borrow to face their financial obligations or to delay some investment operations. They are also not sure if ultimately they will be able to recover all their deposits. Not a desirable position to be in when you manage public funds.

So, what are the lessons for managers of public funds across? Well, only a simple one. Investing available cash is worthwhile, but cash managers have to be aware of the risks involved in investing cash and should limit these risks (recall the Orange County, California investment pool debacle). This implies, to the extent possible, investing their cash in safe financial institutions and on financial assets



presenting limited risks. This is one of the reasons why FAD considers best practice to deposit public funds (at least those of the central government and if feasible of the general government) in a single treasury account located preferably at the central bank. As for financial investments, financial economics 101 indicates that there is an opposite correlation between income and risks: the higher the potential income, the higher the risks born. Managers of public funds should limit the risks encountered and invest on low-risk financial assets.

What happened to Florida municipalities is a reason for being vigilant and more aware of investment risks but not a reason for throwing the baby with the bath water and keeping unremunerated large idle cash balances.

January 4 2008

