



OFFICE OF THE ILLINOIS STATE TREASURER  
ALEXI GIANNOULIAS

February 7, 2008

**Re: Reduced Interest Income from State Investments**

Dear Legislator,

Leading economic indicators have caused many financial experts to predict a decline in the overall U.S. economy in 2008. The problems in the mortgage lending sector have resulted in disruptions in the credit markets, a decline in the housing market, a decrease in consumer spending, and have had a significant effect on the national GDP. While the future remains uncertain, many economists are expecting that these trends will impact the investments made by states throughout the nation and will continue through 2008 and beyond.

As the State's Chief Investment Officer, my office is responsible for investing surplus state funds. The interest income derived from these investments is allocated based on a formula prescribed by statute. In fiscal year 2007, 47 percent of the investment income was allocated to the General Revenue Fund (GRF). Interest income in fiscal year 2007 totaled almost *\$426 million* of which *\$202 million* went into the General Revenue Fund, while the rest went to special purpose and trust funds. Investments made in the first half of fiscal year 2008 have produced approximately *\$230 million* in interest income, yet our projection is that interest income for the entire fiscal year 2008 will likely fall below *\$400 million*.

My office has worked tirelessly to enhance the state's portfolio without jeopardizing state investments with additional risk. It's very important to note that no investments under the direction of the State Treasurer have been made in mortgage-backed securities, collateralized debt obligations, derivatives or other high-risk investments. (In fact, a *Crain's Chicago Business* article published on December 4, 2007 entitled, "State Funds Avoid Subprime Meltdown," explains how Illinois state funds are protected, while other states have experienced significant problems and lost revenue with their investments and exposure to the subprime crisis). Despite great uncertainty in the markets, Illinois' state funds are protected and secure.

In addition, the performance of state investments is expected to improve due to enhancements made by the State Treasurer's Office in the past year.

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The Treasurer's Office recently instituted Securities Lending, a program that allows for the short-term lending of securities that have not yet reached maturity in return for a promise of cash collateral, which is reinvested with the proceeds going to the state portfolio. Since the program is indemnified against the loss of the securities lent and against any loss during the reinvestment of the cash collateral, there is no increase in the risk profile of the state portfolio. With this new program, the portfolio now gains incremental income from what would otherwise be idle securities. Conservatively, we expect that this new investment strategy will add an annual incremental income of more than \$1 million to the General Revenue Fund.

The Treasurer's Office has also established the legal structure to allow for tri-party repurchase agreements. Prior to tri-party agreements, the Treasurer's Office was responsible for the physical transfer of collateral (usually securities) between various investment banks on behalf of our office and our trading partners, resulting in fees and expenses for each transaction for both the buyer and seller. However, tri-party repurchase agreements allow leading investment banks (used by both our office and our trading partners) to hold such collateral in an account on behalf of the state, eliminating the fees and expenses previously imposed on each transaction. This allows for higher yields due to the reduction in fees imposed on our trading partner.

These two new programs will produce higher yields for state investments and enable us to continue outperforming all our benchmarks and other institutional investors. We are constantly looking for innovative ways to help enhance the state's entire investment portfolio. Nonetheless, despite the best efforts of our office to protect our investments and produce higher yields, our analysis predicts a decline in interest income for fiscal years 2008 and 2009. Rates have declined as the market has grown more uncertain. Indeed, U.S. Treasury rates for 3, 6, 12 and 24 month securities have all declined by more than 280 basis points in the past year alone. Market performance appears to have reached its lowest point, and yet the trend in declining interest rates is expected to continue. The State Treasurer's Office will not attempt to offset any anticipated reductions in interest rates by pursuing higher-risk assets. Our investment policy will remain true to our bedrock principles of safety, liquidity and yield.

In anticipation of this decline, our office locked in certain investments while rates were more favorable earlier this year. Until those investments mature, they will continue to produce higher yields than what is currently available in the marketplace. As a result, the full impact of this market decline will not be felt in the state portfolio immediately. We do expect the market decline to trigger a significant reduction in interest income for fiscal year 2008 with total interest income for the year likely to fall somewhere between \$376 million and \$388 million, down from \$426 million in fiscal year 2007. In addition to declining rates of return, the economic downturn is expected to produce a smaller surplus of state funds available for investment, resulting in a significant reduction of investment income in future years. The state will feel the full impact of the lower rates and asset size in fiscal year 2009 when we project that interest income will only total between \$184 million and \$243 million. Previous economic downturns produced declining yields and declining investment balances for up to two years.

Even if the yields return to fiscal year 2007 levels faster than anticipated, total interest income will probably not rise to previous levels because the amount of funds invested will still be smaller. We anticipate that our interest income will not recover to fiscal year 2007 levels for quite some time.

I ask the Governor and the General Assembly to take note of this critical situation. This anticipated reduction in interest income poses significant challenges for the state's fiscal outlook going forward, and I urge the Governor and members of the General Assembly to provide the fiscal responsibility and leadership necessary to offset this decline. At the same time, the State Treasurer's Office will work to further enhance the state portfolio and continue to protect and secure state investments from unnecessary risk.

Sincerely,

A handwritten signature in black ink, appearing to read "Alexi G. Giannoulis". The signature is fluid and cursive, with a long horizontal stroke at the end.

Alexi Giannoulis  
Illinois State Treasurer