

**Public Employees' Individual Retirement
Account Fund**

(A Component Unit of the State of Alabama)

FINANCIAL STATEMENTS

For the Fiscal Year Ended September 30, 2008

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INDEPENDENT AUDITORS' REPORT

The Board of Control
Public Employees' Individual Retirement
Account Fund

We have audited the accompanying statement of fiduciary net assets of the Public Employees' Individual Retirement Account Fund (a component unit of the State of Alabama) as of September 30, 2008, and the related statement of changes in fiduciary net assets for the year then ended. These financial statements are the responsibility of the Public Employees' Individual Retirement Account Fund. Our responsibility is to express an opinion on these financial statements based on our audit. The prior year partial comparative information has been derived from the Public Employees' Individual Retirement Account Fund's 2007 financial statements, which were audited by other auditors who expressed an unqualified opinion on such financial statements in their report dated March 12, 2008.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 2008 financial statements referred to above present fairly, in all material respects, the financial position of the Public Employees' Individual Retirement Account Fund (a component unit of the State of Alabama) as of September 30, 2008, and its changes in fiduciary net assets for the year then ended in conformity with U.S. generally accepted accounting principles.

The management's discussion and analysis on pages 2 and 3 are not required parts of the basic financial statements but are supplementary information required by U.S. generally accepted accounting principles. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Carr, Riggs & Ingram, LLC

January 27, 2009
Montgomery, Alabama

PUBLIC EMPLOYEES' INDIVIDUAL RETIREMENT ACCOUNT FUND
Management's Discussion and Analysis

The Public Employees' Individual Retirement Account Fund (PEIRAF) was established in 1982 to provide public employees of the State of Alabama with an opportunity to invest in an employee contribution plan. The Tax Reform Act of 1986 prohibited contributions to employee contribution plans for years after 1986. Accordingly, on November 26, 1986, the Board elected to discontinue receiving contributions to the PEIRAF after December 31, 1986. Existing PEIRAF member accounts continue to be invested and available for distribution. The following discussion provides an overview of the financial position and results of operation for the PEIRAF as of and for the year ended September 30, 2008, respectively. For more detailed information, please refer to the financial statements, including the Notes to the Financial Statements.

Financial Statements

The financial statements include the Statement of Fiduciary Net Assets and the Statement of Changes in Fiduciary Net Assets. The Notes to the Financial Statements are considered an integral part of the financial statements. The financial statements are prepared using the economic resources measurement focus and accrual basis of accounting. Revenues are recognized when earned and expenses are recognized when incurred, regardless of when cash is received or expended. Investments are reported at fair value.

Statement of Fiduciary Net Assets – Includes all assets and liabilities of the PEIRAF and provides a snapshot of the financial position of the PEIRAF as of the end of the fiscal year. Assets less liabilities results in the net assets held in trust for members at fiscal year-end.

Statement of Changes in Fiduciary Net Assets – Reports all additions and deductions of the PEIRAF for the fiscal year. Additions are primarily comprised of investment income. Deductions are principally made up of normal distributions and member withdrawals. Additions minus deductions provide the change in fiduciary net assets for the fiscal year. The change in fiduciary net assets plus the beginning fiduciary net assets results in the fiduciary net assets held in trust for members at fiscal year-end.

The Notes to the Financial Statements include plan descriptions, a summary of significant accounting policies, credit risk disclosures for cash and investments, concentration of investments disclosures, and securities lending disclosures.

Comparative Summary Statements

Summary Comparative Statement of Fiduciary Net Assets
As of September 30, 2008 and 2007

	2008	2007	Variance	% Increase (Decrease)
<i>Assets</i>				
Cash	\$ 1	\$ -	\$ 1	-
Interest Receivable	1,192,053	1,199,576	(7,523)	(0.63)
Investments	76,837,016	80,702,538	(3,865,522)	(4.79)
Invested Securities Lending Collateral	26,853,800	21,748,392	5,105,408	23.47
<i>Total Assets</i>	<i>104,882,870</i>	<i>103,650,506</i>	<i>1,232,364</i>	<i>1.19</i>
<i>Liabilities</i>				
Securities Lending Collateral	26,853,800	21,748,392	5,105,408	23.47
<i>Total Liabilities</i>	<i>26,853,800</i>	<i>21,748,392</i>	<i>5,105,408</i>	<i>23.47</i>
<i>Net Assets Held in Trust for PEIRAF Benefits</i>	<i>\$ 78,029,070</i>	<i>\$ 81,902,114</i>	<i>\$ (3,873,044)</i>	<i>(4.73)</i>

PUBLIC EMPLOYEES' INDIVIDUAL RETIREMENT ACCOUNT FUND
Management's Discussion and Analysis

Summary Comparative Statement of Changes in Fiduciary Net Assets
For the Fiscal Years Ended September 30, 2008 and 2007

	2008	2007	Variance	% Increase (Decrease)
<i>Additions</i>				
Interest Income	\$ 4,443,676	\$ 4,620,360	\$ (176,684)	(3.82)
Net (Decrease)/Increase in Fair Value of Investments	(5,738,594)	1,852,991	(7,591,585)	(409.69)
Net Income from Securities Lending Activities	183,164	35,713	147,451	412.88
Total Additions	(1,111,754)	6,509,064	(7,620,818)	(117.08)
<i>Deductions</i>				
Normal Distributions	2,761,290	2,851,629	(90,339)	(3.17)
Total Deductions	2,761,290	2,851,629	(90,339)	(3.17)
<i>(Decrease)/Increase in Fiduciary Net Assets</i>	(3,873,044)	3,657,435	(7,530,479)	(205.90)
Net Assets Held in Trust for PEIRAF Benefits -				
Beginning of Year	81,902,114	78,244,679	3,657,435	4.67
<i>Net Assets Held in Trust for PEIRAF Benefits -</i>				
<i>End of Year</i>	<u><u>\$ 78,029,070</u></u>	<u><u>\$ 81,902,114</u></u>	<u><u>\$ (3,873,044)</u></u>	<u><u>(4.73)</u></u>

Financial Analysis

- Assets and liabilities related to invested securities lending collateral increased as a result of increased securities lending activity. Specifically, the demand for U.S. Government backed securities increased causing more lending opportunities.
- Earnings from securities lending activities increased and securities lending expenses had a net decrease, causing an overall increase in net income from securities lending activities for 2008. Increased lending due to greater demand from borrowers caused gross income from securities lending activities to be higher than in 2007. Also, borrower rebates decreased due to the lowering of Federal interest rates, causing a decline in securities lending expenses.
- The struggling economy caused lower earnings and resulted in an overall decrease in the fair value of existing fixed income securities.

PUBLIC EMPLOYEES' INDIVIDUAL RETIREMENT ACCOUNT FUND
Statement of Fiduciary Net Assets
September 30, 2008 with comparative amounts at September 30, 2007

	<u>2008</u>	<u>2007</u>
<i>Assets</i>		
Cash	\$ 1	\$ -
Interest Receivable	1,192,053	1,199,576
Investments, at Fair Value (Note 2)		
Commercial Paper	1,999,028	5,998,537
Money Market and Mutual Funds	3,950,285	2,105,947
U. S. Government Guaranteed Bonds	14,220,496	12,107,945
U. S. Agency Securities	13,379,317	22,373,722
Mortgage-backed Securities	6,364,964	263,252
Corporate Bonds	31,026,885	30,085,331
Private Placements	5,851,340	7,742,035
Common and Preferred Stocks	44,701	25,769
Total Investments	<u>76,837,016</u>	<u>80,702,538</u>
Invested Securities Lending Collateral	<u>26,853,800</u>	<u>21,748,392</u>
Total Assets	<u>104,882,870</u>	<u>103,650,506</u>
<i>Liabilities</i>		
Securities Lending Collateral	<u>26,853,800</u>	<u>21,748,392</u>
Total Liabilities	<u>26,853,800</u>	<u>21,748,392</u>
<i>Net Assets Held in Trust for PEIRAF Benefits</i>	<u>\$ 78,029,070</u>	<u>\$ 81,902,114</u>

See accompanying Notes to the Financial Statements.

PUBLIC EMPLOYEES' INDIVIDUAL RETIREMENT ACCOUNT FUND
Statement of Changes in Fiduciary Net Assets
For the Fiscal Year Ended September 30, 2008 with comparative amounts shown for 2007

	<u>2008</u>	<u>2007</u>
Additions		
Investment Income (Note 2)		
<i>From Investing Activities</i>		
Interest and Dividends	\$ 4,443,676	\$ 4,620,360
Net (Decrease)/Increase in Fair Value of Investments	<u>(5,738,594)</u>	<u>1,852,991</u>
Total Investment (Loss)/Income from Investing Activities	<u>(1,294,918)</u>	<u>6,473,351</u>
<i>From Securities Lending Activities</i>		
Securities Lending Income	858,046	850,766
Less Securities Lending Expenses:		
Borrower Rebates	639,139	808,751
Management Fees	<u>35,743</u>	<u>6,302</u>
Total Securities Lending Expenses	<u>674,882</u>	<u>815,053</u>
Income from Securities Lending Activities, Net	<u>183,164</u>	<u>35,713</u>
Net Investment (Loss)/Income	<u>(1,111,754)</u>	<u>6,509,064</u>
Total Additions	<u>(1,111,754)</u>	<u>6,509,064</u>
Deductions		
Normal Distributions	<u>2,761,290</u>	<u>2,851,629</u>
Total Deductions	<u>2,761,290</u>	<u>2,851,629</u>
Net (Decrease)/Increase	(3,873,044)	3,657,435
Net Assets Held in Trust for PEIRAF Benefits:		
Beginning of Year	<u>81,902,114</u>	<u>78,244,679</u>
End of Year	<u>\$ 78,029,070</u>	<u>\$ 81,902,114</u>

See accompanying Notes to the Financial Statements.

PUBLIC EMPLOYEES' INDIVIDUAL RETIREMENT ACCOUNT FUND

Notes to the Financial Statements

For the Fiscal Year Ended September 30, 2008

1) Organization and Summary of Significant Accounting Policies

A. Plan Description

The Public Employees' Individual Retirement Account Fund (PEIRAF) was established July 8, 1982 under the provision of Act 776 of the 1982 Legislature for the purpose of providing public employees of the State of Alabama an opportunity to receive benefits offered by the Economic Recovery Act of 1981 as it relates to individual retirement accounts for public employees covered by a mandatory public retirement plan. The PEIRAF operates as a deductible employee contribution plan, which began receiving deductible employee contributions November 1, 1982. The responsibility for the general administration and operation of the PEIRAF is vested with its Board of Control. In accordance with the Governmental Accounting Standards Board (GASB), the PEIRAF is considered a component unit of the State of Alabama (State) and is included in the State's *Comprehensive Annual Financial Report*.

All members of the Teachers' Retirement System of Alabama, Employees' Retirement System of Alabama, Judicial Retirement Fund, and employees of employers eligible to participate in the Employees' Retirement System pursuant to provisions of Section 36-27-6, *Code of Alabama 1975* are members of the PEIRAF and were eligible to make voluntary contributions. At September 30, 2008 there were 2,272 participants.

The Tax Reform Act of 1986 prohibited contributions to deductible employee contribution plans for years after 1986. Accordingly, on November 26, 1986, the PEIRAF Board of Control elected to discontinue receiving contributions to this plan after December 31, 1986. Existing PEIRAF member accounts will continue to be invested and reinvested and available for distribution.

B. Cash

Cash consists of deposits held by the State Treasurer in the PEIRAF's name. Deposits are entirely insured by Federal depository insurance or protected under the Security for Alabama Funds Enhancement (SAFE) Program. The *Code of Alabama 1975* requires all State organizations to participate in the SAFE Program. The SAFE Program is a multiple financial institution collateral pool. The SAFE Program requires all public funds to be deposited in a financial institution designated by the State Treasurer as a qualified public depository. Each qualified public depository is required to pledge collateral in accordance with the rules established by the SAFE Board of Directors. In the event that a qualified public depository defaults or becomes insolvent and the pledged collateral is insufficient to satisfy the claims of public depositors, the *Code of Alabama 1975, Section 41-14A-9(3)* authorizes the State Treasurer to make assessments against the other qualified public depositories in the pool so that there will be no loss of public funds.

C. Basis of Accounting

The PEIRAF is a private purpose trust fund that operates under the accrual basis of accounting. Revenues are recognized when earned and expenses are recognized when incurred, regardless of the timing of the cash flows in accordance with standards of the GASB.

PUBLIC EMPLOYEES' INDIVIDUAL RETIREMENT ACCOUNT FUND

Notes to the Financial Statements

For the Fiscal Year Ended September 30, 2008

D. Investments

The Board of Control has the authority and responsibility to invest and reinvest available funds, through the secretary-treasurer of the Employees' Retirement System, in bonds, mortgage-backed securities, common and preferred stock, or other investment vehicles with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use.

All investments are carried at fair value except money market funds with a remaining maturity of one year or less at the time of purchase which are reported at cost, which approximates fair value. Securities traded on national exchanges are valued at the last reported sales price at current exchange rates. Mortgage-backed securities are reported based on estimated future principal and interest payments discounted at the prevailing interest rate for similar instruments. Generally, private placements are valued based on the selling price of similar investments sold in the open market. In those instances where there are no similar investments sold in the open market, an appraisal is performed to determine the fair value of the private placements.

E. Income Distribution

All investment income earned on the accrual basis is posted monthly to member accounts based on average daily balances. The loss posted to member accounts was at an annual rate of -1.42 percent for the fiscal year.

F. Administrative Costs

Under the provisions of Legislative Act 2001-1061, the administrative costs incurred directly for the operation of the PEIRAF are provided from the expense funds of the Teachers' Retirement System and the Employees' Retirement System.

G. Distribution Policy

An employee may receive a lump-sum distribution, a partial distribution followed by equal monthly payments, or a monthly disbursement upon attaining age 59 ½ without penalty. There is no required age at which distributions must begin under this plan.

H. Comparative Statements

The basic financial statements include the prior year Statement of Fiduciary Net Assets and Statement of Changes in Fiduciary Net Assets (Statements) for comparative purposes only. Prior year Note Disclosures are not included. Therefore, the prior year basic financial statement presentation does not meet the minimum level of detail required for a presentation in conformity with generally accepted accounting principles. Accordingly, the prior year Statements should be read in conjunction with the PEIRAF's prior year financial report from which the prior year Statements were derived.

PUBLIC EMPLOYEES' INDIVIDUAL RETIREMENT ACCOUNT FUND

Notes to the Financial Statements

For the Fiscal Year Ended September 30, 2008

2) Investments

A. Investment Risks

Investments are subject to certain types of risks, including interest rate risk, custodial credit risk, and credit quality risk. The following describes those risks:

Interest Rate Risk – The fair value of fixed-maturity investments fluctuates in response to changes in market interest rates. Increases in prevailing interest rates generally translate into decreases in fair value of those instruments. The fair value of interest sensitive instruments may also be affected by the creditworthiness of the issuer, prepayment options, relative values of alternative investments, and other general market conditions. Certain fixed maturity investments have call provisions that could result in shorter maturity periods. However, the Fund's intent is to hold all fixed maturity investments until maturity, and as such, fixed maturity investments are classified in the following tables as if they were held to maturity.

Custodial Credit Risk – For an investment, custodial credit risk is the risk that an entity will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party if the counterparty fails. The PEIRAF's custodial credit risk policy requires the custodial agent to hold or direct its agents or subcustodians to hold, for the account of the PEIRAF all securities and other non-cash property other than securities in the Federal Reserve book-entry system, in a clearing agency which acts as a securities depository, or in another book-entry system. The PEIRAF's safekeeping agent holds all investments of the PEIRAF in the PEIRAF's name except for securities in the Securities Lending Program.

Credit Quality – Nationally recognized statistical rating organizations provide ratings of debt securities quality based on a variety of factors, such as the financial condition of the issuers, which provide investors with some idea of the issuer's ability to meet its obligations. Domestic fixed-maturity investments may consist of rated or non-rated securities. Short-term investments may consist of commercial paper rated at least A-2 and/or P-2, repurchase agreements, short-term U.S. securities, and other money market investments. U.S. government bonds, index linked government bonds, and certain government agency securities (Government National Mortgage Association securities or GNMA's) are explicitly backed by the full faith of the U.S. government and are not considered to have credit risk. The PEIRAF only invests in domestic fixed securities. The PEIRAF has a small amount of equity securities resulting from the conversion of debt securities to equity securities.

PUBLIC EMPLOYEES' INDIVIDUAL RETIREMENT ACCOUNT FUND

Notes to the Financial Statements

For the Fiscal Year Ended September 30, 2008

A. Investment Risks, Continued

The following table provides information as of September 30, 2008, concerning the fair value of investments and interest rate risk:

	INVESTMENTS					
	Maturity in Years at Fair Value					
Type of Investment	Less Than 1	1-5	6-10	More Than 10	Total Fair Value	Cost
<i>Fixed Maturity</i>						
Domestic						
Commercial Paper	\$ 1,999,028	\$ -	\$ -	\$ -	\$ 1,999,028	\$ 1,999,028
U.S. Agency	-	7,886,072	4,744,382	748,863	13,379,317	13,304,041
U.S. Government Guaranteed	1,516,050	4,808,434	7,896,012	-	14,220,496	13,393,842
Corporate Bonds	1,237,659	11,705,426	12,644,109	5,439,691	31,026,885	35,127,579
Private Placements	-	522,031	4,878,649	450,660	5,851,340	9,654,868
GNMAs	-	-	9,322	473,755	483,077	477,670
Collateralized Mortgage Obligations	-	62,324	-	5,819,563	5,881,887	5,913,303
Money Market Funds	3,950,285	-	-	-	3,950,285	3,950,285
Total Domestic Fixed Maturity	<u>\$ 8,703,022</u>	<u>\$ 24,984,287</u>	<u>\$ 30,172,474</u>	<u>\$ 12,932,532</u>	76,792,315	83,820,616
<i>Equities</i>						
Domestic					44,701	449,766
Total Investments					<u>\$ 76,837,016</u>	<u>\$ 84,270,382</u>

PUBLIC EMPLOYEES' INDIVIDUAL RETIREMENT ACCOUNT FUND

Notes to the Financial Statements

For the Fiscal Year Ended September 30, 2008

A. Investment Risks, Continued

The following table provides information as of September 30, 2008, concerning credit risk:

RATINGS OF FIXED MATURITIES

Moody's Ratings	Fair Value	Cost	Fair Value as a Percent of Total Fixed Maturity Fair Value
AAA	\$ 20,992,750	\$ 21,188,162	27.337%
AA1	715,834	725,607	0.932%
AA2	1,477,384	1,554,062	1.924%
AA3	2,382,113	2,982,629	3.102%
A1	3,082,196	3,575,838	4.014%
A2	3,458,034	3,887,839	4.503%
A3	4,641,653	4,934,294	6.044%
BAA1	3,632,161	4,005,708	4.730%
BAA2	7,272,793	8,051,988	9.471%
BAA3	2,072,573	2,361,523	2.699%
BA1	1,021,385	1,072,397	1.330%
B3	215,451	828,628	0.281%
CAA1	660,848	849,966	0.861%
P-1	3,950,285	3,950,285	5.144%
P-2	1,999,028	1,999,028	2.603%
U.S. Government Guaranteed Securities	14,703,573	13,871,512	19.147%
‡ Not Rated	4,514,254	7,981,150	5.879%
Totals	\$ 76,792,315	\$ 83,820,616	100.000%

‡ Primarily consists of private placements.

B. Concentration of Investments

As of September 30, 2008, the PEIRAF owned debt securities of Federal National Mortgage Association and Federal Home Loan Mortgage Corporation, which represented approximately 10.62% and 8.58%, respectively, of the total fair value of investments.

PUBLIC EMPLOYEES' INDIVIDUAL RETIREMENT ACCOUNT FUND

Notes to the Financial Statements

For the Fiscal Year Ended September 30, 2008

C. Securities Lending Program

The PEIRAF is authorized by the Board of Control to participate in a securities lending program. The PEIRAF's custodian, State Street Bank and Trust Company (State Street), administers the program. Certain securities from the PEIRAF are loaned to borrowers approved by the PEIRAF for collateral that will be returned for the same security in the future. Approved borrowers of securities provide acceptable collateral in the form of cash, securities issued or guaranteed by the United States government or its agencies or instrumentalities, sovereign debt, Canadian Provincial debt, convertible bonds, irrevocable bank letters of credit by a person other than the borrower or an affiliate of the borrower if State Street determines to be appropriate, and such other collateral as the parties may agree to in writing from time to time. All security loans are open loans and can be terminated on demand by the PEIRAF or borrower. The initial collateral received shall have (i) in the case of loaned securities denominated in United States Dollars or whose primary trading market is located in the United States, sovereign debt issued by foreign governments (other than Canada) or corporate bonds that are not denominated in United States Dollars (other than those issued in Canada), a value of 102% of the fair value of the loaned securities, or (ii) in the case of loan securities which are not denominated in United States Dollars or whose primary trading market is not located in the United States (and are not referenced in (i)), a value of 105% of the fair value of the loaned securities, or (iii) in the case of loaned securities comprised of UK gilts, a value of 102.5% of the fair value of the loaned securities, or (iv) in all other cases, such value, not less than 102% of the fair value of the loaned securities, as may be applicable in the jurisdiction in which such loaned securities are customarily traded. Pursuant to the terms of the applicable securities loan agreement, State Street shall, in accordance with State Street's reasonable and customary practices, mark loaned securities and collateral to their fair value each business day based upon the fair value of the collateral and the loaned securities at the close of business, employing the most recently available pricing information and shall receive and deliver collateral in order to maintain the value of the collateral at no less than 100% of the fair value of the loaned securities.

The PEIRAF cannot pledge or sell collateral securities received unless the borrower defaults. Cash collateral is invested in the State Street Quality D Short-term Investments Fund (QDF).

The following describes the QDF's guidelines. The QDF's average effective duration is restricted to 120 days or less. The maximum option-adjusted duration of any variable rate security investment of the QDF shall be five years or less. All fixed rate instruments must have an option-adjusted duration not to exceed 30 months. At the time of purchase, all securities with maturities of 13 months or less must qualify as first tier securities and all securities with maturities in excess of 13 months will be rated A or better by at least two nationally recognized statistical rating organizations (NRSROs), or, if not rated, be of comparable quality. The QDF may invest in other State Street managed investment vehicles provided they conform to QDF guidelines.

As of September 30, 2008, the average term of the loans was 2 days. Cash collateral investments in the QDF are matured as needed to fulfill loan obligations. There is no direct matching of the maturities of the loans with the investments made with cash collateral.

PUBLIC EMPLOYEES' INDIVIDUAL RETIREMENT ACCOUNT FUND

Notes to the Financial Statements

For the Fiscal Year Ended September 30, 2008

C. Securities Lending Program, Continued

At September 30, 2008, the fair value of the securities on loan was \$26,013,002. The fair value of the collateral pledged by the borrowers was \$26,853,800. Since the amounts owed by the PEIRAF exceeded the amounts the borrowers owed to the PEIRAF, there was no credit risk exposure as of September 30, 2008. There were no significant violations of legal or contractual provisions, no borrower or lending agent default losses, and no recoveries of prior period losses during the year.

Investments purchased with cash collateral are held by the custodial agent, but not in the name of the Fund. Securities pledged as collateral are held by the custodial agent, but not in the name of the Fund. Letters of credit pledged as collateral are issued by the borrower's bank and are irrevocable. The following table provides information as of September 30, 2008, concerning securities lent:

SECURITIES LENDING
INVESTMENTS LENT AND COLLATERAL RECEIVED
(at Fair Value)

Type of Investment Lent	Totals
<i>For Cash Collateral</i>	
Domestic Fixed Income	\$ 25,968,301
Domestic Equity	44,701
Total Securities Lent	<u>\$ 26,013,002</u>
Type of Collateral Received	
Cash Collateral - Invested in State Street Quality D Fund	<u>\$ 26,853,800</u>

D. Mortgage-backed Securities

As of September 30, 2008, the PEIRAF had investments in mortgaged-backed securities. Embedded prepayment options cause these investments to be highly sensitive to changes in interest rates. Prepayments by the obligors of the underlying assets reduce the total interest payments to be received. Generally, when interest rates fall, obligors tend to prepay the mortgages thus eliminating the stream of interest payments that would have been received under the original amortization schedule. The resulting reduction in cash flow diminishes the fair value of the mortgage-backed securities.