

**MWD**

METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

**Revised 8-10**February 23 March 13, 1995

## (Finance and Insurance Committee--Action)

To: Board of Directors (Committee on Legislation--Action)

From: General Manager

Subject: Policy Principles on Investments

APPROVED  
 By the Board of Directors of  
 The Metropolitan Water District  
 of Southern California  
 at its meeting held

**MAR 14 1995**

EXECUTIVE SECRETARY

Report

A number of bills have been introduced in the California Legislature on the topic of investment practices and related financial issues in the wake of the Orange County Bankruptcy. It is proposed that your Board adopt the policy principles on investment practices set forth below to guide Metropolitan's responses to these bills.

These principles are modeled on and consistent with the preliminary recommendations of the Task Force on Local and State Investment Practices, headed by State Treasurer Matt Fong and presented to Governor Wilson on February 1, 1995. Chief Financial Officer Bert Becker is a member of that Task Force. The Task Force's preliminary recommendations are attached as Exhibit A.

**Issue: Accountability of Local Agency Treasurers**

Examination of the Orange County bankruptcy has repeatedly pointed to the lack of accountability of the Orange County Treasurer and the County Board's lack of knowledge of the investment strategies being pursued by the Treasurer. Metropolitan's Treasurer presently provides your Board with monthly reports describing Metropolitan's investment securities by category, including the percentage of funds invested in each permissible category of investments, average weighted days to maturity and portfolio yield. This report is reviewed each month by the General Counsel to determine compliance of the investments with Administrative Code requirements. The Administrative Code also requires the Treasurer to render, not less than annually, a statement of investment policy for approval by the Board.

Staff recommends support of statutory amendments to require greater accountability of local agency treasurers to their governing bodies, similar to the Administrative Code requirements followed by Metropolitan's Treasurer. Underlying this recommendation is the assumption that local treasurers will retain the ability to invest funds on behalf of their respective agencies. Certain proposed legislation (Senate Bill 44, proposed by Senator Kopp of San Francisco) would take investment authority away from local treasurers and require Board approval for each investment of \$100,000 or more. Support of this policy principle will include opposition to Senate Bill 44 and any similar legislation.

**Recommended Policy #1:** Support amendments to state law requiring each local treasurer or chief fiscal officer (I) to provide, not less than annually, a written statement of investment policy to the legislative body of the local agency for its consideration, and (ii) to submit, not less than quarterly, reports to the legislative body containing a detailed description of the local agency's investment securities, including current market values, a statement of the percentage of investments in each category and a statement with respect to compliance with the written annual statement of investment policy. The reports would be required to be submitted to the legislative body within 30 days after the quarter's end.

#### Issue: Leveraging of Investments

Investigation of the Orange County investment losses has pointed to the hazards of leveraging investments. Staff recommends adoption of a policy limiting the extent to which an investment portfolio may be leveraged. This policy reiterates one of the suggested amendments to S.B. 27 (also introduced by Senator Kopp) approved by your Board at its February meeting. The Task Force on Local and State Investment Practices recommended that the use of reverse repurchase agreements be limited to 20 percent of a portfolio. Metropolitan's Investment Policy limits that use of reverse repurchase agreements to 10 percent of the portfolio. Metropolitan has not engaged in reverse repurchase activity.

If used in an appropriate manner reverse repurchase agreements can provide modest amounts of additional yield in a safe and secure manner.

Staff is preparing to the Investment Policy for Board consideration to further clarify and restrict the use of reverse repurchase agreements.

**Recommended Policy #2:** Support amendments to state law restricting the use of leverage in local and state investment portfolios by limiting reverse repurchase agreements to the lesser of ten percent of the investment portfolio or 25 percent of the U.S. Treasury and Agency securities held in the portfolio.

**Issue: Overreacting to Orange County Crisis**

The Orange County fiscal crisis has generated proposed legislation reacting and, in many cases, overreacting to the problems evident in the Orange County portfolio. Staff proposes adoption of a policy in line with the Task Force preliminary recommendation which opposes all legislation concerned with state and local investments, except as provided in Recommended Policies 1 and 2 above, until the agencies investigating the Orange County investment losses have had time to issue their reports and such reports have been reviewed.

**Recommended Policy #3:** Oppose Not support other changes in state laws concerning permitted state and local investments until after reports on Orange County from the State Auditor and from federal and state law enforcement agencies have been received and reviewed.

**Issue: Education for Local Officials**

Lack of education in financial matters among members of local agency boards may encourage investment abuses, or may prevent abuses from being discovered. The following policy principle proposes support for education programs of the type recommended by the Task Force.

**Recommended Policy #4:** Support efforts by the California Debt Advisory Commission, working with local agency finance officers, elected officials and associations representing them, to develop continuing education programs for state and local officials who have direct or supervisory responsibility for investments.

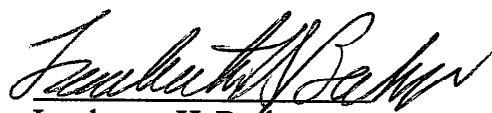
February 23 March 13, 1995

Recommendation

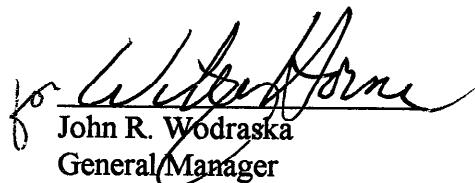
It is recommended that your Board adopt the above four policy principles regarding local agency investments.

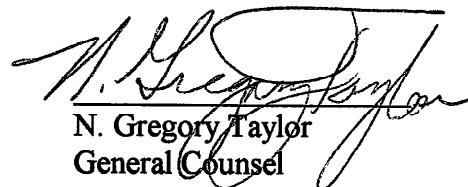
John R. Wodraska  
General Manager

Submitted by:

  
Lambertus H. Becker  
Chief Financial Officer

Concur:

  
John R. Wodraska  
General Manager

  
N. Gregory Taylor  
General Counsel

SBB:gm  
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Encl.

**TASK FORCE  
ON  
LOCAL AND STATE INVESTMENT PRACTICES**

**Preliminary Recommendations**

February 1, 1995

**Recommendation 1:** Amend state law to require each local treasurer or chief fiscal officer to provide annually a written statement of investment policy to the legislative body of the local agency for its consideration at a public meeting, and to submit a report no less frequently than quarterly to the legislative body and the chief executive officer containing a detailed description of the local agency's investment securities, including current market values. Require the State's cash management and investment pool to make such reports to the Pooled Money Investment Board. The quarterly reports would be required (i) to be submitted to the legislative body within 30 days of the quarter's end, (ii) to contain a statement with respect to compliance with the written annual statement of investment policy, and (iii) to be made available to taxpayers upon request for a nominal charge.

**Recommendation 2:** Amend state law to restrict the use of leverage in local and state investment portfolios by limiting reverse repurchase agreements used to buy securities to no more than 20% of a portfolio.

**Recommendation 3:** Refrain from making other changes in state law concerning permitted state and local investments until after a review of the forthcoming State Auditor's report on Orange County and reports from federal and state law enforcement agencies.

**Recommendation 4:** Ask statewide associations representing local agency financial managers and elected officials to work with the California Debt Advisory Commission to develop enhanced continuing education programs for state and local officials who have direct or supervisory responsibility for investments.

Analysis

Recommendation 1: Amend state law to require each local treasurer or chief fiscal officer to provide annually a written statement of investment policy to the legislative body of the local agency for its consideration at a public meeting, and to submit a report no less frequently than quarterly to the legislative body and the chief executive officer containing a detailed description of the local agency's investment securities, including current market values. Require the State's cash management and investment pool to make such reports to the Pooled Money Investment Board. The quarterly reports would be required (i) to be submitted to the legislative body within 30 days of the quarter's end, (ii) to contain a statement with respect to compliance with the written annual statement of investment policy, and (iii) to be made available to taxpayers upon request for a nominal charge.

- Findings:
- (a) Neither the State nor any local agency is required by state law to have a written statement of investment policy, let alone have it reviewed annually, or to file periodic reports more frequently than annually. For example, the Orange County Board of Supervisors received a report containing market values of the Orange County pool's investments only once a year.
  - (b) Annual reporting is too infrequent in today's fast-moving financial markets.
  - (c) Only regular reporting concerning market values of securities is likely to provide sufficiently timely information for adequate protection of invested taxpayer funds.
  - (d) Market value information should be required for all investment securities, not just those with a remaining maturity of more than 12 months. Many risky investments can have short maturities.
  - (e) At a minimum, quarterly reporting of market values should be required of all invested public funds, whether invested by the state, a local agency voluntary pool, or a local agency only investing its own funds.
  - (f) More frequent reporting of market values may be preferable to quarterly reporting, but the Task Force is concerned that mandating reports more frequently than quarterly may be burdensome and costly.
  - (g) Market valuation information for most securities should be able to be obtained inexpensively from custodial banks holding those securities.
  - (h) By requiring that each local agency must have a written annual statement of investment policy, the State is not mandating specific

investment objectives, practices and procedures; the State is simply requiring that each local agency address those issues itself by adopting a written annual statement of investment policy.

- (i) Requiring a written annual statement of investment policy and quarterly reports containing market value information is a reasonable approach to creating balance and oversight to limit a single person's power and control over investment strategy.

Discussion of Recommendation 1:

If Orange County had been required to disclose promptly the declines in the market values of its securities, the county supervisors, investors in the Orange County pool and taxpayers would have learned months earlier than they did that the county's investment strategy was flawed and that losses were building up. No corrective action was taken until losses were publicly disclosed in December, 1994. The former Orange County Treasurer filed reports with the county supervisors just once a year. Taxpayers, investors and perhaps even county supervisors cannot be expected to understand and evaluate complex investment strategies, but everyone understands losses. Thus, losses should be disclosed and disclosed promptly.

Legislation adopted ten years ago (after San Jose suffered big investment losses) required treasurers to report monthly to local officials about their investments. This law contained a "sunset clause" and expired in 1991. If this law had been in effect in 1994, the former Orange County Treasurer would have been required to publicly disclose the market losses that were building up as interest rates rose in 1994. Prompt public disclosure leads to corrective action in time to save taxpayers money.

In making Recommendation 1, the Task Force recognizes that the local agency costs of state-mandated programs can be recovered from the State. Costs for the prior legislation, which required monthly reports, were approximately \$5.5 million for the initial set-up year, and approximately \$2.5 million per year thereafter. By mandating quarterly (rather than monthly) reports, and taking into account the ready availability of market valuation information for most securities from custodial banks without significant additional charges, costs should not significantly exceed costs under the prior legislation and seem warranted to provide reasonable oversight over the investment of taxpayer funds.

The Task Force believes that the legislative body of each local agency needs to consider whether or not it needs a local agency oversight committee to evaluate the required written annual statement of investment policy and quarterly reports. In making that determination, the legislative body needs to determine whether or not it contains enough financial and investment expertise itself to be able to properly evaluate the written annual statement of investment policy and the quarterly reports. The Task Force recognizes that some legislative bodies do have the necessary expertise, while others do not. Further, the size of the local agency and the amount of funds invested by the local agency can vary widely from agency to agency. Thus, the Task Force believes that it is not appropriate to require a state-mandated oversight committee for each local agency.

The issue of whether to have an oversight committee appears best addressed by each local agency.

The Task Force considered whether market valuation should be reported for all investment securities or only those investment securities with remaining maturities of more than 12 months. While securities with remaining maturities of less than 12 months have historically been viewed to entail less risk, particularly if held to maturity, the Task Force believes that the marketplace has developed complex derivatives, structured securities and other instruments which can have significant risks and still have maturities of less than 12 months.

The Task Force requirement that the quarterly reports be submitted to the local agency legislative body within 30 days of the quarter's end is to ensure that the reporting occurs on a regular and timely basis. Requiring a statement of compliance with the agency's statement of investment policy forces each local agency to make a regular and ongoing determination that ongoing investment practices are or are not in conformity with the agency's written investment policy. A statement of nonconformity is obviously a wake-up call for the local agency. Making the reports available to taxpayers for a nominal charge will improve accountability of local agency officials to taxpayers, thereby providing additional oversight over investment practices of local agencies. This additional oversight should help prevent future occurrences similar to Orange County.

**Recommendation 2:** Amend state law to restrict the use of leverage in local and state investment portfolios by limiting reverse repurchase agreements used to buy securities to no more than 20% of a portfolio.

- Findings:**
- (a) Excessive leverage in the Orange County investment pool had been created by successive repeated use of reverse repurchase agreements.
  - (b) Recommendation 2 places reasonable limitations on the use of reverse repurchase agreements without unduly restricting the flexibility necessary for liquidity and legitimate investment purposes.
  - (c) Consideration should be given to amending state law to:
    - (i) Prohibit securities purchased with the proceeds of a reverse repurchase from being used as collateral for another reverse repurchase while the original reverse repurchase is outstanding;
    - (ii) Limit the maturity of each reverse repurchase agreement to the maturity of any securities purchased with the proceeds of the reverse repurchase (but in any event not more than one year permitted under current law); and
    - (iii) Limit reverse repurchase agreements to unencumbered securities already held in the portfolio.

**Discussion of Recommendation 2:**

Current state law allows investments in reverse repurchase agreements if approved by the legislative body of the local agency. There are legitimate and useful reasons for using reverse repurchase agreements. Nonetheless, the Task Force members seem to agree that one of the overriding limitations in state law should be reasonable limitations on the use of reverse repurchase agreements.

In a reverse repurchase agreement, the state or local agency sells an investment security to a dealer and agrees to buy it back at an agreed upon price; the transaction is similar to a loan. The cash proceeds of the reverse repurchase agreement are then used to purchase a second investment security. The Task Force's Recommendation 2 focuses on eliminating speculation resulting from excessive leverage. The 20% limitation permits the legitimate use of reverse repurchase agreements to seek a modest improvement in yield without subjecting the public to high-risk gambling.

Recommendation 3: Refrain from making other changes in state law concerning permitted state and local investments until after a review of the forthcoming State Auditor's report on Orange County and reports from federal and state law enforcement agencies.

- Findings:
- (a) Federal, state and local investigations are underway in Orange County.
  - (b) It seems prudent to learn what the investigators have to say before the Task Force recommends changes in state law other than improved disclosure and restrictions on leverage.

Discussion of Recommendation 3:

In light of Orange County's bankruptcy and the magnitude of its losses, it is tempting to react prematurely with restrictive legislation without a full assessment of all of the circumstances surrounding Orange County's bankruptcy and losses. Existing laws governing state and local investment instruments have been developed over many years with input from public and private sector experts.

Federal, state and local officials have cautioned against confusing investment strategy with investment instruments and point out that Orange County's losses stemmed from a flawed investment strategy and lack of common sense. It would be inappropriate to penalize the State and all other local governments for Orange County's losses and that is exactly what we would do if we narrowed the list of permitted state and local investments. The marketplace is continually developing new financial and investment instruments, whether it be derivatives such as inverse floaters or other products. It should be up to local officials to develop prudent investment policies and make specific investments pursuant to those policies subject, of course, to the overriding limitations in state law.

This Task Force believes that limiting particular investment instruments beyond Recommendation 2 would be a premature reaction to the Orange County situation at this time. Common sense cannot be legislated.

**Recommendation 4:** Ask statewide associations representing local agency financial managers and elected officials to work with the California Debt Advisory Commission to develop enhanced continuing education programs for state and local officials who have direct or supervisory responsibility for investments.

- Findings:**
- (a) Enhanced continuing education programs are essential for keeping public officials responsible for investment decisions abreast with developments in the financial and investment markets.
  - (b) The California Debt Advisory Commission can provide support to statewide associations in developing enhancements to ongoing continuing education programs.

**Discussion of Recommendation 4:**

There should be renewed efforts to reach a wide range of public officials with affordable and accessible continuing education programs on investment practices. Organizations such as the California Association of County Treasurers and Tax Collectors, California Municipal Treasurers Association, California State Association of Counties, and League of California Cities can and should lead such efforts and the State can provide support through the California Debt Advisory Commission. Methods for encouraging attendance by public officials should be developed.

The Task Force recognizes a link between the fourth and first recommendations -- tying continuing education to the ability to produce an appropriate written annual statement of investment policy. Through various local agency associations, guidance can be made available to all California local agencies with respect to model statements of investment policy. Each policy can, of course, be modified to the objectives and needs of each particular local agency. By having model investment policies available for review by local agencies, the Task Force hopes that guidelines and benchmarks can develop over time concerning numerous investment matters, including (without limitation) oversight committees, coverage margins, minimum liquidity ratios or requirements, frequency and methods of reporting changes in market value (monthly, quarterly, fiscal year to date, etc.), ability to meet future expenditures (whether measured quarterly or annually), average weighted maturities, sensitivity to interest rates, fund accounting, procedures for purchases and sales of securities, percentage of transactions with any one broker/dealer, acknowledgement by broker/dealers of their understanding of the agency's investment policy, and other matters as may be developed over time as new financial investment vehicles are brought to the marketplace.

**TASK FORCE  
ON  
LOCAL AND STATE INVESTMENT PRACTICES**

**Appendix A**

**Chairman:**

Matt Fong  
California State Treasurer  
Sacramento, California

**Public Sector Members:**

Alfred P. Balderrama  
Monterey Park City Councilmember  
and Former Mayor  
Monterey Park, California

Lambertus H. ("Bert") Becker  
Acting Chief Financial Officer  
Metropolitan Water District of  
Southern California  
Los Angeles, California

John L. de Russy  
Finance Director/City Treasurer  
City of San Mateo  
San Mateo, California

Russell S. Gould  
California Director of Finance  
Sacramento, California

George W. Jeffries  
Chief Investment Officer  
Los Angeles County Treasurer's Office  
Los Angeles, California

**Private Sector Members:**

Douglas L. Charchenko  
Chairman  
California Public Securities Association  
San Francisco, California

Thomas Kenny  
Senior Vice President  
Franklin/Templeton Group of Funds  
San Mateo, California

Francis X. Lilly  
President  
Bear Stearns Fiduciary Services, Inc.  
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Robert T. Slaymaker  
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Norwin Wong  
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Portfolio Advisory Services, Inc.  
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