

- **Board of Directors**
Executive Committee
Business and Finance Committee

October 14, 2008 Board Meeting

Revised 8-10

Subject

Approve Amendment to Investment Policy

Description

Metropolitan's Statement of Investment Policy (Investment Policy) is approved by the Board annually and includes a delegation of authority to the Treasurer to make investments on behalf of Metropolitan, within the parameters of the Investment Policy and the types of investments permitted under California law. The Investment Policy for 2008/09, approved by the Board on June 10, 2008, included changes to enhance Metropolitan's ability to prudently invest funds in today's rapidly changing marketplace, but did not anticipate the extremely rapid market failures of recent weeks. This letter recommends changes to the Investment Policy to allow the Treasurer to avoid the immediate liquidation of securities when their value is depressed due to extreme selling pressures or other market dislocations. This change would enable Metropolitan to benefit from an increase in value as market conditions improve.

In a move that caught the financial markets by surprise, Lehman Brothers Holdings Inc. filed for bankruptcy shortly after midnight on Sunday, September 14, 2008. While Lehman was known to be having financial difficulties, the financial markets expected Lehman to either be purchased by another firm or be supported by the federal government. Lehman's bankruptcy represented the largest bankruptcy in U.S. history. The credit rating of Lehman's senior unsecured notes dropped from a relatively strong investment-grade "A" on Friday September 12 to a below investment-grade "CCC" or equivalent on Monday, September 15.

Metropolitan's Investment Policy requires the immediate sale of below investment-grade securities. Metropolitan's short-term investment portfolio includes two senior notes issued by Lehman Brothers Holdings Inc., a one-year note in the principal amount of \$288,000 maturing on October 22, 2008, and a thirteen-month note in the principal amount of \$5,000,000 maturing on March 13, 2009. The aggregate market value of these notes plummeted following Lehman's bankruptcy filing and the fire sale of Lehman notes that followed, dropping from \$5,276,470 on September 12 to approximately \$1,800,000, roughly 30 cents on the dollar, as of September 17.

The Investment Policy provides that if a security is downgraded below the minimum criteria in the Investment Policy, the Treasurer or investment manager shall sell the security in such a manner as to minimize losses on the sale of the security. However, if a security is downgraded to a level that is less than investment grade, "the Treasurer or investment manager shall sell such affected security immediately. If the security matures within 60 days of the rating change, the Treasurer or investment manager may choose not to sell the security." (Investment Policy, section IV.5.b.) This provision contemplates downgrading of securities in an orderly manner as the credit quality of their issuer changes over time. It requires liquidation of securities as they fall below investment grade before their ratings deteriorate any further.

The implication of this provision was that the Treasurer would be able to sell the security in a manner as to minimize losses. The policy does not contemplate the current situation whereby a security could be investment grade on a Friday and in bankruptcy (and below investment grade) on Monday morning. Further, given the panic in today's market, immediate sale of Metropolitan's Lehman notes would result in the greatest loss since such

securities are trading at what is anticipated to be near the bottom of the market. The value of these notes is expected to increase over time, following the “cooling off” period mandated by the bankruptcy filing and as Lehman’s reorganization or orderly liquidation progresses. However, it is unlikely that Metropolitan ever will receive face value for these notes.

It is proposed that the Board (i) waive the requirement that the Treasurer immediately liquidate the Lehman notes and instruct the Treasurer, in consultation with an Ad Hoc Committee made up of the Chairman of the Board, the Chairman of the Business and Finance Committee and the General Manager, and with the concurrence of the General Counsel and Chief Financial Officer, to dispose of the Lehman notes in an orderly and prudent manner, considering the bankruptcy proceedings filing and current financial conditions; and (ii) amend section IV.5.b. of the Investment Policy to permit orderly and prudent disposition of other securities that are downgraded below market value under similar conditions. The Treasurer will be required to include the value of these securities and status of their disposition in his monthly reports to the Business and Finance Committee. The proposed amendment is shown in **Attachment 1**, with proposed new language indicated by underscoring.

The Executive Committee approved the recommended action at its meeting on September 23, pursuant to its responsibility to act on behalf of the Board in unexpected situations and emergencies. This approval is subject to subsequent ratification by the Board, as provided in section 2413(f) of Metropolitan’s Administrative Code. In addition, staff agreed to provide weekly updates to the Board on the financial markets and Metropolitan’s debt and investment portfolio as long as the markets remain in flux.

Policy

Metropolitan Water District Administrative Code Section 2413(f): The Executive Committee shall act on behalf of the Board in unexpected situations and emergencies, subject to subsequent approval or ratification of the actions taken whenever such approval or ratification is required by law.

Metropolitan Water District Administrative Code Section 5101: Delegation of authority to the Treasurer annually to invest and reinvest Metropolitan funds.

California Environmental Quality Act (CEQA)

CEQA determination for Options #1 and #2:

The proposed actions are not defined as a project under CEQA because they involve continuing administrative activities, such as general policy and procedure making (Section 15378(b) (2) of the State CEQA Guidelines). In addition, the proposed actions are not subject to CEQA because they involve other government fiscal activities, which do not involve any commitment to any specific project which may result in a potentially significant physical impact on the environment (Section 15378(b) (4) of the State CEQA Guidelines).

The CEQA determination is: Determine that the proposed actions are not subject to CEQA pursuant to Sections 15378(b) (2) and 15378(b) (4) of the State CEQA Guidelines.

CEQA determination for Option #3:

None required

Board Options

Option #1

Ratify the Executive Committee’s action to adopt the CEQA determination and

- a. Waive the requirements of section IV.5.b. of the Statement of Investment Policy, and instruct the Treasurer, in consultation with the Ad Hoc Committee and with the concurrence of the General Counsel, to dispose of the Lehman notes in an orderly and prudent manner; and
- b. Amend the Statement of Investment Policy as shown in **Attachment 1**.

Fiscal Impact: Potential savings of \$1 million if the value of the Lehman securities rises in a manner similar to other securities in similar circumstances

Business Analysis: The change in policy provides the opportunity to take prudent steps to liquidate troubled securities, while requiring ongoing disclosure of actions to the Board through the Business and Finance Committee. This action would provide the opportunity to limit losses as investments are downgraded.

Option #2

Adopt the CEQA determination and waive the requirements of section IV.5.b. of the Statement of Investment Policy, and instruct the Treasurer, in consultation with the Ad Hoc Committee and with the concurrence of the General Counsel, to dispose of the Lehman notes in an orderly and prudent manner.

Fiscal Impact: Potential savings of \$1 million if the value of the Lehman securities rises in a manner similar to other securities in similar circumstances

Business Analysis: This action would provide the opportunity to limit losses due to the sudden downgrade and bankruptcy of Lehman Brothers Holding Company.

Option #3

Adopt the CEQA determination and retain the existing requirement to liquidate below investment grade securities and direct the Treasurer to sell the Lehman Brothers Holding Company investments immediately.

Fiscal Impact: Forego potential savings of \$1 million if the securities are sold in the current market as the value of the securities are likely to rise as markets correct in the future in response to the positive actions taken by the federal government and regulators

Business Analysis: This action would enable Metropolitan to avoid bankruptcy proceedings or the potential that the value of the securities could further deteriorate. But, this would also force Metropolitan to sell the securities in an extremely volatile and down market, possibly reducing the proceeds from such sale.

Staff Recommendation

Option #1



Brian G. Thomas
Chief Financial Officer

9/30/2008
Date



Debra C. Man
for Jeffrey Kightlinger
General Manager

9/30/2008
Date

PROPOSED AMENDMENT TO INVESTMENT POLICY

THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA STATEMENT OF INVESTMENT POLICY

IV PORTFOLIO

5. Portfolio Adjustments

- a. Portfolio percentage limitations for each category of investment are applicable only at the date of purchase. Should an investment percentage of portfolio limitation be exceeded due to an incident such as a fluctuation in portfolio size, the portfolio manager is not required to sell the affected securities.
- b. Should a security held in the portfolio be downgraded below the minimum criteria included in this Statement of Investment Policy, the Treasurer or investment manager shall sell such security in such a manner to minimize losses on the sale of such security. If the security is downgraded to a level that is less than investment grade, the Treasurer or investment manager shall sell such affected security immediately; however, if immediate liquidation of the security is not in the best interests of Metropolitan, the Treasurer or investment manager, in consultation with an ad hoc committee made up of the Chairman of the Board, the Chairman of the Business and Finance Committee and the General Manager, and with the concurrence of the General Counsel, may dispose of the security in an orderly and prudent manner considering the circumstances, under terms and conditions approved by a majority of the members of such ad hoc committee. If the security matures within 60 days of the rating change, the Treasurer or investment manager may choose not to sell the security. The Treasurer shall include a description of any securities that have been downgraded below investment grade and the status of their disposition in his monthly report.