

RESOLUTION NO. 2001-59


A RESOLUTION OF THE CITY COUNCIL OF THE CITY OF ELK GROVE ADOPTING AN INVESTMENT POLICY AND INTERNAL CONTROL GUIDELINES

WHEREAS, recent legislation enacted by the Legislature of the State of California; and


WHEREAS, the City Council of the City of Elk Grove wishes to implement a program of internal controls by which the City's investment program shall be administered; and

NOW, THEREFORE, BE IT RESOLVED that the City Council of the City of Elk Grove hereby adopts an investment policy and internal control guidelines as set forth herein.

PASSED AND ADOPTED this 1st day of August, 2001.


MICHAEL P. LEARY, MAYOR
CITY OF ELK GROVE

ATTEST:


PEGGY E. JACKSON, CITY CLERK

Approved as to Form:


TONY MANZANETTI, CITY ATTORNEY

AYES: Leary, Scherman, Cooper,
Briggs, Soares
NOES: None
ABSTAIN: None
ABSENT: None

CITY OF ELK GROVE



INVESTMENT POLICY

For Fiscal Year 2001-02

CITY OF ELK GROVE

INVESTMENT POLICY

For Fiscal Year 2001-02

CITY COUNCIL

Michael Leary, Mayor

Sophia Scherman, Mayor Pro Tempore

Dan Briggs, Council Member

James Cooper, Council Member

Rick Soares, Council Member

ADMINISTRATIVE PERSONNEL

David M. Jinkens, City Manager

Tony Manzanetti, City Attorney

Peggy Jackson, City Clerk

Leticia T. Espinoza, Director of Finance/Treasurer

Stanley Grady, Community Development Director

William Hetland, Public Works Director

Edwin Flint, Police Chief

CITY OF ELK GROVE

INVESTMENT POLICY

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INVESTMENT POLICY

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CITY OF ELK GROVE

INVESTMENT POLICY

I. PURPOSE

This statement is intended to provide guidelines for the prudent investment of the City's money in a sinking fund of, or surplus money in, its treasury not required for the immediate needs of the City (hereinafter "Investment Cash") and to outline policies for maximizing the efficiency of the City's Investment Cash management system. The ultimate goal is to enhance the economic status of the City while protecting its pooled Investment Cash.

II. POLICY

It is the policy of the City of Elk Grove to invest public funds in a manner which will provide the highest investment return with the maximum security while meeting the daily cash flow demands of the entity and conforming to all state and local statutes governing the investment of public funds. The City of Elk Grove's investment policy has three objectives: (1) protect principal, (2) provide for liquidity needs, and (3) obtain the highest rate of return possible within the first two objectives. The City further operates its investment activities under the "prudent investor" standard (see discussion below). This affords a broad spectrum of investment opportunities so long as the investment is deemed prudent and is permissible under current state and local law.

III. SCOPE

This investment policy applies to all financial assets of the City of Elk Grove. These funds are accounted for in the City's Comprehensive Annual Financial Report (CAFR) and include:

- General Fund
- Special Revenue Funds
- Debt Service Fund
- Capital Improvement Funds
- Internal Service Funds
- Trust and Agency Funds

IV. PRUDENT INVESTOR STANDARD

The City Council and all persons authorized to make investment decisions on behalf of the City are trustees and therefore fiduciaries subject to the prudent investor standard. When investing, reinvesting, purchasing, acquiring, exchanging, selling, or managing public funds, a trustee shall act with care, skill, prudence, and diligence under the circumstances then prevailing, including, but not limited to, the general economic conditions and the anticipated needs of the City, that a prudent person acting in a like capacity and familiarity

IV. PRUDENT INVESTOR STANDARD (continued)

with those matters would use in the conduct of funds of a like character and with like aims, to safeguard the principal and maintain the liquidity needs of the City. Within the limitations of this section and considering individual investments as part of an overall strategy, investments may be acquired as authorized by law.

It is the City's full intent, at the time of purchase, to hold all investments until maturity to ensure the return of all invested principal dollars. However, it is realized that market prices of securities will vary depending on economic and interest rate conditions at any point in time. It is further recognized, that in a well diversified investment portfolio, occasional measured losses are inevitable due to economic, bond market or individual security credit analysis. These occasional losses must be considered within the context of the overall investment program objectives and the resultant long term rate-of-return.

The City Treasurer and other individuals assigned to manage the investment portfolio, acting within the intent and scope of the investment policy and other written procedures and exercising due diligence, shall be relieved of personal responsibility and liability for an individual security's credit risk or market price changes, provided deviations from expectations are reported in a timely manner and appropriate action is taken to control adverse developments.

V. OBJECTIVES

The City's cash management system is designed to accurately monitor and forecast expenditures and revenues, thus enabling the City to invest Investment Cash funds to the fullest extent possible. The City strives to obtain the highest yield possible as long as investments meet the criteria for safety and liquidity.

Safety

Safety of principal is the foremost objective of the investment program. Investments of the City shall be undertaken in a manner which seeks to ensure the preservation of principal in the overall portfolio. To attain this objective, diversification is required in order that potential losses on individual securities do not exceed the income generated from the remainder of the portfolio. Risk associated with an investment refers to the potential loss of principal, interest or a combination of both.

The City shall seek to preserve principal by mitigating the two types of risk - credit risk and market risk:

Credit risk, defined as the risk of loss due to failure of the issuer of a security, shall be mitigated by investing in investment grade securities and by diversifying the investment portfolio so that the failure of any one issuer does not unduly harm the City's capital base and cash flow.

Market Risk, defined as market value fluctuations due to overall changes in the general level of interest rates, shall be mitigated by limiting the weighted average maturity of the City's investment portfolio to three and one-half years, the

V. OBJECTIVES (continued)

maximum maturity of any one security to five years, structuring the portfolio based on historic and current cash flow analysis eliminating the need to sell securities prior to maturity and avoiding the purchase of long-term securities for the sole purpose of short-term speculation.

The City of Elk Grove only invests in those instruments that are considered "very safe".

Liquidity

The City's investment portfolio shall remain sufficiently liquid to enable the City to meet all operating requirements which might be reasonably anticipated. This goal shall be achieved by maintaining a reasonable portion of the City's portfolio in liquid, short-term instruments which can readily be converted to cash if necessary.

Return on Investment

The City's investment portfolio shall be designed with the objective of attaining a rate of return throughout budgetary and economic cycles, commensurate with the City's investment risk constraints and the cash flow characteristics of the portfolio. Return on investment (yield) is the potential dollar earnings an investment can provide. The City attempts to obtain the highest yield possible when selecting an investment, provided the criteria for safety and liquidity are met.

VI. DELEGATION OF AUTHORITY

In accordance with Government Code section 53607, the City Council authorizes the City Treasurer to invest or to reinvest funds of the City, or to sell or exchange securities so purchased on behalf of the City. In addition, the City Treasurer is delegated the management responsibility for the City's investment program. The only official authorized to invest or to reinvest funds of the City, or to sell or exchange securities so purchased on behalf of the City is the City Treasurer.

The Treasurer shall establish written procedures for the operation of the investment program consistent with this investment policy as well as the establishment of a system of internal controls to regulate the activities of subordinate officials (see attached Internal Control Guidelines for related investment activities and party responsible for each activity).

The procedures should include reference to safekeeping, repurchase agreements, wire transfer agreements, banking service contracts and collateral/depository agreements. Such procedures shall include explicit delegation of authority to persons responsible for investment transactions. No person may engage in an investment transaction except as provided under the terms of this policy and the procedures established by the City Treasurer.

VII. PUBLIC TRUST

All participants in the investment process shall act as custodians of public funds. Investment officials shall recognize that the investment portfolio is subject to public review and evaluation. The overall program shall be designed and managed with a degree of professionalism that is worthy of the public trust. In a diversified portfolio it must be recognized that occasional measured losses are inevitable, and must be considered within the context of the overall portfolio's investment return, provided that adequate diversification has been implemented.

VIII. ETHICS AND CONFLICTS OF INTEREST

Officers and employees involved in the investment process shall refrain from personal business activity that conflicts with proper execution of the investment program, or impairs their ability to make impartial investment decisions. Additionally the City Treasurer and the Director of Finance are required to annually file applicable financial disclosures as required by the Fair Political Practices Commission (FPPC).

IX. QUALIFIED BROKER/DEALERS

The City shall transact business only with banks, savings and loans, and with broker/dealers. The broker/dealers should be primary dealers regularly reporting to the New York Federal Reserve Bank. Exceptions shall be made only upon written authorization by the City Treasurer. Investment staff shall investigate dealers who wish to do business with the City to determine if they are adequately capitalized, have pending legal action against the firm or the individual broker and make markets in the securities appropriate to the City's needs.

The City Treasurer shall annually send a copy of the current investment policy to all broker/dealers approved to do business with the City. Confirmation of receipt of this policy shall be considered evidence that the dealer understands the City's investment policies and intends to sell the City only appropriate investments authorized by this investment policy.

X. AUTHORIZED INVESTMENTS

Investment of City funds is governed by the California Government Code Sections 53600 et. seq. Within the context of these limitations, the following investments and their respective additional limitations, are authorized:

1. United States Treasury Bills, Bonds, and Notes are those for which the full faith and credit of the United States are pledged for payment of principal and interest. There is no percentage limitation of the portfolio which can be invested in this category, although a five year maturity limitation is applicable.
2. Obligations issued by the Government National Mortgage Association (GNMA), the Federal Farm Credit System (FFCB), the Federal Home Loan Bank Board (FHLB), the Federal National Mortgage Association (FNMA), and the Federal Home Loan Mortgage Association (FHLMC). There is no percentage limitation of the portfolio which can be invested in this category, although a five year maturity limitation is applicable.

X. AUTHORIZED INVESTMENTS (continued)

Investments detailed in items 3 through 11 are further restricted to a maximum of 15% of the City's Investment Cash that may be invested pursuant to this Investment Policy in any one issuer name. The total value invested in any one issuer shall not exceed 5% of the issuer's net worth. Again, a five year maximum maturity limitation is applicable unless further restricted by this policy.

3. **Bills of exchange or time drafts drawn on and accepted by commercial banks, otherwise known as bankers' acceptances.** Purchases of bankers acceptances may not exceed 180 days maturity or 40% of the City's Investment Cash that may be invested pursuant to this Investment Policy.

4. **Commercial paper** of "prime" quality of the highest ranking or of the highest letter and numerical rating as provided for by Moody's Investors Service, Inc., or Standard and Poor's Corporation." Purchases of eligible commercial paper may not exceed 180 days to maturity nor represent more than 10% of the outstanding paper of the issuing corporation. Purchases of commercial paper may not exceed 15% of the City's Investment Cash that may be invested pursuant to this Investment Policy.

5. **Negotiable certificates of deposit** issued by nationally or state chartered banks or state or federal savings institutions. Purchases of negotiable certificates of deposit may not exceed 30% of the City's Investment Cash that may be invested pursuant to this Investment Policy. A maturity limitation of five years is applicable.

6. **Repurchase agreements** which specify terms and conditions may be transacted with banks and broker/dealers. The maturity of the repurchase agreements shall not exceed 90 days. The market value of the securities used as collateral for the repurchase agreements shall be monitored by the investment staff and shall not be allowed to fall below 102% of the value of the repurchase agreement. A **Master Repurchase Agreement** must be executed with the bank or dealer prior to investing in a Repurchase Agreement.

7. **Reverse repurchase agreements.** The City of Elk Grove does not enter into reverse repurchase agreements.

8. **Local Agency Investment Fund (LAIF)** which is a State of California managed investment pool may be used up to the maximum permitted by California Government Code, Title 2, Division 4, Part 2, Chapter 2, Article 11, commencing with section 16429.1.

9. **Time deposits**, non negotiable and collateralized in accordance with the California Government Code, may be purchased through banks or savings and loan associations. Since time deposits are not liquid, no more than 25% of the investment portfolio may be invested in this investment type.

10. **Medium Term Corporation Notes**, with a maximum maturity of five years may be purchased. Securities eligible for investment shall be rated A or better by Moody's or Standard & Poor's rating services.

X. AUTHORIZED INVESTMENTS (continued)

Purchase of medium term notes may not exceed 30% of the City's Investment Cash that may be invested pursuant to this Investment Policy and no more than 15% of the City's Investment Cash that may be invested pursuant to this Investment Policy may be invested in notes issued by one corporation. Commercial paper holdings should also be included when calculating the 15% limitation.

11. Shares of beneficial interest issued by diversified management companies investing in instruments as authorized above. (Money market and mutual funds) Various daily cash funds administered for or by trustees, paying agents and custodial banks contracted by the City of Elk Grove may be purchased as allowed under State of California Government Code. Only funds holding U. S. Treasury or government agency obligations can be utilized.

Ineligible investments, those that are not described herein, including but not limited to, common stocks or long term (over five years in maturity) notes and bonds, are prohibited from use by the City for the City's Investment Cash that may be invested pursuant to this Investment Policy.

The following summary of maximum percentage limits, by instrument, is established for the City's total pooled Investment Cash that may be invested pursuant to this Investment Policy:

<u>Investment Type</u>	<u>Percentage</u>
Local Agency Investment Funds	\$30,000,000/acct.
U.S. Treasury Bonds/Notes/Bills	Up to 100%
U.S. Government Agency Obligations	Up to 100%
Bankers' Acceptances	Up to 40%
Time Certificates of Deposit	Up to 25%
Medium Term Corporation Notes	Up to 30%
Commercial Paper	Up to 15%
Negotiable Certificates of Deposit	Up to 30%
Repurchase Agreements	Up to 100%

XI. INVESTMENT POOLS/MUTUAL FUNDS

Governmental sponsored pools and money market mutual funds are excellent short-term cash management facilities. These pools/funds can provide safety, liquidity and yield in a single investment instrument.

A thorough investigation of the pool/fund is required prior to investing, and on a continual basis. The investigation should include, but is not limited to, obtaining information regarding the following:

- A description of eligible investment securities, and a written statement of investment policy and objectives.

XI. INVESTMENT POOLS/MUTUAL FUNDS (continued)

- A description of interest calculations and how it is distributed, and how gains and losses are treated.
- A description of how the securities are safeguarded, including settlement processes, and how often the securities are priced and the program audited.
- A description of who may invest in the program, how often, what size deposit and withdrawal are allowed.
- A schedule for receiving statements and portfolio listings.
- Are reserves, retained earnings, etc. utilized by the pool/fund?
- A fee schedule, and when and how it is assessed.
- Is the pool/fund eligible for bond proceeds and/or will it accept such proceeds?

XII. DERIVATIVE INVESTMENTS

Derivatives are investments whose value is derived from a benchmark or index. That benchmark can be almost any financial measure from interest rates to commodity and stock prices. The City of Elk Grove shall not allow use of derivative investments.

XIII. COLLATERALIZATION

Collateralization shall be required on two types of investments:

1. Certificates of Deposit in excess of the amount federally insured, and
2. Repurchase agreements.

For Certificates of Deposit in excess of the amount federally insured, the general collateralization level shall be 110% of the amount invested. If the security used for collateral is a mortgage backed security, the collateralization level shall be 150% of the amount invested. (gov't code sec. 53652).

For repurchase agreements, the collateralization level shall be at least 102% of the market value of the agreement.

The collateral shall be held by an independent third party with whom the entity has a current custodial agreement and the right of collateral substitution is granted. In order to conform with the provisions of the Federal bankruptcy code which provides for liquidation of securities held as collateral, the only securities acceptable as collateral shall be certificates of deposit, commercial paper, eligible bankers' acceptances, medium term notes or securities that are the direct obligations of, or are fully guaranteed as to principal and interest by the United States or any agency of the United States.

XIV. SAFEKEEPING AND CUSTODY

All security transactions, including collateral for repurchase agreements, entered into by the City shall be conducted on a delivery versus payment (DVP) basis. This means that the securities shall be delivered to the City or the City's designated custodian upon receipt of payment by the City.

All securities that may be purchased, including collateral for repurchase agreements, shall be held by a third party custodian designated by the Treasurer whenever possible. These securities shall be held in the City's name and control and third party custody shall be evidenced by safekeeping receipts. The third party custodian shall send the City, on a monthly basis, a statement of what is safe-kept and this statement shall be reconciled to the City's record on a monthly basis. Securities held in custody for the City shall be independently audited on an annual basis to verify investment holdings.

XV. DIVERSIFICATION INVESTMENT

The City's investment portfolio shall be diversified to avoid incurring unreasonable and avoidable risks with regard to specific investment types. Within investment types, the City shall also maintain a mix of securities to avoid concentrations within individual financial institutions, geographic areas, industry types and maturity dates.

XVI. MAXIMUM MATURITIES

To the extent possible, the City of Elk Grove shall attempt to match its investments with anticipated cash flow requirements. Unless matched to a specific cash flow, the City shall not directly invest in securities maturing more than 5 years from the date of purchase. Reserve funds may be invested in securities exceeding 5 years if the maturity of such investments is made to coincide as nearly as practical with the expected use of the funds.

Maturities of investments shall be selected on liquidity requirements to minimize interest rate risk and maximize earnings. Current and expected yield curve analysis shall be monitored and the portfolio shall be invested accordingly. The weighted average maturity of the pooled portfolio should not exceed three and one-half years and the following percentage of the portfolio should be invested in the following maturity sectors:

<u>Maturity Range</u>	<u>Suggested Percentage</u>
On Demand	Up to 50%
7 to 180 days	Up to 30%
180 to 360 days	Up to 30%
1 to 2 years	Up to 30%
2 to 3 years	Up to 30%
3 to 4 years	Up to 30%
4 to 5 years	Up to 30%
Over 5 years	Council Authorization Required

XVII. INTERNAL CONTROL

The Treasurer shall establish an annual review process of the investment program. This process may include testing of the investment program by the City's external auditor to determine the extent of compliance with the Investment Policy.

Separation of functions between the City Treasurer's Office and the Director of Finance's office is designed to provide an ongoing internal review to prevent the potential for converting assets or concealing transactions.

Existing procedures require all wire transfers initiated by Finance Department - Treasury Section - be confirmed to the appropriate financial institution by other staff. Proper documentation obtained from confirmations and cash disbursement wire transfers is required for each investment transaction. Timely bank reconciliations are conducted to ensure proper handling of all transactions.

The investment portfolio and all related transactions are reviewed and balanced to appropriate general ledger accounts by the accounting section on a monthly basis.

XVIII. PERFORMANCE STANDARDS

The City's investment portfolio shall be designed with the objective of attaining market rate of return throughout budgetary and economic cycles, taking into account the City's investment risk constraints and the cash flow characteristics of the portfolio.

Market Yield (Benchmark)

The City's investment strategy is described below (see Portfolio Management Activity). Given this strategy, the basis used by the Treasurer to determine whether market yields are being achieved shall be the six-month U. S. Treasury Bill and the average Federal Funds rate.

XIX. PORTFOLIO MANAGEMENT ACTIVITY

The investment program shall seek to augment returns consistent with the intent of this policy, identified risk limitations and prudent investment principals. These objectives shall be achieved by use of the following strategies:

Active Portfolio Management

Through active fund and cash-flow management taking advantage of current economic and interest rate trends, the portfolio yield may be enhanced with limited and measurable increases in risk by extending the weighted maturity of the total portfolio.

Portfolio Maturity Management

When structuring the maturity composition of the portfolio, the city shall evaluate current and expected interest rate yields and necessary cash flow requirements. It is recognized that in normal market conditions longer maturities produce higher yields.

XIX. PORTFOLIO MANAGEMENT ACTIVITY (continued)

However, the securities with longer maturities also experience greater price fluctuations when the level of interest rates change.

Security Swaps

The City may take advantage of security swap opportunities to improve the overall portfolio yield. A swap which improves the portfolio yield may be selected even if the transactions result in an accounting loss. Documentation for swaps shall be included in the City's permanent investment file documents.

Competitive Bidding

It is the policy of the City to require competitive bidding for investment transactions that are not classified as "new issue" securities. For the purchase of non "new issue" securities and the sale of all securities at least three bidders must be contacted. Competitive bidding for security swaps is also suggested. However, it is understood that certain time constraints and broker portfolio limitations exist which would not accommodate the competitive bidding process. If a time or portfolio constraining condition exists, the pricing of the swap should be verified to current market conditions and documented for auditing purposes.

XX. REPORTING

The City Treasurer shall review and render quarterly reports to the City Manager, internal auditor and City Council which shall include the face amount and cost of the investment, the type of investment, the name of the issuer, the coupon rate of interest, the maturity date, the current market value and accrued interest due for all securities.

XXI. LEGISLATIVE CHANGES

Any State of California legislative action, that further restricts allowable maturities, investment type or percentage allocations, shall be incorporated into the City of Elk Grove's Investment Policy and shall supersede any and all previous applicable language.

XXII. INTEREST EARNINGS

All moneys earned and collected from investments authorized in this policy shall be allocated monthly to various fund accounts based on the cash balance in each fund as a percentage of the entire pooled portfolio.

XXIII. LIMITING MARKET VALUE EROSION

The longer the maturity of securities, the greater their market price volatility. Therefore, it is the general policy of the City to limit the potential effects from erosion in market values by adhering to the following guidelines:

- All immediate and anticipated liquidity requirements shall be addressed prior to purchasing all investments.

XXIII. LIMITING MARKET VALUE EROSION (continued)

- Maturity dates for long term investments shall coincide with significant cash flow requirements, where possible, to assist with short term cash requirements at maturity.
- All long-term securities shall be purchased with the intent to hold all investments to maturity under then prevailing economic conditions. However, economic or market conditions may change, making it in the City's best interest to sell or trade a security prior to maturity.

XXIV. STATEMENT OF INVESTMENT POLICY

The City of Elk Grove's Investment Policy shall be adopted by Resolution of the City Council on an annual basis. This investment policy shall be reviewed at least annually to ensure its consistency with the overall objectives of preservation of principal, liquidity and yield, and its relevance to current law and financial and economic trends. Any amendments to the policy shall be forwarded to the City Council for approval.

XXV. GLOSSARY OF TERMS

Accrued Interest - Interest earned but not yet received.

Active Deposits - Funds which are immediately required for disbursement.

Agencies - Federal agency securities and/or Government-sponsored enterprises.

Amortization - An accounting practice of gradually decreasing (increasing) an asset's book value by spreading its depreciation (accretion) over a period of time.

Asking Price - The price a broker/dealer offers to sell securities.

Bankers' Acceptance (BA) - A draft or bill of exchange accepted by a bank or trust company. The accepting institution guarantees payment of the bill, as well as the issuer.

Basis Point - One basis point is one hundredth of one percent (.01).

Bid - The price offered by a buyer of securities. (When you are selling securities, you ask for a bid) See Offer.

Bond - A financial obligation for which the issuer promises to pay the bondholder a specified stream of future cash flows, including periodic interest payments and a principal repayment.

Book Value - The value at which a debt security is shown on the holder's balance sheet. Book value is acquisition cost less amortization of premium or plus accretion of discount.

Broker - A broker brings buyers and sellers together for a commission.

Certificate of Deposit - A time deposit with a specific maturity evidenced by a certificate. Large-denomination CD's are typically negotiable. CD's may be eligible for FDIC insurance.

Collateral - Securities, evidence of deposit or pledges to secure repayment of a loan. Also refers to securities pledged by a bank to secure deposit of public moneys.

Comprehensive Annual Financial Report (CAFR) - The official annual financial report for the City. It includes five combined statements and basic financial statements for each individual fund and account group prepared in conformity with Generally Accepted Accounting Principals (GAAP)

Constant Maturity Treasury (CMT) - An average yield of a specific Treasury maturity sector for a specific time frame. This is a market index for reference of past direction of interest rates for the given Treasury maturity range.

Coupon - The annual rate of interest that a bond's issuer promises to pay the bondholder on the bond's face value.

XXV. GLOSSARY OF TERMS (continued)

Credit Analysis - A critical review and appraisal of the economic and financial conditions or of the ability to meet debt obligations.

Current Yield - The interest paid on an investment expressed as a percentage of the current price of the security.

Custody - A banking service that provides safekeeping for the individual securities in a customer's investment portfolio under a written agreement which also calls for the bank to collect and pay out income, to buy, sell, receive and deliver securities when ordered to do so by the principal.

Debenture - A bond secured only by the general credit of the issuer.

Delivery vs. Payment (DVP) - Delivery of securities with a simultaneous exchange of money for the securities.

Demand Deposit Account - Accounts whose balance is available to meet immediate cash needs (maturities up to 7 days).

Derivatives - (1) Financial instruments whose return profile is linked to, or derived from, the security, and may include a leveraging factor, or (2) financial contracts based upon notional amount whose value is derived from an underlying index or security (interest rates, foreign exchange rates, equities, or commodities).

Discount - The difference between the cost of a security and its value at maturity when quoted at lower than face value.

Discount Securities - Non-interest bearing money market instruments that are issued at a discount and redeemed at maturity for full face value, e.g., U. S. Treasury Bills.

Diversification - Dividing investment funds among a variety of securities offering independent returns and risk profiles.

Duration - The weighted average maturity of a bond's cash flow stream, where the present value of the cash flows serve as the weights; the future point in time at which on average, an investor has received exactly half of the original investment, in present value terms; a bond's zero-coupon equivalent; the fulcrum of a bond's present value cash flow time line.

Fannie Mae - Trade name for the Federal National Mortgage Association (FNMA).

Federal Credit Agencies - Agencies of the Federal Government set up to supply credit to various classes of institutions and individuals, e.g., Savings and Loans, small business firms, students, farmers, farm cooperatives, and exporters.

XXV. GLOSSARY OF TERMS (continued)

Federal Deposit Insurance Corporation (FDIC) - Insurance provided to customers of a subscribing bank which guarantees deposits to a set limit (currently \$100,000) per account.

Federal Funds Rate - The rate of interest at which Federal funds are traded. This rate is currently pegged by the Federal Reserve through open-market operations.

Federal Home Loan Banks (FHLB) - Government sponsored wholesale banks which lend funds and provide correspondent banking services to member commercial banks, thrifty institutions, credit unions and insurance companies. The mission of the FHLBs is to liquefy the housing related assets of its members who must purchase stock in their district Bank.

Federal Home Loan Mortgage Corporation (FHLMC) – The FHLMC was created under the Federal Home Loan Mortgage Act, Title III of the Emergency Home Finance Act of 1970 as a stockholder owned government-sponsored enterprise. Freddie Mac, as the corporation is called, is charged with providing stability and assistance to the secondary home mortgage market by buying first mortgages and participation interests and reselling these securities in the form of guaranteed mortgage securities. Although agency obligations are not explicitly guaranteed by the federal government, the rating agencies believe that in the unlikely event of financial difficulties, the federal government will support the agency to the extent necessary to provide for full and timely payment on their securities.

Federal National Mortgage Association (FNMA) - FNMA, like GNMA was chartered under the Federal National Mortgage Association Act in 1938. FNMA is a federal corporation working under the auspices of the Department of Housing and Urban Development (HUD). It is the largest single provider of residential mortgage funds in the United States. Fannie Mae, as the corporation is called, is a private stockholder-owned corporation. The corporation's purchases include a variety of adjustable mortgages and second loans, in addition to fixed-rate mortgages. FNMA's securities are also highly liquid and are widely accepted. FNMA assumes and guarantees that all security holders will receive timely payment of principal and interest.

Federal Open Market Committee (FOMC) - Consists of seven members of the Federal Reserve Board and five of the twelve Federal Reserve Bank Presidents. The President of the New York Federal Reserve Bank is a permanent member, while the other Presidents serve on a rotating basis. The Committee periodically meets to set Federal Reserve guidelines regarding purchases and sales of Government Securities in the open market as a means of influencing the volume of bank credit and money.

Federal Reserve System - The central bank of the U. S. which consists of a seven member Board of Governors, 12 regional banks and 5,700 commercial banks that are members.

XXV. GLOSSARY OF TERMS (continued)

Fed Wire - A wire transmission service established by the Federal Reserve Bank to facilitate the transfer of funds through debits and credits of funds between participants within the Fed system.

Freddie Mac - Trade name for the Federal Home Loan Mortgage Corporation (FHLMC).

Ginnie Mae - Trade name for the Government National Mortgage Association (GNMA).

Government National Mortgage Association (GNMA) – Securities influencing the volume of bank credit guaranteed by GNMA and issued by mortgage bankers, commercial banks, savings and loan associations and other institutions. Security holder is protected by the full faith and credit of the U.S. Government. Ginnie Mae securities, are backed by the FHA, VA, or FmHA mortgages. The term “pass-throughs” is often used to describe Ginnie Maes.

Inactive Deposits - Funds not immediately needed for disbursements.

Interest Rate - The annual yield earned on an investment, expressed as a percentage.

Investment Agreements - An agreement with a financial institution to borrow public funds subject to certain negotiated terms and conditions concerning collateral, liquidity and interest rates.

Liquidity - Refers to the ability to rapidly convert an investment into cash with minimal risk of losing some portion of principal and/or interest..

Local Government Investment Pool (LGIP) - The aggregate of all funds from political subdivisions that are placed in the custody of the State Treasurer for investment and reinvestment.

Market Value - The price at which a security is trading and could presumably be purchased or sold.

Master Repurchase Agreement - A written contract covering all future transactions between the parties to repurchase and/or reverse repurchase agreements that establishes each party's rights in the transactions. A master agreement will offer specify, among other things, the right of the buyer-lender to liquidate the underlying securities in the event of default by the seller-borrower.

Maturity - The date upon which the principal or stated value of an investment becomes due and payable.

XXV. GLOSSARY OF TERMS (continued)

Money Market - The market in which short-term debt instruments (bills, commercial paper, banker's acceptances, etc.) are issued and traded.

New Issue - Term used when a security is originally "brought" to market.

Offer - The price asked by a seller of securities. (When you are buying securities, you ask for an offer.) See Asked and Bid.

Open Market Operations - Purchases and sales of government and certain other securities in the open market by the New York Federal Reserve Bank as directed by the FOMC in order to influence the volume of money and credit in the economy. Purchases inject reserve into the bank system and stimulate growth of money and credit; sales have the opposite effect. Open market operations are the Federal Reserve's most important and most flexible monetary policy tool.

Perfected Delivery - Refers to an investment where the actual security or collateral is held by an independent third party representing the purchasing entity.

Portfolio - Collection of securities held by an investor.

Primary Dealer - A group of government securities dealers that submit daily reports of market activity and security positions held to the Federal Reserve Bank of New York and are subject to its informal oversight.

Prudent Person Rule - An investment standard. In some states the law requires that a fiduciary, such as a trustee, may invest money only a list of securities selected by the custody state - the so-called legal list. In other states the trustee may invest in a security if it is one which would be brought by a prudent person of discretion and intelligence who is seeking a reasonable income and preservation of capital.

Purchase Date - The date in which a security is purchased for settlement on that or a later date.

Qualified Public Depositories - A financial institution which does not claim exemption from the payment of any sales or compensating use or ad valorem taxes under the laws of this state, which has segregated for the benefit of the commission eligible collateral having a value of not less approved by the Public Deposit Protection Commission to hold public deposits.

Rate of Return - The yield obtainable on a security based on its purchase price or its current market price. This may be the amortized yield to maturity on a bond or the current income return.

Repurchase Agreement (RP or REPO) - A holder of securities sells these securities to an investor with an agreement to repurchase them at a fixed price on a fixed date. The security "buyer" in effect lends the "seller" money for the period of the agreement, and the terms of the agreement are structured to compensate him for this.

XXV. GLOSSARY OF TERMS (continued)

Dealers use RP extensively to finance their positions. Exception: When the Fed is said to be doing RP, it is lending money, that is, increasing bank reserves.

Reverse Repurchase Agreement (Reverse REPO) - A transaction where the seller (City) agrees to buy back from the buyer (bank) the securities at an agreed upon price after a stated period of time.

Risk - Degree of uncertainty of return on an asset.

Safekeeping - See custody.

Secondary Market - A market made for the purchase and sale of outstanding issues following the initial distribution.

Securities and Exchange Commission - Agency created by Congress to protect investors in securities transactions by administering securities legislation.

Settlement Date - The date on which a trade is cleared by delivery of securities against funds.

Structured Notes - Notes issued by Government Sponsored Enterprises (FHLB, FNMA, etc.) and Corporations which have imbedded options (e.g., call features, step-up coupons, floating rate coupons, derivative-based returns) into their debt structure. Their market performance is impacted by the fluctuation of interest rates, the volatility of the imbedded options and shifts in the shape of the yield curve.

Treasury Bills - A non-interest bearing discount security issued by the U.S. Treasury to finance the national debt. Most bills are issued to mature in three months, six months, or one year.

Treasury Bonds - Long-term coupon-bearing U. S. Treasury securities issued as direct obligations of the U. S. Government and having initial maturities of more than ten years.

Treasury Notes - Medium-term coupon-bearing U. S. Treasury securities issued as direct obligations of the U. S. Government and having initial maturities from two to ten years.

Uniform Net Capital Rule - Securities and Exchange Commission requirement that member firms as well as nonmember broker-dealers in securities maintain a maximum ratio of indebtedness to liquid capital of 15 to 1; also called net capital rule and net capital ratio. Indebtedness covers all money owed to a firm including margin loans and commitments to purchase securities, on reason new public issues are spread among members of underwriting syndicates. Liquid capital includes cash and assets easily converted into cash.

U.S. Government Agencies - Instruments issued by various U.S. Government Agencies most of which are secured only by the credit worthiness of the particular agency.

XXV. GLOSSARY OF TERMS (continued)

Yield - The rate of annual income return on an investment, expressed as a percentage. It is obtained by dividing the current dollar income by the current market price of the security.

Yield to Maturity - The rate of income return on an investment, minus any premium or plus any discount, with the adjustment spread over the period from the date of purchase to the date of maturity of the bond, expressed as a percentage.

APPENDIX

INVESTMENT PROCEDURES

A. Purpose

The purpose of these guidelines is to help create a Procedures Manual to assist the Treasury staff with day-to-day investment operations.

Numerical references and subjects at the beginning of each Section refer to elements in the City of Elk Grove's Investment Policy.

B. Cash Review

- II. Policy
- III. Scope
- VI. Delegation of Authority

The Treasurer or his/her designee must review the cash balances and investment portfolio daily, or as needed. Items to be reviewed should include:

1. Balances, by fund if so deposited, at primary bank;
2. Balances, by fund if so deposited, at other banks;
3. Maturing investments (includes Repo's, CD's, Commercial Paper, Bankers' Acceptances, and general securities);
4. Bond sales and other large, periodic receipts; and
5. Bond and coupon payments (debt service) and other large periodic cash disbursements.

C. Investment Selection

- IV. Prudence
- V. Objective
- X. Authorized and Suitable Investments
- XV. Diversification
- XVI. Maximum Maturities

The Treasurer or his/her designee determines how much of the cash balance is available for investment and selects the area of the yield curve that most closely matches the required maturity date.

C. Investment Selection (continued)

In determining the maturity date, the Treasurer or his/her designee should consider liquidity, cash flow, and expected expenditures. A review of some of the following sources should be made to determine whether the investments should be placed to match projected expenditures or shorter, or to take advantage of current and expected interest rate environments:

1. Wall Street Journal or similar daily business publication,
2. Input from approved broker/dealers,
3. Input from depository banks,
4. Publications on general trends of economic statistics, and
5. Input from data services (Telerate, Bloomberg, Reuters, etc.).

D. Purchasing an Investment

- IX. Authorized Financial Dealers
- X. Authorized and Suitable
- XI. Investment Pools/Mutual Funds
- XIII. Collateralization and Institutions
- XIV. Safekeeping and Custody
- XV. Diversification Investments
- XVI. Maximum Maturities

Establish with whom the jurisdiction is going to transact business. This should be accomplished through the use of a questionnaire, which helps provide the following evaluation:

1. Financial condition, strength and capability to fulfill commitments;
2. Overall reputation with other dealers and investors;
3. Regulatory status of the broker/dealer (providers); and
4. Background and expertise of the individual representative.

Financial (banking) institutions should be selected through the use of a "Request for Proposal (RFP)." The use of a nationally recognized financial institution rating organization will assist in the evaluation.

Contact an appropriate number of institutions, as specified by policy. The Treasurer should be as specific as possible in requesting the offering. If a particular type of investment or a particular issuing agency is to be excluded due to policy limitations, that should be stated to the providers. If collateral is required (i.e. for Repo's or CD's), the collateral limitations (excess margin, types of securities, maximum maturity, etc.) should be specified.

D. Purchasing an Investment (continued)

The following must be determined prior to contacting the providers:

1. Settlement - cash, regular (next day), corporate (three business days) or when-issued if a new issue;
2. Amount - either par value or total dollars to be invested;
3. Type of security to be purchased, or type to be excluded;
4. Targeted maturity, or maturity range; and
5. Time limit to show offering - five minutes, fifteen minutes, etc.

If choosing an external pool or fund as the preferred investment vehicle, the following should be available for inspection prior to purchase and at any reasonable time thereafter:

1. A written investment policy, if a government-run investment pool;
2. A prospectus for money-market funds, mutual funds, or bank-managed funds;
3. A schedule of the types of reports and the frequency of distribution;
4. A clear description of how interest rates are calculated (30/360, actual/365, etc.);
5. A schedule of when and how income is distributed;
6. Are the pool or fund types of investments restricted to your own legal and policy limits?
and
7. Are the pool or fund investments restricted to your own maturity limits?

Before concluding the transaction, the Treasurer or his/her designee should validate the following:

1. The security selected for purchase meets all criteria, including portfolio diversification, collateralization (if appropriate) and maturity. If the security has any imbedded options such as call provisions or coupon adjustments, these should also be reviewed.
2. Yield calculations should be verified.
3. Total purchase cost (including accrued interest) does not exceed funds available for investment.
4. Advise the successful provider that their offering has been selected for purchase. and
5. After confirmation of the purchase, as a courtesy, notify the other broker/dealers that you have placed the investment. Best price may be disclosed, if you choose.

After consummation of the transaction, and prior to settlement date, the Treasurer or his/her designee and the provider should exchange and review the following information to ensure prompt, and uninterrupted settlement:

1. Name of third-party safekeeping agent,
2. ABA number of safekeeping agent,
3. Safekeeping account number,
4. Reconfirm amount of transaction,
5. Reconfirm settlement date, and
6. Acquire CUSIP number of security, if applicable.

E. Settlement and Follow-Through

- **VI. Delegation of Authority**

The Treasurer or his/her designee should forward to the safekeeping agent a report of the investment transaction. The report may be verbal, but a written form should be sent and acknowledged. When applicable, the following should be verified:

1. Provision of receipt or disbursement of funds,
2. Internal transfer or wiring of funds,
3. Validation of written "safekeeping receipt",
4. Notification of discrepancy prior to acceptance or rejection of the transaction, and
5. Immediate notification if a fail has occurred: by provider if they are responsible, by safekeeping agent if they are responsible.

INTERNAL CONTROL GUIDELINES

The following internal control guidelines for segregation of responsibilities for the Treasurer's functions have been compiled by the California Municipal Treasurer's Association, in cooperation with the California Municipal Finance Officer's Association and the County Treasurer's Association.

A. Objectives of Internal Control

Internal control is the plan of organization and all the related systems established by management's objective of ensuring, as far as practicable:

- The orderly and efficient conduct of its business, including adherence to management policies,
- The safeguarding of assets,
- The prevention and detection of errors and fraud,
- The accuracy and completeness of the accounting records, and
- The timely preparation of reliable financial information.

B. Limitations of Internal Control

No internal control system, however elaborate, can by itself guarantee the achievement of management's objectives. Internal control can provide only reasonable assurance that the objectives are met, because of its inherent limitations, including:

- Management's usual requirement that a control be cost effective.
- The direction of most controls at recurring, rather than unusual types of transactions.
- Human error due to misunderstanding, carelessness, fatigue or distraction.
- Potential for collusion that circumvents controls dependent on segregation of functions.
- Potential for a person responsible for exercising control abusing that responsibility; a member of management is frequently in a position to override controls which management has set up.

C. Elements of Internal Control

Elements of a system of internal control are the means by which an organization can satisfy the objectives of internal control. The elements are:

Organization

Specific responsibility for the performance of duties should be assigned and lines of authority and reporting clearly identified and understood.

Personnel

Personnel should have capabilities commensurate with their responsibilities. Personnel selection and training policies together with the quality of supervision are thus important.

C. Elements of Internal Control (continued)

Segregation of Responsibilities

Segregation of incompatible responsibilities reduces the risk that a person is in a position both to perpetrate and conceal errors or fraud in the normal course of duty. If two parts of a transaction are handled by different people, collusion is necessary to conceal errors or fraud. In particular, the responsibilities that should be considered when evaluating segregation are authorization, execution, recording, custody of assets, and performing reconciliations.

Authorization

All transactions should be authorized by an appropriate responsible individual. The responsibilities and limits of authorization should be clearly delineated. The individual or group authorizing a specific transaction or granting general authority for transactions should be in a position commensurate with the nature and significance of the transactions. Delegation of authority to authorize transactions should be handled very carefully.

Controls Over an Accounting System

Controls over an accounting system include the procedures, both manual and EDP, carried out independently to ascertain that recorded transactions are complete, valid, authorized, and properly recorded.

Safeguarding of Assets and Records

Controls should be in place to prevent and detect loss, theft or deterioration of assets. In addition, safeguards are necessary to prevent the loss or destruction of records and documentation. These controls would involve custodial controls, which are designed to prevent or detect unauthorized access to or use of assets and records, and accountability controls, which compare accounting records to determine whether recorded assets exist and are properly recorded, in accordance with generally accepted accounting principles (GAAP).

Management

These are the controls exercised by management including day-to-day supervision, overall supervisory controls, management review of budgets, management review of the adequacy of internal control, and the internal audit function.

SEGREGATION OF RESPONSIBILITY OF THE TREASURER'S FUNCTIONS OF THE CITY OF ELK GROVE

<u>ACTIVITY</u>	<u>RESPONSIBLE PARTY</u>
1. Authorization of investment transactions in a formal policy should be: a) prepared by, and b) submitted to	Treasurer City Manager & City Council
2. Execution of investment transactions	Treasurer, or Designee
3. Timely recording of investment transactions in the accounting records	Director of Finance or Designee
4. Verify transactions by matching broker confirmations to accounting records	Director of Finance or Designee
5. Safeguarding of assets and records: a) Reconciliation of Treasurers' records to the accounting records	Sr. Accountant/Auditor
b) Reconciliation of Treasurers' records to bank statements and safekeeping records	Sr. Accountant/Auditor and Accounting Technician
c) Review of financial institution's financial condition, including safety, liquidity and potential yields of investment instruments.	Treasurer
d) Review reputation and financial condition of investment broker/dealers	Treasurer
e) Periodic review of collateral	Treasurer
f) Investment securities shall be safe-kept unless there are adequate controls limiting unauthorized access. Whenever possible, investment securities shall be held in safekeeping by the City's designated third party custodian.	City's Vault and Trust Departments
6. Management's periodic review of the investment portfolio as prepared by the Treasurer - key areas which should be reviewed are investment types, purchase price, market values, maturity dates and investment yields, as well as, conformance to stated investment policy.	Treasurer