REPORT TO MAYOR AND COUNCIL

NO: 08-307

Council Meeting: October 14, 2008

SUBJECT: Amendment to Investment and Cash Management Policy

REPORT IN BRIEF

Staff is recommending that Council approve an amendment to Section III A of the City's Investment and Cash Management Policy to add Municipal Obligations including variable rate demand bonds issued by any state and local agency, as Authorized Investments.

BACKGROUND

The California Government Code governs the investment of funds by a local agency, including the types of securities in which a California local agency may invest. In addition, each local agency in California is required to adopt an investment policy which may add further investment limitations.

The City Council adopted its Investment and Cash Management Policy governing investment of City funds on July 30, 1985 (the "Investment Policy"). This policy has been updated on an annual basis since that time. The Investment Policy was last updated and approved by Council on August 26, 2008.

Although California law allows cities to invest in municipal and state bonds, the City has not previously included these instruments in the list of authorized investments. Typically, these types of investments are not as attractive as other debt because they are most often tax exempt and therefore pay a lower interest rate than taxable instruments such as U.S. Treasuries. Further, Municipal Obligations tend to have longer term maturities while the City is generally limited to a maturity of no more than five years without express Council authorization.

Recently, however, with the downgrade of some bond insurers and the tightening of the credit markets, the interest rates on Municipal Obligations has increased, making them more attractive. In addition, states and local agencies often have the need to issue taxable obligations, which bear higher interest rates. Finally, the rates on variable rate demand bonds issued by state and local governments have also increased significantly. Staff recommends that the Investment Policy be amended to allow the purchase of Municipal Obligations issued by other states and local agencies as well as by the City of Sunnyvale itself.

EXISTING POLICY
The key principles of the existing Investment Policy are as follows:

1. Safety of principal is the foremost objective of the investment program. Diversification is required in order that potential losses on individual securities do not exceed the income generated from the remainder of the portfolio.

2. Liquidity - the portfolio will remain sufficiently liquid to enable the City to meet all operating requirements which might be reasonably anticipated.

3. Return on Investment - the portfolio will be maintained with the objectives of safety and liquidity first, and then the objective of obtaining a market rate of return throughout the budgetary and economic cycles, taking into account the City's investment risk constraints and the cash flow characteristics of the portfolio.

DISCUSSION
The Investment Policy currently does not include Municipal Obligations. The following such investments are permitted by the California Government Code:

> Bonds issued by Sunnyvale: "Bonds issued by the local agency, including bonds payable solely out of the revenues from a revenue-producing property owned, controlled, or operated by the local agency or by a department, board, agency, or authority of the local agency." Government Code Section 53601(a).

> State Obligations: "Registered treasury notes or bonds of any of the other 49 United States in addition to California, including bonds payable solely out of the revenues from a revenue-producing property owned, controlled, or operated by a state or by a department, board, agency, or authority of any of the other 49 United States, in addition to California." Government Code Section 53601(d).

> California Local Agency Obligations: "Bonds, notes, warrants, or other evidence of indebtedness of any local agency within this state, including bonds payable solely out of the revenues from a revenue-producing property owned, controlled, or operated by the

local agency, or by a department, board, agency or authority of the local agency." Government Code Section 53601 (e).

Collectively, the obligations identified in Government Code Sections 53601(a), (d) and (e) are referred to as "Municipal Obligations."

Municipal Obligations are among the safest investments available. However, they have not been attractive investments to the City because the interest rates are typically tax-exempt and therefore lower than other safe alternatives. Recently, due to the uncertainty in the credit markets, the interest rates on Municipal Obligations have increased relative to taxable alternatives, both with respect to fixed rate and variable rate obligations. In addition, states and local agencies often have the need to issue taxable Municipal Obligations which bear higher interest rates.

To take advantage of the current market conditions mentioned above, staff is recommending that Section III A. of the Investment Policy be amended to add Municipal Obligations to the list of Authorized Investments. Staff recommends that, with respect to Municipal Obligations, the Investment Policy require that the investment must bear minimum long term ratings of AA- by Standard and Poor's (S&P) or Aa3 by Moody's.

Variable rate demand obligations are special types of Municipal Obligations which provide the bond owner with the contractual right to tender its bonds on seven days' notice to a tender agent (usually the trustee bank). Such obligations are supported by third-party liquidity facilities from highly-rated financial institutions which guarantee sufficient funds to pay the tendering bondholder[1]. While variable rate demand obligations have long final maturities, the tender right of the bond owner on seven days' notice effectively converts them to the equivalent of a short-term investment[2]. An example of a variable rate demand obligation is the Government Center Certificates of Participation which the City issued in 2001 to purchase the Sunnyvale Office Center.

Staff is recommending that variable rate demand obligations, in addition to meeting the rating criteria discussed above, must also be supported by a third-party liquidity facility from a financial institution with minimum short-term ratings of A-1 by S&P and P-1 by Moody's.

---

[1] The expectation is that tendered bonds will be remarketed to another investor without the need to draw on the liquidity facility.
[2] For this reason, variable rate demand obligations may be purchased by tax-exempt money market funds.

FISCAL IMPACT

There is no fiscal impact associated with adding these investment types as Authorized Investments under the City's Investment Policy. However, because of current market conditions, interest rates on these investment instruments could be higher than U.S. Treasuries and other instruments with similar ratings. This will allow staff to take advantage of higher earning rates while maintaining safety and liquidity of principal.

PUBLIC CONTACT

Public contact was made by posting the Council agenda on the City's official-notice bulletin board outside City Hall, in the Council Chambers lobby, in the Office of the City Clerk, at the Library, Senior Center, Community Center and Department of Public Safety; posting the agenda and report on the City's Web site; and making the report available at the Library and the Office of the City Clerk.

ALTERNATIVES

1. Adopt the amendment to the Investment Policy as presented to add Municipal Obligations to Section III A. Authorized Investments.

2. Do not adopt the amendment to the Investment Policy as presented.

RECOMMENDATION

It is recommended that the City Council adopt the amendment to the attached Investment Policy Section III A. Authorized Investments.

Reviewed by:

Mary J. Bradley Director of Finance
Prepared by: Therese Balbo, Finance Manager

Approved by:

Amy Chan
City Manager

Attachments

Proposed amended language to the Investment and Cash Management Policy for FY 2008/2009.

d. Such funds invest only in US Treasury and federal agency securities, and in repurchase agreements backed by US Treasury and federal agency securities; and

e. No more than 10% of the City's funds may be invested in money market mutual funds.

13. **Municipal Obligations,** provided that:

a. Such Municipal Obligations are limited to obligations of the City of Sunnyvale, obligations of any of the states or their agencies, and obligations of any California local agency;

b. The maturity does not exceed 5 years from the date of purchase;

c. For Municipal Obligations in the form of variable rate demand obligations, the obligations shall be supported by a third-party liquidity facility from a financial institution with short-term ratings of at least A-1 by S&P or P-1 by Moody's. The right of the bondholder to tender the obligation converts these obligations to a short term investment.

B. Prohibited Investment Vehicles and Practices

1. State law notwithstanding, any investments not specifically described herein are prohibited, including, but not limited to, mutual funds (other than government money market funds as described in Section III A(12), unregulated and/or unrated investment pools or trusts, collateralized mortgage obligations and futures and options.

2. In accordance with Government Code Section 53601.6, investment in inverse floaters, range notes, or mortgage derived interest-only strips is prohibited.

3. Investment in any security that could result in a zero interest accrual if held to maturity is prohibited.

4. Trading securities for the sole purpose of speculating on the future direction of interest rates is prohibited.

5. Purchasing or selling securities on margin is prohibited.

6. The use of reverse repurchase agreements, securities lending or any other form of borrowing or leverage is prohibited.

7. Prohibited investments held in the portfolio at the time of adoption of this policy may be held until maturity at the discretion of the Director of Finance.