Agenda Item No. 3

File Code No. 260.01

CITY OF SANTA BARBARA

COUNCIL AGENDA REPORT

AGENDA DATE: September 20, 2016

TO: Mayor and Councilmembers

FROM: Administration Division, Finance Department

SUBJECT: Statement Of Investment Policy And Delegation Of Investment Authority For Fiscal Year 2017

RECOMMENDATION:

That Council adopt, by reading of title only, a Resolution of the Council of the City of Santa Barbara Adopting the Investment Policy for the City and Rescinding Resolution No. 15-075.

DISCUSSION:

California Government Code (State Code) Section 53600 establishes legally permitted investments for local governments statewide. While not required by the State Code, each year the City Council adopts a Statement of Investment Policy, which further defines the suitable and authorized investments specifically for the City. In some cases, the City's policy is more restrictive than the State Code. Moreover, the policy serves as a guide for setting and achieving the City's own investment objectives and defines guidelines for the management of the portfolio.

Except for County governments, the State Code does not contain any provisions specifying what must be included in the investment policy of a local agency. The City has developed a comprehensive investment policy that includes all critical components recommended by various professional agencies and organizations, and the policy has been awarded several certifications. Therefore, staff recommends that the policy be updated annually to incorporate any statutory and/or internal policy changes, thereby maintaining this standard of excellence.

If a local agency's policy is submitted to the legislative body, it must be an agenda item at a public meeting and should be approved by a vote of the legislative body no later than the end of the first quarter of the year to which it applies.

Revisions to the annual investment policy are made each year, as needed, to incorporate policy or statutory changes affecting the City's investment program and daily investing activities. Policy revisions are generally technical in nature, such as process changes or language clarifications. Statutory changes are changes in state law affecting allowable investments or procedures related to investing activities.

Statutory Change Not Recommended

The passing of Assembly Bill 283 amended Government Code Sections 53601.8 and 53635.8 by extending the authority of local agencies to use a private sector deposit placement service to January 1, 2021. On September 6, 2013, these Government Code sections were amended, repealed and added to authorize local agencies to invest up to 30% of their surplus funds in deposits at a commercial or savings bank, saving and loan or credit union using a private sector deposit placement service. The changes broadened the use of placement services to deposits, while previously only the placement of certificates of deposit was authorized. The changes were scheduled to expire on January 1, 2017; however, with the passing of Assembly Bill 283, the sunset clause has been extended until January 1, 2021. Upon the sunset date, a public agency may no longer use a placement service provider to place deposits; however, the private entity would be able to assist a local agency with the placement of CDs.

The primary example of a private placement service is called the Certificate of Deposit Account Registry Service or "CDARS." CDARS consists of a network of banks around the country. Through a local CDARS member bank, the City could purchase certificates of deposit from other banks around the country. Each of the certificates of deposit would be for less than $250,000, thus ensuring that all principal and interest is fully covered by federal deposit insurance.

In Fiscal Year 2015, staff did not recommend including the use of private placement services in the City's Investment Policy. Staff again does not recommend the addition of private placement services to the City's Fiscal Year 2017 Investment Policy. In Fiscal Year 2016, staff recommended and Council adopted an Investment Policy change whereby Section VII (A) 8. Negotiable Certificates of Deposit was revised to allow purchases of negotiable certificates of deposits, deposit notes and bank notes up to $250,000 in any institution that insures its deposits with the Federal Deposit Insurance Corporation, regardless of Moody's Investors Service or Standard and Poor's Corporation ratings. As these funds are federally insured up to $250,000, a category "A" rating is unnecessary. Due to this change in the investment policy, the City is able to pursue the same deposits offered by the private placement service, without the additional administrative costs. During Fiscal Year 2016, the City purchased numerous CDs for $250,000 each from various banks and financial institutions.

Staff Recommended Changes

The policy, as submitted, contains one statutory change since adoption by Council in September 2015. Section VII (A) 13. Local Agency Investment Fund (LAIF) has been revised to allow the City to invest in LAIF up to the $65,000,000 maximum. Effective January 1, 2016, the State Treasurer, in accordance with State law, increased the LAIF deposit limit from $50,000,000 to $65,000,000. This limit is periodically increased based on the needs of local government participants and recommendations from the Local Investment Advisory Board and was previously increased on November 16, 2009, from $40,000,000. The increased LAIF deposit limit will provide the City with additional liquidity options at a higher interest rate as compared to the City's bank account earnings credit rate.

There is sufficiently broad language in the policy to allow for any changes that may occur during the year to be accommodated on an administrative basis rather than a formal revision to the policy. The policy, as submitted, contains no administrative changes that were made since the policy was adopted by Council in September 2015.

By separate action, Council formally delegates authority to the City Treasurer to invest and reinvest funds and to sell or exchange securities for a one-year period, as specified on page 3 of the proposed Investment Policy. Management and oversight of the investment program is delegated to the Finance Director. The Treasury Manager is authorized to conduct daily investment activities under supervision of the Finance Director per the terms of the Investment policy and the written investment procedures manual established by the Finance Director. All investment purchases and sales require signature approval from the Treasurer and Finance Director or their designee by the close of business on the next business day following the purchase or sale.

ATTACHMENT: Annual Statement of Investment Policy – Fiscal Year 2017

PREPARED BY: Julie Nemes, Treasury Manager

SUBMITTED BY: Robert Samario, Finance Director

APPROVED BY: City Administrator's Office

ATTACHMENT

City of Santa Barbara
Finance Department

Statement of Investment Policy

Fiscal Year 2017

City of Santa Barbara
ANNUAL STATEMENT OF INVESTMENT POLICY
Fiscal Year 2017

TABLE OF CONTENTS

City of Santa Barbara
ANNUAL STATEMENT OF INVESTMENT POLICY
Fiscal Year 2017

I. MISSION STATEMENT

It is the policy of the City to invest public funds in a manner that will provide maximum security, adequate liquidity and sufficient yield, while meeting the daily cash flow demands of the City and conforming to all statutes and regulations governing the investment of public funds.

II. SCOPE

This investment policy applies to all the financial assets of City of Santa Barbara. These funds are accounted for in the City's audited Comprehensive Annual Financial Report. If the City invests funds on behalf of another agency and, if that agency does not have its own policy, the City's investment policy shall govern the agency's investments.

A. Pooling of Funds

Except for cash in certain restricted and special funds, the City shall consolidate cash balances from all funds to maximize investment earnings. Investment income shall be allocated to various funds as identified in the investment procedures manual in accordance with generally accepted accounting principles.

B. Funds Included by this Policy

General Fund

Special Revenue Funds

Capital Project Funds

Enterprise Funds

Internal Service Funds

Trust and Agency Funds

Any new fund created by City Council unless specifically exempted

C. Funds Excluded from this Policy

1. City's Service Retirement System Fund. This fund is managed separately under Article XVA of the 1926 Charter.

2. Bond Proceeds. Investment of bond proceeds shall be subject to the conditions and restrictions of bond documents and are not governed by this policy. Bond investment conditions and restrictions shall be reviewed by the Finance Committee and forwarded to City Council for approval.

III. GENERAL OBJECTIVES

The primary objectives, in priority order, of the City's investment activities are safety, liquidity and yield.

A. Safety

Preservation of principal is the foremost objective of the investment program. Investments of the City shall be undertaken in a manner that seeks to ensure the preservation of capital in the overall portfolio. The objective shall be to mitigate credit risk and interest rate risk. To attain this objective, the City shall diversify its investments by investing funds among several financial institutions and a variety of securities offering independent returns.

1. Credit Risk

   The City shall minimize credit risk, the risk of loss due to the failure of the security issuer or backer, by:

   - Limiting investments to the safest types of securities
   - Pre-qualifying the financial institutions, broker/dealers, intermediaries, and advisers with which the City will do business
   - Diversifying the investment portfolio so as to minimize the impact any single industry/investment class can have on the portfolio

2. Interest Rate Risk

To minimize the negative impact of material changes in the market value of securities in the portfolio, the City shall:

- Structure the investment portfolio so that securities mature concurrent with cash needs to meet anticipated demands, thereby avoiding the need to sell securities on the open market prior to maturity
- Invest operating funds primarily in shorter-term securities, money market mutual funds, and the State of California's Local Agency Investment Fund (LAIF)

B. Liquidity

The City's investment portfolio shall remain sufficiently liquid to enable the City to meet all operating requirements which might be reasonably anticipated without requiring a sale of securities. Since all possible cash demands cannot be anticipated, the portfolio should consist largely of securities with active secondary or resale markets. A portion of the portfolio also may be placed in money market mutual funds or LAIF which offer same-day liquidity for short-term funds.

C. Yield (Return on Investment)

The City's investment portfolio shall be designed with the objective of attaining a benchmark rate of return throughout budgetary and economic cycles, commensurate with the City's investment risk constraints and the liquidity characteristics of the portfolio. Return on investment is of secondary importance compared to the safety and liquidity objectives described above. The core of investments is limited to relatively low risk securities in anticipation of earning a fair return relative to the risk being assumed.

IV. STANDARDS OF CARE

A. Prudence

The standard of prudence to be used by City investment officials shall be the **"**Prudent Investor Standard**"** in that 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 with those matters would use in the conduct of an enterprise of a like character and with like aims. This standard shall be applied in the context of managing the overall portfolio. City investment officers acting in accordance with written procedures and the investment policy and exercising due diligence shall be relieved of personal responsibility for an individual security's credit risk or market price changes, provided deviations from expectations are reported in a timely fashion and appropriate action is taken to control adverse developments.

B. Ethics and Conflicts of Interest

Officers and employees involved in the City investment process shall refrain from personal business activity that could conflict with proper execution of the investment program, or that could impair their ability to make impartial investment decisions. City employees and investment officials shall disclose any material financial interests in financial institutions that conduct business within their jurisdiction, and they shall further disclose any personal financial/investment positions that could be related to the performance of the City immediately to the City of Santa Barbara Treasurer and annually to the Fair Political Practices Commission. City employees and officers shall refrain from undertaking personal investment transactions with the same individual with whom business is conducted on behalf of the City.

C. Delegation of Authority

Authority to manage the City's investment program is derived from the Charter of the City of Santa Barbara. City Council shall delegate to the Treasurer, for a 1-year period, the authority to invest or to reinvest funds, or to sell or exchange securities. The Treasurer shall thereafter assume full responsibility for those transactions until the delegation of authority is revoked or expires.

Management responsibility for the investment program is delegated to the Finance Director who shall establish a separate written investment procedures manual. The operation of the investment program shall be consistent with this policy and the investment procedures manual. 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 Finance Director. The Treasury Manager is authorized to conduct investment related activities, under the supervision of the Director of Finance, on behalf of the City. All investment purchases and sales require signature approval from the Treasurer and Finance Director or their designee, by the close of business on the next business day following the purchase or sale.

The following documents are by reference incorporated in the investment procedures manual:

1. Listing of authorized personnel
2. Relevant investment statutes and ordinances
3. Repurchase agreements and tri-party agreements
4. Listing of authorized broker/dealers and financial institutions
5. Credit ratings and/or reports for securities purchased and financial institutions used
6. Safekeeping agreements
7. Sample investment reports
8. Investment accounting documents
9. Methodology for calculating rate of return
10. Banking services contracts
11. Cash flow forecasting
12. Collateral/depository agreements

D. Internal Controls

The Finance Director is responsible for establishing and maintaining a system of written internal controls. These controls shall be reviewed annually with an independent external auditor who will notify the City Council if there is a material non-compliance with its policies and procedures. The internal controls shall be designed to prevent losses of public funds arising from fraud, employee error, and misrepresentation by third parties, unanticipated changes in financial markets, or imprudent action by City employees and officers. The internal structure shall be designed to provide reasonable assurance that these objectives are met. The concept of reasonable assurance recognizes that (1) the cost of a control should not exceed the benefits likely to be derived, and (2) the valuation of costs and benefits requires estimates and judgments by management.

The internal controls shall address the following points:

1. Control of collusion
2. Separation of transaction authority from accounting and record-keeping
3. Custodial safekeeping
4. Delivery versus payment (DVP)
5. Clear delegation of authority to subordinate staff members
6. Written confirmation of transactions for investments and wire transfers
7. Wire transfer agreements

V. AUTHORIZED FINANCIAL DEALERS AND INSTITUTIONS

The Finance Director shall establish selection criteria for pre-approval of financial institutions and security broker/dealers to do business with the City of Santa Barbara. The Finance Director shall maintain a list of City approved financial institutions and security broker/dealers who are authorized to provide investment services to the City. These may include primary dealers, or regional dealers that qualify under Securities & Exchange Commission Rule 15C3-1 (uniform net capital rule). To qualify for consideration, a financial institution or a security broker/dealer must also have an office in California and that office must perform the transactions with the City.

All financial institutions and broker/dealers who desire to become qualified for investment transactions must supply the following to the Finance Director as appropriate:

- Current audited financial statements
- Proof of Financial Industry Regulatory Authority (FINRA), formerly National Association of Security Dealers (NASD), certification
- Trading resolution
- Complete broker/dealer questionnaire
- Proof of State of California registration
- For banking institutions, a statement of compliance with the Federal Reserve Bank of New York's capital guideline
- Statement of having read, understood and agreeing to comply with the City's investment policy and depository contracts

The Finance Director shall annually review each of the approved financial institutions and security broker/dealers selected for current State of California registrations and financial condition.

VI. 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 which will ensure that securities are deposited in an eligible financial institution prior to the release of funds**.** Securities shall be held by a third-party custodian designated by the Finance Director and evidenced by safekeeping receipts with a written custodial agreement. The only exception to the foregoing shall be depository accounts and securities purchases made with: LAIF, time certificates of deposit, and money market mutual funds, since the purchased securities are not deliverable. Settlement instructions sent to the safekeeping agent shall require dual authorization. The Treasurer and the Finance Director shall be bonded to protect the public against possible embezzlement and malfeasance. Safekeeping procedures shall be reviewed annually by an independent external auditor and any irregularities noted should be reported promptly to the Treasurer and City Council.

VII. SUITABLE AND AUTHORIZED INVESTMENTS

The City shall be governed by the California Government Code, Sections 53600 et seq. If the Code is amended to allow additional investments or is changed regarding the limits on certain categories of investments, the City is authorized to conform to the changes in the revised Code, provided that the changes are not specifically prohibited by the City's policy. The City shall be required to present those changes in the annual review of the policy and to incorporate the new legislation within the policy. Surplus funds are defined as funds not required for the immediate necessities of the City and include investments in individually managed portfolio(s), money market fund(s) and/or State LAIF, and all portfolio limitations and restrictions shall apply to this aggregate amount. For purposes of compliance with the California Government Code and the City's Investment Policy, the credit rating requirement for medium-term notes, deposit notes, bank notes and commercial paper shall be based on the quality ratings at the time of purchase. If the quality rating of the issuer is downgraded, subsequent to purchase, by any of the Nationally Recognized Statistical-Rating Organizations below "A", or its equivalent, it shall be reported to the Finance Committee and City Council with a recommendation, and ongoing information shall be provided if the bond is not sold. Percentage limitations of surplus funds invested are noted for the various investment instruments. Where there is a specified percentage limitation for a particular category of investments, that percentage is applicable only at the date of purchase. A later increase or decrease in a percentage resulting from a change in values or assets shall not constitute a violation of that restriction.

The City is empowered by statute to invest in the following types of securities and are those that the investment managers are trained and competent to handle.

A. Investment Types

1. Bonds, notes, or other forms of indebtedness issued by the City, including bonds payable solely out of the revenues from a revenue producing property owned, controlled, or operated by the City or by a department, board, agency, or authority of the local agency.

2. United States Treasury notes, bonds, bills, or certificates of indebtedness, or those for which the full faith and credit of the United States are pledged for the payment of principal and interest.

3. Federal Agency or United States government-sponsored enterprise obligations (GSE), participations, or other instruments.

4. State of California and Local Agency Obligations. Registered state warrants or treasury notes or bonds of this state, including bonds payable solely out of the revenues from revenue-producing property owned, controlled, or operated by the state or by a department, board, agency, or authority of the state; and bonds, notes, warrants, or other evidence of indebtedness of any local agency within this state including bonds payable solely out of the revenues from revenue-producing property owned, controlled, or operated by the local agency, or by a department, board, agency, or authority of the local agency. Notes eligible for investment, other than those issued by the City or operated by a department, board, agency, or authority of the local agency, shall be rated in a category of "A" or its equivalent or better by two Nationally Recognized Statistical-Rating Organizations.

5. Medium-Term Notes, defined as all corporate and depository institution debt securities with a maximum remaining maturity of 5 years or less, issued by corporations organized and operating within the United States or by depository institutions licensed by the United States or any state and operating within the United States. Purchases of medium-term notes may not exceed 30 percent of the City's surplus funds. Notes eligible for investment shall be rated in a category of "A" or its equivalent or better by two Nationally Recognized Statistical-Rating Organizations. Investments in medium-term notes for any single non-government issuer shall be limited to no more than 5 percent of surplus funds for issuers rated “AA” or its equivalent or better by two Nationally Recognized Statistical-Rating Organizations, and to no more than 3 percent for issuers rated “A” or its equivalent or better by two Nationally Recognized Statistical-Rating Organizations.

6. Bankers Acceptances otherwise known as bills of exchange or time drafts, drawn on and accepted by a commercial bank, which are eligible for purchase by the Federal Reserve System. Purchased bankers acceptances may not exceed 180 days maturity or 40 percent of the City's surplus funds, and no more than 10 percent of the City's surplus funds may be invested in the bankers’ acceptances of any single commercial bank.

7. Commercial Paper of “prime” quality of the highest ranking or the highest letter and number rating as provided for by a Nationally Recognized Statistical-Rating Organization. The entity that issues the commercial paper shall meet all of the following conditions in either paragraph (a) or paragraph (b):

   a. The entity is organized and operating in the United States as a general corporation and has total assets in excess of $500,000,000. In addition, its debt other than commercial paper, if any, must be rated “A” or higher by a Nationally Recognized Statistical-Rating Organization.

   b. The entity is organized within the United States as a special purpose corporation, trust, or limited liability company and has a program wide credit enhancement including, but not limited to, over collateralization, letters of credit, or surety bond. In addition, the entity has commercial paper that is rated “A-1” or higher, or the equivalent, by a Nationally Recognized Statistical-Rating Organization.

   Eligible commercial paper shall have a maximum maturity of 270 days or less. The City may not invest more than 25 percent of its surplus funds in commercial paper, and the City may purchase no more than 10 percent of the outstanding eligible commercial paper of any single issuer.

8. Negotiable Certificates of Deposit issued by a nationally or state-chartered bank or savings association or federal association or a state or federal credit union or by a state-licensed branch of a foreign bank. Purchases of negotiable certificates of deposit shall not exceed 15 percent of the City's surplus money invested and shall be limited to no more than 3 percent of any single issuer. Deposit notes and bank notes purchased through a broker or dealer shall be included with negotiable certificates of deposit in calculating allowable maximum percentages. Purchases of negotiable certificates of deposit, deposit notes and bank notes of up to

$250,000 are allowable in any institution that insures its deposits with the Federal Deposit Insurance Corporation, while purchases greater than $250,000 shall be rated in a category of "A" or its equivalent or better by two Nationally Recognized Statistical-Rating Organizations.

9. Time Deposits. The City may invest in non-negotiable Certificates of Deposit at commercial banks and savings and loan associations that are collateralized in accordance with the California Government Code. To be eligible to receive City funds, the depository institution shall have received an overall rating of not less than “satisfactory” in its most recent evaluation of its record of meeting the credit needs of California’s communities, including low and moderate-income neighborhoods. In selecting depositories, the credit worthiness of institutions shall be considered. Banks and Savings and Loan Associations seeking to establish an investment relationship with the City shall submit an audited financial report that shall be reviewed for compliance with the City's investment standards. Any institution not providing an audited annual financial report shall be removed from the approved list and all funds maturing will be withdrawn. A list of eligible institutions shall be maintained in the investment procedures manual. Qualification shall be determined by the following criteria:

    a. Tangible capital must equal or exceed 1.5 percent; core capital must equal or exceed 4 percent; and, risk-based capital must equal 8 percent of assets adjusted for assigned risk-weightings.

    b. Return on Assets of a minimum of 0.5 percent; a Return on Equity of a minimum of 8 percent; an Equity to Assets Ratio of a minimum of 5 percent; and, City investments shall be no greater than 0.5 percent of the total assets of the depository.

    c. Independent auditor's statement must have a clean opinion.

10. Savings accounts. Savings accounts when used in conjunction with the City's checking accounts at a qualified bank where funds are collateralized in accordance with the California Government Code.

11. U. S. Government money market funds registered with the Securities and Exchange Commission and which comply with rule 2a7 of the Investment Company Act of 1940. The fund must be comprised of only U.S. Treasury bills, notes and bonds, repurchase agreements and obligations issued or guaranteed as to principal and interest by the U.S. Government or its agencies or instrumentalities. The percentage of repurchase agreements in the fund shall be reviewed and approved based on the fund's policy limits. The dollar weighted average maturity of the portfolio shall be less than 90 days and the portfolio is managed to maintain a $1.00 share price. Also, the fund shall meet either of the following criteria: (a) attained the highest ranking or the highest letter and numerical rating provided by not less than two Nationally Recognized Statistical-Rating Organizations; (b) retained an investment adviser registered or exempt from registration with the Securities and Exchange Commission with not less than 5 years' experience managing money market mutual funds with assets under management in excess of $500,000,000. Purchase of securities

authorized by this section shall not exceed 20 percent of the City's surplus money invested and no more than 10 percent may be invested in any single money market fund.

12. Repurchase Agreements. Investments in repurchase agreements or reverse repurchase agreements or securities lending agreements of any securities authorized by the Code, so long as the proceeds of the repurchase agreement are invested solely to supplement the income normally received from these securities. The City shall adopt as a standard the Bond Market Association Master Repurchase Agreement and shall maintain a list of approved counterparts and limit counter parties to primary dealers rated "A" or better by two Nationally Recognized Statistical-Rating Organizations. Reverse repurchase agreements and securities lending agreements shall require City Council authorization separate from City Council approval of this policy. Securities lending agreements shall include the following safeguard measures: terms of lending agreements, indemnification provisions, reinvestment guidelines, liquidity provisions, credit risks and monitoring requirements. Additionally, any securities lending agreement shall be reviewed by the City Attorney to ensure the City's interests are properly protected.

    a. Investments in repurchase agreements may be made, on any authorized investment, when the term of the agreement does not exceed 1 year.

    b. Reverse repurchase agreements or securities lending agreements may be utilized when the security to be sold on the reverse repurchase agreement or securities lending agreement has been owned and fully paid for by the City for a minimum of 30 days prior to sale; the total of all reverse repurchase agreements on investments owned by the City does not exceed 20 percent of the base value of the portfolio; and the agreement does not exceed a term of 92 days, unless the agreement includes a written codicil guaranteeing a minimum earning or spread for the entire period between sale of a security using a reverse repurchase agreement and the final maturity date of the same security.

13. Local Agency Investment Fund (LAIF). The City may invest in LAIF up to the $65,000,000 maximum established by the California State Treasurer on January 1, 2016 in accordance with State law; therefore, there is a $65,000,000 deposit limit for the City of Santa Barbara. The City's investment in LAIF is based on, among other criteria, the following information provided by LAIF: a written statement of portfolio management goals, objectives and policies, including a description of eligible investment securities; a disclosure of LAIF's safekeeping practices; eligible LAIF participants, the monthly transaction limit, and minimum and maximum deposit and withdrawal amounts permitted; calculation of quarterly earnings and apportionment, including gains and losses; disclosure of administrative costs and the assessment process; monthly statements of the City's transaction activity and balances; monthly summaries of LAIF investment data, including market valuation and accrued interest; and a description of the audit process. At least quarterly, the Finance

Director shall report to the Finance Committee on the composition of the LAIF portfolio.

The California Government Code states that moneys placed for deposit in LAIF are in trust in the custody of the State Treasurer and cannot be borrowed or be withheld from the City. Further, the right of the City to withdraw its deposited money from the LAIF upon demand may not be altered, impaired, or denied in any way by any state official or agency based upon the State's failure to adopt a budget by July 1 of each new fiscal year.

B. Collateralization

Collateralization shall be required on two types of investments: certificates of deposit and repurchase (and reverse) agreements. A collateral agreement must be current and on file before any funds can be transferred for collateralized certificates of deposit. Collateral shall be held by an independent third party with whom the City has a current written custodial agreement. A clearly marked evidence of ownership (*safekeeping receipt*) must be supplied to the City and retained. The right of collateral substitution is granted.

1. Certificates of Deposit

    a. Government Securities used as collateral require 102 percent of market value to the face amount of the deposit

    b. Promissory Notes secured by first trust deeds used as collateral require 150 percent of market value to the face amount of the deposit

    c. Irrevocable Letters of Credit issued by the Federal Home Loan Bank of San Francisco require 105 percent of market value to the face amount of the deposit

2. Repurchase and Reverse Repurchase Agreements

    a. Only U.S. Treasury securities or Federal Agency securities are acceptable collateral. All securities underlying repurchase agreements must be delivered to the City's custodian bank versus payment or be handled under a properly executed tri-party repurchase agreement. The total market value of all collateral for each repurchase agreement must equal or exceed 102 percent of the total dollar value of the money invested by the City for the term of the investment. For any repurchase agreement with a term of more than 1 day, the value of the underlying securities must be reviewed on an ongoing basis according to market conditions. Market value must be calculated each time there is a substitution of collateral.

    b. The City or its trustee shall have a perfected first security interest under the Uniform Commercial Code in all securities subject to the repurchase agreement.

C. Investments Not Approved

Any security type or structure not specifically approved by this policy is hereby prohibited. Security types, which are thereby prohibited include, but are not limited to: investment pools (except State LAIF), shares of beneficial interest issued by diversified management companies (except U. S. Government money market funds*)*, collateralized mortgage obligations (CMO's), mortgage pass-through securities, reverse repurchase agreements used as a leveraging vehicle, "exotic" derivatives structures such as range notes, dual index notes, inverse floating-rate notes, leveraged or de-leveraged floating-rate notes, interest-only strips that are derived from a pool of mortgages and any security that could result in zero interest accrual if held to maturity, or any other complex variable or structured note with an unusually high degree of volatility or risk.

D. Exceptions to Prohibited and Restricted Investments

The City shall not be required to sell securities prohibited or restricted in this policy, or any future policies, or prohibited or restricted by new State regulations, if purchased prior to their prohibition and/or restriction. Insofar as these securities provide no notable credit risk to the City, holding of these securities until maturity is approved. At maturity or liquidation, such monies shall be reinvested only as provided by this policy.

VIII. INVESTING PARAMETERS

A. Diversification

The City shall diversify its investments by security type, issuer, maturity, and financial institutions. No percentage limitations are established for United States government, United States government agencies and United States government sponsored enterprises; however percentage limitations are established for other permitted investments, as noted in Section VII of this policy. The investments shall be diversified by limiting investments to avoid over concentration in securities from a specific issuer or business sector (excluding U.S. Treasury securities), limiting investment in securities that have higher credit risks, and investing in securities with varying maturities.

The City recognizes that investment risks can result from issuer defaults, market price changes or various technical complications leading to temporary illiquidity. Portfolio diversification is employed as a way to control risk. Investment managers are expected to display prudence in the selection of securities as a way to minimize default risk. No individual investment transaction shall be undertaken which jeopardizes the total capital position of the overall portfolio. To control market price risks, volatile investment instruments shall be avoided. To control risks of illiquidity, a minimum of 10 percent of the total portfolio shall be held in highly marketable U.S. Treasury Bills and Notes and/or the State of California Local Agency Investment Fund and/or Money Market Funds and/or securities maturing within 90 days.

B. Maximum Maturities

To the extent possible, the City will attempt to match its investments with anticipated cash flow requirements. Where there is no specified maturity limitation on an investment, no investment shall be made in any security, which, at the time of the investment, has a term remaining to maturity in excess of 5 years, unless the City Council has granted express authority to make that investment no less than 3 months prior to the investment.

In addition to the 5 year limitation on investments specified in this policy, the average maturity of the City's combined portfolio shall not exceed 2.5 years without prior approval of the City Council.

IX. REPORTING

The Treasurer shall submit investment reports to the City Council that provide a clear picture of the status of the current investment portfolio and shall contain sufficient information to permit an independent organization to evaluate the performance of the investment program. Based on the discretion of Finance Committee, an independent advisor may be contracted, from time to time to perform one or more of the following functions: confirm that the portfolio is in compliance with the Government Code of the State of California and with the Statement of Investment Policy of the City of Santa Barbara; present an evaluation of the portfolio and investment strategy recommendations; and, provide any other information that may be helpful to Finance Committee in their review of the portfolio.

A. Monthly Reporting to City Council

The Treasurer shall submit to City Council, within 30 days following the end of the month, an investment report that summarizes all securities in the portfolio and a separate listing of investment transactions occurring during the month. The report shall be prepared by the Treasury Manager and approved by the Finance Director. The report shall include:

1. Investment type
2. Purchase date
3. Maturity date
4. Credit quality
5. Coupon and yield
6. Book value
7. Market value
8. Book gain/loss
9. Market gain/loss
10. Source of valuation

11. Average days to maturity
12. Variable rate(s) or call features

B. Quarterly Reporting to City Council

In addition to the components required in the monthly investment report, a narrative shall accompany the portfolio report addressing noteworthy items, deviations from the investment policy, comments on the fixed income markets and economic conditions, possible changes in the portfolio going forward, and thoughts on investment strategies. The quarterly report shall also include a statement of compliance with the investment policy and a statement of the ability to meet expenditures for the next 6 months (or an explanation as to why sufficient money shall, or may, not be available).

C. Performance Standards

The investment portfolio shall be managed in accordance with the parameters specified within this policy and always with consistently safe and prudent treasury management. Securities shall not be sold prior to maturity with the following exceptions:

- A security with declining credit sold early to minimize loss of principal
- A security swap that would improve the quality, yield, or target duration in the portfolio
- Unforeseen liquidity needs of the portfolio require that the security be sold

1. Market Yield (Benchmark)

   The City's overall investment strategy is passive: investments are generally held to maturity. The quarter-to-date LAIF apportionment rate, the 3-month U.S. Treasury Bill and the 2-year U.S. Treasury Note shall also be considered useful benchmarks of the City's portfolio performance.

2. Marking to Market

   The market value of the portfolio shall be calculated at least monthly and a statement of the market value of the portfolio shall be issued at least quarterly. This will ensure that review of the investment portfolio, in terms of value and price volatility, has been performed. In defining market value, consideration shall been given to pronouncements from the Government Accounting Standards Board (GASB) that address the reporting of investment assets and investment income for all investment portfolios held by governmental entities. The fair value of all securities reported in the City's portfolio is based on currently quoted market prices.

X. INVESTMENT POLICY COMPLIANCE AND ADOPTION

A. Policy Compliance and Changes

Any deviation from the policy shall be reported to Finance Committee at the next scheduled meeting and to City Council as part of the monthly review of the portfolio The Treasurer shall promptly notify Finance Committee and City Council of any material change in the policy and any modifications to the policy must be approved by Finance Committee and City Council.

B. Annual Statement of Investment Policy

The Treasurer shall render a written Statement of Investment Policy that shall be reviewed at least annually by Finance Committee and City Council to ensure its consistency with the overall objectives of preservation of principal, liquidity and return, and its relevance to current law and financial and economic trends. City Council shall consider the annual Statement of Investment Policy and any changes therein at a public meeting. The Statement of Investment Policy shall be adopted by resolution of City Council.

GLOSSARY OF INVESTMENT TERMS

AGENCY: A debt security issued by a federal or federally sponsored agency. Federal agencies are backed by the full faith and credit of the U.S. Government (i.e. Government National Mortgage Association). Federally sponsored agencies (FSA's) are backed by each particular agency with a market perception that there is an implicit government guarantee (i.e. Federal National Mortgage Association).

ASK: The price at which securities are offered for sale; also known as offering price.

BENCHMARK: A comparative base for measuring the performance or risk tolerance of the investment portfolio. A benchmark should represent a close correlation to the level of risk and the average duration of the portfolio's investments.

BID: The price offered by a buyer of securities. (When you are selling securities, you *ask* for a bid.)

BOND PROCEEDS: The money paid to the issuer by the purchaser or underwriter of a new issue of municipal securities. These moneys are used to finance the project or purpose for which the securities were issued and to pay certain costs of issuance as may be provided in the bond contract.

BOOK VALUE: The value at which a debt security is shown on the holder's balance sheet. Book value is often acquisition cost plus/minus amortization and accretion, which may differ significantly from the security's current value in the market.

BROKER: Someone who brings buyers and sellers together and is compensated for his/her service.

CERTIFICATE OF DEPOSIT (CD): A time deposit with a specific maturity evidenced by a certificate. Large denomination CDs are typically negotiable.

COLLATERAL: Securities, evidence of deposit or other property which a borrower pledges to secure repayment of a loan. Also refers to securities pledged by a bank to secure deposits of public monies.

COMPREHENSIVE ANNUAL FINANCIAL REPORT (CAFR): The official annual financial report for a public agency. It includes combined statements for each individual fund combined statements for each individual fund and account group prepared in conformity with GAAP. It also includes supporting schedules necessary to demonstrate compliance with finance-related legal and contractual provisions, extensive introductory material, and detailed statistical section.

CREDIT QUALITY: The measurement of the financial strength of a bond issuer. This measurement helps an investor to understand an issuer's ability to make timely interest payments and repay the loan principal upon maturity. Generally, the higher the credit quality of a bond issuer, the lower the interest rate paid by the issuer because the risk of default is lower. Credit quality ratings are provided by a Nationally Recognized Statistical-Rating Organization.

CREDIT RISK: The risk to an investor that an issuer will default in the payment of interest and/or principal on a security.

CUSTODIAN: A bank or other financial institution that keeps custody of stock certificates and other assets.

CURRENT YIELD (CURRENT RETURN): A yield calculation determined by dividing the annual interest received on a security by the current market price of that security.

DEALER: A dealer, as opposed to a broker, acts as a principal in all transactions, by buying and selling for his/her own account.

DELIVERY VERSUS PAYMENT: There are 2 methods of delivery of securities: delivery versus payment and delivery versus receipt. Delivery versus payment, also referred to as "cash on delivery", is delivery of securities with an exchange of money for the securities. Delivery versus receipt is delivery of securities with an exchange of a signed receipt for the securities.

GLOSSARY OF INVESTMENT TERMS

DERIVATIVES: (1) financial instruments whose return profile is linked to, or derived from, the movement of one or more underlying index or security, and may include a leveraging factor, or (2) financial contracts based upon notional amounts whose value is derived from an underlying index or security (interest rates, foreign exchange rates, equities or commodities).

DIVERSIFICATION: Dividing investment funds among a variety of security types by sector, maturity and quality ratings offering independent returns.

DURATION: A measure of the timing of the cash flows, such as the interest payments and the principal repayment, to be received from a given fixed-income security. This calculation is based on three variables: term to maturity, coupon rate, and yield to maturity. The duration of a security is a useful indicator of its price volatility for given changes in interest rates.

FAIR VALUE: The amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

FEDERAL CREDIT AGENCIES: Agencies of the Federal Government set up to supply credit to various classes of institutions and individuals, e.g., savings and loan associations, small-business firms, students, farmers, farm co-operatives, and exporters.

FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC): The federal agency that insures bank deposits up to $250,000 per deposit at participating banking institutions. In an effort to increase consumer confidence in the banking system, the previous $100,000 insurance limit was temporarily increased to $250,000 in 2008, extended to 2013, and then permanently increased on July 21, 2010 with the passage of the Wall Street Reform and Consumer Protection Act.

FEDERAL HOME LOAN BANKS (FHLB): Government sponsored wholesale banks (currently 12 regional banks) that lend funds and provide correspondent banks services to member commercial banks, thrift institutions, credit unions and insurance companies.

FEDERAL NATIONAL MORTGAGE ASSOCIATION (FNMA): 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.

FEDERAL OPEN MARKET COMMITTEE (FOMC): Consists of 7 members of the Federal Reserve Board and 5 of the 12 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 United States created by Congress and consisting of a 7 member Board of Governors in Washington, D.C., 12 Regional Banks and approximately 5,700 commercial banks that are members of the system.

GOVERNMENT ACCOUNTING STANDARDS BOARD (GASB): A standard-setting body, associated with the Financial Accounting Foundation, which prescribes standard accounting practices for governmental units.

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION (GNMA or Ginnie Mae): 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 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.

GLOSSARY OF INVESTMENT TERMS

GOVERNMENT SECURITIES: An obligation of the U.S. government, backed by the full faith and credit of the government. These securities are regarded as the highest quality of investment securities available in the U.S. securities market. See "Treasury Bills, Notes, and Bonds."

INTEREST RATE RISK: The risk associated with declines or rises in interest rates which cause an investment in a fixed-income security to increase or decrease in value.

INTERNAL CONTROLS: An internal control structure designed to ensure that the assets of the entity are protected from loss, theft, or misuse. The internal control structure is designed to provide reasonable assurance that these objectives are met. The concept of reasonable assurance recognizes that 1) the cost of a control should not exceed the benefits likely to be derived and 2) the valuation of costs and benefits requires estimates and judgments by management. Internal controls should address the following points:

- **Control of collusion** - Collusion is a situation where 2 or more employees are working in conjunction to defraud their employer.
- **Separation of transaction authority from accounting and record keeping** - By separating the person who authorizes or performs the transaction from the people who record or otherwise account for the transaction, a separation of duties is achieved.
- **Custodial safekeeping** - Securities purchased from any bank or dealer including appropriate collateral (as defined by state law) shall be placed with an independent third party for custodial safekeeping.
- **Avoidance of physical delivery securities** - Book-entry securities are much easier to transfer and account for since actual delivery of a document never takes place. Delivered securities must be properly safeguarded against loss or destruction. The potential for fraud and loss increases with physically delivered securities.
- **Clear delegation of authority to subordinate staff members** - Subordinate staff members must have a clear understanding of their authority and responsibilities to avoid improper actions. Clear delegation of authority also preserves the internal control structure that is contingent on the various staff positions and their respective responsibilities.
- **Written confirmation of transactions for investments and wire transfers** - Due to the potential for error and improprieties arising from telephone and electronic transactions, all transactions should be supported by written communications and approved by the appropriate person. Written communications may be via fax if on letterhead and if the safekeeping institution has a list of authorized signatures.
- **Development of a wire transfer agreement with the lead bank and third-party custodian** - The designated official should ensure that an agreement will be entered into and will address the following points: controls, security provisions, and responsibilities of each party making and receiving wire transfers.

LIQUIDITY: A liquid asset is one that can be converted easily and rapidly into cash without a substantial loss of value. In the money market, a security is said to be liquid if the spread between bid and asked prices is narrow and reasonable size can be done at those quotes.

LOCAL AGENCY INVESTMENT FUND (LAIF): Chapter 730, Statutes of 1976 of the State of California, established the Local Agency Investment Fund. This fund enables local governmental agencies to remit money not required for immediate needs to the State Treasurer for the purpose of investment. In order to derive the maximum rate of return possible, the State Treasurer has elected to invest these monies with State monies as a part of the Pooled Money Investment Account. Each local governmental unit has

GLOSSARY OF INVESTMENT TERMS

the exclusive determination of the length of time its money will be on deposit with the State Treasurer. At the end of each calendar quarter, all earnings derived from investments are distributed by the State Controller to the participating government agencies in proportion to each agency's respective amounts deposited in the Fund and the length of time such amounts remained therein. Prior to the distribution, the State's costs of administering the program are deducted from the earnings.

MARK-TO-MARKET: The process whereby the book value or collateral value of a security is adjusted to reflect its current market value.

MARKET RISK: The risk that the value of a security will increase or decrease as a result of changes in market conditions.

MARKET VALUE: The current price at which a security is trading and could presumably be purchased or sold at that particular point in time.

MASTER REPURCHASE AGREEMENT: A written contract covering all future transactions between the parties to repurchase-reverse repurchase agreements that establish each party's rights in the transactions. A master agreement will often 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 a financial obligation is due and payable.

MONEY MARKET MUTUAL FUND: Mutual funds that invest solely in money market instruments (short-term debt instruments, such as Treasury bills, commercial paper, bankers' acceptances, repos and federal funds).

MUTUAL FUND: An investment company that pools money and can invest in a variety of securities, including fixed-income securities and money market instruments. Mutual funds are regulated by the Investment Company Act of 1940 and must abide by Securities and Exchange Commission (SEC) disclosure guidelines.

NATIONAL ASSOCIATION OF SECURITIES DEALERS (NASD): A self-regulatory organization (SRO) of brokers and dealers in the over-the-counter securities business. Its regulatory mandate includes authority over firms that distribute mutual fund shares as well as other securities.

NATIONALLY RECOGNIZED STATISTICAL-RATING ORGANIZATION (NRSRO): Standard and Poor's, Moody's, and Fitch Financial Services are examples of such organizations.

OFFER: An indicated price at which market participants are willing to sell a security or commodity. Also referred to as the "Ask" or "Ask Price".

PAR VALUE: The amount of principal that must be paid at maturity. Also referred to as the face amount of a bond, normally quoted in $1,000 increments per bond.

PORTFOLIO: Combined holding of more than one stock, bond, commodity, real estate investment, cash equivalent, or other asset. The purpose of a portfolio is to reduce risk by diversification.

PRINCIPAL: The face value or par value of a debt instrument, or the amount of capital invested in a given security.

PRIMARY DEALER: A group of government securities dealers who submit daily reports of market activity and monthly financial statements to the Federal Reserve Bank of New York and are subject to its informal oversight. Primary dealers include Securities and Exchange Commission (SEC) registered securities broker/dealers, banks and a few unregulated firms.

GLOSSARY OF INVESTMENT TERMS

PRINCIPAL: (1) The face amount or par value of a debt instrument. (2) One who acts as a dealer buying and selling for his own account.

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.

REINVESTMENT RISK: The risk that a fixed-income investor will be unable to reinvest income proceeds from a security holding at the same rate of return currently generated by that holding.

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 the buyer for this. 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: An agreement of one party (for example, a financial institution) to purchase securities at a specified price from a second party (such as a public agency) and a simultaneous agreement by the first party to resell the securities at a specified price to the second party on demand or at a specific date.

RISK: Degree of uncertainty of return on an asset.

RULE 2A-7 OF THE INVESTMENT COMPANY ACT: Applies to all money market mutual funds and mandates such funds to maintain certain standards, including a 13-month maturity limit and a 90-day average maturity on investments, to help maintain a constant net asset value of $1.00.

SAFEKEEPING SERVICE: A service to customers rendered by banks for a fee whereby securities and valuables of all types and descriptions are held in the bank's vault for protection and security.

SECONDARY MARKET: A market is made for the purchase and sale of outstanding issues following the initial distribution.

SECURITIES LENDING: An agreement under which a local agency agrees to transfer securities to a borrower who, in turn, agrees to provide collateral to the local agency. During the term of the agreement, both the securities and the collateral are held by a third party. At the conclusion of the agreement, the securities are transferred back to the local agency in return for the collateral.

STRUCTURED NOTES: Notes issued by Government Sponsored Enterprises, (FLAB, FNMA, SLMA, etc.), and Corporations that 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.

SWAP: Trading one asset for another.

TOTAL RETURN: The sum of all investment income plus changes in the capital value of the portfolio.

TREASURY BILLS: Short-term U.S. government non-interest bearing discounted debt securities with maturities of no longer than 1 year and issued in minimum denominations of $10,000. Auctions of 3- and 6-month bills are weekly, while auctions of 1-year bills are monthly. The yields on these bills are monitored closely in the money markets for signs of interest rate trends.

TREASURY BOND: A long-term coupon-bearing U.S. Treasury security issued as a direct obligation of the U.S. Government and having an initial maturity of more than 10 years and issued in minimum denominations of $1,000.

GLOSSARY OF INVESTMENT TERMS

TREASURY NOTE: A medium-term coupon-bearing U.S. Treasury security issued as a direct obligation of the U.S. Government and having an initial maturity of from 1 to 10 years and issued in denominations ranging from $1,000 to $1 million or more.

UNIFORM NET CAPITAL RULE: Securities and Exchange Commission (SEC) Rule 15C3-1 outlining requirements 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 and commitments to purchase securities, one reason new public issues are spread among members of underwriting syndicates. Liquid capital includes cash and assets easily converted into cash.

VOLATILITY: A degree of fluctuation in the price and valuation of securities.

YIELD: The current rate of return on an investment security generally expressed as a percentage of the security's current price. (a) INCOME YIELD is obtained by dividing the current dollar income by the current market price for the security. (b) NET YIELD or YIELD TO MATURITY is the current income yield minus any premium above par or plus any discount from par in purchase price, with the adjustment spread over the period from the date of purchase to the date of maturity of the bond.