GUIDE TO PUBLIC FUNDS INVESTING FOR LOCAL GOVERNMENTS

Office of the Washington State Treasurer

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I. STATEMENT OF PURPOSE

The Office of the State Treasurer has developed this guide as a resource for local governments[1] with statutory authority to invest who are considering investment options and developing an investment strategy. It lists and discusses the investments permitted under state law for local governments, sets forth the basic elements of a sound investment program, and discusses many of the potential risks and pitfalls of public funds investing. As well, it provides links to additional resources that will help investors to identify and implement industry best practices. While this guide is intended to be broadly applicable to a range of local government investors, some sections may be more useful than others for specific investors.

The information in this guide reflects statutory changes effective June 9, 2016.

II. PRUDENCE IN INVESTMENTS

What does a successful investment program for public funds look like? It focuses on **safety** and **liquidity** of funds as its primary objectives, seeks to maximize **return**, and operates within the bounds of **legality**. It employs defined strategies and procedures in pursuit of these objectives. Insofar as investing involves both opportunities and risks, it is managed to ensure the safety and availability of public funds, with the secondary objective of generating an additional revenue stream. Local government investment managers should adhere to the "Prudent Person" standard, which says that investment decisions must be suitable for the risk and return profile and the time horizon of the investor.

Safety and liquidity are the primary objectives for public funds investors. A strong investment program will go further to focus on performance. In practice, investment performance is the product of a strong investment process. The main elements of the investment process are controlling risk, identifying a reasonable expectation around expected return, and controlling costs (i.e. inefficient or excessive trading). These elements combine to form a mechanism to optimize risk and return. Performance monitoring using an appropriate benchmark enables managers to see whether their investment strategy is effective.

Local government investors with limited resources or experience may find that caution is the best approach in the management of investment performance. Without specific expertise in the area of credit analysis, for example, investments in certain legally permitted instruments may not be a good idea, as adequate control of risk is not possible. Some investors may find that they are best able to

[1] As defined in RCW 39.59.010

structure a successful program by working with an outside advisor who brings experience in developing strategy and monitoring performance. These concepts are discussed further below.

III. INVESTMENT POLICY

A prudent investment strategy should be anchored by a well-structured formal investment policy. The investment policy should articulate the objectives, parameters and benchmarks of the local government portfolio and should be regularly reviewed. The policy serves to protect both the entity and the investment officers and also to provide information to the broker/dealer community that is providing coverage. The Office of the State Treasurer encourages local governments to submit their policies to the Washington Public Treasurers Association (WPTA), which offers an investment policy certification program. This peer review program serves to ensure that the policy adequately addresses all important aspects of an investment program.

At a minimum, a local government investment policy should contain:

- ***Objectives of the investment portfolio/agency:*** The primary objective of public funds investing is generally safety of principal, followed by liquidity in order to ensure availability of sufficient cash (or highly marketable securities) to meet spending requirements. Any objectives around portfolio return should be tied to market returns in order to ensure that managers are not pushed to assume inappropriate levels of risk.
- ***Identification of funds governed by the policy:*** The policy should state which fund or funds it applies to (e.g. operating funds, bond proceeds, or pooled funds).
- ***Delegation of investment authority:*** The policy needs to identify the persons or positions with authority and responsibility for investment and allocation decisions.
- ***Ethical and legal standards:*** The policy should establish a prudent person standard and establish restrictions to mitigate potential conflicts of interest.
- ***Authorized dealers and financial institutions:*** The policy should name the requirements to be met by financial institutions and dealers doing business with the governmental entity. Possible examples include net capital requirements, registration and good standing with appropriate regulatory bodies, and review of the entity's investment policy.
- ***Safekeeping and custody:*** The policy should specify that all security transactions be conducted on a delivery versus payment basis and set forth the requirements for safekeeping of the securities purchased.
- ***Internal controls:*** The policy should outline the internal control structure that governs the investment process.

- ***Authorized investments:*** The policy should identify all authorized investments, referring to applicable state laws as well as any other relevant policies. It should define the following investment parameters:
  - Limits on specific types of securities as a percent of the total portfolio
  - Maximum term, by type of security
  - Issuer limits—maximum percentage of an issuer permitted in portfolio
  - Limits on repurchase agreements
  - Other requirements such as collateralization
  - Requirements around securities lending agreements
  - Procedures for dealing with portfolio out of compliance after purchase
  - Other appropriate diversification restrictions
  - Minimum credit rating requirements, by type of security
- ***Oversight and reporting requirements:*** The policy should make clear which individual or committee has oversight authority over investment officers. It should specify the type, frequency and form of reporting to the person or committee with oversight authority. It should identify an appropriate benchmark that will be used to gauge the performance of the portfolio.

IV. ELIGIBLE INVESTMENTS

In order to ensure the safety and liquidity of public assets, local governments in the state of Washington are restricted to specific investments that are permitted by state law. For an investment to be considered eligible it must be explicitly listed in statute. The Revised Code of Washington statutes that primarily govern the investment of public funds are attached as Appendix I.

While certain investments may be legal, they may not be appropriate for a given entity at a specific point in time. To arrive at a prudent investment strategy it is not enough to consider the range of permitted investments. Investment officers must also carefully consider the risk and return of possible investments in relation to the safety and liquidity requirements of the local investing entity.

V. INVESTMENT CONSIDERATIONS

Cash Flow Forecasting: For some public entities the cash balances they have are destined to be spent as the entity conducts its normal business. However, most entities have cash balances in excess of their immediate needs. The investment of surplus funds can be an important source of revenue, particularly in higher interest rate environments. Through cash flow forecasting you should be able to distinguish between cash that should be invested in short-term instruments and cash that is not expected to be needed for a longer period of time (often invested separately as a “core” portfolio).

In order to forecast cash flows over a period of up to twelve months into the future, managers need to take into account:

- Recurring cash flows: cash flows that take place on a regular basis, such as payroll disbursements or sales tax revenues. The amount and timing of recurring cash flows can be understood and modeled using past years’ data, budget information, debt payment schedules and similar sources.
- Non-Recurring cash flows: one-time cash flows, such as from a bond sale and payments or a major capital expenditure.
- Required and/or desired levels of cash reserves to cover unexpected expenditures or other unanticipated cash flow needs.

Certain cash flows may be recurring but seasonal; for example, tax revenues may show a pattern of increases and decreases over a calendar year.

Cash flow forecasts should be updated on an ongoing basis to align them with actual results. If estimates and results are significantly different, corrections may be needed. Where there are significant variances between forecast and actual cash flows, managers should identify the source of the variance and determine whether future forecasts should be adjusted.

Short-term Investment Options: The following are options for investing cash that needs to be available to meet your short-term needs. In this discussion short-term refers to anything from overnight out to one year. The time horizon may vary depending on the nature and certainty of your cash flows, the instruments you are utilizing and the overall size of the available liquidity.

It is important to consider transaction costs when evaluating options for investing short-term funds, especially in a low rate environment. For example, $100,000 invested at 5.25% (the LGIP and Fed Funds rate in 2007) earns $14.39/day but $100,000 invested at 0.41% (the LGIP rate in early 2016) earns $1.12/ day. In the latter case, if you receive $100,000 and need it for payroll in 10 days, you are better off financially to leave it in your checking account than to invest it in the LGIP for those 10 days. Depositing it with the LGIP will result in a wire fee from your bank for sending and another fee for receiving it back from the LGIP. If your wire fee is $7.50 you would pay $15 and receive $11.23 in earnings, a net cost of $3.77. Additionally, many banks offer a rate on compensating balances that can be used to offset banking fees.

Local Government Investment Pool (LGIP). The creation of the LGIP was authorized by the legislature in 1986. It has been a popular and successful liquidity vehicle for local and state governments since its inception. There are currently over 500 participants in the LGIP, with between $8 billion and $12 billion invested. The LGIP is a voluntary investment option that offers 100% liquidity on a daily basis. The low fee structure provides participants with a competitive short-term investment option. Additional information about the LGIP may be found on the Office of the State Treasurer (OST) website.

Bank Liquidity Accounts. Numerous qualified public depositaries offer interest bearing demand deposit accounts with rates that are close to or even better than the LGIP (see Section IX below: Protection of Deposits). They offer daily liquidity, but there may be a limit on the number of withdrawals during each month. These accounts are a safe option as they are covered under the Public Deposit Protection Commission (PDPC), which provides that all public deposits be either Federal Deposit Insurance Corporation (FDIC) insured or collateralized with the PDPC.

Some products offered by banks may not be statutorily eligible so you do need to make sure that what you are utilizing is a deposit account and not some sort of investment fund. Money market mutual funds are not eligible investments for public funds.

Certificates of Deposit. A Certificate of Deposit (CD) can be a good option, especially if you have known cash flows that will be occurring in the future, e.g., debt service payments on December 1 or June 1. A CD must be completed with a qualified public depositary (negotiable CDs are not eligible investments). Rates will vary from bank to bank so you should explore multiple options.

Other Deposit Programs. There are a few deposit programs available that provide an investor with full FDIC insurance on an initial deposit greater than the FDIC maximum. Your initial deposit must be made with a participating qualified public depositary, which will then place the funds into the program, where it will be divided into a series of smaller deposits with other financial institutions, each of which would be fully FDIC insured. One example of this is the Certificate of Deposit Account Registry Service (CDARS) program.

US Treasury Bills and Notes, US Agency and Supranational Agency discount notes or coupon instruments, and commercial paper are also common short-term investment instruments. For entities with relatively small amounts to invest, these instruments are often not as attractive as the LGIP or deposit accounts. This is because of economies of scale, they are mostly date specific, and you need to allow for safekeeping. Before buying commercial paper investors also need to perform credit analysis, as it is not advisable to rely solely on the ratings provided by the rating agencies. Note that commercial paper purchases must adhere to the investment policies and procedures adopted by the State Investment Board.[2]

[2] http://www.tre.wa.gov/investments/SIBCommercialPaperPolicy.shtml

Repurchase Agreements (Repos) consist of an agreement by a seller (an authorized dealer) to sell to the buyer (a local government investor) authorized investment securities (referred to as collateral), with the agreement to purchase the securities back on an agreed to date and rate of interest, to be paid to the buyer. Detailed repo guidelines may be found on the OST website.

Longer-term Investment Options: For funds that are not expected to be needed within a twelve-month time horizon, there are several additional securities that may be considered.

US Treasury Notes. These are backed by the full faith and credit of the US government and considered to be very low risk. They are highly liquid. They will generally deliver a lower return than other securities having comparable maturities, but at times the spread between Treasuries and other credit instruments is quite narrow.

US Agency Bonds. These are bonds of government sponsored enterprises. While they carry the implicit backing of the US government, they are not backed by its full faith and credit in the same way as Treasury notes. Some of the most commonly invested, highly rated and most liquid of these are bonds of Fannie Mae (FNMA), Freddie Mac (FHLMC), the Federal Home Loan Bank (FHLB) and the Federal Farm Credit Banks (FFCB). Agency securities are sold as both bullet and callable bonds.

Supranational Agency Bonds. These are US dollar-denominated bonds of quasi-governmental organizations that exist in multiple countries to promote economic development. Local governments in Washington State are permitted to invest in those supranational agencies that have the US government as their largest shareholder. Supras are highly rated and have similar structures to US Agency bonds. One of the most commonly invested and most liquid of these is the International Bank for Reconstruction and Development (IBRD, or World Bank).

Municipal Bonds. These are debt securities issued by a state, municipality or county, or any other local government entity. They are considered higher risk than US government securities. While these are an eligible investment option, investment in municipal bonds should only be undertaken by local governments with the ability to perform credit analysis on the issuer, rather than relying solely on the ratings provided by rating agencies.

Corporate Notes. Corporate notes are considered higher risk than US government securities. As a result, they will almost always deliver higher returns, but investment in corporate notes should only be undertaken by local governments with the ability to perform credit analysis on the issuer. RCW 39.59 requires that corporate notes be purchased on the secondary market and in accordance with the investment policies and procedures adopted by the State Investment Board.[3]

Credit Risk: Credit risk is the risk of default or the risk of reduction in market value caused by changes in the credit quality of issuers or counterparties. All securities have credit risk; any security that is not backed by the full faith and credit of the United States has greater credit risk. The rationale for owning credit risk is the additional expected return derived from the interest rate spread for a risky bond over a riskless bond. As well, some diversification can be achieved with the addition of credit to a portfolio as changes in interest rates and credit spreads are not perfectly correlated. Credit risk can affect the value of a portfolio in three ways: default risk, credit spread risk, and downgrade risk.

Default risk is the risk that an issuer will default on its obligations and fail to make timely principal and interest payments.

Credit spread risk is the risk the interest rate spread for a risk bond over a riskless bond will increase after the credit risk has been purchased. If the spread increases, the price of the risk bond will decrease, potentially resulting in a loss if the bond is sold before maturity.

Downgrade risk is the risk that a credit rating organization reduces its credit rating for an issuer. This could impact a portfolio if the bond has to be sold.

In order to evaluate and monitor these risks in relation to investments with higher credit risk, such as municipal or corporate debt, the portfolio manager should perform ongoing credit research and modeling. An external adviser or manager can also offer expertise in credit analysis. Credit modeling and research do not rely solely on a credit rating organization. Credit work usually involves a combination of different approaches. One approach is to look at historical default frequencies and the events that precipitated them. Another approach is to use information from the corporate balance sheet and equity market to create a structural model of default probability. Another popular approach is fundamental analysis; looking at a firm's competitive position, industry trends, and financials.

The key point here is that before investing in securities, be sure to perform thorough analysis on the credit of the security and continue to monitor that credit for as long as you hold that security. The policy should also address the actions required if the rating of an issuer is downgraded.

[3] http://www.tre.wa.gov/investments/SIBCommercialPaperPolicy.shtml

VI. INVESTMENT PROCESS

A methodical and considered approach to investing will look different for different public funds investors. Local government portfolios vary greatly in size, and this will impact the value that a more developed investment process can add. As well, some managers of local government portfolios balance a number of responsibilities within their agency or organization. For those entities with smaller portfolios, an active investment strategy may not deliver enough additional benefit to justify the time involved or the cost of an advisor. Similarly, for those portfolio managers who have other organizational responsibilities, the analysis described below may be overly time-consuming. In these situations it may make sense to identify a more streamlined, hands-off investment process that requires less day-to-day oversight and fewer organizational resources, even if it does not maximize returns. For local government investors with mid- to large-sized portfolios, however, an understanding of the concepts in this section may prove valuable for developing an investment strategy, either internally or in consultation with an investment advisor (discussed in Section VII).

Broadly speaking the investment process spans four major areas:

1) Setting investment objectives and constraints
2) Developing and implementing a portfolio strategy
3) Monitoring the portfolio
4) Portfolio Adjustments

Setting Investment Objectives and Constraints: Investment policies and procedures must be tailored to the needs of each local government. The first step, setting the investment objective and constraints, requires analysis of the source of investment funds. Updated cash flow statements along with other analysis should give an indication of how long-lived the assets to be invested are. Whether the assets are more permanent or short-lived in nature will determine how much risk a portfolio may tolerate. Knowledge of the investing legal authority and authorized investments combined with portfolio risk tolerance and return needs provide the basis of completing a formal investment policy. Forming the investment policy is a critical step in the portfolio management process, as it serves as a roadmap for investment decisions.

A key part of the investment policy roadmap is the selection of the appropriate benchmark. The benchmark should reflect the desired characteristics of your portfolio and is the quantitative expression of the risk and return objectives. A benchmark should have the following general characteristics: first, the benchmark needs to be investable; that is, an investor should be able to buy and hold the benchmark securities. Second, the benchmark should be transparent; that is, all the securities, prices, and returns can be found and calculated. Finally, the benchmark needs to be relevant; that is, an investor is familiar with the securities in the benchmark, the benchmark is consistent with the desired investment style, and the investor's goals are aligned with positive returns in the benchmark.

While safety and liquidity are the primary goals of any public funds portfolio, managers have a responsibility to attain the highest possible yield within those bounds. Any incremental yield achieved without unnecessary risk represents a tangible benefit to the manager's agency or entity. An investment policy that sets appropriate objectives and a benchmark based on the investor's characteristics can help the investor to maximize yield while remaining within an appropriate investment framework.

Effective Duration and Callable Securities

Duration *is a measurement of risk that the principal value of a bond portfolio will fluctuate as interest rates change. It is one of the most important factors to consider as you evaluate the impact of any investment on your portfolio. Generally it is desirable for the duration of a portfolio as a whole to approximately match the duration of the benchmark, although managers may elect to take a somewhat longer or shorter position in an easing or tightening environment.*

Effective duration *is a measurement that takes into account the optionality in a portfolio. The effective duration of a callable security will fluctuate as its probability of call increases or decreases. A high proportion of callable securities in a portfolio, while it can increase yield, means that in the event of a market move the effective duration of the portfolio can shift dramatically. This can result in a portfolio that is much longer (or shorter) than its benchmark and can force managers to give up yield (if securities are called in an easing environment) or cause cash flow problems (if securities extend and are underwater in a tightening environment).*

Developing and Implementing a Portfolio Strategy: After stating the investment objectives and constraints in the investment policy, which identifies an appropriate benchmark, attention can be turned to developing and implementing a portfolio strategy. Relevant fixed income strategies for public funds investors can be broken down into three main types. They are pure passive management (or pure indexing), enhanced indexing (which is a hybrid approach), and active management. The difference between these strategies lies in the degree to which the risk factors of the portfolio match the risk factors of the benchmark. The relevant risk factors are:

- ***Market risk***, defined here as parallel changes in the yield curve, and measured by duration.
- ***Yield curve risk,*** changes in the slope and shape of yield curve, and measured by key rate duration.
- ***Market volatility***, changes in actual volatility or implied volatility of options, and measured by convexity. For local government investors in Washington State, callable securities are the only eligible investments that incorporate (embedded) options.
- ***Credit risk***, changes in credit quality, and measured by changes in credit spread.

- ***Liquidity risk***, changes in liquidity of individual securities as market conditions change, and measured by bid/offer spread.

These risk factors allow a portfolio manager to determine both the benchmark's and the managed portfolio's risk profile, which is a tabulation of sensitivities to market conditions. A pure passive management strategy is the easiest and most straightforward to implement. Essentially, the portfolio attempts to mimic the risks of the benchmark as closely as possible. It is very difficult and expensive to try to replicate the index exactly. A simpler solution is to build out a ladder of investments that matches the risk factors of the index. The advantage to a passive strategy is that the portfolio manager does not need to make independent economic or interest rate forecasts. It is premised on the idea is that it is very difficult to beat the market.

The other two more active management strategies essentially rely on the manager's forecasting ability. If the manager's forecasts of the future path of the factors that influence fixed income returns are more accurate than those reflected in current prices, then the return of the portfolio should increase. An active manager seeks to exploit opportunities in the market.

An enhanced indexing strategy involves creating small divergences in the risk factors between the portfolio and the benchmark. The duration of the portfolio may be matched to the benchmark while other risk factors are allowed to deviate in smaller, controlled ways. For example, issue selection, where the manager may identify and select securities that are undervalued relative to a valuation model. The manager may use yield curve strategies, where areas of the yield curve that are overvalued are underweighted while areas of the curve that are undervalued are overweighted. Partial duration is a good way to monitor a portfolio's interest rate risk at various points along the yield curve. Another example of an enhanced indexing strategy is sector or credit quality positioning, where a manager tilts the portfolio to favor a sector or credit view.

A pure active management strategy involves deliberately creating larger mismatches between the portfolio and the benchmark risk factors. In this instance the portfolio manager is actively pursuing opportunities in the market to increase return. The objective of the manager is to produce sufficient returns to overcome the style's additional transaction costs and risks.

Monitoring the Portfolio: Irrespective of the investment management strategy that is selected, once the portfolio has been constructed it must be monitored. Monitoring involves two activities. The first is to assess whether there have been changes in the market that have changed the key inputs in the portfolio construction process. The second is to monitor the performance of the portfolio. Monitoring the performance of the portfolio is called return attribution analysis, which seeks to explain how the results were achieved. Performance attribution first determines whether the portfolio manager is adding any value by outperforming the benchmark. Second, attribution analysis tackles the detail of why returns were what they were. For example, the process should identify the degree to which the realized performance was a result of changes in the level of interest rates, changes in the slope of the yield curve, changes in credit spreads, or issue selection. The process should be informative for both the portfolio manager and management and give all parties a better sense of the portfolio's risk and return.

Portfolio Adjustments: Investment management is an ongoing process. Monitoring activities should naturally feed directly into an evaluation of whether portfolio adjustments need to be made. For example, if capital markets have changed and result in changes to the portfolio's risk profile an adjustment can be made to get the portfolio back into line. Alternatively, through the portfolio attribution process, adjustments may need to be made to ensure the portfolio performs as expected going forward. However, every adjustment comes with a cost. The cost of trading is measured by the bid offer spread and the frequency of turnover in the portfolio. Any adjustment to the portfolio must weigh the costs of the transactions versus the benefits.

VII. USE OF INVESTMENT ADVISORS, MANAGERS AND CONSULTANTS

Many public entities throughout the United States use the services of investment advisors, managers or consultants. Their use emerged in the 1980s, has expanded over the years, and is usually cost-effective, primarily with governments responsible for portfolios exceeding $30 million.

- **Investment Advisors** typically provide advice only as they assist with the operation of the investment portfolio. They are not given the discretion to execute buy or sell transactions without the authorization of the entity's investment officer. They also provide other services, such as annual investment policy review and recommendations, credit research, financial institution risk analysis, and a full suite of reports and periodic in-person reports to staff, upper management and elected officials.
- **Investment Managers** generally provide the same services as investment advisors. However, they are given discretion to decide upon all buy and sell transactions, provided they conform to the entity's investment policy. Most public fund investment managers in Washington State do not have the authority to enlist the services of investment managers. See below.
- **Investment Consultants** can provide various services, from helping a government develop its investment strategy, to reviewing investment policy, to assisting with credit research. Investment consultants do not advise on specific buy or sell transactions.

Most public fund managers in Washington State do not have the authority to delegate to an external entity those management functions that require the exercise of discretion or judgment in which factual information is weighed and personal judgment is exercised in order to reach a conclusion, e.g., to enlist the services of an investment manager. However, they can enlist the services of investment advisors and the scope of services they may provide can include nearly everything except making the decision to purchase or sell securities. For example, an advisor could recommend the purchase of a particular security. Should the entity authorize the purchase of that security the advisor could then act on your authorization and purchase that security for your entity.

Many governments - large and small - see financial and program management value in the services that external investment professionals provide. The reasons are varied: internal finance staff may not have sufficient time to devote to the program beyond the basics, or they lack a complete range of expertise to effectively manage their investment portfolios. However, even those entities with expertise and time often find value in the third-party view that an outside advisor brings to their investment program. Staff turnover is an additional factor; investment advisors, managers and consultants can help maintain continuity in this highly important function.

Investment advisors help manage the two primary risks inherent in portfolio management: credit risk and duration risk. While credit risk is generally well-understood, duration risk is often the greater of the two. Expertise in managing both risks is key to operating a successful investment program which includes the careful balancing of the two (the risk-reward relationship) in order to achieve optimal earnings. Advisors normally offset their fees with improved earnings and most users of this service confirm that earnings more than offset the fees.

Selection of an investment advisor/consultant should be determined through Requests for Proposals (RFP) and should include minimum qualifications to ensure that proposals are solicited only from those firms that are experienced and have strong reputations in assisting with the management of government investment portfolios. A relatively small number of firms offer the types of services mentioned above. Therefore, policies that limit proposals to a government's own city, county or state may seriously limit the number of firms able to qualify to provide services. RFPs will elicit more and possibly better results by considering proposals from firms anywhere within the United States. As is the case with other types of procurements, the use of specialized consultants to assist in the selection of advisors, managers or consultants may help in achieving optimal results.

The links section of this piece includes a link to the Government Finance Officers Association (GFOA) Best Practices paper on selection of investment advisors.

VIII. SAFEKEEPING ARRANGEMENTS

Once you purchase a security from a dealer you need to make arrangements to pay for the security and for proper safekeeping. Nearly all of the securities that are eligible for public operating fund investors in Washington State are available in book-entry form, e.g., electronic. The paying agents for the issuers are the Fed or the Depository Trust Company (DTC), who keep track of the registered owners of each Committee on Uniform Security Identification Procedures (CUSIP) in their registries and will act as a conduit for payment of principal and interest. Bondholders do not deal directly with the paying agents but must work through a third-party for custody or safekeeping.

There are various ways that this can work, ranging from contracting with an independent third-party to having the safekeeping provided by the dealer you bought the security from. Safekeeping is an important aspect of your investment program because this is one area where fraud can occur. Delivery versus payment is an important principle to follow in your investment program. You do not want to pay for a security until you have received it from the dealer.

Industry standard, and the best option, is for safekeeping to be provided by an independent third-party that the investor has contracted with. However, another option is to have safekeeping provided by the same institution that sold the security, provided it is kept in a separate area of the institution, such as the trust department. One option to avoid is to have the dealer or investment advisor directly provide the safekeeping. This violates the delivery versus payment principle and really puts the investor in a position of putting their complete trust in the dealer or advisor.

Statewide Custody Program: RCW 43.08.280 enables local governments and institutions of higher education to contract for safekeeping with a statewide custody provider named by the State Treasurer as the result of a RFP process.

The intent of this legislation was to make third-party custody available to as many local entities as possible, on the best terms that could be negotiated on a statewide basis. The legislation is designed to enable the State Treasurer to select a custodian and negotiate a model contract and fees with the selected firm. The model contract and fee structure are then available to any local government or institution of higher education in the state for an agreed upon time period. The local entity would therefore not have to conduct its own RFP. However, the decision to sign the model contract rests entirely with each local entity. Nothing in the legislation prevents a local entity from arriving at its own contract, with the same or a different firm. If it should choose to do that, normal procurement regulations applicable to the local entity would apply, however.

Upon execution of the model contract, the resulting agreement is solely between the local entity and the statewide custodian. OST is not a party to the contract. It is the responsibility of the local entity to understand the terms and conditions of the contract prior to executing it with the statewide custodian and to ensure the terms and conditions are met by the statewide custodian during the term of the agreement.

Current information on the statewide custody program is available on the OST website:

http://www.tre.wa.gov/revenueDistribution/statewideCustody.shtml

IX. PROTECTION OF DEPOSITS

RCW 39.58 requires that all deposits of public funds be made with qualified public depositaries, where they would be protected through the actions of the Public Deposit Protection Commission (PDPC). The PDPC, comprised of the State Treasurer, Governor, and Lieutenant Governor, makes and enforces regulations and administers a program to ensure that deposits of public funds are protected if a financial institution becomes insolvent.

The PDPC determines which banks and thrifts are approved to hold public funds and monitors collateral pledged to secure uninsured public deposits. This pledging of collateral secures public treasurers' deposits when they exceed the amount insured by the FDIC ($250,000.00) such that they are 100% protected.

Washington state and federally chartered credit unions may also accept public deposits, within the limitations set forth in RCW 39.58.240. State law allows deposits up to the maximum amount insured by the National Credit Union Share Insurance Fund (NCUSIF) for any one depositor (i.e., state or local government) of public funds. In this instance the PDPC does not insure or collateralize beyond what the NCUSIF insures.

Approximately 80 public depositaries are authorized to accept public deposits in the State of Washington as of this publication. The names of authorized public depositaries may be found at: http://www.tre.wa.gov/documents/pdpc/publicDepositoriesBanks-Thrifts.shtml and http://www.tre.wa.gov/documents/pdpc/publicDepositoriesCreditUnions.shtml

X. LINKS AND RESOURCES:

The following best practices papers may be found on the GFOA website, www.gfoa.org/best-practices , under the topic of Treasury Management.

- ***Investment of Bond Proceeds***, September 2014
- ***Government Relationships with Securities Dealers***, October 2012
- ***Creating an Investment Policy***, October 2010
- ***Ensuring the Safety of Reverse Repurchase Agreements***, October 2010
- ***Establishing a Policy for Repurchase Agreements***, October 2010

- ***Managing Market Risk in Investment Portfolios***, October 2009
- ***Selection and Review of Investment Advisors,*** October 2009
- ***Using Commercial Paper in Investment Portfolios,*** October 2009
- ***Local Government Investment Pools,*** October 2008
- ***Mark-to-Market Reporting for Public Investment Portfolios,*** February 2008
- ***Diversifying the Investment Portfolio,*** March 2007
- ***Monitoring the Value of Securities in Repurchase Agreements,*** February 2006
- ***Due Diligence on Bank and Treasury Management Providers,*** May 2014
- ***Using Safekeeping and Third-Party Custodian Services,*** October 2010
- ***Procurement of Banking Services,*** March 2010

The Washington State Association of County Treasurers has also published a best practices document for county investment pools.

The following are links to investment policy resources:

- Washington State Treasurer Treasury/Trust Portfolio Investment Policy: www.tre.wa.gov/documents/inv_ttpol.pdf
- Washington Public Treasurer's Association: WPTA Investment Policy Certification Program
- GFOA links to sample investment policies: www.gfoa.org/financial-policy-examples-investments
- CFA Institute investment policy guidelines: www.cfainstitute.org/learning/products/publications/ccb/Pages/ccb.v2010.n13.1.aspx?WPID=AlsoViewedProducts

APPENDIX I

Text of Washington Statutes (RCW) Governing Eligible Investments of Public Funds by Local Governments[4]

RCW 39.59.010 Definitions

Unless the context clearly requires otherwise, the definitions in this section apply throughout this chapter.

(1) "Bond" means any agreement which may or may not be represented by a physical instrument, including but not limited to bonds, notes, warrants, or certificates of indebtedness, that evidences an obligation under which the issuer agrees to pay a specified amount of money, with or without interest, at a designated time or times either to registered owners or bearers.

(2) "Local government" means any county, city, town, special purpose district, political subdivision, municipal corporation, or quasi-municipal corporation, including any public corporation, authority, or other instrumentality created by such an entity.

(3) "State" includes any state in the United States, other than the state of Washington.

RCW 39.59.020 Authorized investments—Local government authority

(1) Local governments in the state of Washington are authorized to invest their funds and money in their custody or possession, eligible for investment, in investments authorized by this chapter.

(2) Nothing in this section is intended to limit or otherwise restrict a local government from investing in additional authorized investments if that local government has specific authority to do so.

RCW 39.59.040 Authorized investments—Bonds, warrants, certificates and other investments

Any local government in the state of Washington may invest in:

(1) Bonds of the state of Washington and any local government in the state of Washington;

(2) General obligation bonds of a state and general obligation bonds of a local government of a state, which bonds have at the time of investment one of the three highest credit ratings of a nationally recognized rating agency;

(3) Subject to compliance with RCW 39.56.030, registered warrants of a local government in the same county as the government making the investment;

(4) Certificates, notes, or bonds of the United States, or other obligations of the United States or its agencies, or of any corporation wholly owned by the government of the United States; or United States dollar denominated bonds, notes, or other obligations that are issued or guaranteed by supranational institutions, provided that, at the time of investment, the institution has the United States government as its largest shareholder;

[4] Additional statutes govern specific entities and agencies.

(5) Federal home loan bank notes and bonds, federal land bank bonds and federal national mortgage association notes, debentures and guaranteed certificates of participation, or the obligations of any other government sponsored corporation whose obligations are or may become eligible as collateral for advances to member banks as determined by the board of governors of the federal reserve system[5];

(6) Bankers' acceptances purchased on the secondary market;

(7) Commercial paper purchased in the secondary market, provided that any local government of the state of Washington that invests in such commercial paper must adhere to the investment policies and procedures adopted by the state investment board;[7] and

(8) Corporate notes purchased on the secondary market, provided that any local government of the state of Washington that invests in such notes must adhere to the investment policies and procedures adopted by the state investment board.[6]

RCW 43.250.040 Authority of official to place funds in the public funds investment account--Investment of funds by state treasurer--Degree of judgment and care required.

If authorized by statute, local ordinance, resolution, or other appropriate official action, the state treasurer, a government finance official or financial officer or his or her designee, or authorized tribal official, may place funds into the public funds investment account for investment and reinvestment by the state treasurer in those securities and investments set forth in RCW 43.84.080 and chapter 39.58 RCW. The state treasurer shall invest the funds in such manner as to effectively maximize the yield to the investment pool. In investing and reinvesting moneys in the public funds investment account and in acquiring, retaining, managing, and disposing of investments of the investment pool, there shall be exercised the judgment and care under the circumstances then prevailing which persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of the funds considering the probable income as well as the probable safety of the capital.

[5] For additional information on Federal reserve eligible collateral refer to: http://www.ny.frb.org/banking/collateral_pledging.html

[6] http://www.tre.wa.gov/investments/SIBCommercialPaperPolicy.shtml