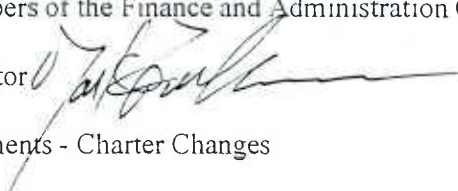




Inter-Departmental Communication

DATE: May 13, 1998

TO: Chair Judy Swope and Members of the Finance and Administration Committee

FROM: Mark Funkhouser, City Auditor 

SUBJECT: Potential Permissible Investments - Charter Changes

During budget hearings, Councilmember George Blackwood asked the director of Finance to explore the possibility of expanding the list of permissible investments for the city. In response to this request, the director proposed amending the city charter to permit the city's investment in U.S. government agency securities, repurchase agreements, commercial paper, and banker's acceptances. Following testimony by the director of Finance at the April 20, 1998, meeting of the Finance and Administration Committee, the City Auditor's Office was asked to review the proposed charter changes.

CONCLUSION

We found that the addition of U.S. government agency securities, repurchase agreements, commercial paper, and banker's acceptances would be consistent with investment practices in other cities. The state of Missouri and all of the benchmark cities that responded to our survey currently authorize investments in U.S. government agency securities and repurchase agreements. Five of the six cities could invest in commercial paper and banker's acceptances.

WORK PERFORMED

To determine whether or not the newly proposed investment instruments would be considered suitable municipal investments and should be added to the investments currently permitted by charter and legal opinion, we contacted eight benchmark cities and requested information on permissible investments. We also reviewed the investment policies provided by some cities and the state of Missouri, the proposed amendments to the city charter and to Article IV of the Missouri Constitution, and financial literature.

ANALYSIS

The Treasury Division of the Finance Department's *Investment Policy* summarizes authorized and suitable investments for the city. Section VIII of the policy lists investment instruments authorized by the city charter or determined by the city's Law Department to be permissible investments. (See Exhibit I.) The *Investment Policy* also establishes the city's investment objectives. The primary objectives, in priority order, are safety, liquidity, and return on investment.

Exhibit 1. Currently Authorized and Suitable City Investments

U.S. Treasury notes, bills, bonds, and strips
Full faith and credit obligations of the U.S. government
Full faith and credit obligations of the State of Missouri
Full faith and credit obligations of Jackson County, Missouri
Full faith and credit obligations of the Kansas City, Missouri school district
Full faith and credit obligations or revenue bonds of the City of Kansas City, Missouri
Time deposits
Certificates of deposit

Source: City of Kansas City Missouri's *Investment Policy*.

Proposed Investments Commonly Used by Other Jurisdictions

The director of Finance, in her response to Councilmember Blackwood's request, proposed a change to the city charter. The change would add United States government agency securities, repurchase agreements, the highest-rated investment grade commercial paper and banker's acceptances to the list of authorized city investments. (For definitions and examples of these investment instruments, see Attachment A.)

We found that the current investment policies for Austin, Denver, Phoenix, Portland, and San Jose permit the use of city funds in all four types of proposed investments. Cincinnati and Missouri permit investment in U.S. government agency securities and repurchase agreements but not commercial paper or banker's acceptances. Missouri voters, however, will be asked to approve the addition of these two types of investments in November 1998.

Based on our survey results, the four investment instruments proposed to be added to the city's list of possible investments are commonly used by other municipalities. Other investment instruments reported by the surveyed cities were not consistently used by a majority of the respondents. (See Exhibit 2.)

Financial Transactions Contain Risks

Differences in the risk associated with investment instruments are usually reflected in the interest rates paid on the investment. Higher returns are usually tied to greater risk. Risks can also be associated with certain transaction practices and the securities trading environment.

In our review of financial literature, specific controls were urged in the use of repurchase agreements. In the late 1970s, a number of cities suffered severe losses when dealers defaulted on repurchase agreements and the security backing the agreements was never delivered. Relevant literature, including Statement No. 3 of the Governmental Accounting Standards Board, now emphasizes the importance of limiting transactions to dealers whose activities are subject to governmental regulation or oversight, and who meet capital adequacy standards. Municipalities are also urged to examine the creditworthiness of the holder of the security and to structure transactions to protect the city's interests under provisions of the Federal Bankruptcy Code, among other items.

Exhibit 2. Investments Used by Other Jurisdictions, but not Currently Approved for Use by Kansas City, Missouri

Investments	Kansas City	State of Missouri	Austin	Cincinnati	Denver	Phoenix	Portland	San Jose
U.S. Government Agency Securities	Proposed	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Repurchase Agreements	Proposed	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Commercial Paper	Proposed	Proposed	Yes		Yes	Yes	Yes	Yes
Banker's Acceptances	Proposed	Proposed	Yes		Yes	Yes	Yes	Yes
State's Local Agency Investment Fund			Yes				Yes	Yes
Corporate Notes						Yes		Yes
Reverse Repurchase Agreements		Yes						Yes
Negotiable Certificates of Deposits								Yes
Security Lending Agreements		Yes			Yes			
Bank/Insurance Investment Agreements GICs						Yes		
Linked Deposits		Yes						
No-Load Money Market Mutual Funds			Yes					

Sources: Responses by Cities Surveyed; Proposed Amendments to the City Charter; Missouri Constitution; Missouri State Treasurer Investment Policy; and Proposed Amendments to the Missouri Constitution.

Restrictions and Controls Needed

Financial markets have undergone tremendous changes in the past decade. New securities have been developed and financial markets have become increasingly volatile. To address the more sophisticated environment of public investing, jurisdictions have developed investment policies to guide the prudent management of public funds.

The investment policies we reviewed contained restrictions or limits on all investment instruments, including those suggested to be added by the proposed charter amendment. For example, maximum maturities are specified by investment type. Limits on the absolute level of dollars, the percentage of a jurisdiction's portfolio invested in a single issuer or category of investment, or the proportion of the dealing firm's liabilities that an issue represents may be restricted. Investment ratings, specific collateral, the dealer, collateral holder, or the location of the issuer may also be specified. If the charter amendment is presented and approved by the voters, the Finance Department will need to review, refine, and update the city's current *Investment Policy*.

Attachment

- cc: Mayor Emanuel Cleaver II
- Members of the City Council
- Robert Collins, City Manager
- Janice Reed, Director of Finance

Attachment A

Definitions and Examples of Investments Proposed in Charter Amendment

U.S. Government Agency Security

The obligations of various agencies and corporations chartered by the federal government and guaranteed by the issuer. Principal agencies issuing securities are federal land banks, federal home loan banks, federal intermediate credit banks, the Federal National Mortgage Association (Fannie Mae) and the Government National Mortgage Association (Ginnie Mae). Maturities range from one month to approximately fifteen years.

Repurchase Agreements

The government entity transfers cash to a broker-dealer or financial institution; the broker-dealer or financial institution transfers securities to the governmental entity and promises to repay the cash plus interest in exchange for the return of the same securities.

Commercial Paper

An unsecured promissory note issued primarily by corporations for a specific amount and maturing on a specific day. The maximum maturity for commercial paper is 270 days, but most is sold with maturities of up to 30 days. Almost all commercial paper is rated as to credit risk by rating services.

Banker's Acceptances

An investment instrument generally created based on a letter of credit issued in a foreign trade transaction and issued in bearer form. For example, a U.S. corporation will order goods from a foreign country and have its bank issue a letter of credit to the foreign supplier in the amount of the purchase price. The foreign vendor, on shipping the goods, then draws a time draft on the U.S. importer's bank and discounts the draft at its local bank. In this manner, the supplier receives immediate payment for its shipment. The foreign bank then sends the draft to the U.S. bank and the draft is stamped "accepted." This banker's acceptance indicates that the U.S. bank guarantees payment of the draft at maturity. The foreign bank may hold the acceptance to maturity or sell it to the accepting bank. The U.S. bank may hold the acceptance or sell it to another party, such as a governmental entity.