



King County

**Metropolitan King County Council
Operating Budget, Fiscal Management, and Select Issues**

Agenda Item No.: 4

Date: June 11, 2008

Proposed No.: 2008-0305

Prepared By: Mamie Marcuss

Staff Report

Subject: A MOTION acknowledging receipt of the King County Investment Pool Advisory Panel's Report on the King County Investment Pool.

Summary:

On May 28, 2008 the King County Investment Pool Advisory Panel briefed this committee on its report on the King County Investment Pool. The Advisory Panel was created by Council last fall and tasked with performing a comprehensive review of the King County Investment Pool. Their report found "significant deficiencies" with the investment pool and recommended "rapid and forceful action to bring the investment pool in-line with industry best practices."

The staff report and the Advisory Panel's power point presentation from the May 28, 2008 meeting are attached for reference (Attachments 4 and 5).

Today's staff report will briefly summarize the Advisory Panel's findings and recommendations. It will then discuss proposed motion 2008-0305, as well as a proposed striking amendment to the motion that was prepared at the direction of the chair and the co-sponsor of the legislation, Councilmember Phillips.

Background: The Report

The Advisory Panel's report on the King County Investment Pool is the product of over 6 months of research into the operations, policies, and governance of the investment pool. The panel's research included interviewing County staff, reviewing written records, consulting with outside experts, and relying on their own professional expertise and experience.

Using “industry best practices” as the standard of comparison, the Advisory Panel’s report finds a “significant gap” between the investment pool’s current practices and these best practices. As a result of this gap, it finds that the investment pool is “deficient in a number of ways, including:

- Unnecessary exposure to investment and operation risk;
- Inadequate measures of performance and risk;
- Lost opportunities to improve investment results;
- Inherent conflicts of interest within the governing structure;
- Insufficient transparency and communication with management and participants; and
- Inaccurate accounting for participant principal and interest.”

The report recommends that the county take “rapid and forceful action” to correct these problems and meet industry best practices. The report recommends changes in three key areas: governance, infrastructure, and accountability, and six sections of the report detail over 30 specific recommendations.

The report’s recommendations are summarized below:

1. External Management:

- *Findings:*
 - Outsourcing is the “most cost-effective, efficient, and timely way to close the investment pool’s current gap with best practices.”
 - State law does not grant the County clear authority to delegate its discretionary investment authority to a third party investment manager.
 - However, there is no restriction on establishing an advising relationship with an external fund manager.
- *Recommendations:*
 - Outsource the management of the investment pool.
 - Consistent with current state law, establish an advising relationship with an external fund manager.
 - Pursue changes in state law to allow county treasurers to fully delegate their authority to invest funds to an external fund manager.
 - If the county chooses not to outsource management, “immediately acquire investment advisory services from SEC-registered investment manager.”

2. Governance:

- *Findings:* The Executive Finance Committee (EFC) is “not an adequate fiduciary,” “does not provide policy makers with adequate access to expert advice,” and “does not allow representation from all participants.”

- *Recommendations:*
 - Create a governing body that:
 - Does not have inherent conflicts of interest;
 - Is supported by a set of external investment professionals;
 - Promotes diversification in the portfolio;
 - Is directly accountable to all participants.
 - Replace EFC with an independent board comprised of county and non-county representatives as well as three appointed citizen experts. The board should be supported by a registered institutional investment consultant who can provide objective financial advice.

3. Investment Goals:

- *Findings:*
 - Current investment strategy is a complex hybrid, with elements of both a constant and variable net asset value (NAV) fund.
 - This structure creates potential confusion for participants and “neither strategy is executed well...there are not sufficient controls to ensure an NAV of \$1, while returns fall short of most variable NAV funds.”
- *Recommendations:*
 - Choose one – either constant NAV or variable NAV fund – and adopt appropriate controls and accounting for the type of fund.
 - Educate participants on the risk, liquidity, and return expectations of the chosen fund type.

4. Infrastructure:

- *Findings:*
 - Infrastructure should be brought in line with industry best practices.
 - “Technology is 12 to 25 years behind current industry standards.”
 - Assets are not held centrally, creating “a fractured reporting environment,” “auditing and reconciliation challenges,” “reduced productivity,” and “increased risk of clerical error.”
 - Credit analysis depends on credit rating assigned by rating agency.
 - “Last major review of investment policies was conducted in 1997.”
 - One staff person, the investment officer, is responsible for the bulk of the investment process, creating operational risk.
- *Recommendations:*
 - Upgrade technology to automate reporting and aspects of the investment process.
 - Consolidate assets within one central repository, or custodian bank.
 - Establish a credit analysis process.

- Develop improved internal controls.
- Update written investment pool policies and procedures.
- Improve staffing structures to eliminate operational risk.
- Improve accounting procedures.
- Institute an annual outside audit.

5. Metrics:

- *Findings:*
 - The metrics currently used to measure performance and risk are “inadequate, simplistic, and potentially misleading.”
 - “The chosen benchmarks are inappropriate.”
 - “The chosen risk metrics are simplistic.”
 - “The current reports are insufficient.”
- *Recommendations:*
 - “Immediately implement a set of metrics that produces transparency regarding risk and expected returns and enables appropriate performance measurement.”
 - Adopt performance benchmarks that are consistent with investment goals, enabling comparison with both the market and other similar investment pools.
 - Adopt a comprehensive set of risk metrics to measure, monitor, and manage all of the risks in the portfolio.
 - Adopt more comprehensive and transparent reports.

6. Impaired Investments:

- *Findings:*
 - Presence of impaired investments in portfolio are weighing down yield and complicating each participant’s principal calculations.
 - Restructuring negotiations on each impaired investment are complex and may take some time before they are resolved.
- *Recommendations:*
 - Immediately bifurcate the investment pool’s assets into a performing pool and an impaired pool.
 - Hire a registered, institutional investment manager with fixed income and credit analysis expertise to manage the impaired investments and to perform a quantitative analysis of the restructuring options.

7. External Relations:

- *Findings:*
 - Participants are not formally included in the policy making process.
 - Communications with participants and the public need improvement.

- The fee structure should be reviewed.
- *Recommendations:*
 - Create formal channels to include participants in the policy making process, including holding an annual meeting for all participants.
 - Improve reports to participants, the public, and the governing body to be consistent with the best practices provided by the Government Finance Officers Association.
 - Develop a website to provide participants and the public with better access to information about the investment pool.
 - Review the fee structure.
 - Seek reinstatement of a top rating by a rating agency.

In conclusion, the report recommends that the county immediately develop an action plan that “lays out the specific steps the County will take to bring the pool in line with industry best practices.” The County should assess its progress against this plan in six months.

Finally, the report recommends that the County conduct an audit of the entire Treasury Services function to ensure that the investment function works efficiently with cash management operations. It further recommends a full-scale business review of the investment pool every three years.

Proposed Motion 2008-0305:

The proposed motion would gratefully acknowledge receipt of the Advisory Panel’s report on the King County Investment Pool and thank the Advisory Panel for their service to the citizens of King County.

Proposed Striking Amendment:

A striking amendment to the proposed motion was drafted at the direction of the chair and the legislation’s co-sponsor, Councilmember Phillips.

The striking amendment would:

- 1) Add a series of whereas clauses pertaining to the report’s findings.
- 2) State that it is the intent of the Council that the investment pool be operated in accordance with industry best practices for a governmental investment pool.
- 3) Create a joint legislative/executive branch work group tasked with creating an action plan for addressing the findings in the report. The work group would also be tasked with examining the report’s recommendations and providing four reports to Council with options for implementation.

- Membership (or their designees):
 - Director of County Council Policy Staff, co-chair
 - Director of Finance and Business Operations, co-chair
 - Director of Management and Budget
 - Lead Staff to the Operating Budget, Fiscal Management, and Select Issues Committee
 - County Auditor
 - County's Chief Accountant
 - County's Chief Economist
 - Reports:
 - July 1, 2008: Submit action plan to Council.
 - September 1, 2008:
 1. External Management: Options for outsourcing.
 2. Governance structure: Options for modifying.
 3. Investment goals and metrics: Options and recommendation.
 4. Infrastructure and accounting: Options and recommendation.
- 4) Accepts many of the specific recommendations made by the Advisory Panel and requests a series of actions by the work group, the Executive Finance Committee (EFC), the Finance and Business Operations Division, and the Director of the Finance and Business Operations Division. (See Table 1, p. 7)

Reasonableness:

As amended, the proposed motion represents a reasonable policy and business decision.

Invited:

Kurt Triplett, Chief of Staff, King County Executive
 Jim Buck, Director, Department of Executive Services
 Ken Guy, Director, Finance and Business Operations Division (FBOD)
 Bob Cowan, Director, Office of Management and Budget

Attachments:

- 1) Striking Amendment, S1
- 2) Title Amendment, T1
- 3) Proposed Motion 2008-0305
- 4) Staff Report on Proposed Motion 2008-0305, dated May 28, 2008
- 5) "A Report on the King County Investment Pool," PowerPoint Presentation, King County Investment Pool Advisory Panel, dated May 28, 2008

Table 1: Proposed Motion 2008-0305: Striking Amendment, S1

Issue Area	Proposed Motion	Responsible Party	Action Required	Due Date
External Management	<ol style="list-style-type: none"> 1) Accepts recommendation that the County outsource the management of the pool. 2) Belives outsourcing as the most cost-effective, efficient, and timely way to close the gap merits examination. 	Inter-branch work group	Report to Council with options for implementing recommendation to outsource, including any changes necessary to state law.	1-Sep-08
Governance	<ol style="list-style-type: none"> 1) Accepts finding that governing structure does not allow representation from all participants and does not provide policy makers with adequate access to expert advice. 2) Accepts recommendation that governing structure modifications are needed. 3) Acknowledges modifications may require changes to state law. 	Inter-branch work group	Report to Council with options for modifying the governing structure, including any changes necessary to state law.	1-Sep-08
Investment Goals and Metrics	<ol style="list-style-type: none"> 1) Accepts recommendation that governing body clearly define investment goals. 2) Accepts recommendation to immediately implement a set of metrics that improves transparency regarding risk and expected returns and enables appropriate performance measurement. 	Inter-branch work group	Report to EFC, Council, and Executive on appropriate goals and metrics and options for their implementation.	1-Sep-08
		EFC	Urged to implement work group's recommendations.	1-Nov-08
Infrastructure	<ol style="list-style-type: none"> 1) Supports recommendation that the investment pool be brought in line with industry best practices. 2) Accepts specific recommendations on technology, consolidation of assets, credit analysis, internal controls, policies, staffing, accounting, and audits. 	Inter-branch work group	Report to Council with options for enhancing infrastructure, including timeline and cost estimates. Include review of outsourcing and audit needs.	1-Sep-08



June 11, 2008

mfm

Sponsors: Ferguson and Phillips

Proposed No.: 2008-0305

1 **STRIKING AMENDMENT TO PROPOSED MOTION 2008-0305, VERSION 1**

2 On page 1, beginning on line 5, strike everything through page 3, line 46, and insert:

3 WHEREAS, the King County investment pool was established in 1989 to
4 preserve and protect capital and provide a market rate of return on public funds through
5 budgetary and economic cycles and today, holds over four billion dollars in public funds,
6 and

7 WHEREAS, the investment pool is available to all districts, agencies and public
8 authorities in King County, except incorporated cities, to invest their cash reserves, and
9 nearly one hundred of these entities have chosen to become participants in the investment
10 pool, and

11 WHEREAS, between August 2007 and January 2008, four of the investments
12 held by the investment pool became impaired, where impairment is defined by section
13 210.9 of the King County investment policies as occurring when the investment's credit
14 quality is rated below investment grade, a default has occurred on payment at maturity, or
15 an enforcement event, as defined by the investment's program documents, has occurred,
16 and

17 WHEREAS, in light of these impairments, the council acting in its oversight role
18 determined a need to conduct a full scale review of the investment pool, including an
19 examination of investment goals, policies, practices, governing structure and relationship
20 with participants, and

21 WHEREAS, in the past, the council successfully relied on the aid of citizens with
22 expertise in specific fields to conduct reviews of county operations, and

23 WHEREAS, through Motion 12595, the council created the King County
24 investment pool advisory panel to review the King County investment pool, and

25 WHEREAS, Motion 12631 appointed three experts from the financial industry to
26 the advisory panel who were selected for their knowledge of financial markets and
27 instruments, public investment pools and macroeconomics, and

28 WHEREAS, the advisory panel appointees were: John Rose, the former chief
29 executive officer of Seattle Northwest Securities, the region's largest underwriter of
30 bonds; John Dobrowolski, who has thirty years of experience in capital markets,
31 derivatives, risk management, and portfolio management and is the former senior vice
32 president and division executive of market risk for Washington Mutual; and Mary Ellen
33 Mullen who has over twenty-five years of institutional investment experience and is a
34 principal at Bridgebay Consulting LLC, and

35 WHEREAS, the advisory panel interviewed county staff, reviewed written
36 records, consulted with outside sources, and relied on its members' professional expertise
37 to produce a report on the investment pool, and

38 WHEREAS, the investment pool advisory panel has completed its report and
39 submitted it to the council, and

40 WHEREAS, the report recommends that the county take rapid and forceful action
41 to bring the investment pool in line with industry best practices, and

42 WHEREAS, the report makes recommendations on how the investment pool can
43 close the gap between its current practices and industry best practices, and

44 WHEREAS, the council has a long history of responsible stewardship of the
45 public's money, and

46 WHEREAS, this motion is intended to provide guidance and to create an
47 investment pool work group to advise the executive finance committee as the committee
48 determines the appropriate policies for the management of the investment pool;

49 NOW, THEREFORE, BE IT MOVED by the Council of King County:

50 **A. Acknowledgement and thanks.** The metropolitan King County council
51 gratefully acknowledges receipt of the report of the investment pool advisory panel and
52 thanks John Rose, chair, John Dobrowolski and Mary Ellen Mullen for their service to
53 the citizens of King County.

54 **B. Intent.** It is the intent of the council that the investment pool will be operated
55 in accordance with industry best practices for a governmental investment pool.

56 **C. Joint legislative and executive branch investment pool work group**
57 **created – responsibilities - membership.** A King County joint legislative and executive
58 branch investment pool work group is hereby created for the purpose of ensuring that the
59 investment pool meets industry best practices for a governmental investment pool.

60 1. On or before July 1, 2008, the King County investment pool work group shall
61 submit to council an action plan for bringing the investment pool in line with such

62 industry best practices. Additionally, the investment pool work group shall be
63 responsible for various reports to the council as prescribed in this motion.

64 2. The investment pool work group shall be cochaired by the manager of the
65 finance and business operations division and the council policy staff director, or their
66 designees. The work group shall include the managers of the finance and business
67 operations division and the office of management and budget, the council policy staff
68 director, the lead staff to the operating budget, fiscal management and select issues
69 committee, or its successor, the county auditor, the chief accountant and the chief
70 economist, or their designees. The investment pool work group shall be informed by
71 input from pool participants.

72 **D. Outsourced management.** To the extent that it is consistent with state and
73 county law, the council accepts the advisory panel's recommendation that the county
74 outsource the management of the investment pool. The council believes the advisory
75 panel's finding that outsourcing is the most cost-effective, efficient and timely way to
76 close the investment pool's current gap with best practices merits further examination.

77 1. The investment pool work group shall examine the advisory panel's
78 recommendation to outsource the management of the investment pool and develop
79 options to implement this recommendation to the extent deemed appropriate and
80 consistent with state law. If the work group perceives a particular measure to be
81 beneficial to investment pool management but inconsistent with state law, the group shall
82 advise the council of the reasons for its conclusions and the changes necessary to state
83 law to implement such a measure.

84 2. The investment pool work group shall report its findings to council on or
85 before September 1, 2008. Eleven copies of the report shall be filed with the clerk of the
86 council, for distribution to all councilmembers.

87 **E. Governance.** The council accepts the advisory panel's findings that the
88 investment pool's current governing structure does not allow representation from all
89 participants and does not provide policy makers with adequate access to expert advice.
90 The council accepts the advisory panel's recommendation that modifications to the
91 governing structure are needed. The council acknowledges that the advisory panel's
92 recommended modifications may require changes in state or county law.

93 1.a. The investment pool work group shall review the investment pool's
94 governance structure and shall develop options for modifying the governance structure in
95 light of the advisory panel's recommendations that:

96 (1) the governing structure be modified to eliminate inherent conflicts of
97 interest;

98 (2) the governing body be supported by a set of external investment
99 professionals;

100 (3) the governing body avoid categorical restriction of specific types of
101 investment securities and promote diversification; and

102 (4) the governing body be held directly accountable to all participants.

103 b. The work group's review shall include the advisability of implementing the
104 advisory panel's recommendation that the executive finance committee be replaced by an
105 independent board comprised of both county and noncounty participant representatives
106 and three appointed citizen experts.

107 2. The work group shall present its findings in a report transmitted to the council
108 on or before September 1, 2008, in the form of eleven copies filed with the clerk of the
109 council, for distribution to all councilmembers. The report shall include a discussion of
110 any amendments to Washington state law, King County Code or King County charter that
111 would be required to implement any of the options.

112 **F. Investment goals and metrics.** The council accepts the advisory panel's
113 recommendation that the investment pool governing body clearly define investment goals
114 for the investment pool. The council accepts the advisory panel's recommendation that
115 the investment pool immediately implement a set of metrics that improves transparency
116 regarding risk and expected returns and enables appropriate performance measurement.

117 1. The investment pool work group shall provide a report on the investment
118 pool's investment goals and metrics.

119 a.(1) The report shall examine the advisory panel's recommendations
120 regarding:

121 (a) appropriate investment goals;

122 (b) the use and selection of one market benchmark and one peer universe
123 benchmark for the entire portfolio, consistent with the investment goals;

124 (c) the adoption of a comprehensive set of risk and performance metrics to
125 measure, monitor, and manage the investment pool;

126 (d) the development of a risk limit framework;

127 (e) the implementation of stress tests; and

128 (f) the establishment of a contract with a third party to provide reporting for
129 the investment pool.

130 (2) The report shall examine the panel's recommendation that absent the
131 outsourcing of the management of the investment pool, the appropriate investment goals
132 are those of a constant net asset value fund.

133 b. The report shall present options for implementing those recommendations it
134 concludes are in the best interests of the investment pool.

135 2. The investment pool work group should obtain the services of a consultant to
136 provide expert advice to inform this report.

137 3. On or before September 1, 2008, the investment pool work group shall
138 transmit the report to the executive finance committee, the council and the executive.
139 Eleven copies of the report shall be filed with the clerk of the council, for distribution to
140 all councilmembers.

141 4. On or before November 1, 2008, the executive finance committee is urged to
142 consider the implementation of the investment pool work group's recommendations as
143 contained in the report.

144 **G. Infrastructure.**

145 1. The council supports the advisory panel's recommendation that the
146 investment pool's infrastructure be brought in line with industry best practices. The
147 council accepts the advisory panel's specific recommendations in these areas:

148 a. technology upgrades to automate reporting and certain aspects of the
149 investment process;

150 b. consolidation of assets within one central repository or custodian bank;

151 c. establishment of a credit analysis process;

152 d. development of improved internal controls;

- 153 e. updated written investment pool policies and procedures;
- 154 f. improved staffing structures to eliminate operational risk;
- 155 g. improved accounting procedures; and
- 156 h. institution of an annual outside audit.

157 2. The investment pool work group shall review the recommendations of the
158 advisory panel and develop options for enhancing the infrastructure of the investment
159 pool. The options shall include the feasibility of using the services of an external fund
160 manager to the extent permitted under state law. The investment pool work group shall
161 also review the advisory panel's recommendation that additional audits of the investment
162 pool are needed, including audits by an auditor with a specialty in fixed income
163 accounting and periodic internal control audits.

164 a. These options shall be presented in a report transmitted to the county council
165 on or before September 1, 2008. Eleven copies of the report shall be filed with the clerk
166 of the council, for distribution to all councilmembers.

167 b. The report shall contain detailed cost estimates for each option and a
168 timeline for implementation.

169 3. The finance and business operations division is requested to review the
170 advisory panel's recommendation to consolidate the investment pool's assets with a single
171 custodian bank on or before October 1, 2008.

172 4. The advisory panel made several recommendations related to the accounting
173 practices of the investment pool. The manager of the finance and business operations
174 division is requested to examine the accounting practices of the pool and present a report
175 to the council on or before July 1, 2008.

176 5. On or before November 1, 2008, the executive finance committee is urged to
177 review the King County investment policies in light of the advisory panel's
178 recommendations to ensure the policies reflect current practice and contain policies in the
179 relevant areas. The advisory panel recommended that the updated policies contain a
180 provision requiring an annual review of the investment policies.

181 **H. External relations.** The council supports the advisory panel's
182 recommendation that formal channels be created to include participants in the investment
183 pool's policy decision making process. The council supports the advisory panel's
184 recommendation that the investment pool improve communications with participants, the
185 public, and the executive finance committee. The council supports the advisory panel's
186 recommendation that the county review the fee structure of the investment pool. The
187 council supports the advisory panel's recommendation that the investment pool continue
188 to be rated by a nationally recognized statistical rating agency.

189 1. The manager of the finance and business operations division is requested to
190 inform all participants of the date, time, and place of all executive finance committee
191 meetings and to send a complete agenda for each meeting to all participants five business
192 days before the meeting.

193 2. As recommended by the advisory panel, the manager of the finance and
194 business operations division is requested to hold an annual meeting beginning in 2008 to
195 discuss the performance of the investment pool during the prior year, solicit participant
196 input on investment pool policies and outline the investment strategy for the coming year.
197 The manager of finance and business operations division is requested to inform all

198 participants of the date, time and place of this annual meeting thirty calendar days before
199 the meeting.

200 3.a. Beginning on or before July 1, 2008, the finance and business operations
201 division is requested to produce a monthly report on the investment pool that includes
202 elements recommended by the advisory panel:

203 (1) investments by type and as a percentage of the portfolio;

204 (2) a listing of issuers;

205 (3) the cost of each investment, its yield to maturity at both cost and market
206 value, accrued interest and maturity date;

207 (4) the market value of each investment;

208 (5) the par value of each investment;

209 (6) total returns for prior periods;

210 (7) comparison of current incomes against forecasts and budgeted income
211 projections;

212 (8) investments by maturity date;

213 (9) average weighted yield to maturity of the portfolio, including comparison
214 to applicable benchmarks;

215 (10) percentage of the total portfolio held by each institution; and

216 (11) principal and type of investment by fund.

217 b. The report should be updated monthly and made available to the executive
218 finance committee, all participants and the public. Eleven copies of the report and each
219 update shall be filed with the clerk of the council, for distribution to all councilmembers.

220 4. As recommended by the advisory panel, the finance and business operations
221 division is requested to develop a website for the investment pool. The website should
222 include general information about the investment pool, a current copy of the investment
223 pool policies, and monthly reports on the investment pool. The website should be
224 operational no later than August 1, 2008.

225 5. The council understands that the executive finance committee is currently
226 undertaking a review of the investment pool fee structure. The executive finance
227 committee is requested to update the council on its review on or before July 1, 2008.

228 **I. Impaired investments.** The council supports the advisory panel's
229 recommendation to bifurcate the impaired investments from the performing investments.
230 The council supports the advisory panel's recommendation that the county obtain the
231 services of a qualified investment manager to advise the county on the management of
232 impaired investments.

233 1. The executive finance committee is urged to immediately consider the issue
234 of bifurcation.

235 2. The executive finance committee is requested to immediately obtain the
236 services of a qualified investment manager to advise the county on the management of
237 impaired investments.

238 **J. Audit.** The council supports the advisory panel's recommendation that an
239 audit be performed of the treasury operations section of the finance and business
240 operations division to ensure that cash management and investment functions work
241 together efficiently. The council will consult with the county auditor about such an audit.

242 K. **Business review.** The council supports the advisory panel's recommendation
243 that the investment pool conduct a business review every three years. The executive
244 finance committee is requested to consider implementing such a review.

245 L. **Quarterly report by manager of finance and business operations division.**
246 The manager of the finance and business operations division is requested to report to the
247 council each quarter regarding the specific steps taken and progress made on the
248 recommendations in this motion. The first report shall cover the third quarter of 2008.
249 The manager shall file eleven copies of the reports to the clerk of the council two weeks
250 after the end of each calendar quarter, for distribution to all councilmembers. The last
251 report shall be made in January 2011, unless otherwise determined by motion by the
252 council.

253
254 **EFFECT: In this amendment, Council accepts the specific recommendations**
255 **contained in the advisory panel's report. A joint executive/ legislative investment**
256 **pool work group is created to 1) present a plan to Council by July 1, 2008 for**
257 **bringing the investment pool in line with industry best practices for a governmental**
258 **investment pool and 2) to examine the advisory panel's specific recommendations**
259 **and report back to Council by September 1, 2008, with findings and options for**
260 **implementation. The amendment also urges the EFC to consider a number of the**
261 **recommendations and requests a number of actions by the finance and business**
262 **operations division. Finally, the amendment requests quarterly progress reports**
263 **from the manager of the finance and business operations division.**



June 11, 2008

mfm

Sponsor: Ferguson and Phillips

Proposed No.: 2008-0305

1 **AMENDMENT TO PROPOSED MOTION 2008-0305, VERSION 1**

2 On page 1, line 1, delete

3 "A MOTION acknowledging receipt of the King County
4 investment pool advisory panel's report on the King County
5 investment pool."

6 and insert

7 "A MOTION acknowledging receipt of the King County
8 investment pool advisory panel's report on the King County
9 investment pool, accepting its recommendations, and
10 creating an investment pool work group to examine these
11 recommendations and develop options for their
12 implementation."

13

14 **EFFECT: Changes the title to reflect the changes made in the striking amendment.**



KING COUNTY

Signature Report

May 27, 2008

1200 King County Courthouse
516 Third Avenue
Seattle, WA 98104

Motion

Proposed No. 2008-0305.1

Sponsors Ferguson

1 A MOTION acknowledging receipt of the King County
2 investment pool advisory panel's report on the King County
3 investment pool.

4
5 WHEREAS, the King County investment pool was established in 1989 to
6 preserve and protect capital and provide a market rate of return on public funds through
7 budgetary and economic cycles and today, holds over four billion dollars in public funds,
8 and

9 WHEREAS, the investment pool is available to all districts, agencies, and public
10 authorities in King County, except incorporated cities, to invest their cash reserves, and
11 nearly one hundred of these entities have chosen to become participants in the investment
12 pool, and

13 WHEREAS, between August 2007 and January 2008, four of the investments
14 held by the investment pool became impaired, where impairment is defined by Section
15 210.9 of the King County investment policies as occurring when the investment's credit
16 quality is rated below investment grade, a default has occurred on payment at maturity, or

Motion

17 an enforcement event, as defined by the investment's program documents, has occurred,
18 and

19 WHEREAS, in light of these impairments, the Council acting in its oversight role
20 determined a need to conduct a full scale review of the investment pool, including an
21 examination of investment goals, policies, practices, governing structure and relationship
22 with participants, and

23 WHEREAS, the council has successfully relied on the aid of citizens with
24 expertise in specific fields to conduct reviews of county operations, and

25 WHEREAS, through Motion 12595, the council created the King County
26 investment pool advisory panel to review the King County investment pool, and

27 WHEREAS, Motion 12631 appointed three experts from the financial industry to
28 the advisory panel who were selected for their knowledge of financial markets and
29 instruments, public investment pools and macroeconomics, and

30 WHEREAS, the advisory panel appointees were John Rose, the former chief
31 executive officer of Seattle Northwest Securities, the region's largest underwriter of
32 bonds, John Dobrowolski, who has thirty years of experience in capital markets,
33 derivatives, risk management, and portfolio management and is the former senior vice
34 president and division executive of market risk for Washington Mutual, and Mary Ellen
35 Mullen, who has over twenty-five years of institutional investment experience and is a
36 principal at Bridgebay Consulting LLC, and

37 WHEREAS, the advisory panel interviewed county staff, reviewed written
38 records, consulted with outside sources and relied on its members' professional expertise
39 to produce a report on the investment pool, and

Motion

40 WHEREAS, the investment pool advisory panel has completed its report and
41 submitted it to the council;

42 NOW, THEREFORE, BE IT MOVED by the Council of King County:

43 The metropolitan King County council gratefully acknowledges receipt of the
44 report of the King County investment pool advisory panel and thanks John Rose, chair,
45 John Dobrowolski and Mary Ellen Mullen for their service to the citizens of King
46 County.

47

KING COUNTY COUNCIL
KING COUNTY, WASHINGTON

ATTEST:

Attachments None



King County

**Metropolitan King County Council
Operating Budget, Fiscal Management, and Select Issues**

Agenda Item No.: 4

Date: May 28, 2008

Proposed No.: 2008-0305

Prepared By: Mamie Marcuss

Staff Report

Subject: A MOTION acknowledging receipt of the King County Investment Pool Advisory Panel's Report on the King County Investment Pool.

Summary:

Last fall, the Council created the King County Investment Pool Advisory Panel to conduct a comprehensive review of the investment pool. The Advisory Panel has completed their review and submitted their report to the Council. Today, the Advisory Panel will brief the Committee on the report's findings and recommendations.

Proposed motion 2008-0305 would acknowledge receipt of the Advisory Panel's report.

Background: King County Investment Pool

The King County Investment Pool was created in 1989 to enable King County agencies to invest financial reserves. In 1995, the County extended investment pool membership to public authorities within the County (with the exception of incorporated cities). Today, nearly 100 non-County participants, including school, fire, sewer, water, and other districts, have joined the investment pool via inter-local agreements with King County. For the majority of these participants, King County serves as their ex-officio treasurer.

Depending on the flow of tax revenues, the investment pool holds between \$3.5 and \$5 billion. As of April 22, 2008, the balance was \$3.96 billion. In accordance with state law, funds are invested in low risk, highly rated fixed income securities including U.S. Treasuries, U.S. Federal Agencies, and municipal bonds. According to the County's investment policies, the investment pool seeks to attain a market rate of return for pool members, while preserving and protecting each member's capital.

King County Investment Pool Advisory Panel:

Recent conditions in the financial credit markets led to uncharted territory for the investment pool, and four of the pool's asset-backed commercial paper holdings became impaired between August 2007 and January 2008:

- o Mainsail II LLC \$53.5 million
- o Rhinebridge LLC \$50.0 million
- o Cheyne Finance \$50.0 million
- o Victoria Finance LLC \$53.3 million

While highly rated at the time of purchase, all four of these investments defaulted, and the County is currently involved in restructuring negotiations to determine how investors will recover the value of their investment.

In light of these developments in the financial markets, the Council created the Investment Pool Advisory Panel via Motion 12595 in October 2007. This three member panel was charged with conducting a comprehensive review of the Investment Pool, ensuring that the pool's current policies, structures, and systems were sufficiently robust to handle today's challenging market conditions. Specifically, the panel was charged with examining the Investment Pool's investment goals, policies, portfolio, as well as its membership, management, and governance structures.

Advisory Panel's Members:

In November, the Council passed Motion 12631, appointing three financial experts to the Advisory Panel:

- **John Rose, chair:** Mr. Rose is the former Chief Executive Officer of Seattle-Northwest Securities Corporation, the region's largest underwriter of bonds. He is also the chairman of the board of trustees for the Nature Conservancy's Washington State chapter, and he served as the King County Budget Director in the early 1980s. He is the current Mayor of the Town of Beaux Arts Village and a member of the Board of Directors of McAdams Wright Ragen brokerage firm.
- **John Dobrowolski:** Most recently, Mr. Dobrowolski was the Senior Vice President and Division Executive of Market Risk for Washington Mutual. He has also worked as a Portfolio Manager for GE Financial Assurance, a Financial Risk Management Specialist for the International Finance Corporation, a member of the World Bank Group, and Vice President of Structured Products for Greenwich Capital, a unit of the Royal Bank of Scotland. He has over 30 years of experience in capital markets, derivatives, risk management, and portfolio management.

- **Mary Ellen Mullen:** Ms. Mullen is a Principal at Bridgebay Consulting LLC. She provides investment consulting services to institutions, focusing on treasury, endowment/foundations, and retirement plans. She has over twenty-five years of institutional investment experience including research, trading, portfolio management, client service, and sales at Loomis Sayles, Seafirst/ Bank of America/ Seattle Capital Management, and Wells Fargo/ Wells Capital Management. She is a member of the Investment Committees of the Pacific Science Center and the City of Bellevue.

Advisory Panel's Review:

Beginning in December 2007, the panel held bi-weekly meetings, totally over 50 hours of research, to carry out its task. To conduct their research, the panel held a series of fact findings briefings with members of the Executive Finance Committee, Finance and Business Operations Division staff, Council staff, and a number of investment pool participant representatives. Additionally, the advisory panel reviewed written records, consulted with outside sources, and relied on its member's own professional expertise.

Advisory Panel's Report:

The Advisory Panel has completed its review and compiled its findings and recommendations into a 75 page report to the King County Council.

The Advisory Panel members are here today to present the Committee with a summary of their report and to answer any questions that the Committee may have at this time.

Proposed Motion 2008-0305:

The proposed motion would gratefully acknowledge receipt of the Advisory Panel's report on the King County Investment Pool and thank the Advisory Panel for their service to the citizens of King County.

Invited:

Jim Buck, Director, Department of Executive Services
Ken Guy, Director, Finance and Business Operations Division (FBOD)
Bob Cowan, Director, Office of Management and Budget

Attachment:

1. Proposed Motion 2008-0305

A Report on the King County Investment Pool

King County Investment Pool
Advisory Panel

May 2008

Agenda

- Work Program
- Main Findings
- Specific Areas of Recommendation
- Conclusion

Work Program

- Areas reviewed:
 - Governance
 - Investment Goals
 - Infrastructure
 - Performance Metrics
 - Impaired Investments
 - External Relations

- Process:
 - Interviewed staff.
 - Reviewed written records.
 - Consulted with outside sources.
 - Relied on our professional expertise.

Work Program

- Industry Best Practices:
 - Practices found in competitive, tightly regulated private sector.
 - Standards expected in management of private funds.

- Forward Looking:
 - Not an audit of past decisions.
 - Recommendations are prospective.

Main Findings

- Investment Pool falls short of industry best practices.
- Creates significant deficiencies:
 - Unnecessary risk exposure.
 - Inadequate portfolio management systems and tools.
 - Missed opportunities to improve investment results.
 - Inherent conflicts of interest in governing body.
 - Insufficient transparency and communication.
 - Inaccurate accounting for participant principal and interest.

Rapid and forceful action is needed to bring the investment pool in line with industry best practices.

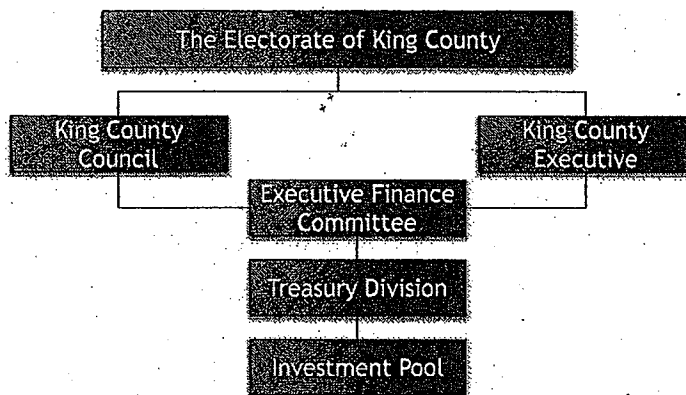
Main Findings

Our recommendations focus on 3 key areas:

- Governance:
 - Institute a fiduciary governing structure.
 - Identify clear investment goals.
- Infrastructure:
 - Enhance infrastructure and operational practices.
- Accountability:
 - Adopt better metrics to measure performance.
 - Improve participant communication and transparency.

Outsourcing is the most cost-effective, efficient, and timely strategy for achieving needed changes.

Current Governance Structure



Current Gaps: Participants are not represented.
Lack of investment expertise.

8

Governance

Best Practice

Fiduciary Standard:

- Duty to avoid conflicts of interest.
- Duty to act prudently.
- Duty to provide diversification.
- Duty to be accountable to all participants.

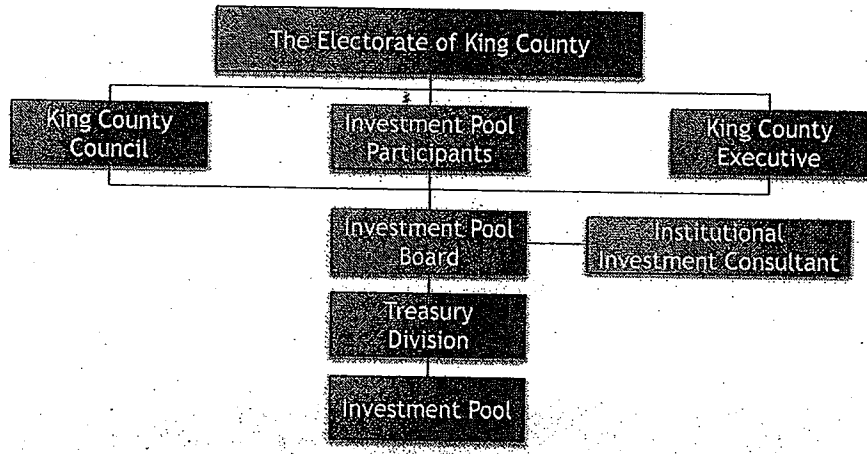
Current Practice

EFC is not set up to be a true fiduciary:

- All members represent King County.
- Expertise is not inherent.
- No formal accountability.

Recommendation: Adopt a new fiduciary governance structure.

Proposed Governance Structure



Investment Pool Board: County, Participants, and Citizen Experts.

Investment Goals

Best Practice

Two possible fund types for investment pools.

- Constant NAV**
- Net Asset Value (NAV) = \$1
 - Money Market Fund
 - "Dollar in = Dollar out"
 - Invests in short term, low-risk securities
 - Targets no change in dollar value of investor's principal
 - Prioritizes principal stability over higher returns

OR

- Variable NAV**
- Net Asset Value (NAV) varies.
 - Shorter Term Bond Fund
 - "Dollar in" not equal to "Dollar out"
 - Invests in longer term securities (max 0-3 years)
 - Fluctuating dollar value of investor's principal
 - Seeks higher returns, principal stability not primary concern

Investment Goals

Current Practice

- King County tries to do both:
 - Participants withdraw and deposit money on “dollar in, dollar out” basis.
 - Pool holds longer term securities for higher returns.
- Does neither well:
 - No controls to meet \$1 expectations.
 - Returns fall short of many variable NAV funds.

Recommendation:

Choose one: Constant NAV or Variable NAV.

Infrastructure

The Daily Investment Process



- Investment process falls short of best practice in a number of areas:
 - Technology
 - Custodial services
 - Credit Analysis
 - Internal Controls
 - Policies and Procedures
 - Staffing
 - Accounting

Infrastructure

Current Practice	Identified Issues	Recommendations
Technology		
<ul style="list-style-type: none"> Outdated, overly manual system 	<ul style="list-style-type: none"> Significant staff time Added operational risk Reduced returns 	<ul style="list-style-type: none"> Automate cash, mark to market, and portfolio reporting systems Portfolio management software with performance measures
Custodian/Bank		
<ul style="list-style-type: none"> Assets not held in central repository Do not fully leverage available custodial services 	<ul style="list-style-type: none"> Manual cash sweep and compliance processes subject to error No quality control from external mark to market Use of fax 	<ul style="list-style-type: none"> All assets with one custodian bank Utilize services of high quality custodian Move to trade date accounting Move to paperless transactions

Infrastructure

Current Practice	Identified Issues	Recommendations
Credit Process		
<ul style="list-style-type: none"> Rely on secondary source for credit ratings 	<ul style="list-style-type: none"> Insufficient credit risk protection Missed opportunities for higher returns Inability to differentiate among investment opportunities 	<ul style="list-style-type: none"> Adopt a credit analysis process to perform credit tests Subscribe to data services of NRSROs
Internal Controls		
<ul style="list-style-type: none"> Investment Officer performs almost all duties 	<ul style="list-style-type: none"> Internal controls protect against potential malfeasance or inappropriate decision making 	<ul style="list-style-type: none"> Regularly update investment procedures Segregate duties Maintain written contracts for all service agreements

Infrastructure

Current Practice	Identified Issues	Recommendations
Investment Policies		
<ul style="list-style-type: none"> Last major revision in 1997 State Law limits eligible investments and instruments 	<ul style="list-style-type: none"> Should be reviewed and updated once a year Changes in the marketplace are not incorporated in a timely fashion Concentration risk 	<ul style="list-style-type: none"> Review and update policies, with specific attention to a number of areas Add a provision requiring an annual review Recommend changes to State Law to diversify investments

Infrastructure

Current Practice	Identified Issues	Recommendations
Accounting		
<ul style="list-style-type: none"> Using simplistic straight-line amortization to value portfolio Using settlement date rather than trade date accounting 	<ul style="list-style-type: none"> Reduced accuracy when valuing the portfolio No audit from specialist in fixed income mutual fund accounting 	<ul style="list-style-type: none"> Adopt SEC requirements Use mark to market pricing to value the portfolio Implement a focused audit every year
Staffing		
<ul style="list-style-type: none"> One investment officer PAO does not have securities law specialist 	<ul style="list-style-type: none"> "Key Man" risk Operational and investment risk exposure 	<ul style="list-style-type: none"> Reexamine staffing model to eliminate risk Enhance current legal structure

Metrics

Best Practice

A robust set of metrics to assess investment decisions and better manage risk.

Current Practice

Current performance metrics are inadequate:

- Benchmarks are inappropriate.
- Risk metrics are simplistic or non existent.
- Reports are insufficient.

Metrics

Best Practice

Sources:

- Securities and Exchange Commission (SEC)
- Global Investment Performance Standards of CFA Institute (GIPS)

Principles:

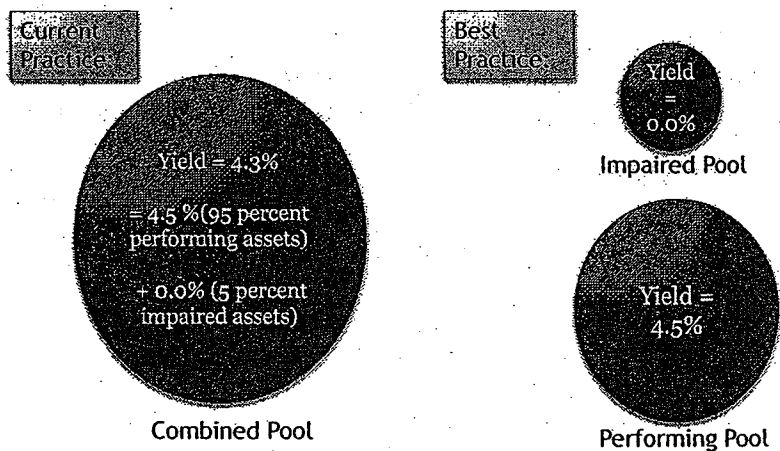
1. Focus on Total Portfolio - Risk and Return
2. Total Return - includes income and principal appreciation
3. Benchmarks:
 - Market Index - relative to unmanaged
 - Peer Universe - relative to other managers
4. Verification of Results - Audit
5. Consistency and Precision:
 - Calculation - Formula Disclosure
 - Time Period
 - Before and After Fees

Metrics

Recommendations:

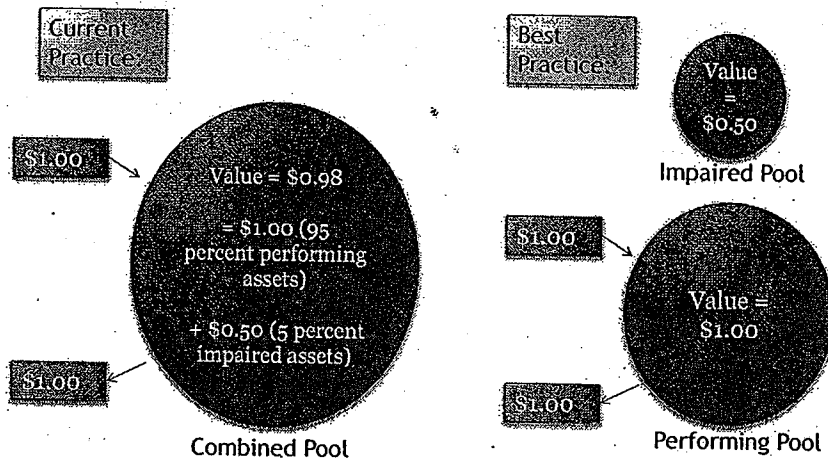
- **Benchmarks:**
 - Establish benchmarks that match investment goals.
- **Risk Management:**
 - Establish comprehensive set of risk metrics.
 - Adopt and manage within a risk metrics framework.
 - Implement stress testing.
- **Reporting:**
 - Overhaul reporting → comprehensive and transparent.
 - Outsource reporting → eliminate operational risk, free up staff time, access needed risk metrics quickly.

Impaired Investments



Recommendation: Bifurcate to ensure correct yields.

Impaired Investments



Recommendation: Bifurcate to ensure correct principal.

Impaired Investments

- Benefits of Bifurcation:
 - Accurate yield and principal calculations.
 - Transparency.
 - Restructuring agreement implementation.
 - Reinstitution of pool rating.

Recommendation: Immediately bifurcate the investment pool.

- Restructuring Agreements:

Recommendation: Base decision on a quantification of options by a qualified fiduciary third party.

External Relations

Recommendations:

- Create formal channels for participant inclusion in policy-making:
 - Inclusion in governance structure.
 - Annual meeting.
- Improve participant communication:
 - More comprehensive reports.
 - Develop website.
- Reinstate rating:
 - Provides outside validation, information, due diligence.
 - Impacts King County's bond rating.

External Relations

Recommendations (cont.):

- Review fee structure based on 5 principles:
 1. Cover costs.
 2. Transparent and regularly updated.
 3. Comparable to market rate.
 4. Equal for all participants.
 5. Sustainable.
- Fee should be set by fiduciary governing body.

Conclusion

- Our recommendations will take time to implement.
- In the interim, the pool is exposed to substantial risk.
- To address this risk, we recommend additional scrutiny and oversight of the investment pool during this time.
- We recommend that the EFC immediately select and hire an institutional investment consultant to advise the EFC in its oversight role.

Conclusion

- Investment Pool provides important public benefit, but falls significantly short of best practices.
- Rapid and forceful action needed to bring it in line with best practices.

Recommendation: Immediately create plan to address challenges. Assess progress after 6 months.

- Future review:
 - Treasury Services.
 - Regular business reviews.