



King County

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

Agenda Item No.: 7

Date: July 23, 2008

Briefing No.: 2008-B0174

Prepared By: William Nogle

STAFF REPORT

SUBJECT: An update on the status of Motion 12796 concerning the King County Investment Pool.

BACKGROUND: On June 16, 2008 the King County Council passed Motion 12796. This motion concerns the King County Investment Pool and the report and recommendations of the King County Investment Pool Advisory Panel (the Panel). The Panel was created by the Council in 2007 to review the policies, procedures, systems and practices of the Investment Pool to identify that should be revised or updated to deal with an increasingly complicated financial market.

The King County Investment Pool (approximately \$4 billion in size) is operated and managed by the Finance and Business Operations Division of the Executive Services Department and includes all invested County funds as well as the funds of approximately one hundred other local governmental agencies. Legal investments for the Pool are prescribed by State law to include US Treasury securities, US government agencies' securities, certificates of deposit, repurchase agreements, commercial paper and local government bonds.

The County charges a fee to the Pool members for such advantages as higher returns on investments and liquidity management.

Elements of Motion 12796 and Progress to Date

Motion 12796 has many sections that each relate to different actions or aspects of Pool operations and management that were addressed by the Panel in their report. Following is a discussion of each separate section and progress to date on the work or processes described in those sections.

❖ Creation of An Inter-Branch Work Group

The IBWG has been meeting weekly. Membership includes the Director of the Finance and Business Operations Division and the Council's Policy Staff Director as co-chairs. The other members are the Director of the Office of Management and Budget, the lead

staff to this committee, the County's chief economist in the Office of Management and Budget, the County Auditor, and the chief accountant in the Finance and Business Operations Division.

❖ **The Charge of the Work Group**

The work group in the Motion is charged with carrying out an extensive work program, summarized below.

Council Intent: That the investment pool will be operated in accordance with industry best practices for a governmental investment pool.

Work Group Purpose: Ensuring that the investment pool meets industry best practices for a governmental investment pool.

Task One: Action plan for bringing the investment pool in line with such industry best practices. Due by July 15, 2008. **Progress: Action plan was submitted to Council on July 16. A new timeline was attached that envisions the due date for the report being extended by one month to October 1.**

Task Two: Work Group's Work Plan

I. Outsourced management

- A. Examine the advisory panel's recommendation to outsource the management of the investment pool
- B. Develop options to implement this recommendation to the extent deemed appropriate and consistent with state law
- C. Advise the council of the reasons for its conclusions and the changes necessary to state law to implement such a measure. **Progress: The Work Group will be briefed on legal issues regarding outsourcing on Wednesday July 23.**

II. Governance

- A. Review the investment pool's governance structure
- B. Develop options for modifying the governance structure in light of the advisory panel's recommendations
- C. Review the advisability of implementing the advisory panel's recommendation that the executive finance committee be replaced by an independent board comprised of both county and non-county participant representatives and three appointed citizen experts. **Progress: The Work Group will be briefed on legal issues regarding governance on Wednesday July 23.**

III. Investment goals and metrics

- A. Provide a report on the investment pool's investment goals and metrics
- B. Examine the panel's recommendation that absent the outsourcing of the management of the investment pool, the appropriate investment goals are those of a constant net asset value fund

- C. Present options for implementing those recommendations it concludes are in the best interests of the investment pool. **Progress: Work on these issues will begin when a consultant is on board (early in August).**

IV. Infrastructure

- A. Review the recommendations of the advisory panel regarding infrastructure
B. Develop options for enhancing the infrastructure of the investment pool
C. Review the advisory panel's recommendation that additional audits of the investment pool are needed. **Progress: Work on these issues will begin when a consultant is on board (early in August).**

V. Prepare Report on I – IV

- A. Provide report to Council by September 1, 2008. **Progress: Action plan was submitted to Council on July 16. A new timeline was attached that envisions the due date for the report being extended by one month to October 1.**

❖ Executive Finance Committee Actions

Investment policies are set by the Executive Finance Committee (EFC) under the King County Code. The EFC consists of the Director of FBOD, the Director of OMB, the County Administrative Officer, and the Council Chair. Motion 12796 requests that the EFC take a number of actions. These actions and progress to date are as follows:

- Review and Update Investment Policies
The investment policies of the Pool have not undergone a major review since 1997. **Progress: FBOD is proceeding.**
- Investment Pool Fee Structure
When other local government agencies encouraged the County to expand Pool membership to other than County funds in the early 1990's, the County agreed to do so as long as there was no negative financial impact to the County. Under State law, the County acts as ex-officio treasurer for most but not all local governments within the County. This includes investing idle cash on behalf of each district and at their specific direction. The County receives a fee for this service but, more importantly, the County could earn interest on any district funds that were not invested (referred to as the "float"). Districts would typically have to leave a portion of their cash balances un-invested in order for them to have enough cash to redeem warrants as they were presented for payment.

By allowing the districts to become part of the Investment Pool, the County would manage the overall pool investments in such a way that all funds of all districts would be 100% invested; in other words, the float would no longer exist. As a condition of allowing these districts to become members of the pool, the County proposed a pool fee sufficiently large enough so that County revenues were not reduced. The initial fee was set at 15 basis points (.15% of average cash/investment balance). The districts agreed to this fee and signed agreements to that effect.

The non-county members became Pool members in 1995. No changes were made to the fee for these pool members over the years even though some of the underlying factors have changed. The Motion requests that the EFC review the fee structure and modify it if such an action was justified.

Progress: On June 26, 2008 the EFC voted to reduce the pool fee to 12 basis points as an interim measure. The fee would be further reviewed during the second half of 2008 as the County determined its direction on the many recommendations of the Panel – changes that could increase the County's direct cost of managing and operating the Pool and that should be considered in setting the fee.

- **Bifurcate the Pool**

In 2007 four of the investments of the Pool became impaired, meaning that the County did not receive its investment back when the securities matured and interest payments were suspended. Separating these impaired investments from the performing investments was recommended by the Panel to better reflect earnings to all pool members. ***Progress: On June 26, 2008 the EFC voted to bifurcate the Pool, effective September 1, 2008.***

- ❖ **Director of Finance Division Actions**

Motion 12796 requests that the Director of the Finance Division take certain actions. These are described below along with progress to date.

- **Review panel recommendation to consolidate assets with a single custodian bank.**

Currently, the County uses a custodian bank for only part of the investments. Certificates of deposit and tri-party repurchase agreements are run through numerous banks. A custodian bank handling all investments would be able to provide services such as pricing, arranging for purchases and sales, collecting interest, managing cash and providing reports. The Director has requested that a consultant analyze of the advantages and disadvantages of consolidating these services, along with cost estimates. A motion approving an RFP for banking services is currently in Committee. The current contracts expire at the end of October.

- **Review accounting practices for the Pool.**

The panel questioned some accounting practices for the Pool. The Finance Director will have finance staff review the accounting practices as well as having a consultant review the same.

- **Inform all pool members of schedule details for EFC meetings and plan for an annual meeting of all members.**

All Pool members are being notified of EFC meetings. Planning is underway to have an annual meeting.

- Enhance current Pool web site and improve the monthly report. Efforts are underway to improve the web site. The Finance division will prepare a briefing for the EFC's July meeting of new elements added to the monthly report.

UPDATE ON IMPAIRED INVESTMENTS: As noted earlier, in 2007 four of the investments of the Pool became impaired, meaning that the County did not receive its investment back when the securities matured and interest payments were suspended. While some return of capital has occurred on these investments, over \$189 million (maturity basis) remains outstanding. These investments were in commercial paper issued by what are called in the financial markets Structured Investment Vehicles (or SIV's). These investments are in receivership with the trustees attempting to restructure them in order to return investors' money to the extent possible.

Given the above factors, the prospects for the County realizing the full amount of these investments is virtually nil. The County for its part wrote off 40% of these investments as of the end of 2007. Any settlement that results in less than 60% recovery would require an additional loss on the books.

The first restructuring auction took place last week for the Cheney SIV. The County selected a cash-out option rather than a zero coupon bond or a "pass-through note. While final settlement is scheduled for this week, it appears that the Pool's recovery on this investment will amount to 60.74% or \$30.4 million on the original investment of \$50 million. This yields a loss of \$19.6 million that will be distributed pro-rata among the pool members who were involved in this particular SIV investment.

INVITED:

- Ken Guy, Manager, Finance and Business Operations Division, Office of Executive Services
- Bob Cowan, Director, Office of Management and Budget

ATTACHMENTS:

1. Matrix: FBOD Director's Action Plan and Progress Report

Adopted Motion #12796: Response to Recommendations of Investment Pool Advisory Panel
 --Action Plan & Progress Report--
 July 22, 2008

Issue Area	Expected Actions (per Motion)	Responsible Party (per Motion)	Due Dates (per Motion)	Progress Report
Out-source Management	<ul style="list-style-type: none"> Examine panel's recommendation to outsource management of pool; develop options for outsourcing to extent deemed appropriate and consistent with state law; and advise council of any changes necessary to state law. 	Inter-Branch Work Group*	Report findings to council by 9-1-08*	<p><i>In progress.</i> Inter-Branch Work Group has reviewed and approved RFP to hire a consultant for under \$25,000. Consultant selection is expected by end of July 2008. Consultant will be asked to prepare a briefing paper on this topic.</p>
Governance	<ul style="list-style-type: none"> Immediately develop plan for including advisory representation on the EFC from non-county participants. 		Implement plan by 10-1-08	<p><i>In progress.</i> Draft plan will be presented to EFC at August 28th meeting.</p>
	<ul style="list-style-type: none"> Receive briefings, at least quarterly, from financial consultant regarding policies, practices and portfolio holdings. 	Inter-Branch Work Group (EFC is also responsible party)	At least quarterly	<p><i>Fully Completed.</i> PFM completed overall evaluation of portfolio in April 2008. Results are posted on county's web site. PFM concluded that with exception of four impaired investments, the county's pool is financially sound.</p> <p>PFM will continue to prepare reports on policies, practices and holdings, at least quarterly. PFM has provided its</p>

* All work products of Inter-Branch Work Group are dependent on consultant deliverables; due dates may shift by a few weeks, but goal remains to complete all tasks for a report to the council by October 2008.

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				<p>perspectives and advice on recent situation involving government sponsored enterprises (Fannie Mae & Freddie Mac). Next quarterly report due in August will be submitted to both the EFC and the Inter-Branch Group.</p>
	<ul style="list-style-type: none"> Advise on longer term modifications to governance structure of EFC, including panel's proposal for independent board of county and non-county representatives and three appointed investment professionals. 	Inter-Branch Work Group	Report findings to council by 9-1-08*	<p><i>In progress.</i> New consultant to be hired by Inter-Branch Work Group will be providing their perspectives on optional governance structures.</p>
	<ul style="list-style-type: none"> Review options for changing limitations in state law regarding types of fixed income investments that may be held by the pool. 	Inter-Branch Work Group	Report findings to council by 9-1-08*	<p><i>In progress.</i> New consultant to be hired by Inter-Branch Work Group will be making recommendations.</p>
Goals and Metrics	<ul style="list-style-type: none"> Provide report on pool's goals and metrics, including an examination of whether pool should be constant or variable NAV and whether in-house staffing would only be appropriate if the pool is a short-term, constant NAV fund. The report should rely on an outside 	Inter-Branch Work Group	Submit report to EFC, the council and executive by 9-1-08* Implement new goals and	<p><i>In progress.</i> This will be one of the key deliverables for new consultant hired by Inter-Branch Work Group.</p>

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	financial consultant for expert advice.		metrics by 11-1-08.	
Infrastructure	<ul style="list-style-type: none"> Develop options for enhancing infrastructure (technology, staffing, and internal procedures), including the feasibility of using an external fund manager to address critical infrastructure needs. 	Inter-Branch Work Group	Present options in a report to council by 9-1-08*	<p><i>In progress.</i> New consultant will address this topic. In addition, PFM provided a memo describing service level scenarios and related costs for out-sourcing certain pool services. This memo will be distributed to Inter-Branch Work Group and the EFC as additional background information. Note that infrastructure needs are heavily dependent on goals selected for the pool.</p>
	<ul style="list-style-type: none"> Review need and scope of annual audit conducted by an auditor with expertise in fixed income securities and practices. 	Inter-Branch Work Group	Present in report to council by 9-1-08*	<p><i>In progress.</i> New consultant hired by Inter-Branch Work Group will provide perspectives and advice.</p>
	<ul style="list-style-type: none"> Review panel recommendation to consolidate assets with a single custodian bank. 	FBOD Director	Present report to EFC by 10-1-08	<p><i>In progress.</i> PFM has been asked to comment on recommendation by August 28th EFC meeting.</p>
	<ul style="list-style-type: none"> Review accounting practices of the pool. 	FBOD Director	Present report to EFC by 8-1-08	<p><i>In progress.</i> Finance have initiated an internal review based on the panel's recommendations. Some accounting practices are influenced by type of investment pool. PFM has been asked to comment on current accounting practices as compared to</p>

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				practices of other government investment pools. A preliminary report will be delivered to the EFC at the July 24 th meeting, with a final report due in August or September, pending decisions about the future goals and direction of the pool.
	<ul style="list-style-type: none"> Review and update investment policies to reflect current practices and polices in relevant areas. 	EFC	EFC completes review by 11-1-08.	<p><i>In progress.</i> Finance staff have started to identify policies that must be updated. PFM will be asked to advise on need for new policies and will assist county in developing such policies. Final drafts of most urgently needed updates or new policies will be ready for EFC adoption by October 23rd meeting.</p>
External relations	<ul style="list-style-type: none"> Inform all pool members of date, time, place, and agenda for EFC meetings five business days before each meeting. 	FBOD Director	Monthly	<p><i>Partially completed.</i> Finance staff will do its best to meet this commitment, with the understanding that urgent demands related to the restructuring of the impaired investments may occasionally affect timing of distribution during the second half of 2008.</p>
	<ul style="list-style-type: none"> Plan and conduct annual meeting of pool members to discuss pool performance and policies, as well 	FBOD Director	Annual	<p><i>In progress.</i> Finance will plan this first annual meeting for either November or early December 2008. Meeting date and location will be set</p>

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	<p>as investment strategy for coming year.</p> <ul style="list-style-type: none"> Develop and distribute improved monthly report. 	FBOD Director	Monthly	<p>no later than August.</p> <p><i>Partially completed.</i> The monthly report for May and June 2008 included additional information about impaired investments and showed NAV of impaired investments separate from NAV of the performing assets. Continued improvements will be made to monthly report based on feedback of pool members and EFC. PFM has agreed to provide sample reports issued by pools they advise or manage. Progress will be reported to EFC members at regular monthly meetings.</p>
	<ul style="list-style-type: none"> Enhance current web site, including general information about the pool, investment policies, and monthly reports. 	FBOD Director	Monthly	<p><i>Partially Completed.</i> Additional information about investments has been added to Treasury web site, including monthly pool reports. EFC will receive updates at regular monthly meetings.</p>
	<ul style="list-style-type: none"> Review the investment pool fee structure. 	EFC	Update council by 7-15-08	<p><i>Partially Completed.</i> EFC met on June 26th and adopted an interim 20 percent reduction to fees from 15 to 12 basis points, contingent on signing amended pool agreements which make the reduction effective July 1, 2008. This is considered an interim</p>

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Impaired Investments	<ul style="list-style-type: none"> • Obtain services of qualified investment manager to advise on the impaired investments. 	EFC	Immediate	<p>approach pending upcoming discussion and reports on panel's recommendations, which could impact future fee structure.</p> <p><i>Fully Completed.</i> Finance entered into a contract with Cairn Capital in March 2008 for reviewing impaired portfolios, establishing pricing levels and evaluating restructuring options. Cairn Capital is a recognized expert in asset-back securities. In addition, PFM was hired in September 2007 and completed a general assessment on commercial paper and separate reports on the quality of each impaired investment. PFM also created financial models to help the County compare and contrast restructuring options. The information and financial models from both consultants were used by the EFC to weigh the economics and risks of each option for the recently completed Cheyne restructuring.</p> <p><i>Partially completed.</i> At the June 26th meeting, the EFC approved a motion to bifurcate the pool effective September 1, 2008. This effective</p>
	<ul style="list-style-type: none"> • Immediately consider the issue of bifurcating the pool, thereby separating impaired investment from the performing investments. 	EFC	Immediate	

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				date was selected based on the feedback from outside pool members who needed time to inform their respective officials/boards. The EFC plans to consider technical amendments to the impaired investment policy that will support pool bifurcation at the July and/or August meetings.
Performance Audit	<ul style="list-style-type: none"> Conduct a performance audit of cash management and investment functions to ensure the two functions are working efficiently together. 	County Auditor	To be determined.	
Business Review	<ul style="list-style-type: none"> Conduct a business review of investment pool functions once every three years. 	EFC	Three year cycle	
Quarterly Reports	<ul style="list-style-type: none"> Report on specific steps taken and progress made on the recommendations in the motion. 	FBOD Director	Quarterly	<i>In progress.</i> Finance plans to complete the first quarterly report by the first week of October 2008. The format for the quarterly report will be this document and a cover letter.