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## **ELIGIBLE INVESTMENTS FOR PUBLIC FUNDS IN THE STATE OF WASHINGTON**

**Following is a list of eligible investments and the RCW cites for them. The complete text of the RCWs may be found at the end of the list.**

### **RCW 39.59.020:**

- Bonds of any state or local government
  - bonds must have, at the time of investment, one of the three highest credit ratings of a nationally recognized rating agency.
- Any investments authorized by law for the State Treasurer or any local government of the State
  - does not include certificates of deposit of banks or bank branches not located in the State of Washington.

### **RCW 35.39.030:**

- Utility revenue bonds or warrants of any city or town in the State of Washington.
- Bonds or warrants of a local improvement district
  - must be within the protection of the local improvement guaranty fund law.
- Bond proceeds subject to the arbitrage provisions of section 148 of the federal internal revenue code may be invested in:
  - Shares of mutual funds that invest in
    - United States government bonds or United States government guaranteed bonds issued by federal agencies with average maturities less than four years, or bonds of state and local governments that have one of the four highest credit ratings of a nationally recognized rating agency;
  - Shares of money market funds that invest in
    - bonds of states and local governments or other issuers authorized by law for investment by local governments, which bonds have one of the two highest credit ratings of a nationally recognized rating agency; or,
    - securities otherwise authorized by law for investment by local governments.

**RCW 43.84.080:**

- Treasury Bills
- Treasury Bonds
- Federal Home Loan Bank Bonds
- Federal Home Loan Bank Discount Notes
- Federal National Mortgage Association Bonds
- Federal National Mortgage Association Discount Notes
- Federal Farm Credit Banks Consolidated System-Wide Bonds
- Federal Farm Credit Banks Consolidated System-Wide Discount Notes
- Federal Home Loan Mortgage Corporation Bonds
- Federal Home Loan Mortgage Corporation Discount Notes
- Government National Mortgage Association Bonds
- Student Loan Marketing Association Bonds
- Student Loan Marketing Association Discount Notes
- Small Business Administration Bonds
- Export-Import Bank Bonds
- Maritime Administration Bonds
- 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.
- Bankers' acceptances purchased on the secondary market.
- Commercial paper: provided that the Treasurer shall adhere to the investment policies and procedures adopted by the State Investment Board.
- State, county, municipal, or school district bonds, or in warrants of taxing districts of the state.
  - Such bonds and warrants shall be only those found to be within the limit of indebtedness prescribed by law for the taxing district issuing them and to be general obligations.
- Motor vehicle fund warrants
  - Must be authorized by agreement between the State Treasurer and the department of transportation requiring repayment of invested funds from any moneys in the motor vehicle fund available for state highway construction.

**RCW 43.250.040**

- The Local Government Investment Pool

## **COMPLETE TEXT OF RCWs PERTAINING TO ELIGIBLE INVESTMENTS FOR PUBLIC FUNDS**

### **RCW 39.59.020 Authorized Investments - Bonds, Warrants, and Other Investments**

In addition to any other investment authority granted by law and notwithstanding any provision of law to the contrary, the State of Washington, and local governments in the State of Washington are authorized to invest their funds and money in their custody or possession, eligible for investment, in:

- (1) Bonds of the State of Washington and any local government in the State of Washington, which bonds have at the time of investment one of the three highest credit ratings of a nationally recognized rating agency;
- (2) General obligation bonds of a state other than the State of Washington and general obligation bonds of a local government of a state other than the State of Washington, 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; or
- (4) Any investment authorized by law for the Treasurer of the State of Washington or any local government of the State of Washington other than a metropolitan municipal corporation but, except as provided in Chapter 39.58 RCW, such investments shall not include certificates of deposit of banks or bank branches not located in the State of Washington.

### **RCW 39.59.030 Authorized Investments - Mutual Funds and Money Market Funds**

In addition to any other investment authority granted by law, the State of Washington and local governments in the State of Washington are authorized to invest their funds and money in their custody or possession, eligible for investment and subject to the arbitrage provisions of Section 148 of the federal internal revenue code or similar provisions concerning the investment of state and local money and funds in:

- (1) Shares of mutual funds with portfolios consisting of only United States Government bonds or United States Government guaranteed bonds issued by federal agencies with average maturities less than four years, or bonds described in RCW 39.59.020 (1) or (2), except that bonds otherwise described in RCW 39.59.020 (1) or (2) shall have one of the four highest credit ratings of a nationally recognized rating agency;
- (2) Shares of money market funds with portfolios consisting of only bonds of states and local governments or other issuers authorized by law for investment by local governments, which bonds have at the time of investment one of the two highest credit ratings of a nationally recognized rating agency; or
- (3) Shares of money market funds with portfolios consisting of securities otherwise authorized by law for investment by local governments.

### **RCW 43.84.080 Investment of Current State Funds**

Wherever there is in any fund or in cash balances in the state treasury more than sufficient to meet the current expenditures properly payable therefrom, the State treasurer may invest or reinvest such portion of such funds or balances as the State treasurer deems expedient in the following defined securities or classes of investments:

- (1) Certificates, notes, or bonds of the United States or any other obligations of the United States or its agencies or of any corporation wholly owned by the government of the United States;
- (2) In state, county, municipal, or school district bonds, or in warrants of taxing districts of the State. Such bonds and warrants shall be only those found to be within the limit of indebtedness prescribed by law for the taxing district issuing them and to be general obligations. The State treasurer may purchase such bonds or warrants directly from the taxing district or in the open market at such prices and upon such terms as it may determine, and may sell them at such times as it deems advisable;
- (3) In motor vehicle fund warrants when authorized by agreement between the State treasurer and the department of transportation requiring repayment of invested funds from any moneys in the motor vehicle fund available for state highway construction;
- (4) In 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) Bankers' acceptances purchased on the secondary market;
- (6) Negotiable certificates of deposit of any national or state commercial or mutual savings bank or savings and loan association doing business in the United States: Provided, That the treasurer shall adhere to the investment policies and procedures adopted by the State investment board;
- (7) Commercial Paper: Provided, that the treasurer shall adhere to the investment policies and procedures adopted by the State investment board.

### **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, or resolution, a local government official or financial officer 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.

## COMMON INVESTMENT VEHICLES

### **Bankers' Acceptance**

A bankers' acceptance (BA) is a unique credit instrument used to finance both domestic and international self-liquidating transactions. By definition, a bankers' acceptance is a time draft, that is, an order to pay a specified amount of money to the acceptance holder on a specified date. BA's are drawn on and accepted by a bank that, accepting the draft, assumes responsibility to make payment on the draft at maturity. From the standpoint of security, a bankers' acceptance is an irrevocable primary obligation of the accepting bank, and a contingent obligation of the drawer and of any endorsers whose names appear upon it. The bank is protected by its customer's agreement to provide good funds by the time the acceptance matures and by the pledge of documents such as invoices, bills of lading, independent warehouse or terminal receipts, trust receipts, and other papers evidencing ownership and insurance of the goods financed. Since its inception 75 years ago, the bankers' acceptance has come through the trials of war and economic depression with no known principal loss to investors. Courts have held that the letter of credit agreement from inception to conclusion is based on the principle that the accepting bank holds the agreement not for its own benefit or the benefit of its general creditors, but in trust for the holder of the acceptance.

Foreign acceptances are U.S. dollar denominated acceptances backed by the credit of foreign banks or agencies domiciled in the United States. Foreign BA's have the same characteristics as domestics. There has been no principal loss to investors in foreign BA's.

An example of a bankers' acceptance creation would be as follows:

Consider a Seattle car dealer who wishes to finance the importation of Japanese cars on an acceptance basis. The American importer, after negotiating with the exporter in Japan, arranges for his American commercial bank to issue an irrevocable letter of credit in favor of the exporter. The letter of credit specifies the details of the shipment and states that the Japanese exporter may draw a time draft for a certain amount on the American bank. The Japanese exporter, in conformity with the terms of the letter of credit, draws a draft on the American bank, receiving immediate payment. The exporter's Japanese bank then forwards the draft to the United States for presentation to the bank that issued the letter of credit. This bank stamps the draft "accepted", thus incurring an obligation to pay the draft at maturity. An acceptance has been created.

The new acceptance is discounted for the Japanese bank by the accepting bank and the proceeds credited to the account of the Japanese bank. The accepting bank, in turn, may either sell the acceptance or hold it in its own portfolio. The importer is obligated to deposit the proceeds of the car sales at the accepting bank in time to honor the acceptance. At maturity, the acceptance is presented for payment by its owner and the transaction is completed.

Acceptances generally have maturities of 180 days or less (with 90 days being the most typical). They are quoted, bought, and sold on a discount basis.

## **Commercial Paper**

Commercial paper (CP) is a short-term debt obligation, where there is a promise to repay a fixed amount on a certain future date. CP is issued by banks, corporations, and other borrowers.

CP is issued with maturities ranging from overnight to 270 days. Though some CP is interest bearing, most are quoted, bought, and sold on a discount basis.

RCW 39.59.020(4) authorizes local governments to invest in “Any investments authorized by law for the treasurer of the state of Washington ...” RCW 43.84.080(7) authorizes the state treasurer to invest in commercial paper, but only to the extent consistent with the policy of the State Investment Board (SIB). The CP policy guidelines adopted by the SIB (Policy No. 2.05.500; adopt. 2/18/99, rev. 10/25/01), for entities with funds under management of less than ten billion dollars, are as follows:

- (1) Commercial paper must be rated with the highest short-term credit rating of any two Nationally Recognized Statistical Rating Organizations (NRSROs), at the time of purchase. If the commercial paper is rated by more than two NRSROs, it must have the highest rating from all of the organizations.
- (2) Commercial paper holdings may not have maturities exceeding 180 days.
- (3) Any commercial paper purchased with a maturity longer than 100 days must also have an underlying long-term credit rating at the time of purchase in one of the two highest rating categories of an NRSRO.
- (4) The percentage of commercial paper may not exceed 25 percent of the total assets of the portfolio.
- (5) The percentage of commercial paper that can be purchased from any single issuer is five percent of the total assets of the portfolio.
- (6) Commercial paper must be purchased in the secondary market and not directly from the issuers.
- (7) Portfolio managers will routinely monitor the ratings of the issuers of the commercial paper they are purchasing. Appropriate personnel will be notified of any credit rating downgrades of issuers of any commercial paper in their portfolios.

## **Federal Agency Securities**

From time to time, Congress becomes concerned about the volume of credit that is available to various sections of the economy and the terms at which that credit is available. Its usual response is to set up a federal agency to provide credit to that sector.

Those agencies borrowing in the open market do so primarily by issuing notes and bonds. These securities bear interest, and they are issued and redeemed at face value. Instead of using the auction technique for issuing their securities, federal agencies look to the market to determine the best yield at which they can sell a new issue, put that yield on the issue, and then sell it through a syndicate of dealers. Some agencies also sell short-term discount paper that resembles a Treasury bill.

Normally, agencies yield slightly more than the Treasury securities of the same maturity. There are several reasons for this. Agency issues are smaller than Treasury issues and are, therefore, somewhat less liquid. Also, while all agency issues have de facto backing from the federal government (it is inconceivable that the government would let one of them default on its obligations), the securities of only a few agencies are explicitly backed by the full faith and credit of the U.S. Government. Thus, some investors view some agency securities as carrying a small but perceptible credit risk. A third disadvantage of some agency issues is that interest income from them is not exempt from state taxation. Agencies are generally traded by the same dealers who trade governments and in much the same way.

The most commonly traded agencies are:

- **Federal Home Loan Banks**

The Federal Home Loan Bank System was organized under the Federal Home Loan Bank Act and opened for business in October 1932. The twelve District Banks comprising the system are distributed geographically around the country similarly to the Federal Reserve Banks and operate as a credit reserve system for the thrift industry to stabilize the flow of mortgage credit to the public. The District Banks are wholly owned by their member institutions but operate under the supervision of the Federal Home Loan Bank Board, an independent federal agency. The Bank Board issues all federal charters for savings and loan associations and mutual savings banks. Membership for thrift institutions chartered by the Banks' Board is mandatory. At the end of 1983, membership consisted of over 3,400 financial institutions. Debt is issued as consolidated obligations of the twelve Federal Home Loan Banks. Although system debt is not guaranteed by the U.S. Government, the banks do operate under federal charter and government supervision.

Consolidated bonds are issued only in book entry form for a minimum of \$10,000 with multiples of \$5,000 thereafter. Bond financings are scheduled once a month and the system enters the market if funds are needed. Bonds are for longer term funding requirements with maturities generally ranging from one year to ten years. Consolidated obligations issued on a discount basis to mature in one year or less are designated consolidated discount notes. The buyer at the time of purchase may select maturities, within the 30-360 day range, subject to the general limitations prescribed by the system. They are issued in book-entry form only and are available in denominations of \$100,000, \$150,000, and \$1,000,000.

- **Federal Home Loan Mortgage Corporation (Freddie Mac)**

The Federal Home Loan Mortgage Corporation (FHLMC) was created in July 1970 through enactment of Title III of the Emergency Home Finance Act of 1970. The organization's purpose is to promote the development of a nation-wide secondary market in conventional residential mortgages. To accomplish this, the FHLMC buys residential mortgages and then resells them via the sale of mortgage related instruments. The FHLMC operations are directed by the Federal Home Loan Bank System. The FHLMC may purchase mortgages only from financial institutions that have their deposits or accounts insured by agencies of the federal government. It purchases only conventional residential mortgages and FHA/VA mortgages, then sells its interest in the mortgages it purchases through mortgage-backed,



pass-through securities. Specifically, the FHLMC sells two types of pass-through securities: mortgage participation certificates (PC's) and guaranteed mortgage certificates (GMC's). Each PC represents an undivided interest in a pool of conventional residential mortgages underwritten and previously purchased by the FHLMC. Each month the certificate holder receives a prorated share of the principal and interest payments made on the underlying pool. The FHLMC guarantees timely payment of interest on PC's and the full return of principal to the investor. While PC's technically have a maturity at issue of 30 years, their average weighted life is assumed to be 12 years or less.

Guaranteed mortgage certificates also represent an undivided interest in conventional residential mortgages underwritten and previously purchased by the FHLMC. These certificates pay interest semiannually and return principal once a year in guaranteed maximum amounts. The final payment date on GMC's is 30 years from the date of issue, but the expected average weighted life of these securities is around 10 years.

Both PC's and GMC's are issued in registered form in initial principal amounts of \$100,000, \$500,000, and \$1,000,000.

- **Government National Mortgage Association (Ginnie Mae)**

The 1968 partition of the Federal National Mortgage Association spawned the Government National Mortgage Association. Ginnie Mae is a wholly government-owned corporation within the Department of Housing and Urban Development. It took over the special assistance and the management and liquidating functions that had formerly been lodged in FNMA. These functions involve activities that could not be profitably carried out by a private firm. Ginnie Mae's mission is also to make real estate investment more attractive to institutional investors which it has done by designing and issuing, partly in conjunction with private financial institutions, mortgage-backed securities for which an active secondary market has developed. Under the pass-through approach, private mortgage lenders assemble pools of mortgages acquired through Ginnie Mae auctions or from other sources and then sell certificates backed by these mortgages to investors. These securities are referred to as pass-through securities because payment of interest and principal on mortgages in the pool is passed on to the certificate holders after deduction of fees for servicing and guarantee. Pass-through certificates have stated maturities equal to those of the underlying mortgages. However, actual maturities tend to be much shorter because of prepayments, the average life on single family mortgages being approximately 12 years. On pass-through securities, principal and interest are paid monthly to the investor. Because payments are made monthly and because the amount passed through varies from month to month due to mortgage prepayment, pass-throughs are issued in registered form only. They have minimum denominations of \$25,000. They carry Ginnie Mae's guarantee of timely payment of both principal and interest and, in addition, are backed by the full faith and credit of the U.S. Government.

- **Federal Farm Credit Banks Consolidated System-wide Bonds**

The Farm Credit System is a cooperatively owned nationwide system of banks and associations that provides mortgage loans, short and intermediate-term credit and related

services to farmers, ranchers, producers, or harvesters of aquatic products, rural homeowners, and agricultural and rural cooperatives. The Farm Credit System is organized geographically into 12 Farm Credit Districts. In each district, there is a Federal Land Bank, a Federal Intermediate Credit Bank, and a Bank for Cooperatives. In addition, there is a Central Bank for Cooperatives in Denver, Colorado, which participates with district banks in larger loans. Responsibility for supervising the Farm Credit System in the public's best interest is the Farm Credit Administration, which is an independent agency of the U.S. Government. Each of the 37 Farm Credit Banks is audited and examined at least once each year by Farm Credit Administration examiners. Federal Farm Credit Banks Consolidated System-wide Bonds are secured joint and several obligations of the 37 Farm Credit Banks. Bonds are issued each month with six and nine-month maturities. Longer-term bonds are issued approximately eight times a year. They are issued in book-entry form, in multiples of \$1,000 for maturities of over 13 months and of \$5,000 for shorter maturities. System-wide bonds sold to the public are secured by collateral consisting of notes or other obligations of borrowers, obligations of the United States or any agency thereof, or other readily marketable securities approved by the Farm Credit Administration, or cash, in an aggregate value equal to the bonds outstanding. The system also issues discount notes with maturities ranging from 7 to 270 days.

- **Federal National Mortgage Association (FNMA)**

The Federal National Mortgage Association is a government chartered corporation owned entirely by private stockholders. It is subject to regulation by the Secretary of Housing and Urban Development. Originally chartered in February, 1938, it was partitioned in 1968 into two corporations: Federal National Mortgage Association and Government National Mortgage Association. FNMA was authorized to render supplementary assistance to the secondary market for federally guaranteed or insured mortgages. However, under the Emergency Home Finance Act of 1970, FNMA is also empowered, with the approval of the Secretary of Housing and Urban Development, to purchase, service, lend on the security of, sell, and otherwise deal in mortgages not federally insured or guaranteed.

Mortgages and loans insured by the Federal Housing Administration, or guaranteed by the Administrator of Veterans Affairs, or insured by the Farmers Home Administration are purchased by FNMA from an approved list of mortgage sellers, including mortgage companies, and from any federal agency authorized to sell such mortgages or loans. Purchases of mortgages by FNMA are financed by the sale of debentures and short-term notes to private investors. FNMA also issues short-term discount notes with maturities ranging from 30 to 360 days. Discount notes are issued in denominations of \$5,000, \$10,000, \$25,000, \$100,000, \$500,000, and \$1,000,000. The minimum order is \$50,000.

- **Student Loan Marketing Association (Sallie Mae)**

The Student Loan Marketing Association is a stockholder owned corporation established by the Higher Education Act of 1965. Sallie Mae has broad statutory authority to provide liquidity for banks, savings and loans, educational institutions, state agencies, and other lenders engaged in the Federal Guaranteed Student Loan Program and the Health Education Assistance Loan Program in a manner which will increase the amount of funds available for lending and to otherwise support the credit needs of students. Loans originated under the

GSLP and HEAL are either insured directly by the U.S. or guaranteed by state or nonprofit private agencies and reinsured by the U.S.

The federal government has oversight responsibilities with respect to certain aspects of Sallie Mae's activities. One third of Sallie Mae's 21 member board of directors and its chairman are designated by the President of the United States. Sallie Mae is permitted to conduct business without regard to any qualification or similar statute in any state of the United States. Sallie Mae finances its market activities primarily from the sale of its debt securities. The Higher Education Act permits the Secretary of Education to guarantee Sallie Mae obligations, regardless of maturity, issued prior to September 30, 1984. From 1974 through 1982, Sallie Mae financed its activities principally through the issuance to the Federal Financing Bank of such obligations. In May 1981, Sallie Mae began to finance its operation in part through the issuance of non-guaranteed discount notes. These notes are unsecured debt obligations having a maturity of no longer than one year and are issued on a daily basis in minimum denominations of \$100,000 and multiples of \$50,000 above that amount. In 1982, they began to offer, on a public basis, non-guaranteed floating rate notes with maturities generally of three years or longer. Interest on these notes is generally adjusted on the basis of the bond equivalent yield of the 91-day Treasury Bill rate. Sallie Mae also offers to the public, from time to time, long-term fixed rate securities. In February 1984, Sallie Mae also began issuing short-term floating rate notes, at a spread to the bond equivalent yield on the 91-day Treasury Bill. The rates are offered monthly.

The Internal Revenue Service has ruled that Sallie Mae is an instrumentality of the United State for the purposes of the IRS code. As a result of this, domestic building and loan associations and mutual savings banks are permitted to include Sallie Mae obligations among those assets defined as "stock or obligations of a corporation which is an instrumentality of the United States".

- **Small Business Administration (SBA)**

The Small Business Administration was created in 1953 and derives its present authority from the Small Business Act of 1958 as amended and various other laws. SBA provides financial, procurement, and management assistance to small business concerns and also assists victims of natural and other disasters. SBA aid to small business firms includes both direct loans and guaranteed loans. As part of its financial assistance functions, SBA makes loans to small business investment companies (SBIC's) which are privately owned, SBA-licensed and regulated companies that supply venture capital and long-term financing to small firms. Under a guaranty authority which became law on December 22, 1971, SBA may (when authorized in appropriate acts) guarantee the timely payment of all principal and interest as scheduled on SBIC debentures. The SBA guaranty is secured by the full faith and credit of the United States. Currently, all such sales of debentures are being made to the Federal Financing Bank which is subject to the general supervision and direction of the United States Treasury. When a lender makes a SBA loan, 90 percent of the loan is guaranteed by SBA. The guaranteed portion of SBA loans can be sold by lenders to brokers/dealers or directly to investors via SBA forms 1084 or 1086 (secondary participation

guaranty agreements), the latter to utilize the services of the fiscal and transfer agent. The overwhelming proportion of SBA guaranteed loans sold into the secondary market are regular business loans. Only the entire guaranteed portion can be sold. Although it is legally permissible that there might be multiple owners of this guaranteed interest, there can be but one registered holder (SBA form 1086) or holder (SBA form 1084) entitled to ownership benefits of the guaranteed interest. Under the fiscal and transfer agent or older 1084 systems below, however, the owner may be an individual, joint tenants, tenants in common, or tenants by the entirety. Borrower payments of principal and interest are apportioned between the lender and investor according to their respective ownership interests and the servicing fee of the lender. SBA's secondary market operations changed materially in 1979, when nationwide implementation of the Fiscal and Transfer Agent program commenced. A registered, negotiable instrument identified as the guaranteed interest certificate is the only documentation evidencing ownership which the secondary investor need retain. SBA's fiscal and transfer agent issues these certificates and serves as the central registry of certificate ownership. All subsequent transfers are made between the seller and buyer without review or approval by SBA, but with the involvement of the fiscal and transfer agent. Trades are effected by the transfer agents issuing a new certificate to the owner. The fiscal and transfer agent is the custodian of loan documentation, bills lenders for monthly payments, and receives borrowers' monthly payments from lenders. In turn, the fiscal and transfer agent provides one aggregate payment to the registered holder, regardless of the number of certificates owned, along with an accounting of the transaction. When a lender decides to sell the guaranteed portion of a fully disbursed SBA loan - and only the entire guaranteed portion can be sold - a sale is negotiated with a broker/dealer or directly with an investor. Secondary market sales to investors electing the services of the fiscal and transfer agent must be accomplished on SBA form 1086, a tripartite secondary participation guaranty and certification agreement. A loan document package (to consist of the 1086, copies of the note, and commitment letter identifying the settlement date, along with a transcript of account) is then forwarded to the SBA servicing district office, SBA executes the 1086 after a satisfactory in-house review. Wire transfer of funds permits settlement and certificate issuance to the investor by the fiscal and transfer agent. The lender remains responsible for servicing the loan.

An optimal method of sale is the use of the old SBA form 1084, secondary participation guaranty agreement. This method of sale does not utilize the services of the fiscal and transfer agent; thus, the benefits of the certificate system do not flow to the investor. A tri-party agreement, SBA form 1084, containing the lender's annual servicing fee, is first executed by the lender and broker/investor. SBA must satisfactorily complete an in-house review before execution of form 1084 at the time of initial sale. The fully executed original of the 1084 and a copy of the borrower's note evidence the investor's ownership. Under both the 1084 and 1086 sale process, a holder of the guaranteed interest must have no interest in the borrower in the note, or in the collateral hypothecated to the loan. All subsequent transfers are arranged between the seller and buyer. Resale of the guaranteed interest by the investor holding a SBA form 1084 includes drafting a transfer instrument and providing written notice to the lender and SBA by copy of the executed assignment document. The transferee must not be the borrower or an associate of the borrower or lender.

There is one caveat that the public funds investor should be aware of in dealing with SBA's. In the event of either default by the borrower or repayment by the borrower, the investor will receive the par value of the SBA. Thus, if the security was purchased at a premium, the investor would face a principal loss on the investment.

## **Local Government Investment Pool**

The LGIP is comparable to a Rule 2a-7 money market fund recognized by the Securities and Exchange Commission (17CFR.270.2a-7). Rule 2a-7 funds are limited to high quality obligations with limited maximum and average maturities, the effect of which is to minimize both market and credit risk.

The objectives of the State Treasurer's investment practices for the LGIP, in priority order, will be: safety, liquidity, and return on investment. To provide for the safety and liquidity of funds deposited in the LGIP, the state treasurer and designated investment officers shall:

- adhere to all restrictions on the investment of funds established by law and by this policy;
- limit the purchase of investments in securities so that the average maturity of the portfolio does not exceed 90 days;
- limit the purchase of investments to securities that have a maximum maturity of 397 days, except securities used as collateral in repurchase agreements;
- limit the purchase of investments in securities other than those issued by the U.S. government or its agencies; and,
- prepare regular reports of portfolio activity.

Within the restrictions necessary to ensure the safety and liquidity of funds, the investment portfolio of the LGIP will be structured to attain a market rate of return throughout budgetary and economic cycles.

## **Repurchase Agreements and Reverse Repurchase Agreements**

The Repurchase Agreement, or repo, is an integral part of the bond and money markets. The investor, dealer community, and Federal Reserve Open Market Committee all depend on the repo. The investor, typified by local public funds managers, relies upon the repo to invest funds that are temporarily available. No other investment vehicle provides the flexibility of the repo.

The dealer community relies upon the repo to finance the huge positions they carry that enable the money markets to operate in the efficient manner in which they do. Without the repo to finance their positions, the market would lose the liquidity that it now enjoys and the U.S. Treasury would find it much more difficult to sell the vast amounts of debt necessary to finance government operations.

Finally, the Federal Reserve depends on the repo to implement its monetary policy. Without it, the Fed would find it extremely difficult to control the money supply. It utilizes the repo to inject funds

into the banking system when it deems necessary. By entering into repurchase agreements with the dealer community, it exchanges funds for securities that are in dealer positions. The dealers then deposit those funds with their banks, thus increasing the amount of dollars available in the banking system. By doing reverse repo's, the Fed accomplishes the opposite goal, or removes funds from the system.

The collapse of several securities firms during the last few years created a great deal of anxiety among investors who routinely utilize the repurchase agreement to aid them in carrying out their cash management responsibilities. Historically, the repurchase agreement was regarded by the investor as a purchase of securities and a simultaneous commitment on the part of the buyer to resell the securities to a dealer at a specified rate of interest. This definition was cast into doubt by the finding of a Federal Bankruptcy judge that the stay provisions of the bankruptcy code applied to repo transactions. This action froze all of the assets of the firm involved, including the securities involved in repos. Those assets would potentially remain frozen until the liquidation of the firm or its reorganization. Previously, investors had felt they were placing their funds in a virtually risk-free investment vehicle. However, in light of these proceedings, the investment community had to reassess the future of the repurchase agreement. The court's decision cast doubt in a bankruptcy context, on the liquidity and safety of repos. The decision not only subjected the repo participants involved to unanticipated liquidity pressures, but also exposed those participants to an increased risk of capital loss because of potential changes in interest rates. If repo's were to be subject to the automatic stay provisions in bankruptcy, the rippling effect of the potential loss of liquidity or capital on market participants could generally disrupt the repo market and cause an otherwise manageable and isolated problem to become generalized. Because of this, and at the urging of various groups, such as the Federal Reserve, the dealer community and the Western State Treasurers, Senator Dole, Chairman of the senate Judiciary Committee, introduced legislation that would exempt repo's from the bankruptcy code. As a result of these concerted efforts, Public Law 98-353 was enacted on July 10, 1984. This Act encompassed a general overhaul of the bankruptcy code. Within its provisions, it specifically exempts certain types of repos from the stay provision. It specifically addresses itself to repo's involving certificates of deposit, bankers acceptances and securities that are direct obligations of, or that are fully guaranteed as to principal and interest by the United States or any agency of the United States, with a maturity of not more than one year.

This legislation removed the uncertainty surrounding the repo but it did not relieve the investor from the obligation to conscientiously monitor his or her investment practices and relationship. The investment policies of the State Treasurer's Office are designed to meet three primary goals. The first of these, and the foremost concern of every public funds trustee, is safety of principal. The second objective is to provide sufficient liquidity to meet the cash flow needs of the state and, finally, the third is the achievement of the highest possible yield within our investment parameters.

In conjunction with our first objective, protection of principal, the State Treasurer's Office has developed the following guidelines to be used in its repurchase agreement transactions:

- The first, and probably most important of these, states that securities should be kept with a third party, acting on the investor's behalf. The necessity for this became very apparent in the failure of Lombard-Wall. Many of the investors who had repos with Lombard had failed to take delivery of the securities involved. By abdicating this responsibility in exchange for

a few basis points in additional yield, they exposed themselves to a great deal of risk. A safekeeping agent acts in the interests of the entity that pays for its services. Even after the bankruptcy court had granted the release of the securities, Bankers Trust, Lombard's safekeeping bank, refused to relinquish the bonds until it had satisfied itself that all of the bank's responsibilities to its customers had been met. In light of this situation, it is important that an investor maintains their own safekeeping arrangements, thereby retaining all possible options in the event of a default. It should also be noted that some dealers in the investment community feel that unless an investor does take delivery, he or she will not be afforded the protection now granted under the bankruptcy law.

- The second guideline is designed for transactions involving local banking institutions. It specifies that securities used in repurchase agreements with banks be held in that bank's safekeeping department for the account of the investor. The safekeeping department should be under the trust area of the bank.
- The third and fourth guidelines are closely allied and state that all securities in a repurchase transaction should be priced to reflect current market conditions and the pricing should allow for a margin of market fluctuation. In carrying out our fiduciary responsibilities in the investment of public funds, it is incumbent upon us to take particular care in the assumptions of risk. When entering into repo transactions, it is imperative that the investor require that securities be priced to market and include what is commonly referred to as a "haircut". A haircut is the difference between the price at which a security is trading in the marketplace and the level at which it is priced for the repo transaction. For example, a bond trading at par might be price at 99 for the purposes of the repo. That one point spread is the haircut. This provides you with a margin of protection from the highly volatile market we've come to expect over the past several years. Any responsible bond dealer will handle your repos in this manner without any recriminations. It is a common market practice that we should all follow.
- Lastly, deal with well capitalized firms that have a good reputation in the industry. Get a current, audited financial statement and look it over carefully. Also, make inquiries about the firm with people in the business with whom you have dealt and whom you respect. The marketplace is generally very efficient at ferreting out those entities that are potential problem areas.

Reverse repurchase agreements, technically called matched sales-purchase agreements, are essentially the mirror image of RP's. In this instance, the investor is the initial owner of the securities, and the bank or dealer is the entity with money. All other aspects remain identical.

The repo rate is a simple interest calculation based on a 360-day year.

## **U.S. Treasury Securities**

US Treasury securities are direct debt obligations of the Federal government and are exempt from state and local income tax. Treasuries are guaranteed by the full faith and credit of the U.S. government.

Treasury bills (T-bills or bills) are discount securities that mature in one year or less. The price of a bill is always quoted as a discount rate from par. The discount rate of bills represents the size of the price reduction for a 360-day period. For example, a bill that matures in 360 days and is sold at a discount rate of 6%, is priced at 94. This means a bill with a face value of \$10,000 would be sold at \$9,400 and pay the investor \$10,000 at maturity. Bills are completely identified by their maturity date, since they have no coupon (e.g. the 10/14/1999 bill).

The Treasury issues 3-month, 6-month, and 1-year bills on a regular schedule. Auctions for 3- and 6-month bills occur every Monday, with settlement each Thursday. Year bill auctions occur every fourth Tuesday, with settlement on Thursday. In addition to this regular schedule, the Treasury can also issue *Cash Management Bills* (CMBs) to meet its short-term borrowing needs.

Treasury notes and bonds are coupon securities. Notes are issued with maturities of 1 to 10 years, while bonds are issued with maturities up to 30 years. Notes and bonds are otherwise identical; for this reason, both will now be referred to as bonds.

The Treasury pays the investor total annual interest equal to the coupon rate. In addition, the bond is traded by its price, which is quoted as a percentage of face value. For example, a dollar price of 99 on \$10mm face amount of bonds is worth \$9,900,000.

The Treasury auctions notes and bonds less frequently than it auctions bills since they don't need to refinance cash raised through long-term issues as frequently as cash raised through short-term issues. Currently, the 2-year note is auctioned monthly. The 5-year and 10-year notes and the 30-year bond are auctioned quarterly in February, May, August, and November.



## **INVESTMENTS NOT ELIGIBLE FOR PUBLIC FUNDS**

- Corporate Stocks
- Corporate Bonds
- Foreign Government Obligations
- Futures Contracts
- Guaranteed Investment Contracts (GICs)
- Investment in Commodities
- Limited Partnerships
- Negotiable Certificates of Deposit
- Real Estate

## **IMPORTANT GUIDELINES**

### ***Repurchase Agreement Guidelines:***

1. Securities should be kept with a third party acting on the investor's behalf for safety purposes.
2. It is acceptable for securities used in repurchase agreements with banks to be held in that bank's trust safekeeping department for the account of the investor.
3. All securities in a repurchase agreement should be priced to reflect current market conditions.
4. Pricing of securities should allow for a margin of market fluctuations.
5. Deal with well capitalized firms which have a good reputation in the industry.

### ***Important Elements of Custodial Agreements:***

1. Agreement should be between the municipal treasurer and custodial third party.
2. Agreement specifies that the custodial third party will act as trustee solely on behalf, and at the direction of the municipal treasurer for the safekeeping of securities purchased by the municipal treasurer and carry out other duties as specified and agreed to between the parties in the agreement (disposition of money coming to the custodian for the benefit of the municipal treasurer, money entrusted to the custodian by the municipal treasurer for the payment of securities, audit requests, account statements, etc.).
3. The responsibilities of the custodial third party and the municipal treasurer in the event of default by the seller.
4. Means of compensation to custodial third party.
5. Terms by which the agreement may be altered or terminated.