

INVESTMENT POLICY

1. Policy

It is the Policy of the City of Merced and all entities of the City of Merced to invest public funds in a manner which will provide the highest investment return with the maximum security while meeting the daily cash flow demands and conforming to all state and local statutes governing the investment of public funds.

2. Scope

This investment policy applies to the investment activities of the City of Merced and all entities of the City of Merced. These funds are accounted for in the Annual Financial Reports and include:

Funds:

- General Fund
- Special Revenue Funds
- Debt Service Funds
- Capital Project Funds
- Enterprise Funds
- Internal Service Funds
- Trust and Agency Funds

This investment policy does not apply to any retirement funds or deferred compensation funds administered by other agencies.

3. Prudence

Investment officials shall use judgment and care in accordance with established procedures and exercise due diligence in investing these funds. The standard of prudence to be used by investment officials shall be the "prudent person" and shall be applied in the context of the overall portfolio.

4. Objectives

Safety: Safety of principal is the foremost objective of the investment program. Funds will be invested in a manner that will preserve and protect capital in the overall portfolio.

Liquidity: A portion of the investment portfolio will remain sufficiently liquid to meet all operating requirements which might be reasonably anticipated, thereby obviating the need for forced liquidation. Liquidity requirements shall be ensured by maintaining sufficient investment amounts in, Local Investment Agency Fund, Savings, or any maturing investment.

Return on Investments: The investment portfolio should at a minimum regularly exceed the average return on three-month U.S. Treasury bills, or the average rate on Fed funds, whichever is higher. These indices comprise a minimum standard for a rate of return that is considered a benchmark for riskless investment transactions. Returns above this threshold will be sought when consistent with risk limitations identified herein and prudent investment principles.

With the use of daily cash balance reports and cash flow projections available funds will be invested as near as possible to 100%.

5. Delegation of Authority

The finance officer is designated as investment officer and is responsible for investment decisions and activities, under the direction of the city manager. The finance officer shall be responsible for developing and maintaining administrative procedures for the operation of the program which are consistent with these policies.

6. Ethics and Conflicts of Interests

Any employee involved in the investment process shall refrain from personal business activity that could conflict with proper execution of the investment program, or which could impair their ability to make impartial investment decisions. Employees and investment officials shall disclose to the city manager any material financial interests in financial institutions that conduct business within this jurisdiction, and they shall further disclose any large personal financial/investment positions that could be related to the performance of this jurisdiction's portfolio. Employees and officers shall subordinate their personal investment transactions to those of this jurisdiction, particularly with regard to the timing of purchases and sales.

7. Authorized Financial Dealers and Institutions

The Finance Officer will maintain a list of financial institutions authorized to provide investment services. All financial institutions and broker/dealers who desire to become qualified bidders must be affiliated as primary dealers with the New York Federal Reserve Bank or broker/dealers who comply with the Federal capital adequacy guidelines. They must also certify that they have read and understood the City of Merced investment policies.

Banks shall be selected through the banking services procurement process. A formal request for proposal of depository services shall be issued no less than every five years. In selecting banks, the finance officer shall review the bank's financial history and creditworthiness.

8. Authorized & Suitable Investments

Funds may be used to purchase the following investment instruments:

- A. U.S. Treasury and U.S. Agency Issues
- B. Certificates of Deposit
- C. Local Agency Investment Fund
- D. Government Bonds and Notes
- E. Passbook Savings
- F. Bankers' Acceptance
- G. Commercial Paper
- H. Medium-term Notes
- I. Repurchase Agreements
- J. Mutual Funds

As far as is practicable two quotes will always be obtained before purchasing or selling securities.

To ensure receipt of securities, all trades will be executed on a delivery versus "payment" or "book entry" basis.

Bankers' Acceptance will only be purchased from prime money-center banks.

All U.S. Treasury and Agency obligations will be purchased at prices that are at or below par.

Commercial paper to be of "prime" quality of the highest ranking or of the highest letter and numerical rating as provided for by Moody's Investors Service, Inc., or Standard and Poor's Corporation. Eligible paper is further limited to issuing corporations that are organized and operating within the United States and having total assets in excess of five hundred million dollars (\$500,000,000) and have an "A" or higher rating for issuer's debt, other than commercial paper, if any, as provided for by Moody Investors Service Inc., or Standard and Poor's Corporation. Purchases of eligible commercial paper may not exceed 180 days maturity nor represent more than 10% of the outstanding paper of an issuing corporation. Purchases of commercial paper may not exceed 15% of the portfolio.

Medium-term notes to be of maximum of five years maturity issued by corporations organized and operating within the United States or by depository institutions licensed by the United States or any state and operating within the United States. Notes eligible for investment shall be rated in a rating category of "A" or its equivalent or better by a nationally recognized rating service. Purchase of medium-term notes may not exceed 30% of the portfolio.

Investments in repurchase agreements is limited to purchase of U.S. Treasury and U.S. Agency Issues and Government Bonds and Notes (collateral) pursuant to an agreement by which the seller will repurchase the securities on or before a specified date and for a specified amount. The term of the repurchase agreement shall be for one year or less.

Investments in mutual funds will be restricted to those funds that invest in securities and obligations otherwise eligible for local agency investment. Purchase of mutual fund shares may not exceed 15% of the portfolio.

Marketable securities will be traded prior to maturity if capital appreciation has occurred and/or yield can be increased with a minimum extension of maturity or the maturity can be shortened with a minimal loss in yield.

Losses are acceptable on a sale before maturity only if the reinvested proceeds will earn an income flow that would have been generated by the old investment considering any capital loss or forgone interest on the original investment. Any such sales will only be made upon the recommendation of the finance officer and approved by the city manager.

If not otherwise stated, the maximum maturity and maximum percent of investment type to total portfolio will be based on State law.

9. Collateralization

Collateralization will be required on two types of investments: certificates of deposit and repurchase agreements.

Certificates of deposit must be fully insured by the FDIC; if over \$250,000 the difference must be collateralized with securities having a market value of at least 110% of the value of the public funds or 150% if the depository uses mortgaged back securities.

Collateral for repurchase agreement will have a market value of at least 102% of the specified amount in the agreement. Collateral will always be held by an independent third party with whom the City has a current custodial agreement. A clearly marked evidence of ownership must be supplied to the City and retained.

10. Safekeeping and Custody

Where practicable, to protect against potential fraud and embezzlement, the City of Merced's ownership of all investments and collateral will be maintained through third-party custodial safekeeping. Bearer instruments shall be held only through third party institutions and all investment officials will be bonded.

11. Diversification

Assets invested shall be sufficiently diversified to eliminate the risk of loss resulting from over concentration of assets in a specific maturity, a specific issue, or a specific class of securities. Investment maturities shall be scheduled to coincide with projected cash flow needs.

12. Maximum Maturities

To the extent possible, the City of Merced will attempt to match its investments with anticipated cash flow requirements. Unless matched to a specific cash flow and authorized by the City Council, the City will not directly invest in securities maturing more than five years from the date of purchase.

13. Internal Controls

The finance officer shall establish a system of internal controls, which shall be designed to prevent losses of public funds arising from fraud, employee error, third party misrepresentation, unanticipated changes in financial markets or imprudent actions by employees and officers.

14. Performance Standards

The investment portfolio shall be designed with the objective of obtaining a rate of return throughout budgetary and economic cycles, commensurate with the investment risk constraints and the cash flow needs.

15. Reporting

The finance officer shall submit a monthly investment report to the city council and city manager. This report will show the investments in the portfolio, specific information concerning these investments and any narrative necessary for clarification.

16. Investment Policy Adoption

The investment policy shall be adopted by resolution of the City Council. The policy shall be reviewed annually by the Finance Officer and any modifications made thereto approved by the City Council.

GLOSSARY

AGENCIES: Federal agency securities.

ANNUAL FINANCIAL REPORT: The City shall issue either a Basic Financial Statement or Comprehensive Annual Financial Report (CAFR) annually. The Basic Financial Statement includes the minimum combination of financial statements and note disclosures required for fair presentation in conformity with Generally Accepted Accounting Principles (GAAP). The CAFR is a broader report that includes at a minimum, three sections 1) introductory, 2) financial, and 3) statistical. The financial section provides information on each individual fund and component unit. It is in conformity with both GAAP and Government Finance Officer Association (GFOA) recommendations.

ASKED: The price at which securities are offered.

BANKERS' ACCEPTANCE (BA): A draft or bill or exchange accepted by a bank or trust company. The accepting institution guarantees payment of the bill, as well as the issuer.

BID: The price offered by a buyer of securities. (When you are selling securities, you ask for a bid.)

BROKER: A broker brings buyers and sellers together for a commission.

CERTIFICATE OF DEPOSIT (CD): A short-term, secured deposit in a financial institution that usually returns principal and interest to the lender at the end of the loan period. Certificates of Deposit (CDs) differ in terms of collateralization and marketability. Those appropriate to public agency investing include Negotiable Certificates of Deposit and Non-Negotiable Certificates of Deposit.

Negotiable Certificates of Deposit – Generally, short-term debt instrument that usually pays interest and is issued by a bank, savings or federal association, state or federal credit union, or state-licensed branch of a foreign bank. The majority of negotiable CDs mature within six months while the average maturity is two weeks. Negotiable CDs are traded in a secondary market and are payable upon order to the bearer or initial depositor/investor. Negotiable CDs are insured by Federal Deposit Insurance Corporation (FDIC) up to \$250,000, but they are not collateralized beyond that amount. No more than 30% of an agency's portfolio may be invested in negotiable CDs.

Non- Negotiable Certificates of Deposit – CDs that carry penalty if redeemed prior to maturity. A secondary market does exist for non-negotiable CDs, but redemption includes a transaction cost that reduces returns to the investor. Non-negotiable CDs issued by banks and savings and loans are insured by the FDIC up to \$250,000. Amounts deposited above \$250,000 may be secured with other forms of collateral through an agreement between the investor and issuer.

COLLATERAL: Securities, evidence of deposit or other property which a borrower pledges to secure repayment of a loan. Also refers to securities pledged by a bank to secure deposits of public moneys.

COUPON: (a) The annual rate of interest that a bond's issuer promises to pay the bondholder on the bond's face value. (b) A certificate attached to a bond evidencing interest due on a payment date.

DEALER: A dealer, as opposed to a broker, acts as a principal in all transactions, buying and selling for his/her own account.

DELIVERY VERSUS PAYMENT: There are two methods of delivery of securities: delivery versus payment and delivery versus receipt. Delivery versus payment is delivery for securities with an exchange of money for the securities. Delivery versus receipt is delivery of securities with an exchange of a signers receipt for the securities.

DISCOUNT: The difference between the cost price of a security and its maturity when quoted at lower than face value. A security selling below original offering price shortly after sale also is considered to be at a discount.

DISCOUNT SECURITIES: Non-interest bearing money market instruments that are issued at a discount and redeemed at maturity for full face value, e.g. U.S. Treasury Bills.

DIVERSIFICATION: Dividing investment funds among a variety of securities offering independent returns.

FEDERAL CREDIT AGENCIES: Agencies of the Federal government set up to supply credit to various classes of institutions and individuals, e.g., saving and loan associations, small business firms, students, farmers, farm cooperatives, and exports.

FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC): A federal agency that insures bank deposits, currently up to \$250,000 per deposit.

FEDERAL FUNDS RATE: The rate of interest at which Fed funds are traded. The rate is currently pegged by the Federal Reserve through open-market operations.

FEDERAL HOME LOAN BANKS (FHLB): The institutions that regulate and lend to savings and loan associations. The Federal Home Loan Banks play a role analogous to that played by the Federal Reserve Banks vis-a-vis member commercial bank.

FEDERAL NATIONAL MORTGAGE ASSOCIATION (FNMA): FNMA, like GNMA was chartered under the Federal National Mortgage Association Act in 1938. FNMA is a federal corporation working under the auspices of the Department of Housing and Urban Development (HUD). It is the largest single provider of residential mortgage funds in the United States. Fannie Mae, as the corporation is called, is a private stockholder-owned corporation. This corporation's purchases include a variety of adjustable mortgages and second loans, in addition to fixed rate mortgages. FNMA's securities are also highly liquid and are widely accepted. FNMA assumes and guarantees that all security holders will receive timely payment of principal and interest.

FEDERAL RESERVE SYSTEM: The central bank of the United States created by Congress and consisting of a seven member Board of Governors in Washington, D.C., 12 regional banks and about 5,700 commercial banks that are members of the system.

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION (GNMA OR GINNIE MAE): Securities influencing the volume of bank credit guaranteed by GNMA and issued by mortgage bankers, commercial banks, savings and loan associations, and other institutions. Security holder is protected by full faith and credit of the U.S. Government. Ginnie Mae securities are backed by the FHA, VA, or FMHA mortgages. The term "pass-throughs" is often used to describe Ginnie Maes.

LIQUIDITY: A liquid asset is one that can be converted easily and rapidly into cash without a substantial loss of value. In the money market, a security is said to be liquid if the spread between bid and asked prices is narrow and reasonable size can be done at those quotes.

LOCAL GOVERNMENT INVESTMENT POOL (LGIP): The aggregate of all funds from political subdivisions that are placed in the custody of the State Treasurer for investment and reinvestment.

MARKET VALUE: The price at which a security is trading and could presumably be purchased or sold.

MASTER REPURCHASE AGREEMENT: A written contract covering all future transactions between the parties to repurchase—reverse repurchase agreements that establishes each party's rights in the transactions. A master agreement will often specify, among other things, the right of the buyer-lender to liquidate the underlying securities in the event of defaults by the seller-borrower.

MATURITY: The date upon which the principal or stated value of an investment becomes due and payable.

MONEY MARKET: The market in which short-term debt instruments (bills, commercial paper, bankers' acceptances, etc.) are issued and traded.

OFFER: The price asked by a seller of securities. (When you are buying securities, you ask for an offer.)

PORTFOLIO: Collection of securities held by an investor.

PRIMARY DEALER: A group of government securities dealers who submit daily reports of market activity and positions and monthly financial statements to the Federal Reserve Bank of New York and are subject to its informal oversight. Primary dealers include Securities and Exchange Commission (SEC)-registered securities broker-dealers, banks, and a few unregulated firms.

PRUDENT PERSON RULE: An investment standard. In some states the law requires that a fiduciary, such as a trustee, may invest money only in a list of securities selected by the custody state—the so-called legal list. In other states the trustee may invest in a security if it is one which would be bought by a prudent person of discretion and intelligence who is seeking a reasonable income and preservation of capital.

RATE OF RETURN: The yield obtainable on a security based on its purchase price or its current market price. This may be the amortized yield to maturity, on a bond it is the current income return.

REPUCHASE AGREEMENT (RP OR REPO): A holder of securities sells these securities to an investor with an agreement to repurchase them at a fixed price on a fixed date. The security “buyer” in effect lends the “seller” money for the period of the agreement, and the terms of the agreement are structured to compensate him/her for this. Dealers use RP extensively to finance their positions. Exception: When the Fed is said to be doing RP, it is lending money that is, increasing bank reserves.

SAFEKEEPING: A service to customers rendered by banks for a fee whereby securities and valuable of all types and descriptions are held in the bank’s vaults for protection.

SECONDARY MARKET: A market made for the purchase and sale of outstanding issues following the initial distribution.

SECURITIES & EXCHANGE COMMISSION: Agency created by Congress to protect investors in securities transactions by administering securities legislation.

TREASURY BILLS: A non-interest bearing discount security issued by the U.S. Treasury to finance the national debt. Most bills are issued to mature in three months, six months, or one year.

TREASURY BOND: Long-term U.S. Treasury securities having initial maturities of more than 10 years.

TREASURY NOTES: Medium-term coupon bearing U.S. Treasury securities issued as direct obligations of the U.S. Government and having initial maturities from two to 10 years.

YIELD: The rate of annual income return on an investment, expressed as a percentage. (a) Income Yield is obtained by dividing the current dollar income by the current market price for the security. (b) Net Yield or Yield to Maturity is the current income yield minus any premium above par or plus any discount from par in purchase price with the adjustment spread over the period from the date of purchase to the date of maturity of the bonds.