



MOORS & CABOT

INVESTMENTS

Banking & Advisory Group



In Consideration of an Investment Policy[©]

Municipal Investments

Applicable Maine law [Title 30-A, §5706 *et seq.* of the Maine Revised Statutes, as amended (the “Act”)] provides basic guidelines that lead to formation of an *Investment Policy*. Pursuant to the Act, all municipal governmental investments must be made with the judgment and care that persons of prudence, discretion and intelligence, under circumstances then prevailing, exercise in the management of their own affairs, not for speculation but for investment considering (i) safety of principal and maintenance of capital, (ii) maintenance of sufficient liquidity to meet all operating and cash requirements with which a fund is charged, that is reasonably expected, and (iii) return of income commensurate with avoidance of unreasonable risk. In addition to the act, prudent investment practice is *to maintain a cash and investment pool that is available for use by all funds and consists of short-term investments*. A conservative portfolio is invested principally in direct obligations of the United States government and its agencies. Statute prohibits an investment in any obligations typically referred to as “derivatives”, meaning obligations created from, or whose value depends on or is derived from the value of one or more underlying assets or indexes of asset values in which the municipality owns no direct interest.

The Investment Official at Risk?

The Act provides a basic framework for investment direction, but too often it is prohibitive rather than permissive. This leads to a vacuum in that it warns an investment official in what they may not purchase ... but may not provide sufficient direction in what may be purchased! Thus, even in compliance with the Act a broad range of subjective latitude is allowed the investment official that, without a *formalized* Investment Policy, leaves at the official at direct risk. And, the elected officials, as the ultimate steward of the government, jointly and severally share the risk!

An Investment Policy is *imperative for the protection* of a fiduciary (i.e., a person or entity entrusted with the assets of another person or entity). This, because it dictates what investments may be entered in to, and for what purposes. Thus, the prior contemplation becomes a platform that, if complied with, releases the investment official from reproach. Of greater import, compliance with a thoughtful, formalized Investment Policy typically prohibits investment pitfalls that lead to portfolio losses.

The Platform for an Investment Policy

The basic caveat is that all municipal governmental investments must be made with the judgment and care that persons of prudence, discretion and intelligence, under circumstances then prevailing, exercise in the management of their own affairs, not for speculation but for investment. Of greatest consideration, in order of specific importance are:

- (i) Safety of principal and maintenance of capital,
- (ii) Maintenance of sufficient liquidity to meet all operating and cash requirements with which a fund is charged, that is reasonably expected, and
- (iii) Return of income commensurate with avoidance of unreasonable risk.

A prudent investment practice is to maintain a cash and/or an investment pool that is available for use by all funds and consists of liquid investments; not to be invested in any obligations typically referred to as derivatives, meaning obligations created from, or whose value depends on or is derived from the value of one or more underlying assets or indexes of asset values in which the investor owns no direct interest; and to only purchase investments of medium to high level "Investment Grade" risk (i.e., "A" rated or better).

The Investment

A fixed-income security (both short-term or long-term) is purchased *to derive a constant stream of income over the life of the investment and to derive the complete return of principal at its maturity.* In buying a fixed-income security the investor is subjected to two levels of risk ... *credit risk and market risk.* By subscribing to a prudent investment philosophy, each of these risks may be mitigated! Fixed-income securities typically have a stated date to maturity. Then, at the expiration of its term and upon repayment of the principal that was borrowed, a borrower's obligation expires. Thus, a critical threshold of the credit quality of an investment, matched with a specific expectation of when maturing proceeds should expire, along with a hedged structure is the formula to long-term preservation of wealth.

Credit Risk

In a typical investment policy, only investments of "investment grade" credit risk are allowable for the purchase and holding by a portfolio. Under present commercial bank regulations issued by the Comptroller of the Currency, bonds rated in the following top four categories are generally regarded as eligible for bank investment and are designated as "*Investment Grade*":

Aaa or AAA is the highest rating. Capacity to pay interest and repay principal is extremely strong.

Aa or AA indicates a very strong capacity to pay interest and repay principal and differs from the highest rated issues only in a small degree.

A indicates a strong capacity to pay interest and repay principal although it is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than debt in higher rated categories.

Baa or BBB indicates adequate capacity to pay interest and repay principal. Whereas it normally exhibits adequate protection parameters, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity to pay interest and repay principal for debt in this category than debt in higher rated categories.

The Act further refines allowable securities for Maine municipalities to be "... rated within the 3 highest grades by any rating service approved by the Superintendent of Financial Institutions." Therefore, "A" or better on the above list.

Any rating below these rating categories are of “*Speculative Grade*”. Speculative Grade categories, including “NR” (or not rated), debt is regarded as having predominately speculative characteristics with respect to capacity to pay interest and repay principal. While such debt will likely have some quality and protective characteristics, these are outweighed by large uncertainties or major exposures to adverse conditions. The Speculative Grade categories are:

Ba or BB rated debt has less near-term vulnerability to default than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial or economic conditions which could lead to inadequate capacity to meet timely interest and principal payments.

B rated debt has greater vulnerability to default but currently has the capacity to meet interest payments and principal repayments. Adverse business, financial or economic conditions will likely impair capacity or willingness to pay interest and repay principal.

Caa or CCC rated debt has a current identifiable vulnerability to default, and is dependent upon favorable business, financial and economic conditions to meet timely payment of interest and repayment of principal. In the event of adverse business, financial or economic conditions, it is not likely to have the capacity to pay interest and repay principal.

Ca or CC ratings are typically applied to debt subordinated to senior debt that is assigned an actual or implied Caa or CCC rating.

C ratings are typically applied to debt subordinated to senior debt that is assigned an actual or implied Caa or CCC- rating. The **C** rating may be used to cover a situation where a bankruptcy petition has been filed, but debt service payments are continued.

CI ratings are reserved for income bonds on which no interest is being paid.

D rated debt indicates payment default. This rating is also used upon the filing of a bankruptcy petition if debt service payments are jeopardized.

N.R. indicates that the debt is not rated by a bond rating agency.

NOTE: Ratings may be modified by the addition of a plus (+) or minus (-) to show relative standing within the major rating categories; or the modifier 1 indicates that the issue ranks in the higher end of its gradation; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates that the issue ranks in the lower end of its category.

Investment Policy Compliance

As previously discussed, formalized Investment policy provides not only specific guidance ... on a permissive basis; but protection of the investment official in the event of future scrutiny. Non-compliance demonstrates either disregard for or lack of knowledge of a policy ... these each or both being egregious ramifications for the person or persons executing investments under the policy. The near term vulnerability to default, the inherent lower liquidity of non-investment grade securities, and the likely event that on-going revenue streams may be jeopardized, from time-to-time jointly and severally violate fiduciary-like investment precepts of safety of principal and maintenance of capital, maintenance of sufficient liquidity to meet all operating and cash requirements with which a fund is charged, that is reasonably expected, and return of income commensurate with avoidance of unreasonable risk.

In Summary

A formalized Investment Policy is a positive discipline and an indication of “good” Management. Furthermore, it protects the investment official and the elected officials; but, of most import, if judiciously followed protects the municipal government, and therefore its constituents, from loss of principal. Any fiduciary not only needs an Investment Policy ... but should require it!

The following pages provide a sample Investment Policy, for consideration:

PROPOSED INVESTMENT POLICY

POLICY

It is the policy of the (City/Town) of _____ to invest public funds in a manner that will provide safety of principal, obtain a market rate of return, meet the daily cash flow demands of the Town and conform to all State and local laws governing the investment of public funds.

SCOPE

This investment policy applies to all financial assets of the (City/Town) as approved by _____ and approved (City/Town) warrants. These funds include but are not limited to:

- Accounts Payable
- Payroll Accounts
- Capital project funds
- Enterprise funds including TIF Accounts
- Trust and agency funds
- Cemetery accounts
- Endowments and trusts
- CDBG Accounts
- Custodial or Escrow Accounts

PRUDENCE

All (City/Town) investments must be made with the judgment and care that persons of prudence, discretion and intelligence, under circumstances then prevailing, exercise in the management of their own affairs, not for speculation but for investment, considering:

1. **Safety:** The safety of principal and preservation of capital in the overall portfolio;
2. **Maintenance of liquidity:** Maintenance of sufficient liquidity to meet all operating and other cash requirements with which a fund is charged that are reasonably anticipated; and
3. **Income.** The income to be derived throughout budgetary and economic cycles, taking into account prudent investment risk constraints and the cash-flow characteristics of the portfolio.

This standard shall be applied to the (City/Town)'s overall investment portfolio and not to individual items within the (City/Town)'s diversified portfolio.

OBJECTIVE

The primary objectives, in priority order, of the (City/Town)'s investment activities shall be:

1. **Safety:** Safety of principal is the foremost objective of the investment program. Investments shall be made by the Treasurer in a manner that seeks to ensure preservation of capital in the overall portfolio. To obtain this objective, the Treasurer shall use basic techniques to diversify the investment portfolio. (He/She) shall utilize

FDIC insured bank deposits and/or obtain collateralized investments that guarantee the (City/Town) a perfected security interest in the underlying security.

Further the Treasurer shall invest (City/Town) funds only in highly capitalized and highly rated financial institutions.

2. **Liquidity:** The (City/Town)'s investment portfolio will remain sufficiently liquid to enable the (City/Town) to meet all operating requirements that might be reasonably anticipated through cash flow analysis.
3. **Return on Investment:** The (City/Town)'s investment portfolio shall be designated with the objective of attaining a market rate of return throughout budgetary and economic cycles, taking into account the (City/Town)'s investment risk constraints and the cash flow characteristics of the portfolio.

DELEGATION OF AUTHORITY

Authority to manage the (City/Town)'s investment program is derived from State law, 30-A M.R.S.A. Sections 5706 through 5719, and the (City/Town) Charter. Upon approval of this document, the Treasurer shall provide written procedures for the operation of the investment program consistent with the investment policy. Such procedures shall include explicit delegation of authority to persons responsible for investment transactions. No person may engage in an investment transaction except as provided under the terms of this policy and the procedures established by the Treasurer. The Treasurer shall be responsible for all investment or cash management transactions undertaken and shall keep the (Council/Board of Selectmen) fully apprised of the same.

ETHICS AND CONFLICTS OF INTEREST

Officers and employees involved in the investment process shall refrain from personal business activity that could conflict with proper execution of the investment program, or that could impair their ability to make impartial investment decisions. Employees and investment officials shall disclose to the Treasurer and the (Council/Board of Selectmen) any material financial interests in financial institutions that conduct business within the (City/Town), and they shall further disclose any personal financial/investment positions that could be related to the performance of the (City/Town)'s investment portfolio.

PROHIBITED INTEREST

No (City/Town) employee shall invest (City/Town) funds in any instrument or institution in which (he/she) has a direct or indirect financial interest, nor shall (he/she) accept any gift, free service or payment of any kind for performing their duties under this policy.

AUTHORIZED FINANCIAL DEALERS AND INSTITUTIONS

The Treasurer shall maintain a list of financial institutions authorized to provide investment services. No public deposit shall be made except in a qualified public depository as established by State law. An annual review of the financial condition and registrations of qualified bidders will be conducted by the Treasurer with the results provided to the (Council/Board of Selectmen).

SAFEKEEPING AND CUSTODY

All security transactions, including collateral for repurchase agreements, entered into by the (City/Town) shall be conducted on a delivery versus payment basis. Securities will be held by a third party custodian agreed to by the Treasurer provided it meets or exceeds the minimum risk category classification of GASB (Governmental Accounting Standards Board).

MAXIMUM MATURITIES

To the extent possible, the Treasurer will match investments with anticipated cash requirements. Unless matched to a specific cash flow, the (City/Town) will not directly invest in securities maturing more than one year from date of purchase. At least annually the Treasurer, at a time preceding the annual (City/Town) meeting, will present a cash flow analysis showing the past year's performance and the projected next year's performance using submitted budget figures. At this time, the Treasurer shall also recommend what amount of surplus revenue should be used to offset the next year's tax rate.

Trust and endowment funds may be invested in securities exceeding one year if the maturity of such investments are made to coincide as nearly as practicable with the expected use of the funds.

INTERNAL CONTROLS

The Treasurer shall establish an annual process of independent review by an external auditor, selected by the (Council/Board of Selectmen) during the annual (City/Town) audit. This review will enhance internal control by assessing compliance with policies and procedures.

ACCOUNTING METHOD

Investments will be carried on the (City/Town)'s books at cost. Interest on securities will be credited to investment income at the time of sale. The values of investment securities will be accrued as of each fiscal year end.

EXTERNAL MANAGEMENT

The (Council/Board of Selectmen) may contract with a qualified external money management company in order to benefit from portfolio diversification, credit research, full-time portfolio management and economies of scale that are unavailable from the (City/Town)'s staff. Any such contract will define and control the risks of the portfolio and establish performance criteria for monitoring and evaluating results.

INVESTMENT POLICY ADOPTION

The (City/Town)'s investment policy shall be adopted by the (Council/Board of Selectmen). The policy shall be reviewed by the Treasurer with the (Council/Board of Selectmen) no less frequently than once a year.

STATUTORY COMPLIANCE

Nothing in the (City/Town)'s investment policy shall be read to contravene with State law, 30-A M.R.S.A. Sections 5706 through 5719 (the "Act").

