Discussion / Direction

of the Investment Committee recommendation to amend the Municipal Investment Policy to prohibit loans from the Permanent Fund as authorized investments.

After discussion, a possible motion if desired, is:

I MOVE TO instruct the Municipal Administrator work with staff to develop an ordinance to amend the Municipal Investment Policy to prohibit loans from the Permanent Fund as authorized investments.

City and Borough of Sitka

100 Lincoln Street • Sitka, Alaska 99835

MEMORANDUM

To: Mayor Paxton and Assembly Members
Keith Brady, Municipal Administrator

From: Jay Sweeney, Chief Finance and Administrative Officer

Date: January 3, 2019

Subject: Investment Committee Recommendation to Amend the Investment Policy to Prohibit Loans from the Permanent Fund as Authorized Investments

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Summary

At its meeting on December 17th, the Investment Committee (IC) voted to recommend to the Assembly that it direct staff to develop an ordinance to amend the Municipal investment policy prohibit loans from the Permanent Fund as authorized investments. Staff seeks Assembly discussion and direction on whether or not to proceed with the drafting of an ordinance.

Background and Discussion

Over the past several months, a proposal has been raised that the Municipality loan itself money from the Permanent Fund for project funding, as opposed to issuing revenue bonds. The supporters of the proposal have stated that they believe that the proposal could save the Municipality money, because it would pay itself interest as opposed to external investors who purchase the Municipality's bonds.

The IC is tasked with a primary responsibility to update the investment policy as needed (SGC 2.62.050 (a)). Given this responsibility and the requirement to amend the investment policy to permit investments in internal loans, the proposal was presented to the IC for evaluation and a potential recommendation to the Assembly.

At its meeting, the IC voted unanimously to recommend to the Assembly to update the investment policy to prohibit internal loans. The IC felt strongly that internal loans were not wise investments, for several reasons.

Reasons for the IC decisions were as follows:

a. First, while the Municipality would pay interest to itself instead of external investors if it borrowed from itself, it would also lose the interest it receives from the entities whose equity securities (in the form of Exchange Traded Fund (ETF) shares) and debt it holds. Thus, the two need to be netted together and the IC believed that the difference, if any, that the Municipality would receive over the long run would amount to an arbitrage play. The all-in true interest cost of the most recent harbor and airport terminal revenue bond issuances was 4.33%. Accordingly, an internal loan at the same interest rate, 4.33%, would need to exceed the dividend and interest yield on Permanent Fund investments over a 20-year span for the proposal to be positive for the municipality, a prospect the IC believed was risky and unlikely given a forecast of gradually increasing interest rates.

b. Second, locking up a substantial portion of the Permanent Fund in a fixed interest rate internal loan would entail the liquidation of most of the equity portion of the Permanent Fund, the ETFs, eliminating the portion of the Permanent Fund which helps its value to grow. Even though the dividend and interest yield of the Permanent Fund is, at this time, below the recent 4.33% all-in true interest cost, the overall investment performance (which includes increases in the market value of equity investments) of the Permanent Fund has been, and is expected to continue to be, above 6%. It is the difference between the 6% investment performance over time and the annual transfer to the General Fund (now at 5.5% and scheduled to decline to 4.5% by FY2023) which helps the Fund to grow. The IC noted that Section 11.16 (a) states that one of the goals for the Permanent Fund is to grow in value, and, that internal loans would likely violate this Charter provision.

c. Third, locking up a substantial portion of the Permanent Fund in a fixed interest rate internal loan would greatly reduce the diversification of investments in the Permanent Fund and increase risk. A loan to itself prior to maturity would be illiquid and very difficult to sell if the Municipality later decided to follow a different path for the Fund. The Municipality's professional advisor noted that it could not opine or advise on an illiquid private internal loan, and, that reducing the diversification of the Permanent Fund was not recommended. IC members also noted that internal loans would not carry the same binding provisions of municipal bonds. At some part in the future, if circumstances changed, there would not be any binding provision to keep future Assemblies from restructuring or forgiving internal loans.

d. Fourth, selling the ETFs and debt securities at the current time could lock in unrealized losses, as current investments would need to be liquidated to raise the cash to finance the internal loans.

<u>Fiscal Note</u>

There is no immediate direct fiscal consequence of this recommended action. Future fiscal consequences would depend on future investment performance and investment market conditions.