

**NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2004**

NOTE 4 – DEPOSITS WITH FINANCIAL INSTITUTIONS, INVESTMENTS, AND REVERSE REPURCHASE AGREEMENTS

King County adopted an early implementation of GASB Statement No. 40, Deposit and Investment Risk Disclosures – an amendment of GASB Statement No. 3, issued in March 2003. This statement addresses common deposit and investment risks related to credit risk, concentration of credit risk, interest rate risk, and foreign currency risk. As an element of interest rate risk, this statement requires certain disclosures of investments that have fair values that are highly sensitive to changes in interest rates.

Deposits

The County maintains deposit relationships with several local commercial banks and thrift institutions in addition to its concentration bank.

All deposits not covered by the Federal Depository Insurance Corporation (FDIC) are covered by the Public Deposit Protection Commission of the State of Washington (PDPC). The PDPC is a statutory authority established under chapter 39.58 RCW. It constitutes a multiple financial institution collateral pool that can make *pro rata* assessments to all public depositories within the state of up to 10 percent of all their public deposits. There is no current provision for PDPC to make additional *pro rata* assessments if needed to cover a loss. Therefore, in accordance with GASB, *Codification of Governmental Accounting and Financial Reporting Standards*, Section 150.110, PDPC protection is of the nature of collateral, not of insurance. Pledged securities under the PDPC collateral pool are held by the County's agent in the name of the County. Some large depositories hold public deposits in amounts in excess of the market value of the entire PDPC collateral pool. To the extent that uninsured public deposits of a financial institution exceed the PDPC's total value, equivalent proportions of the County's deposits in those institutions are exposed to custodial credit risk because they were uninsured and uncollateralized.

Custodial credit risk – deposits The custodial credit risk for deposits is the risk that, in the event of a bank failure, the County's deposits may not be recovered. As of December 31, 2004, the carrying amount of deposits for the Primary Government was \$460,164,931. The total bank balance was \$441,747,417 of which \$89,399,951 was exposed to custodial credit risk as uninsured and uncollateralized.

	<u>Carrying Amount</u>	<u>Bank Balance</u>	<u>Uninsured and Uncollateralized</u>
Demand deposits	\$ 38,977,062	\$ 20,559,548	\$ 1,917,502
Certificates of deposit	421,187,869	421,187,869	87,482,449
Total deposits	<u>\$ 460,164,931</u>	<u>\$ 441,747,417</u>	<u>\$ 89,399,951</u>

Determination of these amounts is based on the conservative assumption that none of the excess public deposits were covered by FDIC insurance. Although such risk is recognized, the PDPC provides additional protection by maintaining strict standards as to the amount of public deposits financial institutions can accept, and by monitoring the financial condition of all public depositories and optimizing collateralization requirements.

Foreign currency risk – deposits Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of a deposit. As of December 31, 2004, \$9,346,559 of the Primary Government's bank balance consists of Japanese yen-denominated certificates of deposit with a final maturity date of July 1, 2005. These deposits were purchased by King

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County's Metro Transit Division as part of a required contract agreement in a crossborder transaction to lease buses for the County. The deposits are held to cover payments required under the lease that are denominated in yen, and as such do not present foreign currency risk to the County.

Investments

For investment purposes, the County pools the cash balances of county funds and participating component units, and allows for participation by other legally separate entities such as special districts, for which the County is *ex officio* treasurer, and public authorities. The King County Investment Pool (the Pool), administered by the King County Treasury Operations Section, is an external investment pool. The external portion of the Pool (the portion that belongs to special districts and public authorities other than component units) is reported in an Investment Trust Fund. It is county policy to invest all County funds in the Pool. All non-County participation in the Pool is voluntary.

Types of Investments State statutes authorize King County to invest in savings or time accounts in designated qualified public depositories or in certificates, notes, or bonds of the United States. The County is also authorized to invest in other obligations of the United States or its agencies or of any corporation wholly owned by the government of the United States. Statutes also authorize the County to invest in bankers' acceptances purchased on the secondary market, 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. The County can also invest in commercial paper within the policies established by the State Investment Board; debt instruments of banking institutions, local and state general obligations, and revenue bonds issued by Washington State governments that are rated at least "A" by a nationally recognized rating agency.

The County is authorized to enter into repurchase and reverse repurchase agreements. County investment policies require that securities underlying repurchase agreements must have a market value of at least 102 percent of the cost of the repurchase agreement for investment terms of less than 30 days, and 105 percent for terms longer than 30 days. Repurchase agreements in excess of 60 days and reverse repurchase agreements exceeding 180 days are not allowed. Currently, the County's tri-party custodial bank monitors compliance with these provisions. The County has not entered into yield maintenance repurchase agreements.

The County voluntarily invests in the Washington State Treasurer's Local Government Investment Pool (LGIP). The amount is carried at cost, which approximates fair value. The LGIP is a 2a7-like pool that is overseen by the Office of the State Treasurer, the State Finance Committee, the Local Government Investment Pool Advisory Committee, and the Washington State Auditor's Office. The LGIP also contracts for an annual outside independent audit.

Derivatives The County operates under the GASB's *Codification*, Section 2300.601, definition of derivatives and similar transactions. During the year, the County did not buy, sell, or hold any derivative or similar instrument except for certain US agency collateralized mortgage obligations securities purchased by the King County Investment Pool to enhance investment yield. Although these securities are sensitive to early prepayments by mortgagees, usually resulting from a

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decline in interest rates, County policies are in place to ensure that only the lowest risk securities of this type are acquired.

Reverse Repurchase Agreements Statutes permit the County Investment Pool to enter into reverse repurchase agreements, that is, a sale of securities with a simultaneous agreement to repurchase them in the future at the same price plus a contract rate of interest. County policy prohibits the use of these agreements as a borrowing mechanism. The investments under reverse repurchase agreements represent the collateral securities transferred to the lender in exchange for the cash received and used to purchase other securities with the same maturities as the collateral securities, resulting in a matched position.

The Pool has outstanding reverse repurchase agreements at December 31, 2004. The assets and liabilities related to the Investment Pool-owned reverse repurchase agreements were allocated to the individual Pool participants based on their equity in the Pool as of December 31, 2004. The liability is reported as obligations under reverse repurchase agreements and the assets are reflected as an increase in cash equivalents in the balance sheets of funds that participate in the internal portion of the Investment Pool. For funds that participate in the external portion of the Investment Pool, the assets and liabilities are reported in the "Combining Statement of Net Assets" of the Investment Trust Funds.

Reverse repurchase agreements are subject to credit risk. Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. Should the dealers default on their obligation to resell these securities to the County, the County would be faced with an economic loss equal to the difference between the market value plus accrued interest of the underlying securities and the agreement obligation, including accrued interest. The credit risk exposure at year-end was \$1,314,565 on reverse repurchase agreements in the Investment Pool.

External Investment Pool The King County Investment Pool is not registered with the SEC as an investment company. Oversight is provided by the King County Executive Finance Committee (EFC) pursuant to RCW 36.29.020. The EFC consists of the Chair of the County Council, the County Executive, the Chief Budget Officer, and Director of the Finance and Business Operations Division. All investments are subject to written policies and procedures adopted by the EFC. The EFC reviews pool performance monthly.

All securities are reported at fair value. Fair value reports are prepared monthly and are distributed to all Pool participants. Fair value pricing is provided by the County's security safekeeping bank. If a security is not priced by the County's safekeeping bank, prices are obtained from Bloomberg L.P., a provider of fixed income analytics, market monitors, and security pricing. The County has not provided or obtained any legally binding guarantees to support the value of the Investment Pool's shares.

The Pool values participants' shares using an amortized cost basis. Monthly income is distributed to participants based on their relative participation during the period. Income is calculated based on: (1) realized investment gains and losses calculated on an amortized cost basis; (2) interest income based on stated rates (both paid and accrued); and (3) the amortization of discounts and premiums on a straight-line basis. Income is reduced by the contractually agreed upon investment fee. This method differs from the fair value method used to value investments in this statement because the amortized cost method is not designed to distribute to participants all unrealized gains and losses in the fair values. The total difference between fair values of the investments in the Pool and the values distributed to the Pool participants using the amortized

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cost method described above is reported in the equity section of the statement of net assets as undistributed and unrealized gains.

The schedule below shows the types of investments, the average interest rate, and the effective duration limits of the King County Investment Pool as of December 31, 2004. The change in the fair value of the total investments for the reporting entity during 2004, after considering purchases, sales and maturities, resulted in a markdown from cost of \$8.95 million. The Primary Government has a balance in the Investment Pool, excluding the equity in the component units, of \$2,617,428,726. There were no losses incurred during the period as a result of default by counterparties to deposit or investment transactions. During the period, there were no known violations of legal or contractual provisions for deposits and investments.

King County Investment Pool

<u>Investment Type</u>	<u>Fair Value</u>	<u>Principal</u>	<u>Average Interest Rate</u>	<u>Effective Duration (Yrs)</u>
Savings Accounts	\$ 160,209,243	\$ 160,209,243	2.35%	0.003
Certificates of Deposit	275,000,000	275,000,000	2.52%	0.465
Repurchase Agreements	398,318,750	398,318,750	2.38%	0.015
Bank Notes	20,056,000	20,000,000	7.12%	0.063
Bank Discount Notes	149,865,000	150,000,000	2.29%	0.038
Commercial Paper	815,009,546	816,298,000	2.31%	0.076
Taxable Municipal Notes	80,628,770	81,600,000	2.90%	1.802
Taxable Municipal Zero Coupon Notes	46,458,636	52,050,000	3.27%	2.723
US Treasury Notes	420,556,557	425,000,000	2.24%	1.524
US Agency Notes	599,715,620	601,640,000	3.24%	1.053
US Agency Discount Notes	114,885,000	115,000,000	2.30%	0.052
US Agency Collateralized Mortgage Obligations	248,192,499	246,158,057	4.65%	2.220
State Treasurer's Investment Pool	27,358	27,358	2.07%	0.003
Totals	<u>\$ 3,328,922,979</u>	<u>\$ 3,341,301,408</u>	<u>2.72%</u>	<u>0.692</u>

Interest rate risk – Investments Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. Through its investment policy, the County manages its exposure to fair value losses arising from increasing interest rates by setting maturity and effective duration limits for the Pool. The Pool is managed as two subportfolios: the liquidity portfolio and the core portfolio. The liquidity portfolio average maturity cannot exceed 120 days and is intended to meet the County's short-term liquidity requirements. The total balance of the liquidity portfolio must be at least 15 percent of the total Investment Pool. The core portfolio is managed similar to a short-term fixed-income fund. The average duration of the core portfolio is currently restricted to a range of one and one-quarter to three and one-quarter years. Securities in the core portfolio cannot have an average life greater than five years at purchase. Based on historical and forecasted cash flows, the EFC established the maximum amount that can be invested in the core portfolio. At year-end, this limit was \$2.2 billion and the County was in compliance with this policy. As of December 31, 2004, the combined effective duration of the liquidity and core portfolios was 0.692 years.

Credit risk of Debt Securities Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The Pool's policy limits the maximum amount that can be invested in various securities. Table 1 summarizes the Pool's diversification policy and Table 2 displays the credit quality for all securities not backed by the full faith and credit of the United States. The credit quality distribution is categorized to display the greatest degree of credit risk

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as rated by Standard and Poor's, Moody's, or Fitch. For example, a security rated "AAA" by one rating agency and "AA" by another would be listed as "AA" in Table 2.

Table 1.

OVERVIEW OF KING COUNTY'S INVESTMENT POOL'S POLICIES TO LIMIT INTEREST RATE & CREDIT RISK

<u>Investment Type</u>	<u>Maximum Maturity</u>	<u>Security Type Limit</u>	<u>Single Issuer Limit</u>	<u>Minimum Credit Rating</u>
US Treasury	5 Years	100%	None	N/A
US Federal Agency	5 Years	50%	50%	N/A
US Federal Agency MBS	5 Year WAL	25%	25%	N/A
Certificates of Deposit	5 Years	15%	5%	PDPC ⁽¹⁾
Municipals Securities ⁽²⁾	5 Years	20%	5%	A ⁽³⁾
Bank Securities	5 Years	20%	5%	A ⁽³⁾
Repurchase Agreements	60 Days ⁽⁴⁾	40%	10%	Collateral
Commercial Paper	180 Days	25%	5%	A1/P1 ⁽⁵⁾
Bankers Acceptances	180 Days	25%	5%	Top 50 ⁽⁶⁾
State LGIP ⁽⁷⁾	N/A	None	None	N/A

(1) Institution must be a Washington State depository. Treasurers can deposit up to 100% of bank's net worth.

(2) Washington state issuers: general obligations and revenue bonds. Other states: only general obligation bonds.

(3) Must be rated "A" or better by two rating agencies.

(4) 102% collateralized, over 30 days 105%.

(5) Must be rated in top credit category by at least two rating agencies. Maturities > 100 days must have "AA" long-term rating.

(6) Bankers' acceptances can only be purchased from the 50 largest banks in the world by asset size.

(7) The state investment pool (LGIP) is a money market-like fund managed by the State Treasurer's Office.

Table 2.

Credit Quality Distribution

<u>Investment Type</u>	<u>AAA or A-1</u>	<u>AA</u>	<u>A</u>	<u>Not Rated</u>	<u>Total</u>
Repurchase Agreements	\$ 398,318,750	\$ -	\$ -	\$ -	\$ 398,318,750
Bank Discount Notes	149,865,000	-	-	-	149,865,000
Commercial Paper	815,009,546	-	-	-	815,009,546
US Agency Discount Notes	114,885,000	-	-	-	114,885,000
Bank Notes	20,056,000	-	-	-	20,056,000
Taxable Municipal Notes	33,648,178	5,081,440	41,899,152	-	80,628,770
Taxable Municipal Zero Coupon Notes	46,458,636	-	-	-	46,458,636
US Agency Notes	599,715,620	-	-	-	599,715,620
US Agency Collateralized Mortgage Obligations	246,076,294	-	-	-	246,076,294
State Treasurer's Investment Pool	-	-	-	27,358	27,358
TOTAL	\$ 2,424,033,024	\$ 5,081,440	\$ 41,899,152	\$ 27,358	\$ 2,471,040,974

Concentration of credit risk – Investments Concentration of credit risk is the risk of loss attributed to the magnitude of a government's investment in a single issuer. At year-end the Pool had concentrations greater than 5 percent of the total investment pool in the following issuers: Federal National Mortgage Association – 14%, Federal Home Loan Mortgage Corporation – 8%, and Goldman, Sachs & Co. – 10%. The concentration of credit risk with Goldman, Sachs & Co. resulted from the County's repurchase agreements; this exposure was offset by US agency securities pledged to the County's tri-party custodian bank by Goldman, Sachs & Co., valued at 102 percent of the County's exposure.

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Custodial credit risk – Investments Custodial credit risk is the risk that, in the event of the failure of the counterparty, the County will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. By County policy, all security transactions, including repurchase agreements, are settled "delivery versus payment." This means that payment is made simultaneously with the receipt of the security. These securities are delivered to the County's safekeeping bank or its tri-party bank.

The King County Investment Pool's Condensed Statement of Net Assets and Changes in Net Assets as of December 31, 2004, are as follows:

<u>Condensed Statement of Net Assets</u>	
Assets	\$ 3,335,303,729
Less: Liabilities	(101,222,146)
Net assets held in trust for pool participants	<u>\$ 3,234,081,583</u>
Equity of internal pool participants	\$ 1,530,905,769
Equity of external pool participants	1,703,175,814
Total equity	<u>\$ 3,234,081,583</u>
<u>Condensed Statement of Changes in Net Assets</u>	
Net assets at January 1, 2004	\$ 3,256,513,772
Net change in investments by pool participants	(22,432,189)
Net assets at December 31, 2004	<u>\$ 3,234,081,583</u>

Individual Investment Accounts

King County also purchases individual investments for other legally separate entities, such as special districts and public authorities, that are not part of the financial reporting entity. Net assets in these individual investment accounts are reported in a separate Investment Trust Fund in the Fiduciary Funds section.

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NOTE 4 – CONTINUED**Component Units**

Harborview Medical Center (HMC) Harborview Medical Center (HMC) participates in the County's investment pool and follows the applicable criteria as described above for the King County Investment Pool deposits and investments.

Custodial credit Risk – Deposits The custodial credit risk for deposits is the risk that in the event of a bank failure, HMC's deposits may not be recovered. HMC has equity in the Pool – Certificates of Deposit (reported as cash equivalents at June 30, 2004) – and maintains demand deposit accounts in various banks (insured up to \$100,000 per bank). As of June 30, 2004, \$5,626,651 of HMC's bank balance of \$213,686,623 was exposed to custodial credit risk as uninsured and uncollateralized. The carrying amount of total deposits was \$212,730,653.

**Harborview Medical Center (HMC)
As of June 30, 2004**

	Carrying Amount	Bank Balance	Uninsured and Uncollateralized
Equity in Investment Pool -			
Certificates of Deposit	\$ 211,047,420	\$ 211,488,793	\$ 5,392,964
Cash in other banks	1,683,233	2,197,830	233,687
Totals	<u>\$ 212,730,653</u>	<u>\$ 213,686,623</u>	<u>\$ 5,626,651</u>

Washington State Major League Baseball Stadium Public Facilities District (PFD)

The Washington State Major League Baseball Stadium Public Facilities District (PFD) participates in the County's investment pool and follows the applicable criteria as described above for the King County Investment Pool deposits and investments.

Custodial Credit Risk – Deposits The custodial credit risk for deposits is the risk that in the event of a bank failure, PFD's deposits may not be recovered. The PFD has equity in the Pool – Certificates of Deposit (reported as cash equivalents at December 31, 2004) – and maintains demand deposit accounts in various banks (insured up to \$100,000 per bank). As of December 31, 2004, \$474,526 of the PFD's bank balance of \$19,918,208 was exposed to custodial credit risk as uninsured and uncollateralized. The carrying amount of total deposits was \$19,918,208.

**Washington State Major League Baseball Stadium Public Facilities Districts (PFD)
As of December 31, 2004**

	Carrying Amount	Bank Balance	Uninsured and Uncollateralized
Equity in Investment Pool -			
Certificates of Deposit	\$ 19,127,522	\$ 19,127,522	\$ 474,526
Cash in other banks	790,686	790,686	-
Totals	<u>\$ 19,918,208</u>	<u>\$ 19,918,208</u>	<u>\$ 474,526</u>

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The Cultural Development Authority of King County (CDA), dba 4Culture, does not participate in the County's investment pool. The CDA has an Investment Policy to guide the management of its assets and ensure that all investment activity is within the regulations established by State and County Code. At December 31, 2004, all CDA investments were in compliance with its investment policy.

Interest rate risk – Investments Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. Through its investment policy, the CDA manages its exposure to interest rates risk by setting maturity and effective duration limits for its portfolio. As of December 31, 2004, the combined weighted average effective duration of the CDA's portfolio was 2.90 years.

Credit risk and Concentration of credit risk Credit risk is the risk that an issuer will not fulfill its obligations. Concentration of credit risk is the risk of loss attributed to the magnitude of the CDA's investment in a single issuer. At December 31, 2004, all issuers of investments in the CDA portfolio had a Standard & Poor's rating of "AAA." At December 31, 2004, the CDA had concentrations greater than 5 percent of its total portfolio in the following issuers: Goldman Sachs Federal Money Market Fund – 36% (Invested 100% in U.S Treasury Obligations and U.S. Government Securities), US Treasury Obligations – 33%, Federal Home Loan Bank – 14%, Federal National Mortgage Association – 10%, and Federal Home Loan Mortgage Corporation – 7%.