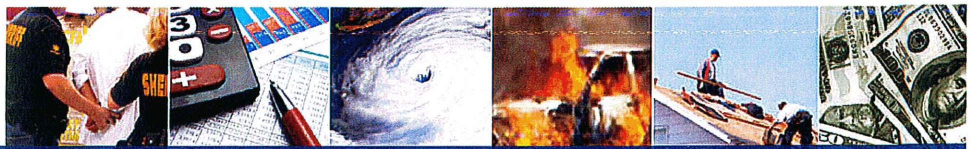
Florida Department of Financial Services



Alex Sink
Chief Financial Officer

Office of Inspector General

Robert E. Clift
Inspector General

March 26, 2009 **Audit Report Number 09030**

Treasury Investments Should Have Increased External Oversight and be Used to Promote Economic Development in Florida

SUMMARY

The objective of this audit was to evaluate the adequacy of the controls over the assets of the Treasury Investment Pool, as managed by the Division of Treasury. We found that:

- External oversight of investment policies and procedures is limited; however, Treasury has begun a process to procure financial advisory services, and
- The Certificate of Deposit Program is not fully meeting its Legislative intent to promote economic development.

We recommend that at a minimum these procured financial advisory services include:

- an annual assessment of investment performance;
- services that ensure compliance by external investment managers with applicable policies; and
- a quadrenial review of investment policies.

We also recommend that Treasury:

- Ensure that all funding not needed to meet the state's immediate disbusement needs is first offered to Qualified Public Depositories willing to pay an established minimum interest rate before investing these funds in longer-term securities; or work with the Legislature to change the governing legislation.
- Consider modifying the Certificate of Deposit Program to increase its contribution to economic development in Florida.

SCOPE

The objective of this audit was to evaluate the the effectiveness of the Division of Treasury in achieving the investment objectives of the Treasury Investment Pool. The primary objective of the Treasury Investment Pool is to ensure that the State is able to meet all of its payment obligations, while preserving the value of the assets in the Pool. Of secondary importance is to maximize returns for the State and other government-related organizations.

BACKGROUND

The Division of Treasury is responsible for investing all the State's general revenue and trust funds.[1] These investments are maintained in the Treasury Investment Pool. As shown in Exhibit 1, the Treasury Investment Pool also includes a Special Purpose Investment Account (SPIA), which consists of funds controlled by entities created by the State Constitution or by law. Entities holding deposits in SPIA include state universities and community colleges, and the Florida Lottery. Expenditures used to manage the Treasury Investment Pool are funded from returns generated from Treasury Investment Pool investments.

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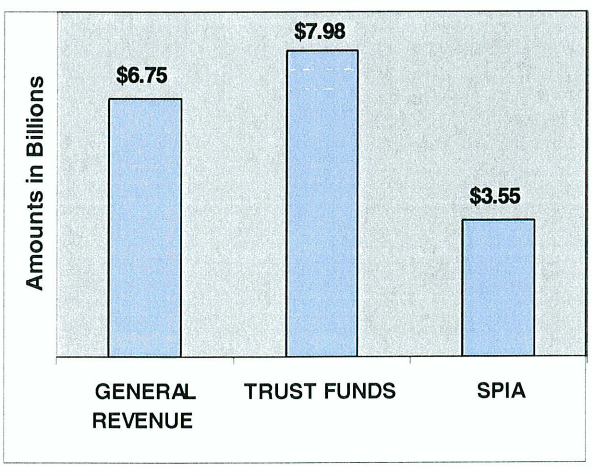
[1]These funds include funds administered by state agencies and the judicial branch as defined in Section 216.011 *F.S.* In addition, the Treasury invests federal funds provided through the Unemployment Trust Fund, which at the end of FY 2007-08 had a balance of $2,080,073,826.

The primary objective of the Treasury Investment Pool is to ensure that the State is able to meet all of its payment obligations, while preserving the value of the assets in the Pool. Of secondary importance is to maximize returns for the State and other government-related organizations.[2]

To achieve these objectives, investments made by Treasury consist of a combination of short and intermediate term fixed income securities. The asset structure of the pool is designed to meet anticipated liquidity requirements using short term investments and produce additional investment income through investments in securities with longer terms to maturity. During the 2007-2008 Fiscal Year, the Treasury Investment Pool produced more than $1 billion in interest earnings; a major source of non-tax revenue.

At the end of FY 07-08, the State Treasury Pool had $18.3 billion. As shown in Exhibit 1, state and federal trust funds constituted $7.98 billion of these investments. General Funds comprised $6.75 billion and the SPIA pool totaled $3.5 billion.

Exhibit 1:
The Treasury Investment Pool had $18.3 Billion Invested at the End of FY 07-08



Source: Division of Treasury

As shown in Exhibit 2, the Treasury allocates invested funds among the following five investment portfolios:

- Certificates of Deposit
- Internal Liquidity
- Internal Bridge
- Internal Intermediate
- External Medium Term

Investments from the General Fund, State Trust Funds are comingled among these five investment portfolios. Half of SPIA funds are allocated to the Internal Liquidity Porfolio, and half are comingled with General and State Trust funds among the other investment portfolios. However, interest earned from Treasury Pool investments are allocated among General and State Trust funds, and SPIA in proportion to the total amount invested in the Treasury Investment Pool.

Treasury reported that this policy of combining funds offers liquidity to participating organizations, as well as producing higher returns through investments in securities with longer-term securities. This policy has resulted in the placement of nearly 80% of its investments in these longer-term securities, which have higher expected returns.

The types of investments made with Treasury Pool funds are limited to those authorized in Florida law.[3] In addition, each of the Treasury Pool portfolios has a separate investment policy, which provide additional investment requirements.

The Certificate of Deposit Program was established to conform to Florida law, which stipulates that funds that are not required to meet the liquidity needs of the State must be offered to the qualified public depositories of the State if they are willing to pay rates established by the State Treasury[4,5] In FY

[2]As described in the General Investment Policy, Florida State Treasury, dated June 16, 2008

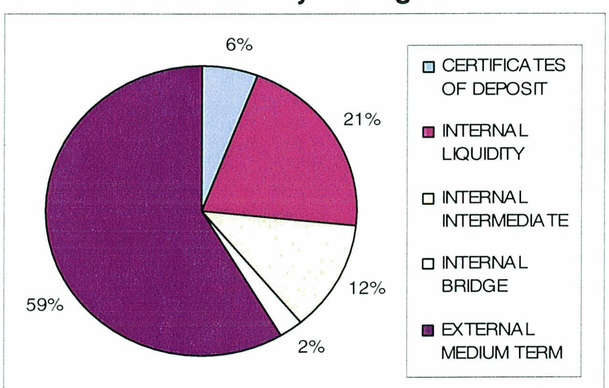
[3]Section 17.57, F.S. identifies authorized investments that can be made with Treasury Pool funds.
[4]As specified in Section 17.57, F.S.
[5]As defined in Section 280.02, F.S.. Qualified Public Depositories are financial institutions that are designated by the Chief Financial Officer. Each designated Qualified Public Depository is statutorily required to have its principal place of

2007-08, the average daily balance of the Certificates of Deposits held by Qualified Public Depositories was $1.12 billion or 6% of the total amount of invested funds.

The Internal Liquidity Portfolio is structured to ensure ready access to funds necessary to meet the State's disbursement needs. The target balance for the internal liquidity portfolio is $2 billion plus half of SPIA monies. In FY 2007-08, the average daily balance of the internal liquidity portfolio was 4.06 billion or 21% of invested funds.

In FY 2007-08, the average daily balance of the Internal Intermediate and External Medium Term Portfolios were $2.38 billion and $11.37 billion respectively. Both portfolios are structured to produce higher returns through investments in longer-term securities. However, the External Medium Term Portfolio utilizes contracted investment managers to select the securities held in the portfolio, while all investment decisions for the Internal Intermediate Portfolio are made by Treasury employees.[6]

Exhibit 2:
In FY 2007-08, 59% of Treasury Pool Funds Were Externally Managed



Source: Division of Treasury

business or operate a branch office in Florida. The limit of any investment with any one institution is $200 million or 10% of the assets of the institution, whichever is lower.

[6]In FY 2007-08, the Treasury paid $13.6 million to 26 companies to manage its investments in the External Medium Term Portfolio.

AUDIT ISSUES

Performance of contracted investment managers did not meet expectations in FY 2007-08

The Treasury authorizes its contracted investment managers to employ an active investment strategy to help maximize the returns of its externally medium term portfolio. These contracted investment managers select securities based on the goal of achieving a rate of return higher than the designated performance benchmark.[7] The performance benchmark is selected based on its similarities to the investment strategy of the portfolio.

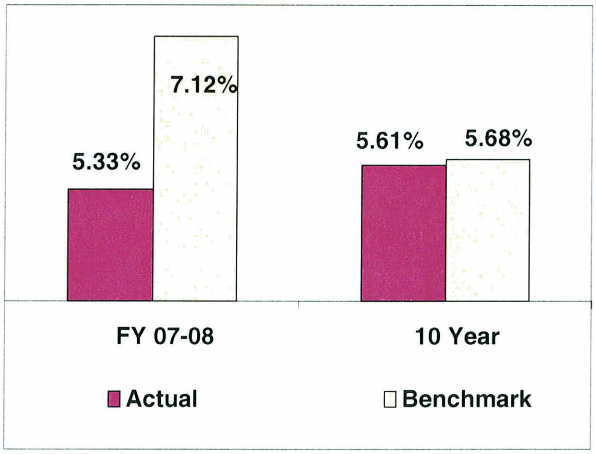
As shown in Exhibit 3, based on returns generated by the performance benchmark, contracted investment managers have not met performance expectations. The primary reason for these poor results by contracted investment managers is due to the significant underperformance in Fiscal Year 2007-08 where the investment return generated by external medium term portfolio was 5.33% or 179 basis points below the performance benchmark return of 7.12%. Due to this significant underperformance in FY 07-08, average annual returns generated by contracted investment managers for the preceding 10 years are now also below the returns produced by the performance benchmark for the corresponding period.

A possible cause for the underperformance of the externally managed portfolio is that external manager performance is evaluated primarily on the returns generated from investments. Consequently, external managers are incentivized to invest in higher risk securities that carry higher expected

[7]The performance benchmark for Treasury's externally managed portfolio is the Lehman Brothers Aggregate Bond Index, which consists of intermediate investment grade securities. The Lehman Aggregate Bond Index is a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type.

returns, rather than maintain a diviersified portfolio that mirrors the characteristics of the benchmark index, and which also reflects the investment strategy of the portfolio.

Exhibit 3:
FY 07-08 Performance of Externally Managed Investments Caused 10-Year Average Returns to Fall Below Performance Benchmark Returns.



Source: Division of Treasury

External oversight of investment policies and procedures is limited

Treasury achieves its objective through management of risks. Risks associated with the management of investments can be classified into two broad categories:

- Credit Risk: The risk that another party to a deposit or investment transaction will not fulfill its obligation. Credit risk exposure can also be affected by a concentration of deposits or investments in any one investment type or with any one investment participant.
- Market risk: The risk that the market value of an investment will decline due to changes in general market conditions. Market risk is highest for securities with above-average price volatility and lowest for stable securities such as Treasury bills.

Credit risk is controlled by purchasing securities issued by entities of high credit quality. Treasury Investment Pool policies requires portfolio investment managers to invest in securities that are issued by companies with an excellent financial rating by a nationally recognized rating agency.

Market risk is best controlled by ensuring that state disbursement requirements can be achieved without having to sell securities prior to reaching maturity. A diversified allocation of securities is generally considered an effective market risk control when state disbursement requirements exceed expectations and securities need to be sold prior to reaching maturity because the correlation between the change in valuation and the change in market condition varies with each type of security.

Treasury has developed policies to help ensure Treasury Investment Pool objectives are achieved. These policies are developed by the Treasury Investment Committee. This committee consists of the Director of the Division of Treasury, the Chief of the Bureau of Funds Management, the Financial Administrator for Internal Investments and the Financial Administrator for External Investments. Final approval of recommended investment policies is made by the Chief Financial Officer or her designee.

Procedures used to ensure that the objectives identified in policies are achieved are also developed by members of the Treasury Investment Committee. In addition, all investment operations are performed by staff under management by members of the Treasury Investment Committee, to include approval of external investments and the actual placement of funds.

External financial advisory services can provide independent assessment that investment objectives are being achieved

To help ensure that investment objectives of general revenue and trust funds maintained in the Treasury Investment Pool are achieved, we recommend that additional external oversight services be performed. Specifically, we recommend that, as a minimum Treasury procure the following services:

- an annual assessment of investment performance as compared to established performance benchmarks and with peers at the asset class and total fund level;
- periodic audits of Treasury's compliance with its written policies and operating procedures; and
- a quadrenial review of investment policies.

Financial advisory services provided by an external entity can provide an independent and objective perspective of Treasury's investment program. External entities that are independent of Treasury investment operations can provide unbiased advice and provide a source of specialized knowledge to access when making investment-related decisions. In addition, an external financial advisor can assist with the development of custom benchmarks to reflect investment policy objectives and provide comparisons of investment performance at the asset class and total fund level.

External oversight can help ensure that Treasury achieves its investment objectives through improved risk management. External financial advisory services can help mitigate operational risk through independent analysis of the governance structure of Treasury Pool investments. Finally, external financial advisory services can mitigate operational risk by providing assistance in the selection and monitoring of external investment managers.

External oversight of Treasury Pool investments can also provide assurances that policies and procedures to manage investment credit and default risks are effective. Periodic compliance audits by an external entity help ensure that investments achieve their primary objective to ensure that the State meets it payment obligations, while preserving the value of the assets in the Pool.

External financial advisory services can also improve investment risk management through assistance with periodic reviews and revisions of Treasury investment policies. Investment policy review and development assistance can help ensure that risk parameters used to govern the plan's investments, such as asset allocation targets will provide management with sufficient assurances investment objectives are acheived.

During our review, Treasury began a process to procure financial advisory services through a new contract for investment custodial services with The Bank of New York. As part of this new contract, the Bank of New York has proposed to provide $100,000 annually for the Treasury to procure external financial advisory services. We recommend that these external financial advisory services be used to ensure that the Treasury's investment objectives are achieved.

Recommendation #1: Specifically, we recommend that these advisory services include an annual assessment of investment performance as compared to established performance benchmarks and with peers at the asset class and total fund level.

Recommendation #2: We further recommend that these advisory services include a biennial audit of Treasury's compliance with its written policies and operating procedures. Currently, a member of Treasury staff is assigned responsibilities to help ensure compliance with investment policies and procedures. While these investment compliance services are beneficial, it does not provide adequate objective and independent assurances that both internally and externally managed investments are achieving intended objectives, and are in compliance with associated policies and procedures.

If funding constraints preclude utilization of financial advisory services from the proposed investment custodial services contract, we recommend that they they be separately procured from funds derived from Treasury Pool investment returns, which are also used to fund internal investment operations.

Recommendation #3: Finally, we recommend that these external financial advisory services include a review of each investment policy every four years. A quadrennial review of the objectives and guidelines for Treasury Pool investment will allow for revision of investment policies to reflect changes in strategies, investment authorities, and operational conditions that could affect the manner in which funds are invested.

To comply with the statutory guidelines and legislative intent, the Certificate of Deposit Program should be modified.

Florida law requires that the Treasury Certificate of Deposit Program place funds, which are not needed to meet the disbursement needs of the State in qualified public depositories that will pay rates of return established by the Chief Financial Officer.[8] Qualified Public Depositories (QPDs) are designated by the Chief Financial Officer and are required to have its principal place of business or a branch office located in Florida.[9] The established rate of return must be at levels not less than the prevailing rate for United States Treasury securities with a corresponding maturity.

The intent of this legislation was to promote economic development by providing Florida financial institutions with funds that could be loaned to Florida citizens and businesses. To encourage participation in the CD Program, the minimum rate of return for the CD Program was reduced on January 18, 2007, from 115% to 105% of the rates paid on U.S. Treasuries with corresponding maturities.

However, due to limitations placed on the amount of funds made available to the CD Program each month, the program is not fully meeting the intent of this legislation. In Fiscal Year 2007-08, the Treasury purchased 88 Certificates of Deposit totaling $390 million.[10] An additional 356 bids totaling $1.87 billion exceeded the established minimum interest bid rate, but were not accepted due to limitations placed on the availability of funds.

During FY 2007-08, the Treasury purchased $922 million of securities with Internal Intermediate and External Medium-Term Porfolio funds instead of CDs that could have been purchased above the minimum rate.[11]

Recommendation #4: To ensure that Treasury investment strategy fully conforms with legislative intent, we recommend that Treasury either work with the Legislature to change existing statutory language or ensure that all funds not needed to meet the state's immediate disbursement needs be first offered to Qualified Public Depositories willing to pay an established minimum interest rate before investing these funds in longer-term securities

The Certificate of Deposit Program can be enhanced to provide a direct contribution to economic development in Florida

The Certificate of Deposit Program can be modified to more fully achieve its legislative intent to enhance economic development in Florida and increase tax receipts. Increases in economic development can be achieved by requiring that particpating financial institutions utilize funds received through CD sales to the Treasury to provide loans to targeted businesses and industries in Florida.

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[8] As specified in Section 17.57(2), *F.S.*
[9] As specified in Section 280.02, *F.S.*

[10] From July through October of 2007, Treasury made $60 million available to the CD program. In November 2007; $40 million was made available. For the remaining monthly offerings in FY 2007-08, $15 million was made available to the CD program.
[11] The $922 million of CD's that could have been purchased is based on a comparison of bids by QPDs that exceeded the minimum bid rate, but were not purchased due to limitations on funding availability, with the amount of securities purchased in the Internal Intermediate and External Medium Term Portfolios for each month in FY 2007-08.

Recommendation #5: To further stimulate economic activity in the State, we recommend that Treasury consider available alternatives to promote economic development in Florida through its CD Program. Several other state treasuries utilize funds not needed for immediate disbursements to promote economic development.[12] These state treasuries have established programs that designate a portion of state deposits in lending institutions to be used to help provide low-cost capital for specified investments in the state. Under these economic development programs, state treasuries do not lend the money directly or guarantee loans. Instead, some of certificates of deposits are purchased at below-market rates with the requirement that the institution that holds the deposits will pass along its interest savings to investors who meet criteria established by the state.

For example, the State of New York's Comptroller and Economic Development entity operate a program that provides businesses with loans based on interest rates subsidized by state deposits.[13] Under this program, eligible businesses can obtain loans from participating lenders at an interest rate that is 2 or 3 percentage points lower than the prevailing rate, thereby making borrowing less expensive. Lenders are compensated by deposits of State funds at comparably reduced rates.

Since its inception in 1994, the New York program reported that it has funded 3,565 projects for a total amount of $1.2 billion, leveraging over $2.6 billion in new capital investment by businesses in New York State. During 2007, the program approved 445 loan applications totaling more than $123.2 million, which are projected to generate $352.1 million in private sector capital investment and create 1,781 new jobs.

The Treasury may also wish to consider partnering with Enterprise Florida to more fully utilize the CD program to promote economic development in Florida. Partnering with Enterprise Florida may allow the Treasury to more effectively employ CD Program funds toward economic development. In addition, it would allow Enterprise Florida to integrate the CD program with the other economic development programs that it administers.

[12]States with Link to Deposit programs to promote economic development include: California, Colorado, Indiana, Maryland, Missouri, New York, Oklahoma, and Washington.
[13]Empire State Development serves as the State of New York's primary economic development entity. The program is currently administered by two employees of Empire State Development.

DISTRIBUTION LIST

Information Distribution:

This report is distributed, with all exhibits and attachments, to:
- Alex Sink, Chief Financial Officer
- Jim Cassady, Chief of Staff
- Bruce Gillander, Director, Division of Treasury
- Bert Wilkerson, Chief of Bureau of Funds Management

File:

The original of the complete report has been placed in the Audit File.

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The Department's vision is to be known as the most ethical, professional and proactive state agency in Florida.

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This audit was conducted pursuant to Section 20.055, Florida Statutes, in accordance with applicable Principles and Standards for Offices of Inspectors General as published by the Association of Inspectors General and the International Standards for the Professional Practice of Internal Auditing as published by Institute of Internal Auditors, Inc. This audit was conducted by Chuck Hefren, Audit Director, with assistance from Trent Kilpatrick. Please address inquires regarding this report to the DFS Office of Inspector General at (850) 413-3112.

REPRESENTING
ALEX SINK
CHIEF FINANCIAL OFFICER
STATE OF FLORIDA

March 26, 2009

Mr. Robert Clift
Inspector General
Florida Department of Financial Services
200 East Gaines Street
Tallahassee, FL 32399-0312

Dear Mr. Clift:

This letter is in response to the Preliminary and Tentative audit report on the Treasury Investment Pool dated March 9, 2009.

Recommendation #1:

Investment performance is currently reviewed by Treasury management semi-annually for the external investment managers and annually for the internal investment portfolios. Performance is compared against established benchmarks. Treasury management is unaware of any other investment programs that have similar characteristics that could be used for peer review. Nevertheless, it is the intent of Treasury management to contract with an investment consulting firm to review the structure and performance of the Treasury investment program in light of established investment principles. The consultant will be asked to determine if comparison with peers can be reasonably performed. We expect the first review by the consultant to take place at the end of this fiscal year.

Recommendation #2:

We concur that an annual review of compliance with investment policies and procedures by an independent organization would be beneficial.

As of the beginning of March 2009, we have been obtaining daily compliance testing reports from our custody bank for investment policy items that can be verified systematically. We are looking for economical ways to obtain compliance testing on the remaining items. We are obtaining quotes from external consulting firms and reviewing internal options. We anticipate that complete compliance testing will be performed on a minimum of a monthly basis beginning with the month of April, 2009.

FLORIDA DEPARTMENT OF FINANCIAL SERVICES
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Recommendation #3:

We concur that a quadrennial review of investment objectives and guidelines by an independent organization would be beneficial.

We are currently in the process of obtaining such services via an external consulting firm. A requirement set forth in the proposed agreement with the external consulting firm is the consultant will review program policies and procedures (including Investment Guidelines), as requested by the Department, and make recommendations. We anticipate initiating the first review at the end of this fiscal year.

Recommendation #4:

We concur that the asset allocation practices of the Division of Treasury in recent years do not give sufficient preference to placement of certificate of deposit funds in qualified public depositories. It is the intent of Treasury management to seek an amendment to Section 17.57(2), Florida Statutes during the 2010 session of the Florida Legislature.

Recommendation #5:

Although placement of Treasury funds in deposits in qualified public depositories at "below market rates" would require statutory change, the Division of Treasury will seek to devise an investment program that will promote economic development in Florida. The target date for implementation of such a program is during the 2009-2010 fiscal year.

Please let me know if you need any additional information.

Sincerely,

Bruce Gillander

Bruce Gillander
Director
Division of Treasury

BG/kka