



**State of Arizona
Office
of the
Auditor General**

PERFORMANCE AUDIT

**STATE BOARD OF
DEPOSIT**

**Report to the Arizona Legislature
By Douglas R. Norton
Auditor General
December 1997
Report # 97-21**



DOUGLAS R. NORTON, CPA
AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

DEBRA K. DAVENPORT, CPA
DEPUTY AUDITOR GENERAL

December 1, 1997

Members of the Arizona Legislature

The Honorable Jane Dee Hull, Governor

The Honorable Tony West, Chairman
State Board of Deposit

Transmitted herewith is a report of the Auditor General, A Performance Audit of the State Board of Deposit. This report is in response to a May 27, 1997, resolution of the Joint Legislative Audit Committee. The performance audit was conducted as part of the Sunset review set forth in A.R.S. §§41-2951 through 41-2957.

The report addresses the following three issues and recommends that the Legislature consider amending §35-311 to: 1) provide that appointees have financial backgrounds and investment expertise; 2) ensure that one of the two appointees also represent a local government entity investing in the Local Government Investment Pool; and 3) change the name of the State Board of Deposit to the State Board of Investment to more accurately reflect its actual duties.

As outlined in its response, the State Board of Deposit agrees with all of the findings and recommendations.

My staff and I will be pleased to discuss or clarify items in the report.

This report will be released to the public on December 2, 1997.

Sincerely,

Douglas R. Norton
Auditor General

SUMMARY

The Office of the Auditor General has conducted a performance audit and Sunset review of the Arizona State Board of Deposit, pursuant to a May 27, 1997, resolution of the Joint Legislative Audit Committee. This review is part of the Sunset review set forth in Arizona Revised Statutes (A.R.S.) §§41-2951 through 41-2957.

The State Board of Deposit was first established by statute in 1980. Currently, the Board consists of the following five members: The State Treasurer, who acts as Chairman; the Director of the Department of Administration; the State Superintendent of Banks; and two individuals appointed by the Treasurer. According to A.R.S. §35-311, the Board is required to hold regular monthly meetings for the purpose of reviewing the State's investment portfolio, which includes permanent endowment funds and nonendowment fund investment pools. The Board has the authority to direct the State Treasurer to sell securities should it be deemed necessary, although it has never exercised these powers. Finally, the Board is responsible for notifying qualified banks of the time and place at which bids will be received to act as the State's servicing bank when that contract is due for award.

The Board of Deposit's periodic review of the Treasurer's portfolio provides independent oversight of how public monies are invested. Without adequate review and oversight of how public monies are invested, the degree of risk associated with those investments could be higher than the public realizes. This occurred in Orange County, California, when the county treasurer invested public monies in high risk types of investments that lost significant value when interest rates rose during 1994. The County was forced to declare bankruptcy when investment pools decreased in value, which ultimately resulted in a loss of \$1.7 billion.

This review recommends continuing the Board. However, the audit addressed the following three issues and recommends that the Legislature consider amending §35-311 to:

- Provide that appointees to the Board have financial backgrounds and investment expertise. The Treasurer's two current appointees have extensive investment expertise; however, this is not currently required by statute.
- Ensure one of the two appointments also represents a local government entity investing in the Local Government Investment Pool. Since the State Treasurer currently invests almost \$2.5 billion of local government monies in the Local Government Investment Pool (LGIP), requiring LGIP representation on the Board would help ensure local government investors have input into Board decisions. Currently one appointee repre-

sents a county investing public monies with the State, but such an appointment is not currently required by statute.

- Change the name of the State Board of Deposit to the State Board of Investment to more accurately reflect the Board's actual duties.

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INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit and Sunset review of the Arizona State Board of Deposit, pursuant to a May 27, 1997, resolution of the Joint Legislative Audit Committee. This review is part of the Sunset review set forth in Arizona Revised Statutes (A.R.S.) §§41-2951 through 41-2957.

Board of Deposit's History and Mission

The State Board of Deposit was first established by statute in 1980. Currently, the Board consists of the following five members: the State Treasurer, who acts as Chairman; the Director of the Department of Administration; the State Superintendent of Banks; and two individuals appointed by the Treasurer. According to A.R.S. §35-311, the Board is required to hold regular monthly meetings for the purpose of reviewing the State's investment portfolio, which includes permanent endowment funds and nonendowment fund investment pools. The Board has the authority to direct the State Treasurer to sell securities should it be deemed necessary, although it has never exercised these powers. Finally, the Board is responsible for notifying qualified banks of the time and place at which bids will be received to act as the State's servicing bank when that contract is due for award.

Board Reviews Treasury Investments

The Board reviews the investment of all public monies by the State Treasurer. The Treasurer's investment portfolio, limited to fixed-income securities, is currently worth nearly \$5.7 billion and includes repurchase agreements, commercial paper, collateralized mortgage obligations, and corporate bonds. Maturities range from overnight to 30 years. The Treasurer currently operates 24 investment pools consisting of 13 permanent endowment funds and 11 nonendowment fund investment pools. The permanent endowment funds contain proceeds from sales of land that the federal government had given Arizona when it became a state, and only the interest earnings from these funds are expendable.

Assets in the endowment funds exceeded \$818 million at the end of fiscal year 1997. Each fund has a statutory purpose. The largest fund, the Permanent Common School Fund, contains over \$750 million. The other 11 nonendowment fund investment pools, however, totaled over \$4.8 billion, with half of that amount contained in the Local Government Investment Pool (LGIP). The approximately 140 LGIP participants, including counties, cities,

school districts, and other governmental agencies, benefit from the substantial aggregate buying power of the state portfolio and the professional investment services the Treasurer's Office provides. Other nonendowment fund investment pools include Arizona Department of Transportation bond proceeds, state agency monies, and special monies for the Arizona Game and Fish Department.

Treasury investments have been increasing rapidly. In June 1991, total assets of endowment and nonendowment investments were worth approximately \$2.7 billion. However, by June 1997, total assets had more than doubled in size, to approximately \$5.7 billion. Almost \$2.7 of this \$3.1 billion increase in assets involves the nonendowment investment pools. During fiscal year 1997 alone, treasury investments increased over \$780 million; approximately \$391 million of this increase was experienced by the LGIP.

The Board meets monthly to review the State Treasurer's Report, which documents the performance of all treasury investments based on the Treasurer's formal investment policies. In 1996, the Treasurer's Office refined its investment policies into a more comprehensive and definitive written document. In order of priority, the Treasurer is to "maintain the maximum safety of principal, maintain liquidity to meet cash flow needs, and provide the highest investment returns." Currently the Board reviews investment performance against selected financial market indices, including the *Salomon Brothers Broad Investment-Grade Bond Index*, *Standard and Poor's Local Government Investment Pool Index*, and U.S. Treasury Bills. The Board also reviews investment information, such as summaries of current holdings, purchases and sales, yield analyses, and cash flow projections.

Board's Independent Review Is Important

The Board of Deposit's periodic review of the Treasurer's portfolio provides independent oversight of how public monies are invested. Without adequate review and oversight of how public monies are invested, the degree of risk associated with those investments could be higher than the public realizes. This occurred in Orange County, California, when the county treasurer invested public monies in high risk types of investments that lost significant value when interest rates rose during 1994. The County was forced to declare bankruptcy when investment pools decreased in value, which ultimately resulted in a loss of \$1.7 billion.

In Orange County, the county treasurer reported to an elected five-member board of supervisors. The board, who lacked sufficient financial expertise and reliable periodic investment reports, had relied on the treasurer's previously successful investment track record. However, a 1995 California State Audit found that the treasurer made investments that were "unsafe, highly risky, and extremely volatile" and violated the public trust. Two of the report's key recommendations were to create an investment advisory committee

independent of the treasurer's office, and to require the county treasurer to report to the board of supervisors at least quarterly on investment activities and holdings. The Government Finance Officers Association also recommends investment committees for governments concerned about the complexity of their investment program and the need for an oversight function.

Recent legislation involving the Office of the State Treasurer will affect investment operations, which means that the Board of Deposit's independent review will also be affected. Senate Concurrent Resolution 1018, which was approved in April 1997 and which still requires passage by the electorate during the November 1998 general election, authorizes the Treasurer to invest in equities for the 13 state endowment trust funds. The funds are currently invested in only fixed-income, interest-bearing instruments such as corporate securities and U.S. Government and Agency Securities. This new equities investment legislation for endowment funds was previously recommended in a 1997 Auditor General report (Report No. 97-6) on the Arizona State Land Department. The Treasurer's Office agrees that equity investing for endowment funds is expected to enhance investment returns by millions of dollars annually. However, this will also require the Board of Deposit to review these additional types of treasury investment instruments.

A second bill, Senate Bill 1339, authorizes the Treasurer to lend nonendowment securities, purchase warrant notes for cities and counties, and contract with investment advisors if needed. Lending securities for interest earnings, and purchasing warrant notes for resale to local governments, is expected to further enhance state treasury investment yields. Authority to loan securities already exists in law for the endowment trusts, the Workers' Compensation Fund, and funds of the Arizona State Retirement System. Local governments will also save money by using the State's lower interest rates. The Board of Deposit's role will be further enhanced by the need to review all of these new investment policies and procedures affecting the State Treasurer's Office.

Audit Scope and Methodology

The purpose of this review was to determine the need for the State Board of Deposit. Our review recommends continuing the Board. In addition, as discussed in the Sunset Factors (see pages 5 through 9), the audit addressed the following three issues and recommends that the Legislature consider amending §35-311 to:

- Provide that appointees to the Board have financial backgrounds and investment expertise,

- Ensure one of the two appointments also represents a local government entity investing in the Local Government Investment Pool, and
- Change the name of the State Board of Deposit to the State Board of Investment.

Audit work focused on evaluating the State Board of Deposit's performance in reviewing the investment of state treasury monies, which includes the 13 permanent endowment funds and 11 other nonendowment fund investment pools. Relevant statutes and rules were reviewed with regard to Board responsibilities; investment reports and other financial information from the State Treasurer's Office was gathered and evaluated; and other states were contacted. In addition, Board meetings were attended, meeting minutes were reviewed, and interviews were conducted with Board members, Treasurer's Office staff, and other interested parties.

This audit was conducted in accordance with government auditing standards.

The Auditor General and staff express appreciation to the members of the Board of Deposit, the State Treasurer, and staff for their cooperation and assistance throughout the audit.

SUNSET FACTORS

In accordance with A.R.S. §41-2954, the Legislature should consider the following 12 factors in determining whether to continue or terminate the State Board of Deposit (Board).

1. Objective and purpose in establishing the Board.

The State Board of Deposit was established by Laws 1980, Chapter 108, now A.R.S. §35-311. Originally consisting of the State Treasurer, who acts as Chairman, the Director of the Department of Administration, and the Superintendent of Banks, the Board is responsible for holding public meetings each month to review the State Treasurer's investment of permanent endowment funds, thus ensuring that these public monies are being invested under established guidelines. In 1996, the Legislature amended this review to include all treasury monies coming into the possession or custody of the State Treasurer. The State Treasurer must invest treasury monies in fixed-income securities authorized by A.R.S. §§35-312 and 35-313. In addition, under A.R.S. §35-311(D), the Board may order the State Treasurer to sell any securities currently held by the State. Also, under A.R.S. §35-315(C), the Board assists the State Treasurer in determining and notifying the servicing bank that had the lowest qualified bid for the State's banking business.

In 1987 the Legislature expanded the Board under A.R.S §35-311, adding two members to be appointed by the State Treasurer. The primary intent in establishing the Board remains that it act as an independent oversight of the state treasury and has changed only to the extent that most monies today are invested in specific instruments rather than being deposited in a bank for overnight interest earnings.

2. The effectiveness with which the Board has met its objective and purpose and the efficiency with which the Board has operated.

The Board has met its objective to review the State Treasurer's investment portfolio, currently valued at approximately \$5.7 billion. The Board holds monthly public meetings to review reports of the State Treasurer's investments, which include projections of cash flow requirements. These public reports, prepared by the Investment Accounting Division of the State Treasurer's Office, currently provide information on both endowment and nonendowment investment fund balances and yields, securities purchased and sold, bank deposit collateral, and investment management fees received from local governments participating in investment pools. A

customized investment accounting/portfolio management system allows the State Treasurer to account for every investment portfolio transaction, and investment activity reports are generated daily for analysis. On a monthly basis, investments are marked (valued) to market, a practice recently recommended by the Government Finance Officers Association.

In addition, the Board has statutory authority to order the State Treasurer to sell any held securities, but has never done so. However, in 1991 the Treasurer did inform the Board that \$10 million worth of investment bonds were expected to default. The Board recommended holding the bonds and pursuing payment through bankruptcy actions. This was done and, to date, the entire \$10 million principal amount has been recouped, including a small yield. According to the Chief Deputy State Treasurer, the Board was instrumental in providing oversight and counsel in this matter.

3. The extent to which the Board has operated within the public interest.

The Board has operated within the public interest by providing an independent monthly review of the State Treasurer's investment portfolio. To help ensure that the Treasurer is earning appropriate rates of return, the Board reviews the performance of treasury investments against the performance of selected market indices such as the *Salomon Brothers Broad Investment-Grade (BIG) Bond Index*, *Standard and Poor's (S&P) Local Government Investment Pool Index*, and 3-month U.S. Treasury Bills. During fiscal year 1997 the State Treasurer earned over \$303 million on all invested monies, an increase from 1996 fiscal year earnings of approximately \$275 million. Endowment fund earnings increased by 8.6 percent, compared to a change in the Salomon Brothers BIG Index of 8.17 percent. The LGIP pool yield of 5.57 percent also exceeded the S&P LGIP Index yield of 5.29 percent. In fact, for the first six months of 1997 (January-June), the LGIP has outperformed the S&P LGIP Index by an average of 0.27 percent, providing Arizona's taxpayers with adequate returns on invested public monies.

4. The extent to which rules adopted by the Board are consistent with the legislative mandate.

In 1996, the Board adopted three administrative rules, all dealing specifically with payment from the General Fund to the bank providing services to the State. According to the Governor's Regulatory Review Council, these rules are within the scope of the Board's rulemaking authority. Since then, the Board has not adopted any further rules.

- 5. The extent to which the Board has encouraged input from the public before promulgating its rules and regulations and the extent to which it has informed the public as to its actions and their expected impact on the public.**

The Board holds regular monthly public meetings, as required by statute. Also, the Board's notification statement regarding open meetings is filed with the Secretary of State and is current. However, the notification is filed under the heading of the State Treasurer's Office instead of the State Board of Deposit. To help ensure the opportunity for public input in Board decisions, a separate public meeting notice specifying the Board of Deposit should be filed with the Secretary of State and kept current.

- 6. The extent to which the Board has been able to investigate and resolve complaints that are within its jurisdiction.**

Since the Board does not have investigative or regulatory authority, this factor does not apply.

- 7. The extent to which the Attorney General or any other applicable agency of state government has the authority to prosecute actions under enabling legislation.**

This factor is not applicable to the Board.

- 8. The extent to which the Board has addressed deficiencies in the enabling statutes which prevent it from fulfilling its statutory mandate.**

In 1987 Board composition was expanded from its original three members to five, with the two additional members appointed by the State Treasurer. Moreover, in 1996, amendments were passed to improve operations and recognize that the Board oversees all treasury investments, and also allowing for any loss to be charged against earnings or capital gains, which conforms to modern investment management practices. The Board has no legislative proposals pending.

- 9. The extent to which changes are necessary in the laws of the Board to adequately comply with the factors listed in the Sunset review statute.**

A.R.S. §35-311(A) should be amended to provide that appointees to the State Board of Deposit have financial backgrounds and investment expertise. Additionally, because the State Treasurer currently invests almost \$2.5 billion of local government

monies in the Local Government Investment Pool, the statute should provide that at least one appointee represent a local government entity investing with the State. Although the Treasurer's two current appointees have extensive investment expertise, and one represents a county investing public monies with the State, these conditions are not required by statute.

Board members agree that investment knowledge and expertise are important for Board membership. In addition, the Government Finance Officer's Association recently developed model language recommending the use of investment committees to some governments because elected policymakers may not have sufficient qualifications to monitor an investment portfolio. The California State Auditor also made such a recommendation in March 1995 following Orange County's bankruptcy and \$1.7 billion treasury loss. Amending A.R.S. §35-311(A) to require investment expertise would help ensure that future Board members have the required knowledge to adequately review the Treasurer's investment portfolio and make recommendations when appropriate. In addition, requiring LGIP representation on the Board would help ensure local government investors have input into Board decisions.

Board members recommend the Legislature consider further amending A.R.S. §35-311(A) to rename the State Board of Deposit. They suggest a new name that would be more indicative of the Board's nature and its activities, such as the State Board of Investment.

10. The extent to which the termination of the Board would significantly harm the public health, safety or welfare.

Terminating the State Board of Deposit could potentially harm the public. Without the Board's independent review and oversight of treasury investments, the approximately \$5.7 billion of public monies could be exposed to unacceptable levels of investment risk. For example, the bankruptcy of Orange County's Investment Pool, which lost approximately \$1.7 billion in 1994, had significant, far-reaching effects. The County was forced to eliminate nearly 1,700 jobs, their discretionary budget was cut by 41 percent, public projects were delayed, and many government services were privatized. In addition, cuts in services had a great impact on social programs, such as children's health care, homeless programs, and other welfare services the County provided. Local governments and school districts who invested with Orange County also experienced significant harm due to the bankruptcy.

The Government Finance Officers Association has determined that investment committees make it "more difficult for an individual to initiate a program of im-

prudent securities transactions or unsound deposits of public funds.” The Association further states that by providing for collective judgments, investment committees can also be invaluable in times of crises and diffuse tension when market losses in a portfolio may occur.

The Board’s review of treasury investments is necessary, and could become even more important in the future. Current treasury investments are predominately short-term in nature, which means that funds are constantly changing, and monthly Board oversight is necessary to adequately provide for review before any significant change in values is allowed to occur. Also, recent legislation, pending passage by the electorate as a constitutional referendum on the November 1998 general election ballot, will allow the Treasurer to invest in equities for the state endowment trusts. This authority is expected to increase investment returns. However, equity investing will require the Board to also expand its role of treasury investment oversight.

- 11. The extent to which the level of regulation exercised by the Board is appropriate and whether less or more stringent levels of regulation would be appropriate.**

Since the Board is not a regulatory body, this factor does not apply.

- 12. The extent to which the Board has used private contractors in the performance of its duties and how effective use of private contractors could be accomplished.**

This factor does not apply since the nature of the Board’s activities does not call for the use of private contractors.

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Agency Response



OFFICE OF THE
State Treasurer

STATE CAPITOL

Phoenix, Arizona 85007-2812

TONY WEST
TREASURER

(602) 542-1463 OFFICE

(602) 542-7176 FAX

(602) 279-3116 HOME

November 25, 1997

Mr. Douglas R. Norton
Auditor General
State of Arizona
2910 North 44th Street, Suite 410
Phoenix, Arizona 85018

Dear Mr. Norton:

On the behalf of the Board of Deposit I would like to respond to the draft of a performance audit recently completed by your office. We found the report thorough and well written and we are in agreement with the three main issues raised:

- Require financial experience and investment expertise for Board appointees
- Require that one appointee represent a public entity that invests in the Local Government Investment Pool (LGIP)
- Change the name to the State Board of Investment

I brought these recommendations to the Board and received their ratification.

It is our plan to propose an implementation of your recommendations to the legislature. We truly feel that the Board will be strengthened and the changes will offer better protections for the citizens of Arizona. Once again, the Board and I thank you and your staff for a well-done audit and review.

Sincerely,

A handwritten signature in black ink that reads "Tony West".

Tony West
State Treasurer

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