Maryland STATE TREASURER
Investing for Maryland's future.

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TESTIMONY OF STATE TREASURER NANCY K. KOPP

Before the

House Appropriations Committee
Public Safety and Administration Subcommittee

March 5, 2015

Good afternoon, Mr. Chairman and members of the committee. I am pleased to appear before you today to present the State Treasurer's Office (STO) proposed budget for FY 2016. As usual, my sincere thanks to the Department of Legislative Services, and particularly Jolshua Rosado for his excellent work and analysis of this budget. We appreciate the critique and agree with the recommendation.

The State Treasurer's Office is tasked with carrying out several constitutional and statutory responsibilities on behalf of the State, including:

- Safeguarding and investment of excess cash balances
- Timely recordation and reconciliation of State funds
- Issuance of statewide debt to finance capital projects
- Procurement of all banking and financial services, insurance and insurance services; and
- Statewide insurance management to provide risk mitigation through loss protection, loss control and loss restoration.

I would like to take the opportunity to highlight some of the unique achievements carried out by the talented and dedicated staff within the Office over this past year before addressing the analyst's recommendation regarding our fiscal year 2016 budget.

Treasury Management Division – As I mentioned in last year's testimony, the Treasury Management Division was created in fiscal 2013 by merging the Banking and Investment Divisions in to division. This merger has already allowed many advances in computerization and streamlining of processes. One of our major ongoing objectives is to become a paperless work environment with all records and business processes merged into an electronic format.

This merger has allowed the Office to strengthen its capacities by cross training employees to cover critical banking and investment functions, while allowing us to take advantage of enhanced synergies in several areas of financial management, such as cash flow modeling and investments timed to meet cash disbursements. Accomplishments of the two Departments are noted below:

Banking Services Department (BSD) - As noted by the analyst, BSD ensures the accurate and timely recordation of State funds and the reconciliation of the State's bank accounts to the State's R*STARS accounting system. The average number of days to reconcile accounts has remained under 4 days since fiscal 2008. For fiscal year 2014, total cash receipts and disbursements each exceeded $106 billion and the State's General Fund bank accounts continued to be reconciled to the State's general ledger on a daily basis to the penny.

The Department and the Office's Information Technology Division implemented a Controlled Disbursement Account which provides for more efficient cash management for State vendor payments as well as a reduction in bank fees by eliminating current manual processes specific to daily reconciliation. In addition to the Controlled Disbursements Account, the Payee Positive Pay Program was also implemented at the State's Disbursement Bank (M&T Bank). These processes have improved control over checks presented to the disbursement account.

Another responsibility of the Department is to ensure protection of all State funds on deposit with financial institutions through monitoring of bank account and collateral balances. Utilizing the Treasurer's Bank Account Information System (TBAIS), BSD monitors over 1,800 agency bank accounts at 23 financial institutions. Total posted collateral as of February 28, 2015 was in excess of $623 million (unaudited). The annual Bank Account Survey, a verification tool used to ensure all accounts are collateralized appropriately and monitored monthly has been completed. The results of the survey were updated in TBAIS and we utilize this information to ensure collection of all interest owed to the General Fund.

Investment Department - Our conservative investment policy and practices have protected the investment portfolio through these volatile and unprecedented economic times. Consistent with past reports, I am pleased to be able to report that all principal is intact and a modest but continuous return has been earned on the portfolio. The par value of the General Fund investment portfolio for February 28, 2015 was $5,639,205,558.10 as compared to February 28, 2014 when it was $5,895,894,995.58. This is a decrease of $256 million dollars.

On February 28, 2015, the portfolio was earning an average of 1.085%, compared to 1.118% for the same date in 2014. The return reflects the diligence of the investment staff despite the impact of the Federal Open Market Committee maintaining the Fed Funds Target rate at .25% or less since December 16, 2008. For comparison, the three month constant maturity Treasury Bill averaged 0.024% from July 2014 until the end of February 2015 as compared with 0.046% for the same time period in the previous fiscal year. The low rate environment combined with the highly conservative portfolio strategy focused on liquidity to offset unpredictable and volatile cash flows has resulted in continued minimal but positive interest earned.

The General Fund gross interest earnings received year-to-date for fiscal year 2015 are $37,734,707 compared with $46,723,822 received for the same time period in fiscal year 2014. The over $8.9 million decrease in interest received in this low-rate environment is compounded by lower portfolio balances upon which to earn interest.

The Securities Lending Program continues to provide additional revenue. The program has earned $114,124.18 so far in fiscal year 2015. This compares with $172,145.67 for the same period in fiscal year 2014. Most financial institutions are deleveraging in order to comply with new rules and regulations, which further decreases their need for securities.

The Office continues to promote MBE participation in the investment of State funds. Twenty-four MBE broker/dealers are on the Office's approved list of broker/dealers for fiscal year 2015. This compares with fiscal year 2014, when the Office had twenty-two approved MBE broker/dealers.

The Maryland Local Government Investment Pool (MLGIP) AAAm rating was reaffirmed by Standard and Poor's on September 29, 2014. The Pool consists of 302 participants with a balance at February 28, 2015 of $4,018,420,142.93 as compared to $3,766,036,434.17 for the same date in 2014. This is an increase of over $252 million dollars due to participants' higher available cash balances. The MLGIP is paying .0485% as of February 28, 2015, compared to .0705% last fiscal year. The participants continue to use the Pool due to the lack of safe short-term investment alternatives for Investment Pool members at a comparable yield. The MLGIP is in total compliance with the 2010 changes in SEC Money Market rules and regulations and is preparing for changes proposed to take effect in October 2016. The MLGIP Advisory Board is monitoring all changes proposed by the SEC for Money Market Funds. The State Treasurer's Office has been very active working with the SEC and now GASB on proposed changes to the Funds and the way in which the changes might adversely impact local investment pools managed by states across the country.

Debt Management Division – As you are aware, Maryland is one of now ten states with AAA ratings from all three rating agencies. S&P has rated the bonds AAA since 1961, Moody's has assigned the bonds a rating of Aaa since 1973, and Fitch Ratings has rated the bonds AAA since 1993. In awarding Maryland this coveted recognition, the rating agencies repeatedly cite the economic and fiscal strength of the State and the State's fiscal management, including our model Capital Debt Affordability process.

On February 19th, in conjunction with the sale of Maryland's General Obligation Bonds State and Local Facilities Loan of 2015, First Series A and B held on March 4th, Moody's Investors Service, Standard & Poor's (S&P) and Fitch Ratings all affirmed their

AAA ratings for Maryland's General Obligation debt. Copies of these ratings reports can be found on our website.

Calendar Year 2015 Bond Sales

The 2015 First Series was sold on March 4, 2015 and totaled $883,360,000. The proceeds were used to finance new projects and refund existing bonds. The sale will close on March 17, 2015 and has two series:

Series A: $518.0 million in Tax-Exempt Bonds sold in a competitive sale primarily to institutions; and
Series B: $365.36 million in Tax-Exempt Refunding Bonds sold in a competitive sale primarily to institutions.

The Series A bonds provided $518.0 million, at a TIC (True Interest Cost) of 2.65%, to finance investments in capital projects critical to our State. Series B was an advanced refunding of certain outstanding General Obligation Bonds and **saved taxpayers a net present value of $21.8 million in debt service costs.**

Calendar Year 2014 Bond Sales

The 2014 First Series was sold on March 5, 2014 and totaled $736,855,000. The proceeds were used to finance new projects and refund existing bonds. The sale closed on March 18, 2014 and had three series:

Series A: $450.0 million in Tax-Exempt Bonds sold in a competitive sale primarily to institutions;
Series B: $50.0 million in Taxable Bonds sold in a competitive sale primarily to institutions; and
Series C: $236.9 million in Tax-Exempt Refunding Bonds sold in a competitive sale primarily to institutions.

The Series A and Series B bonds provided $500.0 million, at a combined TIC (True Interest Cost) of 2.77%, to finance investments in capital projects critical to our State. Series B was an advanced refunding of certain outstanding General Obligation Bonds and saved taxpayers a net present value of $12.6 million in debt service costs.

The 2014 Second Series was sold on July 23, 2014 and totaled $1,149,715,000. The proceeds were used to finance new projects and refund existing bonds. The sale closed on August 5, 2014 and had three series:

Series A: $50.4 million in Tax-Exempt Bonds sold in a negotiated sale with first priority to Maryland citizens
Series B: $449.6 million in Tax-Exempt Bonds sold in a competitive sale primarily to institutions; and
Series C: $649.8 million of Tax-Exempt Refunding Bonds sold in a competitive sale primarily to institutions

The Series A and Series B bonds provided $500.0 million, at a combined TIC of 2.40%, to finance investments in capital projects that benefit communities throughout the State. Series C was an advanced refunding of certain outstanding General Obligation Bonds and saved taxpayers a net present value of $58.3 million in debt service costs.

Qualified Zone Academy Bonds (QZAB) of 2014 were sold on December 8, 2014, closed on December 18, 2014 and totaled $4,625,000. These were tax credit bonds bearing no interest. QZAB proceeds are used to fund capital improvements and repairs at existing schools in which at least 35% of the students are eligible for free or reduced-price lunch.

Closed Financing – Leases

The Capital Lease-Finance Program allows State agencies to acquire equipment and pay for those items over a three, five or ten year time frame. Between July 1, 2014 and February 28, 2015, $400,156 in capital equipment was leased by State agencies through the State Treasurer's Office with an interest rate of 1.1472% for the three year leases and 1.5137% for the five year leases.

Insurance Division

Claims Unit - The Claims Unit continued to proactively pursue debts owed to the State from the negligence of others. The Office **recovered over $1.2 million** from parties responsible for damaging State-owned property in fiscal year 2014. With four months remaining in fiscal year 2015, the Unit expects to recover $1.2 million by the end of the year, having **recovered over $815,899 as of February 28, 2015** and one large subrogation in queue in the amount of $143,794.

Underwriting Unit - The Insurance Division procures broker services for the purchase of commercial insurance to protect the State Insurance Trust Fund from catastrophic loss, to meet statutory or regulatory requirements, and for compliance with agencies' contractual agreements. The Underwriting Unit has been very successful in improving coverage and in achieving competitive premiums for some of the State's largest risks:

- Maryland Transportation Authority (MDTA) – Liability renewal for toll bridges, tunnels, and the Inter County connector

  Total savings $22,194

- State of Maryland - Blanket Boiler and Machinery coverage for State-owned equipment

  Total savings $4,570

- Maryland Transportation Authority (MDTA) Property renewal for toll bridges, tunnels, and the Inter County connector

  Total Savings $749,226

- Maryland Port Administration (MPA) Crane property renewal

  Total savings $43,547

- State of Maryland (various colleges) – Allied Health- student professional liability for internship sites

  Total savings $27,344

STO Budget – The Treasurer's Office recognizes the fiscal challenges facing the State, and has reduced General Fund spending by approximately $254,000 in Fiscal Year 2015. With an appropriation comprised of more than 95% in non-discretionary spending, consisting primarily of Salaries, Benefits and Bank Fees, we were able to achieve these savings as a result of unanticipated vacancies and efficiencies achieved through greater automation of banking processes. We continue to operate within a very lean appropriation, and are consistently looking for ways to streamline and automate processes wherever feasible while continuing to provide a high level of service to State agencies and the citizens of Maryland.

Response to Legislative Analyst's Recommended Actions:

Recommended Actions

1) *Concur with Governor's allowance.*

STO Response

Office concurs.

Comments on Audit Findings

Injured Workers' Insurance Fund (IWIF)

Finding 1 – STO did not ensure the propriety of amounts paid to IWIF.

Finding 2 (Policy Issue) – Services provided by IWIF have not been subject to a competitive bid process.

STO Actions:

Since the audit, the Office has received direction from the General Assembly urging our office to identify and fill positions that would provide the STO with the ability to : (1) analyze the terms of the existing contract; (2) renegotiate the contract with the current vendor to obtain better terms for the State where possible; (3) oversee and manage the new contract with IWIF; and (4) once the new contract is in place analyze the possibility that the State could obtain better coverage terms through a different process.

On November 12, 2014, the BPW approved STO's request for two PINs to provide fiscal oversight, contract development and ongoing workers' compensation contract management for the State's contract with the Injured Workers' Insurance Fund. Funding for these positions is tied to the deficiency request that was included with our fiscal 2016 budget submission. Once funding is provided for these PINs, the Office will recruit to fill these positions and begin to address the issues noted in the audit.

Bank Accounts

Finding 3 – STO did not ensure interest earnings on State agency bank accounts were transferred to the State's General Fund.

STO Actions:

The Office agrees that all interest earned by State agencies on State deposits, subject to transfer to the General Fund, is in fact transferred. As noted in prior audits, we continue to believe that the duty to ensure that this transfer is made is shared between the Office and each State agency using bank accounts. Daily operation of these accounts is the responsibility of the individual agencies and their finance officers. The State Treasurer's Office is ensuring that applicable interest is being transferred into the State's General Fund via several processes listed below:

- Included the requirement as part of the new Agency Bank Depository Contract effective July, 2013, that interest must be transferred to the General Fund via ACH on a monthly basis
- Established requirement for agencies that are not included in the automatic transfer via ACH to submit proof of interest transfers for verification
- Implemented a new certification process whereby Bank Account Validation and Interest Certifications are signed by agency fiscal officers and submitted annually identifying interest bearing accounts

If the Office identifies an account where interest is not being transferred to the General Fund, the Treasury Management Division contacts that agency to ensure they do in fact transfer interest or receives documentation that the account is not subject to this requirement.

<u>Finding 4</u> – STO has not implemented recommended automated processes to improve controls over disbursements.

<u>STO Actions:</u>

This was a high priority initiative for the Office, and while these projects had been started, due to staffing resources and technical issues involved with reprogramming STO's banking system, they were not completed and implemented by the time of the audit. Payee Positive Pay and the usage of Controlled Disbursement Accounts were implemented in May and July of 2014, and are effectively being utilized to assist us in our efforts to improve cash management and prevent fraudulent activity within our disbursement accounts.