

STATE OF WEST VIRGINIA

**UPDATE OF
PRELIMINARY PERFORMANCE
REVIEW OF THE**

BOARD OF INVESTMENTS

OFFICE OF LEGISLATIVE AUDITOR

**Major Issues of the Review Were
Addressed Through Legislation**

**Five Recommendations are
in Compliance**

**Performance Evaluation and Research Division
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PE 97-10-81

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October 1997

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October 19, 1997

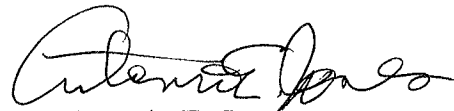
The Honorable Larry Wiedebusch
State Senate
403 Fern Drive
Glen Dale, West Virginia 26038-1005

The Honorable Vicki Douglas
House of Delegates
Building 1, Room E-213
1900 Kanawha Boulevard, East
Charleston, West Virginia 25305-0470

Dear Chairs:

Pursuant to the West Virginia Sunset Law, we are transmitting an Update of the Board of Investments, which will be reported to the Joint Committee on Government Operations on Sunday, October 19, 1997. The issues covered herein are "Major Issues of the Review Were Addressed Through Legislation; and Five Recommendations are in Compliance."

Sincerely,


Antonio E. Jones

AEJ/wsc

Enclosure

_____ *Joint Committee on Government and Finance* _____

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Executive Summary

Since the last update of the Board of Investments (BOI) in February 1997, the 1997 West Virginia Legislature passed SB 563. This bill created the West Virginia Investment Management Board to assume the investment functions of BOI and the West Virginia Trust Fund, both of which were repealed by SB 563. The Trust Fund formerly had the responsibility of investing pension funds which was the responsibility of BOI during the preliminary review in 1995. Although BOI no longer exists, its functions still come under the Sunset Law's compliance review. The preliminary review identified the following three issue areas:

- Issue 1. Excessive liquidity has resulted in the state receiving lower earnings over the past two years.
- Issue 2. The Board of Investments should use greater diligence in carrying out its investment responsibilities.
- Issue 3. Management fees do not reflect actual costs of managing funds.

This update report uses the following categories to measure agency compliance with recommendations of the original report.

Levels of Compliance
<u>In Compliance</u> - The Agency has corrected the problems identified in the final draft of the audit report.
<u>Partial Compliance</u> - The Agency has partially corrected the problems identified in the final draft of the audit report.
<u>Planned Compliance</u> - The Agency has not corrected the problem but has provided sufficient documentary evidence to find that the agency will do so in the future.
<u>In Dispute</u> - The Agency does not agree with either the problem identified or the proposed solution.
<u>Non-Compliance</u> - The Agency has not corrected the problem identified in the final draft of the audit report.
<u>Requires Legislation</u> - Statutory change is necessary to address the issue.

Major issues of the review were addressed by passage of **Enrolled HB 4866 of the 1996 Legislative session and Enrolled SB 563 of the 1997 Legislative session**. Nine recommendations were made, five are in compliance either by actions of the agency or by legislation. Two recommendations require legislation and two recommendations are in planned or partial compliance.

ISSUE AREA 1: Excessive Liquidity Has Resulted in the State Receiving Lower Earnings Over the Past Two Years

Recommendation 1

The BOI should work with the Legislative Auditor's Budget and Fiscal Affairs Division to develop annual projections of daily cash flow for the General Revenue Fund for the upcoming fiscal year. Thereafter, the BOI will develop these projections on its own. These 12 month projections should then be made available to advisors every month.

Level of Compliance: **Planned Compliance**

In the February compliance review, BOI officials indicated that they would develop a system to provide annual projections of daily cash flow without assistance from the Legislative Auditor's Budget and Fiscal Affairs Division. At that time, BOI acknowledged the need for better cash flow data. The Treasurer's Office will be responsible for providing the Investment Management Board (IMB) with cash flow data.

The Treasurer's Office intends to develop daily cash flow projections through computer software called Crystal which is being implemented by the Department of Administration. Crystal is a reporting tool that will allow State agencies to have customized reports generated from data contained in the State's automated financial system (WVFIMS). However, the use of this system has been delayed according to a written statement from the Treasurer's Office. The following is an excerpt from that statement:

However the ability of using Crystal to project future financial obligations has been delayed. The Crystal system doesn't currently provide a daily update. Therefore, we can't utilize this system to provide daily information concerning future financial obligations or information concerning daily receipt of revenue from all sources.

Officials with the Department of Administration indicated that Crystal requires additional programming which will allow it to provide daily updates of disbursements and receipts. The programming is scheduled to be complete in October 1997. The Treasurer's Office indicated that "Once the Crystal system is developed to provide our office with daily updates of revenue, we can then provide the IMB with better cash flow projections."

Recommendation 2

The BOI should consider giving advisors more specific guidelines that reflect the BOI's objectives for the Consolidated Operating Fund overall. The BOI should provide advisors specific information on what levels of liquidity the BOI desires, how much of a liquidity cushion is needed, and specific ranges of average maturities within the pool's structure, instead of giving only the top maturity limit. The performance measures may need to be adjusted periodically if specific

guidelines preclude the possibility of the advisor meeting the performance measures.

Level of Compliance: **In Compliance**

During the February compliance review, BOI minutes showed evidence of BOI taking a more active role in providing more specific guidelines to advisors concerning the Board's investment objectives. BOI encouraged one advisor to invest more in commercial paper because too much was being invested in overnight repurchase agreements resulting in a lower rate of return than another advisor. The advisor invested in commercial paper, resulting in a higher average maturity that compares well with the other advisor of the Cash Liquidity Fund. It is too early to tell if IMB will continue this approach with the investment advisors. However, IMB's financial statements for June 30, 1997 on the Cash Liquidity Fund indicated that the repurchase agreement balance as a percent of the Cash Liquidity pool was at 34%. This is down from 56% at the time of the Legislative Auditor's initial review. The average maturity of the Cash Liquidity Fund was 67 days, up from 39 days at the time of the preliminary audit. This will generally provide a higher rate of return.

Recommendation 3

The BOI should consider rule changes that allow the Consolidated Operating Fund to be invested between the guidelines of a money market structure and a mutual fund structure.

Level of Compliance: **Partial Compliance**

In the February compliance review, the Executive Director of the BOI responded to this recommendation as follows:

*“To the extent that the BOI can obtain better cash flows based on many of the above points (referring to response to **Recommendation 2**), we will be able to increase the amount of state dollars invested in longer term, higher yield investments. However, a large portion of this fund is comprised of participants who do not want the risk of a mutual fund structure.”*

The Legislative Auditor acknowledges that the strict sense of the recommendation has not been complied with because participants are reluctant to completely invest in a mutual fund structure. However, the restructuring of the Enhanced Yield Pool (recommendation 4) complies with some of the intent of the recommendation. The Enhanced Yield Pool was structured as a mutual fund during the preliminary audit, however, it did not provide much of an enhanced yield. The basic contention of the audit was that most of the Consolidated Operating Fund was under a money market structure with no option for investing longer term except for the Enhanced Yield Pool, which was not a significant improvement over the money market structure. The restructure of the Enhanced Yield Pool, in compliance with recommendation 4, doubled the average maturity restrictions. Agencies have been offered the flexibility of investing shorter term or longer term depending on each agency's liquidity needs. A sizable amount of funds has been added to the

Enhanced Yield Pool as indicated in recommendation 4. **The PERD recommends that State agencies be kept informed of their investment options and strive for better cash flow management in order to avoid excessive liquidity.**

Recommendation 4

The BOI should consider restructuring the Enhanced Yield Pool to achieve a higher enhanced yield. The BOI should also consider increasing the amount within the Enhanced Yield Pool from the current level of \$25 million.

Level of Compliance: **In Compliance**

In response to recommendation 4, BOI established new investment policy guidelines. The new guidelines restructured the Enhanced Yield Pool to allow a longer average maturity. The average maturity restriction was doubled from one to two years. According to IMB's June 30, 1997 financial statements, the new guidelines remain in effect for the Enhanced Yield Pool. Also, the amount in the Enhanced Yield Pool is \$231,223,210 as of June 30, 1997. This is in contrast to the \$25 million the pool contained during the preliminary audit.

Recommendation 5

The Legislature should consider amending WVC §5-10D-4 to require the actuary for the pension funds to provide the BOI with monthly projections of withdrawals and contributions for the fiscal year for each pension plan. In addition, the amendment should include the requirement that the projections be updated each quarter or more frequently if necessary. The actuary currently projects annual contributions and benefit payments for the pension funds.

Level of Compliance: **Requires Legislation**

Recommendation 6

The Legislature should consider amending WVC §5A-2-11 to require the Department of Administration to provide the BOI with its monthly revenue projections. The Legislature should also consider requiring the Department of Administration to project daily revenue flows for the General Revenue Fund.

Level of Compliance: **In Compliance**

This recommendation was resolved by the passage of Enrolled HB 4866 in 1996. This bill amended WVC §5A-2-11 as recommended. The Department of Administration is providing the monthly and daily revenue projections to the Treasurer's Office as required by HB 4866. Also, despite the repeal of BOI, §5A-2-11 still makes reference to BOI. The statute needs to be amended to have the projections submitted to the Treasurer's Office.

ISSUE AREA 2: The BOI Should Use Greater Diligence in Carrying Out Its Investment Responsibilities.

Recommendation 7

The Legislature should consider amending WVC 12-6-5(9) to require that the BOI use Delivery-versus-Payment or Tri-Party arrangements in conducting repurchase agreements.

Level of Compliance: **In Compliance**

The Legislature implemented this recommendation by passage of Enrolled HB 4866 in 1996. Passage of SB 563 in 1997 did not affect the language with respect to this recommendation. Under current law, IMB is required to take physical possession of securities involved in its repurchase agreements, or enter into a tri-party arrangement. IMB has made the following statement:

Currently, the WVIMB utilizes a tri-party arrangement for repurchase agreements on the Consolidated Pension Fund. Collateral for the Consolidated Fund repurchase agreements is currently done through physical possession. We are currently working on obtaining a tri-party contract for the Consolidated Fund.

ISSUE AREA 3: Management Fees Do Not Reflect Actual Costs of Managing Funds

Recommendation 8

The Legislature should consider amending §12-6-6a to allow the BOI to calculate the management service fee using an actual cost allocation formula. An alternative amendment would be to have the fee based on net assets. Net earnings are volatile and do not reflect the actual cost of investing the funds. The service fee should pay for the BOI's actual expenses, not its appropriated budget.

Level of Compliance: **In Compliance**

Senate Bill 563 amended the language requiring the charge of management fees for investment services. The current language requires IMB to charge management fees as a percentage of assets, which is consistent with recommendation 8. IMB has indicated that it is charging fees consistent with the statute.

Recommendation 9

If the Legislature decides to amend §12-6-6a to base the service fee on net assets, PERD recommends that the language allow the BOI to transfer to the Consolidated Pension Fund and local governments, any excess service fees charged, rather than have any overcharge diverted to the General Revenue Fund.

Level of Compliance: **Requires Legislation**

**APPENDIX A:
Agency's Response**



State of West Virginia

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October 10, 1997

Antonio E. Jones, Director
West Virginia Legislature
Performance Evaluation and Research Division
Building 1, Room W-314
Charleston, WV 25305

Dear Dr. Jones:

Our office is in receipt of your update of the Preliminary Performance Review of the Board of Investments. We are in agreement with most of the recommendations contained in the report. However, listed below are some comments relating to a couple of the recommendations.

Recommendation 5

The "staff" rather than the "actuary" of the pension funds should be required to provide the required information.

Recommendation 6

The department of Administration has recently provided our office with daily revenue flow for both revenues and disbursements for the 1997-98 FY.

If you need any additional information, please call me.

Sincerely,

A handwritten signature in cursive script, appearing to read "Jerry Simpson".

Jerry Simpson
Assistant Treasurer

RECEIVED

OCT 14 1997

RESEARCH AND PERFORMANCE
EVALUATION DIVISION

