Special Report

Legislative Joint Auditing Committee

September 14, 2012

Arkansas State Treasury

Review of Selected Bond Investment Transactions

INTRODUCTION

This report is presented to the Legislative Joint Auditing Committee in response to questioned transactions identified during the Arkansas State Treasury financial audit for the fiscal year ended June 30, 2011. The Treasury changed its investment practice of holding bonds until the call or maturity date and began selling the bonds to certain brokers earlier than required.

OBJECTIVES

The objective of the report was to review questioned bond transactions identified in the Treasury's fiscal year 2011 financial audit to disclose the financial effects of selling these bonds prior to maturity.

SCOPE AND METHODOLOGY

The investment transactions reviewed in this report occurred from July 1, 2011 to May 17, 2012. Division of Legislative Audit (DLA) staff obtained supporting documentation and information for each transaction and calculated the economic effects of these transactions.

The methodology used in conducting this review was developed uniquely to address the stated objectives and, therefore, was more limited in scope than an audit or attestation engagement performed in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States.

BACKGROUND

The Arkansas State Treasurer is an executive officer of the State, established by the Constitution of the State of Arkansas, and is to perform all duties required by Arkansas Code. The Treasurer is charged with serving as the custodian of monies required by Arkansas Code to be held in the Treasury, which totaled $3.27 billion in state and federal funds at June 30, 2011. As investor of state and federal funds, the Treasurer, pursuant to Ark. Code Ann. § 19-3-518, is authorized to invest Treasury funds in the manner prescribed by the Arkansas State Treasury Investment Policy, which is approved by the State Board of Finance.

ARKANSAS DIVISION OF LEGISLATIVE AUDIT
172 State Capitol, Little Rock, AR 72201
Phone: 501-683-8600 Fax: 501-683-8605
www.arklegaudit.gov

Report ID: PSSR08412A Report Date: August 22, 2012

The State Board of Finance is composed of the Governor, Treasurer of State, Auditor of State, Bank Commissioner, and Director of the Department of Finance and Administration. The Governor chairs the Board, and the Treasurer of State serves as the secretary.

REVIEW OF SELECTED TRANSACTIONS

As noted in the Treasury's 2011 financial audit report, the Treasury sold bonds to brokers before they were called or reached their maturity dates, purchased similar bonds from the same brokers, and then repeated this sell/purchase activity. Historically, the Treasury has held investments to the call or maturity dates, and the Treasury Investment Policy does not allow for speculation on future rates of return or call dates. In addition, DLA staff noted that a significant portion of Treasury bond purchases were made from a single broker.

Selected Bond Transactions Resulting in an Economic Loss

According to records obtained from the Treasury on May 17, 2012, 12 bond sale transactions were completed between July 1, 2011 and May 17, 2012. During this time, the Treasury sold these 12 bonds valued at over $240 million and replaced them with similar bonds, resulting in an economic net loss of $58,172. The loss could have been avoided had the Treasury continued to hold the original bonds until they were called by the bond issuer. DLA staff were able to obtain information on these sales as well as the replacement bonds that were sold to the Treasury for 11 of the 12 transactions. See **Exhibit I on page 3** for a summary of these transactions. Three concerns discussed in the following paragraphs resulted from DLA analysis.

Exchanging Bonds for Lower Rates of Return

The first concern is that some of the replacement bonds sold to the Treasury had lower rates of return than the bonds originally held. For example, in one of the transactions reviewed, the Treasury sold a bond that paid an interest rate of 2.00% that could have increased to 4.00% and replaced it with a bond that paid a fixed interest rate of 1.50%.

Of the 11 bonds reviewed that the Treasury sold to the brokers, 8 were replaced with bonds paying a lower interest rate. While some of the bonds the Treasury sold to the brokers were sold for more than face value, DLA analysis showed the Treasury would have better served the State by holding the original bond to its call date. Holding bonds until they are called or reach their maturity date is also more consistent with the Treasury Investment Policy.

Holding Funds in Accounts Paying Low Interest Rates

The second concern is that the new investment practices place more funds in money market mutual fund accounts, which pay very low interest rates (currently 0.01%), for extended periods of time. When the Treasury sells a bond to a broker, the proceeds are placed in a money market mutual fund account until the settlement date of the replacement purchase. In one of the transactions reviewed, a $25 million bond was sold to a broker, and the proceeds remained in a money market mutual fund account for 80 days. During those 80 days, $548 of interest was earned compared to the $91,667 in interest that the original bond would have earned at its 1.65% interest rate. As seen in **Exhibit I on page 3**, these transactions led to large amounts of money held in money market mutual fund accounts drawing 0.01% in interest for a total of 218 days.

Frequency of Bond Transactions

The third concern raised by DLA analysis is how quickly the replacement bonds sold to the Treasury were either called by the bond issuer or sold to a broker, resulting in the Treasury again having to buy more replacement bonds. In 7 of the 11 transactions reviewed, the replacement bonds sold to the Treasury were called or resold to a broker within six months.

For the transactions reviewed, DLA staff noted that selected brokers received substantial compensation for selling replacement bonds to

Exhibit I

Arkansas State Treasury
Eleven Bond Transactions with Replacement Purchases
July 1, 2011 through May 17, 2012

Transactions	Date of Sale Back to Broker	Date of Replacement Purchase	Days Held in Money Market Account	Original Cost	Economic Net Gain or (Loss) on Transactions *Note 1*
1	11/16/2011	11/28/2011	12	$ 25,000,000	$ 21,697
2	12/20/2011	3/9/2012	80	25,000,000	(97,054)
3	2/6/2012	2/28/2012	22	25,000,000	31,239
4	8/3/2011	8/23/2011	20	10,000,000	(2,251)
5	12/20/2011	1/17/2012	28	20,000,000	(12,902)
6	11/22/2011	12/20/2011	28	15,723,400	2,737
7 - 9	8/17/2011	8/24/2011	7	59,492,107	6,755
10 & 11	10/5/2011	10/26/2011	21	50,000,000	(8,393)
Totals			218	$ 230,215,507	$ (58,172)

Note 1: Division of Legislative Audit staff compared what would have occurred if the original bonds were held to the call or maturity date with what actually occurred when the Treasury sold and replaced the original bonds.

Note 2: Transactions 7 through 9 and 10 and 11 are combined because they were replaced by the same bond, but each is counted as a selected transaction because the original holdings were separate bonds that the Treasury sold before they were called or reached maturity.

Source: *Arkansas State Treasury*

the Treasury. Therefore, while participating in these transactions appears to yield no financial gain for the State, such transactions are very attractive to the brokers involved because they create new sales and broker fees.

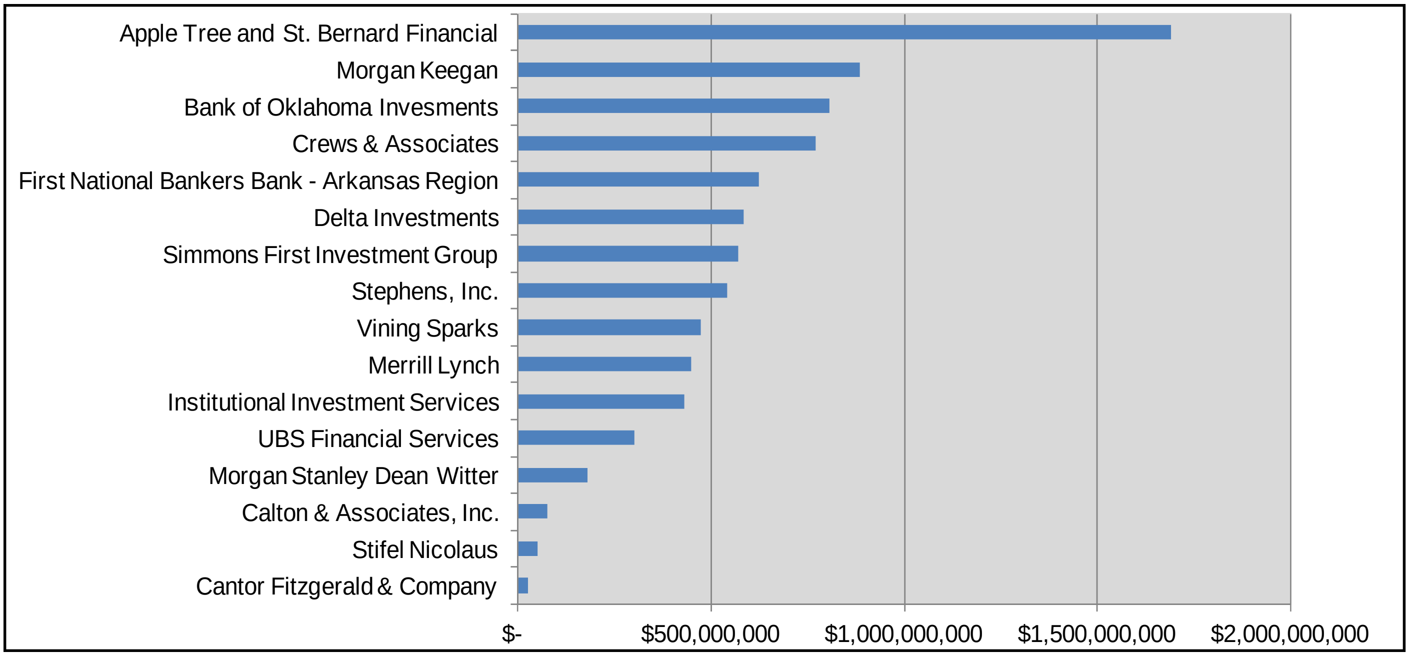
Analysis of Treasury Bond Purchases

Since July 1, 2008, the Treasury has purchased a significant proportion of its bonds from an individual broker associated with two different Arkansas securities firms: Apple Tree Investments, Inc. (May 2008 to May 2009), and St. Bernard Financial Services, Inc. (June 2009 to present). DLA staff obtained purchase records from the Treasury for July 1, 2008 to March 31, 2012, and summarized the purchases by firm in **Exhibit II on page 4**. During this period, a single firm sold the Treasury $1.69 billion in bonds, with the next largest firm selling the Treasury $886.0 million in bonds. In order to determine potential financial benefit of the Treasury's concentrated use of this single firm, DLA staff calculated the dollar value weighted average yield by firm at June 30, 2011, as seen in **Exhibit III on page 4**. Based on this analysis, the individual firm with the Treasury's largest amount of purchases did not have the highest dollar value weighted average yield. This firm's dollar value weighted average yield was only 0.02% higher than the fourth and fifth largest yields received. Therefore, no advantage to the Treasury's concentrated use of this one firm was apparent.

In addition, the three firms that sold the most bonds to the Treasury for this time period (St. Bernard Financial Services, Inc.; Morgan Keegan & Company, Inc.; and Bank of Oklahoma Investments) are the same firms involved in the transactions discussed in **Exhibit I** that resulted in the Treasury's economic net loss of $58,172.

Exhibit II

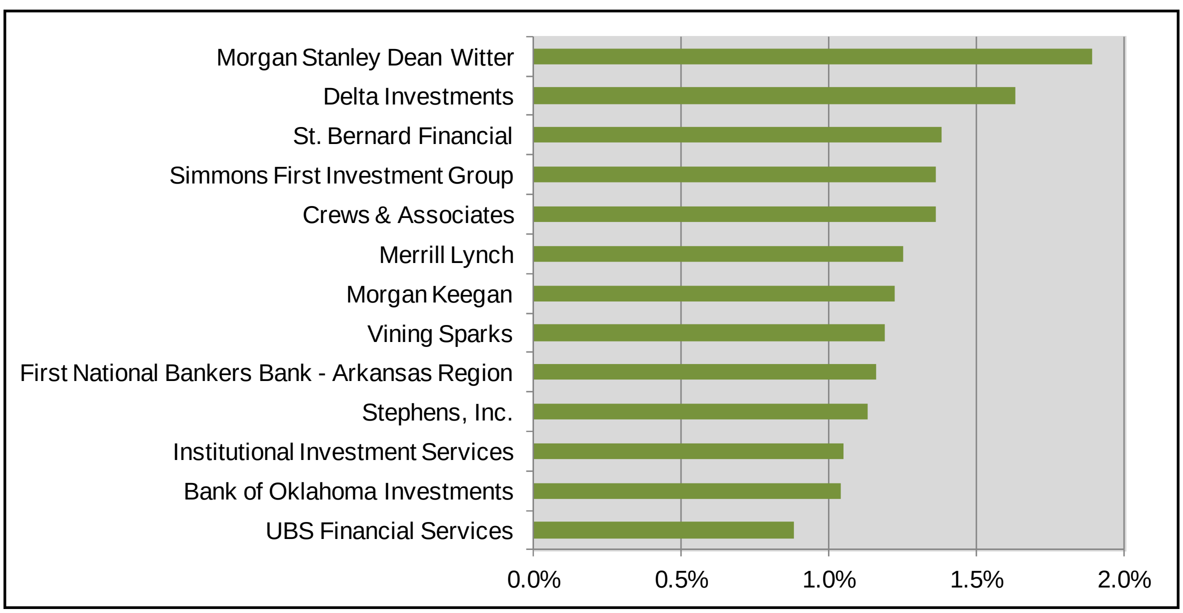
Arkansas State Treasury
Bond Purchases by Securities Firm
July 1, 2008 through March 31, 2012



Source: *Arkansas State Treasury*

Exhibit III

Arkansas State Treasury
Dollar Value Weighted Average Yield by Securities Firm
Fiscal Year Ending June 30, 2011



Source: *Arkansas State Treasury*

CONCLUSIONS

Historically, the Treasury has held investments to the call or maturity dates, and the Treasury Investment Policy does not allow for speculation on future rates of return or call dates. However, DLA analysis of bond sale transactions completed between July 1, 2011 and May 17, 2012, indicated several new Treasury practices resulting in economic loss to the State. These included exchanging bonds for lower rates of return, holding funds in accounts paying lower interest rates, completing frequent bond transactions, and purchasing a significant proportion of bonds from a single broker.

We recommend the Treasury consult a third party money manager regarding investment purchase decisions and obtain input from the State Board of Finance before changing significant investment practices.

Management response is provided in **Appendix A on page A-1** and in Appendix B of the September 2012 report titled "Review of State Board of Finance Investment Policy and Arkansas State Treasury Investment Practices."

DIVISION OF LEGISLATIVE AUDIT
ARKANSAS

This page left intentionally blank.

TREASURER OF STATE
RESPONSE TO LEGISLATIVE AUDIT

The Treasurer of State's Office would like to acknowledge the Division of Legislative Audit (DLA) for its work in assembling their reports presented to this office on August 22, 2012: *"Special Report: Arkansas State Treasury – Review of Selected Bond Investment Transactions"* and *"Special Report: Review of State Board of Finance Investment Policy and Arkansas State Treasury Investment Practices".* In today's volatile investment climate, the challenge Arkansas faces requires cooperative efforts to explore possible opportunities for enhancement while providing uncompromising safety, operating liquidity and wealth building yield.

Concerning the selected transactions, the State Treasury's goal has always been to provide the best yield for taxpayer dollars using the guidelines in the State Board of Finance Investment Policy. In 2009, because of declining economic conditions, Treasury felt it obligatory to try a different approach to generate more money. One area of consideration for potential yields on the bonds Treasury sold were step up bonds. Based on historical data, none of these bonds ever increased to the higher yield; therefore, selling the bonds at a profit was a logical choice. However, as reported, the yield was not as anticipated due to the low interest rate of the money markets. Treasury has not sold any bonds since February and will not sell again until there are better yields in money markets for the time between purchasing bonds and the actual settlement date.

The State Treasury's 40% liquidity is also a concern. As of June 30, 2012, the short-term liquidity percentage was 29.39%. Daily analysis is given to Treasury receipts and expenditures to determine short-term and long-term needs. With additional revenue and expense data from the Department of Finance and Administration, Treasury should be able to decrease the percentage of liquidity even further. The State Treasury will contact DF&A to obtain this information either on a daily, weekly or monthly basis.

As currently allowed in the Treasury Investment Policy, DLA's recommendation to hire one or several outside money managers will be considered. In today's changing economic environment, the Treasury's intent is to insure our state receives the highest return on investments while maximizing safety and minimizing risks. The State Treasury will also consider DLA's recommendation that the State Board of Finance play a larger role in Treasury investment oversight.

The Arkansas State Treasury will continue to follow the guidelines of the Investment Policy and looks forward to continued discussions with DF&A and the State Board of Finance regarding investment strategies.

DIVISION OF LEGISLATIVE AUDIT
ARKANSAS
REGNAT POPULUS
MERCY
JUSTICE