

California State Auditor
RFP No. 15-01
Response to Questions
October 13, 2015

Question Number	Question	Response
1	<p>RFP Attachment A:</p> <p>Would the State please provide or reference where we can obtain the investment details for the Pooled Money Investment Account for pricing considerations including asset type and leveling of the securities?</p>	<p>Refer to page 2 for the complete excerpt of Note 3: Deposits and Investments from the State of California Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2014.</p>
2	<p>RFP Section II – Purpose and Scope of Work, page 4 of 57:</p> <p>Can you please indicate if the Auditor for the State of California will provide the materiality/significance threshold which we will use to determine if the recorded values are reasonable or not?</p>	<p>The State Auditor will provide materiality information to the selected contractor.</p>
3	<p>RFP Section II – Purpose and Scope of Work, page 5 of 57:</p> <p>The State indicates that it wants the auditor to include “a conclusion on the reasonableness of the STO’s market values and market prices”. Further, on page 13 of 57, it indicates that the contractor “must perform the engagement in accordance with the current Government Auditing Standards”. It is unclear what form the contractor’s conclusion will take based on the information in the RFP. Can the State please provide either (1) a report that has been issued in prior years as representative of the conclusion it wants issued or (2) representative language it is seeking to be issued in the conclusion to the contractor’s report?</p>	<p>The prospective contractor’s bid should identify the professional standards it will follow in arriving at its conclusions on the reasonableness of the market values and market prices reported by the State Treasurer’s Office (STO).</p> <p>Examples of conclusions could include the following:</p> <p>Example #1 (Objective 1): <i>Based on our analysis of the XX selected securities, we find that the fair values reported by the STO are reasonable in comparison to the fair values assessed by [the contractor] as of June 30, 2015.</i></p> <p>Example #2 (Objective 2): <i>Of the XX transactions for which we verified market prices or rates, we find the STO paid values consistent with the prevailing market values. Therefore, we believe the acquisition costs, disposition proceeds, and redemption prices the STO offered and received were reasonable.</i></p>

NOTE 3: DEPOSITS AND INVESTMENTS

Cash balances not required for immediate use are invested by the State Treasurer. The State Treasurer administers a single pooled investment program comprising both an internal investment pool and an external investment pool (the Local Agency Investment Fund). A single portfolio of investments exists, with all participants having an undivided interest in the portfolio. Both pools are administered in the same manner.

A. Primary Government

1. Control of State Funds

The State's pooled investment program and certain funds of the primary government are allowed by state statutes, bond resolutions, and investment policy resolutions to invest in United States government securities, federal agency securities, negotiable certificates of deposit, bankers' acceptances, commercial paper, corporate bonds, bank notes, other debt securities, repurchase agreements, reverse repurchase agreements, and other investments.

Certain discretely presented component units and a related organization participate in the State Treasurer's Office pooled investment program. As of June 30, 2014, the discretely presented component units and the related organization account for approximately 3.2% of the State Treasurer's pooled investment portfolio. This program enables the State Treasurer's Office to combine available cash from all funds and to invest cash that exceeds current needs.

Both deposits and investments are included in the State's investment program. For certain banks, the State Treasurer's Office maintains cash deposits that cover uncleared checks deposited in the State's accounts and that earn income that compensates the banks for their services.

Demand and time deposits held by financial institutions as of June 30, 2014, totaling approximately \$7.3 billion, were insured by federal depository insurance or by collateral held by the State Treasurer's Office or an agent of the State Treasurer's Office in the State's name. The California Government Code requires that collateral pledged for demand and time deposits be deposited with the State Treasurer.

As of June 30, 2014, the State Treasurer's Office had on deposit with a fiscal agent amounts totaling \$19 million related to principal and interest payments to bondholders. These deposits were insured by federal depository insurance or by collateral held by an agent of the State Treasurer's Office in the State's name.

Certain funds have elected to participate in the pooled investment program even though they have the authority to invest on their own. Others may be required by legislation to participate in the program; as a result, the deposits of these funds may be considered involuntary. However, these funds are part of the State's reporting entity. The remaining participant in the pool, the Local Agency Investment Fund, is voluntary.

Certain funds that have deposits in the State Treasurer's pooled investment program do not receive the interest earnings on their deposits. Instead, by law, the earnings are assigned to the State's General Fund. Most of the \$16 million in interest revenue received by the General Fund from the pooled investment program in fiscal year 2013-14 was earned on balances in these funds.

Enterprise funds and special revenue funds also make separate investments, which are presented at fair value.

2. Valuation of State Investments

The State Treasurer's Office reports its investments at fair value. The fair value of securities in the State Treasurer's pooled investment program generally is based on quoted market prices. The State Treasurer's Office performs a quarterly fair market valuation of the pooled investment program portfolio. In addition, the State Treasurer's Office performs a monthly fair market valuation of all securities held against carrying cost. These valuations can be obtained from the State Treasurer's Office website at www.treasurer.ca.gov.

As of June 30, 2014, the weighted average maturity of the securities in the pooled investment program administered by the State Treasurer's Office was approximately 239 days. Weighted average maturity is the average number of days, given a dollar-weighted value of individual investments, that the securities in the portfolio have remaining from evaluation date to stated maturity.

3. Oversight of Investing Activities

The Pooled Money Investment Board (PMIB) provides oversight of the State Treasurer's pooled investment program. The purpose of the board is to design and administer an effective cash management and investment program, using all monies flowing through the State Treasurer's Office bank accounts and keeping all available funds invested in a manner consistent with the goals of safety, liquidity, and yield. The PMIB is comprised of the State Treasurer as chair, the State Controller, and the Director of Finance. This board designates the amounts of money available for investment. The State Treasurer is charged with making the actual investment transactions for this program. This investment program is not registered with the Securities and Exchange Commission as an investment company.

The value of the deposits in the State Treasurer's pooled investment program, including the Local Agency Investment Fund, is equal to the dollars deposited in the program. The fair value of the position in the program may be greater or less than the value of the deposits, with the difference representing the unrealized gain or loss. As of June 30, 2014, this difference was immaterial to the valuation of the program. The pool is run with "dollar-in, dollar-out" participation. There are no share-value adjustments to reflect changes in fair value.

The State Treasurer's pooled investment program values participants' shares on an amortized cost basis. Specifically, the program distributes income to participants quarterly, based on their relative participation during the quarter. This participation is calculated based on (1) realized investment gains and losses calculated on an amortized cost basis, (2) interest income based on stated rates (both paid and accrued), (3) amortization of discounts and premiums on a straight-line basis, and (4) investment and administrative expenses. This amortized cost method differs from the fair value method used to value investments in these financial statements; the amortized cost method is not designed to distribute to participants all unrealized gains and losses in the fair value of the pool's investments. Because the total difference between the fair value of the investments in the pool and the value distributed to pool participants using the amortized cost method described above is not material, no adjustment was made to the financial statements. The State Treasurer's Office also reports participant fair value as a ratio of amortized cost on a quarterly basis. The State Treasurer's Office has not provided or obtained a legally binding guarantee to support the principal invested in the investment program.

As of June 30, 2014, medium-term asset-backed securities comprised approximately 1.19% of the pooled investments. The asset-backed securities consist of mortgage-backed securities, Small Business Administration (SBA) pools, and asset-backed commercial paper. The mortgage-backed securities are called real estate mortgage investment conduits (REMICs), and are securities backed by pools of mortgages. The REMICs in the State's portfolio have a fixed principal payment schedule. A portion of the asset-backed securities consisted of floating-rate SBA notes. For floating-rate SBA notes held in the portfolio during the

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fiscal year, the interest received by the State Treasurer’s pooled investment program rose or fell as the underlying index rate rose or fell. The structure of the floating-rate SBA notes in the State Treasurer’s pooled investment program portfolio provided a hedge against the risk of increasing interest rates. A portion of the asset-backed portfolio holdings were short-term, asset-backed commercial paper (ABCP), which represented 0.84% of the pooled investments.

Table 1 identifies the investment types that are authorized by the California Government Code and the State Treasurer’s Office investment policy for the pooled investment program. Maturities are limited by the State Treasurer’s Office Investment Policy for the Pooled Money Investment Program. For commercial paper, the Investment Policy is more restrictive than the Government Code. For corporate bonds and notes, the Government Code requires that a security fall within the top three ratings of a nationally recognized statistical ratings organization (NASRO). Items reported as N/A have no limitation in either the Government Code or the State Treasurer’s Office Investment Policy.

Table 1

Authorized Investments

Authorized Investment Type	Maximum Maturity	Maximum Percentage of Portfolio	Maximum Investment in One Issuer	Credit Rating
U.S. Treasury securities	5 years	N/A	N/A	N/A
Federal agency and supranational securities	5 years	N/A	N/A	N/A
Certificates of deposit	5 years	N/A	N/A	N/A
Bankers acceptances	180 days	N/A	N/A	N/A
Commercial paper	180 days	30%	10 % of issuer’s outstanding Commercial Paper	A-2/P-2/F-2
Corporate bonds/notes	5 years	N/A	N/A	A-/A3/A-
Repurchase agreements	1 year	N/A	N/A	N/A
Reverse repurchase agreements	1 year	10%	N/A	N/A

4. Risk of Investments

The following types of risks are common in deposits and investments, including those of the State:

Interest Rate Risk is the risk that the value of fixed-income securities will decline because of changing interest rates. The prices of fixed-income securities with longer time to maturity tend to be more sensitive to changes in interest rates than those with shorter durations.

Credit Risk is the risk that a debt issuer will fail to pay interest or principal in a timely manner, or that negative perceptions of the issuer’s ability to make these payments will cause security prices to decline.

Custodial Credit Risk is the risk that, in the event a financial institution or counterparty fails, the investor will not be able to recover the value of deposits, investments, or collateral.

Concentration of Credit Risk is the risk of loss attributed to the magnitude of an investor’s holdings in a single issuer.

Foreign Currency Risk is the risk that changes in exchange rates will adversely affect the fair value of an investment or a deposit.

a. Interest Rate Risk

Table 2 presents the interest rate risk of the primary government's investments. In calculating SBA holdings' weighted average maturity, the State Treasurer's Office assumes that stated maturity is the quarterly reset date. Total pooled investments do not include \$4.8 billion of time deposits and \$314 million of internal loans to state funds. Repurchase agreements of the California State University system mature in one day. Most mortgage-backed securities are issued by U.S. government agencies, or government-sponsored enterprises such as the Federal National Mortgage Association, and entitle the purchaser to receive a share of the cash flows, such as principal and interest payments, from a pool of mortgages. Mortgage-backed securities are highly sensitive to interest rate changes because principal prepayments either increase (in a low interest rate environment) or decrease (in a high interest rate environment) the security yield. As of June 30, 2014, only \$130 million, or 0.22% of the total pooled investments, was invested in mortgage-backed securities.

Table 2
Schedule of Investments – Primary Government – Interest Rate Risk
June 30, 2014
(amounts in thousands)

	Fair Value at Year End	Weighted Average Maturity (in years)
Pooled investments		
U.S. Treasury bills and notes	\$ 34,926,335	0.94
U.S. Agency bonds and discount notes	4,685,570	0.50
Supranatural debentures and discount notes (IBRD)	150,040	1.56
Small Business Administration loans	581,690	0.25
Mortgage-backed securities	130,274	2.37
Certificates of deposit	11,993,881	0.22
Bank notes	599,930	0.14
Commercial paper	6,698,100	0.11
Total pooled investments	59,765,820	
Other primary government investments		
U.S. Treasuries and agencies	2,285,376	2.58
Commercial paper	252,683	0.73
Guaranteed investment contracts	210,327	8.66
Corporate debt securities	1,011,356	2.08
Repurchase agreements	2,274	0.00
Other	953,463	3.49
Total other primary government investments	4,715,479	
Funds outside primary government included in pooled investments		
Less: investment trust funds	21,104,087	
Less: other trust and agency funds	1,750,530	
Less: discretely presented component units and related organizations	1,901,592	
Total primary government investments	\$ 39,725,090	

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b. Credit Risk

Table 3 presents the credit risk of the primary government’s debt securities. If a particular security has multiple ratings, the lowest rating of the three major NASROs is used. Similar to interest rate risk shown in Table 2, time deposits and internal loans to state funds are not included.

Table 3

Schedule of Investments in Debt Securities – Primary Government – Credit Risk

June 30, 2014

(amounts in thousands)

Credit Rating as of Year End		Fair Value
Short-term	Long-term	
Pooled investments		
A-1+/P-1/F-1+	AAA/Aaa/AAA	\$ 10,594,908
A-1/P-1/F-1	AA/Aa/AA	13,532,613
Not rated		130,274
Not applicable		35,508,025
Total pooled investments		\$ 59,765,820
Other primary government investments		
A-1+/P-1/F-1+	AAA/Aaa/AAA	\$ 917,961
A-1/P-1/F-1	AA/Aa/AA	1,782,457
A-2/P-2/F-2	A/A/A	768,419
A-3/P-3/F-3	BBB/Baa/BBB	27,441
Not rated		444,488
Not applicable		774,713
Total other primary government investments		\$ 4,715,479

c. Custodial Credit Risk

The State of California has a deposit policy for custodial credit risk that requires deposits held by financial institutions to be insured by federal depository insurance or secured by collateral. As of June 30, 2014, one guaranteed investment contract of the Electric Power Fund in the amount of \$100 million was uninsured and uncollateralized.

d. Concentration of Credit Risk

The investment policy of the State Treasurer’s Office contains no limitations on the amount that can be invested in any one issuer beyond those limitations stipulated in the California Government Code. As of June 30, 2014, the State did not hold debt securities in any one issuer (other than U.S. Treasury securities) that represented 5% or more of the primary government investments.

B. Fiduciary Funds

The fiduciary funds include pension and other employee benefit trust funds of the following fiduciary funds and component units: California Public Employees' Retirement System (CalPERS), California State Teachers' Retirement System (CalSTRS), the fund for the California Scholarshare program, and various other funds. CalPERS and CalSTRS account for 97% of these separately invested funds. CalPERS and CalSTRS exercise their authority under the State Constitution and invest in stocks, bonds, mortgages, real estate, and other investments, including derivative instruments.

Additional disclosure for CalPERS' investments and derivative instruments is included in CalPERS' separately issued financial statements, which can be obtained from CalPERS on its website at www.CalPERS.ca.gov. Additional disclosure for CalSTRS' investments and derivative instruments is included in CalSTRS' separately issued financial statements, which can be obtained from CalSTRS on its website at www.CalSTRS.com.

C. Discretely Presented Component Units

The discretely presented component units consist of the University of California and its foundation, the California Housing Finance Agency (CalHFA), and various nonmajor component units. The University and CalHFA constitute 93% of the total investments of discretely presented component units. State law, bond resolutions, and investment policy resolutions allow component units to invest in U.S. government securities, state and municipal securities, commercial paper, corporate bonds, investment agreements, real estate, and other investments. Additionally, a portion of the cash and pooled investments of CalHFA, and other nonmajor component units are invested in the State Treasurer's pooled investment program.

Additional disclosures for the University of California's investments and derivative instruments are included in the University's separately issued financial statements, which can be obtained from the University on its website at www.ucop.edu. Additional disclosure for CalHFA's investments and derivative instruments is included in CalHFA's separately issued financial statements, which can be obtained from CalHFA on its website at www.CalHFA.ca.gov.