



State of South Carolina Office of the Inspector General

December 20, 2017

The Honorable Hugh K. Leatherman, Sr.
Chairman, Senate Finance Committee
111 Gressette Building
Columbia, SC 29201

RE: Summary results of the State Inspector General's Office review of earnings on investment deposits to the State's General Fund for the Fourth Quarter of Fiscal Year (FY) 2016-17.

Dear Chairman Leatherman:

The purpose of this letter is to provide the results of the State Inspector General's (SIG) review of earnings on investment deposits to the State's General Fund as requested in your letter dated, 10/30/2017. Reporting the results in letter format is being done in view of the fact the State Treasurer's Office (STO) has already provided a detailed written response to the four questions posed in the referenced letter.

Enclosed for your review are the following appendices:

- Appendix A – STO's written response to the SIG, dated 11/30/2017;
- Appendix B – STO exhibits #1 – 11;
- Appendix C – Updated STO exhibits #2 and #8;
- Appendix D – STO/Bank of New York Mellon Settlement Agreement; and
- Appendix E – STO securities lending loss balance as of 12/18/2017.

Purpose of Review

The purpose of this review was to gather relevant information and perform a review of State GF deposits from earnings on investments for the fourth quarter of FY 2016-17 (Q4-FY17). This review was initiated at the request of the Senate Finance Committee chairman.

It was noted the South Carolina Board of Economic Advisor's final General Fund Revenue Monitor for FY 2016-17 documented no investment earnings were remitted to the GF for Q4-FY17. Up to that point in time, remittances of investment earnings were made to the GF in each month dating back to July 1996.

Specifically, the SIG was requested to determine answers to the following four questions:

1. Was money earned on investments during April, May and June 2017, and, if so, how much?
2. If money was earned on investments during April, May and June 2017 (“withheld investment earnings”), should the withheld investment earnings have been deposited into the General Fund of the State? If so, should the withheld investment earnings have been remitted before the close of FY 2016-17 for distribution as prioritized in the FY 2017-18 Appropriations Act (Act 97 of 2017)?
3. If the withheld investment earnings were deposited in an account other than the General Fund, in which account were these funds deposited?
4. Does any authority exercised by the State Treasurer to withhold or redirect earnings on investments supersede: (a) state law requiring the deposit of this revenue into the General Fund, and/or (b) the authority of the General Assembly to appropriate those funds through the annual General Appropriations Act?

Executive Summary

The following executive summary is based upon a review of the enclosed documentation; interviews conducted with STO, South Carolina Enterprise Information System (SCEIS), and State Comptroller General (CG) Office staff; and the SIG’s review of SCEIS documentation. All amounts are rounded to the nearest dollar.

Background of the STO Securities Lending Program

The STO has operated a securities lending program (SLP) since 1982, which is authorized in SC Code of Laws, §11-9-660(b). This program allows the State to earn additional income from securities it owns by lending them to third parties. Borrowers of these securities must provide cash as collateral, generally at 102% of the value of the securities, which is invested on behalf of the State by a custodial bank. For South Carolina the custodial banking relationship is with the Bank of New York Mellon (BNYM). When borrowers return the securities the State is obligated to return the cash collateral to the borrower.

Under the State’s SLP, the general deposit cash collateral account sustained significant losses as a result of the 2008-09 financial crisis. These losses primarily resulted from the purchase of a \$35 million floating rate note (Lehman Brothers) and a large number of asset backed securities. In 2009, the STO established a securities lending reserve account at BNYM to hold securities earnings to recoup losses to the SLP. Subsequently, litigation was filed by the STO in 2010-11 to recoup these losses from BNYM. (*Appendix A – pp. 5&6; Appendix B - STO Exhibit #7*)

In 2012, the STO received \$10,758,709 in payments from the Lehman Brothers bankruptcy settlement and the sale of certain Lehman securities which were applied against the SLP losses. A litigation settlement was reached in 2013 which resulted in a monetary cash payment to the State in the amount of \$4,960,624. In 2014, the STO entered into a new securities lending agreement with BNYM, at which

time \$4,800,000 in securities earnings were credited against the SLP deficit from the STO's securities lending reserve account. Again in 2016, securities earnings in the amount of \$387,236 were credited against the SLP deficit from the securities lending reserve account. Between April 2012 and June 2016, the original \$35 million deficit in securities lending losses was reduced by \$20,906,569, which resulted in \$14,093,431 in realized losses at the beginning of FY 2016-17 in the general deposit cash collateral account, and \$157,693 in pre-existing losses. (*Appendix B - STO Exhibits #8 & 9; Appendix D*)

Senate Finance Committee Questions and Answers

Question #1: *Was money earned on investments during April, May and June 2017, and, if so, how much?*

Earnings on investments of GF deposits for the months of April, May and June 2017 (Q4–FY17) totaled **\$10,263,479**. These investment earnings are net of fees which the STO may charge as provided for under Proviso 98.5. For FY 2016-17, the combined total of GF investment earnings in GF Portfolio account (30417999) and State Investment Pool account (35647999) was **\$40,817,022**. (*Appendix B – STO Exhibit #2*)

Question #2: *If money was earned on investments during April, May and June 2017 (“withheld investment earnings”), should the withheld investment earnings have been deposited into the General Fund of the State? If so, should the withheld investment earnings have been remitted before the close of FY 2016-17 for distribution as prioritized in the FY 2017-18 Appropriations Act (Act 97 of 2017)?*

Throughout FY 2016-17, automatic monthly distributions of GF investment earnings totaling **\$30,569,028** were deposited to the State GF account (28370000). As such, GF investment earnings were deposited into the State GF account prior to the close of FY 2017. (*Appendix B – STO Exhibit #2*)

As previously noted in Question #1, the total investment earnings of GF deposits for Q4–FY17 was \$10,263,479. Of that total, only \$31,664 in net GF investment earnings were deposited into the State GF account for Q4–FY17. This difference of \$10,231,815 was due to: (a) the STO's application of \$5,803,095 in State GF account deposits against existing securities lending losses in the GF Portfolio securities lending cash collateral account “SecLend Loss” (30417999) for the months of April and May 2017; and (b) the June 2017 accounting system correction of \$4,428,720 for the over distribution of cash earnings on the amortization of discounts of investment bonds in the amount of \$5,858,957 which occurred during the period of 10/2016 – 5/2017. (*Appendix A – pg. 5; Appendix B – STO Exhibits #2 & 5*)

Set forth below is a summary of investment earnings deposits to the State GF account and the application of these deposits against securities lending losses and the over distribution of cash earnings.

<u>April 2017:</u>	\$1,826,992 (\$1,795,332)	(GF investment earnings deposited to State GF account) (GF investment earnings applied against securities lending losses, document #1003131462) (<i>Appendix B – STO Exhibits #2, 3, & 6</i>)
<u>May 2017:</u>	\$4,007,766 (\$4,007,763)	(GF investment earnings deposited to State GF account) (GF investment earnings applied against securities lending losses, document #1003365801) (<i>Appendix B – STO Exhibits #2 & 4</i>)

<u>June 2017:</u>	\$1	(GF investment earnings deposited to State GF account) (\$4,428,720 in GF revenue applied as accounting system correction for over distribution (“advance”) of \$5,858,952 in revenue for the period of 10/2016 – 5/2017) (<i>Appendix B – STO Exhibits #2 & 5</i>)
	<u>\$31,664</u>	GF investment earnings deposited to State GF account for Q4–FY17

Question #3: *If the withheld investment earnings were deposited in an account other than the General Fund, in which account were these funds deposited?*

For the months of April and May 2017, \$5,803,095 in State GF account investment earnings deposits were applied against existing securities lending losses in the GF Portfolio securities lending cash collateral account (30417999). This resulted in a net deposit of \$31,663 of GF investment earnings to the State GF account.

For June 2017, an accounting system correction in the amount of \$4,428,720 was made to the State GF account for an over distribution of cash earnings of amortized bonds for the period of 10/2016 – 5/2017. This resulted in a net deposit of \$1 in GF investment earnings to the State GF account.

The full impact of this over distribution of cash earnings to the State GF account was \$5,858,957. According to the STO, this was a general ledger entry and in no instance did any cash leave the depository bank. The general ledger at all times reconciled to the depository institutions.

However, the GF portfolio investment earnings for June 2017 only amounted to \$4,428,720. These earnings were utilized to offset the over distribution of revenue to the State GF account which left an outstanding balance of \$1,430,237 in over distributed revenue. Consequently, the FY 2016-17 investment earnings deposited to the State GF account were overstated by \$1,430,237 as set forth in STO Exhibit #2 and confirmed by STO staff. This was disclosed by the STO through the closing packages submitted to the CG’s office, which properly recorded the FY 2016-17 revenues in the State’s 2016-17 Comprehensive Annual Financial Report. The remaining \$1,430,237 of over distributed cash earnings was reconciled against the July 2017 (FY 2017-18) investment earnings. (*Appendix B – STO Exhibits #2 & 5; Appendix C – Exhibit #2*)

Question #4: *Does any authority exercised by the State Treasurer to withhold or redirect earnings on investments supersede: (a) state law requiring the deposit of this revenue into the General Fund, and/or (b) the authority of the General Assembly to appropriate those funds through the annual General Appropriations Act?*

The STO provided extensive SC Code of Laws citations regarding the State Treasurer’s statutory authority to manage the funds of the State. These authorities are found in SC Code of Laws, and grant the State Treasurer “full power to invest and reinvest all funds of the State” (§11-9-660), as well as being “...the only official authorized to invest and deposit funds...” (§11-13-30). None of these statutes provide for the authority of the State Treasurer to supersede state law requiring the deposit of earnings revenue to the General Fund (§11-13-125) or the authority of the General Assembly to appropriate those funds through the annual General Appropriations Act. (*Appendix A*)

In the STO's written response to the SIG, the STO stated the "decision to apply earnings to offset pre-existing principal losses is an example of this statutory power to invest and reinvest state funds, and sound business practices, so as to maximize long-term returns." Furthermore, the STO provided that §11-13-125 "...is merely an administrative, if not ministerial direction to the Treasurer that for accounting purposes, unless otherwise specified, earnings from the general deposit funds become part of the General Fund." (*Appendix A – page 3*)

The STO's accounting system platform is a module contained within SCEIS. Revenue and investment earnings are posted daily within this system to the various accounts under the STO's custody and authority. At the end of each month, these accounts are automatically swept and GF investment earnings are distributed to the various accounts based on proportionality to the overall deposits. According to the STO, the decision to apply GF investment earnings against existing securities lending losses was made in advance of these monthly sweeps and was within the STO's investment authority to do so, and therefore, did not exceed the State Treasurer's statutory authority.

Other Observations

The STO was requested to provide the most current information for FY 2017-18 related to three specific areas: (1) earnings on investments for GF deposits; (2) accounting system adjustments for the over distribution of cash in FY 2016-17; and (3) securities lending loss payments. The STO provided updated versions of exhibits #2 and #8 in response to the SIG's request.

FY 2017-18 General Fund Deposits of Earnings on Investments

For the period of 7/2017 – 11/2017, the combined investment earnings for GF deposits was \$17,287,741, which resulted in deposits to the State GF account in the amount of \$5,304,508 for the months of July and August 2017. No GF investment earnings were deposited to the State GF account for the months of September, October and November 2017. During the period of 9/2017 – 11/2017, \$10,552,996 in GF investment earnings were applied against existing securities lending losses in the GF Portfolio securities lending cash collateral account (30417999). (*Appendix C – STO Exhibits #2 & 8*)

FY 2017-18 Accounting System Adjustment for Over Distribution of Cash

In October 2016, the STO's accounting records were subject to a platform system conversion. Between October 2016 and May 2017, an over distribution of cash earnings occurred in the GF deposits. The total impact to all GF accounts was \$18,204,207. The State's GF account was impacted in the amount of \$5,858,957. (*Appendix A – page 5; Appendix B – STO Exhibits #2 & 5; Appendix C – STO Exhibit #2*)

To correct this error, the STO made an accounting system correction against the June 2017 investment earnings of the GF portfolio in the amount of \$4,428,720. The remaining \$1,430,237 of over distributed revenue was adjusted in FY 2017-18 against the July 2017 GF investment earnings. The STO stated that at no time did any cash leave the depository bank, and that the general ledger reconciled to the depository institution at all times. (*Appendix A – page 5; Appendix C – STO Exhibit #2*)

FY 2017-18 Securities Lending Loss Payments

Additional payments have been applied against existing securities lending losses from GF investment earnings deposits in FY 2017-18. At the request of the SIG, the STO provided updated versions of STO Exhibits #2 and #8 to account for the use of GF investment earnings in reducing the existing securities lending losses. As provided by the STO, \$6,802,841 in GF investment earnings was applied against existing securities lending losses for the period of 9/2017 – 11/2017. Additionally, \$3,750,156 in GF investment earnings was applied against realized losses incurred from the November 2017 sale of asset backed securities held by the STO, which was previously recognized as unrealized losses. As of 12/18/2017, the outstanding balance of the STO's SLP losses (realized) is \$1,614,853. (*Appendix C – Exhibits #2 & 8; Appendix E*)

In closing, the SIG extends its gratitude to the staff of the Treasurer's office, as well as the assistance provide by CG and SCEIS staff in this review. The SIG is available to answer any questions you may have or consider additional work to address this important area of State budgeting.

Sincerely,

Brian D. Lamkin
State Inspector General

Enc. (5)

Cc: The Honorable Curtis M. Loftis, Jr.

Appendices A – E may be viewed at the following link:
[General Fund Investment Earnings – Appendices A-E](#)