

STATE BOARD OF ADMINISTRATION

FUND B SURPLUS FUNDS TRUST FUND

Operational Audit



STATE BOARD OF ADMINISTRATION

The State Board of Administration (SBA) was established on June 21, 1929, pursuant to Chapter 14486, Laws of Florida (1929). The SBA was subsequently created as a constitutional body corporate on January 1, 1943, by Article IX, Section 16 of the State Constitution of 1885, as amended. The SBA was subsequently continued as a body corporate by Article IV, Section 4(e) of the State Constitution (1968), as amended. The SBA is composed of the Governor, as Chair, the Chief Financial Officer, and the Attorney General. The Trustees delegate administrative and investment authority to an appointed Executive Director. The following individuals served as Executive Director:

Ashbel Williams	From October 2008
Robert Milligan	From December 2007 to October 2008 (Interim)
Coleman Stipanovich	To December 2007

The audit team leader was Allen G. Weiner, CPA, and the audit was supervised by Kathryn D. Walker, CPA. Please address inquiries regarding this report to Kathryn D. Walker, CPA, Audit Manager, by e-mail at kathrynwalker@aud.state.fl.us or by telephone at (850) 487-9085

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STATE BOARD OF ADMINISTRATION

Fund B Surplus Funds Trust Fund

SUMMARY

This operational audit of the State Board of Administration (SBA) focused on the Fund B Surplus Funds Trust Fund (Fund B), and specifically, the steps taken to return to participants as much of the principal of the investments included in Fund B as possible. Our audit disclosed the following:

Finding No. 1: While Fund B collected over \$1.7 billion in principal and interest for Trust Fund participants during the 2008 through 2012 fiscal years, over 700 participants, with original investment balances ranging from \$20 to \$43,000,000 and totaling \$277,000,000, remained invested in Fund B as of June 30, 2012. Because of the potential extended time period for self-liquidation of the remaining balances, as shown by the SBA's most recent cash flows estimate, the SBA should survey the Fund B investors to determine whether they would prefer an alternative that may provide an earlier liquidation of their deposits and the magnitude of loss, if any, they would be willing to accept, in return for an earlier liquidation.

BACKGROUND

State law,¹ effective October 1, 1977, established the Local Government Surplus Funds Trust Fund (Trust Fund). The purpose of the law was to promote, through State assistance, the maximization of interest earnings on invested surplus funds of local units of government. The law authorized the SBA to internally manage investments for Trust Fund participants² in a pooled investment account.

During October and November 2007, the SBA communicated to Trust Fund participants and the Trustees³ information regarding an on-going sub-prime mortgage market crisis and its effect on the commercial paper market. The communications included information on \$2.2 billion of short-term investments, held by the Trust Fund and other SBA owner funds,⁴ which had been downgraded below initial purchase guidelines. During mid-to-late November 2007, Trust Fund participants withdrew over \$13 billion, or approximately 46 percent of the Trust Fund's total balance, and the Trustees, on November 29, 2007, temporarily suspended deposits to and withdrawals from the Trust Fund.

On December 4, 2007, an investment manager engaged to assess the current status of Trust Fund investments proposed two options to optimize Trust Fund value and liquidity. The first option was for the Trust Fund to become a liquidating trust with projected cash distributions over time (run-off option). The second option was to create two separate investment pools under which one pool would continue as an investment account for Trust Fund participants, while the second pool would hold defaulted or impaired assets until liquidation (operation option). The Local Government Investment Pool Advisory Committee⁵ recommended the operation option, which the Trustees

¹ Chapter 218, Part IV, Florida Statutes.

² Pursuant to Section 218.403, Florida Statutes, participants (units of local government) may include any governmental entity within the State but not part of State government and shall include, but not be limited to, any county, municipality, school district, special district, clerk of the circuit court, sheriff, property appraiser, tax collector, supervisor of elections, authority board, public corporations, or any other political subdivision of the State.

³ The Trustees of SBA consist of the Governor, as Chair, the Chief Financial Officer, and the Attorney General.

⁴ The communication discusses, in general, SBA short-term portfolios. These short-term portfolio's included those of the Trust Fund, the Florida Retirement System, the Commingled Asset Management Program Money Market Pool, and the Florida Hurricane Catastrophe Fund.

⁵ The Local Government Investment Pool Advisory Committee consisted of three members, from each of the following: the Florida Association of Court Clerks and Comptrollers, the Florida League of Cities, the Florida Association of Counties, the

accepted on December 4, 2007, and approximately \$2 billion in investments were placed into a separate pool (Restricted Pool) within the Trust Fund. Table 1 lists the defaulted or impaired securities placed into the Restricted Pool.

Table 1
Defaulted or Impaired Securities Transferred to the Restricted Pool
 (in thousands)

Security Name	Par ^a	Amortized Cost ^a	Fair Value ^a
Axon Financial Funding LLC	\$ 175,000	\$ 174,986	\$ 117,250
CIT Group	290,000	290,000	284,577
Countrywide Bank	650,000	650,000	638,712
KKR Atlantic Funding Trust	165,786	165,786	164,559
KKR Pacific Funding Trust	349,987	349,987	344,877
Ottimo Funding Ltd.	176,447	176,447	164,096
Textron ^b	200,000	200,000	199,954
Washington Mutual Bank ^b	<u>90,000</u>	<u>90,006</u>	<u>90,003</u>
Totals	<u>\$2,097,220</u>	<u>\$2,097,212</u>	<u>\$2,004,028</u>

Source: November 30, 2007, and December 31, 2007, SBA Fund B Holdings Reports.

^a Values as of November 30, 2007, except for Textron and Washington Mutual Bank which are as of December 31, 2007.

^b Textron and Washington Mutual Bank were added to the Restricted Pool on December 20, 2007.

The investment manager estimated that over \$300 million of the defaulted or impaired securities would have an uncertain distribution, while the remaining securities would provide distributions within seven months.⁶ The Trust Fund was re-opened to deposits and withdrawals on December 6, 2007.

The CIT Group, Countrywide Bank, Textron, and Washington Mutual Bank securities either matured at par or were sold close to par prior to June 30, 2008. For the remaining four investments, the SBA elected to receive the pro rata portion of the collateral securities underlying the investments. To receive and further distribute the pro rata portion of the collateral securities, the SBA created a limited liability corporation (LLC) for each of the investments. Table 2 shows the value of the underlying collateral as of the date of agreement for each of the LLCs.

Florida School Boards Association, and the Florida Association of District School Superintendents. The Committee also included a representative of the Florida Tax Collectors Association and a Citizens Property Insurance Corporation designee.

⁶ Based on SBA-provided data, the CIT Group, Countrywide Bank, Textron, and Washington Mutual Bank securities matured or were sold close to par in less than seven months. The Axon, KKR Atlantic, KKR Pacific, and Ottimo securities totaling over \$867 million did not mature.

Table 2
Securities for Which Fund B Received the Pro Rata Share of the Underlying Collateral
As of the Date of Agreement and Valuation
(amounts in thousands)

Security Name	LLC Name	Date of Agreement and Valuation	Principal Amount Remaining of Original Security ^a	As of Date of Agreement	
				Current Face Value of Collateral ^b	Fair Value of Collateral ^c
Axon Financial Funding LLC	Florida Funding II LLC	June 8, 2010	\$132,830	\$140,533	\$ 65,164
KKR Atlantic Funding Trust	Florida East Funding LLC	March 25, 2008	158,338	163,828	145,683 ^d
KKR Pacific Funding Trust	Florida West Funding LLC	March 25, 2008	331,547	346,707	297,203 ^d
Ottimo Funding Ltd.	Florida Funding I LLC	November 9, 2009	145,643	145,671	38,554
Totals			<u>\$768,358</u>	<u>\$796,739</u>	<u>\$546,604</u>

^a The amounts shown in this column represent the remaining principal balance due on the collateralized securities as of the date of the agreement and valuation.

^b Current face is defined as the outstanding principal balance of the collateral.

^c The fair value of the collateral received was calculated by multiplying the current face value of the collateral by a rate reflective of the estimated value of the collateral, as of the date of the agreement and valuation.

^d Florida East Funding LLC and Florida West Funding LLC received an additional \$5.1 million in cash upon restructuring.

Source: SBA contract files and financial operations records.

Effective May 28, 2008, Chapter 2008-93, Laws of Florida, created the Fund B Surplus Funds Trust Fund (Fund B). Pursuant to the law, on June 27, 2008, the defaulted or impaired investments, all interest earned, and a reserve⁷ were transferred from the Restricted Pool of the Trust Fund to Fund B.

Table 3 provides a summary of the operations of Fund B from inception through June 30, 2012.

⁷ The reserve primarily consisted of \$22 million of the Trust Fund’s reserve and \$95.7 million of November 2007 Trust Fund earnings. The reserve assets, which were liquid, were subsequently used to purchase illiquid securities proportionately from each Fund B participant, providing for an earlier return of a portion of participant investment principal.

Table 3
Restricted Fund and Fund B Activity by Fiscal Year Ending June 30,
(in thousands)

Fiscal Year Ending June 30,	2008	2009	2010	2011	2012	Totals
Beginning Balance	\$ 0	\$630,516	\$279,844	\$284,585	\$263,774	
Transfers in	2,331,546 ^a	0	0	0	0	2,331,546
Net Income from Investing Activity:	30,974	11,588	9,138	3,190	2,840	57,730
Net increase (decrease) in fair value of investments	(115,255)	(224,110)	117,828	41,474	21,556	(158,507)
Settlements	0	0	0	23,000 ^b	0	23,000
Transfers to Trust Fund	(1,616,749) ^a	(138,150)	(122,225)	(88,475)	(56,300)	(2,021,899)
Net Assets	\$ 630,516	\$279,844	\$284,585	\$263,774	\$231,870	\$231,870

^a Includes over \$230 million in Restricted Fund securities that were exchanged for Trust Fund securities.

^b Amount received from investment firm in settlement of matters relating to SBA’s assertion of the firm’s improper sale of unregistered secured notes to the Trust Fund.

Source: SBA accounting records.

The amounts collected during the period December 2007 through June 2012 are disclosed in Table 4. Principal and interest collections were the primary source of Fund B collections.

Table 4
Fund B Collections
(in thousands)

Fiscal Year Ending June 30,	Principal and Interest Collections	Settlement Collections	Total Collections
2008	\$1,319,316	\$ 0	\$1,319,316
2009	140,793	0	140,793
2010	120,077	0	120,077
2011	65,595	23,000	88,595
2012	57,333	0	57,333
Totals	\$1,703,114	\$ 23,000	\$1,726,114

Source: SBA accounting records.

The Investment Policy Guidelines for Fund B state that the primary objective is to maximize the present value of distributions from Fund B (which correlates to the purpose of Fund B which is to maximize the payout of principal on invested surplus funds of units of local government through a prudent work out, with the ultimate goal of self-liquidating Fund B through maturity and payout of the investments pursuant to statute). As a result, a security was not to be sold if the present value of the future cash flows of the security was greater than the amount for which the securities could be sold.

FINDINGS AND RECOMMENDATIONS

Finding No. 1: Maximization of the Payout of Fund B Investment Principal

State law⁸ provides that the purpose of Fund B is to maximize the payout of principal of invested surplus funds of units of local government through a prudent work out, with the ultimate goal of self-liquidating Fund B through maturity and payout of the investments.

Earlier estimates of the time required for a self-liquidation of Fund B have shown the time required to be as little as 7 to 9 years. However, as shown in Table 5, based on a June 30, 2012, estimate of cash flows provided by SBA⁹ pursuant to our request, absent any sale of investments, the complete liquidation of Fund B could potentially require an additional 30 years or more.

Table 5
Fund B Estimated Future Cash Flows
For the Fiscal Year Ended June 30, 2013, Through the Date of Self-Liquidation
(in thousands)

Fiscal Year Ended June 30,	Florida East Funding LLC	Florida West Funding LLC	Florida Funding I LLC	Florida Funding II LLC	FY Totals
2013	\$ 9,294	\$ 12,189	\$ 5,758	\$ 9,681	\$ 36,922
2014	9,135	12,426	5,286	9,457	36,304
2015	7,389	10,550	3,759	7,409	29,107
2016	5,947	8,616	2,658	6,493	23,714
2017	4,694	7,202	1,970	6,455	20,321
2018-2049 ^a	25,681	60,868	9,642	19,000	115,191
Grand Total	<u>\$ 62,140</u>	<u>\$ 111,851</u>	<u>\$ 29,073</u>	<u>\$ 58,495</u>	<u>\$ 261,559</u>

^a Total estimated annual cash flows from the 2018 through 2030 fiscal years range between \$11 million and \$3 million with over \$15 million estimated to be collected after the 2030 fiscal year.

Source: SBA prepared estimate.

While, as shown by Table 4, Fund B collected over \$1.7 billion in principal and interest for Trust Fund participants during the 2008 through 2012 fiscal years, over 700 participants, with original investment balances ranging from \$20 to \$43,000,000 and totaling \$277,000,000, remained invested in Fund B as of June 30, 2012. Because of the potential extended time period for self-liquidation of the remaining balances, as shown by the SBA’s most recent cash flows estimate, the SBA should survey the Fund B investors to determine whether they would prefer an alternative that may provide an earlier liquidation of their deposits and the magnitude of loss, if any, they would be willing to accept in return for an earlier liquidation. As of December 2012, a recent survey of participants had not been conducted.

Recommendation: We recommend that the SBA provide to participants the June 30, 2012, estimate of cash flows and survey the participants concerning their positions relative to the need for a change in the Fund B objective and the Fund B purpose as defined in Section 218.421(1)(a), Florida Statutes.

⁸ Section 218.421, Florida Statutes.

⁹ The cash flow estimates are based upon various assumptions used to model the estimated cash flows. The actual cash flows may differ materially from the estimates.

OBJECTIVES, SCOPE, AND METHODOLOGY

The Auditor General conducts operational audits of governmental entities to provide the Legislature, Florida's citizens, public entity management, and other stakeholders unbiased, timely, and relevant information for use in promoting government accountability and stewardship and improving government operations.

Section 218.422, Florida Statutes, required us to review, prior to the 2013 regular session of the Legislature, the Fund B Surplus Funds Trust Fund (Fund B) and the steps taken up to that time to return as much of the principal to participants as possible, unless Fund B had been terminated by law or through self-liquidation. We conducted this operational audit from February 2012 to November 2012 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

This operational audit focused on the cash flows, investment management, and communication and education activities for Fund B. The overall objectives of the audit were:

- To evaluate management's performance in establishing and maintaining internal controls, including controls designed to prevent and detect fraud, waste, and abuse, and in administering assigned responsibilities in accordance with applicable laws, administrative rules, contracts, grant agreements, and other guidelines.
- To examine internal controls designed and placed in operation to promote and encourage the achievement of management's control objectives in the categories of compliance, economic and efficient operations, the reliability of records and reports, and the safeguarding of assets, and identify weaknesses in those internal controls.
- To identify statutory and fiscal changes that may be recommended to the Legislature pursuant to Section 11.45(7)(h), Florida Statutes.

This audit was designed to identify, for those programs, activities, or functions included within the scope of the audit, deficiencies in management's internal controls, instances of noncompliance with applicable governing laws, rules, or contracts, and instances of inefficient or ineffective operational policies, procedures, or practices. The focus of this audit was to identify problems so that they may be corrected in such a way as to improve government accountability and efficiency and the stewardship of management. Professional judgment has been used in determining significance and audit risk and in selecting the particular transactions, legal compliance matters, records, and controls considered.

As described in more detail below, for those programs, activities, and functions included within the scope of our audit, our audit work included, but was not limited to, communicating to management and those charged with governance the scope, objectives, timing, overall methodology, and reporting of our audit; obtaining an understanding of the program, activity, or function; exercising professional judgment in considering significance and audit risk in the design and execution of research, interviews, tests, analyses, and other procedures included in the audit methodology; obtaining reasonable assurance of the overall sufficiency and appropriateness of the evidence gathered in support of our audit's findings and conclusions; and reporting on the results of the audit as required by governing laws and auditing standards.

Our audit included the selection and examination of transactions and records. Unless otherwise indicated in this report, these transactions and records were not selected with the intent of statistically projecting the results, although we have presented for perspective, where practicable, information concerning relevant population value or size and quantifications relative to the items selected for examination.

An audit by its nature, does not include a review of all records and actions of agency management, staff, and vendors, and as a consequence, cannot be relied upon to identify all instances of noncompliance, fraud, abuse, or inefficiency.

Our audit included examinations of various records and transactions (as well as events and conditions) occurring during the period December 2007 through June 2012. In conducting our audit we:

- Examined six principal and interest collections totaling \$7,223,713 for KKR Atlantic Funding Trust; KKR Pacific Funding Trust; and Axon Financial Funding LLC, received between January 2008 and February 2009, to determine whether the collections were in the correct amount and properly distributed to the owner funds.
- Examined 84 principal and interest collections totaling \$24,855,220 for Florida East Funding LLC; Florida West Funding LLC; Florida Funding I LLC; Florida Funding II LLC; and Issuer Entity LLC, received between January 2008 and December 2011, to determine whether the collections were in the correct amount and properly distributed to the owner funds.
- Performed analytical procedures to determine whether the amounts deposited into Fund B were allocated to Fund B participants in accordance with each participant's ownership percentage.
- Performed inquiries, inspections, and observations to determine whether Fund B investment management information was periodically communicated to the Fund B Investment Oversight Committee and the Participant Local Government Advisory Council.
- Performed inquiries, inspections, and observations to determine whether the SBA had adequately designed and implemented a compliance monitoring program to monitor Fund B for compliance with investment policy, applicable laws, and contracts.
- Performed inquiries, inspections, and observations to determine whether significant deliverables for Fund B investment management and administrative agreements were received.
- Analyzed data from contracted investment and administrative managers to determine whether Fund B was in compliance with the significant provisions of the Fund's investment policy, applicable laws, and contracts.
- Performed inquiries, inspections, and observations to determine whether the SBA had adequately designed and implemented a communication and education program for Fund B participants.
- Reviewed the compliance certifications required by Section 218.421(2)(a), Florida Statutes, to determine what impact any exceptions reported would have on the scope and objectives of this audit.
- Reviewed minutes of the Investment Oversight Committee, the Participant Local Government Advisory Council, and Trustee meetings in developing our understanding of Fund B.
- Communicated on an interim basis with applicable officials to ensure the timely resolution of issues involving controls and noncompliance.
- Performed various other auditing procedures, including analytical procedures, as necessary, to accomplish the objectives of the audit.
- Prepared and submitted for management response the findings and recommendations that are included in this report and which describe the matters requiring corrective actions.

AUTHORITY

Section 11.45, Florida Statutes, requires that the Auditor General conduct an operational audit of each State agency on a periodic basis. Additionally, Section 218.422, Florida Statutes, required the Auditor General to review, prior to the 2013 regular session of the Legislature, the Fund B Surplus Funds Trust Fund and the steps taken up to that time to return as much of the principal to participants as possible, unless Fund B had been terminated by law or through self-liquidation. Pursuant to the provisions of Section 11.45, and 218.422, Florida Statutes, I have directed that this report be prepared to present the results of our operational audit.



David W. Martin, CPA
Auditor General

MANAGEMENT'S RESPONSE

In a response letter dated February 1, 2013, the Executive Director of the State Board of Administration concurred with our audit finding and recommendation. The Executive Director's response is included as **EXHIBIT A**.

EXHIBIT A
MANAGEMENT'S RESPONSE



STATE BOARD OF ADMINISTRATION
OF FLORIDA

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February 1, 2013

Mr. David W. Martin, CPA
Auditor General
Office of the Auditor General of the State of Florida
G74 Claude Pepper Building
111 West Madison Street
Tallahassee, Florida 32399-1450

Dear Mr. Martin:

We have reviewed the preliminary and tentative audit findings and recommendations which may be included in a report to be prepared on the audit of the State Board of Administration (SBA), Fund B Surplus Funds Trust Fund, pursuant to Section 218.422, Florida Statutes.

As recommended, we agree to provide all Fund B participants the estimate of cash flows as of June 30, 2012. The SBA also agrees to conduct a participant survey of all Fund B investors. The participant survey will gauge investor sentiment and preferences for alternative liquidation options, as well as the desire to amend the fund's investment objective and purpose, as currently defined in Section 218.421(1)(a), Florida Statutes.

As always, we appreciate the Auditor General staff's diligence and professionalism.

Sincerely,

A handwritten signature in blue ink, appearing to read "Ash Williams".

Ashbel C. Williams
Executive Director & Chief Investment Officer

cc: Ms. Florida Rivera-Alsing, Chief Audit Executive, SBA
Mr. Eric Nelson, Chief Risk & Compliance Officer, SBA
Mr. Michael McCauley, Senior Officer – Investment Programs & Governance, SBA