December 28, 2015

Michael Cohen, Director
California Department of Finance
915 L Street
Sacramento, CA 95814

Dear Mr. Cohen,

In accordance with the State Leadership Accountability Act (SLAA), the State Treasurer submits this report on the review of our systems of internal control and monitoring processes for the biennial period ended December 31, 2015.

Should you have any questions please contact Vince Brown, Deputy Treasurer, Administration and Fiscal Policy, at (916) 653-0675, vince.brown@treasurer.ca.gov.

BACKGROUND

The State Treasurer’s Office (STO) was created in 1849 with the adoption of the State Constitution. The STO provides banking services for state government with goals to minimize banking costs and maximize yield on investments. The Treasurer is responsible for the custody of all monies and securities belonging to or held in trust by the state; investment of temporarily idle state and local government monies; administration of the sale of state bonds, their redemption and interest payments; and payment of warrants drawn by the State Controller and other state agencies. The Treasurer serves as the chairperson of fourteen boards, commissions, and authorities (BCAs) that organizationally report to the STO. These BCAs provide various financing tools, credits and grants that provide significant public benefit in a range of areas such as: tax credits and tax-exempt bonds that assist in the development of affordable housing; tax-exempt financing for non-profit hospitals, charter schools, and private colleges and universities, and industrial development projects and waste and recycling projects typically operated by private companies; loan loss reserve contributions, collateral support, and other financial incentives to expand lending to small businesses; tax exclusions and other incentives that fight climate change by expanding alternative energy, advanced manufacturing, and other “green technologies”; low cost loans and grants to small health clinics and charter schools; and the development of investment programs for saving for college and retirement. The Treasurer is also a member of numerous other BCAs providing similar or different products. STO management is responsible for the establishment and maintenance of internal and administrative controls, including: limiting and authorizing access to assets, revenue and expenditures; segregation of duties; providing assurance for achievement of objectives in the following categories: a) reliability of financial reporting; b) safeguarding of assets; c) effectiveness and efficiency of operations; and, compliance with applicable laws and regulations. The Treasurer is responsible for the following organizations, and their operations are taken into account in preparing this report:

<table>
<thead>
<tr>
<th>Business Unit Number</th>
<th>Entity Name</th>
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<tbody>
<tr>
<td>0950</td>
<td>California State Treasurer</td>
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<tr>
<td>0954</td>
<td>ScholarShare Investment Board</td>
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<tr>
<td>0956</td>
<td>California Debt and Investment Advisory Commission</td>
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<tr>
<td>0959</td>
<td>California Debt Limit Allocation Committee</td>
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<tr>
<td>0964</td>
<td>California Transportation Financing Authority</td>
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<td>0965</td>
<td>California Industrial Development Financing Advisory Commission</td>
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<td>0968</td>
<td>California Tax Credit Allocation Committee</td>
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<td>California Alternative Energy and Advanced Transportation Financing Authority</td>
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<td>California Pollution Control Financing Authority</td>
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<tr>
<td>0977</td>
<td>California Health Facilities Financing Authority</td>
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RISK ASSESSMENT PROCESS

The State Treasurer’s Chief of Staff and Deputy Treasurers conducted a meeting with the Department of Finance’s (DOF) Office of State Audits and Evaluations (OSAE) which is responsible for implementing the SLAA. OSAE provided information and made a presentation regarding the changes established by the new law. Specifically, OSAE explained the SLAA report segment and the interim reports required in future months. In addition, the Chief of Risk Management and the Executive Assistant to the Deputy Treasurers also attended a second meeting with OSAE regarding the preparation of the final SLAA report and the proposed corrective action plans.

Based on this information, a timeline was developed for the preparation of the information needed for the report. The timeline included the following actions:

- Division Chiefs and Executive Directors of the BCAs met with staff to develop a list of risks, together with an analysis of how likely the risk was to occur and the potential consequence of the risk occurring.
- The Division Chiefs and the Executive Directors of the BCAs met with the Deputy Treasurers to review the risks and to decide which ones needed to be addressed at the STO level.
- The Deputy Treasurers met with the Chief of Staff to reach agreement on the risks and to agree which ones needed to have corrective action plans.
- The Deputy Treasurers provided information about the final risks and corrective action plans to the Chief, Risk Management.
- The Chief Risk Management prepared a proposed report for review comment by the Deputy Treasurers.
- A final draft report was presented to the Chief of Staff and Treasurer for any additional comments before submission to the Director of Finance.

In the future, the STO will use a similar process to assess how well the corrective action plans are working to mitigate the risks and to identify any new risks.

EVALUATION OF RISKS AND CONTROLS

Compliance- Internal- Disaster Preparedness and Business Continuity

The STO Business Continuity Plan (BCP) was adopted in 2007. The current BCP includes the STO’s mission critical systems and other procedures to mitigate the risk of a natural disaster that existed at the time the BCP was adopted. However, new mission critical systems may have been implemented that are not included in the current BCP creating a risk to STO. Moreover, the BCP does not include the STO Technology Recovery Plan (TRP) which has yet to be developed. Consequently, in the event of a disaster, the STO’s ability to resume mission critical operations may be at risk due to these deficiencies.

A Corrective Action Plan has been developed to update the BCP and include the TRP to mitigate risks to the STO.

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Operations- External- Funding—Sources, Levels

The STO faces risk to its budget due to the funding sources supporting our business activities and programs. The STO’s budget is supported by three funding sources. Specifically, the sources of funds are the General Fund (GF), Reimbursements (for services or work provided for, or on behalf of, another State agency), and Central Service Cost Recovery Funds (CSCRF). The funding split is approximately 15% GF ($4.8 million), 77% Reimbursements ($25.8 million), and 8% CSCRF ($2.6 million) for a total budget of $33.3 million.

As the State experienced budget deficits, departments were subjected to GF budget reductions. As a result, the STO funding split gradually shifted to a greater reliance on Reimbursements: thus placing funding pressure on the Divisions and BCAs to fund the Treasurer’s Executive Office, Legal staff, Information Technology Division, and the Administration Staff.

The primary sources of Reimbursements come from, but are not limited to, the following services provided by the STO:
- The sale of various State bonds.
- Administrative fees charged on the interest earned by LAIF and the Surplus Money Investment Fund.
- Centralized banking services.
- Administrative services provided to the various BCAs.

Given the current budget funding structure and financing stability of the BCAs, the STO business model may not be sustainable.

A Corrective Action Plan is being developed to address this issue. Specifically, the STO will contract with a consultant to conduct an analysis of its budget structure and funding sources to determine if the current business model is sustainable.

Operations- Internal- Staff—Key Person Dependence, Succession Planning

The STO has grown and changed over the last several years with new programs added and revisions to legacy programs. These changes have made the STO’s business programs more complex and more challenging to manage.

The STO relies on specific staff with significant knowledge and expertise to operate and manage mission critical program functions. As such, STO programs are at risk if key professional staff leave the office for higher paying state government jobs, are temporarily absent, or retire. For example, compensation for similar classifications at the Department of Finance, CalPERS, CalSTRS, and the iBank compensate staff at a higher level.

Moreover, the current staff classifications and compensation of professional staff is not adequate or sustainable to ensure that the STO conducts its business effectively and efficiently. These STO risks were identified and documented in a 2007 Classification Proposal to the former Department of Personnel Administration (DPA), now CalHR. The CalHR has not yet acted on the STO Proposal. Consequently, the STO still has recruitment, retention, and succession planning risks that must be addressed.

A Corrective Action Plan is being developed to address this issue. Specifically, STO will update our 2007 Classification Proposal and discuss it with CalHR. Additionally, the STO will work with CalHR to develop and implement a workforce plan that will ensure that it meets its strategic goals, maintains quality, and identifies the competencies that are required of the future workforce to meet the business outcomes and maintain a qualified staff.

Operations- Internal- FI$Cal Conversion
The FI$Cal project is one of the most critical business and technology projects to be implemented statewide in California. The STO is one of the four business partners, including the DOF, State Controller’s Office, and Department of General Services, governing and managing the project.

The STO is currently involved in implementing FI$Cal and providing leadership through serving on the Steering Committee and by voting on critical decisions to manage the project. The FI$Cal project affects STO’s internal operations of budgeting, accounting, and procurement. More importantly, FI$Cal will change the STO’s management and execution of our control function programs of cash management, bond management and investments. In addition, the STO’s coordination and workflow with the State Controller’s Office will change significantly.

To ensure that the business/constitutional needs of the STO are met and maintained we have a Project Business Executive (PBE) and STO staff on sight at the FI$Cal project to mitigate risk and ensure implementation of the project for the office. In addition, STO has ongoing internal Executive and Senior management meetings and other structured meetings to manage the risk of implementing FI$Cal.

**Operations- External- Economic Volatility**

The BCAs face funding risks to conduct business due to economic cycles and their funding sources. For example, the conduit financing authorities—California Health Facilities Financing Authority, California Pollution Control Financing Authority, California Education Finance Authority, and California School Financing Authority—can be affected by market volatility, economic downturns or recessions that may limit the ability of borrowers to issue bonds. Moreover, other issuing entities can take “business” away from the STO authorities. Many of the market and economic factors can also affect the Public Finance Division’s bond sales.

The BCAs are improving the marketing of their programs and conducting analyses of their programs and fee structures.

**ONGOING MONITORING**

Through our ongoing monitoring processes, the State Treasurer reviews, evaluates, and improves our systems of internal controls and monitoring processes. As such, we have determined we comply with California Government Code sections 13400-13407.

**Roles and Responsibilities**

As the head of State Treasurer, John Chiang, California State Treasurer, is responsible for the overall establishment and maintenance of the internal control system. We have identified Walter Barnes, Chief, Risk Management, as our designated agency monitor(s).

**Frequency of Monitoring Activities**

The STO holds bi-weekly Executive staff management meetings and bi-monthly Senior Management meetings. Topics at these meetings include discussion of current and potential internal control issues that need to be addressed. These meetings enable Executive and Senior management to discuss issues that they have been made aware of and what steps are needed to mitigate the issues. The management team is encouraged to share experiences to further assist each other in addressing the issues that may arise.

In addition, staff is continuously monitoring STO programs for issues and corrective actions are taken to address any that arise.
Reporting and Documenting Monitoring Activities

The STO has many external and internal oversight program activities that are used to identify, assess, and manage risks. Some activities include:

- Development of two year Strategic Plans on 2016 and 2017 that will track and monitor risk.
- Audits of Bond and other programs. Audits of the BCAs.
- Performance Reports by various BCAs.
- Meetings of the BCA’s.
- Audits by the Bureau of State Audits.
- Reviews of bond debt prior to issuance of bonds.

Treasurer Chiang established a new Office of Risk Management upon entering office. The office will ensure that all programs run by the Office of State Treasurer are performing in accordance with State and Federal rules and obligations and in accordance with the requirements of the State Treasurer.

The Chief, Office of Risk Management will perform a review of all programs to: 1) determine what is the purpose of the program; 2) develop a list of State and/or Federal or special requirements that apply and whether they are being complied with and if not, what might be done to address this; 3) determine whether the programs goals and objectives are in compliance with the State Treasurer’s interests and if not what might be done to address this; 4) prepare a report of findings and recommendations; and, 5) present the findings and recommendations to the appropriate program head and ensure that they are implemented or determine whether an alternative is appropriate.

In addition, the Chief, Risk Management will perform reviews and audits of special projects as they occur. This includes coordinating the preparation of reports to the Department of Finance regarding the State Leadership Accountability Act (SLAA).

It is estimated that a review of all programs will take approximately two years to accomplish. During the past year, the Chief, Risk Management has performed the following reviews and issued final reports:

- Review of Contracts issued by the State Treasurer’s Office.
- Review of repayment of loans by the California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA) to the Renewable Resource Trust Find (RRTF) and the California Pollution Control Financing Authority (CPCFA).
- Review of a complaint about the Charter School Facilities Grant Program administered by the California School Finance Authority (CSFA).
- Coordinating the development of the first annual SLAA report for submittal to the Department of Finance.
- Review of Issues affecting the operations of the California Treasury and Securities Management Division and the Investments Division.

Currently, the Chief of Risk Management is working on the following:

- A review of the Property Assessed Clean Energy (PACE) Loss Reserve Program administered by CAEATFA.
- Development of a proposed audit program for the PACE Loss Reserve Program.
- A review of funding for the California Education Financing Authority (CEFA).

During the current year the Chief, Risk Management will work in consultation with the Chief of Staff, the General Counsel, the Deputy Treasurers and the Executive Directors of the Boards, Commissions, and Authorities administered by the Office of the State Treasurer to determine the next programs and issues to be examined, many of the risks identified during the SLAA risk assessment process.
Procedure for Addressing Identified Internal Control Deficiencies

All of the information coming from these activities are assessed for risks and are candidates for the next SLAA review.

CONCLUSION

The State Treasurer strives to reduce the risks inherent in our work through ongoing monitoring. The State Treasurer accepts the responsibility to continuously improve by addressing newly recognized risks and revising risk mitigation strategies. I certify our systems of internal control and monitoring processes are adequate to identify and address material inadequacies or material weaknesses facing the organization.

John Chiang, California State Treasurer

cc: Department of Finance
    Legislature
    State Auditor
    State Library
    State Controller
    Secretary of Government Operations