Audit Report

# Office of the State Treasurer

October 2010



**OFFICE OF LEGISLATIVE AUDITS**
DEPARTMENT OF LEGISLATIVE SERVICES
MARYLAND GENERAL ASSEMBLY

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**DEPARTMENT OF LEGISLATIVE SERVICES**
OFFICE OF LEGISLATIVE AUDITS
MARYLAND GENERAL ASSEMBLY

October 27, 2010

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Senator Verna L. Jones, Co-Chair, Joint Audit Committee
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Members of Joint Audit Committee
Annapolis, Maryland

Ladies and Gentlemen:

We have audited the Office of the State Treasurer (STO) for the period beginning May 1, 2006 and ending June 30, 2009. STO is responsible for the receipt, disbursement, safekeeping, and investment of the funds of the State Treasury. STO is also responsible for procuring banking and financial services for State agencies, and maintaining an insurance program for State property and personnel. In addition, STO coordinates the State's general obligation debt functions for the Board of Public Works.

Our audit disclosed deficiencies in STO's oversight of State agency banking services. For example, procedures were not sufficient to ensure all bank accounts maintained by State agencies were authorized and were at banks under STO contract; as a result, a number of active accounts remained at unauthorized banks. For example, according to STO's records, as of July 2009, various State agencies had 22 accounts at five unapproved banks. In addition, STO did not have a sufficient process to ensure agency funds were adequately collateralized. Furthermore, STO had not finalized portions of its banking contracts that were effective July 1, 2004. Certain provisions establishing contractor liability remain contested, such as the window of time provided to the State to identify contractor errors in lockbox transactions and accounting.

STO did not ensure the propriety of payments made for claims processing services provided by the Injured Workers' Insurance Fund for workers' compensation claims filed by State employees, and controls over the State's securities needed improvement. Furthermore, there was not an adequate separation of duties over State Insurance Program claim payments, related billings, and cash receipts. Amounts owed to bondholders for unpresented bonds exceeded the balance of STO's Unpresented Bond Fund by approximately $435,000. Finally, certain information system security deficiencies existed. For example, STO's disaster recovery plan was not comprehensive.

An executive summary of our findings can be found on page 5. STO's response to this audit is included as an appendix to this report. We wish to acknowledge the cooperation extended to us during the course of this audit by STO.

Respectfully submitted,

Bruce A. Myers, CPA
Legislative Auditor

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* **Denotes item repeated in full or part from preceding audit report**

# Executive Summary

**Legislative Audit Report on the Office of the State Treasurer (STO)**
**October 2010**

- **STO did not ensure that all State agency bank accounts were authorized, and deficiencies were noted in certain other aspects of its banking operations. For example, STO did not ensure that State agencies made daily transfers of funds from their lockbox accounts to the State's bank account for investment purposes, and did not have a sufficient process to ensure agency funds were adequately collateralized.**

  STO should periodically identify unauthorized agency bank accounts and take appropriate follow-up action. STO should also take the recommended actions to improve oversight of its banking operations. For example, STO should monitor lockbox accounts, at least on a test basis, to ensure that available cash balances are transferred into the State's depository account on a daily basis, and should establish adequate procedures to ensure agency bank accounts are adequately collateralized.

- **As of May 2010, certain provisions of banking contracts for lockbox services for State agencies and disbursement services for STO had not been finalized even though the contracts became effective July 1, 2004. For example, the lockbox services contract liability error provision had not been finalized.**

  STO should, in conjunction with its legal counsel, promptly complete all operating agreements related to banking contracts and, in the future, finalize contracts before they become effective.

- **STO authorized State agencies to use remote deposit services without providing agencies with written guidance for these services. As a result, proper internal controls and safeguards may not have been established.**

  STO, in conjunction with the Comptroller of Maryland, should develop formal written guidance for State agencies that use remote deposit services.

- **STO did not ensure the propriety of amounts paid to the Injured Workers' Insurance Fund (IWIF), which administers all workers' compensation claims filed against the State.**

  STO should, at least on a test basis, review amounts previously paid to IWIF for propriety and, in the future, determine the propriety of amounts paid to IWIF.

- **Adequate procedures and controls were not established over State-owned securities.**

  STO should safeguard all State-owned securities, as required by State law, maintain accurate inventory records, and properly monitor the existence of these securities.

- **STO had not established adequate controls over State Insurance Program claim payments, related billings, and cash receipts. For example, the same employee prepared receipts for deposit, recorded deposits in the accounting records, accounted for prenumbered receipt forms, and performed recordkeeping and billing functions for the related receivables.**

  STO should take the recommended actions and adequately separate duties over the State Insurance Program.

- **Amounts owed to bondholders for unpresented bonds exceeded the balance of STO's Unpresented Bond Fund by approximately $435,000, and unredeemed bond funds totaling $247,200 were not transferred to the Comptroller of Maryland's Abandoned Property Fund, as required by State law.**

  STO should resolve the deficiency in the Fund and transfer those funds deemed abandoned to the Comptroller of Maryland's Abandoned Property Fund as required.

- **Certain information system security deficiencies existed. For example, the disaster recovery plan did not contain all required elements. STO operates an internal network, as well as a minicomputer that is used to print State of Maryland vendor checks.**

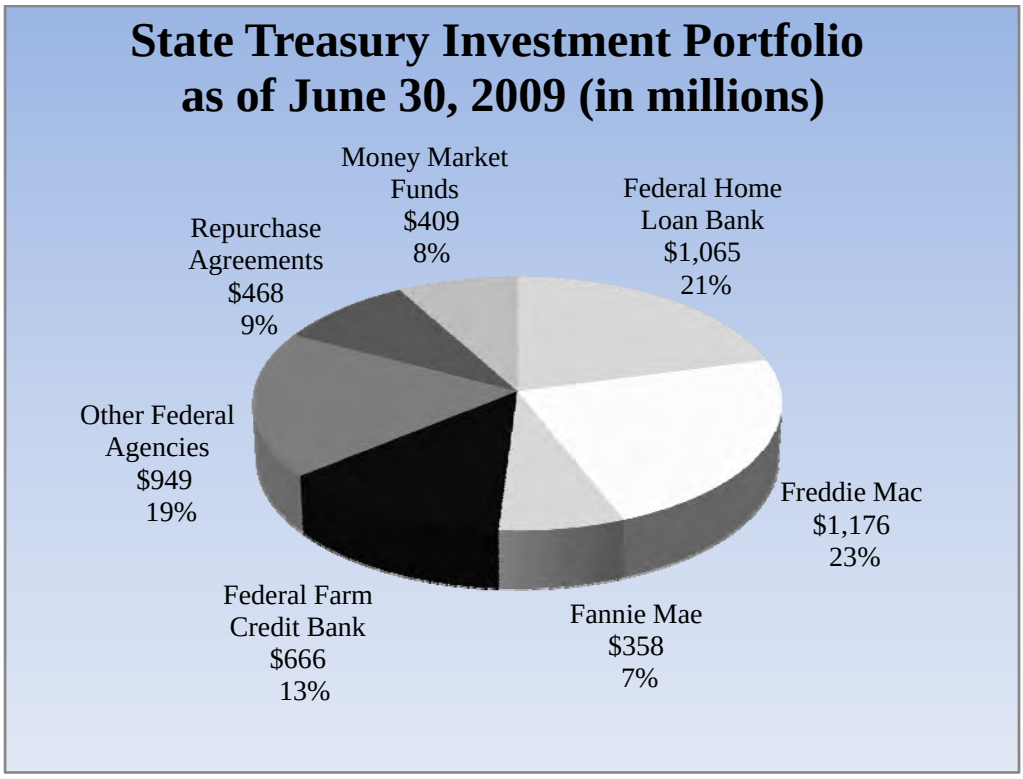
  STO should develop a comprehensive disaster recovery plan and take other recommended corrective actions.

# Background Information

## Agency Responsibilities

The Office of the State Treasurer (STO) is responsible for the receipt, disbursement, safekeeping, and investment of the funds of the State Treasury. It is also responsible for reconciling the related bank accounts, procuring banking and financial services for State agencies, and maintaining an insurance program for State property and personnel. STO also coordinates the State's general obligation debt functions for the Board of Public Works. According to the State's records, STO's operating expenditures for fiscal year 2009 totaled approximately $33.9 million.

According to State law, State Treasury investments are limited to secured bank accounts, full faith and credit obligations of the federal government, obligations of certain federal agencies or instrumentalities, repurchase agreements collateralized by those securities, certain money market mutual funds, and limited amounts of commercial paper. As of June 30, 2009, the State Treasury investment portfolio, based on market value, totaled approximately $5.1 billion.




**Source: STO's records (unaudited)**

## Status of Findings From Preceding Audit Report

Our audit included a review to determine the status of the 19 findings contained in our preceding audit report dated July 24, 2007. We determined that STO satisfactorily addressed 11 of the findings. The remaining 8 findings are repeated in this report, and appear as 9 findings.

# Findings and Recommendations

## Bank Accounts

### Background

The State Treasurer's (STO) authority as the custodian of the State Treasury and its responsibility for the deposit and disbursement of State funds is established in the State Constitution. Accordingly, STO's Banking Services Division is responsible for procuring the following banking needs for all State agencies: (1) maintenance of agency-specific depository accounts and disbursement accounts for State vendor payments, (2) lockbox services, (3) merchant account services, and (4) contracts and procurements for all other agency banking needs.

**Finding 1**
**STO did not ensure that all State agencies were using STO authorized banks and did not adequately monitor certain lockbox accounts.**

### Analysis

STO did not ensure that all State agency bank accounts were authorized by the STO as required by State law and did not adequately monitor certain agencies' use of lockbox accounts. Our review disclosed the following conditions:

- STO did not take adequate steps to ensure all State agency bank accounts were authorized. Accounts that have been approved by STO and the Comptroller of Maryland – General Accounting Division are included on the State's records of authorized accounts. In April 2009, STO attempted to reconcile all known active State bank accounts, identified by its survey of State agencies, with the State's records of authorized bank accounts. However, STO did not complete the reconciliation of open bank accounts, which totaled approximately 1,900 per the survey results, to approved bank accounts. For example, survey results for four banks that had approximately 1,700 of the aforementioned 1,900 accounts, were not reconciled. Furthermore, STO did not conduct follow-up when it did not receive completed surveys from approximately 70 of the approximately 270 agency contacts. Similar conditions were commented upon in our two preceding audit reports.

- In August 2008, STO entered into agreements with 20 banks to provide banking services to State agencies for the period beginning August 1, 2008 and ending June 30, 2011, with three one-year renewal options. STO did not ensure, however, that all active State agency accounts were at these approved banks as required by State law. Based on our analysis of STO's records as of

July 2009 and other bank provided reports, we identified 22 State agency accounts at five unapproved banks. Although STO notified all agencies in October 2008 to close accounts held at unapproved banks and to transfer the funds to an approved bank, STO did not verify that these accounts were closed. State law specifies that State agencies may only have accounts with banks that have a contract with STO. Similar conditions were commented upon in our preceding audit report.

- STO did not periodically monitor agencies that elected not to use the lockbox contractor's auto wire program to ensure that the agencies made daily transfers of available balances from lockbox accounts to the State bank account for investment purposes. The auto wire program automatically transfers the available balance in lockbox accounts daily to the State's bank account. Our test of five agency lockbox accounts, with collections totaling approximately $30.8 million in the month tested, disclosed that two agencies, with collections totaling approximately $2.1 million, did not transfer funds to the State bank account for extended periods; these two agencies had elected not to use the auto wire feature. For example, one of these agencies did not transfer any funds for 50 days, and when funds were subsequently transferred, approximately $1.2 million was deposited into the State's account and approximately $480,000 remained in the lockbox account. By the end of the month, the balance in the lockbox account had increased to approximately $800,000.

  Funds held in lockbox accounts do not earn interest on behalf of the State. By ensuring that the bank performs daily transfers of the available balances to the State bank account, funds available for investment would be maximized. A similar condition was commented upon in our two preceding audit reports. As of June 2009, there were 36 agency lockbox accounts under this contract with an average total daily balance of approximately $14.4 million; this included 6 State agency accounts that were not participating in the auto wire program.

**Recommendation 1**
**We recommend that STO**

**a. perform a periodic analysis (such as bi-annually), using available documents and information, to identify unauthorized accounts and accounts at unapproved banks, and require State agencies to close these accounts and reestablish the accounts with banks under a current contract (repeat); and**

**b. monitor the lockbox accounts, at least on a test basis, to ensure that the available balances are transferred into the State's depository account on**

**a daily basis and require agencies not transferring funds in a timely manner to enroll in the contractor's auto wire program (repeat).**

**Finding 2**
**Deficiencies were noted in STO's oversight of State agency bank account requirements.**

**Analysis**
Deficiencies were noted in STO's oversight of certain other aspects of its banking operations. As of January 2010, STO had 20 banks under contract to provide various banking services to State agencies. In addition, numerous other banks provide banking services to State agencies that are not under contract. Our review disclosed the following conditions:

- STO did not have a sufficient process to ensure bank accounts were adequately collateralized. The banking services contracts require banks to maintain adequate collateral based on the highest daily balances of State funds on deposit. However, our review of STO's September 2009 collateral report analysis, which included 19 banks with reported balances totaling $388.6 million, disclosed that STO did not always use correct or complete data to determine if bank accounts were adequately collateralized.

  For example, STO did not question the sufficiency of collateral for two banks that did not pledge collateral for investment accounts. One of these accounts had a highest daily balance of approximately $7.7 million during September 2009, while the other account had an estimated balance of $20 million. Although these funds were only held in investment accounts overnight, not ensuring that State funds were adequately collateralized could put State funds at risk for loss. In addition, when conducting its collateral analysis for July 2009, STO did not receive collateral reports from 13 banks that maintained 55 accounts with balances totaling approximately $25.2 million. STO's management was unaware that collateral reports were not being received from these banks until we brought this to its attention. Furthermore, collateral reports for four banks disclosed that two banks, with balances totaling approximately $230.2 million (as of September 30, 2009), were not adequately collateralized and STO did not follow up with the bank. A similar condition regarding verification that pledged collateral meets or exceeds the highest daily balance was commented upon in our preceding audit report.

- STO did not enforce certain provisions of the banking services contract. Although required by the contract, annual audited financial statements were not obtained from any of the 20 approved banks since the procurement of the contract in calendar year 2008. STO advised us that this requirement was not enforced since it relies on the banks' financial strength ratings to gauge financial status. However, STO did not take appropriate follow-up actions when certain banks did not maintain the minimum required financial strength rating. For example, 13 of the 20 approved banks, which according to the State agencies had estimated balances of State funds on deposit totaling approximately $821.4 million, did not maintain the minimum required financial strength rating. Furthermore, on January 8, 2010, STO issued a temporary waiver of the minimum financial strength rating requirement—until June 30, 2011—because this is an industry-wide issue resulting from the nation's current economic condition. Accordingly, obtaining and reviewing financial statements would help STO monitor a bank's financial status.

  In addition, 2 of the 20 banks did not provide STO with the highest daily balance of State funds on deposit with the banks, as required by the contract, in order to determine if the funds were adequately collateralized. For example, at the time of the contract award, one bank informed STO that it would only provide the average daily balance of unsecured State funds on deposit and STO accepted the bank's deviation from the contract requirement.

- STO did not ensure that all interest earned on funds in certain State agency bank accounts was transferred to the General Fund as required. Contracts between STO and the banks require each bank to invest funds for State agency accounts and to remit interest earnings to the General Fund (via the State's main depository account). However, STO did not maintain a record of those accounts for which earned interest was required to be transferred to the State, nor had STO established a methodology to determine that interest was being transferred to the State. During fiscal year 2009, interest earned on funds in State agency bank accounts totaling approximately $738,000 was remitted to the General Fund. A similar condition was commented upon in our six preceding audit reports dating back to September 1993.

**Recommendation 2**

**We recommend that STO**

**a. ensure all banks submit collateral reports disclosing the highest daily balance of State funds, as required by the banking services contract;**

**b. monitor to ensure banks maintain adequate collateral for all State funds, including those funds in investment accounts, and take appropriate**

**corrective action when banks do not maintain sufficient collateral (repeat);**

**c. obtain annual audited financial statements from all approved banks as required by the related contracts; and**

**d. ensure that all interest earned on State funds on deposit in agency banks accounts is transferred to the General Fund, as required (repeat).**

**Finding 3**
**As of September 2009, not all provisions of banking contracts had been finalized even though the contracts were effective July 1, 2004.**

**Analysis**

As of May 2010, significant provisions of contracts with two banks, including those establishing liability for errors, had not been finalized even though the contracts became effective July 1, 2004. These contracts are for the operation of lockboxes for State agencies and disbursement services for STO. The contracts are in effect until June 30, 2011. During June 2009, the lockbox contractor maintained 36 lockbox accounts that had an average total daily balance of approximately $14.4 million, and financial activity processed through the State's main bank account totaled approximately $116 billion during fiscal year 2009.

Specifically, the main contract documents include various contractors' operating agreements, which were prepared by the contractors, dated July 1, 2004, and submitted to STO for approval. However, as of May 2010, STO's legal counsel was still in the process of reviewing and modifying the operating agreements prepared by the contractors. The same condition was commented upon in our preceding audit report. In response to our preceding audit report, STO stated that it would renew efforts to finalize the bank operating agreements. However, STO's legal counsel informed us that, in spite of the Treasurer's encouragement, finalizing these operating agreements has not been a priority.

The operating agreements govern significant portions of the State's banking operations. For example, the primary operating agreement prepared by the financial institution that provides lockbox services stated that, if the State does not notify the contractor of errors within 30 days, the contractor is not liable for the errors. STO's legal counsel maintains that the State should have 60 days to identify errors and, after 60 days, the contractor would be relieved of liability for any damages related to the unreported error, omission, or other discrepancy, as well as for interest on any credit or refund due. STO's legal counsel has also objected to various provisions in other operating agreements, which have not been finalized, that limit the contractors' liability. If a dispute arose concerning

provisions of the operations governed by the proposed operating agreements, the State's interests could be at risk. We were advised that no such disputes have occurred during the terms of these contracts.

**Recommendation 3**

**We recommend that STO**

**a. in conjunction with its legal counsel, promptly complete all operating agreements related to the banking contracts (repeat); and**

**b. in the future, ensure all terms and conditions are established and agreed to before contracts become effective (repeat).**

**Finding 4**

**Proper controls were not established over the State's bank reconciliation process.**

**Analysis**

The Office did not sufficiently control the State's bank reconciliation process. Specifically, certain employees were given unnecessary capabilities and, in some cases, employee accesses granted created inadequate separation of duties. For example, two of the four employees with the ability to manually delete deposit transactions in the State's records that did not match items in the bank's records, were also responsible for reviewing and approving the transactions processed by the other two employees. In addition, seven employees with access to record bank adjustments did not need this access based on their job duties, and access granted to four other employees to record bank adjustments created an inadequate segregation of duties. Finally, the ability to manually process wire deposits was unnecessarily granted to another employee.

As a result, STO lacked assurance that all of the State's bank account reconciling transactions were proper. Similar conditions regarding unmatched deposit and bank adjustments were commented upon in our preceding audit report. During June 2009, STO manually processed wire deposits totaling $375 million and unmatched deposit items manually removed from the bank reconciliation records by the two aforementioned employees totaled approximately $8 million. Additionally, according to the State's records, during the audit period, STO processed bank adjustment transactions totaling $3.9 million that decreased agency cash balances, and transactions totaling $8.6 million that increased agency cash balances.

**Recommendation 4**
**We recommend that**

**a. the capability to manually delete deposit transactions, record bank adjustments, and manually process wire deposits, be limited to employees who require the capabilities to perform their job duties (repeat);**

**b. an independent employee verify the propriety of all deposit transactions manually deleted from the automated records (repeat); and**

**c. a proper separation of duties be established over bank adjustments (repeat).**

**Finding 5 (Policy Issue)**
**STO had not established policies governing the use of remote deposit by State agencies.**

**Analysis**

STO had not established Statewide policies governing the use of remote deposit services. In this regard, STO entered into an agreement on April 15, 2009 with the State's depository bank to provide remote deposit services to State agencies. Remote deposit is a web-based application, established by the bank that enables State agencies to deposit checks into a bank account from their location without having to physically deliver the checks to the bank. This is accomplished by digitally scanning a check (using a bank-approved scanner) and transmitting the image to the bank. As of January 25, 2010, STO had authorized two State agencies to use these services. We were advised by these two agencies that they had not implemented internal control procedures and safeguards to specifically address the risks associated with these services.

STO has not provided agencies with policies governing the use of these services, nor does the *Accounting Procedures Manual* issued by the Comptroller of Maryland's General Accounting Division include procedures to govern and control the use of these services. Although the State's depository bank has published user guides, these user guides do not specifically address certain inherent risks related to these services. Based on our review of those guides, available industry literature, and Government Finance Officers Association's best practices, agency guidance should address the following controls:

- Access to the remote deposit scanner and to checks, both prior to and subsequent to scanning them for electronic deposit, should be restricted. Adequate restricted access to the scanner will help ensure that the equipment

is not altered, and adequate restricted access to the checks helps prevent the possibility of misappropriation.

- Restricted access to the bank's remote deposit web-based application, including maintaining proper separation of duties by user role functions (such as administrator, processor, and reviewer) in the depository bank's system based on the employees' job duties, should be established. Maintaining proper restricted access and separation of duties will help to ensure that deposits are properly made and the checks and bank account are not altered, allowing for misappropriation.

- Processes to securely store scanned checks and to timely destroy checks and images once scanned and verified as being properly deposited should be established. Documentation of the destruction of the checks and images should also be maintained. Without a process to secure and destroy scanned checks, there is an increased risk of identity theft and of the checks being presented multiple times.

- Initial recordation and restrictive endorsement of checks immediately upon receipt should be required when deposit delays are anticipated, to ensure they are adequately safeguarded before being scanned for deposit.

- Supervisory review and approval of critical transactions (such as adjustments, overrides, and voids of scanned images) should be required. Proper supervisory review and approval process will help to ensure checks are not misappropriated and scanned checks are not scanned more than once for deposit.

- An independent deposit verification process using initial recordation documentation of checks received, output reports from the remote deposit web-based application, and bank statements should be established. Proper independent deposit verifications using the aforementioned documents will help to ensure that all checks received were properly deposited.

- A process to export images of scanned checks and related information from the remote deposit web-based application to post collections to the state's accounting records and the related accounts receivable records, and to research and correct bank adjustments (such as for insufficient fund checks) should be established.

**Recommendation 5**
**We recommend that STO, in conjunction with the Comptroller of Maryland's General Accounting Division, develop a formal written policy, which incorporates a consideration of appropriate risks, to guide State agencies that use remote deposit services.**

## Injured Workers' Insurance Fund (IWIF)

### Background

Under the terms of a 1990 contract between the Injured Workers' Insurance Fund (IWIF) and the Board of Public Works (BPW), IWIF provides claims processing services for workers' compensation claims filed by State employees. The State is self-insured for such claims. The contract provides that STO is responsible for administering the contract, on behalf of BPW. In addition, an amendment to the contract, executed in November 2001, includes provisions that the State shall receive interest earned on amounts paid to IWIF and that the State may fund future costs of incurred losses to mitigate the State's unfunded liability.

As required by the contract, at the start of each fiscal year, STO sends a payment to IWIF for State workers' compensation claim costs for the upcoming year. The payment includes an amount to pay for anticipated workers' compensation claims and an amount for IWIF's administrative costs associated with providing claims-processing services to the State. Payments for anticipated claims are based on the actual amount of claims paid, as reported by IWIF, in a prior fiscal year. Payments for administrative costs are based on STO's proportionate share of IWIF's administrative costs (allocated based on the State's proportionate share of actual losses compared to actual losses incurred by all clients insured by IWIF, including the State, as reported by IWIF). According to STO's records, during fiscal years 2007 through 2009, payments to IWIF for State workers' compensation claim costs totaled $182.1 million, including $30.3 million for administrative costs. These costs are recovered through State agency assessments prepared by STO.

In addition, based on funds included in the State budget, STO makes payments to IWIF to reduce the State's long-term liability for workers' compensation claims. The long-term liability is the difference between what actuaries have determined is adequate to cover the State's future liability and amounts the State has transferred to IWIF for the liability. According to its records, during fiscal years 2007 through 2009, STO paid $21.1 million to IWIF to reduce the unfunded liability, which, according to IWIF's actuary, is estimated at $275 million as of June 30, 2009. As of August 7, 2009, according to its records, State funds on

deposit with IWIF for the State's long-term workers' compensation liability totaled approximately $10.8 million. This balance includes the effects of a transfer of $28 million to the State's General Fund as required by the Budget Reconciliation and Financing Act of 2009.

**Finding 6 (Policy Issue)**
**The services provided by IWIF have not been subject to a competitive bid process for more than 19 years.**

**Analysis**
The contract to administer all workers' compensation claims filed against the State has never been subject to a competitive bid process and IWIF has been providing these services for more than 19 years. While competitive bids are generally not required for contracts between units of State government, considering the significant amounts paid to IWIF, as well as the availability of this service from private insurance companies, we believe that a competitive bid process should be used to determine if the State is receiving a fair price for services rendered.

Under the contract, IWIF is responsible for investigating, defending, and making payments for claims that the State is legally obligated to pay for damages resulting from bodily harm to or death of an employee of the State, resulting from the employee's employment, such as it does for other clients. The contract contains no specific ending date, but provides that the State can terminate the contract for any reason after giving IWIF 90 days written notice.

The issue of workers' compensations claims services not being subject to a competitive bid process was commented upon in our preceding audit report. In response to our preceding audit report, STO stated that, in conjunction with BPW, it was developing a Request for Proposal (RFP) to obtain independent accounting services to help determine whether it would be in the State's best interest to maintain the contract with IWIF or to competitively procure these services. However, as of May 2010, the RFP had not been finalized and STO management advised us that, regardless of the recommendation it receives, STO would only competitively procure these services if specifically directed to do so by the General Assembly.

**Recommendation 6**
**We recommend that STO take the necessary actions to ensure that workers' compensation claims processing services are obtained in the manner most beneficial to the State (repeat). Specifically, we recommend that STO**

**a. in conjunction with BPW, prepare and issue the RFP for the independent audit services related to competitively bidding workers' compensation claims services; and**
**b. evaluate the results of the audit and take appropriate action.**

**Finding 7**
**STO did not ensure the propriety of amounts paid to IWIF.**

**Analysis**
STO did not take any action to assess the propriety of amounts paid to IWIF. Essentially, STO's only activities with respect to this contract were to make payments to IWIF and to recover the assessments from State agencies.

Specifically, STO did not verify that claims reported by IWIF were for actual payments made on behalf of State employees who suffered work-related injuries. In addition, the validity of administrative costs and costs related to the State's risk management program were not subject to independent verification. Although the contract allowed STO to obtain reports from IWIF to help monitor the contract (including claims activity), STO had not requested any reports or annual accountings from IWIF during our audit period (such as, actual claims paid versus estimated). Since claims reported by IWIF serve as the basis for payments of more than $46 million per year to IWIF, it is essential that STO verify the propriety of the reported claims. In addition, administrative and risk management costs totaled approximately $10.1 million and $583,000, respectively, during fiscal year 2009.

Similar conditions were commented upon in our preceding audit report. As mentioned in Finding 6, in response to our preceding audit report, STO, in conjunction with BPW, is developing an RFP to obtain an independent accounting firm to audit IWIF to help determine if it is in the State's best interest to continue to contract with IWIF rather than competitively procure workers' compensation services. STO anticipates that the scope of the audit may include the performance of claims administration activity, the financial liability of the State (which includes administrative costs), a review of loss experience, and an analysis of the causes of loss. As of May 2010, the RFP had not been finalized and STO had taken no other action to assess the propriety of amounts paid to IWIF.

**Recommendation 7**
**We recommend that STO, at least on a test basis, review amounts previously paid to IWIF for propriety and in the future, determine the propriety of amounts paid to IWIF. This verification should be documented and should**

**include a review of appropriate supporting documentation, such as evidence of amounts paid for injured State workers, and documentation to assess the propriety of administrative and risk management costs (repeat).**

## Investments and Securities

**Finding 8**
**Procedures and controls over State-owned securities were inadequate.**

**Analysis**
STO did not have adequate procedures to safeguard and control State-owned securities, for which it served as custodian. In addition, procedures used to obtain price quotes for repurchase agreements[1] were inadequate. Our review disclosed the following conditions:

- STO's inventory records of State-owned securities (such as stock certificates and bonds) were inaccurate and incomplete, and the securities were not adequately safeguarded. For example, as of November 17, 2009, 17 securities totaling $46.4 million, received between December 30, 2008 and November 3, 2009, had not been added to STO's inventory records. In addition, securities held by STO had not been maintained in the vault at STO since September 2006 because STO believed it was more convenient to store the securities in a locked filing cabinet. Furthermore, missing keys to both the vault and to a rented bank safe deposit box prevented STO from accessing securities held in these locations. Consequently, while STO advised that all securities had been removed from the vault and the safe deposit box, we were unable to confirm this. Furthermore, the locked filing cabinet required only one key to gain access and the key was held by the employee responsible for maintaining the related inventory records.

  Since STO serves as the custodian for all State-owned securities, STO should ensure that its securities records are accurate, complete, and verifiable. Additionally, State law requires that physical securities be maintained in a box or vault located at STO and requires at least two different keys (one for the Comptroller and one for the State Treasurer) to gain access to the securities.

- STO did not ensure it obtained investment interest rate quotes for repurchase agreements from personnel authorized to provide interest rate information.

[1] A repurchase agreement allows the State to earn interest by buying certain collateralized investments, which are then sold in the short-term after earning a fixed rate of interest.

We were advised by STO management that this occurred because they did not obtain updates from the broker-dealers when authorized personnel changed. Specifically, our review of repurchase investments totaling $373 million made on June 30, 2009 disclosed that bids were received from four individuals who were not authorized to provide interest rate information according to the master repurchase agreements.

As of June 30, 2009, STO had outstanding investments totaling $5.1 billion, including repurchase agreements totaling $468 million.

**Recommendation 8**
**We recommend that STO**

**a. maintain accurate inventory records for all State-owned securities and safeguard all physical securities in the manner required by State law;**
**b. monitor the existence of all State-owned securities; and**
**c. take immediate action to obtain the required documentation from the current broker-dealers showing authorized personnel, periodically update this information, and obtain investment interest rate quotes only from authorized broker-dealer personnel.**

## State Insurance Program

**Finding 9**
**Insurance claim payments, related billings, and cash receipts were not adequately controlled.**

**Analysis**
STO lacked adequate controls over State Insurance Program claim payments, related billings, and cash receipts. For example, two employees had the capabilities to both create and approve an insurance claim, and one of these employees could also record the related disbursements in STO's accounting records and recover funds from State agencies without independent review and approval. Furthermore, the duties over billings and cash receipts were not adequately separated since the same employee prepared receipts for deposit; recorded certain deposits in STO's accounting records; accounted for prenumbered receipt forms as to issued, voided, and on-hand; and performed recordkeeping, billing, and reconciliation functions for the related receivables.

The State Insurance Program is a self-insurance program designed to cover State agencies and employees for claims related to property, motor vehicles, torts, and officer and employee liability. STO also procures commercial insurance policies

to provide insurance coverage beyond its self-insurance limits on both a statewide basis (such as property coverage) and an individual agency basis (such as transit liability coverage for the Maryland Transit Administration). Payments for claims under the self-insurance limits and to purchase statewide insurance coverage are made from the State Insurance Trust Fund. STO obtains repayments of insurance premiums and claim losses from state agencies and third parties (such as a third party held responsible for an insurance loss incurred by the State) by billing these entities.

According to STO's records, during fiscal year 2009, claim payments from the State Insurance Trust Fund totaled approximately $7.4 million, the related billings for insurance premiums and claim losses totaled approximately $11.8 million, and the cash receipts received and deposited into the State Insurance Trust Fund totaled approximately $19.8 million.

The Comptroller of Maryland's *Accounting Procedures Manual* requires that the duties of cash receipts handling be segregated from accounts receivable record keeping, billing, and reconciliation functions. The *Manual* also requires that the numerical sequence of prenumbered receipt forms be accounted for as to issued, voided, and on-hand.

**Recommendation 9**
**We recommend that**

a. **employees that have access to process claims not have the ability to approve claims, process disbursements, and recover funds from State agencies;**
b. **an employee who does not have access to cash receipts record deposits in the applicable accounting records;**
c. **employees responsible for maintaining the accounts receivable records not have access to the related cash receipts; and**
d. **prenumbered cash receipts forms be periodically accounted for as to issued, voided, and on-hand by an employee independent of the cash receipts function.**

**We advised STO on accomplishing the necessary separation of duties using existing personnel.**

## Unpresented Bond and Coupon Fund

**Finding 10**
**The amount owed to bondholders for unpresented bonds exceeded the cash balance of the Fund by approximately $435,000. Unredeemed bond funds were not transferred to the Comptroller of Maryland's Abandoned Property Fund, as required.**

**Analysis**
As of January 31, 2010, STO's records indicated that the total amounts owed to bondholders for previously matured bonds exceeded the cash balance of the Unpresented Bond and Coupon Fund by approximately $435,000. Consequently, STO will not have adequate resources in the Fund to cover outstanding bond liabilities in the event that all outstanding bonds are presented for payment. According to STO's research, the Fund's deficit is mainly attributed to approximately $455,000 in unpresented bond funds returned by a paying agent to STO in 1996 that STO cannot account for; however, because of inadequate records at that time, this could not be substantiated. Furthermore, STO management informed us that STO intends to request permission from the Comptroller of Maryland to write off this deficit.

We also noted that STO did not transfer funds for unredeemed general obligation bonds totaling approximately $247,200 to the Comptroller of Maryland's Abandoned Property Fund during the period under audit. As of January 31, 2010, according to STO records, most of the money in the Unpresented Bond and Coupon Fund related to bonds that matured as far back as 1990 and, in accordance with State law, should have been transferred to the Abandoned Property Fund since the funds remained unpresented for more than three years.

The Unpresented Bond and Coupon Fund is used to account for funds returned to STO by the paying agent for bonds that have matured but have not been presented for payment by the bondholders for at least 12 months. In addition, monies that have been transferred from this Fund to the Comptroller of Maryland's Abandoned Property Fund remain available for payment to these bondholders. Similar conditions were commented upon in our preceding audit report.

**Recommendation 10**
**We recommend that STO**

**a. resolve the discrepancy in the Unpresented Bond and Coupon Fund (repeat), and**

**b. transfer those funds deemed to be abandoned in the Unpresented Bond and Coupon Fund to the Comptroller of Maryland's Abandoned Property Fund as required by State law (repeat).**

## Information Systems Security and Controls

**Finding 11**
**STO's disaster recovery plan and controls over passwords were inadequate.**

**Analysis**
STO's disaster recovery plan and controls over passwords were inadequate. Specifically, we noted the following conditions:

- The disaster recovery plan did not contain all of the minimum required elements as specified by the Department of Budget and Management's (DBM) *Information Technology Disaster Recovery Guidelines*. For example, alternate site processing arrangements were not addressed and the plan had not been tested since May 2006. A similar condition was commented upon in our two preceding audit reports.

- Certain password controls on the minicomputer did not comply with the requirements of the Department of Information Technology's (DoIT) *Information Security Policy*. For example, the default passwords for five active group accounts had not been changed and, for all other accounts, the minimum password length was set to only six characters.

STO operated an internal computer network supporting file and print sharing, email, and Internet connectivity. STO also operated a minicomputer that processed financial applications, including the printing of State of Maryland checks for vendor invoice payment, public assistance, child support, and retirement benefits. These check disbursements total several billion dollars annually.

**Recommendation 11**
**We recommend that STO**
**a. develop a disaster recovery policy that addresses the minimum required elements specified by the DBM *Information Technology Disaster Recovery Guidelines* and periodically test the plan (repeat), and**
**b. comply with the password requirements specified in the DoIT *Information Security Policy*.**

## Cash Management Improvement Act (CMIA)

**Finding 12**
**STO did not adequately monitor State agency reporting of CMIA activity.**

**Analysis**

Although STO requires State agencies to submit quarterly and annual reports of federal assistance program activity subject to the federal Cash Management Improvement Act (CMIA), STO did not ensure that the information submitted was accurate. Specifically, STO did not compare financial data recorded on the agency-submitted quarterly or annual reports to the State's accounting records. In addition, STO was unable to provide us with all fiscal year 2009 quarterly reports for five federal assistance programs tested with fiscal year 2009 annual reported federal fund expenditures totaling approximately $4.6 billion. A similar condition regarding the lack of adequate monitoring of State agency CMIA reporting has been commented upon in our three preceding audit reports dating back to June 2001.

STO used the information included in the annual reports submitted by State agencies to prepare the Statewide CMIA annual report, detailing interest liabilities due to and from the federal government. Adequate monitoring, reconciliation, and verification of these reports is significant since the CMIA provides that if federal drawdown requests are not properly timed, or reimbursements are not received timely, interest may be payable to or from the federal government. For fiscal year 2009, federal expenditures subject to the agreement totaled approximately $7.9 billion, and the Office calculated that the federal government owed the State approximately $38,000 in interest.

**Recommendation 12**

**We recommend that STO**

**a. obtain and retain quarterly reports of federal assistance program activity from participating State agencies, and**

b. **review the reasonableness of quarterly and annual reports of federal assistance program activity submitted by State participating agencies by comparing them with the State's accounting records (repeat).**

# Audit Scope, Objectives, and Methodology

We have audited the Office of the State Treasurer (STO) for the period beginning May 1, 2006 and ending June 30, 2009. The audit was conducted 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.

As prescribed by State Government Article, Section 2-1221 of the Annotated Code of Maryland, the objectives of this audit were to examine STO's financial transactions, records and internal controls, and to evaluate its compliance with applicable State laws, rules, and regulations. We also determined the status of the findings included in our preceding audit report.

In planning and conducting our audit, we focused on the major financial-related areas of operations based on assessments of materiality and risk. The areas addressed by the audit included monitoring State agency bank accounts, reconciling the State's bank accounts, monitoring payments to the Injured Workers' Insurance Fund, monitoring the State's securities and investments, information systems security and controls, the State Insurance Program, the Unpresented Bond and Coupon Fund, and the Cash Management Improvement Act. Our audit procedures included inquiries of appropriate personnel, inspections of documents and records, and observations of STO's operations. We also tested transactions and performed other auditing procedures that we considered necessary to achieve our objectives. Data provided in this report for background or informational purposes were deemed reasonable, but were not independently verified.

STO's management is responsible for establishing and maintaining effective internal control. Internal control is a process designed to provide reasonable assurance that objectives pertaining to the reliability of financial records, effectiveness and efficiency of operations including safeguarding of assets, and compliance with applicable laws, rules, and regulations are achieved.

Because of inherent limitations in internal control, errors or fraud may nevertheless occur and not be detected. Also, projections of any evaluation of internal control to future periods are subject to the risk that conditions may change or compliance with policies and procedures may deteriorate.

Our reports are designed to assist the Maryland General Assembly in exercising its legislative oversight function and to provide constructive recommendations for improving State operations. As a result, our reports generally do not address activities we reviewed that are functioning properly.

This report includes findings relating to conditions that we consider to be significant deficiencies in the design or operation of internal control that could adversely affect STO's ability to maintain reliable financial records, operate effectively and efficiently, and/or comply with applicable laws, rules, and regulations. Our report also includes findings regarding significant instances of noncompliance with applicable laws, rules, or regulations. Other less significant findings were communicated to STO that did not warrant inclusion in this report.

STO's response to our findings and recommendations is included as an appendix to this report. As prescribed in the State Government Article, Section 2-1224 of the Annotated Code of Maryland, we will advise STO regarding the results of our review of its response.

**APPENDIX**

MARYLAND STATE TREASURER
Nancy K. Kopp

October 22, 2010

Bruce A. Myers, CPA
Legislative Auditor
Office of Legislative Audits
301 West Preston Street, Room 1202
Baltimore, Maryland 21201

Dear Mr. Myers:

Attached is the State Treasurer's Office (STO) response to the draft audit report for the period beginning May 1, 2006 and ending June 30, 2009, which I am pleased to forward for your review.

I would like to take this opportunity to thank the members of the OLA who spent a great deal of time and effort preparing the audit. They were an impressive, professional team and we appreciated their attention and concern. Needless to say, I would also like to thank the outstanding team at the STO who have accomplished so much with great dedication and determination, despite limited resources.

The Office's responses reflect many significant accomplishments over the past three years since the last Legislative Audit. And, indeed, as I trust you will be pleased to see, significant progress continued during the time your staff was auditing STO and since that time as well.

One of the most important issues for the Office, and our number one priority for the last several years, has been the cash account reconciliation and processes. We have worked diligently to implement the systemic changes required to complete this process. The slow, methodical work on these changes resulted in several repeat audit comments; however, we are pleased to tell you that these repeat items have now been fully addressed. New procedures, controls and reports were developed to assure a stable, long term solution. Our staff's hard work and commitment has resulted in an accurate, timely and completely documented reconciliation. The process is comprehensive and I know it has been producing stable, documented results. This progress is set forth fully in our attached response.

Goldstein Treasury Building • 80 Calvert Street • Annapolis, Maryland 21401
410-260-7160 • 800-322-4296 • FAX: 410-260-6056 • TTY: 800-735-2258 • nkopp@treasurer.state.md.us

I would also point out for your review the significant progress which the Office has made in resolving other items included in the report, including the reconciliation of the State's Unpresented Bond and Coupon Fund and identification of an appropriate process for dealing with the Injured Workers Insurance Fund (IWIF) by working with the Maryland Insurance Administration. These efforts are a reflection of our strong commitment to ensuring the Maryland's citizenry continue to have confidence in the safekeeping and investment of funds in the State Treasury.

Sincerely,

Nancy K. Kopp

Nancy K. Kopp
State Treasurer

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# State Treasurer's Office Responses to Findings and Recommendations

## Bank Accounts

**Finding 1**
**STO did not ensure that all State agencies were using STO authorized banks and did not adequately monitor certain lockbox accounts.**

**Recommendation 1**
**We recommend that STO**

**a. perform a periodic analysis (such as bi-annually), using available documents and information, to identify unauthorized accounts and accounts at unapproved banks, and require State agencies to close these accounts and reestablish the accounts with banks under a current contract (repeat); and**

**b. monitor the lockbox accounts, at least on a test basis, to ensure that the available balances are transferred into the State's depository account on a daily basis and require agencies not transferring funds in a timely manner to enroll in the contractor's auto wire program (repeat).**

**Agency Response:**

The Office concurs with the recommendations and has already implemented the process to resolve 1a and fully implemented 1b.

a) As mentioned in the auditor's analysis, in order to ensure that all existing agency bank accounts are identified, the Office sent "blind" bank account surveys (i.e. no bank account information pre-filled) to 94 agency chief fiscal officers in April 2009. After numerous follow-ups, we eventually received responses back from 84 agencies, listing over 1,200 bank accounts. The remaining 10 fiscal officers were subsequently contacted and any bank account data obtained was added to our master list of accounts. This completed survey forms the basis for our current certification of banks accounts which will be used as the master list for the Treasury Bank Account Information System.

In addition to the earlier survey results, the Office also continues to use the monthly collateral reports received from banks to identify all open State bank accounts. The Office receives monthly collateral reports from 19 banks listing over 1,800 State and other public funds accounts. Reconciling this voluminous amount of information has been challenging, in part because of the differing reporting methods employed by the banks. For instance, one bank with approximately 800 accounts was not able to send its collateral report in an electronic format until March of 2010. In some banks, the number of accounts, such as Clerk of the Court escrow

accounts and Social Services foster care accounts can vary significantly each month as individual accounts constantly open and close. Additionally, many agency accounts are opened in the name of "Maryland State Treasurer", making identification of the specific agency involved difficult.

To solve these difficulties, we have been working on an ongoing basis with each bank to standardize the format of the collateral reports. We have also identified the specific agency custodian of each listed account. New accounts appearing on the collateral reports without corresponding authorizing paperwork (i.e. GAD X-1 forms) are investigated and required to submit forms if applicable. This will assist in promptly identifying any unauthorized agency bank accounts that are opened.

To solve a fundamental problem, we finalized our comparison of the 2009 survey results referred to above with the current Comptroller's Bank Account Information System (BAIS) and our collateral reports, developed a master list of accounts, and have sent all agencies a Certification of Bank Accounts Report. Unlike the prior 2009 general survey to which the auditor refers, this certification report was adapted and targeted to each individual agency and included a current list of identified accounts for that agency. Each fiscal officer was asked to certify that the list is accurate and complete. The results of this certification, in combination with the above referenced collateral report analysis, will provide the input for the new Treasurer's Bank Account Information System (TBAIS) being developed by the Office. The TBAIS is targeted to replace the General Accounting Division's System by the end of December 2010. After this database conversion is implemented, STO will work closely with GAD to ensure that all currently open bank accounts are authorized, and will perform a periodic analysis of open accounts. But the STO will now have more direct access and control over the analyses and spot checks.

To be clear, we do require State agencies to close accounts at banks without current agreements with the State. Of the 22 accounts at 5 banks listed by the auditors we note the following.

- 20 accounts, in fact, were in various stages of closing <u>prior</u> to the audit and <u>all have now been closed.</u>
- 2 accounts were believed to be legally entitled to remain with a non-designated agency bank; we have received final legal ruling that the two accounts can remain with this bank.

Regarding the agencies with accounts that required closing, all of which had been contacted prior to the audit, we would note that all reported accounts were fully collateralized. We continue to monitor collateral for those 2 accounts not required to be with a designated agency bank. Going forward, we will be sure to document the reasons for any exception accounts on the collateral reports received from non-designated agency banks.

b) Beginning in March 2010, the Office began obtaining custom-generated account summary reports from the lockbox provider to verify and document that balances are transferred timely. Should we find that an agency is not transferring balances timely, the STO Banking Services Division will enroll the specific account in the Autowire feature.

The establishment of lockbox accounts and their setup are controlled by the individual agencies. All agencies are encouraged to enroll new lockbox accounts in the Autowire feature. We have previously notified agencies of the need to transfer funds timely, however, and note that the Autowire feature may not be operationally efficient in some cases. Of the 6 accounts the auditor notes that were not part of the Autowire program at the time of their review, 1 account was subsequently closed.

The auditor is right to note that one agency did not transfer funds for 50 days. It had undergone a change in management during that time period and did complete its conversion to Autowire last April 7. The other agency noted did transfer funds several times each month. Their lockbox account was closed on June 30, 2009. It should be noted that although funds held in the lockbox accounts do not earn interest on behalf of the State, they do accumulate earnings credits at a current rate of 25 basis points, thus effectively reducing anticipated expenses.

**Finding 2**
**Deficiencies were noted in STO's oversight of State agency bank account requirements.**

**Recommendation 2**
**We recommend that STO**

- **a. ensure all banks submit collateral reports disclosing the highest daily balance of State funds, as required by the banking services contract;**
- **b. monitor to ensure banks maintain adequate collateral for all State funds, including those funds in investment accounts, and take appropriate corrective action when banks do not maintain sufficient collateral (repeat);**
- **c. obtain annual audited financial statements from all approved banks as required by the related contracts; and**
- **d. ensure that all interest earned on State funds on deposit in agency banks accounts is transferred to the General Fund, as required (repeat).**

**Agency Response:**

The Office concurs with the recommendations and point out that all accounts have been and remain fully collateralized and all required reports received and reviewed.

a) All banks do currently submit collateral reports disclosing the highest daily balance of State funds. The auditor specifically mentions one bank that at the time of contract award informed the Office it would only provide the average daily balance. Banking services contracts are awarded based upon an evaluation of the banks' proposals in response to an RFP. In its proposal, the bank referred to in this finding agreed to collateralize the highest aggregate daily balance of State funds. The STO verified the bank was collateralizing the highest aggregate daily balance by obtaining all internal bank documentation to support their RFP response. The process in use by the bank to monitor collateral does, in fact, base collateral amounts on daily aggregate balances and makes adjustments as needed. Its month end reporting, which is not aggregate and lists each account separately, reports the average collected balance by account. The bank has always provided more than sufficient collateral. The collateralization process for this bank has been moved to a third party provider and reports are now available for us to independently monitor daily account balances.

The auditor also specifically mentions $25.2 million in 55 accounts at 13 banks for which collateral reports were not received. The auditors counted these from our complete list of agency survey data. Of the 55 accounts, only 10 accounts at 6 banks, with a total of $1.8 million, actually require reporting. The remaining accounts are either bond proceeds under a trust, foreign accounts for university research with federal funding, or accounts of Maryland Environmental Services which statutorily do not require our monitoring of collateral. Collateral reports are now being obtained from all banks with accounts that require reporting.

b) We agree with the recommendation to monitor to ensure that banks maintain adequate collateral for all State funds and believe the STO has been doing so. The auditors specifically mention two banks that our documentation did not show collateral for investment accounts. The first mentioned was an account with a balance that averaged $20 million. This account had been transferred to our disbursement bank by an acquisition. The month following the acquisition, we requested that the bank ensure that collateral was posted for the new accounts, and to include the accounts on their reporting. However, due to bank oversight, the new account was not separately listed on the end of month balance report from the bank. We subsequently obtained bank documentation showing that the account had in fact been included in collateral calculations and that sufficient collateral had been posted.

The second bank, with balances of $7.7 million, did include documentation of pledged collateral. The collateral consisted of securities held in our account at the Fed, and a repurchase agreement in the name of the agency. In addition, the repurchase agreement was collateralized at 102%, as required by State statute. Our month end collateral summary, however, did not clearly reflect the bank's reporting; it has been modified for transparency.

We also agree with the auditors that corrective action be taken when banks do not maintain sufficient collateral; we are in compliance with the recommendation. We disagree with the auditor's statement that the STO did not follow up with the bank. In fact, we note on the

collateral report any action taken and maintain a log of these actions. The auditor specifically mentions two banks that were not adequately collateralized. We determined there was not the need to take corrective action against the first bank mentioned because, as documented by us on the collateral report, the large balance was due to a one time, $122 million receipt of Federal American Recovery and Reinvestment Act (ARRA) stimulus money via FedWire. The funds were transferred and invested the next business day. Had it not been for this one anomaly, the collateral pledged was more than sufficient.

The other bank reported by the auditors, for which they say we were unaware of the insufficient collateral, was the $7.7 noted in the second paragraph above. As discussed above, the collateral was sufficient; however our summary report did not clearly reflect the unsecured account balance and collateral. The summary report has been modified for transparency.

c) We agree with the auditor's recommendation and have reviewed annual audited financial statements as required by current contracts. We have always monitored each bank's financial strength by reviewing each bank's rating by the professional analysts at LACE Ratings, and Moody's when applicable. We will continue to monitor the banks' ratings by nationally recognized rating agencies.

The condition of the banking industry has been in decline for several years. Although all banks awarded agency bank account contracts in August 2008 met the minimum financial strength rating at the time of contract, we suspected a decrease in ratings might follow. Two banks did not maintain the required rating and, contrary to the auditors comment, corrective action was taken. The Director of Banking Services sent a letter to these two banks on October 31, 2008, notifying them that their designation as a depository of State funds was temporarily rescinded until such time their rating improved. As ratings across all banks declined over the following year due to uncertainties in the financial markets in general, we had to reevaluate the ratings requirement; almost all banks' ratings decreased below the minimum contract requirement. Legal authority to contractually modify the mandatory requirement was requested and, after several months, obtained in November 2009, and the one-time waivers were issued in January 2010.

d) We agree that all interest earned on State deposits in agency bank accounts is to be transferred to the General Fund. In response to the prior audit, we expressed our belief that the duty to ensure this is shared between the Office and each State agency using agency accounts. Daily operations of these accounts are the responsibility of the individual agencies and their financial offices; collective oversight of interest transfers is impractical due to the very large number of accounts and limited Office staff.

Acknowledging our role and responsibility, we developed and communicated a written policy to all State agencies restating the requirements and procedures for handling the interest on bank accounts. This written policy and an agency certification of interest earnings for agency

bank account interest were included in GAD's annual year-end bank account reconciliation mailing. We received completed certification from 73 agencies. Although a good response, the result was not as complete as we expected; because this Office did not control the GAD's mailing, follow up by the STO proved difficult. To overcome this difficulty and ensure a more complete response while allowing for effective follow-up on non-responses, we have combined the interest earnings certification with our STO agency bank account verification list which is due to be received by October 29, 2010.

**Finding 3**
**As of September 2009, not all provisions of banking contracts had been finalized even though the contracts were effective July 1, 2004.**

**Recommendation 3**
**We recommend that STO**

**a. in conjunction with its legal counsel, promptly complete all operating agreements related to the banking contracts (repeat); and**
**b. in the future, ensure all terms and conditions are established and agreed to before contracts become effective (repeat).**

**Agency Response:**

The Office concurs with the recommendation. We have implemented them already to the extent of our capacity. Regarding 3a refer to the attached response from the Office of the Attorney General.

a) *The Auditor's analysis concerning bank operating agreements is primarily a legal, contract-interpretation issue, concerning which the State Treasurer's Office has been following the advice of the Office of the Attorney General (OAG). Please see the attached response to the contract-interpretation issue prepared by Counsel for the Treasurer*.

b) Since the preceding audit the STO has finalized the following banking services contracts, including bank operating agreements (if any), before they became effective:

1. Contract for Electronic Payment Card Services on behalf of the Department of Labor, Licensing and Regulation, Division of Unemployment Insurance with Citibank, N.A. dated as of March 31, 2008.

2. Twenty (20) Agency Bank Account Services Contracts dated as of August 1, 2008:

Bank of America National Bank of Cambridge

| | |
|---|---|
| BB&T | NBRS Financial Bank |
| Centreville National Bank | Peoples Bank of Elkton |
| Citibank, N.A. | PNC Bank, N.A. |
| Columbia Bank | Sandy Spring Bank |
| Community Bank of Tri-County | SunTrust Bank |
| First United Bank & Trust | Susquehanna Bank |
| Hagerstown Trust | Talbot Bank of Easton |
| M&T Bank | TD Bank, N.A. |
| Maryland Bank & Trust Company, N.A. | (Commerce Bank) |
| | Wachovia Bank |

3. Contract for Maryland Local Government Investment Pool (MLGIP) with PNC Bank, N.A. dated as of May 1, 2009.

4. General Banking Services for the Department of Human Resources, Child Support Enforcement Administration (CSEA) with Bank of America, N.A. dated as of July 1, 2009.

Since the last audit report, the Auditor has not cited any contracts for banking services where all terms and conditions were not established and agreed to before the contracts became effective.

**Finding 4**
**Proper controls were not established over the State's bank reconciliation process.**

**Recommendation 4**
**We recommend that**

**a. the capability to manually delete deposit transactions, record bank adjustments, and manually process wire deposits, be limited to employees who require the capabilities to perform their job duties (repeat);**
**b. an independent employee verify the propriety of all deposit transactions manually deleted from the automated records (repeat); and**
**c. a proper separation of duties be established over bank adjustments (repeat).**

**Agency Response:**

The Office concurs as noted; the recommendations have been implemented and can be verified thru a review of the supporting documents for each daily cash reconciliation, the State's Financial Management Information System or the Treasurer's subsidiary computer system.

While the Office agrees with the intent of the auditor's recommendations, we disagree strongly with the auditor's general statement and implications regarding controls over the State's bank reconciliation process. There are numerous checks and balances, in addition to the controls referenced in the auditor's analysis, built in to all aspects of the reconciliation process. Every number in the overall cash reconciliation is separately reconciled to an independent source document. The reconciliation is transparent, fully documented, and reconciled to the penny every day.

a. The Office agrees that certain processes be limited to those that require the certain capability, and believe we are in compliance with the recommendation.

Unmatched deposits - The unmatched deposit reconciliation ensures all agency bank deposits have a corresponding general ledger entry and that all agency general ledger cash deposit entries have a corresponding bank deposit. One step of this reconciliation, the manual deletion process, is a daily, labor intensive function, and we believe several employees should retain the deletion capability to provide back-up coverage as well as to assist on days requiring large volumes of manual deletions. Access was restricted as a result of the prior audit. However, changes in personnel performing the deposit match process, including the cross training for this critical function, necessitated having a fourth person who could process the deletes. As the newly trained employee has now become proficient in the processing of manual deletes, the supervisor has been removed from the number of employees capable of processing manual deletes. Access to manual delete processing will only be granted to the employees performing the function who do not have review and approval authority. The supervisor's responsibility will solely be to review and approve the manual deletes. It should be noted that at no time did the same employee both process and approve the deletes.

Bank Adjustments (Chargeback Transactions) – Chargeback transactions are discussed in c. below.

Manual wires – A new more automated and controlled process to post incoming FedWires to the State's general ledger was developed by the Office. The employee noted by the auditor was given access only to test the developing system; this access was never used. This employee's access has been removed. It should be noted that a daily reconcilement of incoming wires is completed that compares R*Stars postings with the bank statement to ensure all incoming wires are accounted for. This is completed by an employee who does not have access to process the wires.

b. The Office is in compliance with the auditor's recommendation, with which it agrees. Deletion reports (for both R*STARS and Bank transactions) are automatically generated from the Office's subsidiary I5 system each time transactions are manually deleted from the system. These reports are totaled and compared to the schedules of proposed deletions which were previously approved by a supervisor. These deletion totals are then compared to the deletion totals entered on the daily deposit match reconciliation worksheet to ensure they agree. Finally, a supervisor who did not process the deletions verifies the control totals and initials off on the system generated deletion reports. This after the fact verification by the independent supervisor is further documented by the supervisor checking off specific steps on the Deposit Match Daily Work Checklist, and signing the checklist to indicate completion of the entire checklist. These steps, documenting the post deletion review by the independent supervisor were specifically added to address this finding after the last legislative audit.

c. The Office agrees that a proper segregation of duties should always be in place regarding the bank adjustment (chargeback) process, and that the capability to record adjustments be limited to employees requiring access for their job duties. We believe the procedures currently in place ensure that the transactions are approved by an employee other than the initiator of the transactions. Employees who are able to process and approve transactions in the Office's system can not release the transactions in RStars. In addition, the approval function noted in the preceding sentence is simply the creation of the chargeback batch for subsequent release in RStars. The Banking Director or Deputy Director reviews and approves the batch. The batch is then released to be posted to the ledger by an employee independent of the process.

**Finding 5 (Policy Issue)**
**STO had not established policies governing the use of remote deposit by State agencies.**

**Recommendation 5**
**We recommend that STO, in conjunction with the Comptroller of Maryland's General Accounting Division, develop a formal written policy, which incorporates a consideration of appropriate risks, to guide State agencies that use remote deposit services.**

**Agency Response:**

The Office concurs and has implemented the recommendation.

While the management of each State agency is primarily responsible for establishing an effective system of internal control, we developed and distributed a formal written policy governing risks inherent in the remote deposit process, based on a review of bank publications, available industry

literature, and GFOA Best Practices. As the auditor noted, the bank had previously provided a comprehensive Users Manual and a Best Practices guide to the two agencies using this service.

## Injured Workers' Insurance Fund (IWIF)

**Finding 6 (Policy Issue)**
**The services provided by IWIF have not been subject to a competitive bid process for more than 19 years.**

**Recommendation 6**
**We recommend that STO take the necessary actions to ensure that workers' compensation claims processing services are obtained in the manner most beneficial to the State (repeat). Specifically, we recommend that STO**

**a. in conjunction with BPW, prepare and issue the RFP for the independent audit services related to competitively bidding workers' compensation claims services; and**
**b. evaluate the results of the audit and take appropriate action.**

**Agency Response:**

The Office concurs with the recommendations. We believe an appropriate process for dealing with this issue is underway as it has been for several months. We will keep the OLA informed as the process continues to move forward.

a) The Office agrees that this is a policy issue and further, that the policy decision is one for the General Assembly, first, and the Board of Public Works, second. It is not a policy decision to be made by the Office, which simply serves as the administrator for the State's contract with IWIF. This includes the determination whether the claims processing services currently being performed by IWIF, should be competitively bid.

The State's workers' compensation claims processing services have *never* been competitively bid. IWIF's predecessor, the State Accident Fund ("SAF"), was established by the General Assembly in 1914 as the State agency charged with guaranteeing workers' compensation coverage for all of Maryland's employers and their employees. In addition to serving the State, the SAF and IWIF have served as workers' compensation insurers of last resort for Maryland employers for 93 years.

Until 1988, the SAF was part of the Department of Personnel. The Office of Legislative Audits (OLA) conducted regular audits of SAF and IWIF until 2002, when the General Assembly granted IWIF greater autonomy. In fact, as a result of OLA recommendations, the

General Assembly reorganized the SAF in 1988, and the SAF contract with the State was renegotiated in 1990.

Although there is no statutory mandate that the State contract with IWIF for workers' compensation claims processing services, it is the evident intent of the General Assembly reiterated over many years that IWIF provide such services for the State. The General Assembly created IWIF, granted and amended its powers, periodically reorganized its structure and responsibilities, and annually appropriates funds to pay for its services. In light of the State's historic 93-year relationship with the SAF and IWIF, the Office believes that it would be inappropriate to competitively bid such services absent legislative direction to do so.

The issue of workers' compensation claims services not being subject to a competitive bid process was commented upon in the OLA's 2007 audit report. That finding was the subject of briefings to the Board of Public Works' staff on March 16, 2009, and on June 17, 2009. After the aforementioned briefings, the Board of Public Works' staff advised the Office to prepare a recommendation from the Treasurer to be presented to the Board recommending a course of action.

The Office through its resources and research compiled a draft scope of services and estimated cost for an RFP for an audit to obtain independent audit services. In conjunction with the RFP, the Office had prepared a recommendation to the Board of Public Works for approval of the RFP and for funding of the resulting contract. This recommendation was the subject of a meeting with representatives of the Board of Public Works, the Department of Legislative Services and the Speaker and President's Office on Monday, April 26, 2010.

As a result of this meeting and after consideration of the costs associated with independent audit services, the Office, along with representatives of the BPW members, consulted with the Maryland Insurance Administration (MIA) to ascertain its willingness to expand its current audit responsibilities to perform a targeted exam and address the issues raised by OLA. The MIA has agreed and will be conducting a Target Examination of IWIF as of July 31, 2010. The Scope of Review is as follows: *"The primary objective of the target examinations is to analyze the Funds' specific costs for services and how these costs are allocated to the State under the Memorandum of Understanding (MOU) with the State. In addition, we will determine if the allocated costs are fair and reasonable (e.g. ,comparable to costs charged by other third party administrators), and if the allocation is in compliance with the State Contract and MOU. Finally, we will review how the Fund contains costs for the State of Maryland and consider how the State's relationship with IWIF has impacted the availability and affordability of workers' compensation insurance to Maryland business."*

b) Following production of MIA's audit report, the Office will supply the results to the General Assembly and the BPW for a decision on any recommended actions.

**Finding 7**
**STO did not ensure the propriety of amounts paid to IWIF.**

**Recommendation 7**
**We recommend that STO, at least on a test basis, review amounts previously paid to IWIF for propriety and in the future, determine the propriety of amounts paid to IWIF. This verification should be documented and should include a review of appropriate supporting documentation, such as evidence of amounts paid for injured State workers, and documentation to assess the propriety of administrative and risk management costs (repeat).**

**Agency Response:**

The Office concurs with the intent of the recommendation that the State pay what is due, that the amount be verified and that the verification be documented. We believe the appropriate method of doing this and appropriate agent to do so, will be a result of the study discussed in #6 above.

As noted in response to Finding #6, the Agreement between the State and IWIF was renegotiated in 1990. Under that Agreement, IWIF serves as third-party administrator for claims brought against the State under Maryland's Workers' Compensation Law.

The Agreement describes three primary responsibilities which involve the Office. The first requires that the Treasurer decide all matters relating to contract administration and performance. The second requires IWIF to submit an annual invoice to the Treasurer reflecting the amount of actual losses incurred by the State, as well as an invoice reflecting the balance of the State's account. The third requires IWIF to compile whatever reports the Treasurer determines to be necessary to:

(a) monitor the performance of the claims administration activity;
(b) assess the financial liability of the program to the State;
(c) project loss experience for the purposes of establishing budgets and agency premiums; and
(d) analyze the causes of losses.

A review of the Board of Public Work's files, including the January 31, 1991 agenda item and transcript, does not reveal any other information defining the requirements of this provision, with the sole exception of a general comment made by Treasurer Maurer to the effect that the Office's Insurance Division was working closely with IWIF. Additionally, there is no record to reflect whether these performance reports have ever been deemed "necessary", or have been requested or produced.

Since the inception of the Agreement in 1990, the Office has received an annual report, via the Department of Budget and Management, that identifies the amount the Governor, through

DBM, has proposed and the General Assembly has appropriated, for workers' compensation coverage, including any appropriation for the unfunded liability. The Office prepares a disbursement transmittal, wires this amount to IWIF, and subsequently collects from each agency its share of the appropriated amounts. In the event that an agency questions the amount of its premium, it is directed back to IWIF to request a report listing all claims for their agency.

While the Office has not routinely requested performance reports from IWIF, a report on the State Assessment for Workers' Compensation was prepared by the Department of Budget and Management in August of 2001, and was submitted to the Office. This report reviewed, analyzed and commented on the amounts the State paid and the administrative costs charged by IWIF. In addition, as a State agency, IWIF was subject to periodic Legislative Audits until 2002. It is now subject to audit by the Maryland Insurance Administration. The Office monitors these MIA audits and notes that, to date, there have been no findings questioning the propriety of IWIF premiums or administrative charges.

The Treasurer acknowledges a 1990 contractual provision regarding monitoring claims administration activity, but notes that there is no definition in the historical records of what this monitoring process was intended to entail and there is no record of a performance report ever having been requested or submitted. Since the Treasurer's responsibilities are based on the 1990 agreement *between IWIF and the BPW,* the Office briefed the Board of Public Works' staff on this issue on March 16, 2009, and on June 17, 2009. After the briefings, the Board of Public Works' staff advised the Office to prepare a recommendation from the Treasurer to be presented to the Board recommending a course of action.

As noted in the response to Finding 6, the Office is working with the Maryland Insurance Administration to conduct a targeted audit of IWIF. If the results of the audit reflect the need for detailed monitoring and oversight, as the Auditors suggest, it is likely to require identifying and supplying staff and monetary resources that the Office does not currently have. The Office will present the findings to the BPW and will engage in discussions to address the best way to implement the audit recommendations.

## Investments and Securities

**Finding 8**
**Procedures and controls over State-owned securities were inadequate.**

**Recommendation 8**
**We recommend that STO**

**a. maintain accurate inventory records for all State-owned securities and safeguard all physical securities in the manner required by State law;**

**b. monitor the existence of all State-owned securities; and**

**c. take immediate action to obtain the required documentation from the current broker-dealers showing authorized personnel, periodically update this information, and obtain investment interest rate quotes only from authorized broker-dealer personnel.**

**Agency Response:**

The Office concurs and has implemented the recommendations.

a) The Office currently maintains an up-to-date inventory record for all State-owned securities in the possession of the Office. These records will be verified against the physical inventory on an annual basis to ensure their accuracy. All securities in the possession of the Office are in the safe deposit vault in the Treasurer's Office, as required by State Law, and the Office will ensure that all future securities are promptly placed into the vault on the premises upon receipt.

NOTE: The vast majority of the securities held by the Office are bonds issued by local government units to the Maryland Water Quality Financing Administration (MWQFA) to secure the repayment of loans made from the Water Quality and Drinking Water Revolving Loan Funds. As such, these are in the nature of promissory notes, and are private rather than public securities. They are not negotiable. Each bond may be transferred only by the Registered Owner (MWQFA), appearing in person at the offices of each Borrower (local government unit) with the bond and a written instrument of transfer. They are considered "securities" because they are styled as bonds, *and are issued to evidence local governments' indebtedness under loan agreements with MWQFA, which retains and uses the loan agreements to monitor repayment of loans.* While we agree these local government bonds owned by MWQFA should be properly safeguarded, *because they are not negotiable and are evidence of debt under corresponding loan agreements, their value is more representational than actual.*

b) We agree the Office should monitor the existence and value of all State-owned securities, and believe that our current inventory listing reflects the values of such securities. In addition, we will conduct periodic reviews of the holdings and determine if any action is necessary regarding any expired or outdated holdings, and to ensure we are holding all State-owned securities as required by State Law.

c) Due to the unprecedented turmoil in the financial markets during the last two years there has been extreme employee turnover in the Brokerage Firms. Although the personnel we used were certified or acknowledged by their employers as authorized personnel, we did not attach a change in authorized personnel form to the original Master Repurchase Agreements. The Authorized Repurchase Agreement Personnel Documents are now current and attached to the Master Repurchase Agreements on file with the Office. We will continue to verify that we have

received the proper documentation for changes to authorized personnel during our annual year-end investment policy and authorized broker dealer review.

The Office obtains interest rates only from authorized broker-dealer personnel; and as noted above will assure that that the proper documentation is received and maintained.

## State Insurance Program

**Finding 9**
**Insurance claim payments, related billings, and cash receipts were not adequately controlled.**

**Recommendation 9**
**We recommend that**

**a. employees that have access to process claims not have the ability to approve claims, process disbursements, and recover funds from State agencies;**
**b. an employee who does not have access to cash receipts record deposits in the applicable accounting records;**
**c. employees responsible for maintaining the accounts receivable records not have access to the related cash receipts; and**
**d. prenumbered cash receipts forms be periodically accounted for as to issued, voided, and on-hand by an employee independent of the cash receipts function.**

**We advised STO on accomplishing the necessary separation of duties using existing personnel.**

**Agency Response:**

The Office disagrees with the assertion that our controls over disbursements and related transactions regarding the State Insurance Program were inadequate, but concurs with and has adopted the recommended changes to further enhance our current controls.

a) Changes to our computer system have been implemented to further separate the processing of claims from the approval and disbursement functions.

b-d) The Office has reassigned duties among the current staff to ensure complete separation of duties related to the cash receipts and accounts receivable functions as required under the Comptroller's *Accounting Procedures Manual* and will continue its independent accounting of logged cash receipts.

## Unpresented Bond and Coupon Fund

**Finding 10**
**The amount owed to bondholders for unpresented bonds exceeded the cash balance of the Fund by approximately $435,000. Unredeemed bond funds were not transferred to the Comptroller of Maryland's Abandoned Property Fund, as required.**

**Recommendation 10**
**We recommend that STO**

**a. resolve the discrepancy in the Unpresented Bond and Coupon Fund (repeat), and**
**b. transfer those funds deemed to be abandoned in the Unpresented Bond and Coupon Fund to the Comptroller of Maryland's Abandoned Property Fund as required by State law (repeat).**

**Agency Response:**

The Office continues to concur with the recommendations and has been resolving this difficult issue in phases over several years.

a) Over the last few years, the Office has made extensive reconciliation and collection efforts in connection with Unpresented Bonds and Coupons resulting in the transfer to the Comptroller's Unclaimed Property Division of $1.9 million, along with corresponding updated bond registry reports that were initially received by the Treasurer's Office from 1997 through 2008. To conclude this process and to finalize the transfer of unpresented bond and coupon funds to the Unclaimed Property Division, as of June 30, 2010, the Treasurer's Office has identified $223,163.13 in the Unpresented Bond and Coupon Fund for unpaid general obligation bonds and coupons, together with the three remaining registry reports from 1994 to 1996 which total $657,935.65. The total amount on these registry reports as potentially due to bondholders will exceed the actual cash for transfer to the Comptroller's Office by $434,772.52.

This deficit is attributed to $455,021.25 in unpresented bond funds which the Treasurer's Office believes was escheated by a paying agent in 1996 along with the corresponding unclaimed bondholders' registry report. The paying agent was able to provide evidence that a check was written to the State for $455,021.25 and that the check cleared on the paying agent's records. Despite exhaustive research, the Treasurer's Office cannot identify the receipt of $455,021.25 so that it can be properly credited to the Unpresented Bond and Coupon Fund. The Treasurer's Office believes that the check was most likely deposited and credited to the General Fund in July 1996.

b) In accordance with Advice of Counsel, we have requested that the Comptroller's Office adjust the Unpresented Bond and Coupon Account to conform the State's records to the paying agent's records, thereby allowing for the transfer of the funds along with the corresponding registry reports. Once the adjustment has been made by the Comptroller's Office, the Treasurer's Office will immediately transfer the funds to the Abandoned Property Division.

## Information Systems Security and Controls

**Finding 11**
**STO's disaster recovery plan and controls over passwords were inadequate.**

**Recommendation 11**
**We recommend that STO**

**a. develop a disaster recovery policy that addresses the minimum required elements specified by the DBM *Information Technology Disaster Recovery Guidelines* and periodically test the plan (repeat), and**

**b. comply with the password requirements specified in the DoIT *Information Security Policy*.**

**Agency Response:**

The Office concurs and implemented the recommendations several months ago.

a) The Disaster Recovery Plan has been updated to include the required elements specified in the DBM *Information Technology Disaster Recovery Guidelines.* The Office conducted a Disaster Recovery test on March 17, 2010 which was completed successfully and is on a schedule to test the Disaster Recovery Plan on an annual basis.

b) The Office further concurs with the recommendation to comply with password requirements specified in the DoIT *Information Security Policy*. The Office has always had a written policy of setting passwords to the required 8 characters. A previous Security Officer mistakenly set the default password length to 6 characters. The Office changed the minimum password length back to the required 8 characters on 08/10/09 and is now tracking changes on our daily security reports.

## Cash Management Improvement Act (CMIA)

**Finding 12**
**STO did not adequately monitor State agency reporting of CMIA activity.**

**Recommendation 12**
**We recommend that STO**

**a. obtain and retain quarterly reports of federal assistance program activity from participating State agencies, and**
**b. review the reasonableness of quarterly and annual reports of federal assistance program activity submitted by State participating agencies by comparing them with the State's accounting records (repeat).**

**Agency Response:**

The CMIA Regulations (31 CFR 205.26) provide that a State must submit an Annual Report to the Financial Management Service (FMS) accounting for the CMIA interest liabilities for the State's fiscal year. Guidelines provided by FMS require the submitter to ensure that all major programs as listed in the Treasury-State Agreement are reported in the Annual Report, and that the correct CMIA interest rate is used according to the CMIA website. There are no Federal requirements for the manner in which the report data is accumulated by the State.

Prior to FY2009 reporting, the CMIA Coordinator in the Treasurer's Office reviewed the reasonableness of quarterly and annual reports submitted by participating agencies by comparing them with the State's accounting records. This task was challenging due to the complexity of the various federal programs and the lack of adequate State financial infrastructure to facilitate the task. Unfortunately, the only truly accurate way to directly reconcile CMIA receipts to RSTARS would require installing a CMIA module on FMIS, but the State has never installed this critical module. Furthermore, since some State agencies do not use the RSTARS system for grant accounting and others have not supplied requested RSTARS reconciliations, despite the Office's repeated requests, the Office's efforts to complete the reconciliation process have been thwarted. In addition, reports provided by the FMIS help desk at the Office's request did not provide the Office with the information it needed to perform the reconciliation process.

The Office has previously required that the participating State agencies submit the following quarterly and year end reports:

1. Interest Calculation Report Detail
2. Interest Calculation Report Summary
3. Reconciliation of Draws and Expenses to RStars or the agency accounting system
4. Reconciliation of Draws and Expenses to Federal Agency Draw Reports

These reports require the certification and signature of each participating agency's department head and further require that each year end report for a specific agency must tie and reconcile all quarterly reports together.

The CMIA Coordinator position in the Treasurer's Office was eliminated in August 2009 as a result of cost containment. In eliminating that position, the Office indicated to the BPW and the Legislature that only the minimum requirements of CMIA reporting would be met going forward. Quarterly reports will no longer be required, but the Office will continue to request and ensure that the participating agencies submit the certified year end reports listed above. Since agency grant information and reporting is being reviewed by several different Auditors of State financial data as well as being certified by the agency department head there is reasonable assurance that these certified reports are accurate. The certified year end reports will continue to be the basis for the STO filing of the State's CMIA Annual Report.

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# STATE OF MARYLAND
# OFFICE OF THE ATTORNEY GENERAL

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October 19, 2010

Bernadette T. Benik, Chief Deputy Treasurer
Maryland State Treasurer's Office
80 Calvert Street
Annapolis, MD 21401

Re: Advice of Counsel - Bank Operating Agreements

Dear Ms. Benik:

You have requested advice of counsel in connection with Finding 3 of the current Legislative Audit Report for the State Treasurer's Office ("STO"), which states that not all provisions of certain banking contracts have been finalized, and recommends that all operating agreements relating to such banking contracts be promptly completed. As more fully explained below, bank operating agreements are *not* mandatory or required under the STO banking services contracts, and *the State's interests are not at risk due to unapproved, bank-proposed operating agreements*. The Auditor is simply incorrect in asserting, in the Analysis of Finding 3, that the State's interests could be at risk because certain bank-proposed operating agreements have not been finalized.

**Background**

Following the preceding legislative Audit in July 2007, the STO and its assigned Assistant Attorneys General renewed efforts to finalize appropriate bank operating agreements for two certain banking services contracts. These efforts have been time-consuming and challenging, both because, for much of the intervening time, one of the two non-litigation Assistant Attorney General positions at the STO was vacant and because the banks have revised their proposed operating agreements along the way. Nonetheless, in early 2010, the operating agreements for the lockbox banking contract were finalized. Efforts to come to terms on the operating agreements for the disbursement banking contract, however, have reached a stalemate, although, as described below, the fact that these agreements have yet to be finalized poses no risk to the State's interests.

**Analysis**

As I have previously advised the STO and also explained to the Auditor's staff, each of the State's banking services is governed in order of precedence by: (1) the Contract between the STO and the bank; (2) the Request for Proposals (RFP) describing the performance specifications of the services required; and (3) the bank's proposal in response to the RFP. In the Analysis of Finding 3, the Auditor appears to misapprehend the significance of bank operating agreements. *Bank operating agreements do not control any of the banking services provided to the State, unless and until the STO agrees to and executes the operating agreement.* Otherwise, the performance specifications of the RFP control the banking services.

As clearly stated in the RFP for Banking Services, "....offerors *may request* the STO to enter into modified bank operating agreements for all services they propose to provide.... Bank operating agreements, *modified to the satisfaction* of the STO, will be incorporated into the contract...." (emphasis added). Bank operating agreements are not mandatory or required under the STO banking services contracts. Consequently, I must disagree with that part of the Analysis of Finding 3 which suggests the State's interests could be at risk because certain bank-proposed operating agreements had not been finalized. *The State's interests are not at risk due to unapproved, bank-proposed operating agreements.*

As you are aware, Bank operating agreements are drafted by the banks for the banks' own protection and insulation, reflecting their preferred methods of operation, and are not designed for the benefit of the State. If approved and signed by the STO, these bank operating agreements would serve to limit the performance specifications of the RFP (which was drafted by the STO with the expert assistance of a nationally-recognized banking services consultant) to the agreed-upon methods detailed in each bank operating agreement. These operating agreements typically seek to limit the banks' liability to grossly negligent acts, imposing or shortening timeframes for the State to act, changing the governing law to the banks' home state, and so on. In short, the bank operating agreements only serve to benefit the banks by superimposing their preferred methods of operation on the State's highly effective and State-favorable performance-based specifications in the contracts for banking services.

As a result, bank operating agreements are closely scrutinized by the STO and its counsel to ensure they do not unduly limit or dilute the performance specifications of the banking contracts, and result in the banks dictating the terms and conditions of their own performance. There have been ongoing discussions and negotiations over the bank

operating agreements, resulting in the execution in February 2010 of bank operating agreements for the lockbox banking contract.

In the case of the disbursement banking services contract, however, efforts to finalize operating agreements have reached an impasse because of the bank's insistence that executed bank operating agreements rank first in order of precedence governing the banking services provided to the State. *Such an outcome, in my view, would be an illegal contravention of State Procurement law and regulations*, and would significantly limit and dilute the performance specifications of the disbursement banking services contract.

Completion of the remaining bank operating agreements for the disbursement banking services contract remains a priority for my office, although in light of the bank's intransigence on order of precedence, and the *complete lack of negative impact on the actual banking services* provided to the State, it has been a lower priority than providing legal services for the STO's very active bond sales, capital leasing program, procurements and other operating requirements.

Sincerely,

Steven W. Vanderbosch
Assistant Attorney General
Counsel to the Treasurer

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