INTERNAL AUDIT REPORT

DATE: May 4, 2015
TO: Dr. Joseph Collins, Acting Interim President
FROM: James Martner, Director of Internal Audit JEM
SUBJECT: Review of Investments as of September 30, 2014

BACKGROUND: Board Policy and Administrative Procedure 10-55 (Investment of College Funds) was adopted on March 19, 2009 and amended on March 19, 2013. The Policy outlines the order of priority for the investment objectives of safety, liquidity and return (in that order), the scope of funds included as investments, the authorized financial institutions, the authorized investments, the collateralization of time deposits and the diversification and performance standards of the portfolio.

OBJECTIVES & SCOPE: The objective of the review was to determine if the College's investment portfolio is being managed in compliance with Board Policy and Administrative Procedure 10-55 as well as 30 ILCS 235 Public Funds Investment Act. The investment portfolio as of September 30, 2014 was the basis for testing and included all investments in all funds. Audit testing was performed during November 2014 through February 2015. I obtained reports and documentation from the Finance Department and discussed current procedures with the personnel in that area.

RESULTS: All of the investments are held in the College's name and all balances per the investment schedule and general ledger were verified on the monthly statements from the financial institutions. However, the investment portfolio has several areas of non-compliance including exceeding the limits for specific types of investments and holding investments that do not meet dollar, maturity or asset quality thresholds of Board Policy. The detailed results of the review are included in the following sections:

- Authorized Investments
- Collateralization / Insured Investments
- Authorized Financial Institutions
- Investment Diversification
- Performance Standards
- Reporting Requirements
- Treasurer's Advisory Committee

Authorized Investments

The Policy defines authorized investments as: 1) certificates of deposit, money market accounts, time deposits or savings accounts only with banks, savings banks, credit unions and savings & loan associations which are insured by the FDIC or NCUSIF; 2) bonds, notes, certificates of indebtedness, treasury bills or other securities which are guaranteed by the full faith and credit of the United States of America as to principal and interest; 3) Local government investment pools such as Illinois Funds or the Illinois School District Liquid Asset Fund; 4) collateralized repurchase agreements which conform to specific requirements; 5) commercial paper meeting specific requirements; 6) money market mutual funds that invest in investment grade short term bonds meeting specific requirements; 7) money market mutual funds that invest primarily in U.S. Treasury securities or agencies backed by the full faith and credit of the United States of America as to principal and interest; 8) Illinois Institutional Investors Trust and, 9) PFM/Prime Series Fund. There are limits in the percentage of the portfolio that may be invested in some of these vehicles.

There were several instances in which the investment portfolio as of 9/30/14 was not in compliance with the Policy. Specifically, the investments that had aspects of non-compliance included the Illinois Metropolitan Investment Fund, the Goldman Sachs Short Duration Fund, the Northern Ultra-Short Fixed Income Fund, the Fidelity Conservative Income Bond Fund and a Fannie Mae bond. Management stated that although there were aspects on non-compliance, the Board received monthly reports detailing the investments but did not raise any concerns.

Illinois Metropolitan Investment Fund

The Board of Trustees authorized a resolution allowing management to invest in the Illinois Metropolitan Investment Fund (IMET), a local government investment pool, at their April 17, 2014 regular meeting. The Treasurer began investing funds with IMET soon thereafter as the Investment Schedule dated April 30, 2014 showed the balance in the IMET Convenience Fund to be $10,000,853 (4.4% of the portfolio). As of September 30, 2014 the College had $80,090,485 invested with the IMET Convenience Fund, which represented 29.2% of the College's investment portfolio. However, **Board Policy limits investments in local government investment pools to 5% of the portfolio.** While there are hundreds of governmental entities utilizing the IMET Convenience Fund, the College's significant investment represented ownership of approximately 6.7% of that fund. The Treasurer placed these funds with IMET due to the much higher yield the College would receive compared to other investments.

In October 2014, IMET revealed defaults on certain guaranteed loans totaling approximately $50.4 million which represented 2.8% of the net asset value of the Convenience Fund. Subsequently, each fund member had a proportionate share of the defaulted loans segregated from other funds and effectively frozen. The amount of the College's frozen funds was $2,220,042. Had the investment in the IMET fund been limited to the 5% stated in Board Policy, the College would have invested no more than $13,622,717 in the Convenience Fund and the frozen amount would have been $381,436. It is unknown how long the College's funds with IMET will be frozen or if the College's funds will be fully returned. A small percentage of the funds have been returned as of the date of this report.

In addition to the 5% limitation, the Board Policy also requires any local government investment pool to be rated at the time of investment by at least two of the nationally recognized rating services (Moody's, Standard & Poors and Fitch). However, the Treasurer had investments in both the IMET fund that was rated by only one agency (Fitch) and the Illinois Fund that was also rated by one agency (Standard & Poors). Management stated that although this requirement was not met, the Board of Trustees still approved the resolution to invest in IMET. However, the resolution submitted to the Board did not include any information on the ratings agencies. Since the Act has no requirement on the number of rating agencies and it is evident some types of investments only receive a rating from one agency, the Board Policy may be too restrictive.

Bond Mutual Funds

Board Policy allows investment in mutual funds that invest in investment grade short-term bonds with the caveat that the fund must have at least $250 million in assets and must be rated AA by a nationally recognized rating service. Additionally, no more than 5% of the operating portfolio should be invested in such funds but the 5% restriction does not apply to the investment of the College's bond proceeds. The Public Funds Investment Act does not specify a percentage limitation on mutual fund investments but rather leaves this to each Board of Trustees to determine. As of September 30, 2014 the investment of *bond proceeds* in mutual funds was $36,158,457 (13.2% of the portfolio) and the investment of *operating funds* in mutual funds was $81,830,324 or 29.8% of the portfolio for a combined total of 43% of the portfolio. **The operating funds investment greatly exceeds the 5% Board Policy limit.** Management stated that the mutual funds selected were recommended by the investment advisor, Fifth Third Securities. Management also stated that the mutual funds were originally purchased as an investment for bond proceeds but as the money was utilized for construction activities, the mutual funds were shifted to the operating investments rather than being sold.

In addition to exceeding the 5% investment limit in Board Policy, some of the mutual funds do not meet other criteria.

- The Goldman Sachs Short Duration Fund had approximately $245 million in net assets but the Policy states that a mutual fund must have $250 million in assets.
- While mutual funds are not rated on the AAA, AA, etc. system, the securities they hold are rated on that system. Three of the five mutual funds the Treasurer invested in had a majority of the securities rated *lower* than the minimum requirement rating of AA per the Board Policy. The funds were the Goldman Sachs Short Duration Fund, Northern Ultra-Short Fixed Income Fund and Fidelity Conservative Income Bond Fund.

- The Goldman Sachs Short Duration Fund and the Goldman Sachs Enhanced Income Fund both owned a small percentage (approximately one percent) of derivatives (forward and future swap contracts). Board Policy strictly prohibits the direct investment in derivatives and I believe it would be advisable to avoid even this indirect investment in derivatives.

U.S. Government Obligations

Board Policy allows investments in bonds which are guaranteed by the full faith and credit of the United States of America with the limitation that the maturity date does not exceed five years. The portfolio included a $30 million Fannie Mae bond that was purchased July 26, 2012 with a maturity date of August 14, 2017. Therefore, the maturity date of the bond *exceeded* five years when it was purchased.

> ***Recommendation #1:*** *The Treasurer should divest the mutual fund investments that are non-compliant with Board Policy as soon as possible and limit the remaining mutual fund investments to no more than 5% of the Operating portfolio.*
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> **Management Response:** Management did not respond to this recommendation.
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> ***Recommendation #2:*** *The Treasurer should determine if the internal control structure for investments needs to be modified to include additional screening procedures for potential investments to ensure they comply with Board Policy limitations prior to being purchased.*
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> **Management Response:** Management did not respond to this recommendation.

Collateralization / Insured Investments

The Policy requires that time deposits in excess of FDIC insurable limits be secured by collateral or private insurance. Deposits in excess of the maximum limit provided by FDIC (currently $250,000) in any institution must be collateralized to 102% of market value by specific types of collateral listed in the Board Policy. Collateral is to be held in a safekeeping account at specified institutions and the College receives monthly statements from these institutions listing the collateral being held. To facilitate this requirement, the College stipulates that collateral agreements signed by both parties must be on file at the College. Internal Audit verified that all but one institution (US Bank) had a collateral agreement on file.

Time deposits and cash accounts represent approximately 7% of the investment portfolio and all deposits that require it are collateralized. Pledgee collateral holdings reports from the Federal Reserve Banks indicate the investments are collateralized to a minimum of 102% of market value.

Authorized Financial Institutions

The Policy states that "the Treasurer, with assistance of staff, will limit investments to authorized depository financial institutions authorized to deposit College funds or provide investment services". Further, "prior to initiating any transactions depositing or investing College funds, the financial institution must provide certification to the Treasurer of having read and understood this Policy, agree to comply with this policy and ensure that all investments will conform to this Policy". Board Policy requires a number of documents to protect the College and clearly delineate the responsibilities of all parties. All financial institutions serving as a depository for College funds are required to provide a 1) Depository Contract, 2) Collateral Agreement, 3) Audited financial statements, 4) Statement of Condition (commonly known as a Call Report), 5) Community Reinvestment Act report and, 6) Certification as to having read and agree to comply with Board Policy 10-55.

All security broker/dealers who provide investment transactions for the College must provide 1) Trading Resolution, 2) Custodial Agreement, 3) Audited financial statements, 4) Proof of Financial Industry Regulatory Authority (FINRA) certification and compliance and 5) Certification as to having read and agree to comply with Board Policy 10-55.

There are nine financial institutions serving as a depository of College funds and five security broker/dealers providing investment services to the College. Table 1 shows the institutions utilized by the College and the related documentation that the Treasurer *did not* have at the time of this review. The documents required by Board Policy are much more extensive than those required by the Public Funds Investment Act. However, many of the documents in Table 1 serve an essential purpose to protect the College. For example, depository contracts and custodial agreements include provisions such as restrictions on how funds are to be held or invested, fees, terms for the redemption of funds and the indemnification and liabilities of each party in the case of losses or default.

Concerning the certification to comply with Board Policy, the Treasurer had only a verbal acknowledgment, not a written certification, from all of the institutions that hold or handle College investments. Without written certification that the firms agree to comply with the Board Policy, the College's recourse against such firms could be limited in the event of adverse events, such as the freezing of funds that occurred with the IMET fund. In addition, it is apparent from the findings described earlier that the firms were not complying with the Board's Policy. The Treasurer stated that resources of his office are too limited to ensure all of the documentation is tracked and maintained.

Financial Institution	Depository Contract?	Collateral Agreement	Audited Financial Statements	Community Reinvestment Act report	Written Certification of Policy 10-55	Call Report
US Bank (Illinois Funds)	X	X		X	X	X
Wheaton Bank & Trust	X				X	
MBS Securities	X		X		X	
JP Morgan Chase Bank	X				X	
Illinois Metropolitan Investment Fund	X				X	
Northern Funds	X				X	
Fifth Third Securities	X				X	
Amalgamated Bank of Chicago	X		X		X	
PFM Asset Management	X		X		X	

Security Broker / Dealer	Trading Resolution	Custodial Agreement	Audited Financial Statements	Proof of FINRA Certification	Written Certification of Policy 10-55
MBS Securities		X	X		X
Northern Trust Securities Inc.	X	X			X
Fifth Third Securities, Inc.	X	X			X
Rice Securities	X	X	X		X
PFM Fund Distributors	X	X			X

X - **Documentation not on file in the Finance Department**

Table 1: Investment Documentation Not on File

Recommendation #3: *The Treasurer should obtain all of the missing documentation from the financial institutions and security broker/dealers that do business with the College. The Treasurer should also set up a verification system to ensure that the required documents are obtained from any new institution prior to doing business with the College.*

Management Response: Management did not respond to this recommendation.

Investment Diversification

The Policy states that the College will diversify its portfolio to eliminate the risk of loss resulting in an over concentration in a specific maturity, issuer, financial institution, broker dealer or class of securities. Diversification can be by type of investment, number of institutions invested in and maturity. There was sufficient diversification by the number of institutions and the maturity of the investments but additional diversification in the types of investments appears to be needed. Table 2 below shows the diversification by type of investment.

Investment Type	Amount Invested	% of Total
Bond Mutual Funds	$ 117,988,781	43%
Local Governemnt Investment Pools	$ 80,174,889	29%
US Agency Bond/Note	$ 38,891,091	14%
Cash/Demand Deposits	$ 20,002,639	7%
US Treasury Bond/Note	$ 13,654,116	5%
Commercial Paper	$ 1,949,716	1%
Municipal Bonds	$ 1,481,189	1%
	$ 274,142,421	**100%**

Table 2: Portfolio Diversification by Type of Investment

The investments as of 9/30/14 were concentrated in two primary areas; bond mutual funds and local government investment pools. These two types of investment total 72% of the portfolio and as noted earlier, the Board Policy states that each of these types of investments should be no more than 5% of the portfolio. As of January 2015, the College's investments in local government investment pools has been reduced substantially to approximately $2.2 million (the amount frozen in the IMET Convenience Fund) and the investments in bond mutual funds have been reduced to approximately $81.9 million. The bond mutual funds could be problematic since they are susceptible to interest rate risk, which is the risk that bond values will fall as interest rates rise. Since most predictions are for the Federal Reserve Board to begin raising interest rates in 2015, the Treasurer should consider the risk this will pose to the bond mutual fund investments.

Additional diversification by investment type could include placing more funds in certificates of deposit, municipal bonds and U.S. Treasury securities. For comparison, the investment portfolios of other Illinois community colleges were reviewed to determine how they diversified their portfolios. Table 3 illustrates the results of that analysis.

	College of DuPage	Moraine Valley	Joliet Junior College	Oakton Community College	William Rainey Harper	City Colleges of Chicago	Elgin Community College	College of Lake County
Cash & Money Market Accounts	*7%*	21%	43%	11%	23%	50%	46%	12%
Certificates of Deposit		24%	36%	13%	23%	4%	23%	43%
Local Gov't Investment Pool	*29%*		3%	61%	3%		22%	45%
US Treasury / Agency Notes	*19%*	18%		14%	18%	33%	8%	
Municipal Bonds	*1%*	32%	18%		34%			
Bond Mutual Funds	*43%*							
Other	*1%*	5%				13%		
Total	*100%*	100%	100%	100%	100%	100%	100%	100%

Table 3: Illinois Community College Portfolio Diversification by Type of Investment (based on data from fiscal year 2014 Comprehensive Annual Financial Reports)

Performance Standards

The Policy states that the portfolio should obtain a comparable rate of return during a market/economic environment of stable interest rates and should be compared to benchmarks with similar maturity, liquidity and credit quality as the portfolio. The benchmarks specified are the nationally recognized Treasury indexes of duration appropriate to the portfolio, Illinois Funds and the Prudent Man Index. Internal Audit compared the annualized rate of return of College investments to the annualized rates of return of the benchmarks for the same period. The investment returns of the College's portfolio were in-line with the rates of return of the benchmarks.

However, due to the significant investment in bond mutual funds which carry more risk than other types of investments, the returns on the College's portfolio should have been higher than institutions that invest primarily in the more conservative investments. This does not appear to be the case when the College's portfolio returns are compared with other community colleges (Table 4 provides a comparison of the College's average annual yield over a three year period with other community colleges). This could be due to the unrealized losses from the bond mutual funds. For example, in fiscal year 2013 the College had negative investment earnings due in part to unrealized losses of $380,614 on the bond mutual funds. While all of these losses were reversed in fiscal year 2014, there were additional unrealized losses of $161,840 on the bond mutual funds in fiscal year 2015 (through 9/30/14).

Community College	Average Annual Investment Balance FY12-FY14	Average Annual Investment Earnings FY12-FY14	Average Annual Yield FY12-FY14
Moraine Valley	$ 145,864,313	$ 2,432,361	1.67%
Joliet Junior College	$ 108,964,774	$ 814,597	0.75%
Oakton	$ 135,705,307	$ 793,624	0.58%
William Rainey Harper	$ 283,736,792	$ 1,505,803	0.53%
College of DuPage	***$ 257,419,608***	***$ 977,803***	***0.38%***
City Colleges of Chicago	$ 375,562,159	$ 1,256,633	0.33%
Elgin Community College	$ 124,089,858	$ 295,629	0.24%
College of Lake County	$ 100,386,700	$ 152,344	0.15%

Table 4: College of DuPage versus Other Community College Investment Portfolio Annual Yields

Of particular note are Moraine Valley's results which were achieved through investments in municipal bonds, a significant portion of which were issued by the State of Illinois. Moraine also stated their Chief Financial Officer is very involved in the management of investments. Both Joliet and Harper colleges also have a significant investment in municipal bonds.

Reporting Requirements

The Policy has two reporting requirements. First, the Treasurer should prepare a monthly investment report summarizing the investment activities and rate of return of the portfolio. Second, the Treasurer should also prepare a more detailed quarterly report which includes the portfolio investments by type, issuer, interest rate, maturity, book value, income earned, current market value and comparison to applicable benchmarks. The Public Funds Investment Act requires a report at least quarterly that includes the securities by class or type, book value, income earned and market value as of the report date. A monthly report is included in the Board packet but no quarterly reports have been prepared which would inform the Board of the income earned on each investment and a comparison to the applicable benchmark.

> ***Recommendation #4:*** *The Treasurer should begin preparing a quarterly report to the Board of Trustees detailing the required information in Board Policy 10-55.*

> **Management Response:** Management did not respond to this recommendation.

Treasurer's Advisory Committee

Administrative Procedure 10-55 states that the investments will be reviewed periodically by the Treasurer's Advisory Committee to address issues of investment mix and return. The Committee last met on November 7, 2014 but the meeting prior to that occurred on January 18, 2013, almost two years prior. The Committee's goal is to meet every four months.

In the notes from the November 2014 meeting, the primary topic appeared to be the situation with the IMET Convenience Fund and a number of questions that remained unanswered. The Committee also advised that the Treasurer should avoid funds in which the net asset value (NAV) does not change to avoid potential losses. Four of the five mutual funds owned by the College at the time of the meeting had a NAV that is consistently unchanged. The Committee also advised the Treasurer to make sure the College is not violating the Investment Policy since it would open the College up to criticism.

CONCLUSION: The Treasurer needs to take immediate action to bring the investment portfolio into compliance with Board Policy. This action should include re-allocating the securities owned so the limitations of the Policy are adhered to and securing the necessary documentation to preserve the rights of the College. Additional procedures could also be instated to ensure that investments being added to the portfolio comply with the Policy.

Please contact me if you would like to meet to discuss any of the issues or if you have any questions.