

December 22, 2017

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

Dear Mr. Michael Cohen,

In accordance with the State Leadership Accountability Act (SLAA), the State Treasurer submits this report on the review of our internal control and monitoring systems for the biennial period ending December 31, 2017.

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

BACKGROUND

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

Business Unit Number	Entity Name
0950	California State Treasurer
0954	ScholarShare Investment Board

0956	California Debt and Investment Advisory Commission
0959	California Debt Limit Allocation Committee
0964	California Transportation Financing Authority
0965	California Industrial Development Financing Advisory Commission
0968	California Tax Credit Allocation Committee
0971	California Alternative Energy and Advanced Transportation Financing Authority
0974	California Pollution Control Financing Authority
0977	California Health Facilities Financing Authority
0981	California Achieving A Better Life Experience Board
0983	California Urban Waterfront Area Restoration Financing Authority
0984	California Secure Choice Retirement Savings Investment Board
0985	California School Finance Authority
0989	California Educational Facilities Authority
.....	California Healthy Food Financing Initiative Council*

* The California Healthy Food Financing Initiative Council is an initiative and was never officially established as a BCA; it has no funding source and no authorized positions. We do not provide any financial reporting for the initiative.

ONGOING MONITORING

As the head of State Treasurer, John Chiang, California State Treasurer, is responsible for the overall establishment and maintenance of the internal control and monitoring systems.

EXECUTIVE MONITORING SPONSOR(S)

The executive monitoring sponsor responsibilities include facilitating and verifying that the State Treasurer internal control monitoring practices are implemented and functioning as intended. The responsibilities as the executive monitoring sponsor(s) have been given to:

Vince Brown, Deputy Treasurer, Administration and Fiscal Policy.

MONITORING ACTIVITIES

The STO has many external and internal oversight program activities that are used to identify, assess, and manage risks. Some activities include: Development of two year Strategic Plans on 2017 and 2018 that will track and monitor risk. Audits of bond and other programs. Audits of the BCAs. Performance Reports by various BCAs. Meetings of the BCA's. Audits by the Bureau of State Audits. Reviews of bond debt prior to issuance of bonds. Treasurer Chiang established a new Office of Risk Management upon entering office. The office will ensure that all programs run by the Office of State Treasurer are performing in accordance with State and Federal rules and obligations and in accordance with the requirements of the State Treasurer. The Chief, Office of Risk Management will perform reviews and

audits of special projects as they occur. This includes coordinating the preparation of reports to the Department of Finance regarding the State Leadership Accountability Act (SLAA). Initially, the STO hired a retired annuitant to serve as the Chief of the Office of Risk Management. However, the incumbent retired after performing a number of risk assessments. The Chief of Staff (COS) is now considering establishing a permanent position to perform the risk management function.

ADDRESSING VULNERABILITIES

The Deputy State Treasurers provide management and oversight of their direct reports—Director's and BCA Executive Directors—programs and business functions to assess vulnerabilities. In addition, the Strategic Plans of the STO Divisions and BCAs identify risk and vulnerabilities. Significant vulnerabilities are elevated to the COS for evaluation. A determination is made to mitigate, monitor, or accept the risk and/or vulnerability.

COMMUNICATION

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

ONGOING MONITORING COMPLIANCE

The State Treasurer has implemented and documented the ongoing monitoring processes as outlined in the monitoring requirements of California Government Code sections 13400-13407. These processes include reviews, evaluations, and improvements to the State Treasurer systems of controls and monitoring.

RISK ASSESSMENT PROCESS

The following personnel were involved in the State Treasurer risk assessment process: Executive Management, Middle Management, Front Line Management, and Staff.

RISK IDENTIFICATION

The Executive Sponsor and the Executive Office Analyst attended the October 16, 2017 mandatory SLAA training session that updated 2017 SLAA Report requirements and changes to the 2015 SLAA Report. The Executive Sponsor Deputy developed the SLAA Report schedule for the STO.

The Deputy State Treasurer's discussed the potential 2017 risks based on the 2015 Risk Assessment with their Division Directors and BCA Executive Directors (EDs).

Based on our assessment of the 2017 risks, the most significant risk to the STO was still the funding sustainability of the office. In addition, the existential risk of losing the tax exemption for private activity bonds (PABs) in 2017 would almost eliminate the STO's conduit financing BCAs. As such, this was the second highest risk to the STO in 2017.

RISK RANKING

Based on this information, the Executive Sponsor Deputy proposed a list ranking the risks to the Deputy State Treasurers. The Deputy Treasurers agreed on the risks and the rankings. The Executive

Sponsor Deputy drafted the SLAA Report for review and editing by the other Deputies. The draft was reviewed by the COS and Deputies during a meeting. The final Report was submitted to the State Treasurer for review and approval.

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

RISKS AND CONTROLS

RISK: OPERATIONS -EXTERNAL-FI\$CAL IMPLEMENTATION, MAINTENANCE, FUNCTIONALITY, OR SUPPORT

1. STO FI\$Cal control functionality:

The STO is in the process of implementing the remaining FI\$Cal SCO/STO control functionality release in the first quarter of the 2018-19 Fiscal Year (FY). The STO control functionality includes cash management, bond accounting, and investments. The STO control functionality was positioned to implement in July 2017 as scheduled. However, other FI\$Cal project participants weren't ready to go live.

The SCO/STO control function release will be implemented through an Integrated Solution utilizing an Agile delivery methodology. The plan for the SCO/STO Integrated Solution will be submitted to the California Department of Technology (CDT) and Governor's Office for approval in Special Project Report (SPR) 7 and the FI\$Cal Steering Committee will approve and submit it to the State Legislature for review.

- SPR 7 may not receive the approval of the CDT and Governor's Office. The STO control functionality release may not be implemented on schedule in July 2018.
- If the FI\$Cal project cannot implement the SCO/STO control functionality release on time in July 2018, the STO will be unable to go live with their control functions in the first quarter of 2018-19.
- The FI\$Cal STO control functions would be delayed resulting in increased costs and additional time to complete the FI\$Cal system's complete functionality. Additionally, the state's financial reports, produced by SCO, cannot be produced in FI\$Cal.

2. FI\$Cal implementation of the STO's 15 BCAs:

The STO is onboarding the 15 BCAs onto FI\$Cal July 2018. The implementation of the 15 BCAs is currently on schedule for a July 2018 implementation.

- The FI\$Cal project is unable to onboard the 15 BCAs into the system in July 2018.
- Onboarding of the BCAs onto FI\$Cal is delayed causing increased costs and additional staff work to complete the project.

CONTROL A

- The SPR 7 adds additional time to the SCO/STO control functionality to reduce risk. SPR 7 also changes to an Integrated Solution to implement the SCO/STO control functionality, which also reduces risk.

CONTROL B

- The FI\$Cal project has changed the project methodology from a Waterfall to Agile

- methodology to accelerate the project delivery of the SCO/STO control functionality.
- The Agile methodology improves the delivery of functionality, which reduces the risk of delays in implementing the SCO/STO control functionality release.

CONTROL C

- The FI\$Cal project has used lessons learned from previous Departmental releases to improve the onboarding of new Departments. The BCAs will receive training earlier on the FI\$Cal system and also earlier testing. As the STO BCAs get closer to the "Go Live" implementation date, staff will receive refresher training and testing.

RISK: OPERATIONS -EXTERNAL-FUNDING—SOURCES, LEVELS

The STO faces risk to its budget due to the funding sources supporting our business activities and programs. The STO budget is supported by four funding sources. Specifically, the sources of funds are the General Fund (GF), Reimbursements, (for services or work provided for, or on behalf of another State agency, the Central Services Cost Recovery Fund (CSCRF), and the No Place Like Home Fund (NPLHF). The split is approximately 13% GF (\$5.3 million), 79% Reimbursements (\$32 million), 7% CSCRF (\$2.9 million), and 1% (\$500,000) NPLHF.

As the State experienced budget deficits, departments were subjected to GF budget reductions. As a result, the STO funding split gradually shifted to a greater reliance on Reimbursements. Consequently, funding pressure has been placed on the STO's program Divisions and BCAs to fund the STO's Executive Office, Legal staff, Information Technology Division, and the Administrative Division.

The primary sources of reimbursements come from, but are not limited to, the following services provided by the STO:

- The sale of Various State bonds.
- Administrative fees charged on the interest earned by LAIF and SMIF.
- Centralized banking services.
- Administrative services provided to the BCAs.

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

CONTROL A

- The STO will contract with a consultant to conduct an analysis of its budget structure and funding sources to determine if the current business model funding structure is sustainable. The study will make recommendations to reduce the risk to the STO Budget.

RISK: COMPLIANCE-EXTERNAL-COMPLEXITY OR DYNAMIC NATURE OF LAWS OR REGULATIONS

The US House of Representatives is proposing to eliminate the tax exemption for Private Activity Bonds (PABs) in its version of the Federal Tax Reform bill. However, the US Senate bill does not eliminate the tax exemption for PABs. Therefore, it is not clear at this time, if elimination of the tax exemption will be in the final version of the Federal Tax Reform bill.

The US House of Representatives have introduced the Tax and Job cuts act.

If the tax exemption for PABs is included in the final version of the bill, it will affect the conduit bond financing programs in CHFFA, CSFA, CPCFA, and CEFA. In addition, the elimination of the tax exemption

would eliminate CDLAC's PABs allocation program and also negatively impact TCAC's housing tax credits.

CONTROL A

- The State Treasurer is publicly advocating for the continuation of the tax exemptions for PABs, especially for housing and hospital financing projects. The STO staff and staff of our conduit BCAs are providing information to support the continuation of the tax exemption for PABs. Hopefully, the Treasurer's active verbal, written communications to stakeholders, media articles, and op-ed articles will have some influence on continuing the PABs federal tax exemption.

CONTROL B

- The STO Executive staff and BCA EDs are closely monitoring the congressional debate over tax reform. As we monitor the debate, the STO staff is analyzing the potential impact on the BCAs budgets and staffing, Public Finance Division (PFD) agent of sales funding, and the STO budget. The STO will prepare a budget and staffing contingency plan if the PABs tax exemption is eliminated in the Federal Tax Reform bill.

RISK: OPERATIONS -INTERNAL-PROGRAM/ACTIVITY—CHANGES, COMPLEXITY

The Secure Choice Board is currently working to implement the Secure Choice Retirement Savings Program but delays in paying off the General Fund loan could be possible.

Possible delays in program implementation or potential litigation.

If the Secure Choice Board is unable to successfully launch the Secure Choice Retirement Savings Investment Program in a timely fashion due to delays or litigation, the Board would be unable to pay off the first installment of the General Fund loan, beginning in 2022, as required by the enabling statute.

CONTROL A

- Actively market the program, prevail in any lawsuits and have a successful program launch.

RISK: OPERATIONS -INTERNAL-PROGRAM/ACTIVITY—CHANGES, COMPLEXITY

The CalABLE Board is currently working to implement the investment program in 2018 but delays in paying off the General Fund loan could be possible.

The Board does not have sufficient enrollment data to determine if the administrative fees charged on the investment portfolio will be sufficient to pay off the General Fund (GF) loan.

It will take several years to gather actual enrollment data to make accurate estimates of the fees generated to pay of the General Fund loan.

CONTROL A

- The Board will successfully launch the program in conjunction with an aggressive marketing plan. The CalABLE Board staff will manage its budget prudently and provide quarterly updates of expenditures and revenues to the Board. The staff will provide the DOF with annual five year estimates of expenditures and revenues to determine if the General Fund loan can be repaid.

CONCLUSION

The State Treasurer strives to reduce the risks inherent in our work and accepts the responsibility to continuously improve by addressing newly recognized risks and revising controls to prevent those risks from happening. I certify our internal control and monitoring systems are adequate to identify and address current and potential risks facing the organization.

John Chiang, California State Treasurer

CC: California Legislature [Senate (2), Assembly (1)]
California State Auditor
California State Library
California State Controller
Director of California Department of Finance
Secretary of California Government Operations Agency