

REPORT OF THE
OFFICE OF THE AUDITOR GENERAL

216.2

POLICIES AND PRACTICES OF THE
EMPLOYMENT DEVELOPMENT DEPARTMENT FOR
THE INVESTMENT OF THE CASH RESERVES OF
THE STATE'S UNEMPLOYMENT
COMPENSATION DISABILITY FUND

MARCH 1975

TO THE
JOINT LEGISLATIVE AUDIT COMMITTEE

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March 3, 1975

Honorable Bob Wilson
Chairman, and Members of the
Joint Legislative Audit Committee
Room 4126, State Capitol
Sacramento, California 95814

Dear Mr. Chairman and Members:

Transmitted herewith is our report on the policies and practices of the Employment Development Department (EDD) regarding the investment of the state's Unemployment Compensation Disability Fund (Disability Fund). The Disability Fund is administered by the Director of EDD.

In 1974, a daily average of \$137 million was invested by EDD. Our review has identified estimated interest income lost to the state's Disability Fund of \$908,000 annually.

EDD separately invests the cash reserves of the Disability Fund in lieu of requesting legislative authority to make such investments through the state's centralized Surplus Money Investment Fund.

Over the past 12 years, the Surplus Money Investment Fund has demonstrated investment management superior to EDD. Additional advantages of the Surplus Money Investment Fund are:

- Its broader investment authority enabling it to purchase higher-yielding instruments, such as commercial paper and bankers' acceptances, which are not authorized for purchase by the Disability Fund
- Procedures providing more efficient cash management

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- Procedures allowing withdrawal of funds as needed rather than risking losses from the forced sale of securities prior to their maturity.

The separate investment of the Disability Fund reserves in lieu of investments through the state's centralized Surplus Money Investment Fund results in .52 of one percent less yield to the Disability Fund. As a result, the state's Disability Fund loses interest income of an estimated \$710,000 annually.

EDD's policy of separately investing the Disability Fund reserves requires excessive average daily cash reserves of \$2.2 million to be maintained in the Disability Fund's non-interest bearing general cash account. If such reserves were invested as part of the Surplus Money Investment Fund, the State Controller would only have to maintain a balance of \$10,000 in this cash account. As a result, the state's Disability Fund loses interest income of an estimated \$132,000 annually.

We recommend that legislation be enacted authorizing the investment of the reserves of the Disability Fund as part of the Surplus Money Investment Fund.

Further, excessive cash reserves of \$1.1 million are maintained by EDD in the Disability Fund's non-interest bearing benefit payment checking account merely for the purpose of reflecting a larger cash balance in EDD's financial statements. As a result, the state's Disability Fund loses interest income of an estimated \$66,000 annually.

We recommend that the Director of the Employment Development Department maintain cash reserves in the non-interest bearing benefit payment checking account no larger than required.

Respectfully submitted,



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INTRODUCTION

In response to a legislative request, we have reviewed the policies and practices of the Employment Development Department (EDD) regarding the investment of the cash reserves of the Unemployment Compensation Disability Fund (Disability Fund) of the State of California.

The Disability Fund was created by statute in 1946 to provide disability insurance benefits to disabled or injured workers employed by private industry who are required to contribute to the fund through payroll deductions. The Disability Fund is a trust fund to be administered by the Director of the Employment Development Department exclusively for the benefit of such disabled or injured workers. Disability benefits are paid for sickness or injury not job related or when workmens' compensation is less than disability insurance benefits.

The major source of receipts to the Disability Fund is wage earner contributions which average 93 percent of the total receipts. For the year ended December 31, 1973, total receipts of the Disability Fund were \$397.5 million while total fund disbursements were \$374 million.

For the year ended December 31, 1974, the Disability Fund had an average daily cash reserve balance available for investment of \$142 million. A daily average of \$137 million was invested separately by EDD while an average balance of \$5 million remained in cash accounts in the State Treasury system.

The investments provided an estimated \$10.1 million of investment income, or a yield of 7.10 percent on average daily reserves available for investment and 7.36 percent on invested reserves.

Our review has identified estimated interest income lost to the state's Disability Fund of \$908,000 annually.

As an alternative to the separate investment of the Disability Fund reserves, statutes creating the Surplus Money Investment Fund provide for the centralized investment of temporarily idle monies of most state agencies which may elect to invest cash reserves through the Surplus Money Investment Fund. Currently, approximately 188 separate state funds invest idle monies through the Surplus Money Investment Fund. However, the Legislative Counsel, as well as the Chief Counsel of the Office of the Auditor General, are of the opinion that the Director of the Employment Development Department may not elect to invest the reserves of the Disability Fund under the provisions of the Surplus Money Investment Fund unless the law is amended specifically to authorize such investment.

FINDINGS

THE SEPARATE INVESTMENT OF DISABILITY FUND CASH RESERVES BY THE EMPLOYMENT DEVELOPMENT DEPARTMENT (EDD) IN LIEU OF REQUESTING LEGISLATIVE AUTHORITY TO MAKE SUCH INVESTMENTS THROUGH THE STATE'S CENTRALIZED SURPLUS MONEY INVESTMENT FUND RESULTS IN THE STATE'S DISABILITY FUND LOSING INTEREST INCOME OF AN ESTIMATED \$842,000 ANNUALLY.

EDD separately invests the reserves of the Disability Fund. In 1974 the average daily reserve balance was \$142 million, of which \$137 million was invested. EDD has not requested legislation for authorization to invest the cash reserves as part of the Surplus Money Investment Fund, which has demonstrated superior investment management over the past 12 years. Another advantage of investing cash reserves through the Surplus Money Investment Fund is the broader investment authority of this fund as compared to the investment authority of the Disability Fund.

Additionally, EDD's separate investment of reserves of the Disability Fund necessitates excessive cash reserves of \$2.2 million in state bank accounts which provide no interest income to the Disability Fund. In total, the separate investment of the Disability Fund by EDD results in the loss of an estimated \$842,000 of interest income to the Disability Fund annually which could have been earned by the Disability Fund if the reserves of the fund were invested as part of the state's centralized Surplus Money Investment Fund.

The Separate Investment of the Disability Fund Reserves by EDD Results in .52 Of One Percent Less Yield to the Disability Fund on Invested Cash Reserves, And Approximately \$710,000 Less Interest Income Annually Than If Such Reserves of the Fund Were Invested as Part of the State's Centralized Surplus Money Investment Fund.

The EDD Director is the administrator of the Disability Fund investments. He is advised by an investment committee comprised of key departmental personnel and an investment consultant. The investment committee analyzes conditions and events affecting the Disability Fund, submits policy and investment recommendations to the Director for approval and recommends purchase of short-term securities, usually with maturities of less than six months. The investment consultant, for an annual fee of \$5,000 since 1961, advises the investment committee on economic and interest rate conditions and recommends purchase and sale of securities with maturity dates from six months to six years. The Director then instructs the State Treasurer to purchase or sell securities for the Disability Fund.

The Director's investment goals include liquidity, maximum return and safety of principal consistent with investment authority provided by statute.

The goal of fund liquidity has been emphasized since 1961 when the Director adopted a policy of acquiring securities with maturity dates of less than six years to increase fund liquidity. This policy was adopted because it was determined that long-term securities would have to be sold in 1962, for significantly less than their purchase price, to pay benefits to claimants.

In contrast, reserves invested as part of the Surplus Money Investment Fund may be withdrawn as needed by the depositing fund without risking losses resulting from lack of liquidity and forced sale of securities prior to maturity.

Some of the eligible securities which can be purchased by the Director are as follows:

- Investments in long-term bonds of the United States government and approved federal agency long-term securities
- Investments to finance land and buildings occupied by the Employment Development Department and a parking lot adjacent to the Sacramento office building.
- Investments in short-term securities including United States treasury bills, Tennessee Valley Authority and Federal National Mortgage Association short-term discount notes and repurchase agreements entered into with major banks and security dealers.

On December 31, 1974, the portfolio of the Disability Fund consisted of the following investments valued at cost:

Long-term bonds (average life of one year, three months, par value of \$81 million)	\$81.1 million	--
Investments to finance land and buildings	1.6 million	
Short-term securities	<u>49.4 million</u>	
Total	<u>\$132.1 million</u>	

In addition, the Disability Fund maintained cash reserves in 1974 averaging \$5 million daily. Average daily total reserves for 1975 are expected to average \$138 million.

With the exception of investments to finance land and buildings occupied by the department, eligible investments of the Disability Fund are also eligible investments for the Surplus Money Investment Fund. However, the Surplus Money Investment Fund, unlike the Disability Fund, is also authorized by statute to invest in commercial paper and bankers' acceptances. These securities generally provide .25 of one percent higher return than other short-term investments authorized for purchase by the Disability Fund.

For a 12-year period ending December 31, 1974, EDD has invested an average of \$82.4 million per day in authorized eligible securities for the Disability Fund. EDD obtained an average rate of return on invested resources of 5.57 percent. During this period, the Surplus Money Investment Fund of the State of California obtained a rate of return of 6.19 percent, or .62 of one percent greater annual investment income on invested reserves. The Surplus Money Investment Fund would have provided \$6.2 million additional interest income to the Disability Fund over this 12-year period.

The broader investment authority of the Surplus Money Investment Fund to purchase commercial paper and bankers' acceptances accounted for approximately .02 of one percent of the .62 of one percent greater yield earned by the Surplus Money Investment Fund. Commercial paper and bankers' acceptances were not authorized for purchase by the Surplus Money Investment Fund until 1968 and 1972, respectively.

Disability Fund investments to finance land and buildings occupied by the department decreased interest yield to the Disability Fund over the last 12 years by approximately .17 of one percent.

In future years, the Surplus Money Investment Fund, assuming 35 percent of its resources are invested in commercial paper and bankers' acceptances, is expected to provide .09 of one percent greater overall return. Therefore, as a result of the increased investment authority of the Surplus Money Investment Fund, the deficiency in interest earned by the Disability Fund, when compared to the Surplus Money Investment Fund, is presently estimated to be .52 of one percent or a loss of interest income of approximately \$710,000 annually.

This results primarily because investment management of the Surplus Money Investment Fund is superior to EDD's investment management. The greatest deficiency as measured by performances of investments of the Disability Fund eligible for the Surplus Money Investment Fund compared to the Surplus Money Investment Fund as a whole is with the selection and timing of short-term investments. For a six-year period ending December 31, 1974, the Disability Fund earned a 6.07 percent rate of return on its short-

term investments. The Surplus Money Investment Fund earned an average 6.91 percent rate of return for that period, or approximately .84 of one percent more yield than short-term investments of the Disability Fund.

As of December 31, 1974, the Disability Fund had \$81 million par value of long-term bonds in its portfolio. These bonds had an average life of one year three months, and provided a 6.41 percent return on costs. As of December 31, 1974, these bonds were worth \$1.1 million less than their purchase price. If sold, a loss of \$1.1 million would be incurred. This loss could be recovered through increased investment income over the average life of the bonds if the Surplus Money Investment Fund were to earn a 7.6 percent annual rate of return. In 1974, a 9.76 percent return was earned. However, a rate of 7.6 percent had not been earned previously.

CONCLUSION

The investment of Disability Fund cash reserves as part of the Surplus Money Investment Fund would provide the Director with liquidity and minimize the risk of losses resulting from the forced sale of securities prior to their maturity. Further, since the broader investment authority of the Surplus Money Investment Fund is considered safe and prudent for other state funds, it would also be safe and prudent for the Disability Fund. Over the last 12 years the Pooled Money Investment Board has demonstrated superior

management. The investment of the reserves of the Disability Fund as part of the Surplus Money Investment Fund would increase yield to the Disability Fund by an estimated .52 of one percent. This would provide additional investment income to the Disability Fund of \$710,000 per year based on investable reserves for calendar year 1975 which are estimated to average \$136.3 million.

However, it may not be prudent at this time to sell the \$81 million par value of long-term bonds of the Disability Fund and transfer the proceeds to the Surplus Money Investment Fund. The Director should obtain expert advice as to the outlook for interest rates and as to the Surplus Money Investment Fund's potential performance before selling these bonds to transfer the proceeds to the Surplus Money Investment Fund.

The investments to finance land and buildings are not authorized for investment by the Surplus Money Investment Fund and, in our judgment, could not be sold for cash to transfer cash to the Surplus Money Investment Fund. However, the principal returned to the Disability Fund upon periodic amortization of the current \$1.6 million invested to finance land and buildings should be reinvested in the Surplus Money Investment Fund when received.

The remaining investable reserves for 1975, estimated to average \$53.6 million, are available for investment in short-term securities and should be transferred to the Surplus Money Investment Fund immediately upon the granting of legislative authorization to do so. Approximately \$450,000 could be realized in 1975 by the immediate transfer of short-term monies invested in Disability Fund investments to the Surplus Money Investment Fund.

Separate Investment of the Disability Fund Requires Excessive Average Daily Non-Interest Bearing Cash Reserves of \$2.2 Million to Be Maintained in the Disability Fund's Non-Interest Bearing General Cash Account. As a result, Interest Income of Approximately \$132,000 Is Lost Annually to the Disability Fund.

As administrator of the Disability Fund, which is a trust fund to be administered for the benefit of the insured, the EDD Director should strive to keep uninvested cash to a minimum to earn maximum investment income for the Disability Fund.

All monies received by the Disability Fund are deposited in the general cash account in the State Treasury system. Monies in the general cash account are then invested, used to meet administrative costs incurred by the fund, or transferred to the benefit payment checking account to pay benefits to claimants. Unused balances in the Disability Fund general cash account and the benefit payment account earn no income for the Disability Fund, although the excessive balances may earn interest income directly or indirectly for the General Fund.

Excessive cash reserves maintained in the Disability Fund's non-interest bearing general cash account during the period July 1973 through November 1974 averaged \$2.2 million daily. As a result, interest income of approximately \$132,000 annually has been lost. If the Disability Fund reserves were invested as part of the Surplus Money Investment Fund rather than separately invested, the State Controller would only have to maintain a balance of \$10,000 in the Disability Fund general cash account if requested to do so by the Director. This would provide more efficient cash management.

For funds which invest reserves through the Surplus Money Investment Fund, the Controller can transfer reserves from the Surplus Money Investment Fund to the participating fund's general cash account on a daily basis as needed. This practice eliminates the need for EDD to estimate in advance the amount of money necessary to pay claims presented for payment and results in effective cash management.

CONCLUSION

More effective and efficient cash management would result if the reserves of the Disability Fund were invested as part of the Surplus Money Investment Fund. Unused cash reserves of the Disability Fund's non-interest bearing general cash account averaging \$2.2 million can be reduced to and maintained at \$10,000 resulting in additional interest income to the Disability Fund of an estimated \$132,000 annually, while still providing that sufficient funds are available to pay claims.

RECOMMENDATIONS

We recommend that legislation be enacted authorizing the investment of the cash reserves of the Unemployment Compensation Disability Fund as part of the Surplus Money Investment Fund. Upon receipt of authorization, the Director of the Employment Development Department should proceed as follows:

- Immediately transfer short-term investments to the Surplus Money Investment Fund
- Obtain expert advice on the future course of interest rates, and then either sell long-term bonds and reinvest the proceeds as part of the Surplus Money Investment Fund, or reinvest proceeds from long-term bonds as part of the Surplus Money Investment Fund when bonds mature
- Reinvest principal returned to the Disability Fund from periodic amortization of investments to finance land and buildings in the Surplus Money Investment Fund when they are received
- Request the State Controller to maintain a balance of \$10,000 in the Disability Fund's general cash account.

SAVINGS

Proper implementation of these recommendations will result in additional interest income to the Disability Fund of \$842,000 annually when all reserves of the Disability Fund have been converted to cash and transferred to the Surplus Money Investment Fund.

EDD MAINTAINS EXCESSIVE CASH RESERVES OF \$1.1 MILLION IN THE DISABILITY FUND'S NON-INTEREST BEARING BENEFIT PAYMENT CHECKING ACCOUNT. AS A RESULT, INTEREST INCOME OF APPROXIMATELY \$66,000 IS LOST ANNUALLY TO THE DISABILITY FUND.

Cash reserves maintained in the Disability Fund's benefit payment checking account in the State Treasury during the period July 1973 through November 1974 averaged \$2.8 million daily. From the formula used by the Department of Finance to prescribe account balances necessary to compensate the State Treasurer, State Controller and banks for the costs of services provided, we have estimated that approximately \$1.7 million is needed on the average in the Disability Fund account (assuming interest rates of six percent). Therefore, the cash management goal of EDD should be to have sufficient money in the account to redeem state warrants presented for payment and to maintain an average balance of approximately \$1.7 million.

However, EDD makes large month-end deposits averaging \$8.7 million each which increases the average daily cash balance maintained in the account from \$1.7 million to \$2.8 million, or \$1.1 million in excess of needs. As a result, interest income of approximately \$66,000 annually has been lost by the Disability Fund. These deposits are made to cover all estimated disability payment warrants outstanding at month-end. This practice is followed so that EDD's financial statements show a balance of unexpended cash in the benefit payment account.

CONCLUSION

EDD should maintain reserves, on average, in this cash account, no larger than needed to redeem warrants and to compensate the state and banks for services provided to the Disability Fund. Month-end deposits should not be made merely for presentation of the financial statements. Estimated additional interest income of \$66,000 annually would then be earned by the Disability Fund.

RECOMMENDATION

We recommend that the Director of the Employment Development Department maintain cash reserves in the Disability Fund's non-interest bearing benefit payment checking account no larger than required to redeem warrants and compensate the State Treasurer, State Controller and banks for services provided. Month-end deposits to the benefit payment account made merely for presentation of the financial statements should be discontinued.

SAVINGS

Proper implementation of this recommendation will result in additional interest income to the Disability Fund of \$66,000 annually.

SUMMARY OF COMMENTS OF THE
STAFF OF THE DIRECTOR OF THE
EMPLOYMENT DEVELOPMENT DEPARTMENT

1. The Employment Development Department has recently drafted proposed legislation to provide the department the option of investing the reserves of the Disability Fund as part of the Surplus Money Investment Fund. The department's proposed legislation is presently being considered by the Health and Welfare Agency. If the agency approves, the proposed legislation will be submitted to the Governor's Office.

2. The department agrees in principal that the cash reserves in the Disability Fund's non-interest bearing benefit payment checking account could be reduced substantially and will reduce such reserves providing the Department of Finance has no objections.