



## **Florida State Board of Administration**

### Securities Lending Process and Controls Assessment

Final Report  
December 2001

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# Methodology & Project Worksteps

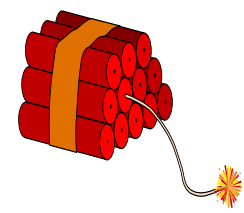
**Core Worksteps**



**SBA & SL Providers**

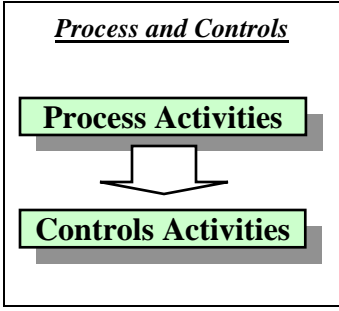
**Create Process Workflows**

- Create process workflows for securities lending activities



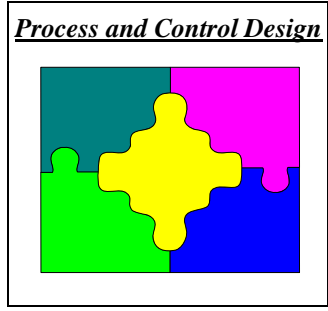
**Identify Risk Points**

- Identify the risks inherent within each workflow process



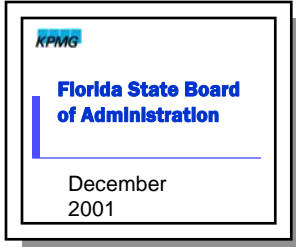
**Assess Processes And Controls**

- Assess the process and control design for each risk point identified



**Challenge Process and Control Design**

- Provide observations on design and control enhancement for each process and control assessed



**Management Presentation**

- Report to management providing prioritized observations

**Deliverable**

- Workflows for SBA's compliance monitoring of Security Lending providers
- Workflows of providers for broker acceptance, broker monitoring and mark to market
- Risk points within the processes documented
- Database of the SBA processes and controls with assessment
- Database of securities lending providers processes and controls with assessment
- Documented observation within database
- SAS 70 assessment
- Security lending contract assessment
- Management reports with observations and recommendations for improvement

*The following outlines this approach, scope and assumptions for the SBA securities lending process and controls assessment*

***Approach:***

- ≡ The approach of the securities lending assessment was executed as defined in the engagement letter. The assessment program developed by KPMG was approved by the SBA prior the start of the procedures.

***Scope:***

- ≡ The primary Securities Lending related activities which were assessed include:

- **SBA**

- Daily Compliance Review
- Monthly Compliance Review
- Daily Asset Transfer
- Semi-Annual Reporting Procedures
- Financial Operations
- Reconciliations (Cash and Position)

- **State Street (Boston), Deutsche Bank (New York) and Met West (Los Angeles)**

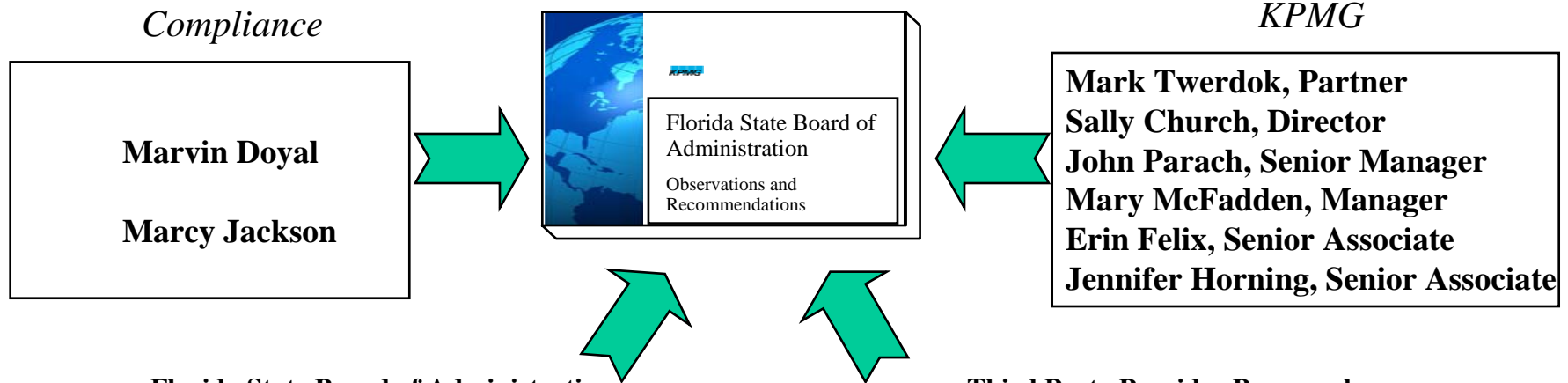
- Compliance functions
- Re-investment procedures
- Collateral monitoring
- Borrower approval and monitoring

***Assumptions & Rationale***

- ≡ The assessment of the providers consisted of inquiry and observation of their processes.
- ≡ Validation of processes and controls was limited to observation procedures on a test basis.
- ≡ As a result of the above procedures KPMG has provided observations and recommendations for improvement, the final decision to implement control enhancements is the responsibility of SBA.

# Participation throughout SBA contributed to the Risk Assessment effort

## SBA and Securities Lending Provider Participants

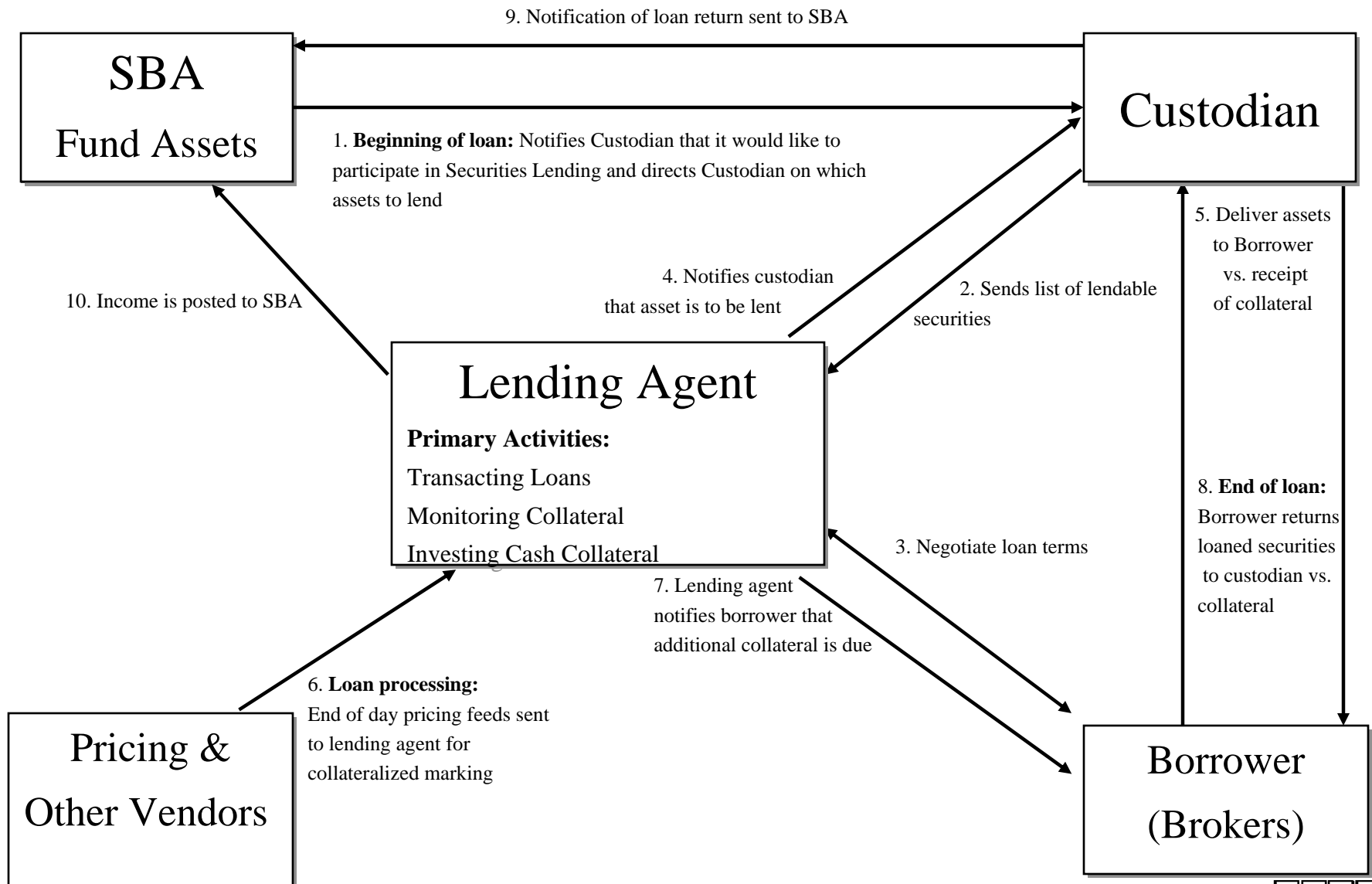


### Florida State Board of Administration

### Third Party Provider Personnel

<u><b>Fixed Income</b></u> Barbara Jarriel Lynn Thompson Amy Crumpler Carmen Ratcliff Lisa Collins Phyllis Cromer	<u><b>Financial Operations</b></u> Lori Guido Margaret Guimaraes Jeanne Hummewell	<u><b>Accounting</b></u> Memi Turkington Selina Hough Carol Simmons	<u><b>State Street Client Service</b></u> Henry Disano  <u><b>Compliance</b></u> Cinzia Liambo Carlotta DiPietro Margaret Nelson (SSgA)  <u><b>Credit Review</b></u> Bill Whitney Gino Timperio  <u><b>GSL Operations</b></u> Jack Saraf Michael Landolfi  <u><b>GSL A/L Management</b></u> Glenn Horner	<u><b>Met West Client Service/Risk Management</b></u> Dan Murphy  <u><b>CIO</b></u> Terry Crow  <u><b>Compliance</b></u> Tom Mackin Matt Riley  <u><b>Operations/Trading</b></u> Rob Womack Kevin O'Connor	<u><b>Deutsche Bank Client Service</b></u> John Fox  <u><b>Audit</b></u> Bruce Goldberg Elissa Diamond  <u><b>Operations</b></u> Frank Gambino Anthony Emilio  <u><b>Trading</b></u> Anthony Toscano Mikael Mulka
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# Securities Lending Transaction Description



***SBA's Lending Program involves interaction with several external parties:***

<b>SBA Fund</b>	<b>Custodian</b>	<b>Sub-Custodian</b>	<b>Securities Lending Provider</b>
Florida Retirement System	<b>State Street</b>	<b>Chase Manhattan</b>	<b>State Street, Met West, Barclays, SSGA, LB &amp; CSFB</b>
Local Government Surplus Fund Pool	<b>Bank of America</b>	<b>State Street, Chase Manhattan</b>	<b>Met West, Deutsche Bank, LB &amp; CSFB</b>
Florida Lottery Trust Fund	<b>Bank of America</b>	<b>Deutsche Bank</b>	<b>Deutsche Bank</b>
Chiles Tobacco Endowment Fund	<b>State Street</b>		<b>State Street, Met West &amp; Barclays</b>
Non-Qualified Domestic Equity Passive Pool	<b>State Street</b>		<b>Met West</b>
Non-Qualified Government / Corporate Passive Pool	<b>State Street</b>		<b>Met West</b>
CAT Fund	<b>Bank of America</b>	<b>Deutsche Bank</b>	<b>Deutsche Bank</b>

# *SBA's Securities Lending Program Summary Assessment*

*(Not necessarily recommendations)*

## ***Control Management***

- ⌘ Compliance monitoring program is comprehensive by industry standards
- ⌘ Informal escalation procedures are in place for reporting provider non-compliance to senior management
- ⌘ The current compliance review program is a manually intense process
- ⌘ Only certain investment guideline components are verified in the daily and monthly compliance review

## ***Performance***

- ⌘ Income opportunities may be lost as Fee Splits are not aggressive by industry standards

## ***Monitoring***

- ⌘ Securities lending income is reported as a part of their respective asset class. Securities lending income should also be reported separate and apart from other income earned on assets.

# *SBA's Securities Lending Program Summary Assessment*

*(Not necessarily recommendations)*

## *Design of Program*

- ⌘ There are seven different providers utilized for securities lending. As a result, there are multiple custodian / sub-custodian relationships which are entered into as well as numerous operational reconciliations and compliance reviews performed
- ⌘ In comparison to each other, the investment guidelines within the provider securities lending contracts are not consistent
- ⌘ On an individual transaction basis, there is an informal (undocumented) process in place over the decision of which securities to make available for loan and to which of the approved providers these securities should be made available to

## *Provider Summary*

- ⌘ State Street and Deutsche Bank each have an established securities lending program and a sizeable broker network
- ⌘ The size of State Street and Deutsche Bank results in a large pool of financial and personnel resources to leverage. Their size, however, can also be a disadvantage in that operational and technology enhancements can be delayed as securities lending is not their primary business focus
- ⌘ Because of the relatively small size of Met West they can focus on securities lending and react timely to customer requests for things such as ad hoc performance or compliance reporting

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# Summary Comments on SBA's Securities Lending Program

## COMPLIANCE DIRECTION OPPORTUNITIES

The current compliance program is comprehensive by industry standards and executed by a knowledgeable staff with an understanding of key business risks, three opportunities for improvement exist for SBA:

### Lending Strategy

- ❧ The assessment of securities lending providers performance could be enhanced to benchmark current provider performance to industry standards for on-loan volumes and return on investment.
- ❧ A formalized policy / methodology should be developed which specifies which funds / securities are eligible for lending and which providers should be used for lending.

### Compliance Approach

- ❧ If information received to monitor provider compliance could be received electronically, this could eliminate manual data entry and allow for automated recalculations and comparison of provider information.
- ❧ Additional compliance procedures should be performed to independently verify provider information such as reviewing reinvestment fund financials, SAS 70's and performing recalculations.

### Performance and Compliance Reporting

- ❧ Current procedures should be formalized which require provider non-compliance with the terms of the securities lending agreements to be reported to SBA Compliance and the applicable SBA Investment Chiefs.
- ❧ Formal procedures should be considered to report to the Board a comparison of provider performance to each other as well as to industry standards.

Detailed observations and recommendations are included throughout pages 14 through 24 within this report supporting the above comments

# *Summary Comments on SBA's Daily & Monthly Compliance Review*

*Securities Lending compliance activities are primarily manual and deployment of automation and process enhancements should be considered*

## **Limiting Factors:**

- ⌘ Dependent upon Securities Lending Providers ability to deliver requested information in format that can be easily manipulated.
- ⌘ Amount of time SBA is able to devote to performing compliance reviews over securities lending.

## **Summary Observations:**

- ⌘ Currently there are **informal** escalation procedures for reporting provider non-compliance to senior management.
- ⌘ Each of the providers have exception reports used to perform daily reviews of compliance with reinvestment guidelines. These exception reports should be incorporated by the SBA in their daily reviews.
- ⌘ The current process to perform the daily and monthly compliance review is a manually intense process. In general, reports are manually verified and provider information manually keyed into databases.
- ⌘ Not all of the investment guidelines that are specified in the securities lending contracts with the providers are verified on a daily basis or monthly. **SBA uses professional judgment to select guidelines for verification.**
- ⌘ Written procedures do not reflect the objectives of the compliance review and are not updated to reflect the provider reports that are actually used to perform the compliance reviews.
- ⌘ Formal written procedures do not exist for certain processes such as the monthly compliance reviews or reviews of adjustments and/or expense items.

## *Observations identified for the process and control activities assessed*

### SUMMARY STATISTICS

	<u>Daily</u>	<u>Monthly</u>	<u>Other</u>	<u>Total</u>
<b>Number of Core Processing Activities Reviewed</b>	<b>3</b>	<b>3</b>	<b>1</b>	<b>7</b>
<b>Number of Tasks supporting Core Processes</b>	<b>8</b>	<b>37</b>	<b>29</b>	<b>74</b>
<b>Number of Core Processes with Observations/ Recommendations</b>	<b>15</b>	<b>37</b>	<b>7</b>	<b>59</b>

- ⌘ All of the observations are included in the process “factsheets” and the most significant process and technology observations are provided on the following pages.
- ⌘ The suggested prioritization of the observations are aligned with the inherent risk of each activity.

## *Daily Compliance Review*

<b>Priority</b>	<b>Observation</b>	<b>Recommendation</b>	<b>SBA Response / Action to Date</b>
<b>Med</b>	Currently only new investments are looked at for compliance with the investment guidelines. An informal review is performed of the entire investment list to identify rating changes or duration exceptions, however, the results of the informal review are not documented.	Consideration should be given to periodically reviewing the entire investment list to determine if the investments held are still in compliance (i.e. no technical non-compliance issues resulting from changes in ratings / market values).	<p>Comprehensive compliance is typically conducted monthly on all FRS portfolios (Domestic Equities, International Equities and Fixed Income) as well as the securities lending portfolios. Intra-month for the securities lending programs, we review daily activity reports to verify new purchases for compliance and monitor the margins of collateral on the loans. If our internal credit staff notifies us of a downgraded corporate security, we check our lending reinvestment portfolios to see if the security is held. If it is held by any of the portfolios, we discuss with the providers and agree on the plan of action.</p> <p>It would be illogical to devote more time or review to securities lending than to the underlying managed assets. An analysis of new holdings and credit monitoring virtually constitutes a comprehensive daily review. Also to conduct a more in-depth daily review of all of the cash reinvestment portfolios would require additional resources. More employees would be needed on our staff or a complex compliance system where we could electronically download the data from the providers and profile per the guidelines.</p>

## *Daily Compliance Review, Continued*

<b>Priority</b>	<b>Observation</b>	<b>Recommendation</b>	<b>SBA Response / Action to Date</b>
<b>Med</b>	Currently, there are informal procedures for communicating provider non-compliance to SBA senior management.	The SBA SL Unit should consider developing a database to capture service provider non-compliance issues. This database could be used to report non-compliance issues to the SBA Compliance unit and the applicable SBA Investment Chiefs.	<p>All violations are reported to the Fixed Income Chief via the monthly compliance summary packet. Luckily, we have not experienced major violations (defaults of borrowers, defaults of issuers, etc); however, if there is a situation (not even a violation) that is considered “serious” by the Senior Portfolio Manager, it is brought to the attention of the Chief of Fixed Income. Also an explanation of how it will be handled is given to the CFI. An example: negative income for a month – why is it happening, how it will be reversed, discussions with the provider and documentation received from the provider will all be explained to the CFI. Also notations will be made on the monthly securities lending compliance for that provider.</p> <p>Asset Class Chiefs are delegated broad programmatic authority within their areas. Judgment is applied as to which circumstances warrant notification to the Executive and Deputy Executive Director. Naturally a major violation as defined would be reported.</p>

## *Daily Compliance Review, Continued*

<b>Priority</b>	<b>Observation</b>	<b>Recommendation</b>	<b>SBA Response / Action to Date</b>
<b>Med</b>	<p>For Deutsche Bank and Met West there are two sets of investment guidelines one for Open Account loans and another for Term Account loans. Currently, the compliance checklist only addresses compliance with the Open Account loans and does not address Term Account loans. In addition, SBA can not distinguish between open and term loans on the reports that are provided from Deutsche Bank.</p>	<p>Reports should be requested from Deutsche Bank which would give SBA the ability to distinguish between Term and Open Account loans. Once this distinction can be made, the applicable investment guidelines should be used to monitor compliance.</p>	<p>These guidelines were originally established with Bankers Trust. Bankers did furnish us reports distinguishing the loans; however when Deutsche Bank came into the picture, the management “style” of the program changed as well as the system used to produce reports. We are working with Deutsche Bank to receive the data necessary on our programs. Dated systems cause many of the reporting issues we are forced to deal with from providers.</p> <p>Most of the “custodian” type providers for securities lending such as Deutsche Bank and State Street are behind the smaller boutique third party lenders in technology. There seems to be obstacles for getting resources committed to update systems in their organizations. Met West has the separate guidelines for loans but with their technology it is easily reportable.</p> <p>We do, however, recognize that our contract with Deutsche Bank (Bankers Trust) needs to be updated and revised. This process is currently underway. Also we will be reviewing combining the guidelines of the open and term loans into one set of guidelines for the reinvestment of cash collateral for both the Deutsche Bank and the Met West programs. The State Street program only has the one set of guidelines.</p>

## *Daily Compliance Review, Continued*

<b>Priority</b>	<b>Observation</b>	<b>Recommendation</b>	<b>SBA Response / Action to Date</b>
<b>Med</b>	Daily reports from Deutsche Bank are in Acrobat file format. These reports can not be modified or reformatted by SBA	The SBA SL Unit request the information in Excel so that information can be systemically analyzed against prior day's information for reasonableness.	We have been in constant and continual discussions with Deutsche Bank concerning reporting issues. Having the information in Excel would be great for us, however, receiving information we consider important, whether it is in Excel or some other format is the ultimate goal. We have provided Deutsche Bank with feedback on each and every report they have produced or are currently working on. This appears to be a slow process for Deutsche Bank and custodians in general. (Refer to paragraph 2 on comment number three)
<b>Med</b>	For Met West the daily information received from Met West is in Excel, however we did not observe that the data is manipulated to perform any analysis on Met West's SL program.	The SBA SL Unit should consider systemically analyzing the information in Excel file for reasonableness.	Met West's reports are received in Excel and are manipulated daily or anytime we feel it is necessary. On a daily basis, we manipulate the reinvestments and loans to determine if Met West has met their minimum liquidity (overnight) requirement of 25%. In addition, Met West's reports are typically fashioned pursuant to prior discussions with the SBA; therefore, it is not necessary to have to manipulate the data in order to check our daily compliance. However, we have the ability to manipulate all daily data received from Met West as we deem necessary.

## *Daily Compliance Review, Continued*

<b>Priority</b>	<b>Observation</b>	<b>Recommendation</b>	<b>SBA Response / Action to Date</b>
<b>Med</b>	<p>For State Street the Daily Compliance checklist only covers concentration risk for corporate issuers. The investment guidelines specify other concentration risks which are not tested for as follows:</p> <ul style="list-style-type: none"> <li>⌘ US Government STRIPS: not more than 20% of the Short Term Fund</li> <li>⌘ Asset Backs: Not more than 20% of the Short Term Fund</li> <li>⌘ U.S. and Foreign Banks: Not more than 5% of the Short Term Fund</li> <li>⌘ Money Market Fund: Not more than 5 % of the NAV, up to 10% of the Short Term Fund's holdings invested in a single money market Fund, up to 50% of the Short Term Fund's assets may be invested in money market mutual funds</li> </ul>	<p>Consideration should be given to testing concentration risk compliance for all issue types as stipulated in the investment guidelines rather than just corporate issues.</p>	<p>Custody banks appear to be lacking in their ability to produce more meaningful reports as compared to third party lenders. The specific information concerning concentration risk is not received from State Street Bank on a daily basis. However, we do receive month-end information that gives us the ability to monitor these concentration issues, and as such, have included this in our monthly compliance checklist. (Refer to comment number one for additional context)</p>

## *Daily Compliance Review, Continued*

<b>Priority</b>	<b>Observation</b>	<b>Recommendation</b>	<b>SBA Response / Action to Date</b>
<b>Low</b>	The SBA SL Unit's desktop procedures for each of the providers do not accurately reflect the reports that are printed from State Street's website on a daily basis.	The SBA SL Unit should confirm that the procedures accurately reflect the reports that are printed/received from each of the providers.	Procedures are reviewed and updated annually, at a minimum. Per review of the comment by KPMG and our State Street procedures (daily and monthly), we see no discrepancies between the reports listed in the procedures and the reports used to complete our compliance.
<b>Low</b>	Broker Exposure Reports are received that list total loan amounts to each broker, however, a formal review to determine if the brokers being utilized are approved is not performed. Note, approved broker lists are received monthly.	Consideration should be given to performing a periodic review to ensure that only approved brokers are utilized to transact securities lending with. Note the securities lending agreement specifies that only approved brokers will be utilized.	We do not approve each and every borrower. We rely on the credit work of our lenders to determine creditworthiness and set limits for each borrower. We require borrower indemnification to mitigate this factor. However, we have added to our monthly compliance a check to ensure we receive the most current approved borrower list for information. SBA would inquire about borrower approval or limits only in extraordinary situations, and then only for credit updates from the provider. It is the responsibility of the compliance group from each provider to monitor if their traders use approved borrowers.

## *Daily Compliance Review, Continued*

<b>Priority</b>	<b>Observation</b>	<b>Recommendation</b>	<b>SBA Response / Action to Date</b>
<b>Low</b>	Organization wide broker exposure amounts, which includes securities lending and activities other than securities lending, are not set by SBA and are consequently are not monitored to ensure that SBA is not overexposed to one broker. Note, risk to SBA is partially mitigated by indemnification from providers.	Consideration should be given to setting SBA wide exposure limits for each of the brokers that SBA has loans to with. This would allow SBA the ability to assess its' credit risk for the total relationship SBA has with the broker.	<p>We agree that the exposure to borrowers over all of our programs would be good information. However, limiting exposure to a borrower would require credit work on our part to derive limits and ongoing credit work to support the decision. This is the main reason we have borrower default protection in our contracts thus relying on the resources of the providers and their decision on limits with borrowers under contract.</p> <p>In terms of “overall” dealer exposure, we are collateralized in the securities lending program and most of our trading transactions are DVP so actual broker “loss” potential is not an issue.</p>

## *Daily Compliance Review, Continued*

<b>Priority</b>	<b>Observation</b>	<b>Recommendation</b>	<b>SBA Response / Action to Date</b>
<b>Low</b>	For State Street the investment guidelines state that exposure to single corporate issuers should not exceed 5% of the total market value of the Short Term Fund. The reports received from State Street which are used to monitor compliance with the aforementioned show the percentage of exposure to each issuer based on par value of the security rather than market value.	A request should be made to State Street to provide reports with market value of securities rather than par value and the market value reports should be used to calculate the 5% exposure amount.	We agree with this recommendation and State Street is aware of this concern. In our guidelines for this program we did not state market value but used 5% of assets. Most cash reinvestment portfolios for securities lending are managed like a money market fund. It is almost impossible to daily mark to market the assets so amortized cost is generally used for valuation. However, State Street's current system for furnishing us data does not provide amortized cost. They are, however, in the process of establishing a new client reporting system but we haven't seen anything to date and expressed our interest in being a beta test for them.
<b>Low</b>	For Deutsche Bank, the Issuer / Counter party limits are set, per the investment guidelines, based on book value. The reports that SBA is using to monitor these limits is based on Principal Cost.	SBA should confirm with Deutsche Bank that Principal cost currently being used to monitor issuer / counter party limits equates to book value.	This issue was discussed with John Fox of Deutsche Bank. He indicated to us that Principal Cost as listed on our reports received is Book Value.

## *Daily Compliance Review, Continued*

<b>Priority</b>	<b>Observation</b>	<b>Recommendation</b>	<b>SBA Response / Action to Date</b>
<b>Low</b>	For State Street the investment guidelines state that the average effective duration of the fund will not exceed 120 days. Currently, SBA uses average days to maturity (approximately 1,500 days) and days to next reset (approximately 35 days) to measure compliance to this benchmark.	In order to ensure that investment guidelines are being properly monitored, SBA should verify the calculation of the average days until maturity with State Street to ensure that is in fact the average effective duration.	This is a limitation of the reports we currently receive from State Street Bank. Upon further questioning of our client representative, this information is available and will be provided.
<b>Low</b>	For Deutsche Bank the investment guidelines have exposure limits for each of the issuer countries that Deutsche Bank invests in. Per review of the reports that Deutsche Bank provides, it appears SBA performs a review of country exposure, however, the review of this report is not documented on or required by the checklist.	Consideration should be given to formalizing and documenting the review of country exposure limits. This can be accomplished by including the review of country exposure limits as a step on the daily checklist and documenting on the checklist SBA's compliance status.	The statement from KPMG is correct. We review the country exposure for Deutsche Bank on a daily basis to ensure compliance with the guidelines. However, it was not formally documented on our daily compliance checklist. We have modified our compliance checklist to formalize this procedure.

## *Daily Compliance Review, Continued*

<b>Priority</b>	<b>Observation</b>	<b>Recommendation</b>	<b>SBA Response / Action to Date</b>
<b>Low</b>	For Deutsche Bank and Met West the investment guidelines have limits set on the amount of illiquid securities which can be purchased. Currently, SBA relies on the providers to notify them of when an illiquid security is purchased and does an informal search of the investment detail. There is currently not a formalized process or formal definition of illiquid securities.	Definitions should be developed for illiquid securities and a process should be formalized with the providers where they notify SBA in writing each time an illiquid security is purchased.	Our investment guidelines define illiquid securities, though broad. We review all new purchases of securities on a daily basis. We can identify securities that are atypical or not generally recognized as readily liquid. We then question the provider as to what these securities actually are and make a determination as to whether they are considered illiquid or not. Met West and Deutsche Bank both provide us with lists of authorized firms for which they are eligible to enter into funding agreements. In addition, Met West provides a daily compliance checklist, which we can use to compare our illiquid holdings, as well as other issues, to ensure we are in agreement.

## *Daily Asset Transfer*

<b>Priority</b>	<b>Observation</b>	<b>Recommendation</b>	<b>SBA Response / Action to Date</b>
<b>High</b>	<p>There is currently no documentation of the rationale as to why the assets were made available for loan or as to which lending agent was selected to make them available to.</p>	<p>Consideration should be given as to whether the SBA SL Analyst should be required to document reasons for making securities available to lending agents. The SBA SL Analyst should also document reasons for making securities available to lending agents.</p> <p>Additionally, the SBA SL Analyst should have standard guidelines (policy) to follow with regards to determining how many and which assets should be sent to each securities lending provider</p>	<p>In managing the securities lending programs since the early 1980s, we have moved from very rigid programs to more flexible programs to allow for movement of assets between providers or to replace maturing securities. We continue to work on our contracts to allow each provider to lend all assets (domestic equities, international equities, and fixed income securities) and for multiple funds (FRS, Chiles, Local Gov't Pool, Lottery). We are allowed by contract to add funds by notification in writing to the provider. This flexibility allows us to monitor the performance of the provider lending the same asset type. The SBA SL Analyst has the knowledge of assets lent by each provider. The Senior Portfolio Manager has set "soft limits" on the Deutsche Bank and the Met West programs. These limits are not set by policy but from experience of managing the programs. The State Street program has access to lend all of the FRS securities with the exception of approximately \$1.2 billion of treasury securities held in the internal passive index portfolio. In the Deutsche Bank and Met West programs, the SBA SL Analyst is aware of these "soft limits" and can move assets in the programs with these limits.</p>

# *Daily Asset Transfer, Continued*

Priority	Observation	Recommendation	SBA Response / Action to Date
<b>High</b>	Continued from prior page.	Continued from prior page.	<p>If the situation arises where there are more securities to be placed with a provider than the “soft limit” allows, the SBA SL Analyst discusses this with the Senior Portfolio Manager and a decision is reached. The SBA SL Analyst works with the portfolio managers to maintain a list of securities that are lendable and nonlendable. The SBA SL Analyst uses this list when a program has maturing assets and replacements are needed. The SBA SL Analyst maintains a current list of available securities for lending. Also, it is not documented but we do have a newly created weekly report (established July, 2001) for all of the programs showing total available for loan, on loan, and percent on loan where we report this “soft limit” for each provider.</p>

## *Daily Asset Transfer, Continued*

<b>Priority</b>	<b>Observation</b>	<b>Recommendation</b>	<b>SBA Response / Action to Date</b>
<b>High</b>	There is significant reliance upon one individual to do asset transfers within Financial Operations. There is another individual who is designated as a replacement for this function, however, it appears that they do not have an in-depth knowledge of the position (only know the mechanics of the function and not the rationale for performing the functions).	SBA should consider cross training staff within financial operations.	Jeanne Hunnewell is the designated FinOps staff person responsible for handling the day-to-day activities of securities lending and our communication with the custody banks involved in the process. Jeanne's designated backup is Margaret Guimaraes. However, Kim Phillips has also been trained to work Jeanne's desk in her absence.
<b>Med</b>	A formal daily confirmation / reconciliation with the Bank of America to verify that asset transfers were processed properly did not appear to be in place.	SBA should confirm that a formal reconciliation with Bank of America to verify that asset transfers were processed properly is performed.	All security transactions with Bank of America result in a physical confirmation being sent to the SBA. These confirms usually are transmitted 3 to 5 days after the transaction is completed. However, Jeanne does talk to BOA's custody group and the SL custodian's group on a daily basis and verbally confirms the completion of each transfer.

## *Daily Asset Transfer, Continued*

<b>Priority</b>	<b>Observation</b>	<b>Recommendation</b>	<b>SBA Response / Action to Date</b>
<b>Med</b>	There is no second SBA SL Analyst reviewing the spreadsheet used to by the SL unit to track the location of securities.	A second SBA SL Analyst should review the spreadsheet to verify that it is accurate.	The securities lending spreadsheets are reconciled back to dealer reports the following morning to confirm spreadsheets totals from the previous day. This allows the SBA SL Analyst to maintain accuracy to the securities lending spreadsheets.

## *Daily Cash & Position Reconciliation*

<b>Priority</b>	<b>Observation</b>	<b>Recommendation</b>	<b>SBA Response / Action to Date</b>
<b>Med</b>	<p>Currently each cash account that is reconciled is assigned to an analyst. The analyst is responsible for reconciling the account identifying variances, sending the reconciling items to the appropriate operations personnel for resolution and monitoring the items until they are cleared. Two observations were noted with this process:</p> <ul style="list-style-type: none"> <li>⌘ Currently a standardized procedure is not in place where the reconciliations are reviewed and signed off by a supervisor.</li> <li>⌘ There is not a “management report” which lists and ages all outstanding reconciling items.</li> </ul>	<p>A summary management report should be developed which lists and ages all outstanding reconciling items. If developed, the report would be used by the manager of the reconciliations area to identify reconciling items and escalate issues identified to the proper levels of management.</p>	<p>The securities lending cash account (JK2Z) is assigned to an SBA accountant. The accountant prepares a daily reconciliation between the Met West activity and the State Street Bank activity. The reconciliation includes a description of the item, the fund affected, and the date that the item was posted. Each reconciling item remains on the daily reconciliation until it is resolved by the appropriate party (either Met West or State Street Bank). This reconciliation serves as an aging schedule and is used by the accountant to identify problems that may need to be forwarded to higher levels of management.</p> <p>In addition, the accountant compares his reconciliation to the one provided daily by Met West. The Met West reconciliation (which also reconciles the activity per Met West to the activity per State Street Bank) includes a detailed description of actions taken to resolve discrepancies. Any discrepancies between the SBA and Met West reconciliation, other than timing issues, are immediately brought to the attention of the responsible party at Met West and closely monitored by SBA until resolved.</p>

## *Monthly Compliance*

<b>Priority</b>	<b>Observation</b>	<b>Recommendation</b>	<b>SBA Response / Action to Date</b>
<b>Med</b>	There are no formal written policies in place detailing SBA’s policy for performing monthly compliance reviews. The procedures currently written do not agree with the compliance steps that are currently being performed by SBA's staff.	Consider developing formal polices for the monthly compliance function and updating the current procedures to detail the monthly compliance processes that are currently being performed.	There is no “formal” written policy on compliance. Compliance monitoring is a process performed on all written policies, guidelines and contracts. When changes occur to these policies, guidelines and contracts, these revised elements are monitored for compliance. The written procedures are the actual compliance forms for each program or portfolio.
<b>Med</b>	Currently, the Monthly Compliance checklist is a review of compliance with investment guidelines and collateral requirements as of the last day of the month as opposed to a summary of compliance with guideline and collateral requirements throughout the month.	Consideration should be given to summarizing the results of the Daily Compliance checklists on the Monthly Compliance checklist. The Monthly Compliance Review would then detail any out of compliance issues regarding the investment guidelines and collateral requirements that occurred during the month.	Compliance is performed on each provider on a daily basis as well as at month-end. Our intra month compliance is more extensive than other programmatic activities (refer to comment number one). All providers, at one time or another, fall out of compliance. Most, if not all, out of compliance issues are corrected the next business day. If there were to be a substantial violation of the contract or investment guidelines, this violation would be brought to the attention of the Senior Portfolio Manager and the Chief of Fixed Income immediately.

## *Monthly Compliance, Continued*

<b>Priority</b>	<b>Observation</b>	<b>Recommendation</b>	<b>SBA Response / Action to Date</b>
<b>Med</b>	A new monthly compliance report for State Street with updated guidelines has been developed but not yet implemented.	Consider updating the Met West and Deutsche monthly compliance forms as has been done for State Street.	As of July, 2001, all compliance forms were reviewed and the necessary changes included for each of the programs. This is part of an annual review that is conducted on our entire Fixed Income compliance process, not just securities lending.
<b>Med</b>	Currently two databases are being maintained (excel and access) for monthly historical information and report preparation. Data is being loaded manually. The goal is to retain and only use the access database.	Develop an electronic interface with State Street, Deutsche and Met West to receive data without manual intervention. Work with the SBA's technology group to facilitate the migration to the access database. Consider writing queries in access to verify the reasonableness of the transmission feeds from the providers.	We agree with the recommendation and all of our providers are aware that eventually we want to receive the data electronically but it doesn't happen just because we say it. Our data center has been very supportive in our use of the Access Database; however, as we have discovered, there aren't "experts" on Access. You have to figure it out for yourself and Amy Crumpler has done an excellent job working on this project. We are making progress on the reports being produced.

## *Monthly Compliance, Continued*

<b>Priority</b>	<b>Observation</b>	<b>Recommendation</b>	<b>SBA Response / Action to Date</b>
<b>Med</b>	Income adjustments and/or expense items are reviewed on a monthly basis using reports provided by Met West. There is currently not a policy in place that establishes requirements for reporting income adjustments / expenses on the monthly compliance report. In addition, there are no formalized escalation procedures where management is informed of income adjustments / expenses once they exceed a certain dollar amount.	Consider developing a formal policy that details the criteria for reviewing and reporting income adjustments and/or expense items on the monthly compliance report. Consider developing a dollar threshold (materiality amount) for those items reported to the unit head.	Most expense adjustments relate to overdraft fees charged by the custodial bank. Met West is responsible for paying all bank fees associated with our lending accounts. However, with most overdrafts, there is typically a claim that has been made to a broker to cover such expense. Most times, the expense shows up in one month and the offsetting claim will follow the next month. We do not believe a formal policy is necessary to address such issues. If we see large expense adjustments, we follow up with Met West as to the status of the items and follow up in subsequent months to ensure we receive proper compensation. If there were items that did not reverse themselves, we would bring this to the attention of the provider and the Chief of Fixed Income. Typically, these are very small dollar amounts.

## *Monthly Compliance, Continued*

<b>Priority</b>	<b>Observation</b>	<b>Recommendation</b>	<b>SBA Response / Action to Date</b>
<b>Med</b>	Securities lending income must be received on a specific date from Deutsche (15 <sup>th</sup> business day) and Met West (5 <sup>th</sup> business day) while State Street's income only has to be received in a reasonable time.	Consider holding State Street to a specific date to submit income. They do provide the largest amount of income. This may mean adding an amendment to the contract.	We agree there are several issues that <u>need</u> to be amended in the State Street securities lending contract. The State Street's contract does not define a date for receipt of income from securities lending. State Street does generally post the income to the individual portfolios by the 15 <sup>th</sup> business day. Our client representative has agreed that the 15 <sup>th</sup> business day is a "reasonable time".
<b>Med</b>	A recalculation of securities lending income is not performed. Only the split is checked. While the date of the receipt of monthly income is shown on the monthly compliance report, the amount is not.	Consider recalculating securities lending income and including the amount of the income on the monthly compliance report. Obtain from State Street sufficient breakout of information such as the gross fees, the providers expenses with an explanation and then the net fees and split.	To recalculate the securities lending income would require the SBA to post every transaction from the providers and receive trade information from borrowers and dealers. We do receive the gross data from the providers and use our own calculation for reinvestment rates and rebate rates. This provides a reasonableness check and allows us a method of comparing data between providers.

## *Monthly Compliance, Continued*

<b>Priority</b>	<b>Observation</b>	<b>Recommendation</b>	<b>SBA Response / Action to Date</b>
<b>Med</b>	Currently, Met West and Deutsche Bank reports are scanned prior the addition of notations. In addition, there does not appear to be a consistent retention policy for the number of months to retain hard copies of provider reports.	Met West and Deutsche Bank reports should be scanned subsequent to review and addition of notations (similar to the State Street process). In addition, retention policies should be developed for the number of months to retain hard copies of the reports.	All notations noted on any report for Deutsche Bank or Met West are now being summarized on the monthly compliance coversheet. The Board is in the process of developing retention policies which will address how long copies of reports are required to be kept. Currently, all information is scanned into our document management system, so the information is retrievable if necessary.
<b>Med</b>	Margins on non-cash loans at State Street are recalculated. If State Street is out of compliance a judgment call is made regarding the reporting of this on the monthly compliance report. There are no formalized escalation procedures in place to report out of compliance issues to management.	Consider developing a formal policy that details the criteria for reviewing and reporting margin items on non-cash loans on the monthly compliance report.	If there is an issue with the margin on any non-cash loan with State Street, we request documentation to either confirm or deny the out of compliance issue. If it is determined that the margin on any particular loan is under-collateralized, the provider would be considered out of compliance. This will be reported to the Chief of Fixed Income on the monthly compliance report that is compiled each month. We do not believe a formal policy is necessary. The provider is either in compliance or not, no dollar threshold would be applicable.

## *Monthly Compliance, Continued*

<b>Priority</b>	<b>Observation</b>	<b>Recommendation</b>	<b>SBA Response / Action to Date</b>
<b>Low</b>	Information is received each month on the tri-party loans outstanding at month end (if any) and any repurchase agreements on reinvestment on the last day of the month (if any). Met West delivers its' reports by the 10 <sup>th</sup> business day after month end, Deutsche by the 15 <sup>th</sup> business day and State Street within a reasonable time period. The cash collateral for each is checked as to segregation in its' own account and as to its' being within the guidelines. A judgment call is made as to whether mention of non-compliance is included on the monthly report.	Consider developing a standardized reporting date with State Street requiring all of their reports to be completed by a pre-determined date. Consider developing a formal policy that details the criteria for reviewing and reporting tri-party loans and repurchase agreements on reinvestment on the last day of the month on the monthly compliance report.	State Street's contract does not specify a particular date for reporting or income receipt. Our client representative has agreed that the 15 <sup>th</sup> business day is a "reasonable time" for which we should receive reports. We do not believe a formal policy is necessary. A provider is either in compliance or not. If not, this information will be summarized on our monthly compliance, which is reported to the Chief of Fixed Income.

## *Monthly Compliance, Continued*

<b>Priority</b>	<b>Observation</b>	<b>Recommendation</b>	<b>SBA Response / Action to Date</b>
<b>Low</b>	The person who signs the “Reviewer” section of the monthly compliance report is actually the preparer of the report and the reviewer of the monthly compliance report initials the report.	Consider including a signature line for “Prepared by” and “Reviewed by” on the monthly compliance report.	Our procedure for compliance has always been to have the person conducting the review to sign and date when completed. The Senior Portfolio Manager would then review all processes, make notations, and initial each review. We have now added two lines to each process – “Prepared by” with date and “Reviewed by” with date consistent with the recommendation.

## *SAS 70 Considerations*

**SAS 70 Benchmarking:** The SAS 70 Reports of the three providers reviewed were benchmarked against one another. The table below indicates which objectives are not included in the respective SAS 70 Reports.

<b>Core Processes</b>	<b>SS</b>	<b>DB</b>	<b>MW</b>	<b>Objective</b>
<b>Client Lending Agreement Provisions</b>	✓	GAP	✓	Verification of entry of data from security lending agreement into system.
<b>Borrower Approval and Monitoring</b>	✓	✓	GAP	Authorization for changes to borrower credit limits
	GAP	✓	✓	Procedure to notify borrower that security has been sold and obtain the security's return.
<b>Collateral Monitoring</b>	✓	GAP	GAP	Procedure in place for safeguarding of collateral.

## *SAS 70 Considerations*

**SAS 70 Benchmarking:** The SAS 70 Reports of the three providers reviewed were benchmarked against one another. The table below indicates which objectives are not included in the respective SAS 70 Reports.

<b>Core Processes</b>	<b>SS</b>	<b>DB</b>	<b>MW</b>	<b>Objective</b>
<b>Collateral Investment</b>	✓	GAP	GAP	Use of independent pricing source to value loans and investments.
	✓	✓	GAP	Initiation of investing/lending transactions by authorized personnel.
	GAP	✓	✓	Capture and monitor interest on loaned securities.
	GAP	✓	GAP	Capturing corporate actions.

## *SAS 70 Considerations*

**SAS 70 Benchmarking:** The SAS 70 Reports of the three providers reviewed were benchmarked against one another. The table below indicates which objectives are not included in the respective SAS 70 Reports.

<b>Core Processes</b>	<b>SS</b>	<b>DB</b>	<b>MW</b>	<b>Objective</b>
<b>Loan Processing</b>	GAP	✓	✓	Maintenance and use of queue process.
	GAP	✓	GAP	Daily update of availability of securities to be loaned
	✓	✓	GAP	Recording of trade desk phone line and retrieval capability.
	✓	✓	GAP	Daily ensure proper recording of transactions for information provided to clients.
	GAP	✓	✓	Procedure to notify borrower of pending sale and obtain the security's return from loan.

## *SAS 70 Considerations*

**SAS 70 Benchmarking:** The SAS 70 Reports of the three providers reviewed were benchmarked against one another. The table below indicates which objectives are not included in the respective SAS 70 Reports.

<b>Core Processes</b>	<b>SS</b>	<b>DB</b>	<b>MW</b>	<b>Objective</b>
<b>Client Reporting</b>	✓	✓	GAP	Proper review of monthly generated client statements.
<b>Systems Information</b>	✓	GAP	GAP	Maintenance of a disaster management plan.
	✓	GAP	GAP	Formally test disaster management plan.

## *Contract Review Summary*

### **Observation:**

- ⌘ **Fee Split:** SBA derives 78% of lending fee revenue under the State Street contract and 75% of lending fee revenue under the Deutsche Bank and Met West authorizations. The difference in the fee split may be attributable to State Street's relationship as a custodian which would allow them to earn additional fee revenue.

### **Recommendation:**

- ⌘ SBA may wish to negotiate similar fee arrangements with both Deutsche Bank and Met West which would be more favorable to the SBA and in turn generate more fee revenue.

### **Observation:**

- ⌘ **Lending Opportunities:** Both the Deutsche Bank and State Street authorizations contain provisions indicating that the securities will be loaned pursuant to some type of equitable process. The Met West contract does not include this type of language.

### **Recommendation:**

- ⌘ The Met West contract should be amended to include a provision whereby Met West agrees that its lending desk will have a process that fairly allocates lending opportunities with respect to the SBA securities available for loan.

## *Contract Review Summary, Continued*

### **Observation:**

- ⌘ **Finder's Fees:** These are specifically not permitted under the terms of the Met West authorizations. The Deutsche Bank does not include this prohibition which according to SBA personnel was inadvertently left out of the contract. Operationally, however, no finder's fees are charged by Deutsche Bank. The State Street authorization does not address finder's fees. It is unclear whether operationally any finder's fees are being charged, since State Street statements do not show any additional fees except fees for the investment management of the separate account.

### **Recommendation:**

- ⌘ Deutsche Bank authorization should be amended to reflect the prohibition on finder's fees in order to ensure compliance in the future. If finder's fees should be prohibited in all contracts, this should be reflected in an amendment to the State Street authorization.

### **Observation:**

- ⌘ **Contract Administration:** The Deutsche Bank authorization has never been modified to reflect the change in the Lending Agent from Banker's Trust.

### **Recommendation:**

- ⌘ An amendment reflecting the proper name of the Lending Agent should be executed, perhaps in connection with the clarification (recommended above) regarding finder's fees.

## *Contract Review Summary, Continued*

### **Observation:**

- ⌘ **Collateral Investment:** Cash Collateral is invested by all three lenders in separate account portfolios governed by specific collateral investment guidelines. The investment guidelines for both Deutsche Bank and Met West are similar with respect to Credit Quality, Eligible Investments and Counterparty Limitations. However, the maximum weighted average portfolio maturity for the Met West portfolio is 45 days, but is 60 days for the portfolio held by Deutsche Bank. Moreover, the Florida STIF, managed under the State Street authorization permits an average effective duration of 120 days.

### **Recommendation:**

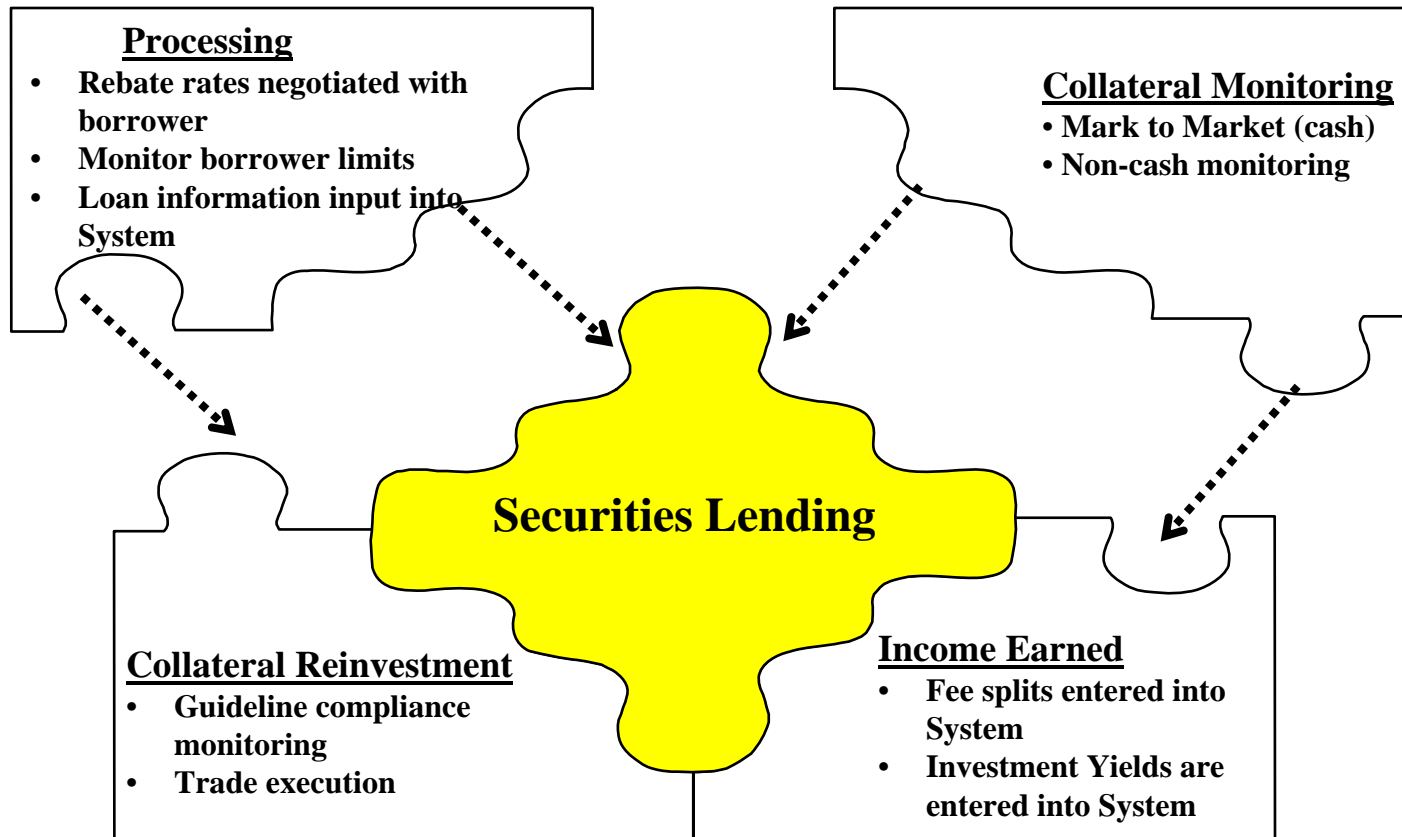
- ⌘ SBA may wish to consider whether all portfolios should have comparable maturity parameters; recognizing that shorter maturity durations will decrease risk but also potentially decrease lending income.

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# Key Components of Securities Lending

*From the provider's prospective, there are several core processes associated with securities lending.*

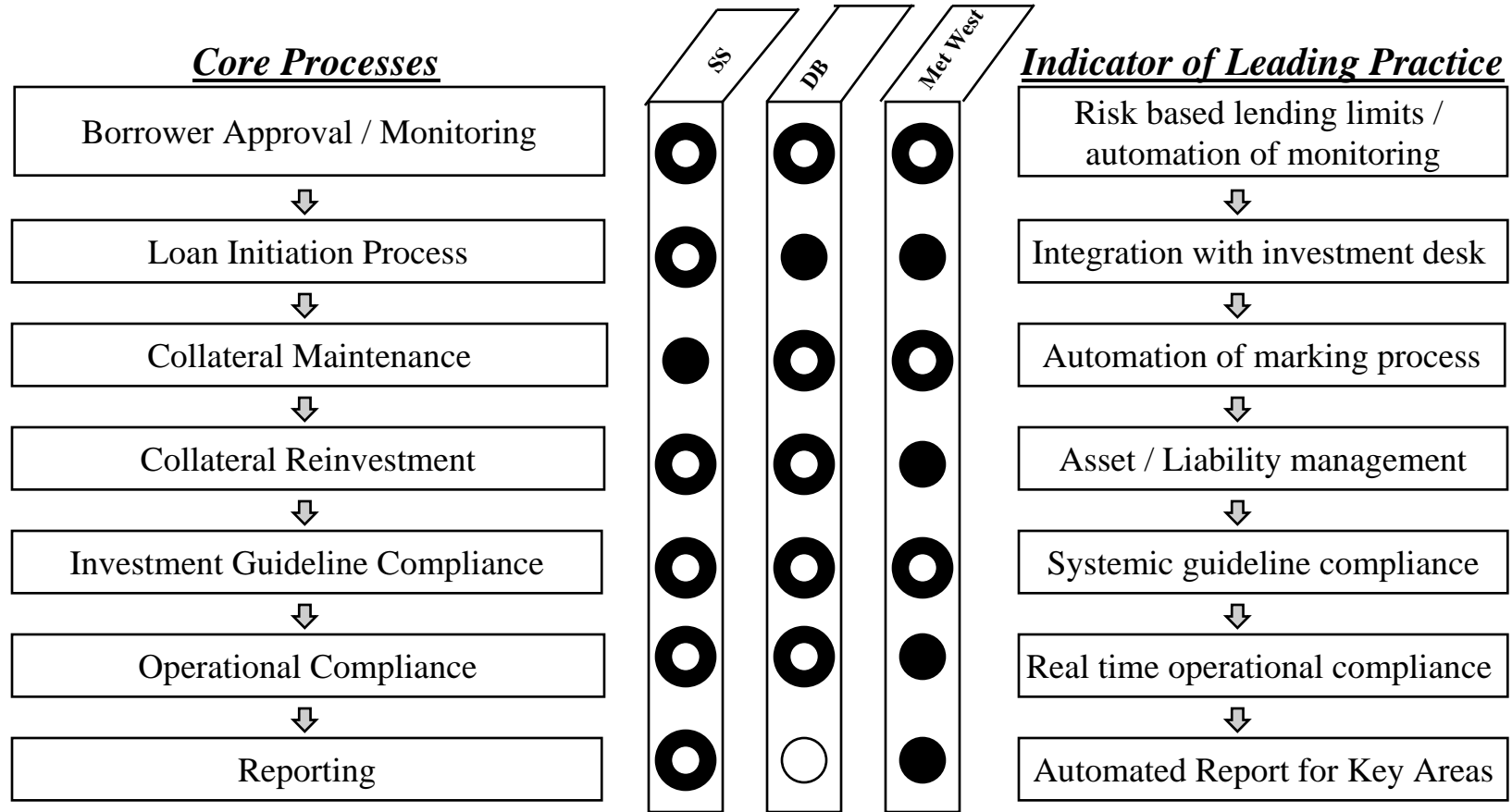


## *Securities Lending Provider Summary Assessment*

	<b>Strengths</b>	<b>Areas for Enhancement</b>
<b>State Street</b>	<ul style="list-style-type: none"> <li>⌘ Established securities lending program and a sizeable broker network</li> <li>⌘ Size of organization translates into a large amount of resources to leverage (financial, personnel, etc.)</li> </ul>	<ul style="list-style-type: none"> <li>⌘ As State Street performs lending primarily for its' large custody clients, they have numerous assets to lend which in turn could affect on loan volume for clients such as SBA</li> <li>⌘ As State Street securities lending is part of a large custody banks' infrastructure technology and operational improvements can be delayed as securities lending is not State Street's primary focus</li> <li>⌘ Trading and reinvestment desks are not centrally located</li> </ul>
<b>Deutsche Bank</b>	<ul style="list-style-type: none"> <li>⌘ Trading and reinvestment desks are centrally located resulting in a potentially more effective asset liability management</li> <li>⌘ Same strengths as noted above for State Street</li> </ul>	<ul style="list-style-type: none"> <li>⌘ The compliance function is not independent of operations</li> <li>⌘ Same as points one and two above for State Street</li> </ul>
<b>Met West</b>	<ul style="list-style-type: none"> <li>⌘ Met West's primary focus is on securities lending allowing it to react quickly customer requests such as ad hoc performance or compliance reporting</li> <li>⌘ Relatively large information technology department (approximately 14% of workforce)</li> <li>⌘ Trading and reinvestment desks are centrally located resulting in a potentially more effective asset liability management</li> </ul>	<ul style="list-style-type: none"> <li>⌘ Because of the relatively small size of the organization (approximately 120 associates) they do not have as large an amount of financial or personnel resources compared to the other providers</li> </ul>

# Risk Management Assessment

## DESIGN OF OPERATIONAL PROCESSES



**Legend:**



Leading practice and/or high degree of automation



Adequate process and/or some degree of automation



Noted area for enhancement and/or primarily manual process

# Securities Lending Service Provider Summary

## SUMMARY STATISTICS

	<u>StateSteet</u>	<u>DB</u>	<u>Met West</u>	<u>Total</u>
Number of Core Processing Activities Reviewed	4	5	7	16
Number of Tasks supporting Core Processes	12	16	25	53
Number of Core Processes with Observations	6	7	16	29

- ⌘ All of the observations are included in the process “factsheets” and the most significant process and technology observations are provided on the following pages.
- ⌘ The suggested prioritization of the observations are aligned with the inherent risk of each activity that it is associated, which included in the “factsheets”.

## *State Street Observations*

*Provided below is a summary of observations based on inquiry and observation procedures performed at the provider location. SBA should assess the impact of the observations to SBA's lending program, if any, and consider developing action plans to mitigate any perceived significant risks*

<b>Priority</b>	<b>Observation</b>
<b>High</b>	The use of State Street's Performance Analyzer should be looked at to ensure that it is being used to its maximum potential. For example, benchmarking forecasted performance results calculated by the Performance Analyzer to actual performance results. The use of Performance Analyzer could be used as an additional test of the reasonableness of securities lending income.
<b>Med</b>	Not all investment guidelines are hard coded into State Street's trading system. Prior to the initiation of a trade the trader manually checks the guidelines. There is also a manual back end process where the SSgA compliance unit checks the investment compliance on a monthly basis.
<b>Med</b>	There is not a process in place where the investment manager (for reinvestment) obtains pre-approval from compliance prior to overriding investment guidelines. There is an informal process where the investment managers notify compliance (via e-mail) when investment guidelines are overridden, however, it is not required per the written policies and procedures and it is performed subsequent to the out of compliance trades taking place.
<b>Med</b>	In association with the Mark to Market process, State Street associates can manually override prices in DML which would result in a Mark no longer being required by the system. Furthermore, there is not an automated operations report which would identify any prices which were manually changed.
<b>Med</b>	Securities Lending income sits in a DDA account for approximately 15 days prior to being posted to SBA's account. Per State Street, this is due to the request by SBA that income is posted to SBA's sub accounts. Note, other clients income is posted on the 8th business day of each month.

## *State Street Observations, Continued*

*Provided below is a summary of observations based on inquiry and observation procedures performed at the provider location. SBA should assess the impact of the observations to SBA's lending program, if any, and consider developing action plans to mitigate any perceived significant risks*

<b>Priority</b>	<b>Observation</b>
<b>Med</b>	In general, the compliance function (internal self assessments, daily monitoring, etc.) is detective in nature as opposed to preventive. A real time compliance function at State Street would further ensure that transactions processed on behalf of SBA are complete, timely, accurate and authorized.
<b>Med</b>	When information is entered into the Value at Risk Exposure Measurement system to calculate broker credit limits there is not a second review or verification of the information that is entered into the system.
<b>Med</b>	In general, State Street's mark to market process is manually intensive where brokers are contacted to discuss price, security discrepancies, etc. The manual nature of the process lends itself to the potential for clerical errors.
<b>Med</b>	When Data Control makes modifications to customer and broker accounts, there is not a system generated report which identifies all/any changes made. This report could be used by compliance to ensure all modifications are authorized.
<b>Med</b>	While there is a manual approval process for queue overrides, the DML system does not require a separate logon id for approval.

## *State Street Observations, Continued*

*Provided below is a summary of observations based on inquiry and observation procedures performed at the provider location. SBA should assess the impact of the observations to SBA's lending program, if any, and consider developing action plans to mitigate any perceived significant risks*

<b>Priority</b>	<b>Observation</b>
<b>Low</b>	There is not a formal Credit Committee, there is currently only 3 individuals involved in approving broker credit limits.
<b>Low</b>	Currently, the reinvestment yields (NAV) are manually entered into DML for calculation of income earned from securities lending. The manual nature of this process could result in input errors and ultimately incorrect income amounts being calculated. It should be noted, however, that State Street stated that a second verification is done for all yield inputs.

## *Deutsche Bank Observations*

*Provided below is a summary of observations based on inquiry and observation procedures performed at the provider location. SBA should assess the impact of the observations to SBA's lending program, if any, and consider developing action plans to mitigate any perceived significant risks*

<b>Priority</b>	<b>Observation</b>
<b>High</b>	Currently a portion of client reporting is done by sending electronic “read only” files to SBA. It was also noted that ad hoc reporting has been historically difficult to obtain from Deutsche Bank’s client reporting system. Deutsche Bank is in the process of enhancing their internet based platform to provide additional client reporting, however, it is currently not in operation.
<b>High</b>	The compliance function at Deutsche Bank does not cover operational areas outside of the collateral reinvestment process. Specifically, compliance does not have a monitoring mechanism (e.g. exception report review) to review daily processing activities such as queue overrides, mark to market, broker credit limits, etc. Rather, Deutsche Bank relies on operational supervisors to perform operational compliance monitoring.
<b>Med</b>	Not all investment guidelines are hard coded into Deutsche Bank’s trading system. Prior to the initiation of a trade the trader manually checks the guidelines. For the investment guidelines that are hard coded, the investment management system would notify the trader if that they were about to invest in a security which is outside of the approved guidelines. The system does not, however, prevent the trader from placing the non-compliant trade. In addition, there is not a real time process in place where the investment manager (for reinvestment) obtains pre-approval from compliance prior to overriding investment guidelines. There is a detective process in place where compliance receives and reviews a daily exception report which identifies any investments that were made the previous day which are out of compliance with the guidelines.
<b>Med</b>	The compliance department has in place an informal process where they will, on a test basis, verify selected accounts’ compliance with investment guidelines. Compliance does not, however, currently have an internal self assessment function to monitor operational compliance outside of the reinvestment process.

## *Deutsche Bank Observations, Continued*

*Provided below is a summary of observations based on inquiry and observation procedures performed at the provider location. SBA should assess the impact of the observations to SBA's lending program, if any, and consider developing action plans to mitigate any perceived significant risks*

<b>Priority</b>	<b>Observation</b>
<b>Med</b>	In association with the mark to market process, Deutsche Bank associates can manually override prices in the securities lending system which would result in a mark no longer being required by the system. Furthermore, there is not an automated operations report which would identify any prices which were manually changed. There is also not a process in place to verify the reasonableness of the prices being used in the marking process (e.g. tolerance check, missing price review, etc.).
<b>Med</b>	Deutsche Bank's mark to market process is manually intense where brokers are contacted to discuss price, security discrepancies, etc. Industry leading practice would be to use Loan Net which would eliminate some operational risk associated with broker negotiations over prices, positions, etc.
<b>Med</b>	When there is a new customer contract or there are modifications to existing customer contracts, there is one individual who is designated to interpret the contract and enter the information into the securities lending system. There is a second review of the information set up in the system for accuracy, however, it does not appear that there is a thorough review performed to ensure that all pertinent information is pulled from the new / modified contracts.
<b>Low</b>	There are three separate securities lending systems being utilized depending on the type of lending that is performed: domestic equity, domestic fixed income or international. Processing or reporting issues as a result of the use of multiple systems is mitigated from SBA's prospective as Deutsche Bank only lends US treasury Strips for the SBA which is on one system.

## *Met West Observations*

*Provided below is a summary of observations based on inquiry and observation procedures performed at the provider location. SBA should assess the impact of the observations to SBA's lending program, if any, and consider developing action plans to mitigate any perceived significant risks*

<b>Priority</b>	<b>Observation</b>
<b>Med</b>	There is currently not an electronic securities lending queue methodology applied by Met West to ensure that securities are lent equitably across their client accounts. The lack of a queuing system could unfavorably impact the amount of securities that are on loan.
<b>Med</b>	The investment guidelines are hard coded into investment management system which would notify the trader if that they were about to invest in a security which is outside of the approved guidelines. The system does not, however, prevent the trader from placing the non-compliant trade. In addition, there is not a real time process in place where the investment manager (for reinvestment) obtains pre-approval from compliance prior to overriding investment guidelines. There is a detective process in place where compliance receives and reviews a daily exception report which identifies any investments that were made the previous day which are out of compliance with the guidelines.
<b>Med</b>	When Met West marks to market fixed income cash loans, rather than receiving cash for the mark amount they accept securities for the additional collateral. As a result there is less cash collateral available for reinvestment.
<b>Med</b>	Broker credit limits are currently risk weighted based on the type of loan, collateral received, etc. Currently, Met West uses a threshold of no more 20% exposure to any one broker to monitor credit limits.

## *Met West Observations, Continued*

*Provided below is a summary of observations based on inquiry and observation procedures performed at the provider location. SBA should assess the impact of the observations to SBA's lending program, if any, and consider developing action plans to mitigate any perceived significant risks*

<b>Priority</b>	<b>Observation</b>
<b>Med</b>	In relation to the mark to market process, Met West does not have a process in place where they perform tolerance checks on the prices they receive from outside vendors. As a result, marks to brokers could be performed based on inaccurate prices resulting in under collateralized loans. State Street associates can manually override prices in the Securities Lending system which would result in a mark no longer being required by the system.
<b>Low</b>	Borrower credit limits are currently set and monitored at the Met West Securities Inc. level. As a result, the exposure at the corporate wide level (Met West Financial) is not monitored or known.

*Next steps involve .....*

***SBA NEXT STEPS***

**Implementation Plan:**

- /// Confirm prioritization of SBA observations
- /// Consider which observations to address
- /// Consider Provider observations and prioritize
- /// Develop project plans and timing
- /// Assign project ownership and resources
- /// Execute plans

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# Overview of Securities Lending

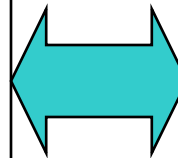
## *Lender*

### Who Lends?

- ⌘ Institutional Investors
- ⌘ Banks
- ⌘ Broker-Dealers

### Why Lend?

- ⌘ Ability to generate additional revenue on an existing portfolio of securities
- ⌘ Increased returns



## *Borrower*

### Who Borrows?

- ⌘ Broker-Dealers
- ⌘ Banks
- ⌘ Investment Companies

### Why Borrow?

- ⌘ Deliver securities they have sold short
- ⌘ Sell securities they have purchased but have not received
- ⌘ Deliver securities they have not yet purchased due to an exercise of a derivatives contract
- ⌘ Cover a failed transaction
- ⌘ Arbitrage opportunities
- ⌘ Cost of Cash for Borrower

## *Securities Lending Terminology*

- ≡ **Securities Lending** - The collateralized Borrowing and Lending of Securities. Securities Lending allows large investors to generate additional income by lending securities currently held in their portfolios.
- ≡ **Indemnification** - An agreement to compensate securities lending clients for damage or loss resulting from the default of a broker to return securities currently on loan.
- ≡ **Open Loan** - A securities loan without a fixed rate to maturity. The loan can be terminated by either the lender or the borrower on short notice.
- ≡ **Term Loan** - A securities loan with a pre-determined return date.
- ≡ **Collateral** - Cash or assets pledged to a lender as security until a loan is repaid. The most common form of collateral in securities lending is cash. Other forms of collateral include foreign currency, letters of credit and securities such as U.S. government and agency bonds.

## *Securities Lending Terminology*

- ≡ **Mark to Market** - Pricing outstanding loans to the current market value of the security to ensure that the loan is collateralized at a predetermined percentage rate greater than market value. The marking process has the following results:
  1. Receipt of additional collateral if under collateralized
  2. Return of excess collateral if over collateralized or
  3. No movement if appropriately collateralized.
  
- ≡ **Rebate** - The interest paid to the borrowing broker for the use of its cash by the lender in the investment of short-term instruments. The amount of the rebate paid to the borrowing broker varies depending on the institution and the current short-term interest rates available.
  
- ≡ **Spread** - The difference between the rate received on the investment of cash collateral and the rebate rate of the loan paid to borrowing broker.
  
- ≡ **Split** - The process of revenue sharing that occurs between a lender and its securities lending agent. For example, a 60/40 split equates to 60% paid to the lender of securities (SBA) and 40% paid to the agent.