



Florida PRIME™ Best Practices Review

Florida State Board of Administration (SBA)

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Executive Summary

Aon Investments (Aon) conducts a Best Practices Review of Florida PRIME on an annual basis. In this report, we review the 2020 Participant Survey responses, provide a performance update given the recent market turmoil, provide an update on the Business Case Review, offer a discussion on Securities Lending and cover the annual Investment Policy Statement Review.

Based on our review, we continue to believe that Florida PRIME is being managed in a manner consistent with best practices and in consideration of participants' best interests and do not have any recommendations at this time.

2020 Participant Survey Results

On a regular basis, the SBA conducts a survey of Florida PRIME participants to gain a better understanding of the participant base, current usage of available services, and overall satisfaction. The survey also seeks to gauge interest in various enhancements and to ensure awareness of participant needs and preferences. The 2020 survey attracted 88 respondents which is in line with the previous rate of response.

A diversified group of governmental units responded to the survey, primarily representing counties, municipalities, school boards and special districts, with respondents roughly evenly split between investment decision-makers and personnel in account operations. Of the respondents, 55% have one account with Florida PRIME and 22% have either 2 or 3 accounts. Approximately half of respondents have over \$10 million of cash assets available for short-term investment, with another 21% having between \$1 million and \$10 million of cash assets available. The survey indicated that approximately 52% of respondents indicated having a balance of over \$10 million with Florida PRIME, and 28% indicated having between \$1 million and \$10 million with the pool. The survey revealed that 26% of respondents maintained greater than 75% of their cash surplus in Florida PRIME over the past year, which is an increase from the previous survey (19%). An additional 21% maintain between 50% and 75% in FL PRIME. On the other end of the spectrum, 23% indicated they have maintained less than 25% with Florida PRIME, which is the same as the previous survey.

The survey includes questions that relate to how and why participants utilize other competing and complementary liquidity vehicles. Of the respondents, 37 indicated that their organization has a policy that dictates a maximum allowable allocation to Florida PRIME and 27, or 73% of those with policies, are restricted to allocating 50% or less to any single governmental investment pool or money market fund. Relatedly, when asked what prevents an organization from using Florida PRIME as the primary source of cash management, 53% of the 76 respondents to this question indicated that investment policy restrictions were a reason for not using Florida PRIME as a primary source of cash management. The next greatest response was 41% of respondents indicating that diversification needs of the cash portfolio was a major or moderate reason. Inadequate participant disclosures was noted as not a reason at all by 82% of respondents. Costs, functionality/operational features and lack of additional investment product offerings were all highly selected as not reasons at all for not using Florida PRIME as a primary source of cash management (70%, 69%, and 68%, respectively). Slightly different than last year, current level of yield was listed as a moderate reason at 17% and a minor reason at 21% of respondents.

When asked about other investment vehicles used in the past 12 months for cash management, results reverted to responses seen a few years back. Respondents indicated the most commonly used vehicles aside from Florida PRIME are SEC registered money market funds at 24%. This diverged from last year's survey when money market funds were less utilized which we attributed to the recent reforms that went into effect. Previous to the reforms, money market funds were often used. Next most common vehicles were Bank Certificates of Deposits at 23% of respondents, followed by peer funds, and specifically the Florida Education Investment Trust Fund and the Florida Local Government Investment Trust at 17% and 15%, respectively. The survey also asked respondents to rank how competing investment services have

added value to the respondent organizations' investment goals from the following list: yield, cost, risk, client service, available funds, and ease of use. Respondents indicated that yield was the most appealing feature, followed by risk, defined as perceived risk levels adjusted for the level of return. Client service and ease of use were ranked the lowest in terms of value add from competing investment services.

The survey questions surrounding current services related to Florida PRIME continue to receive strong feedback. Related to the Florida PRIME website, 80% of respondents indicated that they visit the site at least once a month and 96% responded that they find the website functionality as very easy to use. The survey also indicated that the clear majority of participants continue to utilize the website primarily to access account balances and statements, and approximately 72% and 43% of respondents utilize the website to make transactions and to access the Monthly Summary Reports, respectively. When asked about the usefulness of multiple communication pieces, the responses also continue to be favorable. The survey indicated that over 70% of respondents rated the following communications as very useful: monthly account statements (94%), e-mail notifications of withdrawals (87%) and changes to bank instructions (84%). Further, over 75% of respondents found the following to be at least somewhat useful: Periodic eNotices (97%), Monthly Summary Reports (95%), and Weekly Market Commentary (86%). Lastly, respondents indicated great satisfaction with the Florida PRIME representatives, with over 95% indicating the representatives were very courteous, very knowledgeable and very responsive.

Overall, the survey results continue to be positive from both operational and service-related perspectives. Responses related to the use of competing investment vehicles continue to be mixed, with indications of yield and risk being top of mind, but notably, that a large percentage of respondents' organizations have investment policies limiting available funds to invest in a single entity and/or seek diversification from a single cash management source. Generally, the survey indicates a strong level of satisfaction with the management of the Florida PRIME portfolio. 90% of respondents indicated that they are very likely or extremely likely to recommend Florida PRIME to a colleague or other governmental investor. We continue to believe the survey is a great mechanism to obtain feedback from Florida PRIME participants, as well as to express the SBA's awareness and receptiveness to the participant's needs and wants.

FL PRIME Performance Update

Beginning in the first quarter of 2020, the novel Coronavirus (COVID-19) has wreaked havoc from both a humanitarian and economic perspective. Markets experienced the swiftest equity bear market on record, U.S. investment grade spreads above U.S. treasuries reached levels not seen outside the financial crisis and unemployment numbers have reached unprecedented numbers. The vigorous policy response triggered a strong snapback in equity markets, but volatility and uncertainty remain. Given the significant level of stress on organizations throughout the world and the impact on global capital markets, we thought it was important to provide an update on how Florida PRIME has performed during this time.

The ongoing disruption from COVID-19 from both a personal and business perspective has provided unique challenges to navigating the current environment. We are happy to communicate that FL PRIME has continued to function fluidly and without disruption through this unprecedented time.

From an investment perspective, the portfolio has continued to achieve its primary goals of preserving capital and providing liquidity without interruption. As money markets faced significant liquidity issues prior to the Federal Reserve's intervention, Federated was able to take advantage of certain conditions to earn attractive yields while maintaining the stability of the FL PRIME portfolio. During 1Q 2020, FL PRIME earned 0.41% and outperformed its benchmark. The portfolio's gross yield declined to 1.21% at the end of the quarter as a result of the Fed's rate cuts. Additionally, in anticipation of potentially greater liquidity needs from participants during this uncertain time, Federated has been proactive in increasing the weekly liquidity of the portfolio to ensure ample liquidity for any increased redemption demand.

From a servicing perspective, the SBA's administration of the portfolio has functioned smoothly during this time. As many transitioned to remote workplaces and navigated outside stresses due to the pandemic, participants have not experienced disruption to transactions, reporting or client service. The program maintains normal hours of operation with no limitation on participant functionality. The SBA has pledged to support participants to the best of their ability in instances of financial stress or unforeseen circumstances. Further, the SBA team and Federated have been very active in providing portfolio and market updates to current and potential members. Federated has posted multiple updates every week (sometimes daily) on the website as well as sent directly to participants. The SBA and Federated have also hosted participant calls to provide verbal commentary and to air questions and/or concerns.

Overall, the FL PRIME program has managed this current crisis seamlessly, achieving the preservation and liquidity objectives of the portfolio, in addition to strong investment results, with the backdrop of strong customer service and uninterrupted administration of the pool. The ongoing success of the investment and operational aspects of FL PRIME speak to the strong risk management and governance structure that has been reviewed and reinforced over the years.

Florida PRIME Business Case Review Update

As noted in our 2019 Best Practices Report, the SBA is conducting a business case review of FL PRIME according to the Florida PRIME Strategic Plan. The business case review is intended to evaluate the case for insourcing and/or outsourcing all or a portion of the pool's administration, management and investment services.

Currently, Florida PRIME outsources the investment management to Federated Investment Counseling ("Federated") to manage the pool's assets in accordance with the Investment Policy Statement. Federated also conducts investment related risk management procedures and reporting to ensure compliance and the safety of pool assets.

The Florida SBA handles all other services in house for administering the FL PRIME program. These responsibilities and services are broadly defined below:

- *Administration*: recordkeeping, trade execution, position monitoring and reporting
- *Client Service*: call center, website/user interface, participant communication and experience
- *Risk Management and Compliance*: policies and guidelines, monitoring, reporting, escalation procedures, participant communication, business continuity

The SBA began the Business Case Review (the Review) in the fall of 2019. The initial phase was largely an information gathering exercise. Below we highlight the most prominent topics discussed thus far:

- **Insight into Outsourcing model:** The SBA Review team has had multiple discussions with various parties to understand the functionality and pros and cons of a full service model. Discussions were held with potential full service model providers as well as with other local government investment pools (LGIPs) that currently use a full or partial outsourced service model. These discussions have provided insight into how the pool's administration and services may be mapped from the current state to a potentially fully outsourced state. These conversations helped the SBA identify areas that may pose challenges in an outsourced model or areas that need additional investigation.
- **Peer Practices:** The SBA team sought information from other comparable LGIPs to help better understand the landscape of insourcing vs. outsourcing among peer plans. The results are mixed and the greatest take-away, especially for large pools such as FL PRIME, is that the decision is mostly a unique one. There is no one-size fits all and thus the exercise that is currently underway at the SBA is the best path forward.
- **Risk Assessment:** An internal risk assessment is underway with the objective of clearly understanding and defining the risks that the FL PRIME program presents to the SBA. The risk assessment will evaluate the functional areas noted above (administration, client service, risk

management) on whether the risk of outsourcing is neutral, lower or higher than the current state. Consideration is also being given to whether to bundle services with the current investment manager versus using another provider for the administrative functions. This assessment will help identify the areas where outsourcing or different approaches to insourcing may help alleviate some of the risks the program poses. The criteria being applied is based on the following:

- *Neutral* – The risk to the SBA is the current level of risk or administrative oversight.
- *Lower* – The risk to the SBA is lower/decreased due to operational risk being shifted to the service provider assuming the same level of control and processes currently in place at the SBA and the service provider may be able to leverage operational scale and best practices.
- *Higher* – The risk to the SBA is higher/increased due to additional monitoring required by the SBA to ensure service provider is performing adequately and controls are in place and effective or the possible lack of visibility into the processes and controls or the lack of timely flow of information to internal and external stakeholders.

Current Status

The SBA Review team has garnered a great deal of information that has assisted in identifying the areas where the SBA has an advantage and where there may be room for improvement via a different approach. The exercises thus far have also highlighted some areas where outsourcing could present challenges for the SBA and require some additional investigation. Some of those areas include fund accounting, certain risk management and compliance procedures and annual reporting where the SBA has some distinctive processes in place. Given some of the challenges outsourcing certain functions could present, the SBA is also reviewing potential approaches to improve existing internal operations. One consideration to this approach is a potential increase to the FL PRIME management fee, all of which would be reinvested into enhancing the program. FL PRIME has historically offered among the lowest fees in the industry for an LGIP offering. A modest increase of even one basis point could offer the SBA a notable amount of resources to add value to participants. As noted earlier, the SBA is still in the information gathering phase and thus continues to evaluate all aspects and potential avenues for enhancements to the FL PRIME program.

The Review team is also in the process of drafting a Request for Information (RFI) to be sent out later this year. The team is working through specific questions that will help evaluate the various components of the business review. The information gathering phase is also assisting the Review team in determining if all or only a portion of the administrative and service solutions should be put out for bid, which will impact the RFI.

Next Steps and Timeline

The table below highlights the broad next steps for the Business Case Review and the tentative timeframe for when they will take place.

Next Steps	Tentative Timeframe
Complete RFI and Send to Candidates	Summer 2020
Receive RFI Responses and Evaluate	Fall 2020
Complete Internal Risk Assessment	Fall 2020
Conduct Follow-ups	Winter 2020-2021
Present Findings and Recommended Changes	Spring 2021

The ultimate goal of the Business Case Review is to ensure that the FL PRIME program is being administered in the most efficient way possible while providing the greatest security and value to current and potential participants.

Securities Lending Discussion

Securities lending activities involve the temporary lending of securities in exchange for cash collateral that is then reinvested in a conservatively managed pool (typically in accordance with 2a-7-like guidelines). The attractiveness of the securities sought to be borrowed varies and corresponds with the amount of exchanged collateral (typically 102% - 105%). Securities lending programs are intended to provide a modest level of income at a low level of risk that can help entities offset other investment fees (investment management, custodial, etc.). Many institutional investors participate in securities lending programs, including the FRS Pension Plan. FL PRIME participated in a securities lending program that ended in 2008.

As part of the FL PRIME business case review, we also revisited the merits of a securities lending program. Overall, given the added complexity and monitoring, we do not believe the expected income would make the reinstatement of the securities lending program a worthwhile endeavor at this time.

Background

In the past, FL PRIME participated in a securities lending program. The program used three lending agents and loaned Federal Agency issues and U.S. obligation securities (such as Freddie Mac, U.S. Treasuries, FHLMC, etc.). The program ended in January of 2008 and avoided the turmoil caused by the Global Financial Crisis (GFC).

Since the fallout of securities lending programs due to the GFC, the combination of self-regulation and industry regulation (Money Market Reform/2a-7 Guidelines) have come together to dramatically reduce the risk associated with the cash collateral reinvestment guidelines. Below we highlight the main risks that hurt investors in 2008 (which were centered around reinvestment of the cash collateral) and the actions that have since been taken:

- *Reinvestment Risk*: Cash collateral pools have removed or significantly reduced investment in assets that had potential to be extended 15+ years
- *Liquidity*: Cash collateral pool guidelines shifted to shorter maturities/weighted average life. Also, non-cash collateral is becoming more prevalent
- *Portfolios "broke the buck"*: Overall movement to more conservative cash collateral pool guidelines to help prevent 2008 issues from happening in the future. Some have moved to a floating NAV
- *Imposed gates*: Increased quality and shorter duration of collateral pool investments have reduced the contributing factors that caused the impairments

Today, given the significantly enhanced regulatory environment and the focus on mitigating reinvestment risks, many institutional investors run successful securities lending programs that offer a level of income that offset other investment management costs. Aon's focus for securities lending programs are those geared towards minimizing risks and not maximizing income.

Securities Lending Right for FL PRIME?

The benefits of engaging in a securities lending program for FL PRIME would center around the potential to earn a modest level of income that could be used to offset other costs. Given the significantly increased regulatory environment and ability to minimize reinvestment risks, a securities lending program provides some merit for consideration.

That said, the general demand for the securities FL PRIME has available for lending is very low. FL PRIME's portfolio primarily invests in very short-term and highly liquid securities, mostly comprised of asset-backed and corporate commercial paper and fixed and floating rate bank instruments. Under the existing reinvestment guidelines and current anticipated demand, BNY Mellon estimated FL PRIME could earn approximately 2 basis points on the lendable assets. After accounting for the existing revenue sharing arrangement, this equates to approximately \$83,000 per year, or less than 0.1 basis points on the total portfolio. Given these expectations, we do not find the trade-off between potential income and the resources needed to manage risks and oversee a securities lending program as a worthwhile endeavor at this time. Further, depending on the nature of lending program, it is expected it would add complexities to the existing risk monitoring and reporting.

At this time, we do not find the trade-off between the expected income and required program costs and resources appealing enough to reimplement a securities lending program within FL PRIME. We do believe it is worthwhile to revisit the merits of securities lending on a periodic basis, or as market conditions change and if income potential increases.

Investment Policy Review

As part of Aon's Best Practices review of Florida PRIME we conduct a review of the Florida PRIME Investment Policy Statement (IPS). The objective of the IPS is to set forth the objectives, strategy, guidelines, and overall responsibilities for the oversight and prudent investment of Florida PRIME assets. The purpose of the periodic review is to ensure the document reflects the evolving investment portfolio, current legal and regulatory developments, and best practices. A well-written and unambiguous document is critical to the success of any investment program

Over the past several years there have been modest updates to the IPS that have kept it up-to-date with the current regulatory, legal, and investment environments. The SBA is prudent with staying current with overall best practices in managing the Florida PRIME assets and thus the updates to the IPS have been seamless.

Overall, Aon continues to find the IPS to be comprehensive and appropriate for the management and oversight of Florida PRIME. The topics covered continue to be relevant and critical to the success of the management of Florida PRIME assets. The investment objective of the pool and the roles and responsibilities are clearly defined. The IPS provides the necessary specifics and supplemental guidelines for a clear understanding of the investment strategy, making direct and clear reference to the appropriate GASB guidelines for appropriate fiduciaries to follow and understand. We believe the IPS thoroughly defines the risks that are associated with investing in Florida PRIME and find the detailed control procedures provide the comfort of prudent safe-keeping and oversight of assets.

While it is not expected that the IPS will change frequently, it is a living, breathing document that should be reviewed periodically to ensure it remains appropriate and relevant. Overall, we continue to believe the Florida PRIME IPS is robust and in line with the goals and objectives of the investment pool and continue to find the Policy to be an effective guiding document for the management of Florida PRIME.