Report to the *People*

A look at Indiana's investments

October 2010

Introduction

Fellow Hoosiers,

As taxpayers, we have the right to know exactly how our money is being spent, where it's invested and how it's performing. After all, it is *our* money.

Yet today, despite advances in technology, when it comes to our money, Hoosiers are still largely left in the dark. While Treasurers in other states have moved to put more information online, three decades of one-party control in Indiana have stunted such access for Hoosiers.

In these difficult economic times, when every cent counts, it is time for a new approach. Hoosiers deserve full and regular reports on their money and we should demand no less.

I am not in office yet, but I already sense an obligation—and an opportunity—to help fellow Hoosiers understand what is happening with our money.

In the following pages, you will find my analysis of how key funds managed by the State Treasurer are performing, an overview of where Indiana's tax dollars are deposited, as well as a listing of some of stocks and bonds Hoosiers might be surprised to know that they hold.

Much of this information is only available thanks to public information requests sent into the state by my supporters. On my watch, such information will be much easier to obtain. In the meantime, think of this as a down payment on the kind of clear reporting of our positions that Hoosiers can expect of me if elected.

In addition, I am including a compilation of proposals I have laid out over the course of the last year to help create jobs, protect consumers, reform campaign finance laws, and increase transparency and accountability in the Statehouse.

The days of hiding behind the complexities of public finance to mask bad investments and poor decisions are over. The time when this office was merely a political stepping stone has passed. In the current economic climate, business as usual is no longer acceptable.

It is time for straightforward answers, reasoned analysis and non-partisan solutions. In short, it is time for a return to responsibility in the Office of State Treasurer.

Sincerely,

Pete

Pete Buttigieg, Democratic nominee for Treasurer of State

Executive Summary

The State Treasurer's major responsibilities include managing the Major Moves funds created by the Toll Road lease, investing the State Police Pension Fund, and overseeing public deposits. In each area, there are a number of issues to be examined closely. Our independent analysis has identified losses, areas of concentrated and questionable risk, missed opportunities, and evidence of investment inconsistent with Hoosiers' values. Holding our government accountable for the handling of our state's money begins with understanding how it has been placed. Based on our analysis, the following are key areas of concern:

Major Moves and Next Generation Trust Funds

- At least $266 million worth of non-investment grade assets (a.k.a "speculative" or "junk bonds")
- Highly unusual negative net return on Next Generation Trust Fund in 2009, possibly due to junk bond losses
- Relatively high concentration of risk (12.5 percent) in mortgage-related investments issued by Fannie Mae and Freddie Mac
- Presence of mortgage-backed securities with no government backing; value difficult to assess

State Police Pension Fund

- Net loss of $28.4 million in last 3 years
- Ten-year average annual return on investment of 3.77%
- Millions of dollars in mortgage backed securities and collateralized mortgage obligations (CMOs) issued by banks including Citi, Credit Suisse, Capital One, Wachovia, Goldman Sachs, AIG and the failed banks Countrywide and Lehman Brothers.
- Equity positions in companies with questionable records like Halliburton, News Corp, and Transocean

Public Depositories

- Of Indiana's $950 million in state deposits, approximately $640 million now placed out-of-state banks
- More than $85 million on deposit with non-Indiana banks misleadingly classified as based in Indiana
- Not one of the top five banks receiving the state's public depositories headquartered in Indiana
- Ohio, not Indiana, as top recipient of Indiana deposits at $369 million

Major Moves Construction Fund & The Next Generation Trust Fund

The Major Moves and Next Generation Trust funds were created in 2006 from the proceeds of the leasing of the Indiana Toll Road to a consortium led by the Spanish firm Cintra and the Australian firm Macquarie. Of the $3.8 billion lease payment, $2.6 billion (and any incremental return on that principal) was designated as the Major Moves Construction Fund—part of Governor Mitch Daniels' $12 billion, 10-year transportation campaign designated "Major Moves."

Additionally, $500 million of the lease payment was set aside for the Next Generation Trust Fund. The investment income earned from the Next Generation Trust Fund is to be distributed to the Indiana Department of Transportation every five years, while the principal will remain. To date, the Major Moves project has distributed more than $900 million for infrastructure improvements across the state.[1]

Makeup & Performance

As of June 30, 2010, the Major Moves Fund balance totaled $2.39 billion and the Next Generation Trust Fund stood at $571 million.[2] For reporting purposes, the Comprehensive Annual Financial Report (CAFR) combines the two funds. According to the CAFR, the two funds are to be invested in the same manner as a public employee retirement fund, with the reservation that they should not include equity investments (common stock, etc.).

In 2006, then State Treasurer Tim Berry set a target return on investment (ROI) of 5.25 percent per year for each of the two funds.[3]

Fund	2007	2008	2009	2010
Major Moves Fund	4.50%	4.62%	3.92%	14.05%
Next Generation Trust Fund	6.23%	3.79%	-2.20%	12.02%
*Data from the 2007, 2008, 2009 and 2010 Annual Reports of the State Treasurer				

However, as can be seen in the chart, that goal has rarely been attained by either of the funds. Fiscal Year 2010 appears to be an improvement on past years, but based on the vague reporting provided by the Treasurer's office, it is difficult to determine the extent to which this relies on the recent junk-bond bubble and dubious valuation of mortgage-backed securities.

Most surprisingly, the Next Generation Trust Fund reported a net loss of 2.2 percent during 2009. This is a fund that could be expected to earn only positive returns, like a bank account, unless very high levels of risk are involved

[1] INDOT http://www.in.gov/indot/7039.htm
[2] 2009 Annual Report of the State Treasurer
[3] Indiana Economic Digest http://www.indianaeconomicdigest.net/m/ArticleDisplay.aspx?articleid=54605&sectionid=31

Credit Risk

The table below shows the credit rating distribution for the Major Moves and Next Generation Funds. A rating of BB (Ba for Moody's) or below designates bonds considered "non-investment grade" and speculative in nature, often called junk bonds. Considering this, one can see that the two funds collectively hold between $266 and $330 million worth of non-investment grade assets.

Standard and Poors			Moody's		
Grade	Value	percent of Total	Grade	Value	percent of Total
AAA	$1,500,256.00	50.71%	Aaa	$1,478,907.00	49.99%
AA	$103,561.00	3.50%	Aa	$111,254.00	3.76%
A	$388,516.00	13.13%	A	$340,517.00	11.51%
BBB	$464,906.00	15.72%	Baa	$466,997.00	15.79%
BB	$127,760.00	4.32%	Ba	$154,498.00	5.22%
B	$72,013.00	2.43%	B	$91,881.00	3.11%
CCC&Below	$66,134.00	2.24%	Caa&Below	$83,388.00	2.82%
NR	$235,185.00	7.95%	NR	$230,889.00	7.80%
Total	**$2,958,331.00**	**100.00%**	**Total**	**$2,958,331.00**	**100.00%**
*Values are in thousands of dollars			**Data from the 2009 State CAFR		

Specific Areas of Concern

Between the two funds, $351 million dollars, a 12.5 percent share, is invested in securities issued by the mortgage giant Fannie Mae. This concentration of assets is substantial and can only be maintained if the Treasurer has a high degree of confidence in Fannie Mae's ability to sustain its loan guarantees.

Additionally, the funds hold hundreds of millions of dollars in CMOs and other mortgage backed securities issued by Freddie Mac and other financial institutions like Bear Stearns, Lehman Brothers, Goldman Sachs, Countrywide, Citigroup, AIG, and Morgan Stanley. These kinds of investments are notorious for their role in bringing about the financial crisis.

While the Major Moves and Next Generation funds are not able to invest in equity of companies, they are allowed to invest in bond issuances.

The funds also invest in debt issued by countries and companies whose records may not be consistent with Indiana values. Investments in firms like BP and Transocean may not be appropriate in light of the Deepwater Horizon tragedy. The state also holds debt issued by Russia, Turkey, Indonesia, and several other foreign states whose human rights records might give Hoosiers pause.

State Police Pension Fund

The State Police Pension Trust was established in 1939 to fund retirement, disability, and death benefits for members of the Indiana State Police and their families. Unlike other public employee pension funds, the State Police Pension is not a part of the Public Employee Retirement Fund (PERF). The State Treasurer is the sole trustee of this fund.

Makeup & Performance

As is the case with most public pensions, the State Police Pension Fund allows investment in both equity and fixed income securities. As of June 30, 2010, the fund was valued at $333 million, having sustained investment losses of more than $28 million in the previous three fiscal years. During fiscal year 2009 alone, the fund lost $54.6 million. Additionally, the fund's ten-year average annual return on investment is 3.8 percent.[4]

	2006	2007	2008	2009	2010
Market Value	$340,891,941.00	$364,491,564.00	$381,749,011.00	$301,029,279.00	$333,073,371
Gain (Loss)**	$22,313,036.00	$47,144,757.00	($20,824,552.00)	($54,611,333.00)	$48,881,752
ROI	6.55%	12.96%	-5.46%	-18.14%	14.68%
*Data from the 2006, 2007, 2008, and 2009 Annual Reports of the State Treasurer **Refers to net investment income—excludes any contributions or disbursements					

Specific Areas of Concern

In 2007, the fund held more than $75 million worth of securities issued by the federal government mortgage giants Fannie Mae and Freddie Mac.[5] Undoubtedly, these positions played a major role in the fund's poor performance over the past three years. Though the fund has recently divested a large portion of its Fannie and Freddie holdings, the damage was already done. The fund's portfolio still holds millions of dollars in mortgage backed securities and CMOs.

CMALT CITIMORTGAGE 07-A4 2A1	5.500% 04/25/2022 DD 04/01/07	FIXED INCOME SECURITIES	251,512.3670
CSMC 2009-RR1 A-3A	5.383% 02/15/2040 DD 07/01/09	FIXED INCOME SECURITIES	180,000.0000
CSMC 2009-12R 41A1	VAR RT 03/27/2037 DD 09/01/09	FIXED INCOME SECURITIES	160,263.3030
CWHEQ HOME SER 06-5 CL A3	5.762% 06/25/2035 DD 09/01/06	FIXED INCOME SECURITIES	172,684.0190
CWHEQ INC 06-S2 CL A3	5.841% 07/25/2027 DD 03/01/06	FIXED INCOME SECURITIES	324,933.6140
CWHEQ INC 06-S2 CL A4	6.091% 07/25/2027 DD 03/01/06	FIXED INCOME SECURITIES	262,446.3770
CAPITAL ONE MULTI 2006-9 A	VAR RT 05/15/2013 DD 07/31/06	FIXED INCOME SECURITIES	115,000.0000

*Taken from portfolio provided by the Office of the Treasurer

The snapshot above was taken directly from the pension's current investment statement. Each line represents a separate mortgage-backed security issuance. These assets which were issued by Citi, Credit Suisse, Capital One, and the failed banks Lehman Brothers and Countrywide join countless pages of similar items which were issued by Wachovia, Goldman Sachs, and the insurer AIG. It is unclear what method of valuation was used to determine the value of these securities, since many are not traded on normal markets.

The pension also maintains equity positions in companies with strong ideological profiles and problematic safety records, among other issues, including Halliburton, News Corp, and Transocean.

[4] 1999-2009 Annual Reports of the State Treasurer
[5] 2007 State CAFR

Where is our money?

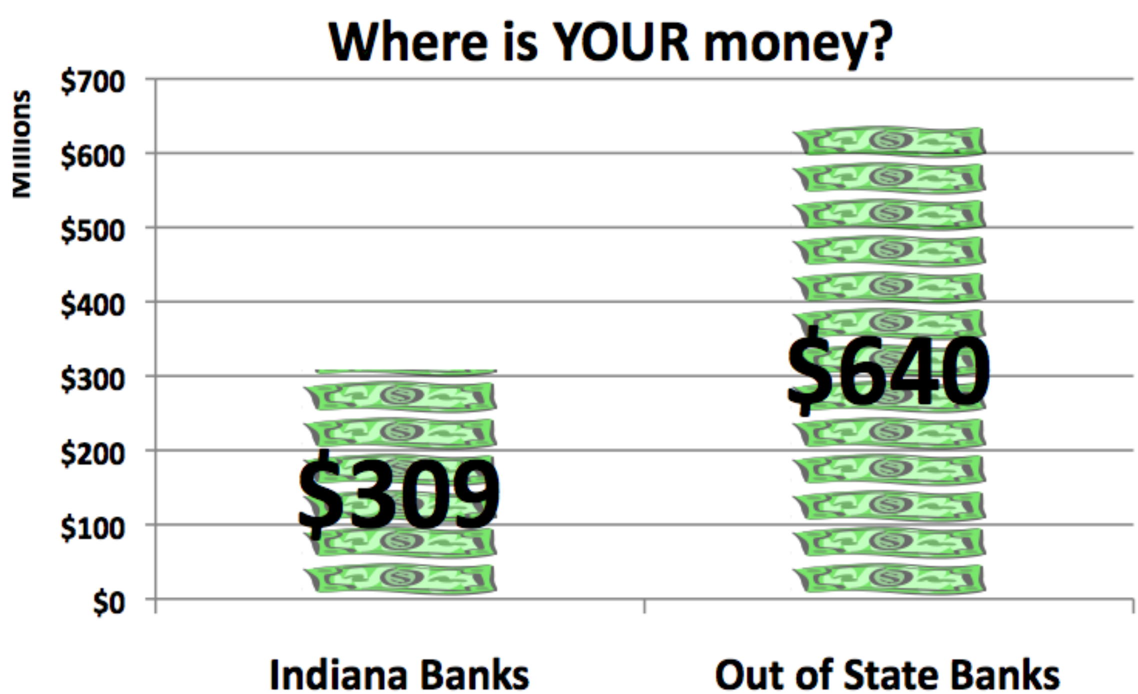
The State of Indiana keeps a large portion of its funds in checking and savings accounts at retail banks. This provides state government with the liquidity needed to maintain day-to-day operations. The State Treasurer is responsible for allocating state funds to institutions which have been authorized by the State Board of Depositories. The Board of Depositories, which consists of nine directors including the State Treasurer, Governor, and Auditor, has identified roughly 190 institutions as possible depositories of public funds. The Treasurer has great latitude in choosing how to allocate funds among these institutions.

Depositories

As of the December 31, 2009 Average Daily Balance Report (the most recent quarterly report currently available online), there are more than 95 depositories holding state funds. However, many receive only token amounts of the State's deposits.

Though the majority of these institutions are domiciled in Indiana, a disproportionate share of the nearly $950 million is allocated to the few out-of-state depositories. As can be seen in the graph below, the balance held out-of-state is more than double that which is held in Indiana institutions.

In addition, the representation of some banks in the Treasurer's report as "Indiana" firms is questionable. Fifth Third and M&I are both listed as Indiana banks, but their headquarters are not in the state. In fact, the over $10,000 in campaign contributions the Treasurer has received from Fifth Third come from an address not in Indiana but in Ohio, where the bank is headquartered.



*Taken from the 12/31/2009 Average Daily Balance Report from the Treasurer's Office

Of the $309 million claimed to be held with Indiana depositories, more than $85 million is held with institutions like Fifth Third Indiana and M&I Indiana which are merely operational units belonging to out-of-state banks. The chart below displays the five depositories with the highest average daily balance.

Remarkably, not a single one is headquartered in Indiana. In fact, with $369 million of Hoosier funds, Ohio depositories claim more deposits than those in Indiana.

Institution	Average Daily Balance
M&I BANK	$248,842,019
FIFTH THIRD BANK	$154,715,104
CHARTER ONE	$140,006,515
HUNTINGTON BANK	$86,918,510
NATIONAL CITY BANK	$60,192,067

*Taken from the 12/31/2009 Average Daily Balance

What's the Issue?

It may never be possible for 100 percent of Indiana funds to be deposited with Indiana banks. But holding this much of Indiana's money with firms not headquartered in Indiana raises questions about the office's commitment to the "Buy Indiana" principle. If allocated to local banks, the $950 million of state money can be used to bolster the lending capacity of those local institutions. In turn, they are then able to provide capital in the form of loans to small business owners in their community.

Indiana banks have also shown a much better record of good customer treatment and responsible finance than the overall banking industry. Funds deposited in banks closer to home thus have a much better chance of reinforcing responsible banking practices.

In contrast, by giving our deposits to large out-of-state conglomerates, hard-earned Hoosier dollars are being used to bolster the balance sheets of corporations far removed from the small business owners on Main Street, Indiana.

The Way Forward

Each day I learn more about Hoosiers' concern for their futures and the direction they want to see the state's finances take, and I grow increasingly certain that we can do more with the State Treasurer’s office. I've met hard-working citizens from all walks of life and their aspirations are both universal and straightforward. They want to work at a job that pays a decent wage, to educate their kids, to keep their homes, and to retire in financial security.

It's an amazingly reasonable take on the American dream, yet for many families it is slipping out of reach. People aren't asking for much, but they need a government that will help make it easier, not harder, to get there.

I am running for State Treasurer because the office’s responsibilities touch every part of our lives, from education to retirement, and I know that this office can help put the American dream back within reach for Hoosier families.

As Indiana's next State Treasurer I can use the "power of the purse" to help bring much needed reform to the banking, credit card and lending industries. We need greater protections and more transparency in place to protect our families from dishonest banking practices, misleading claims and excessive fees. I can work with banks and other lenders to address the mortgage foreclosure crisis so hardworking Hoosiers can stay in their homes. And I can work to ensure that our state's resources are invested in ways that stimulate the flow of capital right here in Indiana, growing businesses and creating jobs.

The following pages outline my specific proposals for moving Indiana forward.

Getting Risk Under Control

As State Treasurer, my first order of business will be to begin a comprehensive review of our risk and to end the current practice of investing state funds in risky investments, including junk bonds and some mortgage-backed securities.

Instead of looking to Wall Street for get-rich-quick schemes, I will focus my attention on investing in local, stable, Hoosier businesses and banks that can provide solid rates of return. And, instead of outsourcing the investment decisions to out-of-state firms that are incentivized to look for the quick buck, I will keep primary responsibility for investment decisions in Indiana.

Making Our Money Work Harder for Us

To better protect consumers, unlock the flow of capital and stimulate job growth in across Indiana, as State Treasurer, I will use the state's position as a major bank customer to encourage more responsible behavior within the financial industry.

The state of Indiana is a very lucrative customer for banks. The treasurer, on behalf of Indiana taxpayers, is charged with depositing about $1.5 billion in banks of his or her choosing. Those banks, in turn, make millions off of the stable cash flow Hoosier taxpayers provide. Without passing one new law or writing a single new word of regulation, we can use our collective power as a customer to effect change and encourage banks to be more responsible community partners.

Currently, there is very little information available on how the State Treasurer decides where to place our money. Not only does this lack of transparency muddle the rules of the road, it squanders an opportunity to encourage better banking practices. When elected, I will establish a set of measures to determine which banks would have the opportunity to do business with the state, including receiving public deposits.

When choosing banks to work with, I will seek banks that provide safety, a good rate of return, and the following:

- An Indiana headquarters, or large proportion of bank employees located in-state
- Compliance with obligations to under-served areas under the Community Reinvestment Act
- Compliance with any future requirements of the newly-created Consumer Financial Protection Bureau
- Commitment to small business lending, including lending to minority-owned and women-owned enterprises
- Availability of "plain vanilla" versions of important financial products such as mortgages and checking accounts, with a minimum of fine print and red tape
- A record of resolving distressed home mortgages through re-negotiation
- A substantial share of revenues donated to charitable or community causes
- A track record of community-oriented financial innovation, such as lending to micro-enterprises and offering financial awareness programs

As State Treasurer, I will also create a toll-free consumer protection hotline. This "early warning system" will allow Hoosiers to contact my office directly to report any mistreatment by banks, allowing me to take appropriate actions.

To ensure that all interested parties have a seat at the table, and clear, fair standards are in force, I will immediately form a committee of financial, business, labor, academic and consumer advocacy leaders to formalize these principles and develop reporting procedures that could be implemented within my first 60 days in office.

Investing in Hoosier Jobs

As State Treasurer, I will work to use the office to help create jobs and support business growth. Through my "Hoosier Capital Connector," we'll work to create jobs by offering low-interest loans to Indiana businesses that commit to creating or retaining jobs that pay at or above the county's average wage.

Under my proposal, the treasurer's office would act as a facilitator for credit, so small businesses could purchase equipment and property necessary to expand or retain jobs through banks already doing business with the state. And, to ensure the loan program is used responsibly, participating financial institutions and businesses will be required to report regularly to the State Treasurer's office on their job creation and retention.

Eliminating Politics as Usual

Early on in my campaign, I announced that I would not accept corporate or political action committee (PAC) donations from any bank, including those doing business or seeking to do business with the Office of State Treasurer and those that accepted federal bailout money.

In the months since I made that pledge, I've kept my word – and when I'm State Treasurer, I'll work to pass permanent bans on this type of behavior. It's the right thing to do. Hoosiers should never have to wonder whether decisions made in the Treasurer's Office about where to place their money are affected by campaign contributions – and when I am State Treasurer, they won't.

Increasing Accountability

With the increasing accessibility of technology, Hoosiers should never have to wonder where there money is or how it is being invested. As State Treasurer, I'll institute new measures to open up the office to the residents of Indiana, providing unprecedented transparency and accountability.

With the help of an expanded, user-friendly website, I will implement the following provisions:

- Increase the frequency of reporting on the state's investments and holdings from once a year to at least quarterly and post detailed investment information online
- Publish the amounts of state money on deposit at each financial institution online at least quarterly
- List the specific criteria expected of banks and financial institutions seeking public deposits online
- Post investment policy statements online for each fund managed by the State Treasurer's office as well as information and links to any outside firm that may manage state funds
- List all outside contractors doing business with the State Treasurer online, including the scope of their work and payment for their services
- Institute an online tracking system, similar to tracking a shipping order, for all public information requests so citizens can view the status of their request live
- Increase the public's input on investment decisions by holding a series or town halls across the state, at least twice a year, to gather public input on the state's investments and to answer citizens' questions in person
- Bar employees who leave the State Treasurer's staff from lobbying the office or doing business with the office for two years

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Conclusion

My intention in this report has been to highlight key areas in which business as usual will no longer work, and to specify ways in which the state's finances can be improved. It is a down payment on the progress we can make by restoring common sense and Hoosier priorities to this often-overlooked but vitally important office.

Our analysis has identified several areas of concern in the management of state funds. While few pension and trust funds have posted stellar returns in these economic times, it appears that Indiana is particularly exposed to unusual kinds of risk. It also appears that we are missing an opportunity to keep our state's funds deposited close to home, and that our values are not always reflected in the kinds of securities held in our name.

The more we, the people, know about what is happening with our money, the more accountable our government is for making the right decisions. As an outsider, this report represents the best analysis my team and I can provide of how our money is being held. As State Treasurer, I will be able to make much more extensive and detailed information available on our state's funds, so that citizens can make their own decisions.

If elected, I look forward to the opportunity to show, rather than occasionally tell, how Indiana can have a stronger, safer, more accountable financial future.

Pete
BUTTIGIEG
★ STATE TREASURER ★

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