Date: 4 January 1982

To: Members of the Board and Representatives

From: Heather L. Ruth, Executive Director

Re: State Audit of the Corporation -- Final Report

Enclosed is a full copy of the final report of the State Comptroller's audit of the Corporation, principally covering the period through June 30, 1979. (Note that, while the report is indicated as "filed" on December 3, 1981, it arrived at MAC only just before New Year's, and we had no other warning of the time of its release.) You will recall receiving an earlier draft of the audit and our response, dated June 30, 1981, a copy of which is appended to the final report.

While the Comptroller's Office has not accepted all of our objections to the earlier draft, I believe you will find that they have accepted many and that the overall tone of the report is quite positive. The principal recommendations continue to be that the Corporation consider competitive bidding, which we say we will, and that we make every effort to reduce underwriting costs.

The Corporation is required by law to submit a response indicating "corrective" actions we intend to take in the future. This response must be filed with the Comptroller and other State officials within 90 days. We are drafting such a response which I expect to be quite brief in view of the fact that our response of June 30 still stands, in our view, except that certain additional actions have already been taken in the investment area. I will send you a copy of the response when it is available.

HLR:dan
Attachment
FINANCIAL AND OPERATING PRACTICES
OF THE MUNICIPAL ASSISTANCE CORPORATION
FOR THE CITY OF NEW YORK

AUDIT REPORT NYC-28-80

Division of Audits and Accounts
Report Filed: December 3, 1981
MANAGERIAL SUMMARY

Scope of Audit

We examined operating and financial practices of the Municipal Assistance Corporation for the City of New York (MAC) up to August 1980, focusing primarily through June 30, 1979, a period when many services (such as accounting) were performed for MAC by the State. The audit included review of MAC's acceptance in the bond market, its method of selling bonds and costs associated with the sales, investment of cash balances and a follow-up on our prior report regarding financial printing contracts.

Background

MAC was created as a public benefit corporation on June 10, 1975 to assist the City in maintaining uninterrupted essential services and restoring investor confidence by providing financial assistance and fiscal oversight. MAC's debt issuance limit is currently $10 billion, of which $7.7 billion had been issued as of June 30, 1981 (with $6.8 billion outstanding). These obligations are secured by revenues derived from the additional 4 percent New York State tax imposed on retail sales in the City, stock transfer taxes and State Per Capita Aid, all subject to annual appropriation by the State Legislature. The laws assigning Sales and Stock Transfer tax revenues as security for MAC debt were successfully defended against appeals to the New York Court of Appeals and to the United States Supreme Court (which dismissed the case on jurisdictional grounds letting the Court of Appeals decision stand).

Major Observations and Recommendations

1. Market Acceptance

We found continuing and increased investor acceptance of MAC debt instruments as measured by MAC's net interest rate in relation to the Bond Buyer Index, the municipal bond yardstick. MAC rates ranged from as much as 283 basis points over the Index in 1977 to the 1980 low of 90. Over this period the percentage by which MAC's net interest rate exceeded that of the Index declined from 37 to 10 percent. The lower MAC debt service payments resulting from this improved performance, increases the funds available for City operations since less revenue must be set aside to support MAC obligations. However, since the general obligation issues comprising the Index enjoy a generally superior rating than MAC bonds the differences probably will continue.
2. Underwriting Fees

Underwriting fees paid by MAC on publicly sold issues have remained relatively stable throughout its history, about 2 percent of the par value of each issue.

In light of the following factors, it might be expected that MAC's underwriting rates would have declined more than they have:*

- Improved acceptance in the market.
- Regularity and predictability of its issues.
- Excellent revenue coverage.
- Ability to meet obligations timely.
- Favorable resolution of legal challenges.
- Improved rating designation by rating services.
- Expanded market for MAC securities in the past few years due to increased promotion of tax exempt money market and trust funds.

In general, MAC's rate was at a higher level than the rates obtained by six other New York State public authorities. If MAC fees (expressed as a percentage of par value) had been equivalent to the lower level paid by the others, bond proceeds would have been $3.3 million greater over the four years that we surveyed, making this additional sum available to the City without any larger repayment burden. This does not imply that MAC overpaid $3.3 million; rather it supports our contention that the increased acceptance of MAC issues now justifies a reduction in underwriting fees to levels closer to those enjoyed by other authorities.

The Corporation should consider intensifying its negotiations with underwriters to reduce fees to a level more in line with those of other public authorities.

3. Competitive Bidding vs. Negotiated Bond Sales

To date, all MAC public bond sales have been accomplished through negotiation. Competitive bidding has not been used.

We analyzed a series of bond sales by six other public authorities which used both competitive bidding and negotiation. Our four-year sample of 29 issues (15 competitively bid, 14 negotiated) indicated that the weighted average interest rate of the competitively bid issues was .43 percent lower than those negotiated, equating to a $500,000 difference for the first year alone on a $100 million issue. The seemingly

* However, it is not yet clear what the adverse effect of the new All-Savers Tax-Free Certificates will have on the marketing of future MAC bonds and notes.
small rate differential equates to significantly greater interest costs when considering the huge amounts of the issues and the long periods over which the bonds are outstanding.

Although many factors affect the net interest rate of a particular bond issue, it is generally recognized that the competitive bidding process provides assurance that the rate obtained was the lowest available at the time. While we recognize that in the early stages of MAC's history competitive bidding was probably not feasible, we believe that resolution of past problems and the ever growing acceptance of its securities indicates that competitive bidding may now be appropriate.

4. Investments and Funds Management

MAC had $51 million in interest earnings for fiscal 1979, but the audit indicated some control weaknesses in the investment process. The responsible MAC staff did not have available a formal clearly defined investment strategy in line with an approved Board policy to guide and ensure compliance in evaluating individual investment decisions.

We found several instances in a two-month sample where cash balances, as much as $800,000, remained uninvested for up to three weeks. Although the amount of lost income was relatively small, the failure to invest such a large balance indicates some internal control weakness.

We recommended that MAC's investment policy be formalized and individual investment decisions documented; its oral investment instructions to its trustee be confirmed in writing; and controls strengthened to ensure timely investment of all cash balances.

5. Financial Printing

MAC implemented our previous audit recommendations to better control financial printing costs by including in its purchase contracts the right to audit vendor's records to verify billings, and requiring advance written authorization for extra printing work. We now recommend that, where necessary, MAC enforce such stipulations.

*   *   *

MAC furnished an extensive response (copy attached) to a draft of this report in order to "present as complete and accurate a picture as possible" since it differed "with some of the assumptions and analyses . . . conclusions and recommendations" of our audit. However, MAC agreed to entertain the alternative of competitive bidding and cited actions it has taken to enhance documentation of financial transactions and control financial printing costs.
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Appendix A - MAC Response to Draft Audit Report NYC-28-80,
Financial and Operating Practices of the Municipal Assistance Corporation for
the City of New York
Ms. Heather Ruth  
Executive Director  
Municipal Assistance Corporation  
for the City of New York  
One World Trade Center  
New York, NY 10048

Re: Financial and Operating Practices of the Municipal Assistance Corporation for the City of New York  
NYC-28-80

Dear Ms. Ruth:

Pursuant to the State Comptroller's audit responsibilities as set forth in Article 10, Section V of the State Constitution and Sections 2503 and 3013 of the Public Authorities Law, we have examined certain operating and financial practices of the Municipal Assistance Corporation for the City of New York (MAC) through June 30, 1979. In addition, other operating practices were reviewed through August 1980.

Our examination was made in accordance with generally accepted government auditing standards and accordingly included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

Office of the State Comptroller  
Division of Audits and Accounts
A. Introduction

1. Background

The Municipal Assistance Corporation (MAC) is a public benefit corporation created on June 10, 1975 by Article 10 of the Public Authorities Law. The legislation was enacted as a result of New York City's accumulated deficit and its inability to borrow money to meet financial obligations.

MAC's mandate is to assist the City in maintaining uninterrupted essential services and restoring investor confidence by providing financial assistance and fiscal oversight. It was authorized to issue bonds and notes, to pay or lend proceeds from such sales to the City, and to exchange its obligations for those of the City. The Corporation's obligations are secured by revenues derived from the additional 4 percent New York State tax imposed on retail sales within the City, Stock Transfer Taxes and State Per Capita Aid, all subject to annual appropriation by the State Legislature. In fiscal 1979, about $500 million of debt service (principal and interest) was secured by $1.8 billion of pledged revenues, a coverage of 3.6 times.

MAC had issued $6.6 billion of debt at June 30, 1979,* exclusive of certain note and refunding issues which were outside the limits of its then $8.6 billion issuance ceiling. Chapters 561 and 562 of the Laws of 1980, enacted in June 1980, increased the Corporation's issuance ceiling to $10 billion, again exclusive of certain issues. The law also extended the period in which new debt could be issued to December 31, 1984. Under the enabling legislation, the Corporation shall cease to exist "... one year after all its liabilities have been fully paid and discharged."

MAC's staff of 16 earned salaries totalling about $326,000 in fiscal 1979.

2. History of MAC

a. Difficulties With Initial Public Issues

MAC sold its first bond issue of $1 billion on July 10, 1975 at a net interest rate of 9.19 percent, 2.23 percentage points higher than the Bond Buyer Index, the municipal securities market yardstick, for

* As of June 30, 1981, $7.7 billion of debt had been issued against the current $10 billion ceiling.
the week of the issue. The underwriting group was able to resell only about one-half of the issue to investors. Consequently, the net interest rate of the ensuing $275 million bond sale on August 21, 1975 was 11.03 percent, 3.85 percentage points above the then current index. In addition to the newness and legal uncertainties involved with the MAC issues, borrowing difficulties were being encountered at that time by various other New York State governmental and quasi-governmental units from disclosures of potential budget balancing shortfalls. All of this had an adverse affect on MAC borrowings. Thereafter, MAC did not enter the public bond market again until June 1977.

b. Legal Challenge to Security Feature of MAC Obligations

A suit filed in 1975 challenged the constitutionality of the laws which provided that revenues from Sales Tax collected within the City and from the Stock Transfer Tax be transmitted to MAC to the extent it certified it necessary to meet its operating and debt service requirements. The New York Court of Appeals upheld the laws in April 1977. A subsequent appeal to the United States Supreme Court was dismissed on jurisdictional grounds, letting stand the Court of Appeals decision and confirming the legality of MAC's revenue flow to prospective purchasers of its obligations.

c. Debt Issuance Plan

The amount and timing of MAC's debt issuances (other than exchange and refinancing issues) were primarily predicated on the City's short-term cash requirements until October 1978. In November 1978, MAC and the City finalized a four-year Debt Issuance Plan delineating the amounts of obligations that will be sold publicly and to institutions in each of fiscal years 1979 to 1982. The Plan provided for up to $4.5 billion of long-term financing for the following purposes: the City's capital needs; refunding prior to maturity certain outstanding bonds of the Corporation; funding the Corporation's capital reserve funds and the Guarantee Fund (security for Federally guaranteed City debt); and reducing the need for an advance from the State to the City of State assistance monies, which were at an $800 million level. It also included expense items permitted to be included in the City's capital budget under State law during a phase-out period. The City completed the phase-out in fiscal 1980, two years earlier than scheduled.

d. Summary of Debt Issuance

MAC's outstanding obligations exceeded $5.9 billion at the close of fiscal 1979 as shown in the following schedule:
<table>
<thead>
<tr>
<th>Item</th>
<th>Fiscal Year 1976*</th>
<th>Fiscal Year 1977</th>
<th>Fiscal Year 1978</th>
<th>Fiscal Year 1979</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds And Notes Outstanding At Beginning Of Fiscal Year</td>
<td>-0-</td>
<td>$3,950,320</td>
<td>$4,139,095</td>
<td>$5,106,358</td>
</tr>
<tr>
<td>Bonds and Notes Issued</td>
<td>$3,975,320</td>
<td>934,625</td>
<td>3,154,458</td>
<td>901,000</td>
</tr>
<tr>
<td>Refinancing, Redemption and/or De feasance of Bonds and Notes</td>
<td>(25,000)</td>
<td>(745,850)</td>
<td>(2,187,195)</td>
<td>(82,265)</td>
</tr>
<tr>
<td>Bonds and Notes Outstanding At End Of Fiscal Year</td>
<td>$3,950,320</td>
<td>$4,139,095</td>
<td>$5,106,358</td>
<td>$5,925,093</td>
</tr>
</tbody>
</table>

*Beginning June 10, 1975.
3. Board of Directors and Officers as of June 30, 1980

a. Board
   Felix G. Rohatyn - Edward M. Kresky -
   Chairman                   Vice Chairman
   Francis J. Barry           Kenneth J. Bialkin
   George M. Brooker          Eugene J. Keilin
   Richard Netzer             Andrew P. Steffan
   Robert C. Weaver

b. Officers
   Robert F. Vagt* -         Stephen J. Weinstein -
   Executive Director        Deputy Executive Director
   Harris A. Decker -        John G. Bove - Counsel
   Deputy Executive          Director & Treasurer
   Director & Treasurer


4. Discussion Of Audit Results

The matters reported herein were discussed with MAC officials
as the audit progressed and at a closing conference. In addition, this
report was provided to MAC in draft for formal comment.

A copy of MAC's full response is attached as Appendix A in
accordance with Chapter 218 of the Laws of 1977, which directs that within
90 days after the release of the final report, the head of the agency
shall report to the Governor, the State Comptroller and leaders of the
Legislature and fiscal committees advising what steps were taken to (1)
implement the recommendations contained herein, and (2) where
recommendations were not implemented, the reasons therefore.

In addition, MAC's comments on individual recommendations and
our position thereon have been included in the related part of the report,
as appropriate.
B. Market Acceptance of MAC Debt Issues

Progressively greater investor acceptance of MAC debt issues is apparent. We documented this by comparing the net interest rate incurred by MAC on specific issues to the concurrent Bond Buyer Index (Index) during the period June 1977 to August 1980. The trend in the spread between the two steadily decreased, from 208 basis points to 90 basis points, i.e., MAC's earlier net interest rate difference of 2.08 percent higher than the average rate of the 20 securities comprising the Index declined to .9 percent. Expressed in other terms, the MAC rate declined from 37 percent in excess of the Index to 10 percent over the Index. This improved market performance results in lower MAC debt service payments. Consequently, more moneys become available to fund City operations because less State held revenues must first be set aside to support MAC obligations. (The Corporation's first two public bond sales, Series A - July 2, 1975 and Series B - August 15, 1975, were excluded from our analysis because of the introductory problems experienced in marketing securities of unknown value to investors and the burden of the City's fiscal crisis as well as the legal uncertainties at the time.)

The following schedule compares MAC's net interest rate for the ten public sales prior to August 31, 1980 to the concurrent Index:
<table>
<thead>
<tr>
<th>Bond Series</th>
<th>Bond Purchase Agreement Date</th>
<th>Amount (in millions)</th>
<th>Net Interest Rate*</th>
<th>Bond Buyer Index</th>
<th>Excess of Net Interest Rate Over Index</th>
<th>Percentage Net Interest Rate Over Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>EE</td>
<td>6/14/77</td>
<td>$250</td>
<td>7.63%</td>
<td>5.55%</td>
<td>2.08%</td>
<td>37%</td>
</tr>
<tr>
<td>8</td>
<td>8/24/77</td>
<td>200</td>
<td>7.63</td>
<td>5.58</td>
<td>2.05</td>
<td>37</td>
</tr>
<tr>
<td>JJ</td>
<td>12/22/77</td>
<td>250</td>
<td>8.45</td>
<td>5.62</td>
<td>2.83</td>
<td>50</td>
</tr>
<tr>
<td>10</td>
<td>11/17/78</td>
<td>250</td>
<td>8.45</td>
<td>6.16</td>
<td>2.29</td>
<td>37</td>
</tr>
<tr>
<td>14</td>
<td>3/9/79</td>
<td>125</td>
<td>8.69</td>
<td>6.30</td>
<td>2.39</td>
<td>38</td>
</tr>
<tr>
<td>15</td>
<td>5/24/79</td>
<td>125</td>
<td>8.20</td>
<td>6.21</td>
<td>1.99</td>
<td>32</td>
</tr>
<tr>
<td>16</td>
<td>7/31/79</td>
<td>132</td>
<td>7.70</td>
<td>6.14</td>
<td>1.56</td>
<td>25</td>
</tr>
<tr>
<td>19</td>
<td>11/1/79</td>
<td>90</td>
<td>9.09</td>
<td>7.26</td>
<td>1.83</td>
<td>25</td>
</tr>
<tr>
<td>23</td>
<td>1/17/80</td>
<td>125</td>
<td>9.18</td>
<td>7.28</td>
<td>1.90</td>
<td>25</td>
</tr>
<tr>
<td>24</td>
<td>8/20/80</td>
<td>100</td>
<td>9.58</td>
<td>8.68</td>
<td>.90</td>
<td>10</td>
</tr>
</tbody>
</table>

* Takes into account such factors as the bond coupon rate, premium or discount and underwriting fees.
The June 1977 sale netted an interest rate of 7.63 percent, some 208 basis points more than the Index. The difference is not unusual since the issues comprising the Index are all general obligations backed by the full faith and credit of the State, City or political entity issuing the bonds and almost all are rated higher than those of MAC. As long as MAC bonds are rated lower than the bonds averaged in the Index, it can be expected that MAC will continue to experience higher net interest rates. However, any improvement in MAC's net interest rates compared to the Index indicates that greater amounts will flow to the City over the lives of the bonds and/or reduced borrowings may be needed in the future.

MAC's net interest rate remained over 200 basis points higher than the Index for the four subsequent sales. The differential narrowed to under 200 basis points for the May 1979 and four ensuing issues. The most dramatic improvement occurred in the last sale we examined - MAC sold its $100 million Series 24 on August 20, 1980 at a net interest rate of 9.58 percent, 90 basis points above the Index of that week.

MAC attributed the improved market acceptance of its securities to several factors. They cited improved City cash forecasting and accounting techniques resulting in planned timing for borrowings instead of the crisis borrowings caused previously by sudden, unanticipated needs for cash. These developments have allowed MAC to issue debt on a more regular schedule and in predictable amounts. In November 1978, Moody's Investors Service upgraded its rating on MAC bonds from Baa to Baa 1, enhancing the market for MAC securities. MAC also instituted an investor information program across the country during fiscal 1979 to broaden the market for its securities.
C. Underwriting Fees

An underwriting fee is part of the financial arrangement negotiated by the syndicate (e.g., brokers and banks joining together) buying and reselling the bonds from the issuer. The fee is intended to compensate the syndicate for direct expenses associated with purchasing the issue, salesmen's commissions, and the profit for assuming the risk involved in resale of the bonds to individual and/or institutional investors.

Excluding the initial issue, we found that MAC generally paid a higher percentage of the par value of its bonds as underwriting fees than the average of those paid by other public authorities. In comparison to that average, the result was $3.3 million less in bond proceeds for the financing of City activities.

We compared the Corporation's weighted average underwriting fees (total underwriting fees & par value of total bond sales) to those incurred by the following public authorities (which comprise the "Indicator" in the following table) during the same period: Battery Park City Authority; Power Authority; Triborough Bridge and Tunnel Authority; Dormitory Authority (only those issued around the same time as Corporation issues); Port Authority of New York and New Jersey; and the Housing Finance Agency (HFA). The results of our comparison follow:
<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>1977</th>
<th>1978</th>
<th>1979</th>
<th>1980</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$250,000</td>
<td>$896,590</td>
<td>$200,000</td>
<td>$928,530</td>
</tr>
<tr>
<td>Number of Issues</td>
<td>1</td>
<td>10</td>
<td>1</td>
<td>10</td>
</tr>
<tr>
<td>Par Value (a)</td>
<td>$5,163</td>
<td>$16,359</td>
<td>$3,900</td>
<td>$14,758</td>
</tr>
<tr>
<td>Underwriters Fees: Dollars</td>
<td>2.065%</td>
<td>1.825%</td>
<td>1.950%</td>
<td>1.590%</td>
</tr>
<tr>
<td>Rate (Weighted)</td>
<td>.240%</td>
<td>.361%</td>
<td>.362%</td>
<td>(.212%)</td>
</tr>
<tr>
<td>Excess of Corporation Over Index Rate (b)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Additional Underwriters Fees Paid by the Corporation (a x b)</td>
<td>$600</td>
<td>$722</td>
<td>$2,716</td>
<td>($736)</td>
</tr>
<tr>
<td>Cumulative Total</td>
<td>$3,302</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: The $1.275 billion borrowed by MAC in fiscal 1976 negated comparison with the other authorities whose total offerings were substantially smaller.
The Port and Power Authorites were the larger bond issuers in our analysis, with a high of $350 million issued by the Power Authority (higher than MAC). Generally, the rates paid by them were lower than MAC's. The Dormitory Authority and Housing Finance Agency were smaller issuers and usually paid higher rates than MAC. The Triborough Bridge and Tunnel Authority accounted for only one $73 million issue in our analysis (fiscal 1979). Its rate was substantially lower than MAC's. Battery Park City accounted for two issues in the 1980 Indictor and its rates were about equal to or better than MAC's. Also, MAC's bonds received a rating from Standard and Poors, a major rating service, that is comparable to the Port, Power, Triborough Bridge and Tunnel and Battery Park City Authorities. Therefore, the "risk" to the underwriter in selling MAC's bonds appears no greater than in marketing the securities of these other authorities.

Competitive bidding in this analysis did not appear to affect underwriting fees. For example, the Port Authority generally bid their issues and the Power Authority did not; yet, for both agencies their fee rates were generally lower than MAC's.

As the schedule shows, the Corporation paid $3.3 million more in underwriter fees over the four-year period than the average paid by the comparison group of public authorities. The rates paid by MAC ranged between 1.950 percent and 2.151 percent. This was more than the Indicator group except for 1980. However, it should be pointed out that the 1980 Indicator includes two HFA bond sales which resulted in unusually higher underwriter rates (2.795 percent - $100 million issue; and 2.895 percent - $101 million issue). The rates paid on these sales were not typical of the rates paid on other HFA issues. If the 1980 HFA issues are excluded from the Indicator, the Corporation's weighted average rate for the year would exceed it by .353 percent. This difference amounts to $1.2 million on the amount of bonds sold by the Corporation in that year. We are not implying that MAC overpaid $3.3 million in underwriting fees over the four-year period. Rather, our position is that the increased stability of MAC issues should now result in underwriting fees being reduced to a level comparable with those paid by other authorities.

As shown below, underwriting fees represented about 2 percent of MAC public issues over the years, other than for the special circumstances of Series A:
<table>
<thead>
<tr>
<th>Series</th>
<th>Date</th>
<th>Principal Amount (in millions)</th>
<th>Underwriting Fees Percent</th>
<th>Underwriting Fees Amount (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>7/75</td>
<td>$1,000</td>
<td>.794%</td>
<td>$7.9</td>
</tr>
<tr>
<td>B</td>
<td>8/75</td>
<td>275</td>
<td>1.978</td>
<td>5.4</td>
</tr>
<tr>
<td>EE</td>
<td>6/77</td>
<td>250</td>
<td>2.065</td>
<td>5.2</td>
</tr>
<tr>
<td>8</td>
<td>8/77</td>
<td>200</td>
<td>1.950</td>
<td>3.9</td>
</tr>
<tr>
<td>JJ</td>
<td>12/77</td>
<td>250</td>
<td>2.528</td>
<td>6.3</td>
</tr>
<tr>
<td>10</td>
<td>11/78</td>
<td>250</td>
<td>1.925</td>
<td>4.8</td>
</tr>
<tr>
<td>14</td>
<td>3/79</td>
<td>125</td>
<td>2.000</td>
<td>2.5</td>
</tr>
<tr>
<td>15</td>
<td>5/79</td>
<td>125</td>
<td>1.948</td>
<td>2.6</td>
</tr>
<tr>
<td>16</td>
<td>7/79</td>
<td>132</td>
<td>2.370</td>
<td>2.1</td>
</tr>
<tr>
<td>19</td>
<td>11/79</td>
<td>90</td>
<td>2.032</td>
<td>2.5</td>
</tr>
<tr>
<td>23</td>
<td>1/80</td>
<td>125</td>
<td>1.914</td>
<td>1.9</td>
</tr>
<tr>
<td>24</td>
<td>8/80</td>
<td>100</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$2,922</td>
<td></td>
<td>$47.6</td>
</tr>
</tbody>
</table>

We would have expected a more discernible downward trend in underwriting rates in light of (1) MAC's continued and improved acceptance in the bond market, (2) the regularity and predictability of its issues, (3) continued excellent revenue coverage as security for its bonds, (4) demonstrated MAC ability to meet its obligations timely, (5) resolution of legal challenges, and (6) higher designation of MAC bonds by major rating services. Also, the market for MAC's bonds has expanded in recent years from the growth and favorability of tax-exempt money market and trust funds. Additionally, the major underwriting groups have dealt with MAC repeatedly and are familiar with the circumstances involved in issuance and sale of MAC bonds. Therefore, it would be expected that the underwriting costs have declined, which should be reflected in their fees.

**Recommendation**

The successful market for, and superior security of MAC bonds justifies an intensified MAC effort to negotiate reduced underwriting fees comparable with those paid by similarly marketable public authority issuers.

(The MAC reply argued that the true cost of an issue must consider initial offering premiums or discounts and interest as well as the underwriting fee. MAC's record in this regard "is a good one," considering the unique nature of the Corporation and its "enormous volume of" issuances. However, "The Corporation always has and will continue to negotiate . . . to obtain the lowest total cost . . .")

**Auditor's Comment:**

We do not agree that the premium or discount which adjusts the stated interest rate and affects the risk (greater or lesser) to the under-
writer, must be linked to the size of the underwriting fee. Our analyses herein demonstrated that the risk for underwriting MAC issuances has decreased markedly. MAC's uniqueness and large scale issues were of major significance in its early history. However, the six positive factors that guide investors and are described in the text, along with the other favorable conditions that MAC underwriters now enjoy justify a lower rate of underwriting fees on MAC's issues.)
D. Competitively Bid vs. Negotiated Bond Sales

The interest rates on all MAC public bond sales thus far have been negotiated with the underwriters. (MAC's enabling legislation does not require competitive sale of its bonds.) In contrast, many other public authorities employed competitive bidding procedures on at least a portion of their public sales. Our comparative analysis of competitively bid sales to those negotiated by the six public authorities (Battery Park City, Port Authority, Housing Finance Agency, Dormitory Authority, Triborough Bridge and Tunnel Authority and the Power Authority) from fiscal 1977 to fiscal 1980 showed that overall, the competitive sales resulted in lower interest rates.

The following schedule compares the weighted average net interest rate of the competitively bid issues to those of the negotiated sales and their relationship to the Bond Buyer Index during the four-year period:

<table>
<thead>
<tr>
<th></th>
<th>Competitively Bid</th>
<th>Negotiated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Issues</td>
<td>15</td>
<td>14</td>
</tr>
<tr>
<td>Range of Issues</td>
<td>$5.4 million-$350 million</td>
<td>$19.6 million-$236 million</td>
</tr>
<tr>
<td>Average Issue Amount</td>
<td>$91.8 million</td>
<td>$106.0 million</td>
</tr>
<tr>
<td>Weighted Average Net Interest Rate</td>
<td>7.05%</td>
<td>7.48%</td>
</tr>
<tr>
<td>Bond Buyer Index Average For Fiscal Years 1977-1980</td>
<td>6.36%</td>
<td>6.36%</td>
</tr>
<tr>
<td>Excess of Net Interest Rate Over Index</td>
<td>.69%</td>
<td>1.12%</td>
</tr>
</tbody>
</table>

Our analysis shows that the higher 43 basis points of the net interest rate of the negotiated bond sales over the competitively bid sales rate, amounted to almost $500,000 in additional interest costs for just the first year for the $106 million average negotiated issue amount.

Corporation officials advised that their past decisions to negotiate rather than bid were based on the judgments of their financial advisor and various underwriters. However, for the sale of bonds for which a demand exists, it is generally recognized that the competitive bidding process provides greater assurance than negotiation that the net interest rate obtained was the most reasonable under the circumstances. Based on this view, and the substantial acceptance of MAC issues, the positive fiscal actions employed by the City, and the lack of prior competitive bid effort, it seems to us that MAC should, where practicable, test competitive bidding procedures on future bond sales.
Recommendation

MAC should test competitive bidding procedures on future bond sales, developing and retaining written justification if not practicable to use such procedures.

(MAC responded that "There simply is no meaningful procedure for comparing ..." competively bid with negotiated bond issuances. Also, "we do not agree with the implication in the Audit Report that competitive bidding assures the lowest possible net interest cost." The Corporation's response acknowledged that the merits of competitive bidding versus negotiating continues to be a matter of "professional and academic debate. ..." and MAC "will continue to entertain the alternative of competitive bidding from time to time ..."

Auditor's Comment:

A June 1979 Journal of Finance article, "Comparative Costs of Competitive and Negotiated Underwritings in the State and Local Bond Market," reported the results of comparing 404 pairs of general obligations and 330 pairs of revenue bonds issued over a 16-year period. The criteria for the pairings insured comparability. The article's Conclusion: "Notably, we found that NIC [net interest cost] is significantly higher for bond issues sold by negotiation. ..." Furthermore, "negotiated sales result in significantly higher new issue borrowing cost - a cost premium that must eventually be borne by state and local governments in the form of increased taxes and/or reduced services."

The same article, in comparing underwriter spreads pointed out that for both general obligation and revenue bonds, the spread was close to $5 per thousand higher for negotiated sales versus those competitively bid.)
E. Investments and Funds Management

MAC's mission as a fiscal agent involved receiving and disbursing over $1 billion in fiscal 1979, including interest earnings exceeding $51 million. Its investments were valued at about $810 million at June 30, 1979.

MAC's fiscal policies and procedures are governed by the enabling legislation and its general and series bond resolutions.

1. Investment Strategy

We found no formalized statements of investment policy or strategy nor were internal and external meetings on the subject documented by minutes or written memoranda. Investment decisions are restricted by various statutory requirements and bond resolutions, but MAC has discretion to select from a range of permissible investments; debt securities issued by the Federal government, specified Federal agencies, and New York State. It is also constrained in scheduling maturities that will generate sufficient cash to satisfy MAC obligations as they fall due.

The absence of documentation supporting these decisions in the past precludes an independent evaluation of whether MAC pursues a reasonable general or specific investment policy. We believe it imperative that formalized policy is necessary to guide its investment decisions considering its fiduciary responsibility for these hundreds of millions of dollars invested.

We were told that MAC's treasurer periodically consults with its financial advisor, Lazard Freres and Co., which serves MAC at no cost to obtain opinions on current and future market conditions. (MAC's Chairman is also a general partner with Lazard Freres and Co.) The treasurer also obtains advice from other brokerage houses and banks and there is a MAC finance committee to guide fiscal operations. MAC officials indicated that the combined outside advice and in-house analyses provided the expertise for its investment strategy. Yet, there is no documentation (minutes of meetings, memos to file, notes of conversations) setting forth the results and/or conclusions of these discussions. Fiscal responsibility and accountability for the management over such vast sums of public moneys requires a formal investment policy with supporting documentation of compliance thereof, pursuant to its mission.

2. Investment Selection

The greater the investment earnings for application to debt service, the larger the flow of funds to New York City after satisfaction of MAC fiscal requirements from State held revenues. We could not determine whether MAC maximized investment earnings because the day-to-day investment selection decisions were not evidenced in writing.

We believe the fiduciary responsibility of MAC for public funds requires that it justify in writing its daily investment decisions. Con-
considering this position and the significant number/amount of investments, we assume that the merits of each investment are thought out and discussed, and it is this process that should be documented in accounting for MAC investment decisions.

3. Uninvested Balances

We found four instances, during a check of a two-month test period, of MAC holding uninvested cash balances ranging from $6,000 to $800,000 from overnight to three weeks. Lost interest was about $2,700, a minor sum compared to the $51 million earned in fiscal 1979. But, holding as much as $800,000 uninvested for even a short time (15 consecutive days) indicates a weakness in controls to ensure the investment of all available funds.

Recommendations

1. The MAC investment decision-making process should be formalized with written:
   a. investment policy,
   b. minutes of meetings and discussions wherein policies and strategies are developed, and
   c. justifications in support of investment decisions.

2. Controls should be strengthened to ensure timely investment of all available funds.

(MAC responded that it considered the audit descriptions of control weaknesses misleading and incomplete. Nevertheless, it also reported on its efforts in this area, including the appointment of an investment advisor and plans to establish in-house computer capability to enhance transaction documentation. The Corporation also hopes to arrange for unusually small repurchase agreements to reduce uninvested cash balances.

Auditor's Comment:

We believe these proposed actions will effectively implement our recommendations.)
F. **Financial Printing Costs**

Our previous audit report "Summary of Financial Printing Audits - April 18, 1977 - August 28, 1978" (NY-MISC-29-79) recommended steps to better control financial printing costs incurred by both New York State and MAC. Recommendation (1) advocated that all financial printing contracts should incorporate specifications establishing the basis and charges for extra hours and weekend work, setup expenses, and meals, transportation and other incidental costs. Also, the contract should allow for post audit with contractors required to retain documentation for all charges. Other recommendations were that (2) printing bills be field audited as necessary, (3) printers be held to bid prices and (4) guidelines on allowable charges be developed. MAC implemented most of the recommendations so that our review of the printing contract for the August 1, 1979, Series 16 issue did not disclose any exceptions. Notwithstanding, we did observe that:

It has not been MAC policy to field audit bills nor have they requested any governmental agency or public accountants to perform such audits in its behalf. While it may not be necessary to field audit all printing contracts, we believe such audits should be conducted from time to time.

The contract permits the printer to incur overtime and additional printing costs only after written authorization from MAC officials. However, we were told that these extra charges were verbally approved, thereby waiving the requirement. We believe that MAC should comply with this contract provision to prevent misunderstanding, errors, etc., and assist in verifying the accuracy of billed charges because the period of time between verbal authorization and invoice receipt date could be substantial. In the case of the billing we reviewed, the time difference was one month.

**Recommendations**

1. We reiterate the prior audit recommendation that printing bills should be field audited as necessary.

2. MAC should comply with the contract provision authorizing extra work in writing.

(The MAC reply agreed with Recommendation 1, although it did not consider audits necessary at this time. The Corporation did not concur with Recommendation 2, because of changes it credited itself with instituting in the financial printing process that obviated written directions to printers.)
Auditor's Comments:

We observed that most of the serious shortcomings in MAC's procedures disclosed in our prior audit have been corrected, other than field auditing of printing bills. The unique demands and resulting large expenditures of this service necessitate adoption of this recommendation. For the same reason, we continue to believe MAC needs to enforce its own contract provisions for printing jobs, except in emergencies.)
30 June 1981

THE STATE OF NEW YORK
Department of Audit and Control
Albany, New York 12236

Attention: R. Wayne Diesel, Deputy Comptroller
Arthur N. Gordon, Director, Metropolitan Office

Gentlemen:

We have received and reviewed the working draft of the Audit Report "Financial and Operating Practices of the Municipal Assistance Corporation of New York" (NYC-28-80), which was transmitted to us by letter dated May 19, 1981. That report covers the period up to approximately one year ago -- principally the first four years of the Corporation's existence, from its establishment in June 1975 through June 1979.

We appreciate the important statutory responsibilities of the Department of Audit and Control, and welcome the independent examination of the Corporation's operations and constructive criticisms from any appropriate source. At the same time, we differ with some of the assumptions and analyses contained in the Audit Report, as well as with certain of its conclusions and recommendations. This response focuses on those differences which we present in the interest of conveying a comprehensive perspective to current and prospective investors in the Corporation's obligations and to other interested taxpayers of the State of New York. Fundamental confidence in the efficiency and integrity of the Corporation's operations -- particularly among investors -- is essential to the continuation of our role in providing a principal source of capital financing for the City of New York and support to the City in its own program of regaining self-sufficiency in the tax-exempt
The recognized achievement of the Municipal Assistance Corporation, both with regard to its financings and its administration, are most accurately assessed when viewed in the context of the circumstances in which they have been realized. At the time of its creation in 1975, in the midst of the unprecedented fiscal crisis being experienced by the City of New York, the Corporation faced what was widely believed to be an impossible financing task. The Corporation's success in carrying out that task and in meeting its legislative mandate to oversee fiscal reform of the City of New York has been remarkable, in our view. To date, the Corporation has issued approximately $12.5 billion of its bonds and notes, an unequalled amount by a single issuer in so short a period. During that same period, the Corporation developed and implemented critical and complex plans to provide financing for the City of New York until such time as the City can regain full market access to meet all of its own needs.

The Corporation's record also indicates its continuous and effective efforts to improve performance in all aspects of its financing and administration, including the areas discussed in the Audit Report. These efforts were undertaken principally on the Corporation's initiative, although some were partially in response to recommendations of outside observers. Through such efforts the Corporation has achieved a steady and substantial increase in market access and investor confidence, reduced its costs of borrowing, and implemented administrative controls and procedures which have produced substantial savings to the Corporation and the City.

The Audit Report acknowledges many of the Corporation's accomplishments. However, we do not believe that the Report fully recognizes the significance of the Corporation's performance or wholly accurately assesses the financial markets in which the Corporation must function.

The five areas discussed in the Audit Report are as follows:

1. Market Acceptance. We heartily agree with the basic conclusion that the Corporation's market acceptance increased markedly between 1975 and 1980, as reflected in the decreasing interest rates on its bonds compared to the "Bond Buyer Index," thereby lowering its debt service expenses and increasing the revenues available to the City of New York. The decline in the gap between the Corporation's interest rates and the Bond Buyer Index from 283 basis points in 1977 to just 90 basis points in 1980 is most dramatic and must reflect a significant growth of investor confidence in the Corporation's
obligations. Even in today's difficult tax-exempt market, characterized by unprecedented high rates and volatility, the Corporation enjoys this increasing investor confidence as evidenced by a continued narrowing of the gap between MAC rates and the Bond Buyer Index.

2. Underwriting Fees. The Audit Report observes that the underwriting fees paid on the Corporation's public bond issuances remained relatively stable between 1977 and 1980 at approximately 2 percent of principal amount. However, we differ with the conclusion that those fees should have shown a more discernable downward trend, and with the analysis purporting to show that those fees were higher than they should have been. The Corporation always has and will continue to negotiate with its underwriters to obtain the lowest total cost for its public borrowings. Such an analysis must look at all costs associated with such a transaction -- including interest rates and initial offering discounts or premiums as well as underwriting fees -- in order to evaluate meaningfully the true cost of such issuances. We believe that the Corporation's record in this regard is a good one, and appears even better when viewed in the context of its unique nature and the enormous volume of bonds which it has sold over a very short period.

The comparison of the Corporation's underwriting costs to those of other selected public authorities in the Audit Report does not take account of important differences among these tax-exempt issuers and among the securities issued, or of relevant market conditions. We believe that it simply is not possible analytically to conclude that, if the Corporation had been able to perform at a level comparable to more seasoned credits with higher ratings, smaller issuance programs and more established markets, the costs of its public financings over the period aggregating $1.5 billion would have been reduced by $3.3 million. In addition, it should be noted that during the period examined the Corporation also sold $4.4 billion of its bonds privately, raising the relevant total for purposes of market impact analysis to $5.9 billion of bonds issued.

3. Competitive Bidding vs. Negotiated Bond Sales. The Audit Report observes correctly that all of the Corporation's public bond sales have been negotiated with a group of underwriters selected by the Corporation, rather than by means of competitive bidding by more than one underwriting group. However, we believe that the net interest cost in each of the borrowings was, in fact, lower because the sale was negotiated than it would have been if competitively bid. It must also be noted that all of the terms of each of the Corporation's negotiated sales were approved by the State Comptroller, as required by law.
Furthermore, we do not agree with the implication in the Audit Report that competitive bidding assures the lowest possible net interest cost. The merits of competitively bid versus negotiated bond sales continues to be one of professional and academic debate. In addition, we do not view as valid the analysis of selected bond sales by other public authorities to demonstrate that competitively bid sales resulted in a somewhat lower average interest cost than negotiated sales. There simply is no meaningful procedure for comparing actual bond issuances which have been competitively bid with different issuances which have been negotiated. The Corporation will continue to entertain the alternative of competitive bidding from time to time, as we have in the past, and will continue to rely on information furnished by its financial advisors in making a determination whether competitive bidding is likely to produce comparable or more favorable terms, given the conditions prevailing in the marketplace at the time.

4. Investments and Funds Management. The Audit Report states that there existed certain control weaknesses in the Corporation’s investment process with regard to establishment of guidelines, documentation of instructions, and full investment of cash balances. Those statements are misleading and incomplete. Moreover, additional controls have been implemented to supplement those already in place.

Investment of all of the Corporation’s funds is clearly and narrowly constrained by express provisions of State law and the Corporation’s general bond resolutions. These provisions do constitute guidelines in that they substantially limit the Corporation’s discretion by restricting the range of permissible investments and further require specific investment decisions to reflect the times at which the invested funds are required for the Corporation’s purposes. In fact, all investments by the Corporation since its inception have been made in accordance with those requirements. Nevertheless, as a continuation of its policy to enhance its funds management, the Corporation has implemented additional investment guidelines. In April 1981, after seeking proposals from 15 qualified firms, the Board selected the Bank of New York to act as its Investment Advisor. In addition, during the past two years the Corporation has improved the documentation of both its investment decisions and its investment confirmations.
The prospective purchase and installation of an in-house computer by the Corporation will enable its staff further to enhance documentation of all such transactions.

The Audit Report cites several instances in a four-month period during which cash balances ranging from $6,000 to $800,000 remained uninvested for periods from overnight to three weeks, resulting in lost interest of about $2,700. First, as the report notes, that number is "relatively small;" in fact, it is minuscule compared to the Corporation's investment income of $51 million for the year in question. The Corporation's investment portfolio exceeded $800 million in 1979, and currently aggregates approximately $1.3 billion. Moreover, Repurchase Agreements -- the customary means of investing cash for short periods -- are generally available for a minimum of $1 million. However, we have, subsequent to the period examined but prior to your Audit Report, improved our internal forecasting ability in order to enable us to attempt to arrange unusually small repurchase agreements when the market permits, in order to reduce even further our already minimal uninvested cash balances.

Finally, it must be noted that the unique role of the Corporation subjects it to a continual high degree of scrutiny by financial, legal and governmental institutions independent of the Corporation. It must also be stressed that its investment procedures have been developed in conjunction with and are periodically reviewed by outside accountants, lawyers and trustees. Furthermore, all our financings are fully documented, including disposition and investment of proceeds.

And the Corporation, along with major public issuers in this country, publishes quarterly and annual financial statements.

5. **Financial Printing.** The Audit Report states that the Corporation implemented most of the recommendations contained in a 1978 report of the Department of Audit and Control with regard to financial printing. While this is certainly true, it implies incorrectly that the initiative in this regard was wholly that of Audit and Control, and that the Corporation's actions were merely responsive to that report, and even then not fully so. It is far more accurate to characterize the Corporation as having taken the lead in developing and implementing a mechanism to control financial printing costs in a meaningful manner which did not exist previously in either the public or private sector. The effectiveness of the procedures put into place by the Corporation has been shown by the substantial decrease in financial printing costs to the Corporation, and the commendation of those procedures to
Municipal Assistance Corporation
For The City of New York

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other public issuers in New York by the State Securities Coordinating Committee, which is chaired by the State Comptroller.

We believe that these procedures have proven more than sufficient in controlling costs over the past few years, and that no real need would be served by reducing to writing all directions to financial printers from authorized officers of the Corporation, as the Audit Report recommends.

The Audit Report also recommends that financial printing bills be field audited as necessary. We agree, and expect to request such field audits from time to time, and further expect that, from time to time, that Audit and Control will undertake such audits on its own initiative. However, no audits appear necessary at this time, inasmuch as the Department during the past few years conducted lengthy and detailed field audits of four of the six printing firms with which the Corporation has done business.

Conclusion

We appreciate this opportunity to review the Audit Report. Our comments are not intended to elicit a wholly laudatory report. We understand that a primary purpose of such an audit is to identify areas in which improvements can be made. Indeed, we believe that such evaluations can assist the Corporation. However, inasmuch as the Corporation's mission requires continual access to the public credit markets, it is also important that any such report present as complete and accurate a picture as possible. These comments are intended to provide such completeness and accuracy, and we submit them for consideration for inclusion in the report on such a basis.

Sincerely,

Heather L. Ruth
Executive Director

cc: C. Mark Lawton
Deputy Director
Division of the Budget
State of New York
Albany, New York 12224