

Executive Summary

In conformance with paragraphs 5.2.4 and 6.8.1 of DoD Instruction 1015.15, on June 3, 2008, Ms. Priscilla Pazzano, OUSD(P&R), Resale Activities and NAF Policy Office, MC&FP, and Ms. Audrea Nelson, OUSD(C), Accounting and Finance Policy Office, conducted a review of the Military Services' Annual NAF Treasury Reports, examined the NAF portfolios, and make recommendations for improvement to policy.

Based on the reports and presentations by each of the Military Service treasury managers, **TAB 2A**, we have reasonable assurance that the Military Departments are exercising oversight, in conformance with DoD Instruction 1015.15 to ensure that:

- NAF are accumulated and invested to meet cash flow requirements (paragraph 4.6);
- The DoD Components are exercising caution to ensure the safety of NAF. Management of NAFs is based, in order of priority, on safety, liquidity, and yield (paragraph 4.6);
- NAFs may be accumulated and invested to meet cash flow requirements to finance NAFI programs. NAFs in excess of installation cash requirements are transferred to a single NAF account (paragraphs 4.6 and 6.8);
- Fiduciary responsibility is identified for NAF deposits and investments (paragraph 4.7);
- NAF accounts are maintained in financial institutions that are U.S. federally insured or designated by the U.S. Treasury (paragraph 6.8);
- Transactions and investments are limited to obligations of organizations or institutions that are sponsored, insured or backed by pledge of collateral by the U.S. Treasury (paragraph 6.8);
- NAF on deposit with financial institutions are sufficiently liquid to meet requirements and earns a rate of return that preserves the value of funds invested (paragraph 6.8);
- Each organization that invests NAF has an investment oversight group (paragraph 5.7.4); and
- Investment funds were audited by a certified public accountant or entity licensed to conduct public audits and the NAF investment function is reported as an assessable unit in the Internal Management Control Program (paragraph 6.8.2).

The review disclosed that the investment portfolios and treasury management practices conform to current DoD policy and previous year findings have been corrected, with the following exceptions:

- DoDI 1015.15 requires that one member of each Component's oversight group be an investment professional that is independent of the management of the portfolio and organization. The U.S. Army Family and Morale, Welfare and Recreation Command (USAFMWRC) has not secured this professional advice. The Army reported that the acquisition process was underway in 2006 and has not yet been completed, although the Army expects to have it completed in 2008.
- Copies of each audit report were received except for the Air Force Morale, Welfare, and Recreation (MWR) Fund and the Air Force Civilian Welfare Fund; all audit reports received contained unqualified audit opinions. The Air Force issued a new audit contract for the headquarters funds for FY 2007 and the audits are expected to be completed by September 2008 for the MWR Fund and the Civilian Welfare Fund.
- The Air Force does not employ available tools for foreign currency hedging to protect construction funds from currency fluctuation. Both forward contracts and foreign currency options are authorized by DoDI 1015.15. GAO, in testimony before the House Committee on Oversight and Government Reform, June 25, 2008, identified \$31.9 million in AAFES and Air Force nonappropriated fund costs due to the devaluation of the dollar against the Euro since the inception of the Kaiserslautern Military Community Center Project, and lack of foreign currency hedging.
- Recommendations resulting from the *PriceWaterhouseCooper* "Evaluation of NAFI Investment Policy," dated January 28, 2005, were incorporated in the revision of DoDI 1015.15, published October 31, 2007 (**TAB 2B**). Consequently, implementation of new requirements will be reflected in the 2008 reports, due April 1, 2009. Major changes include: definitions for financial derivative (E2.8.), leveraged investing (E2.10.), portfolio expenses (E2.17.), and treasury management (E2.25.); authorizing leveraged investing (E9.2.3.); requiring collateral for repurchase agreements to be marked-to market daily (E9.4.3.1.); authorizing institutional government money market funds (E9.4.7.); including a representative of the Secretary of the Military Department on the component's investment oversight committees (E9.7.4.); categorizing investment portfolios according to the primary purpose of the fund (E9.7.4.2.); using specified indices as benchmarks (E9.7.4.5.); marking the portfolio to market on at least a semi-annual basis (E9.7.4.6.); identifying, measuring and reporting credit risk for foreign currency and interest rate hedging (E9.7.6.); providing borrowing and interest rate hedging policy (E9.8.); authorizing one-time loan agreements for individual capital projects not to exceed 30 years (E9.8.2.); and providing both total and realized return and return before and after expenses (E9.9.3.3.).

A summary of cash balances, investments and yields, benchmarks, and loans is at **TAB 2C**:

DoD-wide NAF cash and investments increased from \$2.575 billion at the end of CY 2006 to \$3.005 billion at the end of CY 2007. All of the Military Service MWR and Lodging balances increased with \$348 million of the \$431 million increase attributed to the Army (balance of \$1.262 billion), \$11 million to the Navy (balance of \$388 million), \$30 million to the Marine Corps Community Services (balance of \$222 million), and \$23 million to the Air Force (balance of \$632 million). NEXCOM's cash and investment balance increased \$43 million to \$119 million, while AAFES' balance declined \$23 million to \$34 million and Military Sealift Command Exchange balance declined \$135 thousand to \$970 thousand.

Military MWR funds accounted for \$1.8 billion or 59 percent of the total DoD cash and investment balances with about half of that at the Service headquarters level and the other half almost evenly divided between major commands/regions and installations. Exchanges accounted for \$346 million or 12 percent; Marine Corps installation exchanges owned \$128 million. Civilian welfare NAFIs accounted for \$31 million or one percent, supplemental mission NAFIs accounted for \$108 million or four percent, special purpose NAFIs accounted for \$235 million or eight percent, and lodging NAFIs accounted for the remaining \$544 million or 18 percent. The Services centralize excess installation cash in different ways; the Army and the Navy employ internal borrowing and centralize a portion of the exchange dividends to leverage cash for Service-wide requirements. The Marine Corps computes excess installation cash semi-annually and reports to the Board of Directors for necessary action. The Air Force centralizes a portion of the exchange dividend for major construction and loans for capital leases.

Outstanding loans increased from \$1.523 billion at the end of CY 2006 to \$1.652 billion at the end of CY 2007, with AAFES accounting for \$1.365 billion. The Army has outstanding loans of \$128.5 million used to finance the construction of the Edelweiss Lodge Armed Forces Recreation Center in Garmisch, Germany, and expansion of the Shades of Green Armed Forces Recreation Center in Orlando, Florida. The Marine Corps has loans of \$ 60.07 million, including \$54.37 million used for construction and \$5.7 million remaining on the loan to purchase the inventory and assets for the Marine Corps Air Station Miramar (formally Naval Air Station) exchange from the Navy.

Calendar year 2007 annual yield (total return) on investments ranged from 4.28 percent to 6.52 percent; average yield DoD-wide as of December 31, 2007, was 4.47 percent with an average maturity of 575 days. Ninety percent of total DoD investments as of December 31 were invested in Government-Sponsored mortgage securities. The primary determinant for annual yield was average maturity and the mix of callable versus

non-callable securities, with longer maturities and callable securities earning higher yields.

- Army 2007 annual yield was 5.26 percent for the Army Banking and Investment Fund (ABIF), 5.40 percent for the Army Civilian Welfare Fund (ACWF), and 5.56 percent for the Army Central Insurance Fund (ACIF). As of December 31, the ABIF was 94 percent invested in Federal Home Loan Bank (FHLB), Federal Home Loan Mortgage Corp. (FHLMC or Freddie Mac), and Federal National Mortgage (FNMA or Fannie Mae) mortgage securities with an average maturity of 420 days. ACWF was 80 percent invested in FNMA securities with 20 percent in certificates of deposit (CDs) and an average maturity of 297 days and ACIF was totally invested in treasury notes with an average maturity of 314 days.
- Navy CNIC annual yield was 6.52 percent. Average maturity was 741 days. CDs comprised 20 percent of the portfolio, while mortgage securities accounted for 77 percent as of December 31.
- NEXCOM annual yield was 4.90 percent with average maturity of 45 days. As of December 31, 90 percent of the portfolio was invested in mortgage securities, with the remainder in CDs and cash. The Military Sealift Command portfolio was primarily invested in CDs with an annual yield of 4.90 percent and average maturity of 462 days.
- Marine Corps annual yield was 4.96 percent with average maturity of 1100 days. FHLB securities accounted for 46 percent of the portfolio as of December 31, with another 34 percent invested in FHLMC, FNMA, and Federal Farm Credit Bank (FFCB) securities. Repurchase agreements accounted for 11 percent.
- Air Force annual yield was 6.34 percent with an average maturity of 870 days. Fifty-one percent of the portfolio, as of December 31, was invested in FHLB securities with another 37 percent invested in FHLMC, FNMA and FFCB securities. Ten percent of the portfolio was invested in CDs.
- AAFES had 65 percent of its investments in German Government bonds as of December 31 to secure foreign severance pay liabilities with 20 percent in FHLB mortgage securities and 15 percent in cash. Annual yield was 4.28 percent with average maturity of 332 days.

Summaries of the reports submitted by the Military Services are at **Attachment 2D**.

NAF Treasury Managers

Name	Organization	Phone #	FAX #	E-mail
Clint Lilley	USAFMWRC			
Jim Jordan	AAFES			
Daryl Davis	CNIC			
Seb Inguanti	NEXCOM			
Rich Owens	NEXCOM			
Linda Heikel	MCCS			
Niels Jensen	AFSV			