WISCONSIN LEGISLATIVE COUNCIL

MEETING MINUTES

STUDY COMMITTEE ON THE INVESTMENT AND USE OF THE SCHOOL TRUST FUNDS

Room 411 South
State Capitol
Madison, WI

September 5, 2018
10:00 a.m. – 4:00 p.m.

Call to Order and Roll Call

Chair Katsma called the meeting to order. The roll was called, and a quorum was present.

COMMITTEE MEMBERS PRESENT:	Rep. Terry Katsma, Chair; Sen. Lena Taylor, Vice Chair; Rep. Don Vruwink; Sen. Duey Stroebel; and Public Members Kim Bannigan, Jerry Derr, Stephen Eager, Don Merkes, and Steve O'Malley.
COUNCIL STAFF PRESENT:	Zach Ramirez and Rachel Snyder, Staff Attorneys.
APPEARANCES:	Cathleen Rittereiser, Executive Director, Commonfund Institute; Rochelle Klaskin, Interim Executive Director and Chief Legal Counsel; and William Ford, Legislative Advisor, State of Wisconsin Investment Board; Jeff Gruetzmacher, Senior Vice President, Royal Bank, Elroy; and Jon Turke, Director, Government Relations, Wisconsin Bankers Association; Patrick Schloss, Community Development Manager, City of West Allis; Mike VanLanen, Chairman, and Dave Cerny, Economic Development Coordinator, Town of Scott; Phil Cosson, Senior Municipal Advisor/Director, Ehlers, Inc.; Sean P. Nelson, Vice President for Finance, University of Wisconsin (UW) System; and Brian Sloss, Associate Dean for Outreach and Extension, College of Natural Resources, UW-Stevens Point.

One East Main Street, Suite 401 • Madison, WI 53703-3382
(608) 266-1304 • Fax: (608) 266-3830 • Email: leg.council@legis.wisconsin.gov
http://www.legis.wisconsin.gov/lc

Approval of the Minutes of the August 16, 2018 Meeting

Representative Vruwink moved, seconded by Senator Stroebel, that the minutes of the August 16, 2018 meeting be approved. The motion was approved by unanimous consent.

Presentation by the Commonfund Institute

Cathleen Rittereiser, Executive Director

Ms. Rittereiser provided an overview of the history of endowment fund management practices, noting that what it means to make prudent investment decisions on behalf of beneficiaries has changed over time. In the past, common practice was to favor conservative, low-risk investment with the goal of preserving the historic dollar value of the endowment. Such cautious investment practices favored fixed income assets over equities, which inherently carry more risk. However, over time, this practice fell out of favor as the growth rate of fixed income assets failed to keep pace with rises in inflation and the value, in real terms, of endowments decreased.

Beginning with Ford Foundation reports published in the 1960s, best practice for endowment management has instead focused on preserving intergenerational equity via total return investing. Under total return investing, endowment trustees have the flexibility to invest with a focus on growth, so as to sufficiently fund distributions both to meet present needs and into perpetuity. In summary, Ms. Rittereiser emphasized that overly cautious investment is not prudent; rather, trustees should invest funds according to the endowment model, which favors investing in a diversified portfolio that balances the need for some liquidity in order to make distributions in the present with an emphasis on equities for long-term growth at a rate greater than inflation.

Ms. Rittereiser noted that the rate of return on investment is highly dependent upon the skills of investment managers, especially in regards to asset classes that are not very liquid and, therefore, hold greater potential for returns in the long-term, but also greater risk. She explained that, in general, responsibility for endowment management can be divided between trustees and professional investment staff. Specifically, trustees, as fiduciaries, are generally responsible for governance, including development of investment, spending, and asset allocation policies, risk management guidelines, and performance monitoring.

In response to questions from committee members, Ms. Rittereiser noted the following: (1) that endowments invested according to the endowment model typically do not purchase tax-exempt instruments; (2) that the current 3.5% rate of return to beneficiaries of the school trust funds is low, but that it could be enough to meet current needs; and (3) that the current Board of Commissioners of Public Lands (BCPL) investment policy is too heavily weighted towards fixed income assets to be characterized as following the endowment model.

Mr. Ramirez provided explanation to the committee regarding current legal limitations on how the school trust funds may be invested. Specifically, Mr. Ramirez noted that the Wisconsin Constitution is currently interpreted as preventing the BCPL from making distributions from principal and, therefore, the BCPL is legally prohibited from engaging in pure total return investing. He also explained that, under current state statute, the BCPL may delegate investment authority to the State of Wisconsin Investment Board (SWIB); however, if BCPL were to make such a delegation, SWIB is generally limited to investing in fixed income instruments.

Presentation by the State of Wisconsin Investment Board

Rochelle Klaskin, Interim Executive Director and Chief Legal Counsel, and William Ford, Legislative Advisor

Ms. Klaskin provided the committee with an overview of what SWIB does, explaining that SWIB currently manages over $116 billion divided between the Wisconsin Retirement System (WRS), the State Investment Fund, and six other separately managed funds. Each fund is individually managed and maintained as a separate account, with investments made according to the purpose of each fund. SWIB manages these funds both internally and via contract with external managers. SWIB makes choices about whether to internally or externally manage a fund based upon the cost of management. Costs are charged directly to the investment income of the particular managed fund. In general, internal management costs less than external management, but SWIB's capacity to manage funds internally is limited.

The WRS accounts for about 92% of the total assets under SWIB's management. Ms. Klaskin noted that one of the unique elements of managing the WRS is that SWIB and annuitants engage in risk-sharing. Under the WRS, returns are not guaranteed; rather, annuitants are generally entitled to a base amount and are eligible for increases if there are sufficient returns. However, any increase above an annuitant's base entitlement may be reduced if returns are low in future years.

Representative Vruwink asked whether SWIB believed that it could manage the school trust funds more effectively than the BCPL and thus increase returns to the beneficiaries of the school trust funds. Ms. Klaskin explained that funds must be invested according to their asset allocation policies, which differ. She also noted that the purposes and restrictions of the WRS core fund differ from those of the school trust funds and, therefore, one cannot make an analogous comparison between only the rates of return. SWIB would invest the school trust funds according to the appropriate investment policy, but could not guarantee a certain rate of return.

Senator Taylor asked for additional information about the costs of management and about minority contracting. Ms. Klaskin explained that external managers tend to charge fees based on the amount of assets under management. Therefore, the larger the fund, the more expensive external management becomes. She added that the complexity of an investment plan can add to cost, as well. Mr. Ford noted that SWIB complies with the statutory 5% minority contracting requirement.

In response to questions from Senator Taylor, Mr. O'Malley, and Ms. Bannigan, Ms. Klaskin noted that SWIB has no infrastructure to manage a loan program as is currently managed by the BCPL. A third party could potentially manage such a program, but it may be expensive compared to the costs currently associated with the BCPL's management of the program. She also stated that if SWIB were to be delegated the responsibility to manage the school trust funds, SWIB would likely contract with an external manager.

Presentation by Members of the Wisconsin Bankers Association (WBA)

Jon Turke, Director, Government Relations, WBA, and Jeff Gruetzmacher, Senior Vice President, Royal Bank

On behalf of the WBA, Mr. Turke requested that the Legislature review all of the state lending programs. The WBA believes that those in need of loans should seek them through the private sector first and that the state should be only a lender of last resort. Regarding the BCPL loan program, specifically, Mr. Turke explained that although banks do sometimes lose loans to the BCPL program, there are also circumstances under which the private sector is not even consulted to bid on a project. Mr. Turke added that banks are active members of community and are often small businesses that want to be involved with their schools and municipalities.

Mr. Gruetzmacher began by explaining that his bank, Royal Bank, is active in municipal lending, which he considers to be a great investment for a bank. From his perspective, local banks are often able to provide better terms than the BCPL, but they do lose loans to the BCPL because municipalities do not always check with local banks first. He agrees that the BCPL should not be in direct competition with the private financial sector.

In response to questions from committee members, Mr. Gruetzmacher explained that banks would make a tax exempt loan for two reasons: (1) because local banks should invest in their communities; and (2) banks that make tax-exempt loans pay less tax to the federal government and, therefore, can offer consumers a lower rate. He also explained that part of a bank's underwriting process for a municipal loan involves reviewing the municipality's equalized value compared to its debt load. Mr. Gruetzmacher added that during the recent credit crisis, his bank did not reduce municipal lending and, from his perspective, there may be fewer actual banks available to municipalities, but not fewer lending options. He also noted that his bank does not impose a minimum loan amount.

Local Government Economic Development Panel

Mike VanLanen, Chairman, and Dave Cerny, Economic Development Coordinator, Town of Scott, and Patrick Schloss, Community Development Manager, City of West Allis

Mr. VanLanen and Mr. Cerny provided the committee with an example of how a town may use the BCPL loan program for economic development purposes. The Town of Scott used a BCPL loan to purchase land for the purpose of commercial development. According to Mr. Cerny, the town needed to use a BCPL loan because, as a town, it cannot create a tax incremental district (TID). Part of the town's purpose in pursuing economic development opportunities is to maintain its independence as a community in the face of annexation by the City of Green Bay. Mr. Cerny also explained that the BCPL loan program is an easy tool for small municipalities, like the Town of Scott, that have limited staff who can pursue alternative financial options.

Mr. Schloss described how the City of West Allis has used the BCPL loan program to finance economic development projects relating to TIDs. He explained that the loan program is often faster than private funding options, is low-cost, and is flexible in that it offers refinancing options and imposes no prepayment penalty. Because the interest from a BCPL loan goes to schools, Mr. Schloss described the program as a "win-win" for all. For other municipalities, Mr.

Schloss noted that the loan program is necessary for financially struggling communities because it offers lower interest rates and will make smaller loans than the open market.

Chair Katsma asked whether the municipalities ever approach local banks when financing is needed. In response, Mr. VanLanen explained that the Town of Scott does seek financing from banks, but that a BCPL loan was more desirable for the particular project described because it offered a smaller annual payment for a longer term. This gave the town the flexibility within its own budget to pay for both the economic development project and other routine maintenance projects. In general, Mr. Cerny noted, the town goes to a bank when it needs a short-term loan. Mr. Schloss explained that the City of West Allis typically does not do business with banks. Rather, the city generally either uses the BCPL loan program or goes to the bond market.

In response to committee member questions regarding the application process, the panel members generally agreed that a bank application is typically much longer and more complicated than the two-page BCPL loan application. This makes it much easier for municipal staff to seek financing.

Presentation by Phil Cosson, Senior Municipal Advisor/Director, Ehlers, Inc.

Mr. Cosson explained that Ehlers, Inc., is a public finance municipal advisor that issues debt on behalf of municipalities and helps municipalities structure debt so as to avoid spikes in tax rates. Ehlers, Inc., is bound by the rules of the Municipal Securities Rulemaking Board, under which it owes a duty of care to its client municipalities. According to Mr. Cosson, Ehlers, Inc., strongly supports the BCPL loan program. In meeting its obligations to its clients, Ehlers, Inc., reviews all financial options for a particular project and will recommend use of the BCPL loan program when appropriate.

Mr. Cosson grouped his comments into the following four categories: (1) loan flexibility; (2) private activity debt; (3) access to financing; and (4) loan rates, terms, and fees. He noted that the BCPL loan program offers flexibility because it does not impose a prepayment penalty, it allows for restructuring of debt, and it permits interest-only payments to help a municipality deal with cash flow issues associated with a new TID. In terms of funding debt for private, rather than public, purposes, the BCPL loan program typically offers a better interest rate than that offered by taxable general obligation debt. For small communities, the BCPL loan program offers an easy means of obtaining financing in small amounts and it provides a rate and terms benchmark for those communities with only one bank. Finally, Mr. Cosson noted that the BCPL loan program does not strictly track with the market, so, sometimes it offers terms that are better than the market and sometimes it does not.

In response to questions from committee members, Mr. Cosson noted that access to capital during the credit crisis was limited and the BCPL loan program was a great option for municipalities at the time. He also noted that as a result of recent federal tax reform, the tax break for advance refunding of bonds, another form of prepayment, is no longer available, so the prepayment without penalty option under the BCPL loan program has become even more important to municipalities. If the BCPL loan program were to be eliminated, Mr. Cosson explained that municipalities, especially smaller communities, will face increased risk and reduced security when seeking financing, which will ultimately increase the cost of financing.

Presentation by the UW System

Sean Nelson, Vice President for Finance, UW System, and Brian Sloss, Associate Dean for Outreach and Extension, College of Natural Resources, UW-Stevens Point

Mr. Nelson explained how the UW System benefits from the following three of the four school trust funds: (1) the Normal School Fund; (2) the University Fund; and (3) the Agricultural College Fund. He noted that only about 1% of the amount held in trust by the BCPL benefits the UW System and of that amount, approximately 58% goes to environmental programs at UW-Stevens Point. In fiscal year 2017-18, $495,000 was distributed to the UW System from the Normal School Fund for the purpose of funding the Nelson Institute for Environmental Studies at UW-Madison, the sustainable management degree program at UW-Extension, the environmental program at UW-Stevens Point, and merit scholarships. However, there were insufficient funds distributed in that year to fund any merit scholarships. In fiscal year 2017-18, $7,266 was distributed to the UW System from the University Fund and $10,600 was distributed to the UW System from the Agricultural College Fund.

Mr. Sloss provided details about how UW-Stevens Point uses the funds it receives from the Normal School Fund. Specifically, Mr. Sloss explained that management of funds received from the BCPL is conducted by the Wisconsin Center for Environmental Education in the College of Natural Resources at UW-Stevens Point. Prior to 2013, the amount of funding available generally covered an environmental education position at the Department of Public Instruction, with some small excess in certain years. Beginning in 2017, the Wisconsin Center for Environmental Education began to engage in cooperative planning with the BCPL.

Using the funds provided by the BCPL, Mr. Sloss explained that the Wisconsin Center for Environmental Education focuses on programming in the following two areas: (1) K-12 environmental education leadership; and (2) natural resource management programming. In its K-12 programming, the center is able to provide a statewide consultant to work on environmental education standards and teacher development; to provide environmental education school library resources; to provide opportunities for K-12 visits to school forests; and, to support a variety of other K-12 environmental education efforts. In its natural resource management programming, the center provides a guide to private landowners regarding forest management activities; supports forestry education efforts; and develops forestry professional development programming in support of the forestry industry. Mr. Sloss noted that the BCPL benefits from the center's forestry management programming in its management of school trust lands.

Discussion of Committee Assignment

Chair Katsma opened committee discussion by explaining that he sees benefits to the BCPL loan program and no longer wishes to eliminate it. However, he does see room for change and improvement, so he hoped to frame committee discussion according to the following three topics: (1) making changes to the existing BCPL loan program; (2) legislative changes to facilitate delegation of school trust fund investment responsibility to SWIB; and (3) providing statutory guidance regarding the investment of the school trust funds.

Representative Vruwink noted that he sees value in the tax-exempt loans made by the BCPL, but he also thinks that delegating investment authority to SWIB under the current legal limitations does not make sense.

Chair Katsma asked Mr. Ramirez to provide additional explanation regarding the BCPL's and SWIB's investment authority under current law. Mr. Ramirez explained the current legal framework of investing the school trust funds, noting that, under current law, the BCPL has more freedom to invest according to the prudent investor standard, including investing in equities, than SWIB would be if delegated the investment responsibility. He also noted that a constitutional amendment would likely be needed in order for any agency to engage in pure total return investing of the school trust funds.

Senator Stroebel stated that he believes that the committee should facilitate implementation of the endowment model of investing legislatively and then decide which entity is best positioned to manage it.

Mr. O'Malley expressed that he would consider legislation requiring that the BCPL be the lender of last resort to municipalities and would also consider any other legislation that would reduce the perception that the BCPL is unfairly competing with banks.

Mr. Eager stated that it is clear that the school trust funds could generate more revenue than they are currently generating, but that the Legislature will need to address significant complexities in order to achieve that goal. He also stated that while his bank is active in competitive bidding for municipal financing, he sees that the BCPL loan program serves a need. He is interested in whether banks are limited by statute to make loans to municipalities for no more than 10 years while the BCPL can make longer term loans, and he would like to review the forms in a bank loan application to identify whether they could be reduced or streamlined under state law.

Mr. Merkes cautioned the committee against making changes to the BCPL loan program that could create additional hurdles for small communities with limited staff. He would prefer that the committee review the purposes for which distributions from the school trust funds may be used.

Ms. Bannigan and Mr. Derr both expressed an interest in learning whether the BCPL is receiving all of the fees, fines, and forfeitures that it should for deposit into the Common School Fund. Mr. Derr also noted that he would like to find out whether municipal court fines go to the Common School Fund.

Chair Katsma directed committee staff to prepare an options memorandum for the next committee meeting to facilitate committee discussion and assist members in narrowing the options for legislative action.

Plans for Future Meetings

The next committee meeting is scheduled for October 11, 2018, at 10:00 a.m., Room 411 South, State Capitol.

Adjournment

The meeting adjourned at 4:00 p.m.

RES:jal

[The preceding is a summary of the September 5, 2018 meeting of the Study Committee on the Investment and Use of the School Trust Funds, which was recorded by WisconsinEye. The video recording is available in the WisconsinEye archives at http://www.wiseye.org/Video-Archive.]