WISCONSIN LEGISLATIVE COUNCIL

MEETING MINUTES

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

Room 411 South
State Capitol
Madison, WI

October 11, 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 determined to be 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:	Chris Anton, Manager of Investments, Idaho Endowment Fund Investment Board; Michael Wagner, Assistant Deputy Secretary, Department of Revenue (DOR); Susan Gary, Orlando J. and Marian H. Hollis Professor of Law, University of Oregon; and Mark Ready, Professor and Chair, Department of Finance, Investments, and Banking, University of Wisconsin (UW)-Madison.

Approval of the Minutes of the September 5, 2018 Meeting

Mr. Eager moved, seconded by Representative Vruwink, to approve the minutes of the September 5, 2018, meeting. The motion was unanimously approved by voice vote.

Presentation Regarding Idaho Endowment Fund

Chris Anton, Manager of Investments, Idaho Endowment Fund Investment Board

Mr. Anton discussed the history of Idaho's endowment reform. He discussed the ways in which the Idaho Constitution was amended, and he described the current structure of Idaho's endowment assets, as shown in his presentation materials. He stated that the permanent fund and the earnings reserve fund are invested in the same manner.

Mr. Anton explained that the Idaho endowment fund engages in only one type of lending. Through Idaho's Credit Enhancement Program, the fund guarantees that it will lend money to a school district that is otherwise unable to make payments on the bonds it has issued. He explained that this guarantee has the effect of enabling Idaho school districts to obtain a AAA bond rating, thereby giving them access to lower interest rates.

Chair Katsma referenced the third bullet point on the first page of Mr. Anton's presentation materials, and asked Mr. Anton to describe what is meant by the reference to "artificial restrictions which have led to both underperformance and to a portfolio structure that exposes the endowment to unnecessary risk." Mr. Anton replied that it refers to the fact that, prior to endowment reform, the Idaho Endowment Fund Investment Board was allowed to distribute only moneys meeting the strictest definition of "income," such as interest and dividends.

Chair Katsma referenced Mr. Anton's presentation materials and asked for additional detail regarding the 26% of endowment assets that are invested in fixed income instruments. Mr. Anton replied that 22% are in a Barclays Aggregate Bond Index fund, and 4% are in treasury inflation protected securities.

Ms. Bannigan asked Mr. Anton to describe the beneficiaries of the funds. He replied that the primary beneficiaries are public schools, and that the other beneficiaries are a university, an agricultural college, two hospitals, penitentiaries, a school for deaf and blind persons, and the capitol building.

Mr. Merkes asked when Idaho's earning reserve fund was created, and whether it had an effect on beneficiaries. Mr. Anton replied that the fund was created during the endowment reform effort. He stated that he expects that directing money into the funds likely resulted in decreased distributions for the beneficiaries initially, but that creating the reserve was the prudent thing to do.

Chair Katsma referenced the bar chart on the third page of Mr. Anton's presentation materials, and asked for additional explanation of the $22 million green shaded value in 2011. Mr. Anton replied that the schools requested that the Idaho Legislature appropriate an additional $22 million in 2011, and the legislature did so.

Presentation Regarding Unclaimed Property

Michael Wagner, Assistant Deputy Secretary, DOR

Mr. Wagner provided the committee with an overview of how the unclaimed property program works and how it interacts with the Common School Fund. To begin, Mr. Wagner explained how the program was moved in 2013 from the Office of the State Treasurer to the DOR, at which point the agency began to use its tax records to match unclaimed property with taxpayer information and automatically return it to owners. He went on to explain what types of property commonly become "unclaimed" and how such property is transferred to DOR. Upon receipt, DOR engages in several steps to advertise unclaimed property so as to return as much property to owners as possible. Property that is not returned to its owner is liquidated on a regular schedule, which varies depending upon property type. Mr. Wagner noted that, in general, there is no statute of limitations on claiming unclaimed property. Therefore, DOR maintains a cash reserve account to ensure that claims can be paid if submitted to DOR. Funds in excess of the reserve amount are paid to the Board of Commissioners of Public Lands (BCPL) for deposit into the Common School Fund.

Mr. Wagner explained that the amount DOR keeps in reserve for such claims has changed. Prior to 2018, DOR kept the greater of 10% of all of the unclaimed property in the DOR system or the average of the last three years of payments, which amount to an annual reserve of about $54 million. Beginning in April of 2018, DOR and the BCPL agreed to an arrangement under which DOR will gradually decrease the amount held in reserve to $30 million by fiscal year 2021, thus directing more funds for deposit into the Common School Fund, on average. DOR provides an estimate of the annual payment to the BCPL in April of each year and makes the payment by September 1. DOR projects that payments to the Common School Fund will range between $26 and $30 million over the next few years.

In response to questions from committee members, Mr. Wagner agreed to provide the committee with additional information about the typical costs of advertising unclaimed property. He also noted that the current system for unclaimed property seems to be working, and, therefore, does not believe that creating a statute of limitations for claiming property is essential. Ms. Egan explained that interest earned on the unclaimed property custodial account gets added to the balance of the reserve and is then included in the payment to the BCPL. She also explained that the entire collection of unclaimed property held by the state did receive a significant review when the system used to manage the property changed over from the old system used by the Office of the State Treasurer to the new system used by DOR.

Presentation Regarding Uniform Trust Laws

Susan Gary, Orlando J. and Marian H. Hollis Professor of Law, University of Oregon

Professor Gary explained the evolving history of the standards of prudence governing the investment of trusts and endowments. She described the development of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) and the Uniform Principal and Income Act (UPAIA). She explained that if a trust or endowment is prohibited from using capital gains to make distribution payments, then investment decisions may be based on generating income rather than on creating value for the portfolio. She stated that UPAIA and the Uniform Fiduciary Principal and Income Act were developed to give trustees the flexibility needed for them to invest for the best total return while still being able to make distributions to current beneficiaries. Professor Gary explained that each of the uniform acts serve as the default rules that apply unless overridden by another governing source, such as a constitutional provision or trust document.

Chair Katsma asked under what circumstances it would be a violation of the prudence standard to invest too much in fixed income instruments. Professor Gary responded that investing too much in fixed income would mean that a person is not being prudent, but that the person would not be in violation of the standard if their choices follow a more restrictive governing source, such as the Wisconsin Constitution.

Senator Stroebel asked if the prudent investor standard requires pursuing total return investing. Professor Gary responded that it does, unless there is an applicable governing standard that prohibits a trustee from engaging in total return investing.

Senator Stroebel asked Professor Gary to elaborate on the significance of the provisions of the UPAIA that authorize a trustee to adjust moneys between principal and income. Professor Gary responded that the purpose of granting this flexibility is to ensure that investment decisions are not influenced by the traditional distinctions between "income" and other proceeds from investment.

Senator Taylor asked if it is correct that the prudence standard requires that investment decisions be based on the needs of beneficiaries and how they will use their distributions. Professor Gary agreed that investing prudently entails ensuring that investment risks are appropriate for the particular beneficiaries.

Representative Vruwink stated that he thinks that beneficiaries should have the opportunity to express their preferences regarding how much risk is taken with the investment of the funds, just as individuals in the Wisconsin Retirement System can choose whether to participate in the core fund or the variable fund.

Senator Stroebel, Ms. Bannigan, and Senator Taylor discussed the issue of whether the school trust funds are best managed by the staff of the BCPL or by the State of Wisconsin Investment Board (SWIB). Professor Gary noted that, even when trustees or other fiduciaries delegate the investment function, they remain responsible for establishing the goals for the funds under their supervision.

Presentation Regarding the BCPL Investment Policy

Mark Ready, Professor and Chair, Department of Finance, Investments, and Banking, UW-Madison

Professor Ready described his role in the development of the BCPL investment policy as that of a sounding board. He attended a few meetings and provided his general opinion of the asset allocation based on the information provided to him by the BPCL. He noted that he did not do any analysis of specific investments. He then organized his presentation in response to two questions:

- Why is the BCPL asset allocation so heavily weighted towards fixed income investments?
- Do the loans made to municipalities under the school trust fund loan program make sense in the BCPL portfolio?

Professor Ready explained that the asset allocation of a portfolio should be developed with the risk tolerance of the beneficiary as a primary focus. He understands that the beneficiaries of the Common School Fund, that is, school libraries, are very reliant upon consistent distributions from the fund and are, therefore, very risk averse. With that in mind, he would recommend a portfolio with lower risk, which requires less investment in things like equities and more investment in things like fixed income instruments.

Professor Ready noted important differences between the BCPL managed funds and other endowment funds managed by charitable organizations. From his perspective, unlike the BCPL managed funds, endowments benefit from donations and the ability to smooth potential changes in distributions resulting from losses in the financial market. He stated that the BCPL funds are more comparable to a target date fund because such funds automatically shift over time from a higher percentage investment in riskier equities to a higher percentage investment in fixed income instruments as the risk tolerance of the beneficiary decreases.

Professor Ready finds the loan program to be an unusual tool, but one that offers extra return to the Common School Fund relative to the risk of the actual investment. He noted that the loans are extremely low risk because the BCPL has the statutory authority to intercept a municipality's state aid in the event of nonpayment, but prices the loans at a rate that is competitive with the private financial industry. He understands that smaller municipalities tend to take advantage of the loan program more than larger municipalities and, to the extent that they do, he sees evidence that there must be at least some benefit of the program to municipalities.

Chair Katsma asked why the BCPL, as a tax-exempt entity, is investing in tax-exempt instruments. Professor Ready responded that his understanding is that the BCPL is not investing in tax-exempt instruments. Rather, he understands that the BCPL purchases taxable bonds and that the interest rate it sets for its loans are comparable to those set by taxable banks. However, he generally agreed that a tax-exempt entity generally has no incentive to invest in tax-exempt instruments.

Senator Taylor requested that Professor Ready expand on his comments regarding the benefit of the loan program to small municipalities. He stated that, to the extent that small municipalities are not able to otherwise borrow from banks, they benefit from having ready access to funds via the school trust fund loan program. The ability to borrow allows them to manage unexpected expenses and maintain consistent operations. In response to additional questions regarding the benefits of the program, Professor Ready reiterated that the loan program offers a greater return on the asset than it would generally generate in the open market relative to its risk. He noted that because the risk associated with the loan program is so low, the BCPL has additional flexibility to invest in higher risk fixed income instruments that offer the potential for greater return.

Senator Stroebel found the comparison to the target date fund inaccurate because the school trust funds are held in perpetuity, which is not true of target date funds. Mr. Ready clarified that the comparison is more about the beneficiaries' ability to weather a potential reduction in distributions. He also noted that the asset allocation could be revisited if the law changes and allows for things like more spending flexibility and creating a smoothing effect for distributions.

Senator Stroebel also noted that SWIB manages the retirement fund for state employee beneficiaries, who are very risk averse, and with its flexibility is able to generate a much greater rate of return than the BCPL. Professor Ready agreed, noting that SWIB's ability to reduce a retiree's benefit payment plays a significant role. Senator Stroebel also asked whether it would be advisable to create a loan program without a prepayment penalty. Professor Ready noted that there are many examples of loans without prepayment penalties, but they are generally priced accordingly.

Mr. Derr noted that he believes the reliability of the revenue stream from the Common School Fund is incredibly important. He also values the loan program because he sees it as offering a big benefit to municipalities, which, in turn, benefits the entire state. Mr. Derr also asked whether Professor Ready had an opinion about the qualifications of the BCPL staff to manage the funds. Professor Ready explained that was not his area of expertise.

Ms. Bannigan clarified that the distributions from the Common School Fund cannot be spent on salaries. They can be spent on specific things, approved by the Department of Public Instruction. She noted, however, that libraries are nonetheless dependent on the funds and, therefore, are risk-averse.

Mr. Eager explained that the difficulty faced by municipalities in obtaining loans from banks appears to depend upon where the municipality is located within the state. Banks in certain parts of the state are more active in municipal lending than in other parts. Therefore, the BCPL school trust fund loan program serves a need and, with some exceptions, competes on the same level as banks. Mr. Eager also noted that the committee is generally concerned about the return provided to fund beneficiaries and, although risk is a significant concern, there appears to be an opportunity to update an antiquated system and potentially increase the returns of the funds.

Discussion of Distributed Materials and Committee Assignment

Chair Katsma asked for each member of the committee to share his or her current reflections on the issues before the study committee, and he began the discussion by sharing his views. He stated that the study committee process has shown that Wisconsin communities rely on the loan program, so he thinks that there is value in continuing it. He stated that the legislature has a duty to school libraries, so his goal is to give the BCPL the tools it needs in order to increase the investment returns. He stated that he has an interest in taking steps to facilitate the implementation of the endowment model, and he has concerns about the prudence of having the school trust funds invested in what could be considered tax-exempt investments.

Senator Stroebel stated that his main purpose is to prudently maximize the investment returns for the funds without harming, in any way, the school libraries. He stated that he has become more open to the value of continuing the municipal lending activities, but he thinks that some reforms are needed. In particular, he explained that he has concerns about loan proceeds being used to make incentive payments to private developers. He stated that he is interested in modernizing the investment of the school trust funds in a manner that is more consistent with the endowment model.

Representative Vruwink stated that he is interested in building a better investment model for the school trust funds. He also expressed interest in making some changes that will help private banks without adversely affecting the BCPL loan program.

Ms. Bannigan stated that her goal is to maximize the returns for the funds while remaining mindful of the consequences and risks to school libraries of potential changes.

Mr. Derr stated that his goal is to protect the funds. He expressed concerns about having the state promise to make the school trust funds whole for investment losses.

Mr. O'Malley discussed his experiences using the loan program as well as working with private lenders when La Crosse County has issued debt. He expressed support for the loan program and stated that he is interested in hearing the BCPL staff's views on potential changes relating to the school trust funds.

Mr. Merkes stated that he is concerned about making changes relating to private lending to municipalities because it appears to be outside of the committee's scope. He stated that he is concerned about the school trust funds taking on more risk, but he is also concerned that the funds would lose purchasing power if they are only invested through the loan program.

Mr. Eager expressed support for having the school trust funds invested through the endowment model. He said that no one wants to risk losing the corpus of the funds. He stated that the committee has an opportunity to fix the legal "handcuffs" that constrain the BCPL's investment activities. He stated that his desire is to empower the BCPL, and his desire to improve the investment of the funds should not reflect negatively on the BCPL.

Senator Taylor stated that she believes the loan program provides value to communities and the schools in the communities. She expressed interest in authorizing private lenders to make loans to municipalities for longer than 10 years. She said that she understands the desire for stability on the part of the school libraries that receive the distributions. Therefore, although she is open to some changes to the investment of the funds, she would like to also honor the existing framework provided in the Wisconsin Constitution.

Mr. Eager discussed his interest in amending the statutes to simplify the documentation that private lenders must complete when lending to municipalities. He stated that he does not know what purpose is served by prohibiting private lenders from making municipal loans with a term of more than 10 years.

Mr. Ramirez, Legislative Council staff, explained that the committee could recommend eliminating the 10-year term limitation by amending s. 67.12 (12), Stats. He stated that changing the documentation requirements for private lenders would be more complex. He stated that the Wisconsin Bankers Association (WBA) develops the standard municipal loan documents used by Wisconsin banks. He also stated that the WBA designs the forms to cover all applicable laws, including laws governing a bank's federal deposit insurance, as well as its federal and state tax liability. He said that the committee would not be able to make changes relating to deposit insurance or federal tax liability. As a result, the committee could undertake efforts to reduce the documentation required, but the committee would not be able to reduce the documentation required to the point that it would be identical to the documentation completed by the BCPL when it issues loans.

Mr. Eager stated that he would consult with the WBA for the purpose of identifying ways of reducing the documentation needed to comply with state laws. Chair Katsma stated that he would entertain a motion to direct Legislative Council staff to develop a bill draft for repealing the 10-year limit on municipal loans from private lenders.

Senator Taylor moved, seconded by Representative Vruwink, that Legislative Council staff would develop a bill draft that repeals the 10-year limit on municipal loans from private lenders. The motion passed on a unanimous voice vote.

Chair Katsma asked the committee members to share their thoughts on whether the statute that specifies the minimum interest rate that the BCPL may charge on its loans should be changed. Senator Taylor expressed concern that dictating the interest rates on loans would be too far for the committee to go. She expressed positive views of the BCPL's practices for setting rates. Representative Vruwink stated that he would not like to take any action until learning more from the staff of the BCPL. Mr. Eager observed that banks are accountable to shareholders when setting interest rates for their loans. Senator Stroebel stated that concerns regarding the interest rates on loans could be addressed by making changes to transition the school trust funds to more of an endowment model. Mr. Derr expressed concerns that setting a formula for the interest rates could reduce the competitiveness of the loans.

Chair Katsma asked the committee members to share their thoughts on whether a prepayment penalty should be a required component of BCPL loans. Mr. Eager discussed the reasons that private lenders use prepayment penalties when making long-term fixed rate loans. Mr. Derr stated that he thought that a prepayment penalty would cost the taxpayers money. Mr. Merkes stated that he thinks that borrowers pay for the flexibility of avoiding a prepayment penalty by paying an interest rate that is higher than it would be if there were no prepayment penalty.

Chair Katsma asked the committee members to share their thoughts on whether there should be a limit on the amount of a loan that the BCPL may issue. Mr. O'Malley observed that most of the loans are for $500,000 or less. Ms. Bannigan pointed out that the statute that limits the size of a loan based on the assessed valuation of a municipality serves as a limit on the amount of a loan that a municipality may obtain. Mr. O'Malley stated that he could not support limiting the size of a loan.

Chair Katsma asked the committee members to share their thoughts on whether there should be additional limits added to how a borrower may use the funds it obtains from a BCPL loan. Senator Stroebel expressed concerns about the practice of using loan funds to make direct incentive payments to private developers. Mr. Merkes stated that he shared similar concerns, but he stated that if limitations are placed on payments to developers, those limitations should be applied more broadly and not just to the BCPL loan program. Mr. O'Malley stated that restricting the use of loan funds would incentivize local governments to obtain funds through bonding or borrowing from a private lender. Senator Taylor stated that she values the economic development activities of local governments, in part, because it benefits schools.

Senator Stroebel moved, seconded by Mr. O'Malley, to have Legislative Council prepare a bill draft prohibiting loan funds from being used to make payments to private developers. The motion failed on a roll call vote as follows: Ayes, 4 (Rep. Katsma; Sen. Stroebel, and Public Members Eager and O'Malley); and Noes, 5 (Sen. Taylor; Rep. Vruwink; and Public Members Bannigan, Derr, and Merkes).

Chair Katsma asked the committee members to share their thoughts on whether statutory or constitutional changes should be made with regard to the extent to which the funds may be invested in accordance with the typical endowment model. Mr. Ramirez stated that the committee could take several types of actions, including: (1) recommending statutory changes to accommodate certain practices that the BCPL has undertaken since 2015, such as withholding income from distribution in smoothing accounts; (2) recommending statutory changes to grant the BCPL flexibility in investing and distributing moneys to the fullest extent permitted by the Wisconsin Constitution; and (3) recommending constitutional changes related to authorizing the BCPL to invest and distribute funds in accordance with the endowment model.

Senator Taylor raised concerns about the timing of certain payments that are required to be paid into the school trust funds. Mr. Derr expressed an interest in exploring issues surrounding the deposit of fines and forfeitures in the Common School Fund. Ms. Snyder, Legislative Council staff, provided the committee with a brief overview of the content contained in the Legislative Council options memorandum regarding fines, forfeitures, and civil asset forfeiture. Chair Katsma then asked that the committee turn its focus back to investment-related options for the moment.

Senator Stroebel stated that he wants to move toward the total return investing endowment model. Representative Vruwink stated that he wants to hear from staff of the BCPL before proceeding. Mr. Eager stated that the state has lost out on funding for schools because the constitution prescribes an antiquated model. Mr. Merkes stated that he would like to learn more about the amount of risk that the potential changes would entail. He stated that, before pursuing a constitutional change, he would like to learn more about what could be done without amending the constitution.

Committee members discussed questions that each of them have for staff of the BCPL. The committee reached consensus that it would like the BCPL staff to present at the November meeting on all sections of the Legislative Council options memorandum, except for the section regarding the loan program. Chair Katsma stated that he would like BCPL staff to identify the percentage of its investments that are in tax-exempt instruments. The committee reached consensus that it would like Legislative Council staff to provide further information on the credit enhancement program used by Idaho.

Plans for Future Meetings

The next committee meeting is scheduled for November 14, 2018, at 10:00 a.m., Room 411 South, State Capitol.

Adjournment

The meeting adjourned at 4:00 p.m.

RES:ksm

[The preceding is a summary of the October 11, 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.]