



WISCONSIN LEGISLATIVE COUNCIL

MEETING MINUTES

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

Room 411 South
State Capitol
Madison, WI

November 14, 2018
9:00 a.m. – 12:30 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 (via phone); 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 E. Snyder, Staff Attorneys.

APPEARANCES: Jonathan Barry, Executive Secretary, Tom German, Deputy Secretary, and Richard Sneider, Chief Investment Officer, Board of Commissioners of Public Lands (BCPL).

Approval of the Minutes of the October 11, 2018 Meeting

Mr. Eager moved, seconded by Representative Vruwink, to approve the minutes of the October 11, 2018, meeting. The motion was unanimously approved by voice vote.

Discussion of Distributed Materials

LRB-0438/P1, relating to promissory notes of certain public bodies

Chair Katsma said that he would entertain a motion to approve the bill draft.

Mr. Eager moved, seconded by Representative Vruwink, that LRB-0438/P1 be approved. A vote on the motion was not called.

Senator Taylor requested that the committee wait to vote on anything until the next meeting when it could consider all of the possible bill drafts at once. Chair Katsma agreed to delay the vote and requested a motion to table the bill draft.

Senator Taylor moved, seconded by Senator Stroebel, that the bill draft be tabled until the next meeting. The motion was unanimously approved by voice vote.

Mr. O'Malley requested that Legislative Council staff research the differences in referendum requirements between the issuance of promissory notes and the issuance of bonds and note how those differences relate to the bill draft.

LC Study Committee Memorandum, "Overview of Other States' Constitutional Requirements Regarding the Principal and Income of School Trust Funds" (November 7, 2018)

Chair Katsma introduced the topic of the LC Study Committee Memorandum, noting that the memorandum highlights that this study committee is not the first time that issues regarding school trust funds have been studied and that other states have amended their constitutions in response to their own research. He asked whether any committee members had thoughts or reflections in response to the memorandum. Representative Vruwink noted that states have made changes based on their unique needs, including New Mexico and North Dakota, which seem to allow for smoothing accounts much like the current BCPL investment policy. He thinks that amending the constitution is an issue that the committee should continue to review, but that he would not like to give the Legislature too much authority over the investment process out of a concern that it could become too political. He would prefer that Wisconsin retain at least some constitutional language regarding the school trust funds rather than repealing it all and, therefore, leaving all decisions regarding the school trust funds entirely within the discretion of the Legislature.

At the request of Chair Katsma, Mr. Ramirez explained that, subject to certain limitations, the Wisconsin Constitution currently authorizes the Legislature to determine how the school trust funds are invested. Mr. Ramirez also summarized the contents of the memorandum, noting that there are a variety of ways that states have amended their constitutions, which the committee could consider as options.

Chair Katsma explained that he was intrigued by the Oregon model, which appears to require distribution of a certain percentage of the overall value of the fund, without regard to whether the money is income or principal. He also noted that he wants the committee to think about how, in the long term, the investment and use of the funds should be structured so as to maintain a certain level of purchasing power. Mr. Ramirez provided additional detail about

Oregon's investment model, noting that its current structure is relatively new and was developed in response to a study.

In response to questions from Senator Taylor, Mr. Ramirez explained that the Wisconsin Constitution requires distribution of income and permanent retention of the principal, but state statute further dictates that income from the Common School Fund be distributed annually. He also explained that the most recent Wisconsin Supreme Court decision interpreting the constitutional provisions was written at a time when the current investment options and practices did not exist; therefore, applying past interpretations to current practice is instructive, but perhaps not an absolute guide to how investment activity under modern practices must be managed.

Chair Katsma asked whether state statutes require annual distribution and whether the BCPL investment policy is inconsistent with those statutes. Mr. Ramirez explained that the Wisconsin Constitution requires that distribution from the funds be made as provided by law. He then explained that the statute, related to the Common School Fund, requires that distributions be made annually based on the entire amount that is in the appropriation account on April 15. Mr. Ramirez noted that, on the one hand, it could be argued that creating smoothing accounts, as provided under the BCPL investment policy, is necessary in order to implement the prudent investor standard, which the Legislature applied to the BCPL in 2015. On the other hand, it could be argued that establishing an investment policy that provides for the retention of certain income in smoothing accounts and establishes distribution targets conflicts with the existing statute directing that distribution of all income in the Common School Fund appropriation be made annually.

Presentation by BCPL Staff

Secretary Barry described the BCPL's mission and fiduciary duty as to maximize revenue now and in the future by managing the funds and lands entrusted to the board. He stated that the agency has been in existence for approximately 170 years, but has had the authority to invest under the prudent investor standard for only three years. The investment policy developed under the new investment authority was developed with the need to address intergenerational equity in mind. Mr. Barry noted that, during the period when the investment plan was in development, staff were concerned that future growth in the CSF be able to keep abreast or ahead of inflation so as to preserve intergenerational equity. While the fund was indeed growing, the rate of growth of fines and forfeitures and unclaimed property appeared to be trending lower and this, coupled with the increased size of the fund itself, meant a lower percentage increase could be expected moving forward. The adopted BCPL investment Plan and Asset Allocation model was developed to address this concern and to yield predictable and growing income for beneficiaries. He stated that the BCPL staff sees no need to modify current statutes or the Wisconsin Constitution; rather, staff would prefer that the current investment policy be given time to work before any changes are made. He explained that the approach taken under the investment policy is cautious in order to ensure predictable income for beneficiaries and, absent a constitutional change, the policy will likely continue to contain a relatively low risk asset allocation.

Mr. Sneider read his written testimony, which was distributed to committee members. In summary, Mr. Sneider explained that he is generally in favor of the endowment model, but that management of the Common School Fund is constrained in two ways that prevent full implementation of that model: (1) trust fund beneficiaries are highly dependent upon stable and secure distributions; and (2) the Wisconsin Constitution does not allow distribution of fund principal. He stated that the BCPL investment policy incorporates the most important parts of the endowment model, adapted to suit the needs and constraints of the Common School Fund.

Mr. Sneider also argued that the testimony the committee heard from the state treasurer comparing the investment returns achieved by the State of Wisconsin Investment Board (SWIB) with those of the BCPL was refuted by the testimony from SWIB and by the Legislative Fiscal Bureau in a written memo. He stated that transferring school trust fund assets to SWIB would cost beneficiaries at least \$3.3 million per year.

Mr. Sneider addressed questions raised by committee members in past meetings by noting that the BCPL does invest in tax-exempt securities when there is an opportunity to take advantage of unusual market conditions. He stated that approximately \$4 million of the BCPL's bond portfolio is comprised of tax-exempt bonds, but that the amount accounts for less than half of one percent of managed assets.

Mr. German described his own research into the legal history of the school trust funds and the management practices of trust funds around the country. He noted that a review of the constitutions of each state does not adequately describe the underlying unique conditions of each state that lead to the current provisions. He explained that the BCPL's current investment policy was developed with concerns about increasing principal, maintaining steady distributions, and constitutional constraints in mind.

Chair Katsma asked what recommendations the BCPL staff would have to grow the funds. In response, Mr. German requested that the Legislature give the BCPL time to implement its investment policy to see how far it can go under the current constitutional limitations. He noted that only after implementation of the policy has reached its limit would staff feel comfortable requesting a constitutional change. Mr. Barry added that the smoothing accounts are almost full and that the BCPL staff anticipates increased distributions to beneficiaries in the future.

Chair Katsma also asked about how the smoothing accounts are funded. In response, Mr. Sneider explained that the BCPL has been retaining earnings from bond trading gains as well as small amounts of income from other sources. Mr. German added that retaining certain earnings from the Common School Fund for a period of time, in the form of deferred distributions, has been common practice because distributions from the fund are made in the middle of the fiscal year.

Chair Katsma asked whether statutory language is required in order to authorize the existence and use of smoothing accounts. Mr. Ramirez explained that whether statutory change is necessary is a policy decision for the committee to make. He noted that the committee could choose to do several things, including: (1) doing nothing if the committee feels there is no need for change; (2) giving the BCPL general authority to retain earnings, but leaving the BCPL with

the flexibility to make choices about how much will be retained; or (3) specifying the amounts which may be permissibly retained.

Mr. German added that the distributions from the Common School Fund are made in April or May but must be spent during the same fiscal year, which ends in June of the same calendar year. He explained that, based on the BCPL's conversations with the Department of Public Instruction, for planning purposes, schools prefer to operate based on the estimate they receive from the BCPL in January rather than any extra amount to which they may be entitled in April because of the short time frame in which they must spend the funds. This has resulted in a general practice of retaining any earnings in excess of the January estimate for distribution in the next year.

In response to questions from Chair Katsma regarding its balance sheet, Mr. Barry explained that the BCPL tries to keep as small a cash balance as possible while retaining enough liquidity to meet loan demand and to take advantage of investment opportunities, but that it did have to retain more cash when interest rates were low. Mr. Barry then explained steps that the BCPL staff took to protect the funds from loss at a time when interest rates were dropping and loan recipients were paying loans back early. Mr. Sneider provided an explanation of the various categories included in the BCPL balance sheet. He also reiterated that the BCPL currently holds \$4 million in tax-exempt bonds, but that the loans it makes are taxable.

Chair Katsma asked the BPCL staff to respond to concerns about trust fund loans being used as economic development incentives. Mr. Barry explained that once a municipality receives a loan from the BCPL, the municipality is responsible for using the funds as permitted by state statute. The BCPL does its standard underwriting, but does not second guess what a municipality then does with the money. He also noted that none of their loans have ever defaulted.

Representative Vruwink asked whether any other states have a model very similar to Wisconsin. Mr. German explained that it is difficult to find any two states that are similar because there is such a wide variety of practice and underlying law. He noted that being concerned about the growth of the Common School Fund is appropriate, but that the growth of the fund will be dependent upon deposits from fines and forfeitures, unclaimed property, and capital gains.

In response to questions from Mr. Derr regarding fines and forfeitures, BCPL staff explained that the monthly revenue generated by fines and forfeitures has declined, although the amount of a given fine or forfeiture that must go to the Common School Fund is generally within the power of the Legislature to determine. Mr. Barry also explained that because the Legislature eliminated the authority for the Department of Revenue to use third party auditors to find unclaimed property, the amount of unclaimed property deposited in the Common School Fund may also decline. Mr. Barry added that accessing fines imposed by a municipal court would require a statutory change.

Committee members generally expressed that increases in fines and forfeitures are not politically viable. Chair Katsma expressed that the long-term growth of the fund will be due to capital gains, not to significant increases in deposits from fines and forfeitures.

Mr. Merkes asked whether there are any investments or practices that the BCPL staff would like to make or implement that it cannot because of the constitutional or statutory constraints. In response, Mr. Sneider said no, that the BCPL operates well enough under the prudent investor standard. Mr. Barry added that the BCPL staff consult with SWIB regularly, and the legal constraints primarily force the BCPL to focus on low-cost, high-dividend equities with as little risk as possible so as to ensure sufficient income for distribution to beneficiaries.

In response to questions from Chair Katsma regarding whether there are any types of loans that the BCPL would like to avoid making, Mr. Barry explained that the BCPL is not a low-cost loan shop; rather, the BCPL needs to make money, and it tries to compete fairly with private lenders by setting competitive interest rates. Mr. Sneider noted that, of the borrowers listed in current statute, generally none would be considered too risky because of the BCPL's tax-intercept authority. Staff generally responded that the BCPL has neither the capacity nor the desire to begin issuing consumer loans. Mr. Barry specifically noted that the BCPL is able to issue loans at an extremely low cost, thus allowing for a greater percentage of earnings to be distributed to beneficiaries. He suggested that entering into the issuance of consumer loans would increase the cost of fund management, especially due to the increased underwriting work such loans would require.

Senator Taylor asked that BCPL staff respond to questions about law enforcement reporting of assets seized through the civil asset forfeiture process. Mr. German briefly explained the difference between forfeitures imposed by a court for a violation of the law and civil asset forfeiture, regarding property that was associated with the commission of a crime. He explained that current law provides no standardized process for the tracking and deposit of funds seized via the civil asset forfeiture process. Senator Taylor expressed an interest in standardizing this process to ensure that funds to which the Common School Fund are entitled are actually being deposited.

Mr. Ramirez directed the committee to the options memorandum distributed at the October 11, 2018 meeting as a starting point for a discussion of this topic. He also noted that the committee was not created with representation from the court system or law enforcement and that it may be useful to get feedback from those groups regarding this issue. Chair Katsma expressed that this topic is outside the scope of this committee.

Discussion of Committee Assignment

Chair Katsma opened up committee discussion by requesting that committee members share any big picture thoughts or reflections. He would like to focus on steps that the committee can take to ensure the long-term viability of the school trust funds by preserving purchasing power. He offered that the committee could consider constitutional changes or statutory changes.

Mr. Eager stated that he generally believes that the BCPL is on a good investment path and that the committee should consider statutory changes that would support the BCPL's current investment plan and practice. Representative Vruwink agreed, stating that the committee should protect what the BCPL has been doing.

Ms. Bannigan agreed and added that the committee should ensure that all the funds which should be deposited into the funds are being deposited into the funds.

Mr. Merkes noted that the letter from Attorney General Schimel seemed to support that some statutory changes may be in order, but he would be interested in hearing from the attorney general-elect and the treasurer-elect to see if they have any thoughts or opinions. Chair Katsma thought it would be unfair to ask them to respond to this topic so soon after the election.

Chair Katsma asked whether committee members have any thoughts in response to Attorney General Schimel's letter. Mr. O'Malley noted that although Attorney General Schimel seems reluctant to support statutory changes, the work of the committee seems to suggest that some changes to clarify the BCPL's authority would be helpful. Ms. Bannigan emphasized that, in line with the attorney general's letter, it would be important for the committee to avoid proposing legislation that restricts the BCPL's authority too much.

Chair Katsma asked whether the committee had any desire to consider proposing constitutional change. Mr. Ramirez reviewed the options for constitutional change proposed in the options memorandum distributed at the October 11, 2018 meeting and reviewed the different ways that other states had changed their constitutions as shown in the memorandum dated November 7, 2018. Mr. Ramirez noted that the committee could use the other states as examples, but could also choose to take an entirely distinct path. The choices that the committee makes should be based upon the committee's ultimate goals.

Chair Katsma noted that he likes the idea of eliminating the distinctions in the constitution regarding income and principal and instead authorizing distribution of a percentage of the overall value of the funds. He expressed that investment strategies have changed and investing in equities is necessary to keep up with inflation.

Mr. Merkes agreed that the principal of the funds needs to grow. He thinks that the BCPL staff is on the right track to make this happen and that the current constitutional constraints provide some protection against political whims. He is willing to consider changes that would address the definition of income, but he does not wish to change the protections afforded to the principal and the fact that distributions from the Common School Fund must go to school libraries.

Senator Stroebel stated that he believes the committee should provide the BCPL with more flexibility to make different investment choices so that it could potentially maximize the growth of the funds.

Senator Taylor noted that the BCPL has stated that it is doing everything that it can to grow the principal under current law and that the staff would like time to implement the new investment policy and to assess whether it is working at some point in the future.

Senator Stroebel expressed that the rate of return achieved by the BCPL because of the legal constraints is lower than it needs to be and that it is his duty as an elected official to provide more flexibility so that the BCPL has at least an opportunity to achieve a greater rate of return.

Chair Katsma would like to remove legal constraints, if possible. He directed the committee to then focus on whether the BCPL's current investment policy, or any aspects of it,

should be incorporated into or authorized by statute. Mr. Ramirez described ways that the committee could proceed, including: (1) providing general authorization to the BCPL to defer distribution of income for the purposes of creating smoothing accounts; (2) providing general authorization with some parameters for how much should be distributed each year; or (3) codifying the investment policy, with or without changes.

Mr. Derr expressed concern with specifying certain distribution percentages or other numbers in statute. He would prefer to give the BCPL flexibility to operate as it deems best. He also expressed an interest in exploring options for additional revenue streams to grow the principal of the funds to make them sustainable over the long term.

Senator Taylor noted that she is not likely to be in favor of a constitutional amendment in order to give the BCPL more flexibility, especially because the BCPL is not requesting such a change. However, she would consider a draft. Senator Stroebel stated that he would like to see a draft so that the committee could review actual language and discuss it.

Mr. Eager stated that he would like to see a draft codifying what the BCPL is currently doing to protect them in the future.

Mr. Derr stated that he is not necessarily opposed to a constitutional amendment if it were narrowly approached. He may be in favor of something that allows a small portion of the income earned on the funds to be deposited as principal in order to grow the principal over time.

Representative Vruwink asked whether all of the income earned has to be distributed in the year that it is earned or whether it can be deferred. Mr. Ramirez explained that the constitution does not require annual distribution. Rather, state statutes require that all of the earnings of the Common School Fund are to be put into a single appropriation and annually, on April 15, the amount to be distributed is to be based on what is in that appropriation on that date. He explained that current practice appears to vary from this statutory requirement and described the alternative ways in which this could be viewed. On the one hand, the practice of deferring distributions could be interpreted as a reasonable application of the prudent investor standard. On the other hand, it could be interpreted as contrary to a statutory directive that requires annual distribution of all income and earnings.

Representative Vruwink favors an option that would both grow the principal and maintain constant funding for libraries. He suggested capping distributions at an amount that increases with inflation and putting any extra earnings into principal. Mr. Ramirez generally responded that such a change could be handled in different ways, but that, without a constitutional change, any amount retained would never be considered principal.

Mr. O'Malley asked if there is risk to the BCPL if the committee drafts a bill authorizing the BCPL's practice that is introduced but ultimately does not pass. He wondered if that would be interpreted as a statement that what the BCPL is doing now is not appropriate. Mr. Ramirez explained that only a court could decide whether the BCPL is acting beyond its authority, and then, only if challenged by someone with standing. However, he also stated that a court's decision would be based on interpretation of current law and would not likely be impacted by a bill that is not enacted.

Chair Katsma directed Legislative Council staff to draft a constitutional amendment that would allow for distribution from the principal of the school trust funds.

Mr. O'Malley would like to encourage the BCPL to continue on its current path and may support increasing the agency's flexibility. He would also like to do whatever is possible to eliminate competition between the BCPL and private lenders. He stated that any restrictions on the use of loans by municipalities is beyond the authority of this committee. Mr. Derr agreed that if the constitution can be modified slightly to encourage growth without disrupting funding to beneficiaries, he would consider it.

Senator Stroebel requested that Legislative Council staff produce a bill draft that limits the use of school trust fund loans for pass-through incentives to private developers.

Chair Katsma requested that Legislative Council staff produce a bill draft codifying some of the BCPL's investment policy. Ms. Bannigan requested that the draft generally authorize the BCPL to retain funds for smoothing accounts in a way that leaves as much decision-making power with the BCPL as possible. Mr. Derr agreed that the draft should give flexibility without restricting the BCPL staff too much. Mr. Merkes requested a draft that would allow for the retention and investment of a portion of earnings.

Chair Katsma requested that Legislative Council staff produce a bill draft that would authorize SWIB to invest the school trust funds in accordance with its general investment guidelines if the BCPL would ever delegate investment authority to SWIB.

Chair Katsma asked whether there should be any bill draft modifying the appropriate uses of distributions from the Common School Fund. Mr. Ramirez explained the uses currently authorized under state statute. Ms. Bannigan explained that DPI gives schools a list of items that may be purchased under current law and that, over time, the Legislature has expanded the purposes for which the funds may be used. She does not advocate for any additional changes out of a concern that, if given too much flexibility, a school district may be incentivized to direct the funds away from libraries, which ensure that all students throughout a school benefit from the items purchased. Representative Vruwink agreed with Ms. Bannigan.

Plans for Future Meetings

The next committee meeting is scheduled for December 6, 2018, at 10:00 a.m., in Room 411 South, State Capitol.

Adjournment

The meeting adjourned at 12:30 p.m.

ZR:RES:jal

[The preceding is a summary of the November 13, 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>.]