



Legislative Fiscal Bureau

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Joint Committee on Finance

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Delegation of Investment Authority to SWIB (Board of Commissioners of Public Lands)

[LFB 2005-07 Budget Summary: Page 74, #5]

CURRENT LAW

The Board of Commissioners of Public Lands (BCPL) is authorized to invest monies in its four trust funds (the common school fund, the normal school fund, the university fund and the agricultural college fund) in: (1) bonds or notes of the United States; (2) certain securities issued by the United States related to farm loan programs; and (3) bonds issued by: (a) the state; (b) any city, town, village, county or school district in this state; (c) any local exposition, professional football stadium, professional baseball park or cultural arts district in this state; and (d) any bonds issued by the University of Wisconsin Hospitals and Clinics Authority. Further, under current law, the State of Wisconsin Investment Board (SWIB) is required, upon request from the BCPL, to give advice and assistance to the BCPL concerning the investment of any of the monies in the four trust funds and, in addition, to sell, convey and deed to the BCPL any of the investments that SWIB has made, subject to the mutual agreement of the BCPL and SWIB. SWIB is currently authorized to charge BCPL for any such services that it provides to BCPL.

GOVERNOR

Provide statutory authority for the BCPL to delegate to SWIB the authority to invest part or all of the monies belonging to any of the four trust funds managed by BCPL. Specify that if the BCPL chooses to make such a delegation, SWIB may invest the monies belonging to the trust funds only in fixed income investments or in funds that invest in fixed income instruments. In connection with this requirement, SWIB would be authorized to charge its administrative costs for these investment services to the fund for which the services were provided and to add these amounts to its administrative operations appropriation.

DISCUSSION POINTS

1. The BCPL has had the authority to directly invest in bonds or notes of the federal government and bonds issued by this state or local of units of government in this state since at least the 1940's. Further, Chapter 657, Laws of 1957, created a state investment fund (SIF) to be operated by SWIB and intended to provide a vehicle for the centralized investment of the short-term cash balances of most of the funds of the state.

2. However, some funds, including the BCPL trust funds, were excluded from that provision. In 1961, that statute was amended to allow the BCPL (and authorities with fiduciary responsibility for those other excluded separate funds) to request the transfer of the temporary cash assets of any such fund to the SIF for investment. In the case of the BCPL, this has served as an alternative way for the BCPL to invest the monies of the funds in types of assets similar to those that it is permitted to invest in on its own (primarily bonds).

3. When investment earnings on state funds are discussed, references will often be made to what the current SIF rate is. Such references will usually be to the monthly, quarterly or annual rate of earnings on the pooled monies in that fund. The cash balances in state funds that are available to be invested in the SIF vary daily as cash is added to, or withdrawn from, agency cash balances that are invested in the SIF. The monies in the SIF are invested primarily in obligations of the federal government and its agencies and in high-quality commercial bank and corporate debt obligations. This is because much of that money will be needed within short time-periods as individual program demands dictate. Some liken the SIF to a money market fund. At least a portion of the BCPL trust funds' monies that are available for investment are placed in the SIF because those funds will be needed at certain points in time during the year by BCPL.

4. The Board, under its trust funds loan program, has some need for relative quick access to some of the principal of its trust funds when it makes loans. However, its overall charge is to protect the principal of the four trust funds for which it is responsible and to manage that principal so as to provide monies (investment earnings) to the designated beneficiaries of the funds. Those trust fund earnings are garnered primarily from three investment sources: (a) interest on the loans the Board makes to schools and municipalities under the trust funds loan program; (b) monies it receives from SIF interest payments; and (c) interest on other fixed income investments which currently is investments in state veterans home loan bonds and Lambeau Stadium bonds. The BCPL has indicated that the reason it has been seeking this expanded investment authority is so that it can endeavor to increase the amount of interest earnings on each fund's principal. However, in reality, it is primarily the investment of the principal of common school fund that is at issue. That fund, as of June 30, 2004, had a balance of \$586.6 million and constituted almost 97% of the total assets of all of BCPL's four trust funds.

5. Up until the 1999-01 fiscal biennium, most of the monies in BCPL's trust funds were either loaned to school districts and municipalities or, beginning in 1961, placed in the SIF. For example, as of June 30, 1999, 57% of the total of the trust fund balances was invested in the SIF and the remaining 43% was loaned out. However, beginning in the 1999-01 fiscal biennium, the BCPL began looking at the other investment alternatives (primarily bonds) available to it under current

law. This policy change is demonstrated by following: (a) as of June 30, 2000, 47.8% of the total of the trust fund balances was in the SIF and the remaining 52.2% was loaned out; whereas, (b) as of June 30, 2003, 31% of the total of the trust fund balances was in the SIF, 44% was loaned out and the remaining 25% was invested in bonds. A total of \$132.8 million was invested in bonds as of June 30, 2003, whereas there were no funds invested in bonds on June 30, 1999.

6. As of June 30, 2004, the BCPL trust fund balances were allocated as shown in the following table.

**Allocation of BCPL Trust Fund Balances
As of June 30, 2004**

<u>Fund</u>	<u>State Investment Fund</u>	<u>Loans to Schools</u>	<u>Loans to Municipalities</u>	<u>State Veterans Bonds</u>	<u>Lambeau Stadium Bonds</u>	<u>TOTAL</u>
Common School Fund	\$141,430,100	\$89,158,700	\$225,241,800	\$93,285,000	\$37,450,000	\$586,565,600
Normal School Fund	1,118,800	0	18,736,200	0	0	19,855,000
Agricultural College Fund	305,300	0	0	0	0	305,300
University Fund	<u>234,100</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>234,100</u>
Total -- Amount	\$143,088,300	\$89,158,700	\$243,978,000	\$93,285,000	\$37,450,000	\$606,960,000
Percent	23.6%	14.7%	40.2%	15.4%	6.2%	100.0%

7. The original Lambeau Stadium bonds sold in 2000 and 2001 had annual interest rates of 5.25%. However, when there was a change in the investment climate and the economy, to avoid a call on those bonds the BCPL agreed to renegotiate with the Stadium District. Currently, the \$32.5 million in stadium bonds that the BCPL owns are at a fixed annual interest rate of 3.95%. The \$83.4 million in veterans bonds that the BCPL currently owns are at fixed annual interest rates of from 4.35% to 7.00%, as shown in the table below. For the veterans home loan bonds, the average life of the current bonds is 17.3 years and for the Lambeau Stadium bonds, the remaining life on that issuance is 15.3 years. The BCPL indicates that for fiscal year 2004, the average annual rate of return for the veterans' bonds holdings was 5.98% and for the Lambeau Stadium bonds the rate was 5.0%. The overall rate of return for the total bond holdings for the same period was 5.70%.

**Interest Rates on Veterans Home Loan Bonds Holdings
February, 2005**

	<u>Outstanding Principal</u>	<u>Fixed Interest Rate (annual)</u>
	\$29,370,000	4.35%
	1,000,000	4.50
	1,845,000	4.80
	4,635,000	4.85
	1,000,000	5.15
	24,080,000	5.25
	16,095,000	6.25
	<u>5,340,000</u>	7.00
Total	\$83,365,000	

8. The BCPL has taken these more recent steps to expand its scope of investments under current law in efforts to increase its earnings on fund assets. A few years ago (1995 thru 2001) SIF annual return rates were running in the 5% to 6% range. By comparison, as December 31, 2004, the 10-year average return for the SIF was 4.1%. However, the five-year average return was 2.9% and the one-year average return was only 1.3%. The SIF, in total, is a single pool of cash balances of various state agencies and some 1,200 local governmental units (via the Local Government Investment Pool). These various state agencies and/or local governmental units may need access to these funds on a day-to-day basis or on a more intermittent basis. The stated objectives of the SIF are to provide this needed liquidity, ensure safety of principal and provide a competitive rate of return. The fund is invested primarily in obligations of the U. S. government and its agencies and high-quality commercial bank and corporate debt obligations.

9. The Board also invests a substantial portion of its fund balances through its trust funds loan program. Under this program, the BCPL is authorized to make loans from the principals in its trust funds to: (a) school districts for a variety of statutorily-enumerated purposes (including construction and remodeling costs and land and equipment purchases); and (b) local units of government for any debt purpose authorized under the municipal borrowing statute. The maximum loan period permitted under the statutes is 20 years and, under current Board policy, the loan limit is \$5,000,000 per customer in a calendar year.

10. In the Board's budget request, with respect to justifying the need for this added investment authority, it was further stated that BCPL staff believed it was very difficult to estimate the amount of additional earnings that could be generated by investing its cash reserves in the type of fixed income funds for which the Board wishes the expanded investment authority, particularly during times of declining interest rates. However, the argument was made that even a spread of 1 to 2% (increased annual rate of returns) would generate added earnings for the trust fund beneficiaries.

11. Under the BCPL's current loan policies (as of February, 2005), two categories of

loans with varying interest rates have been established. These are shown in the table below:

(a) General loans, with loan periods and interest rates as follows:

<u>Loan Period</u>	<u>Interest Rate</u>
1 to 5 years	3.50%
6 to 10 years	4.25
11 to 20 years	5.00

(b) Unfunded pension liability loans:

All loans are assessed a 5.25% interest rate.

12. The program's loan rates are set and adjusted by the Board. However, under current Board policy, the Executive Secretary of the Board, with the approval of the Board Chair, may adjust rates by up to 25 basis points (0.25%) without Board approval. The BCPL tends to periodically adjust the rates for new loans to keep the rates in step with the comparable loan rates in the state.

13. In its budget request material for this expanded investment authority, the BCPL estimated that its then current average annual return rate from all of its loans was about 5.1%. The BCPL further estimated that its current average annual return rate for its monies in the SIF was about 1.0%.

14. This is not the first time that the BCPL has requested this type of expanded investment authority. Similar language was requested by the Board in its 1999-01 budget request. However, the Governor did not include the language in his budget recommendations. The language was included by the Legislature in its final version of the budget, but the language was deleted by a Governor's item veto. In the Board's 2001-03 biennial budget submittal, an expansion of the Board's existing investment authority was again requested, but again that language was not included in the Governor's budget recommendations. In the Governor's 2003-05 biennial budget, expanded investment authority involving the services of SWIB as requested by BCPL was included.

15. The language as included in the 2003-05 Governor's budget was very broad and would have allowed SWIB to invest the assets of BCPL's trust funds in any of the range of investments that SWIB may make, including equities and real estate. However, following the introduction of the 2003-05 budget, BCPL staff indicated that the Board's actual goal was only for the BCPL to have expanded authority to invest in a somewhat larger range of fixed income investments than what is now permitted under the statutes or under the types of shorter-term fixed income investments in which the SIF usually invests. Further, BCPL staff suggested that bond index funds or individual bonds with somewhat longer maturities than those the SIF typically invests were the types of additional investments in which the Board was interested. It was stated that the BCPL had no interest in investing in equities.

16. In addition, staff from SWIB also indicated to the Committee that there was concern on SWIB's part with the language in Governor's 2003-05 budget regarding this new investment authority and related new SWIB responsibilities. The Committee was told that SWIB and BCPL staff would work together to attempt to develop mutually agreeable alternative language for the Committee to consider. Subsequently, BCPL and SWIB developed alternative language largely similar to the language now proposed in 2005 AB 100. However, the Joint Committee on Finance chose at that time not to authorize any expansion in BCPL investment authority.

17. A first consideration for the Committee is whether it wishes in principal to consider adopting this proposed change in investment authority. The following points may be considered in this regard.

18. Under the proposed language, SWIB could only invest BCPL trust fund monies in specific fixed income investments (such as corporate bonds and obligations of the federal government) or in funds that invest in fixed income instruments (such as a mutual fund that might hold a variety of individual corporate bonds and/or federal government obligations). Further, SWIB could only take actions to the extent that BCPL delegated specific investment authority to SWIB. Presumably, BCPL could, as a part of the delegation, dictate both the amount of funds to be invested and whether the investments were to be in individual fixed income investments (for example, a specific series of bonds or federal government obligations) or in a fund that invests in fixed income instruments (such as a bond fund) where the BCPL would be investing in a portion of the total investments held by the fund.

19. SWIB, in particular, believes that the use of a bond fund or bond index fund would continue to allow BCPL to have access to its funds on as-needed basis while still offering the opportunity to obtain its goal of a higher investment earnings rate than is obtainable under the SIF. SWIB, however, would likely have concerns if BCPL did not limit its request for such SWIB investment actions primarily to those portions of its funds' balances that could be invested for the longer term, meaning that the portion of its fund balances that might be needed relatively soon ought to continue to be invested in the SIF.

20. SWIB staff have indicated that for comparative purposes, the one, three and five-year average returns for a fund that they might use for this purpose would have compared as follows with the SIF return rate.

**Illustrative Comparative Average Returns
(As of December 31, 2004)**

	<u>SIF</u>	BGI Lehman <u>Bond Index Fund</u>
1 Year	1.30%	4.10%
3 Year	1.40	6.90
5 Year	2.90	8.40

21. Comparable three and five-year average percentage returns for the BCPL's veterans home loan bonds holdings are not available. However, BCPL indicates that average annual return for all its current veterans bond holdings, as of June 30, 2004, was 5.98%. Thus, at least on the one-year basis of measurement, the BCPL already had investment authority options that far exceeded the current SIF annual return rate.

22. However, a bond fund investment option for the BCPL would likely offer the Board a broader exposure to bond offerings than just state bonds. According to BCPL's budget request for this budget, the goal of having this type of investment authority available is to obtain higher return rates while retaining a high degree of liquidity (ready access to cash if needed for the loan program).

23. As noted when SWIB provided information in the last budget about this type of investment, however, there is no assurance that the above types of rates of return for the bond index funds will continue since changes in the interest rate environment will affect future rates of return. In fact, SWIB now indicates that the BGI Lehman Bond Index Fund referenced above, based on updated annualized returns as of March 31, 2005, showed an annualized one-year rate of return of -0.7% compared to average annual rate of return of 6.5% for a three-year period ending March 31, 2005, and an average annual rate of return of 7.3% for the five-year period.

24. Another potential advantage of having the SWIB investment option is that, in addition to having access to additional fixed income investment vehicles and presumably greater ability to reduce investment holdings when cash demands dictate, the BCPL staff would also have the assistance of SWIB investment staff in making those fixed income investments. BCPL does not have any investment specialists on its staff.

25. Almost all of the monies to be invested by the BCPL are in the common school fund (fund balance of \$586.6 million as of June 30, 2004) and the normal school fund (fund balance of \$19.9 million as of June 30, 2004). The balances in the other two funds, as of the same date, totaled \$539,400. Earnings on the principal in the common school fund are distributed as school library aids to each of the state's public school districts. Earnings on the principal in the normal school fund are distributed to the University of Wisconsin System which deposits the money as revenue to the general fund.

26. The Committee could decide that it is desirable to provide the BCPL with added investment options for possible increased earnings on its trust funds. However, if the Committee supports this expansion of investment authority, it could make the following modifications to the expanded investment authority as proposed by the Governor.

27. The language in AB 100 would authorize SWIB to "invest the moneys belonging to the trust funds in any fixed income investment or fund that invests in fixed income instruments." While SWIB envisions only using funds that invest solely in fixed income instruments as is intended, the proposed language could be read to also allow SWIB to invest in funds that invest in both fixed income instruments and other types of investments such as equities. The BCPL has previously indicated that it wants under this expanded investment authority to invest in fixed

income options or in funds that invest solely in bonds or fixed income options. However, the language in AB 100 would appear to allow SWIB to invest in funds that do not invest solely in fixed income instruments, such a mixed bond and equities fund. The language in AB 100 could be clarified to expressly provide that for funds that SWIB could use for this purpose, SWIB would be allowed to use BCPL monies to invest in funds that only invest in fixed income instruments.

28. AB 100 also provides that SWIB may charge BCPL for the costs of its investment services provided to BCPL under this expanded investment authority and may increase its appropriation by the amount of such assessments. Since fiscal year 1999-00, SWIB's budget has been set as a percent of the total assets under management, which includes monies in the SIF. The Committee could delete that assessment language and the provision for increased budgetary authority since it is unnecessary and in conflict with the budget agreement under which SWIB is currently operating.

29. Alternatively, the Committee could take the view that the BCPL has only recently begun to use its existing authority to invest in existing types of bond investments already permitted under existing law and that the BCPL should have more experience under its existing investment authority before obtaining expanded investment authority. The BCPL is, under current law, already allowed to request from SWIB advice and assistance concerning the investment of any of the monies in its four trust funds.

30. Further, the Committee could note that there is not any firm Board policy on the amount of monies that the BCPL chooses to loan out under its trust funds loan program. This may necessitate the BCPL keeping more of the trust funds in SIF rather than in other longer-term investment options with potentially greater investment returns for the funds.

31. The Committee could delete these expanded investment authority provisions from the bill with the expectation that the BCPL could examine these issues further and then either seek the introduction of separate legislation or submit a subsequent biennial budget request for enhanced investment authority once it has more fully reviewed all of its investment goals and options.

ALTERNATIVES

1. Approve the Governor's recommendation.

2. Modify the Governor's recommendation by: (a) deleting the provisions relating to SWIB's assessment of costs to the BCPL and resultant enhanced budget authority; and (b) clarifying the provision that SWIB may invest BCPL monies in funds that invest in fixed income instruments to specify that such investments are restricted to funds that only invest in fixed income instruments.

3. Maintain current law.

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