

SUBJECT: Investment of public funds

COMMITTEE: Pensions and Investments — committee substitute recommended

VOTE: 6 ayes — Telford, Johnson, Averitt, Haggerty, Rangel, Willis

0 nays

3 absent — Berlanga, McCall, Wilson

WITNESSES: For — Mark G. Johnson, Texas Public Funds Investment Pool; George Greanias, City of Houston; Susan K. Anderson, Government Treasurers Organization of Texas; Kathy Hynson, County Treasurers Association; Richard E. Scott, Local Government Investment Cooperation (LOGIC); Cheryll Adair; John W. Fainter, Jr., FGIC Advisors, Inc.

Against — None

On — Thomas Ricks, University of Texas

DIGEST: CSHB 2459 would amend the Public Funds Investment Act to require governmental entities in Texas to have a written investment policy, prohibit funds invested outside the state Treasury from being invested in four types of "derivative" securities, establish reporting requirements and require investment pools to establish advisory boards and have a AAA rating.

The act would apply to public funds invested outside the state Treasury by a state agency, local government or an investment pool acting on behalf of two or more governmental entities. (Local government would be any local government entity including cities, counties, all districts and authorities including school, hospital and fresh water districts, all institutions of higher education, political subdivisions, public corporation, body politic, and nonprofit corporations acting on behalf of those entities.)

The investment provisions of the bill would not affect investments authorized in other laws, but would require that no governmental entity could invest in the four unauthorized "derivative" investment securities

specified in the bill. However, the investment provisions of the bill would not apply to funds invested by public retirement systems, the state Treasury or institutions of higher education with an endowment that has a book value of at \$25 million.

The bill would allow local governments to use electronic means to transfer or invest funds.

Written investment policy. The bill would require the governing body of an investing entity to adopt a written investment policy that would include an investment strategy that stipulates the following priorities in order of importance: suitability of investments, preservation and safety of principal, liquidity, diversification of portfolio and yield. The investing entity would be required to designate persons responsible for investing the funds. All management of investments would have to be made with the express written authority of the governing body or head of the governmental entity, unless otherwise allowed by law. The act would prohibit an officer or employee of a regional planning commission from investing funds. The governing body of an investing entity could specify unsuitable investments in its written investment policy.

Investment companies would have to notify the governmental entity that they had received and thoroughly reviewed the written investment policy and that they have implemented reasonable procedures to preclude any imprudent investment activities; otherwise, the governmental entity would be prohibited from purchasing securities from the company.

The bill would set a standard of care for investments. In addition to the prudent person rule, investments would have to be invested according to the following priorities: preservation and safety of principal, liquidity, and yield. Prudent investments would be relative to the entire portfolio, not just a single investment, and would have to be in line with the written investment objectives.

Unauthorized investments. The bill would specifically not allow investments to be made in the following "derivative" securities:

- obligations whose payment represents the coupon payments on the outstanding principal balance of the underlying mortgage-backed security collateral and pays no principal;
- obligations whose payment represents the principal stream of cash flow from underlying mortgage-backed security collateral and bears no interest;
- collateralized mortgage obligations that have a stated final maturity date of greater than 10 years; and
- collateralized mortgage obligations the interest rate of which is determined by an index that adjusts opposite to the changes in a market index.

Investment pools. The bill would authorize investments in investment pools if the governing body of the investing entity specifically allowed it. The investment pool would be required to invest its funds in investments authorized by the Public Funds Investment Act.

To be eligible to be an authorized investment pool, the bill would require the pool to provide the investing entity with information including the objectives, size and performance history of the pool. To maintain eligibility to invest government funds, the pool would be required to provide the investing entity with certain information including investment transaction confirmations, the percentage of the pool's portfolio invested in securities with maturity dates of more than one year, the number of pool participants and the yield and expense of the pool.

The bill would require a public funds investment pool that acts like a money market mutual fund to market its portfolio daily and, if possible, to stabilize at a \$1 net asset value. The bill would require the money market pool to maintain a ratio between 0.995 and 1.005.

The bill would require a public funds investment pool to be continuously rated no lower than AAA or AAAM by at least one nationally recognized rating service.

Investment pool advisory boards. The bill would require investment pools, including the state Treasury-run TexPool, to establish advisory boards. The TexPool advisory board would have to be composed equally of pool participants and persons who have no business connections to the pool.

Authorized investments. The bill would continue to authorize investment in the following: obligations of the United States or its agencies and instrumentalities; direct obligations of the state of Texas or its agencies or instrumentalities; collateralized mortgage obligations issued and guaranteed by the federal government; other obligations that are unconditionally guaranteed or insured by or backed by the full faith and credit of the state of Texas or the United States; and obligations of states, agencies, counties, cities and political subdivisions of any state with at least an A rating.

It would continue to allow investments in certificates of deposit, repurchase agreements provided they mature in 90 days, bankers' acceptances, commercial paper and no-load money market mutual funds. No-load money market mutual funds would now have to be regulated, not just registered with the Securities and Exchange Commission (SEC), and would have to have a continuous AAA rating.

The bill would add no-load mutual funds registered with the SEC to the list of allowable investments. Approved mutual funds would have to meet certain conditions such as having an average weighted maturity of less than two years and a continuous AAA rating. The bill would also authorize investments in guaranteed investment contracts that have a defined termination date and that meet other conditions set out in the bill.

Authorized investments for institutions of higher education. The bill would allow institutions of higher education, in addition to other allowable investments, to invest in cash management and fixed income funds of certain tax-exempt organizations, negotiable certificates of deposit from banks with certain credit ratings and highly rated corporate bonds or debt instruments.

Reports. The bill would require investment officers to prepare and submit quarterly investment transaction reports to the governing body of the

governmental entity. The report would have to detail the investment position of the entity and be prepared and signed by all investment officers. (Current law requires annual reports.)

Effective date. The bill would take effect September 1, 1995.

**SUPPORTERS
SAY:**

CSHB 2459 would tighten regulation of investment of public funds outside the state Treasury by imposing investing, reporting, disclosure, and safety requirements on entities investing public funds and on the people that sell those investments to assure that public funds are safe.

The bill would expressly prohibit most public funds from being invested in certain types of "derivative" securities so that the kind of financial disaster that befell Orange County, California, would not occur in Texas. (Derivatives are financial instruments whose value is linked to, or "derived" from, changes in interest rates, currency rates, and stock and commodity prices.) Derivative investments have a place in large long-term portfolios such as a pension fund would have, but are generally not appropriate for public fund investment pools used for cash management. The bill would not affect investments made by the state's large university systems, such as The University of Texas and Texas A&M, which have sophisticated investment portfolios and have authority to invest based on the prudent person rule. However, it would apply to all other institutions of higher education, and would protect them from the type of financial problems that occurred at Odessa College, whose entire \$22 million portfolio consisted of mortgage derivatives. The state auditor found seven other colleges or universities with a high concentration of "derivative" investments.

The bill would require that investing entities have written investment objectives that are based on safety first, then liquidity and yield. It would require that investment companies acknowledge they understand the governmental entities investment policy and would not sell them inappropriate investments.

The bill would assure that investment pools are safe by requiring them to have advisory boards and be rated at the highest rating — AAA by a national company such as Standard and Poors or Moodys. Private funds

and TexPool are rated, and there is no reason that investment pools should not have to adhere to the same standards as other funds.

TexPool, the investment pool managed by the state treasury, would be required to have advisers outside of the participants. Governing boards would be responsible for investing funds, not a single employee.

OPPONENTS
SAY:

Although the purpose of the bill — to protect public funds — is admirable, the various provisions could lessen the desire of governmental entities to invest in investment pools and could discourage brokerage firms from doing business with public entities in Texas.

The bill could discourage brokerage firms from doing business with governmental entities in Texas because it would require sellers, or brokerage firms, to acknowledge that they fully understand the entity's investment policies and that they would not sell them any securities that would represent less-than-prudent investments. This would require the brokerage firm to do the investment officers' job for them. In other words, it would require the brokerage firm to determine with due diligence what investments the governmental entity should be making. It is not the responsibility of the brokerage firm, but the responsibility of the investing entity, to determine investments. It would, in effect, be asking a seller to tell the buyer that the purchase they have made is good for the buyer.

Investment pools that are required to have a AAA rating are limited in the types of investments they can make. Basically, they would be relegated to investing in T-bills and U.S. Treasury notes. Furthermore, the expense of being rated would lower the available yield. The statute only allows investment pools to invest in credit worthy investments, so requiring the pools to be rated is redundant and expensive. Furthermore, a AAA rating would prohibit investment pools from investing in the types of securities (bankers acceptances, repurchase agreements, etc.) that governmental entities can invest in on their own.

To assure that the financial problems that occurred in Orange County do not happen in Texas, governing boards need to be educated about various investment options and their consequences.

The bill should not require that the TexPool advisory board be made up equally of pool participants and outside advisers. The participants should be a majority of the advisory board since they have a vested interest in the pool.

NOTES:

The committee substitute made a number of technical changes in addition to the following provisions:

- requiring investment pools to be have a AAA rating;
- exempting from the bill institutions of higher education with endowments of \$25 million and the state Treasury;
- allowing local governments to invest and transfer funds electronically;
and
- requiring advisory boards for investment pools.

SB 1085 by Ellis, the companion bill, has been referred to the Senate Finance Committee.