HOUSE RESEARCH ORGANIZATION bill analysis 5/9/2001

HJR 74
Keel, Gallego, Uher, Bonnen
(CSHJR 74 by Olivo)

SUBJECT: Investment and management of the Permanent School Fund

COMMITTEE: Public Education — committee substitute recommended

VOTE: 5 ayes — Sadler, Dunnam, Hardcastle, Hochberg, Olivo

2 nays — Grusendorf, Smith

2 absent — Dutton, Oliveira

WITNESSES: For — None

Against — Ryan Bangert, Texas Eagle Forum; Cynthia Thorton, for Grace Shore and State Board of Education

On — Demetrius McDaniel, for Russell Stein and First Union Securities

BACKGROUND: The Permanent School Fund (PSF), primarily comprising stocks, bonds, and oil and gas royalties from state-owned lands, was established as a constitutional fund in 1854. Today, the PSF is worth more than $20 billion. Interest and dividend income from PSF generate nearly $700 million per year, and PSF land sale and lease proceeds generate another $300 million for a total annual distribution to all school districts of about $1 billion through the Available School Fund (ASF). The ASF also receives dedicated revenue from one-quarter of state-levied motor fuel taxes. The ASF is a constitutional fund that distributes funds to all school districts for textbook purchases, the technology allotment, and a per-student distribution regardless of district wealth or size. The PSF also is available to insure voter-approved, long-term bonds issued by accredited schools.

The State Board of Education (SBOE) invests and manages the PSF, under Texas Constitution, Art. 7, sec. 8. Before 1995, the SBOE managed the fund exclusively through staff hired by the Texas Education Agency (TEA). In 1995, SBOE decided to allow private portfolio managers to manage part of the PSF. SBOE authorized three firms to begin managing PSF assets on September 1, 1995, and increased the number of managing firms to 12 in 1997. Private firms now manage roughly one-third, or about $7 billion, of the PSF and receive nearly $18 million annually for their services. In addition to the portfolio managers, SBOE also contracts with independent investment firms to provide advice on fund management and economic forecasting. Another firm is employed independently to evaluate the fund's long-term investment strategy and performance.

For additional background information on the SBOE's management of the PSF, see House Research Organization Focus Report Number 76-19, *State Board of Education: Controversy and Change*, January 3, 2000.

DIGEST:

CSHJR 74 would create constitutional authority to transfer PSF management from the SBOE to a new Permanent School Fund Investment Board.

Permanent School Fund Investment Board. CSHJR 74 would amend the Texas Constitution, Art. 7, sec. 5 to create the Permanent School Fund Investment Board to invest and manage the PSF. The nine-member board would consist of three members appointed by the governor, three members appointed by the lieutenant governor, and three members appointed by the House speaker. Appointments would have to be made in the manner provided by law, which could provide that the Art. 4, sec. 12 provisions regarding filling vacancies in state or district offices and Senate confirmation did not apply.

A board member would be required to have appropriate expertise in investing institutional funds, as determined by the appointing authority. The resolution would define "institutional funds" to mean funds held by an incorporated or unincorporated organization that operated exclusively for educational, religious, or charitable purposes; an educational institution; or a foundation chartered for the benefit of an educational institution.

Members would serve staggered terms of six years. The term of one member appointed by each appointing authority would expire February 1 of each odd-numbered year. A temporary provision would require the governor, lieutenant governor, and speaker of the house each to appoint one person to a term expiring February 1, 2003, one to a term expiring February 1, 2005, and one to a term expiring February 1, 2007. Afterwards, appointed members would serve six-year terms. The temporary provision would expire January 1, 2003.

Investment and management. Taking into consideration all assets of the PSF, the board could acquire, exchange, sell, supervise, manage, or retain investments that prudent investors would acquire or retain in light of the purposes, terms, distribution requirements, and other circumstances of the fund.

Ballot proposal. The proposal would be presented to the voters at an election on November 6, 2001. The ballot proposal would read: "The constitutional amendment providing for the transfer of authority to invest and manage the permanent school fund from the State Board of Education to the Permanent School Fund Investment Board and modifying the standard used to determine appropriate investment and management decisions."

SUPPORTERS SAY:

CSHJR 74 would act upon the recommendations of the House General Investigating Committee after its interim investigation of recent SBOE actions relating to management of the PSF as well as critical findings made by the State Auditor's Office. The interim report found "evidence suggesting, at a minimum, the appearance of a conflict of interest affects the SBOE's decisions on consultant and money manager selection, asset allocation, and broker-dealer eligibility requirements." The committee also found that financial relationships between informal advisors and SBOE PSF committee members were not disclosed and limited the full SBOE's ability to safeguard its decisions. The committee also reported that tracing previously undisclosed financial transactions was challenging, particularly in light of the complexity of the investment arena, which can camouflage self-dealing.

CSHJR 74 is needed to address the committee conclusions that private rewards were received for public influence in SBOE's management of the PSF. PSF should be safeguarded by putting it in the hands of experienced investment managers. SBOE members are elected officials who do not have the investment expertise or experience necessary to best manage the PSF. Most voters do not understand what SBOE does or that it manages PSF, and they do not query candidates on their financial background. SBOE members rely on financial experts to make investment decisions. This lack of expertise makes it more difficult for SBOE members to manage the PSF prudently, and avoid conflicts of interest regarding advice from outside investment consultants. SBOE is too inexperienced to be managing PSF in an increasingly complex and volatile market.

The actions of SBOE members and advisors have eroded public trust. The interim committee concluded that SBOE members shared confidential information with an informal adviser and allowed him to participate in interviewing bidders, improperly giving a person with no fiduciary relationship to the PSF apparent authority to speak and act on behalf of PSF.

Changes to PSF management are necessary to restore integrity and public confidence in PSF management. SBOE members have made many decisions about PSF recklessly, based on unreliable and unsubstantiated information. SBOE ignored ethical breaches by a key hired consultant, as well as an unpaid adviser. Some SBOE members also have stated they do not trust TEA personnel assigned to advise them on financial matters. SBOE chose, for example, to hire two financial institutions to oversee the fund, despite TEA's recommendation to hire only one. An investment firm refused to accept a contract to review PSF strategies, citing the lack of a positive working relationship between SBOE and TEA staff. While it is arguable whether these problems have harmed PSF value, that is not the issue. As trustees of public funds, SBOE members must avoid even the appearance of impropriety.

Management of PSF is time consuming and complicated, and is only one of SBOE's 34 powers and duties. Assigning management of PSF to another body would allow SBOE to focus on other vitally important education matters, such as curriculum, graduation requirements, student performance assessment, and textbook selection.

Other state funds, such as the Permanent University Fund, have been managed by appointed boards. These funds have not experienced problems like PSF has.

The way PSF is managed, and the way SBOE works have been changed multiple times. Since 1984, the Legislature and voters have changed the SBOE from an elected entity to an appointed one and back again. The make-up of SBOE is purely a legislative function. SBOE has no "right" to manage PSF, or do anything else — all SBOE duties were given to SBOE by the Legislature, and the Legislature properly can take them away, with voter approval.

OPPONENTS SAY:

The State Board of Education should continue to manage and invest the PSF. The PSF has benefitted from the checks and balances of the constitutional separation of powers, where SBOE manages the fund and the Legislature controls expenditures. SBOE concerns itself only with maintaining PSF growth. If SBOE were removed as PSF manager, as proposed by CSHJR 74 and by its enabling legislation, HB 2414, those checks and balances would disappear, because a majority of the PSF managers/investors would be appointed by the Legislature through its leadership.

There are less invasive ways to solve SBOE problems. There have been no allegations of wrongdoing by SBOE members. All of the allegations in the House General Investigating Committee report and the State Auditor's Office reports concern informal advisors and their failure to disclose economic interests. Under current law, there is no penalty for informal advisors who fail to disclose economic interests. Instead of replacing the elected SBOE with an appointed board, the Legislature should promote disclosure of economic interests by informal advisors by creating penalties for failure to do so.

No one ever has alleged that PSF investments were made improperly or that even one dollar was improperly invested. There has been no showing that the elected SBOE model will not continue to work. SBOE is capable of managing the PSF, which has performed well under its management. The PSF has performed at or above the market in many aspects and is growing at a respectable rate. Moving PSF management to a different body would not necessarily improve performance of the PSF. Use of TEA staff and outside financial advisors provides SBOE with the expertise necessary to manage the fund properly. Personal financial knowledge is not a prerequisite to sound financial management. Many members of the Legislature have no financial or investment experience, and yet they determine the budget for the State of Texas — a budget far larger than the assets of the PSF. It is doubtful that anyone would argue the budget should be taken away from the Legislature and determined by a small, appointed committee.

SBOE has helped protect the PSF from being diverted for questionable purposes such as school employee health insurance. An appointed board would have a conflict of interest and thus be unable to adequately protect the PSF, if those appointing the board wanted to raid the fund. Insulated bureaucrats should not be managing the PSF, because appointed officials are not directly accountable to the people. Replacing SBOE with an appointed body would not address inside dealing or other ethical problems. These problems probably would increase due to lack of public criticism. An elected SBOE is the most accountable to, and most representative of, Texas schoolchildren and parents.

The allegations of unethical behavior involve former, not current, SBOE members. The current board is working hard to prevent future mistakes. SBOE has a new chair and has made some changes to SBOE ethics policies. The PSF committee has changed and is open to working with consultants. In addition, SBOE has planned future changes, such as a required financial management seminars. SBOE should be given the opportunity to prove that it can manage PSF adequately.

OTHER OPPONENTS SAY:

Rather than strip investment authority over the PSF from the SBOE, which as an elected body is accountable to the voters, and transfer it to an appointed body with little or no oversight, it would make more sense to establish an investment advisory committee to assist the SBOE in investing the PSF.

NOTES:

The committee substitute included provisions for initial appointment of board members and specified that members would serve staggered terms of six years, expiring on February 1 of each odd-numbered year. The substitute also provided that the board would have to be appointed in the manner provided by law, which could state that provisions regarding filling vacancies in state or district offices and Senate confirmation do not apply.

HB 2414 by Keel, et al., the enabling legislation for HJR 74, was reported favorably, as substituted, by the Public Education Committee on April 24. S

SB 512 by Duncan, which also addresses management of the PSF, passed the Senate on April 30 and has been referred to the House Public Education Committee. SB 512 would not remove management of the fund from SBOE but rather would appoint an investment advisory committee to advise SBOE on its investment decisions with regard to the PSF.