SUBJECT: Investing a portion of the ESF in excess of the sufficient balance

COMMITTEE: Appropriations — committee substitute recommended

VOTE: 20 ayes — Otto, Sylvester Turner, Ashby, Bell, G. Bonnen, Capriglione, Giddings, Gonzales, Howard, Hughes, Koop, Longoria, Miles, R. Miller, Price, Raney, J. Rodriguez, Sheffield, VanDeaver, Walle

0 nays

7 absent — Burkett, S. Davis, Dukes, Márquez, McClendon, Muñoz, Phelan

WITNESSES: For — (*Registered, but did not testify:* Dale Craymer, Texas Taxpayers and Research Association; Will Francis, Texas Forward; Matthew Geske, Fort Worth Chamber of Commerce; Harrison Hiner, Texas State Employees Union; Chandra Villanueva, Center for Public Policy Priorities)

Against — None

On — (*Registered but did not testify:* Phillip Ashley, Comptroller of Public Accounts; Paul Ballard, Texas Treasury Safekeeping Trust Company)

BACKGROUND: **Economic Stabilization Fund.** Texas Constitution Art. 3, sec. 49-g establishes the Economic Stabilization Fund (ESF), often called the rainy day fund. The fund's balance is expected to reach $11.1 billion by the end of fiscal 2016-17, absent any appropriations from the fund, according to the comptroller's January 2015 *Biennial Revenue Estimate*.

Sources of funding. Funds in the ESF come from biennium-ending balances in the general revenue fund and from a portion of oil and natural gas production taxes.

Sec. 49-g (b) requires the comptroller to transfer to the ESF one-half of any unencumbered balance remaining in the general revenue fund at the end of a biennium. Under sec. 49-g (d) and (e), the comptroller is required to take 75 percent of any oil and natural gas production tax revenue that exceeds the amount collected in 1987 and send half of that amount to the ESF and half to the State Highway Fund.

Sufficient balance. These allocations can be adjusted under certain circumstances to maintain an amount determined to be the sufficient balance of the fund. Government Code, sec. 316.092 establishes a select legislative committee and requires that it meet immediately preceding each legislative session to determine a sufficient balance for the ESF for the following fiscal biennium. The balance must be an amount the committee estimates will ensure an appropriate amount of revenue in the ESF.

In December 2014, the Joint Select Committee to Study the Balance of the Economic Stabilization Fund determined that $7 billion was a sufficient minimum balance for the fund. The balance does not restrict appropriations from the fund but does affect the amounts transferred to the general revenue fund and the State Highway Fund.

Fund cap. Texas Constitution, Art. 3, sec. 49-g (g) sets a cap on the amount of money that the ESF can hold. The fund cannot exceed an amount equal to 10 percent of the total amount deposited into general revenue the previous biennium, minus investment income, interest income, and amounts borrowed from special funds. The cap for the current biennium is $14.1 billion, and the cap is estimated to be $16.1 billion for fiscal 2016-17. The fund has never reached the cap.

*Appropriations from the ESF***.** Any amount from the fund may be spent for any purpose if approved by at least two-thirds of the members present in each house. Funds also may be spent to cover an unanticipated deficit in a current budget or to offset a decline in revenue for a future budget with approval of at least three-fifths of the members present in each house.

Investment of state funds. Government Code, sec. 404.024 outlines the investments that the comptroller is authorized to make with state funds. Under sec. 404.024(j), if the comptroller is required to invest funds other than as provided under sec. 404.024, and if there is no other law establishing a conflicting standard, the funds must be invested under the restrictions and procedures for making the investments that people of "ordinary prudence, discretion, and intelligence, exercising the judgment and care under the prevailing circumstances, would follow in the management of their own affairs […]." Sec. 404.024(j) also specifies that the investments be made "not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital." This is sometimes called the prudent investor standard.

The ESF is invested in a fund called the Texas Treasury Pool that is managed by the Texas Treasury Safekeeping Trust Company, a special-purpose trust that manages some of the state's funds. The Treasury Pool is managed in accordance with Government Code, sec. 404.024.

DIGEST:

CSHB 903 would require the comptroller to change the way the Economic Stabilization Fund is invested. The comptroller would be required to invest a percentage of the ESF balance that exceeds the fund's sufficient balance in accordance with the investment standard specified in Government Code, sec. 404.024(j).

The investment would not be subject to other requirement or limitations in Government Code, sec. 404.024, which lists the type of investments the comptroller is authorized to make and certain restrictions on the investments.

The comptroller would be required to adjust the ESF's investment portfolio periodically to ensure that the balance of the ESF was sufficient to meet the fund's cash flow requirements.

The comptroller would be required to include the fair market value of the ESF's investment portfolio when calculating the cap on the ESF and determining allocations from general revenue to the ESF and the State

Highway Fund.

The bill's provisions requiring investment of part of the ESF would expire when the Government Code's provisions establishing the procedures to determine the ESF's sufficient balance expire, currently set for December 31, 2024.

This bill would take immediate effect if finally passed by a two-thirds record vote of the membership of each house. Otherwise, it would take effect September 1, 2015.

SUPPORTERS SAY:

CSHB 903 would modify the ESF investment strategy to ensure that the state was being a responsible steward of taxpayer funds. The bill would balance the state's need to have an adequate amount of money readily available in the ESF and the need to invest the fund prudently.

Currently, the ESF is in highly liquid, low yield assets that in financial terms are described as cash equivalents. Its recent earnings have been less than inflation, meaning that the ESF is losing purchasing power.

While it is prudent for the state to maintain a certain amount of liquidity so that the ESF is readily accessible in the event of an emergency or other need, it is unnecessary to subject the entire fund to this standard. With the fund's balance estimated to reach $11.1 billion by the end of fiscal 2016-17, absent any appropriations, there is more than enough in the fund to maintain an appropriate threshold of liquidity while investing a portion of the amount above the sufficient balance in a stable, safe class of assets with a slightly higher return.

The bill would protect the ESF by requiring the comptroller to use the prudent investor standard to invest a portion of the fund that is above the sufficient balance. This standard is well defined and considered a best practice by the institutional investment managers. It would judiciously protect the state's money by investing it in a safe class of assets designed to yield a higher rate than the state's current approach.

The investments envisioned under CSHB 903 could be targeted to earn inflation or inflation plus a set percentage. Under some estimates, for every $1 billion invested under CSHB 903, the state could earn $15 million annually. This would preserve the fund's purchasing power and grow the state's savings account.

CSHB 903 would affect only a portion of the ESF. The bill would allow the comptroller to determine what portion of the fund would be invested under the bill, but whatever amount was set as the ESF's sufficient balance — currently $7 billion — would remain in the current class of assets. The comptroller should have the flexibility to determine what portion of the amount above the sufficient balance would be invested — rather than designate that amount in law — so that the investing could ramp up slowly and be changed when appropriate and necessary.

Investing part of the ESF would not make the state vulnerable during emergency or present problems when the Legislature needed to access the fund quickly. The fund's sufficient balance would remain readily available, and at $7 billion the balance is well above the largest appropriation ever made from the ESF, which was $3.9 billion. Funds invested under the bill would be liquid enough to be made available quickly if necessary — the majority within days and the rest soon thereafter. This would be ample time, given that the Legislature usually knows well in advance when it will be appropriating money from the ESF and that the appropriations process, even during an emergency, takes some time. In addition, funds appropriated from the ESF are not spent instantaneously but often over months or years.

The comptroller is the entity best suited to invest ESF funds under the bill. The comptroller currently handles the ESF, and keeping the funds under one entity would make management easier, especially if the state needed to tap the ESF for short-term cash management. The Texas Treasury Safekeeping Trust Company, which manages the fund for the comptroller, would continue in its role. While other entities may do a good job of investing state funds, the Texas Treasury Safekeeping Trust Company has the most experience with a large pool of assets that must be kept relatively liquid compared to other types of investments, such as endowments.

The Legislature would retain its oversight of the ESF and its authority to appropriate funds when it chooses. The Legislature could revisit the provisions of CSHB 903 at any time and change the state's policy for investing the ESF.

OPPONENTS SAY:

CSHB 903 could subject the state's emergency cash reserves to unnecessary risk. The Economic Stabilization Fund was set up for the purpose its name suggests — to stabilize state finances in a time of need caused by recession, depression, or other economic disruption. Investing a portion of the funds in a more aggressive portfolio could expose the state to the risk of losing the very funds on which it would rely in an emergency.

OTHER OPPONENTS SAY:

CSHB 903 should not limit the potential investment entities for the ESF to the comptroller. Other entities such as UTIMCO, which oversees investments for the University of Texas and Texas A&M systems, could be a better fit to manage the funds. The state could solicit potential investment plans from a number of entities and then retain legislative oversight of the investment of the fund by having the elected members of the Legislative Budget Board decide which plan to follow.

Another way to retain appropriate legislative oversight of the investment of the fund would be to establish a legislative committee to evaluate the investments or to set in statute a percentage of the ESF above the sufficient balance to be invested, instead of allowing the comptroller to determine the portion invested.

NOTES:

The committee substitute made several changes to the original bill. The original bill would have required the comptroller to invest the ESF balance that was in excess of 30 percent of the sufficient balance, while the committee substitute would apply to an undetermined percentage of the ESF balance over the sufficient balance. The original bill would have required the comptroller to adjust the ESF portfolio so that as money was withdrawn or transferred from the ESF or as the sufficient balance changed, only the balance over 30 percent of the sufficient balance would be invested. The committee substitute instead would require the comptroller to adjust the ESF's investment portfolio to ensure the fund's balance met the cash flow requirements of the fund. The committee substitute also added provisions that would require the fair market value of the ESF's portfolio to be used in calculating the fund's cap and to make the bill expire upon expiration of the law that sets up how the fund's sufficient balance is determined.

According to the LBB's fiscal note, CSHB 903 could result in an indeterminate change in the investment earnings of the ESF.

The companion bill, SB 116 by V. Taylor, was considered in a public hearing of the Senate Finance Committee on April 9 and left pending.

A related bill, SB 1927 by Seliger, also would allow a portion of the ESF to be invested under the prudent investor standard and would require the LBB to publish an annual report on the performance of the investments. It would apply to an amount of the ESF equal to the sufficient balance of the fund. SB 1927 would require the comptroller to submit at least two investment plans for the ESF to the LBB, which would choose a plan. At least one of the plans would have to exclude participation by the Texas Treasury Safekeeping Trust Company. SB 1927 was considered in a public hearing of the Senate Finance Committee on April 9 and left pending.