

SUBJECT: Creating the Permanent School Fund Management Council

COMMITTEE: Public Education — committee substitute recommended

VOTE: 9 ayes — Eissler, Hochberg, Aycock, Farias, Jackson, Olivo, Patrick, Shelton, Weber

0 nays

2 absent — Allen, Dutton

WITNESSES: For — Bob Craig; (*Registered, but did not testify:* Nan Clayton, League of Women Voters-TX; James Davis; Bill Grusendorf, Texas Association of Rural Schools; Chuck Hempstead, Texas Association of College Teachers; Kathy Miller, Texas Freedom Network; Don Rogers, Texas Rural Education Association; Ken Whalen, Texas Daily Newspaper Association and Texas Press Association)

Against — Don McLeroy; (*Registered, but did not testify:* Merrylynn Gerstenschlager, Texas Eagle Forum)

On — Geraldine Miller; Jerry Patterson, Texas General Land Office

BACKGROUND: The Permanent School Fund is a perpetual endowment for Texas public schools established by the Legislature in 1854. The Permanent School Fund (the fund) includes more than 46.5 million acres of Texas land, including the mineral rights of 7.1 million acres, and all income generated from its assets. Returns earned through investments are constitutionally dedicated to the Available School Fund to be appropriated by the Legislature to school districts to purchase instructional materials. The fund may guarantee bonds issued by school districts to purchase, construct, or maintain instructional facilities.

Tex. Const., Art. 7 grants the State Board of Education (SBOE) authority to manage any financial investment made by the fund. The Constitution requires the SBOE to exercise prudence and discretion without regard to speculation, but with regard to the permanent disposition of the fund, considering the probable income and safety of the capital to be invested. Education Code, sec. 43.005 permits the SBOE to contract with private

professional investment managers to assist the board in making investment decisions, and the board may delegate investment powers or duties to a committee, officer, employee, or other agent of the board. Education Code, sec. 43.0051 permits the board to transfer money from the Permanent School Fund to a sub-fund, the real estate special fund account, controlled by the General Land Office (GLO).

The SBOE controls investment management of cash assets, and the Texas Education Agency (TEA) carries out the administrative duties necessary to implement policies established by the SBOE regarding the fund. TEA holds hiring authority for the chief investment officer of the Permanent School Fund.

The GLO is responsible for the real property assets of the fund. Lease sales and other transactions are approved by the School Land Board chaired by the land commissioner. The governor and the attorney general each appoint an individual to the School Land Board. The board may acquire, sell, lease, trade, improve, maintain, protect, or otherwise manage, control, or use land owned by the fund. The SBOE may invest in real estate without the consent or knowledge of the land commissioner.

The comptroller must report the condition of the Permanent School Fund to the governor before any legislative session, and must provide any report requested by the State Board of Education.

DIGEST:

CSHB 2037 would transfer all investment authority for the Permanent School Fund from the State Board of Education (SBOE) to a new Permanent School Fund Management Council, removing restrictions and prescriptions on investment decisions. The council would assume oversight of the fund bond guarantee program, replace the SBOE in contracts pertaining to the fund, and enter into a memorandum of understanding under which the council would not invest in real estate without the consent of the School Land Board.

Council membership. The council would include:

- two members appointed by the governor;
- one member appointed by the governor from a list prepared by the speaker of the House of Representatives;
- one member appointed by the governor from a list prepared by the State Board of Education;

- one member appointed by the lieutenant governor for a term expiring February 1, 2013;
- one member appointed by the commissioner of the General Land Office for a term expiring February 1, 2011; and
- one member appointed by the comptroller of public accounts for a term expiring February 1, 2013.

The governor would appoint two members for terms expiring February 1, 2011, and two members for terms expiring February 1, 2013. Council members would serve staggered four-year terms, with three terms expiring February 1 of one odd-numbered year and four terms expiring on February 1 of the next odd-numbered year. If a vacancy occurred, the new member would be appointed in the same manner as the previous member. Council members would elect by a majority vote a presiding officer to serve a two-year term expiring February 1 of each odd-numbered year and could elect the same member as presiding officer for unlimited terms.

Administrative support and management. CSHB 2037 would require the council to contract with a corporation formed by the comptroller to provide administrative support to the council and perform any duty delegated to the corporation by the council. The bill would require the council to comply with the corporation's ethics policy or to adopt an ethics policy to which the council would have to adhere. The council would not have to confer with the general counsel of TEA before waiving the requirement that a person filing a written statement disclosing a conflict of interest remove themselves from investment decisions about which they have a conflict.

The council would meet quarterly and would have discretion to adopt rules and operating procedures as necessary to perform its duties. The council could create standing committees to advise the council and would have to create an audit and ethics committee, a policy committee, and a risk committee.

The council would comply with open meetings laws unless the only reason for the meeting were to receive information relating to an investment or potential investment in a private business or publicly traded company, about which disclosure would provide an advantage to a competitor, and the investment was not required to be registered under federal law. During a closed meeting, the council could not deliberate public business or agency policy that affected public business.

CSHB 2037 would make it a class A misdemeanor (up to one year in jail and/or a maximum fine of \$4,000) for someone who was a council member within the past two years to communicate with a council member, the chief investment officer, or a council employee with the intent of influencing actions or decision-making.

Audits and reports. The state auditor would conduct an annual financial audit of the fund and could contract with a third party to conduct an audit. A copy of the auditor's report would be delivered to the council, the governor, the lieutenant governor, the speaker of the House of Representatives, the commissioner of education, and the comptroller.

The council would be required to submit an annual report of the council's investment and fiduciary practices and policies to the governor, the lieutenant governor, the speaker of the House, the state auditor, and the chairs of all Senate and House standing committees whose jurisdiction included public education, state finance, or appropriations.

Effective date. This bill would take effect December 1, 2009, but only if the proposed constitutional amendment creating the Permanent School Fund Management Council were approved by the voters. If that amendment was not approved, this bill would have no effect.

SUPPORTERS
SAY:

CSHB 2037 would allow for management of the Permanent School Fund (PSF) by a new entity composed of individuals with expertise in financial matters. The framers of the Constitution did not intend for the fund to be run by ordinary individuals because in 1876, the Constitution mandated that the governor, the comptroller of public accounts, and the superintendent of schools comprise the State Board of Education (SBOE). These individuals would have had the expertise necessary to manage the fund. In 1928, the SBOE became a nine-member body appointed by the governor, each of whom would have the necessary expertise. In 1949, the SBOE became an elected body, returned to an appointed body in 1984, and again became an elected body in 1989. The original intent for the SBOE was it to be a body of prudent and careful people who would make safe investments in stocks and bonds.

The SBOE in its current form has not successfully managed the fund. A new Permanent School Fund Management Council would improve the effectiveness of fund management. The SBOE does not provide adequate management for the fund because it lacks expertise. As an elected body,

while most members are qualified for education policy-making, they are not qualified in investment fund management. Their lack of knowledge has resulted in each member appointing a personal advisor, none of whom are professional money managers.

This bill would consolidate decision-making authority with the same entity implementing policy. Unlike the SBOE, the council would have complete hiring authority over the fund's chief investment officer. TEA no longer would have to provide administrative support to the SBOE regarding the permanent school fund. TEA, by design, should handle only education policy and not investment management. Administrative support provided by a corporation that deals solely with investments would improve effectiveness.

This bill would provide a comprehensive investment strategy and adequate management that would increase the money available to the public school finance system. The SBOE has duplicated work and employed an ineffective and non-comprehensive investment strategy. External managers have been allowed to invest and divest without consulting one another, resulting in a manager selling what another was buying. The fees of external managers subtract from the investment returns of the fund, decreasing the amount available for distribution to the public school finance system. For example, the SBOE is able to invest in real estate without consulting the General Land Office, resulting in chaotic and ill-informed investments. The SBOE duplication of GLO actions results in double expenses to the fund. CSHB 2037 would require the council to consult the GLO before making real estate investments and would eliminate double expenses to the fund, increasing the money available to the public school finance system.

The state does not need to conduct a study of best practices. In a report to the 77th Legislature in 2000, the Texas House General Investigating Committee recommended that the Constitution be amended to create an appointed Permanent School Fund Investment Board, separate from the State Board of Education, with the jurisdiction of the State Board of Education limited to education policy. In 2003, an independent report contracted through the State Auditor's Office and requested by the State Board of Education stated that "by constitutional amendment a governing board for a state-sponsored, quasi-independent investment management organization [should be] created to administer the Permanent School Fund."

OPPONENTS
SAY:

This bill and its accompanying constitutional amendment would undermine the intent of the framers of the Constitution, who did not intend to place the Permanent School Fund in the hands of financial experts but to have it overseen by those accountable to the people. The SBOE has successfully managed the fund for more than 125 years. The SBOE has survived all the ups and downs in the state's history and provides checks and balances to ensure that the fund produces as much money as possible. Any dysfunction of the SBOE is a result of piecemeal changes made by Legislature to the duties of the SBOE. The Legislature demanded increased returns, so SBOE investments became riskier, which necessitated personal advisors for members of the board.

The SBOE plays an important role in maintaining the permanency of the fund and preserving intergenerational equity, both of which require conservative spending policies. The SBOE is charged with maintaining equity between generations of children, taking into account inflation and the cost of education, so SBOE membership has resisted efforts to overspend the fund. The SBOE, as a separately elected independent body accountable to the voters of the state, is not required to guarantee a fixed disbursement each biennium, but to protect the long-term financial soundness of the Permanent School Fund.

The state does not need to create an entire new governmental entity because the SBOE can correct itself within the existing structure. The SBOE is diverse in beliefs and ideas, which is a strength, not a weakness.

OTHER
OPPONENTS
SAY:

The management of the Permanent School Fund should not be changed until the state examines the policies and procedures of funds managed successfully, such as the University of Texas Investment Management Company (UTIMCO), the Teacher Retirement System (TRS), and the Employees Retirement System (ERS). From this research, the state would determine which best practices suit the Permanent School Fund.

This bill should not allow the SBOE to retain the power to approve the distribution rate that determines the distribution to the Available School Fund. This responsibility should be transferred wholly to the Permanent School Fund Management Council. To ensure intergenerational equity, spending and investment policy decisions should be consistent with one another.

NOTES:

The accompanying constitutional amendment, HJR 77 by D. Howard, is on today's Constitutional Amendments Calendar.

The committee substitute differs from the original bill as filed by decreasing the number of members on the Permanent School Fund Management Council from nine to seven; removing the requirement that each member have substantial investment expertise or financial management experience, and increasing the number of members appointed by the governor; requiring that the council meet quarterly but deleting a requirement that the council prepare quarterly reports; providing for the appointment of a chief investment officer, rather than an executive administrator; requiring the council to contract with a corporation formed by the comptroller, instead of TEA, to provide administrative support to the council and perform any duty delegated to the corporation by the council; requiring the council to comply with the corporation's ethics policy or develop and adopt an ethics policy to which the council would have to adhere; deleting a requirement that any person providing services pertaining to the fund's management detail any expenditure over \$50; and adding members of standing committees on appropriations and education to receive reports prepared by the council.