

Mr. Steve Bender, Principal Legislative Analyst  
Legislative Fiscal Office  
900 Court St. NE  
Room H-178  
Salem, OR 97301

Dear Mr. Bender

Thank you for the opportunity to discuss our plans for improving the treasury management functions within the Oregon University System (OUS). We have several exciting and challenging objectives with respect to treasury management that we will introduce and discuss within this document, which is intended to provide the information requested in your October 5 "OUS Investment Earnings Questionnaire" (Questionnaire). Throughout this document, we have referenced the specific question numbers from the Questionnaire with the related information. We have organized the information in a narrative format to provide important background in a proper context and to reduce the potential of misperceptions.

### **Background**

The genesis of the legislative concept to retain the interest earnings on those OUS funds for which the interest accrues to the State General Fund was the belief that, with the monetary incentive of increased interest earnings, we would take actions and make changes to processes that would increase the interest earnings on our funds beyond what is currently being earned. Over the years, OUS has worked to implement new banking/cash management processes, such as lock boxes, procurement cards, ACH payment processing, and acceptance of VISA/Mastercard to help better serve our students and improve our business processes. There are additional steps that can be taken to improve our banking and cash management processes, including those that require the incremental investment of resources to achieve but are not practical without the resulting interest earnings accruing to OUS. The following are examples of actions and process changes that have been discussed to improve our cash flows that do not require statutory changes or additional statutory authority (Questions 1a, 1b, 1c, 2, 3):

1. Further improve collection of accounts receivable. As an example, for each day we can gain in collection of non-student receivables, such as sales and services revenue, OUS will realize an estimated \$125,000 in increased interest earnings each biennium ( $\$456 \text{ million annual non-student revenues} \times 5\% \text{ divided by } 365 \times 2$ ).
2. Structure payments on accounts payable to maximize interest earnings. For each day OUS can postpone payments on its accounts payable, OUS will realize an estimated \$210,000 in increased interest earnings each biennium ( $\$768 \text{ million in annual S\&S spending} \times 5\% \text{ divided by } 365 \times 2$ ). This is net of the current volume of procurement card purchases. Should procurement card purchase volume increase appreciably, the increment gained here will be reduced.

3. Increase the utilization of the procurement card. OUS is currently in the process of strengthening the controls over its procurement card program in order to expand its use. For example, the implementation of a new system for administering this program, which has been done at OSU and is currently underway at PSU, will allow expansion of the types of goods and services purchased with a procurement card. If we increase our utilization of the procurement card by \$1 million annually, our interest earnings would increase approximately \$100,000 per biennium ( $\$1 \text{ million} \times 5\% \text{ estimated earnings} \times 2$ ). The cost of these implementations is being borne within current operating budgets.
4. Take advantage of the spread between short-term interest rates that may be available for interim financing of construction projects and the rates that can be earned on operating asset balances. For example, if we currently utilize cash balances to advance monies for capital construction projects, the cost of that financing will be the 5% lost investment earnings should we be authorized to retain the interest on our operating cash balances. Utilizing short-term variable rate financing, such as Commercial Paper, generally costs less than the investment earnings on a managed portfolio. Any savings achieved through this process is dependent on the current interest rate environment and the precision of cash flow planning for capital construction. As such, we make no estimate of savings.
5. Accept advance tuition payments (likely no longer than one year in advance) at a discount rate lower than what we can earn on our balances, thereby generating a spread and providing a sought-after service for our customers. Any savings achieved through this process is dependent on the decisions made with respect to discount rates, as well as the current interest rate environment. This is primarily a customer service benefit that we cannot currently implement due to the cost in tuition dollars. If we are able to offset that cost with interest earnings, we would be better able to serve our students.
6. Consider interest earnings/costs when negotiating the terms of contracts for procurement of goods and services, as well as capital construction contracts. Any savings achieved through this process will depend on the terms and conditions negotiated within individual contracts. As such, we make no estimate of savings.

It is for these reasons that OUS agreed to an offsetting reduction in its general fund appropriation for the ability to retain the interest earnings on all of our funds. In theory, continuing with our current processes will put us in a break-even state with the General Fund offset. We wanted to provide the incentives that reward prudent fiscal management practices to motivate fiscal managers to improve cash management processes, analyzing the costs and benefits of each specific process change proposal. Providing the monetary incentive will motivate OUS managers to change our processes to generate incremental returns without a mandate. We believe that we will be able to generate incremental returns that will accrue to the benefit of the students beyond what we would give up in a budgetary offset. It is important to note that what we might do to improve cash flows and increase investment earnings may be one set of actions in

today's business environment, but it might be quite different in a future business environment. As a result, all of the potential fiscal impact of these actions and process changes has not been assessed and provided in detail.

### **Broad Treasury Management Objectives**

After the legislative concept was filed and during the legislative session, we became convinced that there were more comprehensive and fundamental changes that could be made in our treasury management practices that would be, in many ways, transformational in their reach and certainly generate significant cost savings and incremental investment revenues. These concepts were outlined to our Board in May, 2007 and are summarized below (Question 1a, 1b, 2, 3, 4b). (See Attachment 1 for the complete docket material relating to these new treasury strategies).

#### *Investment of Operating Assets*

Currently, investment decisions relating to certain funds, such as the building and equipment reserves of the auxiliary enterprise funds, are based on the expected cash flows of those funds alone, retaining liquidity within that fund necessary to meet the specific cash flow demands. The same is true of unrestricted gift funds, bond proceeds, bond sinking funds, and agency funds. If we were to combine these cash balances and these cash flows, along with the tuition and fees, appropriation, and other income cash balances and flows, volatility can be minimized, liquidity can be kept at a prudent minimum level, and investments can be made more strategically, looking at the overall risk profile of the pool rather than the operational cash flow needs at a granular basis.

The objectives of this structure are to:

- pool operating assets to decrease cash flow volatility and the need for high levels of unnecessary liquidity,
- manage the investment of operating assets from an overall risk basis, rather than a security-type approach,
- maximize return on operating assets within a prudent risk/return profile, and
- increase net assets of the System.

Pooled operating asset investment procedures would be as follows:

- OUS Treasury Office analyzes operating asset flows and, based on historic and projected cash flows, stratifies the balances into three categories:
  - Liquid - invested in short-term, liquid, low-risk assets
  - Contingent - invested in medium term assets that are somewhat less liquid
  - Core - invested in longer term (1-5 year) assets that are less liquid than either the Liquid or Contingent asset "categories."
- Liquid assets would likely be maintained in the checking account(s) of the campuses/System and invested in the State Treasurer's Short-Term Fund.
- The OUS Treasury Office would work with the State Treasurer's office to invest the Contingent and Core "classes," either through current investment funds or strategies managed by the State Treasurer, or through outside investment companies.

- “Deposits” from the campuses would earn a blended rate of return that would be set annually by the Investment Committee in consultation with the System’s financial advisors.

A study performed by the CommonFund calculated investment returns from the pooled approach based on our historical cash balances from FY 2002 to FY 2006 and historical investment returns over a 10 year period. Their analysis showed that different investment strategies yielded incremental investment returns above the short-term rate, which is the rate all OUS funds currently earn (with the exception of the endowment fund). The following table summarizes the applicable findings of the CommonFund study (see Attachment 2):

**CommonFund Investment Analysis:**

Investment Scenario 1 - Similar to Current Approach -- 100% Short-Term Fund

Investment Scenario 2 - 50% Short-Term Fund and 50% Intermediate Term Fund

Investment Scenario 3 - 34% Short-Term Fund, 33% Intermediate Term Fund and 33% Multi-Strategy Bond Fund

Average Balance OUS Funds FY 2002- FY 2006	\$ 490,000,000			
		<u>Scenario 1</u>	<u>Scenario 2</u>	<u>Scenario 3</u>
Average of 5-Year Net Returns Annualized		3.94%	4.64%	5.46%
Biennial Investment Earnings	\$ 38,612,000	45,472,000	53,508,000	
Incremental Biennial Earnings Gained via Pooled Investment Approach	N/A	6,860,000	14,896,000	
Accrues to GF under Current Law	16,217,040	19,098,240	22,473,360	
Accrues to OUS under Current Law	<u>22,394,960</u>	<u>26,373,760</u>	<u>31,034,640</u>	
Total	\$ <u>38,612,000</u>	<u>45,472,000</u>	<u>53,508,000</u>	

The historical incremental returns, when applied to the OUS historical average cash balances, yield incremental biennial returns of \$6.9 million for investment scenario 2, and \$14.9 million for scenario 3. These incremental returns include the amount of incremental earnings on those balances that currently accrue to the General Fund, and those that currently accrue to OUS. It should be noted that this analysis was prepared using balances and rates through June 30, 2006. Accordingly, these numbers will not

correlate to some of the data presented in the fiscal impact statements. If it would be helpful, we will ask the CommonFund to update their analysis with the latest balances and investment returns. However, we do not anticipate that the investment earnings rate spreads between the investment scenarios shown will differ materially.

### Management of Long-Term Debt

The System's current long-term debt management practices, which have been to issue fixed-rate financing and to tie debt service requirements needed from the underlying activity to the debt service schedule of the bonds allocated to a specific capital project, has inhibited flexibility in financing capital projects. With a pooled approach to debt management, the System's Treasury Office can begin to issue and manage long-term debt on a portfolio basis, taking on variable rate debt and loaning debt proceeds to each campus based on a blended interest rate, to take advantage of the cost savings of variable rate debt in a pooled approach and passing on those savings to the campuses through a blended rate that is lower than would be otherwise obtainable through fixed rates, yet maintaining level debt service payments necessary for budgeting.

The objectives of this structure are to:

- provide for equitable distribution of lower cost financings including the potential of utilizing low cost short-term debt,
- stabilize the System's cost of capital for current and future capital programs,
- create and maintain predictability in capital cost for budgeting and planning,
- provide a consistent borrowing rate across institutions, schools, and divisions, and
- de-link external and internal debt structures to optimize lending rates and take advantage of optimal market structures.

Pooled debt management procedures would be as follows:

- The OUS Treasury Office collects all debt issuance proceeds and budgeted debt service payments centrally which is used to:
  - pay external debt service,
  - lend funds internally for projects, and
  - invest for future capital needs or debt service obligations.
- Internal loans are charged the blended rate and structured consistently with level debt service.

The blended debt service rate, which may include a buffer to manage the volatility in the variable rate debt, will be subject to an annual review after debt issuance. The blended rate will be set by the Finance and Administration Committee with advice from the System's financial advisors.

### **Legislative Concepts for 2007 Session (Questions 1c, 4b)**

The statutory change needed to implement these proposals relating to debt management, which was delineated in HB 2199, was signed into law this last session. The statutory changes that we believed would allow the implementation of these

proposals relating to investment management were delineated in HB 2198, which was not passed.

While it was not completely clear whether the current statutes, with changes proposed in HB 2198, would provide a complete framework within which to implement our investment management objectives, we did have a construct that we were planning to test with counsel in the interim period between the 2007 session and the 2008 session. That construct is built upon the following premises:

1. The standard statutory language "...the fund may be invested by the State Treasurer and the earnings from such investments shall be credited to the fund..." that is present in the majority of the statutes creating OUS funds and would be added to ORS 351.540 if HB 2198 were passed, gives the State Treasurer broad latitude, within other statutes and constitutional limits, to invest the funds.
2. The current language in ORS 351.540 relating to the special checking account of OUS authorizes OUS to deposit and disburse monies from the various other OUS funds through this account.
3. The proposed change in ORS 351.540 that comprised HB 2198 would grant the State Treasurer the investment latitude referenced in 1 above and allow the earnings to be credited to the fund.

Based on these premises, we formed the following construct:

1. If a certain investment strategy and vehicle was deemed by Treasury to be appropriate for multiple/all current OUS funds, pooling funds for investment purposes would be allowable. To expound, if we have \$1 million in fund X and \$1 million in fund Y, and both may be invested in investment Z, then pooling these funds for investment purposes would not only be allowed, but would be more prudent in order to gain economies of scale, reduce liquidity and perhaps reduce fees. This is not different conceptually from how we manage our endowment fund. We pool many individual gifts from different donors that were donated for different purposes together and purchase several different investment vehicles.
2. A distinction is made between combining accounts for banking purposes and pooling funds from more than one bank account for investment purposes. It is our premise that accounts do not need to be combined to allow for investing in the same vehicle. It is akin to a unitized investment pool, which is how we manage our endowment fund.
3. We would construct an investment strategy that a prudent investor would implement for all OUS funds in a pooled approach. The CommonFund study included several such approaches. Investment strategies such as these have been utilized by other higher education institutions, some for many years.
4. We could manage liquidity through our checking account that allows monies from multiple funds to flow through and be credited/debited at some later, more prudent date.

5. We have a very comprehensive accounting system that accounts for all transactions of each fund and maintains up-to-the-minute balance information for all funds of OUS, ensuring accountability mandated in statute and accurate earnings attribution in a pooled investing environment.

We discussed this premise with Messrs. Bond and Mueller of the State Treasurer's Office in a meeting on January 18, 2007. While Mr. Bond had doubts that we could achieve our objectives under current statutory authorities, it was our understanding that OUS would work with legal counsel after the 2007 regular session to determine if additional statutory changes or provisions beyond those in HB 2198 were needed to attain our goals. If so, it was our understanding that we would bring those changes to the Legislature in the February 2008 session.

### **Analysis Performed Subsequent to the 2007 Legislative Session**

#### DOJ Analysis (Question 1c)

We asked DOJ to review the current statutory framework that guides our banking and investment processes to identify any statutes that prohibit OUS from implementing the above construct or any authorizing statutes that are insufficient to permit the desired changes. See Attachment 3 for a copy of the complete response from DOJ. In summary, it appears that, while some of the statutory language needed is present, and some of the needed changes were contemplated in HB 2198, additional change is needed. In short, all accounts of OUS should include the following language:

1. "The fund may be invested by the State Treasurer"
2. "The fund is separate and distinct from the General Fund" (we would need to discuss how to handle the XI-G Bond Matching Funds)
3. "Investment Earnings of the fund will be credited to the fund"

Appendix A of the PFM report includes references the relevant current language that can be used to identify the statutes that would need to be changed.

Additionally, DOJ recommended a general statute giving the Treasurer the flexibility to either separately invest all these accounts or commingle one or more of them for investment purposes.

#### Bond Counsel Analysis (Question 4c)

We discussed our pooled investment objectives with OSU bond counsel, K&L Gates, and found that there are no prohibitions within state laws or our bond documents that would prohibit pooling of bond proceeds or bond sinking funds for investment purposes.

#### Consultant's Findings on Proposed Banking Processes (Questions 1a, 1b)

We engaged PFM, the OUS financial advisors, to examine our current banking and cash management structure and propose a structure that would be most efficient to reach our objectives. See Attachment 4 for a copy of their complete report. In summary, PFM recommends combining some of the existing statutory accounts to streamline our banking processes. From a generic funding standpoint, PFM also

concludes that it is not necessary to combine bank accounts to achieve a pooling of their balances for investment purposes. We will ask DOJ in the next several weeks to develop any needed statutory changes to provide the flexibility to modify our banking structure and also meet the objectives outlined above in the response to Question 1c.

#### Types of Expenditures of Bank Accounts (Question 4a)

Attachment 5 lists of our bank accounts showing the types of expenditures that each account supports.

#### **Fiscal Impact Statements (Question 3)**

Throughout this document, we have provided some of the information relating to the fiscal impact of these concepts. To summarize that data, Attachment 6 includes a Word file with the following fiscal impact statements in the standard format:

1. Interest earnings concept (retention of interest/investment earnings without pooling for investment purposes) – as was noted above we have not made any detailed estimates of incremental interest earnings or related costs that would be realized by reengineering our business processes
2. Pooling funds for investment purposes

#### **Why Combine Accounts Now? (Question 5)**

As stated above, a distinction is made between combining accounts for banking purposes and pooling funds from more than one bank account for investment purposes. Based on the results of the PFM study, we may move to combine accounts to streamline our banking processes; however, it is our premise that accounts do not need to be combined to allow for investing in the same vehicle.

The concept of pooling monies for investment purposes is certainly not a new one. In fact entities such as corporations and certain higher education institutions have been managing their operating assets in this manner for some time. However, widespread use of this approach in public higher education has only gained significant attention in recent years. The gelling of the concepts into a workable plan did not develop at OUS until this last Winter/Spring.

#### **Summary**

In conclusion, our objectives for the 2008 Legislative Session with respect to treasury management are twofold:

1. to gain the authority to retain the interest earnings on all of our accounts, which would provide the incentive to make changes in our cash management practices to garner incremental interest/investment earnings and provide the natural hedge needed to take on variable rate debt and lower OUS's overall cost of capital, and
2. to gain the authority to pool our operating asset balances for investment purposes to reduce the need for high levels of unnecessary liquidity and to increase investment returns.

We are very excited about the real opportunities that these legislative changes would bring to OUS to increase revenues and reduce costs; thereby mitigating future tuition increases and/or provide needed services for our students.

Please feel free to contact me with any questions.

Sincerely,

Michael J. Green, CPA  
Associate Vice Chancellor for Finance and Administration and Controller

c: Darren Bond  
Bill McGee  
George Pernsteiner  
Jay Kenton  
Don Blair  
Neil Bryant  
Lisa Zavala

Attachment 1 – OUS Board Docket Excerpt  
Attachment 2 – CommonFund Study  
Attachment 3 – Letter from Department of Justice  
Attachment 4 – Report from PFM  
Attachment 5 – Types of Expenditures from OUS Accounts  
Attachment 6 – Fiscal Impact Statements