

Report on Management and Investment of Department of Higher Education Funds

Introduction

During the 2007 legislative session, the Joint Committee on Ways and Means approved a budget note within the budget report for SB 5515-A – the budget bill for Department of Higher Education operations. This budget note directed the Legislative Fiscal Office (LFO) and Office of State Treasurer (OST) to examine and report on the management and investment of Department of Higher Education funds. The text of this budget note is set forth below:

Budget Note in the SB 5515 Budget Report

The Department [of Higher Education] shall assist the State Treasurer and the Legislative Fiscal Office in an examination of the management and investment of Department funds, and in the development of fund management policy proposals designed to optimize outcomes to both the State General Fund and the Oregon University System. The report findings and policy proposals shall be presented to the interim Joint Committee on Ways and Means or Emergency Board no later than January 1, 2008.

The Legislative Fiscal Office and the Office of State Treasurer are submitting this report to the interim Joint Committee on Ways and Means to comply with the above budget note. We acknowledge and appreciate the assistance provided by the Department of Higher Education [Department] during the course of this examination. We also consulted with the Budget and Management Division of the Department of Administrative Services and the Legislative Revenue Office, and express appreciation for their input as well.

Background

During the 2005-07 biennium, the Department of Higher Education's fund balances in the State Treasury averaged approximately \$534.1 million in total. Under current practice, the Department retains investment earnings on approximately 59% of the funds it holds. Investment earnings on the remaining 41% of Department funds accrue to the General Fund, and provided over \$20.3 million of revenue to the state General Fund during the 2005-07 biennium.

The Department of Higher Education has proposed retaining interest earnings on all of its fund balances since at least the 1995 Session. In 1995, the Department proposed SB 271, commonly called as the Higher Education Efficiency Act. The bill, as introduced, included a number of provisions that would have changed the governance of the Oregon University System [OUS] into a semi-public agency, exempt from legislative budgetary

control. One of the provisions in the introduced version of SB 271 would have allowed the higher education system to retain interest earnings on all of its fund balances. The Legislature passed SB 271 in 1995, but only after amending it to substantially reduce its scope. Among the provisions that were not approved were those that would have allowed the Department to retain interest earnings on all of its fund balances.

The State Board of Higher Education has continued to request authorization for OUS to retain all interest earnings periodically since 1995, but this request never received gubernatorial support until 2007, when the Governor's recommended budget included this provision. A companion bill to establish this statutory authority, HB 2198, was introduced. The Joint Committee on Ways and Means did not pass HB 2198, and rejected the policy option package in the Governor recommended budget relating to the implementation of the bill and the retention of the interest earning. The Committee directed the Legislative Fiscal Office and State Treasurer to examine related issues and to report back to the Committee prior to January 1, 2008.

Current Disposition on Interest Earnings on OUS Funds

As of the end of the 2005-07 biennium, the Department of Higher Education held funds in 90 different Treasury accounts. Some of these accounts were specifically established by statute. In these cases, the establishing statute identifies the funds that may be deposited into the account and the purposes for which these funds may be used. Other distinct accounts were established at the Department's request. The amount of Department funds varied throughout the course of the biennium, but averaged \$534.1 million in total over the course of the biennium. Interest on nineteen of these accounts, with an average total balance of \$217.2 million during the biennium, accrued to the General Fund. Interest on the remaining 71 accounts, with an average total balance of \$317 million, was retained in each individual account.

The Department of Higher Education budget includes both state-supported and self-supporting activities. State General Fund and Lottery Funds are provided to support OUS's education and general programs (essentially the teaching, research and public service activities of the seven OUS campuses and their branch campuses, along with the Chancellor's Office and centrally-funded support services), the statewide public service programs of Oregon State University, capital construction and deferred maintenance expenditures, debt service on certain bonds issued to finance OUS capital projects, and the Sports Action Lottery program. In the state-supported programs within the operating budget, state support is combined with fees and other revenues (Other Funds) to finance the programs. The primary fee revenues that are combined with state support to finance OUS programs are student tuition and associated fee revenues.

In general, the nineteen accounts that transfer interest earnings to the General Fund are those accounts funding programs that are partially financed with state General Fund. Some entirely self-supporting programs are also funded from these accounts, however. Approximately 75-80% of the cash flows into the nineteen accounts consist of Other

Funds and not General Fund. None of the 71 accounts currently authorized to retain interest earnings, with the exception of accounts relating to the Sports Action Lottery program, receive state General Fund or Lottery Funds deposits.

Fiscal Impact of Department Retention of Interest Earnings

If the Oregon University System had retained interest earned on all of its fund balances in the 2005-07 biennium, it would have received an additional \$20.3 million of Other Fund revenues. At the same time, the level of General Fund revenues would have been \$20.3 million less than was actually the case. This figure represents 20% of 2005-07 biennium interest earnings accruing to the General Fund, and 0.2% of total 2005-07 biennium General Fund revenue. Because OUS fund balances do not offset other state agency cash flow needs, permitting the Department to retain all interest earnings on its funds would have no effect on the amount of tax anticipation notes that the state needs to issue to meet its cash flow needs.

The 2007-09 biennium Governor's recommended budget included a General Fund reduction of \$19.1 million, and an Other Funds expenditure limitation increase of the same amount, relating to the proposed change in interest retention policy. The amount was calculated to equal the 2007-09 biennium interest earnings projected to be transferred to the General Fund absent the policy change. Thus, the Governor proposed adopting the policy change in a manner that would have been budgetary neutral to both OUS and the overall General Fund budget (at least in the 2007-09 biennium). The amount of funds available to OUS, and to all General Fund-supported programs (including OUS) would have been unaffected.

Rationales Presented for Interest Income Retention Policy Changes

Although the policy change was projected to be budgetary neutral, several rationales were forwarded to support its adoption. The primary rationale was that the policy would allow for an overall increase in earnings on OUS funds above the levels possible under the existing policy. Under the Governor's recommended budget, any such increase in earnings that could have been realized would have been retained by the Department. A second rationale was based on equity perceptions, i.e., that interest earnings on funds obtained from fees and other sources paid specifically for higher education services should not be made available to support unrelated programs.

There are two mechanisms that could potentially increase investment earnings under a policy to allow OUS to retain interest earnings. The first of these, which was the primary rationale for the change when proposed by the State Board of Higher Education, is that such a policy would establish incentives for OUS to adopt cash management practices that would increase investment earnings. OUS has adopted a number of cash management policies recently, including piloting of the state's procurement card program that reduces processing costs for small-dollar purchases, adopting a lock box program to

facilitate deposit of cash receipts, and expanding payment options for students and other customers. OUS has stated, however, that allowing it to retain the interest earnings on all of its funds would provide incentives to implement additional cash management policies that are costly, but which under existing interest rules, would provide no direct benefit to the system's institutions. If OUS were allowed to retain the returns associated with these cash management practices, then it would have an incentive to implement them. The fiscal impact of implementing these additional policies is uncertain.

The other mechanism that could increase investment earnings would be to change how OUS's fund balances are invested. Currently, all Department funds are held in OST's Oregon Short-Term Fund (OSTF). This fund provides OUS with maximum liquidity, but as such it typically earns a lower rate of return than is offered by investments in longer-term instruments. Investment earning would tend to increase if OUS's funds were managed within a structured portfolio with a longer weighted average maturity than the OSTF. The increased return represents a payment for assuming the additional risk inherent with investing in longer-term instruments. The value of longer-term investments tends to fluctuate over time. A rise in interest rates will reduce the value of these investments, and visa versa. Lengthening the weighted average maturity increases associated risk of loss in the event assets have to be liquidated to fund unanticipated cash flow needs.

To manage this risk, it is necessary to limit the portion of funds invested in longer-term assets so as to exclude any funds that would reasonably be needed to meet regular cash flow needs. OST offers qualified agencies the option of discreetly managed investment portfolios. With these portfolios an agency works directly with the OST Investment Division staff to build an investment policy statement, subject to Oregon Investment Council approval, reflective of the agency's cash and return needs, over time. These needs are revisited on a periodic basis to identify any changes that might require adjustments in the portfolio structure. To qualify for a discreetly managed portfolio, the agency must have a sufficient amount of funds available for longer-term investment to justify the higher costs of administering this type of portfolio, and to address the cash flow needs of programs financed by the particular account.

Each of OUS's 90 separate Treasury accounts would need to be managed separately. OST believes that because OUS funds are distributed among many accounts, there are insufficient balances in any of the individual accounts to permit investment in longer-term instruments while still maintaining the liquidity needed to meet cash flow requirements. As a result, all OUS funds are held in the OSTF. If at least a portion of the accounts could be combined, there may be a sufficient balance in the combined account so that some of the account funds could be invested in longer-term instruments and still have liquidity needs met.

Statutory changes would be needed to allow the necessary account consolidation, as well as to change policies regarding the disposition of interest earned on OUS funds.

Major Findings and Recommendations

Following is a list of the major findings and recommendations relating to the review of the management and investment of Department of Higher Education funds.

Major Findings

1. There is no established state policy on the disposition of interest earned on state agency funds. Absent specific statutory authority to retain interest earnings or designating them for some other purpose, interest earnings accrue to the General Fund [ORS 293.140]. In practice, it is difficult to discern a legislative policy on criteria to exempt interest earnings from the default requirement that they transfer to the General Fund.
2. Approximately 41% of the interest earned on Department of Higher Education funds accrued to the General Fund in the 2005-07 biennium. The remaining fund balances already have statutory authorization to retain interest earnings. This percentage varies each biennium, based on the proportion of total agency funds that are deposited in accounts authorized to retain interest.
3. Department funds are currently held in approximately 100 separate Treasury accounts. This number varies over time. Some of these accounts are established in statute; others were established as separate accounts at the Department's request.
4. Funds in all 100 Department of Higher Education accounts are held in the OST's Oregon Short-Term Fund (OSTF) where they are combined with other state agency monies. The OSTF is invested in short-term instruments to provide state agencies with maximum liquidity on their funds.
5. OST offers management of discreet portfolios to state agencies under certain conditions. In these portfolios, some funds are invested outside of the OSTF in longer-term instruments that generally yield a higher interest rate. These conditions are that accounts with investments in these portfolios must be sufficiently large in size to permit low expense ratios, and that the agency has sufficient funds in the liquid investments to address reasonable cash flow requirements.
6. OST does not believe that the existing Department account structure satisfies the two conditions listed in 5. above, and therefore all Department funds are currently held in the OSTF.

Recommendations

The following recommendations relating to the budget note are made by LFO. Except where indicated below, the State Treasurer has no specific recommendations.

- A. **LFO and OST recommend against allowing the Department to retain interest income on all of its funds for the specific purpose of providing an incentive to improve cash management practices.** The Legislature should expect all state agencies to follow appropriate cash management practices without regard to whether the income resulting from such practices accrues to the agency or to the General Fund. Therefore, LFO does not believe that increasing the incentives for improved cash management practices, in and of itself, is a reasonable rationale for allowing agencies to retain interest earnings. This comment does not reflect any criticism or finding that OUS's current cash management practices are deficient, and indeed as noted earlier, OUS has adopted a number of programs and policies to improve cash management even in the absence of being able to retain interest on all of its cash balances. The Department, however, has indicated that it lacks sufficient resources to implement some other practices that could further improve cash management.

LFO recommends that the Committee direct the agency to review this issue, and to report back to the Committee with its findings within its budget request presentation to the 2009 Legislative Assembly. If the agency identifies cash management practice changes that would increase interest earnings in excess of the cost of implementing these changes, the Committee should expect the agency to include a request for spending authority to implement these changes as a policy option package in its agency request budget submitted to the Governor. This recommendation is made independently of any decision the Legislature may make regarding the disposition of interest earnings on OUS funds.

- B. **LFO and OST recommend approval of statutory changes required to allow and facilitate the Department's meeting of the criteria for establishing a discreetly managed investment portfolio with OST. OST furthermore recommends that all OUS funds be considered eligible for inclusion in this investment portfolio.** These statutory changes would primarily involve eliminating statutory restrictions on combining OUS accounts where feasible. The Department's participation in a discreetly managed portfolio would, over most time periods, result in greater interest earnings than would the current practice of investing of all of the Department's funds in the Oregon Short-Term Fund. The Oregon Investment Council would be responsible for the investment of the portfolio, and for insuring that the risks associated with investment in longer-term instruments remains at acceptable levels.
- C. **LFO recommends that policy decisions relating to the disposition of interest earnings on Department of Higher Education funds be reviewed within the context of a comprehensive review of state agency interest earnings, and not as an independent issue.** The state would benefit from a comprehensive policy on interest earnings. Currently, policies on interest earnings are made on a case-by-case basis as new accounts and funds are established in statute. A comprehensive review could result in more consistent practices across state agencies, and allow for a review of the best uses of interest earnings on a statewide budget basis. For example, one proposal last session would have

transferred all interest earnings currently accruing to the General Fund, to the Rainy Day Fund instead. Although this would not strictly have been inconsistent with a policy to eliminate OUS interest earnings from the General Fund, LFO believes that a comprehensive review of interest issues would assist the Legislature in the policy making process. Both the Treasurer and the Budget and Management Division support such a comprehensive review of interest issues.

- D. LFO recommends against any action that reduces General Fund resources in favor of dedicated funding, unless there is a Legislative finding that there is a compelling reason to do so.** This would include policies that do not technically affect the level of General Fund, but that dedicate portions of the General Fund to be appropriated for specific purposes. The General Fund represents the primary source of funds that the Legislature has at its disposal to address policy needs that it identifies. The Legislature's ability to manage state budgetary needs is diminished to the extent that funds are dedicated to specific agencies and programs.
- E. LFO and OST recommend that any policy approved to allow OUS to retain interest earnings that currently accrue to the General Fund not, in and of itself, reduce General Fund resources available to support other programs.** The Governor's recommended budget was consistent with this recommendation. In that budget, the Governor proposed a fund shift in the Department's budget from General Fund to Other Funds equal to the projected reduction in General Fund revenues resulting from allowing OUS to retain all of its interest earnings. LFO recommends that a similar action be taken if the Legislature approves any changes relating to OUS interest that will result in a decline in General Fund resources. This recommendation in no way restricts the Legislature from approving the ultimate funding level for the Department that it prefers.
- F. LFO recommends that if a policy is approved to allow OUS to retain interest earnings on fund balances, that a portion of interest earnings on OUS funds continue to accrue to the General Fund, reflective of the appropriation of General Fund into OUS fund balances.** Because OUS combines the General Fund appropriated by the state with Other Funds in its fund balances, the level of fund balances is highly reliant on the State General Fund. LFO would recommend that the proportion of total interest earnings accruing to the General Fund be no less than the proportion of total OUS revenues consisting of General Fund and Lottery Funds in the relevant accounts. Because this figure changes over time and is difficult to project even for the budgeted biennium, LFO would recommend that the Legislature simply establish a percentage figure in statute for the portion of interest earnings that are transferred to the General Fund that reflects the existing ratio of General Fund in moneys being deposited into the accounts. This percentage would be subject to change in future biennia if the relative contribution of General Fund to the OUS budget changes significantly. Interest earnings on Sports Action Lottery distributions should be considered separately and continue to accrue to the Department, since these distributions are limited by statute to fund specific Department programs.