HOUSE BILL 4144:

Investment Modernization Act

Less Wall Street, more Main Street!

Goal:

Modernize the State's investment program by reorganizing management and relying less on third-party vendors in order to:

- **Provide immediate cost-savings**
- **Yield long-term PERS savings**
- **Allow for improved oversight and protection**

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Background

The Investment Modernization Act is a money-saving reform that will keep more Oregon investment dollars in Oregon and improve investment management. The Act will:

- Provide **immediate cost savings** compared to current expenses,
- Yield **significant** long-term **savings to the Public Employees Retirement System**, and
- Allow for **improved portfolio and risk management** by bringing more jobs in-house

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Problem

The current structure of Oregon's investment program is largely a creation of 1970s statutes. But as the investment world has evolved to become more complex and nimble, Oregon's model has failed to keep pace.

The current model vests hiring authority over the investment staff in the State Treasurer, financing authority in the Legislature, and responsibility over the investments in the Oregon Investment Council (OIC).

This structure has produced a system that relies greatly on out of state third-party services. Although Treasury aggressively negotiates relatively low fees for these services, this heavily-outsourced model is ultimately more costly to the state than alternative models.

Enabling more internal management by investing in investment division resources will ultimately be less costly and likely result in improved investment performance.

Proposed Changes

The Investment Modernization Act asks for organizational changes in the relationship between the OIC and the State's investment staff, but maintains associated oversight, transparency, and disclosure rules.

The Act will:

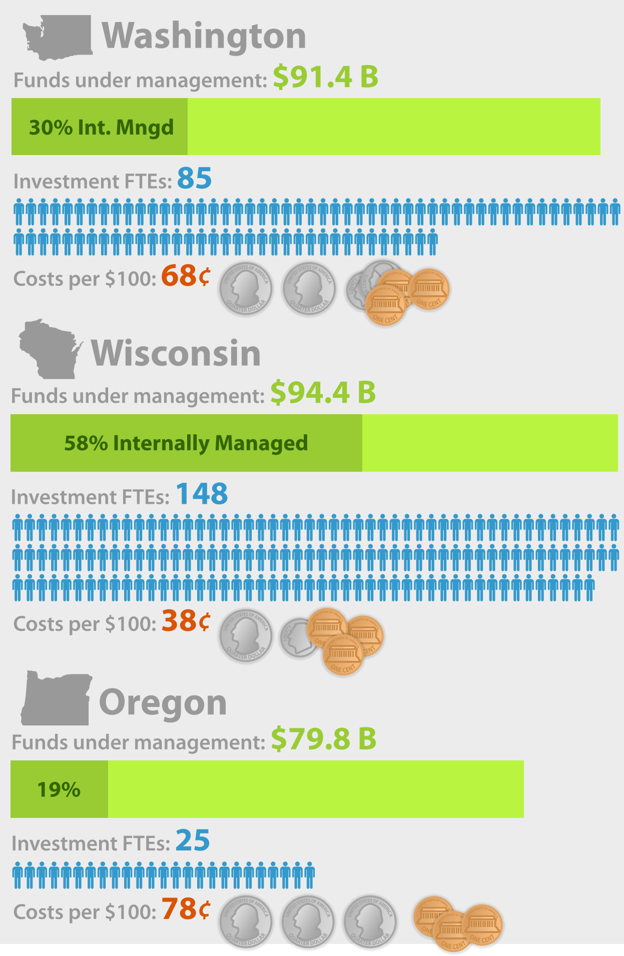
1. **Establish the Oregon Investment Council as its own agency separate from the State Treasury**

2. **Move the State Treasurer's Investment Division under the Oregon Investment Council**

The OIC and investment staff will be subject to the same ethics, reporting, disclosure, personnel, and investment regulations that currently exist. The method of appropriation is not changed, and the Legislature retains ultimate authority over the new entity.

Investing Expensively

Despite having a leaner in-house investment program, Oregon's total investment costs can be **more than twice as expensive** as states like Washington or Wisconsin that insource more services. Although some external management will always be a component of a well-diversified program, the ability to bring some services in-house is key to keeping costs low.



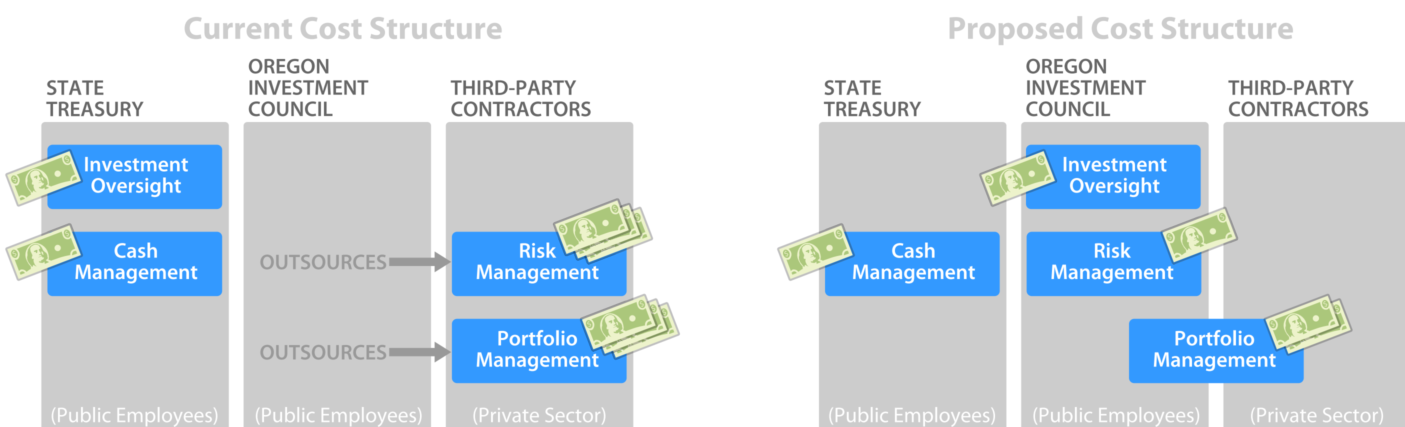
Changes in Policy

Most characteristics of the investment program do not change, but are simply housed at the new entity. The only significant change is that the OIC is not expected to bring an expenditure limitation bill to the Legislature each biennium (although the Legislature could still introduce one).

Item	Currently (Treasury Investment Division)	Changes Under New Model
Investment staff	Answer to the State Treasurer only	Answer to the entire OIC
Budget sources	No tax dollars; uses investment returns	No change
Budgeting authority	Continuous appropriations	No change
Budgeting process	Biennial expenditure limitation bill	Internal process at public meeting
Disclosure	Limited exemptions for investments	No change
Ethics: Reporting	Special quarterly reports in addition to SEI	No change
Ethics: Gifts & Travel	Limited exemptions for official business	No change
OIC members	Governor appoints / Senate confirms	No change
Investment standards	Outlined in ORS 293	No change

Investment Cost Savings

Although more staff will be insourced to Oregon, the total amount of costs for those services will decrease. Currently, many functions are outsourced to out-of-state third parties at a much higher (and less accountable) rate.



Compounded 20-year PERS investment cost savings: $2.8 Billion

(20 years is the horizon used to amortize unfunded actuarial liabilities. Figures are based on projections provided by CM Benchmarking, 2013: $63 million measured over 20 years)

The current structure of Oregon's investment program relies heavily on outsourcing to third-party contractors. While the State Treasury investment program is a relatively small portion of the total costs, outsourced services make up the lion's share of expenses.

Under the Investment Modernization Act, Oregon will be able to shift to an in-sourcing model that is already in place in several other states and Canadian provinces. The State of Washington, for example, manages its investments for 0.10% less on the dollar than Oregon does.

Cutting investment program costs by that same one-tenth of one percent would result in annual savings of $79.8 million for the entire investment portfolio.

PERS Cost Savings

Savings from the management of the pension fund would accrue directly to the fund itself and grow over time. Based on the 7.75% assumed earnings rate, savings of $63 million per year attributable to the pension fund would accrue to just over **$2.8 billion over the 20-year** amortization period over which unfunded actuarial liability is paid off.

Benefits of Modernization

Immediate Cost Savings

Bringing work home to Oregon that is currently outsourced at higher prices elsewhere is estimated to yield short-term savings of $22 million per year. Based on a report from Funston Advisory Services in addition to models in Washington and Wisconsin, savings would be expected to soon reach $80 million per year.

Long-Term PERS Cost Savings

Short term savings to the Public Employees Retirement Fund are realized directly by the Fund itself, thereby adding to net investment returns and ultimately lowering the reliance on taxpayer-financed employer contributions to meet obligations. Savings will also earn returns over time, multiplying the impact year after year, **for a projected 20-year savings of around $2.8 billion**.

Improved Portfolio Management

Some investment functions, particularly risk management, are outsourced to third party contractors. The Act will give the OIC the personnel authority to **establish these positions locally** and better integrate these services with Oregon's investment programs and existing staff.

Clarification of Staff Structure

Currently, the OIC relies on staff that report to only one of its members: the State Treasurer. (This would be akin to all Legislative offices relying on staff that answered only to a single Legislator.) The Act fixes this disconnect by moving to a structure in which staff reports to the OIC as a whole, ensuring an alignment of fiduciary duty and management authority.

Frequently Asked Questions

What will this plan do in the short-term?

The Act will establish the Oregon Investment Council (OIC) as a state agency managing the State's investment program and staff. The move will allow more functions to be in-sourced from Wall Street and other third-party contractors, saving an estimated $80 million per year.

What are the long-term benefits?

OPERF savings accrue to the fund itself, so considering the 20-year horizon used to amortize unfunded actuarial liabilities, the Act will produce compounded cost savings of <u>$2.8 Billion over that time period.</u>

In light of recent positive performance, why "mess with success" by changing the investment program?

Regardless of the returns over the past few years, the investment program is under-resourced and relies too heavily on outsourced third-party services (particularly in risk management) for functions that could be cheaper and more effective in-house. These changes weren't practical in the 1970s when Oregon was a relatively small investor. But as Oregon has grown into a significant investor in a more complex market, it must keep up with the times.

How would this save money if new staff is being added?

The new staff would replace more expensive outsourced staff, such as investment accountants and analysts. This would be cheaper, more effective, and more transparent.

Is the Legislature giving up its authority?

No. Aside from the change in the budgeting process, no statutory controls over the investment program will be changed (such as employee status, ethics rules, disclosure requirements, etc). The only significant difference is that under the Act, the budget will be adopted at a public meeting of the OIC rather than through the Legislative Fiscal Office. However, the Legislature itself would retain the ability to review and adjust any OIC decision.

Why should the investment program make this shift as opposed to any other public entity?

Investing is inherently an entrepreneurial endeavor. For the Oregon Investment Council and investment program to be successful, it needs to be flexible and nimble in order to capture the right opportunities at the right time. The Investment Modernization Act is the right balance between financial success and public oversight.

Why is a governance change necessary to realize in-sourcing savings?

It would be imprudent for the OIC to build out that kind of functionality without a certain level of budgetary independence – and assurances that such a build-out will be preserved with sufficient long-term funding. To do so otherwise exposes the backbone of the State's investment program – and the security of billions of dollars – to unnecessary risk.