

Local Investment Reporting Mandate

On July 28, 1999, the chair of the Senate Local Government Committee requested the Legislative Analyst's Office (LAO) review a proposal to eliminate a state mandate that local financial officers submit investment reports to their governing bodies.¹ Pursuant to Government Code 17562, the LAO is asked to recommend whether the Legislature should adopt, reject, or modify this proposal.

As we describe more fully below, our review indicates that the investment reports mandate costs significantly more than the Legislature anticipated. In addition, given significant changes to the legal, financial market, and professional standards governing local investment practices, a state reporting mandate does not appear necessary to promote local oversight.

Accordingly, we recommend that the Legislature adopt the proposal to eliminate the investment report mandate. Should the Legislature wish to provide a modest enhancement to local governments' existing strong incentives to oversee local investments, we recommend the Legislature consider:

- Enacting legislation requiring local investment officials to annually report to their governing board on the extent to which their investment oversight and reporting practices meet the fiduciary and prudent investor standard in state law, and conform with the standards recommended by the Governmental Accounting Standards Board (GASB) and major professional public finance associations. Such legislation also would impose a state mandate, however, the cost of the mandate would be minimal.
- Providing one-time grant funds to assist local governments in purchasing investment monitoring technology.

BACKGROUND

The California Constitution requires the Legislature to determine local agencies' powers, except for charter cities (which control their own "municipal affairs"). Using its constitutional discretion, the Legislature has given significant investment authority to local governing boards and their elected or appointed treasurers.

Over the years, this delegation of investment authority generally has worked to the advantage of the state's residents. Local governments have used their authority to struc-

¹The report mandate was created by Chapter 783, Statutes of 1995 (SB 564, Johnston); and modified by Chapter 156, Statutes of 1996 (SB 864, Craven) and Chapter 749, Statutes of 1996 (SB 109, Kopp).

ture their investments to meet local program and financial needs. At the same time, the state has avoided the financial risk, cost, and complexity associated with assuming the responsibility for managing thousands of local governments' investment portfolios.

As with any delegation of authority, however, assigning investment responsibility to local governments has not been fail safe. Most notably the City of San Jose (in 1984) and the County of Orange (in 1994) made major errors with regards to their investments. As these errors became apparent, the Legislature chose not to "bail out" the local governments, or to assume greater responsibility for local investments. Rather, the Legislature acted to:

- Focus accountability on local officials for local investment decision making.
- Constrain local investment authority by limiting the type of instruments in which local agencies may invest.
- Impose investment reporting requirements.

HISTORY OF RECENT INVESTMENT REPORTING REQUIREMENTS

While the Legislature has imposed some reporting requirement on local treasurers since 1933, the first detailed reporting requirement was enacted in Chapter 1226, Statutes of 1984 (AB 1073, Cortese) following the City of San Jose's investment problems. Chapter 1226 required local treasurers to prepare an annual statement of investment policy, a monthly report on investments, and a detailed monthly report on financial transactions if the local investment portfolio included repurchase agreements. These investment reports, provided to local governing boards and the public, were intended to improve local oversight of invested local funds.

In 1989, the Commission on State Mandates determined that this first detailed investment report requirement was a state-reimbursable mandate, with annual costs of about \$2.6 million. After reviewing the mandate's costs and benefits, the Governor recommended in his 1990-91 budget proposal that this investment report requirement be suspended. The Legislature concurred with the administration and the report mandate was suspended for three years. The mandate was then modified to make it optional by Chapter 59, Statutes of 1993 (SB 443, Budget and Fiscal Review), and eliminated due to a sunset provision (contained in the original legislation).

In the aftermath of the Orange County bankruptcy, the Legislature again sought to increase the level of local oversight by imposing various investment reporting requirements on local governments. With the passage of Chapter 783 in 1995 (and modified by Chapters 156 and 749), the state required:

- Development of an annual local investment policy. In the case of the counties, the policy must include criteria for selecting security brokers and dealers and a list of the securities and instruments allowable by law.
- Quarterly reports, including a description of all the investments held by the agency or managed by contracted parties, the investments' current market value, and a statement as to whether the portfolio is in compliance with the investment policy and will meet local cash flow needs for the next six months.

The requirement of quarterly reports reflected the Legislature's experience with the 1984 law. Specifically, the Legislature sought to minimize the cost of the post-Orange County investment reporting requirement by requiring that the report be compiled *quarterly*, rather than *monthly*, and by eliminating the requirement for a detailed report of financial transactions. At the time the Chapter 783 reporting requirement was enacted, the staff analysis reported that the cost of the proposed mandate would be in the range of \$100,000 to \$130,000 annually.

INVESTMENT MANDATE'S COST GREATLY EXCEEDS ORIGINAL ESTIMATES

In September 1999, the Legislature appropriated \$15.3 million to reimburse schools (\$1 million) and local governments (\$14.3 million) for mandated investment report activities (required by Chapters 783, 156, and 749) from 1995-96 through 1999-00. This estimate of cost, based on *unaudited* claims by schools and local governments, suggests that the annual ongoing cost of this investment mandate is about \$3.5 million.

At this time, we do not have a more accurate estimate of the mandate's cost because there is dispute between the state agency responsible for auditing and paying these claims (the State Controller's Office, [SCO]) and local governments regarding the scope of reimbursable activities. Based on the value of claims that have been approved by the SCO, however, we think it is likely that the ongoing state cost of the mandate will exceed \$2 million annually. Thus, the cost of the investment report mandate is likely to be at least 20 times more than the Legislature anticipated when enacting the requirement.

STATE REQUIREMENT NO LONGER APPEARS NECESSARY TO ENSURE LOCAL OVERSIGHT

Our review indicates that the state investment report mandate has helped improve local investment practices over the last several years. Notably, local governments have developed formal policies to guide their investments. Local governments have had the experience of developing detailed quarterly reports for their governing boards, and discussing these reports and their cash flow needs with investment oversight committees. Many local governments have also purchased software to allow closer monitoring

of their investments, and some local governments have placed their investment reports on their web sites.

During the years since the Orange County bankruptcy, however, there have been significant legal, financial, and professional developments which have also greatly improved local investment policies and practices. We discuss these developments below.

Higher Legal Standards and Requirements

In the aftermath of the Orange County bankruptcy, the Legislature significantly reformed the laws pertaining to local investment practices. To promote the use of reliable and safe instruments, the Legislature enacted Chapter 784, Statutes of 1995 (SB 866, Craven) and Chapter 156, Statutes of 1996 (SB 864, Craven), restricting how public monies can be invested. For example, the measures specify that local governments only may invest in 17 types of public investments. All other public investments—such as the “inverse floaters” and other complex financial instruments used by Orange County—are prohibited. The measures also impose restrictions on the maximum maturity and quality of many authorized investments. For example, local governments may invest in only the highest quality commercial paper, with a maximum maturity of 180 days, and may not place more than 10 percent of any agency’s surplus funds in any one mutual fund.

To clarify the responsibility and increase the oversight of local governing boards and investment officials, Chapter 784 declares that each person, treasurer, or governing body authorized to make investment decisions is a trustee, and therefore a fiduciary subject to the prudent investor standard.² Chapter 784 also declares that local investment officials’ primary objective shall be to safeguard principal, and requires them to act with care, skill, prudence, and diligence.

Finally, Chapter 784 imposed the first statewide educational requirements for county investment officials. Persons seeking election or appointment as county treasurers or tax collectors must meet certain education requirements, and must complete 24 hours of continuing education in the areas of treasury management or public finance every two years.

Increased Requirements From Financial Community

²As described in CDIAC's *Local Agency Investment Guideline*, the prudent investor standard is a standard of conduct where a person acts with care, skill, prudence, and diligence when investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing funds.

At the same time that the Legislature increased the legal requirements regarding local investments, local governments experienced increased requirements from the financial community. Most notably, in 1997 the GASB issued Statement 31, establishing new accounting and financial reporting standards for all investments held in county investment pools and many investments held by other governmental entities. Among other items, Statement 31 requires governments to report on their balance sheet (or other statement of financial condition) the fair market value of their investments, investment income, and the equity position of each fund in the pool. While GASB standards are not legal mandates, compliance is usually necessary for local governments access to the capital markets. Thus, counties and most other local governments need to comply.

Professional Standards Increased

In recent years, leading professional associations for investment officials (such as the Government Finance Officers' Association [GFOA], and the Municipal Treasurers' Association of the United States and Canada) have played an increased role in improving local investment portfolio management practices. For example, the GFOA developed a model local government public investment policy, with recommended practices, including reporting requirements that meet or exceed the requirements in the California mandates.³

³"The investment officer shall prepare an investment report at least quarterly, including a management summary that provides an analysis of the status of the current investment portfolio and transactions made over the last quarter. This management summary will be prepared in a manner which will allow the [entity] to ascertain whether investment activities during the reporting period have conformed to the investment policy. The report should be provided to the investment officer, the legislative body, and any pool participants. The report will include the following:

- Listing of individual securities held at the end of the reporting period.
- Realized and unrealized gains or losses resulting from appreciation or depreciation by listing the cost and market value of securities over one-year duration that are not intended to be held until maturity (in accordance with GASB requirements).
- Average weighted yield to maturity of portfolio on investments as compared to applicable benchmarks.
- Listing of investment by maturity date.
- Percentage of the total portfolio which each type of investment represents."
(GFOA sample language.)

The professional associations have also expanded their educational programs and publications to help local investment officials and elected officials safely invest public funds. In addition, in 1995, the Legislature renamed the California Debt *and Investment* Advisory Commission, and gave it responsibility—in conjunction with the various professional associations—to develop a continuing education program aimed at state and local officials who have direct or supervisory responsibility for the investment of public funds.

Summary of Changes

Since the time of the Orange County bankruptcy, the Legislature, financial community, and professional associations have all increased their requirements pertaining to local investment practices. Many investment instruments used by Orange County are no longer legal. Obligations of investment officials and governing boards have been highlighted. Significant investment reporting is required for compliance with GASB. Professional standards and educational requirements have been increased.

It is against this backdrop of increased standards, that we next discuss whether the existing state mandate for an investment report should be continued—or if the Legislature could eliminate the requirement for an annual savings of over \$2 million.

LAO RECOMMENDATION

The possibility of another local government engaging in risky or illegal behavior is a significant concern to California. While the state did not bail out Orange County, the ill effects of its investment practices had a detrimental effect on the municipal bond market throughout the country. We are mindful of the fiscal disruption and the losses to investors and public agencies associated with this experience.

At the same time, however, we note that the only way that the state could *fully* eliminate the possibility of local error is to transfer authority over local investments to the state—a transfer which would have many undesirable consequences. Accordingly, when we evaluate the need for the state reporting mandate, we consider it in the context of whether it adds a safeguard which increases the likelihood of sound local investment policies and decisions.

As discussed above, there are myriad significant legal, financial and professional requirements and policies promoting sound local investment practices and reporting. Even without the state mandate, local investment officials would need to provide extensive investment information to meet their responsibilities as a fiduciary, under GASB Statement 31, and as a professional. While it may be possible that a local agency (particularly an agency which does not need regular access to the capital market) could disregard all these legal, financial, and professional standards, we do not think that the existence of a state reporting mandate necessarily would correct the problem. Simply

put, if a local agency is so mismanaged as to ignore its legal, fiduciary, financial, and professional obligations, it is unlikely to meet its state reporting obligations either—or do so accurately.

For these reasons, we see no necessity for the state to continue to mandate the form and substance of local investment reports. While the Legislature may wish to leave the language describing the local investment reports in statute as a *guide* for local officials, we recommend the state mandate be eliminated.

Finally, should the Legislature wish to provide a modest enhancement to local governments' existing strong incentives to oversee local investments, we recommend the Legislature consider enacting legislation requiring local investment officials to annually report to their local governing boards on the extent to which their investment oversight and reporting practices (1) meet the fiduciary and prudent investor standard in state law, and (2) conform with the standards recommended by the GASB and major professional public finance associations. Such legislation would impose a state mandate, however, the cost of the mandate would be minimal.

In addition, should the Legislature wish to provide financial assistance to local governments to facilitate efforts to upgrade local investment monitoring, or put more local investment information on the web, it could consider funding one-time grants for technology purposes.