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EMPLOYEES' RETIREMENT SYSTEM  
HAWAII EMPLOYER-UNION HEALTH BENEFITS TRUST FUND  
OFFICE OF THE PUBLIC DEFENDER

ADMINISTRATIVE AND RESEARCH OFFICE  
BUDGET, PROGRAM PLANNING AND  
MANAGEMENT DIVISION  
FINANCIAL ADMINISTRATION DIVISION  
OFFICE OF FEDERAL AWARDS MANAGEMENT (OFAM)

**TESTIMONY BY CRAIG K. HIRAI  
DIRECTOR, DEPARTMENT OF BUDGET AND FINANCE  
TO THE HOUSE COMMITTEE ON LABOR & PUBLIC EMPLOYMENT  
ON  
HOUSE BILL NO. 2399**

**February 4, 2020  
9:10 A.M.  
Conference Room 309**

**RELATING TO THE MANAGEMENT OF STATE FUNDS**

The Department of Budget and Finance provides comments on H.B. 2399. The Department appreciates the Legislature's attention to the State Treasury's investment program and provides the following information for the committee's consideration.

House Bill No. 2399 proposes to 1) establish the State Funds Investment Board to oversee the short-term investment of state moneys; authorizes this Board to employ investment officers and other employees, and to assume contracting authority on behalf of the State Treasury; and requires the contracting of a private financial services firm to invest the state's moneys; and 2) amends HRS section 36-21 to expand the types of financial instruments in which the state's moneys may be invested in.

The Department provides the following comments on the proposed State Funds Investment Board, which it opposes to the extent that it hampers the ability of the Director of Finance to perform required responsibilities, it transfers control of state finances to the Board, and it interferes with the efficient operation of the State Treasury:

1. The Director of Finance will no longer be able to perform current statutory responsibilities that include the safekeeping, management, investment, and

disbursement of state funds and the ability of the director or subordinates to hire department staff and/or outside vendors will be transferred to the Board;

2. The introduction of potential conflicts of interest and additional bureaucracy may unnecessarily complicate what could be a relatively straight forward operation. Further, flexibility and efficiency will be lost as decisions may need to wait for a meeting to be noticed and held;

3. The ERS and EUTF have their own trust mandates and fiduciary duties to their beneficiaries. Requiring their participation in managing State finances may pose legal dilemmas;

4. Significant effort and expense may be required to service the board and could include hiring additional staff and training for the board members and time will be needed to prepare for monthly meetings and respond to board members that could otherwise be used to do work; and

5. Mandating that private firms take over investment of all the state's funds, a function currently handled by state employees, may not necessarily be an effective use of state resources since the fees charged by these firms could be income retained by the state. This may be especially true in the current low interest rate environment and for the significant portion of the state treasury funds that must be kept in liquid short term instruments to ensure the state's liquidity and operational needs.

The Department provides the following technical comments on the language expanding the types of financial instruments in which the state's moneys may be invested in:

1. The amendment to HRS Section 36-21, (17) “Presidential” should be “Residential mortgage-backed securities...”
2. The definition of “Income” in Section 3 of the bill, should be amended to read “(2) Net Realized gains (realized gains net of realized losses, not “net of costs of investment and management of state moneys”).

The State treasury consists of funds needed to support the operations of government agencies. The investment portfolio is currently invested in highly liquid, high quality fixed income securities. HB2399 introduces additional credit and asset backed securities and a review of associated risks includes the following:

**Credit risk**: this is the risk of permanent loss incurred if the issuer defaults. The probability of default is priced by the market each day, and therefore, security prices may fluctuate even if the default has not occurred or will never actually occur. The current state treasury portfolio does not have any exposure to credit risk. HB2399’s expanded the opportunity set to include Supranational debt and corporate debt, which are subject to credit risk. Staying in AAA and AA categories helps mitigate credit risk. However, the market price of these bonds will still fluctuate due to market perception changes of the probability of a credit loss.

**Duration risk**: this is the risk of pricing change due to market interest rate fluctuation. Interest rate changes every day due to many factors. Therefore, each day, a bond that is not immediately maturing will have a market value priced off the interest rate of that day. The longer the effective maturity of the bond, the higher fluctuation its value, all things being equal. The measurement of such risk is Duration. Duration risk contributes to over 90% of a bond portfolio’s daily value fluctuations. Current State Funds portfolio has a relatively short duration. Extending its duration as suggested in HB2399 will increase the daily portfolio value volatility.

**Prepayment Risk:** this risk associates with the possibility of prepayment by a mortgage borrower when interest rates drop. In this instance, the lender (buyer of the mortgage bond) gets the money back before originally anticipated and has to re-invest the proceeds at lower interest rates. This risk is priced by the market daily in the security pricing, which causes the price of a mortgage bond to fluctuate. While agency mortgage bonds do not have credit risk due to the implicit guarantees by the agencies, they carry mainly prepayment risk. Current State Funds do not invest in mortgages or other securitized bonds that are subject to prepayment risk. H.B. 2399's expanded investment universe will introduce this risk factor that may impact the mark to market value of the portfolio.

**Illiquidity Risk:** all fixed income securities trade over the counter. This means that if one needs to sell a security, a buyer needs to be found. This is different from trading stocks, where an exchange exist as the market maker and will take the other side of the trade even a matching trade was not at the time present. The over the counter nature of bond trading introduces illiquidity risk during market stress times. This is because during such times, a natural buyer or seller may not be present, and securities that are usually liquid could suddenly become illiquid. The current state treasury portfolio invests in Treasuries and Agency debentures that are not subject to illiquidity risk. H.B. 2399 introduces corporates and securitized bonds that could be subject to illiquidity risk.

H.B. 2399 expands the investable market opportunity set. This brings a return enhancement potential. However, it is worth noting that there is no free lunch in financial markets. The potential of return enhancement comes with additional risks the State Funds are not currently exposed to. If measured on a mark to market basis, given the

increased magnitude of the four risk factors mentioned above, the portfolio value of the state funds will fluctuate more significantly than the state's historical experience.

Given the introduced risk factors, it is worth noting the following:

- The main purpose of the State Funds is to support operations of the State Agencies. Given this main purpose, State Funds **should not be considered a “return maximizing” investment pool**. This differentiates the State Funds from other long-term focused entities like a pension trust. Liquidity and safety of principal are of higher priority than total return for the State funds. The liquidity needs of State Funds tend to be counter-cyclical. This is because during economic downturns, tax revenues may fall short, and liquidity needs will increase. Concurrently, during economic downturns, credit default risk tends to increase, interest rates tend to fall and therefore prepayment risks tend to rise, and market tends to become illiquid. This means that taking on additional risks in credit and securitized sectors may introduce more risks than anticipated, if not planned carefully.
- Adopting a total return maximization approach in managing the portfolio will naturally introduce trading needs. Not all trades will generate realized gains. In the cases where the market dynamics have deteriorated, trading may generate losses due to duration positioning, credit or prepayment repricing. H.B. 2399 did not discuss the loss distribution mechanism. Loss distribution mechanism should be defined given the fact that while taking risk may enhance returns, it may also introduce losses.

The objectives of managing Public Funds are: (1) ensure Safety of Principal through suitable investments; (2) maintain sufficient liquidity to cover state's

expenditures; (3) generate a market rate of investment income through economic cycles; (4) optimize and measure investment performance. (Source: Government Investment Officers mission statement <https://www.gioa.us/about/>). Fiduciary responsibility to protect taxpayer monies results in more conservative, low risk outlook for investing.

The Department has submitted a budget request to enable it to modernize the management of its investment program that includes implementation of an industry standard investment software that will help optimize the State treasury investment portfolio. Additionally, we have requested a position and other resources to provide the department with more capability and flexibility in carrying out its responsibilities pertaining to safekeeping, management, investment, and disbursement of state funds. We would appreciate consideration of these requests.

The Department believes parts of this legislation would be helpful and complement efforts to provide more ability and flexibility to meet the intent of the bill to maximize return on investment while protecting capital and ensuring liquidity. Expanding the list of allowed investments could assist in diversifying and increasing the yield on the state treasury portfolio and should be retained. Additionally, the Department would support requiring adopting the use of industry standard analytical tools that we are currently seeking to implement, or the use of professional external discretionary managers as contemplated by this bill. However, we request consideration of removing the proposed state funds investment board from this bill for previously stated reasons. Instead the Department would support increased transparency of treasury investment operations through annual reporting to the Legislature. We would appreciate being able to work with the Committee to draft appropriate language.

Thank you for the opportunity to provide our testimony on this bill.

DAVID Y. IGE  
GOVERNOR



THOMAS WILLIAMS  
EXECUTIVE DIRECTOR

KANOE MARGOL  
DEPUTY EXECUTIVE DIRECTOR

**STATE OF HAWAII  
EMPLOYEES' RETIREMENT SYSTEM**

**TESTIMONY BY THOMAS WILLIAMS  
EXECUTIVE DIRECTOR, EMPLOYEES' RETIREMENT SYSTEM  
STATE OF HAWAII**

**TO THE HOUSE COMMITTEE ON LABOR AND PUBLIC EMPLOYMENT  
ON**

**HOUSE BILL NO. 2399**

**February 4, 2020  
9:10 A.M.  
Conference Room 309**

**RELATING TO THE MANAGEMENT OF STATE FUNDS**

Chair Johanson, Vice Chair Eli, and Members of the Committee,

H.B. 2399 proposes to establish a State Funds Investment Board to oversee the short-term investment of state moneys. One of the five members of the proposed investment board would be the chief investment officer of the Employees' Retirement System (ERS) to serve as an ex officio voting member. Although ERS recognizes the fiscal intent of this bill, it respectfully opposes the inclusion of its chief investment officer as a board member.

Requiring the ERS's Chief Investment Officer to serve on this Board could create the following problems:



Employees' Retirement System  
of the State of Hawaii



1. It could make it more difficult to attract and retain individuals for the position of ERS Chief Investment Officer. This would add work and responsibility without compensation.
2. Requiring a person who is on the payroll of the ERS to provide services to the State of Hawaii for a purpose other than a purpose of the ERS would be an exclusive benefit violation under Section 401(a)(2) of the Internal Revenue Code: use of ERS resources for non-ERS purposes.
3. Requiring a person who is on the payroll of the ERS to provide services to the State of Hawaii for a purpose other than a purpose of the ERS could be a prohibited transaction under Section 503 of the Internal Revenue Code: making ERS services available on a preferential basis to the State or a substantial diversion of ERS resources to the State.

Both 1 and 2 above would risk the tax qualification of the ERS.

The ERS is a trust, separate from the State, and that all assets of the ERS “shall be held in trust by the board [of the ERS] for the exclusive use and benefit of the system and for the members of the system and shall not be subject to appropriation for any other purpose whatsoever.” HRS § 88-127 (declaration of trust); see *also* HRS § 88-22.5(a)(1) (stating exclusive benefit rule).

On behalf of the board of trustees, I respectfully request that the chief investment officer of the ERS be removed as a designated member of the state funds investment board.

Thank you for this opportunity to testify.

**HB-2399**

Submitted on: 2/3/2020 1:19:05 PM

Testimony for LAB on 2/4/2020 9:10:00 AM

<b>Submitted By</b>	<b>Organization</b>	<b>Testifier Position</b>	<b>Present at Hearing</b>
Herbert Hussey	Individual	Support	No

Comments:

I strongly support the intent of this bill.

The Following  
Testimony is  
Marked Late

**LATE**



**STATE OF HAWAII**  
**HAWAII EMPLOYER-UNION HEALTH BENEFITS TRUST FUND**

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**BOARD OF TRUSTEES**  
CHRISTIAN FERN, *CHAIRPERSON*  
CELESTE Y.K. NIP, *VICE-CHAIRPERSON*  
LAUREL JOHNSTON, *SECRETARY-TREASURER*  
RODERICK BECKER  
LINDA CURRIVAN MUSTO  
DAMIEN ELEFANTE  
AUDREY HIDANO  
OSA TUI  
CLIFFORD UWAIN  
RYKER WADA

**ADMINISTRATOR**  
DEREK M. MIZUNO

**ASSISTANT ADMINISTRATOR**  
DONNA A. TONAKI

**TESTIMONY BY DEREK MIZUNO**  
**ADMINISTRATOR, HAWAII EMPLOYER-UNION HEALTH BENEFITS TRUST FUND**  
**DEPARTMENT OF BUDGET AND FINANCE**  
**STATE OF HAWAII**  
**TO THE HOUSE COMMITTEE ON LABOR & PUBLIC EMPLOYMENT**  
**ON HOUSE BILL NO. 2399**

**February 4, 2020**  
**9:10 a.m.**  
**Room 309**

**RELATING TO THE MANAGEMENT OF STATE FUNDS**

Chair Johanson, Vice Chair Eli, and Members of the Committee:

The Hawaii Employer-Union Health Benefits Trust Fund (EUTF) Board of Trustees has not been able to take a position on this bill. Their next meeting is scheduled for February 18, 2020. EUTF staff would like to provide comments.

The EUTF staff has concerns about using EUTF resources for the benefit of the State's treasury function. Hawaii Revised Statutes (HRS) 87A-15 Administration of the fund describes the purpose of the EUTF, "The board shall administer and carry out the purpose of the fund. Health and other benefit plans shall be provided at a cost affordable to both the public employers and public employees." Nowhere in Chapter 87A, HRS does it mention providing investment advisory services to the State or counties. As a trust, the assets and resources of the EUTF should be expended for the beneficiaries of the trust and not for unrelated purposes of one employer.

**EUTF's Mission:** We care for the health and well being of our beneficiaries by striving to provide quality benefit plans that are affordable, reliable, and meet their changing needs. We provide informed service that is excellent, courteous, and compassionate.

Additionally, Section 87A-31, HRS Trust fund; purpose states, “(a) The fund shall be used to provide employee-beneficiaries and dependent-beneficiaries with health and other benefit plans, and to pay administrative and other expenses of the fund. All assets of the fund are and shall be dedicated to providing health and other benefits plans to the employee-beneficiaries and dependent-beneficiaries in accordance with the terms of those plans and to pay administrative and other expenses of the fund, and shall be used for no other purposes except for those set forth in this section.” The remaining sections (b) through (f) do not mention assisting the State and counties on other matters other than implementing and administering cafeteria plans in section (d).

Thank you for the opportunity to testify.

# TAX FOUNDATION OF HAWAII

126 Queen Street, Suite 304

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**LATE**

SUBJECT: MISCELLANEOUS, Management of State Funds

BILL NUMBER: HB 2399

INTRODUCED BY: SAIKI

**EXECUTIVE SUMMARY:** Establishes the State Funds Investment Board to oversee the short-term investment of state moneys. Authorizes the State Funds Investment Board to employ investment officers and other employees. Prohibits board members and employees of the State Funds Investment Board from having a direct interest in the gains or profits of the board's investments. Requires the State Funds Investment Board to invest, through a private financial services firm, any State moneys that are in excess of the amounts necessary for meeting the immediate requirements of the State. Amends other provisions relating to the short-term investment of state moneys, including the types of financial instruments in which state moneys may be invested. Appropriates funds.

**SYNOPSIS:** Adds a new section to chapter 36, HRS, to establish a state funds investment board composed of people with appropriate experience. The board members would be volunteers but would be reimbursed for expenses.

Amends section 36-21, HRS, to provide that the new board shall invest any moneys of the State in excess of the amounts necessary for meeting the immediate requirements of the State; provided that the action, in the state funds investment board's judgment, shall maximize the State's return on investments, net of investment fees and expenses incurred, while protecting capital and not impede or hamper the necessary financial operations of the State. Expands the list of permissible investments.

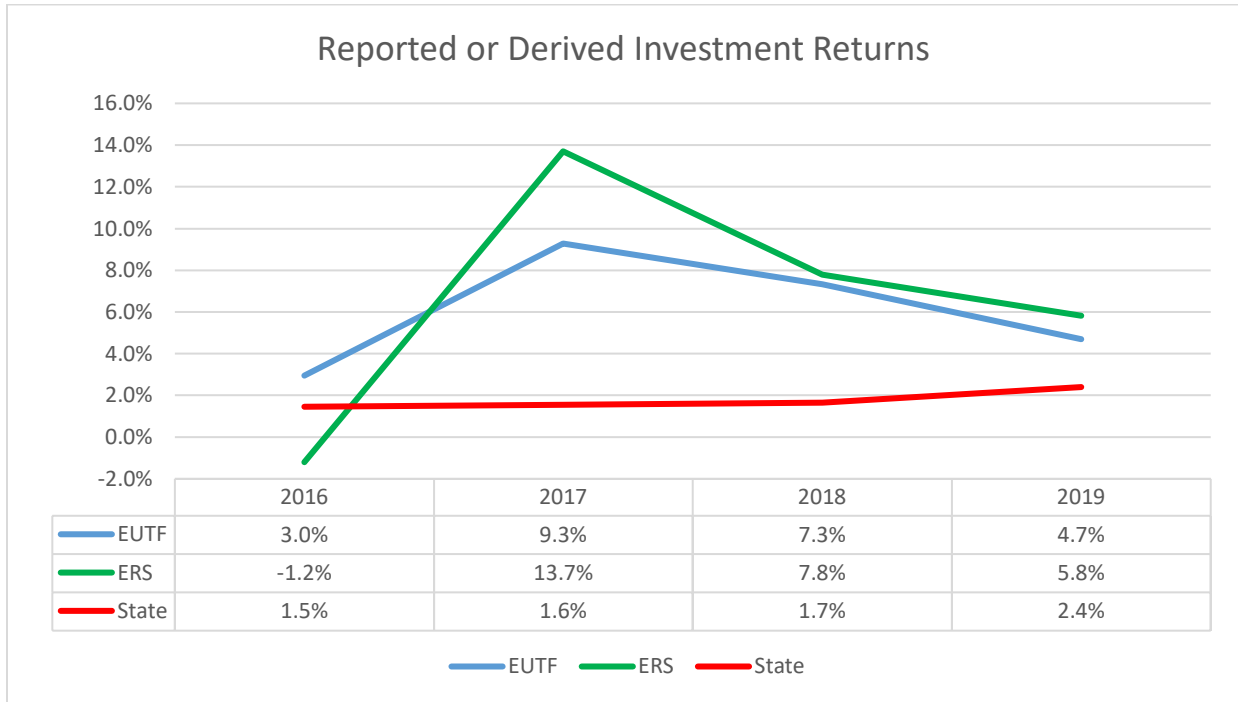
**EFFECTIVE DATE:** This Act shall take effect upon its approval; provided that the appropriation made in the bill takes effect on July 1, 2020.

**STAFF COMMENTS:** As explained in the bill's recitals, the state treasury is invested in certificates of deposit and short-term treasuries or agencies having a duration (average maturity) of less than one year. In other words, the state treasury is invested in cash or cash equivalents. In contrast, Section 36-21, HRS, authorizes government and government-related bond investments that are due to mature not more than five years after the date of investment. The bill also recites that the Department of Budget and Finance (B&F) has less than one full-time equivalent position assigned to invest and manage a \$6 billion portfolio.

It is hard to disagree with the bill's premises, namely that our State interagency portfolio deserves more attention and care than one dedicated worker can give to it.

For comparison, we plotted ERS' and EUTF's reported investment returns as reported on their financial statements as posted on B&F's website. To derive the State's investment returns, we

divided the “Interest and Investment Income” total from the State’s Combined Annual Financial Report (CAFR) Statement of Activities by its total “Investments” per the CAFR Statement of Net Position. Here are the results.



Source: B&F Reports, CAFR

Digested 2/3/2020