



**House
Legislative
Analysis
Section**

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**GOVERNMENT DISCLOSURE OF
"DERIVATIVES"**

**House Bill 5187 as enrolled
Public Act 439 of 1996
Sponsor: Rep. Michael Hanley**

**House Bill 5188 as enrolled
Public Act 427 of 1996
Sponsor: Rep. Greg Kaza**

**House Bill 5223 as enrolled
Public Act 400 of 1996
Sponsor: Rep. Roland Jersevic**

**House Bill 5224 as enrolled
Public Act 401 of 1996
Sponsor: Rep. William Bobier**

**House Bill 5256 as enrolled
Public Act 426 of 1996
Sponsor: Rep. Liz Brater**

**House Committee: Urban Policy
Senate Committee: Financial Services**

Third Analysis (1-14-97)

House Bills 5187, 5188, 5223, 5224 and 5256 (1-14-97)

THE APPARENT PROBLEM:

Most local governmental units have to make investment decisions regarding the money they receive or retain. When money is received through taxes or other forms of revenue, and particularly when money is held for pensions or retirement plans for governmental employees, it is expected that the governmental unit will invest the money in a manner that will, at the very least, retain the money's value against inflation and/or increase the value, if possible.

Unfortunately, investment practices and decisions can lead to significant losses where the money is unwisely invested in risky ventures. Independence Township in Michigan, Orange County in California, Escambia County in Florida, and the State of Wisconsin have all taken significant losses due to unwise investments in one of the more volatile forms of investment, that known as

derivatives. Derivatives are broadly defined as any investment whose rate of return is based on the movement in value of an underlying asset; futures contracts and stock options are forms of derivatives. Investment in derivatives allows investors to speculate on the movement of a particular market. The value of a derivative investment is "derived" from the underlying assets, such as currencies, equities, or commodities; an index, like the stock market; or an indicator, such as interest rates. If the investor predicts correctly which way the market will move, the value of the investment goes up. If the investor is wrong, the value of the investment decreases.

Given the significant losses taken by some governmental entities due to investments in derivatives, legislation has been introduced, in the interest of keeping the public fully informed, to require governmental units to report the amount and nature of their investments in derivatives.

THE CONTENT OF THE BILLS:

The package of bills would require reporting of information concerning the nature and amount of public bodies' (state, county and/or local units of governments) investments in derivative instruments or products. House Bills 5187, 5188, and 5256 contain identical definitions which would describe a derivative instrument or product as either: a) a contract or convertible security that changes value in concert with a related or underlying security, or obtains much of its value through price movements in a related or underlying security, or both; or b) a contract or security whose value is determined in whole or in part by the price of one or more underlying instruments or markets. The bills also specify that a derivative instrument or product could not represent a fund, as created under the provisions of the Surplus Funds Investment Pool Act, which regulates the investment of surplus funds in investment pools by local units of government. The bills would also specify that they would not provide authority for any governmental entity to make any investments not otherwise allowed by law.

House Bills 5223 and 5224 are tie-barred to House Bill 5187.

Local Units of Government. House Bills 5187 and 5223 would amend the Uniform Budgeting and Accounting Act (MCL 141.422d et al.), which establishes reporting requirements for local units of government. Among other provisions, the act requires local units of government to file annual financial reports with the state treasurer. House Bill 5187 would require the fiscal officer of each local unit to make the annual financial report. The reports would still have to be uniform for local units of the same class and the forms for the reports would still be prescribed by the state treasurer. In addition to the current requirement that the report contain a summary of all revenues, expenditures, indebtedness, fund balances, and any other information required by law, the bill would require that the reports include a statement indicating whether there were derivative instruments or products in a local unit's nonpension investment portfolio at fiscal year end, and, if there were, information on their cost and fiscal year end market value in the local unit's nonpension portfolio. The same information would be required for a local unit's pension portfolio. The investments of defined contribution plans and deferred compensation plans that are chosen by employees would be excluded from the information reported. The information required would have to be reported on both an aggregate basis and itemized by issuer and type of derivative investment. In addition, House Bill 5187 would define "disbursement" to mean a payment in cash.

House Bill 5223 would provide that if a local unit failed to report its investments in derivatives as required, the state treasurer would be allowed to make a determination that the local unit was unable to complete its report without assistance. The state treasurer could then submit a written statement of findings and recommendations to the local unit's legislative body. The local unit would then be required to retain a certified public accountant or the state treasurer to complete the report on its investments within 90 days of receipt of the state treasurer's statement. House Bill 5223 would require the local unit to notify the state treasurer, through resolution of its legislative body, of its action.

If the local unit failed to respond to the state treasurer's statement within 90 days, the state treasurer would be required to complete the report on the local unit's investments. The state treasurer would be allowed to charge the local unit for reasonable and necessary expenses required to complete the report, including travel and per diem expenses. The local unit would be required to reimburse the state treasurer for these expenses, and the state treasurer would be allowed to either execute a contract with the local unit or bill the local unit on a monthly basis. The bill would also require audit reports to include, among other things, information regarding any deviations in the reporting of the local unit's investments in derivatives.

The Library of Michigan Act specifies that the Library of Michigan must serve as a depository for public documents and maintain these as a permanent reference file. In addition, the state librarian is required to designate certain libraries as depository libraries, and these libraries also maintain copies of each public document. House Bill 5224 would amend the Uniform Budgeting and Accounting Act (MCL 141.422d and 141.422b) to require that the state treasurer promptly file copies of a schedule of derivative instruments and products with the Library of Michigan. A sufficient number of copies would have to be filed so that one copy would be deposited in the Library of Michigan and one copy in each designated depository library. Both the library and the designated depository libraries would serve as depositories, and would maintain copies of schedules of derivative instruments and products in the same manner that they maintain other public documents. Each library would also be required to make the schedules of derivative instruments and products available promptly to the public. In addition, each local unit would have to obtain and retain a copy of its annual financial report, and either the local unit or the state treasurer would have to make the annual financial report available for public inspection under the provisions of the

Freedom of Information Act (FOIA). In addition, House Bill 5188 would create the Good Government Financial Report Disclosure Act to specify that a public body (the state and local units of government) must retain financial reports and make them available for public inspection under the provisions of the FOIA. However, House Bill 5188 specifies that investments of defined contribution plans and deferred compensation plans that are chosen by participating employees would not be made available to the public.

House Bill 5256 would amend the Uniform System of Accounting Act (MCL 21.41 et al.) to require that county offices comply with the reporting requirements established under House Bill 5187 concerning the nature and amount of their investments in derivative instruments, and that copies of the reports and statements be open to public inspection in the Library of Michigan and in designated depository libraries; that state departments and offices file annual statements regarding derivatives, and that copies of these statements be available for public inspection under the FOIA. The bill would also provide that the auditor general, in the case of state government, and the Department of Treasury, in the case of county offices, take measures to complete these reports should the public body fail to do so.

State Offices. State departments, offices, and institutions would be required to file an annual statement with the auditor general similar to those required of local units under the Uniform Budgeting and Accounting Act within 60 days after the close of the state fiscal year. However, the bill would require that these reports contain additional information. Specifically, the bill would require reporting of the cost and fiscal year end market value of derivative instruments in the office's nonpension investment portfolio at the end of the fiscal year. This information would have to be reported both on an aggregate basis and itemized by issuer and type of derivative instrument. The bill would also require reporting of the cost and fiscal year end market value of each item in the pension system's investment portfolio at the end of the fiscal year. These investments would have to be itemized and listed by category on an aggregate basis. United States government or agency obligations would be itemized by type of security; commercial paper would be itemized by issuing bank; United States government or agency repurchase agreements would be itemized by institution with the type of security specified; United States bank bankers' acceptances would be itemized by issuing bank; mutual funds would be itemized by fund name; common stock would be itemized by issuing corporation; corporate bonds would be itemized by issuing corporation and type of security; real estate would be itemized by separately describing each holding; mortgages would be itemized by mortgagor; derivative instruments or products would be itemized by issuer and

type; and all other types of pension investment would be itemized by type of investment. However, information concerning investments in defined contribution plans and deferred compensation plans where the employee participating in the plan chooses the nature of the investments would not have to be included in the reports.

The bill would also provide that if a department, institution, or office of state government failed to report its nonpension investments in derivatives and its pension investments as required, the auditor general could make a determination that the department, institution, or office was unable to complete its report without assistance from the auditor general. The auditor general could then submit a written statement of findings and recommendations to the office, department, or institution. The institution, department, or office would then be required, within 90 days of receipt of the auditor general's statement, to either retain the auditor general to report the investments, or retain a certified public accountant report on the investments and notify the auditor general of the action. If the office, department, or institution failed to respond to the auditor general's statement within 90 days, the auditor general would be required to complete the investment report. The auditor general would be required to charge for reasonable and necessary expenses required to complete the report, including travel and per diem expenses, and the office, institution, or department would be required to pay for these expenses. The auditor general would be required to execute a contract with the office, institution, or department or to provide monthly billings if a contract is not executed.

County Offices. In addition to the information currently required in its annual financial report, a county office would also be required to file a statement that included an accurate schedule reporting the cost and fiscal year end market value of derivative instruments or products, on both an aggregate and itemized basis, in its pension and nonpension portfolios (with the exception of investments of defined contribution plans and deferred compensation plans that are chosen by employees). In situations where a county failed to report information on derivatives in its financial report, the bill would establish provisions similar to those established for state offices. For a county, the Department of Treasury, rather than the auditor general, would be retained to complete the report.

The state treasurer would be required to file a sufficient number of copies of schedules of derivative instruments and products invested in county pension and nonpension investment portfolios and reported in their annual financial reports -- so that one copy could be deposited in the Library of Michigan and one in each library designated as a depository library. The Library of Michigan and each designated depository library would

have to make a schedule of derivative instruments and products described in the financial reports available to the public. In addition, each county would be required to retain a copy of its annual financial report, and either the county or the state treasurer would make it available for public inspection, as required under the FOIA. Similarly, annual statements concerning state investments in derivatives would have to be made available to the public.

FISCAL IMPLICATIONS:

According to the House Fiscal Agency, House Bill 5188 has no fiscal impact; House Bill 5223 would have a negligible fiscal impact on the state, and the other bills could result in increased costs to local governments to the extent that penalties were applied for violations, with a corresponding revenue increase to the state. (1-15-97)

The Senate Fiscal Agency (SFA) estimates that the provisions of House Bill 5224, which would require that the Library of Michigan act as a depository for information, would have a minimal fiscal impact on state funds. Under House Bill 5256, the auditor general would have to charge reasonable and necessary expenses to a state department, institution, or office for services performed in reporting the value of investments. According to the SFA, the auditor general's total costs for compiling such reports are estimated at \$12,200. (6-20-96)

ARGUMENTS:

For:

Currently, if a local unit or a state governmental entity uses a private money manager for maintaining its investment portfolio, the information on how the money has been invested may be unavailable to members of the public, even if a FOIA request is made. The bills will allow for increased public scrutiny of how local governmental units invest public money. How public money is invested is a matter of some concern to the public; when governmental units lose public money due to poor investments or poor investment strategies, members of the public should be able to find out how and why it happened. The reporting requirements added by the bills would increase the likelihood that members of the public could find out how public money is being invested and as a result could discourage overly risky investments.

The bills are not particularly onerous, as they require only the additional specific reporting on investments in derivative instruments or products. Derivatives are a volatile form of investment and extra scrutiny is necessary to help prevent the type of losses that have occurred due to excessive investments in derivative products.

Response:

If investments in derivatives are so risky, wouldn't it be better to simply restrict the ability of units of government to invest in them?

For:

The Library of Michigan is already designated as the Michigan document depository under the Library of Michigan Act and is responsible for the distribution and maintenance of official Michigan documents; as a result it makes sense to make the library the financial investment clearinghouse. The Library of Michigan already receives 75 copies of all official Michigan documents (those that are printed and intended for general distribution, including statutes, department reports and etc.); the library keeps some copies and distributes the rest to official document depositories under the act. The Library of Michigan has a state-wide network of depository libraries, including 18 state public libraries, 16 academic libraries, 7 county libraries, and 5 public cooperative libraries. Given the existence of this network it makes far more sense to make use of it than to hire or create a new entity to accomplish what is already being done by the library.

Response:

As long as the library is not forced to attempt to collate the information or otherwise create the documents, it is likely that the retention of certain yearly reports and the distribution of them to the other depository libraries would not significantly increase the library's workload. However, it is difficult to know how much increased work would be involved in maintaining the information required under the bills.

Against:

The reporting requirements added by the bills are unnecessary; there are already laws which limit the type and manner of investments governmental units can make. These laws provide ample protection for investments. Particularly, Public Act 20 of 1943 (MCL 129.91 et al), known as the Investment of Surplus Finds of Political Subdivisions Act, restricts the types of investments made by legislative or governing bodies of political

subdivisions. These laws already limit the risks political subdivision may take with public money. Furthermore, merely requiring reporting of the types of investments

held at the end of the year will do little to prevent bad investments; without some form of review and/or oversight of the reports there will be little encouragement to change shaky investment practices.

Investment plans which take significant losses usually do so because the investment plan relied too much upon a particular type of investment. Investment in derivatives is not, in and of itself, a bad thing; when invested in wisely, derivatives can offer a hedge against fluctuations in certain markets.

Additionally, it should be noted that the majority of counties in Michigan rely on the Municipal Employees Retirement System (MERS) to invest pension money. It would make more sense for MERS to report on the types of investments made in the counties pension portfolios directly, since MERS is in control of the investments.

Furthermore, many local units of government are already overwhelmed by the reporting requirements added due to Proposal A's passage; the addition of the requirements of this package will be difficult to meet. The requirement that the local units of government increase their reporting could result in increased costs for the local units. These increased costs should be paid by the state under the Headlee amendment, which limits unfunded state mandates.

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■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.