Fiscal Note & Local Impact Statement

122 nd General Assembly of Ohio

BILL: **HB 701** DATE: **May 19, 1998**

STATUS: **As Introduced** SPONSOR: **Rep. Mason**

LOCAL IMPACT STATEMENT REQUIRED: **No — Offsetting revenues**

CONTENTS: **Adopts Ohio Uniform Prudent Investor Act**

State Fiscal Highlights

STATE FUND	FY 1998	FY 1999	FUTURE YEARS
General Revenue Fund			
Revenues	- 0 -	- 0 -	- Potential gain -
Expenditures	- 0 -	- 0 -	- 0 -

- Over time, increases in the wealth of trust beneficiaries could result in greater income tax and estate tax receipts.

Local Fiscal Highlights

LOCAL GOVERNMENT	FY 1998	FY 1999	FUTURE YEARS
Municipal corporations and townships			
Revenues	- 0 -	- 0 -	- Potential gain -
Expenditures	- 0 -	- 0 -	- 0 -
Other Local Governments			
Revenues	- 0 -	- 0 -	- Potential gain -
Expenditures	- 0 -	- 0 -	- 0 -

- Increases in the wealth of trust beneficiaries could result in greater local revenues via the estate tax and the personal income tax. Townships and municipalities receive 64 percent of estate tax revenue. 10.5 percent of personal income tax revenue is distributed to local governments via the library and local government support fund (5.7 percent) the local government fund (4.2 percent), and the local government revenue assistance fund (0.6 percent).

Detailed Fiscal Analysis

The adoption of the Ohio Uniform Prudent Investor Act will allow Ohio fiduciaries (including banks and savings and loans) and trust companies to make investment decisions utilizing modern portfolio theory. While this is unlikely to have much impact in the near future, it is likely to generate greater wealth to trust beneficiaries. Consequently, it is likely to generate more revenue to the state and local governments through the Ohio personal income tax and the estate tax.

Currently, Ohio follows the "Prudent Man Rule" governing investments by fiduciaries. According to this rule, a fiduciary should focus on investments which preserve the base, generate income, and avoid risk. Bonds and CD's would be acceptable investments, as would some stocks which pay dividends. Growth stocks would typically not be considered "prudent" investments under the prudent man rule; nor would shares of closely held companies.

The "Prudent Man Rule" dates back to the 1830's, when the most important financial instruments were bonds. A great variety of financial instruments have evolved since that time. Asset appreciation has become an increasingly important part of the total return on any asset. In the meantime, the understanding of how markets work has also evolved – especially with respect to the ideas of risk and return on assets.

The Modern Portfolio Theory[1] of investment essentially captures much of this new understanding. It provides a framework for devising an optimal investment strategy – i.e., an investment strategy that will yield the greatest expected return for a given amount of risk. The strategy relies on the principle of diversification in accordance with risk classes. Essentially, investors reduce their exposure to market risk by holding several different assets whose return characteristics are uncorrelated. (That is, the assets would not be expected to react the same way to the same market events – such as a recession in Asia or the devaluation of the dollar.) In this way, investors can decrease their risk without decreasing their expected return. In fact, with the proper diversification techniques, investors can achieve the greatest return for a given amount of risk (or a minimum risk for a given rate of return).[2]

The greater return to be achieved from the Modern Portfolio Theory approach applies to the investment portfolio as a whole – not for any individual asset. Therein lies its inherent conflict with the Prudent Man Rule, as the Prudent Man Rule looks at the "prudence" of each individual asset in the portfolio. This strategy, according to Modern Portfolio Theory (and backed up by substantial empirical research), can - *for a given amount of risk* - never yield as high a total return as one which looks at the investment portfolio as a whole.

Banks, along with other trust companies, are closely regulated. Examiners look at a bank's trust holdings and will question the bank's portfolio management if it does not appear to adhere to the law. Corrections sometimes have to be made, which can be expensive depending

[1] Principles of Modern Portfolio Theory were developed beginning in the 1950's by Harry Markowitz. They were expanded upon over the next 40 years most notably by Markowitz and William F. Sharpe, who jointly won the Nobel Prize in 1990 for Modern PortfolioTheory's contribution to financial decision-making in uncertain environments.

[2] See Jonathan B. Levine, *How Modern Portfolio Theory Works to Optimize Returns,*www.financialengines.com

on the timing of the problem. Therefore, banks currently have an incentive to follow the prudent man rule, in accordance with current Ohio law, even if generally accepted financial theory implies that they could achieve a higher return for their client – given the same level of risk - by following a strategy of diversification. Therefore, adopting the prudent investor rule, which takes into consideration the portfolio theory of investment, is likely to lead fiduciaries to employ different investment strategies and make different investment decisions. Other things being equal, such decisions can be expected to enhance the performance of trusts and increase the wealth of their beneficiaries in Ohio.

The bill establishes the "Prudent Investor Rule" to govern investments by fiduciaries in Ohio. It would specifically allow fiduciaries to take Modern Portfolio Theory into account by specifying in division (D) of section 1339.53 that "A trustee's investment and management decisions respecting individual trust assets shall not be evaluated in isolation but in the context of the trust portfolio as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust." In addition, in division (B) of section 1339.54, the bill states that "A trustee shall diversify the investments of a trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."[3]

Making investments in accordance with the prudent investor rule – and by implication the modern portfolio theory of investment - would allow trustees to look at the total return of a security (which includes both income and growth) instead of looking solely at the amount of income generated by a security. Among other things, this would allow the trustee to hedge against inflation, which at times can exceed the amount of income generated by an otherwise risk-free asset, such as a C.D. or a Treasury bond.

Following the prudent investor rule would tend to increase the wealth of trust beneficiaries in Ohio over time. Trustees could invest relatively more of a trust's assets in non-income generating securities. This greater wealth would ultimately result in larger estates (subject to the estate tax); and more income from capital gains subject to the personal income tax. The prudent investor rule would apply to trusts created on or after the effective date of the act, as well as to decisions concerning existing trusts made after the effective date of the act. Since it takes time to generate income or significant asset appreciation to begin with, it would take some time before the new investment strategy would have a significant impact on either of these taxes.

The personal income tax is a state tax with 89.5 percent being deposited in the state GRF. 4.2 percent is deposited in the local government fund, 0.6 percent is deposited in the local government revenue assistance fund and 5.7 percent is deposited in the library and local government revenue assistance fund. Sixty-four percent of the estate tax returns to the municipal corporation or township of origin; with the remainder going to the state GRF. To the extent that the adoption of the Ohio Uniform Prudent Investor Act causes personal income tax and estate tax revenues to increase, these local governments and funds will benefit accordingly.

It is unlikely that the adoption of the uniform prudent investment act would have any impact on the operations of the courts or the state regulatory agencies. Since it was first proposed by the National Conference on Commissioners on Uniform State Laws in 1993, the act has been

[3] The need not to diversify might arise in the case where the trust needed to maintain ownership shares of a closely held corporation.

adopted in 21 states and is currently being considered in 10 others. As more and more states adopt the act, any conceivable costs will be even further reduced.

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