Prepared by the North Dakota Legislative Council staff for the Budget Committee on Government Finance
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BONDING FUND AND FIRE AND TORNADO FUND - INVESTMENT POLICIES

This memorandum reviews previous and current investment policies of the bonding fund and fire and tornado fund and includes projected returns based on alternative policies.

1995-97 INVESTMENT POLICY

Prior to July 1, 1997, the asset allocation policy of the bonding fund and fire and tornado fund provided that 90 percent of the moneys in each of the funds be invested in either fixed income or cash equivalent type investments. The asset allocation for the 1995-97 biennium was:

Asset Class	Fire and Tornado Fund	Bonding Fund
Equities	10%	10%
Fixed income	30%	20%
Cash equivalents	60%	70%
Total	100%	100%

Total returns for each of the funds for the 1995-97 biennium are listed below:

Total Return	Fire and Tornado Fund	Bonding Fund
Fiscal year 1996	6.45%	6.98%
Fiscal year 1997	9.67%	9.49%

1997-99 INVESTMENT POLICY

Beginning July 1, 1997, after discussions with the Insurance Department, the Retirement and Investment Office changed the asset allocation policy of the bonding fund and fire and tornado fund.

Asset Class	Percentage
Large capital domestic equity	15
Small capital domestic equity	5
Convertible bonds	10
International equity	10
Fixed income	50
Cash equivalents	10
Total	100

The Retirement and Investment Office also established an insurance trust consisting of the commingled moneys of the insurance-related funds which the Retirement and Investment Office is responsible for investing. These funds include the fire and tornado fund, bonding fund, insurance regulatory trust fund, petroleum tank release compensation fund, risk management fund, National Guard tuition trust fund, and the workers' compensation fund. The value of the insurance trust as of November 30, 1997, totaled $637.2 million, $30 million of which is in cash equivalent investments.

Based on bonding fund and fire and tornado fund investment returns for July 1, 1997, through October 31, 1997, the projected fiscal year 1998 annualized returns for these funds would be 13.4 percent.

If bonding fund and fire and tornado fund moneys would have been invested using the 1997-99 asset allocation policy during the 1995-97 biennium, based on benchmark returns for each asset class for that period, the bonding fund and fire and tornado fund would have realized a fiscal year 1996 return of 11.01 percent and a fiscal year 1997 return of 13.32 percent, an increase of 4 to 4.5 percent compared to actual fiscal year 1996 returns and an increase of approximately 3.75 percent compared to actual fiscal year 1997 returns.

SHORT-TERM LOAN OPTION

At its last meeting, the committee considered an option to potentially increase the investment returns of the bonding fund and fire and tornado fund. The option involved authorizing the Insurance Commissioner to obtain a short-term loan from the Bank of North Dakota to meet cash flow needs of these funds in order to allow more longer term investments.

Based on the current investment policy of these funds, it appears the loan option would not lead to improved investment returns. Because the bonding fund and fire and tornado fund are a part of the Retirement and Investment Office's insurance trust, the moneys of these funds are commingled with other insurance-related funds for investment purposes. Due to this commingled structure and the positive cash flow into the insurance trust, the Retirement and Investment Office is easily able to make cash available for required distributions from the bonding fund or the fire and tornado fund. Even very large distributions from these funds would unlikely cause the need for security liquidations because the current cash equivalent amount in the insurance trust is $30 million. The required distribution amount would be withdrawn from the cash pool and a prorated portion of the fund's investments would be redistributed administratively to the other participating funds. The effect of this would be that the fund paying the distribution would maintain its asset allocation structure but shrink in size by the amount of the cash outflow.

LOWER STATUTORY MINIMUM BALANCES

Current law provides that if the balance in the bonding fund is less than $2.5 million, premiums must be charged to bonding fund policyholders. If the fire and tornado fund balance is less than $12 million, an assessment must be levied against every policy in effect in order to return the balance to $12 million.

By lowering these minimum balances, more aggressive investment strategies could be considered for the bonding fund and fire and tornado fund which could potentially increase returns beyond those projected in the current investment strategy; however, potential for greater losses also increases. The following chart shows three investment scenarios. Scenario 1 is the current investment policy, scenario 2 would be somewhat more aggressive, and scenario 3 would be yet more aggressive.

	Asset Allocation		
Asset Class	**Scenario 1**	**Scenario 2**	**Scenario 3**
Large capital United States equity	15%	30%	35%
Small capital United States equity	5%	15%	20%
Convertible bonds	10%	10%	10%
International equity	10%	15%	15%
Fixed income	50%	20%	15%
Cash equivalents	10%	10%	5%
Total	100%	100%	100%

The schedules below present projected fund balances based on the scenarios over a two-year period for a normal investment environment, a pessimistic investment environment, and an optimistic investment environment. In these scenarios, the fire and tornado fund begins with a balance of $16,162,000 while the bonding fund begins with a balance of $4,038,000.

		Fire and Tornado Fund		
Environment	**Years**	**Scenario 1**	**Scenario 2**	**Scenario 3**
Normal	1	$17,422,636	$17,551,932	$17,600,418
	2	$18,796,406	$19,054,998	$19,184,294
Pessimistic	1	$14,691,258	$14,044,778	$13,753,862
	2	$13,576,080	$12,396,254	$11,814,422
Optimistic	1	$18,521,652	$18,861,054	$19,038,836
	2	$21,253,030	$22,044,968	$22,465,180

		Bonding Fund		
Environment	**Years**	**Scenario 1**	**Scenario 2**	**Scenario 3**
Normal	1	$4,352,964	$4,385,268	$4,397,382
	2	$4,696,194	$4,760,802	$4,793,106
Pessimistic	1	$3,670,542	$3,509,022	$3,436,338
	2	$3,391,920	$3,097,146	$2,951,778
Optimistic	1	$4,627,548	$4,712,346	$4,756,764
	2	$5,309,970	$5,507,832	$5,612,820