EBRI ISSUE BRIEF

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TAPPING PENSION FUNDS FOR INVESTMENT CAPITAL

ABSTRACT

In late March, both the Senate and the House held hearings on proposed legislation, supported by powerful advocacy groups, that would expand pension-fund investments in the housing industry. And the Department of Labor (DOL) has promised to issue soon new regulations governing pension-fund investment practices. These examples point to the increased attention being paid to the growth of pension-fund assets and their importance as a source of capital. Now the largest pool of investment funds in the economy, pension-fund assets will likely increase as a growing portion of new savings is channeled into pension reserves.

Although the legal responsibility of pension-plan trustees is to guarantee adequate and secure retirement incomes for participants, experience has shown that innovative and socially beneficial investments--if they also generate adequate returns--will attract pension-fund dollars. The housing and venture capital markets have taken a keen interest in the potential of pension-fund assets to meet their sectors' capital needs. In fact, in the last several years, these two sectors have actively pursued monetary commitments from pension-fund investments. Data recently released by the Department of Housing and Urban Development (HUD) show that housing investments by private pension funds increased 58 percent between December 1980 and June 1983. During 1983, nearly one-third of new venture capital commitments came from pension assets.

Current efforts to simplify federal regulation of pension-fund investment practices are likely to increase the attractiveness of certain nontraditional investments, particularly in the housing and venture capital markets. Policymakers should ensure, however, that pension-fund investments continue to be made in the interests of participants and beneficiaries. Otherwise, plan managers risk harming those with the least ability to protect themselves--the estimated 12 million retirees now receiving pension benefits and the 42 million participants now accruing benefit rights who will retire in the future.

Introduction

Employer-sponsored pension plans now constitute the largest single pool of investment funds in the U.S. economy. In 1982, private- and public-sector pension plans held 42 percent of all institutional assets, compared with 29 percent in 1960.[1] An increasing share of new savings is being channeled through pension funds. Additions to insurance and pension reserves accounted for 27.2 percent of household savings in 1982, up from 18.8 percent in 1970.[2]

This growth, along with high interest rates, persistent federal deficits and cutbacks in federal domestic spending, has focused attention on pension funds as a financing source for unmet capital needs. The $180 billion deficit projected in President Reagan's 1985 budget would have absorbed 59 percent of total net household saving in 1982. As the federal government attempts to meet unprecedented financing needs, competition for available investment funds will become keener. This competition will particularly affect housing and small businesses, two sectors that have traditionally been sensitive to credit conditions. Cutbacks in federal spending for housing and economic development have further increased demands for long-term credit at reasonable rates in these sectors.

The potential role of pension fund investments in these areas, however, is highly controversial. Sometimes referred to as social investing, investment by pension funds to promote goals in addition to retirement security objectives often involves tradeoffs between the social and economic features of an investment. Herein lies the controversy. Proponents of social investing argue that characteristics other than the rate of return should also be considered when determining a plan's portfolio mix. Moreover, they claim that alternative investment approaches can be pursued without harming pension security. Opponents argue that social investing involves increased costs and risks to the employee as well as to the employer.

The concept of social investing has grown to include a variety of nontraditional investment possibilities such as housing and venture capital. This *Issue Brief* discusses the current status and the future potential for pension investments in the housing and venture capital markets, and it highlights regulatory and legislative developments which affect them.

Pension-Fund Investments in Housing

The housing industry has probably been the single most vocal claimant on pension-fund assets. High interest rates and cutbacks in federal spending on subsidized housing have delivered a crippling blow to builders and developers. Whereas an average of 1.8 million new housing units per year were started in the 1970s, only 1.3 million per year were started in the early 1980s.[3] The housing sector has recently turned to pension funds as a source of mortgage financing because of their relatively long investment horizon. Although state and local government pension funds and private insured funds invest in housing-related instruments, private trusteed plans--which account for about two-thirds of private plan assets--have not invested substantial funds in the housing industry. In 1981, the latest year for which survey data on trusteed plans are available, these plans held only 1.3 percent of their assets in mortgages.[4] Even when this figure is revised to account for mortgage-backed securities--housing debt instruments backed by a pool of mortgage loans--pension funds still committed only 7.3 percent of their assets to housing-related investments in that year.[5]

The flow of pension funds into the housing market has been impeded in part by the prohibited transaction and plan asset regulations in the Employee Retirement Income Security Act of 1974 (ERISA). A violation of one or more of the prohibited transactions can easily arise in housing transactions due to a possible relationship between a pension fund and certain parties involved in mortgage transactions. Under ERISA's plan asset definition, investments in pooled mortgage securities--which are common housing investments, attractive to large investors because they are an efficient way to package small, individual mortgages--have been a problem. Until 1982, ERISA's definition of whether the mortgage pool certificates or the underlying mortgages constitute plan assets was unclear. Financial institutions that issued pooled securities were in some cases considered plan fiduciaries under ERISA. This subjected such institutions to a number of ERISA restrictions that would not be encountered if they were doing business with institutional investors other than pension funds.

The Reagan administration has eased some regulatory burdens that may have impeded pension-fund investment into housing. In particular, in 1982 the Department of Labor (DOL) issued two exemptions from ERISA's prohibited transaction rules for residential mortgage investments. The regulations exempted some transactions involving mortgage pools and permitted plans to invest in residential mortgages under certain conditions. DOL also issued plan asset regulations. They provided that plan assets in a mortgage pool whose securities are insured or guaranteed by a federal or federally-related agency include the pool certificates, but do not include any of the underlying mortgages. Thus, the pool issuer would not be a fiduciary of a plan merely by reason of the plan's investment in the pool. In January 1983, DOL expanded the definition of eligible mortgage pools to include pools of second mortgages.

In addition to these deregulatory efforts, the Department of Housing and Urban Development (HUD) has attempted to educate pension-fund managers about the range and features of the new housing investments that have emerged in recent years. New types of mortgage instruments such as graduated payment mortgages (GPMs) and adjustable rate mortgages (ARMs) generally avoid committing the long-term investor to fixed interest rates, a major disadvantage of housing investments in the past.[6]

These educational and deregulatory efforts appear to have been relatively successful. Data recently released by HUD show that housing investments by private pension funds increased 58 percent between December 1980 and June 1983.[7] Moreover, the HUD data show that more than 10 percent of the total increase in pension-fund assets during this period consisted of mortgages and mortgage-related securities.

Pension-Fund Investments in Venture Capital

Small businesses also suffer when credit is tight. Small businesses are a risky proposition for investors; up to half fail within five years of opening. Small businesses are important to economic growth, however, since they can generate both technological innovations and new jobs. If chosen well, they can also yield investment returns that far exceed those available in large, established companies. For example, between 1975 and 1980, annual returns in a sample of venture capital partnerships averaged 30.2 percent.[8] By comparison, the Standard & Poor 500, an index based on the performance of equities of large, established firms, returned an average of 18.5 percent annually over this period.[9]

Pension funds invest in small businesses primarily through venture capital arrangements. Venture capitalists are investors who screen the 6.9 million small businesses in the U.S., selecting those with the greatest potential for high returns on their clients' pension-fund investments.[10] Venture capitalists also may provide management advice and supervision to help ensure the success of participating businesses.

Venture capital supports only a small portion of the small businesses in existence. Pension funds likewise have traditionally had only a small relative interest in venture capital; an estimated one-half of one percent of total pension-fund assets is invested in venture-capital arrangements.[11] ERISA regulations prohibiting incentive compensation, which rewards a pension-fund manager on the basis of the funds' investment performance, have likely deterred venture capital managers from seeking pension-fund clients.

Private and public funds, nevertheless, supply a large share of new venture-capital assets. Nearly one-third of new venture capital commitments in 1983 came from pension assets.[12] Surveys of pension-fund managers suggest a growing interest in venture-capital investments--probably because of their attractive rate of return and the possibility of changes in ERISA's incentive compensation provisions.[13] Whether this interest is translated into new monetary commitments will depend in part on the regulatory environment.

Regulatory and Legislative Developments

The Department of Labor is currently reevaluating the regulatory standards that govern pension-fund investment practices, and is also redefining pension plan assets in a way that will apply to a much broader range of investment possibilities than previous deregulatory actions.

Plan asset regulations were first drawn up in 1979 and amended in 1980. In 1982, the Department issued final regulations governing certain aspects of pension-fund investment in mortgage-backed securities.[14] New, more comprehensive regulations covering a variety of investment situations were written in 1983, but were never proposed. DOL officials now indicate that comprehensive plan asset regulations will be submitted again in a few months. These regulations will cover pension-fund investment in pooled securities and various participation arrangements, as well as debt, equity, and limited partnership arrangements. These regulations should make it easier for pension fund managers to invest in real estate, venture capital and oil and gas partnerships.

While the plan asset regulations are vital for both pension funds and potential borrowers, they will be only one step in opening up pension-fund investment horizons to innovative and possibly higher-yielding investments. Venture capital managers are particularly interested in incentive compensation reform. They argue that such arrangements are appropriate for them because finding good investment prospects among small and unknown businesses is more labor intensive than managing a fund indexed, for example, to the Standard and Poor's 500 stocks. DOL officials indicate that once plan asset regulations are finalized, revising the prohibitions on incentive compensation for plan managers will be a high priority.

Congress has also been active in efforts to deregulate pension-fund investment practices. In the House, two pieces of legislation have been introduced which would facilitate pension-fund investments in residential mortgages. H.R. 4243, introduced by Reps. Ron Wyden (D-OR) and Richard Gephardt (D-MO) and supported by the American Association of Retired Persons (AARP) and the Building and Construction Trades Department of the AFL-CIO, would exempt residential mortgages from ERISA's prohibited transaction rules, which they claim unfairly restrict and discourage this type of investment. Rep. John Erlenborn (R-IL) also sponsored mortgage investment legislation, H.R. 1179, but his bill keeps in place the current investment rule in ERISA.

A companion bill to H.R. 4243 (S.2096), by Sen. Robert Packwood (R-OR), has been introduced in the Senate. This bill would establish a new statutory exemption from prohibited transaction provisions for a wide range of residential mortgage transactions. In addition, the bill would restrict the authority of the Department of Labor or other ERISA enforcement agencies to determine whether qualifying housing investments carry an appropriate rate of interest. Hearings were held on these bills before the Senate Taxation and Debt Management Subcommittee, Committee on Finance, and the House Subcommittee on Labor-Management Relations, Education and Labor Committee, March 26 and March 27, respectively.

The Labor Department strongly opposes any legislation, including H.R. 4243 and S. 2096, which amends ERISA's pension-fund investment standards and which restricts the Department's authority to enforce the law. In his testimony on March 27, Robert A.G. Monks, Administrator of the Labor Department's Office of Pension and Welfare Benefit Programs, said that "while we endorse the basic objective of this legislation--facilitating prudent investments by plans in residential mortgages--"the department believes existing law provides sufficient mortgage investment opportunities, and legislation is not required.

Summary

The growth of pension funds as a source of capital has attracted increased attention to pension-fund investment practices and opportunities. On the one hand, plan trustees have a duty to ensure that pension funds generate the highest returns possible consistent with prudent management standards. On the other hand, credit-deficient sectors of the economy are concerned that restrictions on pension-fund investment practices can restrict the flow of funds to innovative and potentially high-yielding investment possibilities. Pension-related regulatory reform has attracted a broad spectrum of support. Democratic presidential candidate Gary Hart, for example, has proposed broadening the range of investment vehicles available to pension funds as part of his plan to rebuild American industry.[15] Robert Monks also supports certain deregulations of pension-fund investment practices.

As these issues are debated, it is essential that all parties keep in mind that the principal function of pension plans is to provide secure and adequate retirement income. Revising investment restrictions on pension funds to simplify investment decisions and expand the range of available investments can enhance retirement security as well as increase economic growth. Using pension funds as social policy tools, however, might harm those with the least ability to protect themselves--the estimated 12 million retirees now receiving private- and public-sector pension benefits and the 42 million private- and public-sector participants now accruing benefit rights who will retire in the future.

Notes

[1] EBRI calculations based on U.S. Department of Commerce, Bureau of the Census, Statistical Abstract of the United States: 1984 (Washington, DC: Government Printing Office, 1983), table 828.

[2] EBRI calculations based on Economic Report of the President 1984 (Washington, DC: Government Printing Office, 1984), table B-26.

[3] EBRI calculations based on Statistical Abstract of the United States: 1984, table 1328.

[4] Sophie Korczyk, Retirement Income Opportunities in an Aging America: Pensions and the Economy, (Washington, DC: Employee Benefit Research Institute, 1982), p. 51.

[5] Arnold H. Diamond, "Pension Funds and Housing Markets," paper presented at the Conference on Pension Fund Investments in Washington, DC on February 25, 1982.

[6] For a discussion of housing-related investments in pension-fund portfolios, see "Will Pension Plans Save the Housing Industry?" EBRI Issue Brief, no. 7, April, 1982.

7 U.S. Department of Housing and Urban Development, Office of Financial Management, "HUD Pension Fund Survey: Mortgage-Related Investments of Private Pension Funds," December, 1983 (mimeo).

8 Lawrence Litvak, Pension Funds and Economic Renewal (Washington, DC: The Council of State Planning Agencies, 1981), p. 66.

9 EBRI calculations based on Computer Directions Advisors, Inc., Stocks, Bonds, Bills and Inflation: 56 Years of Historical Returns (Silver Spring, MD, undated).

10 This is the number of small businesses in the U.S. that would qualify for aid under the programs of the Small Business Administration using its eligibility criteria. (See Sophie Korczyk, Federal Business Aid Programs: Issues, Effects, and Options (Washington, DC: Congressional Budget Office, 1981, mimeo), p. 81.

11 "Capital Needs of Small Business: Can Pension Funds Help?" EBRI Issue Brief, no. 14, January 1983, p.4.

12 "Capital Transfusion 1983," Venture Capital Journal, January 1984, pp. 6-12.

13 Greenwich Research Associates, Large Corporate Pensions 1981: Report to Participants (Greenwich, CT: 1981), p. 32.

14 See "New Regulatory Actions on Pension Investment in Housing," EBRI Notes Vol. 3, No. 3, May/June 1982, p. 5 for a description of these regulatory actions.

15 Gary Hart, A New Democracy (New York: Quill, 1983) pp. 59-62.

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