EBRI ISSUE BRIEF

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STATE AND LOCAL GOVERNMENT PENSION PLANS: IS FEDERAL REGULATION COMING?

Since the passage of the Employee Retirement Income Security Act (ERISA) in 1974, there has been continuing debate over whether similar restrictions and disclosure rules should apply to state and local government retirement funds. On May 11, 1982, the House Education and Labor Committee approved the Public Employee Pension Plan Reporting and Accountability Act (PEPPRA). This proposed legislation was first introduced by Representative Erlenborn of Illinois in 1975. PEPPRA's provisions include reporting and disclosure, prohibited transactions provisions and fiduciary bonding requirements. If PEPPRA is enacted, it will impose some regulations on state and local plans that are similar to the regulations imposed on private plans by ERISA. Two similar bills, S. 2105 and S. 2106, have also been introduced in the Senate.

State and local government pension funds represent a strong force in financial markets. With $222.1 billion in assets at the end of 1981, they make up nearly one-third of all pension assets. A recent EBRI survey suggests that they have become an attractive source of funds for many credit users unable to compete in the current high interest rate environment.1/

At the same time, state and local plan trustees are experiencing pressures to improve their pension fund investment performance. The concentration of plan assets in fixed-income investments has caused low yields that state and local governments -- many facing statutory revenue limitations -- cannot afford. Fiscal pressures and borrowers' credit demands can thus come into conflict when those who wish to borrow from pension funds cannot match the yields available from other investments.

This Issue Brief discusses:

(1) the current financial status of state and local plans;

(2) recent trends in state and local plan investment policies;

(3) recent federal regulatory initiatives.

1/ Unpublished EBRI survey.

THE CURRENT FINANCIAL STATUS OF STATE AND LOCAL PLANS

State and local pension plans covered almost 14 million employees in 1980; in 1960 only 5 million employees were covered. This growth was caused largely by state and local government employment expansion. In 1979, there were 3,075 of these plans; they covered 86.1 percent of the entire state and local government labor force.2/

Plan assets have grown correspondingly. State and local pension plan assets have grown nearly elevenfold in the last twenty years, and they now constitute 32 percent of all pension assets.

Asset holdings are concentrated in a relatively small number of large plans. In 1981, the sixty-five largest state and local plans held $165.4 billion in assets, or nearly 75 percent of the state and local total.3/

Most state and local government plan assets are held in fixed-income securities. In 1981, fixed-income securities -- that is, public and private sector bonds and mortgages -- accounted for over three-quarters of state and local plan assets. Private plans, in contrast, held just over one-third of their assets in this form. See Table 1. Since 1971, state and local plans have been moving away from corporate bonds and toward federal government securities in response to yield spreads favoring federal securities. Nevertheless, public pension funds have experienced significantly lower investment returns than private funds. The greater bond holdings of public funds have partially contributed to the difference. Between 1971 and 1980, the average return on common stock was just over 9 percent per year. The average yield on corporate bonds over this period was 4.7 percent per year -- just over half the return on stocks.4/

RECENT TRENDS IN STATE AND LOCAL PLAN INVESTMENT POLICIES

High interest rates have led to new credit demands and simultaneously put pressure on state and local funds to raise their yields. In response to these pressures, three trends have emerged in state and local plan investment policies: (1) changes in the mix between stocks and bonds; (2) increased pension plan mortgage holdings; and (3) increased investment in local economic development.

2/ U.S. Bureau of the Census, Employee Retirement Systems of State and Local Governments 1977 (Washington, DC: 1978), p. 1; EBRI calculations of May 1979 Current Population Survey data.

3/ Pensions & Investment Age, "Top 1,000 Funds Hold $519 Billion," January 18, 1982, p. 1.

4/ EBRI calculations derived from data compiled in Roger G. Ibbotson and Rex A. Sinquefield, Stocks, Bonds, Bills, and Inflation: Historical Returns (1926-1978) (Charlottesville, VA: Financial Analysts Research Foundation, 1979), pp. 56-77.

TABLE 1

Investment Patterns in State and Local Government and Private Employer Pension Plans - 1981

	Private Plans (billions)	Private Plans (percent)[1/]	State/Local Plans (billions)	State/Local Plans (percent)[1/]
Cash and Deposits	$ 15.1	5.1%	$ 4.9	2.2%
Government Securities				
Federal	40.5	13.7	46.6	21.0
State/Local	0.0	0.0	3.9	1.8
Nongovernment Securities				
Corporate Bonds	61.7	20.9	105.7	47.6
Stocks	167.1	56.7	48.6	21.9
Mortgages	3.9	1.3	12.4	5.6
Other	6.6	2.2	0.0	0.0
TOTAL	$ 294.9	100.0%	$ 222.1	100.0%

Source: Federal Reserve Board, Board of Governors, Flow of Funds Accounts.

1/ Totals do not add to 100 percent due to rounding.

Changes in the Mix Between Stocks and Bonds

Many state laws limit public pension fund equity investments. Among large public employee retirement systems surveyed by the House Pension Task Force in 1976, 70 percent placed limits on stock holdings. 5/

Prompted by the disastrous effects of recent high interest rates on bond market performance, many fund supervisory bodies are considering or have already approved changes in portfolio composition limits. Within the past two years, five state and local public employee retirement systems have changed their portfolio composition limits to favor equity holdings. Systems in Michigan, New York, Ohio, Illinois and California all expect to increase their equity holdings. Some are more than doubling the proportion of assets to be held in common stocks. The new limits range from 20 percent to 70 percent of total assets.

Increased Pension Plan Mortgage Holdings

Since the housing market has been particularly hard hit by increases in interest rates, many plans have expanded investments in mortgages or mortgage-backed securities. Plans can purchase residential or commercial

5/ U.S., Congress, House, Committee on Education and Labor, Pension Task Force Report on Public Employee Retirement Systems, 95th Cong., 2d sess., 1978, p. 196.

mortgages directly, acting as primary lenders, or they can purchase secondary market mortgage-backed securities, thus making funds available to primary lenders. Secondary-market securities can take several forms. A public pension fund could purchase: (1) bonds issued by a local housing authority (the bond proceeds are then used to finance new mortgages); (2) securities issued by state mortgage investment corporations; (3) mortgage-backed securities guaranteed by federally sponsored credit agencies like the Government National Mortgage Association (GNMA) or the Federal National Mortgage Association (FNMA); (4) mortgage-backed securities from private issuers; or (5) equity real estate investments (relatively few, however, choose this vehicle).

Between 1980 and 1982, fourteen state and local pension funds changed their investment policies to allow for greater mortgage investment. Seven of these funds targeted their investment exclusively to in-state use. Some states are investing only in mortgages that carry market interest rates and do not provide a subsidy to borrowers. By 1985, plans in New York, Pennsylvania, Texas and Ohio are all planning to increase conventional mortgage investments. Massachusetts recently authorized its public employee retirement system to purchase $19 million in mortgage-backed securities from GNMA; these will be targeted for in-state use. Other states are investing in mortgages that carry below-market interest rates. Colorado plans to commit $25 million for in-state, below-market rate, residential mortgages. Florida plans to purchase $125 million in low-interest rate mortgages from local savings and loan institutions at a large discount.[6]

Hawaii probably offers the oldest example of subsidizing home buyer loans through public pension funds. Since 1959, Hawaii's employee retirement system has made mortgage loans to plan participants. It lends at below-market interest rates to lower-income borrowers and at market interest rates to others. These loans constitute 20 percent of the plan's assets.[7]

Increased Investment in Local Economic Development

State and local plans also provide funds for local economic development. These investments take several forms: (1) direct lending to local businesses; (2) providing funds for projects carrying federal loan guarantees; and (3) purchasing state or local government bonds issued either for public sector projects or for local business development. Local economic development investment commitments tend to be similar in size to mortgage investments, but apparently they are not as widespread. For example, six states are committing pension fund assets to local economic development:

6/ Unpublished EBRI survey. The fourteen states are: Alabama, California, Colorado, Connecticut, Florida, Massachusetts, Michigan, New York, North Carolina, Ohio, Pennsylvania, Texas, Washington and Wisconsin.

7/ Unpublished EBRI survey.

(1) Kansas's public employee retirement system has invested $98.8 million in state businesses.

(2) Minnesota's State Investment Board has approved a $93 million investment in certificates of deposit; the incoming capital will then be loaned to local businesses through Minnesota's banks.

(3) Ohio's public employee retirement system has committed 2 percent of its assets to financing new businesses.

(4) The Teacher Retirement System of Texas Fund has agreed to invest funds in-state providing the investment is consistent with other portfolio objectives.

(5) In 1977, Alabama's jointly managed teachers' and employees' retirement system formalized a four-year-old policy which permits in-state investments as long as the yield and security is competitive with available investment alternatives. In 1979, 47 percent of the plan's $1.6 billion was invested in-state in federal or state loan guarantee programs or in corporations.

(6) Seven California public plans have committed $280 million for small federally guaranteed business loans.

In addition to financing local business development, some pension funds buy tax-exempt local government securities. This, however, is a controversial issue. Since taxable securities frequently produce higher yields than tax-exempt securities, investing tax-free pension plan assets in tax-exempt securities does not guarantee a higher net return. Accordingly, between 1960 and 1981, state and local plan holdings of tax-free municipal bonds declined from 22.3 percent to 1.8 percent.[8]

Nevertheless, some public plan sponsors continue to sell securities to their pension funds to relieve current fiscal problems. Detroit's retirement system, for example, recently agreed to purchase $57 million in city bonds to avert Detroit's bankruptcy. Such investments assist the locality and may protect plan participants' jobs; they might not, however, contribute to benefit security.

RECENT FEDERAL REGULATORY INITIATIVES

State and local government plan investment policies are changing rapidly to respond to credit market conditions. However, these plans could face even

8/ Federal Reserve Board, Board of Governors, Flow of Funds Accounts.

greater changes if PEPPRA is enacted. Most of PEPPRA's provisions would affect public pension plan investment policies. Prudence standards, along with requirements that plan assets be managed for the exclusive benefit of plan participants and beneficiaries, could limit the ability of state and local plans to undertake below-market rate investments. PEPPRA's proposed requirement for portfolio diversification would restrict the proportion of total plan assets that can be invested in the securities of the sponsor. It could also restrain state and local governments from using pension fund assets for fiscal relief.

PEPPRA, however, contains no enforcement provisions. It would rely on the reporting and disclosure process to inform participants and taxpayers of plan management practices that would threaten benefit security.

Imposing federal requirements on state and local pension plans is a controversial issue. Those who oppose such regulation argue that: (1) state and local governments are too diverse for one set of federal rules to cover each locality's needs; and (2) state and local governments are making progress in regulating their own pension systems. PEPPRA would exempt state and local plans that presently meet requirements similar to ERISA's from further reporting and disclosure burdens, however, thereby taking such progress into account.

Advocates of federal intervention argue that public disclosure of actions that threaten benefit security may safeguard participants' rights. For example, California (where the expenditure and revenue limitation movement first took hold with the 1978 passage of Proposition 13) intends to divert $180 million in scheduled pension fund contributions to its general revenues. This will prevent California from incurring a constitutionally prohibited deficit. The state retirement system has sued California over this issue; the case awaits resolution. If California had not required that such actions be made public, plan participants may not have known that contributions were to be diverted to general revenues.

SUMMARY AND CONCLUSIONS

While some state and local public employee retirement systems are responding to the poor investment performance of the 1970s by altering investment policies, others are using pension fund assets to achieve social goals and boost local economies. Some are also using pension funds to alleviate local fiscal problems.

PEPPRA could alter the course of investment strategies that many state and local pension funds have chosen. In selecting a new course, both Congress and public pension fund managers will have to rethink the purposes of public pension fund asset accumulation. Public plan participants tend to be concentrated in particular localities. Pressures on public funds to invest in local economies, therefore, may persist despite any federal legislation. A push for federal legislation, however, has arisen because of Congressional concerns over participants' benefit security. State and local governments will have to respond to the benefit security issue regardless of whether PEPPRA is passed.

The Employee Benefit Research Institute (EBRI) was established in 1978 to contribute to the development of public policy in the employee benefit field. EBRI, a nonprofit organization, has a broad membership that includes private sector companies and individuals with interests in employee benefit education, research and public policy.

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