March 2016

REPORT

SAFEGUARDING PUBLIC-PENSION SYSTEMS

A GOVERNANCE-BASED APPROACH

James R. Copland
Senior Fellow

Steven Malanga
Senior Fellow

About the Authors

James R. Copland is director of Legal Policy for and a senior fellow with the Manhattan Institute. In those roles, he develops and communicates novel, sound ideas on how to improve America's civil- and criminal-justice systems. He has testified before Congress as well as state and municipal legislatures; and has authored many policy briefs, book chapters, articles, and opinion pieces in a variety of publications, including the *Harvard Business Law Review*, *Yale Journal on Regulation*, *Wall Street Journal*, *National Law Journal*, and *USA Today*. Copland speaks regularly on civil- and criminal-justice issues; has made hundreds of media appearances in such outlets as PBS, Fox News, MSNBC, CNBC, Fox Business, Bloomberg, C-SPAN, and NPR; and is frequently cited in news articles in the *New York Times, Washington Post, The Economist*, *Forbes*, and other periodicals. In 2011 and 2012, he was named to the National Association of Corporate Directors "Directorship 100" list, which designates the individuals most influential over U.S. corporate governance.

Prior to joining MI, Copland was a management consultant with McKinsey and Company in New York. Earlier, he was a law clerk for Ralph K. Winter on the U.S. Court of Appeals for the Second Circuit. Copland has been a director of two privately held manufacturing companies since 1997 and has served on many public and nonprofit boards. He holds a J.D. and an M.B.A. from Yale, where he was an Olin Fellow in Law and Economics; an M.Sc. in the politics of the world economy from the London School of Economics; and a B.A. in economics from the University of North Carolina at Chapel Hill, where he was a Morehead Scholar.

Steven Malanga is *City Journal*'s senior editor and a Manhattan Institute senior fellow. He writes about the intersection of urban economies, business communities, and public policy. Malanga is the author of *The New New Left: How American Politics Works Today* (2005); *The Immigration Solution: A Better Plan than Today's* (2007), coauthored with Heather Mac Donald and Victor Davis Hanson; and *Shakedown: The Continuing Conspiracy Against the American Taxpayer (2010)*. He was cited as one of Governor Chris Christie's intellectual influences (*Bloomberg Businessweek*, 2010). In 2013, former Florida governor Jeb Bush called Malanga "the best thinker on state and local fiscal matters" in a Twitter tweet; in a 2014 Manhattan Institute speech, he said that Malanga's warnings on states' coming debt and pension crises had influenced fiscal reforms undertaken in Florida.

Before joining *City Journal*, Malanga was executive editor of *Crain's New York Business*, serving on the publication's editorial board and writing a weekly column. Prior to that, he was managing editor of *Crain's*. During his tenure at the publication, it twice won the General Excellence Award from the Association of Area Business Publications. In 1995, Malanga was a finalist for a Gerald Loeb Award for Excellence in Financial Journalism for the series "Nonprofits: New York's New Tammany Hall," which he coauthored. In 1998, a series he coauthored, "Tort-ured State," about the influence of trial lawyers in New York State, was voted best investigative story of the year by the Alliance of Area Business Publishers.

Malanga has written for the *Wall Street Journal*, *Los Angeles Times*, *New York Times, New York Daily News,* and *New York Post*. During 2007–13, he was a regular columnist for RealClearMarkets. He holds a B.A. in English literature and language from St. Vincent's College, as well as an M.A., in the same subject, from the University of Maryland.

Contents

Executive Summary.. 4
I. Introduction.. 6
II. Public Pension-Plan Performance.................................. 8
III. Fiduciary Duties, Board Structure, and Governance..... 11
IV. Policy Recommendations... 17
Endnotes 20

Executive Summary

State and municipal employees' public pension funds have obligations that total, in the aggregate, almost 130 percent of state and local governments' annual budgets. On average, the assets available to meet these obligations fall well short of the amount necessary—by some $1 trillion, even under such plans' own overly rosy growth assumptions. This shortfall jeopardizes public workers' retirement security—or, in the alternative, threatens the broader public with draconian tax increases and/or reduced funding for vital government services. This paper finds that:

1. **Public pension-plan funding has deteriorated.** Since 2000, such plans, in the aggregate, have gone from fully funded to 74 percent funded. In 2014, 63 percent of plans were less than 80 percent funded—the level deemed "at risk" for private-employer pension plans under the Pension Protection Act—and 20 percent were less than 40 percent funded.

2. **Public pension plans have markedly increased the risk profile of their investments.** In 1952, public-employee defined-benefit plans invested 96 percent of assets in cash and fixed-income investments; that percentage fell to 47 percent in 1992, to 27 percent in 2012, and to less than 19 percent in 2015.

3. **Public pension plans make unreasonably high rate-of-return assumptions.** The implied risk premium in state and local pension plans' rate-of-return assumptions has grown from 30 basis points over 30-year Treasuries to 480 basis points today—an increase of 1,500 percent. If public pension plans assumed a "riskless" rate of return, state and municipal pension plans would be only 50 percent funded.

4. **Many public pension funds engage in social activism that harms share value.** In recent years, many state and municipal pension plans have devoted significant attention to various environmental, social, or governance ("ESG") agendas. Empirical research suggests that such social-issue focus, at least in the form of shareholder-proposal activism, is associated with lower firm value in funds' portfolio companies.

To date, little attention has been paid to the role that pension boards have played in managing—and, in some cases, mismanaging—the retirement systems of states and their localities. Large pension plans are among the investors most actively focused on corporate-governance matters relating to the publicly traded companies in which they invest; but the governance structures of public pension funds typically lack many features that such funds champion for private companies. Specifically:

- **Public pension boards lack adequate fiduciary duties.** State and municipal funds are not subject to federal fiduciary duties that apply to private pension plans and are instead subject to a hodgepodge of typically more lenient state-law requirements. Only three states—Maryland, South Carolina, and Wyoming—have adopted fiduciary duties as recommended by the Uniform Law Commission's model Uniform Management of Public Retirement Systems Act.

- **Public pension boards lack diversity and financial expertise.** Among 87 boards studied by the National Association of State Retirement Administrators, 73 percent of all board members are plan beneficiaries or elected officials. A study by the National Education Association of 89 major public-education pension plans found that only 24 required at least one citizen financial expert on the board of trustees.

TO IMPROVE PUBLIC PENSION-BOARD GOVERNANCE, STATES SHOULD:

i. Improve board composition

- Require public-citizen members, members with financial expertise, and a "taxpayer advocate."
- Ensure that union representatives are not a majority of the board.
- Require pension-board members to undergo a mandatory training period.

ii. Define fiduciary duties

- Enact ethics and conflict-of-interest rules for board members.
- Require plan fiduciaries to make all investments for the exclusive benefit of beneficiaries according to a "prudent investor" standard.

iii. Implement systems and controls

- Prohibit pension-fund boards from lobbying for benefit enhancements for workers.
- Standardize the process of choosing discount rates / investment assumptions based on a formula, determined by an independent expert, that reasonably projects long-term rates of return.
- Prohibit boards from changing, at their own discretion, the "amortization period" (the time frame that a pension system commits to paying back its debt).
- Adopt a standard time period—regardless of political or fiscal conditions—over which pension systems will smooth the assets of a plan.
- Prohibit investing assets based on political agendas, including social investing and in-state investment plans.
- Prohibit surplus funds from investment gains from being automatically distributed to workers.
- Aim for 100 percent funding.
- Vest professional staff—in consultation with a separate investment board composed of qualified members operating independently of the plan's board of trustees—with investment decision-making authority.

SAFEGUARDING PUBLIC-PENSION SYSTEMS

A GOVERNANCE-BASED APPROACH

I. Introduction

Public pension funds for state and municipal workers in the United States have accumulated, by most recent estimates, approximately $4 trillion in obligations—roughly one-fourth of U.S. GDP and almost 130 percent of state and local governments' annual budgets—to fund government workers' retirements.[1] Actual assets available to fund these obligations, however, total only about $3 trillion, leaving a $1 trillion shortfall that threatens to jeopardize public employees' retirement security and/or burden the public fisc—potentially squeezing out vital spending on health, education, and infrastructure.[2] In 2014, for example, California governor Jerry Brown signed legislation that will require school districts to increase funding for teachers' pensions from less than $1 billion in school year 2014–15 to $3.7 billion by 2021.[3] The City of Peoria, Illinois, has seen the share of property-tax receipts that it spends on pension costs swell, from 18 percent in the early 1990s to 57 percent in 2015.[4]

Rather than scale back promised obligations or require current governments to account properly for promised future benefits, public pension plans have often shifted toward riskier asset classes and made aggressive assumptions about investment returns, in the hopes of making up the difference. Unfortunately, public pension funds' investment strategies in such risky asset classes may have been suboptimal. In a 2015 study for the Manhattan Institute, University of Tennessee finance professor Tracie Woidtke finds that the valuations of publicly traded companies in which public pension funds disproportionately invested their funds departed significantly from those in which private pension funds invested; and that public pension funds' portfolio companies tended to have lower valuations subsequent to the funds' investment decisions.[5]

One neglected area of attention in America's government-worker pension crisis has been the role that pension boards have played in managing—and, in some cases, mismanaging—the retirement systems of states and their localities. A number of prominent failures can be attributed to pension boards. In Detroit, even as the city spiraled toward bankruptcy, its pension board paid out nearly $1 billion in bonuses to retirees.[6] In 1999, the board of the California Public Employee Retirement System (CalPERS), the largest state/municipal public-employee retirement plan in the country, lobbied aggressively for benefit enhancements—money that ultimately contributed to the steep underfunding of California's public pension system.[7]

To date, little attention has been paid to how board composition and governance might increase the likelihood of such mismanagement: there has been some research (with somewhat inconclusive findings) on governance in the public sector, mostly focusing on the composition of the boards that run state and local pension systems, but almost no research on how the allocation of substantive powers to boards might influence the performance of government retirement systems.

The lack of academic scrutiny of such issues is surprising. Large pension plans are among the investors most actively focused on corporate-governance matters relating to the publicly traded companies in which they invest. Sometimes, such funds have pushed aggressively for procedural-governance mechanisms designed to increase the influence of beneficial equity owners, by eliminating staggered board structures or modifying director-election rules. In other instances, public pension funds have advocated for changes in publicly traded companies' board structures designed to mitigate agency costs between management and beneficiaries—such as eliminating "inside" director chairmanships or mandating increased director diversity. Finally, to lower agency costs, state and local pension funds have looked to impose actual substantive limits on governing boards' power, typically in the area of executive compensation.

The governance structures of public pension funds also often lack many features that such funds champion for private companies. In some instances, board diversity is completely nonexistent—as in New York State, where the public-employee pension plan's sole fiduciary is a single elected official. In other cases, governance boards are wholly dominated by "insiders"—in this case, public-employee union members, whose interests may diverge from plan beneficiaries' and taxpayers'. Board members charged with countering such inside interests on behalf of the broader public are often elected officials with larger mandates that may conflict with plan soundness and public protection, particularly in light of conflicting incentives brought about by public-employee unions' electoral influence.

In addition to questionable board composition, the boards of government retirement plans often wield considerably more substantive power than their counterparts in the private sector. One survey found that 68 percent of public retirement boards have some control over benefit decisions.[8] The survey also found that 88 percent of government pension boards exercised direct authority over the investment decisions of their funds, and 89 percent controlled the funds' actuarial assumptions, which are key components in calculating the funding levels and risks that a plan faces. In contrast, under the federal Pension Protection Act,[9] private-employer pension plans must discount projected future liabilities using market-based discount rates based on high-quality corporate bond yields; benefit payouts are limited for any plan less than 80 percent funded (deemed "at risk"); plan assets cannot be valued over more than a two-year "smoothing cycle"; and plan sponsors have to make up shortfalls within seven years. As such, private-employer sponsors of defined-benefit pension plans' actuarial and benefit decisions are sharply cabined, while plan sponsors have powerful incentives to limit investment volatility risk in their portfolios.

Public-employee pension-fund board members have sometimes lacked the expertise to make sensible decisions in these crucial areas. In other cases, boards have based their policies not on the best interests of those they are supposed to represent, including taxpayers, but on the influence exerted on boards by prominent special interests, including powerful elected officials and unions. Some of the largest public pension funds, including those for California employees and teachers and those for New York City and state employees, have placed substantial emphasis on social, political, and environmental concerns in managing their portfolio investments. Woidtke's research shows that public pension funds that embrace such strategies through shareholder-proposal activism have seen significantly lower company valuations in their portfolios than those that have not, at least for certain periods.

In the past several years, states and localities have passed dozens of pieces of legislation seeking to reduce their pension debt. But little of this legislation focuses on reforming the way pension systems are governed. Crucial reforms are still needed. This paper is designed to help shine a light on the way forward.

II. Public Pension-Plan Performance

Public Pension Funds: An Underfunding Problem

State and municipal pension plans exist to pay public employees benefits in retirement, as do defined-benefit pension plans for workers with private employers. Plan sponsors (in this case, state and local governments) manage assets directly to cover expected future liabilities—unlike pay-as-you-go retirement programs like federal Social Security and the portable, largely self-governed defined-contribution plans now commonplace in the private sector.

Crucial to the viability of public-employee retirement plans—at least without imposing significant new costs on the public, through higher taxes or reduced services—are the decisions to put away adequate resources to meet future promised obligations. The extent to which plans are adequately funded to meet future benefit payouts is determined by the "funded ratio," roughly the percentage of obligations met by investments, given actuarial assumptions. Plans set aside "annual required contributions," according to actuarial standards accepted by bodies such as the Government Accounting Standards Board, to meet expected future payouts.

During the last 15 years, the health of U.S. state and local pension plans has deteriorated, by almost any measure. Since 2000, such plans, in the aggregate, have gone from fully funded to 74 percent funded (**Figure 1**). In 2014, 63 percent of plans were less than 80 percent funded—the level deemed "at risk" for private-employer pension plans under the Pension Protection Act—and 20 percent were less than 60 percent funded (**Figure 2**).

FIGURE 1.

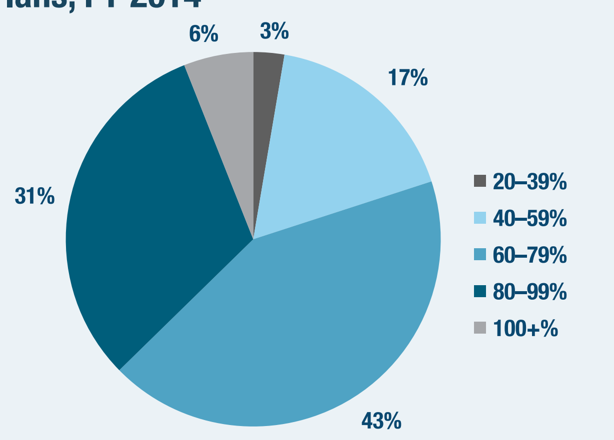
Funded Ratios, State and Local Pension Plans, FY 2000–14*

*Government Accounting Standards Board 25 Standards

Source: Munnell & Aubry 2015—Public Plans Database (PPD) (2001–14), Center for Retirement Research at Boston College

FIGURE 2.

Distribution of Funded Ratios for Public Plans, FY 2014*

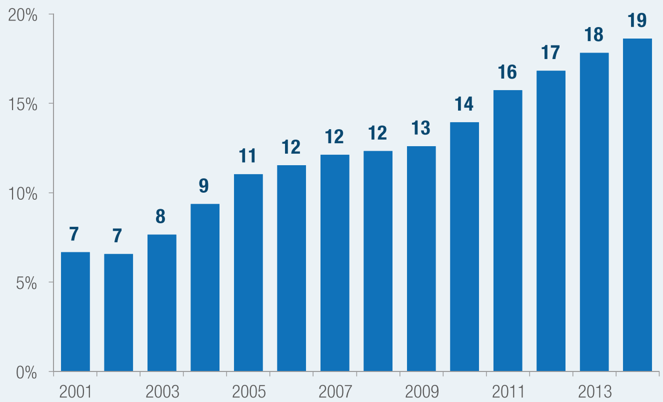


*Government Accounting Standards Board 25 Standards

Source: Munnell & Aubry 2015—Public Plans Database (PPD) (2001–14), Center for Retirement Research at Boston College

FIGURE 3.

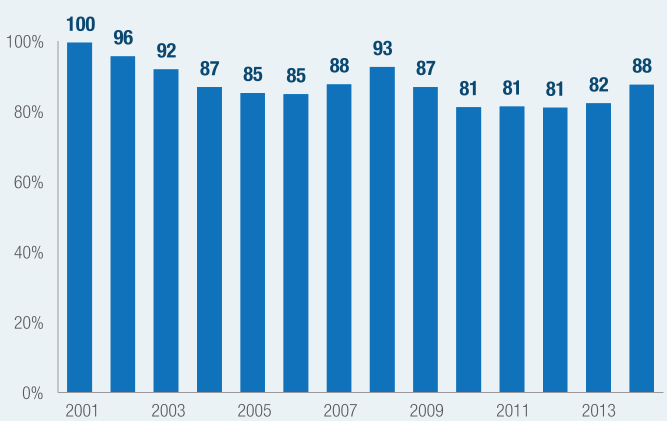
Required Contribution Relative to Payroll, State and Local Plans, FY 2001–14



Source: Munnell & Aubry 2015—Public Plans Database (PPD) (2001–14), Center for Retirement Research at Boston College

FIGURE 4.

Percentage of Required Contribution Paid, State and Local Plans, FY 2001–14*



*Government Accounting Standards Board 25 Standards

Source: Munnell & Aubry 2015—Public Plans Database (PPD) (2001–14), Center for Retirement Research at Boston College

As funding levels for public pensions have declined, their relative drag on the public fisc has grown. Required actuarial contributions to public pension funds, relative to state and local worker payrolls, have ballooned: from 7 percent at the turn of the century to 19 percent in 2014 (**Figure 3**). In a very real sense, public pension obligations are squeezing out other public funding, limiting current public services and investments to meet yesterday's obligations. Rather than confront this problem directly, public officials have tended not to make adequate required contributions to the pension system (**Figure 4**), essentially kicking the can down the road, while increasing the problem as pensions become more underfunded, absent unexpected investment portfolio gains.

Risk and Rate-of-Return Assumptions

Funded ratios do not capture pension plans' overall financial health because one plan's underlying assumptions may be more or less conservative—or accurate—than another's. Plans' benefit structures vary, as do worker and retiree population demographics, investment strategies, alternative funding sources, and abilities to change obligations or assumptions in the future.

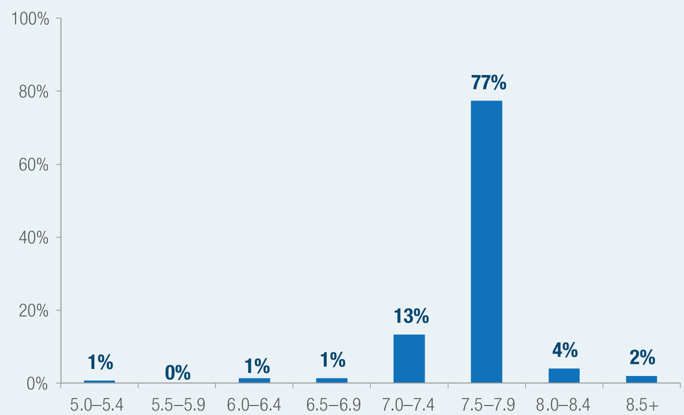
In general, accounting for such considerations makes the underlying problem of public pension underfunding look worse. Over time, public pension plans have sharply shifted investment strategies into riskier asset classes. In 1952, public-employee defined-benefit plans invested 96 percent of assets in cash and fixed-income investments; in 1992, 47 percent; in 2012, 27 percent; and in 2015, less than 19 percent.[10] In addition to corporate equities, public pension plans have invested more aggressively in alternative asset classes, such as hedge funds, private equity, real estate, and commodities: during 2006–12, the share of state and municipal pension-plan assets devoted to such investments grew from 11 percent to 23 percent.[11]

Corporate equities and other riskier asset classes yield higher returns, on average: this strategy led to significant increases in pension assets in the bull market of 1982–2000. Because the stock market can be volatile, however, the move away from conservative investments led to significant pressures on pension-plan assets during pronounced downturns in the early twenty-first century, as the stock Internet bubble and, later, the 2008 financial crisis reduced equity holdings. In 2008, state and local pension plans lost more than $700 billion in equity and mutual-fund value, as their stock portfolios declined by more than one-third.[12] As fund payouts continued, the funds' equity holdings did not recover to their 2007 values until 2013; over the same period, their unfunded liabilities grew by $1.1 trillion.[13]

As state and municipal pension plans have assumed more risk, they have also assumed rates of return that imply a higher risk premium. In the 1990s, as stocks returned 18 percent annually, on average, state and local pension plans' assumed rates of return—the median was 8 percent in 1992—were comfortably below plan returns.[14] Yet subsequent stock-market volatility has coincided with lower returns:

FIGURE 5.

Distribution of Assumed Rates of Return for Public Pension Plans, FY 2014



Source: Munnell & Aubry 2015—Public Plans Database (PPD) (2001–14), Center for Retirement Research at Boston College

FIGURE 6.

State and Local Pension-Plan Funded Ratios, Discounted by Riskless Rate, FY 2001–14

Source: Munnell & Aubry 2015—Public Plans Database (PPD) (2001–14), Center for Retirement Research at Boston College

since 2000, 3 percent–4 percent on average.[15] State and local pension plans, however, continue to assume aggressive rates of return: in 2014, the median assumption was 7.6 percent (**Figure 5**).

Growth in the assumed risk premium is indicated by comparison with 30-year Treasury bond yields: in 1992, 30-year Treasuries yielded 7.7 percent, compared with 2.8 percent today.[16] As such, the implied risk premium in state and local pension plans' rate-of-return assumptions in 1992 was 30 basis points (0.3 percentage points) over 30-year Treasuries; today, that risk premium has grown to 480 basis points (4.8 percentage points)—an increase in risk premium of 1,500 percent. In November 2015, America's largest state pension fund, CalPERS, voted to reduce its assumed rate of return, over time, from 7.5 percent to 6.5 percent.[17] Though such a shift is more in line with market realities, the 6.5 percent return target still assumes a risk premium of 370 basis points over 30-year Treasuries, more than 250 percent higher than in 1992, when CalPERS assumed a then-aggressive 8.75 percent rate of return.[18]

By assuming overly aggressive rates of return, state and municipal pension plans have both understated their unfunded liabilities and created incentives to invest in riskier assets in pursuit of returns. Rather than assuming rates of return in excess of 7 percent, if public pension plans assumed a 5 percent annual rate of return—a level that many financial economists would regard as a "riskless" rate—state and municipal pension plans would be only 50 percent funded (**Figure 6**).

Plan Shareholder Activism and Impact on Plan Returns

In recent years, many state and municipal pension plans have devoted significant attention to various environmental, social, or governance ("ESG") agendas that often have an attenuated, if any, relationship to shareholder value. A 2011 study, for instance, determined that the investment staff of funds in the California retirement system were required to follow 111 different investing directives—on the environment, social conditions, and corporate governance—imposed by the state legislature and the funds' board.[19]

In some instances, such directives involve negative restrictions on investment decisions, such as the current fad for divesting fund resources from petroleum-producing or other "climate impacting" companies. Such limitations generate press attention for social and policy advocates but do little more than reduce portfolio diversity without increasing returns. A 2008 California State Teachers' Retirement System (CalSTRS) report estimated that the fund lost $1 billion in potential gains after State Treasurer Phil Angelides pressured California's pension funds to divest from tobacco companies—just as their share prices had begun to rebound.[20] In 2015, the chief investment officer of CalSTRS told his board: "I've been involved in five divestments for our fund. All five of them we've lost money, and all five of them have not brought about social change."[21]

In other cases, public pension ESG criteria lead funds to invest affirmatively in asset classes for perceived social values, such as California's ill-fated decision to invest pension assets in local real estate. In 2000, the board of CalPERS, led by State Treasurer Angelides, debuted a "smart investments" campaign aimed at investing heavily in local real estate, including purchasing home loans made by California banks to low- and moderate-income families and encouraging residential building around the state. By 2006, the pension fund had pumped some $7 billion of new money into the sector: real estate grew from 5 percent of CalPERS's portfolio to 10 percent, even as America's real-estate bubble was inflating.[22] Among CalPERS's big bets was a nearly $1 billion investment in LandSource Communities Development, a Los Angeles–based real-estate firm that owned some 15,000 acres of land in the Santa Clarita Valley that it planned to turn into thousands of homes. When the real-estate boom ended, however, LandSource went bust and CalPERS's heavy bet on real estate backfired. By the end of 2009, the pension fund's property portfolio had declined by nearly 50 percent.[23]

Many state and municipal pension funds also attempt to affect the behavior of companies they invest in through various forms of shareholder activism, including prominently the process of introducing shareholder proposals on companies' proxy ballots. In 2015, almost one-fifth of all shareholder proposals were sponsored by pension plans for public employees.[24] Over the ten years covered in the Manhattan Institute's Proxy Monitor database, each of the five largest state- and municipal-employee pension plans—CalPERS, CalSTRS, the New York State Common Retirement Fund, the New York City Employees' Retirement Systems, and the Florida State Board of Administration—has sponsored shareholder proposals, though their level of activity, as well as their approaches to shareholder activism more broadly, has varied.

On average, the companies targeted by shareholder proposals by the five largest state and municipal pension funds during 2006–14 saw their share price underperform the broader S&P 500 index by 0.9 percent in the year following the shareholder vote. In 2015, an econometric study by Tracie Woidtke studied this relationship in more detail.[25] Building on a research methodology initially developed for her doctoral dissertation, Woidtke examined the valuation effects associated with pension-fund influence, assessed through industry-adjusted Tobin's Q, measured through ownership, on Fortune 250 companies, during 2001–13—controlling for various factors, including firm leverage, research and development expenses, advertising expenses, index membership, assets, positive income, stock-transaction costs, insider ownership, and year fixed effects. Overall, Woidtke finds that firm value "is negatively related to public pension fund ownership and positively related to private pension fund ownership"—and that, in particular, "ownership by public pension funds engaged in social-issue shareholder-proposal activism is negatively related to firm value."

III. Fiduciary Duties, Board Structure, and Governance

State and Municipal Pension-Plan Fiduciary Duties

Private pension plans in the U.S. are generally governed by the federal Employee Retirement Income Security Act of 1974 (ERISA), which prescribes fiduciary duties—principally to require those with discretionary control or authority over a pension plan "to run the plan solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits and paying plan expenses."[26] These duties apply to plan administrators, trustees, and members of plan investment committees, who may be personally liable for breaches of fiduciary duties. Among core fiduciary duties are: duty of prudence in investment decisions; duty to diversify investments; duty of loyalty (i.e., to avoid self-dealing and conflicts of interest); and duty to adhere to plan documents.

Although the federal Department of Labor traditionally interpreted these ERISA duties to preclude pension fiduciaries from using plan assets to further "social, legislative, regulatory, or public policy agendas,"[27] on October 22, 2015, the Obama Labor Department issued new guidance, Interpretive Bulletin 2015–01, that would appear to substantially loosen such strictures and empower plan administrators to invest in "economically targeted investments" (ETIs)—investments chosen to foster specific social goals such as economic development or home ownership in a particular state or area—or to use ESG criteria.[28]

ERISA rules do not apply to state or municipal public-employee pension plans, which are instead subject to state law. A minority of states impose a "prudent investor" rule similar to ERISA, either by statute or court common-law interpretations; other states apply a more lenient "prudent person" rule, so that fiduciary duties on prudent investment are interpreted to apply not professional-investor standards but rather those that a prudent person would adhere to if investing for his own account. A majority of states have conflict-of-interest rules. Most states also have ethics codes for public officials who oversee or manage pension funds.

In addition, a majority of states have some sort of "legal list" statute that limits certain investment choices by state or municipal pension plans—from total prohibitions on equity investments to prohibitions on types of investments deemed too speculative or against public policy. Many states also have statutes that encourage various noneconomic goals through pension-fund investments, including ETIs and allocation of resources to minority-owned investment managers or firms.

The Uniform Management of Public Retirement Systems Act (UMPERSA),[29] adopted in 1997 by the Uniform Law Commission, proposed a series of duties for public pension-plan fiduciaries, requiring that all "duties with respect to a retirement system" be discharged:

1. Solely in the interest of participants and beneficiaries
2. For the exclusive purpose of providing benefits to participants and beneficiaries and paying reasonable expenses of administering the system
3. With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an activity of like character and purpose
4. Impartially, taking into account any differing interests of participants and beneficiaries
5. In accordance with law governing the retirement program and system

To date, only Wyoming and Maryland have enacted UMPERSA, with South Carolina also using the model act to craft its fiduciary duties.

State and Municipal Pension-Plan Board Structure and Governance

Just as fiduciary duties vary broadly among states for public-employee pension funds, so, too, can the fiduciary actors—including boards—that oversee such funds (**Figure 7**). At one extreme lies the New York Common Retirement System, which is overseen by a sole fiduciary: the state comptroller, who is a partisan, elected official. Connecticut, Michigan, and North Carolina have oversight boards but vest fiduciary authority solely with a single official. Other states and municipalities have boards but place system assets under the oversight of a separate entity: Georgia, Iowa, Massachusetts, Minnesota, Nebraska, New Jersey, Rhode Island, South Carolina, South Dakota, Vermont, and Wisconsin, as well as Phoenix, the Illinois State Employees Retirement System, and the Montana Public Employees Retirement Board. Most states place at least some elected officials ex officio on trustee boards.

Some states have boards that are wholly appointed. For example, the Texas Municipal Retirement System and the Texas County and District Retirement System are overseen by boards in which each individual is appointed by the governor, with legislative confirmation. The current board members are all sitting or retired municipal officials[30]—presumably those deemed to have an appreciation of budget impacts imposed by pension management. Delaware has a mixed board, in which five members are appointed by the governor and confirmed by the legislature; and two others, the state secretary of finance and the director of the state's Office of Management and Budget, sit ex officio. Perhaps unsurprisingly, given Delaware's corporate-law focus, the appointed trustees are all investment professionals and others apparently selected for their financial expertise.[31]

Still other states give substantial sway to plan beneficiaries, with boards dominated by those elected by public employees or appointed or serving ex officio owing to public-employee-union status. In Louisiana, the 17-member board of the Teachers' Retirement System includes 12 members elected locally or statewide by public employees or other plan beneficiaries; the other five are ex-officio public officials.[32] CalPERS, the nation's largest state or municipal pension plan, has 13 board members: six elected by plan beneficiaries, four ex-officio public officials, and three appointees by either the governor or legislature.[33]

A survey by the National Association of State Retirement Administrators of 87 of the largest government pension funds found that 42 of them are dominated by plan beneficiaries.[34] Several others lack diversity in another way: they are composed, in the majority, of elected officials acting ex officio. On average, 73 percent of all board members in the 87 boards studied are plan beneficiaries or ex-officio elected officials. Eighteen of the 87 boards (more than 20 percent of all boards) have *zero* board members apart from plan beneficiaries or ex-officio elected officials; 29 (one-third of all boards) have no more than one outside board member who is not an elected official. Conversely, only 13 of 87 boards have a majority of board members who are not plan beneficiaries or ex-officio elected officials.

Apart from potential conflicts of interest between board members and sound financial management for the public interest, one significant shortcoming of current board structures is that many boards lack the kind of financial expertise that is so necessary to understanding the key issues in pension-fund governance. A study by the National Education Association (NEA) of major public-education pension plans found that only 24 of 89 funds surveyed required at least one citizen financial expert on the board of trustees.[35] The NEA recommended that for all plans, employees and plan beneficiaries should make up no more than 50 percent of the board, that private citizens should be included on the board, and that financial experts should be required on the board.

FIGURE 7.

Composition of Various Public Pension-Fund Boards

STATE RETIREMENT SYSTEM BOARD	BOARD SIZE	APPOINTED	ELECTED	PLAN MEMBERS	EX OFFICIO
AK—Alaska Retirement Management Board	9	7	0	5	2
AL—Alabama Teachers' Retirement System	14	0	10	10	4
AL—Alabama Employees' Retirement System	13	3	6	9	4
AR—Arkansas Teachers Retirement System	15	0	11	10	4
AR—Arkansas Public Employees Retirement System	9	6	0	6	3
AZ—Arizona State Retirement System	9	9	0	4	0
AZ—Arizona Public Safety Personnel Retirement System	5	5	0	4	0
AZ—Phoenix Employees' Retirement System	9	2	3	4	4
CA—California Public Employees Retirement System	13	3	6	6	4
CA—Los Angeles County Employees Retirement Association	9	4	4	4	1
CA—San Diego County Employees Retirement Association	9	4	4	4	1
CA—San Francisco City and County Retirement System	7	4	3	3	0
CA—California State Teachers Retirement System	12	5	3	4	4
CO—Colorado Public Employees Retirement Association	15	3	11	11	1
CT—Connecticut Teachers Retirement Board	12	5	5	5	2
DC—District of Columbia Retirement Board	12	6	6	6	0
DE—Delaware Public Employees' Retirement System	7	5	0	0	2
GA—Georgia Employees Retirement System	7	4	0	3	3
GA—Georgia Teachers Retirement System	10	8	0	6	2
IA—Iowa Public Employees Retirement System	11	6	0	3	5
ID—Idaho Public Employee Retirement System	5	5	0	2	0
IL—Illinois Municipal Retirement Fund	8	0	8	8	0
IL—Illinois State Employees Retirement System	13	6	6	6	1
IL—Illinois Teachers Retirement System	13	6	6	6	1
IN—Indiana State Teachers Retirement Fund	5	4	0	0	1
IN—Indiana Public Employees Retirement Fund	6	5	0	3	1
KS—Kansas Public Employees Retirement System	9	6	2	2	1
KY—Kentucky Retirement Systems	9	3	5	5	1
KY—Kentucky Teachers Retirement System	9	0	7	5	2
LA—Louisiana Teachers' Retirement System	17	0	12	12	5
LA—Louisiana State Employees Retirement System	9	0	6	6	3
MA—Massachusetts Teachers Retirement Board	7	2	2	3	3
MD—State Retirement and Pension System	14	6	5	11	3
ME—Maine State Retirement System	8	5	2	4	1
MI—Michigan Public School Employees Retirement System	12	11	0	6	1
MI—Michigan State Employees Retirement System	9	4	0	4	5
MI—Municipal Employees Retirement System of Michigan	9	3	6	7	0
MN—Minnesota Public Employees Retirement Association	11	5	5	9	1
MN—Minnesota State Retirement System	8	0	5	5	3
MN—St. Paul Teachers' Retirement Fund Association	10	0	9	9	1
MN—Duluth Teachers Retirement Fund Association	9	1	7	7	1
MN—Minnesota Teachers Retirement Association	8	1	5	5	2
MO—Missouri Local Government Employees Retirement System	7	1	6	6	0

MO—St. Louis Public School Retirement System	11	4	7	7	0
MO—Missouri State Employees Retirement System	11	6	3	3	2
MO—Missouri Public Schools Retirement System	7	3	4	4	0
MS—Mississippi Public Employees Retirement System	10	1	8	8	1
MT—Montana Public Employees Retirement Board	7	7	0	2	0
MT—Montana Teachers Retirement System	6	6	0	4	0
NC—North Carolina Retirement Systems	14	12	0	7	2
ND—North Dakota Public Employees Retirement System	7	3	4	4	0
ND—North Dakota Teachers Fund for Retirement	7	5	0	5	2
NE—Nebraska Retirement Systems	9	8	0	6	1
NH—New Hampshire Retirement System	13	12	0	8	1
NJ—New Jersey Teachers' Retirement Board	7	3	3	3	1
NJ—New Jersey Public Employees Retirement Board	9	3	6	6	0
NM—New Mexico Public Employees Retirement Association	12	0	10	10	2
NM—New Mexico Educational Retirement Board	7	3	2	3	2
NV—Nevada Public Employees Retirement System	7	7	0	7	0
NY—New York State Teachers Retirement System	10	5	4	6	1
NY—New York City Teachers Retirement System	7	2	3	3	2
OH—Ohio School Employees Retirement System	9	3	6	6	0
OH—Ohio Public Employees Retirement System	11	3	7	7	1
OH—Ohio State Teachers Retirement System	11	3	7	7	1
OH—Ohio Police and Fire Pension Fund	9	3	6	6	0
OK—Oklahoma Public Employees Retirement System	13	8	0	3	5
OK—Oklahoma Teachers Retirement System	13	11	0	6	2
OR—Oregon Employees Retirement System	5	5	0	2	0
PA—Pennsylvania State Employees Retirement System	11	10	0	6	1
PA—Pennsylvania Public School Employees Retirement System	15	2	6	5	7
RI—Rhode Island Employees Retirement System	15	2	6	6	7
SC—South Carolina Retirement Systems	5	0	0	0	5
SD—South Dakota Retirement System	16	3	13	13	0
TN—Tennessee Consolidated Retirement System	19	4	6	10	9
TX—Texas County and District Retirement System	9	9	0	9	0
TX—Texas Municipal Retirement System	6	6	0	6	0
TX—Austin Employees' Retirement System	11	5	5	6	1
TX—Texas Employees Retirement System	6	3	3	3	0
TX—Teacher Retirement System of Texas	9	9	0	6	0
TX—Houston Firefighters Relief/Retirement Fund	10	3	6	6	1
UT—Utah Retirement Systems	7	6	0	2	1
VA—Educational Employees' Supplementary Retirement System of Fairfax County	7	4	3	3	0
VA—Virginia Retirement System	9	4	5	4	0
VT—Vermont Teachers Retirement System	6	1	2	3	3
VT—Vermont State Employees Retirement System	8	1	4	4	3
WI—Wisconsin Retirement System	13	10	2	2	1
WY—Wyoming Retirement System	11	10	0	5	1

Source: National Association of State Retirement Administrators

Discussion

Overseeing and managing public pension funds involve significant challenges of ownership and control. In essence, such funds have *two* sets of "owners": plan beneficiaries, who depend on investments for their retirement security; and the public at large, which is typically responsible for paying plan benefits in the event of shortfall—thus requiring higher levels of taxation and/or reductions in public services. The extent to which risks in plan management fall on one or the other sets of owners depends on state laws, including constitutional requirements, that govern plan benefit structures. In instances in which state constitutions prohibit any changes to benefits previously promised, investment risk falls disproportionately on the broader public—though, in extreme cases, such constitutional provisions could be preempted by federal bankruptcy law in the event that a state or municipality is unable to meet its obligations.

The ownership and governance problems in managing state and municipal pension plans thus parallel, but materially differ from, those in either the private pension arena or the traditional corporate-governance arena. In private pension law, strict ERISA fiduciary duties are necessary to prevent sponsoring employers, as plan administrators, from risking employees' and retirees' plan assets by underfunding pension plans or misallocating assets. In corporate law, because corporate dividend payments are discretionary rather than mandatory and because equity investors are otherwise unable to protect their interests contractually, owners of common stock face significant "agency costs": absent additional protections for equity owners, managers may choose to pay themselves salaries that deplete the residual earnings available to shareholders, or avoid strategies that investors might prefer they take because they imperil their own job security. To protect against these agency costs, owners of equity shares have traditionally been protected by common-law fiduciary duties and voting rights (chiefly, the ability to elect directors). Investors in publicly traded corporations are, of course, also able to sell their shares and, thus, are protected by right of exit.

In recent years, public pension funds have been keenly involved in shareholder-activism campaigns that are putatively designed to mitigate agency costs by modifying corporate board structures. Among such efforts are various funds' campaigns to eliminate staggered boards (coordinated by Harvard law professor Lucian Bebchuk);[36] CalPERS's effort to require directors to be elected by a majority of voting shareholders, rather than seating directors who receive only a plurality of shareholder support;[37] efforts to ensure that boards have more diverse slates of directors; efforts to require companies to have an "independent" chairman, separate from management; and the New York City pension funds' effort, spearheaded by City Comptroller Scott Stringer, to give investors the ability to nominate their own directors on company proxy ballots, to compete with board-nominated candidates.[38] In addition, public pension funds have played an increasing role in overseeing companies' executive-compensation plans.

The drive to increase board accountability to shareholders stands in significant tension with the lack of appropriate accountability mechanisms in the fiduciary duties and structures of public pension-fund boards. The latter is a crucial weakness. As a World Bank report observed: "The establishment of a fit and proper governing body for public pension funds thus may be even more important than the maintenance of a comparable body for private sector corporations."[39] Because there are two sets of "owners" with interests in fund management—plan beneficiaries and the taxpaying public—ownership costs become a more serious problem than in traditional private fund management. Moreover, in addition to traditional duty of loyalty and duty of care concerns in the corporate-governance and private-plan context—the typical worries about managers absconding owners' assets or being lax in overseeing them—many board members or other fiduciaries of public-plan assets have agency costs owing to the social or political goals of the trustees.

Such agency costs exist for both plan beneficiaries' representatives and for ex-officio publicly elected officials. Plan beneficiaries may choose to take imprudent risks with plan assets because the government—ultimately, the taxpayers—is on the hook for such decisions. They may also wish to allocate plan assets or engage in shareholder activism campaigns to reward or punish corporations, investment managers, or their executives for public statements or political involvement perceived to help or hurt public employees' hiring, pay, or benefits—without regard to the company's or investor's soundness, in terms of plan-investment strategy.

Elected officials may themselves be compromised in the same direction, particularly in areas in which public-employee unions or political activism are strong. They may also hope to invest plan assets according to social, political, or environmental concerns. For example, since 2010, the New York State Common Retirement Fund—under the direction of a single, partisan elected official, currently Thomas DiNapoli (D)—has been particularly aggressive in filing shareholder proposals with a social, political, or environmental bent at large, publicly traded corporations. Looking at those proposals introduced among the 250 largest such companies, as recorded in the Manhattan Institute's Proxy Monitor database, 63 percent of the New York State Common Retirement Fund's shareholder proposals have involved corporate political spending or lobbying, 21 percent have involved environmental issues, and 9 percent have involved employment rights, such as sexual orientation and gender-identity discrimination.[40] In 2015, New York City comptroller Scott Stringer, an elected Democrat, launched a broad "proxy access" campaign seeking more shareholder power to nominate board directors. Although the sought change involved a corporate-governance concern, Stringer selected a methodology for determining which companies to target that was driven not by share value but rather by social concerns like climate change and racial and gender diversity on the company board.[41]

Academic research on how board makeup influences the performance of government retirement systems is not wholly conclusive. Some studies have found that boards dominated by plan members invest more poorly and are more likely to be underfunded;[42] other studies suggest that boards largely run by ex-officio members perform less well than those in which active members dominate.[43] One reason for the varying results may be that the nature of the board itself evolves over time, as the politics of a state or municipality change. Assessed overall, however, the research leads to a firm inference about board composition—namely, that boards dominated by one type of member (whether elected officials, or active members of the pension system and union officials) tend to do less well than diverse boards, particularly those with required financial expertise. Given the noteworthy lack of diversity on many pension boards—and the tendency for boards to be overloaded by employees or elected officials, without financial expertise—there is a compelling case for rethinking board structures.

IV. Policy Recommendations

Board Composition

Reforms should strive for more balance in boards, including requiring public-citizen members and members with financial expertise. Ideally, boards should have a majority of members who are *not* union members or other beneficiaries of the pension system. States and cities would also do well to consider adding at least one member whose sole role should be to look out for the interests of taxpayers—a so-called taxpayer advocate—to bring more balance to boards. Pension-board members should also undergo a mandatory training period before assuming their duties so that they can clearly understand the complex design of pension systems and the long-term consequences of decisions they make.

Fiduciary Duties

States should adopt well-defined fiduciary duties for all public pension boards. The Uniform Management of Public Retirement Systems Act may serve as a possible template for such duties. At a minimum, states should have ethics rules, conflict-of-interest rules, and an investment standard—preferably a higher-threshold "prudent investor" rather than a more lenient "prudent person" requirement. The former standard, which assumes the prudence exercised by an investment professional rather than by an ordinary citizen investing in his own account, is appropriate for public pensions upon which beneficiaries and taxpayers rely.

Systems and Controls

One study on government pension funds defines governance as "the systems and processes by which a company or government manages its affairs with the objective of maximizing the welfare of and resolving the conflicts of interest among its stakeholders."[44] The emphasis on systems and processes is a reminder that governance reform should not be simply about changing the makeup of a board. Rather, states and cities should seek as much as possible to institutionalize how pension funds govern themselves by enshrining best practices into their bylaws and, in the process, removing key decisions from the discretion of board members. Under this scenario, the boards of pension funds become watchdogs, ensuring that the funds are operating in accordance with principles already laid out in the governing structure of a retirement system. Board members, however, would not have the ability to alter those principles on their own.

GOVERNMENT PENSION SYSTEMS WOULD DO WELL TO ADOPT THE FOLLOWING GOVERNANCE BEST PRACTICES:

Prohibit pension-fund boards from lobbying for benefit enhancements for workers.

The role of the board should be to serve as watchdog over the system. But in too many cases, board members become advocates for causes. Detroit's pension board defended and advocated for paying pension bonuses to workers. CalPERS's board lobbied aggressively for benefits enhancements in 1999; these benefits, enacted the next year, sharply increased the cost of California's retirement system.[45] Workers have other advocates, especially unions, to represent them in their quest for benefits. Worker advocacy should not be the role of a fund board.

Standardize the process of choosing discount rates / investment assumptions based on a formula, determined by an independent expert, that reasonably projects long-term rates of return.

One academic study found that many pension systems tend to set discount rates and other key variables in response to fiscal stress that their governments face. In 1992, for instance, New Jersey's legislature passed legislation to change its retirement system's discount rate to reduce the state's annual contribution to its pension system and to more easily balance its budget.[46] That made this crucial measure of a pension system's health a victim of the political process. Governments must remove this variable from the governance of pensions. The Society of Actuaries, for example, recommends a formula that uses a risk-free rate, blended with historical stock-market returns, to determine an appropriate discount rate for pension plans.

Prohibit boards from changing, at their own discretion, the "amortization period" (the time frame that a pension system commits to paying back its debt).

According to standard actuarial practice, a pension system should seek to pay off any underfunding while workers are still active. Typically, such payoff plans should aim to eliminate debt in 20 years or less because, in most public pension systems, the bulk of current workers will retire in 15–20 years. But many public pension systems have amortization plans that extend to 30 and 40 years, which places the burden for paying off debt for the pensions of today's workers on future taxpayers. In some cases, pension boards have instituted and extended these plans specifically to reduce the cost of pensions on current taxpayers, sometimes at the behest of politicians seeking budget relief. This inevitably contributes to underfunding.

Adopt a standard time period—regardless of political or fiscal conditions—over which pension systems will smooth the assets of a plan.

Asset-smoothing is the process of calculating the assets of a pension plan over a multiyear period in order to cushion the blow from sharp drops in the market. Determining the level of assets that a pension system holds is crucial to understanding the health of that system. Best practices allow for a pension system to smooth its assets over a three-to-five-year period. But pension boards have sometimes manipulated this crucial measure of assets to make a retirement system's financial position seem better than it actually is—and, in the process, reduce contributions by governments. In 2005, for instance, CalPERS's board extended its smoothing period to 15 years so that the fund's robust performance in the mid-1990s could be combined with losses in later years to give the fund the appearance that it was in better shape.[47] There is no justification except political expedience for such changes.

Prohibit investing assets based on political agendas, including social investing and in-state investment plans.

The bulk of money that states and cities are promising workers is meant to come from investment gains. So a fund's investment strategy should focus exclusively on maximizing its investment returns. But state legislatures and pension boards have clouded that mission by loading financial managers with a host of investment restrictions. Both anecdotal evidence and empirical research suggest that social- and policy-related investing restrictions and shareholder activism are associated with lower investment returns.

Prohibit surplus funds from investment gains from being automatically distributed to workers.

Surpluses from investment gains are meant to offset years in which a fund's assets decline because of poor market performance. But surpluses have become a tool by which politicians ingratiate themselves to workers by granting them bonuses or higher benefits. San Diego consistently paid out bonuses to pensioners in years when investment returns exceeded projections, even when the city's fund was foundering. Called in to investigate the collapse of the San Diego pension system, former Securities and Exchange Commission chairman Arthur Levitt observed: "Designating earnings in excess of 8 percent as 'surplus' made it look as if the City could grant additional benefits without providing a funding source for them. This impression was (and is) misleading."[48]

Aim for 100 percent funding.

A growing trend among board members and politicians is to declare that pension funds can function adequately if they aim for less than full funding. The aim of these declarations is to lower the cost of paying off pension debt by reducing the target for full funding. But in a system in which investment returns are the crucial component in accumulating assets for workers, aiming for just 80 percent funding, for instance, means that a retirement system's goal is to have at least 20 percent of the money it needs to be at work producing investment returns missing from the system. That puts added pressure on investment managers to produce higher returns with the money they have available and increases the likelihood that a pension system will have to tap taxpayers and workers for higher contributions.

Vest professional staff—in consultation with a separate investment board composed of qualified members operating independently of the plan's board of trustees—with investment decision-making authority.

Some of the biggest problems plaguing pension systems have been caused by investment committees composed of inexperienced or politically motivated members who made investment decisions that caused steep losses for funds. For 13 years, the investment board of the country's largest government pension fund, CalPERS, was led by a former union leader with no investing experience, who twice filed for personal bankruptcy. During his tenure, CalPERS consistently granted investment contracts to some of the state's biggest political givers and had one of the worst investment records of any public pension fund.[49] Similarly, the board of the New Orleans Fire Fighters Pension & Relief Fund, dominated by members without expertise, engaged in a series of disastrous investments, including in a Cayman Islands hedge fund that turned out to be a Ponzi scheme and two golf courses that suffered big losses, which depleted the assets of the fund and sparked a crisis that is ongoing to this day.[50] Establishment of an independent investing board, working in conjunction with the chief investment officer of a fund, can help avoid these kinds of breakdowns. The role of a pension fund's overall board in this organizational structure would be to monitor the work of these investment experts to ensure that they follow fund guidelines and, over the long term, achieve the fund's investment objectives. But the pension fund's board should have no direct say in investment decisions.

Endnotes

1 Pew Charitable Trusts and Laura and John Arnold Foundation, "State Public Pension Investments Shift over Last 30 Years" (June 2014), 1, http://www.pewtrusts.org/en/research-and-analysis/reports/2014/06/03/state-public-pension-investments-shift-over-past-30-years. GDP data are available at http://www.bea.gov/national/an1.htm. State and local budget data are available at http://www.census.gov/govs/local.

2 Pew, "State Public Pension Investments," 1.

3 John Fensterwald, "In Revised Budget, Gov. Brown Details Costly 30-Year Plan to Fix Teacher Pensions," *EdSource*, May 13, 2014, http://edsource.org/2014/in-revised-budget-brown-details-costly-30-year-plan-to-fix-teacher-pensions/63570.

4 Steven Markowitz, "Public Sector Employee Pensions Devouring Tax Revenues," February 4, 2015, http://gooddebtbaddebtbook.com/politics-and-debt/public-sector-employee-pensions-devouring-tax-revenues.

5 Tracie Woidtke, "Public Pension Fund Activism and Firm Value," Manhattan Institute (September 2015), https://www.manhattan-institute.org/html/public-pension-fund-activism-and-firm-value-7871.html. See also Roberta Romano, "Public Pension Fund Activism in Corporate Governance Reconsidered," *Columbia Law Review* 93 (1993): 795, http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=2987&context=fss_papers.

6 Nathan Bomey and John Gallagher, "Nearly $1 Billion in Bonuses Paid from Ailing Detroit Pension Fund," *Detroit Free Press*, September 8, 2013.

7 Steven Malanga, "The Pension Fund That Ate California," *City Journal* (Winter 2013), http://www.city-journal.org/2013/23_1_calpers.html.

8 David Hess and Gregorio Impavido, "Governance of Public Pension Funds: Lessons from Corporate Governance and International Evidence," World Bank Policy Research Working Paper 3110, August 2003, 24, http://elibrary.worldbank.org/doi/abs/10.1596/1813-9450-3110.

9 Pension Protection Act of 2006, Pub. L. 109–280, 120 Stat. 780.

10 Pew, "State Public Pension Investments," 2. Fuller data are available at Z.1 Financial Accounts of the United States, Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts, Third Quarter, 2015, http://www.federalreserve.gov/releases/z1/current/z1.pdf, L.120.b.

11 Pew, "State Public Pension Investments," 6.

12 Z.1 Financial Accounts of the United States, Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts, Historical Annual Tables 2005–2014, http://www.federalreserve.gov/releases/z1/current/annuals/a2005-2014.pdf, L.120.b.

13 Ibid.

14 Pew, "State Public Pension Investments," 3.

15 Ibid., 3–4.

16 Ibid., 4–5. Updated Treasury yield-curve data are available at https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/default.aspx.

17 Rory Carroll, "CalPERS Vote to Lower Investment Return Target Draws Governor's Ire," Reuters, November 18, 2015, http://www.reuters.com/article/us-california-calpers-policy-idUSKCN0T805420151119.

18 Pew, "State Public Pension Investments," 5.

19 Mercer, "Responsible Investment's Next Decade: Developing CalPERS Total Fund Process for ESG Integration," August 2011, 3, https://www.calpers.ca.gov/docs/forms-publications/mercer-report-next-decade.pdf.

20 Pat Geyer, "Report on CalSTRS Meeting," September 4–5, 2008, 5, http://www.calrta.org/dbfiles/nn69mgxs9.pdf.

21 Chriss W. Sweet, "CalSTRS Risks Losing Money if It Divests from Fossil Fuels," *Breitbart*, April 7, 2015, http://www.breitbart.com/california/2015/04/07/calstrs-risks-losing-money-if-it-divests-from-fossil-fuels.

22 Malanga, "The Pension Fund That Ate California."

23 Ibid.

24 James R. Copland and Margaret M. O'Keefe, "Proxy Monitor 2015: A Report on Corporate Governance and Shareholder Activism," Manhattan Institute (September 2015), 9, http://www.proxymonitor.org/pdf/pmr_11.pdf.

25 Woidtke, "Public Pension Fund Activism," 4.

26 U.S. Department of Labor, "Health Plans & Benefits: Fiduciary Responsibilities," http://www.dol.gov/general/topic/health-plans/fiduciaryresp.

27 U.S. Department of Labor, Office of the Inspector General, "Proxy-Voting May Not Be Solely for the Economic Benefit of Retirement Plans," March 31, 2011, http://www.oig.dol.gov/public/reports/oa/2011/09-11-001-12-121.pdf.

28 News Release, U.S. Department of Labor, "New Guidance on Economically Targeted Investments in Retirement Plans from U.S. Labor Department," October 22, 2015, http://www.dol.gov/opa/media/press/ebsa/ebsa20152045.htm.

29 Uniform Law Commission, Management of Public Employee Retirement Systems Act Summary, http://www.uniformlaws.org/ActSummary.aspx?title=Management%20of%20Public%20Employee%20Retirement%20Systems%20Act. The full model act is available at http://www.uniformlaws.org/shared/docs/management_public_employee_retirement_systems/retirsys_amdraft_jul97.pdf.

30 Texas Municipal Retirement System, "TMRS Board of Trustees," http://www.tmrs.org/board.php; Texas County and District Retirement System, "Financially Strong Since 1967," https://www.tcdrs.org/AboutUs/Pages/Governance.aspx.

[31] Delaware Public Employees' Retirement System, "Annual Report 2012," 11, http://auditor.delaware.gov/Reports/FY2013/DPERS%20FY12.pdf.

[32] Teachers' Retirement System of Louisiana, "TRSL Board of Trustees," https://www.trsl.org/main/about_trsl/board_of_trustees.

[33] CalPERS, "Board Members," https://www.calpers.ca.gov/page/about/board/board-members.

[34] Bob Patrician, "Survey of Trustees Board Composition and Pension Investment Policies Among Public Employee, Teacher and University Pension Plans," Appendix 2, 8–9, Update as of 2010, http://www.upte.org/benefits/survey-trustees.pdf.

[35] National Education Association, *Characteristics of Large Public Education Pension Plans* (Washington, D.C.: National Education Association, 2004).

[36] Shareholder Rights Project, "Investors Working with the SRP Clinic," http://srp.law.harvard.edu/clients.shtml.

[37] Phyllis Plitch, "Calpers Majority Vote Push Could Propel Issue Forward," *Dow Jones Newswires*, March 15, 2005, http://www.law.harvard.edu/programs/corp_gov/MediaMentions/DowJones_Mar.15.2005.pdf.

[38] Press Release, "Comptroller Stringer, NYC Pension Funds Launch National Campaign to Give Shareowners a True Voice in How Corporate Boards Are Elected: New York City Pension Funds File 75 Proxy Access Shareowner Proposals to Kick Off the Boardroom Accountability Project," http://comptroller.nyc.gov/newsroom/comptroller-stringer-nyc-pension-funds-launch-national-campaign-to-give-shareowners-a-true-voice-in-how-corporate-boards-are-elected.

[39] Hess and Impavido, "Governance of Public Pension Funds," 1.

[40] Copland and O'Keefe, "Proxy Monitor 2015," 16.

[41] Press Release, "Comptroller Stringer."

[42] E.g., Tongxuan (Stella) Yang and Olivia S. Mitchell, "Public Sector Pension Governance, Funding and Performance: A Longitudinal Appraisal," in *Pension Fund Governance: A Global Perspective on Financial Regulation*, ed. John Evans, Michael Orszag, and John Piggott (Cheltenham, U.K.: Edward Elgar, 2008), 179.

[43] E.g., Natalya Shnitser, "Funding Discipline for U.S. Public Pension Plans: An Empirical Analysis of Institutional Design," *Iowa Law Review* 100 (2015): 699; Romano, "Public Pension Fund Activism," 825–27.

[44] Jeffrey Carmichael and Robert Palacios, "A Framework for Public Pension Fund Management," 2nd Public Pension Fund Management Conference, World Bank, Washington DC, May 5–7, 2003, 7.

[45] Malanga, "The Pension Fund That Ate California."

[46] Pension Revaluation Act of 1992. For a discussion, see Katie Brenner, "The Public Pension Bomb," *Fortune*, May 12, 2009, http://archive.fortune.com/2009/05/12/news/economy/benner_pension.fortune/index.htm.

[47] Marc Lifsher, "CalPERS Plan to Blunt Effect of Losses Slated for Vote," *L.A. Times*, June 17, 2009, http://articles.latimes.com/2009/jun/17/business/fi-calpers17.

[48] Quoted in Steven Malanga, "No Bonus for Taxpayers," *City Journal* (Spring 2015), http://www.city-journal.org/2015/25_2_snd-bonuses.html.

[49] Malanga, "The Pension Fund That Ate California."

[50] Robert McClendon, "10 Investments That Helped Sink the Firefighters' Pension Fund," *Times-Picayune*, April 30, 2015, http://www.nola.com/politics/index.ssf/2015/04/10_outrageous_investments_that.html.

March 2016

REPORT 3

Abstract

To date, little attention has been paid to the role that pension boards have played in managing—and, in some cases, mismanaging—the retirement systems of states and their localities. Large pension plans are among the investors most actively focused on corporate-governance matters relating to the publicly traded companies in which they invest; but the governance structures of public pension funds typically lack many features that such funds champion for private companies.

Key Findings

1. State and municipal employees' public pension funds have obligations that total, in the aggregate, almost 130 percent of state and local governments' annual budgets: on average, the assets available to meet these obligations fall well short of the amount necessary—by some $1 trillion, even under such plans' own overly rosy growth assumptions.

2. Public pension boards lack adequate fiduciary duties: state and municipal funds are not subject to federal fiduciary duties that apply to private pension plans and are instead subject to a hodgepodge of typically more lenient state-law requirements.

3. Public pension boards lack diversity and financial expertise: among 87 boards studied by the National Association of State Retirement Administrators, 73 percent of all board members are plan beneficiaries or elected officials; a study by the National Education Association of 89 major public-education pension plans found that only 24 required at least one citizen financial expert on the board of trustees.

MANHATTAN INSTITUTE