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KEEPING THE PROMISE:
GETTING POLITICS OUT OF PENSIONS

ALEC American Legislative Exchange Council

LIMITED GOVERNMENT • FREE MARKETS • FEDERALISM

Center for
State Fiscal
Reform

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The Center for State Fiscal Reform strives to educate policymakers, the media and the general public on the principles of sound fiscal policy and the evidence that supports those principles. This is done by personalized research, policy briefings in the states and by releasing nonpartisan policy publications for distribution, such as *Rich States, Poor States: ALEC-Laffer State Economic Competitiveness Index*.

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Executive Summary

Pensions are a valuable non-wage benefit that a large majority of state and local governments offer their employees as part of their compensation packages. With approximately $3.8 trillion in total assets, millions of workers rely on the promises made by governments to provide a secure retirement through a lifelong pension. In order to keep these promises, pension funds should be managed for the exclusive purpose of providing retirement benefits to workers, with pension trustees doing their best to achieve the greatest possible return on investments.

Unfortunately, many lawmakers and pension plan officials have other priorities besides doing what is best for workers. They see the billions of pension fund dollars they manage as an opportunity to advance their own agendas. Rather than investing to earn the best return for workers, they use pension funds in a misguided attempt to boost their local economies, provide kickbacks to their political supporters, reward industries they like, punish those they don't and bully corporations into silence and behaving as they see fit.

As lawmakers and trustees knowingly make inferior investment decisions, sacrificing better returns in order to advance political agendas, pension funding declines, jeopardizing workers' retirement benefits and leaving taxpayers to pick up the tab. This reckless decision to place political agendas ahead of what's best for workers is known as pension fund cronyism, and it is happening every year in pension funds across the country. This report exposes these dishonest practices and shows state and local policymakers what they can do to get politics out of their pensions and focus on keeping the promise to workers and retirees alike.

Chapter 1
Background on Public Pension Systems

Before addressing the many forms of pension fund cronyism in detail, some background on the mechanics and current underfunded status of public pensions is necessary. While pension fund cronyism is always detrimental, the alarming and deteriorating state of public pension funds underscores the critical need to get politics out of pensions.

There are three main reasons why most public pension plans are in such trouble. The first relates to the actual funding of the plans. This includes both how the funding required from state and local governments is calculated each year and their commitment to making those payments. The second is related to the structure of the plans themselves, which permits state and local governments to get away with underfunding pension plans for political convenience. The third relates to weak fiduciary standards that enable pension board members and fund managers to use public pension funds to advance political agendas at the expense of securing the best returns on pension investments. An examination of these causes is crucial to understanding the depth and breadth of the problem, and the steps policymakers need to take in order to comprehensively fix public pensions going forward.

Public Pension Plans in the United States

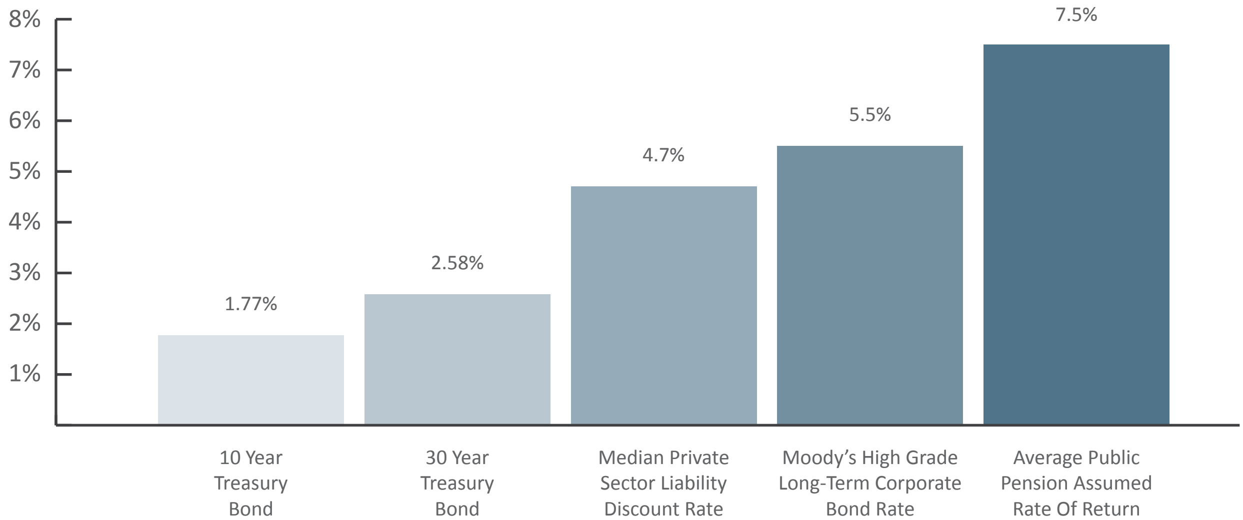
Nearly all state public pension plans operate on what is called a defined-benefit model. In defined-benefit plans, pension systems collect fund contributions from employees, their government employers (such as school districts) and the state or local government itself. The money is then invested on behalf of those participating in the pension system. That fund is then used to pay obligations to retirees. A defined-benefit pension plan guarantees, upon retirement, an employee will receive a specific benefit each period, regardless of market performance or contributions into the system.

While the amount that employees are required to contribute to a defined-benefit pension system is typically set through collective bargaining or other contractual negotiations, and the contribution from government employers is often derived from these negotiations or state law, the amount the state or local government directly contributes is calculated differently. Actuaries calculate the amount the government must contribute to the pension system every year, known as the "annual required contribution" (ARC), based on the number of people in the system, their expected work years, retirement duration and the expected rate of return on the fund's investments. This last variable, the "discount rate," has a significant effect on how large a government's ARC payment will be. As states and cities increase the discount rate, their ARC payments decrease. This is because the higher the investment returns assumed by the plan, the less money the state or local government must contribute through the ARC payment to keep the plan well-funded.

Unfortunately, the vast majority of public pension plans rely on unrealistically high assumptions, often expecting a whopping seven percent or more return — in each and *every year*.[1] This is problematic because most financial experts believe assuming regular returns at these rates is unrealistic. Simply put, the expected return on investment state and local governments use to calculate ARC payments is far too high.

Lowering the expected rate of return on pension investments to a more reasonable level would serve to mitigate financial risks and help improve long-term plan solvency. In fact, these unrealistic assumptions led *The Economist* to declare in 2013 that "States need to wake up. The priority is to make taxpayers aware of the scale of the problem by accounting for it properly, rather than pretending the stock market fairy will magic it away."[2]

FIGURE 1: COMPARISON OF POPULAR RATES OF RETURN



Source: Bloomberg, The Economist and California Policy Center[3]

What happens when a pension fund fails to achieve its expected rate of return? If market returns on a pension's investments fall below expectations, the state or local government is responsible for making up the difference with additional funding beyond the ARC payment. This usually means the state or municipality must raise taxes, cut the budget or borrow money to cover the pension fund's underperformance. Alternatively, some state and local governments simply decline to make this additional payment, or supply only part of the necessary funds. They opt to "kick the can down the road," leaving the pension system underfunded and with fewer assets to invest, setting the state or local government up to have to make even larger payments to fund pension liabilities in the future.

The failure of state and local governments to make these additional payments, or in many cases, even their baseline ARC payments, is one of the major reasons why public pensions' funded ratios have declined precipitously in the last several years. The assumed investment returns have not materialized and many state and local governments have failed to contribute what is required to maintain funding levels.

Part of the reason investment returns have fallen short is because state and local governments have failed to adequately police their pensions' trustees, both pension board members and pension fund managers. They have not reined in trustees who play politics when it comes to pension investment decisions. By directing pension funds to inferior investments for their alleged local economic benefit, to reward their supporters or to attack various industries, many trustees have cost their pension systems billions of dollars in foregone returns and have left state and local governments, pensioners and ultimately the taxpayer with the bill.

Public Pensions Significantly Underfunded

Although rarely in the spotlight, unfunded liabilities in state and municipal public pension systems are among the most significant financial challenges for lawmakers, government workers and taxpayers across the United States. Unlike one-time budget problems that result from natural disasters or a cycle of weak revenue collections, nearly all public pension systems carry long-term financial liabilities that are perpetually increasing as policymakers fail to take action.

The high-profile bankruptcies of Stockton and San Bernardino, California, followed by Detroit, Michigan, have increased public awareness around the issue of unfunded public pension liabilities and helped affirm that these problems will not simply disappear. These examples, along with many others, have highlighted the severe financial risk unfunded public pension liabilities present.

The scale of the unfunded liabilities public pensions now face is shocking. While estimates vary, largely depending on the investment rate of return one assumes, it is generally agreed many public pension funds are heading down the road to major financial problems, and eventually, insolvency. According to the ALEC Center for State Fiscal Reform report, *Unaccountable and Unaffordable 2016*, when a risk-free rate of return is used, the national funded ratio for state pension plans is a meager 35.1 percent, with almost $5.6 trillion in unfunded liabilities.[4] That staggering figure is more than 30 percent of the gross domestic product (GDP) of the United States.[5] The Society of Actuaries, in their *Report of the Blue Ribbon Panel on Public Pension Plan Funding*, recommends pension plans utilize a "risk-free" rate of return, like the ALEC report does, since benefits must be paid to retirees regardless of market returns.[6]

TABLE 1: 2016 STATE PENSION UNFUNDED LIABILITIES

STATE	FUNDED RATIO	UNFUNDED LIABILITIES	UNFUNDED LIABILITIES PER CAPITA
Alabama	30.3%	$74,957,966,779	$15,427
Alaska	31.4%	$31,715,653,280	$42,950
Arizona	31.2%	$90,710,340,087	$13,285
Arkansas	36.4%	$43,976,220,971	$14,766
California	35.6%	$956,081,787,553	$24,424
Colorado	30.3%	$106,382,900,927	$19,496
Connecticut	22.8%	$99,299,024,840	$27,653
Delaware	44.7%	$11,262,866,330	$11,907
Florida	40.5%	$210,153,896,482	$10,367
Georgia	38.8%	$122,645,214,077	$12,007
Hawaii	29.2%	$35,136,593,006	$24,544
Idaho	46.5%	$16,572,789,476	$10,014
Illinois	23.8%	$362,646,966,724	$28,200
Indiana	34.8%	$56,748,217,042	$8,573
Iowa	39.8%	$46,424,775,242	$14,861
Kansas	29.9%	$40,737,986,356	$13,991
Kentucky	23.4%	$95,946,947,928	$21,682
Louisiana	31.3%	$94,320,807,435	$20,194
Maine	42.1%	$17,676,038,583	$13,297
Maryland	33.1%	$93,343,409,896	$15,541
Massachusetts	27.7%	$126,677,266,263	$18,644
Michigan	27.5%	$156,941,092,013	$15,817
Minnesota	34.5%	$110,474,025,601	$20,124
Mississippi	27.9%	$64,300,123,348	$21,488
Missouri	36.9%	$99,369,429,995	$16,334
Montana	33.6%	$19,496,700,717	$18,875
Nebraska	40.3%	$17,367,830,965	$9,159
Nevada	32.7%	$69,697,815,811	$24,110
New Hampshire	28.0%	$17,320,649,176	$13,017
New Jersey	26.9%	$235,489,469,324	$26,288
New Mexico	32.1%	$54,455,339,568	$26,116
New York	44.9%	$347,542,971,698	$17,556
North Carolina	47.9%	$96,402,637,555	$9,599
North Dakota	28.9%	$10,213,597,800	$13,494
Ohio	34.3%	$331,420,701,160	$28,538
Oklahoma	34.9%	$51,903,613,095	$13,270
Oregon	36.3%	$97,781,712,858	$24,270
Pennsylvania	28.9%	$211,586,194,586	$16,527
Rhode Island	29.6%	$18,636,960,291	$17,644
South Carolina	30.1%	$74,095,092,870	$15,133
South Dakota	47.8%	$11,286,522,172	$13,147
Tennessee	47.3%	$47,826,122,962	$7,246
Texas	36.9%	$360,396,676,526	$13,120
Utah	41.7%	$37,987,328,775	$12,680
Vermont	30.4%	$8,707,979,583	$13,910
Virginia	37.4%	$107,648,590,922	$12,841
Washington	39.9%	$107,740,838,715	$15,026
West Virginia	35.5%	$23,640,020,456	$12,819
Wisconsin	63.4%	$52,842,437,646	$9,156
Wyoming	36.6%	$13,642,969,825	$23,277
TOTAL	**35.1%**	**$5,589,633,115,291**	**$17,427**

Source: Center for State Fiscal Reform, American Legislative Exchange Council

The magnitude of unfunded liabilities has been increasing for years. In order to turn things around for failing defined-benefit pension systems – that is if policymakers wish to continue with a defined-benefit model – lawmakers must begin setting more reasonable assumed rates of return and commit to making the larger ARC payments this would require. They must also commit to doing everything they can to meet their assumed rates of return. This means eliminating pension fund cronyism by insisting trustees invest solely in the interest of securing the best long-term, risk-adjusted returns and not allowing them to sacrifice portfolio performance in the pursuit of political agendas.

The Defined-Contribution Alternative

It is worth noting that some states and municipalities have escaped the perils of defined-benefit plans by creating new defined-contribution plans for government workers. A defined-contribution plan sets up a personal account that is owned by the employee and is entirely theirs upon full retirement. The typical defined-contribution plan is very similar to the 401(k) retirement savings accounts that most private sector employees utilize. While defined-contribution plans usually include payments from both the employee and the employer into their account, the employer (state or local government) makes no guarantee on what the eventual payout will be. Most private sector companies have realized the unsustainability of the defined-benefit model and switched to the 401(k) defined-contribution model years ago.

One of the key benefits of public defined-contribution plans is stability for state and local finances. Governments can budget knowing, within a certain predictable range, what contributions they will need to make to employees' retirement accounts. The variation is a result of factors such as provisions to match employee contributions and changes in the number of government workers. These variables are far more predictable than the ups and downs of global markets that determine defined-benefit plans' investment returns, and consequently, the contributions required by state and local governments to keep their pension plans well-funded.

Defined-contribution plans also provide improved accountability for state and local governments. With defined-contribution plans, employees have a legal cause of action if the government fails to make its required contribution. In addition, they provide greater transparency through personal account statements, wherein an employee may see the value of their pension and whether or not the government is making their proper payments. This stands in stark contrast to defined-benefit plans, where employees, and the taxpayers who are ultimately liable, can only hope state and local governments will faithfully make their "required" contributions to the pension fund.

This cause of action, combined with transparency, serves as an enforcement mechanism that ensures defined-contribution plans will be run as pay-as-you-go systems. So long as state and local governments make their reasonably predictable payments to pensioners' accounts, no unfunded liabilities accrue at all. Defined-contribution plans avoid the risk endemic to defined-benefit plans, where fiscally irresponsible lawmakers can make politically-beneficial promises today, but pass down a mountain of unfunded liabilities to future generations – and future lawmakers.

Finally, defined-contribution plans also have the benefit of essentially eliminating pension fund cronyism. Since employees in defined-contribution plans own their personal retirement accounts, they decide how their money is invested, often by choosing from a set of mutual funds managed by large, professional investment firms. The investment policies of these funds are clearly described in their prospectus and most are solely focused on achieving the greatest return within certain parameters of risk. If an employee chooses to invest in a socially-driven fund, they may do so without risking any other employee's investment returns or exposing the government, and taxpayers, to any additional liability.

While few states have adopted defined-contribution plans, one area of the public sector where defined-contribution systems have taken root is academia. Many higher education faculty and administrative employees currently utilize defined-contribution plans, such as those offered by the financial services company, TIAA. These plans have proven highly successful. In Illinois, a state that is on the verge of having its bond rating reduced to junk level, the TIAA defined-contribution plans have recently enjoyed the highest possible credit rating from all four credit rating agencies.[7]

Keeping promises to current retirees and workers is of paramount concern, but this can best be accomplished by changing public pension plans for future employees. Moving away from a defined-benefit pension system caps new liabilities that a state or local government is accruing. Once these pension liabilities are capped, the state or city can then begin the process of paying down debts while still providing sustainable retirement assistance to government workers.

The Importance of Proper Plan Management

Even if reforms are made and public pension systems are put on the path toward long-term financial solvency, there remains the crucial task of ensuring pension systems are managed properly. This means getting politics out of pension policymaking. Switching from a defined-benefit model to a defined-contribution model is one of the most effective ways state and local governments can safeguard pension plans from political manipulation. For those that stop short of a full transition to defined-contribution plans, state and local governments must carefully police state pension systems to protect against cronyism.

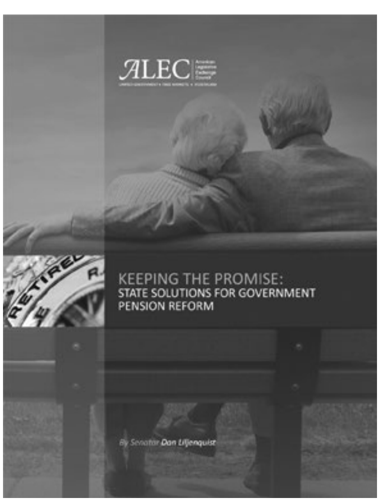
This publication explains the many forms of pension fund cronyism and provides academic research and case studies that demonstrate the magnitude of the resulting financial losses. It then discusses several reforms states and cities can make to get politics out of pensions. These reforms include stronger fiduciary standards, increased financial transparency and reforms to pension board composition and governance.

No state is unaffected by the public pension crisis. Unfunded liabilities are mounting and the problems are becoming more difficult to ignore. This is no time for pension trustees to be sacrificing investment returns for politics. State and local officials must examine the management of their pension funds for cronyism and enact the reforms necessary to stop it. By putting an end to pension fund cronyism, policymakers can help their public pensions begin the process of financial recovery.

Weak Fiduciary Standards Enable Pension Fund Cronyism

Trustees of both public and private pension funds must adhere to fiduciary standards that require prudent management of pension funds. In the private sector, pension plans must conform to the strict fiduciary responsibilities outlined in the Employee Retirement Income Security Act of 1974, better known as ERISA. However, public plans are not subject to ERISA. Instead, public pension trustees derive their fiduciary responsibilities from multiple sources, including state constitutions, statutes, judicial opinions and pension board bylaws. These fiduciary responsibilities vary considerably from state to state and tend to be far less rigorous than what ERISA requires of private-sector trustees.[8] It is these weak fiduciary standards governing public pension trustees that have enabled pension fund cronyism to become widespread in America today.

Perhaps the most important fiduciary provision governing public pension trustees is the prudence standard, the level of care a fiduciary must demonstrate as they manage the pension fund. Most states have adopted a "prudent person" standard, while others have adopted a "prudent investor" standard.[9] The specific language adopted by states varies, but generally the former requires the prudence exercised by an ordinary citizen investing in his own account, while the



For additional information regarding the many benefits of adopting a defined-contribution pension model, the authors recommend the ALEC publication, *Keeping the Promise: State Solutions for Government Pension Reform*. In the study, former Utah Senator Dan Liljenquist lays out many possible solutions for the structural problems facing state pension systems. At its core, however, any solution must honor the promises that have already been made to current retirees and employees; changes should only apply to future employees, with an option for current employees to enter the new system voluntarily.

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TABLE 2: STATE OVERVIEW OF SELECT FIDUCIARY PROVISIONS

FIDUCIARY ELEMENT	STATES ADOPTING
Prudence requirement	50
Exclusive purpose of providing benefits	27
Solely in the interest of participants	26
Reasonable administrative expenses	22
Diversification of investments	27
Economically targeted investments, first prudent	8

Source: The Pew Charitable Trusts

latter requires the prudence exercised by an investment professional.[10] The prudent investor standard is tougher and expects a greater level of prudence from the fiduciary when making plan investment and management decisions. Considering the number of workers relying on their investment decisions and the interest of all taxpayers in seeing their money wisely managed, states should adopt the prudent investor standard for public pension trustees to offer workers, retirees and taxpayers the most protection.

Fiduciaries are also subject to other provisions. Examples include the duty to act in the sole interest of plan participants, diversify the investment portfolio and incur only reasonable administrative expenses. States should enact these additional requirements as each of these provisions strengthens a state's fiduciary standards. When adopted, each should be written in a way that leaves no doubt about what is expected of a trustee as they invest and manage the fund.

The Pew Charitable Trusts recently surveyed states' fiduciary provisions, comparing them to the Uniform Law Commission's Uniform Management of Public Employee Retirement Systems Act (UMPERSA). UMPERSA is a model law that seeks to modernize, clarify and make uniform the rules governing the investment and management of public retirement systems' assets. It contains several model fiduciary provisions that may improve a state's existing fiduciary provisions for pension trustees.

Pew's research included six of the most important fiduciary provisions for pension trustees. The table shows how many states have statutorily-codified fiduciary provisions for pension trustees that meet UMPERSA's standards.[11]

Strong fiduciary standards are important because when fiduciary standards are weak, trustees have latitude to engage in pension fund cronyism. In effect, they are put on a "long leash," permitted to invest in local pet projects, reward supporters with pension fund investments and pursue political agendas by investing in industries they like and divesting from those they don't, regardless of losses to fund performance. On the other hand, when fiduciary standards are strong, trustees have clear and specific directions to control them. They are put on a "short leash," required to invest in a manner that secures the best returns for plan participants. Similar to the Uniform Law Commission's UMPERSA, The ALEC Task Force on Tax and Fiscal Policy has developed its own recommendations to strengthen states' fiduciary provisions for public pension funds in its Retirement System Board of Trustees and Employees Prudent Investor Act.[12] More information on this key model policy can be found in Appendix B.

Finally, accountability mechanisms should be established by states to ensure compliance with fiduciary responsibilities. First, states should require transparency in financial reporting for public pension plans that allows lawmakers, pensions boards and average citizens to see all plan investments and evaluate their performance. In addition, states should reform pension boards to serve as better watchdogs of pension funds. Research suggests certain types of pension board members are more likely to overweight local investment and provide political kickbacks.[13] Therefore, states should consider reforming the composition of pension boards and adopt board procedures to eliminate opportunities for cronyism. These transparency and pension board reforms will help to hold board members accountable.

Chapter 2
Economically Targeted Investments

Economically targeted investments (ETIs) are local investments "that have been selected for their economic or social benefits in addition to the investment return to the employee benefit plan."[14] ETIs are a type of cronyism because they favor local investments over broad-based investing, even if it produces inferior returns. They seek to serve government-defined economic and social goals at the expense of pension fund performance. ETIs may be pursued by individual fund managers or pension boards who support them, acting under weak fiduciary standards that permit them to do so, or endorsed by state and local governments as official policy for pension investments. It is worth noting that some of the states that permit ETIs have specific limits on the percentage of the total portfolio that can be invested in ETIs, indicating recognition of the harm they do to pension performance.[15]

To be clear, not all local investments are ETIs. If a public pension fund, looking at the entire universe of investment options determines a given investment offers the best risk-adjusted return ratio, and that investment happens to be local, this is not an ETI, and is an appropriate investment. However, given the relatively small percentage of global investment opportunities that exist within any particular state or municipality, local investments should make up a very small percentage of a pension fund's total portfolio if a fund manager is acting solely in the interest of securing the best possible long-term, risk-adjusted returns. Unfortunately, when fund managers, pension boards and governments consistently favor local investments, pension returns suffer, and taxpayers must pay the bill.

ETIs Lead to Significant Lost Returns

The theory behind ETIs is that pension funds should favor local investments, even at the cost of investment returns, because doing so will allegedly help the local economy thrive or provide some social benefit. Governments and local initiatives that subscribe to this theory often pressure pension funds to try to stimulate local economic development or pursue social goals by financing major projects with pension fund investments – projects they may not wish to fund with taxpayer dollars. Since trustees have little to lose if the fiduciary standards governing them permit or encourage ETIs, most of the risk is squarely upon pensioners, whose retirement benefits are put at risk, and taxpayers, who may have to ultimately make up the loss of returns caused by inferior investments.

While some may believe this is an acceptable trade-off, the loss of investment returns can be dramatic. Research indicates that ETIs consistently underperform broad-based investments. Regression analysis of the effects of various types of investments on pension fund performance has found underperformance is especially significant among two common forms of ETIs, local real estate and venture capital investments. Local real estate investments are predicted to deliver returns 7.90 percentage points lower compared to real estate investments generally. Local investments in venture capital are predicted to deliver returns 3.55 percentage points lower relative to venture capital investments generally.[16] These are significant losses for any pension fund to sustain and are only compounded over time as any foregone returns in the present could be reinvested to gain further returns down the road.

Another study utilizing regression analysis to evaluate the performance of ETIs was conducted by Yale Professor Roberta Romano. She found, "Even when such investments have not been a total loss, they have often significantly underperformed alternative projects with far less risk. Accordingly, such investments do not meet prudential fiduciary standards."[17] The study cites some specific examples which highlight the failure of these investments. One such instance was the loss of more than $100 million after Kansas' pension fund invested heavily in local businesses, including a steel mill that shut down and a savings and loan corporation that failed. Another example cited in the study was a GAO evaluation of five local housing investments undertaken by public pension funds that found each of those projects' returns were "either lower than comparable benchmarks, or the GAO could not determine the project's risk level."[18]

This significant underperformance in ETIs means the more pension funds invest in ETIs, the lower their returns are likely to be, making it less likely these funds will meet their assumed rate of return. State and local governments put their pensioners and taxpayers at risk by trying to spur the local economy or pursue social goals at the expense of pension investment returns.

Alabama Bets Big on ETIs

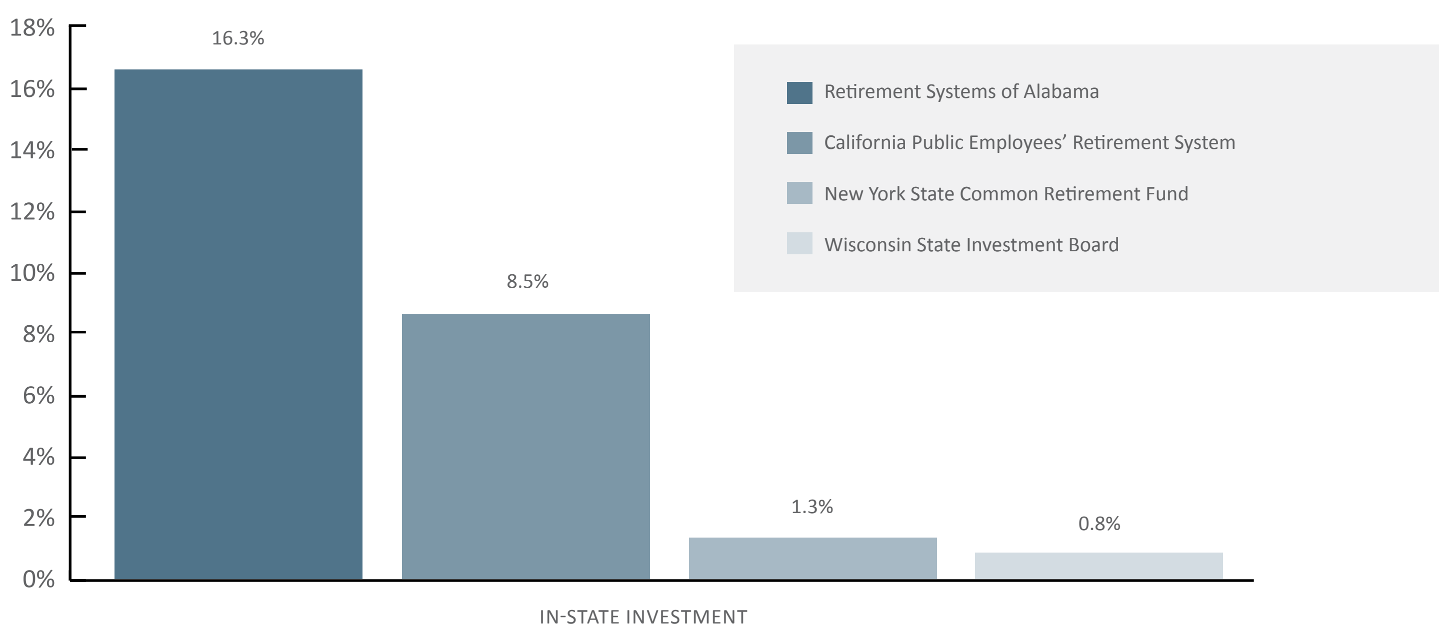
To further examine the effects ETIs can have on public pension funds, the case study of Alabama is instructive, since the state may have the highest allocation of ETIs in the nation.[19] The Retirement Systems of Alabama (RSA) manages a variety of local and state funds, including three statewide government defined-benefit pension plans: The Teachers' Retirement System (TRS), the Employees' Retirement System (ERS) and the Judicial Retirement Fund (JRF).[20]

All of these plans face fiscal challenges. This appears to be due in part to the RSA's policy of allocating a significant share of its portfolio to ETIs and the dramatically inferior returns these investments tend to generate compared to other investments. This investment practice has continued for many years, in part, due to Alabama's weak fiduciary standards for public pension trustees, combined with RSA's lack of financial transparency and poor oversight from RSA's pension boards.[21]

Overview of Alabama's ETIs

According to The Pew Charitable Trusts, Alabama has "arguably the largest ETI allocation in the country."[22] At the end of fiscal year 2014, an estimated 11.5 percent of the RSA portfolio was invested in private equity or private placement investments with Alabama headquartered businesses, while 4.8 percent of RSA's portfolio was invested in Alabama real estate.[23] Together, this represented approximately 16 percent of RSA's total portfolio being invested in in-state interests. Since almost all in-state investments are ETIs, in-state investments can be used as a proxy for measuring ETIs.

FIGURE 2: 2014 IN-STATE INVESTMENT AS PERCENT OF TOTAL INVESTMENT



Source: The Pew Charitable Trusts; State Street Investment Analytics Summary of Performance ending September 30, 2014, as provided by RSA; CalPERS for California Annual Report 2014; Investing in New York State, September 2014; and State of Wisconsin Investment Board

Figure 2 demonstrates the dramatic disparity between Alabama's in-state pension investments and those of other states. State pension programs with public data available on their ETIs include the California Public Employees' Retirement System (CalPERS), New York State Common Retirement Fund and Wisconsin State Investment Board. Although CalPERS also has significant in-state investment at 8.5 percent of assets, Pew notes that the large amount of in-state investments for CalPERS are "driven by the size and volume of business activity in the state."[24]

Poor Performance of ETIs in Alabama

RSA's ETIs are concerning, due to their large volume and poor performance. RSA publishes limited information regarding the performance of its ETIs. However, what is available indicates RSA's ETIs have not performed well and are a major contributor to the state's pension funds significantly underperforming the national average return for similar funds over the last 10 and 20-year time horizons. Table 3 shows how RSA's portfolio has performed compared to the State Street and Wilshire Trust Universe Comparison Service's (TUCS) medians. Both are considered industry benchmarks for the performance of pension assets. RSA's investment underperformance is part of the reason the funding level of the state's pensions has been on the decline.

TABLE 3: TEN-YEAR AND TWENTY-YEAR RETURNS AS OF SEPTEMBER 30, 2014

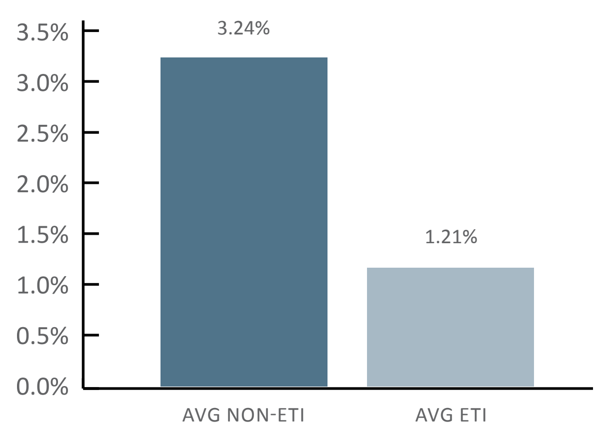
	10-YEAR GROSS OF FEES	20-YEAR GROSS OF FEES
TRS	6.43%	7.51%
ERS	6.15%	7.32%
TOTAL RSA	6.32%	7.43%
STATE STREET MEDIAN	7.28%	
TUCS MEDIAN	7.35%	8.48%
STATE STREET 75TH PERCENTILE (BOTTOM QUARTILE)	6.71%	
TUCS 75TH PERCENTILE (BOTTOM QUARTILE)	6.87%	8.06%

Source: The Pew Charitable Trusts; State Street Investment Analytics Summary of Performance ending September 30, 2014, as provided by RSA; Wilshire TUCS

ETIs Weigh Down RSA Investment Returns

RSA financial documents for the year ending September 30, 2014, the only year where public data is currently available for individual asset performance, show that Alabama's ETIs have significantly underperformed their non-ETI counterparts. Unfortunately, RSA does not provide any longer-term performance data for these individual assets. Still, comparing the performance of ETIs with non-ETIs demonstrates their dramatic difference in performance and suggests ETI returns are unlikely to match non-ETI returns in the long term.

FIGURE 3: ALABAMA ETI VS. NON-ETI ONE-YEAR PERFORMANCE, YEAR ENDING SEPTEMBER 30, 2014



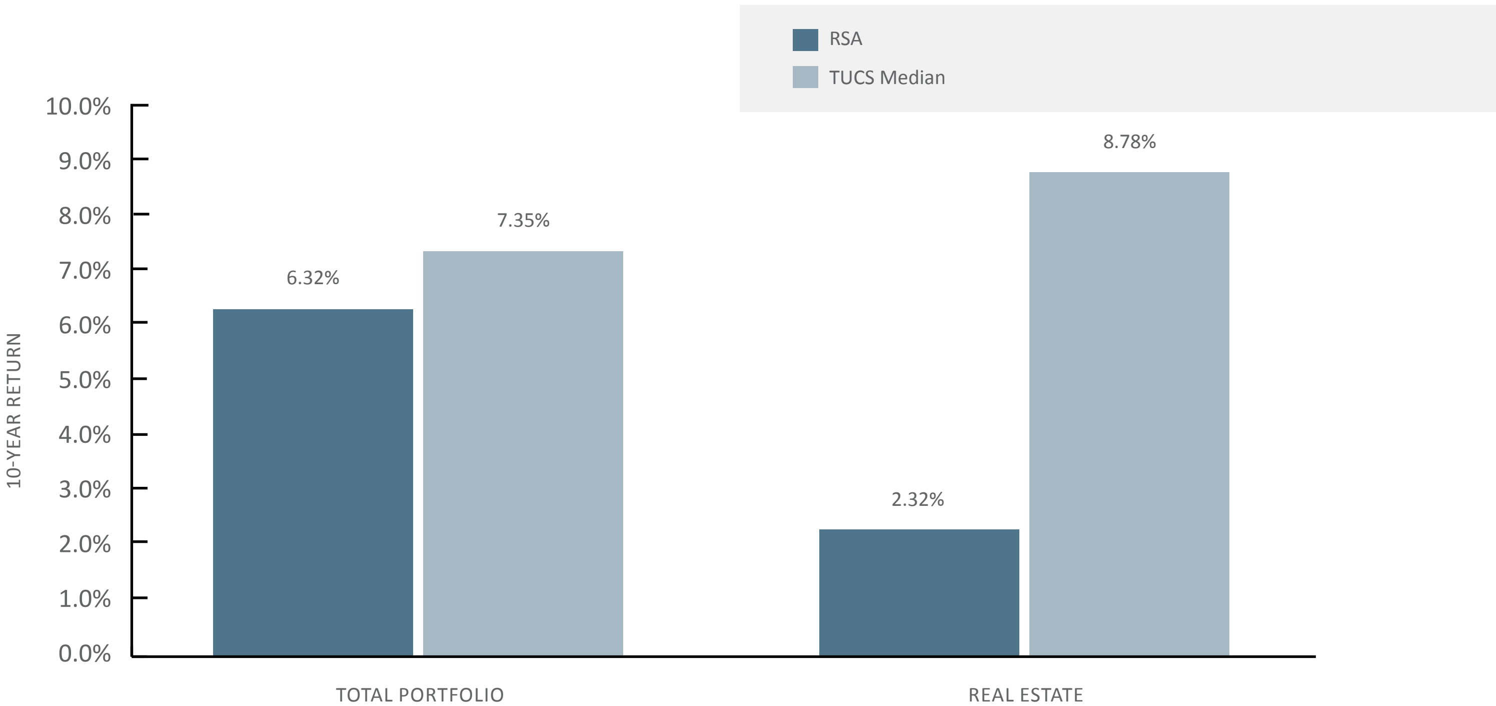
Source: Authors' calculations, based on RSA data for preferred and private equity, private placements and real estate

As Figure 3 demonstrates, Alabama's ETIs returned 1.21 percent for the year ending September 30th, 2014, while their non-ETIs returned 3.24 percent. In other words, RSA's ETIs returned less than half of what their non-ETI counterparts returned. While it is only one year's performance, the dramatic difference in returns indicates just how much RSA is losing by investing in ETIs.

RSA's Real Estate Investments: A Key Contributor to Poor Performance

While many factors influence RSA's poor performance, RSA's local real estate portfolio is a key contributor. About half of RSA's total real estate portfolio consists of in-state properties. A recent news article from an

FIGURE 4: 10-YEAR PERFORMANCE GROSS OF FEES, YEAR ENDING SEPTEMBER 30, 2014



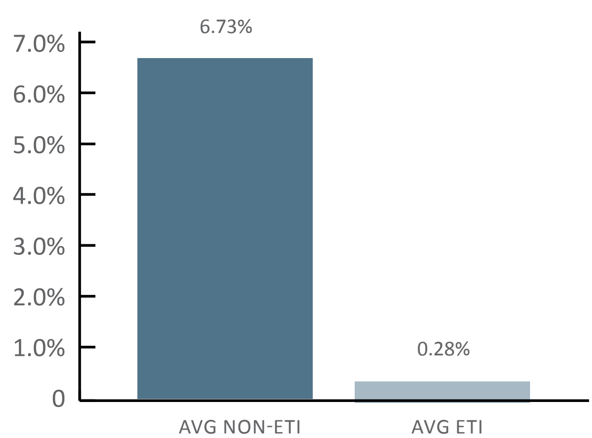
Source: The Pew Charitable Trusts; State Street Investment Analytics Summary of Performance ending September 30, 2014, as provided by RSA; Wilshire TUCS

Alabama investigative reporter citing data from September 2014 for ERS and TRS indicates that RSA's Alabama real estate properties performed well below the RSA's targeted eight percent rate of return over the past three years.[25]

Figure 4 illustrates the poor performance of RSA's real estate investments and how they have affected total portfolio performance.[26] The figure compares RSA's 10-year performance, gross of fees, with the TUCS median. While the 10-year TUCS median for real estate was 8.78 percent, RSA's real estate investments only achieved a disappointing 2.32 percent rate of return.[27]

While these are disappointing returns for RSA's total real estate portfolio, the 10-year performance for RSA's local real estate alone may be far worse. The overall real estate portfolio is buoyed by strong returns from a New York City office building RSA invests in.[28] This single property makes up about half of RSA's total real estate portfolio. Comparing the in-state (ETI) to out-of-state (non-ETI) real estate returns for the past year, the only time horizon for individual asset returns RSA provides, shows how poorly RSA's local real estate investments have fared.

FIGURE 5: ALABAMA ETI REAL ESTATE VS. NON-ETI REAL ESTATE ONE-YEAR PERFORMANCE, YEAR ENDING SEPTEMBER 30, 2014



Source: Authors' calculations, based on RSA real estate data

RSA's non-ETI real estate, which appears to consist solely of the New York property, returned a reasonable 6.73 percent, while RSA's ETI real estate, consisting of multiple local investments, returned a dismal 0.28 percent. This means that for the year ending September 30, 2014, RSA's non-ETI real estate provided a return more than 24 times greater than RSA's ETI real estate.

RSA's poor real estate performance contrasts with the expectations set by Alabama Finance Director Bill Newton. According to Newton, meeting the target eight percent rate of return is, "the most important function of our investing approach. Everything else is not as important."[29] When RSA investments, such as real estate, fail to meet their own investment benchmarks, the financial wellbeing of retirees is on the line. As Dr. Henry Mabry, former Executive Secretary of the Alabama Education Association, explained:

> *"The facts point to losses caused by alternative investments such as real estate. Over the past five years, almost $700 million have gone down a rat hole thanks to these 'investments.' To put it in perspective, $700 million is more than twice what is spent on school transportation for the whole state or over 12,000 teacher units a year...Economic development of the state is great and wonderful, but economic development at the expense of active and retired TRS members does not pass muster."*[30]

RSA's Other ETIs Lead to Significant Losses

Not only has RSA's ETI real estate performed poorly, but RSA's other risky ETIs have put workers, retirees and taxpayers at risk. One example of a less than prudent ETI is the troubled firm Signal International. The Alabama-based oil repair and shipbuilding firm engaged in labor trafficking in 2006. The company enticed Indian guest workers to come to the United States to repair oil rigs, promising them they could receive green cards. In reality, workers had to pay $1,050 per month to live in guarded labor camps.[31]

In 2008, RSA started investing in Signal, eventually owning up to 47 percent of the troubled company.[32] According to September 2014 data, both ERS and TRS invested $21 million in Signal, but these investments suffered a loss of 11 percent over the past three years.[33] Regardless of the poor rate of return, ERS subsequently loaned Signal $24 million and TRS loaned Signal $49 million.[34]

In 2015, Signal agreed to pay $20 million to settle lawsuits over labor trafficking that occurred in 2006. Bradley Myles, chief executive of the anti-human trafficking nonprofit, the Polaris Project, called the Signal lawsuits "one of the largest cases of labor trafficking in modern times."[35] Shortly after settling the lawsuits, Signal filed for Chapter 11 bankruptcy. According to the bankruptcy filing, Signal had, at that time, more than $100 million in debt and less than $50 million in assets.[36] In November of 2015, RSA purchased the bankrupt company for an estimated $90 million.[37] RSA used the assets to start a new company, called World Marine.[38]

In another case, RSA lost millions of dollars in a deal with National Alabama, a subsidiary of National Steel Car. In 2007, RSA loaned $350 million to National Steel Car in a deal with its Chairman and CEO, Gregory Aziz. Aziz promised to build a railcar manufacturing facility in the state that would employ more than 1,800 Alabama citizens.[39] Instead, the results were quite different, as a Business Alabama article explains:

> *"Just before the recession hit in 2007, National Alabama — subsidiary of a Canadian rail car maker — built the plant to make rail cars for the U.S. freight market. When the bust came, those who helped finance the plant in support of jobs for the Shoals — chiefly the Retirement Systems of Alabama — were left with a plant instead of their expected return on investment."*[40]

Under Aziz, employment at the manufacturing facility never reached even 200 employees.[41] Furthermore, Aziz later claimed that he would need an additional estimated $400 million to complete the facility.[42] RSA went on to spend another $215 million to complete the project and took ownership of 100 percent of the stock in the facility from Aziz. The Alabama Securities Commission charged Aziz with 11 counts of securities fraud and arrested him.[43] Eventually the commission dropped the charges after Aziz agreed to pay RSA back $21 million. Currently, RSA owns the property, with an estimated 1,150 citizens working at the facility.[44]

Alabama's Weak Fiduciary Standards Enable ETIs

Alabama's weak fiduciary standards are one of the main reasons RSA has been able to dedicate such a

TABLE 4: COMPARISON OF ALABAMA FIDUCIARY PROVISIONS WITH UMPERSA FIDUCIARY PROVISIONS

FIDUCIARY ELEMENT	STATES ADOPTING	ALABAMA STATUS
Prudence requirement	50	Yes
Exclusive purpose of providing benefits	27	Yes
Solely in the interest of participants	26	No
Reasonable administrative expenses	22	No
Diversification of investments	27	No
Economically targeted investments, first prudent	8	No

Source: The Pew Charitable Trusts

large percentage of its portfolio to ETIs over the years. The Pew Charitable Trusts recently reviewed Alabama's fiduciary provisions and compared them to the fiduciary provisions recommended in the aforementioned Uniform Law Commission's Uniform Management of Public Employee Retirement Systems Act (UMPERSA). Pew compared Alabama's fiduciary provisions for pension trustees to six of the most relevant fiduciary provisions contained in UMPERSA. As the table shows, they found only two of Alabama's statutorily-codified fiduciary provisions meet the standards set by UMPERSA.[45]

While Alabama has adopted a prudence requirement, it is the weaker prudent person standard as opposed to the stronger prudent investor standard, subjecting the investment decisions of the state's pension trustees to less scrutiny. To its credit, Alabama's Constitution requires that RSA funds are held for the "exclusive purpose of providing benefits." However, this has not stopped RSA's pension boards from investing in ETIs, the purpose of which is not exclusively to provide retirement benefits, but instead to encourage economic development and pursue social goals.

Regarding the management of pension funds for the sole interest of plan participants, Alabama has some Constitutional and statutory language requiring pension funds are held "as in trust" and the Secretary-Treasurer is required to invest in the best interest of the funds. In addition, the Alabama Supreme Court has ruled the trust must be held "solely in the interest of the beneficiaries." However, Pew research indicates that this provision is not explicit within Alabama statute and the state's Supreme Court has not rigorously enforced this fiduciary provision found in its ruling. Furthermore, language requiring the Secretary-Treasurer to invest in the fund's best interest is ambiguous and has not stopped extensive investment in ETIs.

When it comes to administrative expenses, Alabama's Constitution provides pension funds may be used only for benefits, refunds and expenses that are "diligently and honestly" deemed to be "current and necessary." This vague language falls short of UMPERSA's standards in regards to reasonable administrative expenses.

The state has some statutory requirements for a diversified portfolio and RSA investment policies call for this as well. However, Pew research indicates Alabama's statutory requirements do not meet UMPERSA's standards for diversification, and to the extent RSA's own investment policies do, these are not properly codified in state statute.

Particularly relevant for Alabama, the state has not adopted UMPERSA's standard for economically targeted investments. This standard allows fiduciaries to consider collateral benefits created by an investment in addition to the investment's returns only if the trustee determines the investment providing these benefits would be prudent even without the collateral benefits. The state has no specific statutory language regarding ETIs, and RSA investment policies only mandate that ETIs have comparable returns to similar investments. While this language may seem reasonable, RSA is responsible for adhering to its own investment policies and, as has been demonstrated, the underperformance of ETIs has not stopped RSA from continuing to invest heavily in them.

Opaque Pension Reporting Conceals Performance of RSA's ETIs

Obtaining the full picture of RSA's ETIs is difficult, due to the lack of detailed reporting and transparency. RSA does not report individual asset returns for all of its investments, and provides only one year of returns for those they do. The fact that none of RSA's financial documents report ETIs as a distinct category and give their cumulative performance means the only way to get a picture of how ETIs have fared in RSA's portfolio is to piece together the limited reporting on individual investment returns across multiple categories, isolating the Alabama-based investments and aggregating their performance. While comparisons of ETI and non-ETI performance are possible, reporting ETIs as a distinct category would allow easier comparisons of their performance with the rest of the portfolio.

RSA could also improve its transparency by reporting longer time horizons for investment returns. This goes for both individual assets and asset classes. While RSA only reports one year returns for individual assets, RSA typically reports time horizons for asset classes between one month and 10 years. Reporting performance over longer time horizons for both would align with the long-term nature of pension liabilities and allow for greater perspective of how various investments have performed over the years. This would also allow more comprehensive comparisons between ETI and non-ETI performance. The fact that RSA provides only one year returns for individual assets may indicate a deliberate effort to obscure the long-term underperformance of ETIs in the portfolio.

RSA's lackluster pension reporting was noted by a recent Mercatus Center study, *Alabama at the Crossroads: An Economic Guide to a Fiscally Sustainable Future*, which explains,

> *"There is a stark difference between investment reports from private companies, such as TIAA-CREF, and those coming from the RSA. In addition, little information is provided to the public on the performance of the RSA's private placement portfolio year to year or on the types of investments undertaken."*[46]

Even with public information requests, the RSA has not been transparent. Since RSA comprehensive annual financial reports (CAFRs) state that more information is available to the public upon request, researchers from the Mercatus Center at George Mason University reached out to RSA on September 8th, 2015 and requested information. When RSA did not respond, the Mercatus Center then filed a formal Alabama Public Records Request on November 9th, 2015.[47] As of the time of this publication, RSA has still not responded.

Alabama's Poor Pension Board Composition and Governance Enables ETIs

Cronyism within the RSA may be due to its poor pension board composition. The RSA's two Boards of Control lack diversity in their representation and primarily consist of plan participants. Furthermore, board members are not statutorily required to have any financial expertise. The TRS Board of Control consists of three ex-officio members and 12 elected plan participants, including 10 current employees and two retired employees.[48] The ERS/JRF Board of Control consists of four ex-officio members and nine plan participants, including three appointees from the governor and six elected plan participants.[49] Notably, unlike many other states' pension boards, Alabama's Boards of Control have no public representatives.[50]

Some may believe this does not represent a problem. After all, shouldn't plan participants, whose own retirement is tied to the pension plan, want to see the highest investment return possible to provide for a better funded pension? Unfortunately, evidence indicates board members, including plan participants, often have other priorities. Statistical analysis of pension investments indicates plan participant representatives tend to overinvest in local investments as a share of their total portfolio, despite their tendency to underperform.

According to a recent Hoover Institution study, a 10 percentage point increase in the proportion of participant-elected board members leads to a 1.34 percentage point higher predicted allocation to in-state investments. Further, a 10 percentage point increase in the proportion of state-appointed board members leads to a 2.48 percentage point higher predicted allocation to in-state investments. Lastly, a 10 percentage point increase in the proportion of state ex-officio board

TABLE 5: ALABAMA PENSION BOARDS' COMPOSITION COMPARED TO THE AVERAGE PENSION BOARD

	TOTAL NUMBER OF BOARD MEMBERS	SHARE OF BOARD THAT IS			
		EX OFFICIO	APPOINTED	MEMBER ELECTED	PUBLIC REPRESENTATIVE
ERS	13	31%	23%	46%	0%
TRS	15	20%	0%	80%	0%
AVERAGE PLAN	9.1	17%	20%	35%	28%

Source: The Pew Charitable Trusts; Andonov, Bauer, Cremers, Pension Fund Asset Allocation and Liability Discount Rates, June 2015

members leads to a 1.31 percentage point higher predicted allocation to in-state investments. This analysis also finds that in-state overweighting by participant-elected, state-appointed and state ex-officio board members is even stronger for real estate and venture capital investments.[51]

So why would these types of board members support so much local investment, given the poor returns, relative to other investments? One possible explanation could be they lack the financial expertise or information necessary to appreciate the negative effect these investments have on overall pension fund performance. As previously discussed, states like Alabama do not report the performance of in-state investments as a distinct category, making it difficult to isolate exactly how these investments perform relative to the rest of the portfolio. Another possible explanation is that these types of board members are motivated to invest pension dollars in local businesses and other interests that have supported them. Yet another explanation may be that some board members are politically motivated to invest in local projects that promise to create jobs and generate economic growth for which the board member can take credit.

Whatever their motivations are, the Alabama Boards of Control have continued to permit a large share of the state's pension funds to go to ETIs. The boards have elected Dr. David Bronner Secretary-Treasurer for the past four decades and granted him essentially unchecked authority over all investment decisions, power he has used to direct a dramatic share of pension funds to ETIs.

While all members of the Boards of Control serve as trustees, the Secretary-Treasurer submits formal recommendations on pension investments.[52] These recommendations need not be approved by the full board. Instead, a three person Investment Committee, elected by and composed of board members in each Board of Control, reviews all investment recommendations made by the Secretary-Treasurer.[53] In order for a proposal to move forward, the Secretary-Treasurer only needs approval from two of the three Investment Committee members.[54] Worse still, for years Bronner cast two of the three Investment Committee votes needed to approve his own investment recommendations.[55] This was done through proxy voting, where at least two Investment Committee members delegated their vote to Bronner.

After years of unchecked authority, the ERS/JRF Board of Control voted in 2013 to stop the proxy vote practice by requiring Investment Committee members to personally sign off on every investment recommendation from Bronner.[56] However, the board still relies on the Investment Committee to approve all investment recommendations. It is unclear if the TRS Board of Control permits proxy voting.

Repeated investment decisions that failed to pay off have led to increased scrutiny by state officials. Nonetheless, Bronner has remained Secretary-Treasurer for nearly half a century. Bronner himself attributes his survival to favorable board composition as reported in a recent *Governing* magazine article:

> *"80 percent of the board members for the teacher's fund are elected by participants in the system. As long as Bronner keeps retirees and current workers happy, elected officials have limited options for telling him what to do. When asked why he's never been fired with so many people after him, Bronner is frank: 'Because,' he says, 'I'd snuggle up to the teacher board. [Otherwise], the politicians would have nailed me decades ago.'"*[57]

The Results of Alabama's Pension Investment Model

Economically targeted investments have negatively impacted Alabama's pension fund performance. For several years, the RSA has had a target of eight percent rate of return for ERS, TRS and JRF. However, according to the RSA's CAFR for the period ending September 30, 2015, ERS only achieved a 5.43 percent rate of return, TRS, 5.41 percent, and JRF, 5.47 percent over the past decade.[58]

These lower than expected returns have led to a precipitous decline in the plans' funded ratios. According to official RSA accounting, based on RSA's assumed rate of investment return, from 1997 to 2014, the ERS plan has declined from 111 percent funded to 63 percent funded. Meanwhile, the TRS plan has plummeted from 105 percent to 68 percent.[59] Together, these plans represent $15 billion in unfunded liabilities, assuming RSA manages to meet its high predicted rate of investment return every year.

However, most financial professionals believe such high assumed rates of return are unlikely to be realized in the coming years. The ALEC Center for State Fiscal Reform study, *Unaccountable and Unaffordable 2016*, examines state pensions through the lens of a risk-free rate of return, as is recommended by the Society of Actuaries' Blue Ribbon Panel. When Alabama's pensions are examined through this more realistic valuation, the pension funding gap is much larger than reported in official state documents. In fact, Alabama's pensions are merely 30 percent funded, while the state's unfunded pension liabilities total an estimated $75 billion.[60] For comparison, the state only collects an estimated $10 billion per year in taxes.[61] Divided evenly among all citizens, the price tag for Alabama's unfunded liabilities is $15,427 for every man, woman and child in the state.

ETIs Put Workers and Taxpayers at Risk

As the Alabama case study demonstrates, ETIs lead to lower returns for a state's overall portfolio and put pensioners and taxpayers at risk. States should invest pension funds with the sole purpose of maximizing returns, rather than pursuing state economic and social benefits at the expense of worker's retirement security. By adopting reforms to strengthen fiduciary responsibilities, enhance transparency and improve pension board diversity and management, lawmakers can keep their pension promises to retirees and workers without the need for difficult budget cuts or economically damaging tax increases.

Solutions for Fighting ETI Cronyism

- Trustees should manage the pension fund for the exclusive purpose of providing pension and other post-employment benefits to plan participants and beneficiaries. Other post-employment benefits should be defined to include healthcare and other benefits outlined in the pension plan and not the limited, tangential benefits local economic development and social projects may provide.

- Trustees should manage pension funds solely in the interest of plan participants and beneficiaries as a whole, impartially. Fulfilling this provision should require pursuing the best long-term, risk-adjusted returns for the pension fund.

- All investments, whether in-state or out-of-state, should be evaluated equally, being held to the same risk-return standards, without favoritism for local investments. States should not use pension investment funds to make in-state investments in a misguided attempt to give special preference to certain companies or industries based on political agendas.

- States and municipalities should dispense with any statutory language encouraging or permitting economically targeted investments which invariably reduce pension fund returns and increase investment risk.

- Reporting of investments should be done separately by asset class and by individual assets so it can be easily determined how investments are performing and increase accountability for fund managers.[62]

- Pensions should report the fund's overall performance, asset class performance and individual asset performance over a 20 or more-year time horizon to show how assets have performed over time and allow stakeholders to see how actual performance has compared with the assumed rate of return.[63]

- Pension boards should be diversified to provide representation for all stakeholders, including taxpayers. This will prevent any special interest group from gaining too much power on the board and using pension funds to overweight local investments.

- Pension boards should have a certain number of seats dedicated to independent financial professionals that serve as public representatives.

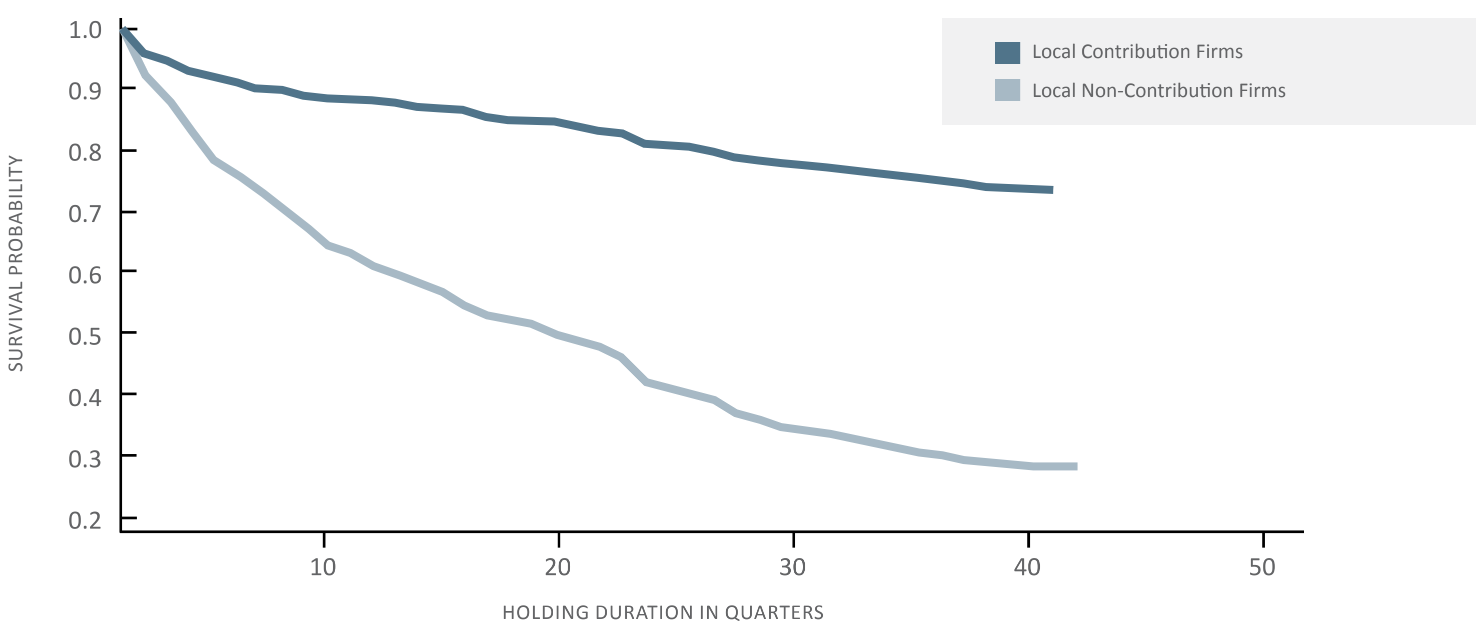
Chapter 3
Political Kickbacks

Another common variety of pension fund cronyism occurs when kickbacks, in the form of pension investment funds, are directed to politically connected businesses and other interests. Sometimes, these political kickbacks come from elected board members who reward campaign supporters by investing pension funds in their businesses or other interests. Other times, ex officio and appointed members may feel there are political gains to be had by investing pension funds in popular local businesses to create or retain jobs and have a local, visible accomplishment for which they can take credit. Whatever the motivation, making investment decisions for personal political gain lowers pension returns, resulting in pensions that are less secure and taxpayers facing a greater risk of having to bail out pension funds in the future.

Political Bias in Public Pension Funds

While pension trustees should be considering all investment opportunities equally and impartially, they are frequently confronted by local businesses lobbying for pension fund investments. Research indicates this lobbying has significantly affected trustees' investment decisions. In a paper forthcoming in the *Journal of Financial Economics*, the authors find public pension funds overweight local firms in their portfolio by 26 percent, relative to a diversified, market portfolio. Further, estimates indicate public pension funds overweight local firms that make political contributions to local politicians by 23 percent, and overweight local firms that have significant lobbying expenditures by 17 percent.[64]

FIGURE 6: PANEL A - POLITICAL CONTRIBUTIONS



Source: Bradley, Daniel, Pantzalies, Christos and Yuan, Xiaojing, The Influence of Political Bias in State Pension Funds

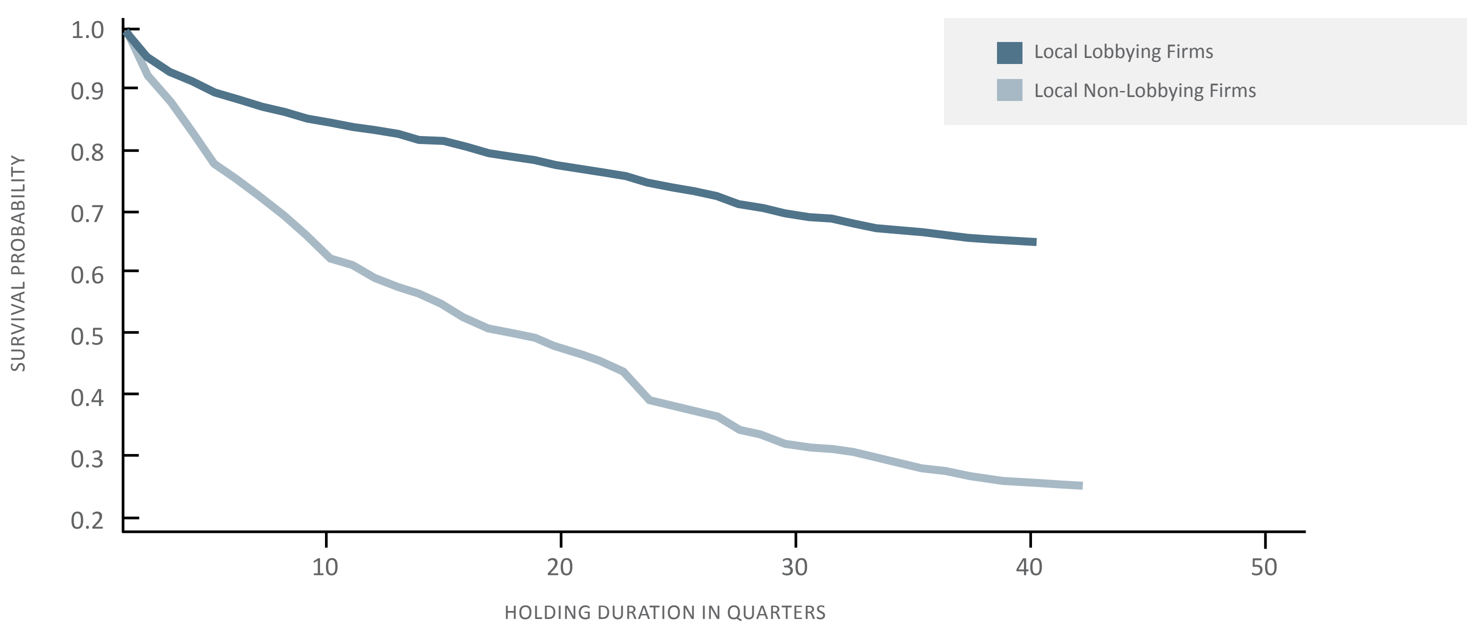
In addition, regression analysis indicates, other factors held constant, local contribution bias and local lobbying bias have statistically significant and negative effects on fund performance.[65] For example, a typical amount of political bias in a $21 billion state pension fund (the average size based on their sample), is predicted to cost the fund between $210 million and $269 million per year in lower investment returns. Of course, funds with larger portfolios would experience even greater losses, as would those with a higher level of political bias. Simply put, the more that pension funds make investment decisions under the influence of political contributions and lobbying from local firms, the lower their returns will be.

Furthermore, the same study found pension funds tend to retain investments for a far longer period of time for firms that engage in political contributions and lobbying compared to those firms that do not. As Figures 6 and 7 indicate, the difference is shocking. Figure 6 shows that after five years, funds were nearly twice as likely to retain investments in firms that gave political contributions than in those that did not. After 10 years, the local firms that gave political contributions had nearly three times better odds of being retained by the fund than those that did not.

The results were similar for lobbying. As Figure 7 shows, after five years, pension funds were nearly twice as likely to retain investments in local firms that engaged in lobbying efforts than in those that did not. After 10 years, investments in local firms engaging in lobbying were nearly three times as likely to be retained.[66] This demonstrates the significant influence that political contributions and lobbying from local firms have on pension fund investment decisions.

The negative effects of political bias on pension fund portfolios are thus twofold. Political contributions and lobbying efforts by local firms reduce fund performance by overweighting riskier local investments. They also raise the probability that pension funds retain these poorly performing assets for longer periods, compounding the effect of lower returns year after year.

FIGURE 7: PANEL B - LOBBYING



Source: Bradley, Daniel, Pantzalies, Christos and Yuan, Xiaojing, The Influence of Political Bias in State Pension Funds

CalPERS Kickbacks

The California Public Employees' Retirement System (CalPERS) is the nation's largest state-administered pension system and has been criticized for cronyist kickbacks over the years. As Steven Malanga explains in a *City Journal* article, CalPERS has made poor investment decisions:

> *"CalPERS has also steered billions of dollars into politically connected firms. And it has ventured into 'socially responsible' investment strategies, making bad bets that have lost hundreds of millions of dollars. Such dubious practices have piled up a crushing amount of pension debt, which California residents—and their children—will somehow have to repay."*[67]

Some of this occurred when union leader Charles Valdes, who had no investing experience and twice filed for personal bankruptcy, served as chair of CalPERS's Investment Committee. Valdes made several poor financial decisions, some of which appear to have been politically motivated. During his time as Investment Committee chair, CalPERS consistently granted investment contracts to some of the state's biggest political givers. In addition, Valdes accepted gifts from a fellow board member, Alfred Villalobos, who allegedly spent thousands of dollars trying to influence pension investments. When questioned about his relationship with Villalobos, Valdes invoked the Fifth Amendment 126 times.[68]

One reason Valdes was not replaced as Investment Committee chair sooner was the board's composition, where 6 of the 13 board members were selected by government workers, an arrangement that led to an increasingly strong union presence on the board.[69] This allowed Valdes to continue to serve despite his cronyist investments and the loss of returns for CalPERS. Malanga explains, "CalPERS's members, who elect representatives to the fund's board of directors, ignored concerns over Valdes's suitability because they liked how he fought for those plusher benefits."[70] Even *The New York Times*, usually sympathetic to union causes, noted critics worried the board had become increasingly partisan and doubted CalPERS's ability "to provide for the 1.3 million public employees whose pensions it guarantees."[71]

Despite the cronyism, Valdes was allowed to serve on the CalPERS board for 25 years, 13 of which he spent as Investment Committee chair. During his tenure as Investment Committee chair, CalPERS had one of the worst investment records of any public pension fund.[72] The takeover of CalPERS board serves as a compelling example of the need for accountability in pension investment decisions.

Political Kickbacks Cost Pension Funds

Using pension funds to reward politically connected businesses and interest groups lowers investment returns and jeopardizes pensioner's retirement security. Pension trustees have an obligation to act in the best interest of pensioners and should never use pension funds to give political kickbacks to their supporters. Strong fiduciary standards defining how pension funds are to be managed can help prevent this. In addition, transparency in the investment process and a board with a greater diversity of ex officio, appointed and elected members, along with board seats for designated public representatives, would ensure public pensions cannot be hijacked by special interests willing to tolerate such cronyism so long as their interests are served.

Solutions for Fighting Political Kickback Cronyism

- States should adopt fiduciary duty of loyalty provisions which require pension trustees to act in the sole interest of beneficiaries as a whole, impartially, not just certain interest groups participating in the plan. Fulfilling this provision should require pursuing the best long-term, risk-adjusted returns for the pension fund.

- Trustees should be required to fully disclose any conflicts of interest, including money and gifts given to trustees that may influence their investment decisions, as well as affiliation with special interest groups.

- Before making any investment, trustees should be required to attest they have no conflict of interest with the investment. If they do, they should be required to recuse themselves from the decision-making process for that investment and any related votes.

- Trustees should be required to fully disclose campaign contributions they have received and recuse themselves from the decision-making process and any votes related to investing in those companies or interests.

- Pension boards should be diversified to provide representation for all stakeholders, including taxpayers. This will prevent any special interest group from gaining too much power on the board and using pension funds irresponsibly.

- Pension boards should have a certain number of seats dedicated to independent financial professionals that serve as public representatives.

Chapter 4
Political Crusades

One type of pension fund cronyism that has proliferated recently is the use of pension funds to advance certain political viewpoints or causes. These political crusades regarding such issues as the environment, political speech and income inequality are frequently waged through divestment initiatives and by promoting shareholder resolutions at publicly-traded companies. When pension funds pick a side in political disputes and decide they are going to use the pension fund as a weapon, investment returns decline and many citizens find their hard-earned retirement funds used to support political positions antithetical to their beliefs.

The Pension Divestment Movement Harms Pension Funds

One of the greatest threats to pension investment returns comes in the form of divestment from certain companies or industries. Pension divestment initiatives have been gaining traction recently, with many on the Left viewing them as a tool to advance their political agenda. By requiring pension funds to remove all investments from certain companies or industries, they hope to increase firms' cost of capital in an effort to put them out of business or change their behavior in some way. In order to examine this issue further, this report considers one of the most notable divestment efforts, fossil fuel divestment, and what it means for pensions.

Fossil Fuel Divestment

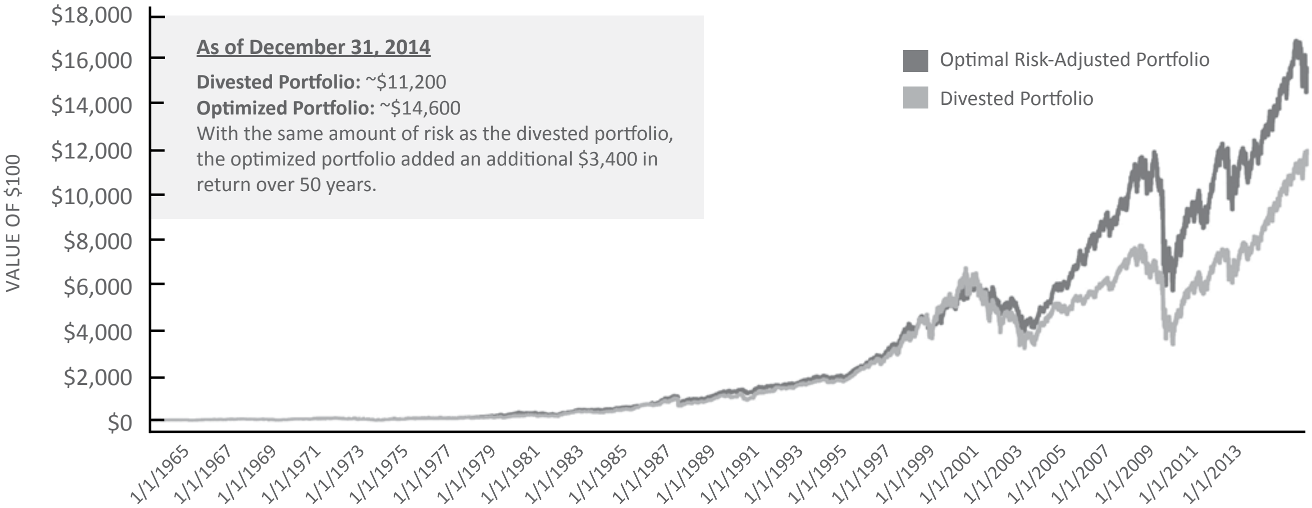
In recent years, various environmental organizations have been encouraging pension funds to divest from fossil fuel companies and other businesses that they believe are contributing to environmental harm. They have had some limited success, with several municipalities enacting plans over the years to divest from fossil fuel companies and other businesses calculated to have a large carbon footprint. Recently, California became the first state to pass a law requiring the state's public pension funds to divest from fossil fuel, specifically coal companies. While it remains the only state to enact such legislation, several governors have publicly called for their state's pension funds to divest from fossil fuel companies as well.

The financial losses from divestment are significant. A study conducted by University of Chicago Law School Professor Daniel Fischel found that a hypothetical portfolio diversified across all industries outperforms a hypothetical portfolio divested from energy stocks over the past 50 years.[73] The divested portfolio produced returns 0.7 percentage points lower on average per year than the optimal risk-adjusted portfolio that did not divest from energy, representing a massive 23 percent decline in investment returns over five decades.[74]

Lower returns are not the only price of divestment. The initial cost of divestment should also be considered. This includes the costs of the initial review of existing investments, along with the commission fees to brokers and other trade costs accompanying every trade necessary to fully divest the portfolio. This is money that could be going to the pension system to improve its funding level and provide greater retirement security for workers and retirees in the future.

The ongoing administrative cost of complying with divestment rules is also significant.[75] Pension plans that divest must continually investigate prospective investments to see if they meet their state's ecological standards, while also monitoring their existing portfolio of investments to ensure none of those companies have begun to engage in business activity that necessitates divestment. This requires significant work on the part of the pension fund's managers, resulting in higher management fees. It also means additional trading

FIGURE 8: OPTIMAL RISK-ADJUSTED PORTFOLIO VS. DIVESTED PORTFOLIO 1965-2014



Notes:
[1] The indices are value-weighted by market capitalization.
[2] The Optimal Risk-Adjusted Portfolio is comprised of the energy index and 1-month Treasury bill, optimized by matching the standard deviation of the Divested Portfolio.
[3] The Divested Portfolio is comprised of only the non-energy index.

Source: Fischel, Daniel, Fossil Fuel Divestment: A Costly and Ineffective Investment Strategy; Center for Research in Security Prices; French, Kenneth

fees from all the trades necessary to remain compliant with the divestment requirements.

Professor Hendrik Bessembinder of Arizona State University recently studied these "frictional" costs that college and university endowments incur when divesting from fossil fuel industries. Frictional costs in this case include the costs of ongoing monitoring, as well as the transaction costs associated with the trades and actions of the management strategy. Bessembinder writes, "Selling and buying assets, as fossil fuel divestment requires, involves transaction costs, which depend on the type of asset, the size of requisite trades, and the market institutes that facilitate trading."[76]

Bessembinder's research suggests divesting funds means dramatically higher management fees. His study compared the net expense ratios of various investment funds and found a significant difference between the net expense ratios of "socially-conscious" funds and those of standard funds. The net expense ratio is a charge assessed to investors to cover the fund's total annual operating expenses, often expressed as a percentage of a fund's average net assets. While active, socially-conscious funds averaged a prospectus net expense ratio of 0.795 percent, passive standard funds averaged only 0.061 percent.[77] The additional expense of active management would be paid annually by funds choosing to divest from fossil fuels. This is money that could have been invested and gained additional returns. Compounded over a 20-year term, the costs of actively managing a portfolio to keep it divested add up to significant losses.

Other frictional costs of divestment are transaction costs, which include fees and commissions paid to brokers and exchanges, as well as the implicit costs of the "bid-ask spread and the price impact of trades." The bid-ask spread is the difference between the highest bid price and the lowest ask price in a market for a given security. This difference is "an implicit payment to the market-maker or other liquidity supplier" for providing the liquidity to execute the trade and is especially relevant to small trades like those that would be necessary to micro-manage a fossil fuel-free account.[78]

The price impact is any additional cost traders may incur when executing very large orders. Just as the Laws of Supply and Demand teach us - when the quantity demanded of a given good increases, the price goes up, and similarly, when the quantity supplied of a given good increases, its price falls. In this case, it is the higher price paid when executing a large purchase, or the lower price received when executing a large sale, such as the trades that would be necessary upon the implementation of a fossil-fuel-free portfolio strategy.

In his regression analysis, Bessembinder finds these frictional costs would reduce the value of a large university endowment by 2 to 12 percent over the next 20 years. Results like these are one reason many universities have been hesitant to divest from fossil fuel and other industries despite pressure, often from their own students, to do so.

Fossil Fuel Divestment Fails to Achieve Its Goals

Climate activists often cite four main benefits to encourage funds to divest. The first holds that companies that allegedly contribute to climate change can be punished by reducing their stock prices through divestment, thereby reducing their access to sources of capital and increasing their costs. However, divestment is unlikely to accomplish this goal, and to the extent the effort is successful, the costs are often borne by the very investors choosing to divest. As was noted earlier, sales of large asset blocks typically occur at a discount to the market prices. Much of this discount is temporary, as it basically represents a wealth transfer from the divesting investors to the market liquidity providers who are "buying" the securities.[79] Little historical evidence would indicate any permanent price effect resulting from divestment.

Another argument from activists is that fossil fuel securities are overpriced, and thus likely to underperform in the long run. This too is not supported by the facts. According to Bessembinder, "Such claims are particularly prevalent at times when these stocks have recently performed poorly – even though price declines over the past several months actually appear to be associated with increased production of fossil fuels."[80]

Yet another common claim by activists is divestment can help stigmatize firms engaging in allegedly harmful activities, hopefully motivating a change in behavior. The channels by which this change would occur, however, are unclear. Research of past divestment behavior has found that divestment efforts have little to no effect.[81] In addition, the Fischell study notes that there is no evidence of any discernable impact on the companies targeted by fossil fuel divestment supporters.[82]

Finally, proponents of fossil fuel divestment claim that divestment will raise awareness of the issue of climate change. In examining this claim, Fischell conducted an empirical review of the amount of news coverage dedicated to the climate change issue and found evidence it is one of the most commonly reported topics in the United States today, indicating a divestment campaign is not necessary to raise public awareness of the matter.[83]

The evidence indicates claims that divestment will reduce reliance on fossil fuels or spur institutions to change allegedly bad behavior are speculative at best, while the costs associated with divestment are real and significant. Nonetheless, the fossil fuel divestment effort continues to target public pension funds. Some of the most notable cases demonstrate that while divestment leads to foregone investment returns, this politically-motivated campaign is still gaining momentum.

California

On October 8, 2015, Governor Jerry Brown signed into law Senate Bill 185, entitled "Investing with Values and Responsibility."[84] This signing was a noteworthy event, as according to California State Senate President Pro Tempore Kevin De León, it marked the first time a state had divested its pensions from coal.[85] This divestment had added significance because California manages the two largest state pension funds in the country by asset value, the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS), with $293 billion and $184 billion in assets, respectively.[86]

Senate Bill 185 prohibits CalPERS and CalSTRS from renewing existing investments or making new investments in thermal coal companies. In regard to existing investments, the two funds must engage with these companies to determine if the companies are transitioning their business model to clean energy. They must liquidate their investments with thermal coal companies on or before July 1, 2017. Finally, the funds must file a report with the Legislature, listing which thermal coal companies they divested from and which current thermal coal companies have agreed to transition to clean energy. This report must be filed on or before January 1, 2018.[87]

Senator De León, who authored the law, remarked upon its signing, "Coal is a losing bet for California retirees and it's also incredibly harmful to our health and the health of our environment," emphasizing that environmentalism was the primary motive for the divestment.[88] Assemblyman Rob Bonta, who presented the bill in the California Assembly, stated upon its passage in the Senate, "coal is the fuel of the past…it's time to move on from this dirty energy source," and "the law aligns investment policies with our values."[89] Unsurprisingly, the signing of the law was applauded by leaders of several prominent environmentalist interest groups.[90]

The bill's final vote of 43-27 was "mostly along party lines with some Democrats abstaining."[91] This, combined with Governor Brown's strong support, indicates this may not be the last climate related divestment legislation California will enact.[92] Before divestment, CalPERS had approximately $167 million invested in 30 coal companies, while CalSTRS had an estimated $40 million invested in the industry.[93]

Despite the best intentions of supporters, divestment puts California's pensioners at financial risk. Chris Ailman, chief investment officer for CalSTRS, expressed misgivings over the economic and social consequences of divestment in California. Ailman explained:

> *"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."*[94]

Furthermore, many pensioners are concerned about the financial costs of divestment. A recent survey commissioned by the Independent Petroleum Association of America reveals that California pensioners are uneasy about divestment. The survey found that 54 percent of California pensioners thought divestment would decrease performance of the pension funds. Additionally, 64 percent of California pensioners stated that they would not recommend divestment from oil and gas to their fund managers.[95]

California legislators should listen to the concerns of their constituents. The research suggests they are correct in believing divestment will adversely affect the state's pension funds' performance. Lawmakers should be directing their pension fund trustees to invest in a way that achieves the best returns for pensioners, not trying to use state pension funds to promote a political agenda.

New York

Similar to California, divestment is also a heated issue in New York. After California's CalPERS and CalSTRS pension funds, New York has the third largest public pension fund in the country. Oil and natural gas investments represented 5 percent of the total assets of New York's two largest pension plans from fiscal years 2005 to 2013. Furthermore, during that time frame, oil and natural gas investments contributed 9.8 percent of the plans' total gains.[96]

Despite this, State Senator Liz Krueger recently introduced Senate Bill S5873, the Fossil Fuel Divestment Act. This Act would "require the fund to sell off its stocks in the top 200 largest fossil fuel companies by 2020."[97] However, the Act does permit New York's Comptroller to cease divestment, as long as the Comptroller can convincingly demonstrate divestment has caused the fund to lose significant value.[98] If the Act became law, New York would be the second state in the nation to enact fossil fuel divestment.

The Fossil Fuel Divestment Act was first introduced and referred to the Rules Committee on June 9, 2015.[99] After seven months, the bill was referred to the Civil Service and Pensions Committee in January 2016 where it was approved. On April 11, 2016, the bill moved on to the Senate Finance Committee, where it stayed for the remainder of the 2016 legislative session.

During debate over the Act, State Comptroller Thomas DiNapoli expressed misgivings. He was concerned divestment could conflict with his fiduciary duty. As manager of New York State's pension funds, the Comptroller is required to generate the best possible returns for pensioners. In a December 2015 letter to Senator Krueger, Comptroller DiNapoli explained:

> *"My fiduciary duty requires me to focus on the long term value of the Fund. To achieve that objective, the Fund works to maximize returns and minimize risks. Key to accomplishing this objective is diversifying the Fund's investments across sectors and asset classes—including the energy sector, where fossil fuels continue to play an integral role in powering the world's electricity generators, industry, transportation, and infrastructure."*[100]

Hopefully, Comptroller DiNapoli's concerns will be taken seriously. Pursuing a political agenda through divestment would hinder the Comptroller's ability to wisely steward pension investments. New York pensioners deserve a well-managed, diversified portfolio that achieves the best possible returns to provide a secure retirement.

Vermont

Governor Peter Shumlin, who is leaving office in January 2017, has also called for pension divestment of coal companies. Beyond this, he has singled out ExxonMobil as a specific company the state's pension funds should target for divestment. The governor is not alone. He is joined in his demands by several environmental activists in the Green Mountain State.

Governor Shumlin argues Vermont has a "moral responsibility" to fight climate change and, as such, the state should divest its pension funds from fossil fuel companies.[101] When it comes to ExxonMobil, the governor claims the company "hid what it knew about the dangers of climate change for decades."[102] However, this statement is merely an unsubstantiated allegation, part of the broader bullying campaign by some state attorneys general to discourage investment in the fossil fuel industry.[103] For its part, ExxonMobil has fervently denied obstructing such information from the public.[104]

Interestingly, one of the governor's most prominent opponents in regards to divestment is State Treasurer Beth Pearce, a fellow Democrat, who was appointed by Governor Shumlin six years ago.[105] Pearce opposes divestment, explaining:

> *"We have a fiduciary responsibility of stewardship of those taxpayer dollars, and the dollars for the members of the system. When those dollars go into a trust we are obliged to maximum return for those individuals," she says. "So ... I'm going to be guided by facts not by politics."*[106]

Despite the treasurer's strong opposition, she agreed to at least review the divestment issue.[107] However, it appears Pearce still believes that the foremost obligation of the state's pension funds should be to provide financial security for retirees, considering her recent statement that her "zeal on behalf of retirees' pension funds hasn't diminished as a result of her consideration of divestment."[108]

Pearce's concerns are well-founded. According to the Vermont Treasury, divestment would cost state pension funds $10 million per year in lost returns. Furthermore, the state pension funds would have to pay $8.5 million to implement the divestment process.[109] Thomas Golonka, chair of the Vermont Pension Investment Committee, agrees that divestment is a complex and costly process.[110]

Despite the significant costs of divestment, Pearce still drew an ardently pro-divestment primary challenger, financial analyst Richard Dunne. This demonstrates how contentious fossil fuel divestment has become in Vermont politics. However, Pearce soundly beat Dunne in the 2016 Democratic primary.[111]

For now, at least, Vermonters are protected from the costs of fossil fuel divestment. As the state's own treasury estimate indicates, there are significant costs to divestment, costs ultimately borne by pensioners and taxpayers.

Pension Divestment at the Municipal Level

In December of 2012, Seattle became the first major city to announce it would divest from fossil fuels.[112] By April 2013, it was joined by nine other cities, including Madison, Wisconsin and San Francisco, California.[113]

As part of Seattle's divestment process, then Mayor Mike McGinn personally issued a letter to Seattle City Employees' Retirement System (SCERS) and the City of Seattle Voluntary Deferred Compensation Plan Committee, the city's two major pension funds.[114] In the letter to SCERS, Mayor McGinn wrote "divesting the pension fund from these companies is one way" the city of Seattle can "discourage" them from extracting fossil fuel.[115]

On April 26, 2013, San Francisco's Board of Supervisors voted unanimously to urge its $16 billion pension fund to divest over $583 million from the fossil fuel industry.[116] However, less than six months later, the board of the San Francisco Employees' Retirement System (SFERS), which manages the pension fund, voted to reject the city's call for divestment. On December 9, 2015, the SFERS board adopted a more limited proposal to divest from thermal coal companies, which amounted to about $21 million of its portfolio.[117]

These examples demonstrate fossil fuel divestment is not just a state issue, but one that municipalities also face. However, as demonstrated by the relatively few cities that have enacted divestment, most local lawmakers and pension board members realize that using pension funds to advance political causes is a costly decision that jeopardizes workers' retirement security.

Fossil Fuel Divestment Threatens Pensioners' Retirement

As the case studies in California, New York, Vermont and various cities demonstrate, fossil fuel divestment is a major initiative that several states and municipalities are considering. However, using public pension funds to advance a political agenda comes at the price of investment returns. With the current underfunded status of so many public pension systems, state and local governments cannot afford to play politics with pension funds.

Divestment from Individuals Based on Personal Beliefs

Another form of divestment is the effort by some interest groups to pressure pension funds to divest from certain fund managers on account of their personal beliefs. Perhaps the most notable example of this effort has been led by the American Federation of Teachers (AFT). In recent years, the AFT has promoted a divestment campaign targeting hedge-fund managers who have supported initiatives with which they disagree. The AFT has targeted some hedge-fund managers for their actions supporting school choice and favoring defined-contribution public pension systems. This is particularly threatening given AFT's influence over an estimated $1 trillion in public defined-benefit plans, many of which hold investments in hedge-funds as part of their portfolio.[118]

By thoroughly examining financial reports and the charitable deductions of hedge-fund managers, AFT created a "blacklist" of roughly three dozen individuals.[119] Individuals earned a spot on the dubious list by personally supporting causes and organizations disapproved of by AFT. Union pension funds then used the AFT blacklist as a guide to divest from the hedge-funds managed by these individuals. As Figure 9 shows, state pension funds in California, Illinois, New Jersey, New York, Oklahoma, Rhode Island and Washington state have all divested from hedge-funds to some degree.[120]

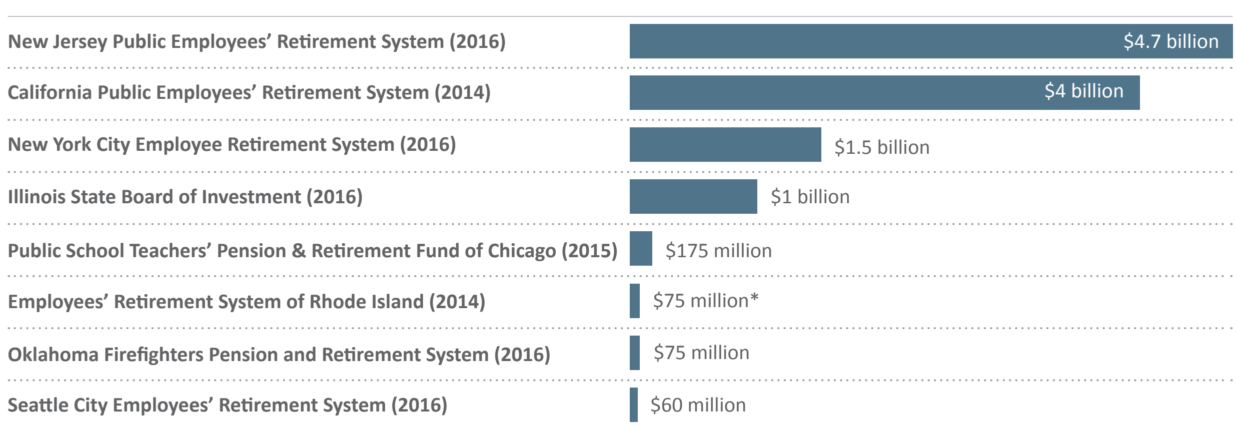
Not only have state pension funds succumbed to divestment pressure, but fund managers have been personally targeted to try to change their behavior. For example, a recent *Wall Street Journal* article detailed what happened when a hedge-fund manager, Cliff Asness, recently found himself on the blacklist.

Asness appears to have been originally blacklisted for serving on the board of the Manhattan Institute for Policy Research, an organization that promotes economic choice and individual responsibility and which supports, among other things, state and local governments moving from defined-benefit public pension plans to defined-contribution plans. Shortly after his firm paid $25,000 to help found a pension policy group with AFT President Randi Weingarten, Asness was removed from the list.[121] However, Asness continued to

FIGURE 9: PUBLIC-EMPLOYEE PENSION FUND DIVESTMENT FROM HEDGE-FUNDS

Getting Out of Hedge-Funds

Public-employee pension funds have pulled billions of dollars from hedge-funds in recent years, sometimes with the encouragement of the American Federation of Teachers.



**voted to divest from Third Point LLC*

Source: The Wall Street Journal; pension officials; published reports serve on the Manhattan Institute board, and when CalSTRS later considered increasing their hedge-fund investments, Weingarten saw an opportunity to apply pressure. Her aide spoke with a CalSTRS official about Cliff Asness's service as a Manhattan Institute board member and shortly after, a CalSTRS official spoke with Asness. Later that year, Asness announced that he would step down from the Manhattan Institute's board. While his spokesperson said Asness already made the decision at the time of the call, the timing is certainly interesting. In a letter to *The Wall Street Journal*, Asness claimed that his decision was not made on account of pressure from AFT.[122] In any case, the fact that such a powerful organization is able and willing to threaten an individual's personal livelihood through divestment is concerning.

Regrettably, AFT's intimidation campaign comes at a great cost—the security of retirees. Pension funds should be managed to generate the best investment returns for pensioners, not target political enemies. By picking and choosing funds based on fund managers' personal beliefs, rather than their funds' investment performance, pension fund returns will likely decline and the financial stability of the fund could be at risk. As a recent *Wall Street Journal* article aptly explains:

> *"Sander Read, chief executive officer of Lyons Wealth Management, which hasn't been targeted, likened what Ms. Weingarten is doing to 'hiring a dentist because of their political beliefs. You may see eye to eye on politics, but you may not have great, straight teeth.'"*[123]

State and local governments should adopt fiduciary standards that prevent this type of personal divestment and put pensioners first by requiring investment decisions be made based on financial considerations, not on political agendas.

Rhode Island Trades Investment Returns for Politics

Another example of targeting individuals for divestment comes from Rhode Island, where an apparently politically-driven decision to divest from a high performing hedge-fund cost the state access to some of the best returns its pension portfolio had earned in recent years. It is perhaps worse considering the decision makers in this case were financially-savvy professionals who should know better than to sacrifice substantial pension fund gains for political capital.

The Employees' Retirement System of Rhode Island (ERSRI) is significantly underfunded. ALEC, in its most recent pension liabilities report, *Unaccountable and Unaffordable 2016*, found Rhode Island's total pension funding ratio was a mere 29.6 percent, with a total unfunded pension liability of more than $18.6 billion.[124] This unfunded liability is equivalent to $17,644 for every man, woman and child in Rhode Island.[125] Knowing that ERSRI is already significantly underfunded makes any further losses from politically-motivated decisions all the more serious.

Rhode Island Governor Gina Raimondo is a key figure in the story. Raimondo was once a strong ally of pension reform. A former venture capitalist, Raimondo seemed to understand the limitations of the market, and why assuming unrealistically high investment returns was not in the best interest of the people of Rhode Island. Before she was elected to the state's highest office, Raimondo served as Rhode Island's General Treasurer, championing reform and a shift toward a hybrid pension model that incorporated elements of managing the pre-existing defined-benefit system with elements of a 401(k)-style defined-contribution system, as well as reforms to cost-of-living-adjustments (COLAs). As observed by former Utah State Senator Dan Liljenquist in the 2013 ALEC publication, *Keeping the Promise: State Solutions for Government Pension Reform*:

> *"Gina Raimondo, the state's treasurer and a Democrat, led pension reform in the state and defended it as a moral imperative. After declaring that Rhode Island had to choose between maintaining the pension system as it was and reducing other spending priorities, she said to a disgruntled public employee, 'I would ask you, is it morally right to do nothing [on pension reform], and not provide services to the state's most vulnerable citizens? Yes, sir, I think this [reform] is moral.'"*[126]

In 2012, *The Wall Street Journal* ran a feature, "The Democrat Who Took on the Unions," cataloguing the reform processes Raimondo spearheaded and the Rhode Island General Assembly eventually implemented.[127] Another

2012 *Wall Street Journal* article, "Rhode Island Miracle Explained," described Raimondo's visit with the Manhattan Institute:

> *"The plan enacted in November cuts $3 billion of the state's $7 billion unfunded liability by raising the retirement age, suspending cost-of-living increases until the pension system is 80% funded, and even moving workers into a hybrid plan that has a smaller guaranteed annuity along with a 401(k)-style defined-contribution plan."[128]*

These efforts demonstrate how Raimondo and Rhode Island officials put in the hard work to start reforming the state's pension system. However, after years of give-and-take with state employee unions, Raimondo seemed to cave under political pressure when it came to one critical decision, leaving doubts about how Rhode Island's public pensions are governed.

Among Raimondo's duties while serving as Rhode Island's General Treasurer was leading the Rhode Island State Investment Commission. During her tenure, Third Point Partners' Dan Loeb was tasked by the Commission to manage $74.3 million of Rhode Island's $8 billion pension fund, an amount that was small considering the size of Third Point's $14 billion portfolio.[129] Loeb had the reputation of being a strong hedge-fund manager, capable of providing better returns than many of his peers. In 2013, Loeb was recognized as one of the elites of his industry, making *Institutional Investor's Alpha's* "Rich List," a ranking of the hedge-fund industry's 25 highest earners.[130] Loeb earned Rhode Island "a 24.71 percent return that ranked Third Point as the state's best performing hedge-fund in 2013, according to state documents."[131] That nearly doubled the pension fund's overall 14.01 percent return for the year.[132] According to a Third Point spokesperson, "Rhode Island's pensioners earned 49 percent, net of fees, over the two years they invested with us," and Third Point's fund had earned "a net annualized rate of return of 21.3 percent since 1995."[133]

In a role unrelated to his management of Rhode Island pension assets, Loeb was an advocate for government reform, and served as director for a New York City-based non-profit, Success Academy Charter Schools.[134] He also sat on the board of StudentsFirst, an organization that advocates for teacher accountability.[135] In a June 2013 *Bloomberg* article, Loeb was described as "escalating a battle between hedge-fund managers and American Federation of Teachers (AFT) President Randi Weingarten over public-worker pensions."[136] A part of his personal activism was having "donated an extra $1 million to a group of charter schools to show his opposition to the head of the second-biggest U.S. teachers union." These actions earned him a distinction from the AFT for being "hostile to traditional public pensions."[137]

AFT began to pressure Rhode Island to divest from Loeb's fund. Alarmingly, "AFT wanted pension trustees to consider fund managers' ties to groups that oppose defined-benefit retirement systems as a reason when hiring or firing them."[138] Ultimately, the Rhode Island State Investment Commission, chaired by Raimondo, unanimously decided to divest from hedge-funds, claiming hedge-funds were not a sound investment.

The Commission cited fees paid to the hedge-fund managers as part of the justification for their decision. They noted that, for three hedge-funds alone, Rhode Island paid a collective $2.6 million in fees in 2012. However, given that Third Point was the best performing hedge-fund in 2013, and the outstanding investment returns they provided, questions persist about the reasoning behind Third Point's dismissal.

An informative *Wall Street Journal* editorial, "The Education of Gina Raimondo," stated:

> *"It's hard to avoid the conclusion that Ms. Raimondo is trying to neutralize union opposition by throwing Mr. Loeb over the side. But Ms. Raimondo is fooling herself if she thinks that divesting from Third Point will atone for her pension-reform heresy. The unions will still try to end her political career. Ms. Weingarten wants to make an example of Ms. Raimondo by showing other Democrats that favoring pension reform is politically fatal."[139]*

When politics enters the policy equation, pension officials can find themselves pressured to make poor investment decisions. Raimondo found herself in such a situation and appears to have been willing to sacrifice the state's pension performance for political considerations.

The Manhattan Institute and Dan Loeb once honored Raimondo for her work reforming the Rhode Island pension system, but even after a successful reform process had begun, AFT was able to apply political pressure to get state officials to punish Loeb for his support of school choice and public pension reform. So long as pension officials are subject to political pressure, there exists a risk that pension funds will be governed with politics, not pensioners, in mind. As noted by *The Wall Street Journal*, "Ms. Raimondo is a politician, and politicians do what they feel they must to get elected."[140] Regardless of whether Raimondo acted on questionable motives, the fact that questions can be so easily and reasonably raised is enough to provide a case study of the potential harm politics can have on proper pension fund governance.

Shareholder Activism in Pension Fund Management

Another startling misuse of pension fund assets occurs when managers use their large equity holdings to promote shareholder resolutions that advance particular political agendas. This is inconsistent with what should be pension fund managers' fiduciary duty to pursue the best investment returns possible for plan participants.

Engagement in politically-driven shareholder activism does not relate to this mandate and wastes valuable time which trustees should be using to seek better fund performance. It also subjects important decisions on how to vote on shareholder resolutions to political concerns, as opposed to basing these decisions on what is best for investment returns. When a pension board considers introducing or supporting a resolution, it should only be considering one thing: what is best for plan participants, in other words, what will help the company achieve the best performance. Finally, politically-driven shareholder activism is unfair to plan participants and taxpayers because it appropriates the pension fund, made up of employee contributions, employer contributions and taxpayer dollars to advance a political agenda with which many of these stakeholders may disagree.

Public Pension Funds Advance Political Shareholder Resolutions

Recently, there has been an increase in public pensions attempting to use shareholder resolutions to advance political agendas. The number of these resolutions is cause for concern. The Manhattan Institute's Proxy Monitor tracks shareholder activism for the Fortune 250 companies and provides a good barometer for what is happening with shareholder resolutions across the country.

Proxy Monitor reports that resolutions to modify corporate activities affecting the environment, to disclose political spending and lobbying activity and to alter executive compensation packages are some of the most common types of shareholder proposals. According to their research, of the 301 shareholder proposals for Fortune 250 companies in 2016, 58 related to environmental concerns, 54 to political spending or lobbying, 11 to equity compensation and 6 to other executive compensation.[141]

For the Fortune 250, labor-affiliated investors constituted 53 percent of those proposing political spending or lobbying related shareholder resolutions from 2006 to 2016.[142] Labor-affiliated investors generally include state or municipal pension funds or multiemployer pension funds for private labor unions. The New York Common Retirement System, New York City Pension Funds and the American Federation of State, County and Municipal Employees (AFSCME) have been the shareholders most frequently sponsoring political spending and lobbying-related resolutions, with a combined 89 proposals from 2006 to 2016.[143]

Environmental activists continue to step up their efforts as well, submitting 459 environment-related shareholder proposals to Fortune 250 companies in just the last 10 years.[144] Of those, 135 were resolutions relating to corporate policy on climate change or greenhouse gas emissions and 82 related to environmental sustainability.[145] Further, social investing, religious and public policy-related institutional shareholders sponsored 74 percent of the 10-year total for environment-related proposals, with 38 percent attributed solely to social investing institutions.[146] Typically, these resolutions ask the company to create a report on the financial risks of climate change, set targets for reducing greenhouse gas emissions or create plans for more "sustainable" operations. Public pensions have also played a significant role in environment related shareholder activism, collectively issuing the second largest number of proposals over the last 10 years. The New York State Common Retirement Fund and New York City Pension funds sponsored 16 and seven, respectively.[147]

Shareholder Activism to Silence Free Speech

In her recent book, *The Intimidation Game*, *Wall Street Journal* columnist Kimberley Strassel details organized efforts to chill free speech. "In June 2011, California state treasurer Bill Lockyer and New York City public advocate Bill de Blasio – both die-hard Democrats and both charged with overseeing the investment of pension-fund money – wrote letters to their respective pension funds calling on them to use their heft to demand corporate political spending disclosure. Both CalPERS and CalSTRS quickly moved to formally adopt policies to do just that."[148] New York's Bill de Blasio was recently quoted in a Media Matters memo about the political Left's real goals regarding corporate disclosure of political activity. In the memo, de Blasio was quoted as saying, "We will use every tool, whether it is actions among consumers up to boycotts, whether it's shareholder actions, whether it's work from pension funds – to use the pension funds to direct Corporate America to change its ways—legal action, you name it, it's on the table."[149]

This is unsettling because it shows some pension fund managers are more interested in using the fund to silence political views they disagree with than managing the fund to get the best returns possible for workers. Pension trustees should not be using public pension funds to advance their own political crusades and should instead be focused on diligently managing the fund they have been entrusted with to earn the best returns possible and provide a secure retirement for plan participants.

Shareholder Activism and Executive Compensation

Another issue where pension funds are pushing political agendas through shareholder resolutions is executive and CEO compensation. Shareholder proposals relating to stock option compensation or other executive compensation are increasingly prevalent, with 17 being introduced among Fortune 250 companies in 2016 alone.[150]

One notable example of these efforts comes from Washington state. In his 2016 State of the State Address, Governor Jay Inslee directed the State Investment Board to vote against executive compensation packages deemed too high. As a large shareholder in many companies, the Board may already vote against the salary of any executive if they believe it does not represent the financial health of the company. However, Governor Inslee wants the State Investment Board to go further by using their voting power to "reduce the widening pay gap between CEOs and their workers," and encouraged the board to "promote this policy with other states and institutional investors."[151] This is not the first time executive compensation has been politicized. Large institutional shareholders such as CalPERS, CalSTRS and AFSCME have regularly demanded decision rights on executive pay at the annual meetings of companies, both domestic and multinational.[152]

Attempts to influence compensation decisions, or any other significant financial actions of private companies, by public pension funds or government for political reasons, are a grave misuse of the time that pension managers should be spending to perform their fiduciary duties. They are an abuse of employee contributions, employer contributions and taxpayer dollars for the politicization of private issues.

Political Crusades Put Pensioners at Risk

As these examples have shown, when pension trustees place their own political agendas ahead of their responsibility to achieve the best returns for the pension fund, pension returns often decline, placing pensioners' retirements in jeopardy. This activism is also unfair to both pensioners and taxpayers because it uses public funds to speak in their name, even when pension trustees take political positions contrary to their deeply-held views. Pension trustees should not be spending their time, and risking other people's money, on political crusades. Rather, they should use their time to research new investment opportunities and provide the best returns for the pension fund. Individuals serve on pension boards as trustees, not political activists.

Solutions for Fighting Political Crusade Cronyism

- Trustees should manage pension funds solely in the interest of plan participants and beneficiaries as a whole, impartially. Fulfilling this provision should require pursuing the best long-term, risk-adjusted returns for the pension fund.

- Enact fiduciary provisions requiring any introduction of or vote on shareholder resolutions to be based solely on pursuing the best long-term, risk-adjusted returns for the pension fund.

- Dispense with any existing divestment requirements for specific companies or industries.

- Require a comprehensive report from an independent financial consultant before any divestment action is approved detailing the estimated short-term and long-term cost of the proposed divestment.

- Require all introductions of and votes on shareholder resolutions to be made in consultation with the whole pension board.

- Require reporting each year of how a pension fund voted on each shareholder resolution and the justification for their decision.

Conclusion

While significantly underfunded, public pension funds represent the retirement future of millions of American workers. As such, lawmakers have an obligation to public employees to ensure these funds are managed in workers' best interest. When pension trustees misuse public pension funds to promote local economic development and social goals, reward supporters or promote political agendas, it endangers investment returns and jeopardizes the future of pensioners.

Workers deserve better. Policymakers have the opportunity to secure the promises made to pensioners and their families by keeping politics out of pension policymaking. This can be achieved by adopting strong fiduciary standards for pension trustees, transparency rules that allow the public to see how pension funds are being managed and smart pension board reforms that hold trustees accountable. These reforms will guarantee proper pension fund management, which in turn will help state and local governments keep the pension promises they have made.

Appendices

APPENDIX A: SOLUTIONS FOR PRUDENT PENSION INVESTMENT AND GOVERNANCE

States can keep their pension promises to workers and retirees through wise pension investment and governance. These solutions fall into three important categories: fiduciary standards, transparency rules and pension board governance reforms.

States should adopt strong fiduciary standards for public pension trustees that require:

- Trustees should manage the pension fund for the exclusive purpose of providing pension and other post-employment benefits to plan participants and beneficiaries. Other post-employment benefits should be defined to include healthcare and other benefits outlined in the pension plan and not the limited, tangential benefits local economic development and social projects may provide.
- Trustees should manage pension funds solely in the interest of plan participants and beneficiaries as a whole, impartially. Fulfilling this provision should require pursuing the best long-term, risk-adjusted returns for the pension fund.
- Dispensing with any economically targeted investments and industry divestment requirements which invariably reduce pension fund returns and increase investment risk.
- Adopting the prudent investor standard for pension fiduciaries.
- Any introduction of or vote on shareholder resolutions to be based solely on pursuing the best long-term, risk-adjusted returns for the pension fund.
- Trustees may only incur administrative costs and fees that are appropriate and reasonable in relation to the assets of the retirement system.
- Trustees should diversify the investments of the retirement system, unless it is reasonably determined that, because of special circumstances, the purposes of the retirement system are better served without diversifying.
- Trustees should be held personally liable for losses deriving from failure to adhere to fiduciary standards.

State should adopt transparency rules that allow lawmakers, board members, pensioners and the public to see how pension funds are being managed, including:

- Reporting of investments should be done separately by asset class and by individual assets so it can be easily determined how investments are performing and increase accountability for trustees.[153]
- Pensions should report the fund's overall performance, asset class performance and individual asset performance over a 20 or more-year time horizon to show how assets have performed over time and allow stakeholders to see how actual performance has compared with the assumed rate of return.[154]
- Require a comprehensive report from an independent financial consultant before any divestment action is approved detailing the estimated short-term and long-term costs of the proposed divestment.
- Require reporting each year of how a pension fund voted on each shareholder resolution and the justification for their decision.
- Pension board meetings should be live-streamed, recorded and easily accessible to the public.
- All pension related documents should be readily available to the public with necessary exceptions for confidentiality.
- Trustees should be required to disclose all personal investments, gifts, affiliations and other interests that may influence their investment decisions to allow the public to evaluate any potential conflicts of interest.

States should adopt board reforms that require and enable trustees to serve as watchdogs, ensuring that fiduciary provisions are being followed and that pension funds are wisely managed:

Board composition:

- Pension boards should be diversified to provide representation for all stakeholders, including taxpayers. This will prevent any special interest group from gaining too much power on the board and using pension funds to overweight local investments, grant political kickbacks or advance political crusades.
- Pension boards should have a certain number of seats dedicated to independent financial professionals that serve as public representatives.

Trustee responsibilities:

- Trustees should be required to report any failure by other trustees, including board members and pension fund managers, to adhere to fiduciary standards and other applicable law.
- Before making any investment, trustees should be required to attest they have no conflict of interest with the investment. If they do, they should be required to recuse themselves from the decision-making process for that investment and any related votes.
- Trustees should be required to fully disclose campaign contributions they have received and recuse themselves from the decision-making process and any votes related to investing in those companies or interests.
- While trustees may represent a specific group's interests, they should be expected to act impartially to achieve the best returns for the fund.[155]
- Trustees should not be allowed to delegate their voting authority by proxy voting.
- Trustees dealing with day-to-day investment decisions, such as those serving on investment committees, should:
    - Be required to have a minimal amount of financial experience and some form of industry certification.
    - Not be allowed to change the bylaws governing pension investments without approval from the full pension board.[156]

Board management and operations:

- All trustees should be regularly apprised of investment performance, with specific details of how all individual assets have performed.
- Require all introductions of and votes on shareholder resolutions to be made in consultation with the whole pension board.
- Pension boards should be required to consult with outside, independent financial advisors regarding their investment strategy and investment decisions.
- States and municipalities should consider creating an independent investment board, apart from the pension board, made up of financial professionals to manage day-to-day investment decisions. Working with a pension fund's chief investment officer, this independent board would work to achieve the pension board's investment objectives with far less risk of political influence.
- Boards should provide education and training to all trustees to develop necessary core competencies for their service:
    - All new trustees should be evaluated to determine their education needs in regards to fulfilling their fiduciary and financial responsibilities.
    - All new trustees should be provided with and required to complete pension investment and finance training to assist them in making investment decisions and improve their ability to understand the effect certain investments have on overall portfolio performance.
    - Periodic educational opportunities should be provided that help to improve core competencies and apprise trustees of any changes in their obligations as fiduciaries.

APPENDIX B: ALEC MODEL POLICIES

Model Policies: Wise Pension Investment and Governance

ALEC offers several model policies that states can reference as they refine their policies toward wise pension stewardship. These documents have the goals of promoting best practices for pension investment and governance. All ALEC model policies can be obtained by visiting www.alec.org.

ALEC Statement of Principles on Sound Pension Practices

- **Stability** – Government pensions should be secure and safe from high risk assumptions. State and local governments should eliminate incentives to underfund pension commitments, or to over-expend benefits beyond available revenues.
- **Predictability** – The pension obligations of states should be predictable and structured to foster certainty for taxpayers and policymakers. Contribution levels should be stable. Benefits of government pensions should be comparable to plans available by private citizens, and the costs and benefits should be sustainable.
- **Adequacy** – An unrealistically high assumed rate of return is a guaranteed way to underfund the government pension systems. State legislatures should fund 100 percent of Annually Required Contributions (ARC). Government pension systems should use assumptions that are consistent with Governmental Accounting Standards Board (GASB) and/or Generally Accepted Accounting Principles (GAAP) standards.
- **Affordability** – Government pension plans should be properly structured within affordable employee contributions and government financial support of their core functions, without imposing an undue burden on taxpayers.
- **Transparency** – Government pension systems should be transparent, open and non-political. Comprehensive Annual Financial Reports (CAFR) should be reasonably simple to understand and published in a timely manner.
- **Responsibility** – Risks should be balanced equitably among employees, government and taxpayers. Lawmakers and fund managers should be accountable for the adequacy and solvency of retirement funds.
- **Ownership** – Pension plans should ultimately benefit, reward, and compensate the work of government employees. Employees should share in the benefits, risks, and decisions of their retirement plans and their money, while protecting against potentially risky or ill-informed individual decisions.
- **Choice** – Employees should be able to choose defined-contribution investment plans to help balance risk and gain within individual investment needs and strategies.
- **Transportability** – Government pension plans should move with employees throughout their careers, without locking employees into government jobs or penalizing those who chose to move in or out of the public sector.
- **Liquidity** – Government pension plans should consider adequate liquidity to allow employees to use or sell some of their assets, especially during personal or family emergencies.
- **Safety** – Legislators and other appropriate government organizations should have sufficient oversight and protections to protect employees against security risks to pension plans, including waste, fraud, and abuse, and crimes such as embezzlement, identity theft, and cyber theft.

Retirement System Board of Trustees and Employees Prudent Investor Act

Summary

This Act promotes security, stability, and accountability in state retirement systems. A trustee or director of a state retirement system must comply with a series of prudent investor guidelines. These guidelines include risk and return objectives, diversification, loyalty, investment costs, compliance, and delegation of management functions. This Act shall be known and may be cited as the "{insert state} Retirement System Board of Trustees and Retirement System Employees Prudent Investor Act."

Model Policy

Section 1. {Prudent Investor Rule}

(A) Except as otherwise provided in subsection B of this section, a trustee or director of any {insert state} retirement system who invests and manages, or delegates the approval of the investment or management of retirement system assets owes a duty to the beneficiaries of the system to comply with the prudent investor rule set forth in the "{insert state} Retirement System Board of Trustees and Retirement System Employees Prudent Investor Act."

(B) A trustee or director or retirement system employee is not liable to a beneficiary or state taxpayer to the extent that the trustee, director or retirement system employee acted in reasonable reliance on the statutory provisions and rules of the retirement system. A trustee or director or retirement system employee who exercises reasonable care, skill, and caution in performance of actions as a trustee or director or retirement system employee is not liable to a beneficiary for the actual investment return results or retirement system operational results.

Section 2. {Standard of Care - Portfolio Strategy - Risk and Return Objectives}

(A) A trustee or director or retirement system employee shall invest and manage or approve the investment and management of retirement system assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the retirement system. In satisfying this standard, the trustee or director or retirement system employee shall exercise reasonable care, skill, and caution.

(B) A trustee or director or retirement system employee's investment and management decisions or approval of investment and management decisions respecting individual assets of the retirement system must be evaluated not in isolation, but in the context of the retirement system's portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the statutory and rules governing the system. Investment and management decisions shall be made on an impartial basis.

(C) Among circumstances that a trustee or director or retirement system employee shall consider in investing and managing retirement system assets or the delegation of approval of investing and managing retirement system assets are those of the following as are relevant to the retirement system or its beneficiaries:

(1) General economic conditions;

(2) The possible effect of inflation or deflation;

(3) The expected tax consequences of investment decisions or strategies;

(4) The role that each investment or course of action plays within the overall retirement system portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;

(5) The expected total return from income and the appreciation of capital;
(6) Other resources of the retirement system on behalf of beneficiaries;
(7) Needs for liquidity, regularity of income, and preservation or appreciation of capital; and
(8) An asset's special relationship or special value, if any, to the purposes of the retirement system or to the beneficiaries.

(D) A trustee or director or retirement system employee or a trustee or director or retirement system employee who delegates approval of investing and managing retirement system assets shall make a reasonable effort to verify facts relevant to the investment and management of retirement system assets.

(E) A trustee or director or retirement system employee or a trustee or director or retirement system employee who delegates approval of investing and managing retirement system assets may invest in any kind of property or type of investment consistent with the standards of the "{insert state} Retirement System Board of Trustees and Retirement System Employees Prudent Investor Act."

(F) A trustee or director or retirement system employee or a trustee or director or retirement system employee who delegates approval of investing and managing retirement system assets shall not make a determination to invest or increase the investment of retirement system assets based on ideological or non-financial related criteria for or against specific industries. A trustee or director or retirement system employee or a trustee or director or retirement system employee who delegates approval of investing and managing retirement system assets shall not make a determination to avoid investment of or reduce the investment of retirement system assets based on ideological or non-financial related criteria for or against specific industries. A trustee or director or retirement system employee or a trustee or director or retirement system employee who delegates approval of investing and managing retirement system assets shall not make a determination to employ or terminate employment of an investment manager or consultant based on ideological or non-financial related criteria. Prior to a determination by a trustee or director or retirement system employee to avoid investment of or reduce the investment of retirement system assets in a specific industry, or employ or terminate employment of an investment manager or consultant, external expertise from an independent third-party must be consulted. The results and recommendation of the consulted expertise shall be made available for public review.

Section 3. {Diversification}

A trustee or director or retirement system employee or a trustee or director or retirement system employee who delegates approval of investing and managing retirement system assets shall diversify the investments of the retirement system unless it is reasonably determined that, because of special circumstances, the purposes of the retirement system are better served without diversifying.

Section 4. {Loyalty}

A trustee or director or retirement system employee or a trustee or director or retirement system employee who delegates approval of investing and managing retirement system assets shall invest and manage the retirement assets solely in the interest of the beneficiaries.

Section 5. {Investment Costs}

In investing and managing retirement system assets, a trustee or director or retirement system employee or a trustee or director or retirement system employee who delegates approval of investing and managing retirement system assets may only incur costs that are appropriate and reasonable in relation to the assets of the retirement system.

Section 6. {Reviewing Compliance}

Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee director or retirement system employee or a trustee or director or retirement system employee who delegates approval of investing and managing retirement system assets' decision or action and not by hindsight.

Section 7. {Delegation of Investment and Management Functions}

(A) A trustee or director or retirement system employee may delegate investment and management functions. The trustee shall exercise reasonable care, skill, and caution in:

(1) Selecting an agent;

(2) Establishing the scope and terms of the delegation, consistent with the purposes and terms of the retirement system; and

(3) Periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

(B) In performing a delegated function, an agent owes a duty to the retirement system to exercise reasonable care to comply with the terms of the delegation.

(C) A trustee or director or retirement system employee of a retirement system who complies with the requirements of subsection A of this section is not liable to the beneficiaries or to the retirement system for the decisions or actions of the agent to whom the function was delegated.

(D) By accepting the delegation of a retirement system function from the trustee or director or retirement system employee of a retirement system that is subject to the laws of this state, an agent submits to the jurisdiction of the courts of this state.

Section 8. {Severability clause.}

Section 9. {Repealer clause.}

Section 10. {Effective date.}

Other ALEC Model Policies:

The summaries of other relevant ALEC model policies are provided below in the interest of space. The full text of all ALEC model policies can be accessed at www.alec.org.

The Promoting Transparency in State Unfunded Liabilities statement of principles says that each retirement plan should report, in full, both its obligations and assets. It says, in part, "It is clear that citizens are demanding greater transparency in accounting for the costs of state and local government. Given the large and growing unfunded liabilities in pension and other post-employment benefit plans, it is crucial for state and local governments to meet accounting standards for these plans established by the Governmental Accounting Standards Board (GASB)."

The Resolution Calling for Enhanced Integrity in Public Employee Pension Plan Reporting calls upon the relevant standard-setting body, the Government Accounting Standards Board (GASB), to adopt reporting standards that require reporting as a liability on a governmental entity's balance sheet any unfunded pension plan obligation for which it is responsible; reporting as a current expense the cost of any changes in benefits awarded on the basis of past service; clear disclosure of discount rates used in the calculation of pension liabilities; why such discount rates were selected; and the liabilities which would result if alternative discount rates were applied. It also requests GASB to send an official representative to present information and answer inquiries at a public hearing to be held by the relevant committee or committees.

The Unfunded Pension Liabilities Accounting and Transparency Act would require state retirement boards or other responsible entities to issue reports to the legislature on the funds they oversee. The reports would give the legislature several different ways of understanding the liabilities of each fund, including the outcomes of several "what if" scenarios. The act's summary statement declares the following: "The legislature finds that the future liabilities of the state's several post-retirement pension and benefits plans may exceed the ability of these plans to fully pay future claims, possibly requiring taxpayers to make unforeseen future contributions to ensure the solvency of these plans or the reduction or elimination of benefits to future and current retirees. Believing both of these alternatives to be unacceptable, the legislature seeks to identify the extent to which the several pension plans lack the necessary capital to pay all future obligations."

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