Mr. James R. Copland  
Mr. Steven Malanga  
Manhattan Institute  
Manhattan Institute for Policy Research  
52 Vanderbilt Avenue, Third Floor  
New York, NY 10017  

April 27, 2016  

Dear Mr. Copland and Mr. Malanga:  

We appreciate your offer to meet with us to share the findings of your recent study, “Safeguarding Public Pension Systems; A Governance-Based Approach,” and we would very much like to accept your invitation. We have observations pertaining to some of the key findings in your paper, which we have outlined briefly below and hope we can further discuss during our meeting.  

In general, the definition of governance in the paper appears to be restricted to the trustees who are charged with overseeing operations or investing the assets, or both, of public retirement systems for employees of state and local governments. We would encourage you to broaden this definition of public pension plan governance to include the full range of entities that control and oversee public retirement systems, particularly state legislatures, governors, and other bodies that are responsible for setting benefit levels, funding benefits, and establishing or influencing policies regarding the investment of assets. Public pension trustees exert limited control over areas that affect key public pension outcomes, such as pension plan required costs and funding levels, and trustees normally do not determine benefit levels nor have authority to approve funding needed to pay for benefits.  

Following are some other observations about the paper’s findings we would like to discuss.  

**Fiduciary duties**  

Your paper states that “public pension boards lack adequate fiduciary duties,” and uses as evidence of this claim that only two states have adopted the Uniform Employee Retirement System Act (UMPERSA). However, the fact that there is no single federal law or requirement, such as UMPERSA, governing public pension board members, does not mean that standards are not in place. In fact, the opposite is true: state fiduciary statutes, ethics laws and prudence rules predate UMPERSA (and in many cases the federal Employee Retirement Income Security Act). Further, public pension trustees are, by definition, fiduciaries and have such duties applicable to them whether or not their state adopted UMPERSA, and they operate under rules consistent with general trust principles inherent in common law. Similar to what is described in the paper, these rules stipulate that trustees operate a) solely in the interest of plan participants; b) for the exclusive purpose of providing benefits to participants and their beneficiaries; c) using the care, skill, and prudence that a prudent person or investor would use under like circumstances, etc.
In addition to fiduciary and prudence standards, trustees also are subject to ethics standards and conflict of interest laws, and an abundance of oversight and reporting requirements, such as open records laws, open meetings laws, financial reporting requirements, sunset requirements, audit standards, etc.

**Board Composition**

The composition of public retirement system boards varies widely in terms of constituent groups that are represented; whether members are appointed, elected, or serve ex-officio; and what knowledge and experience, if any, are required. However, little to no correlation exists between a plan’s board composition or trustee’s background and its funding condition and investment performance. Types and degrees of responsibility and authority vary among boards, depending mostly on differences in state laws. For example, assets for some systems are overseen by the same board that oversees the plan’s operations; by contrast, assets for other systems are overseen by an entity separate from the board tasked with oversight of operations.

Your assertion that public pension plans have “two sets of owners:” the plan participants and the general public, is at odds with trust and fiduciary law. The sole owners of public pension assets are the plan participants. Although the general public and taxpayers may be stakeholders in the plan, and they elect the public officials that oversee, serve on and/or appoint members to the board of the plan, they have no claim to the assets.

The general public’s opportunity to exercise oversight and to effect change in pension plan design and financing is through its right to elect and petition those who set public policy. As a rule with few exceptions, the legislative branch, with approval from the executive branch, establishes pension benefit levels and approves funding needed to pay for those benefits. Once monies are transferred as contributions from employees and employers to public pension trust funds, those assets belong solely to the plan participants.

The role of trustees with respect to public pension plans is generally limited to ensuring that the system is carrying out its statutory and other responsibilities in an efficient and effective manner and operating in compliance with relevant laws; setting policy regarding the operation of the retirement system (and investment of assets, where relevant); and the hiring of key staff and consultants. Trustees have little to no control over benefit levels or the funding of benefits, a reality that belies the reference in your study that “68 percent of public retirement boards have some control over benefit decisions.” Our own research finds such examples to be extremely rare and limited in scope.

**Public Pension Funding Conditions**

Your paper asserts that 20 percent of public pension plans are funded below 40 percent. According to the Public Fund Survey, however, of 126 public pension plans, just two report a funding level below 40 percent.

Regarding the overall funding condition of public pension plans, your paper fails to acknowledge the important facts that public pension funding conditions vary widely, from poorly funded to well funded, and that funding levels are specific to the plan and its plan sponsor—i.e., the state or city that sponsors the plan. States are sovereign and are responsible for their own funding, but not for the funding of other states. State pension funding levels are observed across a wide range, and an assessment about the health of a pension plan at any funding level should include characteristics unique to that plan and its sponsoring government.
Many factors can be used to describe a pension plan’s condition, particularly a public plan, of which the funding level is but one. Others factors indicating the overall condition of a public pension plan include the plan’s cost, amortization period, actuarial assumptions and methods, fiscal condition of the plan sponsor(s), and others. Ultimately, the best measure of the condition of a pension plan is whether or not funding that plan is a source of fiscal stress for its sponsoring government.

Public Pension Investment Risk Profiles

The paper’s assertion that public pension risk profiles are “overly aggressive,” lacks relevance to institutional investors of the same size, maturity and time horizon. For example, compared to the risk profiles of large college and university endowments, the portfolios of state and local pension plans are relatively conservative. According to the latest data from the National Association of College & University Business Officers, on average, 89 percent of such college and university endowments with assets greater than $1 billion are invested in asset classes the paper would characterize as “risky,” including 57 percent invested in Alternatives, which includes such asset classes as private equity. Non-institutional investors or closed plans will have different investment needs and portfolios. Public pension funds are long-term investors, investing assets and projecting returns over periods of 20 to 40 years. The investment return assumption is intended to reflect long-term expected returns, not current economic conditions. The paper’s suggested application of a market spot price, aka “risk-free rate,” to a public plan invested in a diversified portfolio, with a benefits horizon of decades, produces a measure that is not well-suited for state and local government retirement systems.

When plans have been back-tested comparing the effect of a risk-free funding approach vs. the prevailing public plan funding method, both resulted in similar long-term funding levels. However, the risk-free method would have required wildly volatile contributions, and the conventional method used by public plans resulted in contributions levels that were comparatively very stable, an approach that balances the need to fund long-term benefits with the need of states and cities to avoid sharp increases in plan costs from one year to the next. As plans in the public sector are not at risk for having their sponsor go out of business or be sold, market spot prices are irrelevant and funding them on that basis creates unnecessary volatility.

Again, we appreciate your kind invitation, and we look forward to meeting with you and discussing these and other issues soon.

Sincerely,

Keith Brainard, Research Director
National Association of State Retirement Administrators