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July 25, 2011

Hon. Kamala D. Harris
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Dawn McFarland
Initiative Coordinator

Dear Attorney General Harris:

Pursuant to Elections Code Section 9005, we have reviewed the proposed constitutional initiative regarding investments of state and local pension or retirement systems (A.G. File No. 11-0018). This initiative proposes amendments to Section 17 of Article XVI of the State Constitution, which governs these systems.

Background

Public Employee Pension Benefits. State law authorizes establishment of systems to provide pension and other benefits to retired state and local employees and survivors and beneficiaries of certain other public employees. Benefits provided by these systems can be classified as being in two broad categories, as follows:

- ***Defined Benefit.*** "Defined benefit" pensions provide a specific amount after retirement that is generally based on the employee's age at retirement, years of service, salary at or near the end of his or her career, and type of work assignment. Currently, about 4 million Californians—11 percent of the population—are members of one or more of the state's 85 defined benefit public pension systems, including 1 million who currently receive benefit payments.

- ***Defined Contribution.*** In "defined contribution" retirement programs, the rate of contribution by the employer—and sometimes, by the employee—is fixed. Therefore, the employee's pension benefit in these programs is whatever amount the accumulated contributions plus investment earnings can provide at retirement. Unlike defined benefit plans, defined contribution plans do not promise a specific amount to be paid to the retiree each month or each year. Many California public employees also are members of one or more defined contribution plans. Pursuant to state law (Section 53609 of the Government Code), some public employee defined contribution plans managed by public agencies are considered "public pension or retirement funds" under the provisions of Article XVI of the State Constitution.

How Are Public Employee Pension Benefits Financed? In general, public employers and/or employees contribute a specific percentage of each employee's pay to a public retirement system each year. As described above, employer contributions to defined contribution plans generally are fixed.

For defined benefit plans, the combined employer and employee contributions typically are those estimated to be sufficient by the system's actuaries—when combined with future investment returns of the retirement system—to cover the portion of future pension benefits earned by that employee during a given year. To the extent that these actuarial calculations prove to be incorrect over time, the eventual costs to provide a given level of benefits will be less or more. When these costs rise (due, for example, to lower-than-expected investment returns), public employers in California generally are required to provide additional contributions to fund pension benefits and pay down what is called an "unfunded liability." In 2008-09 (the most recent fiscal year for which data is available from the State Controller's Office [SCO]), public employers contributed about $14 billion per year to California's public pension systems, including several billion dollars to retire existing unfunded liabilities. This amount may increase in the near future in some retirement systems due to unfunded liabilities resulting from the systems' large investment losses during 2008.

How Significant Are California Public Pension Systems' Assets? Pension systems invest the contributions they receive from public employers and employees, and over time these assets generate considerable returns. As of 2008-09, California's public pension or retirement systems managed $557 billion of assets, according to SCO data. Three of these systems—the California Public Employees' Retirement System (CalPERS), the California State Teachers' Retirement System, and the University of California Retirement System—had a combined amount of $399 billion of assets under their management. According to the pension systems' actuarial estimates, the assets that they now manage are sufficient—combined with assumed future investment returns—to cover the vast majority of pension benefits required to be paid to current and past public employees in California.

How Do the Pension Systems Invest These Assets? As of 2008-09, SCO data shows that California's public pension or retirement systems invested 41 percent of their assets in stocks, 25 percent in bonds (including mortgage, corporate, and government debt), 5 percent in short-term assets (such as cash, cash equivalents, and other short-term securities), and 30 percent in other asset groups (such as real estate and venture capital). Under the State Constitution, the boards of each public pension or retirement system have "sole and exclusive fiduciary responsibility over the assets" of the system. Board members must "discharge their duties with respect to the system with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims." (This "prudent person rule" is a common one governing the investment and administration of pension funds in the United States and other countries, and it was added to the State Constitution by voters when they approved Proposition 21 in June 1984.) The board members also are required by the Constitution to "diversify the investments of the system so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so."

Consistent with the Constitution's diversification requirement, California public pension and retirement systems invest their assets in companies, enterprises, private ventures, real estate, commodities, and governmental entities throughout California and around the world. For example, one of the largest institutional investors in the world is CalPERS. As of March 31, 2011, CalPERS managed $234 billion of assets. About 40 percent of these assets are invested outside the United States. Of the portion invested within the United States, the vast majority is invested in companies and enterprises based outside California. About 9 percent of CalPERS' portfolio (around $20 billion) is reported to be invested in companies, properties, and projects which are "California-based" (as defined by CalPERS). Included in this total is about $6 billion invested in over 600 companies with headquarters in California. Combined, these companies employ an estimated 700,000 Californians (about 5 percent of the state's total workforce), according to CalPERS estimates.

What Contractual Requirements Do Governments Have? In many cases, California governmental entities are bound by contracts to contribute a given percentage of employee pay to a defined benefit pension system for current and past employees, and in some cases, governments may be contractually obligated to ensure that pension systems for these current and past emloyees remain "actuarially sound." For example, in a 1997 court decision (*Board of Administration v. Wilson*), a court ruled that state employees "have a contractual right to an actuarially sound retirement system." While contractual protections often apply to these current and past employees and limit the ability of public employers to alter pension arrangements, California's state and local governments generally have the ability to modify pension benefits for *future* employees.

Proposal

Increases Required California Investments of Pension Systems. This measure amends the State Constitution to require public pension or retirement systems to "invest and maintain at least 85 percent of the system's assets" in California-based businesses. The measure defines a California-based business to be one "in which at least 70 percent of its employees are employed within California." Public pension or retirement systems would be required to comply with this new requirement beginning January 1, 2016.

Fiscal Effects

Major Change in Pension System Investment Practices. Currently, consistent with the Constitution's requirement for investment diversification and the prudent person rule, a minority of public pension or retirement system investments appear to be invested in California-based businesses, as defined by this measure. Accordingly, if voters were to approve this measure, between the time it is adopted and the beginning of 2016, California's public pension systems would be required to divest themselves of hundreds of billions of dollars of assets in non-California businesses in order to meet the requirements of this measure. Beginning in 2016, public pension or retirement systems would be required to alter their current investment practices substantially, foregoing investment opportunities in various asset classes in other states and around the world in order to make required investments in California companies.

While the measure retains the Constitution's current prudent person rule language, it is unclear that the investment standards required under this measure would meet modern fiduciary standards of prudence. This is because the measure would require a huge concentration of investments in one economic market—California—that is responsible for only about 3 percent of world economic output. Moreover, in the case of defined contribution systems managed by public entities and governed by the provisions of the State Constitution, the requirements of this measure may limit substantially the investment choices for plan members. For these reasons and others, various types of legal challenges might be raised against this measure, and it is unclear exactly how or if it could be implemented.

Likely Decline in Average Annual Pension System Returns. If this measure were approved and implemented, it most likely would result in a decline in average annual investment returns for the state's public pension or retirement systems. In the short term, the systems could incur additional transaction costs to divest themselves of non-California assets, as required by this measure. Over the longer term, California's public pension systems would be forced to forego potentially profitable and sound investments in many non-California-based companies. Instead, they would be required to invest in California-based companies in which they do not now choose to invest. Overall, these investments potentially could result in lower average annual investment returns for the systems. Moreover, since activities of these businesses would tend to be concentrated in the California economic market, overall public pension investment returns probably would become more volatile, moving sharply upward or downward with trends in the California economy. As described above, changes in assumed public pension system investment returns would affect required employer contributions. The changes in public pension investment returns resulting from this measure would tend to increase required state and local pension contributions—potentially by billions of dollars (in current dollars) per year.

Little Net Effect on California Economic Activity Likely Over the Long Term. While this measure is intended to increase economic activity in California, it seems uncertain that it would result in such an increase over the long term. While public pension or retirement systems would invest more of their dollars in California (potentially producing a short-term economic boost for the state), these same systems would forego investment opportunities in other states and internationally over the longer term. Other investors likely would seize these opportunities over time, thereby investing less in California-based companies than they otherwise would. As a result, while the net effect of this measure on economic activity in California is unknown, we suspect there would not be a significant net increase or decrease in this economic activity over the long term. Accordingly, in future years, the net effect of this measure on state and local revenues likely would not be significant.

Fiscal Summary

This measure would have the following major fiscal effects on the state and local governments:

- Potential increase in state and local pension contribution costs of billions of dollars per year (as measured in today's dollars), depending on how this measure is implemented.

- Unknown, but likely not significant, net long-term change in state economic activity and related state and local revenues.

Sincerely,

Mac Taylor
Legislative Analyst

Ana J. Matosantos
Director of Finance