1831

S. HRG. 110–772

YOUR MONEY, YOUR FUTURE: PUBLIC PENSION PLANS AND THE NEED TO STRENGTHEN RETIREMENT SECURITY AND ECONOMIC GROWTH

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

July 10, 2008

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

44–947 PDF WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

JOINT ECONOMIC COMMITTEE

[Created pursuant to Sec. 5(a) of Public Law 304, 79th Congress]

SENATE

CHARLES E. SCHUMER, New York, *Chairman*
EDWARD M. KENNEDY, Massachusetts
JEFF BINGAMAN, New Mexico
AMY KLOBUCHAR, Minnesota
ROBERT P. CASEY, JR., Pennsylvania
JIM WEBB, Virginia
SAM BROWNBACK, Kansas
JOHN SUNUNU, New Hampshire
JIM DEMINT, South Carolina
ROBERT F. BENNETT, Utah

HOUSE OF REPRESENTATIVES

CAROLYN B. MALONEY, New York, *Vice Chair*
MAURICE D. HINCHEY, New York
BARON P. HILL, Indiana
LORETTA SANCHEZ, California
ELIJAH CUMMINGS, Maryland
LLOYD DOGGETT, Texas
JIM SAXTON, New Jersey, *Ranking Minority*
KEVIN BRADY, Texas
PHIL ENGLISH, Pennsylvania
RON PAUL, Texas

MICHAEL LASKAWY, *Executive Director*
CHRISTOPHER J. FRENZE, *Minority Staff Director*

CONTENTS

Members

Witnesses

Submissions for the Record

YOUR MONEY, YOUR FUTURE: PUBLIC PENSION PLANS AND THE NEED TO STRENGTHEN RETIREMENT SECURITY AND ECONOMIC GROWTH

THURSDAY, JULY 10, 2008

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met at 10 a.m. in room SD–106 of the Dirksen Senate Office Building, the Honorable Robert P. Casey, Jr., presiding.

Senators present. Casey, Schumer, and Klobuchar.

Representatives present. Brady, Pomeroy, and Cummings.

Staff present. Christina Baumgardner, Ted Boll, Chris Frenze, Tamara Fucile, Jim Gilroy, Gretta Goodwin, Rachel Greszler, Colleen Healy, Robert O'Quinn, Jeff Schlagenhauf, Annabelle Tamerjan, Christina Valentine, and Jeff Wrase.

OPENING STATEMENT OF HON. ROBERT P. CASEY, JR., A U.S. SENATOR FROM PENNSYLVANIA

Senator Casey [presiding]. The hearing will now come to order. I want to thank everyone for taking the time to be here this morning.

I'll give you an outline of how we'll proceed from this point. I am going to deliver an opening statement, and then we'll turn to Members of the Committee.

Well see, in terms of who appears, in what order, and we'll try to accommodate Members. It's a busy morning for both the Senate and the House, and we'll be as accommodating as we can.

Why don't I just start with my opening, and then we'll eventually get to our witnesses. We'll have Members who will be delivering opening statements, as well, but we'll try to keep within the 5-minute window that we, of course, ask our witnesses to comply with, so we'll try to do that, as well.

But I do want to thank everyone for taking the time to be here. I was saying to the Congressman, Congressman Pomeroy, that the Joint Economic Committee has had an opportunity to review a lot of important issues over many years.

I've been in the Senate 18 months, but I'm not sure we've ever had this big room, and I gave him the credit for it, of course, because he's the one sitting next to me.

[Laughter.]

Senator Casey. But it's nice to have the extra room in a great hearing room, and we're grateful for that today.

The subject of our hearing today, sounds rather obscure to many Americans, and even to all of us here on Capitol Hill: The role of defined benefit pension plans in the American Economy.

However, this type of pension plan plays an important role, a very important role, for reasons that we'll explore today.

Historically, most public and private employers offered their employees defined benefit plans, which pay an annuity based upon the employee's salary and years of service upon retirement.

Under this arrangement, employers and employees share the risk, share the risk of loss of market declines or bad investments of retirement assets and other risks.

Employers offering defined benefit pension plans take on the responsibility of investing retirement funds, either directly, or through outside fund managers.

By contrast, defined contribution plans, like the 401(k)s that most people have today, allocate all investment risk to employees. Over the past 30 years, defined benefit plans have come under severe attack. That's an understatement.

In the private sector, corporate defined benefit plans have declined substantially. Just consider this: In 1975, not too long ago, 88 percent of private-sector workers were covered by defined benefit plans—88 percent. In 2005, that number had shrunk to 33 percent of the private-sector workforce.

There have been a number of well publicized attempts to eliminate defined benefit plans for public pension funds and multi-employer, or so-called Taft-Hartley funds.

Just today, in fact, in the New York Times, an op ed blames the demise of General Motors on its defined benefit pension plan. It seems a little strange to me to blame the struggles of a company that has gone from 50-percent market share to 20-percent market share, on the men and women working on the line.

We'll have some debate about this, but that's basically, in my judgment, what that op ed does. I'm sure we'll have some disagreement about that. This is America and we can disagree, right?

I would also note that the article in today's New York Times mentions in passing that General Motors fell behind on fully funding its pension obligations. That's a continuing theme in this discussion.

That has the double costs of requiring increased contributions later and losing out on market gains in good times.

The GM case only proves that underfunding retirement needs has long-term costs. That's true of any retirement plan, whether it's defined benefit or defined contribution.

I served a decade in Pennsylvania as an elected official, in two Statewide elected offices, the Office of the Auditor General and the Office of State Treasurer, and I took a particular interest in the two-State public pension funds for teachers and for public employees, which are traditional defined benefit plans.

As Auditor General, I audited both funds, and as State Treasurer, I served as Trustee for both funds. It gave me an insight and gave my staff an insight into the benefits of a well-run defined benefit plan, and in both cases, both for retirees and for our economy as a whole.

Defined benefit plans have been proven to earn better returns than defined contribution plans over the long run. For example, a recent study showed that defined benefit plans outperformed defined contribution plans by 1.8 percent per year over an 8-year time period.

This is because defined benefit plans are professionally managed, particularly in their asset allocation decisions, and in addition, have access to alternative investments like venture capital, private equity, real estate, and hedge funds.

These "patient capital" investments actually increase the return to a pension fund, while reducing overall risk to the fund's portfolio. Alternative asset categories have low correlation with other asset classes.

That is, they don't behave—and I know this, for even people who have been exposed to this, this gets a little murky, some of the terminology for the uninitiated, but basically, what we're talking about there when we talk about the correlation question, is they don't behave in the same way that private equity or fixed income markets do, so that when stocks go down, investments like venture capital may not, so it's—it's kind of counterintuitive, and the experts here will explain this better than I will.

Defined benefit plans are a key factor in attracting and keeping excellent teachers, firefighters, police, social workers, and other employees. We can't say this enough. It's lost in the discussion.

One of the biggest problems we have in America today, in terms of our workforce and in terms of meeting priorities like public safety, like healthcare—go down the list—is recruitment and retention. I hear it all the time in the healthcare field.

In order to take care of those in the twilight of their lives, older citizens, we've got to recruit and retain qualified healthcare personnel.

We hear it in the context of so many other parts of our economy, and the same is true when it comes to our pension plans and those who are doing this important work, like teachers and firefighters and police officers and social workers and other public employees.

The best and the brightest of our policemen and policewomen, firefighters, and teachers have a big incentive to stay in their jobs rather than switch careers because of the promise of pension benefits in retirement.

Multi-employer or Taft-Hartley defined benefit plans play the same role for workers in many of our important industries, including manufacturing, building trades, and others, as well.

Money invested in defined benefit plans typically stays there until the employee leaves or retires, and as a result, defined benefit plans can invest in less liquid, alternative asset classes such as venture capital, which are crucial to job creation, particularly in high-tech industries.

This is also lost in the discussion. These discussions aren't limited to the employees. These discussions aren't limited to the jargon and the terminology. The discussions we'll have today impact the wider economy, whether we're competitive or not in a world economy, whether we create high-tech jobs or not.

So this isn't some distant, obscure topic. This is about creating jobs and building an economy here in America.

Over 40 percent of investment capital for venture capital funds in the United States now comes from defined benefit plans—40 percent.

Today, we'll hear from a number of witnesses. We'll hear from four: An active firefighter from Los Angeles who's also a Trustee of his defined benefit pension fund; a well-known economist who has written extensively about this issue; a venture capitalist from Philadelphia who manages money for a number of defined benefit plans and invests in the biotech industry; and a representative of the General Accountability Office, who has studied this subject.

During this hearing, I believe there is one broader issue we must all keep in mind, and that is the issue of how we allocate risk in our society. It concerns me that some here in Washington and across America, want ordinary Americans to assume sole liability for decisions regarding their healthcare, their pension, and their Social Security.

These are risks that have been traditionally shared with employers or with the Government. If we also want people to take 21st century global economy type risks like changing jobs, stopping out for more education and training, or—and those starting their own businesses, we cannot also dump all of the risk of healthcare and retirement on them.

I'm also concerned that moving billions of dollars of retirement assets from defined benefit plans to defined contribution plans adds substantially to the risk we're asking ordinary Americans, our workers, to take.

I plan to ask each of the witnesses today, as well as a number of our other interested parties, for specific recommendations on what to do about the future of defined benefit plans, and at a minimum, we should ensure that the circumstances that led to the decline of defined benefit plans in the corporate world are not repeated in the public or Taft-Hartley sectors.

With economic stability and economic security on the minds of all Americans, I look forward to discussing these issues with our witnesses today.

[The prepared statement of Senator Casey appears in the Submissions for the Record on page 41.]

Senator Casey. Now, at this time, I'll turn to Congressman Pomeroy for his opening, and we'll go from there. Congressman, thank you very much for being here today and for your long and enduring work on this important issue.

OPENING STATEMENT OF HON. EARL POMEROY, A U.S. REPRESENTATIVE FROM NORTH DAKOTA

Representative Pomeroy. Chairman Casey, thank you. This is a good week for pensions, and it was about time we had a good week on Capitol Hill.

Yesterday, the House passed on the Suspension Calendar, at long last, the Technical Corrections Act for the Pension Protection Act. Importantly, it included additions that were initiated by the Senate, relative to asset-smoothing, as well as credited interest rates for public plans.

These had been missing in the initial Technical Corrections Act passed by the House. They are important, in fact, vital improvements, and I'm very pleased that the Senate took its action, very pleased that the House passed the bill with a strong bipartisan vote on the Suspension Calendar.

The second dimension of this being a good week is this hearing, Mr. Chairman.

I have now been in Congress for more than 15 years and I have been astounded at the absence of discussion, the lack of hearing oversight and inquiry into this seismic shift we've seen in the retirement savings area, from the defined benefit structure to the defined contribution structure.

We moved from where the participation in savings from a universal context in a defined benefit plan, to voluntary context in a defined contribution plan; placing investment decisions upon the employee, even while investment advice was lacking; expecting Baby Boomers entering a whole new medical world, in terms of what might be expected in terms of life expectancy and retirement years, expecting them to self-insure the longevity risk and make their assets match the expected time on earth.

All of those are tremendous risk elements transferred to the individual in the defined contribution context. It's occurred, not only without any particular point of concern being raised on Capitol Hill, but we have certainly, in my opinion, made all the wrong moves in terms of strategies to preserve defined benefit structures.

I cite, in particular, the Pension Protection Act advanced by the Department of Labor, and cheerleaded by the Pension Benefit Guaranty Corporation, even while they failed to evaluate what might be the consequences for plan freezing under the new stringent funding requirements.

Well, it all has been a very bleak picture, one we need to turn around, because we're on the precipice, in my opinion, of a very serious income security and retirement crisis.

One-third of the Boomers on the doorstep of retirement have no financial assets, as reported by the GAO. The median savings of those with financial assets is $45,900.

The 2008 Retirement Confidence Survey reflected a drop of one-third in terms of confidence, with only 18 percent of workers very confident that they'll have assets through the retirement years, down from 27 percent a single year before.

I believe, for these reasons, you're precisely spot-on in finding a public good in pensions, and therefore, something Congress and the Administration ought to be advancing is ways to enhance and protect and stabilize this component of the retirement picture.

But we're seeing exactly the opposite occur when 3.3 million workers have seen their pension benefits frozen in some way. The most recent PBGC data on insured plans has found that single-employer plans frozen at the end of the year in 2005, increased by 48 percent over the 2-year period in 2003.

And we can certainly expect that this period with stringent funding requirements, a market downturn, and low interest rates is going to be, in my opinion, deeply punishing on those corporations that want to continue to fund pension plans. Many will freeze their plans.

There is good news, and I know you're going to have it as a part of this hearing in the public pension plans. They protect the retirement security of 12 percent of the Nation's workforce; $150 billion in the checkbooks of 7 million retirees every year.

The trustees invest $3 trillion of assets into our economy. They, as you mentioned, ensure that those who serve the public are going to have their needs met through the defined benefit structure in their retirement years.

Without oversight and regulations, these pensions have funded nearly 90 percent of their outstanding retirement liabilities. Now, some plans are underfunded, but let us not confuse that for the broad picture.

In the broad picture, they are 90-percent funded. Alicia Munnell at the Center for Retirement Research, has said, quote, "the miraculous aspect of the funding of State and local pensions, is that they have been fully funded without Federal law having application to their funding levels."

Well, I believe that it is very important that we early and strongly push back on those, in my opinion, that want to continue their effort to take down the defined benefit structure in the private sector by now looking at the public sector, to continue this same assault on the defined benefit pension structure.

I don't think that this has all been accidental, Mr. Chairman. I believe there are those that wanted to take this protection away from the American worker, and I think that it is completely wrongheaded, as wrong-headed as the efforts to privatize Social Security.

So, I think that having the information about the value of these plans and assessing their funding structure in a calm and reasonable way is precisely what's critically been lacking from the discussions on Capitol Hill. I'm so pleased that you're adding it here this morning.

I'm going to have to take my leave, regrettably, from this hearing. I anticipated being here all morning, but the House Agriculture Committee, of which I am a member, is looking at speculative activity in the commodities marketplace. That will involve pension funds, too, and I need to excuse myself to participate in that hearing, but I thank you very much for allowing me to make these words, and I'll have a statement for the record, if you'd agree to accept it.

[The prepared statement of Representative Pomeroy appears in the Submissions for the Record on page 50.]

Senator Casey. Well, Congressman, I appreciate your being here, and for your work on this. I hope that with your departure we can still stay in the room that you got us. Is that OK?

[Laughter.]

Representative Pomeroy. Yes. As a House member, I would say, yes, use any facility over here you like.

[Laughter.]

Senator Casey. And we will make sure your statement is made part of the record. Thank you very much. We appreciate it.

Representative Pomeroy. Thank you, Mr. Chairman.

Senator Casey. Thank you. And also I want to note that we'll have other Members who, if they don't appear, will have statements for the record.

I do want to note two things for the record, before I introduce our witnesses: One is that I want to note my receipt of written correspondence from 19 different national organizations representing State and local governments and officials, public employee unions, public retirement systems, and more than 20 million public employees and beneficiaries expressing support for our efforts on this issue.

I'd like to submit that for the record.

[Correspondence referenced above appears in the Submissions for the Record on page 43.])

Senator Casey. And also for the record, Congresswoman Maloney, who is a co-Chair of this Committee, has asked that her statement be made part of the record.

She's attending a House hearing today, with Chairman Bernanke of the Federal Reserve Board, as well as Treasury Secretary Paulson, so that's obviously a significant conflict, and we wanted to note that. She's here virtually every hearing we've had, and I appreciate her leadership, in general on the Committee, but also in particular, her work on issues like pensions, and income, retirement and economic security.

But I wanted to note that she'll have a statement for the record, which we will include.

And, as we go, we'll have other statements for the record, as well.

[The prepared statements of Representative Maloney and Senator Brownback appear in the Submissions for the Record on pages 52 and 53, respectively.]

Senator Casey. What I'll do, I think, now, is, rather than introduce our witnesses all at one time, what I think I'll do, is introduce each witness and just do a summary of their biography, have them do their statement, and then we'll go to the next witness.

I think I'm going to be going left to right here. Mr. Pryor will be first, and I'll just do a quick summary of his biography.

William Pryor is vice chairman of the Los Angeles County Employee Retirement Association. He is currently serving as Chair of that Association. He's an active-duty firefighter. Talk about someone who's in the trenches, understanding the challenges we face with this issue, he's an active-duty firefighter in the county of Los Angeles.

He's stationed in Huntington Park, he has been an elected trustee of that association since 1999. The Association has a $40 billion pension plan that provides a defined benefit pension and retiree healthcare program to over 90,000 retirees of the county of Los Angeles.

Mr. Pryor has spent—has represented, I should say, 19 years doing the work of representing the work of firefighters as an IAFF Union representative in Los Angeles County, and has held several positions in the local union.

He's an active trustee and an executive board member of the National Conference of Public Employee Retirement Systems, known by the acronym, NCPERS.

He speaks frequently on the economic impact of defined benefit pension plans, and the necessity of defending those plans from political and corporate-sponsored attacks.

He's an active member and supporter of the Council of Institutional Investors, and the International Corporate Governance Network, the so-called ICGN, as they advocate for open markets and providing value to investors through good corporate governance.

Mr. Pryor lives in Long Beach, California, and spends his off-duty time with his family. Mr. Pryor, we thank you for being here, for making the long trip, and for your witness here today as someone who is not just familiar with these issues, but has lived the life of a firefighter, and we commend you for that work.

Try, as best you can, to keep it at 5 minutes. Thank you.

STATEMENT OF WILL PRYOR, VICE CHAIRMAN, BOARD OF INVESTMENTS, LOS ANGELES COUNTY EMPLOYEES RETIREMENT ASSOCIATION, PASADENA, CA

Mr. Pryor. Thank you, Mr. Chairman. Today I'd like to discuss the importance of pensions to my fellow firefighters, as well as the importance of the pension benefits and pension fund investments to our local and national economies.

Long before firefighters learn how to make a hydrant at a real fire or the right way to pull a ceiling, we learn the importance about our pensions.

Veteran firefighters make it a point to take rookies aside and let them know, under no uncertain terms, what their pensions mean to them and what their pensions will have, once that rookie puts some time on the job.

Admittedly, this is a self-serving conversation. These veteran firefighters are ensuring that their own futures will be protected by a new generation willing to take future fights to save their pensions and support their unions' fights for quality retirement.

For firefighters, a pension means that we will have time to heal our bodies after 33 years of service. Seventy-six percent of my members, leave the job with an injury that prevents them from future work that is any more strenuous than sedentary.

This pension helps them to have a decent salary replacement that will never run out, good medical care, and solid survivor benefits for their families when they die, which may be in the line of service.

Our pension system also provides to the residents we serve. Our Department spends a lot of money training its employees. Paramedic duties, hazardous materials, arson detection, urban search and rescue, wild land firefighting and fire prevention, are not easily learned and very expensive to train.

Offering a good pension with a benefit payout, only after vesting or spending a career with that agency, makes it less likely that employees will leave the job after getting this training and experience.

The public pensions do more than ensure that a community has good public servants. They also mean that when a public employee retires, they can support their local economy, rather than needing to compete with the local job market, or being a drain on local public services.

In the aggregate, public pension payments have had a huge impact on California's economy. As detailed in my written testimony, public pension payments to California public employment retirees in 2006 reached $25.5 billion with a total economic impact of some $41.5 billion in the California economy.

By design and with great success, California's retirement systems also invest heavily in California. They are a key player in private venture, public equity, and real estate investment centered in our State.

These investments mean jobs, many jobs for Californians, that otherwise may have not been created. These investments also mean significant community improvements.

While our pension assets fund real estate projects across the board, all projects have bettered the communities we serve. Urban in-fill projects, develop inner city properties into housing for middle-income workers, who otherwise would face a 3-hour commute, just to get to work.

We're also funding rural revitalization programs.

What our pension plans are doing for California, is not unique. Traditional defined benefit pension plans in both public and private sectors, play an important role in the overall U.S. and international economic cycle.

Pension plans play a unique profile as asset managers. They are long-term, patient investors who generally base investment decisions on annual returns or on returns over several years, not just the next quarter.

Where retail funds or even institutional funds have immediate demands to produce over the short term, pension plans are able to make the sorts of investments that may not be fully realized for as long as 20 years.

Pension plans can also use their capital to smooth economic volatility, as we're seeing in the current credit crisis. Specifically, many lenders have shuttered their doors to many kinds of financing, including private equity.

Pension plans, however, are making private equity investments at a high rate, plugging the hold that the lending banks have left, and have provided much needed capital into the economy.

In conclusion, I'd like to thank you for giving me the time today, letting me share with you, what my fellow firefighters have known for years. Traditional public pension plans are sound retirement vehicles that not only act as an employee benefit, but also have a tremendous impact on those who we serve. I'd be happy to answer any questions.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Pryor appears in the Submissions for the Record on page 64.]

Senator Casey. Thank you very much, Mr. Pryor. I think you came under the limit. That never happens in Washington.

[Laughter.]

Mr. Pryor. Well, when I read it last night, it was right at 5 minutes. I don't know what happened.

Senator Casey. It sometimes happens with witnesses; it never happens with the United States Senators.

[Laughter.]

Senator Casey. So we're grateful. I'm allowed to say that.

Mr. Pryor. No comment.

[Laughter.]

Senator Casey. I can say that and no one can do anything to me when I say it.

Our next witness is P. Sherrill Neff, who is a partner in Quaker BioVentures. He's founding partner of Quaker BioVentures.

Mr. Neff was previously chairman of the Greater Philadelphia Venture Group, and also was president of the Pennsylvania Biotechnology Association.

He sits on several boards of directors. I won't mention every one of them. Prior to forming Quaker BioVentures, he was president, chief operating officer, and director of a technology company, a publicly traded life sciences company.

He also was senior vice president of Corporate Development at U.S. Healthcare, and also formerly a managing director in the Investment Banking Division of Alex Brown and Sons, and formerly a lawyer with the law firm of Morgan, Lewis and Bachius, a tiny little law firm in Philadelphia and, other places—no, it's actually very large.

Mr. Neff is a graduate of Wesleyan University and the University of Michigan Law School. I would say for the record that I know him and he's obviously a Pennsylvanian, so we have no bias here at all.

[Laughter.]

Senator Casey. But we're grateful for your presence here, and look forward to your testimony.

STATEMENT OF P. SHERRILL NEFF, PARTNER, QUAKER BIOVENTURES, PHILADELPHIA, PA

Mr. Neff. Thank you, Mr. Chairman and good morning. Quaker BioVentures is a venture capital firm that invests only in life sciences.

Currently, we manage over $700 million in total committed capital, of which approximately 75 percent comes from large public and private defined benefit plans. Our current investors include ten different public pension funds from six different States, and also major corporate defined benefit plans.

Today I'd like to explain how the venture capital industry raises and invests its money, the economic implications of this investment, and the importance of defined benefit plans in that equation.

Venture capital is a relatively small but extremely unique subsector of what many institutional investors refer to as alternative assets. Venture capital funds are set up as limited partnerships, generally, in which sophisticated institutional investors or limited partners, LPs, provide capital to a fund managed by a group of venture capitalists or general partners, GPs.

The GPs then invest this capital, along with their own capital, in very high-risk private, startup, and early stage companies that demonstrate a tremendous promise for high growth over a very long term.

Our typical investment horizon for a venture-backed company, is 5 to 10 years, often longer, and, given the very high-risk nature of this investment, many venture-backed companies ultimately fail.

However, those that do succeed, return top dollar to investors and create many jobs and revenues for the U.S. economy.

You've heard today about many of the positive contributions that defined benefit plans offer their participants. I would like to address an attribute that may be less well known, and that is the role of these plans in the funding and growth of the venture capital industry, and more importantly, the young, innovative companies that make up the entrepreneurial segment of the U.S. economy.

Defined benefit pension plans have historically been a sizable and reliable pool of capital for venture fund formation, and thereby, for investment into the Nation's emerging growth companies.

The U.S. venture capital industry would not be the economic engine it is today, without the strong investment participation from defined benefit plans.

The growing importance of these private plans in the retirement income equation was begun in 1974 with the enactment of ERISA, followed by the 1979 issuance of the Labor Department's Prudence Regulation which interpreted ERISA as allowing pension plans to invest in young, smaller companies.

As a direct result of the Prudent Man Rule, a relatively small allocation of money from public and private pension funds began to flow at that time into the venture capital space.

Back in 1980, private independent venture funds had just a total of $4 billion in capital under management, and that has risen to $257 billion in capital under management in 2007. Much of this growth is attributable to the success of venture capital investment and the receptivity of defined benefit plans to the high returns the asset class has afforded them.

The mix of limited partners is changing. Because many U.S.-based private pension plans have been converted from defined benefit plans to defined contribution plans over the past years, we are seeing fewer private pension plans actively investing in venture.

This has been particularly acute on the corporate side so far. Filling that gap are LPs from outside the United States, including foreign public and private pension funds, who are becoming increasingly interested in investing in U.S.-based venture capital funds.

U.S. public pension plans continue to be critical and reliable sources of capital for U.S. venture funds. Most State pension funds and many local public pension funds invest a small portion of their assets in venture capital because they understand that venture capital can deliver high returns that boost the overall financial position of the fund.

Today, all but a few States permit their public pension funds to invest a small amount of their assets into the venture capital asset class. States that have been long-term venture capital investors include California, Washington, Pennsylvania, and Wisconsin.

Venture capitalists who take defined benefit pension plans into their funds do so because these fund managers are long-term patient investors who understand the nuances and risks of venture investing.

When a defined benefit pension plan invests in a venture capital fund, it is not only creating higher returns for its pensioners, but it's also supporting one of our country's most important economic engines.

Literally thousands of companies would not exist today were it not for the venture capital investment support they received early on.

In our portfolio alone, our companies are developing novel approaches to eye disease, diabetes, depression, infectious disease, cancer, rare genetic diseases, et cetera.

On the tech side of the world, similarly, companies whose names are now newspaper headlines, like Cisco, Google, eBay, Yahoo, FedEx, et cetera, and countless other companies were all at one time or another, just ideas that needed startup capital.

Last year, U.S.-based venture capital-backed companies accounted for more than 10.4 million jobs and generated over $2.3 trillion in aggregate revenue. Nearly 1 out of every 10 private-sector jobs is at a company that was originally venture-backed.

Almost 18 percent of our U.S. GPD comes from venture-backed companies. None of this would have been possible without the active investment of public and private defined benefit pension plans.

The relationship between the venture industry and defined benefit managers is symbiotic, and it creates high returns for investors and their beneficiaries, and it also creates high returns for the U.S. economy.

Thank you very much for the opportunity to weigh in on this important issue.

[The prepared statement of P. Sherrill Neff appears in the Submissions for the Record on page 67.]

Senator Casey. Thank you very much. We're joined by Senator Klobuchar and Representative Brady. I know that in the Senate we'll be having a vote, probably in about 10 minutes or 15 minutes, so we may have to intersperse some opening statements between our witnesses.

But let me introduce our third witness, Dr. Christian E. Weller who is a senior fellow at the Center for American Progress.

His expertise is in the area of retirement income security, macro economics, and international finance.

Prior to joining the Center for American Progress, he was on the research staff of the Economic Policy Institute where he remains a research associate.

Dr. Weller has also worked at the Center for European Integration Studies at the University of Bonn in Germany and also is a respected academic with close to 100 publications. Don't worry, we won't read all those today.

[Laughter.]

Senator Casey. He was also, in 2006, awarded the Outstanding Scholar Practitioner Award from the Labor and Employment Relations Association.

He's frequently cited in the press and is often a guest on national TV and radio programs. He's got a Ph.D. in Economics from the University of Massachusetts.

Dr. Weller, thank you for your presence here, and we look forward to your testimony.

STATEMENT OF CHRISTIAN WELLER, PH.D. SENIOR ECONOMIST, CENTER FOR AMERICAN PROGRESS, WASHINGTON, DC

Dr. Weller. Thank you, Mr. Chairman, and thank you, Members of the Committee for inviting me here today for this important hearing.

In my testimony today, I will make the case that public sector defined benefit pension plans offer adequate retirement benefits on a sustainable and efficient basis.

Consider for a minute, if you will, what a model retirement would look like and compare that to what actually defined benefit plans in the public sector look like.

First of all, such a plan would offer broad coverage. In the public sector, eligible public-sector employees are automatically enrolled.

Second, funds would be secure for retirement. In the State and local DB plans, beneficiaries typically cannot borrow from their pension; there are no lump-sum payments, and plan sponsors typically do not liquidate.

Third, the plan would offer lifetime benefits, and because assets are secure, public-sector pension plans are better suited than other plans to offer annuity lifetime income.

Fourth, benefits would be portable between jobs. Often if employees move to another Government position within the State, or in some cases, out of State, they can purchase service credits.

Fifth, the plan would offer survivorship and disability benefits. State and local government DB plans typically provide survivorship and disability benefits for workers and their families.

Disability benefits are particularly important for State and Government employees in hazardous occupations, such as police officers and firefighters.

Survivorship benefits are particularly important for women who still tend to have much lower retirement incomes and higher life expectancies than men.

Sixth, both employers and employees would contribute to a plan. In the public sector, employer contributions comprised about 18 percent of all public pension revenue from 1996 to 2006. Investment earnings made up 73 percent of revenue and employee contributions accounted for the remaining 9 percent.

Seventh, the assets would be professionally managed. In analyzing public-sector pension plan investment behavior, Professor Jeffrey Winger from the University of Georgia and I found that State and local plans exercise a great deal of prudence in their asset allocation and that these plans may have actually become more cautious in their asset allocation following a period of underfunding after 2000.

Eighth, participants would face loan costs and fees. Costs are relatively low for DB plans, and I'll talk more about this later due to economies of scale, professional management, and risk-sharing.

Because public-sector plans typically meet all of the criteria for a model retirement plan, beneficiaries receive secure retirement benefits, the private sector enjoys a source of stable, long-term financing, and governments can allocate taxpayer dollars in a fiscally responsible manner.

Let me talk a little bit about adequate retirement benefits. The National Institute of Retirement Security recently summarized the evidence on DB pensions and adequate retirement income and found that retirees with DB pensions are much more likely to have adequate retirement income than those relying solely on DC plans.

Public-sector plans offer adequate, but not lavish retirement benefits. In simulations done for Pennsylvania, my co-authors and I found that a typical retiree can come close to but not exceed a typical standard of adequate retirement income equal to about 75 to 80 percent of pre-retirement earnings.

These plans are efficiently run. This retirement is achieved efficiently. It is estimated that asset management fees average just 25 basis points for public pension plans, or between 35 to 145 basis points less than for individual accounts.

That adds up substantially over long periods of time. Also, DB plans can take advantage of broader diversification strategies, allocating a small percentage of their holdings to so-called alternative investments in venture capital, hedge funds, and private equity.

These investments can help to improve the returns of a plan's portfolio, by introducing assets whose returns are not correlated with each other. Professionally managed DB plans consistently outperform individually managed DC plans.

One widely cited estimate from the Center for Retirement Research, puts the difference in annual return at 0.8 percentage points. Other estimates are even larger than that.

Further, DB plans lower costs by pooling mortality risks. Because an individual does not know what their ultimate lifespan will be, each person must ensure that he or she accumulates enough savings to last for the maximum lifespan and not just the average lifespan, as would be the case under a DB plan.

A DB plan will require fewer assets to be accumulated than the comparable DC plan, reducing costs by 15 to 35 percent.

Finally in conclusion, public-sector retirees will be secure in their golden years and less likely to rely on public assistance, which is often offered through State and local government employees to retirees who do not have enough private savings.

Public-sector plans serve as a patient source of capital for many productive investments because they are prudently managed with a long-term investment horizon.

And finally, they are ultimately an efficient and sustainable retirement savings vehicle for public employers managing fiscally responsible taxpayer dollars.

Consequently, many design features DB plans already apply to DC plans, and automatic savings, universal coverage, and safer, lower-cost investment options are among them.

In the end, though, much of what public-sector DB plans can offer will be hard or impossible to recreate in the DC setting, hence policymakers at the Federal and the State level should help strengthen existing DB plans in the private sector and the public sector where appropriate, as well.

Thank you very much for the chance to talk to you.

[The prepared statement of Dr. Weller appears in the Submissions for the Record on page 70.]

Senator Casey. Thank you very much. Our fourth witness is Barbara Bovbjerg, who is the Director of Education, Workforce, and

Income Security Issues at the U.S. Government Accountability Office.

In that capacity, Barbara oversees evaluative studies on aging and retirement income policy issues, including Social Security and private pension programs; operations and management at the Social Security Administration, the Pension Benefit Guarantee Corporation, and the Employee Benefits Security Administration of the Department of Labor.

She was previously Assistant Director of Budget Issues at the GAO where she managed a variety of budget policy projects, including studies on the long-term effects of budget deficits.

Before joining GAO, she led the Citywide Analysis Unit of the DC Budget Office and analyzed State and local government finance issues for the Urban Institute, as well.

She holds a Master's Degree in public policy from Cornell University, and a B.A. from Oberlin College, and we appreciate her being here today and look forward to her testimony. Thank you.

STATEMENT OF BARBARA D. BOVBJERG, DIRECTOR, EDUCATION, WORKFORCE, AND INCOME SECURITY ISSUES, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC

Ms. Bovbjerg. Thanks so much, Mr. Chairman. One thing my bio didn't mention was that I was born in the Commonwealth of Pennsylvania.

Senator Casey. I'm very happy to hear that.

Ms. Bovbjerg. I did mean to put it on there.

Senator Casey. You get an extra 15 minutes.

Ms. Bovbjerg. OK.

[Laughter.]

Ms. Bovbjerg. All right, thank you. Well, thank you, Mr. Chairman and Members of the Committee. I should have said in my bio that we have also been doing work on public plans over at GAO.

I am especially pleased to be here today. We've done a couple of reports in the last year on public plans and have not yet had an opportunity to speak about them before Members of Congress, so we're especially excited.

As Mr. Pomeroy had noted earlier, there are nearly 20 million active employees and 7 million retirees and dependents who rely on the pension promises of State and local governments.

And although these pension plans are largely not subject to Federal laws that govern plans in the private sector, the retirement security of millions of public employees is nonetheless a Federal concern, and that's why we're here today.

Today, my testimony describes the structure of the benefit plans and their financial soundness, and it is, again, based on the reports we issued last year.

With regard to plan structures, most State and local governments offer the traditional defined benefit pensions as the primary plan for their workers, as we've heard from other witnesses. Nationwide, about 90 percent of full-time State and local employees participate in such plans, and that includes general government employees, teachers, and public safety workers.

In Fiscal Year 2006, the DB plans covered over 18 million of these workers, paid $152 million in benefits to more than 7 million beneficiaries. Unlike in the private sector, most of these plans require participants to make contributions calculated as a percentage of their own pay.

Each of the 50 States makes a defined contribution plan available to public employees, but generally as a supplemental, voluntary plan without an employer match. However, there are three States—Alaska, Michigan, and the District of Columbia—who offer defined contribution arrangements as primary plans.

These are similar to the 401(k)s that have come to dominate the private-sector retirement benefit world. A few States have hybrid plans as primary, and these, like cash balance plans you may have heard about, combine features of defined benefit and defined contribution plans—both.

State constitutions, local government charters, and statutes at both levels nearly universally protect public employee pensions from being eliminated or diminished.

Thus, workers who are hired under a particular plan cannot lose future benefit accruals, even if the plan is closed to new hires. In public plans, changes that reduce benefits must only be applied to those hired after the changes take effect, much like the Federal Government did when shifting from the Civil Service Retirement System to the Federal Employees Retirement System.

Also in some locales, benefit formulas are specified in law, which in effect, bars even changes like the CSRS to FERS, because benefit specifications would be different.

So, it's not surprising that public pension benefits have changed so little over the years. But let me now turn to the finances.

Although a few plans have reported very low funding levels, most State and local plans have enough resources set aside to pay for benefits promised for decades to come.

And even for plans with poor funding, benefits are generally not at risk in the near term because current assets and new contributions are likely sufficient to support benefits for at least several years.

However, many governments have contributed less than the amount needed to improve or even maintain current funding ratios; that is, the percentage of liabilities that their assets cover.

Such low contributions raise concerns for the future and may in effect, shift costs to future generations of taxpayers, since benefit changes under current State and local laws generally take decades to have an impact on the public budget.

Available data suggest that although more than half of plans reporting to the Public Funds Survey had a funded ratio of more than 80 percent, which is generally considered adequate for public plans, these 2006 results suggest that funding levels have fallen steadily since 2000. Because State and local governments, unlike private employers, are expected to continue operations indefinitely in the future and are unlikely to go out of business, public pension plans are unlikely to present themselves for Federal bailout, even with these falling funding levels.

Indeed, a simulation we performed last year, suggested that just slightly higher contributions from governments as a sector would fund plans overall for the next 40 years. However, rising healthcare costs and the resulting fiscal pressures could have an impact.

Retiree health costs, not previously considered a long-term liability for State and local governments, are now being recognized as such in State and local financial statements.

Medicaid costs are an even larger piece of State budgets and are driven by the same cost factors. States' ability to fund pension costs in the future will be affected by these other budgetary claims.

So in conclusion, although most State and local pension plans are reasonably sound financially, the ability to maintain current benefit levels will depend, at least in part, on the extent of the fiscal challenges these governments face in the decades to come.

Governments with underfunded plans today will be most vulnerable to those pressures in the future, but all will have to address the consequences of uncontrolled healthcare costs, a challenge that is not the State and local government's alone, in fact, but will call for leadership at the Federal level, as well.

On that happy note, that concludes my statement, and I'd like to ask that my written statement be included in the record.

Senator Casey. It will be.

[The prepared statement of Ms. Bovbjerg appears in the Submissions for the Record on page 78.]

Senator Casey. It will be. And I should note for the record that all the written statements will be made part of the record. I don't think I said that before.

I know we have a vote that's going to be starting shortly, but I wanted to have both Senator Klobuchar and Representative Brady offer their openings at this time, and then we'll proceed from there.

Representative Brady.

OPENING STATEMENT OF HON. KEVIN BRADY, A U.S. REPRESENTATIVE FROM TEXAS

Representative Brady. Thank you, Mr. Chairman. It's a pleasure to join in welcoming the panel of witnesses appearing before us today. I've had the pleasure of working through the years with Ms. Bovbjerg on a number of Social Security issues, and it's nice to see you again.

Retirement security of those covered by both public and private pension plans is an important priority of policymakers, and I appreciate Senator Casey's leadership in convening this hearing.

Turning though to the situation faced by the beneficiaries of pension plans today, there is an emerging threat to retirement security,which is in the form of rapidly increasing prices on oil and gasoline, which have also spilled into higher prices for many food products, as well.

Retirees on these pension plans, especially those on fixed incomes, are very vulnerable to such price spikes for basic necessities. And I think Congress's failure to act to lower gas prices in America threatens the retirement security of our seniors, it erodes the buying power for the beneficiaries of our pension plans, and it has become yet another obstacle to improving our anemic savings rate here in America.

For example, seniors 65 and over devote about 10 percent of their income to energy expenditures such as utilities, fuel, and transportation. Since half of that is petroleum based, steep increases in oil prices will seriously erode seniors' living standards.

This year alone, oil prices have risen about 40 percent already, with some predicting even higher price increases. The oil price increase to date this year is equivalent to about 2 percent of seniors' income, a very significant amount especially over such a short time span.

These higher energy costs leave retirees with less money to cover other necessities, including food, and of course rising food prices also reflect higher costs for fertilizer, transportation, packaging, and our ethanol policies, among other issues.

Congress should not sit idly by while oil prices go through the roof undermining the retirement security of seniors as well as Americans who are still in the workforce.

Congress should act to encourage more American production of energy. Congress should permit the States to allow offshore exploration and drilling for oil and natural gas if they wish to do so. However, unfortunately the majority in the House and Senate continue to block repeated attempts to facilitate more American production of oil and natural gas.

I worry that this do-nothing and drill-nothing policy must come to an end.

While many public Defined Benefit Plans have cost-of-living adjustments, few private plans do. However, it is safe to say that soaring oil prices and associated increases in food have far outstripped all of these cost-of-living adjustments. The result is an erosion in the standard of living.

And in conclusion, it is also likely that higher oil prices will have a significant negative impact on the returns of both public and private pension funds, as well as other retirement investments in coming years.

With a number of experts predicting relatively low returns on equity investments in the future, workers and retirees may be hit with lower than expected balances in their other retirement investments as well. This makes Congress's failure to act on America's energy production all the more inexcusable. This is an issue that continues to face this Congress.

I am hopeful that at some point, sooner rather than later, we will have some straight up or down votes on production in America in measures that both Republicans and Democrats can support together.

Thank you, Chairman.

Senator Casey. Thank you, Representative Brady.

Senator Klobuchar.

OPENING STATEMENT OF HON. AMY KLOBUCHAR, A U.S. SENATOR FROM MINNESOTA

Senator Klobuchar. Well thank you so much, Senator Casey, and thank you for holding this very important hearing.

As we face tough economic times I think the subject for this hearing becomes more and more important. We see families across the United States who are stretched by rising prices in every direction, whether it is gas prices or the cost of health care, or their housing prices, and what has been happening is that the savings rate has been hovering around zero.

I do not think I have to tell our experts this, but when you look at what has happened the last say 8 years where the average American family's wages have gone down $1000 a year and their expenditures have increased about something like $3000 to $4000 a year, they have had a net loss, middle-class families, of $5000 a year. It leaves very little for savings.

There is very little for them to fall back on, and that is why I think that talking about how we can do a better job with retirement plans is going to be key to our future.

I will tell you that I feel fortunate to come from a State with a great Public Defined Benefit Retirement Plan. My mother is a teacher, so I am well aware of this—a retired teacher.

There are three State-wide plans in Minnesota: the Minnesota State Retirement System; the Public Employees Retirement Association; and the Teachers Retirement Association. They are well funded and have an average funding ratio of 88 percent.

This money helps support over ½ million Minnesotans' plans for their future. Workers that retire without adequate income, or cannot retire because of a lack of savings, face tough choices at a time when they should actually be able to reap the benefits of their work.

More and more we are seeing workers living paycheck to paycheck putting nothing aside. And without sustainable retirement—what I am concerned about is that it is my daughter, who is now 13 years old, who will end up suffering because we are not planning ahead for our future.

I know it is very important in the public sector, but I also think that we can take some lessons from this and apply them to the private sector.

And then finally, Mr. Neff, I am sure as this hearing goes on I hope that we discuss some of the benefits from having investments in communities and business development. In Minnesota State Retirement Funds invest $1 billion each year in the growth and expansion of our businesses, like 3M and Target, and MedTronic, and General Mills, and Hormel. If you can't invest in Spam, what can you invest in?

So anyway, I just think that that aspect of this, in addition to the importance for individual families, of what this means to have these investments made in your own businesses in your own country is very important as well. So thank you very much for being part of this panel.

Senator Casey. Thank you, Senator Klobuchar.

We are joined this morning by the real Chairman of this Committee, not just the Chairman-for-today, Senator Schumer from the Great State of New York. Thank you, Senator.

OPENING STATEMENT OF HON. CHARLES E. SCHUMER, CHAIRMAN, A U.S. SENATOR FROM NEW YORK

Chairman Schumer. Well thank you. And first I want to thank you, Bob Casey, for holding this hearing. There are very few Senators who are as much in touch with the needs of average folks than Bob Casey. It has been true throughout his whole career and has certainly been true here in the Senate where he is one of our most powerful voices.

That is why it is so appropriate that he is chairing the hearing of the JEC on pensions, and on public pension plans, because we have two conflicting things happening.

The average person, whether they be a public worker or a private worker, is caught in sort of the pincers of two things.

One is, people live much longer. That's the bottom line. Average life expectancy keeps going up. That is a tribute to this country. With all the complaints about the health care system, we cannot forget the good. When I was a little boy I had a great grandmother who was 82, and the kids would come on their bikes in our neighborhood and say: come to Schumer's house and see the oldest lady in the world, because no one had ever seen anybody 82 years old. Now, praise God, my dad is 85. My mom is 80. And they are driving around and playing golf. So it shows you how the world has changed. But that means people's pensions are more and more important. It covers a greater and greater portion of their life span.

And second, the average person does not have the buying power they once had. So the ability to save, the ability to put things away on your own, are declining. The great study of Elizabeth Warren of Harvard Law School showed that in 2001 the average worker's income, average family's income, rather, was $48,000. It had gone down to $47,000 by 2007. That is before this recession. So that was during the prosperity where we all see those large macro numbers.

The middle class actually went down a little bit, the median. But it is much worse than that. Buying power went down to $41,000 because wage increases were not keeping up with inflation. And if you had a child in college, it went down to $39,000 because tuition is both so expensive and the increase was so great.

So you put that altogether and pensions are more and more important and need more and more discussion. That is why this hearing is so timely. I just, as Chair of the Committee, want to thank Senator Casey for suggesting and putting together the hearing, and I think it is going to influence not just those of us on the JEC, but the entire Senate as we look into the new world we face and try to make the average middle class person's life a little bit better, both while they are working and in retirement.

[The prepared statement of Senator Schumer appears in the Submissions for the Record on page 39.]

Senator Casey. Mr. Chairman, thank you very much for that perspective, and also for allowing us to have a hearing like this.

This is an issue that would not get this kind of attention were it not for the work of this Committee, and for the leadership of Senator Schumer. We are grateful for that.

We have a vote going on, so we are going to take a short break, as they say on television, but we hope it is about 10 minutes for me to get over there and get back. It is only one vote, I guess, so it should not be too long. That would give our witnesses a chance to breathe before the hours of questioning ahead of you.

[Laughter.]

Senator Casey. We hope it is only maybe 2 hours or less, but we will return here as fast as we can and resume the hearing. Representative Brady, I do not know if you will be able to join us after this break, but we are grateful for your presence here. Thank you.

The hearing is adjourned for about 10 minutes.

[Recess.]

Senator Casey [presiding.] We will resume the hearing. I wanted to thank everyone for their indulgence while I ran to vote. I tried to keep it in the time window.

I think what we will do is we will go to questions now for all of our witnesses. I and Representative Brady might have questions for one particular witness, or we might move around, but we will try to keep it as free-flowing as possible.

We do not have tremendous time constraints, but I want to be cognizant of the Congressman's time, as well as the witnesses'. So we will try to keep it to 1 hour, if that is possible.

Let me start with Mr. Pryor. I wanted to note in particular, based upon your own experience, not just on the more technical matters we're talking about here, but just the human dimensions of this challenge and the reality for those who are in public safety positions, whether it is a fire fighter or police officer.

I noted at the very beginning of your testimony, and I made a note of it after I heard you say it, you talked about, "healing our bodies," meaning fire fighters.

Could you talk about that just for a moment in terms of that before we get lost in the technical jargon? I think it is important to note that.

Mr. Pryor. Sure. Our occupation, as most of you know—I think basically people know what firefighters do—it is a very strenuous occupation. Not only are you doing heavy lifting and doing sort of consistent arduous activities, you are also doing them at unexpected times. You are doing them when you have just woken up in the middle of the night and trying to lift somebody out of a house or something, just does not bode well for good ergonomics.

It is a very hard occupation on your body is what I am trying to say. And we have a very high rate of people that have bad backs, shoulders, knees—you know, I cannot think of too many people that actually retire healthy. It is not a matter of who retires sick, it is who retires healthy.

It does not happen very often. These are not people that can go out and get another job doing something of a similar nature. A retirement they can look forward to and not have to push themselves to the limit, and to be able to spend time with their grandchildren and their families and be able to live in the same house that they have had over the years is very important to my members.

But what is really important to them is that they do not have to go out and try and earn a living after they have retired because they have an insufficient income. They want to retire and stay retired.

That includes a pension benefit, and that includes health care, which is also very important. Of course they are going to need long-term medical care after they retire. So we try and make sure that those firefighters that do retire have a good health plan that will provide them with benefits to take care of those long-term injuries.

Senator Casey. Thank you. And I wanted to move to the other area of your expertise, which is dealing with the mechanics of Defined Benefit Plans.

Mr. Pryor. Sure.

Senator Casey. You are a trustee of one of the country's largest plans, and you have a lot of experience at this. I wanted to ask you about the investment opportunities that are available to DB plans that may not be available to, or in some cases are wholly inaccessible to individuals relying upon a Defined Contribution Plan for their retirement security.

Describe in summary fashion in terms of the opportunities that are available to your fund that might be not available or are inaccessible to an individual, for example.

Mr. Pryor. The two examples that really come to mind are private equity investments and real estate investments. We have a—we pride ourselves in having long-term relationships with quality managers.

And when we do invest with those managers, usually it is on a very long-term basis, not just our relationship with those managers, but also the actual investments that we buy into.

This can be seen in private equity with startup mezzanine financing, with buyouts. This can be seen in real estate where we have some holdings where we literally keep on for decades. And it gives us the opportunity to buy or sell in market cycles that are advantageous to us.

So not only are we holding these for a long time, but we are also able to pick out good market timing opportunities and be able to sell those off at the best time, or buy them at the best time.

And I just do not know how that could be done with any other kind of Defined Contribution plan. The investment opportunities in the alternative assets and real estate just are not the same, in the same universe when you are involved in a Defined Contribution versus a Defined Benefit Plan.

Senator Casey. Thank you. And I am going to move to Mr. Neff only because—or to other witnesses who will not be ignored by me, but I want to try to keep it at 5 minutes at a time. Representative Brady will go about 5, and then we will alternate.

But Mr. Neff, I wanted to zero in on something that you and others have raised, but you in particular because of your own experience in the private sector, about this aspect of the question: the utilization by venture capital, utilizing that revenue to nurture innovation, to foster job creation, to actually contribute to the economy, which is often not emphasized enough.

I was looking at Pennsylvania alone. Venture-backed companies in Pennsylvania employ nearly 700,000 people and these are in high-quality, high-paying jobs. Can you discuss the role that pension funding plays in your own world, your own Fund's ability to promote new technology and business and therefore generate jobs for Pennsylvania, and even beyond Pennsylvania?

Mr. Neff. Absolutely. As I mentioned earlier in my testimony, approximately 75 percent of our committed funds come from public pension funds, including the two leading funds in Pennsylvania, the School Teachers' Fund, and the State Employee Retirement Fund, PSERS and SERS. PSERS has been one of our led investors since our inception.

So while on the one hand we are helping to provide retirement benefits for school teachers and others who are employed by the State or local districts, we are taking a tiny slice of that asset pool and employing it directly into startup companies and early stage companies exclusively in the region.

Our fund is particularly regionally focused in the Mid Atlantic, and a significant portion of our investment activity is in Pennsylvania.

I think we have over 20 portfolio companies now in Pennsylvania. And these companies are investing in innovative new drug technologies for a variety of diseases. They are investing in groundbreaking medical devices. They are investing in innovative healthcare services. And they are investing in clinical diagnostics technologies that allow both providers and patients to get appropriate care for the disease conditions that they have.

In a typical startup company, we are employing not your average employee in the State with a $27–$28,000-wage level, but we are typically employing scientists and other highly skilled professionals who have much more typically wage levels in the $75–$80,000-a-year level. And those employees, in turn, typically spend upwards of $200–$250,000 per employee per year in their research and investment activity in the early stages of these companies.

I think if I probably cut all of our companies across the board, it would look something like that. So this is very high-impact investment, if you will, wherever it happens.

We are agnostic as to the source of the research that forms one of our companies. It can come from Singapore; it can come from Sweden, but for the talent that is used to actually commercialize that technology we find a motherlode in our particular region, and those are the people that we can pull together to put into a company to actually make that investment work.

I hope that is responsive.

Senator Casey. And it is all life sciences, which has the double benefit of that you are not only creating, or helping to create high-paying jobs, but you are also fostering the curing of diseases and helping our health-care system. So it is a fascinating combination of, I think, positive benefits.

I am now 4 minutes over my time, so the Congressman has at least 9 minutes, and I will come back. Thank you.

Representative Brady. I will try not to take that much time, Senator. These questions deserve deliberation.

This is a great panel. I appreciate you very much. Mr. Pryor, you are right; the experience of retirement plans when they deal with special occupations like firefighters presents a challenge.

Two years ago from my seat on Ways and Means we were able, working across the aisle with Congressman Gene Green, to change the drop formula for the penalties for firefighters and other police using that pension plan because, in fact, their bodies wore out before they reached the standard retirement level, and it sort of points out how we need to be flexible in these formulas as we address retirement benefits.

Dr. Weller, in your written testimony you praised Defined Benefit Plans for their ability to make alternative high-risk investments. For example, in futures and venture capital funds.

According to an article published just last week in the Washington Post, State and local government pension funds have collectively become the largest investors in the oil futures markets. By speculating on higher oil prices, the pension funds have earned spectacular returns.

For example, California's Employee Retirement Fund earned a return of more than 68 percent on an initial investment of $1.1 billion in oil futures, just during the last 12 months.

However some of my colleagues, including the Speaker of the House, Nancy Pelosi, have blamed much of the recent increase in gasoline prices on such speculation. Apparently, big speculators who were driving up gas prices turn out to be our State and local government workers and retirees whose pension plans are investing for a high return.

In Congress, some have proposed closing the so-called swaps loophole through which pension funds have invested in oil futures.

Dr. Weller, if such legislation were enacted, would it have the unintended consequence of diminishing the ability of pension funds to earn high returns from alternative investments that you have praised?

Dr. Weller. Well let me talk a little bit about commodities' speculation in oil prices. I think clearly when you look at what is happening to American families, they are caught between declining incomes and rapidly rising prices, and that is certainly worthy of consideration.

However, one of the problems we see when it comes to price increases is the sharp volatility in oil prices. If oil prices had always been—or gasoline prices—at $4 a barrel—at $4 a gallon—we probably would not have these discussions, but because they have promptly risen, that is what concerns us.

So the problem is, if you are looking at the swings in the commodities markets, you have got to be very careful in terms of regulating those markets. If you say, OK, will we completely shut off the ability for large investors who bring a lot of liquidity to the market—you are probably doing more harm than good, because you are ultimately increasing the volatility of those prices.

The other side is that if you have some of the proposed regulations, you probably have very little effect in terms of overall driving speculation or participants in a market.

So, I think where you want to go is more transparency of some of these speculations, but I think ultimately you have got to touch this very carefully, because the problem that we are concerned with is the big price swings in commodities.

And I think closing some of these loopholes could have adverse consequences in the sense that they could increase volatility by taking out the big players in a market who have a long-term outlook in the market, and who can ultimately provide the liquidity that to some degree actually does tend to reduce the volatility of the market, and particularly the public sector pension plans tend to be somewhat followers rather than leaders in the commodity market according to studies by the CFTC.

Representative Brady. So the impact, if I heard you correctly, in addition to the market—the impact on pension funds, if we limited their ability to make these investments, would lower their return by having forced them to switch to other perhaps less——

Dr. Weller. Well the plans are investing in these things, in commodities, for inflation hedges and other things. Their rates of return on commodity investments are somewhat uncorrelated with other investments, and it is a diversification strategy that is the benefit of large pension plans and large institutional investments.

Representative Brady. But is it your——

Dr. Weller. So reducing their ability to do that would increase the risk exposure in the short run, or in the long run—it remains a little bit to be seen—but presumably, it would reduce their rate of return. But it remains to be seen how much, and honestly, I am not prepared to give you an estimate on that.

Representative Brady. I will take that as a "probably yes."

Conversely, do any of the panelists take the position that speculation by these pension plans have driven up the price of oil? Do any panelists take that position?

Mr. Pryor. I would not.

Representative Brady. Great. Thank you, Mr. Chairman. I have got another question, but I will hit it after you are completed.

Senator Casey. Thank you very much, Congressman.

I am going to try to get back to our first two, but I do want to go in order so we are covering everyone.

Dr. Weller, I wanted to ask you about the assertion that I and others have made here today about better annual return for Defined Benefit Plans as opposed to Defined Contribution Plans: ability to pool risk, access to professional management, lower administrative costs, ability to invest in alternative asset classes without posing risk.

All of that, you know the list. But can you talk for a moment about two things? One is, in whatever order you want, but one is the criteria that you outlined and how important that is that Defined Benefit Plans meet that criteria for performance and for the health of a fund.

But also, in particular, in a similar way that I asked Mr. Pryor about, what are some specific opportunities that are available to DB plans that are unavailable to an individual based upon the work that you have done—especially when you think about the long term?

Dr. Weller. I think the overall—when you look at the rate of return—that is obviously an outcome measure. I think when we look at the inputs, you do have risk pooling, especially the mortality risk pooling is particular important.

Again, let me reiterate what I said in my testimony. When you have a Defined Contribution Plan, as an individual, you have to plan for the maximum possible life span. You don't want to run out of money. In most plans, 95 percent of people do not annuitize their income. So if you want to manage your own lifetime, your own lifetime income, you have got to basically over-save, which you do not have to do in a DB Plan.

That does actually add a substantial cost in a Defined Contribution side.

The other part is economies of scale. I think whatever I have studied over my 20 years in financial markets, economies of scale do play a substantial role. They allow, by having pooled assets, they allow plans to reduce the cost. Regardless, even if they have the same investment profile as an individual with their 401K Plan, the fact that they are larger, that you need to collect the same information, whether you invest $10,000 in a company, or $100 million in a company, that can reduce substantially costs.

And as I said, the asset management fees are about 25 basis points for a DB Plan. They are substantially higher for a DC plan. Over a 40-year period of 1 percentage point difference reduces, roughly speaking reduces your savings by about 25 to 30 percent. That is substantially lower retirement savings. So that is one thing.

And then finally, the ability to diversify assets is certainly important. That is something that ultimately is only—it plays a little bit into the economies of scale argument. If your portfolio is $40,000, you do not want to really start speculating on currencies or commodities.

But if you are a large pension plan, you want to diversify across all potential asset classes, including commodities and currencies. And I think that would be—that adds to an improved risk and return profile in the whole mix.

So I would say probably risk pooling first, economies of scale second, and ultimately the diversification third. And especially diversification is a particularly important aspect here. The interaction between diversification and DB plan, with a very long-term horizon, basically an infinite time horizon for the public sector pension plans.

Senator Casey. Tell me a little bit about—and I am going to respond to some of the points that Representative Brady raised about hedge funds and the interplay in the commodities market.

Talk about that for a moment—we know that DB Plans do invest in hedge funds, often hedging other investments. If they are doing commodities' hedging, it is usually a small percent of their overall investments.

Talk about that for a moment, if you agree with that, and amplify or expand on that.

Dr. Weller. Well I think when it comes to hedge funds they are part of an overall diversification strategy, as is common for a lot of institutional investors, and I know my two colleagues to my right can probably speak a little bit more in terms of how that interacts with their plans, or the world that they know.

I think the issues we face with hedge funds, though, are hedge fund issues that have nothing to do with public sector pension plans. That is that just simply they are a black box in many cases.

They are not that well regulated. We often do not know exactly who are the investors in those, and I think that is—but that is a separate issue. I think that is an issue that is something that I think all institutional investors should be concerned about. It is a financial stability issue generally in terms of increasing transparency and regulatory oversight over hedge funds.

But I do not think it has anything to do with public sector pension plans investing in hedge funds as part of their overall diversification strategy.

Senator Casey. This is obviously an important issue for the debate on energy and how we deal with the current economic crisis, which a lot of it is centered on the price of gasoline.

I have talked a lot about the issue of speculation and that there has to be more transparency, not just in the context of larger investors, but just generally in the area of speculation. But there are some real conflicts on the issue.

But I do think, in the context of the debate we are having in Washington, the one area where there is some common ground between Democrats and Republicans is on this issue of speculation. It is probably the only area where there is common ground right now, other than maybe some tax issues.

So we need to explore it more than we have today. But I wanted to, before my time runs out for this round, I wanted to ask you. Sometimes in this debate we talk about let's just look at this from the perspective of a taxpayer. Let's set aside beneficiaries. Let's set aside government. Let's set aside the impact that DB plans can have on the economy overall—taxpayers.

Because in my State of Pennsylvania, one of the real challenges we will face in the State is taxpayers saying: Well, look, do you mean to tell me I've got to pay more to support these pension plans? Because there is obviously a taxpayer role to play here.

And that is a reality we have got to deal with. It would be nice if the world were different, but taxpayers have a very low tolerance right now for paying more on a number of fronts, and one of them that is around the corner, maybe even if gas prices go down or stabilize, when as a country we do something about health care, which we have not yet—Congress has not; the Administration has not—we, both parties bear some responsibility here, but around the corner in Pennsylvania and a lot of other States, this question of the taxpayer role in this equation is going to become—to say it is going to become prominent is an understatement.

So just from the perspective of a taxpayer, when you were giving your opening—during your opening statement you talked about "efficient allocation of taxpayer dollars." Talk to us about that, in particular, and how taxpayers when they look at this issue, what you think they should know about how DB Plans play into their lives by efficiently allocating taxpayer dollars.

I know it is a broad question, but do your best in a couple of minutes.

Dr. Weller. I will try to keep it short.

I think for taxpayers—and often when you ultimately explain it, it becomes clearer—but taxpayers want to have firefighters who are willing to go into a burning building and save people. They want to have police officers who take public safety seriously.

They want to have qualified and skilled teachers educating their children for the jobs of the future. And in order to both recruit very skilled and courageous people, but also retain them, you do have to offer in the public sector Defined Benefit Pension Plans, a good benefit.

Then the question becomes, OK, what's the best way of offering that benefit? So, far, defined benefit public-sector pension plans is the biggest bang for the buck.

In terms of offering a solid retirement benefit that not only offers retirement income for life, but also offers survivorship benefits and disability benefits, as we've heard, are particularly important for the hazardous occupations for the public safety occupations.

So if you, as a taxpayer, are concerned with public safety, with a good education quality in your State, and in other good public services, you ultimately have to agree that you have to pay a good salary, but also overall, offer a good benefits package, including retirement and healthcare benefits.

Then the question becomes, OK, how do you get to that point? How do you deliver that benefit to the public service employees at the lowest cost to the taxpayer.

A large-scale pooled pension plan in the public sector is by far the best way of doing it.

Senator Casey. Thank you. I have some follow-up, but I want to give the Congressman another chance. I violated my minutes rule. Thank you.

Representative Brady. Thank you, Mr. Chairman. Even though high gas prices and food prices are eroding the benefits that retirees enjoy from their pension plans, the take-away from this hearing seems to be that by most measures—at least within the State and local government pension plans—that they are adequately funded over the next two decades or so.

But turning to the question the Senator raised about healthcare, before 2005 the Government Accounting Standards Board didn't require State and local governments to calculate and disclose their liabilities for retiree healthcare benefits.

By the end of this year, all State and local governments will be required to make this disclosure in their financial statements.

In January, the General Accountability Office estimated that the unfunded liabilities of State and local governments for retiree healthcare benefits was between $600 billion and $1.6 trillion.

Ms. Bovbjerg, just starting with you, have State and local governments generated these huge liabilities largely because they did not fund healthcare benefits over time, as they did for retiree pension benefits?

Ms. Bovbjerg. It's a whole different model, Mr. Brady, that pensions traditionally have been pre-funded with contributions. I don't know if anyone here pointed this out, but probably two-thirds of the assets in a pension fund are from investment returns, not from contributions.

In the retiree health area, it was traditionally considered part of employee health benefits, so it was treated much the same way that health insurance for active employees was treated, so although there are a few governments out there who have prefunded retiree health to some extent, virtually none of them have fully done that.

And we offered that number, but that's actually not our estimate. We talked to all these different people who thought about this, and we give the resulting range of anywhere from $600 billion to over a trillion, because States have not yet been required to report this. This is just starting to come out now.

Representative Brady. So this is just the early estimate of what it may turn out to be?

Ms. Bovbjerg. That's right. The reports are required in the fiscal year starting after December 2007, so just now, just now you'll start to get the end of this period.

You'll start to get reports on what these liabilities look like. When we talked with rating agencies and with States about this, the general view was that no one's going to rush to try to fund all of this right away because it's going to be a pretty big number in each case.

But there seems to be a consensus among the rating agencies and among States, that having a plan is important, so we'll start to see some of these plans emerge, as well.

We have work just now underway for the Committee on Aging to look at what actually are States going to do in dealing with the retiree health liability. When we did this earlier work, they were still trying to grapple with just what are the numbers; how big a liability might this be?

Representative Brady. Well, isn't it critical to States and local governments, to begin now to address those liabilities because, as Senator Casey pointed out, taxpayers end up covering those liabilities. There's rarely cuts in public retiree healthcare benefits, it's a huge number.

And just the thought that local taxpayers would pay more to support benefits when, in fact, their private benefits are oftentimes lower than that, when their savings rate is lower, as well, seems to be yet another hickey that the public simply can't make room for in their family budgets.

Are there States that you know of that are addressing, or local governments that are really addressing—have drawn up a plan or are following a plan to eliminate those liabilities?

There are some that have plans. For example, some have issued bonds, so essentially, they've borrowed to finance the liability. They kind of locked themselves, and we'll see whether that was a good decision or not a good decision.

I think the jury is still out on that. There will be States that will just do what they can to start the process of prefunding and fund up. And you see pockets of places that are doing that, often at the county level.

And you will see some that will reduce benefits or ask for greater employee contributions to those benefits.

Retiree health benefits are not protected legally the way the pension benefits are in State and local government, so that's a vulnerability for public employees—for retirees.

They really need to deal with this. They need to have a plan because States, in our estimate, have about a decade before healthcare costs are going to eat them alive, not just retiree health, but active employee health, Medicaid.

That's why we've called for the whole public sector, including the Federal Government to really give attention to the issue of healthcare costs and how we can address it.

The States won't be able to take that on, on their own.

Representative Brady. Legally, these plans may not be protected, but politically—in the real sense—they are in a way.

Other panelists, any other thoughts on unfunded liabilities in healthcare?

Mr. Pryor. In our county, which is currently a pay-as-you-go system, for retiree healthcare funded by the county of Los Angeles, we're considering funding options.

We really want to take advantage of the real strength of defined benefit pension plans and that is to use prefunding, to use investment income to pay for a benefit.

Now, the problem with retiree healthcare, of course, is the rapid escalation of the cost of providing this healthcare.

You know, we know what general cost of living is within a small parameter. We know what it's going to be for our retirees, to preserve their purchasing power.

We don't know what healthcare is going to cost in the next 20 years. And what level do we have to fund retiree healthcare to be able to keep a good retiree healthcare program?

You know, we can still fund it. We can still provide, you know, with excess money—with bonds—whatever we decide to do. We can start this asset pool going, but we're very careful about predicting our liabilities; we're very careful about making sure our liabilities are matched with contributions in the pension world.

You can't do that for retiree healthcare, but again, we're going to try; we're going to put our excess earnings, not from the pension system, but we're going to be putting funds and possibly bonds together to start an asset pool and see if we can start meeting those obligations with investment income.

Representative Brady. So, the ability to invest and get higher returns is very important.

Mr. Pryor. Absolutely.

Representative Brady. Not just for the pension side, but the healthcare side, as well. I do think—go ahead. I'm sorry.

Mr. Pryor. It's using what we've learned in the defined benefit pension world, and trying to use that as a way to fix the funding of retiree healthcare.

Representative Brady. The two biggest questions that I get at home in Texas, from State and local governments, is one, how can we afford the rising cost of healthcare, and second, how much next year do I budget for gasoline? What's the price at the pump.

Now this year, I budgeted $3.50 a gallon. Is it $5 next year? Is it $6 next year? Law enforcement asks me that; school boards and districts ask me that; every local government asks me that, again, continuing the belief that at some point Congress needs to act, the sooner the better.

Thank you, Mr. Chairman.

Senator Casey. Thank you very much. I wanted to finally get to the other end of the table to Barbara Bovbjerg.

In particular, I wanted to ask you about the—I know there was—and I just made a note of it and didn't write down every word you said, but when you talked in your opening about State and local governments having enough money set aside, can you just restate that—kind of where you see things right now in terms of what State and local governments have set aside for pension benefits going forward?

Ms. Bovbjerg. We looked at the sector of State and local governments in the aggregate.

Senator Casey. Right.

Ms. Bovbjerg. And we used an 80-percent funding level. It's a little different than in the private sector because they governments are ongoing concerns.

And we found that the majority of the big plans have enough money set aside, that as a sector, they actually look pretty good. We did a little simulation model where we tried to look at what would it really take to fund pension commitments for 40 years, and we found that it would take very little more than what State and local governments are putting in right now, as a percentage of pay.

I think they are putting in about 9 percent of pay now as sector, and it would have to go up to 9.3 percent. So it all seems very doable and very reasonable.

The caution is that there are other things going on out there that are going to make claims on State and local resources, but I think one of the messages we really wanted to bring to Congress is that you do see in press coverage that certain plans are very underfunded, really struggling to make their payments, and that is true.

There are such plans out there, and some of them are very big plans, but by and large, the sector is keeping up pretty well with their required payments.

And that's a good thing because if you don't keep up, then it gets harder and harder and harder and you lose the magic of compound interest, the magic of the investment returns, and you just get further and further behind.

But, as a sector, they seem to be doing reasonably well.

Senator Casey. I'll tell you, that's good news. In Washington, if part of the message we send to the State and local governments is you need to do a little more, that would be sweet music to their ears. Usually Washington is saying, you've got to do the whole thing, pal, get ready.

Ms. Bovbjerg. For some plans it's a little more; in other plans, it's a lot more.

Senator Casey. I'm being a little cavalier.

I wanted to move to—as I said in my opening, I'd ask each of you for specific recommendations, and we'll do that.

We're joined by Congressman Cummings, and I wanted to give him a chance to do an opening now or to ask questions now, but just as a preview to something that I want to do before we leave is to ask each of you for your recommendations about what the Congress should do.

We're elected to serve you; we're elected to serve constituents across this country, and I think hearings should not end without an action plan or at least the outlines of an action plan of things that we must do here.

Sometimes the best thing Congress can do is get out of the way or not get in the way, but sometimes there are specific steps we can take legislatively or otherwise, or even just be better advocates to help at the local and State level.

So I'd ask you for those recommendations, each of you, before we leave here today, but also if you have more work to do on them, or if you want to amplify or expound in the record on those recommendations, we would not only invite that, but encourage that.

But before we get to that segment, I know that both Representative Brady might have more questions, but I wanted to have Representative Cummings either present questions, or give commentary.

Congressman, the floor is yours, and you have plenty of time.

Representative Cummings. Thank you very much. Thank you all for being with us.

Ms. Bovbjerg, I have a question about the interaction of defined benefit pension plans and Social Security. When employees are receiving more of their private pensions from defined contribution plans, one assumedly should also raise the payout rate from the traditional Social Security, rather than trying to privatize part of it.

What's your opinion on this matter, and what would be the respective pros and cons of partial privatization?

Ms. Bovbjerg. Well, as you know, we've done a lot of work on Social Security and the different issues. One of the points that I infer you're making is something that we've raised, which is this concern about risk for individuals that, as we move to a defined contribution world in the private sector, would we then also move to a more defined contribution world in our social insurance program, in Social Security?

And we think you'd really want to think about that before doing so, because you don't want the same market conditions that are affecting someone's 401(k) to also be affecting their Social Security benefit. You want them to have a little more diversity in their retirement income.

That said, we have also heard a number of proposals that would create a separate savings mechanism. I testified a couple of weeks ago on automatic IRAs and those sorts of things that would offer people an ability to have some sort of savings account, which is an ability that they have now, but would make it easier for them to participate.

I know there are a number of proposals that would have a mandatory savings account that would be separate from Social Security. There is sort of this range of ways to think about that.

But I would really encourage the Congress to think about this as retirement income more broadly. Think about Social Security, personal savings, and pensions all together, so that we do not inadvertently do something that then has a pernicious effect at the end of the day, at someone's retirement.

Representative Cummings. Mr. Pryor——

Mr. Pryor. Yes, sir.

Representive Cummings [continuing]. In the State of Maryland over 133 parts of local governments participate in the State's pension plan. Moreover as a whole, Maryland has $38.5 billion in pension funding as of May of 2008.

Maryland, unlike California, has a combined pension plan rather than one that is divided amongst the various public sectors such as CalStar.

In your opinion, is there a greater benefit to dividing such plans based upon the various government sectors?

Mr. Pryor. I think as long as you have an employee pool that shares similar needs in retirement, I think that you can pool. I'm sure there are plenty of studies out there about the size of a fund. You know, does it have to be $1 billion to $40 billion to fully take advantage of asset allocation and use all those good things that I think Defined Benefit Pension Plans use?

So I think you really have to look at the size of the fund and look at whether that fund can appropriately diversify rather than just look at employee pools. I think administratively you can really—

you can figure out what kind of benefit and what kind of payment different employees are going to have to pay.

But I think that asset pool needs to be an appropriate size to give proper diversification, and my fund is almost the same size as your Maryland fund and we find that we are nimble enough, not so big that we don't take over a sector, but at the same time we are able to hire staff and hire the right managers to get us in the door on some quality investments.

Representative Cummings. Some people suggest replacing a Defined Benefit Pension Plan with a Defined Contribution Plan such as 401K. Currently the average 401K account has a balance of less than $40,000 upon retirement.

As a firefighter do you think that that is enough money for a typical public safety officer to retire?

Mr. Pryor. I think I have made my position very well known in the State of California where I stand on this, and frequently through a bullhorn and carrying a sign as I was doing. I am horrified at the prospect of members switching to Defined Contribution from a Defined Benefit Pension Plan.

We are doing it right. We have good investments. We have solid plans that provide a good retirement for hardworking people. Why change things?

These are plans that do not cost the taxpayer too much money. They do not—you know, we are well-run plans. And I think that when everything—you know, hearings like these, and meetings like we have had in California when taxpayers, when local government hear the advantages and the savings they get from having these plans, and the doubling and tripling of investment income, and benefits paid out to retirees, and how this stimulates local economies and provides good quality health care opportunities for our retirees, I think people understand.

And they understand that the Defined Benefit Plans are the way to go. The days of Defined Contribution Plans, you know, trying to take over Defined Benefit Plans, I do not know where that is going to go but I know how I feel about it, and I feel very strongly that Defined Benefit Pension Plans are what our public employees need, and we are here to protect those Defined Benefit Plans.

Representative Cummings. Just one other question, Mr. Chairman. I understand that firefighters—and I have dealt with a lot of firefighters as a State Legislator——

Mr. Pryor. Yes, sir.

Representive Cummings [continuing]. And here in the Congress—often retire many years before they are eligible for Social Security. As a matter of fact I remember back when I was in the State Legislature they were saying that research showed that, sadly, firefighters quite often pass away within 5 or 6 years, which I found incredible, after retirement.

Mr. Pryor. Yes.

Representative Cummings. And so they retire before they are eligible for Social Security, and many of them have serious physical ailments in their retirement years stemming from spending a long career in a demanding profession, and of course inhaling all kinds of smoke, fumes, and what have you.

Are Defined Benefit Pension Plans able to better address these kinds of issues?

Mr. Pryor. Yes. Eventually our bodies are going to break from our job, and we realize this. Some sooner, some later; some people are able to make it to 55, 56 years old. But we have quite a few people that have to leave with just a couple of years on the job because they have taken hazardous—you know, solid injuries that require them to leave. They cannot do arduous employment anymore.

Really, our Defined Benefit Plans act as the insurance plan, act as the annuity for those people when they do have to leave. And they can, you know, take time to find other employment of a less arduous nature, and they have the insurance of those benefit plans behind them.

And in the most extreme circumstance, and the most unfortunate and one they have to deal with quite a bit, is the death of a firefighter. That is, that it provides a survivor benefit, a Defined Benefit Survivor Benefit for the families of those people that are killed in the line of duty.

And in the situation you had said before, if this was just a 401K account that is $40,000. How long does that last a family of four? We have been told, well, you can purchase insurance to back it up so we will be able to provide for those survivors.

We cannot. We cannot find insurance to cover that kind of benefit, that level of benefit, if somebody is killed in the line of duty. It is not offered. People do not want to cover us for those kinds of injuries.

So we have—and as I said in my testimony—a Defined Benefit Pension Plan is a lot more to us than just a Pension. It is also an insurance system that provides for us, that provides for our family if we are killed or injured in the line of duty.

Representative Cummings. Thank you, Mr. Chairman.

Mr. Pryor. Thank you, sir.

Senator Casey. Thank you very much, Congressman. I want to thank you for your presence here today, your questions, and your leadership on this issue. Also, for traveling all the way across from the House to join us. We do not get over to see you guys enough, and we are grateful for your presence here today.

Before we get to recommendations—and I will just go. We will not call it a lightening round, but we will try to get to everybody to make recommendations. And again you can add more for the record.

But the Joint Economic Committee staff does a great job with, among the many things they do, with charts. I forgot earlier—and I did not need a staff member to remind me; I actually reminded myself, which is rare in Congress; we can actually think for ourselves once in awhile, right—but we have two charts here I just wanted to quickly highlight for the record.

Nathan, maybe you can put them up, just because I know the work that went into them. The first one—and actually the one I wanted to highlight more was this one we have up there.

The Defined Contribution Plans are nearly four times as expensive to administer than Defined Benefit Plans. I think that is important to point out because sometimes when arguments are made in these kinds of debates where there is something new, a different road to take, a different direction, some kind of whiz bang different way to do things, they always preach it is more efficient, it gets better results, all of those arguments.

[The above chart entitled, "Defined Contribution Plans Are Nearly Four Times as Expensive To Administer" appears in the Submissions for the Record on page 48.]

In this context I think it is very important to point out the differential here between the Defined Benefit—the public plans, their administrative costs, versus the Defined Contribution costs. This is little known information. It's probably never been in a headline, never been on a news show, but it is important to point out.

The second chart just does a very basic calculation, but Defined Benefit Plans are providing better income security for retirees. We have made this argument, this assertion, but the chart here is based upon $100 invested in a DB plan paying almost $200 more over time, the long run so to speak, over 25 years, than the same money in a Defined Contribution Plan. The green line going upward is the Defined Benefit versus Defined Contribution.

[The chart entitled, "Defined Benefit Plans Provide Better Income Security for Retirees" appears in the Submissions for the Record on page 49.]

I wanted to make sure we saw that graphically because it helps to have some graphic presentations of some of these concepts.

But let's move to recommendations, and then we will wrap up. We can go in any order. We can start with Mr. Pryor, or start on the other end with Ms. Bovbjerg. If someone has to run out the door, you can go first.

Ms. Bovbjerg. Well I can go first because, as you know, from GAO if I had recommendations in this area you would have already seen them in print.

Senator Casey. Right.

Ms. Bovbjerg. With regard to public plans, the number of States that provide Defined Benefit Plans now is the same that it was 10 years ago. The mix changes a little bit with the hybrids, but it is pretty stable.

If your goal is to preserve Defined Benefits in the public sector, I do not think there is much to be done there. Now I am not in the trenches the way some of the other people here are, particularly Mr. Pryor on this panel, who might have a different perception about the debate in Los Angeles.

On the private sector side, it is a much different situation. As you know, Defined Benefit Plans are disappearing. We are not seeing a lot of new Defined Benefit Plans.

We do have work coming out very soon on the dynamic of frozen plans that Mr. Pomeroy raised earlier. I think that will be some important work that is going to provide a foundation for us to think more about what really needs to be done on that end of employee benefits.

We have also been asked to start work on looking at what would be a really good hybrid plan, a combination of the best characteristics of Defined Benefit Plans and the best characteristics of Defined Contribution Plans.

That is something that we were asked to look at some time ago when we convened a Comptroller General's Forum on Defined Benefit Security, and we are happy to be able to start that work.

So we will stay in touch with you on this issue, and I hope we will have recommendations for you later.

Senator Casey. Thank you very much. I appreciate that, and I appreciate your work and your scholarship and also your contribution here on your testimony. Thank you, very much.

Ms. Bovbjerg. Thank you, Senator.

Senator Casey. Doctor.

Dr. Weller. Well I believe a series of publications by the National Association of State Retirement Administrators and the National Council on Teacher Retirement says it all. The public sector plans are getting it right.

So I think they serve as a model in terms of how we can achieve retirement security and allow hard-working Americans to achieve a middle class lifestyle in retirement after a lifetime of hard work.

Having said that, I would say that we can use this model and the lessons from public sector plans to improve, to ultimately improve retirement income security in the private sector.

I think much of the discussion focuses there on how we can implement a number of those features that are important in Defined Benefit Plans into Defined Contribution Plans. That goes into automatic enrollment, automatic default investments, life cycle funds, and model investment funds. Those kinds of things are already on the table, and I think we can do more.

I think the big question that still needs to be addressed is how we can ultimately lower the costs, the fees on Defined Contribution Plans. That is a tall order.

The other part is also—and Barbara already mentioned this—looking at, and it has been mentioned a number of times in this hearing today, on why is it that in particular single employer Defined Benefit Plans have disappeared very rapidly in the last few years.

Multi-employer plans, which were somewhat similar to the public sector pension plans, have actually remained relatively stable. And what can be done to promote multi-employer Taft-Hartley type pension plans in the private sector, which are somewhat similar to the public sector plans, as a particular model for private sector retirement benefit security.

I think one subaspect of that is I think we need to look at accounting rule changes on the increased uncertainty in terms of contribution volatility for the plan sponsors and what that has done in terms of plan sponsorship and the maintenance of those plans.

As I said, I think the public sector plans and the State and local governments are actually getting it right. They are well regulated through State and local government regulations.

I think they can serve as a model as lessons for what we can do both in the Defined Benefit side and the Defined Contribution side in the private sector, and I think we need to draw out those lessons and implement them in the future.

Senator Casey. Doctor, is there anything—and this is for today or if you want to amplify the record—but is there anything that you think Congress should do in the near-term on this?

Dr. Weller. I think on defined——

Senator Casey. And I am saying as opposed to a lot of the legislating in this area obviously will be done at the State level as well.

Dr. Weller. I think on the public sector side, as I said, they are well governed. That shows up in their asset allocations and their overall performance. I do not think that there is any role really for the Federal Government here. The States are doing it right. They are closer to those issues.

I think however on the private sector DB side, the lessons—again of the lessons that I think it is important to learn is regular contributions matter. I mean, that is one thing that makes the public sector plans different from the private sector plans.

There are regular employee contributions for instance going into those plans. And that is something that you definitely could pick up for the private sector side.

Again, on the multi-employer private sector side, it already exists because it is often collectively bargained contributions from the employer. But I think that is an important lesson.

And then the other part is the accounting rule differences between the public sector and the private sector, which seem to have been harmful the last few years to the private sector side.

Senator Casey. Thank you very much.

Mr. Neff.

Mr. Neff. Mr. Chairman, I think we have heard today that on balance the Defined Benefit Retirement System works. It works well for beneficiaries. It works well for taxpayers. And it has worked well for the economy.

The Defined Contribution System I don't think we can say has worked nearly so well in those three categories. So relative to recommendations, I would say please do nothing that will further encourage the disintermediation of funds from the Defined Benefit System to the Defined Contribution System.

From where I sit as a venture capital partner, putting to work a very small slice of the Defined Benefit pool of capital, I would say that this is the only pool of capital that is consistently and reliably available to those of us who are company builders, company creators with a long-term, multi-decade horizon.

And the characteristics of the Defined Contribution System are completely anathema to that long-term investment in the economy. So this may be a very good place to do nothing as it relates to this system.

Senator Casey. We appreciate your candor. Thank you very much. I appreciate your testimony today and making the trip to be with us today and anything that you or the other witnesses want to add to the record, of course, you could.

We will conclude now with Mr. Pryor. Thank you for having travelled the longest.

Mr. Pryor. Thank you. I definitely had the risk of having my thunder stolen, which apparently has happened by Mr. Weller, but I will try and rephrase a little bit.

That is, that to me a huge step forward is going to be the resuscitation of Defined Benefit Pension Plans in the private sector. These are good pension plans that provide for a quality income, health care upon retirement after a long career, and we need to put that back into the economy in the United States. Because not only is it good for the owners of these companies who will have-as taxpayers have—a quality pension that is affordable for those companies, but also it is going to hopefully lead to recruitment and retention and provide for their own needs.

Also we see the defined benefit impact on the economy as a whole, and how these pension dollars are reinvested back into the economy. I think that that is something that the Federal Government and State Government needs to concentrate their efforts on again revitalizing these private defined benefit pension plans and realize what a big give-back those plans are to local economies.

Maybe when we can start getting more research and have more hearings like these to discuss the impact of Defined Benefit Pension Plans, maybe more people will catch on.

So I think my recommendation is to keep doing what we are doing here today. Thank you, sir.

Senator Casey. Thank you very much. And thanks for your testimony.

Congressman Cummings.

Representative Cummings. Just one question.

Mr. Neff, I was listening to your response to the Chairman, and I was thinking that in Maryland we ranked fifth among States in bioscience venture capital investment between 2002 and 2007, and that amounted to about $2 billion invested.

Moreover, there were sectors of the economy that rely on venture capital investment that would be—I'm just trying to figure out, if the venture capital funds were to dry up, what sectors would be most affected? And would it affect all of this—I am concerned about my constituents.

Mr. Neff. Sure. It is an excellent question. As I testified earlier, approximately 42 percent of the entire venture capital industry in this country is funded by Defined Benefit Pension Plans. And if that source of capital were to dry up, it would have a dramatic impact on investments in biosciences.

It would have a dramatic effect in investments in all kinds of technology sectors. And it would have a dramatic effect on some of the newer attention foci of venture capital such as Cleantech.

So it is an enormously important little engine that drives the future of our economy. And again as a slice of the entire Defined Benefit pool, it is very small, maybe 3 percent, two, 3 percent is allocated to venture capital, out of maybe 5 to 10 percent totally allocated to alternative investments. It is a very small set of dollars. But in the aggregate, it is a very significant slice of the $250 billion of capital that is tied up in the entire U.S. venture capital industry right now.

Representative Cummings. Thank you, very much.

Senator Casey. Congressman, thank you.

I want to thank all of our witnesses and those who attended today. This hearing is adjourned.

[Whereupon, at 12:28 p.m., Thursday, July 10, 2008, the hearing was adjourned.]

Submissions for the Record

PREPARED STATEMENT OF CHARLES E. SCHUMER, CHAIRMAN

Good Morning. I would like to begin by thanking Senator Casey for holding this important hearing highlighting the need to strengthen our nation's retirement security. Whether he is fighting to keep rising health insurance premiums down for workers or making sure there is sufficient emergency funding for food assistance to help families deal with skyrocketing grocery prices, there is no doubt that Bob Casey is a true champion for America's families. The people of Pennsylvania—and we here on the Joint Economic Committee—are fortunate to have him in the Senate today.

It is no wonder that American workers today are feeling increasingly anxious about their jobs, their wages, and their ability to eventually retire. Every day it seems we learn more bad news about the economy:

- Just 2 days ago we learned that the already anemic housing market continues to plummet. Sales of existing homes fell an additional 4.7 percent in May—down 14 percent from where they were a year ago—and by all accounts the bottom is nowhere in sight, leaving millions of Americans with less access to credit and increasingly worried about whether they owe more on their homes than they are worth.
- This news comes on the heels of last week's Labor report showing that the country lost another 62,000 jobs last month—marking the 6th straight month of job losses and bringing the total number of jobs lost just this year to almost 440,000. And as we all know, unemployment has devastating consequences for families. Not only must they struggle to make ends meet in the short term, but also their retirement savings suffer as they miss out on the opportunity to contribute to their retirement funds—assuming they were lucky enough to have a retirement fund to begin with.
- All of this news comes at a time when wages are stagnating and prices of everything—from oil to food to consumer products—is skyrocketing.

The most important thing we in Congress can do today is take steps to improve the nation's economy. But we must also be taking steps to ensure that Americans' long-term financial health is protected. We need to ensure that all workers, and in particular those in the public sector—our firefighters, our teachers, our police officers, have access to retirement plans that will provide them with the security they deserve.

Senator Casey is right to point out that strong public pension plans benefit more than just the workers they are designed to serve. Public sector defined benefit pension plans provide workers with 34 percent higher earnings over a 25 year period than defined contribution plans and save taxpayers hundreds of millions of dollars in reduced state and local government contributions.

At the same time, these plans help fuel the economy by driving investment to venture capital funds that play a critical role in nurturing American innovation and breakthroughs across the technological spectrum—including life saving advances in health care. So, it is critical that we in Congress do all we can to ensure that public defined benefit pension plans are protected.

But we must do more than that if we are to truly improve the retirement security of all Americans. We must encourage Americans to save more—something I have long been a proponent of. It is unacceptable that the U.S. ranks lowest of all industrial nations in personal savings, with a personal savings rate of negative 1 percent according to the U.S. Department of Commerce.

This is why I have sponsored the bipartisan ASPIRE Act that encourages families to start saving accounts for their children. As everyone here knows, in today's economy, asset building is essential to getting ahead. Yet despite that fact, we are not encouraging children, who have the most to gain from starting savings earlier in life, to become savers. By encouraging families to start accounts at birth (rather than when people enter the workforce), making the accounts universal, and providing a match to low-income people, and allowing anyone to contribute to them—the ASPIRE Act would go a long way in helping to improve this country's savings rate.

It is clear that there is no easy answer to solving our savings and retirement security problems. But I believe that today's discussion about what we here in Congress can do to strengthen the retirement security of all Americans is an important first step. I look forward to hearing from our panelists today, and I once again thank Senator Casey for highlighting this issue.

Pennsylvania
U.S. Senator Bob Casey
Press Release

For Immediate Release
July 10, 2008

Contact:
Kendra Barkoff (Casey)
202-228-6367

Senator Casey's Opening Statement on Defined Benefit Pension Plans in the American Economy

The subject of our hearing today sounds obscure: the role of defined benefit pension plans in the American economy. However, this type of pension plan plays a very important role for reasons that we will explore today.

Historically most public and private employers offered their employees defined benefit pension plans, which pay an annuity based upon the employee's salary and years of service upon retirement. Under this arrangement, employers and employees share the risk of loss of market declines or bad investments of retirement assets. Employers offering defined-benefit pension plans take on the responsibility of investing retirement funds, either directly or through outside fund managers. By contrast, defined contribution plans, like the 401ks that most people have, allocate all investment risk to employees.

Over the past 30 years, defined benefit plans have come under severe attack. In the private sector, corporate defined benefit plans have declined substantially. In 1975, 88% of private-sector workers were covered by defined benefit plans; in 2005 that number had shrunk to 33% of the private sector workforce. There have been a number of well publicized attempts to eliminate defined benefit plans for public pension funds and multiemployer or Taft-Hartley funds.

As Auditor General and State Treasurer of Pennsylvania, I took a particular interest in the two state public pension funds, for teachers and public employees, which are traditional defined benefit plans. As Auditor General, I audited both funds and as State Treasurer, I served as a trustee for both funds. It gave me an insight into the benefits of well-run defined benefit plans, both to retirees and to our economy as a whole.

Defined benefit plans have been proven to earn better returns than defined contribution plans over the long run. For example, a recent study showed that defined benefit plans outperformed defined contribution plans by 1.8% per year over an eight-year period. This is because defined benefit plans are professionally managed, particularly in their asset allocation decisions and, in addition, have access to alternative investments like venture capital, private equity, real estate and hedge funds. These "patient capital" investments actually increase the return to a pension fund while reducing overall risk to the fund's portfolio. Alternative asset categories have low correlation with other asset classes; that is, they do not behave the same way that public equity or fixed income markets do, so when stocks go down, investments like venture capital may not.

Defined benefit plans are a key factor in attracting and keeping excellent teachers, firefighters, police, social workers and other public employees. The best and the brightest of our cops, firefighters and teachers have a big incentive to stay in their jobs rather than switch careers because of the promise of pension benefits in retirement. Multiemployer or Taft-Hartley defined benefit plans play the same role for workers in many of our important industries, including manufacturing, building trades and others.

Money invested in defined benefit plans typically stays there until an employee leaves or retires. As a result, defined benefit plans can invest in less liquid, alternative asset classes, such as venture capital, which are crucial to job creation, particularly in high-tech industries. Over 40% of investment capital for venture capital funds in the United States now comes from defined benefit plans.

Today, we will hear from four witnesses: an active firefighter from Los Angeles, who is also a trustee of his defined benefit pension fund; a well-known economist who has written extensively about this issue; a venture capitalist from Philadelphia who manages money for a number of defined benefit plans and invests in the biotech industry; and a representative of the GAO, who has studied the subject.

During this hearing, I believe there is one broader issue that we must all keep in mind. That is the issue of how we allocate risk in our society. It concerns me that some here in Washington and across America want ordinary people to assume sole liability for decisions regarding their health care, their pensions and their Social Security. These are risks that have traditionally been shared with employers or with the government. If we also want people to take 21st-century, global economy-type risks, like changing jobs, stopping-out for more education and training or starting their own businesses, we cannot also dump all the risk of health care and retirement on them. I am concerned that moving billions of dollars of retirement assets from defined benefit plans to defined contribution plans ads substantially to the risk we are asking ordinary Americans to take.

I plan to ask each of the witnesses today, as well as a number of other interested parties, for specific recommendations on what to do about the future of defined benefit plans. At a minimum, we should ensure that the circumstances that led to the decline of defined benefit plans in the corporate world are not repeated in the public or Taft-Hartley sectors.

With economic stability on the minds of all Americans, I look forward to discussing these issues in our hearing today.

National Conference of State Legislatures (NCSL)
American Federation of State, County and Municipal Employees (AFSCME)
National Association of Counties (NACo)
American Federation of Teachers (AFT)
United States Conference of Mayors (USCM)
Fraternal Order of Police (FOP)
National League of Cities (NLC)
International Association of Fire Fighters (IAFF)
International City/County Management Association (ICMA)
National Association of State Treasurers (NAST)
National Association of Police Organizations (NAPO)
National Association of State Auditors Comptrollers and Treasurers (NASACT)
National Education Association (NEA)
Government Finance Officers Association (GFOA)
Service Employees International Union (SEIU)
International Public Management Association for Human Resources (IPMA-HR)
National Association of State Retirement Administrators (NASRA)
National Conference of State Social Security Administrators (NCSSSA)
National Conference on Public Employee Retirement Systems (NCPERS)
National Council on Teacher Retirement (NCTR)

July 10, 2008

VIA ELECTRONIC MAIL

The Honorable Robert P. Casey, Jr.
United States Senate
Washington, DC 20510

RE: Hearing of the Joint Economic Committee, "Your Money, Your Future: Public Pension Plans and the Need to Strengthen Retirement Security and Economic Growth"

Dear Senator Casey:

On behalf of the 20 national organizations listed above—representing state and local governments and officials, public employee unions, public retirement systems, and more than 20 million state and local government employees, retirees, and their beneficiaries—we commend the Joint Economic Committee for examining the need to strengthen retirement security and economic growth in our country. The negative national savings rate, lack of pension coverage and participation in many parts of the private sector, and number of baby boomers that are currently ill-prepared for retirement, will place increased strain on our public assistance programs and our economy.

While pensions are seriously on the decline in most sectors of the workforce, State and local government employee pensions continue to provide a modest, secure benefit to those who spend a career in public service—providing for public safety, protecting the homeland, caring for the sick, and educating our children. The management of public pension assets also promotes economic growth and vitality. Through their size, broad diversification, and focus on long-term investment returns, public pension funds stabilize and add liquidity to the nation's financial markets. They additionally distribute consistent and inflation-protected revenue streams to local communities throughout the nation.

Independent sources such as the U.S. Government Accountability Office (GAO) and the Center for Retirement Research at Boston College (CRR), have found the vast majority of public sector pension plans to be sound and on track to meet their future obligations, with over $3 trillion in financial assets accumulated for the retirement security of millions of Americans.[1]

We hope your efforts to examine these programs may additionally serve to strengthen retirement programs. We are pleased to share the following facts:

- **State and Local Pension Plans are an Integral Component of National, State and Local Economies.** Public plans distribute more than $150 billion annually (an amount greater than the total economic output of 22 states) in benefits to 7 million retirees, disabilitants and beneficiaries, with an average annual pension benefit of roughly $20,500. These payments are steady and continuous and provide a considerable benefit to national, state and local economies. Several state-specific studies have documented the significant contributions public pensions make to local and state economies. On the whole, personal income from state and local government pensions exceeds the personal income derived from the nation's farming, fishing, logging, and hotel/lodging industries **combined**.[2]
- **State and Local Retirement Plan Assets are Professionally Managed and Provide Valuable Long-term Capital for the Nation's Financial Markets**. The $3 trillion in assets held in plan portfolios—and managed by professional investment managers—are an important source of stability for the economic marketplace and are designed to withstand short-term fluctuations of the financial markets while providing optimal long-term growth potential for the plans. Public pension portfolios are broadly diversified: approximately $1.74 trillion of public pension assets are held as equities in publicly traded companies; $850 billion is in corporate bonds and US treasury notes and bonds; and another $150 billion is in real estate.[3] The bulk of assets are invested on a long-term basis, creating a stabilizing effect on these financial markets, while public pensions' cash and short-term holdings add essential liquidity. For the 3- and 5-year periods ended 12/31/07, public pension funds generated strong investment returns of 10.0% and 12.7%, closely tracking returns generated by corporate pension plans.[4]
- **Public Retirement Plans Attract and Retain the Workforce That Provides Essential Public Services**. State and local government employees comprise 12 percent of the nation's workforce, and two-thirds are employed in education, public safety, corrections, or the judiciary. Retention of experienced and trained personnel in these and other positions is critical to the continuous and reliable delivery of public services. Retired public employees live in virtually every city and town in the nation (90 percent stay in the same jurisdiction where they worked).
- **Public Pension Plans are Well-Financed**. As a group, public pension plans have pre-funded nearly 90 cents for each dollar they owe in liabilities. Unlike the contribution volatility that may exist in a private plan setting, state and local plans receive a steady stream of both employer and employee contributions that typically is mandated by statute. Required contributions to public pension plans often represent historically low amounts as a percentage of total state and local government spending and payroll. This is because these programs are

---

[1] U.S. Government Accountability Office. 2007. *State and Local Government Retiree Benefits: Current Status of BenefitStructures, Protections, and Fiscal Outlook for Funding Future Costs.* GAO-07-1156. Washington, DC.

U.S. Government Accountability Office. 2008. *State and Local Government Retiree Benefits: Current Funded Status of Pension and Health Benefits.* GAO-08-223. Washington, DC.

Munnell, Alicia H., Kelly Haverstick, Steven A. Sass, and Jean-Pierre Aubry. 2008. *The Miracle of Funding by State and Local Pension Plans.* Center for Retirement Research at Boston College and the Center for State and Local Government Excellence.

[2] U.S. Department of Commerce Census Bureau and Bureau of Economic Analysis

[3] National Association of State Retirement Administrators and National Council on Teacher Retirement, Public Fund Survey, 7/8/08

[4] Wilshire Associates, Trust Universe Comparison Service, 2/13/08

pre-funded trusts where the vast majority of funding comes from investment income. Employer (taxpayer) contributions to state and local pension systems over the last quarter century have made up less than one-fourth of total public pension revenue. Earnings from investments and employee contributions comprise the remainder. This ratio has improved over time. In 2006, investment earnings accounted for 75 percent of all public pension revenue; employer contributions were 16 percent. Unlike corporate workers, most public employees are required to contribute to their pension.

- **State and Local Plans are Subject to Comprehensive Oversight**. While private sector plans are subject solely to federal regulation, state and local government plans are creatures of state constitutional, statutory and case law and must comply with a vast landscape of state and local requirements, as well as government accounting standards. These plans are highly transparent and accountable to the legislative and executive branches of the state; independent boards of trustees that include employee representatives and/or ex-officio publicly elected officials; and ultimately, the taxpaying public.

We share your interest in providing a secure retirement for American workers and future economic growth for our country. Indeed, we believe many public sector retirement systems are innovative models. Their independence and flexibility has enabled them to achieve important objectives related to the recruitment and retention of quality workers, while also promoting participants' ability to attain financial security in retirement, reduce reliance on public assistance programs, and provide significant economic benefits to communities and the financial markets.

We welcome the opportunity to work with the Committee as you further examine these important issues. Please feel free to call upon the legislative representatives of our organizations:

Diana Noel, NCSL, (202) 624-7779
Barry Kasinitz, IAFF, (202) 737-8484
Tim Richardson, FOP, (202) 547-8189
Jeannine Markoe Raymond, NASRA, (202) 624-1417
Deseree Gardner, NACo, (202) 942-4204
Bill Cunningham, AFT, (202) 393-6301
Robert Carty, ICMA, (202) 962-3560
Alfred Campos, NEA, (202) 822-7345
Cornelia Chebinou, NASACT, (202) 624-545
Ed Jayne, AFSCME, (202) 429-1188
Bill Johnson, NAPO, (703) 549-0775
Dan DeSimone, NAST, 202-624-8592
Barrie Tabin Berger, GFOA, (202) 393-8020
Tina Ott Chiappetta, IPMA-HR, (703) 549-7100 x 244
Leigh Snell, NCTR, (703) 684-5236
Alison Reardon, SEIU, (202) 730-7706
Hank Kim, NCPERS, (202) 624-1456
James Driver, NCSSSA, (502) 564-6888
Neil Bomberg, NLC, (202) 626-3000
Larry Jones, USCM, (202) 293-7330

CalPERS
Executive Office
P.O. Box 942701
Sacramento, CA 94229-2701
Telecommunications Device for the Deaf - (916) 795-3240
(916) 795-3829, FAX (916) 795-3410

July 10, 2008

The Honorable Robert P. Casey, Jr.
United State Senate
383 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Casey:

I am writing to you on behalf of the California Public Employees' Retirement System (CalPERS) to applaud your decision to conduct today's hearing of the Joint Economic Committee regarding public pension plans and the need to strengthen retirement security and economic growth in America.

CalPERS is the nation's largest public pension fund, managing pension and health benefits for approximately 1.5 million California public employees, retirees, and their families with a total fund value of approximately $232 billion. CalPERS serves the retirement needs of the State of California's employees as well as those of more than 2,500 contracting public agencies and school districts. In addition, CalPERS is the largest purchaser of healthcare in California and the third largest purchaser in the nation.

We commend you and the members of the Joint Economic Committee for your interest in examining the growing need to strengthen retirement security and economic growth in our nation. While the availability of traditional pensions continues to seriously decline in most sectors of the workforce, state and local government employee pension plans continue to provide a modest but secure benefit to those who spend their careers in government employment. Furthermore, because of their size, diversity and focus on long-term investment returns, public pension funds provide stability and add liquidity to our nation's financial markets, distributing consistent and inflation-protected revenue streams to local communities throughout the nation.

Over the past year, CalPERS commissioned three studies looking at the economic impact of its retirement benefit payments, its health benefit payments and its investments in California. These studies were conducted by the California State University/Sacramento, Applied Research Center using the Impact Analysis for Planning (IMPLAN) which was developed by the federal government and has been widely used and recognized for economic impact studies.

In these studies, California State University researchers found that the $13.8 billion in pension payments made to retirees by CalPERS and the California State Teachers' Retirement System (CalSTRS) in 2006 produced a total economic impact of $21 billion in the California economy alone. This positive economic impact occurred as retirees spent their retirement income on everyday expenses and indirectly generated additional economic activity which is commonly referred to as the economic "ripple effect."

Furthermore, a similar analysis of the $8.3 billion of CalPERS $26 billion of pension fund investments in California found a total direct and indirect economic impact of $15.1 billion. Additionally, another study found that CalPERS $4.2 billion in premium payments to health plans in 2006 generated a total economic impact of $7.6 billion to the State's economy.

When all three lines of business – retirement, health and investments – are added up, they produce a total direct economic impact of $43.7 billion to the California economy, providing a powerful stimulus to the overall State economy to the benefit of all residents. Copies of each of these reports are enclosed for your information.

CalPERS would welcome the opportunity to work with you and with the Joint Economic Committee as you seek to strengthen retirement security and economic growth. Please contact our Washington representative, Tom Lussier of Lussier, Gregor, Vienna & Associates at 703-684-5236, if we can be of further assistance in this regard.

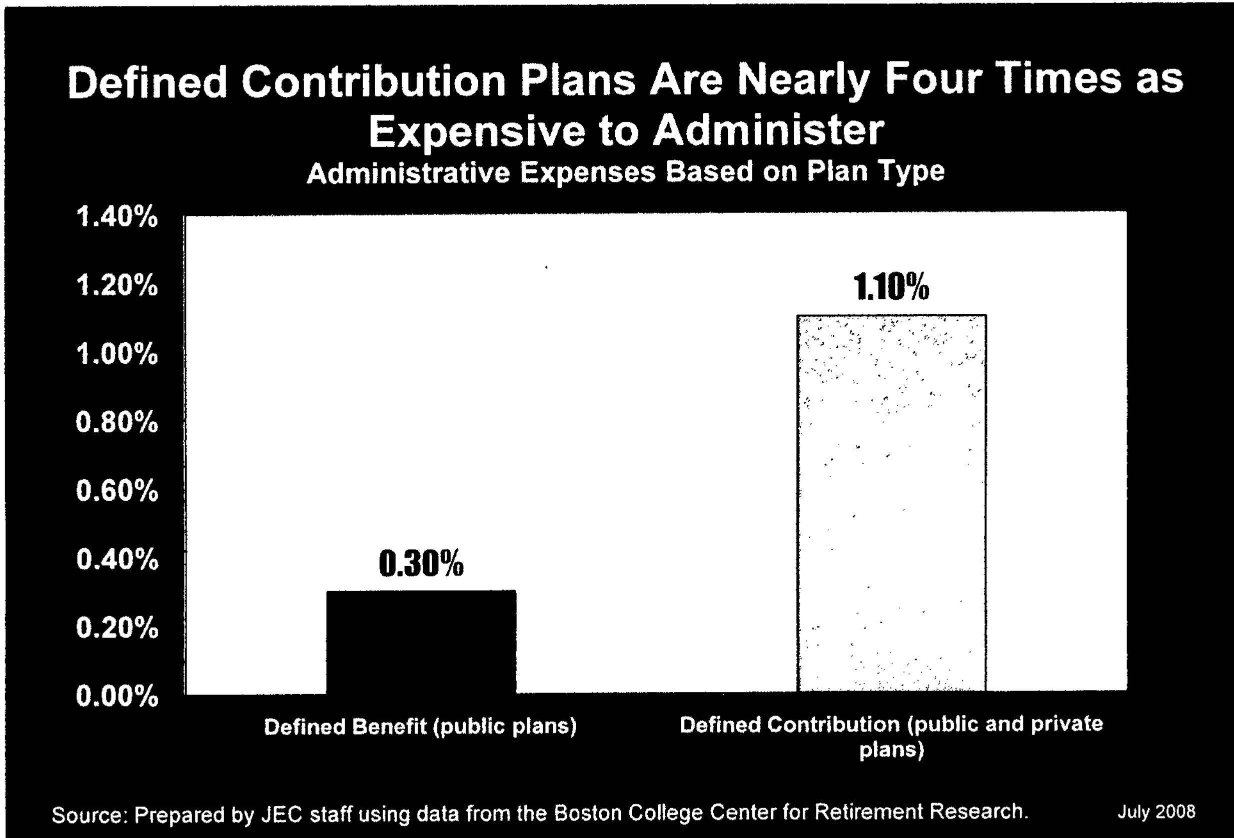
Sincerely,

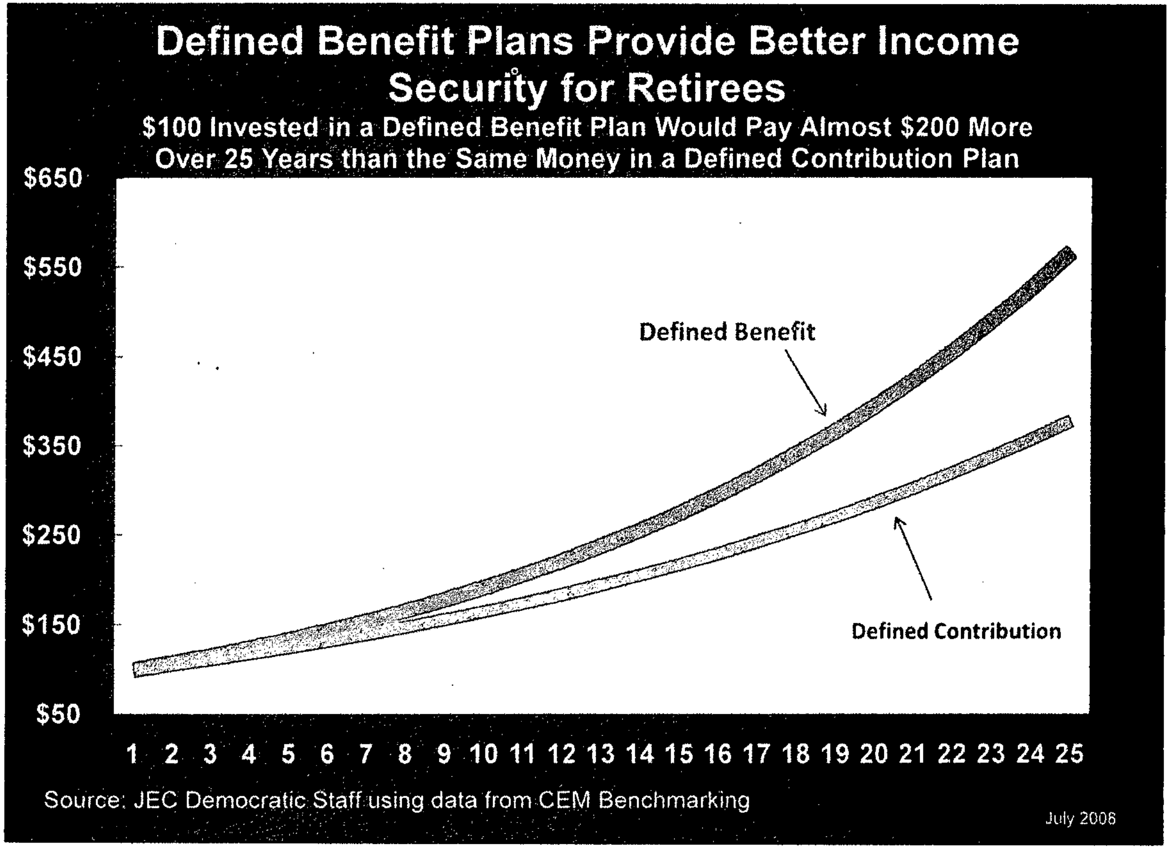
Kenneth W Marzion

KENNETH W. MARZION
Interim Chief Executive Officer

Enclosures

cc: Members of the Joint Economic Committee
Members of the California Congressional Delegation
The CalPERS Board of Administration


Defined Contribution Plans Are Nearly Four Times as Expensive to Administer
Administrative Expenses Based on Plan Type
1.40%
1.20%
1.00%
0.80%
0.60%
0.40%
0.20%
0.00%
0.30%
1.10%
Defined Benefit (public plans)
Defined Contribution (public and private plans)
Source: Prepared by JEC staff using data from the Boston College Center for Retirement Research.
July 2008


Defined Benefit Plans Provide Better Income Security for Retirees
$100 Invested in a Defined Benefit Plan Would Pay Almost $200 More Over 25 Years than the Same Money in a Defined Contribution Plan
$650
$550
$450
$350
$250
$150
$50
Defined Benefit
Defined Contribution
1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25
Source: JEC Democratic Staff using data from CEM Benchmarking
July 2008

PREPARED STATEMENT OF REPRESENTATIVE EARL POMEROY

Chairman Casey, Senator Brownback, Vice Chairman Maloney and Representative Saxon, I commend you for holding this hearing "Your Money, Your Future: Public Pension Plans and the Need to Strengthen Retirement Security".

Americans are anxious. Recent figures on the economy loosing 436,000 jobs over the last few months underlie part of those uneasy feelings. Americans are also concerned for the long run, rightfully so. *If it is your money that you must rely on in retirement,* then baby boomers need to be concerned. One-third of boomers, on the door step of retirement, have no financial assets and among those who have financial assets the median value of their holdings is a meager $45,900. (GAO Baby Boom Generation)

In April, the Employee Benefit Research Institute (EBRI) reported that workers confidence in their financial prospects for retirement have reached a 7-year low. In EBRI's 2008 Retirement Confidence Survey, only 18 percent of workers were very confident that will have enough money to live comfortably throughout their retirement years. In fact, this figure represents a sizable drop—it is one third lower than the 27 percent of workers who were very confident just 1 year ago.

Why? We are witnessing a seismic shift in the risks of retirement as corporations with expertise and capacity to bear such risks place the retirement risks on individuals. Workers must not only save enough but then individuals must figure out how to make their money last throughout their future years in retirement. Rather than feel fully "empowered" by their 401(k) accounts when it comes to protecting financial security, Americans are finding that *we are all in this alone.* Luckily, this is not so with public pensions.

I believe that Congress needs to champion the pension plans that are the focus of this hearing. Clearly, defined benefit plans provide greater retirement security to workers at a lower cost, and they encourage economic growth in many ways.

Public pensions are the vibrant core of defined benefit plans; unfortunately, their private sector counter parts face tough challenges at the hands of this Administration and Congress. Prior to effective date of the Pension Protection Act, the nation's 100 largest defined benefit pensions rebounded from 3 years of investment losses to an aggregate $111 billion surplus position as of the end of 2007. (Pensions and Investments)

We have businesses struggling in this recession to pony-up more money than they ever had to contribute before because of the Pension Protection Act's stiffer funding requirements. While some argued that could be a good thing for workers, there is a hitch. Private sector pensions are a voluntary system. Employers can decide that offering a pension no longer makes good business sense. "Can we freeze this pension liability?" financial executives question as they shift more risk to workers.

Already, 3.3 million workers have seen their pension benefit plans frozen in some way. Many of the recently frozen plans were well funded. According to the most recent PBGC data on its insured plans the number of single employer-plans frozen at the end of 2005 increased by 48 percent over the 2 year period after 2003. For older workers, a frozen pension can leave them with little time to make up for the loss in benefits.

There is good news in today's hearing—Public Pension Plans. They protect retirement security for 12 percent of the nation's workforce, the plans put $150 billion dollars into the checkbooks of 7 million retirees each year and their trustees invest $3 trillion in assets in our economy. The public servants protecting our families and educating our children covered in these pensions have their benefits protected in many cases by the state constitutions which mean that plans can not be frozen and obligations must be met. These plans are models.

Without oversight and regulation by the Federal Government, these pensions have funded nearly 90 percent of their outstanding retirement liabilities, in aggregate. No doubt, some plans fall short. Alicia Munnell at the Center for Retirement Research calls this "the miraculous aspect of the funding of state and local pensions" since it occurred without a Federal law.

GAO's work on public pension confirms the general soundness of these retirement plans. GAO also found that when governments had difficulty making the needed annual contribution or experienced low funding ratios, concerns about the plan's future status may exist. But public employees do not bear the brunt. When private sector plans face the same circumstances, they can choose a less painful way out for the business by freezing the pensions, but public pensions must make good on their promises to employees.

Chairman Casey, with my thanks for today's hearing, I also bring positive news to my colleagues in the Senate. Yesterday, the House took a strong bipartisan step forward to build retirement security by unanimously passing a technical corrections bill that had several important clarifications—such as asset smoothing. The Senate added these provisions last year. There is a real urgency to fix the asset smoothing problem for private pensions and strengthen public pensions which the bill does. I hope the Senate moves to pass H.R. 6382 soon.

Again, I thank you for putting the retirement security needs of American workers at the top of Congress' to do list today. I am pleased to join you.

Let this be the starting point for a simple but forgotten truth that Jacob Hacker highlighted in his book the *Great Risk Shift: economic security is a cornerstone of economic opportunity.* Both businesses and people invest in the future when they have basic protection against the greatest downside risks of their choices.

JOINT ECONOMIC COMMITTEE
SENATOR CHARLES E. SCHUMER, CHAIRMAN
REPRESENTATIVE CAROLYN B. MALONEY, VICE CHAIR

PREPARED STATEMENT OF CAROLYN B. MALONEY, VICE CHAIR

Good morning. I would like to thank Chairman Schumer for holding this hearing to examine public pension plans and how they affect retirement security, entrepreneurship and economic growth. I also want to thank Senator Casey for chairing.

The current turmoil in the financial markets, the housing crisis, increasing credit card indebtedness, and the economic downturn have exacerbated concerns about the retirement prospects of many Americans. Rising unemployment, long-term joblessness, and falling or stagnant wages are leaving workers feeling not only squeezed now, but also unable to save for retirement in the future. Unfortunately, economic downturns and bear markets have lasting, as well as immediate, implications.

Over the past two decades, employer-sponsored retirement plans have not only declined, but also have steadily shifted the risk and responsibility of retirement investment to workers. Employers increasingly have abandoned the promise of defined benefits at retirement for defined contribution plans, where the individual ultimately ends up bearing both the risk of longevity and investment decisions before and after retirement.

As a result, today too many Americans are either worried that they won't have enough money saved for a comfortable retirement or they won't ever be able to retire. This is particularly true for women, who typically live longer than men, but earn less over their lifetime.

Our focus today is on public pension plans, which offer a model for providing retirement security to workers. In the defined benefit plans offered by public pension systems, individuals are provided a steady stream of income throughout their golden years that is protected from market fluctuations. Moreover, public pension plans typically have lower costs and fees while generating higher returns than defined contribution plans, because they have a wider range of investment expertise and opportunities available to them than individuals do.

As Mr. Pryor points out in his testimony, employee contributions and earnings from investments make up the vast majority of public pension funding, not taxpayer funds. In contrast to private defined benefit plans, most public employees contribute to their pension plans. Defined benefit plans help to attract and retain talented employees—firefighters, police officers, teachers—to a life in public service.

The advantages to workers are clear, but there are also economic benefits that are not as well known. Defined benefit plans provide a "patient pool" of available capital for investment, such as venture capital, which leads to job creation and the promotion of new industries and technologies. In the current credit crisis, pension plans have played an important role in providing liquidity to the markets.

Mr. Chairman, thank you for holding this hearing and I look forward to the testimony today.

JOINT ECONOMIC COMMITTEE
Senator Sam Brownback, Senior Republican Senator

Opening Statement of Senator Sam Brownback
"Your Money, Your Future: Public Pension Plans and the Need to Strengthen Retirement Security and Economic Growth"
July 10, 2008

Thank you, Mr. Chairman. I want to express my appreciation to you for scheduling today's hearing and to our witnesses for offering us their insights into the important issues surrounding public pension plans. This is an issue that affects not only governments and government employees, but taxpayers as well.

There is a clear trend away from defined benefit plans in both the public and private sectors in favor of defined contribution plans. While defined benefit plans appear to offer greater certainty to employees, they are not without drawbacks. Notably, defined benefit plans pose greater risks to taxpayers, especially since delivering promised benefits requires meeting certain returns on investments, among other factors. Defined benefit plans are more valuable to long term employees, but are less favorable to employees who may have many jobs during their working years.

I would like to take a couple of brief moments to raise two related issues that concern me. Specifically, I am concerned about potential risk to taxpayers and future retirees of investment practices currently employed by many public pension plans. As retirement systems face increased pressure to generate superior returns to meet benefit obligations, many are increasing significantly the risk profile of their investments. It is a fundamental economic fact that greater returns are accompanied by greater risk.

As public pension plans have grown in size and expanded their investment portfolios beyond traditional equity and bond investments, significant losses by some major pension funds have led to calls for greater scrutiny and regulation.

For example, the San Diego County pension fund lost about half of its $175 million investment in the Amaranth hedge fund when the fund crashed due to what turned out to be a disastrous bet on natural gas. All told, approximately 20% of the pension fund's assets are invested in alternative strategies through hedge funds and other money managers.

Although the Governmental Accounting Standards Board (GASB) maintains standards for accounting and financial reporting for state and local governments, GASB has no authority to enforce its standards on public pension plans. Many states require local governments to follow GASB standards and bond raters take into account whether such standards are followed, but many states nonetheless operate outside the financial disclosure, contribution, and asset to liabilities ratio standards set by the GASB.

In the case of the San Diego County Employees Retirement Association (SDCERA) pension plan, its summary of retirement portfolio in its 2006 annual report appears to account for relatively healthy investments of its $7.3 billion portfolio. Yet, over $2.5 billion of its portfolio was actually exposed as collateral through "derivative financial instruments," making it much riskier than first suggested.

Mr. Chairman, I'd like to include in the record two articles published in the July 21st edition of Forbes. The first article, titled "The Other Real Estate Disaster" discusses how the investments by the Pennsylvania Public Schools' pension fund in Broadway Partners' real estate "opportunity funds" went bad. Pension fund managers reported that the firm was delivering returns of up to 40% per year. Unfortunately, the story doesn't end there. To quote the article, "[t]he funds' previous gains? Mostly, if not entirely, gone. It will be months before Pennsylvania's 500,000-plus public school employees and retirees know how much of their $196 million in principal in Lawlor's funds is left."

The investment loss isn't the only tragedy. Both taxpayers and public pension fund beneficiaries suffer from a lack of transparency by public pension plans. The second article I'd like to include in the record, also from Forbes, is entitled "A Code of Silence." Let me quote:

> *Do state pension officials have something to hide? The senior investment officer at the Virginia Retirement System was apparently so terrified at having to disclose performance information for the fund's $3.3 billion in private equity investments that he asked his staff to box up every quarterly and annual report they received from general partners and ship them back. Return them to us when nobody's asking for them anymore, John Alouf, now head of private equity for the pension fund, told the managers.*
>
> *His fear: that Virginia's freedom of information law might force him to reveal results to the fund's 580,000 retirees and the public. Not anymore. VRS got the law changed to exempt all private equity funds from disclosing returns.*
>
> *It's part of a national epidemic of self-censorship. Thirteen states now have such secrecy laws, many of them championed by pension funds. Why? Mostly the fear of being shut out of a big-name private equity fund--and giving up the chance of a big score. VRS says one firm with purported 93% annual returns (it won't disclose which one) refused to do business with it because of disclosure concerns. Many private equity groups insist on confidentiality agreements, claiming that all information is proprietary--or, at least, easily misinterpreted by the public.*

Mr. Chairman, this lack of transparency is frightening. It leads to pension funds taking on increased levels of risk and puts employees, retirees, and taxpayers at enormous potential risks. Let me reiterate, you can't perpetually generate astronomical returns indefinitely. High returns inherently carry greater risk. My concern is that some public pension funds have been enticed to chase returns, effectively rolling the dice with the effective backing of general taxpayers while not adequately reporting risk exposures.

There has been a lot of discussion around here about the degree to which speculators, pension funds and index funds are driving up commodity prices and creating a "bubble." If they are responsible, then pension funds engaged in these types of investment strategies will sustain major, if not catastrophic, losses if a bubble bursts in commodities as it did in real estate.

"It seemed like a prudent investment at the time" will be of little comfort to public employees who have seen their gas prices skyrocket past $4 a gallon, from $2.30 when the Democrats took the majority of Congress and promised lower gasoline prices, when they learn that large portions of their pension fund has evaporated as a result of imprudent and risky investments. So whether you believe that commodity prices are being driven by speculators, index funds, pension funds or the fundamentals of supply and demand, the fact is that commodity investments and hedge fund strategies carry significant risks. And that risk is magnified when there is little and declining transparency surrounding these investment activities.

I believe that we should act to impose strict limits on the aggregate level of risk that public and private pension managers can expose their funds to through these alternative investment strategies. I look forward to the testimony from our witnesses and any reaction to the issues I have raised.

Forbes.com

Companies, People, Ideas

The Other Real Estate Disaster

Stephane Fitch 07.21.08

Your state's employee pension fund is probably (a) doing badly with recent real estate pools and (b) working very hard with the private equity operators of these pools to keep you in the dark. By Stephane Fitch

Scott Lawlor and the managers at Pennsylvania Public Schools' $63 billion pension fund had a beautiful relationship. From an office on New York's Park Avenue Lawlor and his firm, Broadway Partners, ran real estate "opportunity funds," fat with capital from the teachers' pension and other institutions. He had invested the funds in a $10 billion pool of glamorous office properties like Boston's John Hancock Tower. Lawlor delivered profits--or so the Pennsylvania fund managers reported--of up to 40% a year. The state fund managers kept capital flowing, both to his funds and to his pocket, in the form of fees.

Everything was private. No Wall Street analysts, no regulators, no outsiders and no interference. No ordinary Pennsylvania pensioner got to see Lawlor's quarterly financial reports. The managers in their pension plan's Harrisburg headquarters had all signed nondisclosure agreements with Lawlor.

The picture turned grim by March. Lawlor was struggling to keep his buildings, purchased with as much as 90% debt, from falling into the hands of lenders. He owed $1.2 billion of short-term "mezzanine" debt to New York investment bank Lehman Brothers and other lenders. (The debt has since been extended.) The funds' previous gains? Mostly, if not entirely, gone. It will be months before Pennsylvania's 500,000-plus public school employees and retirees know how much of their $196 million in principal in Lawlor's funds is left.

The retirement plan "has seen some decline in value this past quarter," says Charles Spiller, head of private equity and real estate investments at the Pennsylvania teachers' fund. But he refuses to comment on Broadway. Last September he valued positions in 58 private real estate investment funds at a total $3.6 billion. What's this pot of money worth now? That's a secret for a few more months, and Spiller isn't releasing any of the communications he's had from the fund operators about their recent results.

Enticing investors with the lure of returns exceeding 20%, opportunity funds are the slickest deal in real estate. They account for one-sixth of $2 trillion in total net assets in private equity, says the London firm Private Equity Intelligence, which tracks the industry. A year ago the most closely studied funds in the U.S. were holding $213 billion in commercial real estate equity, leveraged 70% on average. Traders of swaps contracts on the leading commercial property index were recently betting on a correction of up to 15% in values--which would result in $100 billion in writedowns.

This is the other meltdown--the one you haven't heard much about. It's not part of the real estate and credit contagion that started with the subprime calamity, then spread to all corners of the debt market. This misadventure has its own origins in hubris, battered further by dumb mistakes and bad timing. The catastrophe may not stack up quite as high as the $350 billion in writedowns that investment funds and banks have registered in the bond markets, but for small investors all across America whose retirement pools poured 1% to 5% of their assets into opp funds, heavy losses--only beginning to surface--could be a sizable blow If the setbacks for pension funds are severe enough, it could force state governments to raise taxes to cover shortfalls and induce companies to cut back on dividend payments to shareholders in order to set aside additional money for their private workforce pensions

Many opportunity funds are black boxes. What these investments are worth is often anybody's guess until they're liquidated, typically seven to ten years after they finish raising capital. They're virtually unregulated--a recent statement by the Financial Accounting Standards Board leaves it to the funds to address fair value--and private equity groups don't have to file regularly to the Securities & Exchange Commission. When they do give out internal rates of return, they're usually expressed as a rough percentage of money originally invested. Rarely are they adjusted for leverage.

The failure to account for leverage is what makes these private equity pools so popular. In a rising market, which real estate enjoyed until a year ago, leverage turns average performers into seeming geniuses. In an up market a mediocre real estate manager enjoys million-dollar paydays, according to the customary formula that gives operators of private equity pools up to 20% of gains.

Say the manager buys a building for $100 million, putting down $30 million of your money and borrowing the rest. Over the next three years it appreciates to $150 million. Interest on the mortgage adds up to 20%, or $14 million. Before fees, you have made $36 million, a 120% return. That comes to 30% a year But the unleveraged return was only 14.5%. Which return number, 30% or 14.5%, is the one most likely to be talked about?

In a down market, of course, leverage turns average performance into a disaster. But the operators of the pools are not expected to share 20% of the losses. No, the losses belong 100% to the providers of the equity capital That would be you, if you're a taxpayer

Some real estate managers are indeed superior performers. To find out which ones they are, the state pension sponsors would have to interrupt the PowerPoint presentation on past returns to ask some pointed questions about risk-adjusted returns. Do they ever do this? Perhaps some do but consider the answers a state secret. Others don't have a clue how to measure performance. forbes asked seven government pension funds to release risk-adjusted performance numbers for individual operators and got not a single number.

"We don't know how you define 'risk-adjusted returns,'" says Joseph Dear, executive director of the $82 billion (assets) Washington State Investment Board, a heavy investor in opportunity funds. "We feel we are properly compensated for the risk we are taking." Dear doesn't offer net figures to back up those feelings. Few will admit, as Charles Grant of the $58 billion Virginia Retirement System does without offering specifics, that the performance of their opportunity funds has been "mixed." Wittingly, or otherwise, many pension funds have become complicit in a legally sanctioned cover-up.

It's easy to see why. Even in a roaring real estate market, which prevailed for most of the last 15 years, returns for many opportunity funds have fallen in the band between merely okay and truly awful. Getting the information often requires Freedom of Information Act requests; even then private equity firms and pension funds drag their feet. According to a sample of 77 opportunity funds, launched between 1992 and 2005, the top-performing third delivered 20%-plus internal rates of return; the middle third, 10% to 19.5%, and the bottom third, less than 10%.

Some duds were sponsored by the industry's most vaunted investment firms. Here are their numbers, and they are all before any accounting for leverage

--Annualized returns of 8% and 11%, respectively, for two funds Morgan Stanley syndicated in 1999, msref III and msref III International;

--10 4%, 8%, 8% and 6.6% for four Goldman Sachs funds, raised between 1996 and 2000;

--4.5% and 9% for two funds syndicated by billionaire Thomas Barrack's Colony Capital, Colony Investors II and Colony Investors IV;

--10%, 0.1% and --4.8% for three funds, from 1996 to 2000, from Olympus Real Estate, founded with money from Texas billionaire Tom Hicks' buyout firm;

--8.8%, 9.4% and 10.6% for three funds, from 1996 to 1999, from Apollo Real Estate Advisors, cofounded by New York City buyout king Leon Black.

Those are the returns if you don't adjust for risk. On half as much leverage, REITs beat them all. "Risk-adjusted returns? There isn't such a thing," insists Chicago billionaire Neil Bluhm, whose firm Walton Street Capital is raising its fifth opportunity fund. Comparing the returns of opportunity funds with those of a levered-up REIT index fund is "for eggheads," he says. "You talk about leverage, which is great in an academic way. But you need to know how to handle leverage, when to put on 70% and when to put on less."

Something--mystique, desperation for better returns, fear of being locked out of the deal flow--keeps pension funds coming back. New York Common owns $2.3 billion worth of opportunity funds (1.5% of its assets); the Pennsylvania State Employees Retirement System has $583 million (1.7%). Washington State Investment Board has $2.2 billion (2.6%), and Virginia Retirement System owns $643 million (1.1%). Even tiny Chicago Teachers' Pension Fund has $300 million invested in opp funds (2.5%). In most cases they're willing to pay opp fund managers the standard 1.5% a year of money under management plus 20% of profits over an 8% minimum "hurdle rate" return.

They're also willing to keep their own investors in the dark. Most pensioners can't find out anything about an opportunity fund's changes in nav levels from quarter to quarter, or volatility in the fund compared with other real estate funds. They probably won't discover how much leverage the fund has used in its initial purchases, how much debt it keeps off its balance sheet in development ventures or whether it's close to defaulting on its loans. Why all the hugger-mugger? Because pension fund managers sign confidentiality agreements that prohibit them from disclosing basic facts. "Investors who refuse to enter these confidentiality agreements risk losing many of their best investment opportunities," says Thomas DiNapoli, New York State comptroller.

In what looks like an epidemic of self-censorship, pension fund managers across the country have lobbied their legislatures to get permission to reject freedom of information requests for quarterly financial statements from their opportunity funds. In Pennsylvania the teachers' fund releases basic fund-level data, but the fund for state employees doesn't. Full disclosure "is a matter of good governance," says Pennsylvania Treasurer Robin L. Wiessmann. "The pensioners should be concerned."

"If you ask to see leverage-adjusted returns, there's no way an opportunity fund manager will do that for you," says Rob M. Kochis, a principal with Cleveland consultancy Townsend Group, which helps its pension fund clients find investments. Partly, for those reasons, Robert Maynard, investment chief of the Public Employee Retirement System of Idaho, won't allow any opp funds into his state's $11 billion retirement pool. He pays Oakland, Calif. investment firm Adelante Capital Management roughly 0.7% to run his $264 million in REITs. "Maybe it's the farming tradition out here in Idaho--people here don't believe in a free lunch."

One of the more lavish lunches is provided by Blackstone Group. Since 1991 it has made 200-plus real estate investments, totaling roughly $160 billion, with assets as varied as Canadian property giant Cadillac Fairview in 1995 and the mortgage on 7 World Trade Center in 2000 It has leveraged those purchases 85% on average. The firm states that its funds have produced annual returns to investors of 31%.

If only all those purchases were quick flips. Last year Jonathan Gray, Blackstone's head of real estate, outbid other wealthy suitors to buy Chicago office landlord Samuel Zell's Equity Office Properties Trust for $38.7 billion on 83% leverage, the largest private equity transaction ever at the time. He immediately resold two-thirds of those buildings for modest markups. But magnified by high leverage, the profits to

Blackstone funds were quick and stunning--they showed annualized return rates of up to 80%. Blackstone's real estate funds business earned $762 million in net fees in the first quarter of 2007, four times what the corporate-buyout division saw.

But the risk-adjusted returns of Blackstone's funds aren't always so impressive. Its $1.5 billion third real estate fund--the only one whose returns are known and whose record is long enough to be meaningful--has underperformed. Closed in 1999, the fund, says Gray, has earned a 21% annualized return since then. Impressive, until you realize that a basket of REITs over the same period would have earned 26%, if the investment trusts had been bought on 60% margin to boost their total effective leverage to the 80% levels that Blackstone deploys "That's our worst fund," Gray concedes. Still, he says, the Blackstone family as a whole has outperformed REITs. Even if opportunity funds underperform on a leverage-adjusted basis, says Gray, they're worth having for diversification· "What we do is different."

It can't be that different. Last July Gray engineered the acquisition of Hilton Hotels for $26.9 billion on 80% leverage. The ownership of the company was split between one of Gray's real estate funds and one of the firm's corporate leveraged buyout funds.

How well has Hilton done? In a good year it might be up in value by 10%, say, to $29.6 billion. Over that same good year, interest might have cost $1.1 billion while operating earnings (Ebitda) would have brought in $1 9 billion. Capital gains plus net earnings would have come to $3.8 billion--a 70% gain. But hotel company values have been heading south. The stock prices of comparable rivals, Marriott International and Starwood Hotels & Resorts, were recently down 39% and 36%, respectively. Their enterprise values--interest-bearing debt, plus market value, minus cash on hand--are down 27% and 23%. Even if you assume that Hilton's total value is down just 23%, to $20.7 billion, that's less than the amount Blackstone borrowed. Marked to market, Hilton looks like a washout.

"We paid a reasonable price," Gray says, reeling off a list of improvements the company has made in the past year. "I feel better about that deal today than I did when we did the deal." But Gray won't discuss numbers.

"Every company that's comparable to Hilton is down enormously," says Michael Kirby, cofounder of Green Street Advisors, which rates shares of REITs. "But these opportunity fund guys don't have to admit a thing."

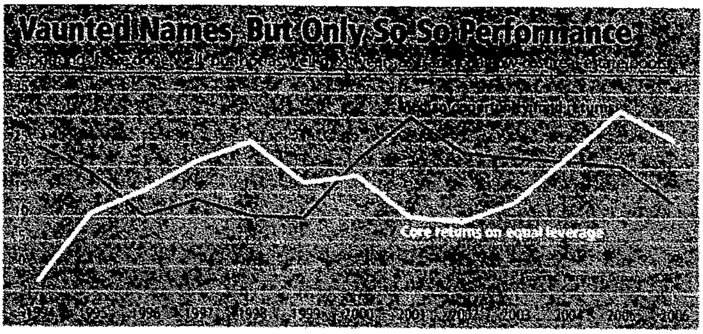
Nor, he says, do Lehman Brothers and Tishman Speyer Properties. In May 2007 Tishman's opp fund, with Lehman acting as primary lender and minority stakeholder, agreed to pay $60.75 a share for Archstone Communities, a hefty 18% markup to the company's price earlier that month. Their $22.2 billion purchase of the Denver apartment-building giant was leveraged 75%, after two other large banks joined the group

Bad timing. By October, when the deal finally closed, comparable apartment REIT stocks were trading at 10% to 15% discounts to their May 2007 levels. Marked to market, on this basis $2 billion to $3.5 billion of the private buyers' equity in the purchase was gone the day the deal closed. Lehman recently wrote down its $2.2 billion stake by 25%. Of its $250 million stake, "We are taking a 25% markdown for the second quarter of this year," says a Tishman spokesman, adding, "We are confident that our seven-to-ten-year business plan for Archstone will be successful."

Another high-flying family of private equity funds, Fortress Investment Group of New York City, is dealing with an ugly self-inflicted wound. Last fall Fortress Investment Funds I and II sold their shared 50% stake in a publicly traded London office property REIT, Mapeley, to another, newer fund, Fortress V. The deal was struck at about $40 a share, for a total value of roughly $590 million.

Mapeley shares, already sliding as U K stock traders backed away from the frothy prices of all British REITs, soon crumbled to $24, leaving Fortress V's investment in shambles. Fortress considered doubling down in March, buying the half of Mapeley's stock it didn't already own but was rebuffed by Mapeley's board. Fortress declined to comment.

"We know funds are sitting on investments that have gone totally belly-up," says Nori Gerardo-Lietz, whose Partners Group in San Francisco advises pension funds like Calpers on real estate investments. Barring a miraculous resurgence in values, she predicts opp funds will produce poor returns and a few devastating writedowns of pension fund investments in the coming year or two. "They're trying to hold on, so they get debt extensions," she says. This month Gerardo is publishing her "Lake Wobegon Revisited" report, so called because it questions the impression that all opportunity funds, like the children in Garrison Keillor's mythical Minnesota town, are above average. Adjusting for leverage, however, opportunity funds bombed out and trailed low-cost "core" real estate funds in 7 of the last 11 years.



That was before the market started to curdle. So why have pension funds embraced these dogs? "Most simply aren't considering the risk-adjusted returns," says Gerardo.

There's ample evidence that the risk-adjusted returns of opp funds are a fraction of those produced by less risky real estate funds. The National Council of Real Estate Investment Fiduciaries, the master trade association for all real estate funds, calculated the volatility of opp funds that started in 2003 using quarterly nav data for all known funds of that vintage. The data are closely guarded, but ncreif got it all from the Cleveland pension fund consultancy Townsend Group. ncreif then compared the Sharpe ratios--which adjust for volatility on a quarterly basis--of opp funds to those of conservative, low-fee, 20%-levered, open-ended private funds that own office buildings, warehouses, malls and such. Seen through this lens of risk-adjusted returns, the core funds' median return was twice as good.

Those standard measures seem to stymie even the pros. K S. (Sonny) Kalsi, Morgan Stanley's real estate chief, won't comment about the disappointing performance of his two 1999 funds. But asked what the risk-adjusted returns are for funds with very high returns, Kalsi leans back in his chair and ponders his answer like a man who's rarely asked the question.

It should be a snap--as easy as rattling off the management fees these funds charge. Sometimes they exert a killer drag on returns. For the first three or four years of a fund's life, called the "commitment period," nearly every fund sponsor (except Morgan Stanley and Goldman Sachs) charges a fee equal to 1 5% of the maximum amount that investors have committed to invest in the fund--not the assets under management. The longer it takes a fund manager to find investments, the greater the gravitational pull on net returns. Blackstone's new $11 billion opportunity fund, for instance, will haul in $150 million in fees whether or not it finds enough distressed assets to buy.

Management fees are just the beginning. A pension fund may have to cover "dead deal costs"--expenses related to mounting a property bid that ultimately fails. Some funds charge acquisition fees for the costs associated with mounting a bid that succeeds. A few even charge disposition fees to reimburse the closing costs of a sale. Legal and administrative costs over $1 million usually get passed through to the pension funds.

Those fees handily help pad the historical returns reported by funds in the offering prospectuses for new funds. "We call it the magic page," says Gerardo, who has reviewed close to 3,000 fund prospectuses over the past decade. Many fund managers, she says, advertise gross returns, which reflect profits generated by their investments, not the net amounts passed on to investors. Prospective investors must guess the internal rate of return. Sometimes, says Gerardo, a fund sponsor publishes what are purported to be net returns, but without subtracting all the fees. In sum, false advertising.

It's instructive to compare the gross returns that Colony Capital in Los Angeles promotes with the poor net irrs of its oldest funds: 4.5%, 9% and 15%. The firm's latest pitchbook emphasizes that six of its eight funds produced gross returns of 20% to 60%, with only one falling below 10%. "Gross returns are the standard for the entire asset management industry," says Tom Barrack, Colony's chief. Promoting net irrs, he insists, would be even more misleading: "Especially early on in the life of a fund, they're very speculative."

At the very least, advertised returns are highly mutable. Consider the case of Chicago's Walton Street Capital, whose founder, Neil Bluhm, headed jmb Realty, a syndicator of real estate limited partnerships that tanked in the early 1990s. Chicago Teachers had $26.5 million in Walton Street I and II. In 2000, when Bluhm set out to raise his third fund, he was showing unrealized net returns of 20% for his first two funds and Chicago Teachers pledged another $15 million. After the office market softened the following year, Bluhm marked down returns of his first two funds to the low teens.

Poor returns or no, peddlers of opportunity funds are having a banner year. Private Equity Intelligence reports there are 273 real estate funds in the offing aiming to raise a total of $127 billion--to take advantage of the distress that started last year when the debt markets seized up. As of June they'd succeeded at raising $56 billion. Among the diehard believers: Chicago Teachers, which reupped for Walton Street's next fund in 2004. "Historically, Walton had delivered on equity multiple," says Rob Kochis, of Townsend, who recommended that Chicago Teachers sign on again with Bluhm. "Sometimes, the annualized return numbers don't tell the whole story."

By the Numbers

Realty Check

Pension funds might do a lot better buying REITs than opportunity funds.

$11 billion The amount committed to the latest Blackstone opp fund.

1.5% The net IRR for Lazard Frères' Strategic Realty Investors II since 1997.

13.1% The average net return of a REIT since 1997.

Sources: Pension fund filings; Nareit; Forbes calculations

Forbes.com

Companies, People, Ideas

A Code of Silence

Kai Falkenberg 07.21 08

Do state pension officials have something to hide? The senior investment officer at the Virginia Retirement System was apparently so terrified at having to disclose performance information for the fund's $3.3 billion in private equity investments that he asked his staff to box up every quarterly and annual report they received from general partners and ship them back. Return them to us when nobody's asking for them anymore, John Alouf, now head of private equity for the pension fund, told the managers.

His fear: that Virginia's freedom of information law might force him to reveal results to the fund's 580,000 retirees and the public. Not anymore. VRS got the law changed to exempt all private equity funds from disclosing returns.

It's part of a national epidemic of self-censorship. Thirteen states now have such secrecy laws, many of them championed by pension funds. Why? Mostly the fear of being shut out of a big-name private equity fund--and giving up the chance of a big score. VRS says one firm with purported 93% annual returns (it won't disclose which one) refused to do business with it because of disclosure concerns. Many private equity groups insist on confidentiality agreements, claiming that all information is proprietary--or, at least, easily misinterpreted by the public.

Performance data were largely under wraps until 2001, when the California Public Employees' Retirement System voluntarily published returns on its Web site --sparking a firestorm among its outside money managers. Turned out that some firms, like Hicks Muse Tate & Furst, had lousy results (one Hicks fund, reportedly raised in 1996, had a cumulative return of 5% through 2000). The firms quickly mobilized and pressured Calpers to remove the information. After suits by the media and public interest groups, state judges ruled that top-line performance data and management fees were not protected; Calpers reposted the limited information on its site. In Texas, challenges have pried loose a variety of information about state pension funds, including amounts invested, rates of return and management fees paid.

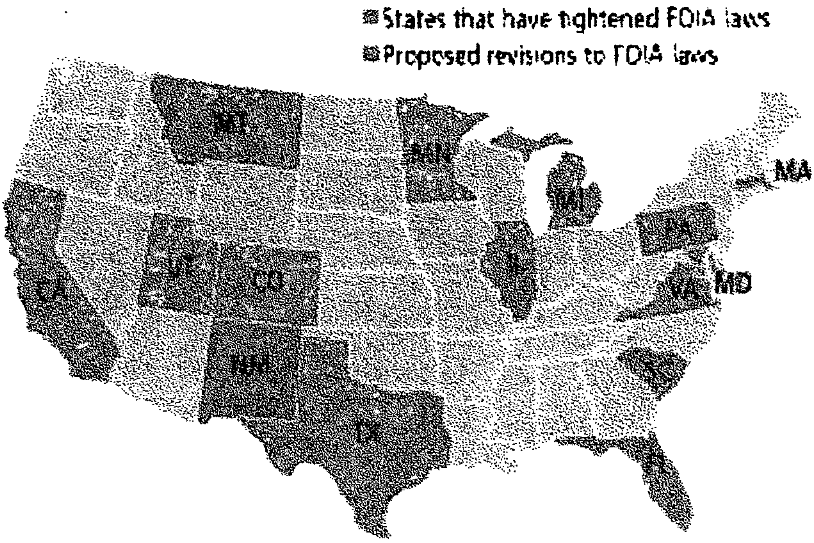
But in some states the trend has gone the other way, toward greater concealment. Requests for private equity performance figures have been blocked by statutes forbidding the disclosure of "trade secrets." Massachusetts keeps hidden all commercial or financial data whose revelation could cause competitive harm. South Carolina's freedom of information law now excludes "proprietary" information from the state's venture capital program but, strangely, includes rates of return. In Alaska, despite broad open-records laws, the $39 billion Permanent Fund has no obligation to disclose performance data for any of its investments in private equity funds

Private equity firms have also played a big part in the cover-up. To help spur changes in the law, Sequoia Capital, Charles River Ventures and Austin Venture Partners, among others, refused to accept investments from public pension fund partners. Other groups simply limited the amount of information they gave to public limited partners or shared that information orally.

In many cases, state pension funds have led the way, urging legislatures to pass laws even more restrictive than what private equity firms have asked for. Virginia, for example, refuses to publicize each fund's separate results, even though lots of private equity firms no longer object. More information blackouts may be on the way: New Mexico and Montana have proposed legislation to keep taxpayers in the dark about what's happening to their money.

Keeping Taxpayers in the Dark

States are banning funds from disclosing their returns.



PREPARED STATEMENT OF WILLIAM PRYOR, VICE CHAIRMAM, BOARD OF INVESTMENTS, LOS ANGELES COUNTY EMPLOYEES RETIREMENT ASSOCIATION, PASADENA, CA

INTRODUCTION

Mr. Chairman, members of the Joint Economic Committee, thank you for inviting me today. My name is William Pryor and I serve as Chairman of the Board of Investments at the Los Angeles County Employees Retirement Association, serving approximately 151,000 participants and managing $41 billion assets.

I also serve on the Executive Board of the National Conference on Public Employee Retirement Systems, the largest public pension trade association with approximately 500 public pension members who collectively oversee nearly $3 trillion in assets for the benefit of 21 million public servants.

State and local retirement plans in the United States cover 14.1 million active employees (about 10 percent of the U.S. labor force) and 6.9 million retirees, including teachers, police officers, firefighters, legislators, judges, and general employees. Ninety percent of state and local governmental employees are covered by defined benefit retirement plans. Approximately 25 percent are not covered by Social Security, including close to half of public school teachers and about 70 percent of police officers and firefighters. State and local retirement plans paid annual benefits of $150 billion averaging about $20,700 per retiree in 2007.

The bulk of public pension benefit funding is not shouldered by taxpayers. On a national basis, employer (taxpayer) contributions to state and local pension systems make up less than one-fourth of all public pension revenue. Earnings from investments and employee contributions comprise the remainder. In 2006, investment earnings accounted for 75 percent of all public pension revenue; employer contributions were 16 percent; and employee contributions accounted for 9 percent. Unlike corporate workers, most public employees are required to contribute to their pension plans.

Traditional public employee pension systems have resisted the shift to defined contribution (DC) plans recently seen in private sector employment. The decision to remain with traditional pension plans is a policy decision by local governments carefully made with its costs and benefits considered. Local governments support defined benefit (DB) plans as a cost effective measure to pay for a sustainable retirement for employees and to allow for recruitment and retention of a well trained work force. Additionally public DB plans play an important role in local economies as a consistent and long term investor in multiple asset classes.

BACKGROUND

Generally traditional pension plans attempt to support an employee at a 70 to 90 percent salary replacement rate upon retirement. This replacement level may consider not only the traditional pension annuity, but supplemental allowances or health care supplements the employee may have earned during active employment. Additionally, many public employees are outside of Social Security. It is estimated that a third of all public employees and 75 percent of public safety employees are not covered by Social Security. Thus, for many of us, our pension plans may be our only retirement income. With recent dramatic rises in health care costs and general living expenses, studies now indicate a replacement rate of over 100 percent and as high as 126 percent of final salary may be required for a sustainable retirement.[1]

Traditional local and state public pension plans are well run, well diversified and provide a return on investment that cannot be duplicated with private retail mutual funds. Recently a report from Morningstar compared retail mutual funds with traditional public pension plans and found those public DB plans out performed their private counterparts by 3.22 percent.[2] In traditional Morningstar comparisons public pension plans averaged four stars, while moderate allocation mutual funds (assumed peer group) only getting three.[3]

Traditional public pension plans hold nearly 3 trillion dollars in assets, equal to more than 20 percent of the nation's entire gross domestic product,[4] and capture over 20 percent of the nations entire retirement market. These plans play an important part in the U.S. economy as long term, well diversified investors.

[1] Hewitt Associates "Total Retirement Income at Large Companies: The Real Deal." June, 2008.

[2] "The Relative Performance Record and Asset Allocation of Public Defined Benefit Plans" Morningstar in conjunction with NCPERS. December, 2007, Page 5.

[3] Ibid 2, page 7.

[4] Federal Reserve Board—2008

A majority of local and state agencies participate in Social Security, but not all agencies are required to participate. Most pension systems provide either retiree health plans and life or long term care products to retirees on a pooled and guaranteed basis. Plan designs for public pension plans vary with size, geography and classifications of employees represented.

PUBLIC EMPLOYEE DB PENSION PLANS PROVIDE BENEFITS NOT TRADITIONALLY OFFERED IN PRIVATE DC SCHEMES.

Traditional pension plan benefits provide income that attempts to replace a portion of employee's salaries upon retirement. This may be an employee's salary for service with either one employer or multiple employers who participate in direct reciprocal agreements. Most traditional pensions are supplemented by death and survivor benefits, additional annuities purchased through the pension plan, health care provided by the plan and other pooled insurance services offered as optional benefits for participants. These additional benefits may be paid by the employer, provided on a matching basis, or with no employer subsidy.

Traditional pension plans usually provide a death and survivor benefit that will ensure a defined benefit survivor allowance to family members of employees that may have lost their lives as a result of public service employment. These survivor benefits provide a "floor" level allowance even if the employee has not gained enough retirement credit to allow a sustainable income replacement. This survivor allowance may be higher if the dead or disabled employee has gained enough service credit to exceed this floor benefit.

There are many insurance products designed for temporary or permanent income replacement that are available for employers' purchase. However, only DB plans are capable of generating a high level of allowance (in many cases, 50 percent of the employee's annual income) while spreading risk among the entire employee pool.

When trying to insure public safety employees; most insurance underwriters will not carry police and fire employees without a larger group of general employees to share the risk. The possibility of large scale loss of life and high rates of industrial disability are outside the boundaries of an acceptably insured employee group. As testimony, our 3000 member firefighter local has sought coverage under an underwritten long term care policy for active duty firefighters for 6 years but has not had coverage through a common long term care provider. No larger underwriter of LTC policies will accept a safety only pool.

Next to survivor and disability benefits the next most common ancillary benefit is health care insurance. Because of the ability to pool beneficiaries and guarantee coverage, pension plans are ideally suited to provide this benefit. System-provided health care allows employees to begin saving for retirement medical care as an active duty employee through benefit funds that will be utilized on retirement. Many pension plans allow retirement medical savings within the retirement plan design, with the fund administering the benefit. This allows for consistent crediting of investment interest with very low fees. As a result, employees are provided health insurance with guaranteed coverage at low cost and very high level of quality of care.

DB PENSION PLANS AND THEIR EFFECT ON LOCAL ECONOMIES IN CALIFORNIA

The contribution of traditional public employee pension plans in California can be seen in the stable and sustainable income paid to their retirees and the impact of those pension payments on California's economy. These benefits also "compound" where retiree payments are invested back into the retirement system investments (real estate, venture capital, equities) through normal spending and those investments again, returning to the retiree because they are spending on their own investments. While most traditional public pensions are well diversified investment vehicles, California public pension plans invest heavily in local real estate and private ventures due to familiarity with the sector and its participating managers and owners.

California pension plans, with similar numbers nationwide, pay around 76 percent of retiree payroll with investment income. The remaining amount is generally equally divided between employer and employee contributions.[5] These payments are paid to retirees as pension payments or other pension benefits. Currently, the average CalPERS retiree left service at 60 years old and will receive an average monthly allowance of $1,876 or $22,512 per year.[6] Typical of most pension systems, the value

[5] Sacramento State University "The Combined Annual Economic Impacts of CalPERS and CalSTRS Retirement Income Benefit Payments." April 2007, Page 2,5,7.

[6] "Facts at a Glance" CalPERS, July 2008, Page 1.

of this retirement can be enhanced with other pension system provided benefits such as a funded cost of living enhancement or retiree health care.

With over two million public employees retired and contributing to the California economy, those CalPERS; CalSTRS and County payments are a significant part of the California salary base and as is their eventual disbursement into the California economy. For CalPERS alone this means over 13 billion dollars in direct retiree payments and estimated total economic activity for the State. Those allowances can mean over 21 billion dollars in total economic revenues for the state.[7] Additionally this output means employment to 137,974 state residents. When teachers and County retirement systems total payments and their impact is reviewed, total direct retiree payments reach 25.5 billion and their total economic impact reach an annual 41.5 billion dollars on the California economy solely as a result of benefit payments to resident retirees.[8]

The provision of good retiree health care also has an impact on the California economy. Again, there are over 2 million employees pooled into retirement system negotiated health care contracts. This means that a pooled, guaranteed insurance product can be offered. Since over 50 percent of retirees having two or more serious medical conditions,[9] up to one million retirees would be left in jeopardy of losing health care coverage due to chronic health problems. With pension system negotiated health insurance, these retirees have a vehicle to negotiate quality care at a reasonable price and guarantee coverage for those whom may otherwise be in jeopardy.

LOCAL AND STATEWIDE INVESTMENT BY CALIFORNIA PENSION PLANS

Like most large traditional public pension funds, CalPERS, CalSTRS and County retirement systems spend a slightly larger share of certain asset classes on California centered investments. This can be attributed to a political emphasis on local investment, a familiarity by investment staff with private investments, and an awareness by their managers of investment projects specifically designed to target an undervalued market.

Usually with the assistance of asset managers or other intermediaries, local investment has become a common practice across most asset classes. Since returns have been equal to or greater than other investments this trend is expected to continue.

As a natural result of California's large stake in private equity or venture capital holdings and the large base of real estate investments centered in the state, public DB plans will naturally have a bias toward state investments. The large proportion of hi-tech industries and now clean-tech sectors based in California meant a natural "overweight" to California businesses. The origination of these industries in California has meant opportunities for "ground floor" investments in startup companies in California companies. These opportunities are usually brokered through private equity and venture capital funds that also have a California bias in their investment style. This regional emphasis allows both the pension system and their outside managers to find proper investments in private equity investments and fulfill their obligation for due diligence on the investment with other, familiar managers or companies.

There is also a concentration of California plans in local real estate options. This can be directly attributed to the familiarity of investment staff in California real estate opportunities and the managers making those investments. Real estate managers tend to be centered in one geographic area, as with many of our alternative assets they generally are more successful when they are smaller in size but large enough attract cash investments and partnerships from large institutional clients. Often, manager styles and investment types can be matched to a need of some members of the system. One example would be the recent investment in urban centers in multi-family apartment and condominium sales. Not only were units built with retirement system investments in urban centers in need of revitalization, members of the system are seen as quality owners with good credit and income and were given the opportunity to purchase these investments with attractive financing incentives.

[7] Ibid footnote 1, page 6, Table 2.

[8] Russel Read—Powerpoint "Impact of CalPERS Investments on the State of California" *http//www.calpers.ca.gov/index jsp?bc=/investments/video-center/view-video/cpfi-conference/calif-invest-econ-study.xml*

[9] "Health Care Coverage for Retirees" Congressional Research Service, Cornell University 2006. Page 3.

DB PENSION PLANS AND THE ECONOMIC CYCLE

In addition to contributing to California's investments public pension systems, traditional DB pension plans play an important role in the overall U.S. and international economic cycle. Traditional public pension plans have a unique profile for asset managers: we are long term, patient investors that generally base our performance on annual returns, or returns over a several years, not the next quarter. While other retail funds, or even institutional funds have immediate demands to produce over a short term horizon, traditional pension plans may make investments in venture or real estate funds that may not be fully realized for as many as 20 years.

A current reminder of the importance of DB capital on the economy would be the current credit crisis and the importance of DB plans in smoothing some of the volatility of the event. While many lenders have shuttered their doors to many kinds of financing due to risk, pension plans and their managers are lending to private equity investments at a high rate, plugging the hole that lending banks have left. This recent trend provided our funds an investment opportunity in well researched cash outlays and provide much needed capital to companies hungry for loans. The pension funds' abilities to lend large amounts within a reasonable asset allocation with low risk provide them with unique opportunities and advantages in contrast to other asset managers.

CONCLUSION

Traditional public employee pension plans are well funded, diversified investment vehicles that serve their members in all aspects of retirement. They also provide an important role in the local and national economy as patient, long term investors. Finally, these are nimble enough to take advantage of local investment opportunities that are frequently overlooked by other large investment vehicles.

Again, thank you for this opportunity to present my views. I would be happy to answer any questions the committee may have.

PREPARED STATEMENT OF P. SHERRILL NEFF, PARTNER, QUAKER BIOVENTURES, PHILADELPHIA, PA

INTRODUCTION

Members of the Committee, good morning. My name is Sherrill Neff and I am a partner with the venture capital firm Quaker BioVentures located in Philadelphia, Pennsylvania. Thank you for the opportunity to testify today on a very important issue for the venture capital industry: the role of defined benefit pension plans as a critical source of capital formation for both our industry and the startup companies in which we invest.

By way of background, Quaker BioVentures is a venture capital firm investing in life science companies, including biopharmaceuticals, medical devices, human diagnostics, specialty pharmaceuticals, and healthcare services. My partners and I invest in companies at all stages of development, from the earliest stage of businesses to later pre-public companies. The firm was formed in 2003 and is currently investing Quaker BioVentures II, a $420M fund raised in 2007. In total, Quaker BioVentures manages over $700M in committed capital of which approximately 75 percent percent comes from large public and private defined benefit plans. Our investors include 10 public pension funds from six different states and major corporate pension funds. Since 2003, we have invested in 28 life sciences companies, most of which were startup or early stage companies, and all of which are pursuing important and innovative therapies, devices, diagnostics or other healthcare services.

My firm is also a member of the National Venture Capital Association (NVCA). The NVCA represents more than 480 venture capital firms in the United States and advocates for policies and legislation that are favorable to American innovation and entrepreneurship. In 2007 alone, venture capitalists invested approximately $30 billion into small, high-risk, emerging growth companies in areas such as life sciences, information technology, homeland security, and clean technology. The goal of our industry is simple—using the most innovative new products and services to market in the most efficient manner, while maximizing returns for our institutional investors.

Today I would like to explain how the venture capital industry raises and invests money, the economic implications of this investment, and the importance of defined benefit pension plans in that equation.

VENTURE CAPITAL FUND STRUCTURE

Venture capital is a relatively small, but extremely unique sub-sector of what many institutional investors refer to as alternative assets. Venture capital funds are set up as limited partnerships in which sophisticated institutional investors or limited partners ("LPs") provide capital to a fund managed by a group of venture capitalists or general partners, ("GPs"). The GPs invest this capital along with their own in high risk and often high tech private startup companies that demonstrate a tremendous promise for growth over the long term. The typical investment horizon for a venture-backed company is 5 to 10 years, often longer and rarely less. Once the company has grown to a viable size, it either goes public or becomes acquired by a strategic buyer, hopefully at a significant investment return to the venture capital fund, the entrepreneur, and the LPs. Given the high risk nature of the investment, it is understood that many venture-backed companies ultimately fail. However, those that succeed return top dollars to investors and create jobs and revenues for the US economy. Yet, it is not an investment for the faint at heart.

For that reason venture capital LPs are highly sophisticated investors who understand the value of "patient capital". They recognize that their investment will not be liquid for some time but they are willing to make that commitment for the benefit of higher returns. The life of a venture capital fund is typically set at 10 years but in reality, it is often much longer—15 to 17 years—until the last investment is harvested and distributions are made. Yet, on a pooled basis over the long-term, the venture capital asset class has outperformed the public markets for many years. The 10 year performance for all venture funds through 12/31/2007 was 18.3 percent as opposed to NASDAQ which registered 5.3 percent and the S&P 500 which was 4.2 percent. Source: Thomson Reuters/NVCA.

Approximately 90 percent of venture capital commitments come from institutional investors—defined benefit pension funds, insurance companies, university endowments, corporations and foundations. The small percentage of individual investors who become venture fund limited partners are designated as high net worth and have the financial resources and staying power to commit large amounts of capital to illiquid investments for periods of time that, as I explained, can exceed a decade. All of these investors have the ability to obtain significant independent financial advice in order to evaluate potential investments. For this reason, under applicable securities laws, venture capital limited partnerships are not required to be registered with the Securities and Exchange Commission.

The relationship between the GPs and the LPs is extremely important in the venture capital life cycle. GPs spend a considerable amount of their time and effort raising the fund which they intend to invest in emerging growth companies.. The fundraising process consists of preparing offering materials, identifying and meeting with appropriate and compatible investors (LPs) and their professional advisors, responding to LP due diligence requests, and negotiating the terms of their commitment. It is not unusual for this fundraising process to take a year or longer. However, once an institutional investor joins a fund as an LP, they are likely to invest in follow on funds if the relationship is a good one. Participation in the most successful funds is highly competitive. Funds will indeed turn away money from institutional investors once their target fund level is achieved.

The venture capital industry would not exist without the support of limited partners who provide the majority of the capital invested in the young businesses. In return, the general partners provide time, management expertise and experience in identifying and nurturing these companies so that they grow into viable and valuable businesses.

THE ROLE OF DEFINED BENEFIT PLANS IN THE VENTURE CAPITAL SYSTEM

You have heard from the other witnesses today about many of the positive contributions that defined benefit plans offer their participants. I would like to address an attribute of the defined benefit plans that may be less well known: the role of defined benefit plans in the funding and growth of the venture capital industry and the entrepreneurial segment of the US economy.

Defined benefit pension plans have historically been a sizable and reliable pool of capital for venture fund formation and thereby for investment into the nation's emerging growth companies. The US venture capital industry would not be the economic engine it is today without the strong investment participation from defined benefit plans. Federal rules first permitted defined benefit plans to invest in venture capital in the 1980s.

In 1974, the Employment Retirement and Income Security Act (ERISA) was enacted to protect the pension and welfare benefit rights of workers and beneficiaries. Private pension plans had already been in existence for many years, but the passage of ERISA marked the growing importance of these private plans in the retirement income equation.

One of the critical regulations which was established for the first time by the Federal Government in ERISA concerned the investment of pension assets by those responsible for their control. The Department of Labor was given exclusive authority to issue regulations and rulings that define who is an ERISA fiduciary. Thus, in 1979 the Department of Labor issued its "prudence regulation" which interpreted ERISA as allowing pension plans to invest in young, smaller companies. This regulation provided managers of pension funds the ability to channel money into venture capital funds which they have done in increasing, yet reasonable amounts ever since.

As a direct result of the ERISA "prudent man rule" money from public and private pension funds began to flow into the venture capital space beginning in the 1980s. In 1980 private independent venture funds had just over $4 billion in capital under management. This rose to $18 billion in 1985, $28 billion in 1990, $41 billion in 1995, $225 billion in 2000, and $257 billion in 2007. Much of this growth is attributable to the success of venture capital investment and the receptivity of defined benefit plans to the high returns the asset class afforded them.

Yet the mix of limited partners is changing. Because many US based private pension plans have been converted from defined benefit plans to defined contribution plans over the past several years, we are seeing fewer private pension plans actively investing in venture. Filling that gap are LPs from *outside* the United States, including foreign public and private pension funds who are becoming increasingly interested in investing in US based venture capital funds.

Yet US public pension plans continue to be critical and reliable sources of capital for US venture funds. The vast majority of state pension funds and many local public pension funds invest a small portion of their assets in private equity because they understand that, while long-term and sometimes riskier than bonds and stocks, venture capital can deliver returns that boost the overall financial position of the fund. Today all but a few states permit their public pension funds to invest a small amount of their assets into the venture capital asset class. States that have been long-time venture capital investors include California, Washington, Pennsylvania, and Wisconsin.

Most public entities invest only a small portion of their investible assets in private equity/alternative assets, often less than 5 percent, because of the potential risk and long term nature of the asset class. Thus, in exchange they expect to receive a return on investment that is much higher than traditional asset classes. Defined benefit plans usually diversify their commitments to alternative asset classes two ways: (1) by investing across different alternative asset sub-classes (real estate, buyout, private equity, venture capital and hedge funds; and (2) within each sub-class investing in a large number of different managers. As a result, the pension plan's exposure to any one alternative asset class or to any one manager is very limited.

Venture capitalists who take defined benefit pension plans into their funds do so because these fund managers are long-term, patient investors who understand the nuances and risks of venture investing. Additionally, VCs have found defined benefit pension LPs to be knowledgeable, forthright and valuable investment partners over the length of the fund. With demand for participation in venture capital funds at an all time high, this trusted relationship helps guarantee a coveted spot for defined pension plans. However, should these plans convert to defined contribution plans, that spot will be forfeited to other institutional investors as the requirements for investment in the venture capital industry are not compatible with the characteristics of defined contribution plans.

THE ECONOMIC IMPACT OF VENTURE CAPITAL INVESTMENT

When a defined benefit pension plan invests in a venture capital fund, it is not only creating higher returns for its pensioners, but it is also supporting one of our country's most important economic engines. Literally thousands of companies would not exist today were it not for the venture capital investment support they received early on. Federal Express, Staples, Outback Steakhouse and Starbucks are well known examples of traditional companies that were launched with venture backing. Cisco, Google, EBay, Yahoo and countless other technology companies were all, at one time, just ideas that needed startup capital and guidance.

In the same vein, venture capital has been an important catalyst for innovation in the life sciences and a multitude of medical innovations would not have been possible without it. Genentech started with venture backing. So did Amgen, Genzyme and Medtronic. Over the last several decades, venture capitalists have partnered with scientists to build successful businesses and bring to market such drugs as

Herceptin, an important part of our war on cancer and Integrilin, which significantly reduces blood clotting. Studies suggest that more than one out of three Americans will use a medical product or service generated by a venture- backed life sciences company.

According to the econometrics firm Global Insight, last year US based, venture-backed companies accounted for more than 10.4 million jobs and generated over $2.3 trillion in revenue. Nearly one out of every ten private sector jobs is at a company that was originally venture-backed. Almost 18 percent of US GDP comes from venture-backed companies.

Venture investors are constantly looking for the next "big thing" and these days, many of my colleagues are active in building alternative energy companies in what is called the "clean technology" industry, a sector which I'm sure we all agree will play a vital role in America's global competitiveness for years to come.

None of this value would have been possible without the active investment of public and private defined benefit pension funds. The relationship between the venture industry and defined benefit managers is a symbiotic one that creates high returns for the investors and the US economy. It represents a highly efficient use of capital that we assert should remain in the system. I can tell you unequivocally that most venture firms would prefer to ensure (1) that the jobs and technologies we fund be based here in the US, and also (2) that the returns we generate on our investments also be returned to American pension beneficiaries. That will continue to occur as long as the defined benefit plans are embraced as an important part of our overall retirement system.

CONCLUSION

Thank you for the opportunity to weigh in on this important issue. We look forward to working with many of the large defined benefit pension managers for years to come. The support of these programs not only helps pension holders, but also creates jobs, generates revenues and fosters innovation for our country, contributing to a healthy US economy at both a micro and macro economic level.

I am happy to answer any questions.

PREPARED STATEMENT OF CHRISTIAN WELLER, PH.D., SENIOR ECONOMIST, CENTER FOR AMERICAN PROGRESS, WASHINGTON, DC

Thank you Chairman Schumer, Vice-Chair Maloney, Ranking Republican Brownback, Ranking Member Saxton, Senator Casey, and members of the Joint Economic Committee for this opportunity to speak to you today. My testimony this morning will address the public- and private-sector impacts of defined benefit pension plans in the public sector. I will specifically discuss the long-term economic performance of state and local defined benefit pension plans and how this performance compares with that of defined contribution plans.

A recent poll conducted by Bankrate Inc. found that only about 3 in 10 workers expect to have enough money to retire comfortably. Nearly 7 in 10 Americans have set low expectations about their retirement prospects. One in five Americans says they are afraid they will never be able to retire (*Austin Business Journal*, 2008).

It is not hard to see why so many Americans feel so uneasy about their future retirement prospects. An ever smaller share of workers has a retirement savings plan at work. For instance, only 43.2 percent of private sector workers had an employer-sponsored retirement plan, either a traditional pension or a retirement savings plan, in 2006, the last year for which data are available (Purcell, 2007). This is the lowest share in more than a decade and a substantial drop from 50.0 percent in 2000, the last peak. In addition, a growing number of workers are saving with defined contribution retirement savings plans. This can leave workers exposed to a number of new risks—a point I will return to later in my testimony. It also means that wealth creation carries unequal tax rewards, depending on one's earnings. Because contributions to these retirement savings plans are tax deductible, higher-income earners tend to receive a larger tax benefit from contributing to their DC plans than lower-income ones.

These longer-term trends have been overshadowed by recent drops in financial and nonfinancial market wealth. Families have lost a lot of financial wealth due to a sharp decline in stock prices. Since the beginning of the year alone, the S&P 500 had lost 12.5 percent of its value by the end of June 2008. Also, the fact that homeowners were highly leveraged due to the recent mortgage boom meant that they stood to lose a lot when house prices began to fall (Weller, 2006). Recent data from the Federal Reserve, for example, show that home equity relative to income dropped by 5.0 percentage points by March 2008, compared to a quarter earlier, the largest such drop on record.[1] These adverse trends have meant that a growing number of families will have to rely solely on Social Security as source of retirement income (Baker and Rosnick, 2008).

In light of such trends, policy solutions are necessary to restore the promise of a retirement in dignity for the all working families in America. Here, policymakers could focus on elements of our retirement system that are working well. State and local defined benefit, or DB, pension plans stand out as an example of what works when it comes to achieving broad-based retirement income adequacy at a reasonable cost. A review of the economic evidence on state and local DB plans tells us that these pension plans have proven themselves as model retirement systems. They have a successful track record of performance in delivering adequate benefits in a sustainable and efficient manner.

FEATURES OF A MODEL RETIREMENT PLAN

If one were to design an ideal retirement plan, it would probably encompass the following features:

- broad-based coverage, which covers all workers automatically
- secure money for retirement, with limited opportunities for leakage of retirement assets
- portability of benefits, which will allow workers to retain benefits if they switch jobs
- shared financing, with contributions from both employees and employers
- lifetime benefits, so that retirement income cannot be outlived
- spousal and disability benefits to provide protections against death or the inability to work
- professional management of assets
- low costs and fees.

The DB plans that provide retirement benefits to employees of state and local governments typically meet all of these criteria for a model retirement system.

Broad-based coverage

Employees must simply meet the eligibility requirements of the DB plan to earn benefits in a public sector DB plan. They are then automatically enrolled without having to make any active decisions.

This truly "automatic" enrollment is a typical characteristic of DB plans. Private sector DB plans also automatically enroll all eligible workers.

Defined contribution, or DC, plans, on the other hand, often require employees to enroll themselves, and then to make difficult decisions about how much to save and where to direct their investments.

In passing the Pension Protection Act of 2006, Congress acknowledged this flaw inherent in DC plans, and attempted to make automatic enrollment and efficient asset allocation easier. It is too soon, however, to reach any conclusions about the law's effectiveness on increasing automatic enrollment in DC plans.

Secure money for retirement

State and local DB plans provide a secure source of income in retirement for a number of reasons. First, one's funds cannot be borrowed from, and typically are not distributed as a lump-sum payment. That is, benefits under a public sector DB plan, as well as many private sector DB plans, will be there to provide a lifetime stream of retirement income. Moreover, a rather obvious point is that the plan sponsors of public sector DB plans are state and local governments, which typically do not go bankrupt, which is sadly not always the case for single-employer private sector DB plans.

The security of assets in DC plans for future retirement income is, in comparison, compromised. Importantly, the vast majority of individuals in DC plans can borrow from their retirement accounts or withdraw funds before retirement age. Economists use the term "leakage" to describe assets that are drawn out of retirement savings plans for purposes other than providing retirement income. According to one conservative estimate, a full 10 percent of all retirement wealth is lost due to leakage from DC plans (Englehart, 1999) Another study found leakage to be "concentrated among individuals vulnerable to poverty in old age" (Hurd and Panis 2006). Loans from DC plans have risen, especially to allow families to smooth over economic hard times, which will likely reduce their retirement income security (Weller and Wenger, 2008).

[1] Author's calculations based on BOG(2008).

Portability of benefits

Public pension plans are responding to changing workforce needs in public service by offering much greater portability than in the past. Often, if employees move to another government position within the state, they are able to carry pension benefits with them; should they move to other jurisdictions, they can usually purchase service credits (Brainard, 2008).

This portability also exists for most DC plans and in some private sector DB plans, so-called multiemployer plans.

Shared financing

The funding of state and local DB plans is a shared responsibility between employee and employer unlike private sector DB plans, in which employers typically finance the entire benefit. In 2004, for workers covered by Social Security, the median employer contribution rate was 7 percent of salary, while the employee contributed an additional 5 percent of salary (Munnell and Soto, 2007).

Also, because public sector DB plans are prefunded—they accumulate assets to cover all expected current and future benefit payments—employer contributions account for only a small share of the funds flowing into public plans that can be used to pay benefits. According to data from the Census Bureau, employer contributions comprised about 18 percent of all public pension revenue over the 10-year period 1996 to 2006. Investment earnings made up 73 percent of revenue during that time, and employee contributions accounted for the remainder (Census, 2008).

Lifetime benefits

State and local DB plans are designed so that retirement income can never be outlived—retirees are a guaranteed paycheck for life. This is also the case with private sector DB plans that have to offer an annuity benefit, even if it is as an alternative to a lump-sum distribution.

This is in stark contrast with DC systems. Here, the burden of managing one's retirement income, so that retirees do not run out of savings in retirement falls mostly on the individual. In many cases, though, employees do not understand how much money they will need in retirement, the result being that many workers do not save sufficiently and face inadequate income in retirement. In order for a private sector worker to purchase a modest annual annuity of $20,000, she must accumulate an estimated $260,000 in a 401(k). The median 401(k) balance for heads of households approaching retirement in 2004, however, was just $60,000 (Munnell and Soto, 2007). Further, Boston College researchers have found that, in part due to the shift from DB to DC plans in recent years, between 44 percent and 61 percent of households are at risk of being unable to maintain their living standards in retirement (Munnell, Webb, and Golub-Sass, 2007).

Spousal and disability benefits

State and local DB plans typically provide special protections for spouses of married beneficiaries, as well as disability benefits for active employees who are stricken by illness or injury that prematurely ends a career.

Disability benefits are especially important for state and local government employees, since many workers, such as police officers and firefighters, have high-risk jobs.

Spousal benefits are particularly important as well, as women have much lower retirement incomes than men (Even, 2004) and single elderly women have even lower incomes. According to one recent study, among the entire population aged 65 and older, 19.1 percent of women living alone were in poverty in 2006, compared to 11.5 percent of all women and 6.6 percent of all men who lived in poverty in that year (Hounsell, 2008).

Professional management of assets

Public sector plans and private sector DB plans are managed by professionals with "considerable financial education, experience, discipline, and access to sophisticated investment tools" (Watson Wyatt, 2008).

The individualized nature of DC plans, though, means that these rely on self-management. I will elaborate in greater detail on the significant economic benefits professional management provides further below.

Low costs and fees

Evidence shows that administrative costs are substantially higher for DC plans as compared to DB plans. An international study of plan costs finds that while, on average, fees can range between 0.8 percent and 1.5 percent of assets, larger institutional plans can reduce such fees to between 0.6 percent and 0.2 percent of assets (James, Smalhout and Vittas, 2001). The UK Institute of Actuaries finds very high administrative costs for DC plans—of 2.5 percent of contributions and up to 1.5 percent of assets—leading to the equivalent of a 10 to 20 percent reduction in annual contributions; DB administrative costs, however, amount to just 5 to 7 percent of annual contributions (Blake, 2000). Similar differences exist in the United States, with DB plans incurring substantially lower fees than DC plans (CII, 2006; Weller and Jenkins, 2007).

ADEQUATE RETIREMENT BENEFITS

Obviously, designing a model retirement plan is not a means unto itself. It is intended to generate adequate retirement income for beneficiaries. DB plans, whether in the public or private sector, tend to be very effective at ensuring that employees will have adequate resources in retirement to support themselves because these types of retirement plans often incorporate all of the features laid out in the previous section.

An "adequate" replacement rate is typically defined as one that allows a retired household to enjoy roughly the same standard of living as it did before retirement. This standard of adequacy might be deemed to fall anywhere between 75 percent and 85 percent of preretirement income.

Research shows that retirees with DB pensions are much more likely to have adequate retirement income than those relying on DC plans (Munnell et al., 2008). Also, a 2007 Federal Reserve study found that the median wealth held in a DB pension plan is about two times larger than the median holdings in DC plans and IRAs. This indicates that DB pension plans tend to be better at ensuring employees are able to accumulate adequate resources for retirement (Love, Smith, and McNair, 2007).

In a DB plan, an individual employee's benefit is typically determined based on a simple formula; this benefit is calculated by multiplying the employee's final salary (averaged over three to five final years of employment) by their number of years of service, and then by a set retirement multiplier. For example, under a system with a retirement multiplier of 1.8%, an employee with a final average salary of $40,000 and 30 years of service will receive an annual benefit of $21,600 ($40,000 x 30 x 1.8%). This benefit, then, would replace 54% of the employee's final average salary. This amount, when added to Social Security benefits, would enable the employee to maintain their middle-class standard of living throughout their retirement years.

However, it should be noted that approximately 25 percent of all state and local government employees do not participate in Social Security (Brainard, 2007) and therefore require a larger pension benefit in retirement in order to compensate for their lack of Social Security income. In 2006, the median retirement multiplier was 1.85 percent for Social Security-eligible employees and 2.20 percent for non-Social Security-eligible workers (Brainard, 2007). This means, on average, employees who work for a full 30 years in public service will receive a pension that replaces 55.5 percent of final earnings if they are Social Security eligible, and 66 percent of final earnings if they are not Social Security eligible.

Given these replacement rates, public pensions offer income adequacy in retirement that is manageable and sensible. In 2006, for example, the median public sector retiree received a benefit of $22,000 per year (McDonald 2008). Combined with Social Security, such pension benefits generally add up to an adequate retirement income. For instance, a typical worker in Pennsylvania, where the multiplier is 2.5 percent of the final average pay for each year of service, could expect to replace about 78 percent of their pre-retirement earnings after a full-career and 52 percent with a partial career in state employment due to the combination of a DB pension, Social Security, and savings in a DC plan (Weller, Price, & Margolis, 2006). State and local DB plans, then, comprise a system of reasonable and adequate income replacement in retirement.

SUSTAINABILITY AND EFFICIENCY OF DB PLANS

Importantly, these adequate benefits are sustainable in the long run. Because of their group nature, public sector DB plans create significant economies for taxpayers and employees, which allow them to offer retirement benefits in an efficient manner.

Two sets of factors drive these economies. First, because public DB plan assets are pooled and managed by professionals, these systems can achieve higher returns, at a lower cost, than DC plans based on individual accounts. Second, DB plans lower costs for participants and plan sponsors by pooling mortality and other risks.

The benefits ofpooled, professional asset management

By pooling assets, state and local DB plans are able to drive down administrative costs and reduce asset management and other fees. Asset management fees average just 25 basis points for public pension plans. By comparison, asset management fees for private 401(k) plans range from 60 to 170 basis points (Munnell & Soto 2007). Thus, DC plans suffer from a 35 to 145 basis point cost disadvantage.

This disadvantage may appear small, but like water carving a canyon out of rock, over a long period of time, it compounds to create a significant affect on assets. For example, over 40 years, a 100 basis point cost disadvantage compounds to a 24 percent reduction in the value of assets available to pay for retirement benefits (Weller & Jenkins, 2007).

Investment decisions in state and local DB plans are made by professional investment managers, whose activities are overseen by trustees and other fiduciaries. Public pension plan assets are broadly diversified and managers follow a long-term investment strategy.

In analyzing public sector pension plan investment behavior, Professor Jeffrey Wenger and I have found that state and local plans exercise a great deal of prudence, tending to rebalance their assets regularly in response to large price changes. Also, public sector plans holdings of higher-risk/higher-return assets increases when these plans have higher funding levels, thereby indicating that plans do not "chase return" in response to lower funding levels. Specifically, the equity allocation is larger in the period after we observe higher funding levels, which suggests that trustees wait to know what their financial situation is before they change the risk exposure of their portfolio. In addition, public sector plans' holdings of equities is smaller when demands on employers in the form of higher contributions increase. This relationship seems to have become stronger after 2000, which suggests that public sector plans not only avoided employer conflicts of interest as larger demands on employers in the previous period translated into a "flight from risk," but if anything, these plans may have become more cautious in their asset allocation following a period of underfunding (Weller & Wenger 2008).

The prudent investment behavior of professionally managed DB plans stands in contrast to the situation in DC plans where individuals direct their own investments. Research finds that asset allocation in retirement savings plans is considerably more volatile than what is found in professionally managed DB plans (Boivie & Almeida 2008).

In addition, a wide literature in the field of behavioral finance finds that despite their best efforts, individuals often make poor decisions when it comes to investing for retirement (Benartzi & Thaler 2007). For example, Holden and VanDerhei (2001) found that more than half of all DC plan participants had either no funds invested in stocks—which exposes them to very low investment returns—or had almost all their assets allocated to stocks, making for a much more volatile portfolio. Other research has found that many individuals' inertia subjects asset allocation in individual accounts to acute imbalance. At the other extreme, some individuals engage in excessive trading, which results in the problem of buying high and selling low (Mitchell & Utkus 2004; Munnell & Sunden 2004). This puts individual savers at a disadvantage vis a vis professionally managed DB plans, leaving individual savers to pay more for fewer benefits.

Another advantage of pooling and professional management is that DB plans can take advantage of broader diversification strategies. In recent years, some DB plans have allocated a small percentage of their holdings to include so-called "alternative" investments such as private equities, venture capital, and hedge funds. These investments can help to improve the returns and/or reduce the overall risk of a plan's portfolio by introducing assets whose returns are uncorrelated (Seco 2005; Phillips & Surz 2003; Indjic & Partners 2002).

Such diversification may allow a plan to show just single-digit losses in a market decline, for example, when other equities may show double-digit losses—a result that can significantly affect a retirement plan's compounded rate of return over time. Data from Watson Wyatt (2008) show that during the 2000 to 2002 market downturn, DB plans outperformed DC plans, in part because of their exposure to a broader range of assets, including alternatives.

However, in order to successfully invest in such "alternative" assets, investors must have a long time horizon and must have a high degree of sophistication to understand these often complex investments. Such factors make alternative investments a sound investment choice for some DB plans. Individual investors in retirement savings plans typically have neither the access nor the expertise to invest in these types of assets.

Because of these three effects—lower fees, professional and pooled investment management, and access to more sophisticated diversification strategies—it should not be surprising that professionally managed DB plans consistently outperform individually managed DC plans. One widely cited estimate from Munnell and Sunden (2004) puts the difference in annual return at 0.8 percent. Over a 30-year time period, this compounds to a 25-percent difference in total return. A 2007 report from the global benchmarking firm, CEM, Inc., concluded that between 1998 and 2005 DB plans showed annual returns 1.8 percentage points higher than DC plans, largely due to differences in asset mix (Flynn & Lum 2007). And Watson Wyatt (2008) found that between 1995 and 2006 DB plans outperformed DC plans by 109 basis points, on average.

The benefits of risk pooling

DB plans create additional economies for participants and plan sponsors by pooling mortality and other risks. By pooling the mortality risks of large numbers of people, DB plans need only accumulate assets sufficient to fund retirement benefits over the *average* life expectancy. By contrast, in a DC plan based on individual savings accounts, more assets will be required. Because an individual does not know what their ultimate lifespan will be, it is extremely difficult to know exactly how much one needs to save for retirement and to be certain that one will not outlive those savings. Thus, in a system of individual accounts, each person must ensure that he or she accumulates enough savings to last for the *maximum* lifespan. Thus, a DB plan will require fewer assets to be accumulated than a comparable DC plan, reducing costs by 15 percent to 35 percent (Fuerst, 2004).[2]

To summarize, state and local DB pension plans provide taxpayers an excellent "bang for the buck." DB plans possess several sources of economic efficiencies when it comes to delivering retirement benefits. They combine the effects of lower fees, professional management, more sophisticated diversification strategies, and risk pooling. Actuaries have determined that DB plans are much more efficient than DC plans and that they provide retirement benefits at a far lower cost (Fuerst 2004; Waring and Siegel 2007). Thus, to the extent that public retirement systems are supported (at least partially) by taxpayer funds, a DB plan design for state and local retirement systems supports the goal of fiscal responsibility.

CONCLUSION

My review of the economic evidence on state and local DB plans tells the story of a thriving, well-designed system. State and local DB pension plans have been remarkably successful in providing adequate benefits to public sector retirees in a sustainable and efficient manner. Their proven performance makes these plans a model to emulate.

DB plans in the public sector incorporate the features policymakers should look for in successful retirement systems: broad-based coverage, secure money for retirement, portability, shared financing, lifetime benefits with spousal and disability protections, professional management of assets, and low costs and fees.

Public sector DB plans have been highly successful in ensuring that the millions of middle-class Americans who work in service to the public have the resources they need to take care of their own needs in retirement. They provide modest benefits that retirees can count on to last as long as they do.

And public DB plans serve taxpayers and public employees alike with their cost-effective structure. The sustainability and efficiency of public sector DB plans hinge on the pooling of assets and risks. By pooling assets, DB plans can benefit from professional management which drives down costs and enhances return. By pooling longevity risks, DB plans reduce the cost of providing retirement benefits even further.

The lessons that we can learn from the experience of DB plans in the public sector can and should be applied to private sector retirement savings. This is particularly true for the design of DC plans. Much is already done in this way to make saving in these plans more automatic, increase its coverage, and secure its assets. In the end, though, much of what public sector DB plans can offer will be hard or impossible to recreate in the DC setting. For instance, mortality risk will likely remain a feature of DC plans for the foreseeable future. Hence, policymakers should help strengthen existing DB plans, in the private and public sector. Against the backdrop of widespread and rising retirement income insecurity, models of strong retirement security are rare and yet desperately needed.

---

[2] Employers that offer individual retirement savings plans could come close to approximating these economies by offering annuity distribution options. In practice, however, it is the rare plan that does so (Perun 2007).

REFERENCES

Almeida, B. 2008. "Retirement Readiness: What Difference Does a Pension Make?" Issue Brief Washington, DC: National Institute on Retirement Security.

Almeida, B., K. Kenneally, and D. Madland. 2008. *The New Intersection on the Road to Retirement: Public Pensions, Economics, Perceptions, Politics, and Interest Groups.* Submitted to the Pension Research Council, The Wharton School, University of Pennsylvania.

Austin Business Journal. 2008. "Poll reveals Americans feel ill-prepared for retirement." June 23.

Baker, D., and D. Rosnick. 2008. "The Housing Crash and the Retirement Prospects of Late Baby Boomers." CEPR Report. Washington, DC: Center for Economic and Policy Research.

Benartzi, S. and R.H. Thaler. 2007. "Heuristics and Biases in Retirement Savings Behavior." *Journal of Economic Perspectives* 21 (3): 81–104.

Blake, D. 2000. "Does it matter what type of pension scheme you have?" The Economic Journal 110 (461): F46–F81.

Board of Governors, Federal Reserve System. 2008. Release Z.1 Flow of Funds Accounts of the United States. Washington, DC: BOG.

Boivie, I. and B. Almeida. 2008. "Patience is a Virtue: Asset Allocation Patterns in DB and DC Plans." NIRS Issue Brief Washington, DC: National Institute on Retirement Security.

Brainard, K. 2007. "Public Fund Survey Summary of Findings for fiscal year 2006." National Association of State Retirement Administrators and National Council on Teacher Retirement.

Brainard, K. 2008. "Redefining Traditional Plans: Variations and Developments in Public Employee Retirement Plan Design." Prepared for presentation at the Pension Research Council Symposium, May 1–2, 2008.

Council of Institutional Investors. 2006. "Protecting the Nest Egg: A Primer on Defined Benefit and Defined Contribution Retirement Plans." Washington, DC: CII.

Flynn, C., and H. Lum. 2007. "DC Plans Underperformed DB Funds." Toronto, ON: CEM Benchmarking, Inc.

Fuerst, D. 2004. "Defined Benefit Plans: Still a Good Idea?" AARP Global Report on Aging. Washington, DC: AARP International.

Holden, S. and J. VanDerhei. 2001a. "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2000." EBRI Issue Brief 239. Washington, DC: Employee Benefit Research Institute.

Indjic, D. and F. Partners. 2002. "Strategic asset allocation with portfolios of hedge funds." *Alternative Investment Management Association Journal* (December): 29–33.

Love, D. A., P.A. Smith and L. McNair. 2007. "Do Households Have Enough Wealth for Retirement?" Finance and Economics Discussion Series. 2007–17. Washington, DC: Federal Reserve Board,

Mitchell, O. and S. Utkus. 2004. *Pension Design and Structure: New Lessons from Behavioral Finance.* New York: Oxford University Press.

Munnell, A. H., A. Webb, and F. Golub-Sass. 2007. "Is There Really A Retirement Savings Crisis? An NRRI Analysis." CRR Issue in Brief No. 7–11. Boston: Boston College, Center for Retirement Research.

Munnell, A. H. and M. Soto. 2007. "State and Local Pensions are Different from Private Plans." Center for Retirement Research State and Local Pension Plans, No. 1. Boston College.

Munnell, A. H. and A. Sunden. 2004. *Coming Up Short: The Challenge of 401(k) Plans.* Washington, DC: Brookings Institution Press.

Phillips, K.S. and R.J. Surz. 2003. *Hedge Funds: Definitive Strategies and Techniques.* New York: John Wiley & Sons.

Purcell, P. 2007. "Pension Sponsorship and Participation: Summary of Recent Trends." CRS Report RL30122. Washington, DC: Library of Congress, Congressional Research Service.

Seco, L.A. 2005. "Hedge funds: Truths and myths." *Revista de Economca Financiera 6: 82–114.*

U.S. Census Bureau. 2008. "State and Local Government Employee Retirement Systems." Washington, DC: Census.

Watson Wyatt. 2008. "Defined benefit vs. 401(k) plans: Investment returns for 2003–2006." Watson Wyatt Insider 18(5).

Waring, M. B. and L.B. Siegel. 2007. "Don't Kill the Golden Goose." *Financial Analysts Journal* 63 (1): 31–45.

Weller, C. 2006. "The End of the Great American Housing Boom." Center for American Progress Economic Policy Report. Washington, DC: Center for American Progress.
Weller, C., and S. Jenkins. 2007. "Building 401(k) Wealth One Percent at a Time: Fees Chip Away at People's Retirement Nest Eggs." CAP Economic Policy Report. Washington, DC: Center for American Progress.
Weller, C., M. Price, and D. Margolis. 2006. "Rewarding Hard Work: Give Pennsylvania Families a Shot at Middle Class Retirement Benefits." CAP Economic Policy Report. Washington, DC: Center for American Progress.
Weller, C., and J. Wenger. 2008a. "Robbing Tomorrow to Pay for Today." CAP Economic Policy Report. Washington, DC: Center for American Progress.
Weller, C. and J. Wenger. 2008. "Prudent Investors: The Asset Allocation of Public Pension Plans." Unpublished manuscript. University of Massachusetts Boston.

United States Government Accountability Office

GAO

Testimony
Before the Joint Economic Committee

For Release on Delivery
Expected at 10:00 a.m. EST
Thursday, July 10, 2008

STATE AND LOCAL GOVERNMENT PENSION PLANS

Current Structure and Funded Status

Statement of Barbara D. Bovbjerg, Director
Education, Workforce, and Income Security

GAO
Accountability * Integrity * Reliability

GAO-08-983T

G A O
Accountability Integrity Reliability

Highlights

Highlights of GAO-08-983T, a testimony before the Joint Economic Committee

July 2008

STATE AND LOCAL GOVERNMENT PENSION PLANS

Current Structure and Funded Status

Why GAO Did This Study

Millions of state and local government employees are promised pension benefits when they retire. Although these benefits are not subject, for the most part, to federal laws governing private sector benefits, there is a federal interest in ensuring that all American have a secure retirement, as reflected in the special tax treatment provided for private and public pension funds. Recently, new accounting standards have called for the reporting of liabilities for future retiree health benefits. It is unclear what actions state and local governments may take once the extent of these liabilities become clear but such anticipated fiscal and economic challenges have raised questions about the unfunded liabilities for state and local retiree benefits, including pension benefits. GAO was asked to report on (1) the current structure of state and local government pension plans and how pension benefits are protected and managed, and (2) the current funded status of state and local government pension plans. GAO spoke to a wide range of public experts and officials from various federal and nongovernmental entities, made several site visits and gathered detailed information about state benefits, and analyzed self-reported data on the funded status of state and local pension plans from the Public Fund Survey and Public Pension Coordinating Council.

What GAO Recommends

GAO is not making recommendations at this time.

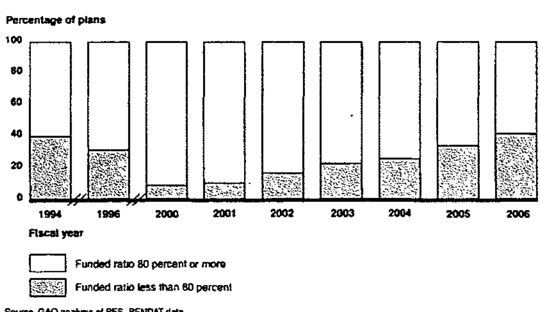
To view the full product, including the scope and methodology, click on GAO-08-983T. For more information, contact Barbara Bovbjerg at (202) 512-7215 or bovbjergb@gao.gov.

What GAO Found

State and local entities typically provide pension plans with defined benefits and a supplemental defined contribution plan for voluntary savings. Most states still have traditional defined benefit plans as the primary retirement plans for their workers. However, a couple of states have adopted defined contribution and other plans as their primary plan. State and local entities typically offer tax-deferred supplemental voluntary plans to encourage workers to save. State statutes and local ordinances protect and manage pension benefit and often include explicit protections, such as provisions stating that pensions promised to public employees cannot be eliminated or diminished. In addition, state constitutions and/or statutes often require pension plans to be managed as trust funds and overseen by boards of trustees.

Most state and local government pension plans have enough invested resources set aside to fund the benefits they are scheduled to pay over the next several decades. Many experts consider a funded ratio (actuarial value of assets divided by actuarial accrued liabilities) of about 80 percent or better to be sound for government pensions. We found that 58 percent of 65 large pension plans were funded to that level in 2006, a decrease since 2000 when about 90 percent of plans were so funded. Low funded ratios would eventually require the government employer to improve funding, for example, by reducing benefits or by increasing contributions. However, pension benefits are generally not at risk in the near term because current assets and new contributions may be sufficient to pay benefits for several years. Still, many governments have often contributed less than the amount needed to improve or maintain funded ratios. Low contributions raise concerns about the future funded status.

Percentage of State and Local Government Pension Plans with Funded Ratios above or below 80 Percent



Source: GAO analysis of PFS, PENDAT data

Mr. Chairman and Members of the Committee:

I am pleased to be here today as you consider the current structure and funded status of state and local government pension plans. Nearly 20 million employees and 7 million retirees and dependents of state and local governments—including school teachers, police, firefighters, and other public servants—are promised pensions. Although state and local pension plans are not subject, for the most part, to federal laws governing private sector pension plans, there is a federal interest in ensuring that all Americans have a secure retirement, an interest that is reflected in preferential tax treatment for contributions and investment earnings associated with qualified pension plans in both the public and private sectors.

Many pension benefits represent actuarial accrued liabilities[1] for state and local governments and ultimately the taxpayer. Typically, pension benefits are paid from a fund made up of assets from employers' and employees' annual contributions and the investment earnings from these contributions. Such a fund has an unfunded liability when the actuarial value of assets is less than actuarial accrued liabilities. Accounting standards have called for state and local governments to report their unfunded pension liabilities since 1986. Recently, new government accounting standards were issued, calling for the reporting of liabilities for future retiree health liabilities. The extent of these liabilities nationwide is not yet known, but some predict they will be very large, exceeding $1 trillion dollars nationwide in present value terms. It is unclear what actions state and local governments may take once the future costs of these liabilities become clear but such anticipated fiscal and economic challenges have raised questions about the unfunded liabilities for state and local retiree benefits, including pension plans.

My comments today are based on findings from our September 2007 report entitled State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections, and Fiscal Outlook for Funding Future Costs[2] and our January 2008 report entitled State and Local Government

[1] Actuarial accrued liabilities, referred to in this testimony as "liabilities," are the portion of the present value of future benefits that is attributable to employee services in past periods, under the actuarial cost method utilized.

[2] GAO-07-1156 (Washington, D.C.:Sept. 24, 2007).

Retiree Benefits: Current Funded Status of Pension and Health Benefits.[3] My remarks focus on (1) the current structure of state and local government pension plans and how pension benefits are protected and managed, and (2) the current funded status of state and local government pension plans.

To determine the structure of state and local pension benefits and protections, we spoke with experts, advocacy groups, and union officials from various national organizations and associations, various federal agencies, and nongovernmental entities that analyze government data and conduct surveys on these topics. We also conducted site visits and gathered detailed information about the benefits provided in three states, California, Michigan, and Oregon. To illustrate a wide range of retiree benefit system characteristics, in some instances we complemented information gathered during our site visits with information gathered about retiree benefits provided in other state and local jurisdictions. To determine the current funded status of state and local government pension plans, we analyzed self-reported data from the Public Fund Survey (PFS) as well as surveys by the Public Pension Coordinating Council (PPCC).[4] We conducted our performance audits from July 2006 to January 2008 in accordance with generally accepted government auditing standards, which included an assessment of data reliability. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions on our audit objectives.

In summary, we found that state and local entities typically provide a pension plan with defined benefits and a supplemental defined contribution plan for voluntary savings. As of 2007, most states still have traditional defined benefit plans as the primary retirement plans for their workers. Only two states (Alaska and Michigan) and the District of Columbia had adopted defined contribution plans as their primary plans for general public employees. Two other states (Indiana and Oregon) had

[3] GAO-08-223 (Washington, D.C.: Jan. 29, 2008).

[4] The PFS is sponsored by the National Association of State Retirement Administrators and the National Council on Teacher Retirement. In 2005, the PFS data we used represented 58 percent of total assets invested in public pension plans nationwide, and 72 percent of total members. PFS data covered years beginning with 2001. PPCC data covered years 1994, 1996, and 2000.

adopted primary plans with both defined benefit and defined contribution components, while one state (Nebraska) had adopted a cash balance defined benefit plan as its primary plan. State statutes and local ordinances typically protect pension plan benefits, often including explicit protections such as provisions stating that pensions promised to public employees cannot be eliminated or diminished. State constitutions and/or statutes often require pension plans to be managed as trust funds and overseen by boards of trustees, which typically establish overall policies for the operation and management of the pension plans, including adopting actuarial assumptions for calculating liabilities, establishing procedures for financial control and reporting, and setting investment strategies. We also found that more than half of public pension plans reported that they have put enough assets aside in advance to pay for benefits over the next several decades. Although many experts consider a funded ratio of about 80 percent or better to be sound for government pensions, the percentage of pension plans with funded ratios below 80 percent has increased in recent years. Available data show that 58 percent of 65 large pension plans were funded to that level in 2006, a decrease since 2000 when about 90 percent of plans were so funded. A few plans are persistently and significantly underfunded, and although members of these plans may not be at risk of losing benefits in the near term, the unfunded liabilities will have to be made up in the future. Finally, a number of governments reported not contributing enough to reduce unfunded liabilities. Low contributions raise concerns about the future funded status, and may shift costs to future generations.

Background

Pension plans can generally be characterized as either defined benefit or defined contribution plans. In a defined benefit plan, the amount of the benefit payment is determined by a formula typically based on the retiree's years of service and final average salary, and is most often provided as a lifetime annuity. For state and local government retirees, postretirement cost-of-living adjustments (COLAs) are frequently provided in defined benefit plans. But benefit payments are generally reduced for early retirement, and in some cases payments may be offset for receipt of Social Security.[5] In a defined contribution plan, the key determinants of the benefit amount are the employee's and employer's contribution rates, and

[6] Unlike in the private sector, there are large groups of state and local government workers who are not covered by Social Security. According to data from the Social Security Administration, about 30 percent of all state and local government workers nationwide are not covered, although the extent of coverage varies widely by state and by occupation.

the rate of return achieved on the amounts contributed to an individual's account over time. The employee assumes the investment risk; the account balance at the time of retirement is the total amount of funds available, and unlike with defined benefit plans, there are generally no COLAs. Until depleted, however, a defined contribution account balance may continue to earn investment returns after retirement, and a retiree could use the balance to purchase an inflation-protected annuity. Also, defined contribution plans are more portable than defined benefit plans, as employees own their accounts individually and can generally take their balances with them when they leave government employment. There are no reductions based on early retirement or for participation in Social Security.[4]

Both government employers and employees generally make contributions to fund state and local pension benefits. For plans in which employees are covered by Social Security, the median contribution rate in fiscal year 2006 was 8.5 percent of payroll for employers and 5 percent of pay for employees, in addition to 6.2 percent of payroll from both employers and employees to Social Security. For plans in which employees are not covered by Social Security, the median contribution rate was 11.5 percent of payroll for employers and 8 percent of pay for employees. Actuaries estimate the amount that will be needed to pay future benefits. The benefits that are attributable to past service are called "actuarial accrued liabilities." (In this report, the actuarial accrued liabilities are referred to as "liabilities." Actuaries calculate liabilities based on an actuarial cost method and a number of assumptions including discount rates and worker and retiree mortality. Actuaries also estimate the "actuarial value of assets" that fund a plan. (In this report, the actuarial value of assets is referred to simply as "assets"). The excess of actuarial accrued liabilities over the actuarial value of assets is referred to as the "unfunded actuarial accrued liability" or "unfunded liability." Under accounting standards, such information is disclosed in financial statements. In contrast, the liability that is recognized on the balance sheet is the cumulative excess of annual benefit costs over contributions to the plan. Certain amounts included in the actuarial accrued liability are not yet recognized as annual benefit costs under accounting standards, as they are amortized over several years.

[4] There could, however, be federal tax penalties if funds are withdrawn before the employee reaches a certain age. 26 U.S.C. § 72(t).

State and local government pension plans are not covered by most of the substantive requirements, or the insurance program operated by the Pension Benefit Guaranty Corporation (PBGC), under the Employee Retirement Income Security Act of 1974 (ERISA), which apply to most private employer benefit plans. Federal law generally does not require state and local governments to prefund or report on the funded status of pension plans. However, in order to receive preferential tax treatment, state and local pensions must comply with requirements of the Internal Revenue Code. In addition, the retirement income security of Americans is an ongoing concern of the federal government.

Although ERISA imposes participation, vesting, and other requirements directly upon employee pension plans offered by private sector employers, governmental plans such as those provided by state and local governments to their employees are excepted from these requirements. In addition, ERISA established an insurance program for defined benefit plans under which promised benefits are paid (up to a statutorily set amount) if an employer cannot pay them—but this too does not apply to governmental plans. However, for participants in governmental pension plans to receive preferential tax treatment (that is, for plan contributions and investment earnings to be tax-deferred), plans must be deemed "qualified" by the Internal Revenue Service.[7]

Since the 1980s, the Governmental Accounting Standards Board (GASB) has maintained standards for accounting and financial reporting for state and local governments. GASB operates independently and has no authority to enforce the use of its standards. Still, many state laws require local governments to follow GASB standards, and bond raters do consider whether GASB standards are followed. Also, to receive a "clean" audit opinion under generally accepted accounting principles, state and local governments are required to follow GASB standards. These standards require disclosing financial information on pensions, such as the amount of contributions and the ratio of assets to liabilities.

Three measures are key to understanding pension plans' funded status: contributions, funded ratios, and unfunded liabilities. According to experts

[7] Contributions to qualified pension plans that meet certain requirements—whether defined benefit or defined contribution—are not counted as taxable income to employees when the contributions are made. However, when pension benefits are paid, amounts not previously taxed are subject to federal and perhaps state tax. This also applies to the interest income such contributions generate.

we interviewed, any single measure at a point in time may give a dimension of a plan's funded status, but it does not give a complete picture. Instead, the measures should be reviewed collectively over time to understand how the funded status is improving or worsening. For example, a strong funded status means that, over time, the amount of assets, along with future schedule contributions, comes close to matching a plan's liabilities.[8]

Under GASB reporting standards, the funded status of different pension plans cannot be compared easily because governments use different actuarial approaches such as different actuarial cost methods, assumptions, amortization periods, and "smoothing" mechanisms. Most public pension plans use one of three "actuarial cost methods," out of the six GASB approves.[9] Actuarial costs methods differ in several ways. First, each uses a different approach to calculate the "normal cost," the portion of future benefits that the cost method allocates to a specific year, resulting in different funding patterns for each.[10] In addition to the cost methods, differences in assumptions used to calculate the funded status can result in significant differences among plans that make comparison difficult. Also differences in amortization periods make it difficult to compare the funded status of different plans. Finally, actuaries for many plans calculate the value of current assets based on an average value of past years. As a result, if the value of assets fluctuates significantly from year to year, the "smoothed" value of assets changes less dramatically. Comparing the funded status of plans that use different smoothing periods

[8] For more extensive information on the three key measures see *State and Local Government Retiree Benefits: Current Funded Status of Pension and Health Benefits*, GAO-08-223 (Washington, D.C.: Jan. 29, 2008).

[9] The three most commonly used actuarial cost methods are the projected unit credit (projected benefits of each employee covered by the plan are allocated by a consistent formula to valuation years); entry age normal (the current value of future benefits of each employee is allocated on a level basis over the earnings or service of the employee between entry age and assumed exit age); and aggregate (the excess of the value of future benefits of all employees over the current value of assets is allocated on a level basis over the earnings or service of the group between the valuation date and assumed exit. This allocation is performed for the group as a whole, not as a sum of individual allocations).

[10] Actuarial cost methods are used to allocate the current value of future benefits into amounts attributable to the past, to the current year, and to future years. The cost of future benefits that are attributable to past years under the actuarial cost method is called the actuarial accrued liability (AAL), while the cost of benefits accrued under the cost method in the current year is known as the normal cost.

can be confusing because the value of the different plans' assets reflects a different number of years.[11]

We reported recently that state and local governments will likely face daunting fiscal challenges, driven in large part by the growth in health-related costs, such as Medicaid and health insurance for state and local employees. Our report was based on simulations for the state and local government sector that indicated that in the absence of policy changes, large and growing fiscal challenges will likely emerge within a decade.[12] We found that, as is true for the federal sector, the growth in health-related costs is a primary driver of these fiscal challenges.

State And Local Government Pension Plans Typically Include A Defined Benefit Plan And A Supplemental Voluntary Savings Plan And Laws Protect Benefits

State and local governments typically provide their employees with retirement benefits that include a defined benefit plan and a supplemental defined contribution plan for voluntary savings. However, the way each of these components is structured and the level of benefits provided varies widely--both across states, and within states based on such things as date of hire, employee occupation, and local jurisdiction. Statutes and local ordinances protect and manage pension plans and are often anchored by provisions in state constitutions and local charters. State and local law also typically requires that pensions be managed as trust funds and overseen by boards.

Defined Benefit Plans Provide the Core Benefits for Most Retirees

Most state and local government workers are provided traditional pension plans with defined benefits. About 90 percent of full-time state and local employees participated in defined benefit plans as of 1998.[13] In fiscal year 2006, state and local government pension systems covered 18.4 million members and made periodic payments to 7.3 million beneficiaries, paying

[11] For more extensive information on the actuarial cost methods and comparisons see *State and Local Government Retiree Benefits: Current Funded Status of Pension and Health Benefits*, GAO-08-223 (Washington, D.C.: Jan. 29, 2008).

[12] GAO, State and Local Governments: *Persistent Fiscal Challenges Will Likely Emerge within the Next Decade*, GAO-07-1080SP (Washington, D.C.: July 18, 2007).

[13] The last year for which the Bureau of Labor Statistics published these data was 1998. U.S. Department of Labor, Bureau of Labor Statistics, *Employee Benefits in State and Local Governments, 1998* (Washington, D.C.: 2000).

out $151.7 billion in benefits. State and local government employees are generally required to contribute a percentage of their salaries to their defined benefit plans, unlike private sector employees, who generally make no contribution when they participate in defined benefit plans. According to a 50-state survey conducted by Workplace Economics, Inc., 43 of 48 states with defined benefit plans reported that general state employees were required to make contributions ranging from 1.25 to 10.5 percent of their salaries. Nevertheless, these contributions have no influence on the amount of benefits paid because benefits are based solely on the formula.

In 1998, all states had defined benefit plans as their primary pension plans for their general state workers except for Michigan and Nebraska (and the District of Columbia), which had defined contribution plans as their primary plans, and Indiana, which combined both defined benefit and defined contribution components in its primary plan.[14] Almost a decade later, we found that as of 2007, only one additional state (Alaska) had adopted a defined contribution plan as its primary plan; one additional state (Oregon) had adopted a combined plan, and Nebraska had replaced its defined contribution plan with a cash balance defined benefit plan. (See fig. 1.) Although still providing defined benefit plans as their primary plans for general state employees, some states also offer defined contribution plans (or hybrid defined benefit/defined contribution plans) as optional alternatives to their primary plans. These states include Colorado, Florida, Montana, Ohio, South Carolina, and Washington.

[14] See GAO, State and Pension Plans: Similarities and Differences Between Federal and State Designs, GAO/GGD-99-45 (Washington, D.C.:Mar. 19, 1999). Also, as of 1998, across all state and local employees nationwide, Bureau of Labor Statistics survey data indicate that 90 percent were covered by defined benefit plans.

Figure 1: Types of Pension Plans in Place for Newly Hired General State Employees, as of 2007

Traditional defined benefit

Cash balance defined benefit

Combined (with both definite benefit and defined contribution components)

Defined contribution

Source: GAO analysis of data from various national organizations and from individual states' reports and publications

Note: Plans depicted are those in which newly hired general state employees in each state are required to participate as their primary pension plan. In some states, employees may opt to participate in alternative or supplementary defined contribution plans, but participation in these plans is not mandatory.

In states that have adopted defined contribution plans as their primary plans, most employees continue to participate in defined benefit plans because employees are allowed to continue their participation in their previous plans (which is rare in the private sector).[15] Thus, in contrast to the private sector, which has moved increasingly away from defined benefit plans over the past several decades, the overwhelming majority of states continue to provide defined benefit plans for their general state employees.

Most states have multiple pension plans providing benefits to different groups of state and local government workers based on occupation (such as police officer or teacher) and/or local jurisdiction. According to the most recent Census data available, in fiscal year 2004-2005 there were a total of 2,656 state and local government pension plans. We found that defined benefit plans were still prevalent for most of these other state and local employees as well. For example, a nationwide study conducted by the National Education Association in 2006 found that of 99 large pension plans serving teachers and other school employees, 79 were defined benefit plans, 3 were defined contribution plans, and the remainder offered a range of alternative, optional, or combined plan designs with both defined benefit and defined contribution features.

In addition to primary pension plans (whether defined benefit or defined contribution), data we gathered from various national organizations show that each of the 50 states has also established a defined contribution plan as a supplementary, voluntary option for tax-deferred retirement savings for their general state employees. Such plans appear to be common among other employee groups as well.[16] These supplementary defined contribution plans are typically voluntary deferred compensation plans under section 457(b) of the federal tax code.[17]

While these defined contribution plans are fairly universally available, state and local worker participation in the plans has been modest. In a

[15] In the private sector, when a new plan is adopted, the previous plan is often frozen. Existing employees keep the benefits they have accrued to date, but cannot continue to participate in the previous plan from that point forward. In the public sector, when a new plan is adopted, existing employees generally are allowed to continue to participate in the previous plan. Generally only new employees, hired after adoption of the new plan, are required to participate in the new plan from that point forward.

[16] In addition, over the past 10 years, many public sector employers have established deferred retirement options plans (DROP). DROPs were created to retain experienced employees by permitting those eligible to retire to stay on the job and earn a lump-sum payment at retirement in addition to their defined benefit annuity.

[17] 26 U.S.C. § 457(b).

2006 nationwide survey conducted by the National Association of Government Defined Contribution Administrators, the average participation rate for all defined contribution plans was 21.6 percent.

One reason cited for low participation rates in these supplementary plans is that, unlike in the private sector, it has been relatively rare for employers to match workers' contributions to these plans, but the number of states offering a match has been increasing. According to a state employee benefit survey of all 50 states conducted by Workplace Economics, Inc., in 2006 12 states matched the employee's contribution up to a specified percent or dollar amount.[18] Among our site visit states, none made contributions to the supplementary savings plans for their general state employees, and employee participation rates generally ranged between 20 to 50 percent. In San Francisco, however, despite the lack of an employer match, 75 percent of employees had established 457(b) accounts. The executive director of the city's retirement system attributed this success to several factors, including (1) that the plan had been in place for over 25 years, (2) that the plan offers good investment options for employees to choose from, and (3) that plan administrators have a strong outreach program. In the private sector, a growing number of employers are attempting to increase participation rates and retirement savings in defined contribution plans by automatically enrolling workers and offering new types of investment funds.[19]

Laws Protecting Pensions Are often Anchored in State Constitutions and Local Charters

State and local laws generally provide the most direct source of any specific legal protections for the pensions of state and local workers. Provisions in state constitutions often protect pensions from being eliminated or diminished. In addition, constitutional provisions often specify how pension funds are to be managed, such as by mandating certain funding requirements and/or requiring that the funds be overseen

[18] The Workplace Economics, Inc. 2006 survey instructed states to provide information on benefits that cover the largest number of employees, or that were otherwise deemed representative.

[19] GAO, *Employer-Sponsored Health and Retirement Benefits: Efforts to Control Employer Costs and the Implications for Workers*, GAO-07-355 (Washington, D.C.: Mar. 30, 2007).

by boards of trustees.[20] Moreover, we found that at the sites we visited, locally administered plans were generally governed by local laws. However, state employees, as well as the vast majority of local employees, are covered by state-administered plans.

Protections for pensions in state constitutions are the strongest form of legal protection states can provide because constitutions—which set out the system of fundamental laws for the governance of each state—preempt state statutes and are difficult to change. Furthermore, changing a state constitution usually requires broad public support. For example, often a supermajority (such as three-fifths) of a state's legislature may need to first approve proposed constitutional changes and typically if a change passes the legislature, voters must also approve it.

The majority of states have some form of constitutional protection for their pensions. According to AARP data compiled in 2000, 31 states have a total of 93 constitutional provisions explicitly protecting pensions.[21] (The other 19 states all have pension protections in their statutes or recognize legal protections under common law.) These constitutional pension provisions prescribe some combination of how pension trusts are to be funded, protected, managed, or governed. (See table 1.)

Table 1: Constitutional Protections for Pension Benefits

Constitutional provisions requiring	States	Number of states
Certain standards are to be in place for how the retirement system should be funded.	Arizona, Florida, Georgia, Louisiana, Maine, Michigan, Mississippi, Montana, New Hampshire, New Mexico, North Dakota, South Carolina, Texas, and Virginia	14
Assets in a trust fund are to be for the exclusive purpose of the retirement system.	Alabama, Arizona, California, Louisiana, Maine, Mississippi, Montana, New Hampshire, New Mexico, North Carolina, Oklahoma, Texas, Virginia, and Wyoming	14
Trust fund assets are not to be diverted for nonretirement uses.	Alabama, Louisiana, Maine, Mississippi, Montana, Nevada, New Hampshire, New Mexico, North Carolina, Oklahoma, South Carolina, Texas, and Virginia	13

[20] Given the ways in which defined contribution plans differ from defined benefit plans, these types of provisions may be less readily applicable or relevant to them.

[21] Although the AARP study focused on pension plans for a particular group of public employees (retired educators), our analysis revealed that the provisions identified in all but two states were applicable to pension plans for all state employees. In addition, we learned that subsequent to this study, Oregon adopted a constitutional provision in 2003 to authorize the issuance of pension obligation bonds.

Constitutional provisions requiring	States	Number of states
Retirement system boards of trustees are to be off limits to the legislature.	California, Montana, Nevada, New Mexico, and Texas	5
Participants in a retirement system have a guaranteed right to a benefit, and that accrued financial benefits cannot be eliminated or diminished.	Alaska, Arizona, Hawaii, Illinois, Louisiana, Michigan, Missouri, New Mexico, and New York	9
States have investment authority for their retirement systems.	Indiana, Michigan, Montana, Nebraska, South Carolina, Washington, and West Virginia	7
Retirement system money is to be held in a separate trust fund.	Arizona, California, Nevada, New Mexico, and Virginia	5
Retirement benefits may be increased.	Georgia, Nebraska, Pennsylvania, Washington, and Wisconsin	5
A retirement system is required.	Louisiana, Texas, and Virginia.	3
The payment of retirement benefits is authorized.	Georgia and Oklahoma.	2
Other protections are in place, such as prohibiting constitutional changes to the retirement system through the initiative process.	Mississippi, Missouri, Nebraska, and Nevada.	4

Source AARP, 2000

Pensions Benefits, Once Accrued, Are Generally Protected

In nine states, constitutional provisions take the form of a specific guarantee of the right to a benefit. In two of the states we visited, the state constitution provided protection for pension benefits. In California, for example, the state constitution provides that public plan assets are trust funds to be used only for providing pension benefits to plan participants.[22] In Michigan, the state constitution provides that public pension benefits are contractual obligations that cannot be diminished or impaired and must be funded annually.[23]

The basic features of pension plans—such as eligibility, contributions, and types of benefits—are often spelled out in state or local statute. State-administered plans are generally governed by state laws. For example, in California, the formulas used to calculate pension benefit levels for employees participating in the California Public Employees' Retirement System (CalPERS) are provided in state law.[24] Similarly, in Oregon, pension benefit formulas for state and local employees participating in the

[22] Cal. Const., art. XVI § 17.

[23] Mich. Const., art. IX §19 and 24.

[24] For example, see Cal. Gov't. Code § 21353 (Deering 2007).

Oregon Public Employees Retirement System (OPERS) plans are provided in state statute.[25] In addition, we found that at the sites we visited locally administered plans were generally governed by local laws. For example, in San Francisco, contribution rates for employees participating in the San Francisco City and County Employees' Retirement System are spelled out in the city charter.[26]

Legal protections usually apply to benefits for existing workers or benefits that have already accrued; thus, state and local governments generally can change the benefits for new hires by creating a series of new tiers or plans that apply to employees hired only after the date of the change. For example, the Oregon legislature changed the pension benefit for employees hired on or after January 1, 1996, and again for employees hired on or after August 29, 2003, each time increasing the retirement age for the new group of employees.

For some state and local workers whose benefit provisions are not laid out in detail in state or local statutes, specific provisions are left to be negotiated between employers and unions.[27] For example, in California, according to state officials, various benefit formula options for local employees are laid out in state statutes, but the specific provisions adopted are generally determined through collective bargaining between the more than 1,500 different local public employers and rank-and-file bargaining units. In all three states we visited, unions also lobby the state legislature on behalf of their members. For example, in Michigan, according to officials from the Department of Management and Budget, unions marshal support for or against a proposal by taking such actions as initiating letter-writing campaigns to support or oppose legislative measures.

Pensions Are Typically Managed as Trust Funds with Board Oversight

In accordance with state constitution and/or statute, the assets of state and local government pension plans are typically managed as trusts and overseen by boards of trustees to ensure that the assets are used for the sole purpose of meeting retirement system obligations and that the plans

[25] Or. Rev. Stat. § 238.300 (2005).

[26] San Francisco City Charter A8.525.

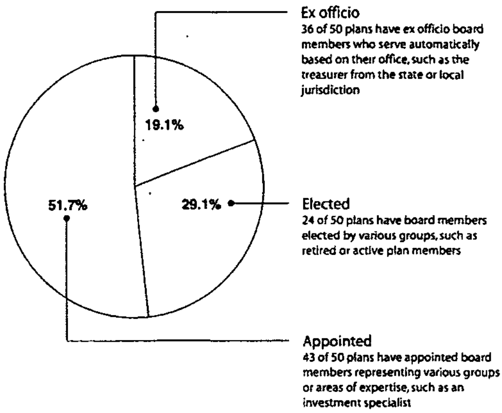
[27] The influence of unions on public employees benefits is stronger than in the private sector. Over 40 percent of public sector workers—including federal, state, and local government—are covered by union agreements, compared with about 10 percent of private sector workers.

are in compliance with the federal tax code.[28] Boards of trustees, of varying size and composition, often serve the purpose of establishing the overall policies for the operation and management of the pension plans, which can include adopting actuarial assumptions, establishing procedures for financial control and reporting, and setting investment strategy. On the basis of our analysis of data from the National Education Association, the National Association of State Retirement Administrators (NASRA), and reports and publications from selected states, we found that 46 states had boards overseeing the administration of their pension plans for general state employees.[29] These boards ranged in size from 5 to 19 members, with various combinations of those elected by plan members, those appointed by a state official, and those who serve automatically based on their office in state government (known as ex officio members). (See fig. 2.)

[28] A trust established by an employer for the exclusive benefit of its employees, and any income it generates, is exempt from federal income tax. 26 U.S.C. § 501(a).

[29] The four states that do not have boards overseeing the operation and management of their pension plans for general state employees are Florida, Iowa, New York, and Washington. (In addition, the District of Columbia does not have a board overseeing its pension plan for its general employees.)

Figure 2: Various Interests Represented on Boards of Each State's Pension Plan for General State Employees



Source: GAO analyses of board membership for the primary pension plans for general state employees in each state, based on data from various national organizations and from individual states' reports and publications.

Note: Percentages do not total 100 because of rounding.

Different types of members bring different perspectives to bear, and can help to balance competing demands on retirement system resources. For example, board members who are elected by active and retired members of the retirement system, or who are union members, generally help to ensure that members' benefits are protected. Board members who are appointed sometimes are required to have some type of technical knowledge, such as investment expertise. Finally, ex officio board members generally represent the financial concerns of the state government.

Some pension boards do not have each of these perspectives represented. For example, boards governing the primary public employee pension plans in all three states we visited had various compositions and responsibilities. (See table 2.) At the local level, in Detroit, Michigan, a majority of the board of Detroit's General Retirement System is composed of members of the system. According to officials from the General Retirement System, this is thought to protect pension plan assets from being used for purposes other than providing benefits to members of the retirement system. Regarding responsibilities, the board administers the General Retirement System and, as specified in local city ordinances, is responsible for the system's proper operation and investment strategy.

Table 2: Composition and Responsibilities of Boards of Primary Public Employee Pension Plans in California, Michigan, and Oregon

State	Pension plan	Number of board members	Composition of board members	Board responsible for
California	California Public Employees' Retirement System (CalPERS)	13	3 appointed 6 elected 4 ex officio[a]	Management and control of CalPERS, including the exclusive control of the administration and investment of the retirement fund.[b]
Michigan	Michigan State Employees' Retirement System (MSERS)	9	4 appointed 5 ex officio[c]	Administering and managing the defined benefit plan by making investment decisions and arranging for an actuarial valuation.[d]
Oregon	Oregon Public Employees' Retirement System (OPERS)	5	5 appointed[e]	Managing the retirement system, including responsibilities such as arranging for actuarial services and publishing an annual report on the retirement system.

Source: Statutes, as cited below

[a]Cal. Govt. Code § 20090 (Deering, 2007).

[b]Cal. Gov't. Code § 20120 (Deering, 2007).

[c]Mich. Comp. Laws § 38.3 (2007).

[d]Mich. Comp. Laws § 38.2 (2007). The defined contribution plan is administered and its assets invested by the state treasurer. Mich. Comp. Laws § 38.9 (2007)

[e]Or. Rev. Stat § 238.660 (2005).

Pension boards of trustees typically serve as pension plan fiduciaries, and as fiduciaries, they usually have significant independence in terms of how they manage the funds. Boards make policy decisions within the framework of the plan's enabling statutes, which may include adopting actuarial assumptions,[30] establishing procedures for financial control and reporting, and setting investment policy. In the course of managing pension trusts, boards generally obtain the services of independent advisors, actuaries, or investment professionals.

[30]Actuarial assumptions are assumptions as to the occurrence of future events affecting pension costs, such as mortality, retirement, and rates of investment earnings.

Also, some states' pension plans have investment boards in addition to, or instead of, general oversight boards. For example, three of the four states without general oversight boards have investment boards responsible for setting investment policy. While public employees may have a broad mandate to serve all citizens, board members generally have a fiduciary duty to act solely in the interests of plan participants and beneficiaries. One study of approximately 250 pension plans at the state and local level found that plans with boards overseeing them were associated with greater funding than those without boards.[31]

When state pension plans do not have a general oversight board, these responsibilities tend to be handled directly by legislators and/or senior executive officials. For example, in the state of Washington, the pension plan for general state employees is overseen by the Pension Funding Council—a six-member body whose membership, by statute, includes four state legislators.[32] The council adopts changes to economic assumptions and contribution rates for state retirement systems by majority vote. In Florida, the Florida Retirement System is not overseen by a separate independent board; instead, the pension plan is the responsibility of the State Board of Administration, composed of the governor, the chief financial officer of the state, and the state attorney general.[Footnote 37] In New York, the state comptroller, an elected official, serves as sole trustee and administrative head of the New York State and Local Employees' Retirement System.[33]

Most Public Pensions Have Assets To Pay Benefits Over Several Decades, But Contributions Vary

Currently, most state and local government pension plans have enough invested resources set aside to pay for the benefits they are scheduled to pay over the next several decades. Many experts consider a funded ratio of about 80 percent or better to be sound for state and local government pensions. While most plans' funding may be sound, a few plans have persistently reported low funded ratios, which will eventually require the government employer to improve funding, for example, by reducing benefits or by increasing contributions. Even for many plans with lower funded ratios, benefits are generally not at risk in the near term because

[31] Marquerite Schneider and Fariborz Damanpour, "Public Choice Economics and Public Pension Plan Funding: An Empirical Test," *Administration and Society*, vol. 34, no. 1 (2002).

[32] Wash. Rev. Code §41.45.100 (2007).

[33] Fla. Stat. § 215.44 (2007).

current assets and new contributions may be sufficient to pay benefits for several years. Still, many governments have often contributed less than the amount need to improve or maintain funded ratios. Low contributions raise concerns about the future funded status, and may shift costs to future generations.

Most Public Pension Plans Have Enough Funds to Pay for Benefits over the Long-Term

Most public pension plans report having sufficient assets to pay for retiree benefits over the next several decades. Many experts and officials to whom we spoke consider a funded ratio of 80 percent to be sufficient for public plans for a couple of reasons.[34] First, it is unlikely that public entities will go out of business or cease operations as can happen with private sector employers, and state and local governments can spread the costs of unfunded liabilities over a period of up to 30 years under current GASB standards. In addition, several commented that it can be politically unwise for a plan to be overfunded; that is, to have a funded ratio over 100 percent. The contributions made to funds with "excess" assets can become a target for lawmakers with other priorities or for those wishing to increase retiree benefits.

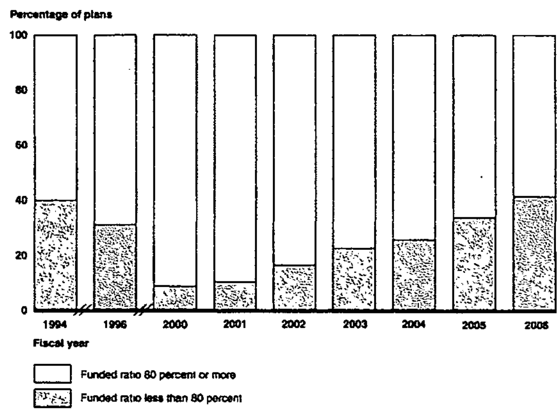
More than half of state and local governments' plans reviewed by the Public Fund Survey (PFS) had a funded ratio of 80 percent or better in fiscal year 2006, but the percentage of plans with a funded ratio of 80 percent or better has decreased since 2000, as shown in figure 3.[35] Our analysis of the PFS data on 65 self-reported state and local government pension plans showed that 38 (58 percent) had a funded ratio of 80 percent or more, while 27 (42 percent) had a funded ratio of less than 80 percent. In the early 2000s, according to one study, the funded ratio of 114 state and

[34] The Pension Protection Act of 2006 provided that large private sector pension plans will be considered at risk of defaulting on their liabilities if they have less than 80 percent funded ratios under standard actuarial assumptions and less than 70 percent funded ratios under certain additional "worst-case" actuarial assumptions. When private sector plans default on their liabilities, PBGC becomes liable for benefits. These funding standards will be phased in, becoming fully effective in 2011, and at-risk plans are required to use stricter actuarial assumptions that will result in them having to make larger plan contributions. Pub. L. No. 109-280, sec. 112(a), § 430(i), 120 Stat. 780, 839-42.

[35] In this section, we refer to our analysis of the PFS and PENDAT database. The PFS is sponsored by the National Association of State Retirement Administrators and the National Council on Teacher Retirement. These sources contain self-reported data on state and local government pension plans in years 1994, 1996, and 2000 to 2006. Each year, between 62 and 72 plans were represented in our dataset. In 2005, the 70 plans represented 58 percent of total assets invested in public pension plans nationwide in 2005, and 72 percent of total members

local government pension plans together reached about 100 percent; it has since declined.[36] In fiscal year 2006, the aggregate funded ratio was about 86 percent. Some officials attribute the decline in funded ratios since the late 1990s to the decline of the stock market, which reduced the value of assets. This sharp decline would likely affect funded ratios for several years because most plans use smoothing techniques to average out the value of assets over several years. Our analysis of several factors affecting the funded ratio showed that changes in investment returns had the most significant impact on the funded ratio between 1988 and 2005, followed by changes in liabilities.[37]

Figure 3: Percentage of State and Local Government Pension Plans with Funded Ratios above or below 80 Percent, by Fiscal Year



Source: GAO analysis of PFS, PENDAT data

[36] K. Brainard, *Public Fund Survey Summary of Findings for FY 2006*, National Association of State Retirement Administrators (Georgetown, Tex.: October 2007).

[37] These findings may be unique to the time period examined (1988-2005). In other periods, other factors, such as changes to benefits, may account for more of the change in the funded ratio than the rates of return on the investment portfolio.

Although most plans report being soundly funded in 2006, a few have been persistently underfunded, and some plans have seen funded ratio declines in recent years.[38] We found that several plans in our data set had funded ratios below 80 percent in each of the years for which data is available. Of 70 plans in our data set, 6 had funded ratios below 80 percent for 9 years between 1994 and 2006. Two plans had funded ratios below 50 percent for the same time period. In addition, of the 27 plans that had funded ratios below 80 percent in 2006, 15 had lower funded ratios in 2006 than in 1994. The sponsors of these plans may be at risk in the future of increased budget pressures.

By themselves, lower funded ratios and unfunded liabilities do not necessarily indicate that benefits for current plan members are at risk, according to experts we interviewed. Unfunded liabilities are generally not paid off in a single year, so it can be misleading to review total unfunded liabilities without knowing the length of the period over which the government plans to pay them off. Large unfunded liabilities may represent a fiscal challenge, particularly if the period to pay them off is short. But all unfunded liabilities shift the responsibility for paying for benefits accrued in past years to the future.

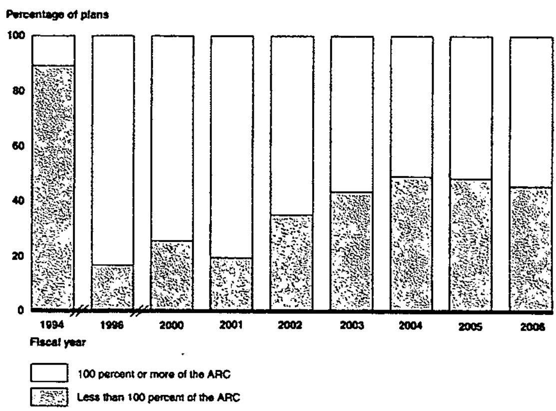
Unfunded liabilities will eventually require the government employer to increase revenue, reduce benefits or other government spending, or do some combination of these. Revenue increase could include higher taxes, returns on investments, or employee contributions. Nevertheless, we found that unfunded liabilities do not necessarily imply that pension benefits are at risk in the near term. Current funds and new contributions may be sufficient to pay benefits for several years, even when funded rations are relatively low.

[38] Reports estimate total unfunded liabilities for public pension plans nationwide between \$307 and \$385 billion, but the estimates do not cover all state and local government plans. One study by the National Association of State Retirement Administrators reviewed the funding status of 125 of the nation's large public pension plans in fiscal year 2006 and found total unfunded liabilities to be more than \$385 billion. Another study reviewed state-only pension plans and found that in 2005, the most recent year for which substantially complete data was available, total unfunded liabilities for 108 plans were about \$307 billion. Neither study is a random sample of state and local government pension plans that represents all public plans nationwide. NASRA *Public Fund Survey* (2006). This estimate represents 85 percent of public plan assets nationwide. Wilshire Consulting, *2007 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation* (2007). This study includes only state plans, not local plans.

Some Pension Sponsors Do Not Contribute Enough to Improve Funding Status

A number of governments reported not contributing enough to keep up with yearly costs. Governments need to contribute the full annual required contribution (ARC) yearly to maintain the funded ratio of a fully funded plan or improve the funded ratio of a plan with unfunded liabilities.[39] In fiscal year 2006, the sponsors of 46 percent of the 70 plans in our data set contributed less than 100 percent of the ARC, as shown in figure 4, including 39 percent that contributed less than 90 percent of the ARC. In fact, the percentage of governments contributing less than the full ARC has risen in recent years. This continues a trend in recent years of about half of governments making full contributions.

Figure 4: Percentage of State and Local Government Pension Plans for which Governments Contributed More or Less Than 100 Percent of the ARC, by Fiscal Year



Source: GAO analysis of PFS, PENDAT data

[39]The ARC is made up of the amount of future benefits promised to plan participants that accumulated in the current year, plus a portion of any unfunded liabilities. Although the ARC refers to the annual required contribution, the use of the word "required" can be misleading because governments can choose to pay more or less than this amount.

In particular, some of the governments that did not contribute the full ARC in multiple years were sponsors of plans with lower funded ratios. In 2006, almost two-thirds of plans with funded ratios below 80 percent in 2006 did not contribute the full ARC in multiple years. Of the 32 plans that in 2006 had funded ratios below 80 percent, 20 did not contribute the full ARC in more than half of the 9 years for which data is available. In addition, 17 of these governments did not contribute more than 90 percent of the full ARC in more than half the years.

State and local government pension representatives told us that governments may not contribute the full ARC each year for a number of reasons. First, when state and local governments are under fiscal pressure, they may have to make difficult choices about paying for competing interests. State and local governments will likely face increasing fiscal challenges in the next several years as the cost of health care continues to rise. In light of this stress, the ability of some governments to continue to pay the ARC may be questioned. Second, changes in the value of assets can affect governments' expectations about how much they will have to contribute. Moreover, some plans have contribution rates that are fixed by constitution, statute, or practice and do not change in response to changes in the ARC. Even when the contribution rate is not fixed, the political process may take time to recognize and act on the need for increased contributions. Nonetheless, many states have been increasing their contribution rates in recent years, according to information compiled by the National Conference of State Legislatures. Third, some governments may not contribute the full ARC because they are not committed to prefunding their pension plans and instead have other priorities.

When a government contributes less than the full ARC, the funded ratio can decline and unfunded liabilities can rise, if all other assumptions are met about the change in assets and liabilities.[40] Increased unfunded liabilities will require larger contributions in the future to keep pace with the liabilities that accrue each year and to make up for liabilities that accrued in the past. As a result, costs are shifted from current to future generations.

[40] When a government does not contribute at least the normal cost plus interest on the unfunded liability (which is an amount less than the full ARC), unfunded liabilities will increase.

Conclusions

The funded status of state and local government pensions overall is reasonably sound, though recent deterioration underscores the importance of keeping up with contributions. Since the stock market downturn in the early 2000s, the funded ratios of some governments have declined. Although governments can gradually recover from these losses, the failure of some to consistently make the annual required contributions undermines that progress and is cause for concern. This is especially important as state and local governments face increasing fiscal pressure in the coming decades.

The ability to maintain current levels of public sector retiree benefits will depend, in large part, on the nature and extent of the fiscal challenges these governments face in the years ahead. As state and local governments begin to comply with GASB accounting and reporting standards, information about the future costs of retiree health benefits will become more transparent. In light of the initial estimates of the cost of future retiree health benefits, state and local governments will likely have to find new strategies for dealing with their unfunded liabilities. Although public sector workers have thus far been relatively shielded from many of the changes that have occurred in private sector defined benefit commitments, these protections could undergo revision under the pressure of overall future fiscal commitments.

We are continuing our work on state and local government retiree benefits. We have two engagements underway; the first study will examine the various approaches these governments are taking to address their retiree health care liabilities, while the second examines the ways state and local governments allocate the assets in their pension and retiree health care funds. We are pleased that this committee is interested in our work and look forward to working with you in the future.

That concludes my testimony: I would be pleased to respond to any questions the committee has.

Contacts and Acknowledgments

For further information regarding this testimony, please contact Barbara D. Bovbjerg, Director, Education, Workforce, and Income Security Issues at (202) 512-7215 or bovbjergb@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony include Tamara Cross (Assistant Director), Bill Keller (Assistant Director), Anna Bonelli, Margie Shields, Joe Applebaum, and Craig Winslow.

GAO's Mission

The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday, GAO posts newly released reports, testimony, and correspondence on its Web site. To have GAO e-mail you a list of newly posted products every afternoon, go to www.gao.gov and select "E-mail Updates."

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are $2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. Government Accountability Office
441 G Street NW, Room LM
Washington, DC 20548

To order by Phone: Voice: (202) 512-6000
TDD: (202) 512-2537
Fax: (202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Ralph Dawn, Managing Director, dawnr@gao.gov, (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, DC 20548

Public Affairs

Chuck Young, Managing Director, youngc1@gao.gov, (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, DC 20548