# Testimony of William Pryor

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**Before the Joint Economic Committee:**

# "The Economic Impact of Traditional Public Pension Plans on the Communities They Serve"

**July 10, 2008**

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## 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 nine 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.

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,

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[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

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 six 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 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,

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[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.
[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.

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 start-up 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.

## 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.