SOCIAL BENEFIT INVESTMENT OF PUBLIC PENSION FUNDS: IDENTIFYING OBSTACLES TO THE INVESTMENT IN AFFORDABLE HOUSING.

By

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SOCIAL BENEFIT INVESTMENT OF PUBLIC PENSION FUNDS: IDENTIFYING OBSTACLES TO THE INVESTMENT IN AFFORDABLE HOUSING.

By

DIANA IVETTE MEJIA

Submitted to the Department of Urban Studies on May 22, 1989 in partial fulfillment of the requirements for the degree of Master of City Planning

ABSTRACT

This thesis analyzes social benefit investment strategies of public pension funds. In particular, the research focuses on the call for social benefit investment of these funds in the development of affordable housing. It will make the argument that there is a quantum leap from the call for social benefit investment of public employee pension funds (which address and meet the social needs of the public sector) and the actual feasibility or facility of investing public pension funds in non-conventional investment ventures.

The increased participation of pension funds in real estate demonstrates a growing interest and trend of pension investment in this field. Within the field of real estate development, there is a proposition that pension funds should invest in housing development. It has been suggested that these funds may play a critical role in housing finance. More precisely, there are those who advocate the investment of public pension funds in affordable housing development. This is commonly recognized as the call for "social benefit investment" of public pension funds.

The introduction of this paper sets the general framework of this research, namely introducing its three main components: public pension funds, social benefit investment advocacy and affordable housing. Chapter One discusses, in detail, public pension funds. General characteristics of these pension funds are described. The various standards and constraints which social benefit investments must observe are discussed in Chapter Two. Institutional barriers, (for both pension and investment industries) are presented.
Chapter Three explores the disparities that exists between the interested parties seeking public pension funds in social benefit investments, (i.e. pension trustees, state and local governments, financial institution, housing developers and local communities). As a result, an rhetorical discussion has developed which presumably matches public pension fund investment in affordable housing. This marriage, under the call for social benefit investment, has been obscured by misinterpreted nomenclature of each party. This factor combined with institutional barriers has created a gap between the advocacy for social benefit investment for the development of affordable housing and the actual undertaking of public pension funds investment in affordable housing.

Chapter four presents the principal conclusion that social benefit investment, as defined, directly conflicts with fiduciary standards, thereby compromising existing funds and future retirement benefits. In cases where social benefit investment has taken place, insurance or guarantees have offset the high risk associated with housing development. These guarantees have encourage public pension fund investment in mortgage related instruments. However, they do not necessary fulfill a social benefit criteria.

The prevailing debate which marks social benefit investment suggests a divergence between the actual investment of public pension funds in housing and the advocacy of these funds in socially beneficial ventures.
INTRODUCTION

In the summer of 1988, democratic presidential candidate, Jesse Jackson announced that, as president, he would establish a "national investment program" that would market new types of securities to public pension funds in order to "rebuild America." The program would issue federally backed securities to finance "economically viable" projects such as low-income housing, neighborhood revitalization, small business loans, and infrastructure investment. Jackson proposed that 10 percent of public pension plan assets be so invested. [excerpt from EBRI Issues Brief, 1988a]

The above proposal suggests that pension funds as investment capital are an appropriate resource which should be targeted for specific endeavors. However, the issue of whether or not pension funds¹ should be invested in socially useful² ways has been debated since the late 1970's [Rosen, 1976; Drucker, 1976; Rifkin/Barber, 1978].

In the 1980's, the interest in pension funds has intensified considerably. Total assets of private and state and local government (public) pension funds continue to grow at an exponential rate. They now exceed $2 trillion, representing the single largest pool of investment capital in the nation. Recognizing the magnitude of total pension assets--both present and future--many have focused on the potential impact on how and where these funds are placed.

¹ Unless specified, referring to the broad spectrum of private and public funds.

² Socially useful will be defined in Chapter 1 and fully discussed in Chapter 2 of this thesis.
The 1970's marked a period of rapid evolution in domestic financial markets. The thrift industry witnessed severe disintermediation crises during the recessions of 1969-70 and 1974-75. Housing investment and production fluctuated wildly between boom and bust. As inflation steadily mounted competition between financial institutions increased.¹

In the 1980's these changes continued. The effects of a rising inflation rate in the 1970's, with Consumer Price Index reaching double-digit levels, were equally felt in the early 1980's. Disintermediation of the mortgage market broadened.

In the spring of 1981 major changes were authorized in the types of mortgage instruments offered by federally chartered financial institutions. In March 1981, national banks were allowed to make an adjustable-rate mortgage loan. Interest rates could be raised or lowered according to changes in a specific index, by 1 percent every six months. There was no limit on the cumulative change in the interest rates of the life of the loan.

By April 1981, mortgage instruments were completely deregulated. The adjustable mortgage loan was authorized, under which no limits were placed on payments or interest rate adjustments on a periodic or cumulative basis. However, limits have been put in place since originally authorized.

In March 1983, new regulations were developed for national banks, allowing them to use any interest rate index upon which to base the adjustable-rate mortgage indices. These new regulations removed all limits on periodic or aggregate changes to interest rates or monthly payment amounts.

During this period (1970-80), the importance of the secondary mortgage market developed, although changes were noted as early as 1970. The seventies marked the importance of the secondary mortgage market, although the importance fluctuated cyclically, increasing in bad financial times, decreasing in good financial times.

In the 1980's, a sizeable jump in secondary mortgage market importance has occurred. Within this market, which includes all transactions involving already existing mortgage loans, a shift has occurred toward mortgaged-backed securities. The mortgaged-backed securities market has experienced more rapid change in the short time between 1984 and 1986 than it did during the whole period from 1970 to 1983.4

The emphasis on mortgage investments for the rapidly expanding investor base led to the creation of the collateralized mortgage obligation. The securitization of mortgages simplified mortgage investments and reduced concerns regarding liquidity and marketability of mortgage assets.

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In the early 1970s, mortgage-backed securities were synonymous with the Government National Mortgage Association (GNMA). Within its first issues, mortgaged-backed securities accounted for 13% of the secondary market. By 1982, they accounted for over 74%. In 1987, GNMA accounted for more than three quarters of the secondary mortgage market. The ability to sell large numbers of mortgages and mortgage-backed securities suggest the inherent soundness and competitive quality of mortgage-backed investments.5

New federal regulations have resulted in a decade in which depository institutions have competed for liabilities in a deregulated environment. The institutional foundations of the financial system--the passbook account and the fixed rate mortgage--have declined in their importance. Residential finance has been transformed from a relatively sheltered system to one of complete deregulation. This financial deregulation has been and continues to be, the catalyst for change in the mortgage lending institutions.

The changes in the financial industry over the last twenty years illustrates the volatility of the financial industry, changes in capital markets, and consequential changes in federal regulations which have brought forth a revolution in the housing finance system.

Prior to deregulation, the nation's capital markets were separated primarily into two segments—a large segment concerned mainly with housing and another large segment concerned with other types of investments (i.e. corporate bonds, corporate stocks, nonresidential real estate, investment banking, etc.) Housing finance was separated from other types of finance mainly because thrifts were regulated under specific rules. Deregulation removed many of the institutional and legal barriers that formerly separated these two segments.\(^6\)

The increasing size of pension funds, and their increasing participation within the capital market has inevitably thrusts the funds (and their managers and investment practices) in to the public focus, especially in view of predictions that their share in available US capital will continue to increase sharply.

The role of pension funds in the capital market is of critical importance, as are the concerns about the risks associated with various pension fund investment strategies. In terms of suppliers of funds, pension funds because of their growing size, have increased their flow of capital to the capital market consistently over several decades. In 1950,

pension assets' accounted for 3% of all outstanding funds advanced to credit markets. By 1973, pension funds had tripled as a source of credit and by the mid-1980s, pension funds held one of every six dollars of outstanding funds.\textsuperscript{8}

The importance of pension fund capital in the capital market goes well beyond its immense size. Pension funds are most notable because of their financial characteristics, especially the very long term nature of their financial liabilities. These liabilities (the payment of retirement benefits) in general, will not mature for decades. This long term horizon suggests a unique role pension funds may play as a potential resource of long-term capital for housing.

It has been suggested that pension funds should be used to address some of the problems cities are now facing. In particular, investment of public pension funds in affordable housing has been advocated by various interest groups. To date, few public pension funds have invested in housing. While state and local government pension funds total over $521 billion (at year-end 1987), investment in housing has been estimated at a minimal two or three percent of public pension assets; public pension funds appear to be an untapped resource for housing finance.

\textsuperscript{7} Pension assets are the sum of employer and employee contribution plus the amount of earnings gained from the investment of original contributions.

\textsuperscript{8} Employee Benefit Research Institute, EBRI Issues Brief, #40, Washington, D.C., 1985.
The entry of public pension funds, in particular, into the conventional residential mortgage market is a recent and growing phenomenon. This entry has been precipitated in part by public pension funds' growing awareness of this market sector, and in part, by the inability of traditional mortgage market participants to maintain long-term investment posture in a volatile market.

Since 1970, state and local public pension funds have increased their holding in mortgaged related securities from 11.1 percent of the market to 14.2 percent by the end of 19819 to 16.3% in 1986. While this increase maybe slight, the base of pension assets has rapidly grown over time. The trend of holding mortgage related securities is expected to continue and accelerate as the pace of pension fund asset growth exceeds that of other financial intermediaries. This shift in mortgage securities is further encouraged by their relative attractiveness as alternative high-yielding investments, with relatively risk free or low risk offset. The enactment of local legislation facilitating pension fund investment in mortgage securities further encourages the move of public pension funds into mortgage-related securities.

The recent entry of public pension funds into residential mortgages has tempted many jurisdictions to consider, and in some cases, implement a policy of "social benefit investing"

in connection with their real estate investments. While social benefits cannot be generalized because they correspond to specific instances under any given condition, social benefit investment is specifically defined. The investment of pension assets under social benefit investment policy are a) intentionally, ventures of direct social benefit with little regard to investment risk or return or; more commonly, b) investments which are as competitive or comparable in investment yield as other pension investments of similar type with socially beneficial consequences constitute a social benefit investment strategy. The former definition of social benefit investment strategy encourages pension managers or trustees, to consider factors other than, and often in place of, traditional tests of prudence, (i.e. investment return, safety of principal or diversification) in making an investment decision. The latter emphasizes portfolio diversification.
The potential impact of public pension funds in the
development of affordable[^10] housing is broad. It is argued
that if social benefit investment is promoted and targeted
towards investment in local affordable housing programs, many
low- and moderate-income residents facing housing shortages
will have potential access to an untapped alternative
financing resource. Further, proponents of affordable housing
development argue that public pension funds are suitable for
social benefit investment in housing due to their long-term
commitment, minor demand for liquidity, and minor waver with
intermediate fluctuation of interest rates [Litvak, 1981].

Historically, pension fund investment has consisted of
investment in government bonds, and Treasury bills.
Investment in residential mortgages (i.e. housing) has
consisted of recommending the purchase of secondary mortgage-
backed securities--guaranteed by quasi-public agencies such as
GNMA, Federal National Mortgage Association, FNMA, and Federal
Home Loan Mortgage Corporation, FHLMC. The investment of

[^10] Affordable: The traditional measure of affordable has
been a ratio of current housing expenses to current income. The
accepted norm has been that households should not spend more
than 25 to 30 percent of their incomes on housing. However one
must question whether this definition is being advocated by
social benefit investments in housing or if indeed, housing is
defined as that portion of the housing market made up of three
distinct segments with respective affordability measures based
on the area median income: Moderate-income households would have
80 to 120 percent of an area median income; low-income
households which has 50 to 80 percent of an area median income;
or very low-income households would have 50 percent of an area
median income.
these funds in residential mortgages has primarily resulted in investment of capital in a capital market which already has built in participants (i.e. investors within the secondary mortgage market, syndicators, etc.), or, the more secure investment of pension funds into residential properties that do not necessarily address the need of affordable housing (market rate housing developments such as condominiums, or townhouses, etc.). These investments, while geared toward residential mortgages, do not necessarily meet the call or the criterion of social benefit investment in affordable housing.

This thesis analyzes social benefit investment strategies of public pension funds. In particular, the research focuses on the call for social benefit investment of these funds in the development of affordable housing. It makes the argument that there is a quantum leap from the call for social benefit investment of public employee pension funds (which address and meet the social needs of the public sector) and the actual feasibility or facility of investing public pension funds in non-conventional investment ventures, such as affordable housing.

To achieve socially beneficial investment of public pension funds in the development of affordable housing, they must be targeted towards meeting specific capital needs of cities and their low- and moderate-income residents. For a social benefit investment strategy to evolve, consolidated efforts between pension fund managers, federal and state governments,
traditional financial institutions, and local communities must take place in order to develop an investment strategy which will best meet the goals of "social benefit" investment.

Chapter One discusses in detail public pension funds. General characteristics of these pension funds are given. Chapter Two defines and discusses social benefit investment, its criteria, current practice and critiques. In addition, the chapter focuses on the institutional standards and constraints social benefit investments must adhere to.

Chapter Three presents the disparities that exists between the interested parties seeking public pension funds in social benefit investments, (i.e. pension trustees, state and local governments, financial institution, housing developers and local communities). As a result, an illusive rhetorical discussion has developed which presumably matches public pension fund investment in affordable housing. This marriage, under the call for social benefit investment, has been obstructed by institutional, ideological and practical hurdles which exist within the industries that are linked under this banner. As a result, a gap exists between the actual undertaking of public pension funds investment in affordable housing and the advocacy for social benefit investment for the development of affordable housing.

Chapter Four presents the atmosphere under which social benefit investment in affordable housing may take place. While certain aspects of this atmosphere currently exist, the
practice of social benefit investment fails to gain usage due to several factors. These factors are identified and presented in a model case scenario.

The principal conclusion of this paper is that the gap between the actual facility of using public pension fund investment in socially beneficial ventures and the advocacy for social benefit investment in affordable housing has constrained the development of such undertakings. This raises the question, is social benefit investment viable as currently propositioned? What are the implications for those who advocate these funds given the existing atmosphere and constraints of these funds?
CHAPTER ONE
PUBLIC PENSION FUNDS

HISTORY:

The rapid growth of private and public pension plans has made them into one of the largest and most dynamic sources of capital. Although the huge growth in pension capital is a relatively new phenomena, pension plans are more than a hundred years old. New York City established the nation's first public pension plan in 1850 (New York City Teachers Fund); in 1875, the American Express Company established the first private pension plan, and the Metropolitan Life Insurance Company sold the first group plan in 1921. Over the next fifty years pension programs were established by many large employers including banks, utilities, mining and petroleum companies and manufacturers. In 1929, there 397 private plans in operation. By the early 1980's, there were more than 640,000.

Pension plans were initially used by employers as an incentive for maintaining a stable workforce, given as a gratuity to compensate loyalty to the firm. Today, pension plans serve as retirement income or benefits paid to employees and/or their beneficiaries upon retirement. Pressure from private sector unionized labor to gain employer accountability

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in providing retirement benefits, established the precedent for public acceptance of pension plans.\textsuperscript{12} By the mid-1980's, pensions had become a standard feature for most public and private employers: over two-thirds of all private sector full-time employees and more than 92% of full-time public employees were covered by pension plans.\textsuperscript{13}

When discussing pension funds, two distinct categories are covered: private sector and public sector funds. These funds are in themselves subdivided by specific pension programs:

* defined benefit employer pensions--Program that assures benefit upon retirement with the contribution fluctuating and the employer bearing the risk of poor investment returns;
* defined contribution employer pensions--Program that pledges a given contribution with the ultimate benefit fluctuating and the employee bearing the risk of poor investment; and,
* individual pensions--Program generally offering defined contribution in approach with the employee making some of the contribution and bearing all of the risk of poor investment returns.

Within the private sector, funds are divided into single-employer funds and multi-employer funds. Public sector funds, on the other hand, are composed of state and local government pension funds (which included teachers, police, fire, public university funds). While public pension funds usually refer to state and local plans, they are distinct from plans which cover all federal employees, including the military and members of Congress. Other differences between public and

\textsuperscript{12} ibid, p. 14.
\textsuperscript{13} op cit, \textit{EBRI Issue Brief} #40, 1985.
private pensions include distinct funding mechanisms, investment practices and laws governing them. These factors add to the complexity of the scope in which pension funds operate.

An important distinction between pension funds and other investment sources further illustrates the distinctive characteristics of these funds. While banks or insurance companies solicit investment capital, pension funds do not compete for investment dollars. They are recipients of paid contributions and interest/investment income. Furthermore, pension funds are not innovators in that they are not players outside of the traditional investment market, although they are increasingly beginning to move into new investment areas that others investors have proven profitable. Unlike profit-maximizing investors in the capital markets who seek optimal returns from innovative investment, the fundamental purpose of pension funds is the payment of retirement benefits. Hence, their tendency towards conservative investment behavior. Between the time they receive contributions and pay out benefits, pension managers seek investments that will preserve the existing capital, while hopefully, producing an attractive investment return.

In light of the above, it is critical to understand the clear distinctions between the role of pension funds to other investors, and more importantly, the categoric distinctions within the broader label of "pension fund" (i.e. public versus
private). Pension funds cannot be viewed monolithically. There is an enormous variation among private and public plans and in the ways different kinds of pension funds are invested. The most integral aspect of pension fund investments is their historically conservative approach to investment. Pension funds will almost never knowingly accept reduced rates of return in order to support social needs. This pattern has not changed over the last twenty years nor is it likely to change in the near future because of their designation as a safety net as retirement income. However, pension funds can be expected to move towards more innovative investment ventures once they are proven profitable by private investors, and seek out new ways to assist plan participants without jeopardizing the ultimate payment of benefits.

The above discussion serves as a foundation for illustrating the characteristics of pension plans within the broad spectrum of pension funds. The focus of subsequent discussion will now specify public (state and local government) pension funds. Any mention of pension funds, hereafter, refers to this particular sector.
Public Pension Funds

As the entire state and local government sector has grown, so too has their pension assets. At year-end 1987, projected estimates, based on American Council of Life Insurance and data from the Federal Reserve Board, put state and local government pension assets at $521 billion.

The 1978 Pension Task Force Report on Public Employee Retirement Systems identified 6,630 separate retirement systems covering employees of state and units of local government. These systems had approximately 10.4 million active members and an additional 2.4 million inactive members (retirees, disability or survivor beneficiaries, and persons qualified for benefits at a later date.) Although fewer in number than those in the private industry, public pension funds are generally larger, many totalling several billions of dollars for thousands of public employees.

State and local pension funds are financed by contributions from the employer (government) and the employees. However, financing does vary. State and local employees covered by social security for example, pay about 6-7%, while those employees not covered contribute 8-10%. The government (i.e.

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employer) contributes to what amounts to 150% of what the worker pays into the fund (US House Pension Task Force, 1978). In addition, investment earnings influence the amount of employer contribution. The greater the investment earnings, the less the employer must contribute.¹⁶ Contributions to the fund are tax-exempt.

The majority of these funds are handled through a defined benefit plan as opposed to a defined-contribution plan. A defined benefit plan indicates that an employer guaranteed compensation (a specified amount of money) is paid to the employee upon retirement. It is a fixed benefit based on a formula which takes into account years of service and average annual salary. Investment risk of pension funds under this plan is born by the employer since, regardless of investment performance, the employer is obligated to pay out a specified amount to retirees. Yet, the benefit is a function of whatever this money can earn while invested. A defined-contribution plan is based on a base amount regardless of length of employment, hourly wage, etc. In general, most state and local plans are a combination of defined-benefit and defined-contribution plans.

Standards for Public Pension Funds

Unlike the private sector, where management decides and negotiates policy and practices in accordance with the 1974 Employment Retirement Income Security Act (ERISA), state and local government pension funds have no one standard. Rather, the management and control of public pension funds are determined by state and local statutes. Specific guidelines range from "prudent man" restrictions to legislative regulations (state and local statutes) to "interest of the participant" rule. In addition, the Internal Revenue Service requires certain eligibility rules which qualify pension fund contribution as tax exempt.

As fiduciaries--one to whom property is entrusted to manage for others--the trustees and managers of public pension funds must observe certain duties in investing retirement funds. Two essentials of fiduciary law are the duty of loyalty and the duty of reasonable care.

The duty of loyalty is designed to prevent conflicts of interest between the fiduciary and the beneficiaries. A fiduciary cannot choose self or someone else's interests over those of the beneficiary. This duty is required by common law and the requirements of the Internal Revenue Service for public retirement system tax exemption.¹⁷

The duty of reasonable care is designed to insure that investment decisions will be informed, rational and appropriate to the needs of the pension fund. This forms the fundamental of the "prudent man" principle whereby reasonable care translates into "the use of methods and techniques which take into account principles, theories, customs and conventions generally observed by the investment community" [Bines, 1978].

The federal Employee Retirement Income Security Act of 1974 (ERISA) enacted fiduciary standards for the investment of private pension plans, further defining the scope of the "prudent man" rule. Fiduciary as defined in ERISA states:

A person is a fiduciary with respect to a plan to extent i) he/she exercises any discretionary authority or discretionary control respecting management or disposition of its asset, ii) he/she renders investment advice for a fee or other compensation direct or indirect with respect to any moneys or other property of such plan or has any authority or responsibility in the administration of such plan.

This defined fiduciary must adhere to specific responsibilities as set forth in Section 404 of ERISA:

A fiduciary shall discharge his duties with respect to a plan solely in the interest of the participated beneficiaries and a) for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying participants reasonable expenses of administering the plan. b) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in conduct of an enterprise of a like character and with like aim c) by diversifying the investment of the plan so as to minimize the risk of large losses, unless under circumstances it is clearly prudent not to do so; and

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d) in accordance with the documents and instruments governing the plan in so far as such documents and instruments are consistent with the provisions of this title.\(^9\)

Although ERISA does not directly regulate public pension plans nor their investments, ERISA does influence public pension investment policies or strategies. It is not uncommon for public pension funds to adhere to the prudent man guidelines nor for legal counsel to advise public trustees to follow the ERISA guidelines. The prudent man standard is in part measured by what other managers are doing in similar situations, thereby setting the atmosphere for public pension fund managers to follow within similar management practices of the industry.

As an outcome of the ERISA rule, there have been multiple attempts to legislate a federally sponsored law which will also regulated public pension funds in a similar fashion as ERISA. Like ERISA, the proposed Public Employees Retirement Income Security Act [PERISA] contains standards that would require the fiduciary to (1) exercise the care, skill, prudence and diligence of a prudent person, (2) select investments solely in the interest of the participants and beneficiaries of the plan, and (3) avoid certain type of transactions. In addition, it would limit the public pension plan from acquiring more than 10 percent of the fair market

\(^9\) ibid, ERISA, 29CFR, Section 2550.404-1, 29 U.S.C., Section 1104 (a)1. 1974.
value of its assets in the securities, obligations and real property of the contributing government. The federal regulation, as it exists and is proposed, is one that encourages accountability, attempting to protect against conflicts of interest and protect fund assets. This effort has been strongly lobbied against by state and local government advocacy groups.

Many state and localities do have specific legal guidelines (legal lists) that limit the scope of public pension fund investments. Each state has its own statute governing public pension fund investment. However, most states set limit on the amount of equity and real estate their public funds can hold, to less than 10%. In 1976, for example, most large state and local plans statutorially limited stocks to less than 35% of their portfolios, and 10% of all public plans could not invest in stocks at all. Other common restrictions include limitations on investments in one company, in one industry, or in mortgages. Some plans also mandate minimum company size for pension fund investment, limit the percentage of assets that can be held in cash reserve or set minimum rates of returns to be earned on investments. However, many state legislatures have recently revised their outdated

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21 op cit, EBRI Issue Brief, Number 40, 1985.
pension fund restrictions.

In developing investment strategies, public pension trustees must always adhere to the requirement that retirement assets are to be managed for the sole interest of the plan beneficiaries. The Internal Revenue Service requires that both public and private pension funds invest their assets for the "exclusive benefit" of plan participants and beneficiaries. However, in Revenue Ruling 69-495, 1969-2 CB, 88 the IRS interpreted "exclusive" as in effect meaning "primary."

Thus, while public pension funds are not explicitly regulated by federal law, there exist extensive standards both industry specific as well as unique to the public sector of pension funds. State and local statutes, legal lists, and ERISA standards set the principles in which public pension funds operate.
Public Pension Fund Investment Management

Pension fund assets, on a general basis, are managed by bank trust departments, insurance companies, independent investment firms or in-house management. A large portion of all pension assets are managed by a rather small proportion of portion of these managers; they consist of fifteen bank trust departments, twelve insurance companies, twenty four private investment firms who manage ninety percent of the approximate $2 trillion dollars in total pension fund assets.\(^{22}\)

State and local employee public pension plans vary in their administration. A small percentage of public pension plans are administered by insurance companies.\(^{23}\) The great majority of these plans are independently and directly operated, at varying governmental levels and with varying employee coverage groupings. Between the various states, the scope of coverage differs widely. The extremes are Hawaii, with a single statewide plan covering all public employees in the state, and Pennsylvania, with 1413 separate plans.

Management of plan assets may be handled by the Treasurer of the public body, by banks or trust companies, or by insurance companies or more than one of them. However, in most pension plans, ultimate authority for investing plan assets is exercised or directed by the public employee retirement or

\(^{22}\) op cit, Landecker, 1982, p.21.

investment boards themselves.

About two-third of state and local systems and almost all states have statutes providing for boards of administrations to make retirement system policy. These statutes also designate the make-up of the board and how its members are to be chosen.

Administering bodies are themselves usually dominated by employee or governmental official members, with only occasional membership including finance experts outside of government. However, pension managers may use and rely on outside financial advisors and investment managers (external management) in setting investment policy or making individual investments. Some states also provide for unified investment management via investment boards, even where the retirement features of systems may be administered independently.

Public pension funds tend to rely more heavily on in-house management than private funds. This reflects, in part, the history of more conservative investments by the public system. Public pension funds have been able to function with small, relatively non-competitive staff since active management has played less of a role in the stock market, (a traditional area for public pension fund investment). This explains to some degree the large portion of public pension assets concentrated in the bond market. In addition, public pension funds also

\[24\text{ op cit, Litvak, 1981, p.64.}\]
rely heavily on outside investment managers. The Government Finance Research Center's 1980 survey of retirement systems found that external management was favored slightly for corporate government bonds, internal management favored moderately for mortgages, and external management favored heavily for common stocks.

To varying degrees, in-house managers are not as experienced as those in the private sector. This is in part a result of the lower compensation for such jobs in state and local sector. Nonetheless, internal and external pension managers (both public and private) have strong professional biases toward investing in the public stock and bond markets, largely reflecting their training.
Public Pension Fund Investment Policies

All state and local systems have statutes which provide for boards of administration to make pension investment policies. In some cases these boards do not have investment authority, but in general, the boards make all investment policies. In those cases where boards of administrations or investment boards do not exist, investment policy-making normally resides in a relevant state or local agency, like the department of finance.

The real involvement of trustee boards, however, in setting investment policy and reviewing investment decision is often limited. This is usually due to the boards lack of expertise, time or ready access to alternative sources of information and judgement [Pennsylvania Public School Employees' Retirement Fund, 1973]. As a result, investment decisions are often made by advisers. Decision-making, thus, is performed by in-house but advised by external managers of the funds.
Public Pension Fund Performance Criteria

There are two primary concerns when public pension funds make a financial investment or set of investments (known as the portfolio.) The first is the return on the investment--how much money can be gained. The second is the associated risks of the investment--the chance or degree of probability of loss.

Periodic payments are earned by a public pension fund through interest on debt investment (debt investment is the issuance of a loan/debt on set terms and conditions, upon which interest is earned) and dividends on equity investments (equity investment is the cash investment into a venture whereby the investor earns a share of the profits). In addition, market value of the investment that will increase (or decrease) in the future creates a capital gain (or loss) earned on the investment. The combination of interest, dividend earnings and changes in the market value represents the measure of return which concerns the public pension fund manager.

Return is a measure of expected performance of an investment since the realized return is a function of events that cannot be completely predicted. This uncertainty of future economic events gives rise to the risk of a particular investment.

The risk of an investment is dependent upon the risk of the proposed investment being financed (in relationship to other potential investments), its sensitivity to the business cycle,
the number of competitors and whether the money is invested as
debt or equity.

Risk can be assessed for the individual investment project
or as an aggregate to the overall investment portfolio. This
analysis is known as portfolio diversification. Some risk can
be minimized relative to the overall portfolio. This
financial analysis of risk has several implications for public
pension fund managers [Litvak, 1981].

Investors want to both maximize their expected returns and
minimize risk at any time. However, there is an inherent
trade-off between expected return and risk. Higher expected
returns is accompanied with higher risk. This is the
fundamental concept of investment. But, the promise of a
higher return does not always materialize, thus, presenting
the adverse result (or risk) of an investment.

In addition to the risk-return standard analysis of an
investment proposal, public pension fund managers must also
consider the liquidity and management/transaction cost of the
proposed project.

Liquidity is the ease (low cost) with which a portfolio
investment can be converted to cash. The need for liquidity
will depend upon the degree to which the investor needs to
draw on its portfolio for operating funds (benefit payments in
the case of public pension funds) and/or sell investment
quickly in order to offset poor portfolio management
investments or take advantage of new information.
Management/transaction costs are the expenses incurred in evaluating, purchasing, monitoring and selling investments.

Investment performance is also measured or compared against other investment opportunities in the market. Investment and investment portfolio are compared on the basis of the ratio of their desirable characteristics (return) to their undesirable characteristics (risk, liquidity, management costs). By comparing an investment proposal to other opportunities in the market, the investor looks at the going rate of compensation to an investor for assuming a specific amount of investment risk. An investment "hurdle rate"—the return it must promise to be competitive with other investment opportunities—must equal the sum of the compensation necessary for each of its undesirable financial characteristic.25

A noncompetitive or concessionary investment is one where the expected return is not commensurate with the other undesirable characteristics of the investment. That is, the competitive price of risk, liquidity, management costs, is not being paid to the investor. A concession in the form of not demanding this compensation has to be made if the investment is to take place. It may be that the investment is of average risk but below average return, high risk-low return, above average risk-average return, etc. This has been the analysis applied to social benefit investments proposals.

The primary criteria for public pension fund investment, therefore, are a composite of the risk-return analysis, a liquidity of investment analysis, an examination of the cost of management associated with the investment, and lastly, appraisal of the overall investment relative to comparable investment measures elsewhere. These investment criteria form the basis pension managers use in investment decision-making.
Summary:

Extensive standards and constraints exist which define the scope of public pension funds and their investments. Although distinct in operation from private plans, public plans operate within the pension fund industry, thereby judged implicitly and explicitly by the standards and constraints of private and public sector pension plans.

These standards combined with financial performance standards of investments (risk and return analysis) further define the investment criteria of public pension plans. In analyzing an investment proposal, public pension funds must consider many factors ranging from risk, to liquidity, to opportunity costs, which help form the investment decision-making criteria. These factors determine the acceptance or rejection of an investment proposal.

Proposed investments are also scrutinized based on their conformity to public pension fund standards stipulated in state and local statutes, legal lists and prudent man standards. On an industry-wide standard, the fundamental test of prudence must prove an investment to be a safe, sound and prudent. Since the ultimate goal of a pension plan is to provide retirement benefits, investments must offer competitive rates of returns which do not jeopardize the existing capital stock. This feature has affected the investment behavior of pension managers, resulting in a conservative approach in reviewing investment risk and return.
The conservative nature of pension investment has identified strategies for investment which serve to maximize returns with minimal risks. Where this is not the case, concessionary investment is perceived. Social benefit investment practice of public pension funds has been labeled concessionary investment practice. This analysis of social benefit investment will be further explored in Chapter Two.
Chapter Two

Social Benefit Investment

Origin and Definition:

In recent years, due to the reorganization of the financial industry and the massive growth in pension assets, many voices have begun to advocate new, more diversified uses for pension funds.26

Traditional pension investment27 practices have been called into question for several reasons. First, the poor financial performance of past pension fund investments has fueled the pension fund investment debate at all levels of government, corporate boardrooms, union halls and among other interest groups. Secondly, due to their enormous structural power in the economy, public officials, corporations and unions are realizing pension fund's potential for supporting certain sectors of the economy which need capital. Thirdly, traditional investing methods are under scrutiny because they have ignored much of the social and economic impact of their investments. These conditions have contributed to the search for new investment strategies.


27 Traditional investment practice under prudent investment standard is the investment of pension assets in government securities, stocks and bonds.
Dialogue generated around the "social" aspect of pension investment were presented in books by Peter Drucker, Jeremy Rifkin and Randy Barber. Drucker introduced the contention that employees own, control and should direct pension fund capital.² Rifkin/Barber, tracing social investing back to church and university activism between 1968-72, argued that church and university activism succeeded in introducing a "new lexicon, which has broaden the definition of investment to include social and moral consideration in economic decision-making. They stated:

Twenty years ago, the term social investment was used more as a throwaway line and conjured up the image of token do-goodism and charity. Today, it has come more and more to represent an alternative way of looking at economic decision-making and planning.²⁹

These books prompted the placement of pension funds on the political agenda in the late 1970's and early 80's.

The conscious design of investment policies which consider the social and economic impact of pension fund investment, as well as the associated risk and rate of return, is often referred to as "social benefit investment."

Social benefit investment as a topic of research has generated diverse discussion. Literature on this topic refers


to social benefit investment under various labels. These labels include "strategic investing," "alternative investment," "development investment," and "social investment." These labels all cover one key concept: the introduction of social and political considerations in the investment decision-making process of pension fund investment.

To date, the appropriateness of social benefit investment policy has generated more debate than the actual implementation of the approach. Much of this is due to the polarization of positions the concept has generated. Social activists favor the concept, while academicians, investment adviser, legal counsel, the Department of Labor, and others, dismiss it as being imprudent. Opponents attribute the primary conflict of this approach to the lack of established measures, under current standards, in which to weigh the risks and return of the social or political aspect of an investment.

The call for social benefit investment of pension funds is offered by a spectrum of voices. Furthest from the traditional investment approach are those who advocate investing pension funds for the expressed purpose of bettering society, with return and risk being of secondary

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considerations. This position encourages pension managers to consider factors other than, and often in place of, traditional tests of prudence, (i.e. investment return, safety of principal or diversification) in making an investment decision. This position, however, has not found widespread support.

More commonly, is the call for diversification of pension investments to serve functions beyond the accumulation of assets. This view encourages pension managers or trustees to consider non-traditional investments. So long as such investments pay competitive rates of returns, pension fund managers may willingly consider them. In this view the social or political aspect of the investment is of consequential importance. Instead, the emphasis is on diversification of pension assets. This approach may result in the use of pension funds as a capital resource for residential mortgages, equity investment in real estate outright, or venture capital for small business or new high technology enterprises. These investment vehicles, while non-traditional investment mediums, may or may not extend social or political benefits to society at large.

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32 Diversification of pension assets is the attempt to diffuse adverse affects of high risks of some portion of a portfolio with other less risky investments to enhance the overall performance of the portfolio.
I shall use the term "social benefit investment" to refer to that investment strategy that explicitly factors in a broad range of social and/or economic goals in the investment process. This approach aims to illustrate that diversification of public pension funds in the non-traditional investment of affordable housing may offer competitive rates of return and serve a social end. However, a social benefit investment strategy may not be the best tool to achieve diversification objectives.
Social Benefit Investment Strategies

Advocates of both traditional and social benefit investment policies recognize that the ultimate purpose of a pension fund is to provide a steady, secure retirement income. The preservation of pension capital is the main concern for pension fund managers in developing investment policies. The traditional pension investment strategy, characteristic of capital investors, is geared toward receiving an optimal rate of return on an investment with minimum amount of risk, regardless of the social or economic consequences of an investment.

In contrast, a social benefit investment strategy identifies and purposely targets capital investment to projects that i) have a capital need that can not or will not be fulfilled by traditional financial resources and ii) create social benefits in addition to a secure retirement income [Litvak, 1981]. In cases where unsatisfied credit demands for projects which are otherwise feasible, the flow of pension capital into such investments should then result in greater resources for these types of investments (usually high risk), as well as address the social needs of a region.[Petersen/Spain, 1980]

Existing examples of social benefit investment strategies identify approaches that are:

* designed to reward or punish particular forms of investment behavior
* designed to expand capital placement in particular sectors
* designed to provide direct benefits to pension fund members
The oldest strategy in social benefit investment is designed to reward or punish particular forms of investment behavior. This approach incorporates the economic interest or philosophical preferences of pension plan members in the investments of pension funds. Rifkin/Barber articulate this strategy; they discuss investments in securities of corporations which are endorsed if such investments do not conflict with pension members' philosophical or economic interest. The prime example of this strategy is the rejection of investment securities in those corporations which deal with countries that follow discriminatory or repressive policies, such as South Africa.

The goal of a strategy designed to expand capital placement in a particular sector aims to provide capital that otherwise would not be available to that sector, without making financial concessions to the pension fund. To accomplish this goal, pension investments must be targeted to fill a capital gap rather than displace existing capital investment in a particular sector [Litvak, 1981].

Strategies designed to provide direct social benefits to pension plan members encourage job creation, localized economic development and housing. An often cited example of private pension fund utilizing this strategy is the employment of unionized construction labor in residential mortgage investments. An example of public pension funds utilizing this approach is New York City public employees pension
purchase of restructured municipal bonds; these events serve as examples of pension fund investments providing outright social benefits.

The strategies employed to meet the call for social benefit investment of pension funds have been critiqued because of the difficulty to assess the gains made by this particular approach. No econometric models exist to measure social or political benefits nor are there standard criteria to judge social benefit investment. The standard financial risk-return analyses of investment vehicles is the current measure used to weigh investments, and as a result, this analysis often assesses social benefit investment as high risk for average returns or more bleakly, high risks with low returns [Litvak, 1981].

Nonetheless, social benefit investment strategies have been implemented. However, the manner in which public pension funds implement the strategies to achieve social benefits has varied. Some may establish a social benefit investment policy as a guideline for pension managers or trustees to utilize when identifying investment vehicles. This allows for the development of investment strategies which target pension fund invested. In many cases, a social benefit investment policy is the result of plan membership demanding the use of their pension funds to address a specific need.

The manner in which pension plans have given priority to social benefit investment vehicles has not been systematic.
Pension plans do not compile a list of goals and then rank them according to some level of preference. In some cases, a pension plan will identify a goal and will accept any number of strategies to accomplish their specific objective in meeting this goal. An example is a pension plans' goal to invest in local economic development. This broad goal has potential for multiple investment vehicles to achieve economic development--venture capital for new, high technology business, small business start-up loans, housing related investment instruments, neighborhood revitalization, etc. The point being the commitment to social benefit investment.

Social benefit investment vehicles which result in social political, or economic benefits include:

* meeting housing needs of plan participants
* increasing local employment opportunities
* providing venture capital to small business
* supporting goals of worker rights and safety
* supporting alternative energy development

Recent discussion has suggested investment vehicles which encourage local employment opportunities, neighborhood revitalization or support of existing economic sectors.

However, the most common investment vehicle has been the use of pension funds in residential mortgage investments.

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34 See Jesse Jackson statement before the Democratic Convention, Summer 1988.
The pressure to adopt investment policies which result in social benefit have been felt by both public and private pension funds. The rigidly regulated private pension industry maintains a skeptical approach in practicing social benefit investment; much of this is due to their conservative investment behavior. Yet, there have been instances where private pension funds have initiated social benefit investment. Union pension plans, members of the private sector, have taken the lead in implementing a social benefit investment strategy, employing investment in residential mortgage investment or outright housing development [Landecker, 1982] This investment strategy benefits union labor (hence, plan participants) not only with employment creation which results from this type of activity but, as recipients of the end product, housing.

Public pension funds have been faced with increasing public pressure to expand existing investment practice to include investments which address local needs, particularly housing. The potential role of public pension funds as a capital resource has been identified by many public officials and local interest groups. These groups have given rise to inquiries regarding the "public" duty of public pension funds, and whether public pension investments should benefit plan participants at present and in the future. The call for public pension funds to invest in housing invokes the use of a social benefit investment strategy.
Public Pension Funds and Social Benefit Investment:

State and local pension funds account for nearly 38% of the nation’s $2 trillion of pension assets. In year-end 1987, the aggregate of state and local pension funds were invested as follows: 34% in corporate equity, 58% in bonds, 4% in cash (which includes demand deposits, certificates of deposit and open market paper), and most of the remainder in mortgages and mortgage-backed securities. This distribution reflects a growing trend toward greater diversification. Traditionally, state and local pension assets were heavily invested in federal government securities or those of their own sponsoring government.

In general, public employee pension funds have been more receptive to social benefit investments than private pension funds, especially where social (non-investment related) benefits are a motivating factor. Social benefit investing began to influence the public pension fund community in the mid-1970’s when several public employee pension funds were

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35 This is the ratio of total public pension funds to total pension assets; $521 billion divided by the total sum of $2 trillion.


asked to bail out bankrupt local governments--the most viable example being the commitment of New York City public employees pension fund purchase of restructured municipal bonds.

Public pension funds are not legally required to justify their investments under the Employee Retirement Income Security Act (ERISA). Consequently, most social benefit investment is confined to public pension plans. Proponents of social benefit investment policy argue that conventional application of the prudent man rule solicited by ERISA, and other statutory laws impose such conservative investment standards that the use of pension capital is severely constrained. Unlike private pensions, public pension funds experience: more flexibility within the investment regulatory system; greater ability to introduce amendments to relax strict state or local statutory laws, and; greater flexibility to consider investments viewed as imprudent by private pension fund standards.

The receptivity of public pension funds to practice social benefit investment has historically been in large part because public pension funds are subject to state and local political pressures to address local needs and political pressures to invest these funds locally.

Public pension plans have been under strong political pressure to undertake activities benefiting their constituents. Public officials are responding to the growing public awareness of pension fund investment and thus,
incorporating pension funds as an issue for political agendas. The enormous structural power of pension funds in the economy, as a whole, has motivated public officials to consider the impact pension funds may have if targeted to certain sectors of the economy which are in need of capital.

State and local pension plans are moving rapidly in the direction of investing funds locally. Since 1980, pensions in at least 14 states have announced plans to increase local investment. Most are concentrated in local mortgage markets but some plans are earmarking funds for local business development.38

The pressure to use public pension funds within the local jurisdiction of cities and counties has been expressed by public officials, public sector employees and public interest groups (i.e. community development corporations, development agencies, etc.) Much of the pressure has been directed towards investment of public pension funds in the development of affordable housing, community revitalization, and community economic development.39 These investment vehicles have been identified as ventures which address local public needs.

Various types of social benefit investment vehicles for public pension funds have emerged which include: investment in

38 op cit, EBRI Issues Brief #170, 1985.

residential mortgages, either through outright equity participation, debt financing or mortgage-backed securities; venture capital—in the form of "seed" money for small business development or a start-up capital for locally-based enterprises; and loan pool certificates for other social investments such as community revitalization, infrastructure rehabilitation.

A relatively new vehicle of social benefit investment strategy is credit enhancement. This vehicle does not require outright investment of pension funds in any particular investment. Rather, the key behind this strategy is the pledging of collateral by a pension plan in support of non-traditional investment ventures. This pledge serves to leverage the credit value of a development proposal. In the case of default, the public pension fund would be obligated to cover the debt liability. This vehicle has only recently gain credibility among advocates of social benefit investment as a means to reinforce investment value of non-traditional investments.

Of the above mentioned investment vehicles, the primary vehicle for social benefit investment of public pension funds has been investment in residential mortgages within a given state or local region. While other investment instruments have been utilized in an attempt to address social benefit

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Barber, Randy, "Pension Funds and Community Investment" interview essay in Community Economics, No. 16, Fall 1988, p.2.
investment, residential mortgages have been the main investment vehicle for both public and private pension funds.

The connection between social benefit investment of public pension funds and housing or housing-related instruments initiated from the timing of the two concerns as a national interest. As simultaneous national concerns a natural convergence between the two was assumed: one as a financial resource, the other as a financial investment instrument.
Public Pension Funds and Affordable Housing Development:

The late 1970's marked a period of public interest in the social and political impacts of pension fund investments, which coincided with a period of rapidly rising house prices and mortgage interest rates. The concurrent emergence of housing and pension investments as national concerns coalesced a presumed correlation between the two issues. The provision of affordable housing, consequently became a goal of those advocating the use of pension funds for social purposes [Munnell, 1983].

In the 1980's, concerns persist about the continued rise in house prices, the affordability of housing and issues regarding the traditional financing institutions and their role in homeownership. Similarly, the rapid growth of pension assets continues to maintain public attention on the potential and untapped capital resource pension funds possess.

State and local government face national crises in their ability to provide affordable housing to local residents. Public pension funds have been viewed by many as the prime resource to realize homeownership.

In their 1982 report, the President's Commission on Housing stated: "The current crisis in housing is primarily a crisis in the financing of housing." Although disputes over regulation were argued, some recommendations which could facilitate the usage of public pension funds in housing finance were issued. These recommendations were designed to
eliminate inadvertent and unreasonable technical constraints for pension investment in housing related instruments such as mortgages or mortgage-backed securities.

The investment in housing-related instruments that furthered other "social" objectives was not proposed, such as below-market rate home mortgage loans, despite intense pressure from some housing lobbies. There was some support from within the committee for proposals to allow pension funds to acquire mortgage assets as long as these assets carried yields at least as high as the average rate of return on fund investments. This practice, however, was recognized as below-market-rate investment in disguise (in a rising-rate environment) and not condoned.41

Two main recommendations specific to public pension funds were offered:

* States should be encouraged to develop program strategies and regulations that facilitate housing investment by public pension funds.
* The National Conference on Commissioners on Uniform State Laws should recommend changes to state legal investment statutes to provide authority for regulated fiduciaries to invest in conventional mortgage-backed securities meeting a common set of reasonable investment criteria.

These recommendations illustrate a growing recognition of public pension funds and their role in housing finance.

Seeing that most of public pension investment under a social benefit investment policy has been in residential mortgages or mortgage-related instruments, understanding the mortgage

markets, therefore is vital in comprehending the housing industry. Mortgages are vital to housing for two major reasons i) a large majority of housing sales and construction is financed through debt, thereby making the provision of housing crucially dependent upon the availability and cost of credit, and ii) residential mortgage financing is one of largest uses of available credit in the US economy; about a fifth of all funds are raised in the US credit markets and one third of funds are raised by the nations' private non-financial sector. 42

The analysis of pension fund participation in mortgages and mortgage-backed securities, thus, is critical in understanding whether pension fund investments actually i) result in more affordable housing capital and ii) if social benefit investment policy is the tool which promotes the use of pension fund capital in this area of investment.

42 ibid, p. 170.
Social Benefit Investment Vehicles in Housing:

It has been suggested that the investment of pension funds in housing is eminently suitable for public pension funds [Schur, 1981]. Schur contends public pension funds are able to make long-term commitments, without minimal need for liquidity or concerns with intermediate fluctuations in interest rates. Furthermore, housing as an investment offers long-term increases in value which have outpaced the erosion of the dollar through inflation.

In this analysis, public pension funds are viewed as "patient money" in which the financial needs of the pension are projected over the life of its membership. As such, pension funds are not heavily concerned with short-term fluctuations in return or cash flow. The logic follows that public pension funds, therefore do not have a great need for liquidity as do other investors such as banks.

In addition, the affects of fluctuating interest rates are diffused through housing investment since real estate investments, in general, offer a strong hedge to inflation. That portion of a pension fund, therefore, targeted in housing investment could have some protection to risk. Housing in this case would be a prudent balance for the highly volatile and disappointing performance of stocks and bonds.

According to Schur, the changing cost of money which threatens most financial institutions and investors does not adversely affect public pension funds. The funds are directly
a product of workers and governmental cash contributions. At any given rate of return which is deemed adequate to fund the actuarially" anticipated costs of the pension participants, pension funds need not worry about the fluctuations in the rates of return of other investments. The implication from this analysis is that a pension fund can with impunity invest in fixed-rate securities, similar to the dissipating fixed-rate real estate mortgage.

Housing as an investment vehicle for public pension funds falls under the category of non-traditional investments which may generate social benefits. As such, it qualifies as an investment vehicle for social benefit investment. However, for public pension fund investment in housing to be meaningful and effective, i.e. resulting in a social benefit for the general public, the term "housing" must be clearly defined.

Public pension funds to be considered a "social investment" must also be tailored and targeted to meet the needs of a particular sector in a state or local municipality. Therefore, if affordable housing is being advocated under the banner of social benefit investment of public pension funds, then these funds must be made available to that sector, (low and moderate income residents), which has an un-met capital demands.

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*3 An actuary is a person whose work is figuring out risks, rates, premiums, etc, for pension funds.
Public pension fund investment in residential mortgages and related instruments range from a multitude of whole loan products to a wide spectrum of mortgage-backed securities. Residential mortgages suggested under a social benefit investment strategy include graduated mortgage payments, equity participation mortgages and shared equity mortgages. Other suggested vehicles include a revolving loan fund for rehabilitation loans, and loan pool certificates aimed at pooling city and state monies with pension monies. However, the most common investment vehicle under the advocacy of social benefit continues to be mortgage-backed securities.

Exiting financial instruments such as mortgage-backed securities allow public pension fund participation in the purchase of first and second mortgages or mortgage securities. These securities have facilitated a move of public pension capital into the capital markets and the development of a secondary mortgage market which serves as a medium for pension fund investments.

A growing participation of public pension funds in mortgage or mortgage-backed instruments has occurred over the last fifteen years. The biggest motivation for public pension support of the mortgage market has come from the creation of several new capital market instruments, either backed directly with government guarantees or representing highly protected pools of conventional mortgages.

Mortgage backed securities pools were a major innovator in
the mortgage market by early 1970 with GNMA. Total mortgage investment accounted for nearly 13% of the holdings of state and local pensions by mid 1983 [Munnell, 1983]. The most popular form of social benefit investment in housing among state-administered pension funds has been the purchase of mortgage-backed securities of GNMA, actually targeted at low and moderate income residents.

Some proponents of social benefit investment and traditional pension managers have lauded the soundness and prudence of mortgage-backed securities and support such social benefit investment strategies which make use of these types of securities. With the growing secondary mortgage markets which trades mortgage-backed securities, concerns regarding the liquidity of pension fund investment, security of pension fund investments and competitive investment returns have been reduced.

Mortgage-backed securities yield competitive returns, especially over similar quality corporate bonds. These types of securities are also low risk; they are guaranteed by either the federal government or a private mortgage guarantee insurance company or federally linked agencies.

However, many researchers have argued that pension fund participation in mortgage-backed securities 1) do not increase

the aggregate supply of mortgage funds or mortgage credit within a particular state or municipality 2) displace other mortgage investors in the capital market and 3) do not necessarily increase the resource of housing capital for those seeking capital whom traditional financial institutions are hesitant to commit. [Litvak, 1981; Munnell, 1983; Peterson, 1984]

Like U.S. government bonds and Treasury bills, mortgage-backed securities have a ready market on and off the nation's securities exchanges. There is the argument that public pension fund investment in these securities produces a flow of funds into housing finance which simply displaces money from other sources. [Schur, 1981; Litvak, 1981; Munnell, 1983] However, it is not clear that this is true.

It appears that mortgage-backed securities satisfy the social benefit analysis of non-traditional investment vehicles for public pension funds, in the simplest sense. Yet if one weighs in social or political factors, in addition to simple risk/return analyses, then this investment vehicle fails to qualify as social benefit investment.

Public pension fund participation in mortgage-backed securities has not resulted in an increase in the pool of mortgage capital. One must, therefore, question if their participation expands the overall resource of mortgage capital, if it lessens the cost of capital as a result of their participation and if their participation creates
affordable mortgage capital for homeownership.

Some argue that social benefit investment in housing presents a conflict of interest, within the regulations that govern public pension funds. The established guidelines which outline the scope of interest a fiduciary may support. The primary interest is the protection of pension benefits and the investment of pension funds in vehicles which benefit the plan participants explicitly. Clearly, public pension investment of residential mortgages not directly aimed at benefiting the plan participants creates a potential claim for conflict of interest. However, there is support in administrative rulings, case law and legal commentaries for the notion that an investment can provide collateral benefits to third parties if its primary purpose is to benefit the retirement system participants.45

Where the introduction of social objectives has served to dilute the primary objective of pension funds, the Department of Labor has taken the position that such conduct by a plan fiduciary is imprudent. However, if the socially beneficial investment meets objective investment criteria which are appropriate to the financial goals of the portfolio, it may be considered in the same manner as other investments which these criteria. That is, if after evaluating the economic factors in a transaction, two investments appear to be equally

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desirable, then social benefits may be considered in determining which to select.

The investment of public pension funds in housing, under a social benefit investment policy, appears to create a conflict of goals between pension funds and the development of affordable housing. Total return for public pension funds is of paramount consideration. Investment which compromises a maximum return jeopardizes the existing stock of pension assets, threatens future benefit payouts, and may be in legal conflict with the legislature which regulates this industry.
Summary:

Social benefit investment is a complex investment strategy. While the past 15 years have witnessed an evolution in the practice of social benefit investment, it is evident that the lack of public pension fund participation in more social benefit investment vehicles suggests that the condition under which this strategy may develop has not yet been realized.

Residential mortgages have been the primary investment vehicle utilized by pension funds to address housing development. Investment in housing has been realized through the investment of pension assets in mortgages and, more commonly, mortgage-backed securities.

While favored among the existing vehicles for social benefit investment, mortgage-backed securities, as a strategy, do not accomplish the social goal of affordable housing development. Much of the support for this particular type of investment stems from the low risks they exhibit as an investment vehicle. This aspect has persuaded conservative pension managers to support this particular type of investment labeled social benefit investment.

Public pension investment opportunities exists for housing development. However, many of the current investment vehicles targeted under social benefit investment fall short of extending social, political or economic benefits. Various factors exist which impede the implementation of social benefit investment as a strategy for public pension funds.
These factors include: institutional factors, performance measures, legislative charters and investment issues. Chapter Three will explore these obstacles, highlighting the fundamental problems in the advocacy of social benefit investment. The presumed match between public pension funds and housing development operates in a complex environment of strict standards, regulations and objectives which exists among the associated industries which comprise the endorsement of social benefit investment.
Chapter Three
The Link Between Public Pension Fund Investments and Advocating A Social Benefit Investment Strategy in Housing

Public attention has focused upon the massive size of public pension assets and their projected growth. The current estimate of five hundred and twenty-one billion dollars in public pension assets easily creates a vision of massive wealth. This vision has led many to view these funds as an untapped capital resource, potentially capable of serving an innovative role in the financing of various investment projects, particularly housing. As a result, the use of these funds is being sought. For many in the public sector, (i.e. public officials and agencies, community organizations, etc) a social benefit investment strategy has been viewed as an instrument which could facilitate the flow of these funds into local investment projects.

Social benefit investment has evolved from a strategy whose aims was to gain greater accountability of pension investments to a strategy which requires the assessment of investment risks and returns as well as the consequential social good an investment may produce. While this application is more explicitly defined, social benefit investment has not been widely adopted within the pension industry. Yet, it has been the primary strategy of those outside the pension industry seeking the use of these funds.

A connection between public pension fund investment and the
advocacy of social benefit investment has presumably links these funds to social investments, such as housing. Yet, no clear correlation has been offered by advocates of this proposal as to why public pension funds should be used in socially beneficial investments, especially in those cases where investment risks are high (i.e. affordable housing).

On the one hand, critics of this proposal have identified the pitfalls of social benefit investment [Munnel, 1983]. On the other hand, supportive research has offered various investment vehicles, particularly in housing, which offer diversification of pension assets and achieve the goal of social benefit investments—i.e. the use of pension funds in vehicles which promote a social good and are viable investment projects [Rosen, 1978; Litvak, 1981; Schur, 1981].

Yet, the call for social benefit investment in housing is more complex than it appears. This strategy solicits the comprehension of the discrete components it incorporates. Each component—pension funds, investment, and housing—references a distinct field of application. To understand the relationship among pension funds, investment and housing, extensive knowledge of the objectives, standards and regulations particular to each field is essential. This knowledge is necessary to understand how the three terms are related and how that relationship impinges on the realization of social benefit investment.
The Debate:

Despite a increasing interest and involvement of public pension funds in social benefit investment⁴⁶, the new direction of pension investing that social benefit investment proposes raises difficult issues and concerns that have not been resolved since the initial debate began in 1976.

The primary debate regarding social benefit investment relates to the appropriateness of this strategy within the constructs of public pension standards. Much of the reluctance of public pension fund managers to practice social benefit investments has stemmed from a belief that prudent financial standards would necessarily be lowered. Opponents have argued that social benefit investing will impair portfolio performance, violate state and federal law, and be impossible to implement. Advocates of social benefit investment have frequently contributed to this criticism by failing to understand the implications of their proposals given the financial standards that pension funds must meet. Other advocates have ended up at another extreme by proposing investments that, while financially sound, are so unimaginative that they merely displace existing investors.

Advocates of social benefit investment strategies suggest that the key in realizing the goals of this strategy is in concentrating on sectors and enterprises which have been underfinanced due to gaps and inefficiencies in the financial systems. [Litvak, 1981; Schur, 1981; Munnel, 1983] Although this recommendation was more appropriate in the early 1980's, the more recent innovations in the capital market have made available a large pool of capital resource for various types of investments, making the argument of capital shortage difficult to endorse. However, inefficiencies in the financial market remain. Under this analysis, social benefit investment may be a mechanism to amend market failure. The debate arises, however, whether public pension funds are a suitable financial resource to finance sectors or enterprises that are not being financed by the market.

In regards to affordable housing, many proponents of social benefit investment view this strategy as an instrument by which public pension funds may be streamlined to finance non-traditional investments, satisfying a social need outright and providing financing of housing development. In this analysis, the point of debate centers on whether public pension funds are indeed a resource for local housing finance, given the constraints of the pension industry and existing financial resources (both in traditional financial institutions, such as banks, and in capital investors.)
The fundamental debate centers on whether or not social benefit investment supplements or interferes with the primary objective of pension funds—the ensuring the long-term safety and soundness of existing public pension funds. With so few examples of social benefit investment, and persistent dispute over the appropriateness of this investment strategy, it is clear that there exist obstacles beyond the simple impediment of copious debate which impede the implementation of a social benefit investment strategy by the public pension industry.
Identifying Obstacles to Social Benefit Investment

As previously stated, much research has criticized social benefit investment. Under "rule of thumb" prudent man analysis, social benefit investment fails to compensate pension fund investors for assuming high investment risks by offsetting it with a high return--instead, social benefit investment usually offers high risk with average to low returns.

The nature of this type of research has, for the most part, utilized existing measures of analysis to assess the appropriateness of social benefit investment. That is, researchers have utilized financial measures of return, which generate finite numbers for analysis, gauged these numbers to existing statutes, policies and standards for public pension funds and standards for capital investors, and issued a judgement of the appropriateness of social benefit investment under these criteria. However, it has been acknowledged that the lack of a criterion which measures the value of the social, economic or political gains a social benefit investment may offer makes it difficult to truly assess social benefit investment [Litvak, 1981].

Supporters of social benefit investment strategy for housing suggest alternative investment approaches: targeting capital investment--by sector, by region or by product; suggesting investment vehicles in which to invest pension funds to meet a
social need (i.e. loan pool certificates for affordable housing development); or recommending the formation of intermediary agencies which may facilitate social benefit investment.

The nature of this advocacy requires the entry of public pension funds into un-precedented waters. Innovative investment is solicited. Yet, historically, pension investors have pursued a traditional investment behavior that invests in vehicles which have been proven safe, sound and prudent. Social benefit investment falls far from this measure of safety.

With so few examples of social benefit investment, and persistent dispute over the appropriateness of this investment strategy, it is clear that obstacles exists. The lack of measures, precedent and consensus in assessing the appropriateness of social benefit investment may lead one to conclude that these have been the primary obstacles to the implementation of this strategy. However, I would suggest there are institutional, ideological and practical obstacles that exist which have impinged the realization of a social benefit investment strategy.
Institutional Obstacles

Institutional standards include those standards for the pension industry and financial investment industry. Each has a distinct scope of operation with instituted regulations which monitor the management and investment behavior of those who administer funds within these industries.

Chapter Two discussed in detail the distinct restrictions and criteria which exist within the pension industry. The institutional demand for safety, soundness and prudence—as established by federal law, local statutes and pension board guidelines—forms the basis of pension fund management and investment. Jeopardy to existing pension assets, through poor management, poor investment vehicles or high risk investments is not endorsed.

Two key institutional factors within public pension industry—management standards and performance measures—form base measures which pension managers must consider in the everyday operation of pension funds.

Management dominates the investment policies and portfolio choices of pension funds. An important factor is the delegation of managerial responsibility for investment of funds. Most public pension funds have delegated this authority to banks and to investment managers. Influence of banks and investment managers is illustrated in the orientation of public pension investment vehicles—traditional
stocks and bonds. Public pension managers are trained and accustomed to investing in the top 500 corporate stocks and bonds; this training makes it difficult to re-orientate them to look at non-traditional investment vehicles, such as residential mortgages.

Performance measures of public pensions, emphasizes short-term portfolio gains rather than providing an investment evaluation based on long-term risk-adjusted returns. Optimal investment performance are related to short-term performances of the stock portfolio. As such, social benefit investment vehicles are often negatively assessed because the investment does not measure up to the triple A grade corporate bond of a particular investment quarter.

Financial investment standards further define the parameter in which social benefit investment must be assessed. Investments made to promote social benefit investment generate financial, social and political returns. However, the social and political returns are difficult and often impossible to measure in dollar returns. Under simple prudent man analysis, social benefit investment fails to compensate pension funds in a manner that can be accounted by a project manager to the overall portfolio. If the pension manager evaluates an investment on the basis of financial returns, the additional criteria of social benefit often does not receive the appropriate assessment of such an investment.
Additionally, legislative charters presents an institutional obstacle which stems from state and local governments. Restrictive legislative charters may limit the types of investments pension funds can invest in. Most often state and local statutes prevent investment of public funds in common stocks and bonds, mortgage restricted to conventional holdings, or specify a set percentage of any particular type of investment. In more recent times, many states have begun to re-evaluate restrictive laws and modifying them to allow pension fund investment in areas which had not been allowable prior to these changes. This change has been viewed as a positive step towards encouraging social benefit investments.

Institutional Terminology:

There exist such a dense set of terms which characterize the pension, investment and housing industries, that a basic statement such as "pension funds should invest in housing", once analyzed and delineated, would produce volumes of definitions describing multiple interpretations.

Much of the public attention around pension funds has been raised by public officials launching political agendas which address local economic distress and point to the immense capital resource accumulating in pension funds. This attention projects the vast size of pension assets, and beckons the investment of pension funds in local projects.
What is often lacking is an explicit appeal which places into proper perspective the role pension funds may take as a capital resources.

Unlike banks and insurance companies, which have departments that specifically target a portion of their assets to "social" investments⁷, pension funds are not required to develop a specific division obliged to assess local community needs, and target a given percentage of assets for local community investment. Social benefit investment strategies are not standard operations for pension funds nor are they expected to be incorporated into a pension plans investment strategy.

One can appreciate the complexity behind the call for social benefit investment. But it should be questioned whether it is clear what social benefit investment means. Social benefit investment is not simply a request to channel "pension funds" to local development projects. Rather, it is a specific call issued up a particular sector within the pension industry, ie. public pensions. No longer is it simply "investment," but rather, a social benefit investment strategy, which in turn,

⁷ The development of a specific community investment division within banks and insurance companies results from the federal Community Reinvestment Act (CRA) of 1974, which has been used to track local investments by these industries to residents within local communities. To date, many communities have relied on the CRA threat-- a threat which grants local communities power to demand capital investments within those neighborhoods which have been found to be under-serviced by these institutions. See Community Reinvestment Act, 1974.
refers to that portion of pension assets targeted to non-traditional investment vehicles which result in a social good while offering competitive returns. Housing, as the last component of the social benefit investment proposal, has been defined to a specific housing type, i.e. affordable housing, further delineating the scope of this advocacy.
Ideological Obstacles:

Since the late 1970's, pension funds have been investing more of their assets in income-producing real estate and could conceivably become one of the principal sources of capital for that business. Yet the pension investor does not fully understand the income property business, nor does the real estate community understand how pension funds operate. Each is only vaguely aware of the other's motivation.

The misunderstanding between the two businesses stems largely from ignorance, but it also results from differing ideological goals. Public pension funds operate for the ultimate purpose of providing secure retirement income to the beneficiaries of a plan. In contrast, investors in the real estate market, such as housing, seek to capture maximum returns on any given venture. Their attitudes toward risks differ from pension managers who must seek safe investments which do not jeopardize existing pension assets. Pension managers are fiduciaries--trustees of their funds--and they are bound by law to run them prudently and exclusively for the benefit of the people in the plans. They can be sued for imprudent investing by those in the plan, so they invest the money at conservatively as possible.

An investor, on the other hand, sits on the opposite end of the risk spectrum. He is not fiduciary. He invests for his own account or that of his employer and he has one goal--to
make money. He pays far less attention to the risks involved since he runs no risk of being sued for imprudent investing and can make a great deal of money if his investments do well. More elementary, an investor can entertain a high risk project with the expectation of compensation in assuming high risks by obtaining high returns.

The separate approach towards investments has often reserved public pension fund investment away from more high risk investments. Social benefit investment, as viewed by the pension industry, suggests investments in high risk ventures such as affordable housing. As such, much skepticism arises from the flow of these funds to such investments. Because safe investments have been the pension industry tradition and few examples exists which illustrate the merits of social investments, pension managers tend to resist the implementation of an investment strategy that potentially threatens pension asset reserves.

In contrast to pension managers, public officials face political pressure to address the funding of local development projects. Because these officials do not manage pension funds nor experience the legislative or industry constraints pension managers face, their advocacy of using public pension funds in social investments rests upon the identification of large capital resource which could fund local development. Little regard is given to the comprehension of the industry except to
the extent of recognizing an investment proposal must be made to pension managers in order to present an investment proposal for consideration.

Similarly, local community agencies, development groups and residents seek the use of pension funds with the belief that these funds are "the answer" to the financing of affordable housing, job creation, neighborhood revitalization, etc. Little regard is given to the financial analysis of such investments. Little attempt is made to understand the dynamics of pension investment. Only recently, has literature documented the need to develop sound and competitive proposals under social benefit investment which may gain the approval of investment managers.
Practical Obstacles:

The move from theory to practice has often been unsuccessful. This can be said of social benefit investment. The structure of the pension system as it currently exists places such stringent restrictions under which investments are analyzed that the proposition of social benefit investments conflicts with these restrictions and hence, fails to gain support as an investment strategy. Theoretically, pension funds could be invested in ventures that are viable and produce a social good. Social benefit investment in this case would offer the diversification of pension investments to ventures that are sound and competitive, and may produce a social good. However, diversification of pension assets is not an excuse to accept below-market yields or accept high risk projects for investment. In practice, the institutional barriers which exist demand that pension investments be competitive market-rate investments, thereby requiring a market return for a given risk. In reality, many social benefit investments have resulted in below-market yields, have an estimated high risk without a commensurate returns, or an estimated average risk with below-market returns. The few examples the exist do not confirm that social benefit investments offer competitive market yields nor high returns nor necessarily safe investments. Looking at the primary example of social benefit investment in housing--mortgage-
backed securities--it has been documented that much recognition is issued to such an investment for its relative safeness but criticized for its lack or compromise in meeting social benefits.

Taking the worse-case scenario, assume public pension funds are invested in high risk social benefit investments which offer only average returns. Assume that public pension funds continue to investment 5% of their assets in such investment projects. Assume that these investment prove to yield below-market returns. Who is ultimately liable for the recapture of these funds when paying out the guaranteed benefits to pension plan members?

Ultimately, the state and local government will bear the brunt of imprudent, un-sound investments. If pension fund investments fail to generate investment earnings and jeopardize the stock of pension assets, the state and local governments which sponsor these plans must be accountable to its public employees and the guaranteed benefits promised to them. As defined-benefit recipients, public pension members need not worry about the investment performance of their pension assets; the benefits the employees are guaranteed are defined as a product of an established formula which defines employee benefits. Investment earnings secure the actuarial need of a system and the contributions of the participants. However, these earnings bear little upon the amount of
benefits received by a pension plan member.

What implications does social benefit investment have to public pension members? Aside from the argument that direct social benefits are earned, in financial terms, social benefit investments offer greater risk to the stock of pension assets than traditional pension investments. Where, then, does the marriage between public pension funds and social benefit investment such as housing emerge from? Chapter Four explores whether social benefit investment as approached, is an appropriate investment strategy for public pension funds.
Summary:

The call for pension fund investment in housing raises difficult issues and concerns that have not been resolved since the initial debate began in 1976. The primary debate regarding social benefit investment is the appropriateness of a social benefit investment strategy within the constructs of public pension standards. The presence of institutional, practical and ideological obstacles has delayed the implementation of a non-traditional public pension investment strategy.

The call for social benefit investment of public pension funds has assumed an association among distinct groups interested in pension funds and their investments. This assumption holds that a common goal exists among the various groups. Such is not the case. If everyone involved endorsed (and not everyone does) the diversification of pension investment through a social benefit investment strategy, the realities of implementing such a proposal would still pose difficult questions. One is the issue of unity, or consensus. Not all interested parties have the same objective or goal in mind for pension investments. Corporate management, union leadership, pension trustees, local government and the beneficiaries of the plan may all approach investment decision and risk quite differently.

Each of the groups affected by a pension plan has a unique
perspective, raising another issue. Pension trustees charged with fiduciary responsibilities must respond to different pressures than members of the legislature. The same is true for investment managers, who often are judged on fund performance rather than on regional economic development or the rate of innovation that strategically placed pension investments might help address a local demand. Whichever perspective, obstacles whether institutional, practical or ideological continue to impede the implementation and usage of a social benefit investment strategy.
Chapter Four
Social Benefit Investment in Affordable Housing:
From Theory to Practice

The reader might wonder if given the unfavorable view of
social benefit investment presented in the previous chapter,
and the obstacles which exist that impair the implementation
of this strategy, is it even possible to introduce social
considerations into an investment program in light of the
considerable institutional and practical barriers to doing so.

One may question what is inappropriate about social benefit
investment. While there is no simple answer, often the direct
conflict between social goals and generally accepted levels of
prudence has deemed this strategy as inappropriate within the
constructs of public pension regulations. There is often a
trade-off in which the overall risk of the investment is
increased, with no commensurate increase (or decrease) in
yield; a form of market aversion occurs in which the investor
receives a lower return at higher risk.

Few instances exist to illustrate the implementation of this
strategy. A look at past attempts may give light to the
conditions in which social benefit investment can take place.
Experience over the last few years has demonstrated that a
small portion (less than three percent)\(^8\) of state and local

\(^8\) Kennedy, Gordon and Eugene B. Burroughs, "Adopting an
Institutional Real Estate Investment Policy" in Real Estate
pension assets has been used to fill local capital gaps without sacrificing return or diversification objectives.

While the majority of social benefit investment has been generated by the public sector, a number of private plans, especially associated with unions, have been putting their pension assets to new uses. [See Landecker, 1981, for a more elaborate discussion on unions and strategic investments]

Most recently, the Department of Housing and Urban Development (HUD), recognizing union initiative to implementing social benefit investment, has recommended that unions consider investing their pension plans in projects that provide affordable, moderate-income housing. At an April 12, 1988 investment workshop held in conjunction with an AFL-CIO conference, HUD officials stressed that in addition to being socially desirable, such investments can be designed to be secure for pension participants. [Bureau of National Affairs, 1988]

Other action taken upon by the unions has been the targeting of pension funds specifically for social benefit investment. The AFL-CIO has developed a $500 million program to use pension funds for job creation in the construction industry. In Southern California, 19 unions formed a consortium to invest over $150 million drawn from their pension assets in 25 union construction projects within the state. Projects included residential housing, condominiums and townhouse
loans, office buildings, a hotel complex and a shopping center. In Oregon, eight building and construction funds, with approximately $300 million in assets, joined together to form the Pacific Northwest Construction Finance Forum, which aimed to invest in commercial and residential mortgages in the Pacific Northwest. In Florida, the Palm Coast Affirmative Investment Roundtable aimed to develop programs to use pension funds in issuing market rate construction loans in union-constructed commercial, residential and industrial real estate projects.

In the public sector, much of the activity aimed at implementing social benefit investment has been through the development of state or local home loan programs. Hawaii Public Employees Retirement System is the oldest example of social benefit investment. Since 1959, it has made mortgage loans to plan participants, lending money at favorable rates to low-income borrowers and at market-rate to others; these loans constitute 20% of the plan's assets. As of 1983, the program accounted for $560 million of the pension's $1.8 billion investments. Roughly, 40 percent of the system's 51,000 active and retired members have taken advantage of the program.

Other states, such as California and New York, have take the lead in implementing mortgage programs or intermediaries which ease the investment of public pension funds in residential
mortgages. The most popular form of investing in housing among state-administered pension funds has been and continues to be the purchase of mortgage-backed securities.

While it appears that housing investment would be welcomed given the above examples, in actuality, the aggregate of public pension funds has not been engaged in housing investment. Thus far, public pension funds have basically taken only two kinds of action in targeting their mortgage investments--providing preferential interest rates on home mortgage loans to public employees and targeting pension investments in mortgage-backed securities [Munnell, 1983].

These two actions illustrate two contrary approaches in implementing social benefit investments--neither of which have gained full endorsement by all parties involved. On the one hand, preferential interest rates on home mortgage loans often solicits a sacrifice in yield, which conflicts with the prudent man standards of the pension industry. On the other hand, investment in mortgage-backed securities have taken place within a sector of the financial market which has done little to expand or lower the cost of capital resource for housing finance [Munnell, 1983]. While safe and prudent investments, as well as a vehicle for diversification, mortgage-backed securities have failed to address the social

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need of affordable housing.

Few public pension funds could properly initiate and manage social benefit investments without either first establishing internal goals and objectives which aim to address local social concerns, establishing the management capacity internally to target these funds, or obtaining assistance from external intermediaries which aid the transfer of pension funds to these investments.

Social benefit investment requires extensive networking among the players involved. A concerted effort between pension managers, financial institutions, local government, and housing advocates needs to take place if social benefit investment as currently defined, is to be implemented.

Yet one must ask, under what climate would a public pension manager collaborate with local government, financial institutions and housing advocates to support social benefit investments. The question follows, what would make social benefit such a good deal? Would others invest in such investments?
Social Benefit Investment in Affordable Housing: A Model

An elementary model (as proposed by advocates of social benefit investment) of public pension fund investment in socially beneficial housing ventures would obviously have a climate in which the necessary mechanisms—such as non-restrictive regulatory legislature, pension investment policies which incorporate a social benefit investment, integrated financial programs with local financial institutions, state and local financial intermediaries, investment-literate housing advocates, and pension managers who are real estate literate—existed in order to compliment the call for social benefit investment. These mechanisms would encourage the risk and return analysis while promoting the social gains these investments offer. Concessionary investments would not be endorsed since high risk ventures would be offset by the amalgamation of these resources.

Under this scenario, social benefit investment of public pension funds, is a suitable strategy in meeting diversification objectives, has the potential to produce market yields on investments (particularly if intermediaries serve securitize an investment or insurance it through a local guarantor) and if specifically targeted, may result in social benefits for the general public. In one analysis, social benefit investment in housing has been regarded as a prudent balance for the highly volatile and disappointing performances
of stocks and bonds [Schur, 1981].

Because public pension funds pay out benefits to its membership in the future, they have a long-term investment horizon. Unlike other investors, public pension funds can tolerate investments that promise good long-term returns but do not necessarily have substantial short-term cash flow. A long-term horizon also suggests that pension funds can better tolerate upswings and downswings in investment value (risk). For social benefit investments, this aspect would suggest a propensity in supporting long-term investments in housing.

While this model encourages the advancement of a social benefit investment strategy, this model functions on imperfections and non-existent market conditions. In reality, no actual model exists. Social benefit investment, as practiced, fails to encourage public pension funds investment in less than traditional and/or financially sound investments; fails to encourage investments which produce obvious social benefits; and conventional wisdom suggests that it is not the mechanism by which to solicit public pension fund investments—fifteen years of debate attest to its lack of implementation.
Social Benefit Investment Strategy Under the Model Setting

In the last ten years public pension funds have financed more projects which have been positive and alternative. The increase in public knowledge of pension assets and the 15 years of debate have assisted in extending some knowledge of public pension systems and their investment policies [Barber, 1988].

Given the regulations and constraints which dictates the pension industry, why has discussion on social benefit investment persisted? It appears that there is some anticipated desire to channel the flow of pension funds into vehicles that address local needs. In a decade of federal cutbacks, the vast size of public pension funds makes them an easy target for public attention. Public officials continue to project their vast size to the public as a mountain of wealth, which, through some measure can ultimately serve as a panacea to the social ills many major cities now face.

One may ask what does it mean to promote an idea which clearly does not transfer from theory to practice. Many advocate of this strategy have suggested several methods which they believe may facilitate social benefit investment. In their view adopting a social benefit investment policy would require an effort which comprehends the merits of this approach; integration of several key concepts behind this approach needs
to be adopted into: the investment objectives of the public pension plans; state and local government policies; financial investment programs; and must be understood by proponents of affordable housing development. The following highlights the techniques suggested by advocates which aim to advance the practice of social benefit investment.

Criteria for Public Pension Funds:

To the purpose of facilitating a social benefit investment strategy, investment objectives of a public pension plan should directly confront the issues of risk tolerance, and stipulate the flexibility allowed in assessing an investment risk. The investment objectives should also directly address the issue of safety and expected returns. Lastly, an investment policy objective should include a statement of the role in which non-financial factors, such as those resulting from social benefit investing, play in the assessment of an investment project and in the assessment of the benefits to the overall portfolio.

Role of State and Local Government and Public Officials

The recent interest and activities of public pension funds in social benefit investment raises several policy question for the various levels of government in fostering public policy goals in general and social benefit goals in specific.
Federal, state and local governments have the ability to encourage social benefit investments of public pension funds.

State governments have the ability to influence public pension investment decision-making by regulating the investment practices of state and local plans. With regard to investments, state laws usually control the conduct of fiduciaries by requiring them to invest pension funds in accordance to the prudent man rule.

In most cases, public officials are not in a position to implement social benefit investing directly. However, indirectly, they can influence the decision-making process of public pensions.

Public officials can ensure that pension investment laws that currently exist do not containing rigid legal lists the prevent prudent social benefit investments. These laws should not remain outdated formulas but be revised with the basic notion of reasonable care and responsibility to the retirement plans' participants.

Public officials can also provide other forms of support for effective social benefit investing to take place. These range from research and analysis of the local demographics which characterize a local municipality; identifying economic gaps which have un-met local supply, (particularly affordable housing); identifying and give priority to specific investments and investment vehicles that pension fund trustees
can consider. The latter requires a willingness to establish the necessary public intermediaries or investment insurance programs which will lessen the impact of adverse high risk ventures.

Part of the task in implementing social benefit investment rest in the creation of intermediaries which channel funds where they are needed. These can either be quasi-governmental operations or independent entities created to alter or eliminate the conditions which impede pension participation in non-traditional investment vehicles.

Types of intermediaries that government has created in response to facilitate pension funds participation in the capital markets has been the creation of institutions like the Government National Mortgage Association and other debt intermediaries financed by tax-exempt bonds, tax revenues or investment guarantee.

Various financial programs have emerged which also serve the role of intermediaries—mechanisms which assist the use of pension funds. These programs bridge or pool pension funds with other investment funds in particular investment vehicles.

Role of Financial Institutions:

The role of financial institutions in the advancement of a social benefit investment policy of public pension fund rests
in the support of non-traditional investments which are identified and targeted by pension funds and public officials as prudent investments. Support may come in the form of originating residential mortgage loans for low-income housing development, selling the mortgage-backed security to pension funds, etc. Other support may include honoring the credit enhancement a pension fund may extend to a socially beneficial investment endeavor.

Since much of the advocacy centers on the direct use of pension funds into an investment venture, the role of the financial institution has been overshadowed, however it should not be underestimated.

**Role of Affordable Housing Advocates:**

Fifteen years of advocacy and debate has done little for the advancement of social benefit investment of pension funds in housing development. This debate has stressed upon all interested in pension investments, but more so, advocates of housing, the importance of packaging sound and competitive investments which may facilitate pension investment consideration. Randy Barber, in an lecture addressing pension funds and community investment, clearly articulates this point: "You [community groups] represent a base of infrastructure, knowledge and skill, and if you are willing to plan for the long term--putting together technically sound and
competent proposals—you will be able to find [pension]
investors who are willing to listen to you."\textsuperscript{50}

The soliciting of public pension funds in housing
development has been a strenuous battle which has resulted in
few instances of implementation. These instances however,
serve as models for other pension plans seeking precedent in a
field that has been viewed as highly speculative. Yet, if as
discussed, real estate is a solid, long-term investment with
stronger hedge to inflation that stocks and bonds, why do
pension managers continue to be so conservative in their
investment decision-making? Are they overly conservative,
especially when vehicles like mortgage-back securities have
proven to safe and prudent?

\textsuperscript{50} op cit, \textit{Community Economics}, Fall Issue 1988, page 2.
Summary:

The current climate under which advocacy of social benefit investment has take place is characterized as an atmosphere of resistance. There are significant obstacles which have barred the implementation of social benefit investment as an investment policy and objective of public pension funds. Few cases exist which illustrate the potential applications of social benefit investment. These cases serve to counterpoint the lack of social benefit investment instances.

Even with these few instances of social benefit investment, it continues to be more a point of discussion than an actual strategy for investment. This would suggest that even in those environments where obstacles have been removed, or a clear objective has been adopted and developed, institutional barriers continue to hinder the widespread adoption of social benefit investing as a policy for a portion of public pension funds.
The debate on whether or not public pension funds should be invested in socially useful ways persists to present day. Use of such funds in the development of affordable housing is being viewed by many public officials, public interest groups and social activists as an un-tapped capital resource. However, the realization of a social benefit investment strategy for public pension funds has failed to gain usage due to several factors.

The gap between the advocacy of social benefit investment and its implementation is a product of stringent industry standards, restrictive state and local legislature, poor common knowledge of each interest group, and no common terminology between each group. This gap has resulted in a 15 year old debate regarding the appropriateness of social benefit investment.

In essence, the call for social benefit investment of public pension funds creates a self-contained paradox. In theory, public pension funds could be invested in viable, socially beneficial investments. In practice, however, the institutional barriers which exist demand that investments be market-rate, competitive investments, thereby requiring market-rate returns for a given risk. Conventional wisdom
CONCLUSION

Public pension funds are being viewed by many public officials, public interest groups and social activists as an un-tapped capital resource. However, the realization of low-income housing as an investment strategy for public pension funds has failed to gain usage due to several factors.

The gap between the advocacy of public pension fund investment in "affordable" housing and its implementation is a product of several component: stringent industry standards, restrictive state and local legislature, lack of communication among the actors, and lack of common terminology between each group. This gap has resulted in a 15 year old debate regarding the appropriateness of social benefit investment.

In essence, the call for social benefit investment of public pension funds in housing for low-income residents is a logically contradictory appeal. Public pension funds can be invested in viable, socially beneficial investments. But the institutional barriers which exist demand that investments be market-rate to insure that the beneficiaries of the funds, the retired public employees get the maximum return on their invested funds. Conventional wisdom shows that most current social benefit investments have resulted in below-market yields and/or involvement in high risk ventures without commensurate returns. The few instances in housing investments have offered competitive market-rate yields but have compromised the
objective of producing a social benefit. The trade-off is between prudent investment and investment in "affordable housing."

Vehicles do exist which offer an investment choice in housing to a pension manager. These investments conform to the financial standards and investment performances that pension investors seek in selecting ventures to finance. The mortgage-backed securities unquestionably meets this application. If "social investment" simply means investment in housing, then mortgage-backed securities have been found to meet this goal.

On the other hand, if social benefit investment summons the use of public pension funds in projects which do not satisfy the established financial criteria and/or conflict with pension standards, but satisfy the social good of financing low-income housing, then pension managers must engage in unprecedented, innovative investing which poses high investment risks for average to below-market yields. Acceptance of below-market yield directly jeopardizes the preservation of existing pension assets, (and potentially, the defined-benefits retirees are guaranteed) and defies "prudent man" standards (i.e. investments which have not been proven to be safe, sound and prudent).

One must recognize that social benefit investment--meaning low income housing rather than housing per se--fails to gain usage within the regulated environment of the pension industry. It is a proposal that is not appropriate within these parameters. Ultimately, the responsibility of producing secure
retirement income to pension plan members mandates that investments of public pension funds be safe, sound and prudent. Conformity to these measures demands that only competitive and sound investments be financed.

The criteria of supporting technically sound and competitive investments raises the point that public pension funds are not an "alternative" capital resource that can in and of themselves finance low-income housing. They represent a market-rate capital resource, and pension managers as their investors demand market-rate returns on their investments. Like banks and capital investors, pension managers seek a maximum return on investments. While public pension fund managers are historically more conservative in the risks they are willingly to assume than other investors, fundamentally, public pension funds operate on the same standards as other capital investors.

If public pension funds cannot be other than market-rate capital, then the proposition of many advocates including public officials--that public pension funds be used to finance affordable housing and neighborhood revitalization--suggests that such investments will be at market-rate standards. If this is the case, then why aren't other capital investors being targeted? If market rate-of-return is not the case, then public pension funds are not the appropriate resource. The gap between the advocacy of social benefit investment of public pension funds and the logic of such practice remains debatable.
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