Joint Economic Committee Republicans

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Economically Targeted Investments (ETI's): The Issues

Pension funds have grown dramatically in the last ten years, from $1.5 trillion in 1983 to nearly $5 trillion by 1995.[1] The Federal Reserve estimates that one-fifth of all assets in the United States are held by pension funds, and a recent study indicates that pension funds represent 32% of the daily trading on the New York Stock Exchange. This immense wealth has attracted the attention of the Clinton Administration, which has begun implementing its strategy to steer these pension funds toward a variety of social projects labeled as economically targeted investments, or ETIs.[2]

What exactly are ETIs? While many disagree on a precise definition,[3] the essential characteristic of ETIs involves adding a second goal to the traditional pension fund investment strategy of maximizing return for the pension's beneficiaries. That second goal may be to build public housing, to provide union jobs, or even to forward the investor's political agenda. Robert Reich, the Secretary of Labor, issued Interpretive Bulletin 94-1 (IB 94-1) that promotes ETIs. IB 94-1 defines them as investments "selected for their economic benefits apart from their investment return to the employee benefit plan."

Secretary Reich issued IB 94-1 because pension fund managers have traditionally felt that formally considering such collateral benefits in the investment process would violate the fund manager's fiduciary duty under the Employee Retirement Income Security Act, or "ERISA."[4]

Section 404 of ERISA defines a fund manager's fiduciary duties and clearly states that pension funds must be managed "for the exclusive purpose of (1) providing benefits to participants and their beneficiaries; and (2) defraying reasonable expenses of administering the plan."[5] This fiduciary duty section of ERISA created a wall of separation between investment managers and any interest besides the plan participants and beneficiaries. Reich's Interpretive Bulletin is not faithful to the original understanding of section 404's duty of loyalty standard because Reich introduces another purpose, and a very vaguely defined one, that opens a huge range of social goals that the pension fiduciary may now pursue.

Besides the legality of ETIs, a number of other problems raise serious doubts about the economic and political viability of ETIs. The predominant percentage of ETI funding has been focused in the area of housing development. The proponents of ETIs see the large pool of pension fund money as the best source of capital to replace the declining savings and loan investments in housing. Unfortunately, the causes of the S&L debacle that cost taxpayers over $150 billion could also threaten any future pension fund's investments in real estate, but this time the losers would be thousands or even millions of pensioners.

A serious concern among many pension managers is the possibility that ETI investments could easily become mandatory once they are accepted among the pension community. This has happened already in Arkansas while Clinton was governor, and to varying degrees in a number

of state legislatures.[6] Many states are following the model legislation designed by Richard Ferlauto of the Center for Policy Alternatives (a spin-off of the Institute for Policy Studies). Ferlauto's model calls for a 5% to 10% quota on public ETIs on the state level. If such a policy were adopted on a federal level, it would mean for every $100 invested in private pensions, $5 must be spent on ETIs. Assuming even the smallest figure of a 5% quota for private pensions, that would give the Administration as much as $175 billion in private pension money to spend on various social projects.

Ferlauto also proposed that ETI programs must be enhanced through the development and use of appropriate risk reduction mechanisms that include government-funded guarantee programs, combined government and private insurance pools, insurance premiums charged to the borrower's loan loss reserve pools, equity contributions from trust funds, and targeted subsidies. The bureaucracy that would result from such ambitious and broad government involvement would dramatically alter the shape of the pension system.

Ultimately, the issue becomes whether one believes that the most effective and efficient method for investing pension is the free market guided by the general framework of ERISA, or whether the state and federal governments should become an active participant in nearly every aspect of the pension investment process. The Clinton Administration wants the federal government to become more and more involved in the private pension market, while those who oppose him want to allow the market to freely choose the best investments for its retirement plan needs.

The last and most troubling question regarding ETIs is whether the possibility of pension failures or lower investment returns would cause an underfunding crisis in the pension system. A recent book by Thomas Donlan, entitled *Don't Count on It*, goes to great lengths to document the serious financial crises facing many pensions in the not so distant future. For instance, Mr. Donlan, a senior editor at Barrons, points out that many of the over-funded plans are currently taking assets out of the pension plans, and "total underfunding increases every year" according to statistics compiled by the Pension and Benefits Guarantee Corporation. If private pension plans invest even as little as 5% of their $3.5 trillion of pension funds in ETIs, they could lose billions of dollars and create huge gaps between pension liabilities and pension reserves. Senior citizen's will be the most affected by failures in ETIs, and a number of senior citizen's groups have been actively fighting Clinton's ETI strategy.[7]

To avoid this potential crisis, Jim Saxton, the Vice-Chairman of the Joint Economic Committee introduced the Pension Protection Act of 1995 (PPA), H.R. 1594. The primary purpose of Saxton's bill is to restore ERISA to its original meaning that required pension managers to invest worker's pension funds solely for the interest of the beneficiaries.

The PPA makes it clear that ETIs violate ERISA because they involve the pension manager in pursuing investments for the benefit of social and political goals in addition to the goal of serving the plan's beneficiaries. In addition, no governmental agency would be allowed to create a list or database of ETIs, or make any guarantees or subsidies for the purpose of investing in ETIs. This provision would abolish the ETI Clearinghouse established by Secretary Reich in 1994.

Endnotes

1. Pension fund assets are now twice as large as the total bank assets of $2.1 trillion, the traditional source of investment financing (Investor's Business Daily, August 15, 1994).

2. Clinton in his 1992 campaign promised to create a "Rebuild America Fund" calling for billions of dollars to be invested in infrastructure with the help of a combination of government and pension funding, and since then the Clinton Administration has expanded the purpose of ETIs to assist in the creation of public housing, job creation, and a host of other liberal social spending projects.

3. For instance, a recent Goldman Sachs survey of over 100 pension investors could not find any consistent use or understanding of the term 'economically targeted investment.'

4. The Employee Retirement Investment Security Act "ERISA," was enacted in 1974 in response to a number of pension investing abuses which led to a number of pension failures that left millions without adequate pensions. ERISA strengthened the common law by clearly spelling out the duties of private pension fund managers, including the duty to act solely and exclusively for the benefit of the beneficiaries.

5. 29 U.S.C. sec. 1104(1)(a).

6. Legislation based on Ferlauto's model legislation calling for state ETI quotas has been introduced or approved in a number of state legislatures.

7. The United Seniors Association and the Seniors Coalition have been the most outspoken critics of ETIs and the negative effect that such investments would have on senior citizens.