

## **PUBLIC EMPLOYEE RETIREMENT SYSTEMS; INVESTMENTS**

### **House Bill 5754 (Substitute H-1) First Analysis (5-18-00)**

**Sponsor: Rep. Jerry Vander Roest  
Committee: Senior Health, Security and  
Retirement**

#### ***THE APPARENT PROBLEM:***

The Public Employee Retirement System Investment Act authorizes the investment of assets of public employee retirement systems in Michigan, and places limitations on the ways in which those funds can be invested. The act applies to all retirement systems operated by the state or by local units of government in Michigan. It has been amended periodically to bring it up to date with current investment practices. Generally, the purpose of these periodic amendments has been to balance the dual aims of ensuring prudence in investment decisions to safeguard the public assets involved, and to allow pension managers flexibility to maximize investment returns so as to produce the greatest benefit for the pension systems. The act was updated in 1982, and again in 1996. Legislation has been proposed to once again update the act to reflect the rapid pace of change in the financial marketplace.

#### ***THE CONTENT OF THE BILL:***

The bill would amend the Public Employee Retirement System Investment Act to make the following changes:

Investment fiduciaries. Under current law, an investment fiduciary (other than a state or local government employee) must meet certain requirements, including that he or she be a registered investment advisor under both the federal Investment Advisors Act and the Michigan Uniform Securities Act. The bill would modify this provision by allowing an investment fiduciary to be registered under either the federal or state act.

MacBride principles. Current law requires the investment fiduciary to use all capital stock, common stock, preferred stock, American depository receipts, or any other evidence of residual ownership of a corporation in which it has investments to support shareholder resolutions and initiatives proposing the adoption of the MacBride principles, or to support

shareholder resolutions and initiatives proposing to recognize efforts to end employment discrimination contained in the Anglo-Irish agreement dated November 15, 1985. (The MacBride principles are requirements for companies doing business in Northern Ireland designed to end discriminatory employment practices.) The bill would amend this provision so that it would apply only to direct stock investments, including stocks and foreign securities.

Investments in domestic stocks. The act currently authorizes an investment fiduciary to invest up to 65 percent of a system's assets in stock. The bill would raise this threshold to 70 percent. Further, the bill would allow an investment fiduciary to designate an American depository receipt (ADR) that meets the requirements of the act for a stock investment to be classified as either a domestic stock investment, or an investment in foreign securities.

Real estate investment trusts. Current law allows investment in publicly or privately issued "real estate investment trusts" (REIT) or in certain other real or personal property. An investment in stock under this provision is not considered to be an investment in stock subject to the 65 percent threshold (see above). The bill would delete this provision, and instead would allow an investment fiduciary to designate this type of investment as either a real estate investment or an investment in domestic stock for purposes of determining asset limitations.

Pooled funds. Current law allows a financial institution or a management company retained as an investment fiduciary to invest the assets of a system in a collective investment fund, common trust fund, or pooled fund that is established and maintained for investment of those assets by the financial institution or management company. The bill would amend this provision to include trust companies along with financial institutions and management companies.

Basket clause. The act allows a system with less than \$250 million in assets to invest up to five percent of the system's assets in investments not specifically authorized by the act. A system with assets of \$250 million or more may invest up to 10 percent, and the state treasurer is authorized to invest up to 15 percent of the system's assets in this manner. The bill would increase the "basket clause" limit for the state treasurer to 20 percent, and would add a provision allowing a system with assets of \$1 billion or more to invest up to 15 percent of the system's assets in investments not specifically authorized by the act.

Loan of securities. The act currently permits an investment fiduciary to loan bonds, stocks, or other securities if, when the loan is executed, at least 102 percent of the full market value of the security loaned is secured by collateral of cash to be invested in investment grade securities or repurchase agreements collateralized by investment grade securities (among other things). The term "investment grade" is defined in the act to refer to securities graded in the top four major grades as determined by two national rating services (e.g., Moody's, Standard and Poor's). The bill would eliminate use of the term "investment grade securities" in this provision, and instead would allow the use of unrated securities in addition to securities graded in the top four major grades as determined by at least one national rating service, but not graded below the top four grades by any of the national rating services. The investment fiduciary could only use unrated securities if it determined that they were of comparable quality to the eligible rated securities.

Loan guarantees. Currently, a system with assets of \$100 million or more and established by a city is authorized to invest in certain loan guarantees. The bill would repeal this provision.

MCL 38.1132b et al.

### ***BACKGROUND INFORMATION:***

The State of Michigan Retirement System represents the combined assets of the Public School Employees Retirement System, the State Employees Retirement System, the Michigan State Police Retirement System, and the Michigan Judges Retirement System.

### ***FISCAL IMPLICATIONS:***

Fiscal information is not available.

### ***ARGUMENTS:***

#### ***For:***

Public employee retirement system managers have recommended several changes in the Public Employee Retirement System Investment Act that would allow them to take maximum advantage of the dynamic conditions of today's financial markets, while maintaining prudence in safeguarding the assets of these public pension systems. Among the major changes in the bill are an increase in the domestic stock limitation, which would help many of the local pension systems as well as the state, and an increase in the "basket clause" that would benefit primarily the state's pension system.

With regard to the increase in the domestic stock limitation, it should be noted that while this limit was raised from 60 percent to 65 percent in 1996, at the same time the 1996 legislation required, for purposes of the asset limitations in the act, that the various classes of assets be considered at market value, rather than at cost value. The ramifications of this change were significant due to the astounding growth in stock prices in the past several years. Despite the increase in the stock limitation from 60 to 65 percent, some systems actually had to sell shares of stock to stay within the legal limitations. Pension managers report that allowing them to increase investments in stocks, which traditionally outperform other types of investments, will allow them to continue to maximize investment income, which helps governmental units keep their pension systems fully funded with less reliance on employer contributions. According to testimony, most public retirement systems in Michigan are investing less than 50 percent of system assets in stocks, so it is argued that changing the limit to 70 percent would provide more flexibility to well-funded systems, but that the increased limit would not be used by many systems.

The bill would also greatly benefit the state pension system by increasing the "basket clause" limitation -- the amount of assets that it can invest in alternative investments (those categories not specifically authorized under the act). Treasury department investment officials report that there has been strong growth in this class of investments. Because the market opportunity has grown dramatically in the United States, pension systems have increased their commitment in this area, and growth in global markets is expected to expand rapidly as well. The bill would

also create a new category in this provision for systems with assets of \$1 billion or more, and allow them to invest up to 15 percent of their assets in this manner. This is said to benefit the Detroit and Wayne County pension systems.

Other provisions of the bill would update the act to reflect current practices and trends in investments. In particular, allowing systems to designate real estate investment trusts (REITs) as either real estate or stock investments reflects the current reality that these kinds of investment vehicles are often traded as stocks are; treating them as stocks would be appropriate. Likewise, American domestic receipts (ADRs) are certificates issued by a U.S. bank, but represent foreign shares, so the bill would allow pension managers to treat them as foreign stocks for purposes of asset allocation limits.

***Against:***

It should be noted that though investments in stocks yield the highest returns over time, it is also true that they are riskier than other investment categories. Some people believe that the recent dramatic conditions in the stock market cannot continue forever, and that a downturn should be expected. Given this, is it wise to allow public pension assets to be invested in ever-higher amounts in these kinds of investments?

***POSITIONS:***

A representative of the Department of Treasury testified in support of the bill. (5-10-00)

A representative of the Michigan Association of Public Employee Retirement Systems testified in support of the bill. (5-10-00)

The Municipal Employees Retirement System submitted testimony in support of the bill. (5-10-00)

The City of Kalamazoo Employees' Retirement System and the County of Kalamazoo Employees' Retirement System submitted testimony in support of the bill. (5-9-00)

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■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.