Supporting the City's Economic Development Agenda Through Direct Investment of Pension Funds

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SUMMARY

QUESTION: WHAT ADDITIONAL INVESTMENT VEHICLE CAN THE CITY UTILIZE FOR ITS ECONOMIC DEVELOPMENT AGENDA WHILE SIMULTANEOUSLY LEVERAGING ASSETS FOR THE GREATEST RETURN?

WHY IMPORTANT:

1. *Currently, the city finances its public (social) infrastructure by selling bonds, and these bonds are not issued for single projects but rather for a mixed pool of a portion of projects. The bonds are backed by general obligations (taxes) the city collects, as well as fees and other revenues collected by the city. Debt service payments on the bonds are paid out of the expense budget. However, this financial method increased New York City's debt from $39.55 billion to $95.03 billion, or 140 percent, over FY 2000-FY 2020.*

2. *By utilizing an additional financing method of "direct investment" of New York City pension funds" it will help reduce the City's burden to fund the initial payments from its expense budget while also helping to reduce the debt service expenses as well.*

3. *The method of direct investment of New York City pension funds in New York City public (social) infrastructure can also become the means to invest in the City's future while preserving pension benefits for retirees, capitalizing on City assets and easing the debt burden on the expense budget. Through this investment method, NYCRS has the opportunity to be at the forefront of leading New York City's recovery and expand their Economically Targeted Investment Model (ETIs) program reach.*

RECOMMENDATIONS:

The City should use the additional financing method of "direct investment" of the city's pension funds (equity capital) into a select group of infrastructure projects.

- *Direct investment is but an additional tool in the range of tools to finance public infrastructure and enables the discussion to move past a choice between public or private ownership.*
- *This method could also close New York City's digital divide.*

CONSTRAINTS:

1. *Requires convening the best minds in municipal finance and public pension investments to harness New York's entrepreneurial spirit and diverse workforce to identify the best projects for investment.*

2. *Requires cooperation from the City's pension fund boards which include labor and management representatives.*

INTRODUCTION

As New York City emerges from the pandemic, it will be confronted with the shock waves the pandemic sent through the social and economic fabric of our communities. The virus exposed the vast racial and economic inequalities in our city and laid bare our disparate health care system, our broadband wastelands, and the lack of affordable housing, to name a few. As New Yorkers, we must step in and address these complex issues. Our actions (or inaction) now will drive the future of New York City for decades. As New York City gets set to elect a new wave of public officials, we have a rare opportunity to recommend creative public policy solutions to ensure a prosperous and progressive city of the future. The City's infrastructure needs are vast, and we must put the pedal down to the metal to address this need. One such recommendation is the use of New York City public pension funds as a catalyst for growth through direct investment of funds in infrastructure projects. Direct investment would provide an additional tool to complement the existing financing mechanisms the City currently utilizes, while leveraging assets for the greatest return.

This paper will specifically address the direct investment of New York City pension funds in New York City public (social) infrastructure as a means to invest in our own future while preserving pension benefits for retirees, capitalizing on city assets and easing the debt burden on the expense budget. The paper will provide a brief overview of economically targeted investments and pension funds, the use of direct investments in infrastructure by other pension funds, and the case for New York City.

ECONOMICALLY TARGETED INVESTMENT MODELS (ETIs)

The use of pension fund assets to support public policy objectives beyond paying retiree benefits is an established concept. In fact, according to the New York City Comptroller's Office (who serves as the custodian of the pension funds), since the 1980s, "$3.9 billion has been invested in New York City's five boroughs and the six surrounding New York counties" by the New York City pension funds (collectively referred to as "NYCRS"). According to the Comptroller's Office, currently 2% of pension fund assets are allocated to ETIs "In an effort to generate risk-adjusted market rates-of-returns and to promote economic development within New York City."[1]

[1] NYC Comptroller's Office, "Economically Targeted Investments," Comptroller.nyc.gov, Dec. 31, 2020, https://comptroller.nyc.gov/services/financial-matters/pension/initiatives/economically-targeted-investments/.

More specifically, during my tenure with the Comptroller's Office, NYCRS began two investments focused on affordable or workforce housing for low, moderate, and middle-income neighborhoods and populations in the five boroughs. In 2002, NYCRS began investing in the AFL-CIO Investment Housing Trust and, since inception to December 2020, "$1.5 billion has been invested in the Trust to create or preserve 35,181 units of housing".[2] Additionally, since 2007, NYCRS has invested an additional $968 million in the ACS Separate Account, an affordable housing/anti-predatory lending strategy. The account is managed by RBC/Access Capital and primarily invests in single-family mortgage-backed securities with an impact on over 46,000 units of housing.[3] These investments have helped to revitalize neighborhoods and bring needed property tax revenue to the City, while also ensuring a risk-adjusted return to NYCRS to pay benefits.

NYCRS is not alone in these types of investments, but other pension funds in the United States and around the globe have taken this a step further. The Retirement System of Alabama "according to one third-party analysis, invests 16% of its assets in the state and local economy. Its investments include a dizzying array of Alabama real estate holdings including premium office buildings, golf course properties, and hotels."[4] The California Public Employees Retirement System (CALPERS) has taken it even further, investing in infrastructure projects with an equity investment like the investor-owned London Gatwick Airport. Closer to home, the Indiana Toll Road project was rescued by a consortium of 70 U.S. public pension funds put together by Australia's IFM Investors after an unsuccessful P3 company managing the concession went bankrupt.[5]

DIRECT INVESTMENT MODEL

In the United States, most public pension fund investments in infrastructure are made through a private equity and real estate allocation rather than as a direct investment, as has been more common in other countries like Canada and Australia. The direct investment model of infrastructure investing eliminates the middleman. Pension funds

[2] Ibid.
[3] Ibid.
[4] Minnesota Center for Fiscal Excellence, "Underfunded Pensions and Underfunded Infrastructure: A Match Made in Heaven?", 2013, www.fiscalexcellence.org/policy/pension-legacy-costs/underfunded-pensions-underfunded-infrastructure.html.
[5] Robert Poole, "An Infrastructure Investment Strategy That Works for Democrats and Republicans," Reason.org, May 6, 2021, http://reason.org/commentary/an-infrastructure-investment-strategy-that-works-for-democrats-and-republicans/.

invest directly in projects, “avoiding the ‘2 and 20’ fee structure private equity firms commonly use (a 2% annual management fee on capital deployed plus 20% of profits).”[6] The Canadian pension funds are probably the best known for moving beyond ETIs to direct infrastructure investment and management. According to an OECD Report on Pension Funds Investment in Infrastructure: A Survey, for Canada, “…Infrastructure is treated as a separate asset and is part of the allocation to inflation sensitive investments which tend to correlate closely with changes in inflation acting as a hedge against increases in the cost of future pension benefits.”[7] As such, in 1999, the Ontario Municipal Employees Retirement System (OMERS) created an in-house entity “devoted exclusively to direct investments and management of public infrastructure.”[8] In 2015, OMERS was one of three Canadian pension plans in the Canadian Pension Consortium which purchased the lease for the Chicago Skyway project for $2.8 billion, giving them the rights to operate and collect tolls on the skyway until 2104.[9] Additionally, Quebec’s public pension fund recently financed and managed the construction of a 67-kilometer light rail in Montreal. According to Norman Anderson in a recent Forbes article, “Canadian pension funds have become extraordinarily successful infrastructure investors. Returns over the last five years for these funds (Quebec Pension Fund, PSP and OMERS) were 8.1%, 5.8% and 8.5% respectively.”[10]

Direct investment is beginning to take off with U.S. public pension funds, and CALPERS is at the forefront once again. In 2015, CALPERS announced a $1 billion deal with an Australian Pension Fund, Queensland Investment Corp (QIC), to invest in Asian Pacific infrastructure. Unique in this investment is the direct investment it made rather than using the intermediary of a private equity fund and paying the associated fees. Rather, CALPERS invested with an experienced infrastructure investor who can lend their expertise to CALPERS. According to the Stanford University Global Projects Center, CALPERS partnered with a successful pension fund who made billions of dollars on the sale of the Queensland Motorways, “a broken-down highway, bridge, and tunnel network that the Queensland government conveyed to QIC in 2011 to

[6] Minnesota Center for Fiscal Excellence.
[7] Raffael Della Croce et al, “Pension Fund Investment in Infrastructure: A Survey by OECD and Oliver Wyman,” Oliverwyman.com, 2011, www.oliverwyman.com/content/dam/oliver-wyman/global/en/files/archive/2012/Pension_Fund_Investment_in_Infrastructure_-_OECD-OW.pdf.
[8] Minnesota Center for Fiscal Excellence.
[9] Center for Innovative Finance Support, “Project Profile: Chicago Skyway,” U.S. Department of Transportation – Federal Highway Administration, www.fhwa.dot.gov/ipd/project_profiles/il_chicago_skyway.aspx.
[10] Norman Anderson, “A $1.6 Trillion Pension Fund Gap - Is Infrastructure Investment the Answer?”, Forbes, August 25, 2020, www.forbes.com/sites/normananderson/2020/08/25/a16-trillion-pension-fund-gapis-infrastructure-investment-the-answer/?sh=3f001e21415a.

satisfy pension liabilities."[11] The other major California public pension system, the California Teachers Retirement System (CALSTERS), also invested directly in a partnership with a Dutch pension fund. Both systems have developed capacity to directly invest in infrastructure projects abroad and, given the current focus of the federal government on infrastructure, it is time for these investments to turn back towards home.

The United States is a ripe market for public pension fund investment in infrastructure, and, given the experience some of the largest pension funds in the U.S. have had with the direct investment model, Anderson believes that "the balance of power for infrastructure investment will shift from private equity firms to the managers of pension funds in Columbus, Denver and Austin – moving from Wall Street to Main Street…Investment in infrastructure projects will be less a political tug of war, and more a question of returns, economic returns, user benefits, national wealth."[12] New York can and should be a part of this important shift to add another funding mechanism to its toolkit for addressing the vast infrastructure needs in the city. Direct investment would provide NYCRS the opportunity to expand their ETI program reach.

[11] Jill Eicher, "How Public Pensions Are Getting Smart About Infrastructure," Stanford University Global Projects Center, July 20, 2015, https://gpc.stanford.edu/gpcthinks/how-public-pensions-are-getting-smart-about-infrastructure.
[12] Anderson.

THE CASE FOR NYCRS

Before analyzing this additional investment vehicle, let's first review how the City currently finances its infrastructure. New York City sells bonds to finance its public (social) infrastructure, including new construction, improvements, and equipment. Projects and equipment needs are determined by the City and must have a useful life longer than five years (3 years for technology projects) and a value greater than $50,000. The bonds are backed by general obligations (taxes) the City collects, as well as fees and other revenues collected by the City. Debt service payments on the bonds are paid out of the expense budget. It is also important to note that the expenses associated with the projects being built are initially paid out of the City's expense budget (General Fund) as well. Once the spending occurs, bonds are issued, and the revenue is used to reimburse the General Fund. Moreover, bonds are not issued for single projects but rather for a mixed pool of a portion of projects.

According to the NYC Comptroller's Fiscal Year 2021 Annual Report on Capital Debt & Obligation issued in December 2020, "NYC debt outstanding has increased from $39.55 billion to $95.03 billion, or 140 percent, over FY 2000-FY 2020".[13] It is no surprise, as the City's infrastructure of buildings, roads, and bridges continues to age and requires greater and greater maintenance. According to the report, "the annual average growth rate of city debt service payments between FY 2000 and FY 2020 was 4.1 percent per year, growing from $3 billion in FY 2000 to $6.65 billion in FY2020. According to OMB, from FY 2021 to FY 2029, the City's debt service is expected to grow at an annual average rate of 6.0 percent to $11.65 billion by FY 2029" page 23).[14] The Comptroller's Office analyzes several measures of the affordability of such a debt burden and suffice it to say that New York City's "debt per capita was more than twice the average of a sample of eleven other large U.S. cities and 1.6 times the per capita debt burden of Chicago, which had the next highest debt burden."[15]

An additional method of financing the City's infrastructure in this manner would be the direct investment of the City's pension funds (equity capital) into a select group of infrastructure projects. Direct investment would enable the City to reduce its burden to fund the initial payments from its expense budget, while also helping to reduce the debt service expenses as well. With the right type of projects, the pension funds would be able to realize a market rate return for their investment while also contributing to the long-term sustainability of the City's infrastructure. This scenario

[13] NYC Comptroller's Office, "Fiscal Year 2021 Annual Report on Capital Debt and Obligations," Comptroller.nyc.gov, Dec. 1, 2020, 5, https://comptroller.nyc.gov/wp-content/uploads/documents/Annual_Report_on_Capital_Debt_and-Obligations_FY-2021.pdf.
[14] Ibid., 23.
[15] Ibid., 27.

would be a win-win or, in the parlance of economic development, a double bottom line return. If the projects that are chosen add a sustainability component – i.e. solar panels on city buildings – we have now accomplished the triple bottom line. For NYCRS, an increase of their allocation to ETIs from 2% to 10%, for example, would dramatically change the pace of infrastructure building in New York City for generations and pay social dividends for decades.

CLOSING THE DIGITAL DIVIDE THROUGH PENSION FUND INVESTMENTS

One project ripe for a direct investment is the City's $157 million investment to close the digital divide in New York City. According to the NYC Internet Master Plan, "broadband may be as important to New York City in the 21st century as the subway or electricity was in the 20th century."[16] The plan calls for optimizing existing infrastructure and building new infrastructure to be shared by multiple providers. The City plans to seed this investment to build the infrastructure required and leverage partnerships to install, operate, and maintain the infrastructure. This project could benefit from the involvement of the public pension funds through a direct investment, permitting the City to reduce its investment and redistribute those dollars to other badly needed city services. The Master Plan projects that "getting all New Yorkers connected and establishing equitable infrastructure citywide could, in the best-case scenario, result in up to 165,000 new jobs, up to $49 billion increase in personal income, and up to $142 billion in incremental gross city product by 2045."[17] The pension funds should and must be an instrumental player in enabling this important effort to be successful, accomplishing the double bottom line of doing well while doing good.

Direct investment of this nature will require a fundamental rethinking of how to finance public projects. According to the Minnesota Center for Fiscal Excellence, "direct infrastructure investment by pension plans is really only part of a much larger policy framework" to generate capital to invest in new assets or refurbish existing infrastructure (i.e., broadband) public assets.[18] Direct investment is but an additional tool in the range of tools to finance public infrastructure and enables the discussion to move past a choice between public or private ownership. NYCRS could act as the anchor investor in projects, attracting further direct investment from CALPERS, CALSTERS, or even the Canadian pension funds, as well as some of the union pension

[16] Mayor's Office of the Chief Technology Officer, "NYC Master Internet Plan," NYC.gov, Jan. 2020, v, www.nyc.gov/assets/cto/downloads/internet-master-plan/NYC_IMP_1.7.20_FINAL-2.pdf.
[17] Ibid., vi.
[18] Minnesota Center for Fiscal Excellence.

funds. There is no shortage of projects to be funded, and the pension funds are in a unique position to provide the needed equity capital as long-term investors looking to the double or triple bottom line. Jill Eicher at the Stanford University Global Projects Center says it best: "by working directly with state and local governments to structure pension-right, public–right infrastructure projects, U.S. public pensions could open the most coveted infrastructure world to the global community of institutional investors. This would result in a win for public pension funds, state and local governments, and most importantly, taxpayers and retirees."[19]

Direct public pension fund investment in New York City's public infrastructure must be seriously explored by NYCRS, putting NYCRS at the forefront of leading NYC's recovery. This initiative requires no new taxes, no additional debt, and "will also send a strong cross-generational message that we are all in this together, rowing the same boat."[20] It will require convening the best minds in municipal finance and public pension investments to harness New York's entrepreneurial spirit and diverse workforce to identify the best projects for investment. And it will require the courage to change the conversation to meet the growing demands in New York City. In short, it will require leadership to help the City build back better than ever.

[19] Eicher.
[20] Anderson.