United States General Accounting Office

GAO

Report to the Subcommittee on Labor-Management Relations, Committee on Education and Labor, House of Representatives

July 1990

PENSION PLANS

Public Plans in Four States Have Generally Similar Policies and Practices

RESTRICTED——Not to be released outside the General Accounting Office unless specifically approved by the Office of Congressional Relations.

RELEASED

GAO/HRD-90-133

GAO

United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

B-239812

July 24, 1990

The Honorable William L. Clay
Chairman, Subcommittee on Labor-Management Relations
Committee on Education and Labor
House of Representatives

The Honorable Marge Roukema
Ranking Minority Member
Subcommittee on Labor-Management Relations
Committee on Education and Labor
House of Representatives

This report responds to your request for information on public pension plans in four states. In December 1989 and in subsequent discussions, your staffs asked us to obtain data on the plans' administrative organization; fiduciaries and their responsibilities; funding processes; investment policies and practices; and oversight, reporting, and disclosure requirements. We do not name the four plans in this report because section 11016(d) of the Single-Employer Pension Plan Amendments Act of 1986 prohibits us from publicly disclosing their identity.

Background

There are about 2,400 public employee pension plans in the United States covering some 11.8 million employees and having over $600 billion in assets. These public employee plans are not covered by the Employee Retirement Income Security Act of 1974 (ERISA), the law that protects participants and beneficiaries of most private sector employee benefit plans. ERISA establishes minimum standards for private plan operations in such areas as fiduciary responsibility and funding, as follows:

- ERISA defines a fiduciary, generally as anyone who exercises discretionary control or authority over the management of a plan or provides investment advice to a plan. Fiduciaries usually include plan trustees, investment managers, and advisers. They are required to carry out their duties solely in the interest of plan participants and beneficiaries and to act with the same care, skill, prudence, and diligence that a prudent person, in the same circumstances, would use in conducting an activity of like character and with like aims.

5-year, in-state investment plan and to report biennially to the legislature on progress in implementing it.

All plans report annually to the governors and legislatures and provide reports to plan participants on the status of the participants' individual accounts. The plans are audited annually.

Objectives, Scope, and Methodology

Following discussions with your staffs, we obtained information on the public pension plans in four states in which you expressed interest. The plans covered state and local governmental employees. We reviewed the four plans' (1) administrative structures; (2) fiduciaries and their responsibilities; (3) investment policies and practices; (4) funds and funding processes; and (5) oversight, reporting, and disclosure requirements. Using a structured interview instrument, we interviewed the plans' officials to obtain these data. We also obtained and reviewed pertinent state laws, rules, and regulations governing plan administration; audit and actuarial reports of the plans' operations; and the plans' latest annual reports. Our review was performed between January and April 1990.

How Are the Plans Administered?

Boards of trustees and their staffs administer the pension plans. Each board establishes policy and appoints a chief administrative officer responsible for hiring and overseeing the staff that carries out the plan's daily operations. The number of boards and staffs that administer each plan varies:

- Two plans have a single board and staff responsible for all aspects of plan administration.
- The other two plans have two separate boards and staffs. One carries out all investment activities; the other performs all other plan administrative functions, such as maintaining participant accounts, paying benefits, and collecting contributions.

Board membership ranges from 5 to 11 and includes various combinations of (1) public officials (most are elected, such as the state treasurer, while a few are cabinet positions appointed by the governors); (2) plan participants, active and retired; and (3) private citizens with investment experience. Except for the public officials, whose membership is specified by statute, most board members are appointed by the state governors, either independently or from a list of candidates compiled by under these statutes include removal from office, fines, and imprisonment.

What Are Plan Funding Requirements and Practices?

The plans are funded on actuarial bases by annual employee and employer contributions. The funds, which are held in trust for the benefit of plan participants and beneficiaries, may not be diverted to other uses. Only the boards can direct how the funds are invested.

The plans' enabling statutes require that employees and employers make annual contributions on an actuarially sound basis. Generally, the statutes either (1) specify the contribution rates or (2) prescribe a range, floor, or ceiling rate of contributions. For the four plans, the employers' contributions ranged from about 1.3 to 17 percent of salaries and the employees' from 4.5 to about 15 percent, as discussed below.

- Plan A: The statute requires actuarially based funding, and the board adjusts rates according to periodic actuarial valuations. In 1988, the employer rates varied from 1.3 to 15.3 percent for various employment categories (for example, public safety, firefighters, teachers, and judges). The employee rates ranged from 6.0 to 14.8 percent for the same categories.
- Plan B: The statute requires actuarially based funding. The board determines the contribution rates and adjusts them according to periodic actuarial valuations. The statute provides that the employer's rate cannot be less than 6 or more than 10 percent of employees' earnings; in 1988 it was 7.2 percent. Also, by law the employee contribution rate cannot be less than 6 percent of earnings; in 1988 it was 6.4 percent.
- Plan C: The statute requires actuarially based contributions. The employer rate is adjusted as needed by the board per periodic actuarial valuations; in 1989 the rate varied by employment category from 6.0 to 16.9 percent. The employee rates are fixed by statute and ranged from 5.0 to 8.0 percent, depending on employment category.
- Plan D: The statute requires actuarially based funding and provides that (1) the employer contribution cannot exceed 10.5 percent of payroll and (2) the employee contribution cannot be less than 3.5 or more than 4.5 percent of annual earnings. In 1989, the rates, as determined by the board, were 9.5 and 4.5 percent, respectively, for employers and employees.

In accordance with the statutes, the boards give employers (state and local governments) an estimate of the amounts needed each year for the seeks to achieve a long-term annual rate of return of 3 percent above the inflation rate.

The boards have independence and flexibility in setting investment parameters. Some boards establish investment mixes and specify the percentage of the funds that can be invested in each asset, including the amounts that can be invested in a single entity (see table 1). Two boards allow investments in venture capital. One allows up to 1 percent of its portfolio; the other does not specify an amount but requires board approval for each investment. A third board, having decided that venture capital investments would be inconsistent with the prudent person rule, does not permit them.

Table 1: Investment Parameters for Three Plans

	Percent of funds allowed by plan (range)		
Asset type	**A**	**B**	**C**
Cash equivalents	[a]	0–10	0–20
Fixed income	30–40	35–55	30–50
Real estate/mortgages	7–13	0–15	5–15
Equities	50–60	35–55	40–65

[a]No range stated

In the fourth state, the statute establishing the pension plan also established how the plan's funds could be invested. The statute provided that funds were to be invested in any securities or investments in which the sinking funds of the state could be invested. Under this provision, funds may be invested in various types of instruments of indebtedness, such as certain public and private bonds and mortgages, but not in stocks.

Two boards had in-state investment policies. In one state, legislation requires the board to develop a 5-year, nonbinding plan for making investments in the state and to report to the legislature biennially on progress under the plan. The plan is to include estimates of the dollar amount of investments to be made in each fiscal year. The board's policy requires that such investments meet the same criteria as out-of-state investments. The board's 1989 annual report states that the plan had invested about $2.9 billion of its $21 billion portfolio in businesses in the state pursuant to this requirement. The other board had established its own policy of in-state investment without any mandate from the legislature. About $26 million of the plan's portfolio of about $0.9 billion is invested under this policy.

If you have any questions concerning this report, please call me on (202) 275-6193. Other major contributors to this report are listed in appendix I.

Joseph F. Delfico

Joseph F. Delfico
Director, Income Security Issues

Requests for copies of GAO reports should be sent to:

U.S. General Accounting Office
Post Office Box 6015
Gaithersburg, Maryland 20877

Telephone 202-275-6241

The first five copies of each report are free. Additional copies are $2.00 each.

There is a 25% discount on orders for 100 or more copies mailed to a single address.

Orders must be prepaid by cash or by check or money order made out to the Superintendent of Documents.

Major Contributors to This Report

Human Resources Division, Washington, D.C.

Robert F. Hughes, Assistant Director, (202) 535-8358
Cameo A. Zola, Evaluator-in-Charge
Endel P. Kaseoru, Senior Evaluator

The four plans' assets totaled from about $0.9 billion to $21 billion, according to their annual reports. The funds were invested as shown in table 2.

Table 2: Investment Mixes of the Four Plans

	Percent of funds invested by plan			
Asset type	**A**	**B**	**C**	**D**
Cash equivalents	10.0	3.0	14.9	0
Fixed income	37.5	57.3	36.0	98.2
Real estate/mortgages	7.8	8.7	2.6	1.8
Equities	44.7	31.0	46.5	0

What Are the Plans' Investment Oversight, Reporting, and Disclosure Requirements?

To help ensure compliance with their policies, the boards have various methods for overseeing investment activities. For example, at their meetings the boards review reports of staff investment activities and changes in assets since the previous meetings. The boards also received reports on investments and their performance from either state auditors or external advisers with whom they had contracted. In addition, one board issues a list of stocks the staff may purchase; the board updates the list quarterly.

Certified public accountants or state auditors audit the plans annually. Each plan also is subject to reporting and disclosure requirements. All plans are required to file annual reports with the governor and legislature and to report to plan participants on the status of their individual accounts. The annual reports include (1) audited financial statements; (2) discussion of funding matters, including actuarial valuations and the adequacy of contributions; and (3) detailed listings of the assets owned by the plan. One plan also reports to a state pension review board.

As arranged with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time we will send copies of the report to interested congressional committees and other interested parties and make copies available to others upon request.

employers' and employees' contributions. Generally, the employees' contribution rates remain constant, and the employers' rates are revised as determined by actuarial valuations. The employers include the estimates in the budgets they send to their governing bodies.

Under their plans' enabling legislation, officials of all four plans said, employers are required to fund the contributions as determined by the boards. If they provide less funds, they are in violation of the plan's funding provisions. However, if the board determines that a greater or lesser amount is needed than allowed by the statute, funding at the statutory level still would be required while the legislature changed the funding requirements.

The latest annual reports or actuarial valuations for the plans showed that, on a going concern basis,[3] their funded levels[4] are as follows: Plan A, 80 percent; Plan B, 87; Plan C, 101; and Plan D, 87.

What Are the Plans' Investment Policies and Practices?

The boards of trustees establish the investment parameters. Only one plan's investments are limited by state law. Each plan's investments are governed by the prudent person rule, explained on page 2, whose provisions vary among the states. One is similar to the requirements of ERISA (see p. 1). The others generally require that in making investments the trustees use the same judgment and care that persons of ordinary prudence, discretion, and intelligence would use in the management of their own investments.

Investment policies set by the boards tend to be similar and to reflect the same kinds of concerns. Such policies generally include asset quality ranking features (such as rating levels that stocks and bonds have to meet), limits on investments in any single enterprise, diversification or asset-mix parameters, and a total goal of achieving earnings greater than a certain rate over time. For example, one plan's goal is to achieve earnings that exceed wage rate growth by 1.5 to 2.5 percent; another

[3]The going-concern valuation concept assumes that the plan will continue indefinitely, with no future termination anticipated, and that benefits earned by participants will be paid in the normal course of operations.

[4]To gauge whether the plan will have sufficient assets to pay benefits, the funded level or ratio is determined by comparing the plan's current assets to current liabilities, which is the present value of benefits earned by plan participants. If the computation shows that current assets may not be sufficient to cover liabilities, the plan is considered not fully funded and the difference is made up over a number of years.

participant organizations. The appointed board members serve 4-to 6-year terms and may be reappointed without limit.

Generally, the boards appoint an executive director or executive secretary to carry out daily operations with a staff. The staffs are organized into support and operational units with responsibility for such activities as personnel, accounting, general counsel, participant benefits and accounts, and investments.

Who Are Plan Fiduciaries, and What Are Their Responsibilities?

Plan fiduciaries include both individuals responsible for overall plan administration and those involved in daily investment activities. They are responsible to the plan participants and the state legislatures for the operation of the plans in accordance with applicable laws. Breaches of fiduciary trust may result in civil or criminal penalties.

For all four plans, the fiduciaries are the board members. In the plans administered by a single agency, the trustees have two major areas of fiduciary responsibility: (1) ensuring that the annual employee and employer contributions are made to the plan as required by law and (2) ensuring that funds are invested in accordance with the prudent person rule. For the plans that have two administrative agencies, the fiduciary responsibilities for each are limited to one of these areas.

Generally, other individuals who are involved in investment decisions are also fiduciaries. Among the four plans this includes agency staff having discretion with regard to investments, and external investment advisers and managers used by the staffs and the boards. For each plan the degree of staff involvement in making investment decisions depends on the plan's overall investment process. Two plans' investments are completely internally managed, and the third plan's investments are wholly managed by external advisers. The fourth plan manages all but about 5 percent of its investments internally. This plan uses external managers to manage venture capital, international investments, and leveraged buy-outs because these are a small part of its portfolio and specialized expertise is needed.

The plans' enabling statutes do not include provisions concerning penalties for violations of fiduciary responsibilities. But inappropriate actions could constitute violations under other statutes, plan officials said. Among them are laws concerning fraud, standards of conduct by trust fiduciaries in general, and state employees' codes of conduct. Penalties

- To ensure that defined benefit plans[1] have funds to pay benefits when they are due, ERISA generally requires annual, actuarially based contributions sufficient to meet the plan's current-year costs and any amounts needed to pay off unfunded liabilities (the difference between the present value of the estimated pension liability and the present value of plan assets). This amount can be paid off over a period of years.

The Congress has become concerned about whether public plan beneficiaries have protections under state laws comparable to ERISA protections for private plans.

Results in Brief

The pension plans for state and local government employees that we reviewed in the four states were similar in many ways. All four plans are administered by independent boards of trustees composed of public officials, plan participants, and private citizens with investment experience. Most trustees are appointed by the state governors. The boards establish policy and appoint chief administrators, who are responsible for hiring and overseeing the staffs that carry out the plans' daily operations. The board members and all individuals who make and advise on investment decisions have a fiduciary responsibility to the plan participants and the state legislatures.

The boards use actuarial valuations to determine the contributions necessary to fund earned benefits; accumulations of 80 to 101 percent of the needed assets were reported by the plans. Contributions are held in trust for the benefit of plan participants, subject only to the control of the boards.

The boards establish investment policies independently, subject mostly to a general standard, referred to as the "prudent person" rule.[2] All the plans' investment policies tend to reflect similar concerns: that is, an overall earnings goal over time related to an economic indicator, such as the inflation rate. Only one state limits the types of investments the plan can make. Another state encourages its plan to invest some funds locally; legislation enacted in 1985 requires the board to develop a

[1]In a defined benefit plan, the employer promises a specific retirement benefit that is generally based on a worker's years of service, earnings, or both. In defined contribution plans, employers make periodic contributions to participants' accounts but guarantee no particular benefit amount. We reviewed defined benefit plans.

[2]These standards vary among the states, but generally require that individuals exercise the same care, diligence, judgment, intelligence, and skill in managing plan funds as they would in managing their own investment affairs