

August 2010

# STATE AND LOCAL GOVERNMENT PENSION PLANS

Governance Practices  
and Long-term  
Investment Strategies  
Have Evolved  
Gradually as Plans  
Take On Increased  
Investment Risk



GAO

Accountability \* Integrity \* Reliability



Highlights of [GAO-10-754](#), a report to the Ranking Member, Committee on Finance, United States Senate

### Why GAO Did This Study

Recent market declines have significantly diminished the asset value of state and local pension plans. Reported unfunded liabilities for these plans are estimated in the hundreds of billions of dollars. As a result, in the long term, these governments may need to make significant fiscal adjustments such as modifying employee benefits, or increasing contributions to plans. They may also alter investment strategies to attempt to maximize returns by assuming increased risk. Consequently, GAO was asked to examine: (1) who makes investment decisions for state and local defined benefit pension plans and what guides their decision making; (2) how plans allocate their assets and manage their investments; and (3) practices that plans are using to meet a range of challenges in governance, investment, or funding.

To address these objectives, GAO reviewed relevant literature, interviewed experts in pension and retirement systems, conducted a survey of state and local plans, and performed more detailed reviews of plans in seven states.

### What GAO Recommends

GAO is not making recommendations in this report. We incorporated technical comments from the Departments of Labor and Treasury and the Securities and Exchange Commission as appropriate and received clarifications from select outside experts and plan officials.

[View GAO-10-754 or key components.](#) For more information, contact Barbara Bovbjerg at (202)512-7215 or [bovjberg@gao.gov](mailto:bovjberg@gao.gov).

## STATE AND LOCAL GOVERNMENT PENSION PLANS

### Governance Practices and Long-Term Investment Strategies Have Evolved Gradually as Plans Take On Increased Investment Risk

#### What GAO Found

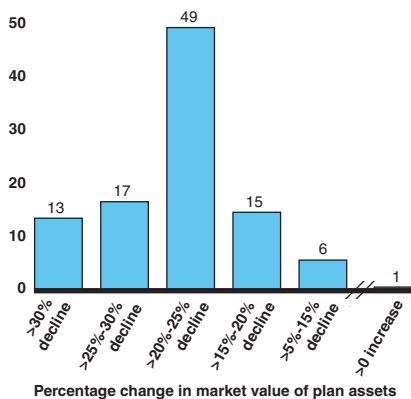
A variety of stakeholders, such as boards of trustees and external consultants and managers, are involved in guiding plan investments. Plan officials generally expressed a commitment to policies or principles cited by many experts as key to sound governance, such as enhancing the knowledge and skills of plan fiduciaries and increasing organizational transparency.

State and local plans reported gradually changing their asset portfolios over many years by increasing their allocations in higher risk investments partly in pursuit of higher returns but also for diversification following well-accepted techniques of portfolio management given their long investment horizon. Indeed, currently about two thirds of public pension funds are invested in such higher risk assets. Plan officials stated they are focused on the long term and generally reported they had not made any major changes to their investment strategies in response to the market downturn, in which they lost nearly a quarter of their asset value from June to December 2008. Despite these losses, plans have reported having sufficient assets to cover years of benefit payments. Still, according to our survey, an estimated 60 percent of large and medium plans anticipate changes to their investment strategies in response to the current economic environment.

Plans have devised various approaches to attempt to address governance, investment, and funding challenges. These include pooling assets to pursue lower fees and higher quality managers, consolidating the governance structures of multiple plans to improve accountability and transparency, and issuing pension obligation bonds to overcome funding shortfalls. While some of these approaches predate the market downturn, their impact on plan health remains to be seen. Still, efforts at increasing disclosure may be helping plan stakeholders understand the considerable challenges they face.

**Estimated Change in Market Value of Plan Assets by Amount of the Change, June – December, 2008, Reported by Officials for Medium and Large Plans**

Estimated percentage of large and medium-sized plans  
60



Source: GAO survey of state and local plans.

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## Abbreviations

CAFR	consolidated annual financial report
CalPERS	California Public Employees' Retirement System
CALSTRS	California State Teachers Retirement System
DB	defined benefit
DC	defined contribution
ERISA	Employee Retirement Income Security Act
FINRA	Financial Industry Regulatory Authority
GARS	General Assembly Retirement System of Illinois
GASB	Government Accounting Standards Board
ILPERS	Illinois Public Employees Retirement System
ISBI	The Illinois State Board of Investments
JLARC	Joint Legislative Audit & Review Commission
JRS	Judges Retirement System of Illinois
MASS PRIM	Massachusetts Pension Reserves Investment Management Board
PBGC	Pension Benefit Guaranty Corporation
POB	pension obligation bonds
PRIT	Massachusetts Pension Reserves Investment Trust
SDCERA	San Diego County Employees Retirement Association
SEC	Securities and Exchange Commission
SWIB	State of Wisconsin Investment Board
TMRS	Texas Municipal Retirement System
VRS	Virginia Retirement System
WRS	Wisconsin Retirement System

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United States Government Accountability Office  
Washington, DC 20548

August 24, 2010

The Honorable Charles E. Grassley  
Ranking Member  
Committee on Finance  
United States Senate

Dear Senator Grassley,

Nearly 20 million employees and over 7 million retirees and survivors are covered by state and local government pension plans. The recent downturn in investment markets has significantly diminished the asset value of these plans. Many state and local retirement benefits are guaranteed by state law or contract, and, ultimately, taxpayers are liable for them.<sup>1</sup> Investment losses and underfunding in these pension plans will also likely require increased contributions from state and local governments and/or their employees in future years.<sup>2</sup> Nevertheless, the federal government has an interest in assuring that state and local retirees, like all Americans, have a secure retirement, as reflected in the federal tax deferral for contributions to both public and private pension plans.<sup>3</sup> Some studies have estimated the unfunded liabilities of these pensions in the hundreds of billions of dollars, and there have been suggestions that, over the long term, some of these governments may need to make significant fiscal adjustments. In light of these trends and our prior work,<sup>4</sup> at your request, we are reporting on the investment practices and governance structures of public defined benefit (DB) plans that collectively invest pension plan assets on behalf of their participants. Specifically, we are reporting on (1) who makes investment decisions for state and local defined benefit pension plans and what guides their decision making, (2) how plans allocate their assets and manage their investments, and

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<sup>1</sup>GAO, *State and Local Government Retiree Benefits: Current Funded Status of Pension and Health Benefits* [GAO-08-223](#) (Washington, D.C.: Jan. 29, 2008).

<sup>2</sup>This will add to the severe fiscal challenges state and local governments already face.

<sup>3</sup>State and local pension benefits are not subject to federal funding requirements that apply to pensions sponsored by private employers.

<sup>4</sup>GAO, *State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections, and Fiscal Outlook for Funding Future Costs*, [GAO-07-1156](#) (Washington, D.C.: Sept. 24, 2007); and [GAO-08-223](#).

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(3) practices that plans are using to meet a range of challenges in governance, investment, or funding.

To address these objectives, we reviewed relevant literature. In our examination, we did not review state or local laws or regulations, nor did we independently verify the legal accuracy of such information that was provided to us in the course of our work. However, we did review relevant federal laws and regulations. We interviewed experts in pension and retirement benefit systems to identify sound governance and investment practices state and local pension plans should follow, and conducted a survey of a stratified sample of large-, medium-, and small-sized plans between July and November, 2009. Our response rates from the large- and medium-sized plans were 89 and 67 percent respectively. These were sufficient to generalize with a 95 percent confidence interval of plus or minus 8 percentage points for both sizes combined and plus or minus 10 percentage points for each size separately, unless otherwise noted. The response rate from the small plans was 35 percent which did not meet our standards for generalizing to the entire population; the results we report for small plans reflect only the plans that responded. We also conducted in-depth reviews of plans in seven states (which included both state and local plans) in order to explore these trends and practices in more detail.<sup>5</sup> These states were selected based on diversity in plan governance structures; use of asset classes in investments; use of money managers, consultants, or other experts; plan size and organization; and geographic representation. Appendix I discusses our scope and methodology in more detail. We conducted this performance audit from September 2008 to August 2010 in accordance with generally accepted government auditing standards. The standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for findings and conclusions based on our audit objectives.

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<sup>5</sup>The states that we reviewed were California, Illinois, New Jersey, Texas, Virginia, Washington, and Wisconsin.

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## Background

DB pension plans still provide the primary pension benefit for most state and local workers.<sup>6</sup> A DB plan determines benefit amounts by a formula that is generally based on such factors as years of employment, age at retirement, and salary level.<sup>7</sup> The benefit amount is typically guaranteed regardless of changes in investment markets or the fiscal condition of state and local governments. Typically, pension benefits are paid from a fund made up of assets from employers' and employees' annual contributions and the investment earnings from those contributions. About 79 percent of eligible full-time state and local employees participated in DB pension plans as of 2007.<sup>8</sup> In fiscal year 2008, state and local government pension systems covered 19.1 million members and made periodic payments to 7.5 million beneficiaries, paying out \$175.4 billion in benefits. Nearly 7 million state and local government employees, which is about one-fourth, are not required to pay Social Security taxes on the earnings from their government occupations and therefore receive no Social Security benefits based on their government earnings.<sup>9</sup> As a result, their employer pension benefits are higher than for employees covered by Social Security, and employee and employer contributions are higher as well.<sup>10</sup>

Many state and local governments also offer retirees health care benefits—in addition to Medicare benefits provided by the federal government—the costs of which have been growing rapidly. One study estimated that state and local governments paid \$20.7 billion in fiscal year 2004 for retiree health benefits, and some studies have estimated that the unfunded liabilities for these health benefit promises may exceed \$1 trillion dollars nationwide in present value terms.<sup>11</sup> Such estimates have raised concerns

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<sup>6</sup>[GAO-08-223](#).

<sup>7</sup>In contrast, for defined contribution plans, the key determinants of the benefit amount are the employee's and employer's contribution rates and the rate of return achieved on assets.

<sup>8</sup>U.S. Department of Labor, Bureau of Labor Statistics, *National Compensation Survey: Employee Benefits in State and Local Governments in the United States, September, 2007* (Washington, D.C., 2008).

<sup>9</sup>42 U.S.C §410(a)(7)

<sup>10</sup>National Association of State Retirement Administrators, *Public Fund Survey Summary of Findings for 2008* (Georgetown, Tex., October 2009).

<sup>11</sup>JP Morgan Chase and Co., *OPEB for Public Entities: GASB 45 and Other Challenges*, (September 2005).



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about the fiscal challenges that state and local governments will face in the coming decades.

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## Financing of State and Local Defined Benefit Pensions

Both state and local government employers and employees generally make contributions to fund state and local pension benefits.<sup>12</sup> Many state and local governments are statutorily required to make yearly contributions based either on actuarial calculations, or according to a statutorily specified amount.<sup>13</sup> In a typical DB pension plan, employer and employee contributions are made to a specific fund from which benefits will be paid. From 1982 to 2006, employer and employee contributions combined made up 42 percent of pension fund revenues—accounting for 28 and 14 percent of such revenues respectively.<sup>14</sup> The contributions from both employers and employees are invested in the stock market, bonds, and other investments. Approximately 58 percent of revenues for pension benefits come from investment earnings.<sup>15</sup>

State and local government pension plans with assets of \$500 million or more lost, in the aggregate, an estimated \$621 billion,<sup>16</sup> or 22 percent of the market value of those assets from June 2008 to December 2008, according to our survey. As shown in figure 1, an estimated 79 percent of plans saw declines in asset value greater than 20 percent.

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<sup>12</sup>For plans in which employees are covered by Social Security, the median contribution rate in fiscal year 2008 was 8.7 percent of payroll for employers and 5 percent of pay for employees, in addition to 6.2 percent of payroll from both employers and employees to Social Security. For plans in which employees are not covered by Social Security, the median contribution rate was 11.8 percent of payroll for employers and 8 percent of pay for employees.

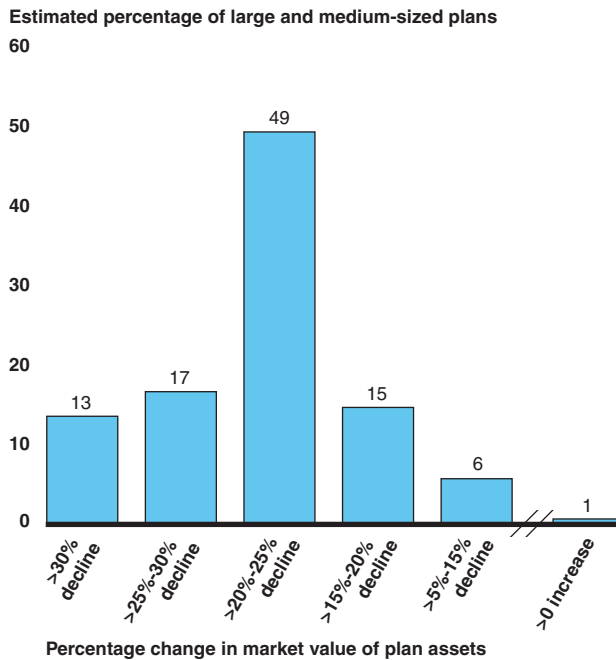
<sup>13</sup>[GAO-08-223](#).

<sup>14</sup>*Public Fund Survey Summary of Findings for 2008*.

<sup>15</sup>*Public Fund Survey Summary of Findings for 2008*.

<sup>16</sup>For the \$621 billion estimate, the 95 percent confidence interval was plus or minus \$82 billion.

**Figure 1: Estimated Change in Market Value of Plan Assets by Amount of the Change for Large- and Medium-Sized Plans, June—December, 2008**



Source: GAO survey of state and local plans.

Note: The 95 percent confidence interval for the estimates in this figure are within plus or minus 9 percentage points.

Preliminary evidence indicates this trend continued into 2009. In a nonprojectable sample of 21 state and county Comprehensive Annual Financial Reports (CAFRs) we reviewed, all 21 plans reported losing between 11 and 30 percent of their market asset value from 2008 to 2009. However, based on their December 31, 2008, asset value and the amount of their most recent year's benefit payments as reported in our survey, plans still have enough assets to cover, on average, 13 years of benefit payments, and investment markets have increased.

Actuarial calculations of state and local plan liabilities and assets determine the contributions that sponsors need to make to the plans to fund them on an actuarial basis.<sup>17</sup> Actuaries estimate the present (discounted) value of all future benefit payments, using a variety of

<sup>17</sup>For more information on actuarial funding calculations, see [GAO-08-223](#).

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assumptions, including worker and retiree mortality rates. For the discount rate, they use the expected return on the plan's assets. Actuaries also estimate the "actuarial value of assets" that fund a plan. The excess of these accrued liabilities over the actuarial value of assets is referred to as the "unfunded liability," and the ratio of actuarial assets to liabilities is referred to as the "funded ratio."<sup>18</sup> Under standards set by the Governmental Accounting Standards Board (GASB), unfunded liabilities should be amortized over a period of up to 30 years in order to provide reasonable assurance of the payment of future benefits.<sup>19</sup> According to our survey, the median funded ratio was an estimated 86 percent for medium-sized plans and 82 percent for large-sized plans.<sup>20</sup> Figure 2 shows the distribution of funded ratios for medium- and large-sized plans together.

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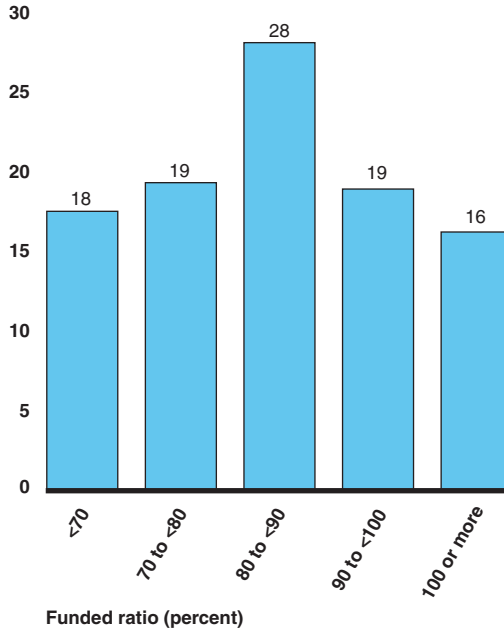
<sup>18</sup>For more information on unfunded liabilities, see [GAO-08-223](#).

<sup>19</sup>GASB Statements 25 and 27.

<sup>20</sup>Plans use different dates to calculate their actuarial valuations which were as of July 1, 2008, or earlier or an estimated 65 percent of the large- and medium-sized plans.

**Figure 2: Estimated Distribution of Funded Ratios for Medium and Large State and Local Pension Plans**

Estimated percentage of large and medium-sized plans, combined



Source: GAO survey of state and local plans.

Note: Plans use different dates to calculate their actuarial valuations. These estimates reflect valuations of July 1, 2008, or earlier for 65 percent of the plans.

Nine plans in our sample of 21 CAFRs had actuarial valuations and unfunded liability data available for 2008 and 2009. Based on our analysis of these data, the unfunded liability for the nine plans increased between 8 and 115 percent. The funded ratio for these nine plans declined between 2 and 7 percentage points.

## Oversight of State and Local Defined Benefit Pensions

All states have legal protections for their pensions. While state and local plans have no guarantor, the majority of states have constitutional provisions prescribing how pension trusts are to be funded, protected, managed, or governed. The remaining states have pension protections in their statutes or recognize legal protections under common law.<sup>21</sup> Legal protections usually apply to benefits for existing workers or benefits that

<sup>21</sup>GAO-07-1156.

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have already accrued; thus, state and local governments generally can only change the benefits for newly hired employees.<sup>22</sup>

Certain standards of governance also apply to these plans, and, based on our review, these standards may or may not be required under state or local law. Plan governance generally refers to the systems and processes that plans use to manage the administration of benefits for the plan beneficiaries and manage the investment of retirement assets, with the objective of maximizing investment returns at an acceptable level of risk and reducing potential conflicts of interest. These systems and processes cover areas such as organizational transparency; having clear, documented, and accessible policies; and commitment to knowledge and skill enhancement. Based on our review, members of governing bodies are subject to fiduciary standards set by their respective state and local governments and other entities. As plan fiduciaries, they have a duty to act solely for the exclusive purpose of providing benefits to plan participants and beneficiaries.<sup>23</sup> Other standards of governance may also apply to these plans, some required under state or local law, and some required by other means.

Accounting standards also affect the treatment of pensions in some circumstances. The GASB is responsible for establishing generally accepted accounting principles (GAAP) for state and local governments. GASB operates independently and has no authority to enforce the use of its standards. Still, many state laws require local governments to follow GASB standards, and bond raters consider whether GASB standards are followed. Also, to receive a “clean” audit opinion on financial statements prepared using GAAP, state and local governments are required to follow GASB standards. These standards require reporting financial information

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<sup>22</sup>State and local government pension plans are not covered under Title IV of the Employee Retirement Income Security Act of 1974 (ERISA), which applies to most private employer benefit plans. Moreover, ERISA does not cover an employee benefit plan that is a governmental plan which means a plan established or maintained by the government of the United States or by the government of any state or political subdivision thereof or any such agency or instrumentality. However, because employer contributions into the plan are tax deferred, state and local pensions must comply with the qualification requirements of the Internal Revenue Code (other than the requirements that are part of ERISA). For more information on the protections for state and local retiree benefits, see [GAO-07-1156](#).

<sup>23</sup>Under ERISA, private plan fiduciaries must satisfy a prudent expert standard and must adhere to requirements to act solely in the interest of plan participants and their beneficiaries and with the exclusive purpose of providing benefits to them. Government plans are subject to a small subset of the ERISA fiduciary rules. See [GAO-07-1156](#).

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on pensions, including items such as contributions and the ratio of assets to liabilities.<sup>24</sup>

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## A Variety Of Stakeholders Guide Plan Investments, and Commonly Hold To Certain Principles Of Governance

A variety of stakeholders are involved in setting investment policies and guidelines and guiding investment decisions for state and local plans. Most plans responding to our survey reported having governing bodies with members representing a variety of constituents. Despite this variety, stakeholders in investment decision making generally attested to operating under certain principles endorsed by experts as being important prerequisites for sound governance. Plans commonly reported they had policies and practices in place to enhance the knowledge and skills of plan fiduciaries and to support organizational transparency.

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## A Variety of Governing Entities and Stakeholders Influence Investment Policies

Plans typically reported many stakeholders influenced plan investment decisions. Survey responses and interviews revealed that investment strategies and policies are determined by state agencies or state investment boards, boards of trustees, investment committees, and, in some cases, state and local officials. Stakeholders, themselves, variously include state legislators, state or local boards of trustees, external consultants and managers, and pension plan investment staff.

The vast majority of plans reported that a governing body determines the investment strategy and allocation of assets. Specifically, over an estimated 85 percent of large- and medium-sized plans reported that a governing body sets their plans' investment strategy and asset allocations, according to our survey (see table 1). Seventy-one percent reported using an investment committee to determine their investment strategy, and 64 percent reported using an investment committee to set asset allocations.<sup>25</sup> About 20 percent of large- and medium-sized plans had their investment strategy and asset allocations set by a state investment body, agency or board.

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<sup>24</sup>GASB Statements 25 and 27.

<sup>25</sup>An investment committee is typically internal to the plan and may be formed from members of the plan's governing body.

**Table 1: Estimated Percentages of Large- and Medium-sized Pension Plans with Specific Entities Responsible for Investment Strategy and Setting Asset Allocations**

Governing entities	Investment strategy	Asset allocations
Governing body	89%	86%
Investment committee	71	64
State investment body	23	21
State/local officials	10	7

Source: GAO survey of state and local plans

Notes: Percentages do not total 100 because more than one entity will often have investment strategy and asset allocation responsibilities for a plan.

The 95 percent confidence intervals for the estimates in this table are within +/- 10 percentage points.

We found that 30 of 42 of small plans responding to our survey also had a governing body responsible for determining their investment strategy and 26 of 42 had a governing body determining their asset allocations.

These varying governance structures, as well as specific responsibilities and the individuals to be included, are often specified in state and local laws, regulations, and administrative codes. As we previously reported, state laws may govern both state- and locally administered plans, and local laws may also augment state laws for locally administered plans.<sup>26</sup> Experts noted there is no one governance structure to be found among state and local pension plans, as many factors contribute to their plan structure and leadership. These factors include plan goals; restrictions; legal requirements; political environments; market conditions; and management, staff, and the various competencies of governing board members.

A number of plan administrators also reported that many entities and individuals influence investment decisions. For example, the governing body for New Jersey’s seven statewide pension plans—the New Jersey State Investment Council—sets broad investment guidelines and provides oversight over the state Division of Investment, which manages the investments for the seven plans.<sup>27</sup> Division of Investment staff make day-

<sup>26</sup> [GAO-07-1156](#).

<sup>27</sup> New Jersey state officials manage the Public Employees’ Retirement System, Teachers’ Pension and Annuity Fund, Police and Firemen’s Retirement System, State Police Retirement System, Judicial Retirement System, the Consolidated Police and Firemen’s Pension Fund, and Prison Officers’ Pension Fund.

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to-day investment decisions within parameters set by the plan board and may also advise the state investment council to make changes to their investment strategy. Additionally, external consultants and actuaries have advised the council on their allocation of assets and actuarial assumptions.

Some plans have a single investment body that manages and invests pooled assets for multiple plans, while each has their own boards to set actuarial assumptions, or to set and pay benefits. For example, the Illinois State Board of Investment (ISBI) has the fiduciary responsibility for managing and investing the assets of three statewide plans.<sup>28</sup> The board is responsible for setting the overall investment strategy, determining the target asset allocations, and overseeing external managers who invest on behalf of the plan. However, each of the three retirement plan boards separately certifies its actuarial assumptions.

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## Members of Governing Entities Typically Represent a Variety of Constituents

State and local pension plan governing entities are typically composed of board members who represent different constituencies and may have varied levels of investment experience. Board members may be elected, appointed, or serve automatically based on holding a particular office, such as a state treasurer. Changes to plan governance structures and board composition appear to be infrequent.<sup>29</sup>

Experts generally hold that board membership should be drawn from different constituencies, including the employer, employees, management, taxpayers, and unions (when applicable), to ensure that varied interests are represented and balanced. Additionally, experts said that governing bodies should be composed of individuals with a range of skills, especially those that allow the group to make responsible, informed investment decisions.

An estimated 72 percent of large- and medium-sized plans reported having at least one board member who represents retirees, and 88 percent of such plans have at least one board member who is a current employee of the plan according to our survey. Table 2 shows the percentage of large- and medium-sized plans whose voting members represent different plan constituencies.

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<sup>28</sup>Illinois State Board of Investment Letter to Trustees, January 20, 2009. The Illinois State Board of Investment manages the State Employees' Retirement System of Illinois, the Judges Retirement System of Illinois, and the General Assembly Retirement System of Illinois.

<sup>29</sup>For more information on governing boards and their members, see [GAO-07-1156](#).



**Table 2: Estimated Percentage of Plans Reporting Having Voting Members Representing Different Constituencies**

Different constituencies board members represent	Percentage of large- and medium-sized plans
Retirees	72%
Current employees	88
Elected officials	56
Former elected officials	0
Independent citizens	43
Management	26
Appointed officials	58
Separated employees	1
Union representatives	20
Other	32 <sup>a</sup>

Source: GAO survey on state and local plans.

Note: The 95 percent confidence intervals for the estimates in this table are within +/- 10 percentage points.

<sup>a</sup> The 95 percent confidence interval for this estimate is +/- 13 percentage points.

A majority of small plans responding to the survey reported having an elected official or a board member representing current employees as voting members of the board. Twelve of 42 small plans reported having a voting member representing retirees and 21 of 42 small plans reported having a voting member who was an appointee.

Officials from the Washington State Investment Board told us that non-voting investment experts serve on the board to help broaden the board's range of investment knowledge. The board's 10 voting board members appoint 5 nonvoting members who are experienced investment experts and who can, therefore, advise other board members on investment decisions.

Our survey results showed the criteria for selecting board members are typically set by the state or local statute or by another authority that established the pension plan. Table 3 shows the authority under which governing body membership is determined. State statute was the most frequently cited authority although medium plans also frequently cited local ordinance.

**Table 3: Estimated Percentage of Plans Whose Governing Body Membership Is Determined by State Statute or Local Ordinance**

	Large-sized plans	Medium-sized plans
State statute	94%	60% <sup>a</sup>
Local ordinance	4	42 <sup>a</sup>
Other authority	8	9

Source: GAO survey of state and local plans.

Note: Percentages do not total 100 because more than one authority may determine governing body membership.

<sup>a</sup> The 95 percent confidence intervals for these estimates is +/- 11 percentage points.

During our review, we found indications that plan governance structures and board composition are changed infrequently. In such cases where changes are made, state or local governments themselves must make the changes since these structures are usually prescribed by law or in administrative code. For example, Virginia and Illinois are two states we found in our discussion with plan officials that made major changes to board structures as follows to address the potential for misuse of pension plan funds:

- Officials in Virginia told us that in 1994, the Virginia legislature changed the way appointments are made to the Board of Trustees for Virginia Retirement System (VRS) and it established regular oversight over the plan by the state’s Joint Legislative Audit & Review Commission (JLARC). Before 1994, the Virginia governor had appointed the board’s chairman and all members of the board. Officials explained that because JLARC believed the governor had too much control over the fund, the legislature changed the appointment process to five gubernatorial appointments and four appointments by the legislature’s Joint Rules Committee. Also in the 1990s, following a controversy regarding VRS ethical standards, the legislature separated the responsibilities of board members and investment staff. The board was restricted to setting broader investment practices to guide the professional staff in day-to-day investment decisions.
- Illinois officials told us their legislature passed a state ethics and transparency reform bill in 2009 that made significant changes to many of the state governing boards. Prior to the act, one board was composed of 9 members who were all gubernatorial appointees. The bill increased the size of the board from 9 to 11 members, and decreased the number of gubernatorial appointees to 4.

## Investment Decision Makers Commonly Hold to Certain Governance Principles

State and local pension plan investment decision-makers generally attested to having either practices or policies that support the principles of fiduciary education and organizational transparency. Most plans responding to the survey and in interviews reported having policies and practices for educating and training for board members and policies that clearly delegated duties for board members and investment staff.

## Organizational Transparency

Experts generally described the principles of organizational transparency and fiduciary education as important prerequisites for sound investment decision-making. Plans that have either policies or practices that reflect these principles may see increased organizational performance and attainment of investment goals due to having increased accountability, fewer conflicts of interest, and increased efficiency of the investment decision-making process. Some practices recommended by experts include:

- a written investment policy;
- publicly available plan governing documents;
- clearly defined duties and lines of authority between members of the governing body and investment staff;
- established processes for reporting and disclosing actual or potential conflicts of interest;
- an orientation for new board members; and
- ongoing education and training opportunities for plan fiduciaries.

According to survey responses, most plans reported having a written investment policy available to the public in several formats. Investment policies include the targeted allocations and diversification requirements, and most include risk preferences for the plan. Additionally, plans reported they outline how they will evaluate investment performance, such as using performance benchmarks and target allocations, in their investment policies. Most large- and medium-sized plans also reported having many facets of governance, and evaluation and oversight incorporated into their governing documents that support organizational transparency.

Nearly all large- and medium-sized plans reported communicating their investment strategies upon request, and about three-quarters provide printed material. Not quite half the plans posted information about their investment strategies online. An estimated 70 percent of large-sized plans have their investment policy available online, while about 41 percent of medium-sized plans reported having their investment policy available online. Two large- and medium-sized plans that completed the survey reported that their investment policy is not publicly available in any format. (See table 4.)

**Table 4: Estimated Percentage of Plans with Investment Policy Publicly Available in Different Formats**

	Large-sized plans <sup>a</sup>	Medium-sized plans <sup>b</sup>
Online	70%	41%
Brochure/Hardcopy	66	77
Upon request	98	98

Source: GAO survey of state and local plans

<sup>a</sup> The 95 percent confidence intervals for the estimates for the large plans is within +/- 15 percentage points.

<sup>b</sup> The 95 percent confidence intervals for the estimates for medium plans is within +/- 13 percentage points.

For small-sized plans that responded to the survey, it is much less common to have their investment policy publicly available online.

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According to our survey responses, most large- and medium-sized plans reported having many facets of governance that support organizational transparency incorporated in their governing documents. Generally, an estimated 90 percent or more of large- and medium-sized plans included legal responsibilities of fiduciaries; the delegation of duties for decision-making, oversight, and managing investments; and established ethical standards and guidelines for addressing (actual or potential) conflicts of interest in their governing documents. A smaller percentage of medium-sized plans incorporated compliance requirements with the fund's conflict of interest and ethics policies, and guidelines for selecting service providers than large-sized plans.

Additionally, based on our survey, over 90 percent of large- and medium-sized plans are estimated to include standards of performance for measuring investment outcomes and evaluating investment staff, consultants, or money managers. About three-quarters of large and medium-sized plans incorporated regular processes of reaffirming the absence of conflicts of interest and/or disclosing (actual or potential) conflicts of interest.<sup>30</sup> Two-thirds of large- and medium-sized plans incorporated requirements for external review of investment consultants and money managers into their governing documents.

Thirty-one of 42 small plans responding to the survey reported establishing ethical standards and guidelines, and 27 reported establishing compliance requirements within the fund's conflict of interest and ethics policies for any investment staff, consultant, or money manager who interacts with the fund.

## Enhancement of Board Member Knowledge and Skills

Most plans reported having policies and practices for educating and training board members. Some state and local plans reported having requirements establishing minimal levels of experience and expertise for voting board members. A majority of large- and medium-sized plans had both initial and ongoing requirements for educating and training board members (see table 5). Less than half are estimated to require board members to have a minimal level of education or experience.

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<sup>30</sup>The 95 percent confidence interval for this estimate was plus or minus 9 percentage points.

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**Table 5: Estimated Percentage of Educational Requirements for Board Members**

	<b>Total</b>
Requirements establishing minimal level of experience/expertise	<b>43%</b>
Education/training for orienting new governing body representatives	<b>66</b>
Requirement for ongoing education training for governing body	<b>67</b>
Use all elements (excluding "other")	<b>32</b>

Source: GAO survey of state and local plans.

Nine of 42 small plans responding to the survey reported having initial education and training requirements for new board members and 10 of 42 reported having ongoing education and training requirements for board members.

In interviews, plan officials reported having informal practices for educating and training plan fiduciaries on their fiduciary and investment responsibilities. Some plans with no formal policies for investment related education and training reported that they offered optional training and most trustees have attended in-house and external training and workshops. For example, staff at the Employees Retirement System of Texas provide training on new asset classes on an ad-hoc basis that is not required by the state in addition to the formal ethics training required by its investment policy.

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## State and Local Plans Have Gradually Included More Higher-risk Investments in Pursuit of Higher Returns

Over the past few decades, state and local pension plans have gradually changed their asset portfolios by increasing their allocations in higher-risk investments. Most plans have used external managers to actively manage substantial portions of their portfolios. While plan officials used such practices and strategies partly in pursuit of higher returns, they also viewed them as providing diversification and following well-accepted techniques of portfolio management in an effort to mitigate risk, given their long investment horizon.

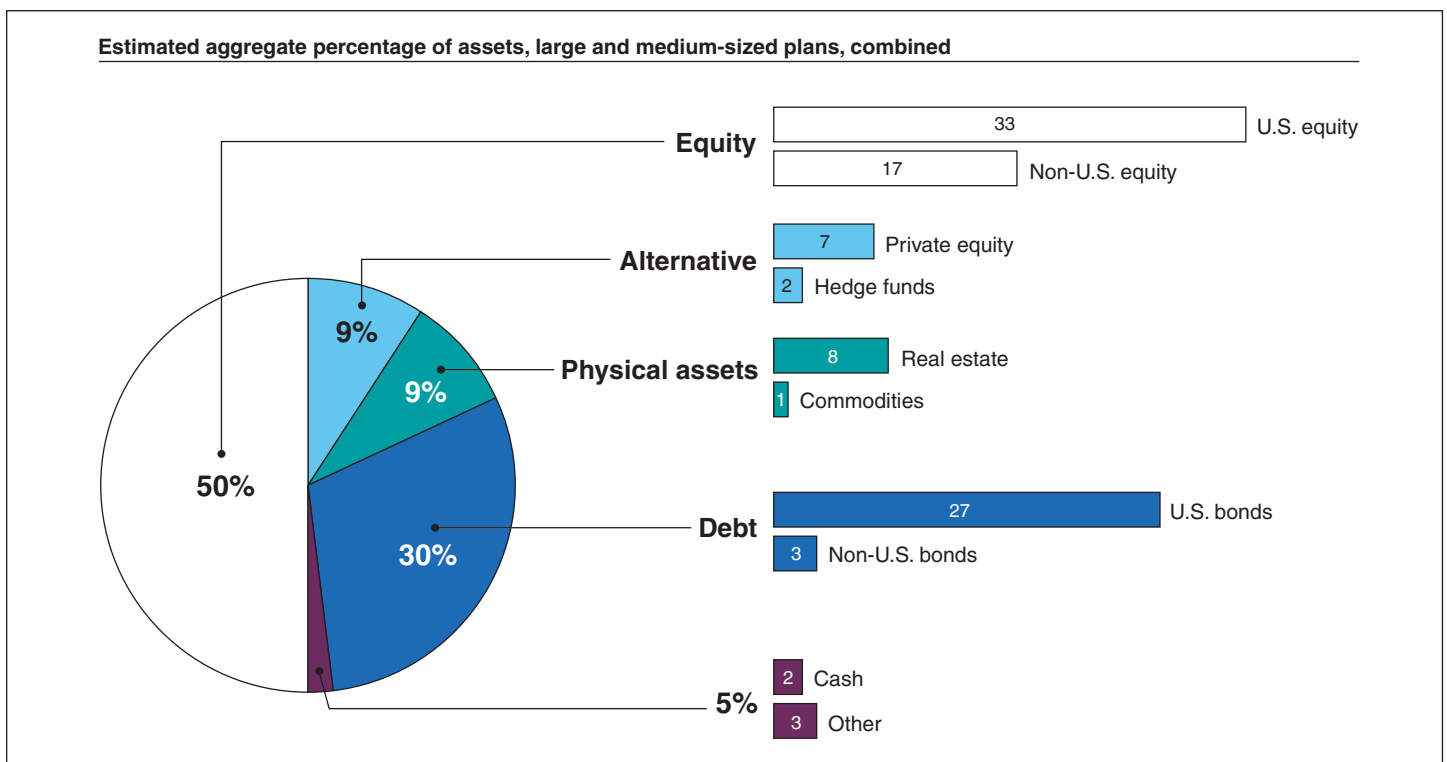
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## Most Plan Assets Are Invested in Equities and Other Higher-risk Assets

In the aggregate, according to our survey, large- and medium-sized plans had invested an estimated 68 percent of their assets in equities and other higher-risk assets, such as hedge funds, private equity, and real estate. They had invested 30 percent in bonds, which are relatively lower-risk assets, and the remaining assets were invested in cash and other assets. (See fig. 3.) The average asset allocations were not generally different

between large- and medium-sized plans. However, these are necessarily broad asset categories since plans define their asset categories in a variety of ways. In addition, each of these categories can encompass a wide range of risk.

**Figure 3: Most Plan Assets Invested in Equity and Other Higher-risk Assets**



Source: GAO survey of state and local plans.

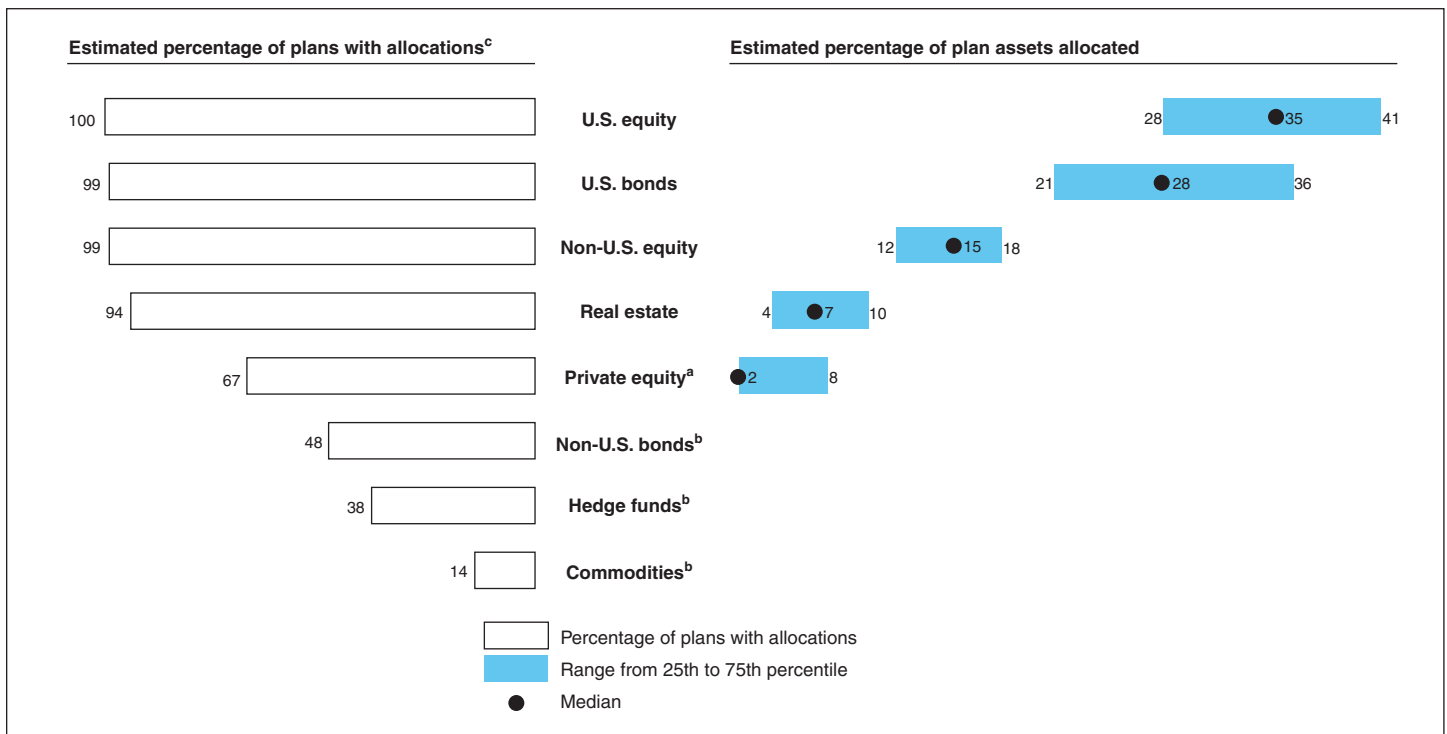
Notes: Numbers do not sum to 100 due to rounding. The "other" category reflects that some plans had asset allocations that did not fit well into the classes listed in our survey.

Survey responses showed that allocations varied considerably across plans. (See fig. 4.) For example, while the median allocation of U.S. bonds was an estimated 28 percent of plans' portfolios, the minimum was zero and the maximum was 87 percent for our sample. While the median for U.S. equities was 35 percent, the minimum and maximum for our sample were 6 percent and 55 percent, respectively.<sup>31</sup> In addition, while 9 percent

<sup>31</sup>As shown in figure 3, equities and debt combined account for 80 percent of assets invested.

of plan assets were invested in private equity and hedge funds in the aggregate, 33 percent and 62 percent of plans had no allocations in these asset classes, respectively.

**Figure 4: Asset Allocations Vary Widely**



Source: GAO survey of state and local plans.

<sup>a</sup>Range shown is from 50th to 75th percentile because confidence intervals for 25th percentile cannot be calculated.

<sup>b</sup>Percentiles not shown because confidence intervals for 25th, 50th, or 75th percentiles cannot be calculated.

<sup>c</sup>Confidence intervals at the 95 percent level for the estimated percentage of plans with allocations were less than plus or minus 10 percentage points for private equity, hedge funds, and non-U.S. bonds and were less than plus or minus 8 percentage points for the remaining asset classes.

## Changes in Asset Allocations Have Been Gradual

Changes in the asset allocations of state and local pension plans have been gradual over the past few decades from a standard practice of investing primarily in lower-risk, low-return assets, such as government bonds. For example, the California State Teachers Retirement System (CALSTRS) reported it has gradually changed its allocation to fixed income from 80 percent in 1981 to about 20 percent in 2009. The Texas Municipal Retirement System (TMRS) had about 87 percent allocated to fixed

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income and 12 percent to equities at the time they responded to our survey but has set a target of 40 percent to equities by 2013.

Plan officials we interviewed generally reported they had not made any major changes to their investment strategies in response to the market downturn, although several plans reported they had undertaken a review of them. Plan officials generally stated they maintained a long-term investment horizon. Still, many officials reported they had rebalanced their portfolios as needed.<sup>32</sup> According to our survey, an estimated 82 percent of large- and medium-sized plans rebalance more often than once a year.<sup>33</sup> In addition, some plan officials reported they had made small changes in asset allocations, such as increasing liquidity with a small allocation to cash. This can increase their ability to respond to investment opportunities as they arise. Also, they hold some cash to pay benefits without having to disrupt their investment strategies.

While plans may not have made major changes, many do anticipate some changes will be made. According to our survey, an estimated 60 percent of large- and medium-sized plans anticipate changes to their investment strategies and target asset allocations in response to the current economic environment.<sup>34</sup> Also, an estimated 81 percent of large- and medium-sized plans reassess their investment strategies at least once a year. Financial market changes and asset performance prompt a reassessment to a great or very great degree for nearly 60 percent of plans and to some degree for virtually all plans.

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## Many Plans Have Pursued Alternative Investments

In recent years, according to plan officials we interviewed, state and local plans have increasingly been pursuing alternative investments, such as hedge funds and private equity.<sup>35</sup> Plan officials told us that the purpose

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<sup>32</sup>Rebalancing restores allocations to the desired targets for each asset class when the current values of the allocations fall out of balance with those targets.

<sup>33</sup>The 95 percent confidence interval for this estimate was plus or minus 9 percentage points.

<sup>34</sup>The 95 percent confidence intervals for the estimates in this paragraph were less than plus or minus 9 percentage points.

<sup>35</sup>The term hedge fund is commonly used to describe pooled investment vehicles that are privately organized and administered by professional managers who often engage in active trading of various types of securities, commodity futures, options contracts, and other investment vehicles. The term private equity generally includes privately managed pools of capital that invest in companies, many of which are not listed on a stock exchange.



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was not only to seek higher returns but also to manage risk through further diversification. Plans have entered into alternative investments at different times.<sup>36</sup>

According to our survey, hedge funds account for an estimated 2 percent of aggregate assets for large- and medium-sized plans, and private equity accounts for 7 percent of assets. Real estate accounted for 8 percent of assets, and commodities accounted for 1 percent.

State and local plans use leverage in their investment strategies to varying degrees.<sup>37</sup> Some plans indicated they do not generally use leverage when investing in standard equity or bond portfolios, and some plans reported having policies that prohibit or limit it, especially for real estate investments. However, hedge funds, private equity funds, and more conventional investment funds often use leverage within their fund investments, so plans that do not use leverage otherwise may use it indirectly when they invest in such funds. For example, in New Jersey, 65 percent of the Division of Investments' funds are leveraged. While leverage has the potential to greatly magnify returns in rising markets, its downside potential in falling markets can result not only in losses but losses that exceed the total value of the original investment for some types of investments. For example, the California Public Employees' Retirement System (CalPERS) has suffered considerable losses in real estate investments that involved leverage and adopted new guidance on the use of leverage in all its investments in May 2009.

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<sup>36</sup>Plans have also varied in the sorts of alternatives they have pursued, and they have various ways of classifying them. For example, some considered hedge funds an asset class of its own, while others distributed their hedge fund assets across different classes they use, since hedge funds themselves can include a variety of asset classes. As a result, our survey results provide an imperfect picture of the allocation to these alternative classes.

<sup>37</sup>"Leverage" refers to taking on debt to make an investment.

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## Most Plans Actively Managed Their Portfolios Using External Managers

State and local pension plans generally used a mix of passive and active portfolio management.<sup>38</sup> Virtually all plans use external managers for some portion of their assets.

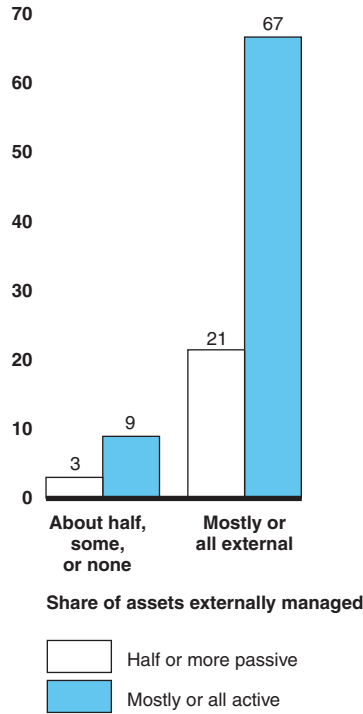
According to our survey, an estimated 76 percent of large- and medium-sized plans described their investment strategy as mostly or all active. (See fig. 5.) Passive management is especially suitable in highly efficient markets, in which it is difficult to find any advantage to exploit. In contrast, officials from one state, for example, explained they use active management when they believe they are able to capitalize tactically on the day-to-day investment environment. Nevertheless, according to our survey, comparing plans whose assets were mostly or all actively managed with those whose assets were mostly or all passively managed, the difference in the decline of the plans' market value of assets between June 30, 2008, and December 31, 2008, as reported by the plans in the survey, was not statistically significant.

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<sup>38</sup>Passive management involves buying or creating an investment portfolio that closely tracks the investment performance of a broad class of assets usually defined by an index, such as the S&P 500. For example, indexed mutual funds are passively managed. Passive managers attempt to match the performance of that class (typically with lower fees), while active managers attempt to exceed it using their judgments about which individual investments within that class will do better than average. Still, a plan that only invests in passively managed portfolios may still make an active choice about how much to allocate to a variety of such portfolios. Plans can create a passively managed portfolio using either internal staff or external managers or invest in an existing external fund for each of different asset classes, according to their allocation targets. Alternative investments such as hedge funds and private equity funds are actively managed by external managers.

**Figure 5: Most Plans Use External Managers to Actively Manage Their Portfolios**

Estimated percentage of large and medium-sized plans, combined



Source: GAO survey of state and local plans.

According to our survey, virtually all large- and medium-sized plans use external managers for some portion of their assets. Among medium-sized plans, an estimated 93 percent have most or all of their assets externally managed, compared with 76 percent of large-sized plans.<sup>39</sup> In addition, according to our survey, for an estimated 75 percent of large- and medium-sized plans, resources available to hire qualified advisors shaped their investment strategy to at least a moderate degree; for 85 percent, the ability to identify qualified advisors shaped their strategy to a similar degree.<sup>40</sup>

<sup>39</sup>The 95 percent confidence intervals for these estimates are less than plus or minus 14 percentage points.

<sup>40</sup>The 95 percent confidence intervals for these estimates are less than plus or minus 9 percentage points.

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## Long-term Investment Horizon and Other Factors Influence Investment Strategies

State and local plan officials told us they have a long-term investment horizon and viewed diversification as a way to minimize risk while allowing for the prospect of higher returns over time. However, even with well-diversified portfolios, extraordinary losses can still occur in outlier years, and increased contributions or subsequent investment gains may be required to make up for such losses.

According to our survey, for an estimated 58 percent of plans, the funded status influenced their investment strategy at least to a moderate degree,<sup>41</sup> though officials from one state, for example, told us that funding status should not influence investment strategy. Investment returns play a significant role in funding pension plans. From 1982 to 2005, investment returns provided nearly two-thirds of revenue to pension funds, compared with about a quarter from employer contributions and about an eighth from employee contributions. Strategies that produce higher returns help improve the funded status and reduce the need for employer contributions. Conversely, investment losses may hurt the funded status and require increased contributions over the short term.

However, a plan's investment strategy affects how the funded status is calculated. As noted in a previous GAO report, one key assumption is the rate at which governments assume their invested assets will grow.<sup>42</sup> If governments assume a high growth rate, their calculations will indicate they do not have to pay as much today because the assets set aside are assumed to grow more rapidly. According to our survey, the average rate of return that plans assume was an estimated 7.84 percent and fell within the range of 3 to 10 percent in our sample.<sup>43</sup> (See fig. 6.) In contrast, according to a Wilshire forecast for state pension plans, the long-term median plan return, given their asset allocation, is expected to equal 6.9 percent.<sup>44</sup> Over the long term, if a plan's assets fail to grow at the

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<sup>41</sup>The 95 percent confidence interval for this estimate is less than plus or minus 9 percentage points.

<sup>42</sup>When evaluating state and local government pensions, the standard practice is to use a discount rate based on the expected rate of return on pension fund investments, which is used in determining the present value of liabilities. See [GAO-08-223](#).

<sup>43</sup>In addition, we reviewed the CAFRs for plans included in our detailed reviews to identify any changes since the time of our interviews in 2009. Of 25 such plans, more recent information on the discount rates used was available for 15. Of those 15 plans, only one had changed their discount rate assumption; that change was from 8.5 percent to 8.8 percent.

<sup>44</sup>Wilshire Consulting, *2010 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation*. March 3, 2010. Santa Monica, California.

**Some Experts Call for Assuming Risk-Free Investment Returns**

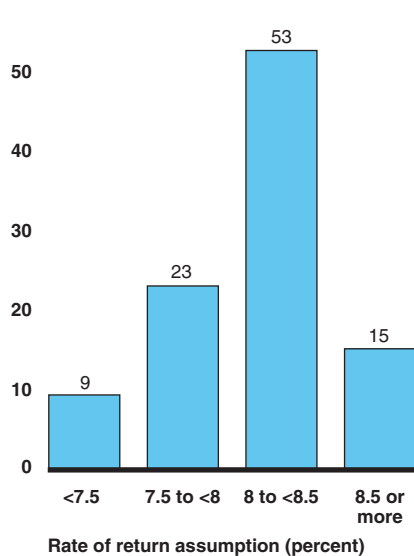
Some in the pension community have been advocating an alternative approach to measuring the funded status of public plans. Proponents of this approach point to certain implications of the field of financial economics that suggest that using the expected rate of return to project future fund earnings does not adequately take into account the risk inherent in some investments. They believe it is preferable, for disclosure purposes, that a plan's assets and liabilities be "marked to market." In particular, plan liabilities should be measured, independent of the actuarial cost method used for funding, as the cost of closing out the plan's accrued benefit obligations based on service to date. This implies using the cost of annuities or discounting the expected cash flows using a risk-free rate of return and would likely result in much less favorable funded status estimates. Further, they believe that using a "smoothed" value of assets rather than the market value of assets obscures the plan's risk profile and may have operational consequences as well.

Most governments do not use risk-free return assumptions to calculate funded status. (Under ERISA, private pension plans measure liabilities using higher quality corporate bonds (see 26 U.S.C. § 430(g)(2)(B).) Most actuaries providing services to public employer plans believe that using this approach is inappropriate because their plans invest in diversified portfolios with higher rates of return than risk-free rates. Those higher returns are reasonable to expect, they feel, based on past experience and will decrease the contributions that would be required if assumed returns were lower. Their current practice, they argue, produces estimates of contributions that best reflect what will actually be required on average over the long term. Using a risk-free return assumption would result in higher current contribution rates, requiring current taxpayers to pay more in the short run for the cost of benefits earned to date.

assumed rate of return, unfunded liabilities will increase and contributions will need to increase in turn. But in the short term, a higher assumed rate of return lowers the value of the liabilities, improves the funded status, and reduces the required contributions, all else equal. So an unrealistically high rate of return assumption reduces the actuarially calculated contributions in the short run but will require increased contributions later, shifting the burden to future taxpayers. For example, some officials in one state felt that the assumed rates of return were too high at 8.5 percent for most statewide plans in that state. According to one state official, plans have testified they have not come close to meeting that assumed rate, but officials told us they do not expect the assumed rate will change.

**Figure 6: Distribution of Plans' Assumed Rates of Return**

Estimated percentage of large and medium-sized plans, combined



Source: GAO survey of state and local plans.

Note: The 95 percent confidence intervals for these estimates are less than plus or minus 9 percentage points.

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For some plans, other factors influence their investment strategies as well. For an estimated 62 percent of large-sized plans and 35 percent of medium-sized plans,<sup>45</sup> socially directed investment requirements influenced investment decisions at least to some degree. Such requirements permit no investments with particular companies, industries, or countries, for example tobacco companies or those doing business in Sudan. For example, state fund managers GAO surveyed for a recent report indicated that their primary reason for divesting or freezing Sudan-related assets was to comply with their states' laws or policies.<sup>46</sup> When determining whether and how to divest, they have considered whether divesting from Sudan is consistent with their fiduciary responsibility. In addition, for an estimated 40 percent of large-sized plans and 19 percent of medium-sized plans, economically targeted investment requirements influenced their strategies to at least some degree. Such requirements dictate that a percentage of investments must be invested locally or remain within state borders. According to a public pension expert, in most of these cases, such investment must still also be prudent and often, such requirements dictate that, all other things being equal, an investment in-state will be preferred over a similar one out-of-state.

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## State And Local Plans Used Various Methods to Address Governance, Investment Management, and Funding Challenges

Public pension plans reported pursuing or implementing a variety of strategies to address challenges confronting them—whether related to governance, management of their investments, or funding. Some have introduced new governance policies for the use of placements agents through increased disclosure and transparency requirements. Other plans have pooled assets to reduce the cost of managing their investments and to acquire more skilled investment management talent. Additionally, some plans have issued debt in the form of pension obligation bonds in order to raise additional cash.

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<sup>45</sup>The 95 percent confidence intervals for the survey estimates in this paragraph are less than plus or minus 12 percentage points for medium plans and less than plus or minus 8 percentage points for large plans.

<sup>46</sup>*Sudan Divestment: U.S. Investors Sold Assets but Could Benefit from Increased Disclosure Regarding Companies' Ties to Sudan* [GAO-10-742](#) (Washington, D.C.: June 22, 2010).

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## To Improve Transparency Some Plans Have Made Changes to Governance Practices

Several of the plans we reviewed are making changes to their governance structures to address transparency and improve accountability. These changes include consolidating multiple plans, using governance consultants, and developing disclosure policies for the use of placement agents.

### Consolidation of Governance Structures

Plans have attempted to use methods of consolidation as a mechanism to improve accountability within their governance structures. For example, according to Wisconsin state officials, after decades of fragmented pension systems in the state, in the 1970s, the Wisconsin State Legislature merged its separate statewide plans to create the Wisconsin Retirement System (WRS). State officials explained that WRS is comprised of two arms—one responsible for administration and the other for investments. The State of Wisconsin Investment Board (SWIB) is responsible for the prudent management and investment of all WRS retirement assets. SWIB sets the investment guidelines, including establishing asset allocation policies and performance benchmarks for the retirement assets of WRS. State officials also noted that the Wisconsin Legislative Audit Bureau, has oversight over SWIB, and conducts an annual financial audit and a biennial performance review.

### Use of Outside Consultants

To meet various governance challenges, some plans we reviewed have sought the outside services of governance consultants to improve plan transparency and cited this as a practice worthy of emulation. The San Francisco Employees' Retirement System indicated that, since 1996, it had made use of a governance consultant to help set up a clearly documented structure for executive director and board member responsibilities. The consultant has also helped the system put parameters in place to help make decisions surrounding complicated benefit eligibility determinations. Officials from the Texas Municipal Retirement System, which serves municipal employees in the State of Texas, told us they began using the services of a governance consultant in 2001. An official at TMRS told us this practice was key in helping to develop a strategic plan that increased transparency, improved communication between board and staff, and improved communication with customers, the legislature, and the media. In addition, the consultant created guidance on board orientation and education, specifying areas where members needed to be informed.

### Disclosure Policies for Placement Agents

Plans have begun to address increased organizational transparency and disclosures of potential and real conflicts of interest related to the use of placement agents. Placement agents serve as external, third-party marketers for money managers, consultants or firms seeking to provide services to pension plan officials or other institutional investors.

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In August 2009, the Securities and Exchange Commission (SEC) proposed a ban<sup>47</sup> on the use of placement agents after the SEC and other authorities had uncovered improper compensation between placement agents and some plan officials in New York, New Mexico, Illinois, Ohio, Connecticut, and Florida. These improper campaign payments between placement agents and elected officials and even some board members, commonly referred to as “pay to play,” seriously compromise the integrity of the plan and specifically whether a plan’s investment contracts were improperly influenced.

Many plans we interviewed and surveyed reported having established ethical guidelines and processes for disclosing conflicts of interest, but they noted that some of these may not be specific to placement agents. In our interviews, we observed a range of strategies to address placement agents—from no formally articulated policies, to a full ban on their use. For example, CalPERS announced a policy in May 2009 requiring its investment partners and external managers to disclose their retention of placement agents, the fees they pay them, the services performed, and other information about their engagement. CalPERS also said it will not retain or invest with external managers or investment partners unless its placement agents are registered as broker-dealers with the SEC or the Financial Industry Regulatory Authority (FINRA). Also, external managers and investment vehicles must disclose specific information about placement agents, including their identities and a description of their services.<sup>48</sup> In February 2010, a New York City press release announced revisions to the city’s ban on placement agents to allow agents who provide value-added services, such as due diligence and other professional services, but expanded an existing ban on the use of private equity placement agents and on third-party marketers who exclusively provide finder or introduction services. Under the New York City revised ban, political campaign contributions and gifts would be also be banned.

Plan officials that we spoke to generally believe that increased disclosure policies are adequate to stop conflicts of interest and improper payments.

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<sup>47</sup>SEC proposed rule [Release No. IA-2910; File No S7-18-09] RIN 3235-AK39

<sup>48</sup>According to CalPERS, AB-1743, a bill proposed in February 2010 would define placement agents as lobbyists in accordance with California’s Political Reform Act. The bill would require placement agents, their firms and employees to disclose their fees to prohibit political contributions and would impose limits on gifts that placement agents could give board members.



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For example, the State Association of County Retirement Systems in California asked the SEC to consider requiring that all individuals or firms seeking investment funds from a public retirement plan provide full disclosure of their political contributions, gifts, reimbursements, honoraria and any personal or business relationships.

Several plans have written comment letters to the SEC arguing that an outright ban would hurt plans on grounds that placement agents can serve a legitimate purpose. For example, they said placement agents are traditionally useful in connecting emerging managers to institutional investors, including state or local pension plans. In a letter to the SEC, the SWIB expressed its concern that a ban on placement agents could be especially detrimental because it would make it more difficult for the board to find emerging private equity funds. The SWIB asserted that reputable placement agents play an integral role within the private equity class of assets.

In December 2009, the SEC approached the FINRA, suggesting that an alternative to the ban might be feasible if FINRA were to implement rules that would prohibit pay-to-play activities by registered broker-dealers. FINRA responded in March 2010, offering to promulgate a proposal imposing regulatory requirements on member broker-dealer placement agents as a viable solution to a ban on placement agents serving a legitimate function. The final rule was adopted on June 30, 2010.<sup>49</sup> Under the new rule, an investment advisor who makes a political contribution to an elected official in a position to influence the selection of the adviser would be barred for 2 years from providing advisory services for compensation, either directly or through a fund. The rule also prohibits an adviser and certain of its executives and employees from paying a third party, such as a placement agent, to solicit a government client on behalf of the investment adviser, unless that third party is an SEC-registered investment adviser or broker-dealer subject to similar pay-to-play restrictions.

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<sup>49</sup>SEC Final Rule [Release No. IA-2910; File No S7-18-09] RIN 3235-AK39.

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## To Address Investment Challenges Some Plans Have Attempted Consolidation and Employed Investment Management Practices

### Consolidation for Asset Pooling

Some plans we reviewed have also considered consolidation to achieve investment-related cost savings. One expert that we consulted with believed that plans that attempt to consolidate to pool assets or for investment purposes are able to negotiate terms with fund managers that result in decreased costs. Some plan officials stated they are able to negotiate better fees because this practice allows plans to take advantage of economies of scale and reduce the investment fees they pay to external managers.

For example, officials from ISBI told us they oversee the investments of three DB pension funds: the State Employees' Retirement System of Illinois, the Judges Retirement System of Illinois, and the General Assembly Retirement System. According to these officials, all of ISBI's \$11.3 billion pension assets are externally managed.<sup>50</sup> Illinois unsuccessfully attempted consolidation of five pension systems to form a single fund managed by a new Illinois Public Employees' Retirement System. The proposal projected that consolidating the boards' investment activities would have resulted in a savings of \$12 million annually in administrative costs, and up to \$70 million annually in fees that would otherwise be paid out to the private firms hired to manage and invest each systems' assets.

TMRS administers the pensions of member cities who elect to participate in the system. In 2008, TMRS invested the retirement assets of 833 cities in Texas according to officials. TMRS officials stated that all TMRS member cities pool their assets for investment purposes to achieve advantages through economies of scale, however the cities' benefits are set at the plan level.

In addition to the financial benefits of asset pooling, a plan official stated that consolidated plans have the advantage of attracting higher-quality

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<sup>50</sup>The fair value of ISBI's net assets totaled \$11.3 billion at fiscal year ended June 30, 2008.

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managers. An official from the Massachusetts Pension Reserves Investment Management Board (MASS PRIM) told us that larger investment funds can attract better investment managers. MASS PRIM was established to capitalize on economies of scale to achieve cost-effective operations, and provide access to high-quality, innovative investment management firms, all under the management of a professional staff and members of the board. A MASS PRIM official stated that investment firms are more likely to assign a more highly skilled, knowledgeable manager on a high-profile, large pool of assets.

#### Use of a Contracted Chief Investment Officer

One plan that we examined employed a strategy of using a contracted Chief Investment Officer (CIO). The San Diego County Employees Retirement Association's (SDCERA) retains its CIO under contract as a portfolio strategist; however the Board of Retirement retained its control of investment and allocation decisions. Through the use of a contracted CIO, the association expects to benefit from greater talent and experience to guide the fund through the current volatile and challenging market environment and position it for the future. The CIO guides SDCERA's asset allocation, manager selection and portfolio construction, in addition to implementing board-approved policy. The CIO intends to expand his business to serve simultaneously as a contract CIO for other plans.<sup>51</sup>

#### Internal Management of Investments

Other plans that we reviewed rely on internal money management and have developed human resource policies in an attempt to assure they can attract top quality internal money management staff. For example, the state of New Jersey's Division of Investments' internal staff make investment decisions within parameters set by an oversight board, and are required to make reports to the board on investment changes. A New Jersey state official stated that the Council tries to give the investment staff the flexibility to be opportunistic and use changes in the market to the plans' benefit. New Jersey officials stated that they were able to better minimize losses during the market downturn by having the internal resources and capacity to move money quickly, as needed. VRS officials also stated they use internal money managers to direct the investment of approximately one-third of their assets. In addition, VRS purposely retains

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<sup>51</sup>According to press reports, the San Diego County Employees Retirement Board recently voted to outsource investment management activities, from in house staff to a dedicated external advisor, eliminating the organization's 10 person investment team and outsourcing it to the private company. The board distributed an invitation-only request for proposal on April 28, 2010.

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unfilled positions to give it the capacity to quickly hire additional staff with particular expertise or skills to bring in-house.

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### To Address Funding Challenges Some States Have Issued Pension Obligation Bonds or Have Attempted to Consolidate Local Plans

Some pension plan sponsors have issued pension obligation bonds to address severe plan underfunding or have attempted consolidation to raise additional funds.<sup>52</sup>

### Issuance of Pension Obligation Bonds

Some pension plans use deficit financing—such as the use of pension obligation bonds (POB)—to raise additional investible funds for their plans. POBs are taxable general obligation bonds that governments issue to finance pensions.<sup>53</sup> They transfer a current pension obligation into a long-term, fixed obligation of the government issuing the bond.<sup>54</sup> In a recent brief, the Center for State and Local Government Excellence reported there was a trend toward increased use of taxable POBs from the early 1990s to July 2009.<sup>55</sup> In 2003, the Illinois Governor took out an additional \$10 billion in general obligation bonds for pension funding. According to the Illinois Commission on Government Forecasting and Accountability, some of the \$10 billion was used for the fiscal year 2003 unfunded portion of the state’s contribution, and the rest was for the fiscal year 2004 contribution. \$7.3 billion went to reducing the unfunded

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<sup>52</sup>It has also been noted in news reports that some plans have reduced benefits, particularly for newly hired employees.

<sup>53</sup>Center for State and Local Government Excellence, *Issue Brief: Pension Obligation Bonds: Financial Crisis Exposes Risks* (Washington, D.C., January 2010)

<sup>54</sup>According to the Center for State and Local Government Excellence, the city of Oakland was the first to issue POBs in 1985; the bonds were tax-exempt, and the city government could immediately invest the proceeds in higher-yielding securities which would lock in a positive net return from the transaction. Congress passed the Tax Reform Act of 1986, ending the tax-exempt status for POBs and stopped state and local governments from issuing tax-exempt bonds for the sole purpose of reinvesting the proceeds into higher yielding securities. Later, taxable POBs became an attractive option for some governments in the 1990s because taxable interest rates and pension obligation bond borrowing costs were considerably low. In addition, pension funds had increased their equity holdings substantially over the decade, which generated higher returns for the plans and thus led actuaries to assume higher future returns.

<sup>55</sup>Center for State and Local Government Excellence, *Issue Brief: Pension Obligation Bonds: Financial Crisis Exposes Risks* (Washington, D.C., January 2010)

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liabilities of the state-funded retirement systems. In addition to Illinois, New Jersey, and California, also recently issued POBs.

The use, however, of POBs can be very risky because the investment returns on the bond proceeds can be lower than the interest rate on the bonds. The Center for State and Local Government Excellence reported that, by mid-2009, most POBs were a net drain on government revenues. It attributed this to reduced long-term returns on investment to the pension funds as a result of the market downturn between 2007 and 2009, also noting that, through 2007, the returns on investment had exceeded the interest rate on the bonds. The brief also suggested that this type of funding has been limited as the total amount of POBs issued in any given year has never exceeded more than 1 percent of the total assets in public pensions.

## Consolidation of Local Plans

Some pension plan sponsors have attempted consolidation arrangements to address severe plan underfunding. For example, according to its Web site, the Massachusetts Pension Reserves Investment Trust Fund (PRIT) was created in 1983 with a mandate to reduce the state's significant unfunded liability and to assist participating local retirement systems in meeting their future pension obligations. Later, in 1997, PRIT merged with the Massachusetts State Teachers' and Employees' Retirement System Trust to create a pooled investment vehicle. PRIT invests the assets of this trust and also the assets of Massachusetts county, authority, district, and municipal retirement systems that choose to or are otherwise mandated to invest in the fund. According to the PRIM Fund Web site, in 2007, Massachusetts passed legislation mandating any plan whose investments underperformed by 2 percent (relative to the PRIT Fund) and is less than 65 percent funded must transfer its assets into the PRIT Fund permanently. According to the PRIT Fund Comprehensive Annual Financial Report for the year ended June 30, 2009, 21 retirement systems have transferred their assets into the pooled investment vehicle under the provisions of this act.

Not all attempts at consolidation have been successful, however. Because of the extent of underfunding among many of the state's plans, the state of Pennsylvania has unsuccessfully attempted repeated consolidation of the over 3,100 state and local pension plans. In 2007, the unfunded accrued liability of municipal pensions in Pennsylvania was approximately \$6.8 billion according the Pennsylvania Public Employee Retirement Commission. Researchers within the state have reported that the relatively high administrative costs that can result from the fragmentation exacerbate the fiscal condition of many of the plans. Plans within the state

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have access to assistance in the form of Act 205, which classifies the severity of municipal pensions' distress, and mandates that all of a city's pensions be combined into one aggregate fund in order to qualify for assistance.<sup>56</sup> One Pennsylvania official stated that because of Act 205, smaller plans have been generally well funded, while cities such as Philadelphia and Pittsburgh have chosen to use longer amortization periods to reduce annual costs. This practice has also resulted in rapidly rising annual pension repayment costs in cities such as Philadelphia, due to investment losses in preceding years and additional retirees entering the retirement systems.

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## Concluding Observations

In recent years, many state and local pension plans have faced increased benefit costs, insufficient employer contributions, and, more recently, significant market losses. While the financial markets have started to rebound, some experts believe these plans will be unable to achieve a healthy level of funding by relying primarily on investment returns. Many state and local governments are facing considerable and even unprecedented fiscal challenges, and unfunded pension obligations are an important component of these fiscal problems. Though already difficult, the challenge of making the necessary contributions and affording guaranteed benefits can be expected to become even more so—especially for those state and local governments whose fiscal position continues to erode—and, as a result, many governments are being forced to make difficult choices. Some states have increased borrowing as a means to provide short-term funding relief, and some have started to change the pension benefit structures for current and future workers in an attempt to address these challenges in the long term.

State and local plans appear to have moved toward investing in higher-risk assets with the goal of achieving a balanced, diversified portfolio that seeks higher returns and manages risk over the long term. As plans look to diversify their investment risk through the increasing use of alternative investments, they could expose plan assets to new types of risk. If state and local pension plans and their sponsors are unable to properly monitor and manage these new risks, they may exacerbate recent market losses, which could result in increased employer contributions—costs that many governments are unable to afford.

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<sup>56</sup>The Pew Charitable Trusts and the Economy League Greater Philadelphia, *Philadelphia's Quiet Crisis: The Rising Cost of Employee Benefits*, (Philadelphia, PA, 2008)

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Plans' actions to provide greater access to investment policies and investment allocations—such as posting them online—may help employers, beneficiaries, and taxpayers gain a better understanding of such matters. State and local pension plans are designed to be long-term concerns and, while they appear to have the assets needed to pay current benefits, their long-term prospects bear continued monitoring and vigilance—which increased transparency and disclosure facilitate. It remains to be seen what impact increased exposure to investment risk, and practices such as plan consolidation and the use of pension obligation bonds, will have on plan health, but efforts to offer increased disclosure may be important to helping all plan stakeholders understand the considerable challenges they face.

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## Agency Comments

We provided a draft of this report to the Departments of Labor and Treasury, the Securities and Exchange Commission, and to an outside expert on public sector pension plans for comment. Each provided technical comments which we incorporated as appropriate. We also asked officials from plans we discussed in the report to provide corrections or clarifications to those statements and incorporated those as appropriate.

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As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution until 30 days after the date of this letter. At that time, we will send copies of this report to the Secretary of Labor, the Secretary of the Treasury, the Chairperson of the Securities and Exchange Commission, appropriate congressional committees, and other interested parties. In addition, the report will be available at no charge on GAO's Web site at <http://www.gao.gov>.

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If you have any questions concerning this report, please contact Barbara Bovbjerg at (202) 512-7215. Contact points for our Office of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix II.

Sincerely yours,

A handwritten signature in black ink that reads "Barbara D. Bovbjerg". The signature is written in a cursive style with a large, prominent initial "B".

Barbara D. Bovbjerg  
Managing Director, Education, Workforce,  
and Income Security Issues



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# Appendix I: Objectives, Scope, and Methodology

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The objectives of this report were to address the following questions: (1) who makes investment decisions for state and local defined benefit (DB) pension plans and what guides their decision making; (2) how plans allocate their assets and manage their investments; and (3) practices that plans are using to meet a range of challenges with regard to governance, investment, or funding.

To address the first two questions, we undertook a survey of pension plans sponsored by state and local governments and performed more in-depth reviews of pension plans in seven states. We chose to conduct a survey because it would provide current data on commonalities and trends among plans and identify changes in governance or investment practices that we could generalize to all state and local plans. In addition, we conducted a literature review and interviews with experts in pension and retirement policy and planning to identify accepted standards and best practices for plan governance, organization and transparency, and development and implementation of investment policy and strategy. We used the information obtained from these sources to develop our survey and also compare the extent to which plans responding to our survey and those we reviewed in-depth were following these accepted standards and best practices. We selected the experts we interviewed from previous GAO work identifying individuals specializing in retirement income security; individuals identified with research, advocacy, or outreach specializing in retirement security; and through referrals from associations or previously identified experts. Our review focused only on DB plans.

To address the third question, we obtained information on specific tools and practices used by the plans included in our in-depth reviews. We used our literature search and our expert interviews to identify and obtain information about accepted standards and best practices. We then developed questions for the plans about their use of these standards, practices, or tools. We also identified practices used in some plans directly from our literature search and our expert interviews, some of which were being used in states where we did not conduct in-depth reviews.

In our examination, we did not review state or local laws or regulations. Additionally, we did not independently verify the legal accuracy of any of the information pertaining to state or local laws that was provided to us in interviews, surveys, or other materials that were furnished to us. Similarly, we did not independently research, review, or verify information furnished to us concerning the legal structure, organization, and operation of state and local plans. However, as appropriate, we did review relevant federal laws and regulations.

For our survey of plans, we used a stratified random sample of large-, medium-, and small-sized DB plans. It was designed to provide estimates generalizable to all such plans administered by state and local governing entities in the United States. The population we used to select the sample was the 2007 Census of State and Local Government Employee Retirement Systems survey.<sup>1</sup> For the 2007 survey, there were 2,547 public employee retirement systems in the Census Bureau’s universe. We used this population because it is the only source that reports information on the total number of state administered plans in addition to the more than 2,000 locally administered plans that they have identified. Before drawing our sample, we conducted a data reliability assessment and determined that the data are sufficiently reliable for our purposes.

Table 6 below describes how we stratified our sample and how our sample compares with the total number of plans in the Census survey.

**Table 6: Stratification of Plans by Value of Assets Under Management**

Strata	Value of assets	Number of plans in universe	Percentage of all plans	Percentage of state plans	Percentage of local plans	Percentage of assets	Number of plans in sample
Small-sized	<\$500 million	2,288	89.8%	42%	94%	2.6%	123
Medium-sized	\$500 million to < \$10 billion	186	7.3%	28%	5%	13.9%	85
Large-sized	\$10 billion and more	73	2.9%	30%	1%	83.5%	56
<b>Total</b>		<b>2,547</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>264</b>

Source: GAO Analysis

After drafting the questionnaire, we asked for comments from an outside expert who represents state retirement plan officials, and from an independent survey reviewer in GAO. We made changes to the content and format of the questionnaire after both reviews. We then conducted pretests to check that (1) the questions were clear and unambiguous, (2) terminology was used correctly, (3) the questionnaire did not place an

<sup>1</sup>According to the Census Bureau, a retirement system is a pension plan in which investments, contributions, and benefits are administered as a separate entity independent of the parent government general fund. Assets are accumulated and benefits paid under a particular set of actuarial assumptions, including employee age, compensation, and service credits. They include single employer systems, in which one government is the sole sponsor of the pension plan, as well as multiple employer systems, where two or more governments maintain membership on behalf of their employees.

undue burden on agency officials, (4) the information could feasibly be obtained, and (5) the survey was comprehensive and unbiased.

The practical difficulties of conducting any survey may introduce errors, commonly known as nonsampling errors. For example, difficulties in interpreting a particular question, sources of information used by respondents, or entering data into a database or analyzing them can introduce unwanted variability into the survey results. We took steps in developing the questionnaire, collecting the data, and analyzing them to minimize nonsampling error. We pretested draft questionnaires with pension plan officials to ensure the questions were relevant, clearly stated, and easy to understand. An independent analyst checked all computer programs used for data we analyzed. Since this was a Web-based survey in which respondents entered their answers directly, there was no need to key data into a database, minimizing error. After activating the survey, we identified one question that was not properly formatted for a numerical response. At that time, we replaced the questionnaire and contacted plans that had already responded asking them to update their response to this question.

We conducted an initial round of pretests with three plan administrators, revised the questionnaire based on the comments of the pretesters, and conducted two subsequent rounds of pretests with three additional plan administrators using two successively revised versions of the questionnaire. Both state and local plan administrators participated.

The questionnaire asked for specific information on plan governance, investment strategies and target asset allocations, and plan descriptive information.

We administered the questionnaire via the Web accessible through a secure server. We sent a notification e-mail in June 2009 to officials from each plan or plan sponsor in our sample to confirm they were the individual who should receive the questionnaire, notified them it would be activated in several weeks, and advised them that the person in their office most knowledgeable about the questions asked should complete it. In August, 2009 we sent a subsequent e-mail notifying the plan officials that the questionnaire had been activated and was available online. We assigned each respondent a unique password and username to access the questionnaire.

We sent e-mail reminders to plans that had not responded in late July 2009; early and late August 2009; and in mid September 2009. To further

maximize our response rate, in August, 2009 we also began contacting the nonrespondents by telephone and continued this through the time we closed the survey in mid-November 2009.

Table 7 shows the number of responses and our response rates for each strata.

**Table 7: Response Rates by Strata**

Strata	Value of Assets	Final Sample Size	Number of Responses	Response Rate
Small-sized	<\$500 million	123	42	34%
Medium-sized	\$500 million to< \$10 billion	85	57	67
Large-sized	\$10 billion and more	56	50	89

Source: GAO Analysis

The response rate from the small strata was not sufficient to generalize to the population of small plans. It also caused our overall response rate to be insufficient to generalize to the population of all plans. Therefore, we do not report estimates for small plans or all three strata of plans combined. We were able to develop estimates to generalize for medium- and large-sized plans both separately and combined. The weighted response rate for medium- and large-sized plans combined was 73 percent. These response rates allowed us to produce attribute estimates (percentages) having 95 percent confidence intervals no larger than plus or minus 10 percentage points within strata and 8 percentage points for medium- and large-sized plans combined unless otherwise noted in the report. The results we are able to report on for both large- and medium-sized plans represent 97 percent of all state and local plan assets under management.

For the in-depth reviews of plans, we selected seven states based on diversity in plan governance structures; use of asset classes in investments, and use of money managers, consultants or other experts; plan size and organization; and geographic representation. The selected states were California, Illinois, New Jersey, Texas, Virginia, Washington, and Wisconsin. Our reviews included both state and local plans and explored trends and practices in governance, investment strategy, and asset allocation in more detail. We also asked plans to identify any best practices they believed were worthy of emulating. For each plan, we interviewed officials responsible for plan management and investment

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decision making. We completed these reviews through both on-site visits with some plans and teleconferences with others.

We conducted our work from September 2008 to August 2010 in accordance with generally accepted government auditing standards. The standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for findings and conclusions based on our audit objectives.

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# Appendix II: GAO Contacts and Staff Acknowledgments

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## GAO Contact

Barbara D. Bovbjerg (202) 512-7215 or [bovbjergb@gao.gov](mailto:bovbjergb@gao.gov)

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## Staff Acknowledgments

In addition to the contact named above, David Lehrer, Assistant Director; Jason Holsclaw; Ken Stockbridge; Joel Marus; Najeema Washington; Sara Olds; Erin Preston; Aron Szapiro; Jean McSween; Justin Fisher; Susan Baker; Roger Thomas; Susan C. Bernstein; and Joseph A. Applebaum made important contributions to this report.

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# Related Products

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*State and Local Government Retiree Benefits: Current Funded Status of Pension and Health Benefits.* [GAO-08-223](#). Washington, D.C.: January 29, 2008.

*State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections, and Fiscal Outlook for Funding Future Costs.* [GAO-07-1156](#). Washington, D.C.: September 24, 2007.

*State and Local Governments: Persistent Fiscal Challenges Will Likely Emerge within the Next Decade.* [GAO-07-1080SP](#). Washington, D.C.: July 18, 2007.

*Retiree Health Benefits: Majority of Sponsors Continued to Offer Prescription Drug Coverage and Chose the Retiree Drug Subsidy.* [GAO-07-572](#). Washington, D.C.: May 31, 2007.

*Employer-Sponsored Health and Retirement Benefits: Efforts to Control Employer Costs and the Implications for Workers.* [GAO-07-355](#). Washington, D.C.: March 30, 2007.

*State Pension Plans: Similarities and Differences Between Federal and State Designs.* [GAO/GGD-99-45](#). Washington, D.C.: March 19, 1999.

*Public Pensions: Section 457 Plans Pose Greater Risk than Other Supplemental Plans.* [GAO/HEHS-96-38](#). Washington, D.C.: April 30, 1996.

*Public Pensions: State and Local Government Contributions to Underfunded Plans.* [GAO/HEHS-96-56](#). Washington, D.C.: March 14, 1996.

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