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May 2014

# RETIREMENT SECURITY

## Oversight of the National Railroad Retirement Investment Trust

# GAO Highlights

Highlights of [GAO-14-312](#), a report to congressional requesters.

## Why GAO Did This Study

The Trust was established by federal statute effective in 2002 to manage a portion of the assets the Board uses to pay benefits to retired railroad workers, and managed about \$25 billion in assets as of 2013. The Trust invests assets in stocks, bonds, and other investment vehicles in a manner similar to that of defined benefit plans. To insulate the Trust from political influence over its investment decisions, the Trust was established independent of the federal government. It is exempted from the federal law that governs the financial operations of the U.S. government and which establishes the duties and powers of the GAO. GAO assessed (1) the performance audit policies and practices that exist for oversight of the Trust; (2) the performance audit policies that apply to comparable organizations, such as large state public pension plans; and (3) what options, if any, could be pursued to improve Trust performance audit policies and what tradeoffs stakeholders believe such options entail.

GAO reviewed applicable federal laws, Trust policies and procedures, and relevant reports such as state, federal, and Trust-commissioned performance audit reports. GAO also interviewed officials of the Board, state and federal pension plans, the state Auditors General, and private plan fiduciary experts.

## What GAO Recommends

This report makes no recommendations.

View [GAO-14-312](#). For more information, contact Charles A. Jeszeck (202) 512-7215 or [jeszeck@gao.gov](mailto:jeszeck@gao.gov).

May 2014

## RETIREMENT SECURITY

### Oversight of the National Railroad Retirement Investment Trust

## What GAO Found

Oversight of the National Railroad Retirement Investment Trust (Trust) includes both regular reporting and communications with the Railroad Retirement Board (Board), and periodic performance audits that the Trust has opted to commission; however, no written requirement for such audits exists. The Trust's mandatory annual management report includes financial and descriptive information, including a discussion of the evolution, current status and performance of the Trust's investment portfolio and administrative costs, including investment manager fees. The Trust has also commissioned four external performance audits since its creation—the first in 2004 and the most recent in 2012. These reviews have encompassed a wide range of issues, including the accuracy of monthly reports, compliance with Trust investment manager hiring policies, processes to ensure accuracy of financial recordkeeping and internal controls, adequacy of due diligence procedures, and the role of non-traditional investments.

Performance audit practices of comparable entities can differ from the Trust in scope and frequency. The large majority of state pension plans and two federal programs GAO reviewed that manage investment assets are subject to performance audits that can be initiated and conducted by an external entity, and some of these audits have addressed issues Trust-commissioned audits have not included. Forty-two of the 50 state plans GAO contacted are subject to performance audits that can be initiated and conducted by an external auditor, such as state Auditors General or equivalent, or by offices of internal audit. In some cases, the external auditor reviews the plan annually, while in others, plans are audited less frequently. Both federal programs—the Pension Benefit Guaranty Corporation's single-employer insurance program and the Thrift Savings Plan—are also subject to externally initiated and conducted performance audits. State and federal audits varied in subject and scope, and in some cases, examined issues that Trust-commissioned reviews have not yet included, such as ethics and conflict of interest policies. Experts told GAO that Trust performance audit practices are comparable to those of large private sector plans governed by the Employee Retirement Income Security Act of 1974.

Based on our review of oversight models that apply to state plans and other information, GAO developed several options to enhance the Trust's performance audit practices, and stakeholders identified potential advantages and limitations pertaining to them. For example, the Board's Office of Inspector General (OIG) could be granted authority to conduct performance audits, which would help ensure these reviews are initiated and performed independent of the Trust. However, both Board and Trust officials had reservations about this option, stating that the OIG lacks sufficient expertise in aspects of the Trust investment program, and expressing concerns about what they perceive as an unconstructive working relationship. The Trust's practice of commissioning periodic performance audits could be established as a formal requirement, either through a memorandum of agreement between the key parties, or through a statutory amendment, with external input on subject and scope of the audits. Trust and Board officials stated that this would be a reasonable option, and in early 2014 developed an initial proposal to implement such an agreement.

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**Abbreviations**

Board	Railroad Retirement Board
DB	defined benefit
EBSA	Employee Benefit Security Administration
ERISA	Employee Retirement Income Security Act of 1974
MOU	memorandum of understanding
OIG	Office of Inspector General
OMB	Office of Management and Budget
PBGC	Pension Benefit Guaranty Corporation
SOSI	Statement of Social Insurance
Treasury	Department of the Treasury
Trust	National Railroad Retirement Investment Trust
TSP	Thrift Savings Plan

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May 15, 2014

The Honorable Lamar Alexander  
Ranking Member  
Committee on Health, Education, Labor, and Pensions  
United States Senate

The Honorable Michael B. Enzi  
Committee on Health, Education, Labor, and Pensions  
United States Senate

The Honorable Johnny Isakson  
Committee on Health, Education, Labor, and Pensions  
United States Senate

The National Railroad Retirement Investment Trust (Trust)<sup>1</sup> is responsible for investing and overseeing about \$25 billion in federal assets used to pay benefits to retired railroad workers through the railroad retirement program managed by the Railroad Retirement Board (Board).<sup>2</sup> The Trust was established by statute effective in 2002 to manage and invest these funds and was granted broad authority to invest in equities, bonds, and other assets in the same manner as private sector pension plans.<sup>3</sup> The statute establishing the Trust provides that it is not a department, agency, or instrumentality of the federal government and that it is not subject to statutory provisions governing the financial operations of the federal government. As a result, oversight requirements that typically apply with respect to federal programs and activities do not apply to the Trust and its activities, although the Trust is subject to limited oversight by the Board and is also required to have its financial statements audited annually. Recent financial markets crises and instances of malfeasance in the

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<sup>1</sup>The Trust is managed by a Board of Trustees, which is responsible for investment decisions related to the Trust. 45 U.S.C. § 231n(j)(3) and(4). In this report, we generally use the term “Trust” to refer to both the Trust itself and to the Board of Trustees.

<sup>2</sup>The Board is an independent agency in the executive branch that manages the Railroad Retirement Program. 45 U.S.C. § 231f(a) and (b). In this report, when we refer to the Board, we are referring to the Railroad Retirement Board and not to the Trust’s Board of Trustees. References to the Trust’s Board of Trustees will be made explicit in context.

<sup>3</sup>Railroad Retirement and Survivors’ Improvement Act of 2001, Pub. L. No. 107-90, § 105(a), 115 Stat. 878, 882-86 (codified as amended at 45 U.S.C. § 231n(j)).

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management of some large public pension plans have raised concerns about the financial risks that pension plans face generally, and the adequacy of existing Trust oversight.

In light of the importance of these assets to the future financial security of railroad retirees, and the limited oversight of the Trust, we reviewed existing Trust oversight mechanisms. Because the Trust's financial statements are audited annually, we focused our review on performance audits, broadly defined; issues pertaining to financial statement audits were excluded from our scope.<sup>4</sup> Specifically, we sought to answer the following questions.

1. What performance audit policies and practices exist for the oversight of the National Railroad Retirement Investment Trust (Trust)?
2. What performance audit policies apply to comparable organizations, such as large state public pension plans?
3. What options, if any, could be pursued to improve Trust performance audit policies and what tradeoffs do stakeholders believe such options entail?

To answer the first question, we interviewed representatives of the Board, the Railroad Retirement Board Office of Inspector General (OIG), and the Trust, including officials who were intimately involved in creation of the Trust. We also reviewed relevant federal law, regulations, and legislative histories, the Trust's written policies and publications—including annual reports and audit reports—and related publications of other federal agencies such as the Social Security Administration. To answer the second question, we interviewed officials of large public retirement plans in each of the 50 states, and conducted in-depth case studies of seven

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<sup>4</sup>According to GAO's Government Auditing Standards, performance audits provide "objective analysis to assist management to improve program performance and operations, reduce costs, and facilitate decision making, by parties with responsibility to oversee or initiate corrective action and to contribute to public accountability". GAO, *Government Auditing Standards*, [GAO-12-331G](#) (Washington, D.C.: Dec. 1, 2011). For purposes of this review, we defined performance audits broadly to include any type of audit or oversight review other than financial statement audits.

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large state plans.<sup>5</sup> For each case study, we interviewed state pension officials, such as the Executive Director of the largest plan or investment entity, and representatives of state auditors general or comparable entity with authority to audit or otherwise review state plans. We also reviewed relevant audit reports pertaining to each plan we contacted. Additionally, we interviewed representatives of the Pension Benefit Guaranty Corporation (PBGC) and the Federal Retirement Thrift Investment Board—two federal agencies which oversee large pools of invested assets—and reviewed relevant performance audits of these two agencies. We also interviewed private plan fiduciary experts and representatives of the Department of Labor’s Employee Benefit Security Administration (EBSA), and PBGC’s Office of Inspector General. To answer the third question, we interviewed relevant stakeholders—including representatives of the Board, Trust, and the Board’s OIG—to discuss the benefits and drawbacks of policy options that could potentially enhance Trust audit and oversight.

We conducted this audit from April 2013 to May 2014 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient and appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Background

The Trust was established by statute as a tax-exempt entity to manage and invest the assets used to pay a portion of Railroad Retirement Program benefits. Congress anticipated that the Trust would be managed much like a private sector pension plan trust.<sup>6</sup> The Trust is governed by seven trustees that, like trustees of multiemployer plans established

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<sup>5</sup>We interviewed officials from each state’s largest pension plan or from an agency that, like the Trust, solely manages the investment of pooled pension assets. Case studies were selected to provide a range based on region, plan participation, and governance and oversight structure. States structure their public employee pension systems in a variety of ways. For instance, Illinois has a distinct entity that manages the investment of pooled public employee pension assets, but that does not administer benefits. Other states, such as Tennessee, have a consolidated retirement system that administers benefits and invests the pooled pension assets of all the state’s public employees.

<sup>6</sup>See S. Rep. No. 107-82, pt. 1, at 14 (2001) (accompanying H.R. 1140, the language of which was included in the enacted law).

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through collective bargaining, include representatives of both management and labor. Three of the trustees are selected by railroad management, three by railroad labor, and one independent trustee is selected by the other six. The Trust may invest Trust assets in stocks, bonds and other investment vehicles in a manner similar to other defined benefit (DB) plans.<sup>7</sup> While the Trust is not subject to the Employee Retirement Income Security Act of 1974 (ERISA),<sup>8</sup> which governs private sector pension plans, its trustees are subject to fiduciary standards comparable to the fiduciary duties under ERISA.<sup>9</sup> For example, each member of the Board of Trustees must act solely in the interests of the Board and, thereby, plan participants and beneficiaries; for the exclusive purpose of providing plan benefits and defraying administrative costs; with the care, skill, prudence, and diligence that a prudent person familiar with such matters would use; and diversify investments to minimize the risk of large losses and avoid disproportionate influence over any industry or firm.<sup>10</sup> As of September 2013, the Trust held about \$25 billion in assets, placing it among the 50 largest DB plan trusts in the nation as of 2013.<sup>11</sup> Trust assets consist mostly of equity and fixed income investments, but also include substantial assets allocated to alternative investments such as private equity, absolute return strategies, and commodities.<sup>12</sup> From 2003 through 2013, according to a Trust representative, the Trust has had an average annual return on investment of about 6.4 percent. However, along with other plans, the Trust also suffered substantial investment losses during the financial crisis of 2008

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<sup>7</sup>In DB plans, formulas set by the employer determine employee benefits, typically based on earnings and years in service.

<sup>8</sup>Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 26 U.S.C. §§ 401-436 and 4971-4982 and 29 U.S.C. §§ 1001-1453).

<sup>9</sup>29 U.S.C. § 1104.

<sup>10</sup>45 U.S.C. § 231n(j)(5)(A).

<sup>11</sup>According to Pensions and Investments' 2013 survey of the 1,000 largest retirement funds, as of September 2013, the Trust was the nation's 48<sup>th</sup> largest plan trust in terms of DB asset holdings.

<sup>12</sup>Alternative investments can include a wide range of assets such as hedge funds, private equity, real estate, and commodities. While there is no commonly accepted definition of private equity for example, such funds are generally privately managed pools of capital that invest in companies, many of which are not listed on a stock exchange. Absolute return strategies are investment strategies that are intended to yield positive returns regardless of the conditions in the stock market.



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and 2009. The Trust lost 19 percent in 2008 alone and suffered much lower losses in 2009 and 2011.

The Trust operates in coordination with the Board, a federal agency established in 1937 to provide old-age pensions to retired employees of the nation's railroads.<sup>13</sup> In 2013, the Board oversaw the payment of about \$11.6 billion in retirement and survivor benefits to about 568,000 beneficiaries. The Board pays two types of benefits to retired workers and their spouses, which are funded through federal payroll taxes assessed on private railroads and their employees. Tier I benefits are calculated to be comparable to Social Security benefits, for which railroad retirees generally are not eligible.<sup>14</sup> The Board also pays Tier II benefits, which are intended to provide a benefit similar to that of a DB plan.<sup>15</sup> Benefits under Tier II are based on a worker's 5 years of highest earnings and the number of years spent in railroad employment. Assets not needed for immediate payment of Tier II benefits are invested by the Trust in accordance with its investment policy.

The legislation creating the Trust includes language making it clear that the Trust is not part of the federal government. Specifically, the Trust is not a department, agency, or instrumentality of the federal government, and it is exempted from title 31 of the U.S. Code which governs the financial operations of the federal government and establishes the powers and duties of the U.S. Government Accountability Office.<sup>16</sup> In addition, the Board is not represented on the Board of Trustees because the Board is a federal agency. However, as required by law, an independent qualified public accountant audits the Trust's financial statements each year.<sup>17</sup> It

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<sup>13</sup>The Board is an independent agency in the executive branch of the United States Government and is charged with the administration of the Railroad Retirement Act of 1974 (45 U.S.C. § 231 *et seq.*) and the Railroad Unemployment Insurance Act (45 U.S.C. § 351 *et seq.*)

<sup>14</sup>Workers with fewer than 10 years of covered railroad service, and fewer than 5 years after 1995, are not vested under the railroad retirement program and their accounts are transferred into Social Security. 45 U.S.C. § 231a(a). Once vested, workers with accrued Social Security benefits have those benefits transferred to the Board. 45 U.S.C. §§ 231b(h) and 231f(c)(2).

<sup>15</sup>Tier II benefits are a component of a railroad retiree's benefit calculated under a formula based only upon earnings and years of service. 20 C.F.R. § 216.2.

<sup>16</sup>45 U.S.C. § 231n(j)(2).

<sup>17</sup>45 U.S.C. § 231n(j)(5)(E).

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has been reported that these aspects of the Trust stemmed from concerns about government involvement in investment decisions that were repeatedly raised in Congress and elsewhere. It was reportedly feared, for example, that politically motivated investment decisions would lead to suboptimal investment returns and would provide political advantages to those influencing the decisions.<sup>18</sup> Concerns about this “political risk” were of particular concern because the partial privatization of the much larger Social Security Trust Fund was a prominent public policy issue at the time.<sup>19</sup> These concerns led to a desire to eliminate even the appearance of possible political influence and significantly influenced the Trust’s current structure.<sup>20</sup>

While the Trust manages the pool of assets in a manner similar to that of a private or public sector traditional DB plan, it also differs significantly from such plans in certain ways. As figure 1 illustrates, the Trust’s role is important but relatively narrow—its sole purpose is to manage and oversee the assets used to ensure payment of Tier II railroad retirement benefits. The Board assumes various other responsibilities of a DB pension plan, such as keeping track of benefit accruals and ensuring benefit payments. As a result, the Trust is a relatively small organization compared to the Board and pension plans of comparable size. While the Trust employs about 18 staff, the Board, which has many other duties—including unemployment and sickness benefit programs—and regional offices around the United States, employs about 865. A public pension plan like the Pennsylvania State Employees’ Retirement System, whose assets under management are comparable to that of the Trust, employs about 200 staff.

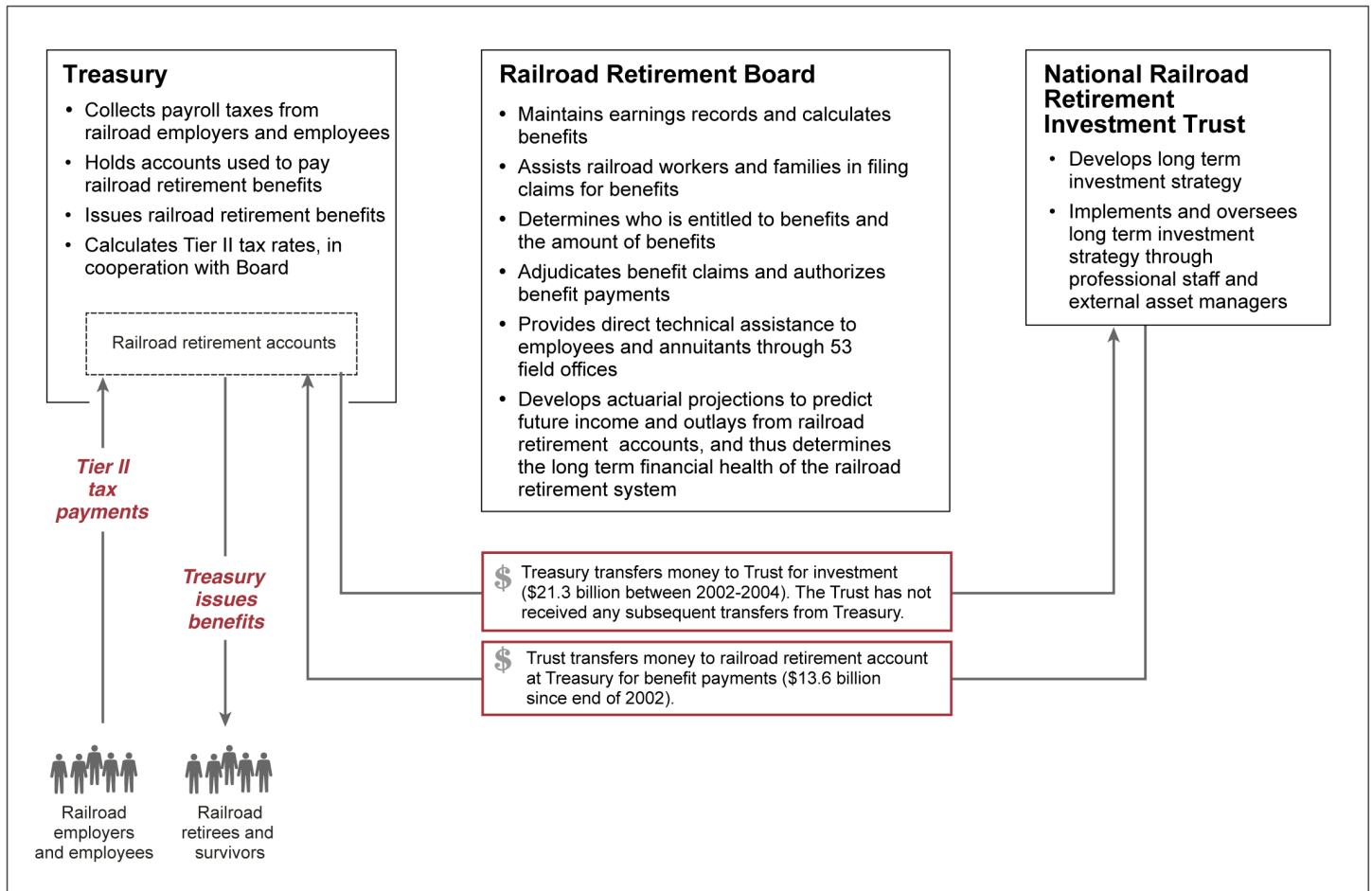
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<sup>18</sup>Steven A. Sass, *An Assessment of the 2001 Reform of the Railroad Retirement Program*, Center for Retirement Research (Boston: Boston College, June 2013)

<sup>19</sup>A proposal during the Clinton Administration would have invested a portion of the Social Security trust fund in publicly traded equities, and a proposal during the Bush administration would have allowed contributors to divert a part of the Social Security payroll tax to individual accounts, where they could be invested in equities. See Sass, p.2

<sup>20</sup> For an extended history of the development of the Trust and the political debate surrounding it, see John J. Salmon, *The Creation of the National Railroad Retirement Investment Trust: Improving Railroad Retirement for Labor, Management, and Beneficiaries*, copyright November 2013. Mr. Salmon serves as counsel to the Trust.

**Figure 1: Division of Key Responsibilities and Flow of Money between the Trust and Board Accounts at Treasury**



Source: GAO representation of Board and Trust descriptive information.

Other essential aspects of a typical DB plan, such as maintaining records of accrued benefits, providing technical assistance to participants, and authorizing and making benefit payments, are carried out by the Board or the Department of the Treasury (Treasury). In addition, the Board assumes responsibility for interacting with workers or beneficiaries as needed. The Trust is thus free of these responsibilities, and is able to focus on overseeing its invested assets. Table 1 compares the Trust and the Tier II program to typical public and private DB plans.

**Table 1: Comparison of Railroad Retirement Board Tier II Benefits to Public and Private Sector Defined Benefit (DB) Plan Benefits**

Aspect	Public and private sector DB plans	Trust and Tier II Railroad Retirement Benefits
Organization and functions	Make and manage investments, and typically perform other plan functions, such as tracking employee vesting and benefit accruals, paying benefits, and conducting or contracting for actuarial studies, etc.	The Trust makes and manages investments for the Tier II benefits only; other duties are performed by the Board and Treasury.
Revenue stream	Typically funded through employer contributions. Employees often contribute to public plans.	Funded through federal payroll taxes levied on railroads and their employees.
Funding rules	Forward funded: Plans are designed so that the present value of assets in a well-financed fund roughly equals the present value of expected future liabilities.	Modified Pay as you Go: Designed so that Trust assets at any time will equal between 4 and 6 years of current benefit payments.
Revenue adjustments	Plan sponsors increase or reduce contributions depending on the financial health of the plan.	Employer and employee payroll taxes are by law automatically adjusted in light of the goal of having a 4-6 year benefit cushion.
Coverage/membership	A private sector single-employer plan generally covers employees of a single employer, and multiemployer plans cover employees that are party to a collective bargaining agreement with two or more employers; public sector plans cover public employees within a particular jurisdiction or unit of government.	Covers employees of all private railroad firms.
Security net	In the case of financially distressed private sector single-employer plans, PBGC can assume the assets and liabilities and pay some portion of benefits, and can provide assistance to help multiemployer plans pay a portion of benefits. Public sector plans may be backed by taxpayers and contributing employees.	None for Tier II benefits. According to Board officials, railroad employers and employees are expected to make the necessary contributions, and if they are unable to do so, benefits are to be reduced. Tier I benefits are guaranteed by the Social Security Trust Fund.

Source: GAO analysis of information GAO collected regarding the Trust, Tier II benefits, and public and private sector defined benefit plans.

Although the Trust does not have its own OIG, since the Trust's inception, the Board's OIG has repeatedly expressed concerns about the adequacy of Trust oversight. In November 2002, the OIG contacted the Trust's Chief Investment Officer to inquire about investment practices and the transfer of assets from Board accounts at Treasury to the Trust. The OIG requested written confirmation that transferred funds had been received, which investments had been purchased, and current investment yields. The Trust Chair responded by noting that the Trust transmits investment information in a statutorily-required annual report, as well as monthly reports pursuant to a memorandum of understanding with the Board,

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Treasury, and the Office of Management and Budget (OMB). In a subsequent correspondence, the Chairman noted that Congress had specified that the Trust was to be audited by an independent auditor, and delegated to the Board the responsibility to bring civil action if it believes the Trust is not complying with the statute. Since that time, the Trust has declined to provide any information directly to the OIG, although the Board has opted to share information pertaining to the Trust in some cases.<sup>21</sup> In 2008, the OIG issued a report expressing concern that the Trust's authorizing legislation provided the Board with a passive oversight role, and did not provide the Board with the ability to uncover circumstances requiring enforcement action.<sup>22</sup> The report further noted limitations of annual financial statement audits, stating that such audits provide a "snapshot" of an organization's financial health at a point in time, are not equivalent to a performance audit, and cannot assess program performance compared to applicable criteria. The report concluded that the annual financial statement audit should be supplemented by performance audits, which can offer information about the effectiveness of internal controls, assess compliance with law, and assess the efficiency of recruitment and retention strategies.

The overall importance of adequate oversight of pension assets has been highlighted in recent years by a number of incidents involving officials responsible for managing large pools of retirement assets. For example, in 2011, high ranking officials of a large state pension plan were implicated in practices that violated fiduciary and ethical duties. Specifically, they were found to have guided investments to certain middlemen known as "placement agents" in exchange for trips and other benefits, possibly to the detriment of beneficiaries.<sup>23</sup> Similarly, in 2009, the PBGC Office of Inspector General (PBGC OIG) issued a report regarding a former PBGC Director's inappropriate involvement in contracting for investment services. Among other things, the PBGC OIG found that the former Director was communicating directly with some

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<sup>21</sup>For example, Board officials stated that pursuant to the OIG's request, the Board shares all e-mail communication between the Board and the Trust.

<sup>22</sup>Railroad Retirement Board, Office of Inspector General, *Statement of Concern: National Railroad Retirement Investment Trust Lack of Provision for Performance Audits* (March 31, 2008).

<sup>23</sup>Placement agents are intermediaries or middlemen paid by external money managers to help gain access to capital from institutional investors.

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bidders at the same time he was actively considering their proposals, and so had clearly violated prohibitions against contact with potential service providers.<sup>24</sup>

As an entity established by federal law that invests or facilitates investing in the public markets the Trust is unusual, but not unique. PBGC operates an insurance program for single-employer DB plans that pays benefits (up to a statutory maximum) to retirees whose pension plans have been terminated.<sup>25</sup> Financed by premiums paid by employers and returns on investment, this program operates a trust fund in which assets are also invested in stocks, bonds, and other investment vehicles with the aim of ensuring adequate funds to pay benefits. To manage this fund, PBGC has developed and implemented an asset allocation strategy comparable to DB plans. As of the end of fiscal year 2013, PBGC managed assets amounting to about \$85 billion. Another agency—the Federal Retirement Thrift Investment Board<sup>26</sup>—operates the Thrift Savings Plan (TSP), a defined contribution plan under which federal employees can save for retirement. The TSP offers a range of investment funds that invest in stocks, bonds, or both. Because the TSP requires participants to determine how their assets will be allocated, it differs from the Trust where the Board of Trustees determines how assets will be invested. At the end of fiscal year 2012, the TSP included assets of about \$330 billion.

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<sup>24</sup>Pension Benefit Guaranty Corporation, Office of Inspector General Audit Report, *Former Director's Involvement in Contracting for Investment Services Blurs Roles and Raises Fairness Issues*, AUD 2009-5 / PA-08-63-1 (Washington DC: May 15, 2009).

<sup>25</sup>29 U.S.C. § 1302. PBGC also manages a program that insures multiemployer pension plans, which are established through collective bargaining and include two or more employers. 29 U.S.C. §§ 1002(37) and 1322a. However, this program does not manage a trust fund that invests in public financial markets.

<sup>26</sup>5 U.S.C. § 8472.

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## Trust Oversight Includes Mandatory Reporting and Voluntary Periodic Performance Audits

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### The Trust Regularly Communicates with the Board and Other Federal Agencies

Under the law, the Trust must submit an annual management report to the Congress, President, Board, and Director of OMB. This report is required to address various matters pertaining to the Trust's administration and financial position.<sup>27</sup> As table 2 outlines, the most recent annual report contains information about the investment results, financial activity, operations and management. For example, the report includes a discussion of the evolution, current status and performance of the Trust's investment portfolio. It also includes a history of asset transfers and current book and market values.<sup>28</sup> The report also includes a section on internal accounting and administrative controls including a description of the custodial arrangements under which Trust assets are primarily in the custody of a custodial bank, as well as the custodian's responsibility to provide the Trust with a full record of all transactions involving Trust assets. The Annual Management Report also includes relevant Trust policies such as Trust by-laws, investment guidelines, and a conflicts of interest policy statement. In addition to Annual Management Reports, the Trust also submits monthly and quarterly reports to the Board. The monthly reports include financial information such as information on the purchase and sale of federal and non-federal securities, the monthly cash balance, and aggregate administrative expenses. Quarterly reports include a summary of investment objectives, quarterly investment returns, and aggregate asset values.

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<sup>27</sup>45 U.S.C. § 231n(j)(5)(E). Specifically, the annual management report must contain 1) statements of financial position, operations, cash flow, internal accounting and administrative control systems; 2) the report on the annual audit of financial statements, and 3) any other comments and information needed to inform Congress about Trust operations and financial condition.

<sup>28</sup>Book value is the historical amount that has been invested and market value is the amount that an investment is currently worth. In the case of the Trust, the book value represents the assets that the Trust has received for investment and the market value is the current value of Trust assets.

**Table 2: Trust Annual Management Report Contents**

Information	Annual Management Report Contents
<b>Administrative matters</b>	<ul style="list-style-type: none"> <li>• Coordination with federal government agencies</li> <li>• Audit committee activity</li> <li>• Description of internal accounting and administrative controls</li> <li>• Administrative costs, including investment manager fees</li> </ul>
<b>Financial transactions and management</b>	<ul style="list-style-type: none"> <li>• Summary of transfers from Trust to Treasury</li> <li>• Year-end account benefits ratio</li> <li>• Summary of cash flows and changes to Trust assets</li> <li>• Financial statements and independent auditor's report</li> </ul>
<b>Investments strategy and management</b>	<ul style="list-style-type: none"> <li>• Description of long term asset allocation</li> <li>• Overview of investment manager hirings and terminations, by asset class</li> </ul>
<b>Other</b>	<p>Appendices include various documents and policies, including:</p> <ul style="list-style-type: none"> <li>• investment guidelines</li> <li>• conflicts of interest policy</li> <li>• publication of new Tier II tax rates</li> <li>• audit and administrative committee charters</li> </ul>

Source: GAO review of Trust annual reports

Under the terms of a memorandum of understanding with three federal agencies, the Trust also submits a monthly report to the Board.<sup>29</sup> The memorandum states that because the Board is responsible for the overall management of the Railroad Retirement System, it is responsible for all budgetary and proprietary reporting of Trust transactions. Consequently, as table 2 describes, the Trust must submit information on investment and other transactions to the Board, and may do so on a 1-month delayed basis. The Board then uses this information to prepare monthly financial reports submitted to Treasury.

In addition to reviewing these reports, Board and Trust officials stated that the organizations conduct regular formal meetings. In addition, the Board, in cooperation with the Trust, receives and reviews communications and information throughout the year. Board officials explained that Board

<sup>29</sup>Established shortly after the Trust was created, this memorandum is co-signed by officials of the Trust, Board, OMB, and Treasury. It also outlines budgetary, transfer, accounting, and financial reporting responsibilities for Trust assets and railroad retirement system assets held by Treasury.



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members and trustees meet face-to-face twice annually, during which the Board receives a presentation on economic, legal, and other issues that could affect the Trust and its investments. The presentation may also include a detailed discussion of investment performance and outlook by asset class. A Board official said that such meetings typically include a question and answer session. These meetings are supplemented by quarterly conference calls between Trust and Board financial and legal staff in which investment performance, ongoing audits, or other issues are discussed.

Board officials indicated that, after more than 10 years of experience working with and overseeing the Trust, they saw no need for enhanced oversight, noting that these reports and communications effectively provide continuous oversight, and in the event of a participant complaint, the Board would stand in for a claimant's interest and take action in the event of malfeasance or mismanagement. Further, Board and Trust representatives told us that the Trust has never declined to share information that the Board has requested. Based on this working relationship, Board officials stated they believe they would be aware of any cause to file a lawsuit under the statute.

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**The Trust Has Commissioned Periodic Performance Audits Since 2002, but Has Not Established a Formal Policy for Such Audits**

While not required by law to do so, the Trust has commissioned four performance audits since the Trust was organized in 2002. As table 3 illustrates, these audits have occurred roughly every 2 to 3 years, and have covered a wide range of issues from technical compliance with the terms of the MOU between the Board, OMB, and Treasury, to the Trust's approach to non-traditional investments such as hedge funds and private equity.

**Table 3: Overview of Scope and Objectives of Trust Performance Audits**

Subject category	2004 Review of selected Trust systems and processes	2006 Internal risk assessment <sup>a</sup>	2009 Operations review	2012 Internal financial control assessment
<b>Financial controls and reporting</b>	<ul style="list-style-type: none"> <li>Verify reconciliation of monthly reports with Trust financial statements</li> <li>Verify that unauthorized investments, transactions or expenditures are not processed</li> <li>Verify timely recording of funds receipt and transfer</li> </ul>	<ul style="list-style-type: none"> <li>Risk of untimely submittal of required annual reports and failure to submit monthly reports</li> <li>Risk of inaccurate calculation or reporting of portfolio values</li> </ul>	<ul style="list-style-type: none"> <li>Assess investment performance reporting</li> <li>Assess Trust and custody arrangements</li> <li>Review investment accounting policies and practices</li> </ul>	<ul style="list-style-type: none"> <li>Evaluate Trust policies and procedures regarding financial controls</li> </ul>
<b>Selection and oversight of external investment managers</b>	<ul style="list-style-type: none"> <li>Adherence to investment manager hiring policies</li> </ul>	<ul style="list-style-type: none"> <li>Risk of failure to perform due diligence in selecting investment managers</li> <li>Risk of asset managers' failure to comply with investment management guidelines</li> </ul>	<ul style="list-style-type: none"> <li>Assess due diligence procedures</li> </ul>	
<b>Investment strategy, performance, and practices</b>		<ul style="list-style-type: none"> <li>Risk of unclear investment performance objectives and metrics</li> <li>Risk of unexpected market volatility</li> <li>Risk that illiquid assets prohibit divestiture to meet cash obligations</li> </ul>	<ul style="list-style-type: none"> <li>Review of non-traditional investment practices, including hedge funds, private equity, commodities, and private real estate</li> </ul>	
<b>Qualifications and compensation of trustees and staff</b>		<ul style="list-style-type: none"> <li>Risk that staff compensation structure may drive inappropriate behavior or fail to attract and retain good performers</li> </ul>		
<b>Plan operations (non-investment)</b>	<ul style="list-style-type: none"> <li>Ensure disaster recovery plan is in place</li> </ul>	<ul style="list-style-type: none"> <li>Risk that staff are insufficient to manage back office operations</li> </ul>		

Source: GAO review of Trust performance audit reports.

<sup>a</sup> The 2006 internal risk assessment sought to examine 19 specific risk areas. This table includes selected examples.

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These performance audits varied considerably in subject matter and breadth. For example, the 2004 audit, conducted by the internal audit departments of two railroad firms, sought to ensure that various core functions, including financial reporting functions, were in place and operating as intended. In contrast, the 2009 review sought to examine various aspects of investment related practices, for which a railroad internal audit department would not likely have sufficient expertise. Instead, according to a Trustee, the Trust hired a consulting firm that it believed to have considerable expertise in investment strategy and management. This report went into some detail about the nature and management of the Trust's alternative investments such as hedge funds and private equity, and examined the Trust's "due diligence" procedures regarding the search for investment managers and ongoing manager oversight.

Each report contained recommendations and, according to Trust documents, the Trust either implemented, committed to implement, or explained why it would not implement each recommendation. In at least one instance, the Trust has not pursued the auditor's recommendations. Specifically, while the 2006 internal risk assessment generally found few gaps in Trust processes and controls of risk, the auditor also proposed a second audit phase to explore a number of issues more deeply.<sup>30</sup> According to a Trust representative, the Trust audit committee opted not to commit to the significant cost of this second phase, since the risk analysis found only a few "gaps" out of the 19 areas evaluated, and because the Trust either took corrective action or determined that the

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<sup>30</sup>This review found some degree of risk in two areas. First, the reviewer found that the Trust did not have an adequate process for ensuring it received reports on investment managers' control activities. The Trust responded that it had taken corrective action. Second, the reviewer found that when the Trust needed to sell assets so as to provide cash to the Board for benefit payments, its policy was to sell from the asset class(es) that were over their allocation. However, the Trust did not have a clear policy regarding what assets to sell if asset classes were at their target allocation. The reviewer recommended that Trust staff document decisions regarding which assets to sell in such situations. According to a Trust representative, the Trust has not done so because the rebalancing policy contained in the Trust's investment guidelines defines parameters within which staff may act in these instances.

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Trust's existing policies sufficiently addressed the concern.<sup>31</sup> Since that time, some of the specified issues have been addressed in subsequent reviews, but others have not. For example, the audit proposed a more in-depth review of recruiting, staff compensation, and organizational culture, but the Trust has not followed up with an audit of these issues.

Although Trust representatives indicated that they intended to continue the practice of periodic performance audits, the Trust does not have a written policy regarding performance audits, their frequency, or their subject matter. For example, the Trust's Audit Committee Charter specifically assigns the Committee responsibility for, among other items, 1) retaining and working with the independent financial auditor, 2) overseeing the Trust's conflict of interest and confidentiality policies, and 3) overseeing Trust staff compliance with the MOU. However, the charter is silent on performance audits.<sup>32</sup>

Recently, a second MOU—developed between the Trust and the Board—has been drafted that would formalize the practice of commissioning periodic performance audits. Under a draft MOU, starting in 2015, performance audits would be performed at least every 3 years, in consultation between the Trust and the Board. The document also lists 12 areas that would be appropriate subjects of the audits, and provides that the Trust and the Board would meet to review the audit results and assess what changes to Trust practices or procedures would be warranted. However, the document does not include some audit subjects, such as fiduciary responsibility and conflict of interest policies, and does not specify timeframes for addressing particular areas subject to audit.

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<sup>31</sup>As of March 2014, the Trust's audit committee consisted of five Trustees—two representing labor, two representing management, and the independent Trustee. According to its charter, the duties of the Audit Committee include retaining and overseeing an independent auditor to conduct the annual audit of the Trust's financial statements, overseeing the Trust's conflicts of interest and confidentiality policies, and overseeing compliance with the MOU between the Board, OMB, and Treasury.

<sup>32</sup>As discussed later in this report, the large majority of state pension plans are subject to performance audits, which in some cases have covered topics that Trust audits have not. In addition, best practices identified by the National Conference on Public Employees Retirement Systems—a trade association representing more than 550 public sector plans in the United States and Canada—state that plans should document a program of assessments and audits to evaluate internal controls, performance, and risk.

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## Performance Audit Practices of Comparable Entities Can Differ from the Trust in Scope and Frequency

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### Most Comparable Entities Are Subject to Multiple Levels of Performance Audits, but the Nature and Frequency of Reviews May Vary

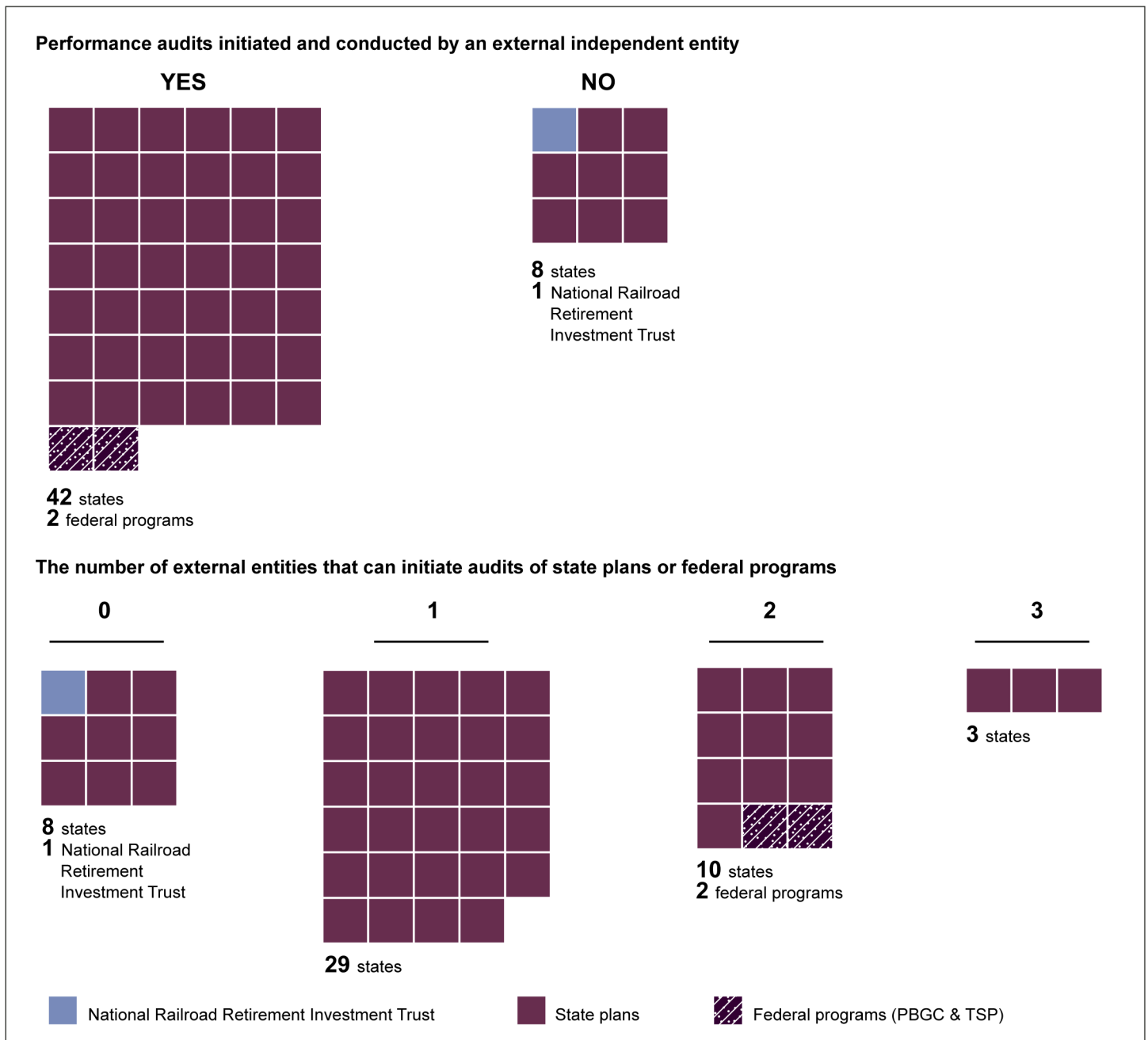
#### Subject to Independent External Auditors

Unlike the Trust, most state plans and both federal programs we contacted are subject to performance audits that can be initiated and conducted by an independent entity. As figure 2 shows, 42 of the 50 state plans we contacted are subject to external audits conducted by the states' Auditor General or a comparable entity with authority to audit or otherwise review them. External audits of these plans can be initiated and conducted independent of the plans' governing board and management. The remaining 8 of these 50 state plans are not subject to external audit. Plan officials in these 8 states stated that oversight can be achieved in other ways, such as through the preparation of publically available reports as well as through board of trustee and legislative oversight.<sup>33</sup>

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<sup>33</sup>Such states may or may not opt to commission, as the Trust has, performance audits conducted by outside firms of their choosing.

**Figure 2: Trust, State, and Federal Performance Audit Practices**



Source: GAO analysis of select Trust, state, and federal performance audit practices.

Note: While Trust officials may commission external firms to conduct periodic performance audits, such audits cannot be initiated by an independent external entity.

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Two federal programs that oversee large asset pools for the benefit of retirees and their beneficiaries are also subject to independently initiated performance audits. For example, PBGC's single employer insurance program is subject to OIG audits and TSP is subject to Employee Benefit Security Administration (EBSA) audits.

While the large majority of state and federal officials noted the importance of performance audits conducted by an independent external entity, officials of some state plans subject to audit noted potential drawbacks as well. A plan official in one state said auditors should be independent because they need to be unbiased, and conduct their work without influence. An EBSA official stated that given the value of TSP's asset holdings, they would be concerned if EBSA was not able to initiate an audit to examine program areas they felt warranted closer review. Nonetheless, a plan official in one state said the plan resisted such audits in part out of a concern for politically motivated reviews and a perceived lack of expertise in investment matters. The official explained that the Auditor General's office was seen as a stepping stone to the governorship, and that plan officials were concerned that audits could be used for political purposes. According to the official, when a state court ruled that the Auditor General had the power to initiate an audit, plan officials commissioned an external firm in 2006 to conduct a separate review so state legislators could consider the findings of both audits.<sup>34</sup>

#### Number of Independent External Auditors

In contrast to the Trust, several state and both federal programs we contacted are subject to multiple audits initiated by independent agencies. As indicated in figure 2, 13 of 50 state plans can be reviewed by two or more entities. In one state for example, the plan is subject to review by three state agencies: the Auditor General, a legislative oversight agency, and the state's Inspector General. In some cases, state oversight agencies do not conduct audits but monitor investment strategy and activities in other ways. For example, one state's legislative oversight committee informs and advises the legislature about different investment options for pension assets. Both federal programs we contacted are also subject to audit by multiple agencies. As noted above, PBGC is subject to

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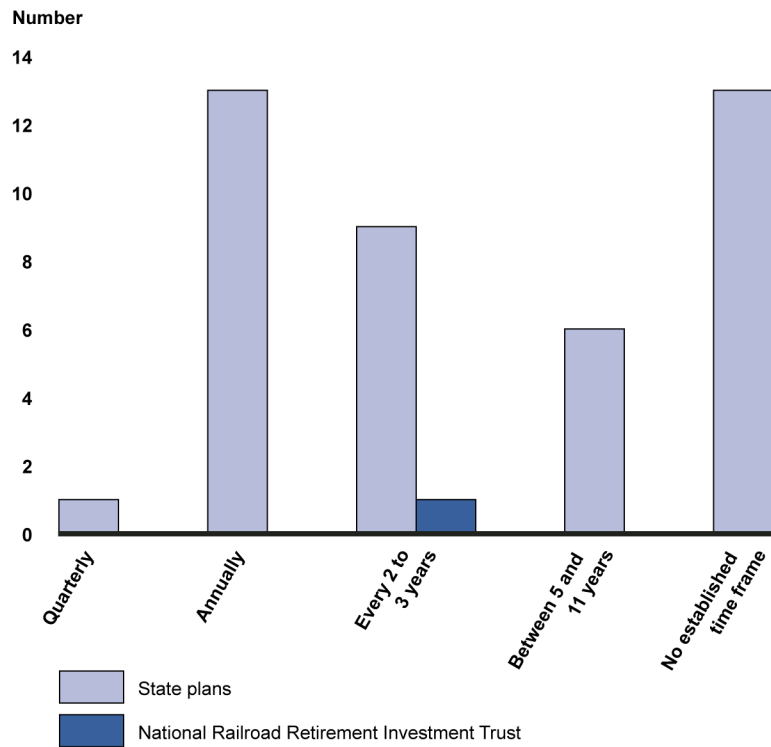
<sup>34</sup>The two audit reports had different conclusions regarding the plan's ability to operate and invest independently. While the Auditor General's report stated that the Governor's oversight did not compromise plan independence, the audit the plan commissioned stated that as a result of such influence, its investment program was not as effective as it should be and was subject to unnecessary political risk.

Frequency of External Performance Audits

audit by its OIG, and TSP is subject to audit by EBSA. In addition, unlike the Trust, both are subject to GAO’s audit jurisdiction.

As illustrated in figure 3, the frequency with which the Trust has commissioned performance audits is comparable to or exceeds most state efforts. Unlike the Trust, 29 of the 50 state plans we contacted are subject to external audits on a specific calendar cycle. While 14 of the 42 state plans are subject to quarterly or annual external audits, most state plans are audited about as frequently as or less so than the Trust. For instance, similar to the Trust, nine state plans are audited at least once every 2 or 3 years. The remaining 19 state plans were subject to audits at longer set intervals that varied from state to state or were not reviewed according to any established time frame.

**Figure 3: Frequency of External Performance Audits**



Source: GAO analysis of select Trust and state performance audit practices.



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While the Trust had not established time frames for periodic reviews of any topic, in some states, external auditors are required to review certain topics within specified intervals. In one state, the Auditor General conducts a performance audit every 2 years focusing on plan operations while a second state agency audits the plan's investment strategy, performance, and practices every other year. In another state, a state agency is required to conduct an audit every 3 years related to investment strategy, performance, and practices as well as ethics and conflicts of interest. The most recent of these audits assessed whether fiduciaries act for the sole benefit of participants, and whether the highest ethical practices were being upheld. Plan officials in this state stated that the requirement is relatively new, resulting from allegations that investment firms made improper payments to politically connected intermediaries in exchange for managing the investment of state pension assets.

#### Internal Audit Offices

Thirty-seven of the 50 plans we examined report being subject to performance audits by an office of internal audit located within the plan itself. In 32 of these plans, internal audits supplement external audits, but in 5 others, the office of internal audit is the only entity that conducts performance audits. According to plan officials, internal audits are typically conducted on an ongoing basis in accordance with an annual audit plan, and are conducted with a significant degree of independence. For example, plan officials in two states stated that, although the board of trustees must formally review and approve their annual audit plan, trustees do not influence what internal auditors should or should not review. One plan official said that such independence is important because—if problems or malfeasance were occurring—the board of trustees might try to divert the focus of these reviews. Nonetheless, an official of one state plan that, like the Trust, solely manages and invests pooled pension assets, told us that given their relatively small size, an office of internal audit would not be appropriate. Instead, the official said they plan to retain a third party firm to conduct a broad-based risk assessment related to the plan's investment allocations.

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#### State and Federal Audits Cover Certain Areas Not Included in Trust Reviews

Trust performance audits are comparable to state and federal audits in terms of the breadth of topics reviewed. We examined relevant performance audit reports of plans in seven selected states and two federal entities and compared these to the four audits the Trust has commissioned. Our examination indicated that the range of topics the Trust has reviewed included some topics that state or federal audits have not included, and in some cases Trust audits addressed topics in more

detail. For instance, as shown in table 4, unlike TSP and four states, a Trust audit included a review related to the qualifications and compensation of its Board of Trustees and Trust staff. Further, Trust audits of some topics have been more detailed than those of some state audits. For instance, the Trust’s 2009 audit included an assessment of its practices for selecting and monitoring external investment managers, as did several state audits. However, the Trust audit also assessed the Trust’s practices for terminating contracts based on the performance of external investment managers which one state audit did not include. Table 4 lists broad audit topics and indicates whether the Trust, state plans, and federal agencies have conducted related reviews.

**Table 4: Subject Categories of Selected State, Federal, and Trust Internal and External Performance Audits**

Subject category	Trust	PBGC	TSP	State 1	State 2	State 3	State 4	State 5	State 6	State 7
Financial controls and reporting	•	•	•	•	•	•	•	•	•	•
Selection and oversight of external investment managers	•		•	•	•	•	•	•		•
Investment strategy, performance, and practices	•	•	•	•	•		•	•	•	•
Ethics and conflicts of interest		•	•	•	•		•	•	•	•
Qualifications and compensation of board and staff	•	•					•		•	•
Plan operations (non-investment)	•	•	•	•	•	•	•	•		•
General compliance		•	•	•		•	•	•	•	•

Source: GAO examination of selected Trust, state, GAO, and other federal audit reports.

Note: Our examination included relevant performance audit reports of plans in seven selected states and two federal agencies issued since 2008. For two states, we included reports published in 2006 and 2007 because they were the most recent. We then compared the topics reviewed in these reports to those included in each of the four audits the Trust has commissioned since 2002. State pension plans or federal agencies may take important steps regarding the subjects listed above outside the scope of a performance audit. For example, state plans may periodically commission consultants to assist in developing or adjusting investment policy or compensation structures. Also, some matters, such as Board membership and compensation may be established in law, and so may not be matters a performance audit would examine.

Conversely, some state and federal performance audits have included findings on topics that Trust audits have not included, or addressed topics in more detail. As table 4 indicates, two federal and six state entities have audited plan ethics and conflicts of interest policies and practices whereas the Trust audits have not. In some cases, such reviews have resulted in findings and recommendations in areas that could be relevant to the Trust. For instance, one state audit found that the plan did not have

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a process to independently identify potential conflicts of interest. Several states have also conducted audits that solely assessed whether the plan was in compliance with law and plan policies whereas the Trust has not. Although limited in scope, officials in one state said these types of reviews have identified issues such as conflicts of interest and the misuse of state funds. Finally, while a 2006 Trust audit considered qualifications and compensation of the Board of Trustees and Trust staff as part of a broad risk assessment, some state audits examined this issue in more detail. For example, a Trust audit considered the risk that improper compensation of staff would drive inappropriate behavior or limit ability to attract and retain staff. The review found that the Trust has processes and controls in place to address this concern, including a staff handbook and an annual review for each employee. In contrast, an audit of a state plan appeared to encompass more, finding that while the plan has a consistently high quality investment staff, it has relatively low staffing levels in several asset classes, a tendency to leave vacancies unfilled for many months, and underdeveloped and underutilized human resources. As a result, the fund has had to make more extensive use of external consultants, which, according to the audit report, resulted in higher costs to the plan.

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### According to Experts, the Trust's Performance Audit Practices Are Similar to Those of Large Private Sector Plans

According to experts on private sector pensions, the Trust's practice of commissioning external firms to conduct performance audits every 2 to 3 years is comparable to the practices of large private sector plans. While such plans are generally not subject to independently-initiated audits, fiduciary experts stated that large private sector DB plans commission periodic audits that are typically conducted by external consulting firms. In discussing the Trust's current practice of commissioning audits every 2 to 3 years, one investment fiduciary expert said that this is similar to many large private sector plans. Experts indicated that such audits are fairly common among large pension plans, but that smaller plans—those managing assets of fewer than \$100 million—do not typically commission these reviews. One expert stated that smaller plans may have a more difficult time justifying the use of the resources necessary to commission performance audits. Nonetheless, where resources are available, experts said that audits can be beneficial to a plan's trustees and management. For instance, one expert said these reviews help ensure the plan is complying with all reporting and disclosure requirements.

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In addition to periodic audits, private plans are also subject to potential external review by ERISA enforcement agencies. To enforce the fiduciary standards established in ERISA,<sup>35</sup> for example, EBSA may review private sector plans to ensure officials are in compliance with ERISA standards<sup>36</sup> and, like plan participants and others, take civil action<sup>37</sup> to enforce compliance.<sup>38</sup> While not subject to ERISA, the Trust's authorizing legislation includes similar fiduciary standards<sup>39</sup> and the Trust is subject to potential civil action by the Board for violations of law.<sup>40</sup> While such action is possible, Board officials stated that the Board has never had cause to take such action.

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## Key Parties Noted Tradeoffs with Expanded Trust Oversight

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### Key Parties Disagreed about Need and Extent of Additional Oversight

The Board's OIG officials emphasized their long-held belief that the current level of oversight is inadequate, and that the Trust should be subject to more rigorous performance audits.<sup>41</sup> In a 2011 report, the OIG stated that without stricter accountability, transparency, and oversight on issues such as administrative expenses and overall financial health, the

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<sup>35</sup>29 U.S.C. § 1104.

<sup>36</sup>29 U.S.C. § 1134.

<sup>37</sup>29 U.S.C. § 1132(a).

<sup>38</sup>In 2007, GAO reviewed EBSA's ERISA enforcement program: GAO, *Employee Benefits Security Administration: Enforcement Improvements Made but Additional Actions Could Further Enhance Pension Plan Oversight*, [GAO-07-22](#) (Washington, D.C.: Jan. 18, 2007). The report also provides more information on the role other federal agencies play in enforcing ERISA.

<sup>39</sup>45 U.S.C. § 231n(j)(5)(A).

<sup>40</sup>45 U.S.C. § 231n(j)(5)(F).

<sup>41</sup>Railroad Retirement Board, Office of Inspector General, *Statement of Concern: National Railroad Retirement Investment Trust Lack of Provision for Performance Audits*, (March 31, 2008).

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Trust runs the risk of fraud, waste and abuse.<sup>42</sup> Further, according to the OIG, there is no comparable example where federal program assets are completely outside the jurisdiction of a federal agency's appointed Inspector General. OIG officials told us that the Board can take enforcement action if it believes the Trust is not in compliance with its founding legislation, but that without more transparency, fraud or mismanagement would be difficult to detect. The OIG maintained that an external organization should have oversight authority so that it can independently verify Trust reports. The OIG added that—despite explicit statutory language making it clear that the Trust is not an agency of the federal government—the Trust's control of about \$25 billion in federal government assets makes its status as a non-governmental organization somewhat illogical, and that it should be subject to greater oversight. The official added that if the railroad industry fell on hard times and the Trust was unable to make benefit payments, industry officials would likely need to seek federal financial assistance.

Both Trust and Board representatives stated that, in their view, the current oversight is adequate, citing annual mandatory financial audits, regular reporting and communications between the Board and Trust, and voluntary periodic Trust-commissioned performance audits. Also, officials cited the statutory "tax ratchet", which raises or lowers the Tier II employer and employee tax rate to ensure that the Trust assets equal between 4 and 6 years of expected benefit payments. Officials noted that this mechanism both ensures that the Trust's financial position will not unduly deteriorate so long as there is a viable railroad industry in the United States to pay required taxes, and ensures that railroad labor and management have a self interest in overseeing a financially healthy Trust.

Selected representatives of railroad management and labor generally concurred with Board and Trust officials. For example, representatives of the Association of American Railroads—an organization representing U.S. railroads—stated that they did not have concerns about the Trust's current oversight structure. Similarly, an official of the Brotherhood of Maintenance of Way Employees indicated that the Trust is doing well financially, and did not have concerns with regard to Trust oversight

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<sup>42</sup> Railroad Retirement Board Office of Inspector General, *Office of Inspector General's Proposal to Improve Business Efficiency at the Railroad Retirement Board*, (September 21, 2011).

because the Trust is quite transparent, and labor organizations are able to obtain periodic reports.

### Stakeholders Identified Important Tradeoffs with Enhanced Trust Oversight Policy Options

Based on discussions with experts and key stakeholders, as well as our review of oversight models that apply to large state plans, private sector plans subject to ERISA, and comparable federal entities, we identified four possible policy options for expanding Trust oversight. We spoke with key stakeholders about these policy options and solicited their views on the potential benefits and drawbacks of each. Table 5 summarizes stakeholder views on these policy options.

**Table 5: Possible Policy Options for Enhancing Trust Oversight**

<b>Policy option</b>	<b>Potential benefits</b>	<b>Potential drawbacks and other considerations</b>
Permit OIG audits	Ensures performance audits are independently initiated and conducted	Could require statutory change; concerns exist about working relationships; could impose additional cost on government
Require periodic audits with external input on scope	Ensures Trust-commissioned performance audits do not cease and provides influence external to Trust	None identified by stakeholders
Establish external investigative authority	Subjects Trust to oversight in event of complaint or allegation	Trust has little to no interaction with beneficiaries, so complaints might be rare; could require statutory change
Establish office of internal audit	Ensures performance audits are independently initiated and conducted	Benefits might be outweighed by additional cost of such a unit

Source: GAO analysis of stakeholder views and other data.

Note: The primary focus of our work was on possible policy options. We also solicited stakeholder input on the mechanisms—statutory or otherwise—by which the options could be implemented.

### Permit OIG Audits

An OIG official told us that, in their opinion, this would be the most logical option because the Trust controls Board assets and the OIG is responsible for overseeing the Board. However, the official noted that the OIG has limited staff, and that such authority would require additional staff resources. To make this option more agreeable to the Trust, an OIG official said that any necessary statutory language could clearly delineate what the OIG’s role would and would not be. The official said the OIG would seek to verify that there are proper checks and balances in place and to assess internal controls. The official stated the OIG would not seek to advise the Trust on investment policy, which is beyond the OIG’s area of expertise.

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However, representatives of the Trust and the Board that we contacted were unanimously opposed to such a proposal. Board officials stated that such a development would be counter to the Trust's originating legislation, and one official stated that externally-initiated audits could open the door to political influence, stating that audit objectives could be framed in a way that would pressure the Trust's investment policies in a particular direction. For example, an audit could be designed to review "politically incorrect" investments, or investments that might be portrayed as not environmentally conscious. Similarly, a Trustee expressed concern about "headline risk", where an outside auditor might make an issue about the Trust's investments in alternative investments such as private equity. Trust representatives also expressed concerns about what they perceived as an unconstructive, confrontational relationship with the OIG. One official said this has been manifest in a number of ways since the Trust was established, including on matters relating to investment management and returns. A Trust official noted that the OIG has commented on Trust investments and related issues, and said that should the OIG be granted authority to audit the Trust, such concerns could result in an audit that would influence Trust investments. The official added that the Trust has a professionally developed investment strategy, and does not wish to take advice about investments or about its selection of investment advisors from the OIG or any other government agency.

Also, as summarized below, Trust officials noted that the OIG's stance with regard to the Statement of Social Insurance (SOSI) has led them to undertake a costly and, in their view, unnecessary second audit of their financial statements each year. An OIG official told us that because the SOSI is included in Board financial statements, in their view the audit of the December 31 asset values is necessary based on OMB guidance. The official further noted that while the difference in the value of Trust assets between September 30 and December 31 is generally not large, in 2008 there was an 18 percent difference.

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## Disagreement over Audit Related to Statement of Social Insurance

### Background

U.S. generally accepted accounting principles require federal agencies charged with responsibility for selected federal social insurance programs such as the Railroad Retirement, Social Security and Medicare programs—to present the Statement of Social Insurance (SOSI) as a basic financial statement in their respective annually audited financial statements. The SOSI presents the projected actuarial present value of the estimated future revenue and estimated future expenditures of these social insurance programs over 75 years. In preparing its annual SOSI for the Railroad Retirement program, the Board considers projections of employment levels, economic factors, and demographic factors such as mortality rates, widow remarriage rates, retirement rates, as well as current asset values provided by the Trust. The Department of the Treasury has cautioned that the assumptions used to prepare SOSI's are inherently subject to substantial uncertainty, and that depending on future events, there will be differences between the SOSI estimates and actual results.

### OIG Action

In 2006, the OIG informed the Board that it would not provide an unqualified opinion on its financial statements if the Board continued to accept unaudited December 31 asset values from the Trust. The Board then requested that the Trust pay for an audit of the December 31 asset values.

### Trust Position

A Trust official stated that this is unnecessary because Trust assets are audited at the end of the Trust's fiscal year—September 30. Further, the Trust noted that the variance between audited December 31 and unaudited December 31 values are invariably quite small—averaging about .12 percent and never exceeding ½ of 1 percent. According to a Trust official, the various assumptions made by the Board actuary in preparing the SOSI have much more impact on the projections than the difference between the audited and unaudited asset values.

### Impact

According to the Trust, the additional audit is also wasteful—costing \$152,000 in 2013 and a total of about \$1.6 million since 2005.

Finally, Board and Trust officials indicated that the OIG would not have sufficient expertise to conduct performance audits of the Trust. One official noted that the internal audit departments of two railroad firms were hired for the first audit that covered various administrative issues. However, Trust officials decided that these auditors would not have the expertise to conduct subsequent reviews, the scope of which required



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Require Periodic Audits with External Input on Scope

greater knowledge of investment management. Instead, the Trust opted to hire private consulting firms with recognized expertise in the relevant subject matter. For the same reason, a Trust official contended that OIG lacks the expertise to conduct these audits.

Key stakeholders—including Board and Trust officials—generally supported this option. The Trust does not have a formal policy regarding the frequency or subject matter of its performance audits, or a policy regarding obtaining external advice on the subject and scope of such audits. However, one trustee stated that, while the Trust has every intention of continuing the practice of conducting periodic audits, they would be amenable to formalizing this process. An OIG official also generally supported this idea, but had previously stated that reviews every 3 years would not be sufficient, and that more ongoing oversight is needed. Board and Trust officials were also supportive of the Board serving in an advisory role with regard to such audits.

Recently, the Trust and the Board have been developing a memorandum of understanding (MOU). According to a draft version of this MOU, starting in 2015, performance audits would be performed at least every 3 years based on mutual agreement between the Trust and the Board. The draft MOU also lists 12 areas that would be appropriate subjects of such audits, and provides that the Trust and the Board would meet to review the results and assess what changes to Trust practices or procedures are warranted. However, the draft MOU does not mention some audit subjects, such as fiduciary responsibility and conflicts of interest policies, and does not specify that key subjects should be addressed within specified timeframes for addressing particular areas subject to audit.

Establish External Investigative Authority

Larger private sector DB plans have, according to experts we contacted, performance audit practices resembling those of the Trust. However, in response to participant complaints or other information, such plans are also potentially subject to EBSA investigations. As we have previously reported, EBSA does not conduct routine compliance audits, but rather investigators rely on various sources for case leads, such as staff reviews of plan annual reports or media reports, participant complaints, or referrals from other agencies.<sup>43</sup> As noted previously, the Board can bring a civil action against the Trust for violations of law. Trust officials are

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<sup>43</sup>[GAO-07-22](#).

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subject to fiduciary standards similar to those under ERISA, and are prohibited from transactions in the trustees' own interest, or receiving any benefit from any party dealing with Trust assets. However, the Trust's authorizing statute does not provide for any mechanism other than a lawsuit with regard to a violation.

Trust officials stated that establishing an external investigative authority might have limited benefits because railroad retirees and survivors do not interact with the Trust in the same way that retirees interact with a DB plan. A Trust representative noted that because the Trust's sole duty is to manage the assets pertaining to Tier II benefits, it does not have responsibility for determining benefit levels, making benefit payments, or the other matters about which a pension plan may communicate with beneficiaries. According to Board representatives, workers taking issue with some aspect of Trust management or actions would likely contact the labor representative on the Board, and management officials would likely contact the Board's management representative.

#### Establish Office of Internal Audit

An office of internal audit is common in state plans, but according to stakeholders, the Trust may be too small an organization to justify such a unit. The majority of the state plans were subject to audits conducted by an internal audit department. Internal auditors generally conducted audits on an ongoing basis, following a routine audit plan.

Both Board and Trust officials stated that, given the small size of the Trust's staff, an office of internal audit would not be suitable. One Trust representative noted that, if the Trust was comparable in size to a large public pension plan, establishing an internal office would make some sense. However, he noted that the Trust employs few staff, and investment management is entirely carried out by external firms. The official stated that such an entity would need considerable skill—including in-depth expertise in investment, accounting, and financial controls—and such a professional would likely command a much higher salary than the Trust would be willing to pay for someone who would have limited responsibility for most of the year. A trustee also expressed concern about the substantial cost of such a position given that there would not be much for them to do most of the time.

A representative of the OIG stated that establishing an internal compliance officer or auditor is a reasonable idea, but expressed concern about the operational independence of such a position. This official was not familiar with the status of internal audit offices within public pension

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## Statutory Amendment or Administrative Agreement

plans, but indicated that such an office would need to be independent of management and Trustees, just as the OIG is independent of the Board.

With respect to the policy options we discussed with stakeholders, Trust and Board officials stated that they would prefer any changes be established through an interagency agreement such as an MOU as opposed to a statutory amendment.<sup>44</sup> Representatives of the Trust and the Board strongly preferred to avoid a statutory change. Trust representatives explained that any statutory amendments would offer less flexibility and opportunity for modification than would an administrative agreement such as an MOU. Further, Trust and Board officials expressed concern that the process of a statutory change might bring unexpected and disruptive consequences. For example, once begun, industry or labor might use the legislative process to impose additional amendments, which could cause unnecessary strife. An OIG official noted advantages and drawbacks to both options, noting for example that while the statutory option could be more difficult to achieve, it would have the benefit of greater permanence, since the Trust could not legally opt to discontinue new oversight practices.

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## Concluding Observations

The National Railroad Retirement Investment Trust manages a \$25 billion pool of federal assets that are critical to providing retirement benefits for railroad workers and their families. To protect these assets—and the entity that manages them—from political influence, the Trust was established independent of the federal government and explicitly exempted from the title 31 of the U.S. Code, which governs the financial operations of the federal government and establishes the powers and duties of GAO. However, the Trust is not without oversight beyond mandatory financial audits. Through regular reports and other communications, the Trust's financial condition is monitored by the Board and other agencies of the federal government. Further, the Trust has appropriately recognized the importance of oversight and transparency by taking the initiative to commission four performance audits since it was organized in 2002. These voluntarily initiated audits are comparable to and in some cases more comprehensive than those of the state pension plans we reviewed.

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<sup>44</sup>The primary focus of our work was on possible policy options. We also solicited stakeholder input on the mechanisms—statutory or otherwise—by which the options could be implemented.

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Nonetheless, our review suggests that there are aspects of the approach to accountability for the Trust that could be strengthened. First, while 42 of the 50 state plans we surveyed and both federal agencies we reviewed are subject to performance audits that are initiated and conducted by external entities, the Trust is not. Instead, it has commissioned private firms to conduct audits whose subject and scope the Trust defines. However, a lack of independently initiated audits raises the risk that auditors could be directed away from potentially problematic issues. Second, 29 of the 50 state plans we contacted are subject to external audits on a specific calendar cycle, and those plans with an internal auditor are audited on an ongoing basis. Although the Trust has opted to commission performance audits every 2 to 3 years since its creation, it does not have a written policy requiring such audits, defining their scope, or establishing their frequency. Finally, while some states require that specific subjects be periodically reviewed, the Trust does not. For example, one state now requires plans to undergo ethics and conflict of interest reviews every 3 years—the most recent of which assessed whether fiduciaries act for the sole benefit of participants, and whether the highest ethical practices were being upheld.

Any improvement in Trust's performance audit oversight should help ensure that its investment decisions are insulated from political influence. Our review of state pension plans and selected federal programs suggests that while external audits are not necessarily a source of such influence, such influence may not be beyond the bounds of possibility. However, concerns about such "political risk" should be balanced against the management and financial risk that exists in situations where oversight is not clearly independent.

The Trust's recent initiative to document a performance audit policy and to involve the Board in determining the subject and scope of future audits adds a welcome external perspective that is likely to enhance the independence of future audits. However, Trust action—including any interagency agreements—would not necessarily be permanent, and under current law the parties could revoke such an agreement at any time. After more than a decade of Trust operation, it may be time to consider whether such an arrangement should be made permanent, while still ensuring that Trust assets are managed solely with the long term best interest of railroad retirees and their families in mind.

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## Agency Comments

We provided a draft of this report to the National Railroad Retirement Investment Trust, the Railroad Retirement Board, and the Railroad Retirement Board Office of Inspector General for review and comment. We received formal written comments from all three organizations, and each generally agreed with our findings and analysis. Among other comments, the Trust indicated that it would seek to address two issues GAO noted with regard to the draft memorandum of understanding between the Trust and the Board regarding performance audits between the Trust and the Board. The Board's OIG summarized some of its long-standing concerns about oversight of the Trust, and raised other concerns. For example, the OIG stressed the importance of audits conducted by independent external entities, and expressed opposition to any arrangement that would allow the Trust and the Board to control performance audits. The OIG also disagreed with the concern expressed by the Board that its audits could lack independence or be a source of political influence. The Trust, Board, and OIG formal comments are reproduced in appendixes II, III, and IV, respectively. The Trust and Board also provided a number of technical comments, which we incorporated as appropriate.

Because performance audit policies or the work of the Pension Benefit Guaranty Corporation, the PBGC Office of Inspector General, the Federal Retirement Thrift Investment Board, and the Department of Labor's Employee Benefit Security Administration are reflected in our report, we also provided those agencies with a copy of the report for technical review and comment. None provided formal written comments, but the Federal Thrift Investment Board and the PBGC provided technical comments, which we have incorporated at appropriate.

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As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies of this report to appropriate congressional committees, the agencies named above, and other interested parties. In addition, this report will be available at no charge on the GAO website at <http://www.gao.gov>.

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If you have any questions about this report, please contact Charles Jeszeck at (202) 512-7215 or [jeszeck@gao.gov](mailto:jeszeck@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are found in appendix V.

A handwritten signature in black ink, reading "Charles Jeszeck". The signature is written in a cursive style with a large, prominent initial "C".

Charles A. Jeszeck,  
Director, Education, Workforce,  
and Income Security

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# Appendix I: Objectives, Scope, and Methodology

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Our objectives were to answer the following questions:

1. What performance audit policies and practices exist for the oversight of the National Railroad Retirement Investment Trust (Trust)?
2. What performance audit policies apply to comparable organizations, such as large state public pension plans?
3. What options, if any, could be pursued to improve Trust performance audit policies and what tradeoffs do stakeholders believe such options entail?

To answer our first question, we reviewed applicable federal laws, regulations, and Railroad Retirement Board (Board) policies and procedures regarding oversight of the Trust and the memorandum of understanding established between the Board, the Trust, the Office of Management and Budget (OMB), and the Department of the Treasury. Additionally, we interviewed representatives of the Board, the Trust, and the Railroad Retirement Board's Office of Inspector General (OIG) to determine the nature and frequency of oversight and audit policies and practices regarding the Trust. We also obtained and reviewed relevant documents including each of the four Trust-commissioned performance audit reports, the Trust's annual reports to Congress, and the Trust's financial statement audit reports. Additionally, we reviewed relevant OIG reports and communications between the Board and OIG related to Trust audit and oversight.

To answer our second question, we conducted in-depth illustrative case studies of audit policies and practices in seven states: California, Florida, Illinois, New York, Tennessee, Texas, and Pennsylvania. We purposefully selected case studies based on region, plan participation, and governance and oversight structure.<sup>1</sup> As part of each case study, we interviewed representatives of the state's Auditor General or equivalent and either representatives of the state's largest public employee pension plan or state agency that, similar to the Trust, solely managed the investment of pooled pension assets. Further, we obtained and reviewed

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<sup>1</sup>States structure their public employee pension systems in a variety of ways. For instance, Illinois has a distinct entity that manages the investment of pooled public employee pension assets, but does not administer benefits. Other states, such as Tennessee, have a consolidated retirement system that administers benefits and invests the pooled pension assets of all the state's public employees.

relevant state performance audit reports. Specifically, we reviewed relevant state audit reports issued since 2008.<sup>2</sup> We generally obtained these reports from the website of the states' Auditors General or equivalent. During interviews with state Auditors General or equivalent and state pension officials, we discussed these reports and asked for copies of other relevant audit reports issued since 2008. Where available, we also reviewed audit reports produced by state plans' offices of internal audit. As internal audit reports are generally not publically available, we asked officials to provide us with copies of these reports particularly those that reviewed aspects of the plan related to investment strategy and management that would be most applicable to the functions of the Trust. To obtain higher-level data regarding the performance audit policies and practices of the remaining 43 states, we also conducted structured interviews with officials of each state's largest defined benefit (DB) public employee pension plan or pension investment entity as available. To identify the state DB plans or pension investment entities, we used information obtained from Pension and Investment's Research Center and the National Association of State Retirement Administrators (NASRA).<sup>3</sup> Based on our audit objectives, we developed standard questions and held pre-tests with officials in two states to obtain feedback on the clarity and relevance of our questions. While the majority of our questions could be answered with a yes or no response, we also included more open ended questions regarding the frequency of external and internal performance audits and to what extent plan officials found such audits useful.

To obtain information on comparable federal entities, we also interviewed officials from the Pension Benefit Guaranty Corporation's (PBGC) single employer insurance program and the Federal Retirement Thrift Investment Board that administers the Thrift Savings Plan. While the functions of these organizations are not completely analogous to the functions of the Trust, like the Trust, both programs manage large asset pools for the benefit of retirees and their beneficiaries. Further, we also interviewed officials from two federal agencies that have audit authority of these programs—respectively, PBGC's Office of Inspector General and

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<sup>2</sup>For two states, we reviewed audit reports published in 2006 and 2007 because they were the most recent relevant audit reports issued by the states' Auditor General or equivalent.

<sup>3</sup>We identified the largest state plans in terms of the total amount of DB pension assets managed.



the Department of Labor's Employee Benefit and Security Administration—to determine the nature and frequency of their audit practices. Additionally, we obtained and reviewed relevant federal audit reports issued since 2008. Further, we interviewed representatives of NASRA, and the Association of Public Pension Fund Auditors to discuss audit practices of public plans. To obtain information on the audit practices of private sector DB plans, we reviewed relevant provisions of the Employee Retirement Income Security Act of 1974 (ERISA) and interviewed private sector plan fiduciary experts, ERISA experts, and representatives of an external consulting firm that has been commissioned by private sector plans to conduct performance audits.

To answer our third question, we developed four policy options regarding improved Trust oversight. These options were based substantially on the oversight models that apply to state pension plans or comparable federal agencies, as developed under objective 2. We then interviewed experts and stakeholders familiar with the Trust—including representatives of the Board, the Trust, the OIG, and other federal officials, as well as railroad labor and management—to discuss the potential benefits of establishing independent performance audits of the Trust. We discussed with them the benefits and drawbacks of four possible policy options: 1) permitting OIG audits, 2) requiring periodic audits with external input on scope, 3) establishing external investigative authority, and 4) establishing an office of internal audit. We also solicited input on the mechanisms—statutory or otherwise—by which the options could be implemented. We also obtained and reviewed existing principles and guidelines regarding the audit and oversight of DB pensions plans, especially those applicable to investment management activities. Examples of such principles include the guidelines published by the Organisation for Economic Cooperation and Development (OECD) and the National Conference on Public Employee Retirement Systems (NCPERS) among others.<sup>4</sup> Additionally, we reviewed academic articles on pension plan governance and oversight and relevant auditing and internal control standards such as the American Institute of Certified Public Accountants Statements on Auditing Standards, Government Auditing Standards, International Standards for the

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<sup>4</sup>OECD Working Party on Private Pensions, *OECD Guidelines for Pension Fund Governance* (June 2009); NCPERS, *Best Governance Practices for Public Retirement Systems* (March 2012).

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Professional Practice of Internal Auditing (Standards), and Standards for Internal Control in the Federal Government.<sup>5</sup>

We conducted this audit from April 2013 to May 2014 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient and appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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<sup>5</sup>American Institute of Certified Public Accountants, *Statements on Auditing Standards*; GAO, *Government Auditing Standards*, [GAO-12-331G](#) (Washington, D.C.: December 2011); The Institute of Internal Auditors, *International Standards for the Professional Practice of Internal Auditing (Standards)* (October 2012); GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: November 1999).

# Appendix II: Comments from the National Railroad Retirement Investment Trust

## PICARD KENTZ & ROWE

Picard Kentz & Rowe LLP  
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April 21, 2014

Charles A. Jeszeck  
Director  
Education, Workforce, and  
Income Security Issues  
U.S. Government Accountability Office  
441 G Street, NW  
Washington, DC 20548

**Re: Retirement Security: Oversight of the National Railroad Retirement Investment Trust (GAO-14-312)**

Dear Mr. Jeszeck:

This is in response to your April 11, 2014 request for written comments on the draft report, Retirement Security: Oversight of the National Railroad Retirement Investment Trust (GAO-14-312) ("Draft Report") prepared by the U.S. Government Accountability Office ("GAO").<sup>1</sup> We appreciate the opportunity to submit our views and would offer the following observations.

1. Proposed Memorandum of Understanding on Performance Audits. The Draft Report discusses the proposed memorandum of understanding (MOU) between the Railroad Retirement Board (RRB) and the National Railroad Retirement Investment Trust (NRRIT) regarding performance audits as a positive development, but expresses concern in several places (notably, pages 14, 25, and 28) that the draft MOU "does not mention some audit subjects, such as fiduciary responsibility and conflicts of interest policies" within its list of potential topics.<sup>2</sup> The exclusion of these topics was not intentional. The NRRIT Board will propose adding these topics to the draft MOU at our next joint oversight meeting with the RRB on May 1, 2014. The GAO Draft Report (page 14) also observes that the draft MOU "does not specify that key subjects should be addressed within specified timeframes for addressing particular areas to audit." Again, this is not an area of controversy and the NRRIT Board will work with the RRB to include appropriate language to establish subject priorities

<sup>1</sup> In addition to these written comments, we have also communicated with GAO staff about other changes that we would consider to be clerical or technical in nature.

<sup>2</sup> As you are aware from your review, the Trust has had a Conflicts of Interest policy in place since July 2002. Each year, every Board member and member of NRRIT's staff is required to review the policy and sign a confirmation that he or she is familiar with its terms and agrees to comply with its requirements.

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**Appendix II: Comments from the National  
Railroad Retirement Investment Trust**

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and timelines in the draft MOU. Finally, the GAO Draft Report (page 14) observes that the NRRIT Audit Committee Charter does not expressly assign responsibility for performance audits to the Audit Committee. Each of the four performance audits conducted by NRRIT to date has been overseen by the Audit Committee. Nonetheless, the Audit Committee Charter will be updated to include this responsibility more explicitly.

2. Statement of Social Insurance Audit. The Draft Report (page 24) includes a discussion about the costly Statement of Social Insurance (SOSI) audit that the RRB requires NRRIT to perform to provide the RRB Actuary with an audited December 31 net asset number to be used in the annual SOSI calculation. Prior to 2006, the Trust routinely provided the RRB Actuary with a preliminary net asset number calculated as of December 31. The difference between the preliminary unaudited number and the audited number has always been insignificant.<sup>3</sup> In fact, over the past eight years during which NRRIT has been required to incur the cost of a second financial audit for the SOSI, the average percentage difference between the December 31 unaudited net asset number and the audited net asset number has been less than two tenths of one percent (.1184%), and at no point has it exceeded one half of one percent.

This differential is very small and relates almost entirely to updated information received by the custodial bank on private equity and real estate investment partnerships. Because of the delay in getting updated market valuations of these illiquid assets, these partnership valuations are presented by NRRIT's custodian, Northern Trust Company, on a quarter lag.<sup>4</sup> Presenting "unaudited" net assets with a portion of Trust assets valued on a quarter lag allows the Trust to provide timely performance information to relevant parties, with the understanding of all recipients that, in the information provided, a portion of Trust assets (< 15%) are valued at the end of the prior quarter. This is consistent with the practices of other plans of which we are aware. In addition to this being standard industry practice, it also is appropriate for the vast majority of the Trust's internal and external reporting requirements.<sup>5</sup>

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<sup>3</sup> Use of the contrasting terms "unaudited" vs "audited" net assets may be misleading and may indicate to a reader that, in going from "unaudited" to "audited" figures, any difference is attributable to an error or misstatement identified during an audit. In reality, a more accurate label may be "preliminary" vs "final" net assets. The "preliminary" figures are presented on a certain accelerated timeline that precludes current valuations for illiquid investments from being incorporated. The "final" net assets reported in the SOSI financial statements are released three months after the end of the December 31 quarter on March 31 and, as such, allow for the valuations to be updated in accordance with GAAP. While the differences in going from "preliminary" to "final" net assets have been insignificant over the past eight years, there has never been a difference (of any size) in going from "final" net assets to "audited" net assets.

<sup>4</sup> On any given quarter end, the custodian provides an "unaudited" net asset figure, which is comprised of two components. First, it includes current quarter-end valuations for the majority (> 85%) of Trust assets, which are highly liquid investments with readily available market values. In addition, this "unaudited" figure includes valuations from the previous quarter end for that portion of Trust assets (<15%) which are illiquid, and do not have a readily determinable market value.

<sup>5</sup> This practice also is specified in NRRIT's reporting responsibilities to Treasury and RRB as set forth in the 2002 MOU.

Generally Accepted Accounting Principles (“GAAP”) require that all assets be valued as of the balance sheet date in the financial statements. As such, for audited GAAP financial statement purposes only, an adjustment is made to “true up” the valuations for these illiquid investments, when such more recent valuations are available. Thus, the difference between the “unaudited” and “audited” figure is simply an adjustment made in order to comply with GAAP, rather than the correction of any sort of error or misstatement in the “unaudited” numbers. In completing the SOSI audit, NRRIT takes note of any updated valuation reports received from these investment partnerships prior to the agreed upon March 31 deadline for transmittal to the RRB. The Trust’s independent auditor spends a significant amount of time testing the valuations and the adjustments booked during every financial statement audit. As noted earlier, while the differences in going from “preliminary” to “final” net assets have been insignificant over the past eight years, there has never been a difference (of any size) in going from “final” net assets to “audited” net assets. Furthermore, there has never been an accounting error or audit adjustment proposed by our external auditors for any of the SOSI audits since these audits began eight years ago.

The Draft Report includes a quote attributable to the OIG in the context of the SOSI discussion which is misleading. It makes the point that asset values can be significantly different between September 30 and December 31.<sup>6</sup> This is a fact with which we agree. However, NRRIT has never proposed using September 30 net assets for the SOSI calculation. Our disagreement is over the value, if any, of requiring an expensive audit of the December 31 net asset number, when the difference between the audited and unaudited number is insignificant.

3. 2006 Performance Audit. The Draft Report (page 13) discusses the 2006 internal audit undertaken by the Trust and indicates criticism of the Trust for not pursuing one of the auditor’s specific recommendations and for not pursuing a second audit phase proposed by the outside firm. In 2006, the NRRIT Audit Committee hired one of the major accounting firms to do a broad-based assessment of NRRIT’s internal controls and evaluate whether there were any gaps that needed to be addressed. At the outset of the audit, the firm was asked to do a broad-based “Stage 1” review, to evaluate all internal control areas and identify any gaps that posed risk to NRRIT. If any were found, the auditor was to recommend corrective action and/or identify areas of concern that needed more detailed review. As noted in the Draft Report, footnote 29, the review found only three potential gaps in 19 areas examined, all relatively small issues. NRRIT took corrective action with respect to the firm’s two comments regarding the review of SAS70 reports from its key vendors. With respect to the third issue identified -- how to select asset categories to be drawn from in order to pay benefits when the asset classes are in complete balance -- the Audit Committee concluded that this was a hypothetical issue that the Trust’s rebalancing policy adequately addressed. The firm did not identify other areas of concern that specifically required attention. Rather, the firm proposed an additional work project to perform a detailed survey of other areas for the Trust. The new survey was expected to take 680 hours, with a proposed budget of several hundred thousand dollars. The Audit Committee determined that nothing had been identified

<sup>6</sup> It should not be lost on the reader that in making the September 30 – December 31 comparative, the OIG official chose to highlight the fourth quarter of 2008, which saw the greatest 3-month drop in the financial markets going back to 1932 and the Great Depression, further driving home the effect of the non-relevant comparative.

in the Stage 1 report that warranted the additional review and accompanying expense, and elected to conclude this engagement.

4. NRRIT Governance and Best Practices. The Draft Report (page 8) discusses the importance of adequate oversight of pension assets and cites incidents of improper behavior at certain other plans. The Draft Report should make it clear that no issues with NRRIT's governance structure, audit practices, due diligence, or any other operational matter have been identified, and that this GAO review was not initiated in response to any perceived existence of such issue.

We also would note that in addition to the existing RRB oversight regimen, and the practice of NRRIT-initiated performance reviews, all other professional reports on NRRIT's governance practices have been universally positive.

- In the context of a November 2007 GAO review of alternative investment practices of pension funds undertaken at the request of the Senate Committee on Finance, the GAO surveyed NRRIT's investment evaluation and diligence practices and complimented NRRIT on its detailed screening process for such investments. Subsequently, the GAO asked for a copy of NRRIT's detailed internal checklist questionnaire to help guide GAO as to issues that other pension fiduciaries should examine as they evaluate these more complex investments.
- In April 2009, senior staff of the U.S. Senate Special Committee on Aging, accompanied by a GAO investigator, spent several hours with NRRIT staff and counsel reviewing the role of the NRRIT Board in decision-making on asset allocation, risk/reward choices, and approval of investment recommendations. They also examined the staff's processes for manager searches and diligence review. Finally, they inquired about how the statutory tax adjustment mechanism serves as an automatic risk adjustment protection, by increasing tax rates if fund balances drop below a certain level. This meeting with NRRIT was scheduled in the context of a separate Aging Committee investigation of controversial management practices at the Pension Benefit Guarantee Corporation. At the conclusion of the NRRIT meeting, the Aging Committee representatives commented that NRRIT's Board and staff processes and practices were well thought out and implemented consistently, and should serve as a positive model for investment decision making in complex institutions.
- In 2011, the Social Security Bulletin published a detailed review of NRRIT's governance structure completed by a Social Security Administration policy analyst whose conclusions about the steps that NRRIT had taken to develop its governance structure were consistently positive.<sup>7</sup>
- In 2013, the Center for Retirement Policy Research at Boston College published three articles by its Program Director, Steven Sass, on the development of NRRIT, including

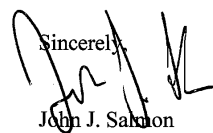
<sup>7</sup> Whitman, Kevin. 2011. "Managing Independence: The Governance Components of the National Railroad Retirement Investment Trust." *Social Security Bulletin* 71(2).

one cited on page 5 in the Draft Report. That same article reviewed NRRIT's governance structure and practices against a detailed, best practices standard and concluded that "By these criteria, NRRIT is an exemplary manager of public pension assets."<sup>8</sup>

5. Required Statutory Separation of RRB and the Trust. The Draft Report (page 5) notes that the RRB is not represented on the NRRIT Board of Trustees because the RRB is a federal agency. The legislative history of this required separation is more extensive and is indicative of the steps that Congress took to separate the federal government from the NRRIT decision-making process. The original proposal for this new investment entity, agreed to by rail management and rail labor in January 2000, would have included the three members of the RRB on the investment entity's board. However, Congress wanted the new entity to operate and make investment decisions in a manner more removed from the potential influence of the federal government and rejected this approach. The legislation that passed the U.S. House of Representatives later in 2000 removed the three RRB members from the proposed investment board. Under that version of the legislation, the RRB still would have selected the seven members of NRRIT's Board. The 2000 legislation was not enacted. In reconsidering the legislation in 2001, the House of Representatives took a further step to separate the RRB from the operation of the proposed investment entity and removed the power to appoint Trustees from the RRB and vested it directly with rail labor and rail management. This is how the statute was enacted in December 2001, and it remains as such today.
6. Quarterly Conference Call Meetings between RRB and NRRIT Officials. The Draft Report (page 11) briefly mentions that the financial and legal staffs of the Trust and Board conduct quarterly conference calls on "which investment performance, ongoing audits, or other issues are discussed." To be more specific, these conference calls are scheduled after every regular NRRIT Board meeting and are used primarily to review each item on the NRRIT Board agenda (e.g., investment recommendations, operational issues, administrative or legal issues) and action taken by the Board with respect to each such agenda item. This exchange provides the RRB with a timely review of all key issues and decisions of the NRRIT Board, and supplements the RRB members' semi-annual in-person meetings with NRRIT's Board of Trustees.

We appreciate having the opportunity to comment on the Draft Report and would request that our comments be reflected either in the final version of the report or in its appendices.

Sincerely,



John J. Salmon  
Counsel to the Board  
National Railroad Retirement Investment Trust

<sup>8</sup> Sass, Steven A. 2013. "An Assessment of the 2001 Reform of the Railroad Retirement Program" Center for Retirement Research, Boston College, p. 25.

# Appendix III: Comments from the Railroad Retirement Board



UNITED STATES OF AMERICA  
RAILROAD RETIREMENT BOARD  
844 NORTH RUSH STREET  
CHICAGO, ILLINOIS 60611-2092

BOARD MEMBERS:

MICHAEL S. SCHWARTZ, CHAIRMAN  
WALTER A. BARROWS, LABOR MEMBER  
JEROME F. KEVER, MANAGEMENT MEMBER

APR 28 2014


Charles Jeszeck  
Director, Education, Workforce, and  
Income Security  
U.S. Government Accountability Office  
441 G St. NW  
Washington DC 20548

Dear Mr. Jeszeck:

This letter is to provide the comments of the Railroad Retirement Board to the draft report entitled "Oversight of the National Railroad Retirement Investment Trust." The Board understands that the National Railroad Retirement Investment Trust (the Trust) will submit comments separately.

Initially, the Board reaffirms the view which it expressed to the Government Accountability Office (GAO) during the study. That is, that sufficient information is provided to the Board by the Trust through formal and informal channels to allow oversight by the Board within the limits of the law. The Trust provides both an annual report to the Board based on an October to September fiscal year, and a Statement of Social Insurance based on a calendar year. The Board Members meet twice annually with the Trustees, and the Trust staff confers with the General Counsel and Chief Financial Officer after each quarterly Trust meeting. The Trust also reports monthly on the market value of Federal and non-Federal holdings. As the draft GAO report notes, the NRRIT and the Board are currently drafting a Memorandum of Understanding which would require the Trust to undertake periodic performance audits, beginning in 2015.

Moreover, the Board believes it has correctly interpreted the intent of Congress with respect to limiting the influence of the Federal Government over investment of the assets held by the Trust. A comparison of House Bill 4844 as set forth at 146 Cong. Rec. H7335 with the text of section 15(j) of the Railroad Retirement Act (45 U.S.C. § 231n(j)) as amended by Public Law 107-90, shows that Congress removed earlier language providing for the appointment of Trustees by the Railroad Retirement Board. By providing for the

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appointment of six Trustees by industry and labor, with the seventh independent member chosen by the industry and labor Trustees, the final draft as enacted clearly indicates Congress intended to insulate the Trust from control by the Board. It is also noteworthy that section 15(j) prohibits Members of the Railroad Retirement Board from serving as Trustees. The same provision further requires that Trustees have experience and expertise in the management of financial investments and pension plans.

In addition to the foregoing, the Board also notes the following technical corrections to the draft report:

- The report should clarify in footnote 13, on page 4, that the Railroad Retirement Board (Board) is an independent agency in the Executive branch of the United States Government and is charged with the administration of the Railroad Retirement Act of 1974, as amended (45 U.S.C. § 231 et seq.) and the Railroad Unemployment Insurance Act (45 U.S.C. § 351 et seq.). The Railroad Retirement Act of 1974 (P.L. 93-445) (88 Stat. 1305) amended the former Railroad Retirement Act of 1937 in its entirety.
- Both employer and employee tier II taxes are tied to the average account benefits ratio pursuant to section 3241 of the Railroad Retirement Tax Act (26 U.S.C. § 3241).
- While the Board understands that the draft GAO report intends to state the funding of benefit payments under the Act in broad terms, the Board notes that in addition to the tier II annuity component calculated under section 3(e) of the Act (45 U.S.C. § 231b(e)), fund transfers from the NRRIT to the Railroad Retirement Account fund supplemental annuity benefits under section 2(b) of the Act (45 U.S.C. § 231a(b)) and tier I benefit component payments for cases where the Social Security Act does not provide equivalent benefits.
- Similarly, the Board notes that while the report refers to Tier I benefits broadly, more precisely only the social security equivalent portion of the Tier I benefits is not funded through transfers from the Trust.

The Board wishes to express its thanks to GAO for this opportunity to present its comments to the draft report.

Sincerely,



FOR THE BOARD  
Martha P. Rico  
Secretary to the Board

# Appendix IV: Comments from the Railroad Retirement Board Office of Inspector General



UNITED STATES RAILROAD RETIREMENT BOARD

OFFICE OF INSPECTOR GENERAL

April 18, 2014

Charles A. Jeszeck  
Director, Education, Workforce,  
and Income Security  
Government Accountability Office  
441 G Street, NW  
Washington, DC 20548

Dear Mr. Jeszeck:

The Railroad Retirement Board (Board) Office of Inspector General (OIG) appreciates the opportunity to review and comment on the Government Accountability Office Draft Report entitled: Retirement Security: Oversight of the National Railroad Retirement Investment Trust (GAO-14-312).

The OIG has a long-standing position regarding the lack of provision for performance audits for the Trust. For example:

- In March 2008, the OIG released a statement of concern highlighting the lack of performance audit requirements for the Trust. We noted that the lack of performance audits of Trust activities and operations leaves the Railroad Program with fewer safeguards than those established to protect the retirement investments of Federal and private sector workers.
- In September 2011, the OIG reviewed the Trust's administrative expenses and found that since its inception, the expenses have steadily risen and increased the overall cost structure by more than 70%. This increase can be partially explained by the number of fund management staff that would be needed to manage increasingly complex risk-based investment strategies and transactions. However, minimal information is released publically to justify the recurrent increases in administrative expenses.
- In August 2012, we reviewed the significant compensation, bonus, and incentive payments made to the Trust's staff. From FY 2007 through FY 2009, when Trust's net assets declined by more than 28%, select Trust staff received bonus and incentive compensation exceeding \$1.2 million. We recommended that the Board enforce sensible limits on future compensation, bonus, and incentive payments to the Trust's staff. The Board responded that the law limits the decisions and actions of the Trust which are subject to oversight by the Board. According to the Board, this situation failed to demonstrate a basis for civil action by the Board under RRA section 15(j) against the Trustees.

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OIG Comments on Performance Audits

The GAO report highlights the four performance audits commissioned by the Trust which equate to one audit every three years. Performance audits were defined broadly by GAO to include any type of audit or oversight review. With respect to GAO's broad definition of performance audits, the OIG believes that the \$25 billion in Federal funds reported on the Board's Federal financial statements should be subject to performance audits in compliance with Generally Accepted Government Auditing Standards (GAGAS). There is no indication that the Trust's commissioned audits were performed in accordance with GAGAS.

We limited our comments regarding the performance audits to focus on self selection of audit areas. The majority of comparable state and Federal programs studied by GAO were subject to performance audits by one or more independent external entities. The two Federal programs are also subject to performance audits by GAO. These independent auditors can initiate performance audits without the prior consent of the audited entity. In contrast, the Trust defines the subject and scope of its performance audits. In our opinion, selection by the Trust of the audits to be performed would appear to represent a potential conflict of interest.

The report states that the Trust and the Board have prepared a draft Memorandum of Understanding (MOU) that would require a performance audit at least every 3 years addressing 1 of 12 undisclosed "appropriate subjects" based on mutual agreement. However, the subjects detailed in the MOU do not address fiduciary responsibility and conflicts of interest. As previously stated, the OIG is opposed to any arrangement that allows the Trust and the Board to control performance audits. In our opinion, a statutory amendment to provide for performance audits would have greater permanence, since the Trust could not legally opt to discontinue new oversight practices.

We strongly disagree with the suggestions that the OIG's performance audits would lack independence, would be politically influenced or motivated, or would be designed to impact investment performance. The Office of Inspector General adheres to the highest ethical principles and conducts its work with integrity by encompassing the GAGAS elements of objectivity, independence, professional judgment, confidentiality, and competence. In our opinion, concerns of political influence or risk originating from the OIG community are illogical when weighed against the real threats of private self-interest and maximization of personal wealth.

OIG Comments on Statement of Social Insurance Audit

The report indicates that differences in the value of Trust assets between the three month period of September 30<sup>th</sup> and December 31<sup>st</sup> are "generally not large" and do not warrant the conduct of multiple audits. However, history has shown that an entity's financial stability can change in a single day. In addition, the second audit is required to

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maintain consistency with other Federal agency Statements of Social Insurance. The \$1.6 million cumulative cost of the December 31<sup>st</sup> audit accounted for significantly less than 1% (.31%) of the Trust's total expenses for the period since 2005 and should not be considered wasteful when considering the valuation of net assets of approximately \$25 billion. The Trust's investment staff bonuses and incentive payments exceeded \$2.5 million during this same period. The Trust's bonuses and incentive payments might also be considered wasteful if the plan participants were made aware of them.

OIG Comments on Transparency

The Board indicated that they saw "no need for enhanced oversight" and in the event of a participant complaint it would take action. However, in our opinion participant complaints are unlikely to be identified due to the Trust's limited transparency and ineffective oversight structure.

The report indicates that the Trust employs 18 staff but does not disclose the number of external asset managers that would fall under Trust oversight. The OIG previously reported that detailed individual compensation paid to these external investment managers has never been publically disclosed. During FY 2012, the Trust's 135 investment managers received fees totaling approximately \$58 million or an average of approximately \$430,000 per manager.

During FY 2012, the Trust reported to the Internal Revenue Service that compensation of \$3.1 million had been paid to its 9 full-time officers and directors. On an individual basis, this compensation exceeds that of Congress; and the CEO's compensation exceeds that of the President of the United States. Bonuses and incentives paid to these individuals ranged from 17% to 43% of base compensation. During this period, an additional \$102,000 was also paid to 2 part-time Trustees where the number of hours worked was not disclosed. The remaining 8 Trustees did not receive any form of compensation. This continued lack of transparency and oversight with regard to the Trust's compensation, bonuses, and incentives cannot be offset if the Trust and Board propose that an audit of an "appropriate subject" be performed once every three years.

In addition, during the last 10 years, 4 of the Thrift Savings Plan (TSP) funds have outperformed the Trust and 1 TSP fund resulted in nearly equal performance. The C Fund and S Fund are designed to mimic the Standard & Poor's 500 and Dow Jones indexes. Since inception, Trust administrative expenses have increased significantly; while TSP administrative expenses have remained stable. In contrast with the Trust, the TSP, with assets over \$300 billion, is administered by an Investment Board with comparable investment experience and there is no indication of any political influence or performance impact.

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Again, thank you for the opportunity to comment on this draft report. The OIG appreciates the time and effort that GAO placed in its evaluation. Please feel free to contact me if you have any questions.

Sincerely,

A handwritten signature in blue ink that reads "Martin J. Dickman". The signature is fluid and cursive, with a long horizontal stroke at the end.

Martin J. Dickman  
Inspector General

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# Appendix V: GAO Contacts and Staff Acknowledgments

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## GAO Contact

Charles A. Jeszeck, Director, (202) 512-7215 or [jeszeck@gao.gov](mailto:jeszeck@gao.gov)

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## Staff Acknowledgments

In addition to the contact named above, David Lehrer (Assistant Director), Michael Hartnett, and Justin Dunleavy made key contributions to this report. In addition, key support was provided by Susanna Clark, Mimi Nguyen, Kate van Gelder, Walter Vance, and Craig Winslow.

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