Chapter 4

Governing Public Pension Plans

It is almost impossible to discuss public pension plan governance without first discussing the difference in the legal framework governing public and private pension plans. The difference is that private pension plans are governed by the federal Employee Retirement Income Security Act (ERISA) of 1974, whereas public pension plans are exempt from ERISA.

4.1 ERISA

ERISA is the most comprehensive federal regulation of private pension plans. It was the culmination of a long list of federal legislation on employee benefit plans. The closing of the Studebaker plant in South Bend, Indiana, in 1964, which inflicted heavy pension losses on workers, led to congressional hearings on pension benefits, and these hearings eventually led to the passage of the Employee Retirement Income Security Act (ERISA) on Labor Day in September 1974 (General Accounting Office, 1979).

ERISA does not require any private employer to establish a pension plan. It only requires that those who establish plans must meet certain minimum standards. ERISA prescribes standards for plan participation, vesting, funding, fiduciary duties, disclosure, and reporting. It also provides mechanisms to enforce these standards and to ensure that employees receive some of their accrued pension benefits. The main goal of ERISA is to prevent abuses of private pension plans and protect

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the benefits of pension beneficiaries. These standards and rules are contained in four titles.

4.1.1 ERISA Standards

Title I establishes minimum requirement for participation, coverage, vesting, funding, fiduciary standards, and reporting and disclosure. Title I is enforced by the Employee Benefits Security Administration of the U.S. Department of Labor.

Part 1 of Title I requires the administrator of an employee benefit plan to furnish participants and beneficiaries with a summary plan description, their rights, benefits, and responsibilities under the plan. He is also required to furnish participants with a summary of any material changes to the plan. The administrator must file an annual report each year with the Department of Labor, containing financial and other information concerning the operation of the plan, and the report must be audited by an independent public accountant. The summary of the information in the annual report must also be given to plan participants and beneficiaries.

Part 2 of Title I sets the minimum standard for participation and vesting. The minimum standard for participation in a pension plan is that an employee either attains the age of 21 or completes one year of service. Prior to ERISA, 53 percent of workers in plans with vesting provision needed to work for 15 years before they could qualify for full vesting.* ERISA sets a maximum of 10 years for full vesting. This part also contains an anticutback rule, which, with narrow exceptions, does not allow a pension plan to decrease the accrued benefit of a participant through an amendment of the plan.

Part 3 of Title I sets the minimum funding standards. Employers are required to fund the normal cost plus an amount to amortize the unfunded accrued liability of a plan. The maximum amortization period is 40 years for plans established before 1974 and 30 years for plans established after 1974.

Part 4 of Title I sets the standards and rules governing the conduct of plan fiduciaries. ERISA considers a person as fiduciary of a pension plan if (1) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets; (2) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so; or (3) he has any discretionary authority in the administration of such plan.† Fiduciaries are required to discharge their duties "solely in the interest of plan participants and beneficiaries and for the exclusive

* U.S. Department of Labor, Bureau of Labor Statistics. Defined Benefit Plans at the Dawn of ERISA. http://www.bls.gov/opub/cwc/cm20050325ar01p1.htm (Accessed 7/27/06.)

† § 3(21)(A) Fiduciary § 1002(21)(A)

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purpose of providing benefits and defraying reasonable expenses of administering the plan." The fiduciary must discharge such duties

> with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims; by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly present not to do so; and in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title and Title IV.*

This standard set by ERISA for fiduciary responsibilities is commonly known as the "prudent expert" rule.

ERISA also prohibits the fiduciary from engaging in certain transactions. A fiduciary shall not (1) deal with the assets of the plan in his own interest or for his own account, (2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or (3) receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan. This standard is commonly known as the conflict of interest rule or code of ethics. ERISA also holds a fiduciary personally liable for breaches of any of the responsibilities, obligations, or duties imposed upon fiduciaries by this title:

> Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary.

Title II of ERISA contains standards that must be met by employee pension benefit plans in order to qualify for favorable tax treatment. Noncompliance with these tax qualification requirements of ERISA may result in disqualification of a plan and/or other penalties. The Internal Revenue Service (IRS) of the Department of Treasury administers Title II of ERISA. Title III contains provisions regarding administration and enforcement of the ERISA requirements. Title IV establishes

* § 404 Fiduciary duties (§ 1104)

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the private pension insurance program by creating the Pension Benefit Guaranty Corporation (PBGC), a government entity that insures protection for defined benefit plans that terminate without sufficient assets. The assets used to guarantee the pension benefits come from the insurance premium paid by the employers and the pension assets transferred to the PBGC once the employer terminates the pension plan. There is, however, a cap on the benefit payout from the PBGC.

In all, ERISA sets in place a legal wall of protection for pension benefits for private sector employees by requiring plan administrators to report and disclose plan information regularly, by setting minimum funding standards, by requiring plan fiduciaries to manage plan assets responsibly, and by insuring plan participants' and beneficiaries' pension benefits.

4.1.2 ERISA and Public Pension Plans

In general, ERISA does not cover plans established or maintained by state and local governments. At the time of passage in 1974, Congress excluded governmental retirement systems from the major provisions of ERISA pending further study of the need for federal regulation of governmental plans. In March 1978, in accordance with the ERISA mandate, the House of Representatives Committee on Education and Labor (1978) issued a report to the Congress. The House Committee's Pension Task Force estimated that about 42 percent of the defined benefit plans in the public sector were funded in ways not related to their accrued pension liabilities, either using the pay-as-you-go method or some other nonactuarial method, such as matching of employee contributions. Adopting a funding standard similar to that required by ERISA would require many of these governments to raise their contributions by more than 100 percent, and a few by more than 400 percent. In that year, a bill called the Public Employee Retirement Income Security Act of 1978 was introduced in the House to regulate public pension plans. It, however, failed to pass.

4.2 Public Pension Benefit Protection

Despite the lack of federal regulation, state and local governments over the years have established a body of laws and regulations that in aggregate are substantially similar to ERISA in terms of the protection of plan participants' benefits, vesting requirement, financial reporting, and fiduciary responsibility standards. In this section, we examine the legal protection of pension benefits and, in the next two sections, we examine the administration and oversight of public pension plans. Whenever possible, the practice in the public sector is compared to the standards of ERISA.

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Even though there is no pension benefit insurance program in the public sector, employees in the public sector enjoy a higher level of protection of their pension benefits than their counterparts in the private sector. There are two reasons for this stronger protection in the public sector. First and foremost, the nature of the employer who establishes the pension plan and the pledge to pay for pension benefits is different. The difference between private companies and government entities is that the former can file for bankruptcy and eventually liquidate. When that happens, the assets in the private pension plans will be transferred to the PBGC who will then pay for the accrued benefits of the plan participants up to the limit set by the PBGC, and the participant will have lost any opportunity to accrue benefits with the same employer in the future. As discussed in Chapter 2, since much of the defined benefit accrues later in one's career, this involuntary termination can lead to substantially smaller accumulation of pension benefits. In the public sector, state and local government entities are bankruptcy remote. While a handful of municipalities filed for bankruptcy in the past, municipal bankruptcy is very different from corporate bankruptcy. It does not lead to liquidation of the municipality, but it still has to pay all its financial obligations after coming out of bankruptcy. Therefore, public sector employees do not have to fear losing accrued benefits due to the bankruptcy of the government employer who sponsors the pension plan.

The nature of the pledge to pay pension benefits is also different in the public sector. While theoretically it is the assets in the pension plan, which are used to pay for pension benefits, government sponsors of pension plans are ultimately responsible for paying the pension benefits promised to government employees. In other words, it is the government entity's ability to collect revenue that is the ultimate security behind the payment of pension benefits. As long as the revenue base does not completely erode, the government employer will need to find revenue to pay for the promised benefits even if there are not sufficient assets in the pension plan to do so.

This assurance of having the financial resources to pay for pension benefits does not amount to much if the pension benefits themselves are not protected. The second major reason for stronger pension benefit protection in the public sector is that this protection covers not only accrued benefits, but also benefits yet to be accrued. Even though ERISA protects against any reduction in the accrued benefits, it offers no protection against reduction in future pension benefits yet to be earned. This means private pension plan sponsors can change the pension plan at any time during the period an employee is working at the company. The company can change the pension benefits formula, or it can simply stop the current plan and start a completely different plan. If such change leads to a reduction in future pension benefits accrual compared to that under the old plan, there are no specific federal laws that plan participants can use to prevent the company from doing so.

In the public sector, plan participants have legal protection against reduction in not only accrued benefits, but also promised future benefits that are yet to be earned as long as the plan participant stays with the same government employer.

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In other words, it is the promise of pension benefits at the time of initial participation in the benefit program that is protected. The stronger legal protection against impairment of future pension benefits is derived from state constitutions, statutes, and case laws. Embedded in such protection is the concept of "contractual right." Once a person enters into employment with a government entity and starts earning pension benefits, he thus earns the "contractual rights" to all future pension benefits as long as he is vested and continues to work for the same government employer. Such "contractual rights" are protected by the U.S. Constitution and state constitutions.

According to a survey by the National Council on Teacher Retirement, nine states have constitutional guarantee of public pension rights and another twenty states have statutory guarantee of such benefits (Moore, 2005). An example of constitutional guarantee can be found in Illinois. Article XIII, section 5, of the Illinois Constitution, which pertains to pension and retirement rights, provides that:

> Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired.

As for an example of statutory protection of pension benefit, Section 692 of Kentucky State Statute 61, *Benefits not to be reduced or impaired—Exception*, stipulates:

> It is hereby declared that in consideration of the contributions by the members and in further consideration of benefits received by the state from the member's employment, KRS 61.510 to 61.705 shall, except as provided in KRS 6.696 effective September 16, 1993, constitute an inviolable contract of the Commonwealth, and the benefits provided therein shall, except as provided in KRS 6.696, not be subject to reduction or impairment by alteration, amendment, or repeal.

For states with or without constitutional or statutory protection, court decisions have also established protection of pension benefit. Such court decisions, usually in favor of plan participants and beneficiaries, are based either on the specific state constitutional guarantee of pension benefit or on the more general contractual right guaranteed by U.S. and state constitutions. For example, in *Felt v. Board of Trustees of the Judges Retirement System*, Illinois Supreme Court found unconstitutional an amendment to the Illinois Pension Code that changed the salary base for determining pension benefits from the judge's salary on the final day of service to the average salary over the last year in service.* The Court found that the amendment violated

* 107 Ill.2d 158, 89 Ill.Dec. 855, 481 N.E.2d 698 (1985)

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the constitutional right of judges because it diminished their retirement benefits and impaired their contract rights under the Illinois Constitution.

In some cases, the protection provided by constitutional guarantee and contractual right is extended beyond the pension benefit itself to include protection of financial resources, such as government employer pension contribution, used to pay for pension benefit:

- In the early 1990s, the New York state government skipped pension contribution to the state pension system as a result of fiscal stress. The court ruled in the subsequent lawsuit that such action was unconstitutional because it impaired the pension benefit of the pension system's members and beneficiaries.*
- In the late 1990s, Hawaii state and county governments underfunded pension contribution by about $350 million. State of Hawaii Organization of Police Officers, later joined by the trustees of the state retirement system, sued the state. In 2007, the Hawaiian Supreme Court ruled that the state's action was unconstitutional as it violates the nonimpairment clause of accrued benefits in the state constitution.† Although the Supreme Court did not require the state government to repay the retirement system, the ruling effectively prohibits the state government from underfunding pension contribution again in the future.
- In 2003, facing massive budget deficit, the California state government withheld $500 million in pension payments to California State Teachers Retirement System (CalSTRS). CalSTRS sued the state government. In 2005, a Sacramento Superior Court ruled that the state government's action violated state constitution. California finally paid $500 million to CalSTRS in 2007.

Because of such strong legal protection, there appears in the public sector a unique phenomenon of the tiered pension system. When the plan sponsors find that the pension benefits are too expensive and not affordable in the future, they cannot make changes to the pension benefits of participants already in the plan. However, they can establish a new pension plan with reduced pension benefits for future new employees who have not earned any "contractual rights" to the old pension benefits. Thus, a two-tiered pension system is created. For example, New York State has a four-tiered pension system, due to new pension legislation enacted in 1973, 1976, and 1983 that divided the workforce into four tiers. In recent years, several states established either mandatory or optional defined contribution pension plans. In both cases, current participants in defined benefit plans are given

* More discussion of the New York State court decision can be found in the case study on New York State pension plan management in Chapter 6.

† *Georgia Kaho'Ohanohano, et al. vs. State of Hawaii*. The full text of the Supreme Court ruling can be read at http://www.state.hi.us/jud/opinions/sct/2007/26178.pdf (Accessed September 19, 2007.)

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the option of staying in the old defined benefit plan or joining the new defined contribution plan. In the private sector, when a company switches to a defined contribution plan from a defined benefit plan, all employers, new and old, will have to enroll in the new defined contribution plan.

For the minimum vesting requirement prescribed in ERISA to protect employees, public pension plans have substantially similar standards. As explained in Chapter 2, no public pension plans have a vesting period longer than 10 years, the maximum allowed by ERISA, and most plans adopt a five-year vesting period. The average vesting period has also been decreased considerably over the past 25 years.

4.3 Public Pension Plan Administration

Even without federal regulation of pension administration, state and local governments have adopted legislations that are also similar to ERISA in many aspects of pension plan administration. In this and the next section, we examine the major aspects of public pension plan administration: administrative structure, Board and staff responsibilities, internal control, financial reporting, funding policy, and oversight.

As briefly explained in Chapter 1, public pension plans are administered by public employee retirement systems (PERS), legal entities specifically set up by the sponsors of pension plans to administer such plans. A PERS can manage either one or multiple public pension plans.

4.3.1 Pension Plan Administration: The Governing Board

With few exceptions, the typical administrative structure of a retirement system consists of a board of trustees and a supporting staff headed by an executive director.* As the board of trustees establishes the overall policy for the operation of the pension system, it plays the most critical role in pension plan administration.

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* Of the major state level retirement systems, those in Florida, Iowa, and Washington do not have an independent governing board. In Florida, the retirement system is managed by the Division of Retirement within the Department of Management Services. The governor appoints the department's secretary who appoints the director of the division. In Iowa, the retirement system is an independent agency within the executive branch of the government. In Washington, the Department of Retirement Systems manages several state-level retirement systems. The department's director is appointed by the governor. However, in all of these cases, the most important management activity of a retirement system, namely the pension asset investment management, lies with a separate independent investment board.

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4.3.1.1 Election of Trustees to the Board

In order to be a trustee of a governing board, the person has to be either elected by plan participants, appointed by the plan sponsor, or serve as *ex officio*. Trustees may be elected by either active members or retired plan members, and they themselves may be active or retired plan members. Appointments are typically made by a chief elected official, such as the governor or mayor, or by a governing body, such as a state or local legislative body. Some trustees serve on the board by virtue of their holding a particular public office, such as that of state treasurer or controller.

The governing boards vary significantly in terms of the number of trustees and the board composition. According to a survey of 86 large state and local public pension boards by the National Education Association (2006), the number of trustees varies from one in New York to 26 for the University of California Retirement Plan, with the median being 9. About half of all trustees are either active members or retirees, and about 40 percent of the systems have a majority comprised of active and/or retired members. The selection method also shows significant variation. In some states, such as Arizona, the governor makes all the appointments to the governing board, whereas in other states, such as Arkansas, all appointments are made by the plan members and/or the legislative body. Some states require members of the governing board to have certain specific skills, especially skills in investment management. For example, Arizona requires that four trustees are not members of Arizona State Retirement System and have at least 10 years of substantial experience in investment, economics, or finance.

The New York state pension system has a unique board structure, with the board consisting of only one trustee. The state comptroller, an official elected statewide, is the sole trustee of the New York state pension system for state and local employees. As will be seen in Chapter 6, this unique governing structure plays a key role in the New York state public pension plan management.

4.3.1.2 Board's Fiduciary Responsibility Standard

Even though ERISA fiduciary rules do not apply to public pension plans, most state pension codes have languages with regard to fiduciary rules that are essentially the same as those in ERISA. Illinois is one typical example. In Section 1-109 of the Illinois Pension Code, fiduciary duties are defined as follows:

> A fiduciary with respect to a retirement system or pension fund established under this Code shall discharge his or her duties with respect to the retirement system or pension fund solely in the interest of the participants and beneficiaries and:
>
> (a) For the exclusive purpose of:
>
> (1) Providing benefits to participants and their beneficiaries; and

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> (2) Defraying reasonable expenses of administering the retirement system or pension fund;
>
> (b) With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims;
>
> (c) By diversifying the investments of the retirement system or pension fund so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
>
> (d) In accordance with the provisions of the Article of the Pension Code governing the retirement system or pension fund.

By examining this language with that of ERISA discussed in the first section of this chapter, it is easy to find that they are almost identical.

4.3.1.3 Conflict of Interest Rule and Code of Ethics

Just like ERISA, trustees of public pension systems are also subject to conflict of interest rules and other ethics laws governing their behavior. According to the National Council on Teacher Retirement, 38 states have conflict of interest rules and all states have code of ethics laws (Moore, 2005). Conflict of interest clause and ethics laws are put in the board governance policy to prevent trustees from engaging in any activities and decision making that puts their own interest above that of the members they service. For trustees, the code covers such issues as acceptance of gratuities and what behavior constitutes conflict of interest. It provides guidance to trustees and instructs them to avoid certain practices that may adversely affect plan members.

Ohio Public Employees Retirement System (2005) board governance policy offers a typical example of such codes of conduct. In the conflict of interest rule, the policy states:

> Board members are prohibited by law from engaging in certain party-in-interest transactions (i.e., furnishing of goods or services between the system and a relative of a board member), and are prohibited from using assets of the system for their own interests. Board members are prohibited from receiving any consideration for their own personal account from any party dealing with the system in connection with a transaction involving the system assets. Board members may not act on behalf of a party whose interests are adverse to the system, its participants, or beneficiaries. The system is prohibited by law from making investments or doing business with individuals or entities controlled by individuals who were board members, officers, or employees of the

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> system from being involved in investment recommendations to the system where such individuals or entities would benefit by any monetary gain. Board members are prohibited from having any direct or indirect interest in the gains or profits of any board investment.

In recognition of the importance of this policy, California Teachers' Retirement System (2006), the second largest public pension system in the country, adopted a more rigorous conflict of interest policy that went into effect in 2007: Full disclosure of communication initiated by a board member to a staff member or consultant if the communication could reasonably be interpreted as an attempt to influence a specified outcome regarding an investment transaction; 12-month recusal from any decision involving a campaign contributor or gift maker where the amount exceeds $250 to a board member.

As in the case of ERISA, state pension ethics policy also typically lays out the consequences when the code of ethics is breached by a trustee. For example, the Ohio pension ethics policy states that the failure of any board member or employee to abide by the Ethics policy will result in discipline, such as dismissal and potential civil or criminal sanctions. In 2006, a former Ohio State Teachers Retirement System (STRS) board member, Hazel Sidaway, was sentenced to two years probation and 200 hours of community service on convictions for two conflict of interest charges for accepting $670 worth of tickets to sporting and entertainment events from investment advisors to STRS (Ohio Ethics Commission, 5/12/2006). Four other STRS board members were also sentenced to one-year probation and 30 to 60 hours community service for Ethics Law conflict of interest violations for their acceptance of entertainment paid for by an investment advisor to STRS (9/19/2006).

In all, what is expected of the trustees of public pension plans, codified in state pension legislation and policies, is the same as that expected of the trustees of private pension plans, codified in ERISA.

4.3.1.4 The Board's Main Functions

The board's main functions in fulfilling its fiduciary responsibilities can be divided into two major categories: acquisition of sufficient assets to pay pension benefits and effective operation of the pension system.

Acquisition of sufficient assets — The board's fiduciary responsibility to the plan beneficiaries is to acquire the necessary assets for paying pension benefits. This is achieved through pension contribution from the plan sponsor and members and pension asset investment. For pension contribution, it requires the board to determine the pension contribution level under the advice of actuaries. Minimally, this involves choosing the actuarial valuation method and appropriate economic and demographic assumptions in calculating the pension liabilities and in determining

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the pension contribution rate that is sufficient to fund pension benefits. As will be discussed later in this chapter, not all plan governing boards have the full responsibility for setting the contribution rate. In some states, this rate is set by the plan sponsor itself through legislation. Even in plans where the governing board has the responsibility of setting the contribution rate, public pension boards typically do not force the plan sponsor to pay the annual required amount.

The governing board has more authority over the second aspect of asset acquisition, namely investment strategy. With the advice of experts, the governing board has the authority to design an investment policy with a particular focus on asset allocation. As pension asset investment management is by far the most important responsibility of the pension governing board and the pension system, this subject will be discussed in more detail in the next chapter.

To ensure the accumulation of sufficient assets, the governing board also needs to establish a risk management and control system to protect pension assets from loss, theft, or misuse, and major risks to the pension plan's long-term fiscal health can be identified.

Effective operation of the pension system — Given the complexity of public retirement systems, effective governance calls for the governing board to focus on policies with regard to the operation of the pension system and leave the day-to-day administration to staff through prudent delegation of authority. The board needs to establish clear roles and responsibilities for all key parties involved in the decision-making process, including the board, board committees, chief executive officer, and other key staff members, such as chief investment officer. Such clear expectation of rules and responsibilities is essential to the prudent delegation of authority. Along with the delegation, staff performance evaluation should also be conducted, based on established performance measures, to make sure their responsibilities are met.

4.3.2 Pension Plan Administration: The Staff

The responsibility of the staff of public pension system, under the leadership of the executive director, is to implement the policies designed by the governing board and manage the day-to-day administration of the pension system. Their duties can be divided into three main areas: member service, supporting service, and investment management.

4.3.2.1 Member Service

The staff provides a wide range of services to members and beneficiaries, from the time they first participate in the plan until the time they receive their last pension check:

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1. Enrollment: The starting point of all member services is to enroll a new employee into the retirement system.
2. Consultation and education: The staff will help members project their retirement benefits for the members' financial planning purpose. If a member terminates employment, he can either leave his contributions in the system or withdraw his contributions. The staff can assist the member in determining the one that is more beneficial to the member. If the member wants to purchase service credit, the staff can assist in determining the cost. Prior to a member's retirement, the staff will also assist the member in calculating his or her annual benefits and application process. The pension system staff also holds periodic seminars on financial planning to help members plan for the future.
3. Communication: There are four main types of publications a pension system distributes to communicate with its members and retirees. First, there are the handbooks for members, acquainting them with the pension plan and all the benefits available to them as well as the rules for obtaining these benefits. Second, there are pamphlets published by the pension system that discuss some aspects of the pension plan and pension benefits in more detail than are discussed in the handbooks. Third, there are periodic newsletters published by the pension system that alert the members and retirees to the new developments in and changes to the pension plans. Fourth, the pension system also sends annual statements to members and retirees. The annual statement to the member contains information about her membership, beneficiary, service credits earned, and projected benefits. The statement to the retiree contains information about his/her annual retirement payment and tax withholding.
4. Loan program: Some pension systems also have loan programs for its members. The members can take out a loan against their own contributions, usually for financial emergencies, after becoming a member for a certain period of time. The repayment of the loan is made through payroll deduction and the loan has to be paid back with interest. For example, with the New York state retirement system, a member must have at least one year of member service credit to apply for a loan and he may borrow up to 75 percent of the contribution balance. The loan has to be repaid within five years with interest.
5. Disability: When a member becomes disabled and applies for disability benefits, the pension system decides whether the disability is permanent and disability benefits should be given. If the decision is not in favor of giving the member disability benefits, the member can appeal the decision and an administrative hearing ensues.
6. Retiree service: The staff determines each retiree's eligibility for retirement and his annual retirement payment. At the request of the retiree, the system can also directly deposit monthly payments into the retiree's bank account. If the retiree can no longer handle his finances due to incapacitation, the system will work with the person designated by the retiree to handle the

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retiree's finances. If the retiree passes away, the deceased retiree's payments will stop and the pension system will start paying benefits to his designated beneficiary, if any.

While many of these services for members and retirees can be done through phone calls, mailings, and the Internet, some of these services require personal consultation. Therefore, a statewide pension system usually sets up service centers across the state to facilitate the service provision to the members and retirees, For example, in addition to its headquarters in the state capital, the New York state pension system has 15 service centers throughout the state.

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4.3.2.2 Supporting Services

While providing direct services to the members and retirees is an important task performed by the retirement system staff, there are also many important supporting services performed by the administrative staff to make this possible:

1. Information system management: As a large pension system can contain tens of thousands and in many cases hundreds of thousands of members and retirees, providing services to them also involves information system management. Integrating advanced data processing technology into all aspects of retirement system management is quintessential in providing efficient and effective services to the members and retirees. This information management system is required to perform many important tasks and lies at the heart of pension system operation. It is required to process monthly reports sent by employers on members' salaries paid, pension contributions made, and services provided in order to maintain an up-to-date record of all the active members. It is required to process benefit payment checks and make direct deposits of monthly benefit payments to retirees. It is also required to support the production of system reports, system studies, and system control.
2. Accounting and financial services: The staff performs the accounting and financial services of the pension system, such as recording and depositing of contributions made by members and employers to the pension system, daily accounting of the invested assets of the system, and preparation of the annual financial statement of the pension system.
3. Legal services: Legal services provided by the pension system staff are also essential in running the pension system within the legal framework. Due to the importance of fiduciary duties in pension management, the legal staff will have a responsibility to provide advice to the board of trustees on the fiduciary duties. The legal staff also interprets legislation related to retirement that affects the pension systems' members and plan sponsors.
4. Actuarial service: Most large pension systems hire outside actuaries to provide this critical service. A few state pension systems, such as New York and

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Washington state pension systems, have their own in-house actuaries to conduct actuarial valuations.

4.3.2.3 Investment Management

The staff is involved in various aspects of investment management, from advising the board on investment policy to selecting investment managers and managing investment. This topic is covered in more detail in the next chapter.

4.3.3 Risk Management and Control

Due to the vast assets under management, the long-term nature of pension benefits and investment, and the numerous parties involved, pension plan administration is fraught with risks, more so than other aspects of public financial management. There needs to be a risk management and control mechanism in place to ensure that all persons or entities with operational and oversight responsibilities act in accordance with the objectives set out in the pension entity's bylaws, statutes, and policies. This risk management and control mechanism is maintained by both internal staff and external professionals. Externally, it means an independent auditing of the system's financial statements by certified public accountants. Internally, while the governing board, the executive director, and the staff are all responsible for internal control, a linchpin in the implementation of a more comprehensive internal risk management system is internal auditing by an internal auditor. Internal auditors serve many functions, from being a watchdog over the management of the pension plan to teaching board trustees and staff about pension management.

For example, in 1995, Wisconsin Act 274 created an internal audit function within the board. Directed by the internal auditor, the internal audit unit may review any activity of the board and has access to the records of the board and any external party under contract with the board (State of Wisconsin, 2006). The auditor plans and conducts audits, risk assessments, research projects, and management reviews under the direction of the board; assists with external audits and reviews of the board; and monitors the board's contractual agreements with financial institutions, investment advisors, and any other party providing investment services to the board. By directly reporting to upper-level management and fund trustees, internal auditors advise decision makers about potential problems and the ways to correct them. Therefore, compared to an external auditor, an internal auditor has a more intimate knowledge of and also exerts greater impact on the operation of the whole pension system.

Internal auditors belong to an organization called the Association of Public Pension Fund Auditors (APPFA). APPFA was formed in Chicago in 1991 by four internal auditors from pension systems in Colorado, Illinois, New York, and Wisconsin. Since then, APPFA has grown to 72 members from the United States and

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Canada, including most of the large state and local pension systems in the United States.*

In 2000 and 2003, APPFA published two documents titles *Public Pension Systems: Statements of Key Investment Risks and Common Practices to Address Those Risks* and *Operational Risks of Defined Benefit and Related Plans and Controls to Mitigate Those Risks*.† These two documents systematically examine all the major risks facing public pension systems and the mechanisms in managing such risks.

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4.3.4 Financial Reporting

Even though public pension systems are not subject to federal regulation on financial reporting, they are nonetheless subject to substantial reporting requirements by state statutes and the Governmental Accounting Standards Board (GASB). First and foremost, the pension system is required to publish an annual comprehensive financial report (CAFR), prepared based on the standards set in GASB 25. The CAFR is divided into four sections: financial, investment, actuarial, and statistical:

- The Financial section begins with a management discussion and analysis (MD&A), which explains the main operational results of the pension plan in the past year and alerts the readers to any major events and changes that will have an impact on the plan in the future. The bulk of the Financial section consists of the two statements (Net Assets and Changes in Net Assets), notes to the statements, two schedules (Funding Progress and Contributions from Employer), and notes to the schedules, as discussed more fully in Chapter 3.
- The Investment section contains information on the plan's asset allocation, current and historical investment returns, external investment managers, and their fees.
- The Actuarial and Statistical sections contain more information on the actuarial valuation of the pension plan and historical trends, such as benefits paid.

The CAFR also has to be authenticated by an outside auditor who issues a statement of opinion as to whether or not the financial statements and schedules are presented fairly and in accordance with generally accepted accounting principles. All pension systems' CAFRs are available to any citizen upon request and most of them can be found on pension systems' Web sites as well.

* Association of Public Pension Fund Auditors. *The Insiders Who Audit Public Pension Funds.* http://www.appfa.org (Accessed 5/16/2007.)

† Both reports are available at APPFA's Web site at http://www.appfa.org/

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The public pension plan sponsor also has to disclose information on the pension plan according to the standards set in GASB 27, as discussed in the previous chapter. In addition to the annual financial report, most public pension systems are also required to submit reports to a legislative body and, in some cases, government agencies created by plan sponsors to oversee the pension systems.

4.3.5 Funding Policy

While public pension plans show little variation in the various aspects of plan administration discussed so far and conform substantially to the standards set by ERISA, funding policy is one aspect of pension plan administration that displays more substantial variation among public pension plans and deviation from ERISA standard for some plans. Funding policy refers to the method used by the pension plan sponsor to determine the periodic contribution it has to make to the pension plan so as to accumulate sufficient assets for paying future pension benefits. ERISA requires that pension plans be funded on an actuarial basis, meaning the periodic contribution to the pension plan should include normal cost plus an amount to amortize the unfunded pension liability, with the maximum amortization period set to 30 years.

An examination by the author of the funding policy of all major state-level pension plans found that there are three different types of funding policy in the public sector.* The first type of funding policy is the same as that required by ERISA. State pension plan sponsors in 34 states have adopted the funding policy that requires pension contributions be determined actuarially and the pension plan sponsor should pay fully the amount determined actuarially. While the vast majority of the plan sponsors with this funding policy pay the full amount, the funding policy by itself does not necessarily guarantee that the full actuarial amount will always be paid. For example, even though the Kentucky state government is required to contribute at an actuarially determined rate, it significantly underfunded its pension contribution to the Kentucky Employees Retirement System from fiscal year 2004 through 2007 (Kentucky Retirement System, 2007).

The second kind of funding policy is similar to the first kind, but with some adjustment or flexibility built into it. Such a funding policy is used by plan sponsors in four states:

1. **Alaska**: The employer contribution rate is determined actuarially. However, state regulation 2AAC 35.900 prohibits the rate from going up or down by more than five percentage points from the rate adopted in the prior year.

* This examination is conducted through a review of each pension plan's comprehensive annual financial report, which is required by Governmental Accounting Standards Board (GASB) to disclose its funding policy.

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2. **Kansas**: The employer contribution rate is determined actuarially. However, there is a statutory cap on the increase in the contribution rate from the prior year, set to 0.6 percent in fiscal year 2008 and beyond.
3. **Massachusetts**: Chapter 32 of the General Laws directs the secretary of administration and finance to prepare a funding schedule to meet actuarially determined requirements and to update this funding schedule every three years on the basis of new actuarial valuation reports prepared under the secretary's direction. Any such schedule is subject to legislative approval. If a schedule is not so approved, payments are to be made in accordance with the most recently approved schedule.
4. **New Jersey**: The employer contribution rate is determined actuarially. However, the rate can be amended by state legislation.

The third kind of funding policy, found in 10 states, is loosely linked to the actuarially based funding policy. In these states, the pension contribution rate is set by the state government through legislation. The ability of a plan sponsor to set a contribution rate through legislation is one of the most critical differences between public and private pension plans. As a public pension plan sponsor is also a legislative body, and since there is no federal regulation of public pension plans, it is thus unavoidable that some plan sponsors will use legislative power to set the contribution rate.

Statutory contribution rate by itself does not necessarily mean that it is substantially different from the actuarially determined rate. Those states that set statutory contribution rates can be divided into two groups, depending on the circumstances under which statutory rates are set.

In the first group, the statutory rate is initially set at a level that is linked to the actuarial rate, meaning that if the statutory rate is met every year and all the actuarial assumptions are met, the statutory rate is sufficient to fully fund the pension benefits. The purpose of setting the statutory rate is to have a more stable contribution rate over time as the actuarial rate can change depending on the funding ratio of the pension plan. This means that the statutory rate can be higher or lower than the actuarial rate from time to time. Examples of states using such funding policy are Wyoming, Texas, Iowa, Minnesota, Nevada, Colorado, and Connecticut. The statutory rate does not change unless it deviates substantially from the actuarial rate, usually as a result of a significant drop in pension funding ratio and the present statutory rate leads to an amortization period much longer than the maximum 30 years. For example:

1. In Iowa, the statutory contribution rate remained unchanged from 1979 to 2007. The pension plan was near full funding in 2000. Due to a drop in funding ratio to 88 percent in 2006, the Iowa State Legislature passed legislation to increase the contribution rate. The increase of two percentage points from 9.45 percent to 11.45 percent will be phased in over four years beginning July 1, 2007 (Iowa Public Employee Retirement System, 2006).

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2. In Colorado, members and employers are required to contribute to Public Employees' Retirement Association (PERA) at a rate set by statute. On December 31, 2005, the state division of PERA had a funded ratio of 71.5 percent. In the 2004 legislative session, the Legislature passed Senate Bill 04-257, which established Amortization Equalization Disbursement (SAED). The Bill requires PERA employers to pay an additional 0.5 percent of total salaries paid beginning January 1, 2006, increasing by 0.5 percent in 2007 and by 0.4 percent of salary each subsequent year, reaching a maximum of three percent in 2012 and thereafter. This payment will be used to pay for unfunded liability and will be terminated once the unfunded liability is eliminated (Colorado PERA, 2007)

In the second group, which includes Illinois, Oklahoma, and West Virginia, the state government sets the statutory rate to correct severe underfunding. In these states, the state government has been contributing substantially below the actuarial rate for a long period of time so that the pension plan is severely underfunded. Facing very low funding ratio and sometimes court ordered to correct the funding situation, the state government has been forced to increase contributions to bring the pension plan to full or near full funding status over a period of time. To avoid the shock to the government budget, the state sets the statutory rate and gradually increases it to bring it close to or above the actuarial rate. All of these three states are in the midst of a multidecade funding schedule to bring the funding ratio to 80 or 90 percent.

Of the 49 states that have state-level defined benefit pension plans,* Indiana is the only state that funds one of its two state-level pension plans partially on a pay-as-you-go basis. Indiana State Teachers' Retirement Fund (TRF) is funded on a pay-as-you-go basis for employees hired prior to July 1, 1995. State appropriations are made for the amount of estimated pension benefit payout for each fiscal year. If the actual pension benefit payout for the fiscal year exceeds the amount appropriated, the difference is paid from the Pension Stabilization Fund. For employees hired on or after July 1, 1995, the individual employer will make annual contributions that are actuarially determined. Due to the partial pay-as-you-go funding method, the funding ratio of TRF improved very slowly. Over a 10-year period from 1996 to 2005, the funding ratio increased from 31.6 to 44.8 percent.

4.4 Public Pension Plan Oversight

In the private sector, the Employee Benefits Security Administration of the Department of Labor is responsible for the administration and enforcement of Title I of

* As explained in Chapter 7, Nebraska is the only state that does not have a state-level defined benefit plan.

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ERISA. Because the Congress exempts state and local pension plans from ERISA, no federal government agency has oversight and regulatory authority over public pension plans other than the Internal Revenue Service, which determines the tax-exempt status of public pension plans. Despite this lack of oversight from the federal government, state governments, which are the plan sponsors of all the large public pension plans, have vested various institutions with oversight authority over public pension plans, although some have more authority than others. Such oversight authority is generally vested with two types of government entities: state legislative committee or independent pension commission created by the state legislature.

4.4.1 Legislative Committee

Since a state-level public pension system is created through state legislation, the state legislative body has the ultimate oversight authority over the pension system. Legislative committees that oversee pension systems can be divided into two general groups. In the first group, many states do not have a specific committee dealing with public pension issues. Thus, the oversight authority generally falls under committees that deal with overall public financing issues, such as finance or ways and means committees. In the second group, still a significant number of states establish legislative committees dedicated to pension financing issues. These committees vary in the scope of their responsibilities. Some are responsible for pension policies and state laws governing pension systems, and others have more direct authority over the administration of pension system. Some examples of state legislative pension committees include: Indiana Pension Management Oversight Commission (PMOC), Louisiana Joint Legislative Retirement Committee, Minnesota Legislative Commission on Pensions and Retirement (LCPR), North Carolina Standing Committees on Pensions and Retirement, and Wisconsin Joint Survey Committee on Retirement Systems.* A brief description of Indiana PMOC and Minnesota LCPR shows the general structure and responsibilities of such legislative pension committees:

- Indiana PMOC was created in 1985. It consists of four members from the Senate and the House of Representative each, and four lay members. The statutory duties of the commission include: (1) studying the investment and management practices of the boards of the public retirement funds; (2) determining what constitutes adequate wage replacement levels at retirement (including benefits from public retirement funds and social security) for public employees; (3) studying the impact of federal law and proposals concerning pensions, annuities, and retirement benefits; (4) studying the retirement

* For all state legislative committees on pension-related matters, please see Moore (2005).

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funds established in IC 36-8; and (5) studying methods and levels of funding for public retirement funds (Indiana Legislative Services Agency, 2006).

- Minnesota LCPR makes recommendations to the legislature including financing of the various pension funds and financing of accrued liabilities. It oversees over 700 state and local plans. The commission has fourteen members, five members from the House and Senate each and four staff members. The larger plans are required to submit an actuarial valuation to the LCPR. The LCPR sets the guidelines for actuarial assumptions used in the valuations. Plans' investments are monitored by the state auditor, in conjunction with the LCPR.

4.4.2 Independent Pension Commission

An independent pension commission is different from legislative pension committees in two important ways. First, the membership is different. The majority of members on a legislative committee are legislators, whereas the majority of members on an independent pension commission do not come from the legislative body. The membership of an independent commission typically represents a broader scope of interests and usually one or more members are required by the enabling statute to have expertise in pension financing. The size of independent commission, including both members and staff, is also much larger than that of legislative committee. The larger size of independent pension commission also brings it more responsibilities. Second, the source of financing for the activities of an independent commission can come from the pension systems themselves without legislative appropriation.

There are many reasons why an independent pension commission can be advantageous to a legislative committee. The main reason is the short-term and political nature of the budget cycle and the long-term nature of pension funding. Politicians tend to think of public financing issues in terms of the immediate cost over the next budget cycle, lasting one to two years. As discussed in more detail in Chapter 6, pension policy can be easily influenced by short-term budgetary concerns. Pension financing, however, is very long-term in nature, with the cost distant in the future. This makes long-term planning and analysis far more important for pension than for most other government programs and calls for more consistent policy guidance in the long run. Another reason is that pension is a very complex subject that requires a high degree of expertise and knowledge. A permanent independent pension commission, thus, can give a state legislature a more consistent independent source of information and policy guidance regarding public pension financing issues. There are five state-level independent pension commissions with a broad scope of responsibilities in Massachusetts, Ohio, Oklahoma, Pennsylvania, and Texas. Following is a brief discussion of three of these permanent pension commissions.

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1. Massachusetts Public Employee Retirement Administration Commission (PERAC): PERAC was created in 1996 to oversee, guide, monitor, and regulate 106 Massachusetts public pension systems. It consists of seven members, with three appointed by the governor, three by the state auditor, and one chosen by the first six members. Of the three persons appointed by the governor, one is the governor or his designee, one is a representative of a public safety union, and one is qualified by having training and experience in the investment of funds for at least ten years. Of the three persons appointed by the state auditor, one is the state auditor or his designee, one is the president of the Massachusetts AFL–CIO or his designee, and one is a representative of the Massachusetts Municipal Association. The commission has approximately fifty staff members in nine units, including actuarial, legal, audit, investment, disability, and fraud. The commission monitors disability claims, investigates fraud, performs actuarial valuations and experience studies, and conducts audit reports for the state's pension plans. The members serve without compensation and the budget for the commission is funded from the investment income account of the state retirement systems.
2. Ohio Retirement Study Council: The Ohio Retirement Study Council (ORSC) was created in 1968.* The Council is composed of fourteen members: three members of the House; three members of the Senate; three members appointed by the governor, one representing the state, one representing local governments, and one representing public education institutions; and the five executive directors of the state retirement systems, who are nonvoting members. Council members serve without compensation and the budget for the council is paid out of the investment earnings made on the assets of the five state retirement systems. The council receives no legislative appropriations and performs the following statutory duties:
    1. Makes a review of all laws governing the public retirement systems and makes recommendations to the legislature on any changes with respect to benefits, sound financing of benefit costs, and prudent investment of funds.
    2. Reports to the governor and legislature on its evaluation and recommendations with respect to the operations of the public retirement systems and their funds.
    3. Studies all proposed changes to the public retirement laws and reports to the legislature on their costs, actuarial implications, and desirability as a matter of sound public policy.
    4. Reviews semiannually the policies and objectives of the systems' investment programs.

* Ohio Retirement Study Council. *About ORSC*. http://www.orsc.org/aboutorsc.cfm.

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5. Prepares, at least once every ten years, an independent actuarial review of the annual actuarial valuations and quinquennial actuarial investigations prepared by each system.

3. Texas Pension Review Board (PRB): The PRB was created in 1979 as an independent state agency to oversee and review state and local government retirement systems in Texas. The board is composed of nine members, appointed by the governor, the lieutenant governor and the speaker of the House. The board employs an executive director to be the executive head of the board and perform its administrative duties. The board is financed by a special fund created in the state treasury, with the funds coming from both legislative budget appropriation and contribution from the public pension systems in Texas. The board's responsibilities include:

   1. Conducting a continuing review of all public retirement systems within the state, compiling and comparing information about benefit structures, financing, and administration of systems
   2. Conducting intensive studies of existing or potential problems that weaken the actuarial soundness of public retirement systems
   3. Recommending policies, practices, and legislation to public retirement systems and their sponsoring governments
   4. Examining all legislation for potential effect on Texas' public retirement systems, overseeing the actuarial analysis process, and providing actuarial review when required by law

4.4.3 Other Oversight Mechanisms

For those states that do not have an independent pension commission or standing legislative committee on pension issues, they also form temporary pension commissions from time to time to study pension-related issues. They are temporary because they exist for only a short period of time, usually about one year. Compared to a permanent commission, a temporary commission is usually charged with limited authorities, with the main purpose to review current policies and practices and to make recommendations on pension reforms. A temporary pension commission is formed usually at a time when the public pension system is facing a severe long-term funding shortage and major reform is needed to put the pension system on a more sustainable path. For example, the Michigan Commission on Public Pension and Retiree Health Benefits was created in 1999 to (1) review those state laws that govern or affect the funding, management, oversight, and fiscal integrity of public pension and retirement systems; (2) review the adequacy of funding for public pension and retirement systems and the extent of unfunded accrued liabilities; and (3) consider, recommend, and report such modifications in state laws governing or affecting public pension and retirement systems. The commission consisted of nine

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members appointed by the Governor and had to complete its work not later than one year after the commission was appointed.

In the early 2000s, after the severe stock market downturn that led to a decrease in the funding ratio of pension plans, many states, such as Illinois, New Jersey, and California, formed pension commissions to study pension financing issues. However, the recommendations by the commissions are usually not binding on the state legislature. Despite the lack of enforcement authority, temporary pension commissions still achieve the purpose of alerting the elected officials and the public to the important systemic and policy issues facing the pension plans.

Another state oversight mechanism is auditing. In some states, state legislatures and state agencies have direct auditing authority over public pension systems. For example, the Virginia Retirement System (VRS) Oversight Act (Section 30-78 et seq. of the Code of Virginia) directs the Virginia Joint Legislative Audit and Review Commission (JLARC) to be responsible for continuing oversight of the Virginia Retirement System. JLARC is required to publish periodic status reports and semiannual reports, which summarize the performance of VRS investments. In Wisconsin, the Legislative Audit Bureau conducts a financial audit of Wisconsin Retirement System, including an assessment of the fair presentation of the financial statements. The audit also evaluates the board's internal controls and compliance with applicable statutes, policies, and guidelines. The Legislative Audit Bureau conducts a biennial performance evaluation that includes an audit of the board's policies and management practices.

In Minnesota, the Office of State Auditor monitors investment, financial, and actuarial reporting for over 700 public pension funds. Each year, public pension plans with a market value of less than $10 million in assets are required to report to the State Auditor's Office.

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