NEA Issue Brief on
Retirement Board Governance and Independence

Introduction

Good governance--the way in which an organization is managed and significant decisions are made--is key to the success of any organization. Most state and local government retirement systems are governed by boards. The membership of these boards usually includes representatives of the “plan participants,” the active and retired members of the retirement systems. This ensures that the plan participants have a seat at the table during retirement system decisions. The membership can also include state officials and individuals with financial expertise. This range of membership provides a diversity of views.

This issue brief discusses:

- Why the membership of retirement boards should include plan participants; and
- Why retirement boards should be independent of the government that sponsors them.

Background on State and Local Government Retirement Systems

State and local government retirement systems provide various benefits, including disability benefits for active employees, pension benefits for retired employees, and death and survivor benefits for beneficiaries of deceased active or retired employees. In some states, the retirement systems provide other types of benefits, such as health benefits. The state and local government retirement systems may cover teachers, educational support professionals (ESPs), public safety workers, and general employees. Some states have more than one retirement system. In these states, membership in a system usually depends on an employee’s job classification, his/her employer, or both. Many local governments also offer retirement programs to their employees.

Most retirement systems have two major functions: administration of benefits and investment of assets used to pay benefits. Administration of benefits includes such activities as calculating benefits, paying them out, and determining the amount of funding needed to pay for them. In a minority of states, the retirement system administers benefits only and another entity invests the assets. In either case, investments must be managed in the plan participants’ best financial interests.

Management of Retirement Systems

To provide a context for why it is beneficial for plan participants to sit on retirement boards, it is important to look at how retirement systems are managed around the country. A board of trustees generally administers a retirement system. The responsibility of the board is to oversee the operation of the system and set policy. The day-to-day management resides with the retirement system staff.

Board management of retirement systems is the norm in virtually all states. A board governs 47 of the 50 statewide retirement systems that provide benefits to retired teachers and other employees. Florida, Iowa, and Washington are the only three systems without boards.[1]

The size of board membership, however, varies considerably. Some boards have as few as five members, such as the Alaska Teachers' Retirement System and the Indiana Teachers' Retirement Fund. In other states, particularly those in which a single retirement system serves most public employees, the number of members is larger. For example, the board of the Colorado Public Employees' Retirement Association has 16 members; the South Dakota Retirement System board has 17 members; and, the Tennessee Consolidated Retirement System board has 18 members.

Irrespective of the number of members, the composition of the board almost always includes representatives of plan participants. The rationale for plan participant membership on boards is twofold. First, board members who are plan participants bring a special viewpoint to retirement system decision-making. Plan participant representatives who are active members want sufficient assets in the retirement system to pay future benefits. Those who are retired members share that interest, but also need to know that adequate funds are available for the present. This self-interest heightens their concern that they manage the retirement system in the most effective manner possible. Second, plan participant representatives along with their fellow board members who come from other walks of life bring varying perspectives to decision making. Although all board members must always make their decisions according to the applicable fiduciary law, their differing backgrounds help contribute to a full and frank airing of the issues.

A National Education Association (NEA) publication reviewed board composition (*Characteristics of* 100 *Large Public Pension Plans*, September 2003). The publication lists 91 board-governed retirement systems that 1) administer benefits and invest assets or 2) administer benefits only. Eighty-seven of these boards include representatives of plan participants.

Not only do representatives of plan participants usually serve on boards, but also the total number of plan participants on the boards surveyed by the NEA study is large. Active and retired members make up 42 percent and 14 percent of board membership, respectively, for a total of 56 percent. The remaining 44 percent include state officials and other types of individuals.

These plan participant representatives are generally chosen by their peers. The NEA publication shows that 53 of the 91 board-governed systems have plan participant representatives (including both active and retired members) who stand for election by their peers. In the remaining systems, such members are selected through gubernatorial appointment or other methods.

In several retirement systems, representatives of plan participants who are elected by their peers constitute a *majority* of board members. Such retirement systems include the Colorado Public Employees' Retirement Association (covering most public employees in the state), the Missouri School Retirement System (covering teachers and ESPs, except those in St. Louis and Kansas City), and the Ohio Public Employees' Retirement System (covering state and municipal workers).

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[1] In these three states, the retirement system administers benefits, but does not invest assets. The investment of the assets in each of these states is carried out by a separate entity that is governed by a board. Iowa and Washington include plan participants on their investment boards. In Florida, by contrast, a board composed of state officials invests the assets.

NEA favors the approach taken by these three states. The Association advocates that state and local government retirement systems “should include boards of trustees with a majority elected by and from the membership.[2] NEA also urges that retirement boards be of “sufficient size to assure an adequate number of representatives from among retired members.”[3] NEA found that 79 out of the 91 board-governed systems currently have board members from among retired members.[4]

Need for Board Independence

To ensure that retirement systems operate well, board members must have a degree of autonomy and independence that many other governmental officials do not possess. Individuals who are retirement board members are fiduciaries. A fiduciary exercises discretionary authority to manage a retirement system, including investing assets if his/her scope of authority includes that function. As fiduciaries, the primary obligation of board members is to *act for the exclusive benefit of the retirement system members*. Their loyalty must be undivided and uncompromising. They are forbidden from acting in their own interest. If they fail to properly carry out their obligations, they breach their duties to the retirement system members.

State statutes set out these fiduciary duties, usually in the form of a comprehensive list of board member responsibilities. A principal obligation of fiduciaries is to pay out benefits from money held in the retirement system trust fund, according to the relevant laws. If a board has investment authority, board members must invest the trust fund assets in a prudent manner.

Governmental officials, such as the individual who directs a state agency, have a different set of duties. They are responsible to all the citizens of the particular state. The duties of retirement board members, by contrast, are far narrower. They are responsible to the members of the retirement system only. These differing scopes of responsibilities create confusion. Some people think that the boards of retirement systems should serve the citizens in the state, not just retirement system members. Because of these special responsibilities, retirement system boards require a degree of independence that other governmental entities do not possess.

The drafters of the Uniform Management of Public Employee Retirement Systems Act (UMPERSA) provide a detailed rationale for the independence of retirement board members.[5] UMPERSA specifies that board members must have a level of independence sufficient to allow them to perform their duties and to do so effectively and efficiently. Board members are different from other state officials because they are subject to the extensive and stringent set of fiduciary obligations described above. These duties both require and justify some level of board member independence.

Independence is required because it allows board members to perform their duties in the face of pressure from others who may not be subject to the obligations. In the absence of independence, board members may be forced to decide between fulfilling their

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[2] NEA Handbook, 2002-2003, Resolution F-56, p.355.

[3] Ibid

[4] NEA *Characteristics of 100 Large Public Pension Plans,* September 2003.

[5] UMPERSA was drafted by the National Conference of Commissioners on Uniform State Laws (NCCUSL) and released in 1997. NCCUSL drafts uniform laws that states may adopt, though they are not required to do so. NCCUSL seeks out the advice of experts during the drafting of uniform laws and, as a result, uniform laws are viewed as representing the most authoritative and up-to-date thinking about an area of the law. South Carolina adopted portions the fiduciary sections of UMPERSA when it created an investment panel. The Colorado legislature used UMPERSA as a model when it re-codified the statute for the Denver Public School Employees’ Pension and Benefit Association. UMPERSA and its commentary are available at http://www.law.upenn.edu/bll/ulc/fnact99/1990s/umpers97.htm.

fiduciary duties to retirement system members or complying with the directives of others who are responding to a more wide-ranging (and possibly conflicting) set of interests. Independence is thus an important corollary of board members' fiduciary duties (Comments accompanying UMPERSA § 5).

Board members' fiduciary duties also justify the level of independence set out by UMPERSA. Board members must have the required level of independence when they are empowered to:

- Establish an administrative budget sufficient to perform their fiduciary duties;
- Obtain by employment or contract the services necessary to exercise their fiduciary duties and perform their duties, including actuarial, auditing, custodial, investment, and legal services; and
- Procure and dispose of goods and property necessary to exercise their powers and perform their duties (UMPERSA § 5).

Board members are not independent without constraint, however. They must comply with their fiduciary duties when exercising judgment. Although UMPERSA specifies more independence for board members than other state officials, board members must, in exercising that independence comply with a more extensive and stringent set of fiduciary obligations than do other state officials.

As the result of the recognition that board independence is a necessary component of sound management, many retirement system boards have been given extensive independence. The National Council on Teacher Retirement studied the independence of the boards of statewide retirement systems that cover teachers and some other types of employees. Nearly all had the power to set the retirement system's actuarial assumptions.[6] Over two-thirds can hire retirement system staff and about one-third have the authority to set their budgets. (See http://www.nctr.org/content/indexpg/framewk.htm for more information.)

NEA also advocates that independent retirement boards are critical to sound, well-managed systems. NEA Resolution F-56 states, in pertinent part, that retirement board members should have all the powers necessary, subject to their fiduciary duties, to ensure their independence from the plan sponsor. (The "plan sponsor" is either the state or applicable local government that creates the retirement system.) These duties include the power to obtain by employment or contract the services necessary to exercise their powers and perform their duties, including actuarial, auditing, custodial, investment, and legal services (NEA Handbook).

Recommendations

This issue brief identifies the following recommendations for the governance of public employee retirement systems and cites NEA resolutions in support of these recommendations:

- Boards should govern retirement systems;
- The composition of retirement boards should include a majority of plan participants;
- Both active and retired members should be represented; and,
- Retirement boards should be fully empowered and independent.

[6] Actuarial assumptions determine the amount of funding needed to pay promised benefits. The assumptions include the rate of investment return of the retirement system's assets.

These good governance practices would allow member trustees, who are legally bound to promote secure benefits and sustainable long-term returns for fund beneficiaries, to take an active role in protecting plan assets and making sure that the system is operated and investments are managed in the participants' best interests, free from undue political influence and other interference.