

Who Should Make Pension Fund Decisions?

Research says: beneficiary reps on pension boards work better with investments and tax dollars than political appointees.

Retirement system boards can include three types of trustees: representatives of plan beneficiaries, *ex officio* members (government officials who become members of the board due to their particular office or position), and political appointees. Through resolutions approved by its Representative Assembly, the National Education Association (NEA) advocates that every board include trustees elected by active and retired plan members, and that this group “should constitute a majority of the board.”

Legislation in each state sets out the duties of trustees, usually in the form of a comprehensive list of board member responsibilities. These statutes also designate a state or local pension board trustee as a *fiduciary*, fiscally prudent and loyal *exclusively* to active and retired fund members.

A typical retirement system board might recommend pension, disability, and/or retiree health benefit levels to legislators; hire and oversee system staff; consult outside experts; adopt actuarial cost methods (predicting long-term fund usage and needed funding); determine investment “allocation” categories, and even, with help from financial experts, choose actual investments within those categories.

Retirement system trustees have the responsibility to ensure the pension fund’s long-term financial health, while minimizing the taxpayer contribution and maximizing investment returns. Historically, about 75 cents of every dollar paid in pensions comes from investment returns, not tax dollars.

Proposals have recently been made in some state legislatures to reduce the number of beneficiary members on pension boards. Proponents of such measures maintain that “member” trustees are novices who lack knowledge of complex investments and actuarial determinations that are so critical to the continued health of the systems.

NEA argues that trustees do not need to be financial “experts,” but they do need to ask questions and make decisions *solely in the best interest of plan participants*. Through a fair bidding process, retirement systems routinely hire professionals—including investment consultants, actuaries, and legal counsel—to advise board members. And board members are generally subject to formal training requirements and budgeted for travel to trustee seminars and educational conferences.

NEA agrees that it’s good to have a mix of perspectives and knowledge on any governing board, but stresses there is empirical data to show retirement funds actually do better when

there are “workers on the board.” Quite simply, note outside experts, member-elected pension board trustees, unlike political appointees, have a direct stake in a fund’s long-term health and are shielded from outside pressure. Board members who are plan participants bring a special viewpoint to retirement system decision-making. Plan participant representatives have a special interest in assuring that there are sufficient assets in the retirement system to pay current and future benefits. This perspective heightens their concern that they manage the retirement system in the most effective manner possible.

Independent Boards Gain Better Returns

Back in 1993, Yale law professor Linda Romano stressed in the *Columbia Law Review* that “Board members who are elected by plan participants are likely to be less susceptible to political influence or pressure because their personal retirement funds are at stake and their positions do not depend on the good graces of state officials.”¹

Romano, who is today director of the Yale Law School Center for the Study of Corporate Law, explained, “designation of employer executives as fund trustees...raises serious conflict of interest problems, as [these] trustees have dual roles, representing employers as well as employees.” That makes public pension funds an “inviting target” for state officials seeking new financing for a range of “local projects” and “social investments,” especially in times of fiscal difficulty.²

Romano actually conducted a statistical analysis of 50 public employee retirement plans to investigate the correlation between governing board composition and fund performance. Earnings were “significantly positively related to board independence,” she found. “The smaller the proportion of board members who are appointees and *ex officio* members, the higher the fund’s returns. This finding is consistent with the hypothesis that public pension funds experience political demands that adversely affect their performance.”³

One possible interpretation of these results, Romano observed, was that “less independent boards are more apt to choose fund managers who are politically connected, rather than those who perform best.”⁴ Thus, the formal financial expertise of board members “does not appear to be a factor in fund performance,” she wrote.⁵

Needed: Board Members Who Attend Meetings

David Hess, an associate professor of law and ethics at the University of Michigan, has driven home this criticism of “political” fund investment practices. Researchers have argued, Hess reported in 2005, “that politically-appointed trustees will not make decisions based on the interests of pension beneficiaries, but principally to improve their own political situation...[That] creates short-term interests that can conflict with the significantly longer-term interests of plan beneficiaries.”⁶

Trustees who are plan members have a direct interest in the fund’s financial performance, Hess wrote. “Overall, member-elected trustees seem to have strong incentives to perform their board-related duties, while politically-appointed trustees have incentives to shirk and act opportunistically.”⁷

Hess offered an anecdote to demonstrate this point. In 2001, he noted, the Baltimore Sun reported that most *ex officio* trustees of the Maryland state pension system missed more than 40 percent of board meetings, while most elected members attended 90-100 percent of the meetings.⁸

Hess pointed out that pension trustees determine not only investment strategy but also the required sponsor (government) contribution. But when pension systems are subject to political pressure, a governing board can *manipulate* actuarial assumptions on the expected rate of return to “simultaneously lower the government’s required contributions and make the pension plan appear to be funded at a higher level,” Hess warned.⁹ “...The presence of member-elected trustees or unions, however, may work to prevent that abuse.”¹⁰

Such abuse is a temptation in hard economic times, warned Linda Romano. States experiencing fiscal difficulty, she noted, “take unilateral action against fund assets... [A]mong the tactics employed are reducing contributions to retirement funds, altering actuarial and income assumptions in order to decrease contribution levels, and transferring assets from pension fund to general state accounts.”¹¹

Beneficiary Board Members Have ‘Skin in the Game’

David H. Webber, an assistant professor of law at Boston University Law School, emphasized that beneficiary-elected trustees, who are plan members themselves, have skin in the game.” They are, he explained, more reliant than political appointees on the pension fund for retirement security and, unlike politicians, do not have to report to a “broader constituency.”¹²

In February 2011, Webber testified against a proposed measure to drastically reduce the number of beneficiary representatives on the New Hampshire Retirement System Board. “Empirical research has shown,” he told legislators, “that beneficiary board members engage in more active and successful stewardship of public pension funds than other types of board members, such as politicians and political employees...Concern for the safety and security of their own retirement may explain why beneficiaries have proven to be better trustees.”¹³

Fellow researchers Romano and Hess “recommend increasing the number of elected beneficiary board members to reduce the politicization of public pension funds,” Webber concluded. “Beneficiary board members have their own money at stake—and [that] of peers and co-workers—when making decisions for the fund, in the same way that managers do in making decisions for a company in which they have equity.”¹⁷

Have questions about the management of your own retirement system? NEA’s pension study, [*Characteristics of Large Public Education Pension Plans*](#), includes information about the governance of the plans in the study.¹⁸

Questions you might ask: How does the composition of your retirement board compare to others? What has been the investment rate of return of the fund over the past 20-30 years? How does that compare to other funds? Has the fund met its assumed rate of return? What is the historic funding ratio level? Is it on an upward or downward trend? Has the state made its contributions?

For more information, please contact the NEA Collective Bargaining and Member Advocacy Department at (202) 822-7080 or CollectiveBargaining@nea.org.

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¹ Roberta Romano. "Pension Fund Activism in Corporate Governance Reconsidered," *Columbia Law Review*, Vol. 93, No. 4 (May 1993), p. 820.

² Ibid. p. 801.

³ Ibid. p. 825.

⁴ Ibid. p. 827.

⁵ Ibid. p. 840.

⁶ David Hess. "Protecting and Politicizing Public Pension Fund Assets: Empirical Evidence on the Effects of Governance Structures and Practices," *University of California-Davis Law Review* (November 2005), pp. 13-14.

⁷ Ibid. p. 17.

⁸ Ibid. pp. 17-18.

⁹ Ibid. p. 21.

¹⁰ Ibid. p. 24.

¹¹ Op cit., Romano, p. 802.

¹² David H. Webber. Feb. 11, 2011. Testimony before the Public Employee Pensions Reform Committee of the New Hampshire House of Representatives.

¹³ Ibid.

¹⁷ Ibid. p. 2070.

¹⁸ National Education Association, *Characteristics of Large Public Education Pension Plans* (2010).
<<http://www.nea.org/assets/docs/HE/CharacteristicsLargePubEdPensionPlans2010.pdf>>