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CIVIC FEDERATION CALLS FOR PUBLIC PENSION BOARD REFORM
Cites Need for Taxpayer Representation, Increased Financial Expertise

(CHICAGO) – Concerned by the lack of taxpayer representatives and independent financial experts on the boards of trustees governing public pension systems in Illinois, the Civic Federation today called for legislative action to reform those boards and provide well-informed, balanced oversight for the multi-billion-dollar funds.

Although recent dramatic declines in state and local public pension fund balances have drawn headlines, a research report released today by the Civic Federation stresses the critical role that board membership plays in ensuring the fiscal health of these pension systems.

In its review of best practices in pension board governance throughout the United States, the Federation report found that many states and other jurisdictions require a balance between employee, management and citizen representatives on their pension governing boards. In Illinois, by contrast, the membership requirements of most public pension fund boards give lopsided weight to employee interests; only one Illinois public pension board requires any taxpayer representation.

“Given that billions of taxpayer dollars are paid into those pension systems, it seems only reasonable that taxpayers should have a voice in deciding how those systems are managed,” said Laurence Msall, president of the Civic Federation. “The bottom line is, if these funds run out of money to pay their retirees, the state constitution puts the taxpayers of Illinois on the hook to make up the difference.”

The Civic Federation report noted that, when employees and retirees are over-represented on pension boards, those board members may face conflicts between their fiduciary responsibility to the funds’ fiscal health and their allegiance to their constituency.

As an example, the Civic Federation cites the Chicago Public School teachers’ pension system board, which numbers 10 employees or annuitants among its 12 trustees. The Civic Federation noted that the trustees’ stated goals include working “toward improving benefits for the members” – even though that goal has no necessary relationship to a board’s basic responsibility to build and protect the fund’s assets, and to guard the interests of all stakeholders, including taxpayers.

(more)

* Executive Committee
☼ Past Chairmen’s Council

“Those pension boards should not be advocating or lobbying for the interests of only one stakeholder, especially when the stated goal is to increase benefits – which will further increase the funds’ liabilities,” Mr. Msall said. “The board’s first and foremost responsibility should be to safeguard the fund’s assets to ensure that there is enough money on hand to pay promised benefits when they come due.”

The Civic Federation report also noted that, under current state law, most public pension system trustees are not required to demonstrate any financial expertise, or even to undergo any basic financial training. Some other states do require public pension systems to set aside board seats for members with professional expertise or certification in financial asset investment, and further require all members to receive some basic education in their fiduciary responsibilities.

“Public pension boards are charged with making complex financial and investment decisions affecting millions of dollars contributed by employees and taxpayers,” Mr. Msall said. “This is a weighty responsibility that requires a thorough understanding of asset management.”

To bring Illinois law in line with the best practices of other states, the Civic Federation urges the General Assembly to take legislative action to:

- Balance employee and management representation on pension boards;
- Develop a tripartite structure that includes independent citizens on pension boards, as well as representatives of government and beneficiaries’ interests, and
- Include financial experts on pension boards, and require financial training for non-experts.

The full text of the Civic Federation’s *Recommendations to Reform Public Pension Boards of Trustees in Illinois* is available on-line at www.civicfed.org.

The Civic Federation is a 112-year-old nonpartisan independent government research organization whose members include business leaders from the region’s largest corporations, service firms and institutions.

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**Recommendations to Reform
Public Pension Boards of Trustees in Illinois**

**Prepared By
The Civic Federation
February 13, 2006**

EXECUTIVE SUMMARY

Many state and local public pension funds in Illinois face negative outlooks driven by recent declines in investment returns coupled with years of increasing pension benefits, while payments into the pension systems have been skipped or reduced.

In the face of mounting shortfalls in these public pension funds, the Civic Federation and others have worked to draw the attention of public officials and voters to the need to reform these pension systems and return them to sound financial condition. Far less consideration has been given to the related, and equally significant, issue of the composition of the governing boards that oversee these pension funds.

Clearly, the task of public pension fund oversight carries significant responsibilities, and the individual backgrounds and viewpoints of pension board members will affect the decisions made by those boards – decisions that ultimately have a serious impact on taxpayers. For these reasons, The Civic Federation has undertaken the task of examining the composition of public pension boards in Illinois, reviewing the required background qualifications for members and the balance between management representatives, employee representatives, and private citizens. Our research finds that the composition of most public pension fund boards in Illinois favors employees; only one board includes citizen trustees, and only one board includes financial experts.

In reviewing public pension board composition in other states, The Civic Federation finds that many other jurisdictions require their pension governing boards to reflect a balance between employees, management and citizens. Many others also require financial training or expertise for at least some of their trustees.

The Civic Federation believes that balance in pension board composition is of critical importance if Illinois is to confront and more equitably debate the escalating costs of public pensions. Consequently, it recommends the following reforms for public pension fund governance in Illinois, and urges the General Assembly to take legislative action to:

- Balance employee and management representation on pension boards;
- Develop a tripartite structure that includes independent citizen representation on pension boards, and
- Include financial experts on pension boards, and require financial training for non-experts.

INTRODUCTION

Many state and local public pension funds in Illinois face negative outlooks driven by recent declines in investment returns coupled with years of increasing pension benefits, while payments into the pension systems have been skipped or reduced.

The five State pension funds are in crisis, with a combined estimated actuarial funded ratio of 61.6% for FY2006 and unfunded liabilities of over \$37 billion. This crisis was created over the last 30 years, as the General Assembly and governors past and present jointly failed to meet the State's pension fund obligations.¹ The Civic Federation repeatedly has called on the General Assembly to take decisive action to control the spiraling costs of state employee pensions and to fund the state's pension systems at the levels required by law.²

Likewise, many of Illinois' local government pension funds are watching funding shortfalls mount while insufficient contributions are made to cover the costs of benefit increases.³ The Civic Federation has supported a number of reforms to curb the runaway costs of public pensions in Illinois.⁴

Previous calls for reform by the Civic Federation and others have focused, appropriately, on the need to restore financial health to these public pension systems. Yet while the attention of public officials and voters has been drawn to the fiscal crisis facing State and local public employees' pension funds, little examination has been given to the related, and equally significant, issue of the composition of the boards of trustees that govern those pension funds.

A review of pension board composition in other states demonstrates that many jurisdictions do require balanced membership of pension governing boards, to give equal weight to the interests of employees, management, and private citizens. Many states also require financial training or expertise for at least some of their trustees.

The Civic Federation believes that balance in pension board composition is critically important if Illinois is to confront and resolve the escalating costs of public pensions. Pension boards also must be equipped with the financial expertise required for serious fiduciary decision-making, by including finance experts on the boards and providing relevant financial training for all trustees.

The following analysis identifies flaws in the current governance structure of Illinois public pension boards and reviews practices in other states. It then recommends reforms to the rules governing composition of the boards of trustees of public pension funds in Illinois.

¹ The Civic Federation, *State of Illinois FY2006 Recommended Operating Budget: Analysis and Recommendations*, (Chicago: The Civic Federation) May 2, 2005. http://www.civicfed.org/articles/civicfed_187.pdf

² The Civic Federation, *State of Illinois Pension Systems*, (Chicago: The Civic Federation), May 2, 2005. http://www.civicfed.org/articles/civicfed_188.pdf

³ The Civic Federation, *Status of Local Pension Funds Fiscal Year 2003: An Evaluation of Nine Local Government Employee Pension Funds within Cook County* (Chicago: The Civic Federation), February 16, 2005. http://www.civicfed.org/articles/civicfed_185.pdf

⁴ *Ibid.* See also *The Governor's Pension Commission: Pension Reform Report and Recommendations*, February 11, 2005. http://www.civicfed.org/articles/civicfed_184.pdf

CURRENT COMPOSITION OF ILLINOIS PUBLIC PENSION BOARDS

There are three serious flaws in the current composition of the boards of trustees of public pension systems in Illinois: They favor employees' interests, they lack citizen representation, and they do not require financial expertise.⁵

Illinois Public Pension Boards Favor Employees' Interests

The primary mission of a public pension fund board of trustees should be to safeguard the fund's assets through prudent investments and effective management. The board should not function as an advocate for the interests of one stakeholder, especially when advocating those interests creates increased liabilities for the fund. Rather, the trustees should focus on conserving and increasing the fund's assets to ensure that sufficient amounts are available to pay promised benefits when they come due. Although not all pension boards produce results favoring one stakeholder over another, board composition serves as an indicator of the interests most likely to be represented in the board's actions.

Unfortunately, the membership of most Illinois public pension boards does not reflect a balance of interests; instead, the majority of board members are active employees or retirees.⁶ As seen in the table below, which lists state statutory requirements for the composition of all Illinois' public pension fund boards, only two of the 16 boards evenly match employee/retiree representation with management and independent citizen representation.⁷ The Illinois Municipal Retirement Fund's membership is evenly matched numerically, but the annuitant member cannot vote. Employees and annuitants are currently in the minority on the State Universities Retirement System Board; however, while state statute requires four of the nine members to be annuitants or actives, the governor is empowered to shift that balance by appointing other board members who "may, but need not, be participants or annuitants of the System."⁸ These five discretionary appointees currently include the president of the Service Employees International Union Local 73, so it can be argued that the majority of the SURS Board represents the interests of the employees.

⁵ The term "citizen" as used here signifies a member of the general public who is neither a participant in the retirement system (active or retired), a government official, nor a member of a related board of trustees.

⁶ While the interests of active employees and retirees may diverge on some points, on the whole their interests are assumed to be more similar than different.

⁷ "Management" is here defined as the employer (usually a top government executive) responsible for setting employee compensation and benefits or bargaining for such with employee unions. Although some managers are also members of the pension system, they are presumed to represent government interests.

⁸ 40 ILCS 5-15-159

Illinois Public Pension Boards of Trustees Composition	
Fund	Employees and Retirees less than 50% of Board?
General Assembly	No, 7 out of 7
Downstate & Suburban Police Funds	No, 3 out of 5
Downstate & Suburban Fire Funds	No, 3 out of 5
Chicago Police	Even, 4 out of 8
Chicago Fire	Even, 4 out of 8
IMRF	Even, 4 out of 8 (Yes, 3 out of 7 voting)
Chicago Municipal	No, 3 out of 5
Cook County and Cook County Forest Preserve*	No, 5 out of 7
Chicago Laborers'	No, 4 out of 6
Chicago Park District	No, 4 out of 7
MWRD	No, 3 out of 5
SERS	No, 4 out of 7
SURS	Yes, 4 out of 9, but variable**
TRS	No, 6 out of 11
CPS	No, 10 out of 12
Judges	Not, 4 out of 5

*Cook County and the Cook County Forest Preserve are separate funds governed by the same board of trustees

**State statute allows the Governor discretion to shift the balance of representation by appointing additional active employees or annuitants to the Board

Source: Illinois Pension Code, 40 ILCS 5

Imbalances in board composition can lead to board actions that favor employees' and retirees' interests over the interests of the government and the taxpayers. For example, 10 of the 12 Trustees of the Chicago Public School Teachers' Pension and Retirement Fund are employees or annuitants. Not surprisingly, the Fund's 2004 *Comprehensive Annual Financial Report* states the Board's commitment to advocating benefit increases for employees: "The Trustees and Fund administrators will continue to work diligently to represent the interests of the members through further accomplishment of the Trustees' legislative agenda. The Board, in conjunction with Fund consultants, continues to work in Springfield toward improving benefits for the members."⁹ In our view, a pension board's goal should not be to advocate or lobby for the interests of one stakeholder, especially when advocating those interests creates greater liabilities for the fund. Rather, the first and foremost responsibility of a board of trustees should be to safeguard the fund's assets to ensure that sufficient amounts are available to pay promised benefits when they come due.

Illinois Public Pension Boards Lack Citizen Representation

Trustees are stewards of the contributions made both by employees and employers, with the latter's contributions ultimately provided by taxpayers. To that end, the board has a duty to balance the interests of both active and retired employees, the employer, and the taxpayers. Taxpayers have a dual stake in public pension systems; in addition to providing the funds for the employers' share of pension contributions, taxpayers effectively act as the pension plans'

⁹ Public School Teachers' Pension & Retirement Fund of Chicago. *109th Comprehensive Annual Financial Report for the year ended June 30, 2004* (Chicago, Illinois), 13.

insurers. Under the Illinois State Constitution, taxpayers are required to bail out any public pension funds that run out of money to pay benefits to annuitants.¹⁰ However, only one Illinois public pension fund, the Teachers' Retirement System, is statutorily required to have *any* citizen representation on its Board of Trustees.¹¹ As noted above, the statute for the State Universities Retirement System would permit, but does not require, the governor to appoint up to five independent citizen members.¹²

Illinois Public Pension Boards Lack Financial Experts

Public pension boards are charged with making complex financial and investment decisions affecting millions of dollars contributed by employees and taxpayers. This is a weighty fiduciary responsibility that requires a thorough understanding of asset management. It would be prudent to set aside some board seats for members with professional expertise or certification in financial asset investment, and to require all members to receive some basic education on their fiduciary responsibilities.

Although some Illinois funds require their comptroller or financial officer to sit on the pension board *ex officio*, only one Illinois public pension fund, the Teachers Retirement System, explicitly requires inclusion of at least two independent citizen board members with financial experience.¹³

PRACTICES IN OTHER STATES

Numerous pension funds across the country require their board membership to reflect the interests of various pension fund stakeholders, including private citizens. A 2004 National Education Association (NEA) survey of major public education pension funds found that at least 40% of U.S. public education retirement plans included citizen members who were neither retirement system participants nor government officials.¹⁴ Usually these citizen members are appointed by the governor or the state legislature.¹⁵

Of the 89 funds surveyed in the NEA report, 24 also required at least one citizen financial expert on the board of trustees, a trend that appears to be growing. For example, the State of Ohio

¹⁰ In Illinois, as in most states, pension benefits granted to public employees are guaranteed by the State Constitution. *Constitution of the State of Illinois, Article XIII Section 5.*

¹¹ 40 ILCS 5/16-163 requires "four persons, not members of the System, to be appointed by the Governor, who shall hold no elected State office."

¹² 40 ILCS 5/15-159

¹³ 40 ILCS 5/16-164: "The Governor shall appoint 2 members as trustees in each even-numbered year who shall hold office for a term of 4 years. Each such appointee shall reside in and be a taxpayer in the territory covered by this system, shall be interested in public school welfare, and experienced and competent in financial and business management."

¹⁴ National Education Association. *Characteristics of Large Public Education Pension Plans.* Washington, D.C.: National Education Association, 2004. <http://www.nea.org/takenote/images/char2004.pdf>

¹⁵ On the boards of trustees of the Ohio School Employees Retirement System and the Ohio State Teachers Retirement System, the State Treasurer appoints one citizen investment expert and the governor appoints two citizen investment experts.

recently enacted pension reforms to require at least three financial experts on the boards of trustees of each of its major state pension funds.¹⁶

Empirical evidence suggests over-representation of employee interests on pension boards may have a negative impact on a fund’s financial well-being. A recent study by the Pension Research Council of the University of Pennsylvania found that higher numbers of employee representatives on pension boards are associated with a lower funded ratio.¹⁷ In an econometric analysis of survey results from the Public Pension Coordinating Council, the study authors found that each additional active employee on a pension board was associated with a 0.7 percentage point reduction in the funded ratio, while each additional retiree on the board was associated with a 1.7 percentage point reduction in the funded ratio.¹⁸ The study also found a statistically significant relationship between higher retiree representation and lower investment returns, and suggested that this could reflect a lack of investment expertise on the part of retirees. The authors’ findings related to active and retired employees’ participation on pension boards are summarized in the table below.

Relationship of Increasing Numbers of Employee/Retiree Representatives to Pension Fund Funded Ratio, Required Contributions, and Investment Rate of Return			
	Funded Ratio	Ratio of Actual to Required Contributions	Investment Rate of Return
1 Active	-0.7 percentage pts.	no significant difference	no significant difference
1 Retired	-1.7 percentage pts.	-2.3 percentage pts.	-0.4 percentage pts.

Source: Tongzuan Yang and Olivia S. Mitchell, “Public Pension Governance, Funding, and Performance: A Longitudinal Appraisal,” (working paper PRC WP 2005-2, Pension Research Council, The Wharton School, University of Pennsylvania, 2005). <http://rider.wharton.upenn.edu/~prc/PRC/WP/WP2005-2.pdf>

The following table presents examples of major public education pension funds, selected from the NEA study, and their adherence to the following recommended practices:

- Employees make up 50% or less of the board;
- Private citizens are included on the board, and
- Financial experts are required on the board.

¹⁶ Ohio 125th General Assembly, Senate Bill 133, effective September 15, 2004.

¹⁷ Tongzuan Yang and Olivia S. Mitchell, “Public Pension Governance, Funding, and Performance: A Longitudinal Appraisal,” (working paper PRC WP 2005-2, Pension Research Council, The Wharton School, University of Pennsylvania, 2005). <http://rider.wharton.upenn.edu/~prc/PRC/WP/WP2005-2.pdf>

¹⁸ For more on the Public Pension Coordinating Council and its survey, see <http://ppcc.grsnet.com/>

Selected Teacher Pension Boards: Best Practices in Board Composition			
Fund	Employees and Retirees less than 50% of Board?	Citizen Members?	Financial Experts?
Arizona ASRS	No, 5 out of 9	Yes, 4	Yes, 4
California PERS	Yes, 6 out of 13	Yes, 2	Yes, 1
Connecticut TRS	Yes, 5 out of 12	Yes, 4	No
Georgia TRS	Even, 5 out of 10	Yes, 2	Yes, 1
Maryland SRPS	Yes, 5 out of 14	Yes, 5	Yes, 5
Montana PERS	No, 4 out of 7	Yes, 3	Yes, 1
Nebraska OSERS	Yes, 3 out of 10	Yes, 2	No
New Jersey TPAF	Yes, 3 out of 7	Yes, 3	No
New York STRS	Yes, 4 out of 10	Yes, 1	Yes, 3
Ohio SERS	No, 5 out of 9	Yes, 3	Yes, 3
Ohio STRS	No, 7 out of 11	Yes, 3	Yes, 3
Rhode Island ERS	Yes, 6 out of 15	Yes, 2	Yes, 1
Texas TRS	Yes, 4 out of 9	Yes, 3	Yes, 5
Utah SRS	Yes, 2 out of 9	Yes, 4	Yes, 4
Virginia VRS	Yes, 4 out of 9	Yes, 5	Yes, 5
West Virginia TRS	Yes, 6 out of 14	Yes, 3	No
Wyoming WRS	Yes, 5 out of 11	Yes, 5	Yes, 1

Source: National Education Association. Characteristics of Large Public Education Pension Plans. Washington, D.C.: National Education Association, 2004. <http://www.nea.org/takenote/images/char2004.pdf>

Three funds listed above – the Maryland State Retirement and Pension System, the Texas Teacher Retirement System, and the Virginia Retirement System – are particularly exemplary in their board composition practices.

Maryland State Retirement and Pension System (SRPS)

The State Retirement and Pension System of Maryland administers retirement benefits for 250,000 active and retired teachers, judges, legislators, corrections officers, and law enforcement officers. In response to SRPS's poor investment performance and its relationship with an external investment manager under criminal investigation, the General Assembly in 2003 passed significant reforms of the SRPS governance structure. These reforms were intended to improve the balance and knowledge base of the Board of Trustees.

Senate Bill 721, effective July 1, 2003, replaced some ex officio and employee trustees with citizen pension experts, increasing the number of citizen trustees from two to five. The board is now well balanced between the three stakeholder groups, with five employees/retirees, five government representatives, and five members of the public. The bill also required all trustees to receive at least eight hours of investment and fiduciary training each year, and specified that the board is not responsible for considering benefit enhancements.

The mandate of the SRPS, as stated in its 2004 Comprehensive Annual Financial Report, is: "The System is charged with the fiduciary responsibility for properly administering the retirement and pension allowances and other benefits, while striving to keep employer

contribution rates as affordable as possible while maximizing investment returns and maintaining an acceptable level of risk.”¹⁹

Texas Teacher Retirement System (TRS)

The Texas Teacher Retirement System serves 860,000 active K-12 and higher education employees, including teachers and faculty, administrative staff, food service personnel, and maintenance and transportation workers. TRS, which provides benefits to 217,000 current annuitants, is the sixth largest pension fund in the United States.²⁰

The governor of Texas appoints all nine of the TRS trustees; some of those appointments are based on nominations by employees or the State Board of Education, and some are subject to State Senate confirmation. Five trustees—the majority of the board—must have demonstrated financial expertise, preferably in pension fund investment. The TRS board is well balanced, with four employee/retiree members, three citizen members, and two representatives of the State Board of Education.

TRS produces an exemplary five-year strategic plan, outlining future challenges and strategies to meet those challenges.²¹ The strategic plan focuses on meeting funding goals and providing efficient, effective delivery of services to active members and retirees. Although no financial training is required for board membership, trustees must receive training in the rules and functions of the retirement system, and also must receive instruction on ethics policies and recent audit results.²²

Virginia Retirement System (VRS)

The Virginia Retirement System serves 521,000 active employees and annuitants from 800 state agencies, school boards, political subdivisions, and special authorities.

Of the nine VRS trustees, four must be investment experts, and one must have experience in the management and administration of employee benefit plans. The governor appoints five trustees, and the General Assembly Joint Rules Committee appoints four trustees. The board has four employee/retiree members and five citizen members; no elected or appointed officials may serve on the board. Although tripartite balance would require representatives of all three stakeholder groups, the presence of five citizen experts on the board of trustees is very positive. No special training is required for trustees.

¹⁹ State Retirement and Pension System of Maryland, *Comprehensive Annual Financial Report for the Year Ended June 30, 2004*, p. 4.

²⁰ *Teacher Retirement System of Texas Strategic Plan: 2005-2009*. July 2, 2004.
http://www.trs.state.tx.us/Publications/strat_plan%202004.pdf

²¹ Ibid.

²² TEX. GOV. CODE § 825.0041

CIVIC FEDERATION RECOMMENDATIONS ON PENSION BOARD COMPOSITION

In the view of the Civic Federation, the best pension board structure is tripartite, representing the three stakeholder groups of employees (active and retired), management, and independent citizen taxpayers. Pension boards should also require demonstrated financial expertise in some members, and should further require relevant training for the non-expert trustees. Therefore, the Civic Federation makes the following recommendations for reforms to the composition of the boards of trustees of public pension systems in Illinois:

1. Balance employee and management representation on pension boards

The mission of a public pension fund's board of trustees should be to safeguard the fund's assets through prudent investments and effective management. The board should not function as an advocate for the interests of one stakeholder, especially when such advocacy may result in policy changes that increase fund liabilities. Rather, the trustees should focus on safeguarding the fund's assets to ensure that sufficient amounts are available to pay for promised benefits when they come due.

The composition of a board, and the backgrounds and affiliations of the individual members, serve as an indicator of the interests that are likely to be represented and promoted by that board's actions. Unfortunately, most of Illinois' public pension system boards do not reflect a balance of interests because a majority of members on those boards are active employees or retirees.

The Illinois General Assembly should pass legislation revising the composition of public pension boards in Illinois to ensure that board composition does not favor employee and retirees' interests over those of other stakeholders.

2. Develop a tripartite structure that includes citizen representation on pension boards

Pension Board trustees act as stewards for all pension system contributions, both those made by individual employees and those made by employers, using taxpayer funds. If those funds are unable to meet their obligations to annuitants, taxpayers will act as the funds' effective insurers, because the State of Illinois is constitutionally required to make benefit payments regardless of any shortfall in those funds. Therefore, board composition should represent the interests of the employees (both active and retired), the employers, and the taxpayers. However, only one Illinois public pension fund, the Teachers' Retirement System, is statutorily required to include any private citizen representation on its Board of Trustees.

The Illinois General Assembly should pass legislation to include citizen members on pension board of trustees, thus creating a tripartite structure that would balance the distinct interests of the three stakeholder groups: taxpayers, management, and current and retired employees.

3. Include financial experts on pension boards, and require training for non-experts

Effective stewardship of millions of dollars of assets is a major task that requires significant financial expertise. While trustees can seek financial advice from the systems' staff and consultants, the board should have a firm, independent command of investment-related issues to fulfill its fiduciary function as the systems' ultimate investment decision-making body. For that reason, each pension system board should include several financial experts with experience in investing and managing large asset portfolios.

Although some Illinois funds require the system's comptroller or financial officer to sit on the pension board, only one Illinois public pension fund, the Teachers Retirement System, explicitly requires its board to include some members with experience and competency in financial and business management.²³

The Illinois General Assembly should pass legislation to require the membership of public pension boards to include financial experts with experience in investing or managing large asset portfolios. Furthermore, all pension trustees should receive some relevant financial training on an annual basis.

²³ 40 ILCS 5/16-165