# ORSC

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# *Analysis*

## H.B. 177 – Reps. Huffman and Bubp
## (*As Introduced)*

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## ORSC Position

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H.B. 177 would prohibit the State Teachers Retirement System (STRS) from awarding performance-based bonuses to investment officers in years in which the system experiences an overall negative return from its investments and declares an emergency.

Current law gives the board the authority to establish the compensation for all personnel.

**Staff Comments** - The bill would prohibit STRS from awarding performance-based bonuses to investment personnel in years in which the system experiences an overall negative return from its investments. "Investment officer" is defined as a person employed by the STRS board for purposes of engaging in securities transactions or making any other investment of funds on behalf of STRS.

The bill would apply only to contracts and employment agreements entered into, amended, or renewed on or after the effective date of the bill.

The legislature established all five statewide retirement systems and vested each board with the general administration and the management of the system. (R.C. §§145.04, 742.03, 3307.04, 3309.04, 5505.04.) The board's duties include administering the statutory pension benefits and discretionary healthcare benefits. Another one of the board's duties is to approve the compensation for the system's employees (R.C. §§145.09, 742.10, 3307.11, 3309.14, 5505.07). In 2004, the legislature passed S.B. 133, which added the additional requirement that each board must establish a policy regarding bonuses (R.C. §§145.092(B), 742.102(B) 3307.041(B), 3309.041(B), 5505.062(B)).

STRS manages approximately 80% of its investments internally, whereas PERS manages approximately 60% of its investments internally. SERS' assets are 100% externally managed, however, they have a small number of investment staff working at SERS. All three systems provide performance-based incentive plans for their investment staff in order to attract and retain qualified personnel, however, H.B. 177 applies only to STRS.

Investment bonus incentives are common in both the public and private investment sectors. They are used to attract and retain the necessary investment expertise to manage prudently investment assets. According to an article appearing in the January 8, 2007 issue of Pensions & Investments, they are even more widespread among private investment firms than public pension funds and the level of bonus incentives at public pension funds are significantly lower than those at private investment firms. McLagan Partners, a leading investment compensation consultant for both public and private investment management entities, has conducted numerous surveys that substantiate the findings above.

According to CEM Benchmarking, a global benchmarking company, the use of internal management versus external management saved more than $100 million for STRS and over $30 million for PERS in 2007, even *after* the payment of bonus incentives. The ORSC investment consultant, Evaluation Associates, has concurred that internal management saves the systems money.

At its January 2009, meeting the STRS board voted 9-1 to suspend its Performance-Based Incentive (PBI) program for eligible employees as of February 1, 2009. This plan called for a

20% reduction of an eligible employee's bonus if the total STRS investment fund does not earn a positive absolute return. Any PBIs that had been earned prior to the discontinuation of the plan will be calculated based on the performance results for the first seven months of the fiscal year (July 1, 2008 – January 31, 2009) and the award will be limited to 7/12 of these results if the board approves the payments.

The board voted 8-0 at the May 2009 board meeting to implement a new PBI program for fiscal year 2010. The new program prohibits the payment of PBIs if the total STRS investment fund has a negative absolute return for the fiscal year. If the total fund earns a positive absolute return but the total market value of investment assets is less than $65 billion by the end of the fiscal year (June 30, 2010), incentive awards will be reduced by 3% for every $1 billion of the shortfall from $65 billion. Further, the board adopted a motion stating that in future years, when the total investment fund returns are negative, no Investment Department staff will receive PBIs. This will be effective in fiscal year 2011 going forward.

This bill would diminish the authority of the STRS board to manage the system and instead give some of that authority to the legislature. Traditionally, the legislature has provided oversight of all five retirement systems but has declined to involve itself with the day-to-day management of the systems. There are a number of instances in the Revised Code that require the STRS board to adopt specific policies, but the details of the policies are left to the board. As noted above, the bonus policy is one example. Additional examples include investment policies (R.C. §3307.04), policies for the operation of the system (R.C. §3307.04), travel policies (R.C. §3307.041(A)), and ethics policies (R.C. §3307.042).

Although the boards have the authority to manage the retirement systems, they are subject to oversight from the legislature. The legislature currently provides oversight in the form of the Ohio Retirement Study Council. The Council has representatives from both houses of the legislature (three representatives and three senators) and the Governor (three governor's appointees). The Ohio Revised Code mandates that the Council <u>shall</u> perform the following statutory duties:

(1) Make an impartial review from time to time of all laws governing the public retirement systems and makes recommendations to the legislature on any changes the ORSC finds desirable with respect to benefits, sound financing of benefit costs, and prudent investment of funds [R.C. §171.04(A)];
(2) Report to the governor and legislature on its evaluation and recommendations with respect to the operations of the public retirement systems and their funds [R.C. §171.04(B)];
(3) Study all proposed changes to the public retirement laws and reports to the legislature on their probable costs, actuarial implications and desirability as a matter of sound public policy [R.C. §171.04(C)];
(4) Review semiannually the policies, objectives, and criteria of the systems' investment programs [R.C. §171.04(D)];
(5) Have prepared, at least once every ten years, an independent actuarial review of the annual actuarial valuations and quinquennial actuarial investigations prepared by each system [R.C. §171.04(E)];
(6) Have conducted a fiduciary performance audit of each system at least once every ten years [R.C. §171.04(F)];

(7) Provide each Council member with copies of all proposed rules submitted by the retirement systems and submit any recommendations to the Joint Committee on Agency Rule Review [R.C. §171.04(G)];
(8) Review the police and fire contribution rates and makes recommendations to the legislature that it finds necessary for the proper financing of OP&F benefits [R.C. §742.311]; and
(9) Prepare an independent actuarial study every three years on the required employer supplemental contribution to be made on behalf of academic and administrative employees of higher education electing an alternative retirement plan [R.C. §171.07].

Additionally, the retirement systems are required by statute to submit various documents to the ORSC to assist the Council in its oversight duties. The law provides legislators with an opportunity to review these items and ask for any additional information. The following is a listing of reports the retirement systems are required to submit to the ORSC:

- Annual Actuarial Valuation
- Annual Report on Discretionary Health Care
- Quinquennial Evaluation
- Audit Committee Report
- Annual Report on Disability Experience
- 30-Year Funding Period in any year the system's funding period exceeds thirty years
- Actuarial Analysis of Legislation
- Investment Managers and Brokers
- Budgets (includes personnel, bonuses)
- Rules
- Deferred Retirement Option Plan Neutrality Report (OP&F, HPRS)

The rationale for providing these reports to the legislature and for the Council's statutory duties is to provide the legislature with the tools it needs to adequately oversee the pension funds in conjunction with the boards' statutory authority to manage them.

It is important to note that the Council does not approve any of these reports because that is the duty of each system's board. The STRS board is comprised of 5 active members elected by the active membership and disability retirees; 2 retiree members elected by service retirees; 1 investment expert appointed by the Governor; 1 investment expert appointed jointly by the Speaker of the House and Senate President; 1 Treasurer of State investment designee; and 1 Superintendent of Public Instruction designee. The Board's composition allows the opinions of the various stakeholders to be heard during the democratic voting process the board uses to make decisions.

If the legislature chooses to involve itself in the day-to-day management of the funds by limiting compensation in the manner proposed by H.B. 177, this would establish a precedent for overriding the board's authority on other issues. For example, the boards of each system have made unpopular changes to the health care benefits the systems offer, as they are authorized to do by law. In 2007, the systems paid over $2.1 billion combined for health care. If the legislature involves itself in matters that traditionally have been part of the board's administrative and/or managerial responsibilities, members dissatisfied with the board's decision to increase health care premiums may expect the legislature to intervene by enacting a law to prohibit any changes to health care. Another example is the actuarial assumptions used to determine the actuarial soundness of the system. Currently, the Board relies on its actuary to develop actuarial assumptions, which the board approves. Based on the precedent this bill would set, the legislature could find itself being asked to set the actuarial assumptions.

**Fiscal Impact** – This bill would have no actuarial impact on the system.

**ORSC Position** – The Ohio Retirement Study Council voted at the July 8, 2009 ORSC meeting to recommend that the 128th General Assembly disapprove H.B. 177.