Management Information Report
Monitoring of Investment Committee Activity
Report No. 02-03, January 28, 2002

Introduction

The Railroad Retirement Act (RRA) authorizes the investment of Railroad Retirement Board (RRB) trust funds, as directed by the RRB Board Members, in securities issued by or guaranteed by the Federal government. The Board Members delegated the authority for investing the trust funds to an Investment Committee. The Investment Committee also advises the Board Members on policy and decisions related to the investments. The market value of the trust funds as of the end of fiscal year 2001 was over $21 billion.

The Office of Inspector General (OIG) has closely monitored the activities of the Investment Committee and issued its initial evaluation of investment policies and procedures in September 1996. The OIG identified several serious control weaknesses in this evaluation. The OIG has also issued numerous memorandums and letters related to the activities of the Investment Committee. The Investment Committee has made some changes in its operating practices but several weaknesses still exist. The remaining weaknesses include the lack of a consistent long-term investment strategy, poor cash management practices and a lack of documentation to justify investment decisions.

On December 21, 2001, President Bush signed into law the Railroad Retirement and Survivors' Improvement Act of 2001 (RRSIA). The legislation provides for significant changes in the structure and financing of future benefits as provided under the RRA. In addition to the benefit and tax provisions, the RRSIA establishes a trust, under the direction of an independent board of trustees, that is responsible for the investments used to support RRA benefit programs.

The RRB will be required to transfer the balance of its investments to the new trust in accordance with the provisions of the RRSIA. The OIG will monitor the actions of the Investment Committee and will ensure the RRB adheres to the requirements of the RRSIA and completes the transfer within a reasonable period of time.

Monitoring Activities

In September 1996, the OIG issued its initial evaluation of the investment policies and procedures of the agency's Investment Committee. The Committee's practices affect the earnings on the railroad retirement trust funds.

The OIG identified three serious weaknesses:

- conflict of interest in the responsibilities of the Chief Actuary who serves as the Committee Chairman,

- insufficient long-term strategy, and

- lack of a formal procedure for justifying and documenting investment decisions.

The OIG has expressed concern that Committee members lacked any formal experience and expertise to manage trust fund investments. In addition, the Committee could not adequately respond to OIG requests for fundamental information on investment strategy and supporting documentation for trades.

Despite the OIG findings, the agency's Board Members at that time remained firm in their belief that no changes were required. Two RRB selected expert consultants, Dr. Kenneth French and Bear Stearns, as well as KPMG Peat Marwick LLP in its audit of the RRB's financial statements, also advised the agency to implement changes in its investment practices.

Starting in May 1995, the Investment Committee purchased a significant number of November 15, 2009 zero coupon bonds. These bonds had a face value in excess of $6 billion as of July 1998. The OIG requested an explanation from the Committee as to why it concentrated its purchases in this security. The only reason offered by the Committee members was they viewed the bonds as being cheaply priced relative to other securities. It was unclear if the Committee understood why callable bonds would be priced differently than bonds without a callable feature. In 1998, the Committee began selling these bonds because they no longer considered them to be attractive investments. The OIG could identify no meaningful rationale or explanation for such active trading. Again, the OIG requested justification for the Committee's actions; no meaningful information was provided.

On September 23, 1998, the agency's Chief Financial Officer issued a letter to the Office of Management and Budget requesting guidance on policy and accounting considerations regarding the potential purchases and sale of new types of securities the RRB may consider for investment. The agency sought to invest in securities issued by Federal government agencies.

The OIG wrote to the Department of the Treasury regarding the RRB's investment authority and the operations of the Investment Committee. The OIG summarized the serious weaknesses identified during the earlier evaluation and the Committee's practices that may jeopardize the long-term integrity of the trust funds. In addition, the OIG contacted the Office of Management and Budget expressing opposition to any possible expansion of the types of securities available for RRB trust fund investment. The OIG recommended that the management of the RRB's trust funds should be transferred to the Department of the Treasury.

The OIG, in the initial evaluation of the Investment Committee, expressed concerns that the Chief Actuary calculated actuarial projections to determine cash flow needs and, as the Investment Committee's Chairman, generated security trading data and initiated trades. This office recommended that the role of the Bureau of the Actuary be limited to providing updates on required cash flows of the trust funds based on projected surpluses or deficits to resolve this obvious conflict of interest. The OIG also questioned the prior investment experience of the Chief Actuary as well as the other members of the Investment Committee.

In February 1999, the OIG provided the RRB's Chair with a summary of OIG findings concerning the agency's Investment Committee. The Chair subsequently requested that the Board establish a working group comprised of representatives of the three Board offices and the voting and non-voting members of the Investment Committee in response to recommendations made by outside consultants. As a result, the Board Members issued a decision to change the status of the Chief Actuary. He is now a non-voting member and the RRB General Counsel assumed the chairmanship of the Committee.

On March 29, 1999, the OIG again issued a memorandum to the agency's Chair expressing concerns about the operations of the Investment Committee. A fundamental difference in opinion continues to exist between the Investment Committee and the OIG. The Committee favors an active trading strategy, while the OIG believes a buy and hold strategy is a more prudent and conservative method for investing the trust funds.

The OIG subsequently provided updated information on the RRB's investment practices to officials of the Office of Management and Budget, the Department of the Treasury, and members of select congressional committees. The OIG letter included supporting documentation that clearly illustrated the reckless trading program employed by the Committee. The letter cited several transactions that resulted in realized losses of over $64 million for the trust funds. At the end of fiscal year 1999, the OIG, in its Semiannual Report to Congress, again expressed concern regarding the frequency of trades over the preceding twelve months.

The OIG continued its monitoring of Investment Committee activities throughout fiscal years 2000 and 2001. The number of investment transactions declined but characteristics of the trading pattern continued. The Investment Committee continued to sell higher yielding bonds rather than using available PAR value funds to finance the purchase of longer-term bonds. The lack of effective cash management practices was evident in October 2000 when the OIG questioned why the Investment Committee had not invested a larger portion of its PAR value funds in a short-term Treasury Bill purchase. There was no direct response to the question; however, the following week the Investment Committee committed the balance of its available funds to a similar Treasury Bill purchase.

The Committee's willingness to commit large portions of the portfolio to the purchase and sale of securities to achieve short-term results is the antithesis of the long-range strategy that should be employed by a pension fund. The long- term nature of the RRB's significant retirement liabilities suggest that a more conservative buy and hold strategy would be a more prudent course of action. The Investment Committee has consistently executed purchase and sale transactions in response to short term fluctuations in interest rates.

The results of the Committee's actions have been detrimental to the trust funds for several reasons. The Committee sacrificed long term favorable yields to report short-term capital gains that represent no more than window dressing relative to the overall performance of the funds.

The Railroad Retirement Account has an excess of invested cash due to a lack of consistent planning. Forecasts of the RRB's cash position suggest no cash flow problems for the next twenty-five years, yet the Investment Committee maintains a cash equivalent balance of approximately $8 billion that represents over 40% of the market value of the fund and currently yields 4.5%. The Committee has managed to increase the cash equivalent portion of the portfolio in a declining interest rate environment while sacrificing the favorable yields that were earned on the long-term bonds.

A review of the past eight fiscal years indicates a continuous pattern of selling the longest held and highest yielding securities in the portfolio. The sale of these securities generates capital gains for reporting purposes but does not enhance the long-term solvency of the trust fund. The Committee has divested assets with yields to maturity as high as 11.68% to retain an excessive cash position that was subject to monthly interest rate risk in the PAR value specials. The analysis used by the Investment Committee compared securities as if the sale and purchase transactions were the only alternatives available. This analysis consistently avoided the consideration of purchasing securities from PAR value funds.

At the end of fiscal year 1993, the PAR value account had a balance of $7.9 billion. The balance has been maintained at or close to this level for the past eight years without explanation as to why such a large cash balance was needed. Investing just $4 billion of this account at an additional 1% for the past eight years could have produced an additional $330 million in value to the Railroad Retirement Account.

The relative size of the "actively managed" portfolio and the performance over time is indicative of the lack of expertise in this area. The Investment Committee has continuously churned the bond portfolio causing the overall book yield, the initial yield to maturity, to decline from 8.32% at the end of fiscal year 1994 to 6.02% at the end of fiscal year 2001. The yield to maturity within the bond portfolio ranged from 6.74% to 11.68% at the end of fiscal year 1994. At the end of fiscal year 2001, the yield to maturity ranged from 4.92% to 7.73%.

Recent Legislation

The President signed the RRSIA into law on December 21, 2001. The major benefit provisions include the improvement in annuity payments to certain widows and widowers, the elimination of an overall maximum benefit that may be payable and restoring the unreduced annuity benefit for those retiring after age 60 with 30 years of service. In addition, the vesting requirement for entitlement to tier 2 benefits was reduced to five years for service after December 31, 1995.

The financing provisions of the RRSIA include the establishment of an independent trust, under the direction of an independent board of trustees, that is responsible for the investments used to support RRA benefits. The law provides for specific reductions in the level of tier 2 taxes being paid by employers and employer representatives during 2001 and 2002. Future tier 2 tax rates will be based upon a pre-determined schedule that considers the value of fund assets in relation to benefits paid and expenses incurred. The law provides for the repeal of the employer's supplemental annuity tax and elimination of separate fund accounting for supplemental benefits.

Investment Provisions of RRSIA

The RRSIA provides for the establishment of the National Railroad Retirement Investment Trust (Trust) as an independent entity to manage the investments of the RRB. The Trust is to be administered by seven trustees, three who represent the interests of labor, three representing the interests of management and one independent member. The trust is specifically exempted from income taxes.

The appointment process for the labor and management trustees requires representation of two-thirds of the active employees covered by the RRA through the labor organizations and employers respectively. The law specifies that each trustee must be experienced in financial investments and pension plans. The RRSIA also defines the powers, duties and responsibilities of the trustees.

The Trust is required to engage a certified public accountant to audit its financial statements each year. The Trust must also prepare an annual management report, which is to be submitted to the Congress within 180 days after the end of the Trust's fiscal year. Copies of the management report are also to be submitted to the President, the RRB and the Director of the Office of Management and Budget. The RRB may bring civil suit to enforce the provisions of the RRSIA.

The Board of Trustees is to retain investment advisers to assist in the formulation of investment guidelines and can hire investment managers or invest the assets of the trust in accordance with the guidelines that it has adopted. There is no specific prohibition against any specific investment or class of investments for funds of the Railroad Retirement Account. The trustees are required to discharge their duties in the interests of the RRB and the participants and beneficiaries of programs under the RRA. The Trustees are also bound by a prudent person standard similar to that imposed upon private plan administrators subject to the Employee Retirement Income Security Act of 1974.

Once the Trust has been established, the RRB is to direct the Secretary of the Treasury to transfer those assets, not needed to pay the current expenses of the Railroad

Retirement Account, to the Trust. Similarly, the RRB is to direct the transfer of the Social Security Equivalent Benefit Account, in excess of the amount needed to pay current benefits and administrative expenses, to the Trust but the Trustees can only invest these assets in obligations of the Unites States. Additional transfers of funds to the Trust are to be made if revenues exceed the amount needed to cover expenses of the RRB.

The RRSIA also provides for the RRB to contract with an independent disbursing agent to make payments under the RRA. Once this arrangement has been made the RRB will certify the amount of benefit payments to be made and direct the Trust or the Secretary of the Treasury to transfer funds from the appropriate accounts to the disbursing agent for remittance to the annuitants and beneficiaries. Existing disbursement procedures will be followed in the interim.

Recommendations and Conclusion

The RRSIA clearly states that the responsibility for the investment of RRA assets is to be transferred to the newly established Trust. The Investment Committee should not make any further investment decisions that may complicate the transfer of authority to the Trust. The RRB should limit its investment activity to routine decisions such as reinvesting coupon interest in PAR value specials. The OIG recommends that the Board rescind the Investment Committee's authority (Recommendation No. 1).

The OIG will continue to monitor the investment activities of the RRB to ensure that the requirements of RRSIA are being followed. The agency should be taking steps to ensure that the trustees have been duly appointed and have satisfied the requirements set forth in the law prior to the transfer of funds or investments. Once these requirements have been fulfilled, the RRB should respond in a timely manner to facilitate the transfer of investment authority.